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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Public Version

July 2007

Rebuttal Testimony of Mark Eisenberg

I previously filed written direct testimony discussing the factors that SONY BMG considers when licensing its sound recordings for exploitation on an array of digital platforms and the various rates SONY BMG receives when doing so. My background was provided with my written direct testimony.

I have reviewed the public versions of the written direct statements of the economists of XM Satellite Radio, Inc. ("XM") and Sirius Satellite Radio, Inc. ("Sirius") (collectively, "the Services") who use as a benchmark, and argue that the royalty rate for sound recordings should be derived from, the royalty rate for musical works paid to performance rights organizations such as ASCAP, BMI and SESAC.[1] The musical works benchmark, however, has no logical application to the exploitation of sound recordings by the Services. As discussed below, the relative economic values (i.e., compensation) attaching to the musical works and master recordings distributed to end-users as music products and services are routinely asymmetrical. Indeed, as this Court itself recognized in its recent webcasting decision, in all cases in which end-users enjoy master recordings in a manner similar to the entertainment experience within a DMCA-licensed radio service, the sound recording copyright owners are compensated at significantly higher levels than musical works copyright owners.[2] This disproportionate allocation of the economic pie reflects a variety of considerations, including the significantly greater levels of investment and risk that sound recording copyright owners take in discovering and developing talent and in creating, marketing and promoting artists and their music to the general public.

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[1] I note that in Docket No. 2005-5 CRB DTNSRA, XM, Sirius and MTV Networks similarly rely on the same type of musical works benchmark. I include those services in my definition of "Services" in this written statement.

[2] *See Determination of Rates and Terms of Digital Performance Right in Sound Recordings and Ephemeral Recordings*, Docket No. 2005-1 CRB DTRA (Mar. 2, 2007) (*"Webcasting Determination"*).

I. The Distinct Markets for Sound Recordings and Musical Works

The fundamental hypothesis underlying the Services' use of a musical works benchmark is that sound recordings and musical compositions share the same economic value in the marketplace and that, for a given service, the licenses, fees, and rates for sound recordings are or should be no more than the licenses, fees, and rates for musical compositions. That tired hypothesis is directly contrary to my experience and is contradicted by historical fact. It was flatly rejected by the Judges in the Webcasting Determination, and should be similarly rejected here.

As I stated in my written direct testimony, I oversee the negotiation of all of SONY BMG's licensing of sound recordings for distribution in all forms over digital platforms, including the Internet. I oversee these negotiations whether the recordings are distributed by (i) performance or permanent reproduction such as interactive, or "on-demand," and non-interactive streaming; (ii) audiovisual works (i.e., music videos) or audio-only works (i.e., sound recordings), and/or (iii) by full-length, complete sound recordings (e.g., tracks and albums) or fractional excerpts (e.g., ringtones and mastertones). SONY BMG grants extensive catalog rights encompassing substantial portions of its commercial music archive and encompassing these myriad formats and functionalities.

In each instance – across all of the differentiated business models, product configurations and consumer experiences – music distributors must clear separate, independent rights to the master recording and the underlying musical composition, respectively. However, in *none* of these markets does musical works copyright owners receive compensation equal to that of sound recording copyright owners. Nor, to my knowledge, do musical works copyright owners themselves, in their direct negotiations, posit that a musical works rate should be equal to or on

par with the compensation received by sound recording copyright owners with respect to digitally-delivered audio products and services. Indeed, in the pending proceeding before this Court to determine mechanical royalties, Docket No. 2006-3 CRB DPRA, the music publishers themselves have proposed musical works royalties for various digital services that, while much higher than I believe appropriate, are nonetheless a fraction of the compensation received by sound recording copyright owners with respect to the very same services.

To my knowledge, the Services have never tendered an offer to music publishers which proposes paying equivalent rates to music publishers for the reproduction, distribution and/or public performance made in the course of digital audio transmissions. That is simply because the market values for sound recordings and musical works are different – and the Services themselves have economically benefited from this marketplace distinction.

Moreover, regardless of what piece of the pie music publishers might seek in their negotiations with digital distributors, SONY BMG negotiates economic terms with digital retailers and distributors based upon SONY BMG's own valuation of the use of its sound recordings in conjunction with the benefits and enjoyment accorded service providers and end-users. SONY BMG does not predicate its economic valuation upon what the music publishers might negotiate. From my perspective, as an executive charged with negotiating rates and developing sound business models for our music across newly emerging distribution platforms, such as the Internet and mobile networks, the publishers' level of compensation from digital music services is of little consequence to me. The only time such a reference might be made would be in instances when a distributor is looking to suppress our economic participation by claiming that the distributor had already committed its "pot of monies," otherwise allocable for all "licensing," to other copyright holders, such as musical works owners and/or other labels. In

my experience, however, rates requested or received by music publishers from others are irrelevant to my task of establishing a fair economic return for our company's level of investment and risk in our artists and in our recorded music business. Our objective is to obtain a fair market rate without regard to what the publishers receive from digital music services.

II. Comparing the Markets For Sound Recordings and Musical Works

As I discuss above, there is no basis whatsoever for using negotiations by ASCAP, BMI, and SESAC as a benchmark for determining the Services' rates that should be paid to copyright owners of sound recordings. The two markets are simply distinct.

My written direct testimony described the levels of compensation that sound recording copyright owners receive in many of these markets. For purposes of illustration below, I have collected information relating to the rates that music publishers receive for those very same exploitations, relying on a variety of publicly available information, as well as proprietary information from SONY BMG and my personal experiences negotiating with digital music services and music publishers. In every case, the sound recording copyright owner receives substantially more than the musical works copyright owner — hands down. Moreover, "most favored nations" clauses, which equate the amounts received by sound recording copyright owners to musical works copyright owners, do not exist in these licensing and distribution scenarios. One need only look at the actual rates that sound recording copyright owners and musical works copyright owners are paid in catalog digital distribution agreements to appreciate the marked distinctions. Indeed, they are not even close:

Service	Sound Recording Rate (in SONY BMG agreements)	Publishing Rate	Rough Multiple (Sound recording rate/publishing rate)
Wireless Full-Length Audio Downloads (Portable)	[ ][3]	$.091 per track[4]	[ ][5]
Digital Downloads		$.091 per track[6]	[ ][7]
Mastertones and Ringtones	[ ]	[ ][8]	[ ][9]

There are some caveats with respect to some of the markets discussed above. Record labels and distributors set the wholesale rates for sound recordings sold to end-users as digital downloads via individual, bilateral voluntary negotiations (though in essence, the theoretical "free market" rates for sound recordings are compromised to a large degree by the deleterious effects of online piracy), whereas the royalty rates for musical works in digital downloads are

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[3] In my written direct testimony in this proceeding, I testified that the current rate that SONY BMG receives for wireless full-length audio downloads is [ ] per track. At the hearing, however, I testified that SONY BMG was in the process of renegotiating some of its contracts for wireless full-length audio downloads. Since then, SONY BMG has amended its wireless full-length audio download agreement with Verizon. In addition to other changes, we lowered the per track rate for wireless full-length audio downloads to [ ]. See SX Ex. 254 RR. Similarly, we are currently operating under the terms of a draft amendment with Sprint Spectrum in which we have reduced the per track rate for wireless full-length audio downloads to [ ]. See SX Ex. 253 RR. The rates in our contracts with other providers remain at [ ] per track. I am submitting with this testimony a number of agreements showing the range of sound recording performance rates across the range of digital services. *See* SX Ex. 253 RR - SX Ex. 254 RR; SX Ex. 256 RR - SX Ex. 258 RR.

[4] Statutory Rate set by the Copyright Office and to be set by the Judges.

[5] This multiple reflects my having backed out $.091 from the indicated sound recording rate, which is a gross number that includes the rate owed to the publishers.

[6] Statutory Rate set by the Copyright Office and to be set by the Judges.

[7] This multiple reflects my having backed out $.091 from the indicated sound recording rate, which is a gross number that includes the rate owed to the publishers.

[8] Based on SONY BMG's own agreements and published reports.

[9] This multiple reflects my having backed out $.091 from the indicated sound recording rate, which is a gross number that includes the rate owed to the publishers.

statutory rates (and new such rates will be set by the Judges). Nonetheless, the [ ] difference is a reflection of the significantly greater value of sound recordings and the investment of sound recording copyright owners. Indeed, in many cases, record companies pay less than the statutory rate for mechanical licenses, showing that the current rate is actually above a free market rate.

Even in markets where the musical works rates have not yet been determined, the aspirational rates being sought by the publishers still do not reflect the 1:1 ratio assumed by the Services. Some of these are set forth in the following chart.

Service	**Sound Recording Rate (in SONY BMG agreements)**	**Aspirational Publishing Rate**	**Rough Multiple (Sound recording rate/publishing rate)**
Preprogrammed Music Videos	[ ]	5.1% of revenue for performance[10]; plus additional fees for synch rights under negotiation	[ ]
On-Demand Music Videos	[ ]	6.5% of revenue for performance[11]; plus additional fees for synch rights under negotiation	[ ]

With respect to music videos, the rates incorporated in the chart above reflect aspirational fees sought by the performance rights societies and do not include the synchronization right, for which negotiations with the publishers are still pending. Once those are determined and added in, they will lower somewhat the ratios that I have provided above. [ ]

[10] Based on ASCAP Internet Music License Agreements, *available at* http://www.ascap.com/weblicense (last visited July 20, 2007).
[11] *Id.*

[redacted]

The royalty regimes for other closely analogous services largely defy comparison altogether. For noninteractive webcasting, for example, this Court recently set a per-play sound recording performance royalty of $0.0011 in 2007, going up to $0.0019 in 2010. The PROs, by contrast, publicly seek a rate of 5.1% of reveune, unconnected to the number of performances.[12] Although the per-play sound recording rate certainly would translate to a revenue share for webcasters that is multpiles higher than 5.1%, the exact ratio could vary significantly among webcasters, thus making comparisons as the Services attempt to do here extremely difficult.

Similarly, for interactive streaming services, SONY BMG receives [[redacted]]. The PROs, by contrast, publicly seek a rate of 6.5% of reveune, unconnected to the number of performances.[13] At the same time, the publishers have proposed a complex mechanical royalty rate regime of the greater of 12.5% of revenue; "$.00275 per use or $0.00053 per minute of playing time or fraction thereof"; or "27.5 percent of the total content costs paid for mechanical rights to musical compositions and rights to sound recordings."[14] Here again, the differences in the structres of the regimes renders it difficult to make the type of comparison that the Services are attempting. In any event, even the aspirational rates sought by the publishers for interactive streaming appear to be significantly lower than the prevailing rates that SONY BMG receives for sound recording performances.

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[12] *Id.*
[13] *Id.*
[14] These numbers represent what the publishers have sought in their rate proposal in the mechanicals proceeding in this Court in *In the Matter of mechanical and Digital Phonorecord Delivery Rate Adjustment Proceeding*, Docket No. 2006-3 CRB DPRA. The aspirational rates thus represent an unrealistic upper bound.

At bottom, music publishers themselves do not argue that they should receive parity in compensation with sound recording copyright owners. Music publishers – in negotiations or in other contexts, such as legislative lobbying and even in their advocacy in ratemaking proceedings before the Judges – do not advance the equivalency theory that the Services claim here. In other words, the Services here are making an argument about the value of musical works that even the music publishers themselves do not make.

The overall point is *not* that there is a particular economic "ratio" between the rates payable to sound recording copyright owners relative to musical work copyright owners. Rather, it is simply that the two markets operate completely distinct from one another. While the musical work copyright owners may ride the coattails of the sound recording copyright owners' success (if any), they do so at a much lower level of economic participation.

Of course, none of this is new to the Judges. As the Judges conclusively held in their Webcasting Decision, "contrary to . . . expectations that the prices paid for the rights in each respective market dealing with similar rights should be the same, substantial empirical evidence shows that sound recording rights are paid multiple times the amounts paid for musical works rights in the markets for ring tones, digital downloads, music videos and clip samples." *See Webcasting Determination* at 40. I am not aware of any changes in the relevant marketplaces which would lend credibility to the Services' attempt to resuscitate this rejected benchmark here.

III. The Example of Ringtones

Ringtones provide a useful example of why the musical works benchmark is inapt. The ringtone market is a market that 1) music publishers tout as an example of the value of their content, and 2) record companies believe reflects a market in which publishers have extracted above-market rates for a variety of reasons. As I explained in my written direct testimony,

ringtones are excerpts of music that play exclusively on cell phones and serves as a substitute for a traditional "ringer" or "pager." While there are several types of musical ringtones available in the marketplace, at a basic level, ringtones can be categorized into 2 general groupings: a) poly- or monophonic ringtones, which consist of electronic "synthesizer-like" versions of musical works that do not incorporate the original sound recording, and b) mastertones, which consist of an excerpt of a label's master recording (together with the underlying musical work). A distributor of a mono- or polyphonic ringtone need only license the underlying musical work, whereas a distributor of a mastertone must obtain clearances for *both* the underlying musical work and the original sound recording.

The market for ringtones has substantially developed with the rapid deployment of cell phone handsets capable of playing different kinds of music. The earliest cell phones could not play music at all. Thereafter, "first generation" versions of music-enabled cell phones were introduced that could play mono- and then polyphonic sounds like ringtones, but not multi-track, fully-mixed recordings or even excerpted tracks like mastertones. In response to the heightened demand for high quality digital music products, cell phone manufacturers and carrier networks began moving as quickly as possible to incorporate full music functionality into their handsets and wireless data networks. At present, all mobile carriers in the U.S. now offer mastertones to their subscribers. Moreover, in the coming years, including during this license period, virtually all cell phones and carrier networks will feature sound recordings, both as mastertone or ringback excerpts and as full-length masters delivered in the form of downloads and streams.

Since mono- and polyphonic ringtones were developed years before the advent of more progressive technologies enabling the wireless delivery of master recordings, music publishers negotiated their licenses with mobile distributors with respect to musical compositions first,

before sound recording copyright holders even had a product to sell. Publishers were thus successful in extracting relatively high prices for their copyrights because the cell phone carriers had only one (rather than two) copyright owners to pay for the synthesizer-like instrumental versions of songs incorporated as mono and polyphonic ringtone products. Typically, publishers received approximately 10% of the retail selling price of a polyphonic ringtone. In the infancy of that market, polyphonic ringtones often sold for $1.99. With the subsequent introduction of mastertones which incorporated the actual "hit" sound recording, the retail value of mono and polyphonic ringtones dropped off significantly.

In fact, once cell phones designed to play mastertones arrived on the market, consumers demonstrated their heightened interest in such a premium product by paying higher prices for mastertones – often $2.99 or higher per excerpted master. For mastertones, publishers receive [ ] However, in contrast to the publishers, SONY BMG receives [ ] – which is significantly more than the music publishing rate. Out of the [ ] that SONY BMG receives, the publishers recevie only [ ].

Indeed, to accelerate the mastertone clearance process for mobile carriers and to ensure a steady flow of "hit" product releases in a timely manner, SONY BMG itself entered into direct licenses with music publishers for mastertones. Under these license agreements, the distributor pays SONY BMG [ ] Thus, publishers receive just [ ] of the monies allocated to the copyright holders in respect of a mastertone (which is [ ] of what SONY BMG receives). While SONY BMG continues to believe that even this rate demanded by the

publishers is disproportionately high when viewed in the context of allocations of risk and investment (and the traditional splits between record companies and publishers), we acquiesced thereto on an interim, non-precedential basis, in order to avoid staying out of the marketplace altogether while pirated substitutes overtook the market, in a manner similar to what the industry had regrettably experienced in the online world.

The ringtone paradigm – while disproportionately valuing the musical composition in relation to the sound recording, due to the historical anomaly of polyphonic ringtones – nevertheless refutes the "value parity" proposition that the Services advance. The Services argue that, because one needs licenses for both copyrights, they should be valued the same. In reality, however, they are valued very differently, and the only product consumers are interested in is the sound recording.

IV. The Substitutional Impact of the Services

The Services repeatedly make the argument that their exploitation of our sound recordings increases or promotes sales of CDs and digital downloads. In turn, they argue that this proposed promotional effect warrants a decreased sound recording performance royalty. In the context of their proposed musical works benchmark, they take this argument further and contend that the supposed promotional effect justifies a sound recording royalty that is lower even than the musical works royalty. This argument is wrong for several reasons.

As an initial matter, the Services concede that if satellite radio were promotional, the promotional effect would benefit the musical works copyright holders as well as the sound recording copyright holders. They claim, however, that the economic return from each incremental sale of a sound recording due to satellite radio benefits the sound recording copyright holder more than it does the musical works copyright holder because the sound

recording copyright holder makes more money from the sale of a CD or a digital download than does the owner of the copyright in the corresponding musical work. That the sound recording copyright owner makes more money than the owner of the musical work copyright from each sale of a CD or digital download merely makes my point from above – that the sound recording copyright is worth more than the musical work copyright. As a relative matter, however, the alleged benefit touted by the Services to the owner of each right is the same – for every incremental sale, the owner of each right would earn the rate or margin to which it is entitled.

More importantly, however, my experience in the industry is consistent with other evidence that I understand that SoundExchange simultaneously is submitting which shows that subscribing to satellite radio, in fact, results in a significant and measurable net substitution effect – that is, subscribing to satellite radio actually causes subscribers to purchase *fewer* CDs. The significance of this substitutional effect cannot be overstated.

Sony BMG's gross margin on the sale of a top-line priced CD is [[redacted]], before taking into account costs such as recording costs, A&R, marketing, overhead, and unrecouped artist advances. That figure represents the net sale price of a top-line CD of [[redacted]], less average variable costs of sale of [[redacted]]. The gross margin of [[redacted]] is a number of which I remain keenly aware, as it is critical to my work in negotiating license agreements with digital service providers. As I have testified, where the service of a given digital licensee has the potential to substitute for – i.e., to decrease – CD sales, SONY BMG demands a higher rate from the service.

The reason for this should be obvious. SONY BMG depends on its margin to pay for things such as recording costs, A&R, marketing, overhead, and unrecouped artist advances. Lost CD sales that result from a particular service's substitutional effect thus are an economic loss for SONY BMG. Accordingly, if a potential licensee's service would result in a net loss of some

number of CDs per subscriber, SONY BMG knows that it needs to recover at least the value of those lost CDs through the rate *just to break even.* And because SONY BMG is not in the business of licensing its content just to break even, we would demand – *on top of that break even sum* – the normal licensee fee to which we would be entitled in the marketplace absent a substitution effect. We could never allow the loss that would result from a known substitution effect to result in SONY BMG receiving, at the end of the day (i.e., subtracting out the loss due to the substitution effect), anything less than the market rate that SONY BMG otherwise would be able to obtain.

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

Mark Eisenberg

Date: July 24, 2007

Exhibits Sponsored by Mark Eisenberg

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 253 RR	Amendment No. 3 to Sony BMG Digital Download Sales Agreement with Sprint Spectrum L.P. (Mar. 25, 2007)
SX Exhibit 254 RR	Amendment No. 4 to the Nov. 5, 2004 letter agreement between Verizon and Sony BMG (Apr. 27, 2007)
SX Exhibit 256 RR	Ringtones agreement between Sony BMG and Alltel Communications, Inc. (SE 0000617 et seq.) (Nov. 7, 2006)
SX Exhibit 257 RR	Ringtones agreement between Sony BMG and Helio LLC (SE 0001138 et seq.) (Dec. 22, 2006)
SX Exhibit 258 RR	Video license agreement between Sony BMG and Yahoo! Inc. (SE 0005328 et seq.) (June 16, 2005)