Before the
COPYRIGHT ROYALTY BOARD
LIBRARY OF CONGRESS
Washington, D.C.

In the Matter of DIGITAL PERFORMANCE RIGHT IN SOUND RECORDINGS AND EPHEMERAL RECORDINGS	)	Docket No. 2005-1 CRB DTRA

REBUTTAL TESTIMONY OF

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PUBLIC VERSION

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Rebuttal Testimony of Michael Pelcovits

I am a Principal with Microeconomic Consulting & Research Associates, Inc. ("MiCRA"). I previously provided a written direct statement in this proceeding and my background and qualifications as an expert are included with that testimony. I provide this statement to respond to a number of points made by witnesses produced by the various webcasters, as well as issues raised during cross-examination.

1. Other Benchmarks

In my earlier testimony in this case, I proposed that the royalty rate negotiated between willing buyers and willing sellers for the use of sound recordings by on-demand, interactive music services should serve as a benchmark for the rates to be set in this proceeding. Other potential benchmarks have been suggested in the course of the proceedings to date. I will address the suitability of those other potential benchmarks below.

a. Fees paid for musical works

On behalf of several participants, Dr. Jaffe proposes using as a benchmark for this case the fees negotiated for the right to use copyrighted musical works for non-interactive webcasts. Dr. Jaffe's theory is that, because webcasters require a license for both the musical work and the sound recording in order to webcast any music, the two fees of necessity would be equal in the free market. As support for this theory, Dr. Jaffe points to a study done in 2001 during the Webcaster I CARP proceeding concerning fees paid for music played as background in television and movies.

As I explained in my direct testimony, Dr. Jaffe's theoretical model does not apply to the situation that would face the willing buyers and willing sellers in a hypothetical market for a blanket license to use music in non-interactive webcasts. Further, with respect to his empirical claims, it is clear that Dr. Jaffe ignored markets much more similar to webcasting, latching on to the only market he could find that would fit his theory. As discussed below, that market tells us nothing about how willing buyers and willing sellers would behave in a market for blanket licenses for webcasting.

Dr. Jaffe states that "if both the buyers and sellers would be approaching these negotiations from economic positions that are similar with respect to musical works and sound recordings, then there is no economic basis for concluding that the market for the two rights would differ."[1] The reasoning behind his belief that the sellers of each right would come to the negotiation from a similar position is twofold. First, he states that the "costs of producing the underlying intellectual property are 'sunk,' by which economists mean that the investments have already been made."[2] Second, he argues that, because the creators of the sound recording and publishing rights look to recover their costs in other markets, they would approach the "decision whether or not to sell and [at] what price with exactly the same framework."[3]

Both of his arguments are wrong. The claim that sunk costs are the right framework for analyzing the decisions of the copyright holders is not consistent with the situation facing sound recording copyright owners. The rates set in this proceeding will be applied through 2010. For any new sound recordings created between the time the rate is set and 2010, the record companies will incur additional costs -- that is, costs that are not already sunk. Since the record industry earns the majority of its revenues from recently released albums,[4] it is reasonable to expect that much of the music played by statutory webcasters after this rate is established will be newly-created sound recordings. This Board, therefore, is setting a rate that will affect how much the record companies earn for the use by webcasters of new sound recordings for which costs are not yet sunk.

Dr. Jaffe's fallback argument is that even if the creative costs of sound recordings and musical works are not sunk, webcasting revenues are so small, relative to other avenues for cost recovery, that such revenues are "economically irrelevant" to the rates

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[1] Written Direct Testimony of Dr. Adam Jaffe, Oct. 31, 2005, at 20-21 ("Jaffe WDT").
[2] Jaffe WDT at 23.
[3] Testimony of Dr. Adam Jaffe, Vol. 26, June 28, 2006, at 31 ("Jaffe Test.") (claiming that the initial investment has "no consequences of any significance for ...continued investment in the creation of this [intellectual] property"); *see also* Jaffe Test. at 103 ("those costs are not relevant...to the licensing decision.").
[4] SX Ex. 24 RR at 5 (Citigroup, *Warner Music Group Get Together*, Sept. 22, 2005). According to information released by Nielsen SoundScan and Nielsen BDS, more than half of all sound recordings sold in the U.S. are "current" or new releases, i.e., sound recordings released in the last two years. Business Wire, *Music Industry Report*, New Radio Star, *available at* http://newradiostar.com/NEWS/MUSICINDUSTRYREPORT2003.htm (last visited Sept. 27, 2006).

that the willing seller would set.[5] The economic reasoning behind this argument is flawed. A business will not be indifferent economically about how much revenue it can earn from a service (and how much of its costs it can recover), simply because the service currently accounts for a small portion of its total sales. Rather, a rational business will consider each opportunity to increase revenues and cover a portion of its costs as worthwhile in its own right. So long as the business does not have to incur a transaction cost that offsets the benefit of charging what would otherwise be a profit-maximizing price, it will attempt to do so. With respect to the sale of sound recordings for use by webcasters, it is nonsensical to say that it is not worth the effort involved to negotiate a price that more closely reflects conditions in the webcast market and in particular the willingness to pay of the consumer. Indeed, this is especially true for the webcasting market, because the record companies perceive that the market for the sales of physical products such as CDs -- long their primary source of revenue -- is steadily eroding, and the digital distribution of music through webcasting and other digital distribution channels is what they must increasingly look to for their cost-recovery and profits in the future. *See* Written Direct Testimony of Lawrence Kenswil, Oct. 31, 2005, at 2-3; Written Direct Testimony of Mark Eisenberg, Oct. 31, 2005, at 3-4; SX Ex. 236 RP at 25 (*Vivendi Investor Presentation*).

On a more fundamental level, Dr. Jaffe ignores the structure of the markets that he is looking at and the relationships that define these industries. Although there are separate licenses at issue -- one for the musical work and one for the sound recording -- there is only one final product that is actually provided to webcasters and to their customers -- the sound recording. As discussed in the testimony of Charles Ciongoli from Universal Music Group, the structure of the market for music is one in which record companies invest in the creation, development, and marketing of sound recordings from which both record companies and music publishers benefit. Music publishers earn the vast majority of their revenues from sales or licenses of sound recordings that use musical works as an input, not on sales or licenses of musical works by themselves.

Dr. Jaffe does not dispute that the value of and payments for the two copyrights are different for individual works or even for the average music title. [Jaffe Test. at 81-

[5] Jaffe Test. at 110.

82]. He says things are different for the webcast license, because "what makes them [the musical work and sound recording copyright] equivalent is that the business that the webcaster wants to engage in is the public performance of a relatively large and diverse set of musical works and sound recordings . . . ." [Jaffe Test. at 82-83]. It is central to Dr. Jaffe's theory that the webcasters purchase a blanket license or a very large number of sound recordings, because whatever ability exists to substitute one musical work or one sound recording for another when making individual purchases allegedly does not exist when buying a blanket license or a large number of copyrighted works. [Jaffe Test. at 82-89]. Dr. Jaffe has no empirical evidence to prove this theory that, in such circumstances, music publishers and sound recording copyright owners would be compensated identically, and the empirical evidence that does exist refutes his theory. In virtually every market where broad or blanket licenses are at issue, the sound recording commands significantly greater compensation than the musical work.

As explained in the rebuttal testimony of Mr. Eisenberg, the breakdown of copyright fees in other markets is:

Media	***Sound Recording Fee***	***Musical Work Fee***
Interactive webcasting	[redacted]	6 to 16%
Master ringtones	[redacted]	[redacted]
Digital downloads	[redacted] per track	9.1 ¢ per track
Music Videos	[redacted]	5.1% - 6.5%[6]
Clip samples	[redacted]	5.1%

Some of these markets are affected in various ways by statutory licenses and consent decrees, but they show one thing very clearly: without exception, where blanket or broad licenses for sound recordings and musical works are at issue, sound recording copyright owners receive multiples of what musical works copyright owners receive. Indeed, the variety of rates, as well as the operation of different legal regimes, makes the point that one cannot find a simple ratio (1:1 in Dr. Jaffe's case) and apply it to derive the value of

[6] Mr. Eisenberg's testimony provides more detail about open issues related to negotiations concerning the fees for musical works in music videos, which may lead to additional payments to music publishers, though at a level much lower than that received by sound recording copyright owners.

sound recordings from the price paid for musical works. The markets -- economically and legally -- are simply too different to draw conclusions that such a simple ratio exists between the two prices.

In contrast to the empirical evidence from the markets listed above, the empirical evidence on which Dr. Jaffe purports to rely (a 2001 study on synch and master use rights in the television and movie industry that was rejected in the Webcaster I CARP proceeding) is, by Dr. Jaffe's own theory, utterly irrelevant. First, with respect to Dr. Jaffe's theory that the rights are valued the same because there is no possibility of substitution when the purchaser is buying a blanket license, the synch rights/master use market does not involve the purchase of blanket licenses or a large volume of copyrighted material. Instead, the evidence Dr. Jaffe relies on from the synch and master use market is from a market where the users purchase *individual* sound recordings or musical works, and therefore have the ability to find substitutes for both the musical works and sound recordings. Second, since the music played on most television shows or movies is in the background, the producers can use a cover band to play a particular musical work, and thereby substitute for the sound recording copyright altogether. The relative bargaining power of the sound recording copyright owners is correspondingly diminished compared to the webcasting market, where it would be unacceptable to customers and impractical for webcasters to use cover bands as substitutes for the recording artists. Third, in his study of the movie market, Dr. Jaffe examined the sale of copyrighted material that was already in existence -- that is, as to which costs were "sunk" -- in contrast to the webcasting market for which new sound recordings are constantly being created and for which the costs are not sunk. Finally, the market Dr. Jaffe chose to look at is the one market where -- in contrast to webcasting -- musical works and sound recordings truly are sold as separate goods. In that market, the musical work can be sold without the sound recording, because of the producers' ability to re-record the musical work. That certainly is not true in the context of webcasting, where webcasters need a broad catalog that includes the most popular sound recordings performed by the most popular artists.

Dr. Jaffe has no explanation for the contrast between the market he looked at and the other markets where sound recordings receive much more than the musical works. He failed to examine the evidence from these other markets [Jaffe Test. at 125] or

dismissed the evidence without reason as inappropriate as a benchmark for webcasting. [Jaffe Test. at 123-129].

b. Rates charged to Satellite Digital Audio Radio Services

One benchmark that counsel for DiMA suggested in cross-examination is to use the fees paid by the satellite digital audio radio services (SDARS) to license sound recordings. These fees are paid in accordance with a negotiated agreement between RIAA and the two satellite companies, XM and Sirius, which was entered into in early 2003 (the "SDARS agreement"). [ ] One rationale for using these contracts is that copyrighted sound recordings are used in a similar manner on the SDARS service as they are in subscription non-interactive DAT services. Namely, music programs are streamed (or broadcast) to listeners for a fee, often without commercials, and without any user control of the content or the ability to replay or pause the music. While I agree that these services share important characteristics, I disagree that the current SDARS agreement provides a meaningful benchmark for setting rates in this proceeding. There are several reasons for this.

First, satellite radio was a nascent industry at the time of the negotiations. XM, which first launched its satellites in 2001, had approximately 350,000 customers at the beginning of 2003.[7] Sirius had barely entered the business and had about 30,000 customers at the beginning of 2003.[8] Hence, the parties to the negotiation had virtually no track record to rely on in the negotiations. RIAA had to rely on projections of subscription levels and revenues, and understood there was considerable skepticism as to whether the SDARS business would survive in the marketplace.[9] In such circumstances (not present here), [ ]

[7] XM Satellite Radio Holdings Inc., Form 10-K, filed March 3, 2006, at 33.
[8] Sirius 2005 Annual Report, Data Appendix.
[9] Deposition of Steven Marks, Apr. 3, 2006, at 43-44.

Other factors distinguish the SDARS negotiation in 2003 from the webcasting business of 2006. The SDARS have a high proportion of fixed costs, relative to the webcasting business. This means the willing buyers would appraise the effect of a copyright license fee structure in a different manner. Further the market has changed dramatically in three years, which affects the behavior of willing buyers and willing sellers. This adds to the difficulty of using the SDARS fees as a basis for calibrating the willing buyer/willing seller standard for this proceeding. Indeed, the parties to the agreement themselves recognized that the SDARS agreement was not a valuable precedent even for determining future rates to be charged in the SDARS market and expressly prohibited each other from relying on the agreement reached in future copyright royalty proceedings.[10] If the parties themselves apparently recognized the unique circumstances under which the agreement was reached, and acknowledged that the agreement had no value with respect to the rights specifically at issue, there is little reason to see how the agreement could be of value here.

Finally, the SDARS agreement suffers from the same problem that participants in this proceeding have identified with the agreement between webcasters and SoundExchange to push forward the Webcaster I CARP rates: the agreement was made in the midst or on the verge of a rate-setting proceeding in which litigation and other costs likely had a significant impact on the decisionmaking. *See* Testimony of Jonathan Potter of DiMA, Vol. 20, June 19, 2006, at 155-56; Testimony of John Simson of SoundExchange, Vol. 4, May 4, 2006 at 51-53. The same factors that DiMA says made the agreement to push-forward webcasting rates a poor benchmark would have affected the participants to the SDARS copyright royalty proceeding in 2003 and their conclusions as to an appropriate rate. Indeed, the SDARS agreement is an even poorer benchmark because the negotiators might have been uncertain how the different statutory factors would be interpreted, which would have colored the negotiation of that "voluntary" agreement.

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[10] *See* Section 2.1 of SDARS Agreement; SX Ex. 238 RP (Notification of Settlement and Motion to Suspend CARP Proceedings (filed March 19, 2003)) ("The parties to the Agreement intend that it shall be non-precedential, and shall not be admissible as evidence or otherwise taken into account in any administrative, judicial, or other government proceeding, except that it may be taken into account to a limited degree in one circumstance relating to the bankruptcy of a Service, as described below. The parties would not have entered into the Agreement but for this understanding.").

For all of these reasons, I believe that the SDARS agreements should play no part in the setting of the license fees in this proceeding.

c. Yahoo! Agreements with Independent Record Companies

Since the filing of written direct statements in this proceeding, it appears that Yahoo! has sought to enter into agreements with small independent record companies ("indies") and aggregators[11] of indie label content. I have reviewed the agreements between Yahoo! and the following parties: [ ] With the exception of one agreement that is no longer in effect, these agreements appear to have been negotiated after the filing of written direct statements in this proceeding.

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[11] Aggregators are entities that act as representatives of a collection of indies.

[redacted]

[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]

[redacted]

[12] *In re Rate Setting for Digital Performance Right in sound recordings and Ephemeral Recordings*, No. 2000-9 CARP DTRA 1&2, (CARP Feb. 20, 2002) (Report of the Copyright Arbitration Royalty Panel to the Librarian of Congress) at 53 (SoundExchange Exhibit 405 DP in the Direct Case).

[redacted]

d. RLI/DiMA Agreement

On May 3, 2006, RLI entered into an agreement with DiMA to license sound recordings for music services that met the statutory criteria for the compulsory blanket license for statutory webcasting. That agreement purported to have been negotiated just prior to the filing of written direct statements in this proceeding, but was not formalized until just prior to the opening statements of this proceeding. The agreement does not constitute an independent, reliable benchmark upon which the Board should base its decision in this case.

Even if there were not serious questions about RLI's motivation for entering into such an agreement on the eve of the proceeding,[13] the DiMA-RLI agreement would nonetheless be of no value in setting a royalty rate. It is, in reality, a sham agreement. The rate agreed to by RLI and DiMA will never actually apply, unless the Board adopts that same rate in this case. The reason is that the RLI/DiMA agreement contains a provision that the rate will be superseded by the decision of the Board in this case.[14] Further, if the Board adopts a different rate than the rate contained in the agreement, there will be a "true-up" applied retroactively to the beginning of the period covered by the

[13] Testimony of Ronald Gertz, Vol. 18, June 14, 2006, ("Gertz Test.") at 283-290.
[14] RLI-DiMA Agreement, ¶3.4.

agreement. Purportedly, this is to prevent either party from suffering competitive harm vis-à-vis the rest of the industry.[15] In effect, it makes the contract's rate term meaningless. Also, the agreement gives each DiMA member the option of joining or not joining the agreement with RLI -- something that no DiMA member had opted to do as of the time of the direct case hearings in this case.[16]

2. Per-play rate for non-subscription services

Based on agreements negotiated in the benchmark market for the use of sound recordings by interactive, on-demand music services, I proposed a three-part fee structure under which statutory webcasters would pay the greater of a percentage of their revenue, a per subscriber rate, or a per play rate. Because the benchmark interactive music services generally are subscription services, and many of the statutory webcasting services that are the subject of this proceeding are ad-supported, I was asked questions during the hearing about the appropriateness of using subscription services as a benchmark for ad-supported services. Many of these questions focused on the per-play metric of the three-part fee structure, since a per-subscriber rate is irrelevant to ad-supported services, and a percentage of revenue rate will automatically self-adjust downward if ad-supported services earn less revenue than subscription services. I will address issues related to the per-play rate below.

a. *The Relationship between Subscription and Non-subscription Markets*

I was asked several questions during the hearing about the rationale for deriving a per-play rate for the non-subscription market based on evidence about willingness-to-pay from the subscription market. The suggestion appears to have been that a willing seller would always lower the single price it charges to all webcasters in order to attract more people to a non-subscription offering. That suggestion, however, ignores the relationship between the subscription and nonsubscription markets.

[15] Gertz Test. at 288.
[16] Gertz Test. at 284-285.

Mr. Steinthal posed a hypothetical to me where ten percent of the demand in the market is willing to pay $9.00 per unit and ninety percent of the demand is willing to pay no more than $1.10 per unit. He asked me whether the supplier would be better off charging $9.00 or $1.10 per unit, assuming the seller must charge a single price.[17] The answer I gave is that the supplier would earn greater profits by charging $1.10 per unit and selling more units, but only if the assumptions used in the hypothetical about willingness-to-pay were derived correctly.

Quite apart from the fact that no evidence has been presented to support Mr. Steinthal's assumptions about consumers' willingness to pay, his questions fail to account for the fact that some of the non-subscription customers almost certainly are "cannibalized" customers – namely, customers who would otherwise buy subscription services if they had no choice. The effect of even a small amount of cannibalization can be shown in a modified hypothetical in the table below. Scenario #1 represents the hypothetical case posed by Mr. Steinthal. The price paid by customers is assumed identical to their maximum willingness to pay for a music service. Therefore, if a uniform price is set at $1.10, all of the customers in the non-subscription and subscription markets will buy the service.[18] In this case, total revenues are $20.00 higher ($110 versus $90) than if the lower uniform price of $1.10 is adopted.

Scenario #2 shows the effect of modest cannibalization, by which I mean that there are some small number of non-subscription customers who would pay the higher price for a subscription service if the non-subscription service was not available. Here, I assume that the uniform price is increased to the level that the current subscription customers are willing to pay. (This can also be interpreted as a case where the non-subscription service is no longer available). By contrast to Scenario #1, I assume for the sake of argument that the vast majority of non-subscription service users would cease listening if paying the higher subscription price was their only option, but that 5 of the 90 non-subscription service customers would shift to a subscription service at the higher price. This alters the payoff and now the supplier is much better off charging a higher price. Its total revenues are now $25 higher ($135.00 versus $110.00) when the higher

[17] Testimony of Michael Pelcovits, Vol. 9, May 16, 2006, at 251 ("Pelcovits Test. II").
[18] Although there is no explicit price for non-subscription services, we will assume for this hypothetical that the willingness of the customers to tolerate advertisements reflects their willingness to pay for the service.

price is adopted. This demonstrates the importance of taking account of the substitutability of non-subscription and subscription services.

Hypothetical Scenario #1 – No cannibalization

	Current Demand	Price	Revenue	Demand with Uniform price of $1.10	Revenue at uniform price of $1.10	Demand with Uniform price of $9.00	Revenue at uniform price of $9.00
Non-subscription Customer group	90	$1.10	$99.00	90	$99.00	0	0
Subscription Customer group	10	$9.00	$90.00	10	$11.00	10	$90.00
Total	100	n/a	n/a	100	$110.00	10	$90.00

Hypothetical Scenario #2 – Cannibalization

	Current Demand	Price	Revenue	Demand with Uniform price of $1.10	Revenue at uniform price of $1.10	Demand with Uniform price of $9.00	Revenue at uniform price of $9.00
Non-subscription Customer group	90	$1.10	$99.00	90	$99.00	5	$45.00
Subscription Customer group	10	$9.00	$90.00	10	$11.00	10	$90.00
Total	100	n/a	n/a	100	$110.00	15	$135.00

As a side matter, it is worth noting that subscription services, which offer the benefit of commercial-free programming for a fee, are not a tiny piece of the overall market. Rather, [redacted] SX Ex. 022 RR (Receipt and Enforcement Effectiveness Tracking Spreadsheet). That amount likely does not include many hours of programming for "bundled" services, such as those offered by AOL and Yahoo!, in which users pay a fee for a bundle of products including commercial free webcasting and Internet connectivity.[19] Moreover, based on information provided by

[19] [redacted]

SoundExchange, [SX Ex. 022 RR.

Despite the growth of subscription and bundled services, however, webcasters continue to believe that ad-supported services will ultimately win out. *See* Testimony of Robert Roback, Vol. 22, June 21, 2006 ("Roback Test.") at 83. As Dr. Brynjolfsson discusses, ad-supported services have a higher up-side than subscription services and, as webcasters begin earning revenues closer to those of terrestrial radio (the webcasters' avowed goal), ad-supported webcasting, on a per listener hour basis, will be more lucrative than subscription webcasting. *See* Testimony of Dr. Eric Brynjolfsson, Vol. 5, May 8, 2006 at 110. Thus, it makes perfect sense to extrapolate the fee that copyright owners would charge in the nonsubscription market from the subscription market. The markets are close substitutes, and webcasters believe that the ad-supported market is likely to be most successful.

b. SoundExchange's Revised Rate Proposal

I am aware that SoundExchange is proposing a revision to its original rate proposal, which would result in increasing the per play rate in steps from its current level to the level that I proposed in my original testimony (with a cost-of-living adjustment). As a result, the per play rate would be lower in the early years of the license. I believe that this proposal is not in conflict with the framework I proposed in my direct testimony for several reasons.

First, as I noted in my written direct testimony, in the market for interactive music services, although the license agreements feature a three-part fee structure, [ ] As Mr. Eisenberg explains in his testimony, the per play component ensures that services that are failing to earn reasonable revenues (e.g., through a decision to use music to earn revenues indirectly) do not avoid paying copyright owners an adequate fee. In this proceeding, if the Board decides to utilize a similar three-part fee structure, it is rational to achieve the

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same purpose by phasing in a higher per play rate that ramps up as the advertising market matures.

Second, the proposal makes sense because we are already well into the license period. Webcasters in 2006 have been paying SoundExchange under the rate set by the Librarian in 2002 and pushed forward in 2003, but the statute provides for a "true-up" once a new rate is set. The proposal will thus avoid significant retroactive payments by ad-supported services and will give webcasters the opportunity to plan for increases in the per play rate over the term of the license. Beginning the current license term with the existing per play rate ensures that there will be no disruption in the webcasting industry, since there can be no dispute that major webcasters in this proceeding have been willing buyers who have substantially expanded their businesses at the existing rate. Increasing the per play rate progressively over time from this starting point makes sense because all of the data provided in the testimony of webcasters, as well as Dr. Brynjolfsson's analyses, show that revenues are increasing rapidly (and are projected to continue to do so), both on an aggregate level and on a per listener hour level.

Importantly, the new proposal would only adjust the per-play rates. The other two components of the proposed "greater of" structure remain unchanged as part of the SoundExchange proposal. There is no reason to adjust the per subscriber rate, because all of the evidence shows that webcasters can pay such rates for subscription services, which, according to Yahoo!, have a gross profit margin of [[redacted]] under the current fee structure.[20] Nor is there any reason to adjust the percentage of revenue rate, because that rate effectively self-adjusts as the revenues earned by webcasters rise or fall.

As Dr. Brynjolfsson notes in his testimony, if nonsubscription webcasters continue to build toward the advertising revenues received by terrestrial broadcasters, they will reach the point where they will always pay on the revenue share rather than the per play rate. Nonetheless, it is important to retain the per play rate for those webcasters who do not choose to monetize the benefit that consumers gain from listening to their services or who monetize it in ways that are not captured by the definition of revenue.

[20] Roback Test. at 184 (Closed Session).

3. Substitution/Promotion

The question of whether webcasting promotes the sale of CDs and digital downloads, or alternatively substitutes for the sale of CDs and digital downloads, is relevant to the economic analysis in this case for two reasons.

First, in my direct testimony I used the market for interactive webcasting as a benchmark to derive proposed rates for the statutory (non-interactive) webcasting market. I concluded that there was no empirical basis to conclude that interactive webcasting is any more substitutional or any less promotional than non-interactive webcasting. Consequently, when I derived the proposed rates for the non-interactive market from the rates observed in the interactive market, I did not believe that any adjustment was necessary to account for a difference in substitution or promotion between the benchmark and target markets. Nevertheless, at the request of counsel for SoundExchange, in my direct testimony I presented a sensitivity analysis which adjusted my recommended fee for a net substitution/promotion difference in the two markets of two CD purchases a year per subscriber.

Second, the webcasters argued in their direct cases that non-interactive webcasting is highly promotional, although they neither attempted to quantify that supposed promotional value nor provided any analytical or empirical framework to assess the effect of promotion on their proposed rates.

The empirical evidence produced thus far in this proceeding demonstrates quite clearly that statutory webcasting provides, at most, a miniscule promotional effect on the sale of music CDs. The anecdotal evidence adduced during the trial suggests that both interactive and non-interactive webcasting are substitutional. New evidence that I acquired after the end of the opening phase of the trial demonstrates that at most only a slight difference exists between interactive music services and non-interactive webcasting. I believe this evidence shows that the webcasters' claims concerning promotion should be entirely rejected, and that my sensitivity analysis based on net substitution of 2 CD sales per person per year provides a much greater allowance than necessary for this potential effect.

a. *Evidence that non-interactive webcasting is not promotional*

The webcasting services allege that non-interactive webcasting is highly promotional of CD sales, and in support of that proposition they argue that webcasting is analogous to terrestrial radio. At the most basic level, there are two problems with this argument.

First, although it seems to be the received wisdom in the music business that terrestrial radio is promotional, there is precious little empirical evidence to support this view, and academic literature has reached a contrary conclusion.[21] Second, as several witnesses testified, there are important differences between terrestrial radio and webcasting which render it less likely that webcasting is promotional. *See, e.g.* Eisenberg WDT at 5-6; Written Direct Testimony of Michael Kushner, Oct. 31, 2005, at 9-10; Written Direct Testimony of Cathy Fink, Oct. 31, 2005, at 14. I will not repeat that testimony here. At bottom, however, the webcasters produced no reliable evidence of the promotional effect that the webcasters tout.

To the contrary, the *only* empirical evidence introduced during the trial of this case demonstrates that webcasting is *not* significantly promotional. I have examined the data provided by webcasters concerning the purchases of CDs or digital downloads that their listeners make using the "buy" button that appears on the media player of some webcasters. Adopting several assumptions favorable to the webcasters, the data nevertheless shows an almost non-existent promotional effect.

Perhaps most instructive is the experience of a multi-channel Internet webcaster called Accuradio. Accuradio's CEO, Kurt Hanson, testified about the efforts he makes to promote sales of CDs to his webcast audience. None of these efforts are required by the Copyright Act or the statutory license. Accuradio runs banner ads and in-stream announcements promoting purchases of CDs using a direct link to Amazon that appears on the Accuradio media player. Accuradio also displays CD cover art for the last three CDs played on the station. Mr. Hanson believes that he probably does more than any

[21] SX Ex. 227 DP, at 16-41. (Stan J. Liebowitz, *The Elusive Symbiosis: The Impact of Radio on the Record Industry*, Review of Economic Research on Copyright Issues, March, 2004).

other webcaster to promote CD sales through the link on his website,[22] and he concedes that Accuradio has a powerful incentive to do so because it earns a commission on these sales.

In spite of these efforts, the number of CDs sold via the links on the Accuradio website is miniscule. [

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It is possible that Accuradio's listeners hear music on Accuradio and decide to buy it, but do not use the Accuradio link to Amazon. If so, the Accuradio data would understate the promotional effect of webcasting. It seems unlikely, however, that a high percentage of people who choose to buy the music they hear on Accuradio will pass up the quickest and most efficient means to do so -- the Accuradio buy button -- in favor of a trip to a brick-and-mortar store or a separate transaction with an on-line vendor.

Similar data for one of the broadcast companies, Bonneville, yields similar results. Bonneville provided information for two of its terrestrial stations that simulcast their signal, showing that for four weeks in October of 2005, KOIT and KZBR listeners bought a total of [ ] digital downloads -- individual tracks, not CDs.[25] For the month of October, KOIT and KZBR streamed to [ ] listeners. SX Tr. Ex. 91. Thus the average listener to Bonneville's simulcasts purchased

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Finally, data from Yahoo! further confirms the minimal promotional impact of webcasting. Yahoo! is the largest webcaster and has a complete set of music services, including music videos, interactive, on-demand services (portable and non-portable), and webcasting (subscription and non-subscription). Yahoo! also sells digital downloads, and

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[22] Testimony of Kurt Hanson, Vol. 33, Aug. 3, 2006, at 60.

[23] *Id.* at 27 (although the question is posed in terms of sales in 1995, this must have been understood by everyone as referring to 2005, because Accuradio was not in business in 1995).

[24] *Id.* at 13-14.

[25]

users can purchase a digital download through Yahoo!'s music store directly or while listening to a music video, an on-demand service, or its webcasting service.

The evidence, however, is that Yahoo! sells very few downloads. According to internal Yahoo! documents, Yahoo! has approximately [ ] unique listeners each month to its various subscription and nonsubscription webcasting services. SX Ex. DR 44 (Ex. 6 to Yahoo!'s response to SoundExchange's First Set of Interrogatories). As discussed in the testimony of Mark Eisenberg, in the first six months of 2006, Yahoo! *in total* sold [ ] downloads and [ ] digital albums whose copyrights are owned by SONY BMG. Based on SONY BMG's market share, one can assume that, in total, Yahoo! sold, over a six-month period, [ ] downloads and [ ] digital albums. Even assuming that every single one of these downloads and albums was sold to a listener to Yahoo!'s LaunchCast (and there is no reason why purchasers of downloads would all fall into that category[26]), that would mean that the average LaunchCast listener buys [ ] through the buy buttons on Yahoo!.[27]

The data that we have from these three webcasters is quite consistent in showing, *at most*, a marginal promotional benefit from webcasting. And, as I said at the outset, this is so even if one assumes that each of the sales by these webcasters was a net additional sound recording that would not have been sold but for the webcast. In fact, however, none of the webcasters can show that sales of CDs or digital downloads made through their websites reflect a net increase in sound recording sales. In other words, they cannot show that music purchased through their websites did not simply replace a different sound recording that the listener would otherwise have purchased. They also cannot show that the music purchased through their website was music that the consumer was motivated to purchase *because* the consumer listened to it during a webcast. In the case of websites that sell music through download stores, such as Yahoo! and Bonneville, they cannot even show that sound recordings were sold to a webcast listener as opposed

[26] As shown by the testimony of Mark Eisenberg, [ ] See Rebuttal Testimony of Mark Eisenberg at p.16.

[27] These numbers differ somewhat from those in Mr. Eisenberg's testimony because I have access to restricted data about Yahoo!'s actual listenership that Mr. Eisenberg does not.

to someone who came to the site for the express purpose of buying music through the website. And, any minor promotional effect that emerges from the data -- after making every possible assumption in the webcasters' favor (including some unrealistic ones) -- does not factor in the potentially offsetting effect of substitution.

b. Evidence of the magnitude of substitution

In the first phase of this proceeding, I testified that it is logical to believe that people who listen to many hours of non-interactive webcasting each month will have less time to listen to music in other ways -- and thus spend less money purchasing music in other forms, thereby making webcasting rival on demand services in its substitution for other forms of consumption of music. As discussed below, I have obtained additional evidence that reflects the difference in substitution effect between interactive and non-interactive services and confirms that the difference between the two is small -- far smaller than the two CD differential I assumed in the sensitivity analysis in my written direct testimony.

i. The trial evidence

The evidence at trial regarding the substitutional effect of statutory webcasting was primarily anecdotal. Several industry witnesses testified to their belief that non-interactive webcasting is substitutional (Testimony of Mark Eisenberg, Vol. 8, May 11, 2006 at 181, 187-88, 256, 380; Kenswil Test. at 18, 87), and SoundExchange witness James Griffin testified regarding the substantial number of available software products that will rip webcast streams. Testimony of James Griffin, Vol. 2, May 2, 2006, at 112; Testimony of James Griffin, Vol. 3, May 3. 2006 at 182, 288-89.

Of particular relevance to my benchmark analysis, however, is the question of whether non-interactive webcasting has less of a substitutional impact than interactive music services. The evidence that interactive music services are substitutional comes primarily from the testimony of SoundExchange witnesses. But if these witnesses' statements are relied on as proof of the substitution effect of interactive music services, then their statements that non-interactive webcasting (i.e., the statutory services) also substitute for CD sales should be given equal weight. The trial testimony, if accepted,

establishes only that both methods of delivering digital music may substitute for CD sales, but does not provide a basis to determine to what degree the substitution effects differ.

ii. Marketplace Evidence

In the absence of any other evidence, one might attempt to estimate substitutional effects by making various observations about the actual marketplace. As I discuss below, however, this indicator is imperfect. For example, if one looks at pricing to establish what marketplace actors believe about promotion and substitution, one must recognize that substitution and promotion are not the only considerations affecting prices in this market. Fees should still maximize the sellers' profits, which are the sum of the revenues received from the fees net of the effect of substitution and promotion on profits earned in other markets. The fee that copyright owners charge in the interactive service market represents more than simply a replacement for lost sales in other places. Nonetheless, marketplace evidence is fully consistent with a substitution effect from interactive services that is less than 2 CDs per consumer per year.

As an initial matter, it is worth examining the data concerning the number of CDs purchased by the average U.S. consumer in a year. According to RIAA data, shipments of recorded music in 2005 were approximately 820 million CD equivalents.[28] The U.S. population in 2005 was 296 million, and 257 million if we exclude the population under 10 years old.[29] Therefore, on average approximately 3.2 CDs are purchased each year by each person 10 years or older. If the average consumer buys only 3 CDs per year, an assumption that interactive services substitute for 2 CD purchases per year is highly conservative, since it represents a very high percentage of total CD purchases.

CD sales certainly may be higher among certain types of customers. In a recent working paper, Professor Stan Liebowitz has analyzed CD purchases using a data set for 99 American cities and containing information on Internet use, actual record sales, television viewing, radio listening, and other demographic variables. The results of his

[28] RIAA, *U.S. Manufacturers' Unit Shipment and Value Chart, available at* http://www.riaa.com/news/newsletter/pdf/2005yrEndStats.pdf (last visited Sept. 27, 2006). I estimated CD-equivalents by converting download singles to CDs at a ratio of seven-to-one.

[29] U.S. Census Bureau, Annual Estimates of the Population by Sex and Five-Year Age Groups for the United States: April 1, 2000 to July 1, 2005 (NC-EST2005-01).

analysis of 2003 data are that the average number of album sales per capita is 2.32.[30] Using the Liebowitz data, it is possible to make some assumptions about a hypothetical demographic group that would be skewed toward the consumers most likely to be the heaviest purchasers of CDs. This group would be composed entirely of broadband Internet users, with average annual income of $75,000, and above 29 years old. I performed an econometric projection for per capita album purchases of this group and this yields an average of 5 CD purchases per year. Once again, assuming substitution of 2 CDs per interactive service subscriber would reflect a very large substitution effect, relative to the average level of CD purchases in this high-volume group.

iii. Hypotheticals Posed in Cross-Examination

During my cross examination I was asked questions about the possible relationship between the price set for the use of sound recordings by interactive music services, and the perceived degree to which those services substitute for the sales of CDs. Specifically, I was asked whether the fees charged by record companies for interactive services were sufficiently high to leave them "ahead of the game" even if interactive webcasting substituted for 7 or 8 CD sales per subscriber.[31] My answer then, which I will elucidate now, is that the question is based on a false premise. Copyright fees in the interactive market cannot be explained by a calculation of whether the record companies are "ahead of the game." There is a large gap between being "ahead of the game" and maximizing profits. The record companies would not set fees of $4.00 per subscriber per month, if CD substitution were as high as 7 to 8 per year. This would not be an optimal strategy and would yield the record companies significantly lower profits than they could earn otherwise.

To illustrate this point, I will use the fee levels presented in my direct testimony. For rounding purposes, let me assume that the copyright fee in the interactive market is

[30] Stan J. Liebowitz, *Testing File-Sharing's Impact by Examining Record Sales in Cities*, School of Management, University of Texas at Dallas, Second Draft: April 2006, at p. 9. Across the 99 cities the minimum number of album sales per capita is 1.499, the maximum is 3.879, and the standard deviation is 0.440.

[31] Pelcovits Test. II at 68-69.

$3.00 per month and the profit margin per CD was $6.00.[32] According to Mr. Steinthal's logic, the record companies would be "ahead of the game" so long as the substitution effect was less than six CDs per year. The math is straightforward: A fee of $3.00/month times 12 months equals $36.00 in revenue per consumer per year, and that sum divided by a $6.00 margin per CD yields six CDs per consumer per year as the breakeven point. Thus, if the copyright fee for sound recordings used by interactive music services was $3.00 per month, the record companies would break even if listening to an interactive music service caused the average subscriber to buy six fewer CDs per year.

But although that math is correct, the economics are not. If the point of Mr. Steinthal's example was to suggest that the record companies would set the fee at $3.00 if they believe they would be losing 6 CD sales per year for each subscriber, that would make no economic sense. Certainly, one would not expect record companies to set a fee *lower* than the amount of profit they would lose through substitution. But neither would one expect record companies to set a fee at the break-even level. Instead, one would expect the record companies to attempt to maximize profits based on, among other things, the willingness to pay of the consumer.

In fact, it will almost always be more profitable to raise the copyright fees significantly above the breakeven level. Let me explain, using the example above. If six CD sales were lost for each subscriber, and the current fee was $3.01, then the record companies would earn a profit of only 1¢ per month per subscriber. If the record companies raised the fee by one penny, to $3.02, they would increase their profit, unless the increase in the fee was passed on by webcasters to the consumers and that price increase caused a fifty percent decrease in consumer demand. In other words, it would make sense for record companies to double the per subscriber profit from 1¢ to 2¢ unless they would lose half of the subscribers as a result.

It is almost inconceivable, however, that consumer demand for interactive music services would be so elastic that a 1¢ price increase (representing less than .2% of the total consumer price) would cause any perceptible suppression of demand, much less a

[32] In my written direct testimony, I used $5.60 as the margin per CD, based on industry sources approximating that amount. That figure is consistent with other publicly reported figures. *See* Goldman Sachs, Warner Music Group Corp., *Unlocking the Value of Content Through New Distribution Channels/Formats,* June 25, 2005, at 9.

50% drop in demand. If we engage in this thought experiment of continuing to increase fees until the increase in profit per subscriber is fully offset on the margin by the loss of subscribers, we will have solved for the optimal, profit-maximizing fee.

Unless the elasticity of demand is extremely high[33] -- well above what would be expected for a wide range of consumer goods -- it would make no sense for record companies to set the price in the on demand market at just above the break-even level. Indeed, if one were to assume an elasticity of demand of four, which is well above the demand elasticity in most consumer good markets,[34] there is no question that the fee that record companies seek and obtain in the interactive music service market is predicated on a level of substitution that is less than 2. Although the mathematics is complex, the result is straightforward: if record companies believed that nonportable interactive services substituted more than 2 CDs per subscriber per year, they would charge more for them.

c. Additional Evidence of the Small Substitution Differential Between Interactive and Non-interactive Services

Since the time of my original testimony, I have become aware of additional evidence bearing on the question of whether and to what degree interactive music services and non-interactive webcasting are promotional or substitutional. The NPD Group conducts an annual Digital Music Survey. The NPD survey collects information on the music listening habits of a representative sample of over 4,000 U.S. consumers, including information on their purchases of recorded music in various forms and their use

[33] The meaning of a demand elasticity of four is that for a 10% change in price, demand will change in the opposite direction by 40 %.

[34] The price elasticity of demand for most consumer goods is very low. For example, a review of the economics literature by The Mackinac Center for Public Policy concluded that "For most consumer goods and services, price elasticity tends to be between 0.5 and 1.5." MacKinac Center for Public Policy, *The Universal Tuition Tax Credit*, Nov. 1997, p. 58. For information goods, like music, the elasticity of demand for bundles of titles is also below 2.0. For example, Brynjolfsson, Smith, and Hu (2003) found that the price elasticity of demand for a book publisher was between 1.56 and 1.79, Erik Brynjolfsson, Michael Smith, and Yu Hu, *Consumer Surplus in the Digital Economy: Estimating the Value of Increased Product Variety at Online Booksellers*, Center for Ebusiness at MIT working paper No. 176, June 2003, at 14. Mortimer (2004) estimated that the elasticity of demand for video rentals ranged from 0.6 to 1.1 depending on the characteristics of the titles in the group. Julie Holland Mortimer, *Vertical Contracts in the Video Rental Industry*, Department of Economics, Harvard University, Apr. 1, 2004, at 37.

of different digital music services, including music websites. The most recent survey was conducted in December 2005.

NPD recently provided me with information on the recorded music purchases of two different groups of customers. The first group consists of the subscribers to digital music services, who claim they are paying more than $4.99 per month for the service. I used this subset of digital music service customers in an attempt to approximate results for customers who subscribed to interactive services, as these services are generally more expensive than non-interactive services. The second group consists of the customers who listened to streamed music from a free website, but did not subscribe to a digital music service. I used this set of customers to represent customers of non-interactive, i.e. statutory, services.

I examined the survey results to see if there was any evidence to suggest that the difference in net promotion/substitution would exceed 2 CDs per user between the two types of uses. I was especially interested in whether the volume of purchases of recorded music changed after the customers had joined a subscription music service or begun to listen to free streamed music. If such a pattern existed, it would be suggestive of a promotional or substitutional effect.

NPD asked customers how long they had subscribed to a subscription music service or listened to free streamed music and also asked about purchases of recorded music during 2005 and 2004. NPD provided me with a cross tabulation of the survey results on purchases of recorded music each year sorted by the type of music service (subscription or free streaming) and the length of time the customer was using the service. The results of the cross tabulations are shown in the table below. They indicate that neither listening to music streamed from a free website (i.e., statutory webcasting) nor subscription to a music service that costs more than $4.99 per month (i.e., an interactive music service) had an effect on purchases of recorded music significant enough to undermine my assumption that any difference between the two equates to two CDs or less per year. New subscribers to digital music services purchased 5.7 CDs during 2004, compared to 5.5 CDs during 2005. New users of free streaming webcasting services purchased 5.6 CDs during 2004 and 5.3 CDs during 2005.

Similarly, if we look at the group of customers who had subscribed to a digital music service or listened to music streamed from a free website for more than a year, we find very limited evidence of changes in their purchasing of recorded music over time. Customers who had subscribed to digital music services for more than a year decreased their purchases somewhat over the two year period, going from 8.6 in 2004 to 7.6 in 2005. Customers who had used free streaming services for more than a year decreased purchases from 6.9 CDs in 2004 to 5.9 CDs in 2005.

Results from NPD Survey of Digital Music

	CD Purchases		
Subscribed to a Digital Music Service (DMS)			
	2004	**2005**	**Change**
Less than One Year	5.7	5.5	-0.2
One Year or More	8.6	7.6	-1.0
Streamed Music from a Free Website but Did Not Subscribe to a DMS in Past 12 Months			
	2004	**2005**	**Change**
Less than One Year	5.6	5.3	-0.3
One Year or More	6.9	5.9	-1.0

Source: NPD Survey of Digital Music, December 2005.

Note: Survey respondents who didn't know how long they had subscribed to a DMS or streamed music were excluded. In addition, respondents who paid less than $4.99/month were excluded.

Where the goal is to determine if there is a large differential in the marketplace between the two services, one would expect to find an indication of such an effect from data such as this. No such large difference appears. I conclude that any difference in the promotional/substitutional effects between the benchmark and target markets is considerably less than two CDs per year, and therefore the two CD sensitivity analysis in my direct testimony should provide a greater allowance than necessary for this effect.

d. The Impact of the Evidence Regarding Promotion and Substitution on the Parties' Rate Proposals

The benchmark market for interactive music services that I used to derive a license fee for non-interactive webcasting already took into account the effects of promotion and substitution. Consequently, in adjusting the fees observed in the

interactive market in order to propose an appropriate fee for the non-interactive market, I needed to adjust only for the *difference*, if any, between interactive music services and non-interactive webcasting with respect to promotion and substitution. In my direct written statement I assumed a difference of 2 CDs -- that is, that interactive music services suppressed CD sales by 2 CDs more per year than non-interactive webcasting -- and I conducted a sensitivity analysis to determine the impact of a 2 CD differential. Reviewing the evidence above, it now appears that my assumption of a 2 CD differential was, if anything, too high:

- The evidence introduced at trial regarding listeners' use of "buy" buttons to purchase CDs and digital downloads demonstrates that the promotional effect of non-interactive webcasting is exceedingly weak.

- A review of marketplace evidence suggests that a 2 CD substitution effect would be a very large one and that the actors in that market likely assumed a CD substitution effect of 2 CDs per year or less for interactive services.

- The NPD data indicates that the likely difference in net substitution/promotion between interactive and noninteractive services is small -- far smaller than 2 CDs.

Taking all of this into account, I conclude that if any adjustment is made to the benchmark interactive service rates in order to account for a differential substitution effect, that adjustment should be less than the 2 CD sensitivity analysis explained in my direct written testimony.

Finally, I would note that even if the Board were to conclude that there is some promotional benefit from webcasting and were to ignore any possible substitution effect, that does not compel the kinds of low royalty rates sought by webcasters in this proceeding. Evidence in the market shows that record companies regularly receive percentages of revenues that are [[redacted]] or even higher for services that pose little threat of substituting for CD sales or sales of digital downloads and indeed are viewed by record companies as being part of a record company's marketing efforts. Music videos -- both on-demand and non-interactive -- have long been viewed by record companies as having some promotional effect, but the record companies earn revenue shares from music video services in the range of [[redacted]]. Mastertones provide another good example. Record companies view mastertones primarily as a product in itself, but also as part of their marketing efforts. Mastertones are only a short clip of a sound recording and

are only available on cellular phones so they are unlikely to substitute for CD sales. Despite the possible promotional benefits and the relatively little additional costs (two factors that Dr. Jaffe claims would compel an exceedingly low rate for webcasting), record companies receive a substantial percentage of the retail price -- generally around [[redacted]] -- for mastertones. Thus, just as substitution for other sales is not the only driver of the price that record companies would receive in the free market, neither is possible promotion of other sales. Rather, as willing sellers of a valuable good, they would, consistent with the free market, set prices taking into account what willing buyers will pay. As shown by the various markets for sound recordings, willing sellers regularly receive compensation similar to or in excess of what copyright owners and performers are seeking in this proceeding.

4. Costs and Margins in the Target and Benchmark Markets

During cross-examination, Mr. Joseph asked a hypothetical concerning whether, if current prices, costs and profit margins all remained exactly the same, the model I used in my direct testimony implied that the appropriate copyright fee would be negative.[35] I answered affirmatively, but my response was based on an understanding that the hypothetical he posed was whether the webcaster would receive a negative margin if webcasters maintained the same prices and production costs, including webcaster margins, stayed the same at the same time copyright fees increased to the level I recommended. That hypothetical, however, is both theoretically unsound and counterfactual.

In order to clarify this issue, I will restate the example used in Mr. Joseph's question. Assuming that interactive DATs are provided in a fully competitive market at a price of $8 and the copyright fee is $3, the production costs (including a market-based return on capital) would equal $5. If we further assume that the production cost of non-interactive webcasting is also $5 and the current subscription price for the service, then it would not be possible to set the copyright fee above $1, as I have proposed, without causing the webcaster to receive a negative margin.

[35] Pelcovits Test. II at 48.

The reason I have for rejecting this hypothetical is that it falsely assumes that the non-interactive webcast subscription price would remain unchanged if the copyright fee were to increase. If the market in which webcasters operate is fully competitive, as my model assumes, then the subscription fee would increase to pass through the increase in the copyright fee on a dollar-for-dollar basis. This is a fundamental economic principle with respect to fully competitive markets, where by assumption all firms must set price equal to cost. Hence, as a result of passing on the increased copyright fee to subscribers, the webcasters would experience no change in profits. My recommendation for a copyright fee increase is therefore fully compatible with the model I used and does not imply that webcasters will be forced to lose money.

Moreover, the hypothetical is counter-factual. As an empirical matter, webcasters can earn a competitive return on subscription non-interactive services while paying the increased copyright fee. Yahoo! reports a gross profit margin in the range of [[redacted]].[36] For a service priced at [redacted]] per month, the margin under the current rates would be [redacted]], which would allow Yahoo! to absorb an increase in the copyright fee without raising prices to subscribers, while still allowing the service to yield a large profit margin. Whether they would choose to pass through some or all of an increase in copyright fees, however, would depend on the competitive pressure they face in the marketplace.

5. Application of Proposed Rates -- the Definition of Revenue and Bundled Services

a. Overview of the Definition of Revenue

In my direct testimony I proposed using the fees paid to license copyrighted sound recordings in the interactive DAT market for purposes of setting compulsory license fees in this proceeding. By extension, it would be logical to be guided by the definition of revenues in those agreements for purposes of defining revenue for the statutory license fees. The definition of gross revenues in a typical interactive DAT

[36] Roback Test. at 184 (Closed Session).

contract[37] includes revenues from several different categories, such as advertising of all kinds, net sales of products and services sold on the service, revenues from granting access to or use of the service, e.g., subscription fees, revenues from access to, use of, or upgrades to proprietary software used for access to the service, e-commerce bounties or click-through royalties, and sales of data related to users of the service.

A definition based on these categories would be consistent with the interactive services agreements and would be appropriate for the webcasting services. For the sake of clarity, it would be helpful to provide some additional specifics to break down these broader categories. This is especially true because of the many different ways that webcasters earn revenues from webcasting. Simulcasters bundle webcast advertising with over-the-air broadcast advertising. Webcasters such as Yahoo! draw users to their different web properties, especially their music web pages, and earn significant advertising revenues from those sources.

To serve its purposes, a definition of revenue needs to: 1) fairly capture the value derived by the webcaster, and use this as a revenue base, for both subscription and nonsubscription services; 2) ensure that advertising revenues attributable to the service are captured, even if such advertising is sold in a fashion that makes attributing the value to webcasting difficult; and 3) make certain that bundled services are addressed.

b. Options for the Definition of Revenue

It is worth noting that DiMA's own witnesses present opposite views concerning the revenues to be considered for purposes of this license. Dr. Jaffe testified that all revenues, of any kind, direct or indirect, should be part of the revenues shared between webcasters and sound recording copyright owners. Jaffe Test. at 131-32. In direct contrast, Mr. Fancher proposed a definition of revenue that limited the revenue to be considered. Mr. Fancher's approach would have excluded revenues generated by webcasting in several different ways, for example, by excluding revenues from software or web pages that are at least partially derived from webcasting and vastly understating the revenue for bundled subscription services.

[37] Attached to my rebuttal testimony are the 17 agreements that were the basis of the analysis in my written direct testimony. SX Exs. 1-17 RR.

As an example of the first case of excluded revenues, Mr. Fancher does not include revenues from software used to access the music service, if the software can also do other things such as play video.[38] He also does not include any benefit derived from time and space provided on the music service to promote the other products of the on-line service.[39] Similarly, Mr. Fancher would neglect the value of the music to a webcaster that charged no subscription fee and sold little or no advertising but derived value by driving additional traffic to other aspects of the company's web services.[40] This definition cannot be supported under a willing buyer/willing seller standard, since the buyer would be willing to pay more than zero and the seller would demand more than zero for the use of the music.

I find that Mr. Fancher's approach is neither reasonable in comparison to the agreements in the benchmark market nor in relationship to economic reasoning and logic. I agree with Dr. Jaffe's approach, which is to attempt to include all revenues, but recognize that there are trade-offs to be made between capturing every bit of revenue derived from webcasting and defining revenue with sufficient specificity to avoid disputes.

One option is a very general definition of revenue that would sweep all advertising revenue attributable to a service, however derived. An example would be the SBC-Yahoo agreement, [ ] SX Ex. 027 RR. [ ] AOL's agreement with XM [ ] SX Ex.026 RR.

[38] Testimony of Donald Fancher, Vol. 23, June 22, 2006 ("Fancher Test.") at 270-276.
[39] *See e.g.* Fancher Test. at 268, 287, and 292.
[40] Fancher Test. at 287.

The second option is to provide a more specific definition of revenue with concrete categories that provides better guidance to the participants. It must be recognized that such a definition may exclude some revenues that should be counted.[41] I believe this second approach to the definition of revenue is consistent with the marketplace agreements that I have reviewed. Such a definition would seek to specify revenues derived from webcasting and, where revenues are likely derived from both webcasting and other services (such as advertising sold together for both over-the-air broadcasting and webcasting or advertising on web pages that offer both webcasting and other music services) to fairly attribute those revenues. I have reviewed the definition proposed by SoundExchange and believe that it seeks to achieve those objectives while providing greater specificity to webcasters and being consistent with the revenue approaches in free market agreements.

c. The Problem of Bundled Services

Based on my review of the evidence, it is probably necessary for the CRB to set a separate rate for bundled services, i.e., services such as AOL's subscription service and the SBC-Yahoo! service in which a webcaster makes available its webcasting service (generally commercial-free) for a fee as part of a broader array of services that are offered to consumers with their Internet access.

Bundled services are different from non-subscription services in that webcasters are being paid for access to the services and in most cases forgo advertising on such services. Thus, they are more like subscription services. Because of their bundled nature, however, it may be difficult to determine the revenues the webcaster is receiving for the webcasting part of the service.

As an initial matter, Mr. Fancher's approach to bundled services makes no economic sense and is totally at odds with the willing buyer/willing seller concept. Mr. Fancher proposes to use the ad revenue from a free service provided by the webcaster (possibly one with fewer channels and less music because it is peppered with advertising)

[41] There is an obvious trade-off between the completeness of the revenue definition and the percentage of revenue the CRB selects (presuming it concludes that such an approach is appropriate as part of the rate to be applied). The Board could choose a narrower, more specific definition of revenue and could address the revenues missed by increasing the percentage to be applied.

as a proxy for the revenues ascribed to a subscription service that bundles music and other products. Under Mr. Fancher's approach, the revenue base for a webcaster offering a bundled product that includes 150 high-bit-rate, commercial-free channels would be based on the ad revenue from its 50-channel, low-bit-rate service.[42] This approach is flawed, because it ignores the economic value that the webcaster receives from inclusion of commercial-free music in the bundled service.

SoundExchange's proposed definition of revenue reflects a better approach. In the situation where the webcaster also sells a materially similar service to consumers for a price, SoundExchange proposes to base revenues for purposes of calculating the percentage of revenue component of the "greater than" formula on the amount that a consumer would pay for the same service on an a la carte basis. In that situation, under the rate structure that SoundExchange proposed, the webcaster would then pay the greater of the a la carte price times the percentage of revenue factor, a per subscriber minimum, or a per performance amount.

For situations where the webcaster bundles a service that it never sells directly to consumers on an ala carte basis, it is necessary to come up with a different methodology. In such circumstances, it may be more difficult to determine an appropriate revenue base from which to calculate a percentage of revenue (because the service has no a la carte price). In this narrow category of circumstances, it may be appropriate to use a rate structure different from the three-pronged rate structure that I discuss in my written direct testimony. One possibility is to use a per performance rate alone. This rate should be adjusted upward to offset the sacrifice by the record company of any greater amount it could otherwise have collected from either of the other two components of the "greater of" formula.

To calculate this uplifted per performance rate, I would recommend starting at the rate that I derived in my written direct testimony -- $.0019 per performance. The reasons why SoundExchange has offered a reduced rate in the early years of this license do not apply to bundled services, where webcasters are getting paid a fee for a commercial-free service.

[42] Fancher Test. at 298-299.

SoundExchange has proposed a 25% increase to this rate. This approach has some marketplace precedent. Indeed, [ ].

Finally, I would note that this approach to bundled services reflects a point that is important for the CRB's consideration. If the CRB determines to select a single metric for all webcasting services (rather than a "greater of" rate structure which I recommend and which is the norm in industry agreements), the only logical choice is a per performance metric. A rate structure based solely on a percentage of revenue or a "lesser of" percentage of revenue and a per performance amount would almost certainly result in SoundExchange receiving much less than fair market value. As has been shown in this case, webcasters are able to earn revenues in many different ways, to "hide" them through bundled services or "indirect" advertising revenues, or to avoid showing revenue by throwing in webcast advertising as an enticement to persuade advertisers to buy over-the-air broadcast advertising. Although I believe a rate structure based solely on the per performance metric is inconsistent with the free market, if the Board determined that it was preferable to go only with one metric, that would be the only logical choice.

d. Conclusion

In summary, I propose that the definition of revenue adopted in this proceeding should be based on the definition used in the benchmark market, and appropriately modified to recognize the benefits accruing to the webcaster from the use of music for bundled subscription services and the value to the overall business of the webcaster derived from non-subscription music services. The definition proposed by SoundExchange is consistent with that approach.

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[43] I continue to believe, as I explained in my written direct testimony, that the custom radio agreements are not a good benchmark because the rates therein are so affected by the royalty rates determined in proceedings such as these. Nonetheless, this agreement shows one way to address the problem of bundled services.

I declare under penalty of perjury that the foregoing testimony is true and correct to the best of my knowledge.

Michael Pelcovits

Michael Pelcovits

Date: 9/29/06

Exhibits Sponsored by Michael Pelcovits

Exhibit No.	Description
SX Exhibit 001 RR	Amendment to Amended and Restated Subscription Services Agreement between EMI and MusicNet, Inc., May 11, 2005; Amended and Restated SubscriptionServices Agreement between EMI and MusicNet, Oct. 15, 2002.
SX Exhibit 002 RR	Amendment between EMI and Napster, May 18, 2004; Agreement between Pressplay and Virgin, Sept. 25, 2001.
SX Exhibit 003 RR	Amendment to Modified Agreement between Musicmatch and Sony, Aug. 4, 2004.
SX Exhibit 004 RR	Content Integration Agreement between FullAudio and Sony, Mar.18, 2003.
SX Exhibit 005 RR	Agreement between Musicmatch and BMG, May 17, 2004.
SX Exhibit 006 RR	Amendment to Subcription Services Agreement between MusicNet and BMG, Jan. 15, 2003; Amendment to Agreement between MusicNet and BMG, July 12, 2002
SX Exhibit 007 RR	Amendment to Content Integration and Distribution Agreement between Napster and BMG, Nov. 5 2003; Amendment to Content Distribution and Integration Agreement, Mar. 26, 2002; Content Distribution and Integration Agreement; Oct. 1, 2002.
SX Exhibit 008 RR	Content Integration Agreement between RealNetworks and SONY BMG, Apr. 1, 2005.
SX Exhibit 009 RR	Agreement For UMG Recordings between MusicNow and UMG, Mar. 16, 2005.
SX Exhibit 010 RR	Agreement for the Inclusion of Universal Sound Recordings in Online, On-Demand Subcription Services between UMG and MusicNet, Nov. 13, 2004.
SX Exhibit 011 RR	Agreement for UMG Recordings Between RealNetworks and UMG, July 1, 2004.
SX Exhibit 012 RR	Agreement for UMG Recordings Between MusicMatch and UMG, May 14, 2004.
SX Exhibit 013 RR	Content Integration and Distribution Agreement between UMG and Pressplay, Dec. 21, 2001.
SX Exhibit 014 RR	Subcription Services Agreement between WMG and MusicNet, Jan. 1, 2005.
SX Exhibit 015 RR	Amendment No. 1 to Subscription Services Agreement between WMG and MusicMatch Inc., Oct. 15, 2004; Subscription Services Agreement between WMG and MusicMatch Inc., May 4, 2004.
SX Exhibit 016 RR	Subscription Services Agreement between Warner and Pressplay, Nov. 13, 2002.
SX Exhibit 017 RR	Subscription Services Agreement between Warner and FullAudio, Mar. 5, 2002.
SX Exhibit 026 RR	Interactive Services Agreement between America Online, Inc. and XM Satellite Radio Inc., effective Oct. 20, 2005 (CRB-AOL 004773-004820)

SX Exhibit 027 RR	Strategic Alliance Agreement Between SBC Communications Inc. and Yahoo! Inc., Nov. 14, 2001 (CRB-YAH051451-051582); Consolidated Amendment to and Extension of the Strategic Alliance Agreement between SBC Communications Inc. and Yahoo! Inc., Nov. 11, 2004 (CRB-YAH051149-051234)
SX Exhibit 236 RP	Vivendi S.A. Form 6-K, Sept. 12, 2006
SX Exhibit 237 RP	Stan J. Liebowitz paper "The Elusive Symbiosis: The Impact of Radio on the Record Industry," Mar. 2004
SX Exhibit 238 RP	Notification of Settlement and Motion to Suspend CARP Proceeding and Notice and Recordkeeping Rulemaking Applicable to Preexisting SDARS (filed Mar. 19, 2003)