Before the
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LIBRARY OF CONGRESS
Washington, D.C.

In the Matter of DIGITAL PERFORMANCE RIGHT IN SOUND RECORDINGS AND EPHEMERAL RECORDINGS	Docket No. 2009-1, CRB Webcasting III

CORRECTED REBUTTAL TESTIMONY OF
ALEXANDER "SANDY" SMALLENS

I. BACKGROUND & QUALIFICATIONS

1. My name is Alexander "Sandy" Smallens. I am the Founder and Managing Director of Audiation, Inc., a digital media consultancy which provides leadership, strategy and business development for start-ups and multi-national media companies, including Oddcast, My Damn Channel, AdBlade, TuneGenie, Vibe Media and MyNet. Much of my focus with Audiation is selling digital solutions to brands and agencies, as well as developing and selling sponsorships for new digital radio channels. As a seventeen-year digital media executive,[1] I have had operational responsibility for divisions in the following industries:

a) The Record Industry: I was the founder of Atlantic Records' multimedia department in 1995, one of the first fully-staffed such departments in the industry, which debuted the first full-length online streams of major artists such as Tori Amos. I was employed at Atlantic Records from 1993-1996.

[1] A copy of my curriculum vitae is attached as Exhibit 1.

b) Online Music Content: As a Senior Vice President of online music website SonicNet, and subsequently at MTVi (after their acquisition of SonicNet) in the last 1990s, I launched and oversaw the industry's first-ever audio-visual streaming radio product, Flash Radio, and oversaw the first-ever music video on demand site, Streamland. Later, as Executive Vice President of GetMusic (1999-2001), a joint venture of BMG Entertainment and the Universal Music Group which was eventually acquired by Vivendi and named Vivendi Universal Net USA, I created and oversaw Videolab, the first site to enable users to remix popular music videos, as well as GetMusic Karaoke, the first online karaoke application to feature major recording artists.

c) Broadcast Radio: In my capacity as Vice President for Interactive Sales & Marketing at CBS Radio (2005-2006), I was the corporate executive responsible for sales of all CBS Radio digital assets. Then, as Senior Vice President for the digital division at Entercom Communications (2006-2009), I had oversight of the entire digital platform, including the creation, operation and monetization of the company's streams, websites, podcasts and mobile products. At both CBS and Entercom, I engineered digital sales strategy, oversaw pricing and collateral, trained local sales staff and personally pitched multi-platform programs to hundreds of agencies and brands.

d) Digital Advertising: As Chief Operating Officer of Oddcast (2002-2004), a viral marketing agency and technology company, I sold complex branded entertainment solutions to advertising agencies and brands. I continue to work closely with the company.

2. At CBS, in particular, I was responsible for creating and selling digital asset sponsorship packages – including everything from station websites, streams, HD2 channels and podcasts – to companies such as DaimlerChrysler, Vonage, Verizon, AT&T, Quiznos, Monster.com, Motorola and many others. I also oversaw CBS's relationship with advertising networks like Yahoo! and worked closely to train ad sales teams in many of the company's markets to ensure fluency in online ad sales.

3. At Entercom, I had profit and loss (P&L) responsibility for the company's digital department, and had direct and dotted line responsibility for over 60 staff members, including a corporate operations team and webmasters and digital sales managers across the country. My team was responsible for all policies, decisions, deals, third-party vendor relationships and day-to-day operations of Entercom's digital assets, as well as all sales activities and ad operations. I reported to the CEO and was a member of Entercom's Operating Committee, a small team of senior executives charged with setting strategic priorities and policies for the company.

4. I have spoken at numerous digital conferences, including Radio Ink's Convergence, AdTech, Digital Hollywood, Streaming Media East, and several others. I was also involved in the development, testing and launch of TargetSpot, an online audio advertising network, in my capacities at both Oddcast and CBS Radio. Under my tenure, Entercom became the second major radio group to sign a partnership deal with TargetSpot, and I directly oversaw all aspects of that relationship.

5. I have been a songwriter and musician since high school, and from 1987 through 1994, I composed and performed with Too Much Joy, a Giant/Warner Brothers recording artist. Too Much Joy enjoyed Top 15 success on modern rock radio and toured nationally, performing with major acts such as The Go-Go's and The Flaming Lips.

6. I graduated from Yale University in 1987 with a B.A. in Political Philosophy. As a student at Yale, I was Editor-in-Chief of the campus' music magazine, *Nadine,* and concurrently interned at *Spin Magazine*, where I authored several articles.

7. The following testimony is based on my seventeen years of experience in the digital media industry, including five years in senior positions related to the digital space at top-tier terrestrial broadcasters; ongoing business development and sales responsibilities in the digital advertising space; extensive responsibilities at Atlantic Records; and my years as a recording artist.

II. OVERVIEW OF TESTIMONY

8. My testimony will rebut SoundExchange's rosy assessment of statutory webcasting that was presented at the direct hearing. Contrary to statements made in SoundExchange's direct case – and specifically by Dr. Pelcovits – statutory webcasting services are facing substantial economic challenges that point to a less-than-robust market, especially under the current royalty scheme. My testimony discusses the unique challenges that statutory webcasters face in attempting to maximize revenues for their product.

9. My testimony primarily addresses the following issues:

a) The growth of listenership in the statutory webcasting industry does not necessarily create a proportional growth in revenues. In fact, the glut of advertising inventory created by increased audience sizes exerts downward pressure on the revenue potential of statutory webcasters. Moreover, surplus advertising inventory is exacerbated by a unique set of challenges.

b) The marketplace for ad-supported music services is quite challenging, as witnessed by the failure and/or fire-sale of various entities in the space. For example, after Last.FM's sale to CBS Interactive, Last.fm has not yet achieved profitability, and has in fact scaled-back its ad-supported offerings.

c) Subscribers account for a small and dwindling amount of statutory webcasting listening. The vast majority of statutory webcasting – unlike on-demand interactive services – is based on ad-supported, *non-subscription* listening.

d) Pandora, the most successful "pure play" webcasting company in terms of audience size and revenue, would have to spend almost every cent of its 2009 revenues on the sound recording royalty if it were subject to the full statutory rate for 2009 that was determined by the Copyright Royalty Board in the Webcasting II proceeding. Therefore, a royalty rate that is *higher* than (or even close to) the current rates – as SoundExchange has proposed in this proceeding – would not represent what a willing buyer would agree to.

e) Statutory webcasters have inherent economic disadvantages compared with the National Association of Broadcaster ("NAB") and Sirius XM simulcasters with respect to operating, marketing and sales costs as well as revenue generation.

f) Statutory webcasting provides promotional benefits, increases album/download sales, and provides much-needed exposure to copyright holders.

III. DR. PELCOVITS' ASSESSMENT OF THE STATUTORY WEBCASTING MARKET IS FUNDAMENTALLY FLAWED

10. In Section 4 of his written testimony, entitled "The Statutory Webcasting Market," Dr. Pelcovits provided a lofty assessment of the statutory webcasting industry as "the backdrop for [his] analysis."[2] He relies upon various secondary and tertiary sources for his

[2] SoundExchange Trial Ex. 2 (Amended & Corrected Written Direct Testimony of Dr. Michael Pelcovits ("Pelcovits ACWDT")), at 6-14.

premise of a "robust and evolving market for webcasting."[3] He makes this analysis without having spoken to any executives at any webcasting companies.[4] Instead, he cites growth in reported performances and listenership based on usage reports from SoundExchange, a report by Arbitron/Edison Research, as well as an examination of two recent market entrants, Last.fm and Slacker, which purportedly have been able "to succeed in the market."[5] In addition, Dr. Pelcovits points to the estimated growth of the overall advertising market for Internet radio as evidence of a "robust" market for webcasting.

A. Webcasting Listenership Has Flattened Over The Last Year

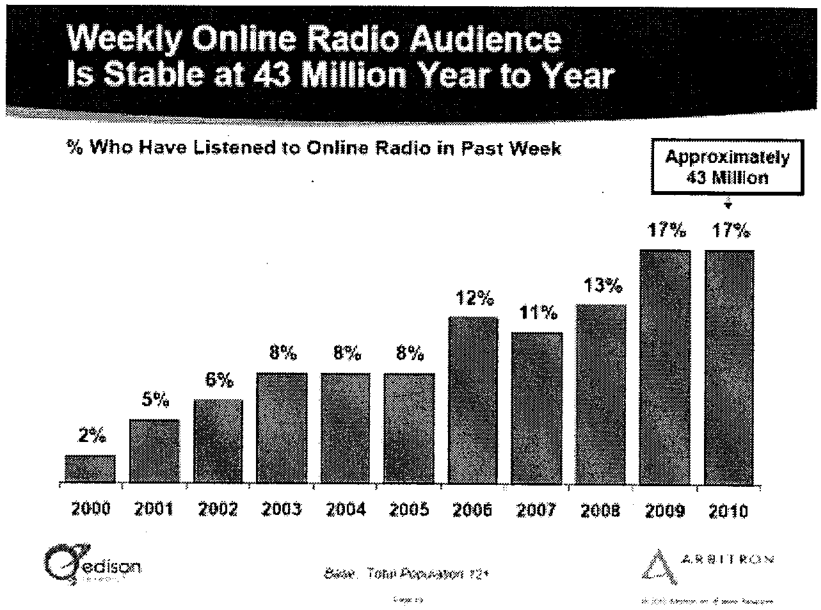
11. Dr. Pelcovits' assessment of the webcasting market is flawed in numerous ways. His finding that "the webcasting industry continues to grow" refers primarily to listenership, and does not take into account the difficulties in monetizing this growth. One of the main sources to support his growth assertion, the 2008 and 2009 "Infinite Dial" reports by Arbitron and Edison Media Research, combine both news/talk/sports and music formats, and does not provide a specific breakout. In my experience, for many terrestrial simulcasters, non-music formats – which do not have the same royalty obligations of Internet music services – dominate overall online listening and drive listenership growth. Therefore, Dr. Pelcovits' failure to take into consideration the allocation of listenership attributable to news, talk and sports formats, with respect to the report he cites, is a considerable flaw. In addition, as Internet penetration has leveled off, so too has online radio listenership. Since Dr. Pelcovits' testimony, the April 2010 Arbitron/Edison "Infinite Dial" study shows that listenership growth flattened from 2009-2010, as shown in the table below. Therefore, future growth of Internet radio listenership is uncertain.

[3] SoundExchange Trial Ex. 2 (Pelcovits ACWDT), at 11.

[4] Direct Hearing Tr., April 19, 2010, at 172:3-172:6.

[5] SoundExchange Trial Ex. 2 (Pelcovits ACWDT), at 10.

Table 1



B. Dr. Pelcovits Ignores Economic Realities Of The Webcasting Marketplace

i. Consolidation Of Listenership

12. Before addressing Dr. Pelcovits' disregard for industry economics, it is worthwhile to briefly examine the consolidation of listenership among Pandora and simulcasters (terrestrial and satellite). Specifically, the aggregate statutory webcasting market demonstrates that an increase in aggregate tuning hours and/or aggregate revenue of the entire industry is, in fact, heavily skewed by a few companies. According to Sound Exchange's 2009 usage reports, the top four entities in terms of aggregate performances are: Pandora ([redacted]% market share by volume); CBS Radio and Clear Channel ([redacted]% market share by volume); and satellite radio companies Sirius-XM ([redacted]% market share by volume). Combined, these four entities account for over 80% of 2009's aggregate yearly performances reported to SoundExchange.[6] The statutory webcasting market was not nearly as consolidated just a few years earlier, during which

[6] Live365 Trial Ex. 14 (SXW3_Native_0015 (RESTRICTED)), at 8.

time the top four entities represented only 50.58% and 53.82% of the aggregate performances in 2006 and 2007, respectively.[7] In his direct statement, Dr. Pelcovits did not break down the revenue growth, specifically for ad revenues, that are attributable to each company.

ii. Audience Growth Does Not Equate To Increased Revenues

13. An obvious point neglected by Dr. Pelcovits is that growth in webcasting listenership does not, in and of itself, translate to financial success or even viability – especially with the risk of increasing royalty rates. First, the overwhelming majority of statutory listening is ad-based, hence heightening the importance of advertising revenues. Second, every single song streamed triggers additional costs; however, ad-supported webcasters cannot recover these costs in the same per-song manner. Therefore, unless CPM (i.e., cost per thousand impressions) and inventory sell-out rates (i.e., the percentage of the total advertising impressions sold) keep pace with the growth in listenership, statutory webcasters – which are already saddled with increasing hosting, bandwidth and royalty costs due to this growth – are indeed penalized for the success of their increased listenership. However, given persistent industry trends, CPMs are subject to significant downward pressures. Consequently, the inverse relationship between costs associated with listenership growth and CPM revenues will likely continue. These findings are all consistent with my own observations in the industry.

iii. Dr. Pelcovits Disregards The Decline In Advertising Rates And Its Impact On The Economic Health Of The Statutory Webcasting Industry

14. Dr. Pelcovits' analysis of the statutory webcasting industry suffers from other deficiencies. Specifically, he failed to consider CPM rates, inventory sell-outs, and the impact of each factor on the statutory webcasting market. Again, these are important factors because the majority of statutory webcasting is ad-based listening.

[7] Live365 Trial Ex. 14 (SXW3_Native_0015 (RESTRICTED)), at 2, 4.

15. In addition to audience size, the most relevant factors are advertising *rates* (in the form of CPMs) – not aggregate advertising *revenues* – and inventory sell-out rates. In my experience, these metrics determine the revenue potential for ad-supported services (and, implicitly, the royalty rate they could afford to pay). Statutory webcasters can assess their revenue potential in a variety of ways. One manner is to assess the total impressions served over the course of a given time period and factor in average CPMs and sell-out percentage. Impressions can be determined by multiplying total monthly listening sessions by average spots served per listening session. In other words, if my station's listeners generally stay connected for 90 minutes (i.e., that is the station's Average Time Spent Listening, or TSL), and I serve six spots per hour, I know that each listening session generates an average of nine ad impressions. Put into practice, if I know my listenership generates a total of one million ad impressions over a month, and I generally sell 50% of that inventory at a $3 CPM, then I know the current revenue potential of this station is $1,500/month (500,000 impressions sold at a $3 CPM). No such analysis, which could have illustrated webcasters' ad revenue capabilities, was provided by Dr. Pelcovits.

16. In my experience with terrestrial broadcasters, CPMs for online audio ads have generally been stagnating or declining – especially for inventory that is sold via multi-market deals or ad networks (such as TargetSpot). Multiple sources confirm this stagnation and/or reduction in average statutory webcasting industry CPMs. Dr. Pelcovits, for example, acknowledged that there is no evidence of CPMs increasing:

> *Q.* *Sitting here today, you cannot say that CPMs have been rising, can you?*
>
> *A.* *Are you talking about CPM in terrestrial broadcasting or in webcasting?*
>
> *Q.* *Well, let's start with the webcasting market.*

A. I have not seen evidence of CPM increasing.[8]

17. Further, Live365's General Manager of Media, Johnie Floater, cites internal data that reveal a decline in CPMs since 2006 for streaming audio ads as well as CPMs for ad banners and video gateway ads (short, video-based ads that play automatically when a user clicks to listen to a stream).[9] And in his testimony, BIA/Kelsey Vice President Mark Fratrik, PhD, confirms that CPMs for audio ads have fallen steadily since 2005, citing figures from AccuStream iMedia Research released in 2009.[10] Even major streaming media destinations such as MySpace and YouTube are plagued by low CPMs and "low-value," excess ad inventory "that can only command weak CPMs, and they're not growing its value as quickly as content costs are growing."[11] All of these findings are consistent with my own observations.

C. Statutory Webcasters' Necessary Reliance On Ad Networks Results In Lower Yield And Higher Cost Of Sale

18. Non-interactive webcasters face a specific challenge in monetizing their audio ad inventory. Since there is theoretically no limit on a statutory webcasters' ad inventory – as opposed to the finite inventory of terrestrial radio stations, which can drive demand and command higher CPMs (as I observed during my experience at two of the largest terrestrial radio companies in the U.S.) – adding listeners does not necessarily drive more value creation. As Mark Mulligan of Forrester Research concludes, "many ad-supported content destinations are

[8] Direct Hearing Tr., April 19, 2010, at 177:15-20.

[9] Live365 Trial Ex. 29 (Corrected Written Direct Testimony of Johnie Floater, April 25, 2010 ("Floater CWDT")), at 5.

[10] Live365 Trial Ex. 30 (Corrected & Amended Written Direct Testimony of Mark Fratrik, April 26, 2010), Exhibit 3 at Section Three

[11] Mark Mulligan, "Paying for Success: When Audiences Grow More Quickly Than Ad Revenue." Forrester Research, April 17, 2009 (SXW3_00018073 – 00018079), at 3. *See* Exhibit 2.

not growing ad revenue effectiveness as quickly as their audiences are growing in size and level of engagement."[12]

19. Audience growth without complimentary growth in sell-out rate creates a "glut" of unsold inventory. To address this, non-interactive webcasters who do not have sufficiently-sized local audiences that can be targeted and who lack the robust, specially-trained sales forces of the NAB simulcasting entities, must rely on ad networks. Ad networks aggregate unsold advertising inventory from a variety of online entities and make it available to marketers. This inventory is commonly referred to as "remnant" – left-over advertising spots which generate a small number of ad impressions. By collecting this disparate inventory from multiple websites, ad networks hope to amass enough impressions to be able to sell it. Marketers generally expect to pay lower CPMs for ad network inventory because it is an amalgamation of remnant impressions. [redacted]

20. In addition, ad networks charge aggressive commissions to sell this low-priced inventory. These commissions are generally higher than the commissions that would be paid to an in-house salesperson for selling the same inventory. So webcasters that are reliant on ad networks yield lower revenues from their ad inventory and realize a much smaller percentage of revenue for every dollar made. For this reason, media companies generally consider ad networks to be a last resort, backfill for the less desirable inventory that their sales team cannot monetize. In fact, in December 2009, CBS Interactive – whose online properties contain highly trafficked

[12] *See id.* at 2.

content (including CBS.com, CNET, Gamespot and TV.com) – declared they would almost completely eliminate their reliance on third-party ad networks.[13]

21. Further, there are not enough streaming media advertisers making big enough buys to fill even this lower-priced inventory. As Johnie Floater has testified, "advertising orders consistently do not fill all of Live365's advertising inventory; therefore, increasing the number of ad spots her hour would not generate more revenues since Live365 already cannot fill all of its commercial availabilities."[14] I am not surprised by this comment. In my capacity at both CBS Radio and Entercom, most major online ad buys happened in the context of cross-platform deals (including on-air and online inventory). Marketers generally earmarked a small percentage (5-10%) of their total spend to online[redacted]. Frequently, the online portion of the buy would be the first thing to go if their budgets tightened up. This problem is exacerbated by the fact that many streaming network buys are "dayparted" – limited to airing during specific hours of the broadcast day, which means that weekends and overnight hours are vastly undersold. The shortfall of paid ads results in webcasters over-delivering for their existing advertisers or rotating "house" or promotional spots through the ad inventory, prompting a deterioration of the quality of the listening experience for the user. This can lower Average Time Spent Listening (TSL) and, therefore, reduce the number of ad impressions served per listening session, further reducing revenue generation. At the same time, the webcaster is incurring per performance costs for the listenership during the undersold non-daypart hours.

22. There is a variety of reasons for this shortfall in advertising sales. Streaming audio advertising is still relatively new to marketers, and commands a low single-digit

[13] Michael Learmonth, "CBS Interactive Dumps Ad Networks," *AdvertisingAge*, Dec. 14, 2009, available at http://adage.com/digital/article?article_id=141054. *See* Exhibit 3.

[14] Live365 Trial Ex. 29 (Floater CWDT), at 4-5.

percentage of overall broadcast radio revenues. In addition, producing quality streaming radio ads requires a different expertise than producing, say, a compelling banner ad, and many marketers are reluctant to delve into this area. In many cases, webcasters display synchronized ad banners when a streaming audio spot plays, but it is difficult to determine if the listener is looking at their streaming web player when these banners display or has either minimized the player or buried it beneath other browser windows. It has been my experience that synchronized banner ads for streaming audio spots have historically generated low click-through rates for this reason, another discouraging factor in the eyes of media buyers.[15]

23. Also, as I explain below in my discussion of the differences between pure Internet radio services and broadcast simulcasters, Internet radio companies – which do not have mass audiences concentrated in a particular geographical market – have to rely on national advertisers as a source of revenue. These national advertisers are few, and have many other established outlets for their advertising (e.g., radio, television and cable networks; print, etc.) that offer larger audiences than Internet radio. Thus, it is not easy to cause these advertisers to change their practices to dedicate money to Internet radio. For these reasons, plus simply the amount of inventory that is available in the marketplace, webcasters generally have low CPMs and low sell-out rates that have not kept pace with their audience growth.

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[15] Another factor leading to a misplaced view of the robustness in the online radio industry is Dr. Pelcovits' apparent reliance on inconsistent ad spending numbers, which seem to suggest a *decrease* in ad spending through 2011. On page 11of his Amended & Corrected Written Direct Testimony (SoundExchange Trial Ex. 2), he cites a $101 million figure in digital advertising spending for the radio industry *for the first quarter of 2009*. This suggests that digital advertising spending for the radio industry would be over $400 for the entire year in 2009. In the next sentence, he cites a different analysis that projects $350 million *for the entire year in 2011*. Note that the $350 million figure originally came from a report prepared by ZenithOptimedia, which revised its projections downward two times, and is now down to $286 million for its 2011 estimate.

D. Far From Dr. Pelcovits' "Robust And Evolving Market," The Ad-Supported Music Space Is Withering Under The Weight Of Royalty Payments To Record Labels; Last.fm Is Under-Performing

24. The Internet music space is littered with examples of failed and shuttered ad-supported music services (e.g., SpiralFrog, Ruckus Network) as well as once-promising music start-ups forced to sell themselves for a fraction of their previous value. imeem "raised above $50 million in funding over the last two years...with the valuation north of $200 million."[16] The company ended up selling to MySpace for "$1MM in cash" in December 2009.[17] Prior to its sale, the service had been "reportedly running out of money, especially because of how much it has to pay for music licensing deals it has with record labels."[18] Lala Media, Inc. ("Lala"), another popular music service, was recently acquired and then shuttered by Apple as of May 31, 2010.[19] Further, two of the largest companies subject to statutory rates and terms of Webcasting II – i.e., Yahoo! LAUNCHcast and AOL Radio – exited the webcasting business shortly after the Webcasting II determination by partnering with CBS Radio, who "powers" Yahoo! and AOL-branded offerings and provides all content licensing, programming and royalty payments.

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[16] Rafat Ali, "Music Social Network Imeem In Play; Hires Bank; Laying Off 25 Percent," *PaidContent*, Oct. 22, 2008, available at http://paidcontent.org/article/419-music-social-network-imeem-in-play-does-25-percent-layoffs/. *See* Exhibit 4.

[17] Michael Arrington, "Ok, Now It's Done. MySpace Music Completes Acquisition of iMeem," *TechCrunch*, Dec. 8, 2009, available at http://techcrunch.com/2009/12/08/imeem-myspace-music-completes-acquisition/. *See* Exhibit 5.

[18] Eric Eldon, "Music startup imeem making money, not dying unless the labels kill it," *Venture Beat*, March 26, 2009, available at http://venturebeat.com/2009/03/26/music-startup-imeem-making-money-not-dying-unless-the-labels-kill-it/. *See* Exhibit 6.

[19] Lala had been losing money before its acquisition by Apple, and its value had declined precipitously. During the first quarter of 2009, Warner Music Group recorded a charge of $11 million to write-down its $20 million investment in Lala to its estimated fair value of $9 million. *See* SEC Form 10-Q, Warner Music Group Corp. (May 7, 2009). This write-down occurred only one year after Warner had made its $20 million investment in Lala. *See* SEC Form 10-K, Warner Music Group Corp. (Nov. 25, 2008).

25. Dr. Pelcovits points to the purported success of Last.FM, purchased for $280 million in May 2007 by CBS Interactive. Now, in 2010, Last.FM is a poster child for how difficult it is to create a successful, ad-supported streaming model – even with the backing of a major media company, such as CBS. According to Forrester Research, "Last.FM has struggled to find its new identity within CBS and its paymasters recently took the decision to turn off free-streaming outside of the major territories due to the inability to generate sufficient advertising revenue....further evidence of the challenges of making free pay."[20] *Digital Music News* acknowledges that "CBS appears to be struggling to properly monetize its $280 million investment."[21] Also, Last.FM's ability to attract subscribers has been lackluster to date. The CBS Interactive VP overseeing Last.FM recently admitted that it has only "tens of thousands" of paying subscribers despite self-reported traffic of about 10 million unique visitors per month in the U.S. alone, and hopes to be profitable (finally) by 2010.[22] These examples hardly paint the picture of a robust market.

E. Demographic Targeting Has Not Materialized In An Impactful Way

26. Dr. Pelcovits also touts "the ability of advertisers to obtain detailed demographics on listeners" as a revenue-driver for webcasters.[23] Beyond rudimentary IP-based geo-targeting, however, more detailed targeting is reliant on users voluntarily filling out registration forms. But most terrestrial simulcasters do not require user registration, nor do many statutory webcasters.

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[20] Mark Mulligan, "Last.FM's Fond Farewell to Streaming (Sort of)," *Forrester Research*, April 13, 2010, available at http://blogs.forrester.com/mark_mulligan/10-04-13-lastfm's_fond_farewell_streaming_sort. *See* Exhibit 7.

[21] "Last.fm Flips the Subscription Switch... In Smaller Markets," *Digital Music News*, Dec. 30, 2009, available at http://www.digitalmusicnews.com/stories/032409last/. *See* Exhibit 8.

[22] Robert Andrews, "Interview: CBS Thinks Last.fm Will Turn A Profit This Year," *PaidContent*, March 18, 2010, available at http://paidcontent.org/article/419-interview-cbs-thinks-last.fm-will-turn-a-profit-this-year/. *See* Exhibit 9.

[23] SoundExchange Trial Ex. 2 (Pelcovits ACWDT), at 11.

And for good reason: there is a plethora of "no registration required" options for listening to streaming music online; hence, requiring it makes a webcaster less competitive. "Consumers are...spoiled for choice for free music on streaming sites such as Last.FM, Pandora and YouTube."[24] Ultimately, in this competitive environment, requiring registration is still the exception, not the norm.

27. Moreover, I have observed that, while targeting may increase the CPM rate for a particular demographic, the net effect may still reduce overall per-performance revenue. By way of example, a service could obtain a CPM rate of $12 for men in the 24-35 age bracket in select major markets during certain hours of the day. The problem, however, is that much smaller revenue – or even no revenue – may be obtained for listeners who do not meet these restrictions, even though the per-performance royalty rate is the same for both. Consequently, demographic targeting can and does lead to further excess inventory and lower overall per-performance revenue. In sum, targeting has yet to have any material impact on overall online radio CPMs.

F. Dr. Pelcovits Ignores The Costs Associated With New Platform Launches, And Over-Estimates The Profit Potential

28. Dr. Pelcovits identifies new features, such as song skipping and mobile access, provided by webcasters and asserts – without any authority – that such features should yield copyright holders greater royalty payments. For example, Dr. Pelcovits states that mobility "in a free market would generate additional payments to the owners of the copyright in the sound recordings."[25] While it may be true that mobility will increase listening and overall revenue, the same issue of glut and low-bucket CPMs comes into play in the mobile space. Because the

[24] Mark Mulligan, "Paying for Success: When Audiences Grow More Quickly Than Ad Revenue." *Forrester Research*, April 17, 2009 (SXW3_00018073 – 00018079), at 1. *See* Exhibit 1.

[25] SoundExchange Trial Ex. 2 (Pelcovits ACWDT), at 13.

mobile audience is a fraction of the overall streaming audience, and because more expensive video pre-roll ads and display ads are even less relevant in the overall ad mix on a mobile device, webcasters face significant challenges in monetizing this mobile audience. Thus, merely increasing audience size through mobile application does not mean that there is any increase in revenue per listener. Again, this means that services are increasing their costs without any unique way to increase their per listener revenues.

29. Moreover, Dr. Pelcovits did not take into consideration the additional cost of developing and delivering these new features. For instance, Apple's successful new portable device, the iPad, requires many webcasters to develop a new, device-specific player. Also, any of these new features are the result of web services' significant investments in creating and maintaining these players. Therefore, even if one assumes that new features (such as mobility) increase revenues, Dr. Pelcovits still fails to take into consideration the services' additional investments and costs. Finally, Dr. Pelcovits also fails to consider whether his identified new features would ultimately increase revenue *per play*, the key metric for a license that is paid on a per-performance basis.

IV. EVERY DOLLAR OF REVENUE EARNED BY PANDORA, THE MOST SUCCESSFUL STATUTORY WEBCASTER, WOULD HAVE BEEN PAID TO COVER THE SOUND RECORDING ROYALTY IN 2009

30. Dr. Pelcovits' assessment of webcaster growth is heavily skewed by a single entity, Pandora, the best-known Internet radio service by a substantial margin.[26] The positive trajectory of the "Statutory Webcasters' Aggregate Monthly Performances 2006-2009" graph on page 8 of Dr. Pelcovits' Amended & Corrected Written Direct Testimony primarily reflects

[26] The Infinite Dial 2010: Digital Platforms and the Future of Radio, *Edison Research*, at 23.

Pandora's growth, as Dr. Pelcovits himself acknowledged.[27] This is further illustrated in Table 2 (below), which derives from graphs prepared in connection with Dr. Pelcovits' report.

Table 2

[redacted]

As Table 2 shows, the purported "popularity" of webcasting and the upward trend in aggregate performances is almost completely a function of one service's growth: Pandora's. Moreover, over this same time period, the amount of aggregate performances by other statutory webcasting services has been flat or declining over the past few years, again undermining Dr. Pelcovits' conclusion of a robust market. Indeed, removing Pandora from this consideration reveals a very different trajectory in terms of aggregated performances, as shown in Table 3 below.

[27] Pelcovits Depo Tr. (Dec. 14, 2009) at 214:1-215:4.

Table 3

[redacted]

31. Further, Pandora, which "accounts for roughly 44-45 percent of total SoundExchange royalties for non-interactive streams,"[28] would not be able to sustain a viable business were they subject to the full statutory rates. From January 2009 through October 2009, Pandora reported [redacted] performances. Based on averaging the amount of monthly performances during those 10 months, one can conservatively estimate that the remaining two months of 2009 would amount to [redacted] performances. This is conservative because, historically, streaming hours rise significantly during the holiday season as people tune into holiday-themed channels and spend more time listening. Therefore, we can conservatively estimate that Pandora's total performances for 2009 were [redacted] If you multiply that

[28] "Pandora: These Numbers May Surprise You," *PaidContent*, March 18, 2010, available at http://paidcontent.org/article/419-pandora-these-numbers-may-surprise-you/. *See* Exhibit 10.

amount by the statutory royalty rate for 2009 – i.e., $.0018 – Pandora would have owed [redacted] for only the sound recording performance royalty! **This means that just about every dollar in reported revenue that Pandora earned in 2009 – and it's widely reported to have been about $50 million – would have gone to a single cost.** Pandora's founder and Chief Strategy Officer, Tim Westergren, put it in stark terms, stating that if Pandora had not entered into the Pureplay WSA agreement, "we [Pandora] would have been done."[29]

32. A 10-year old company, Pandora represents one of the most successful, most listened-to, and most established statutory webcaster in this space. No willing buyer – much less the biggest buyer in the statutory webcasting industry – could realistically ever agree to a rate that ate up all of its revenues, leaving no money to meet other expenses or to provide a return to investors. Expecting willing buyers to pay rates through 2015 that are substantially higher than the 2009 rate – as SoundExchange proposes – is utterly unrealistic and unsustainable for the statutory webcasting industry. Therefore, this reality check refutes Dr. Pelcovits' testimony that the proposed rates "fall within a reasonable range that would be paid by a willing buyer" as not even the biggest "buyer" could afford such rates.[30]

V. INTERACTIVE AND NON-INTERACTIVE MARKETS ARE HIGHLY DIFFERENT

33. The interactive and the non-interactive marketplaces are vastly different. First, interactive or "on demand" services like Napster, which enable users to pinpoint the exact song they want to hear, serve as a celestial catalogue for listeners. Essentially, people can hear what they want, when they want it. The experience is more akin to the experience of owning a CD or

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[29] John Timmer, "Pandora lives! SoundExchange cuts deal on webcasting rates," *Ars Technica*, July 7, 2009, available at http://arstechnica.com/media/news/2009/07/soundexchange-cuts-deal-on-music-webcasting-rates.ars.

[30] Direct Hearing Tr., April 19, 2010, at 163:22-164:6.

digital track that can be played on demand than it is to listening to the radio. On the other hand, Pandora and other non-interactive webcasters are essentially more tailored versions of the traditional radio experience and can be considered a "passive" or "lean back" listening experience. Second, while on-demand interactive services have faced significant challenges in growing their subscriber base, adding subscribers to a non-interactive service is even more challenging due to the plethora of free sources, such as NAB simulcasters. Consequently, ad-supported listening is the primary business model in non-interactive webcasting. Moreover, the competitive landscape for non-interactive services is much more crowded.

A. Majority Of Statutory Webcasting Is Based On Ad-Supported, Non-Subscription Listening

34. Dr. Pelcovits assumes that comparing subscription figures in the interactive and non-interactive webcasting markets will provide a suitable framework for setting rates. The flaw with this assumption is that the vast majority of the statutory webcasting listening is *not* based on subscription listening. Subscription levels for statutory webcasters are small and not growing. Live365 reports that fewer than 2% of its users are subscribers.[31] As previously stated, Last.FM's subscription users number in the tens of thousands. Rhapsody's self-reported shrinkage from 800,000 subscribers in Q1 2009 to 650,000 subscribers in Q1 2010 further bear out the difficulty of subscription-based models for online music companies.[32] And, based on my experience and observations, subscription-based streaming by NAB entities and other simulcasters is non-existent or, at best, negligible.

[31] Live365 Trial Ex. 29 (Floater CWDT), at 5.

[32] Glenn Peoples, "Analysis: Subscription Model Takes Another Hit," *Billboard.biz*, May 10, 2010, available at http://www.billboard.biz/bbbiz/content_display/industry/e3i975b286fc2a9c455fe7816e39f48bd1b. *See* Exhibit 11.

B. Statutory Webcasting Services Will Likely Continue To Be Ad-Supported And Not Subscription-Based, Unlike Interactive Services

35. On a practical level, the assumption that the webcaster can increase subscription rates significantly simply does not make sense. The vast majority of music listeners are casual listeners, some using more than one Internet service interchangeably. They listen to music that they can get for free, on their radio or from other sources, and buy few CDs or digital music files each year. The subscription services cater to a limited percentage of the public that finds music more important, and is willing to pay for the interactive service to get access to that music. The non-interactive market for the most part serves the more causal listener, who may want to hear some music, but need not be involved in selecting exactly what they want to hear. There is nothing to indicate that this more casual audience, which traditionally has not spent significant amounts on music in the past, will suddenly want to spend more of their disposable income on a service where they cannot dictate what they want to hear. Thus, based on my observations within the industry (including the evidence cited above), it is my opinion that non-interactive streaming will continue to be a mainly advertising-supported medium.

VI. NAB AND SATELLITE SIMULCASTERS HAVE SIGNIFICANT ADVANTAGES OVER NON-NAB STATUTORY WEBCASTERS

36. There is no basis for Dr. Pelcovits' establishment of the WSA agreements as the "low end" of the range of market outcomes. This assertion ignores several advantages that NAB and satellite simulcasters have over statutory webcasters. It is an understatement to say that these the business of simulcasting has a different cost/revenue structure from the operations of pureplay statutory webcasting companies. On the cost side, NAB/satellite simulcasters do not need to invest in any "start up" costs to create content to stream – they merely require a small investment to encode and deliver their existing station signals through the Internet. Years of

marketing and developing audiences for their on-air personalities and programming present an instant competitive advantage in the world of webcasting. Their stations' appeal is broad-based and programmed to appeal to a mass audience. In contrast, many statutory webcasters have more specialized formats that are not available on over-the air radio/simulcast formats and that are meant to appeal to a niche audience via their more tailored offering.

37. Additionally, simulcasters do not need to invest in a new ad sales team – they already have a team of seasoned experts who have sold audio advertising for years to local (in the case of NAB simulcasters) and national marketers (in the case of both NAB and satellite simulcasters). Also, they have a built-in source to market and cross-promote their simulcast streams: promotional or programming inventory on their over-the-air signals and station websites. It should also be noted that NAB entities historically have not had to pay sound recording performance license fees for their over-the-air broadcasts given their promotional value – despite evidence that the Internet is quickly over-taking radio as a source for new music discovery. This year, 52% of people in the 12 to 34 year old bracket turn to the Internet first to discover new music; 32% turn to radio.[33]

38. Simulcasters have many other inherent cost savings. Unlike the statutory webcaster, who must pay all of its operating costs from the revenues derived from its operations, most of the costs of the simulcaster have already been paid by the revenues of its primary operations. The offices of the simulcaster are already paid for by the primary business. Computer systems for billing, traffic (i.e., the scheduling of advertising) and for other purposes are already on hand. Other personnel (e.g., receptionists, clerical personnel, technicians and engineers, etc.) and infrastructure already exist, being paid for by the primary business of the

[33] The Infinite Dial 2010: Digital Platforms and the Future of Radio, *Edison Research*, at 16.

simulcaster. As these costs do not need to be spent on the streaming, the simulcaster can afford royalties that its webcasting competitors cannot.

39. On the flip side, the NAB simulcasters can derive higher CPMs for their inventory than can statutory webcasters. The radio groups' streams are primarily sold locally by a seasoned team of experts to an audience of buyers who have been buying inventory on their stations for years. In addition, streaming spots are frequently packaged with over-the-air inventory to maximize value for the marketer, increase online inventory-sell out rates, and command a greater piece of the marketing spend, boxing out other online radio entities. To the extent that broadcasters rely on ad networks such as TargetSpot, it is as a last resort when inventory remains unsold. TargetSpot accounted for a very small portion of total streaming revenues in my terrestrial radio experience. NAB simulcasters' selling is fundamentally local, and because it is targeted as such (and further refined by the established demographics of a station format's audience), their sales teams can and do extract higher CPMs. Statutory webcasters, in general, lack this local edge and are much more reliant on advertising agencies and networks, which take enormous commissions. In the competitive landscape of Internet radio, the business of pure play and other webcasters are clearly disadvantaged in relation to the NAB and satellite simulcasters, and thus less able to meet royalty rates. Thus, rates paid by statutory pureplay webcasting companies, not those paid by NAB stations or satellite simulcasters, should be considered the "low end" of the market outcome.

VII. STATUTORY WEBCASTING PROVIDES PROMOTIONAL BENEFITS TO COPYRIGHT HOLDERS

40. Numerous studies have confirmed the positive sales impact and promotional benefits of statutory webcasting for recording artists. NPD Group's Russ Crupnick was quoted in February of this year as stating that "online radio services lead to a 41% increase in paid