Before the
COPYRIGHT ROYALTY JUDGES
Washington, D.C.

In the Matter of ADJUSTMENT OF RATES AND TERMS FOR PREEXISTING SUBSCRIPTION SERVICES AND SATELLITE DIGITAL AUDIO RADIO SERVICES	)	Docket No. 2006-1 CRB DSTRA

REBUTTAL TESTIMONY OF

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WRITTEN REBUTTAL TESTIMONY OF JANUSZ A. ORDOVER

I. Introduction

1. In my initial report, as well as in my hearing testimony, I concluded that the section 801(b) statutory criteria, in this case, are best satisfied by a rate that is set through voluntary negotiations in a marketplace free of regulatory compulsion or other distortions that might obstruct the negotiating parties from reaching an efficient outcome, taking into account the need to avoid substantial disruptions to suppliers and purchasers of musical content. I explained that freely negotiated deals, by the very nature of the economic factors that influence the end result, necessarily reflect the considerations enumerated in the first three statutory criteria, unless there is substantial evidence of market power or beneficial externalities which would potentially mandate adjustment of rates under the first three statutory factors. Here, there is no evidence that market rates for musical content reflect unchecked exercise of market power and there is no evidence that subsidizing musical content to the SDARS would engender beneficial external effects on the American public. As to the fourth statutory factor, I articulated my view that the selected market rates may require adjustment in one direction or the other to account for the potential disruptive effects that the fourth factor addresses.

2. To be abundantly clear, my opinion is that observed market rates that are the product of voluntary negotiations between copyright holders and service providers represent the proper starting point to develop a reasonable rate (or range of rates) in this case. To that end, in my earlier testimony I presented several alternative marketplace analogies from which I calculated rates that the SDARS could be reasonably expected to pay to SoundExchange for the relevant blanket license. These rates served to corroborate the reasonableness of the rate proposal submitted by SoundExchange.

3. Coincident with the filing of my initial report, Dr. Woodbury submitted testimony on behalf of the SDARS. He also provided testimony at the hearing before the Court in June of this year. I have been asked by counsel for SoundExchange to respond to Dr. Woodbury's conclusions.

II. Summary of Conclusions

4. My review and consideration of Dr. Woodbury's testimony has led to the following conclusions:

a) The rate paid by the pre-existing subscription services (PSS) to SoundExchange is not a proper benchmark for setting rates to be paid by the SDARS. There is no sound basis upon which to conclude that the PSS rate reflects the 801(b) criteria as they would apply to the development of the appropriate rate in this case. Attempts to defend the PSS benchmark, as articulated by Dr. Woodbury in his testimony, should be rejected as a matter of economics.

b) The PSS rate is not an appropriate benchmark for the SDARS rate because it was negotiated in the shadow of regulation. That is, it is a rate negotiated against the backdrop of a previous regulatory determination and against the prospect of further regulatory intervention in the event of a breakdown in negotiations. As such, it reflects the parties' expectations as to the determination the Copyright Arbitration Royalty Panel would have made, if such a proceeding were to occur, and the parties' aversion to regulatory risk.

c) When setting a rate under section 801(b), the Court should, if possible (as it is here), rely on market rates as initial benchmarks, and not regulated rates or rates negotiated in shadow of regulation. Market-based rate (or rates) may have to be adjusted to reflect the 801(b) factors. However, in this rate-setting proceeding, there is no compelling public policy need to adjust market-based rates other than to ensure that the new rate is not disruptive to the operations of the industry.

d) The PSS rate is also an inappropriate benchmark because pre-existing subscription services differ substantially from satellite radio in a number of relevant dimensions as evidenced by Dr. Woodbury's proposed adjustments to the prevailing PSS rate. Moreover, consumer demand for the

PSS is extremely weak, as evidenced by the small monthly amount of [[redacted]] per subscriber paid by the cable companies to the PSS, the fact that cable companies were not successful in their attempts to provide PSS on an *a la carte* basis, and the exit of two of the three PSS from the marketplace as of 2003 (when Dr. Woodbury's benchmark rate was established). As a result, even in an arms-length deal with the PSS, a record company's ability to obtain a fee that is more than trivial would be seriously constrained.

e) Moreover, Dr. Woodbury's PSS benchmark is based on the unsupported assertion that sound recordings have a "commodity" price that should apply in all cases in which sound recordings are an input to a service. In his view, the PSS rate reflects the "commodity" price of music. Dr. Woodbury's premise that there is such a thing as a "commodity price" for music is demonstrably false as an empirical matter and is unsound as a matter of economics.

f) Dr. Woodbury's second proposed benchmark, the rate for musical works rights, is not a proper benchmark for purposes of determining the sound recording royalty rate to be paid by the SDARS. As a rate set under regulatory constraints, the musical works rate suffers from some of the same significant shortcomings as does the PSS rate. Moreover, there is overwhelming empirical evidence that copyright holders of sound recordings receive substantial multiples relative to their musical works counterparts.

5. I discuss in detail the above conclusions in the remainder of this report.

III. The PSS Rate Is An Inappropriate Benchmark

A. Introduction

6. It is my overarching conclusion that the Court's analysis in this proceeding should first attempt to identify a rate that would be set in an arms-length transaction between an SDARS and a record company. It appears that Dr. Woodbury agrees that a market-based rate represents a useful starting point. Voluntarily negotiated deals, absent a market failure, would be expected to

account for the objectives identified in statutory factors one through three.[1] In the current proceeding, there are two sources of market failure that theoretically could come into play. The first would arise in the event of demonstrated monopoly power on either the buying side or the selling side. In my view, observed market-based rates in other channels of music distribution are not distorted by unconstrained exercise of monopoly power on either side of the bargain. The second potential market failure would arise in the presence of externalities, specifically a situation where there are significant social benefits to producing (or distributing) more music, but the producer (or distributor) for whatever reason cannot capture a remunerative portion of that value. As with the issue of monopoly power, I do not see externalities as being a relevant concern in this case. Nor does Dr. Woodbury suggest that either possible market failure in this case amounts to more than a theoretical concern.

7. Given the absence of the sorts of market failures noted above, there is no reason to adjust market-based rates in order to satisfy the first three statutory criteria. Possible adjustment, if any, thus would be confined to the fourth factor. As I have previously testified, I rely on the testimony of Mr. Butson for the proposition that the rates proposed by SoundExchange will not threaten the financial viability and long-term business prospects of the SDARS. Insofar as the proposed rates represent a significant increase relative to what the SDARS anticipated paying or budgeted to pay, whatever resulting disruptive impact from higher rates is attenuated by the gradual implementation of rate increases over the six-year license.

B. The observed PSS rate should not inform the determination of an appropriate rate in this case.

8. As an initial matter, the PSS benchmark proposed by Dr. Woodbury is flawed because it is the product of a negotiation that took place in the shadow of a previous regulatory determination and under the specter of further regulatory

[1] Expert Report of Dr. John R. Woodbury, October 30, 2006 ("Woodbury Report") at 3.

intervention. As such, it does not necessarily reflect the marketplace dynamics embedded in the first three statutory criteria. While I acknowledge that the PSS rate could, in theory, reflect a "market rate," Dr. Woodbury has not made this demonstration.

9. In negotiating the current PSS rate, the parties understood that a failure to come to agreement would result in costly litigation and ultimate resolution by a copyright royalty panel. The CARP's potential finding is inherently uncertain. Consequently, it is plausible that the parties would, in their negotiations, factor in their expectations about how the CARP would have applied the 801(b) factors to arrive at a licensing rate. In the end, as I stated previously, the negotiated rate might mimic a market-based rate, but absent a deep understanding of the considerations of each party during the negotiations, one cannot reliably conclude how closely, if at all, the observed rate conforms to a market-based outcome free of regulatory oversight. Moreover, the negotiated rate does not offer any indication as to how the four statutory criteria influenced the negotiation. Thus, the observed rate could very well reflect an aggregate adjustment for the four factors that is entirely unsuitable for the current proceeding.

10. Moreover, the litigation costs of proceedings such as these may have further affected the parties' decisions and led to an agreed upon rate that is not fairly characterized as market-based. Given that the total amount of royalties paid by the PSS is quite small, significant legal fees and other expenses create incentives to reach a settlement in advance of formal adjudication. Dr. Woodbury offers no evidence that would guide a determination of how these factors affected the negotiated rate, despite the fact that his proposed analysis should account for their effect.

11. As I understand Dr. Woodbury's testimony, his response to this argument is that the optimal starting point for purposes of selecting a benchmark in this case is a rate that is determined with reference to the four statutory criteria. As I stated in my initial report and at the hearing, this response cannot be squared with the meaning of the statutory factors. The four factors are quite plainly time and

service (license) specific. A rate that balances the varying interests of buyers and sellers in accordance with the factors in this case will be a function of the SDARS' competitive positioning, their business model, their current and forecasted financial status, consumer demand for their services, and many other variables pertinent to them. As such, determination of a rate in this case must begin with recent market-based rates for distribution of content in channels that as closely as possible resemble distribution of content via the SDARS along the relevant dimensions. As I discuss below, the PSS rate fails to meet this requirement. In addition, I explain that even if one were to accept Dr. Woodbury's contention that the optimal starting point is a rate established with reference to the 801(b) factors, the PSS rate, in my view, does not represent a reasonable benchmark.

C. The rate paid by the PSS is an outlier and thus an improper benchmark

12. Even a cursory comparison between the PSS and satellite radio reveals many substantive differences between their respective business operations. As an initial matter, there is, at best, extremely weak demand for the services offered by the PSS. The initial business model developed and implemented by the PSS envisioned an *a la carte* offering that cable consumers would separately subscribe to and pay for. This model failed because consumers were not willing to pay an additional sum for music programming delivered through their television sets. The services of the PSS were then included in the basic tier of programming offered by the cable companies. I understand that, as of 2005, cable companies paid the PSS, on a monthly basis, approximately [[redacted]] per-subscriber per month.[2] The very low PSS rate reflects the fact that consumers place very little, if any, value, on the service provided by PSS. Indeed, I am not aware of any evidence – and Dr. Woodbury adduced none – that consumers subscribe to cable in order to obtain access to the PSS. Consequently, whether

[2] *See* SX Ex. 205 RR (Direct Written Testimony of George G. Strong, Jr. in Docket No. 2006-1 CRB DSTRA, at 12 and attached Ex. MC 36).

negotiated in the shadow of regulation or in a pure arm's length deal, a record company likely would be unable to obtain anything more than a very low fee from the PSS on a monthly, per-cable subscriber basis. The weak demand for the PSS, irreducible fixed costs, and their resulting financial fragility, simply prevents the PSS from paying very much, at least under the conditions present today and in the recent past.

13. It is also worth noting that as of today, two of the three PSS have exited the market. Furthermore, I understand that Music Choice is shifting the focus of its business to the provision of video on demand and other new services,[3] which would seem more attractive to consumers, relative to music, given distribution through television sets. The exit of two of the three providers of PSS, and the re-orientation of the business of the third, provides further compelling evidence of the extremely weak consumer demand for the PSS.

14. Furthermore, XM and Sirius offer a service comparable to the PSS to the direct broadcast satellite operators, EchoStar and DIRECTV. XM and Sirius view these services principally as a promotional vehicle to stimulate consumer demand for their core satellite radio service. The materials presented by Dr. Chipty and referenced at note 4 below supports these propositions. These types of services are thus primarily a marketing cost, not a direct source of revenue, for XM and Sirius. The revenues they receive are insignificant.[4]

15. These circumstances could not be more different when it comes to satellite radio, where even Dr. Woodbury acknowledges that more than [[redacted]] of the quite substantial overall revenues collected by the SDARS are reasonably attributable to music programming.[5] Thus, while the PSS appear to add practically no value

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[3] *See* SX Ex. 207 RR (MC Ex. 10); SX Ex. 208 RP.

[4] *See* SX Ex. 209 RP (Trial Testimony of Dr. Tasneem Chipty on behalf of XM and Sirius Radio, Docket No. 2005-5, Tuesday July 10, 2007 at 166).

[5] *See, e.g.*, Woodbury Report at 20 and n. 51 (Dr. Woodbury's channel attachment index indicates that [[redacted]] of survey respondents would cancel their subscriptions to Sirius if music programming were not available, and [[redacted]] would cancel if Stern channels were excluded.); Tr., June 13, 2007, at 52 (Dr.

(footnote continued...)

to cable television service, music is clearly the backbone of satellite radio and the most important driver behind its rapid subscriber growth. As such, there is no reason to believe that the rate paid by the PSS reflects considerations that are relevant for purposes of determining an appropriate rate for the SDARS. This is true whether one views the PSS rate as a market-based rate or a rate that incorporates the 801(b) factors.

D. The value of music is properly assessed in the context of consumer demand for the ultimate service.

16. One argument Dr. Woodbury offers to defend his PSS benchmark is that "the inherent value of music" is the same for both the PSS and the SDARS, and presumably also for all other channels that distribute sound recordings.[6] Under this view, all of the additional value of a service, as measured by consumers' willingness to pay, comes from the delivery mode and thus should be retained by the service provider. One fundamental problem with this argument is that, even if it were true, Dr. Woodbury does not establish why the PSS is the appropriate benchmark that "reveals" this "universal" value. Indeed, if anything it appears to be an outlier, paying a much lower royalty rate than virtually all other services in the marketplace. As the table below illustrates, record companies are able to capture a significant portion of the value that is created by combining music with attractive distribution media.

(...footnote continued)

Woodbury testimony acknowledging that his channel attachment index implies that subscribers to satellite radio pay roughly $6.00 per month for music content).

[6] *See, e.g.*, Tr., June 12, 2007, at 359 (Woodbury testimony).

Table 1: Licensing Rates across Digital Distribution Services

Channel	Per-Play	% of Revenue	Per-Unit or Subscriber
Permanent Audio Download	n/a	[redacted]	[redacted]/track
Cellular (OTA Download)	n/a	[redacted]	[redacted]/track
Cellular (Ringtone)	n/a	[redacted]	[redacted]/tone
Interactive Subscription (Portable)	[redacted]	[redacted]	[redacted]/sub/mo
Interactive Subscription (Non-Portable)	[redacted]	[redacted]	[redacted]/sub/mo

Source: Compass contract analyses

17. The rates provided in Table 1 reflect an analysis of contracts between record labels and service providers undertaken by my staff, under my direction. What the analysis clearly shows is that record companies obtain licensing rates in the marketplace that capture a significant portion of the overall value of the service. In particular, the bottom two rows are highly informative. The only difference between these two services relates to portability. If Dr. Woodbury is right that there is an inherent value of music, record companies should receive the same payment from providers of interactive subscription services, irrespective of whether the service offers consumers portability. There is no evidence that *direct costs* to a record company of providing music content to a portable service are any higher than the costs of providing the same content to a non-portable service. What differs is the package of rights that a record company licenses and the consumer demand for the particular service. Since portability of music is revealed in the market to be relatively more valuable to subscribers, record companies capture some of that benefit and receive a per-subscriber rate that is [redacted] as high for interactive subscription services that offer portability.[7]

[7] At the hearing in June before the Court, Dr. Woodbury was asked whether record companies received greater payments for a portable service as compared to an otherwise identical non-portable service. He replied that he did not know the answer to the question. *See* Tr., June 13, 2007 at 22-23 (Woodbury testimony). I find his answer perplexing insofar as licensing rates for portable and non-portable

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Cellular (OTA Download)	n/a	[ ]	[ ]/track
Cellular (Ringtone)	n/a	[ ]	[ ]/tone
Interactive Subscription (Portable)	[ ]	[ ]	[ ]/sub/mo
Interactive Subscription (Non-Portable)	[ ]	[ ]	[ ]/sub/mo

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Moreover, while as a percentage of revenue the figures are nearly identical, they are applied against quite different retail prices. Research undertaken by my staff shows that the average monthly retail price for portable, interactive subscription services is approximately $15; the analogous figure for the non-portable version of the service is roughly $10.[8]

18. It is plain, I think, that in the marketplace copyright holders receive some portion of the value to consumers from utilizing a particular distribution channel, beyond Dr. Woodbury's inherent value of music. As discussed in the preceding paragraph, an increase in the value of a digital music service to a consumer (due to portability, say) will generate incremental payments to record companies, measured on a per-play or a per-subscriber basis. Dr. Woodbury's approach in this case wholly ignores actual marketplace outcomes and instead advances a theory that payments to copyright holders should be based on a commodity value of music. It is rather astonishing that Dr. Woodbury disregards market evidence as to valuation of music content in various distribution channels as a basis for setting a rate and, instead, relies solely on rates that were set in the shadow of proceedings conducted under a possible compulsory license, and which apply to a failing service. In fact, he further deflates the already low PSS rate for reasons that, at least to me, are totally nontransparent.

19. Because his conclusions are clearly inconsistent with the application of the market-based approach, Dr. Woodbury is perhaps of the view that his approach is consistent instead with application of the 801(b) factors. But in his report he stated that he views "… rates negotiated at arms-length as a promising start to developing the rate in question."[9] Moreover, in an earlier proceeding before a

(…footnote continued)

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interactive subscription services were presented in my original report. *See* Written Direct Testimony of Dr. Janusz Ordover at 51 ("Ordover WDT").

[8] *See* SX Ex. 210 RP (summarizing data).

[9] Woodbury Report at 3.

Copyright Arbitration Royalty Panel, Dr. Woodbury endorsed an approach based upon observed marketplace rates.[10] Thus Dr. Woodbury clearly acknowledges a connection between observed market rates and the rate resulting from an application of the 801(b) factors. Otherwise, both could not represent reasonable approaches to answering the same question. It thus follows that if Dr. Woodbury's approach in this case is flatly inconsistent with actual marketplace outcomes, as I have demonstrated it to be, his approach is similarly at odds with the 801(b) statutory criteria. Furthermore, 801(b) rates cannot be deduced from "first principles": if the rate is to be set with reference to the 801(b) factors, it must start from somewhere. To an economist, the best starting point is one or more observed market rates.

20. Perhaps as an attempt to square his "inherent value of music" hypothesis with the empirical evidence, Dr. Woodbury testified that the "value" to which he refers is actually "the 801(b) value of the music."[11] I am not sure what to make of this testimony, other than to say it is either circular or irrelevant. The 801(b) factors cannot be relied upon in the abstract to establish the "value" of music. Instead, these criteria can be understood only as possibly modifying the value of music, as revealed by marketplace transactions or other appropriate benchmarks, to account for possible market failures that I discussed above, as well as any potential disruptive impact to the industry and its participants.

21. Dr. Woodbury's use of his "801(b) value of music" formulation would seem to imply that the first 801(b) determination for digital PSS services in 1997, as extended by the negotiated settlement in 2003, must necessarily form the basis for all future determinations. However, such an approach in this case would run directly counter to observed marketplace outcomes and, equally importantly, be inconsistent with sound public policy objectives that the four factors are supposed

[10] Tr., June 13, 2007, at 73 (Woodbury testimony). Dr. Woodbury stated at the hearing that he still agreed with his earlier testimony "as a general matter." *Id.*

[11] Tr., June 12, 2007, at 351 (Woodbury testimony).

to promote. The evidence of significant dispersion in payments to copyright holders in different channels reflects the differing values of the music provided by the services to consumers, and the record companies' ability to capture some of that value. In other words, market-based rates make clear that music does not have a single "value" irrespective of the service into which it is incorporated, and I am not aware of any language in section 801(b) that suggests the Court is supposed to assign a single value to recorded music.

22. Dr. Woodbury contends that his approach is not undermined by observed differences in market-based rates by arguing that copyright holders should receive greater compensation when they provide value-added enhancements to their sound recordings.[12] I certainly do not quarrel with this conclusion. I do disagree with what Dr. Woodbury makes of this observation in the instant rate-setting proceeding. He points to downloading and interactivity as two examples of functionality that is provided by the record companies for which the record companies should be compensated.[13] On the other hand, he contends that portability (mobility) is an attribute that is provided by the distributor, and consequently, copyright holders should earn the same compensation irrespective of whether a service is portable (or mobile), even if consumers value a mobile (portable) service more highly as compared to some alternatives.

23. To begin with, I have already shown that copyright holders receive greater compensation for a portable service as compared to an otherwise identical non-portable service. In addition, the distinction he draws between portability and other functionality is flawed. The attributes that a distributor is able to offer, including portability, are defined by the copyright holders in the licenses that permit the provision of services with particular attributes. This is no less the case with portability than it is with interactivity and other functionality. That is, a service that does not have a license that permits portability of music cannot offer a

[12] *See, e.g.*, Tr., June 13, 2007 at 14 (Woodbury testimony).

[13] Tr., June 13, 2007 at 14 (Woodbury testimony).

portable service, period. On the other hand, it is always the distributor that executes the necessary engineering and other work to develop and offer a service with specific attributes as permitted under the license. So the distinction that Dr. Woodbury relies upon to explain observed differences in market-based rates, and to justify his use of the PSS rate in this case, is entirely vacuous. As I have shown, what explains variations in marketplace rates is the fact that copyright holders are able to obtain a portion of the value of the service, as reflected in consumers' willingness to pay for the service, and that the portion which they are able to obtain may vary across services. There is no basis in economics to conclude that the SDARS rate should substantially deviate from this paradigm.

24. Dr. Woodbury further defends the relatively low PSS rate by pointing out that the amounts paid by the SDARS to SoundExchange represent for the record companies a trivial fraction of their total revenues.[14] The implication is that a higher rate, namely one that is in-line with observed marketplace rates, will only slightly increase record company revenues, and thus will have, at best, a minimal effect on their incentives to create new works, and thus would not advance the 801(b)(1) criterion.

25. Dr. Woodbury's argument is fatally flawed. First, even at current subscriber levels,[15] that is, ignoring net subscriber additions going forward, the difference between the two sides' proposals in dollar terms over the course of the statutory license is obviously quite substantial. The assertion that either the record companies or the individual artists would consider amounts of this magnitude to be a mere "rounding error" is without basis and not pertinent.[16] Dr. Woodbury has no basis on which to opine on the levels of additional revenues that record

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[14] Tr., June 12, 2007 at 327-328 (Woodbury testimony).

[15] In press releases announcing financial results for the first quarter of 2007, XM reported that it had recently passed the 8 million subscriber mark, *see* SX Ex. 212 RP, and Sirius announced a subscriber count of approximately 6.6 million, *see* SX Ex. 211 RP.

[16] Tr., June 12, 2007 at 327-328 (Woodbury testimony).

companies and artists would (or would not) consider meaningful contributions to their revenue streams.

26. Second, even taking Dr. Woodbury's characterization at face value, namely that payments by the SDARS amount to a trivial fraction of total record company revenues, the conclusion he draws is entirely inapt. Record companies undertake significant and irreversible investments to develop talent and produce new works, and in order to maximize their incentives to continue to do so, it is important that they receive from each distribution channel revenues that reflect the value of their contributions. Dr. Woodbury's view seems to be that record company revenues from a particular channel need only reflect the value of their contributions when the channel in question contributes a not insignificant amount to their overall revenues.[17] Such a conclusion finds no support in economics. Record companies' incentives to produce new music are based upon their expected revenues from all available sources. A claim that one particular channel should pay very little because it accounts at present to a small percentage of total record company revenues directly undermines incentives to create new works. Indeed, under this view, record companies would collect market-based rates only from CDs, and perhaps audio download services. This claim makes even less sense as record companies' businesses increasingly depend on a diverse range of revenue streams, none of which, as yet, is individually as significant as CD sales revenue. If record companies could not reflect the value of their contributions in all of their revenue streams because only one or two of them were adjudged to be sufficiently significant, their viability as a business going forward would be undermined. Moreover, such arbitrary limits on what each service should be required to contribute could distort a competitive playing field among music distribution channels, which would not be sound public policy.[18]

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[17] Tr., June 12, 2007 at 327 (Woodbury testimony).

[18] Dr. Woodbury does not explain why costs of music to SDARS should be kept low so that it would cost potential subscribers less to obtain Howard Stern or ESPN.

27. Perhaps Dr. Woodbury reckons that the SDARS should pay very little for sound recording rights because the record companies are able to cover their costs and earn a normal rate of return from other available sources of revenue. Leaving aside whether such an opinion is even factually correct, the flaw in his reasoning is apparent when it is applied to the SDARS themselves. Indeed, there is no indication that the SDARS intend to offer very low rates to incremental subscribers once they have covered their costs and earned a normal rate of return from inframarginal subscribers. At roughly $12 per month over 12 months, $144 from an incremental subscriber is surely "a drop in the bucket" compared to an SDARS' annual revenues. Hence, by Dr. Woodbury's reasoning, each satellite radio distributor should offer subscription rates equal to marginal cost of serving one additional subscriber after it hits its revenue target (or an appropriate rate of return on its assets). It is quite clear that this would not make sense as a business matter or be sound public policy: the SDARS, just like the record companies, undertake investments based upon the aggregate expected revenues from all sources, and to arbitrarily curtail the revenues available from a particular source would only serve to weaken investment incentives on a going forward basis.

28. Finally, for the reasons I set out in some detail in my initial report, as a matter of economic principles it is simply not the case that intellectual property, such as sound recording copyrights, should be priced uniformly across all of its uses. While a uniform low price that reflects marginal costs serves the goals of static efficiency, it undermines dynamic efficiency considerations because it precludes the owner of the intellectual property from ever being able to recoup its initial investment. As a result, the investment will never be undertaken in the first place. A solution to this tension is found in so-called Ramsey pricing principles, where the value a consumer (or group of consumers) places on the product determines the price they pay in market-based transactions. Through application of Ramsey pricing principles, consumers with a high willingness to pay (*i.e.,* those with inelastic demands) contribute disproportionately to the recovery of up-front investments, while consumers with a lower willingness to pay (*i.e.,* with highly elastic demands) pay less but still have the opportunity to access the

content. In this way, Ramsey pricing provides the proper incentives for producers of content insofar as overall revenues from all sources are expected to recover the costs of creating the content in the first place, while minimizing the consequences of pricing above marginal costs.[19] These well-established economic principles are directly contrary to the unproven assumption embraced by Dr. Woodbury, namely that music is a commodity-like product that should command the same price irrespective of the value of the service to which it contributes.

E. Other critiques of the PSS rate

29. In addition to being flatly inconsistent with observed marketplace rates for sound recording rights in other digital distribution channels, Dr. Woodbury's PSS benchmark is similarly untethered to the deals the SDARS have reached with various providers of non-music content. These agreements appear to reflect the expected value, *i.e.*, additional subscribership, to the SDARS from being able to offer specific content to their subscribers. This may explain why Howard Stern and Oprah receive more than the National League Hockey. Thus, if non-music content providers are compensated based upon the value that they add to the SDARS' services, I can think of no sound economic basis upon which to conclude that compensation to copyright holders of sound recordings should be determined any differently.

30. Dr. Woodbury may respond that non-music content deals are exclusive and thereby provide added value relative to a non-exclusive deal. Even if this is so, in the end, the value to the SDARS is based upon the expected incremental revenues that the content will generate. Exclusivity, all else being equal, simply means that expected incremental revenues are higher relative to the same content being licensed on a non-exclusive basis. While it is the case that the relevant blanket license is non-exclusive, Dr. Woodbury and I agree that music is the basis for

[19] Of course, I do not for an instant recommend that the recording music industry should be subject, through regulation, to Ramsey pricing. My point is that Ramsey pricing provides sound underpinnings for differential pricing in industries (such as recorded music or satellite radio) in which up-front fixed costs are high relative to incremental costs.

roughly 50% of the SDARS' overall revenues. No single non-music content provider can make this claim, and yet there are numerous non-music content deals under which the licensor earns compensation well in excess of the amounts SoundExchange would earn under Dr. Woodbury's PSS benchmark.

31. The reasonableness and reliability of Dr. Woodbury's PSS benchmark rate is further undermined by the numerous and arbitrary adjustments he implements which reduce the rate from 7.25% all the way down to 0.88%. A reliable benchmark should not require a series of arbitrary adjustments and cost allocations in order to arrive at a rate for the SDARS. As I explained in my initial report, the principal disadvantage of a benchmark rate based upon payment terms voluntarily negotiated between record companies and other digital distribution channels is that consumers may value music differently when it is delivered *via* different media, with different functionalities, varying features, and so forth. Consequently, the selected benchmark should mimic, as closely as possible, the pertinent factors as they apply to the SDARS.

32. A comparison of the PSS and the SDARS highlights a number of critical differences. Dr. Woodbury claims that the PSS and the SDARS offer similar services, but as shown above, this is an untenable position. In particular, the PSS are offering a service for which there almost no willingness to pay, as evidenced by its failure as a standalone offering and the near zero monthly, per-subscriber revenues the PSS receive from cable companies. By contrast, the SDARS, since their inception, have grown rapidly in terms of subscribership, and have done so at a monthly subscription price of almost $13.

33. Observed marketplace rates across a number of digital distribution channels (which I presented in my initial report) demonstrate that the PSS rate is an outlier, and thus an inappropriate candidate for a benchmark in this case. Other digital audio services represent much closer analogies to the SDARS' target market and business operations. In my initial report, for example, I presented two benchmark rates based upon interactive subscription services. These services, like satellite radio but unlike the PSS, are sold on a subscription basis to consumers. The PSS

attempted to implement such a business model and failed. Interactive subscription service providers, like satellite radio but unlike the PSS, are actively promoting their services in the marketplace and have provided no indication that they intend to exit the marketplace or otherwise re-vamp their operations. Interactive subscription services receive monthly revenues of approximately $10 to $15 per-subscriber, a range that is consistent with the monthly, per-subscriber revenues received by the SDARS, but substantially different than the nominal retail value implied by the [[redacted]] per-subscriber wholesale price received monthly by Music Choice, even if we allow for the fact that Music Choice does not sell directly to listeners. It should be clear, then, that interactive subscription services are a decidedly superior starting point for purposes of determining a SDARS rate in this proceeding. Certain adjustments still must be made, but they are substantially less drastic and arbitrary than the adjustments to which Dr. Woodbury subjects the PSS rate.[20]

IV. Musical Works Benchmark

34. As a second benchmark Dr. Woodbury points to the musical works royalty payments made to the performance rights organizations – ASCAP, BMI, and SESAC.[21] It is Dr. Woodbury's opinion that the royalty rate established in this proceeding should not exceed the royalty rate for musical works.[22] To defend his

[20] Subsequent to the filing of my written direct testimony in October 2006, I received additional information relevant to one of these benchmarks. Specifically, as it relates to the interactive webcasting service benchmark, I understand that Universal Music and SONY BMG each have indicated that users of non-interactive video services listen [[redacted]] as intensively as compared to users of interactive video services. This leads to a downward reduction to the interactivity adjustment I proposed by a factor of two. Subsequent to my written testimony I also learned that both SONY BMG and Universal have entered into new contracts for audio download services to cell phones that are [[redacted]] the rates indicated in my report, also suggesting a change to my "immediacy" adjustment. That royalty rates remain fluid in the marketplace with respect to these functionality adjustments highlights the wisdom of not placing undue weight on any one particular benchmark when the marketplace is highly dynamic and still evolving. Rather, a more robust approach, and the one used by myself and Dr. Pelcovits to corroborate SoundExchange's rate proposal, is to develop a series of calculations, based upon benchmark markets and otherwise, that yield a range of reasonable rates.

[21] Woodbury Report at 36.

[22] Woodbury Report at 37.

view, Dr. Woodbury first points out that a buyer of sound recording performance rights requires as well the musical works right in order to distribute a public performance of the sound recording.[23] While true, the fact that a distributor like XM or Sirius requires both rights does nothing to support the proposition that the two rates should be equivalent, or even remotely close. Numerous products and services require multiple inputs, but that fact alone does not lead to price parity across those inputs to the buyer. For example, a personal computer requires both a microprocessor and dynamic random access memory (DRAM), but the computer manufacturer pays very different prices for those two essential inputs. Similarly, the SDARS require both satellites for transmission and recorded music for content, but nobody is suggesting that, assuming that flows of services can be made commensurate, they should be priced the same to the satellite radio company.

35. The evidence from marketplace for the digital distribution of music also shows that two necessary inputs -- sound recording rights and musical works rights -- command different license fees. A quick review of the royalty rates paid by various services, including permanent download services like iTunes, interactive subscription services like Rhapsody, and so on, demonstrates that copyright holders of sound recordings are paid multiple times the amounts paid for musical works rights. These rates are presumably influenced by many factors, but they demonstrate that there is not a single ratio that can be used to translate musical works rates into sound recording rates, and certainly not a 1:1 ratio. These differences in the rates are plausibly explained by the fact that sound recording copyright owners provide the bulk of the investment in the products that benefit both sound recording copyright owners and musical works copyright owners. For that reason among others, the sound recording royalty is typically many multiples higher than the musical works royalty. The Court earlier this year

[23] Woodbury Report at 37.

pointed to this substantial empirical evidence as a compelling reason to reject the use of musical works rates in setting a rate for sound recording rights.[24]

36. The musical works rate is further flawed as a benchmark because it, like the PSS benchmark, was established in the shadow of regulatory intervention. As I explained earlier, a rate that is negotiated under regulatory constraints may bear little or no relationship to a rate that would prevail in an unfettered market setting. Absent a demonstration that observed musical works rates are consistent with market-based rates for such rights and that there is a reasonable link between these rights and the rights at issue in this proceeding, their use as a benchmark in this proceeding is, in my view, inappropriate.

[24] 37 CFR 380 at 24094 (2007).

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

Janusz A. Ordover

Date: July 23, 2007

Exhibits Sponsored by Janusz Ordover

Restricted exhibits, which are identified by the suffix "RR," are not included in the Public Version of SoundExchange's Rebuttal Case

Exhibit No.	Description
SX Exhibit 205 RR	Excerpts from Written Direct Testimony of George G. Strong Jr., and Music Choice Ex. 36
SX Exhibit 206 RR	Excerpts from the Written Direct Testimony of David J. Del Beccaro
SX Exhibit 207 RR	Music Choice Financials, 1996-2010 (Strong Dep. Ex. 10)
SX Exhibit 208 RP	Music Choice On Demand web page
SX Exhibit 209 RP	Excerpts from the oral testimony of Dr. Tasneem Chipty in Docket No. 2005-5 CRB DTNSRA
SX Exhibit 210 RP	Monthly Retail Price for Audio Interactive Subscription Services
SX Exhibit 211 RP	Sirius press release: "SIRIUS Satellite Radio Reports Strong First Quarter 2007 Results" (May 1, 2007)
SX Exhibit 212 RP	XM press release: "XM Satellite Radio Holdings Inc. Announces First Quarter 2007 Results" (Apr. 26, 2007)