## Index of Witness Statements

<table>
<thead>
<tr>
<th>Tab</th>
<th>Witness</th>
<th>Title</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Janusz Ordover</td>
<td>Professor of Economics and former Director of the Masters in Economics Program at New York University</td>
</tr>
<tr>
<td>2</td>
<td>Thomas Z. Lys</td>
<td>Eric L. Kohler Chair in Accounting and Professor of Accounting and Information Management, Kellogg School of Management, Northwestern University</td>
</tr>
<tr>
<td>3</td>
<td>J. Gregory Sidak</td>
<td>Chairman, Criterion Economics, L.L.C. and Ronald Coase Professor of Law and Economics, Tilburg Institute for Law and Economics, Tilburg University</td>
</tr>
<tr>
<td>4</td>
<td>George S. Ford</td>
<td>President, Applied Economic Studies</td>
</tr>
<tr>
<td>5</td>
<td>Jonathan Bender</td>
<td>Chief Operating Officer, SoundExchange, Inc.</td>
</tr>
<tr>
<td>6</td>
<td>Stephen Bryan</td>
<td>Executive Vice President of Digital Strategy and Business Development, Recorded Music, Warner Music Group</td>
</tr>
<tr>
<td>7</td>
<td>Charles Ciongoli</td>
<td>Executive Vice President and Chief Financial Officer, Universal Music Group North America</td>
</tr>
<tr>
<td>8</td>
<td>Raymond M. Hair</td>
<td>International President of the American Federation of Musicians of the United States and Canada</td>
</tr>
<tr>
<td>9</td>
<td>Darius Van Arman</td>
<td>Founder, Jagjaguwar</td>
</tr>
</tbody>
</table>
Before the
UNITED STATES COPYRIGHT ROYALTY JUDGES
Washington, D.C.

In the Matter of:
Docket No. 2011-1
CRB PSS/Satellite II

TESTIMONY OF

JANUSZ ORDOVER

Professor of Economics and former Director of the
Masters in Economics Program at New York University

Public Version

Witness for SoundExchange, Inc.
I. Introduction and Qualifications

1. My name is Janusz A. Ordover. I am Professor of Economics and former Director of the Masters in Economics Program at New York University, where I have taught since 1973. I am a Special Consultant at Compass Lexecon, which is a division of FTI, Inc. During 1991-1992, I served as Deputy Assistant Attorney General for Economics at the Antitrust Division of the United States Department of Justice. As the chief economist for the Antitrust Division, I was responsible for formulating and implementing the economic aspects of antitrust policy and enforcement of the United States, including co-drafting the 1992 U.S. Department of Justice and the Federal Trade Commission Horizontal Merger Guidelines. I also had ultimate responsibility for all of the economic analyses conducted by the Department of Justice in connection with its antitrust investigations and litigation.

2. My areas of specialization include industrial organization, antitrust, and regulation economics. I have served as an advisor on antitrust and regulatory issues to many organizations, including the American Bar Association, the World Bank, the Organization for Economic Cooperation and Development, the Inter-American Development Bank, and the governments of Poland, Hungary, Russia, the Czech Republic, Australia and other countries. I have provided economic testimony in policy hearings conducted by the Department of Justice, the Federal Trade Commission and the United States Senate. I have also consulted and testified in a wide range of antitrust and intellectual property litigation matters. In February 2011, I was the recipient of Global Competition Review’s Economist of the Year award. Currently I also serve as a Member of the ABA Antitrust Section’s Economics Task Force.

3. My work as an economic expert has involved a number of engagements dealing with issues related to the pricing and distribution of content. This experience spans several industries, including music, motion pictures, and software. With respect to the music industry in particular, I previously have provided testimony on behalf of SoundExchange in matters before the Copyright
Royalty Board regarding determinations of reasonable performance royalty rates associated with the digital transmission of music via satellite radio and internet radio (webcasting); I was retained by Universal Music Group and Warner Music Group as an economic expert in an action brought by the Federal Trade Commission (FTC) relating to a joint venture between Warner and Polygram (subsequently acquired by Universal) to produce and distribute an album featuring the “Three Tenors;” I testified on behalf of Universal Music in conjunction with the company’s petition to adjust mechanical royalty rates in the European Union. I also served as an economic consultant to Sony and BMG with respect to the FTC and European Commission investigations of a proposed joint venture. Finally, throughout my nearly 40 years in academia, one focus of my research has been on the incentives that drive the creation and dissemination of intellectual property, and the potential tension between the rights to exclude afforded by the intellectual property laws and the consumer benefits engendered by the widespread diffusion of intellectual property.1

II. Overview of Testimony

A. Assignment

4. In mid-2011, I was engaged by counsel for SoundExchange to assess the economic issues underlying application of the policy factors enumerated in 17 U.S.C. § 801(b)(1), which govern the determination of rates applicable to Sirius XM’s access to sound recordings. The license at issue in this proceeding provides Sirius XM with non-exclusive rights to broadcast to its subscribers digital performances of copyrighted sound recordings. This license is compulsory, by which I mean that sound recording copyright owners cannot withhold from Sirius XM access to sound recordings.

1 My curriculum vitae, which includes a complete list of my publications, is attached as Appendix 1.
5. To develop the conclusions that are discussed in the main body of my report, I relied on my experience in assessing pricing issues generally, as well as pricing of access to content across numerous industries (such as music, motion pictures, software, and cable television), the relevant economic literature, and my knowledge of the music industry. In addition, I reviewed and analyzed data pertaining to the royalty payments made by interactive audio mobile/portable subscription streaming services ("interactive subscription services") to record labels, as well as contracts between non-statutory services and the record labels. Finally, I conducted interviews with executives at the four major record companies who are centrally involved with the licensing of sound recordings to digital music distribution services.

B. Summary of Conclusions

6. The core economic principle underlying my work in this matter is that the section 801(b)(1) statutory criteria are most consistent with the development of a royalty rate that approximates the terms that would be reached by the parties in an unfettered marketplace setting, i.e., one free of the applicable compulsory licensing regime. Such a rate would reflect the value of sound recordings to Sirius XM subscribers, given the pricing and availability of other channels of distribution through which consumers are able to listen to music. It is reasonable to expect that a material portion of that value would flow to sound recording copyright holders inasmuch as music represents a critical element of satellite radio that attracts subscribers to the service.

7. I am aware of no direct evidence on what rates might be negotiated between Sirius XM and copyright holders in an arms’ length setting for access to a record company’s entire catalog of music for use on Sirius XM’s satellite radio service. This is so because, on the one hand, Sirius XM is assured access to the music content at a statutory rate, if the negotiations were to fail, and on the other hand, the record companies do not bargain individually with Sirius XM. Consequently, it is necessary to develop an appropriate benchmark that could serve as a basis for setting the required backstop rate for Sirius XM.
8. My analytical framework assesses which non-statutory channels of music distribution reasonably can serve as benchmarks for the rates agreed to between buyers and sellers in the absence of a regulatory backstop. These rates must be adjusted to account for relevant differences between satellite radio and the benchmark non-statutory services, in line with the governing statutory criteria, in order to estimate the outcome of voluntary negotiations between Sirius XM and sound recording copyright holders. My conclusion is that interactive subscription services represent the most suitable benchmark for purposes of estimating a rate schedule that should apply to Sirius XM’s licensing of digital sound recording performance rights.

9. Using interactive subscription services as the benchmark marketplace, I undertake several approaches to calculate appropriate rates for Sirius XM. The rates yielded by these approaches range from 22.32% to 32.5% of Sirius XM’s gross subscription revenues.

10. I develop the bases for these conclusions in the rest of this testimony.

III. The Economics Underlying the Section 801(b)(1) Criteria

A. Introduction

11. The following four policy objectives govern rate-setting for the blanket license at issue in this proceeding:

a. To maximize the availability of creative works to the public;

b. To afford the copyright owner a fair return for his creative work and the copyright user a fair income under existing economic conditions;

c. To reflect the relative roles of the copyright owner and the copyright user in the product made available to the public with respect to relative creative contribution, technological contribution, capital investment, cost, risk, and contribution to the opening of new markets for creative expression and media for their communication; and

d. To minimize any disruptive impact on the structure of the industries involved and on generally prevailing industry practices.
In my view, the relevant issue to examine with respect to these four policy objectives is whether their application compels adjustments to benchmark rates arrived at by the record companies and digital music distribution services through bargaining in unfettered marketplace settings. That is, the necessary first step is to identify comparable benchmark rates, and then to determine whether these rates require modification in light of application of the governing policy objectives in this proceeding dealing with satellite radio. As I discuss below, rates negotiated outside the shadow of regulation should satisfy the first three policy objectives.

12. With regard to the fourth objective, I understand that the relevant factors that may compel adjustment to the benchmark rates are analyzed extensively in the expert reports of Gregory Sidak and Thomas Lys, which are to be submitted simultaneously with my report. I note, however, that from the standpoint of economically sound competition policy, and not as a matter of legal interpretation of the statutory language, the fourth policy objective should be limited to a temporary facilitation of the ability of nascent and emerging services to gain consumer acceptance and potentially achieve an efficient scale of operation. By the same token, sound competition policy would not regard the fourth objective as advocating protection to an established service from the rigors of competition, either from existing services or from future entrants. Once a company achieves a material presence in the marketplace, as Sirius XM indubitably has, use of the fourth policy factor to reduce market-based rates should be considered only with extreme caution, and should never be used to shield the service at issue from the

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2 A Sirius XM presentation from 2010 characterizes the company as “the world’s largest pure-play audio entertainment company,” and “one of the few large media companies currently growing revenue and EBITDA.” (Sirius XM Board of Directors Meeting, February 2, 2010, at p. 5.) In terms of subscriber counts, Sirius XM outpaces DirecTV, Dish Network, Time Warner Cable, Charter, and Cablevision. (Id. at p. 8.) Similarly, a Morgan Stanley report from February 2011 indicates that Sirius XM “can sustain subscriber momentum.” (“Sirius XM Radio Inc., Sell-off on 2011 Guidance is Overdone, Reiterate OW,” Morgan Stanley, February 15, 2011, at p. 5.)
full rigors of vigorous marketplace competition. Doing so is likely to harm consumers and also impede (or deter) entry and expansion of rival services.

B. Objective One: To Maximize the Availability of Creative Works to the Public

13. There are no sound economic reasons to adjust market-based rates because of this statutory objective. A market-based rate fosters this objective because it provides copyright holders with incentives to create content, as reflected in the services’ (and, hence, consumers’) willingness and ability to pay for creative works; and it also gives service providers sufficient incentives to distribute content to the listening audience. Rates determined through voluntary negotiations in a competitive marketplace can be expected to meet these requirements: they will not be so low as to suppress the creative endeavors of copyright holders, nor will they be so high as to materially weaken the incentives of service providers to expand output and improve the quality of their services, to the ultimate detriment of consumers. Or stated differently, the first policy objective directs that licensing rates should be high enough to foster the creation of new content, but not so high as to jeopardize the forward-looking viability of a service that has gained acceptance among consumers in the marketplace.

14. At a minimum, based on Sirius XM’s own advertising of its service, it is reasonable to assume that music content accounts for a significant portion of the service’s overall value as perceived by the subscribers to the service. Consistent with this assumption, sound recording copyright holders should receive a

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3 To the extent that there is a “market failure” whereby some types of music are undersupplied, this market failure should not be remedied by the services “overpaying” for music.

4 To the extent that there is a “market failure” whereby some services cannot be provided profitably, this market failure should not be remedied by implicit “subsidies” from content providers.

substantial portion of the overall value of the satellite radio service, as reflected in its subscription prices.

15. Naturally, there are limits to the share of the service’s overall value that the record companies could extract through arms’ length bargaining. After all, Sirius XM’s elasticity of demand for sound recordings certainly is not zero. From here, two conclusions follow: first, the higher the licensing rates the stronger is the incentive for Sirius XM to increasingly shift its service away from music and towards non-music content; second, the higher are the licensing rates the more likely it is that Sirius XM would raise subscription prices, resulting in lower subscriber demand for the service and possibly lower payments to copyright holders. With that said, Sirius XM’s announced intention to increase prices in the first quarter of 2012 is consistent with the view that the demand for the service at current rates is sufficiently inelastic so that rising rates will neither discourage music programming nor divert sufficient volume of subscribers from the service to other venues, thereby reducing net revenues.6

16. The constraints mentioned above limit the rates that record companies would be able or willing to demand in individual negotiations with Sirius XM, even in the absence of the regulatory backstop. In the end, individually negotiated licensing rates should reflect the value of each label’s sound recordings repertoire, as well as Sirius XM’s expectations regarding each label’s ability to

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6 “Sirius XM Radio’s CEO Discusses Q3 2011 Results – Earnings Call Transcript,” Seeking Alpha, November 1, 2011 (Monthly price for Sirius XM Select packages to increase starting January 1, 2012 from $12.95 to $14.49. According to Mel Karmazin, the company’s CEO, the increase will “help us to accelerate revenue growth next year.”) The reason that Sirius XM is able to profitably raise its subscription rates stems from the expiration of the cap on its rates that was agreed to between the company and the FCC to secure the clearance of the merger between Sirius and XM, and that was subsequently extended by Sirius XM as a settlement of litigation. See Applications for Consent to the Transfer of Control of Licenses, XM Satellite Radio Holdings Inc. to Sirius Satellite Radio Inc., Memorandum Opinion and Order and Report and Order, 23 F.C.C.R. 12,348, 12,394-95 ¶¶ 107-08 (2008); Blessing v. Sirius XM Radio Inc., 2011 WL 3739024, No. 09 CV 10035(HB), 2011-2 Trade Cas. ¶ 77,579 (S.D.N.Y. Aug. 24, 2011).
generate value through future releases, and the pertinent constraints, including
competition among record companies. Because these same dynamics shape the
negotiations between record companies and service providers in other distribution
channels, the licensing rates voluntarily established in those channels provide
probative benchmarks for the licensing rates at issue in this proceeding.

17. It is also important to note that when negotiating rates with service
providers in a particular channel, record companies will take into account the
extent to which consumer purchases in that channel will divert (i.e., cannibalize)
purchases – hence record company licensing revenues – from other channels.\(^7\) In
their negotiations with service providers, record companies similarly would be
expected to factor-in the promotional effects, which reflect the extent to which the
distribution of music through a given channel tends to stimulate the overall
demand for music by consumers.

18. From this perspective, the pertinent issue to examine in this proceeding is
not the relative strength of these two effects with respect to satellite radio, but
rather whether the balance of the two effects differs materially from the selected
benchmark service(s). Based on the information available to date, I find no sound
basis on which to conclude that the balance of substitution and promotion effects
for satellite radio differs in any meaningful degree from the interactive
subscription services that I employ as the market-based benchmark to derive
appropriate rates for Sirius XM.\(^8\) Insofar as Sirius XM will present information or

\(^7\) As should be clear, lower licensing rates in a particular channel quite likely will lead to lower
retail prices and greater consumer demand for the service. Insofar as that demand represents a
substitution away from other channels in which applicable licensing rates are higher, record
companies would have legitimate concerns about the adverse impact on profitability arising from
lower rates in a given channel.

\(^8\) This view is consistent with my discussions with record label executives who expressed
substantially uniform opinions that the balance of substitution and promotional effects as between
satellite radio and interactive subscription services is not materially different. Both types of
service reasonably divert some consumer demand away from other channels, and similarly both

(footnote continued ...)
analysis purporting to demonstrate that the substitution and promotional effects of its service vis-à-vis interactive subscription offerings warrant a downward adjustment to the interactive subscription benchmark rates discussed below, I reserve the right to consider this evidence and to respond accordingly.

C. Objective Two: To Afford the Copyright Owner a Fair Return for His Creative Work and the Copyright User a Fair Income under Existing Economic Conditions

19. As a threshold matter, the notion of “fairness” in the abstract is not an objective that economic policy seeks to promote, if only because “fairness” is not a concept based in fundamental principles of economics. Of course, given an externally provided notion of “fairness,” economic analysis can offer guidance on how that goal can be achieved at the lowest resource cost to society. Setting this issue aside, one way to characterize a “fair” outcome from an economic perspective is to associate it with an outcome that results from the voluntary interactions of participants in effectively competitive markets, i.e., markets not distorted by undue exercise of monopoly power on the part of sellers or monopsony power on the part of buyers. From such a vantage point, a “fair” outcome would entail rates that are consistent with rates paid by services in other distribution channels that arise through market-based interactions.

20. Importantly, providing a copyright user with a “fair income” should not be interpreted as setting a guaranteed minimum rate of return for the copyright user. Given that the benchmark rates are established through voluntary transactions, and that the benchmark services are at this time active in the marketplace while paying those rates, there is no compelling economic reason to question the utility of those rates in the instant proceeding, unless there is a clear showing that the benchmark rates were elevated by the exercise of monopoly power. I have seen

(... footnote continued)

types of service expose some users to new music, and hence potentially stimulate demand in other channels.
no evidence to suggest that this is the case with respect to interactive subscription services, which I am putting forth as the appropriate benchmark, or with respect to other non-statutory distribution channels. Consequently, it is my view that observed rates paid to the record labels by interactive subscription services require no adjustment pursuant to the second policy objective. In fact, any downward adjustment would amount to a "subsidy" for Sirius XM, which would provide the company with an unwarranted competitive advantage relative to rival distributors of music content, and also dilute the incentives for the creation of new works and for the efficient transmission of music through new and emerging channels.

D. Objective Three: To Reflect the Relative Roles of the Copyright Owner and the Copyright User with Respect to Their Relative Creative and Technological Contributions, Cost, Risk, and Contribution to the Opening of New Markets for Creative Expression

21. As is the case with the first two objectives already discussed, achievement of the policy goals set out in the third objective are best accomplished with licensing rates consistent with those negotiated voluntarily in market-based settings. Effectively competitive markets do not ensure that participating firms are invariably able to earn normal rates of returns on their investments. This is especially true of investments that are sunk in the sense that they would not be recovered if the firm were to exit the business. At the same time, effectively competitive markets reward firms that have undertaken investments and other expenditures on products and services that consumers find attractive, given the availability of other options. Generally, firms will continue investing if the expected rate of return on these investments is higher than the firm’s cost of capital, taking into account the risks associated with the project. This is true for a firm like Sirius XM, which has made substantial investments in its distribution

infrastructure; firms like the record companies, which invest in their A&R (i.e., artists and repertoire), marketing and distribution chain; and recording artists, who invest their time and other resources to produce the content that is disseminated through various channels.

22. From this perspective, the relevant costs and risks translate into prices that the seller charges for its product or service. In a competitive market, no seller is assured that it will earn the risk-corrected, expected cost of capital. A service like Sirius XM may not be able to recover the costs of its satellite footprint (if its service does not attract enough demand); the record company may not recover the costs it expended on the artist and the recording (and it rarely does!); and the recording artist may never recover the opportunity cost of time devoted to producing a song (and many do not!). None of this means that rates should be set in such a manner as to ensure a risk-adjusted return on investment. If a market participant sinks resources into the provision of a product or service, no matter how “large” these might be, the marketplace will only reward those investments if the ultimate consumers find these products or services sufficiently attractive relative to the alternatives. No participant in the market should be required to ensure the success of any other participant, be it a nationwide satellite radio service or a fledgling recording artist producing songs in a basement. In fact, basic economics teaches that investments that are not generating enough in revenues should be “marked to market” and valued at their true economic value and not at their initial value.

23. There are several relevant considerations to address with respect to the third policy objective as it pertains to the fact that Sirius XM has substantial fixed (and possibly sunk) costs (such as those associated with the costs of satellites in particular) and was the first satellite radio service.

10 To the extent that Sirius XM’s satellites can be repurposed, the magnitude of its sunk costs is less than one would presume.
a. First, while Sirius XM's contributions (technological and to opening new markets for creative expression) and its costs are significant, it is important to recognize the contributions and costs of the record labels as no less significant, including the contributions and opportunity costs of performers who split statutory license fees with record companies. In particular, it would be wrong as a matter of sound economics and competition policy to assess the contributions and costs of the record labels solely on an incremental basis, i.e., to limit the analysis to the incremental contributions and costs associated with the distribution of music via Sirius XM. Indeed, the record companies undertake substantial and irreversible investments in development and promotion of artists that are designed to provide artists with strong incentives to create new sound recordings. Consideration of the third objective should not underestimate the massive and quite risky investments record labels make to identify new talent and to encourage the continuing productivity of existing artists.

b. Second, the sizable capital invested by Sirius XM to deploy new satellites and to maintain its network may suggest that the balancing of factors spelled out in the third objective should shift rates in favor of Sirius XM, i.e., in favor of a downward adjustment to rates obtained from market-based benchmarks. This would be wrong, however. First, consideration, if any, of a possible downward adjustment should account for the fact that the five-year time horizon over which licensing rates in this matter will be determined is substantially shorter than the useful physical life of Sirius XM's investments in its satellite network. Second, what is relevant for rates is the economic life and the rate at which the investment would depreciate in the competitive market. If the economic life is affected by competition from other services, there is no reason why rates should be set to assure a level of profitability that a competitive market would make unattainable. Third, it is my understanding that Sirius XM has no plans to launch additional satellites in the coming rate term. To the extent the Court finds the investment in satellites relevant, I believe that the issue

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11 See, e.g., “Sirius XM Radio’s CEO Discusses Q3 2011 Results – Earnings Call Transcript,” Seeking Alpha, November 1, 2011 (Noting the company “will have many years without the need for substantial satellite capital expenditures.”); “Sirius XM Board of Directors Meeting,” February 2, 2010, at p. 30 (Graphic showing “sharply reduced” satellite expenditures after 2011.).
appropriately is addressed under the rubric of the fourth policy objective.

c. Finally, Sirius XM is a distributor of music and non-music content. Moreover, while Sirius XM creates some original programming that it provides alongside the music (the so-called “wrapper”), it is beyond dispute that the music itself, and not the programming, represents the content that is absolutely essential for the service to be attractive to a sufficient number of consumers to make it even potentially economically viable. This is not to say that the programming expertise of Sirius XM is without value – it surely does have value, especially for the “lean-back” listeners. But it is also the case that the programming inputs paired with the music content would have no value if delivered in isolation, i.e., not accompanied by sound recordings. The inverse, however, does not hold: separate and apart from its transmission via satellite radio, music content has an established value in the marketplace in a variety of distribution channels.

E. Conclusion

24. In sum, the determination of licensing rates in this proceeding should begin with the identification of rates voluntarily negotiated between copyright holders (individual record companies) and service providers in unfettered market settings, i.e., in settings free of the compulsory licensing regime underlying the

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12 To be complete, the company does offer packages limited to news, sports, and talk programming (i.e., no music beyond incidental performances) and packages whose channel line-up is heavily weighted towards music. My understanding is that the vast majority of Sirius XM customers subscribe to a “blended” package, i.e., one whose channel line-up features a significant amount of both music and non-music programming. In a March 2011 conference call, Sirius XM’s CFO, David Frear, noted that there has been limited subscription to “Mostly Music” or “Mostly News, Sports & Talk.” According to Mr. Frear, customers are “used to a mix of music, talk, news and sports.” On the same call, Mr. Frear indicated that a limited number of Sirius XM’s customers (less than 30,000) subscribe to the company’s a la carte packages. From Mr. Frear’s comments, one can infer that Sirius XM’s customers, for the most part, subscribe to the one of the company’s “blended” offerings which include the Select and Premier packages.

13 In the parlance of the music industry, a “lean-back” is a “passive” customer who does not in any way interact with the channel. A “lean-forward” is an “active” customer who interacts with the supplier of music. There is a whole range of interactivity afforded by the plethora of distribution channels available in the U.S. today. And more are likely on the way.
instant proceeding. In my view, such rates satisfy the first three of the operative statutory objectives insofar as those objectives advocate consideration of factors that shape negotiations undertaken, and rates agreed to, in the absence of potential regulatory intervention.

25. With the foregoing discussion of the first three policy objectives as a backdrop, I now turn to my assessment of marketplace rates that support the reasonableness of the range of rates put forward by SoundExchange.

IV. Market-based Benchmark Rates

A. Introduction

26. The discussion in this section flows from the basic proposition that rates arising from voluntary transactions in a competitive marketplace free of regulatory overhang best advance the statutory policy objectives and promote the economic welfare of consumers, record companies, and distributors of music content. As such, rates negotiated in the absence of possible regulatory intervention are of significant probative value for purposes of setting appropriate licensing rates for the digital distribution of sound recordings by Sirius XM. More specifically, reasonable licensing rates to apply to Sirius XM’s transmission of music can be derived from the licensing rates found in modes of digital distribution other than satellite radio, after taking into account any economically relevant differences between satellite radio and other distribution channels that might impact the value of the music in the benchmark channel to consumers, as reflected in consumers’ willingness to pay for the service. The compelling benefit of a benchmark approach is that it is based on actual market outcomes that reflect the very same factors deemed relevant by the first three statutory criteria.

27. In addition to identification of comparable benchmark services, determination of reasonable benchmark royalty rates requires the selection of an appropriate rate structure, i.e., the particular mechanism with which licensing fees are calculated. Historically, the Court has exhibited a preference for a per-performance (i.e., per-listen/per-song transmitted) mechanism, reasoning that
intensity of usage most directly reflects the value of the licensed sound recording rights to the licensee (the service). I understand that implementation of a per-performance metric for satellite radio service is not feasible, for the simple reason that satellite radio transmission is one-way. That is, there is no listener data transmitted back to the satellite that would permit Sirius XM to collect the data required to administer the payment of royalties based on a per-performance metric.

28. Given that a usage-based metric cannot be readily calculated, the remaining potentially viable options are percentage-of-revenue and per-subscriber mechanisms. Neither metric represents a perfect proxy for usage, although I view a percentage of revenue mechanism as preferable because revenues, as a function of price, are related to usage insofar as subscribers' willingness to pay for a service is influenced by the subscriber's planned intensity of usage.\(^{14}\) While it is true that a percentage of revenue metric requires one to estimate the portion of the total value of the Sirius XM service that ought to be attributed to music, a per-subscriber metric would require the same determination.

29. I undertake several analyses to develop a range of reasonable licensing rates applicable to Sirius XM's use of sound recordings. First, I examine the licensing fees currently paid by interactive subscription services to the record companies. Such payments reflect license fees voluntarily negotiated by the parties, and as such represent an appropriate starting point for calculating rates in this proceeding, given the relevant policy objectives (see Section III). Second, the information enables me to calculate the percentages of total revenues represented by payments. Rates based on percentage of revenues do not require an adjustment to account for the interactivity of the benchmark service, as the value of such interactivity (and other attributes and functionalities of the service) is reflected in

\(^{14}\) And actual intensity of usage as well, insofar as a subscriber's expected usage in the future is based to some degree on historical usage.
subscription prices and in the overall attractiveness of the service, as measured by the number of subscribers. Thus, the service's gross revenues (which are a product of price and quantity) best capture its overall value of consumers. That is, while the particular attributes of the benchmark service will influence its retail price, and hence the pool of revenues against which licensing fees are calculated, these attributes do not require separate treatment for purposes of determining a percentage-of-revenue rate to apply to Sirius XM's revenues. This proposition is true not only as a theoretical matter, but is also reflected in the licensing agreements negotiated across digital music distribution services that are analyzed below and included in Table Two. This table shows the general clustering of, and consistently high, percentage-of-revenue rates for access to digital sound recording rights across different distribution channels.

30. However, it is necessary to adjust the benchmark rates to account for the fact that the Sirius XM service, unlike interactive subscription services, transmits both music and non-music content. This means that only a portion of Sirius XM's total subscription revenues can be attributed to the sound recordings. Once this adjustment is made, observed payments to the record labels by interactive subscription services, as percentages of the services' total gross revenues, yield "percentage of revenue rates" for Sirius XM between 30% and 32.5% for the 2013-2017 period.

31. Second, I tested whether the rates obtained through my investigation of rates for interactive subscription services reflect more generally the rates voluntarily negotiated between record companies and service providers across a variety of modes of digital distribution for music content. For this task, I and the staff working under my direction examined numerous licensing agreements between the record companies and services that are currently in place. As discussed below, the percentage of revenue rates stipulated in these licensing agreements cluster in a range that corroborates the reasonableness of the benchmark rates derived from interactive subscription services.
32. My third approach starts with the effective per-subscriber rates paid by interactive subscription services (i.e., actual licensing fees paid divided by subscriber counts) and then adjusts those rates to account for differences in attributes and functionality between interactive subscription services and satellite radio. I adjust for such differences by estimating the market price of a hypothetical music-only satellite radio offering and then compare that price to the subscription prices for interactive subscription services. Because price reflects the lower-bound of valuations that active subscribers attach to a service (given the content plus the service's characteristics and attributes), a comparison of prices yields a plausible metric with which to adjust per-subscriber rates in the interactive subscription services realm to an equivalent market-based per-subscriber rate applicable to Sirius XM, which can then be converted to an equivalent percentage-of-revenue rate.

B. Interactive Subscription Services as a Benchmark

33. Identification of a candidate benchmark marketplace should place heavy emphasis on the extent to which the service under consideration is comparable to satellite radio along the relevant dimensions, as well as on the ability to account for any material differences between them. In my view, interactive subscription services are comparable to satellite radio in key respects and thus are well-suited to serve as a benchmark service for purposes of determining reasonable rates in this proceeding.

34. On the seller side, both interactive subscription services and satellite radio require access to the same sound recording rights controlled by the same copyright holders. On the buyer side, Sirius XM's business model obviously differs from that deployed by providers of interactive subscription services, e.g., in terms of how music is transmitted to subscribers. However, what matters is that absent persuasive evidence to the contrary, there is no reason to expect that a hypothetical negotiation between Sirius XM and a major record label would culminate in a percentage-of-revenue rate that differs materially from the observed rates agreed to by the record companies and Microsoft, Rhapsody, and
other interactive streaming providers. For both Sirius XM and the interactive subscription services, sound recording rights are an essential input, which means that their demand for sound recording rights is derived from downstream consumer demand for the services. In both downstream markets, music content is distributed through a digital channel and is offered at monthly subscription prices that afford subscribers unlimited usage. In addition, both services provide subscribers with the ability to listen to music while “on the go”: satellite radio primarily delivers music content to consumers while traveling in their vehicles and mobile interactive subscription services provide subscribers with the ability to listen to music on mobile devices such as laptops, iPhones, and iPads.15

35. I, and the staff working under my direction, analyzed data on licensing fees paid by a number of interactive subscription services to each of the four major record companies – EMI, Sony, Universal Music Group, and Warner Music Group. In general, the licensing fee contracts of interactive subscription services are governed by a “greater-of” provision that calculates the license fees under separate per-play, per-subscriber, and percentage-of-revenue mechanisms. Such calculations for each label are done on a pro-rata basis according to the proportion of total songs played accounted for by each record company’s sound recordings catalog, e.g., if a label accounts for 20% of the music distributed on a service, the label’s licensing fees would be computed using 20% of the service’s revenues. Licensing fees ultimately owed by the service are equal to the largest fee amount calculated as among the operative metrics. Notably, the percentage-of-revenue mechanism is, in some cases, applied to a net revenue figure that equals gross revenues less certain carve-outs defined in the licensing agreement. Below, when I calculate actual licensing fees paid as a percentage of revenue, I use gross

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15 There are also “non-portable” interactive subscription services available to consumers. These command lower retail prices. These services allow for streaming only through a personal computer and are not included in my analysis.
revenues so as to capture the actual revenues received and thus to maintain consistency with my use of actual licensing fees paid.

36. In the table below, I report results for licensing fees paid to each of the four major record labels by a number of interactive subscription services, including well-established services like Microsoft Zune, Napster,\(^{16}\) and Rhapsody, and newer market entrants like Rdio and MOG.\(^{17}\) As shown, annual payments as a percentage of gross revenues generally range from 50% to 70%, and tend to cluster in a narrower range of 60% to 65%.\(^{18}\)

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17. My decision to include or exclude any given interactive subscription service was a function of the availability of royalty payment data and the relevance of the service. In particular, I excluded from Table One the following services, with a brief explanation for each included in parentheses: Altnet (Ringtone downloads bundled with streaming service), Classical Archives (Service limited to classical music sound recordings), iMesh (Unable to determine from Internet research the terms of iMesh subscription offering), MediaNet (Does not offer its own digital music service but rather provides a back-end platform for digital music distribution services [http://www.mndigital.com/services/]; Thumbplay (Recently acquired by Clear Channel and no longer active [http://www.thumbplay.com]; operated as a hybrid streaming/ringtone service). For Slacker Premium, because the service was introduced in May 2011 [http://www.slacker.com/company/pressreleases/05172011-Slacker-Premium.jsp], my calculations use royalty payment data from May 2011 and forward.

18. I start my analysis with data from July 2010 for two reasons. First, because the digital music distribution marketplace is highly dynamic, data used to develop estimates of reasonable rates should be relatively current and thus reflective of extant marketplace conditions. Second, and more specifically, I selected July 2010 as my starting point because a number of interactive subscription services implemented lower monthly prices in the first half of 2010 (or thereafter). See Amended and Corrected Testimony of Michael D. Pelcovits, Docket No. 2009-1, CRB Webcasting III, February 16, 2010, at p. 25, as compared to Table Four infra.
Table One: Royalty Payments by Interactive Subscription Services  
(as a percentage of gross revenues)  
(RESTRIC TED)

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<thead>
<tr>
<th>Label</th>
<th>Service</th>
<th>2H2010</th>
<th>2011</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>EMI</td>
<td>Napster Streaming + Mobile</td>
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<td></td>
<td>Rhapsody Limited Portable + Portable</td>
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<td>Zune Portable</td>
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<td>MOG</td>
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<td></td>
<td>Spotify Premium + Mobile</td>
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<td></td>
<td>Slacker Premium Service</td>
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<tr>
<td></td>
<td>Rdio Portable</td>
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<td>Sony</td>
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<td></td>
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<td>Slacker Premium Service</td>
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<tr>
<td></td>
<td>Rdio Portable</td>
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</tbody>
</table>

Source: Royalty payment data from EMI, Sony, Universal, and Warner.  
Note: All reported percentages are based on gross subscription revenues.

37. As noted earlier, to translate percentage of revenue payments by interactive subscription services into an equivalent rate for Sirius XM, it is necessary to account for the fact that unlike the all-music benchmark services, Sirius XM’s revenues are derived from the delivery of both music and non-music content. Estimation of the portion of total service value reasonably attributable to music is greatly aided by the fact that Sirius XM offers service packages that
essentially consist of non-music content (Sirius News, Sports & Talk\(^{19}\) and XM News, Sports & Talk\(^{20}\)) and service packages consisting mostly of music programming (Sirius Mostly Music\(^{21}\) and XM Mostly Music\(^{22}\)). Each of the Mostly Music packages provides access to a channel line-up heavily weighted towards music programming: approximately 80% of the channels are music channels.

38. At this time, the non-music and mostly-music packages are offered at identical prices – $9.99 per-month.\(^{23}\) The fact that the same price is charged for both types of service packages suggests that the marginal subscriber(s) to each of these packages values music and non-music content, respectively, at roughly equivalent levels.\(^{24}\) This finding has important implications for the various “blended” packages (i.e., packages whose channel line-ups prominently feature

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\(^{19}\) http://www.SiriusXM.com/subscriptions/packages/sirius/newssportstalk.


\(^{22}\) http://www.SiriusXM.com/subscriptions/packages/xm/mostlymusic.

\(^{23}\) It is my understanding that at least some Mostly Music subscribers are required to pay a monthly Music Royalty Fee (MRF) of $1.40. At this point, I do not have data on the pervasiveness with which the MRF is imposed. Pending discovery on the extent to which Mostly Music subscribers pay a $1.40 MRF on top of the $9.99 monthly subscription price, it may be appropriate to add the MRF to the subscription price for purposes of estimating the relative value of music content.

\(^{24}\) For purposes of estimating the portion to the total value of satellite radio attributable to music content, it is most appropriate to focus on the marginal consumer, i.e., the consumer for whom the value of music is just equal to the price of the service. Infra-marginal subscribers value music more highly than marginal subscribers, of course. Hence the average valuation of music by all the subscribers to the mostly-music service is higher (and can be substantially higher) than the marginal valuation. Furthermore, if one reasonably assumes a uniform distribution of tastes across consumers, for both music and non-music content, the identical prices of Sirius XM’s non-music and mostly music packages suggest that consumers, on average, value music and non-music content equivalently. That is, the average valuation of music among consumers who value non-music at $X/month is the same as the valuation of non-music among consumers who value music at $X/month.
both music and non-music content) to which, it is my understanding, all but a small fraction of Sirius XM’s customers subscribe. In particular, for packages that combine a substantial amount of both music and non-music content, it is reasonable to estimate that the music content, for the average marginal subscriber, accounts for one-half of the service’s total value. Consequently, the percentage-of-revenue rates obtained from the benchmark all-music interactive subscription services, when applied to Sirius XM, need to account for the fact that Sirius XM’s service revenues are generated by and large from subscription packages that combine music and non-music programming.

To illustrate the mechanics of the calculation, start with the monthly price of $12.95 for Sirius XM’s Select packages, which represent the opening price point for the company’s menu of “blended” offerings. Applying the range of percentage-of-revenue rates obtained from the interactive subscription services benchmark yields a per-subscriber royalty payment on the Select packages of between $7.77 (0.60 * $12.95) and $8.42 (0.65 * $12.95). Based on the estimated 50% proportional value that music content contributes to the Sirius XM service, an equivalent range of royalty payments for Sirius XM is obtained by taking 50% of the benchmark figures. Doing so yields a range of $3.885 ($7.77 * 0.50) to $4.21 ($8.42 * 0.50). Finally, dividing these figures by the $12.95 monthly price for the Select packages generates a range of percentage-of-revenue rates of 30% ($3.885/$12.95) to 32.5% ($4.21/$12.95). To be clear, these rates should be applied to Sirius XM’s total subscription revenues rather than the portion of the company’s revenues reasonably attributable to music content. This follows

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25 Supra note 12.

26 As a general proposition, a percentage-of-revenue metric has two critical components—the percentage rate and the revenue base against which that rate is applied to determine licensing fees. Importantly, these two components should be assessed jointly, as they are in this report. In particular, because my derivation of a percentage rate takes account of the fact that only a portion of Sirius XM’s total subscription revenues is attributable to music content, that rate should be applied to the company’s total subscription revenues.
because the halving of the benchmark rates already accounts for the estimated portion of total value (50%) attributable to Sirius XM’s provision of non-music programming.

40. The Mostly Music packages do include non-music channels, and consequently, insofar as these channels are assigned positive value by subscribers to the Mostly Music package, one would need to adjust downward the estimate that music represents one-half the total value of the satellite radio service. Alternatively, if one believes that the marginal consumer would pay $9.99 per-month for the Mostly Music package even if the non-music channels were not included, then no downward adjustment would be necessary. Moreover, the imposition of the U.S. Music Royalty Fee on at least some customers who receive subscriptions that feature music content could require an upward adjustment. Relatedly, implementation of the recommended range of percentage of royalty rates may need to account for the breakdown of Sirius XM subscribers across its menu of programming packages.27 With that said, given the earlier noted statements of David Frear, Sirius XM’s CFO, that only a small fraction of Sirius XM customers subscribe to the company’s “non-blended” offerings, specific accounting for these offerings is unlikely to have a material impact on the range of rates recommended in this report.

C. Other Modes of Digital Music Distribution as Corroborative Evidence

41. To ensure the robustness of the rates determined from the interactive subscription services benchmark, I analyzed marketplace rates negotiated for several additional well-established distribution channels for digital music. In the

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27 Sirius XM’s additional subscription offerings, including Sirius Select and XM Select and the Premier packages, offer a large number of channels not available on either the Mostly Music or News, Sports & Talk packages. Some of these additional channels are music and some are non-music. Some are available only if a subscriber adds the $2.99 Internet listening feature and some are not available online even with the add-on. But there is nothing to suggest from the channel lineups of the various packages that my estimation of a 50-50 split in value between music and non-music content for the average marginal subscriber is unreasonable.
table below, I present percentage of revenue rates found in the licensing agreements between the major record companies and digital music distributors. The figures in the table reflect rates that currently govern record companies' compensation under a sampling of recent agreements.

Table Two: Contractual Percentage-of-Revenue Rates

<table>
<thead>
<tr>
<th>Product</th>
<th>% of Gross Revenue Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Permanent Audio Download</td>
<td>70%</td>
</tr>
<tr>
<td>Cellular (Ringtone/Ringback)</td>
<td>45% - 50%</td>
</tr>
<tr>
<td>Interactive Subscription (Non-Portable)</td>
<td>50% - 65%</td>
</tr>
</tbody>
</table>

Source: Licensing agreements between four major record companies and service providers. The specific agreements summarized in the table are set forth in Appendix 2.

42. As the table illustrates, across services built around the digital distribution of sound recordings to consumers, copyright holders consistently earn a substantial percentage of distributors' gross revenues. These high percentages reflect the fact that access to music content represents the core and indispensable element of these services.

43. The consistency of rates found in the contract data is hardly surprising, insofar as services across modes of digital music distribution are substitutes for one another, albeit likely to varying degrees. The average daily consumption of music by consumers necessarily is limited, which means that increased listenership in one channel diverts some of the time spent listening to music through other channels. Thus, insofar as digital music distribution channels are substitutes, a reasonable expectation is that sound recording copyright holders would seek to garner roughly comparable percentages of the value of music content to consumers (as reflected in the prices, and thus the revenues, of the various services). While the quantum of value differs across services, such differences reflect the mode of distribution and other pertinent attributes, and are captured in retail prices. The observed consistency of percentage-of-revenue rates across distribution channels is consistent with this view.
V. Per-Subscriber Rates from Interactive Subscription Services as Benchmarks

A. Introduction
44. As already discussed, it is my opinion that benchmark “percentage-of-revenue” rates represent the most appropriate basis on which to derive plausible market-based rates for licensing of sound recordings to Sirius XM. This is the case because revenues are a direct function of prices, which in turn reflect the value consumers in the aggregate place on the various attributes and functionalities provided by any given service. For example, if consumers in the aggregate reduce their valuation of the functionalities offered by one service relative to another service, we would expect the price of the now less desirable service to fall, all else remaining the same. Stated another way, for consumers who are just indifferent between subscribing to one service versus another, the relevant prices fully capture the influence of all the relevant factors on the valuation of the two services. Thus, by using percentage-of-revenue rates, one avoids the need to adjust benchmark rates to account for differences in characteristics between the benchmark service – here interactive subscription services – and satellite radio. Simply stated, prices reflect such differences, as perceived by consumers, which means, in turn, that rates based on percentage of revenues also will reflect such differences, given that the “music” – understood as an input – is the same.

45. Nevertheless, one could, as part of the rate determination exercise, attempt to account directly for differences in service attributes as between satellite radio and interactive subscription services. There are econometric techniques that could be used on the available data for that purpose. For example, because retail prices effectively capture the marketplace value marginal consumers place on the collection of characteristics and functions that define any given service, ratios of retail prices can serve as a useful estimate of the difference in value between the
features and capabilities of one service versus another to marginal consumers. In addition, if one can identify two services that are essentially identical save for one feature, e.g., interactivity vs. non-interactivity, retail prices of the two services offer meaningful insight into the incremental value interactivity adds to a service.

B. Ratio of Retail Prices for Sirius XM and Interactive Subscription Services to Account for Differences in the Two Services

With this discussion as a backdrop, I now offer two alternative estimates of market-based rates for the licensing of sound recordings to Sirius XM. The starting point for each approach is the actual per-subscriber rates paid by a number of interactive subscription services, i.e., actual monthly licensing fees paid divided by the monthly subscriber counts. The rates presented in the Table Three below yield an unweighted average monthly rate of $5.95 per-subscriber.

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28 In other words, insofar as consumers derive greater (or lesser) value from a certain collection of attributes, a service with these attributes will command a premium (or require a discount) in the marketplace, as reflected in retail prices to consumers.

29 In determining the services to include in the following analysis, I focused primarily on the subscription services that currently are offered to new subscribers. The one exception is Napster Streaming + Mobile, which, as a result of Rhapsody’s purchase of Napster, is no longer offered, but still maintains a meaningful number of subscribers. Moreover, I excluded from the following analysis those services that bundle other platforms, such as permanent downloads or mobile phone ringtones, with an interactive streaming service for one price. I also excluded those services that permit streaming to more than one mobile device for a single subscription fee.

30 A comparison of Tables One and Three reveal two differences in terms of the services presented, specifically the exclusion of Zune and Rhapsody Portable from Table Three. In the case of Zune (which until recently featured an interactive subscription service that included a limited number of download credits), licensing fees for the applicable time period are calculated according to an allocation scheme that assigns a portion of revenues and subscribers to the streaming component of the service and another portion to the download credits. The mechanics of the allocation scheme do not impact the percentage-of-revenue calculations, but they do serve to artificially reduce the actual per-subscriber rates to levels substantially below those observed for the interactive subscription services listed in Table Three. That is, the allocation scheme results, in my view, in an understatement of the actual per-subscriber rates paid by Microsoft because it assigns a disproportionate amount of the service's subscribers and revenues to the download component. In particular, the download component is allocated a portion of revenues (footnote continued ...)
Table Three: Actual Royalty Payments Per-Subscriber
(RESTRICTED)

<table>
<thead>
<tr>
<th>Label</th>
<th>Service</th>
<th>2H2010</th>
<th>2011</th>
<th>Total</th>
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<tbody>
<tr>
<td>EMI</td>
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<td>Spotify Premium + Mobile</td>
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<td>Slacker Premium Service</td>
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<td>Rdio Portable</td>
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<td>Rhapsody Limited Portable</td>
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<td></td>
<td>Rdio Portable</td>
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Source: Royalty payment data from EMI, Sony, Universal, and Warner.

47. In order to develop from this $5.95 monthly per-subscriber rate an equivalent monthly per-subscriber rate for Sirius XM, it is necessary to account for the different features and functions embodied in each service. In many important respects, the two services are quite similar. They both (i) distribute digital music content to consumers, (ii) employ subscription models that provide and subscribers that appears to be based on an expectation that all download credits will be redeemed, but as the royalty statements make clear, this has not been the case. With respect to Rhapsody Portable, the service allows subscribers to stream music to multiple mobile devices. The services included in Table Three uniformly allow streaming to a single mobile device, and thus to maintain consistency, Rhapsody Portable is not included. For purposes of Table One, which again focuses on license payments as a percentage of revenue, the particular features, and resulting higher monthly price, of Rhapsody Portable are not, in my view, material grounds for its exclusion. And in any case, its exclusion would not compel any alteration to my conclusions.

(... footnote continued)
unlimited access to content, (iii) are mobile, and (iv) provide immediate access to content, i.e., neither service requires a subscriber to download content prior to listening.

48. Interactivity is one important dimension along which the two services differ. While interactive subscription services afford consumers complete control over the music to which they listen, subscribers to satellite radio control the delivery of music only to the extent that they can choose from a broad range of channels, some of which focus on a particular narrow genre of music.\(^{31}\) This is not to say that the two services are otherwise identical. For example, there are differences in audio quality and in availability of transmissions (e.g., Sirius XM’s satellite coverage offers availability almost anywhere in the United States, while mobile streaming services require access to a high-speed wireless network). Moreover, while each service offers mobility in a general sense, its specific form differs: satellite radio primarily provides in-vehicle mobility while interactive subscription services provide mobility in the sense that users can enjoy the service on a mobile device with an Internet connection. It is theoretically possible that there is no meaningful difference in value between the two forms of mobility, but there is no \textit{a priori} reason why this has to be the case.

49. My first approach to adjusting actual per-subscriber rates paid by interactive subscription services (i.e., licensing fees divided by total subscribers) utilizes a method of adjustment that incorporates all differences in attributes and functionality as between satellite radio and the benchmark marketplace. In other words, its underlying premise is that material differences between the two services are not limited to interactivity. A reasonable estimate of the value differential between the two services, taking account of the collection of features and functions that define each service, can be obtained by comparing their retail prices.

\(^{31}\) Interactive services also generally offer radio-like functionality as part of their offering.
50. To do so first requires an estimate of the retail price for a hypothetical music-only satellite radio service, because unlike satellite radio, interactive subscription services offer access to music content only. As noted already, Sirius XM offers “Select” packages that represent the opening price point for offerings that bundle together music and non-music content. Currently, subscribers to the “Select” packages are charged $12.95 per-month. Based on my earlier estimate that music content accounts for roughly one-half of the overall value of the Sirius XM service, the price of a hypothetical music-only satellite radio service reasonably can be estimated as 50% of $12.95, or $6.475.

51. In Table Four below, I present monthly retail prices for the interactive subscription services listed in Table Three. These data show a uniform monthly retail price of $9.99.


33 As noted earlier, Sirius XM has announced its intention to increase, starting January 1, 2012, the monthly price of Select packages to $14.49.

34 The applicability of the Music Royalty Fee to this hypothetical music-only service offering could also increase the price. Without more information as to the prevalence of the Fee, however, I have excluded it from the current calculations.

35 Based on a review of other interactive services operating in the marketplace, it appears that $9.99 is the prevailing price for a subscription interactive service that allows for streaming to one mobile device. A number of these services have entered the market too recently to have generated sufficient data to be included in Table Three.
Table Four: Monthly Prices for Interactive Subscription Services

<table>
<thead>
<tr>
<th>Service</th>
<th>Monthly Retail Price</th>
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<tbody>
<tr>
<td>Mog Primo</td>
<td>$9.99</td>
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<td>Rdio Unlimited</td>
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<td>Rhapsody Premiere</td>
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<td>Slacker Premium Radio</td>
<td>$9.99</td>
</tr>
<tr>
<td>Spotify Premium</td>
<td>$9.99</td>
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</tbody>
</table>

Source: Service websites

Using a monthly retail price of $9.99 for interactive subscription services, the ratio yielded by a comparison of this price and the estimated $6.475 monthly price for a hypothetical music-only satellite radio service is $6.475/$9.99, or 64.81%. This percentage, when applied to the actual per-subscriber rate of $5.95 calculated from data on the licensing fees paid by interactive subscription services to the four major record companies, results in an equivalent per-subscriber rate of ($5.95 * .6481), or $3.86 for a hypothetical Sirius XM music-only service.

The final step in this analysis is to convert the estimated per-subscriber rate for a hypothetical Sirius XM music-only service into an equivalent percentage-of-revenue rate. This is accomplished by finding the ratio of the estimated monthly per-subscriber rate ($3.86) and the monthly retail price paid by subscribers to Sirius XM’s Select packages. As noted above, that monthly retail price is equal to the subscription price of $12.95. ³⁶ Thus, the estimated monthly per-subscriber rate for a hypothetical Sirius XM music-only service yields a percentage-of-revenue rate of ($3.86/$12.95), or 29.81%. Importantly, because the numerator reflects a music-only service while the denominator reflects the retail price for a service that combines music and non-music content, the resulting rate appropriately is applied against Sirius XM’s total subscription revenues. That

³⁶ I again note the potential applicability of the monthly $1.40 Music Royalty Fee as relevant to the value of music on Sirius XM and the overall subscription price.
is, application of the rate does not require any further adjustment to Sirius XM’s subscription revenues to account for the estimated portion reasonably attributable to the distribution of non-music content.

C. Accounting Specifically for Interactivity of Benchmark Streaming Services vs. Non-Interactivity of Satellite Radio

53. My second approach is similar in concept to the first, but differs as a practical matter in that it assumes interactivity represents the only non-trivial difference between interactive subscription services and satellite radio, i.e., the only difference that is sufficiently material to warrant an adjustment. This approach, in my view, is the most conservative of those presented in this report (i.e., it generates a lower-bound estimate of reasonable rates) insofar as it ignores other differences between the two types of service that would support imposition of higher rates. In particular, as demonstrated below in a comparison of retail prices for interactive and non-interactive subscription services, which effectively isolates interactivity as the only difference of any consequence, the addition of interactivity increases the value of the service by roughly 2.1 times. The fact that this ratio is substantially greater than the ratio of retail prices for interactive subscription services and satellite radio strongly suggests that there are other differences between the two services that influence their relative values to consumers. In other words, accounting only for interactivity leads to a downward adjustment of benchmark rates that quite likely overstates the extent to which the average marginal consumer values interactive subscription services more highly relative to a hypothetical music-only satellite radio offering.

54. A reasonable estimate of the incremental value of interactivity can be developed by comparing the retail prices of two services – interactive and non-interactive subscription streaming services – that are distinguishable only with respect to interactivity. The table below presents a summary of monthly retail prices for non-interactive subscription services. A simple average of the reported monthly prices is $4.86.
Table Five: Monthly Prices for Non-Interactive Subscription Services

<table>
<thead>
<tr>
<th>Service</th>
<th>Monthly Retail Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pandora One</td>
<td>$3.00</td>
</tr>
<tr>
<td>Last.fm</td>
<td>$3.00</td>
</tr>
<tr>
<td>Live365 VIP Annual/6-month/3-month</td>
<td>$5.95/$6.95/$7.95</td>
</tr>
<tr>
<td>Musicover Premium Annual/3-month</td>
<td>$4.00/$5.00</td>
</tr>
<tr>
<td>Sky.fm Premium 2-year/Annual/Monthly</td>
<td>$3.71/$4.08/$4.99</td>
</tr>
</tbody>
</table>

Source: Service websites

55. A reasonable estimate of the incremental value of interactivity can be obtained by comparing the average monthly price of non-interactive subscription services, reported above as $4.86, and the earlier reported average monthly price for interactive subscription services of $9.99. The ratio of these two prices, .4865 ($4.86/$9.99), provides the adjustment factor to apply to the actual monthly per-subscriber rate of $5.95 for interactive subscription services in order to estimate an equivalent rate for satellite radio, which is being treated as a non-interactive service. In other words, under the assumption that interactivity is the only material difference between interactive subscription services and satellite radio, the actual monthly licensing fees per-subscriber paid by interactive subscription services is adjusted by the factor .4865 to derive an equivalent monthly per-subscriber rate for Sirius XM. This calculation yields a monthly per-subscriber rate of $2.89 (.4865 * $5.95).

56. The final step is to convert the monthly $2.89 per-subscriber rate into a percentage-of-revenue rate. As before, this is accomplished by dividing $2.89 by the $12.95 monthly charge paid by subscribers to Sirius XM’s Select packages, which results in a percentage-of-revenue rate of 22.32%.

D. Conclusion

57. The table below summarizes the range of percentage-of-revenue rates generated by the several alternative approaches discussed in my report.
Table Six: Summary of Reasonable Percentage-of-Revenue Rates for Sirius XM

<table>
<thead>
<tr>
<th>Approach</th>
<th>% of Revenue Rate(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Actual Licensing Fees as % of Gross Revenues (Interactive Subscription Services)</td>
<td>30% - 32.5%</td>
</tr>
<tr>
<td>Actual Licensing Fees Per-Subscriber (Interactive Subscription Services), adjusted by ratio of Monthly Price for Hypothetical Music-Only Satellite Radio Service and Average Monthly Price across Interactive Subscription Services</td>
<td>29.81%</td>
</tr>
<tr>
<td>Actual Licensing Fees Per-Subscriber (Interactive Subscription Services), adjusted by ratio Average Monthly Price for Non-Interactive Subscription Services and Average Monthly Price for Interactive Subscription Services</td>
<td>22.32%</td>
</tr>
</tbody>
</table>

In sum, the range of rates developed in this report support the reasonableness of the rates advocated by SoundExchange, and indeed, if anything, reinforce the conservative nature of SoundExchange’s rate proposal.
I declare under penalty of perjury that the foregoing is true and correct.

Date: 11/28/2011

[Signature]

Janusz A. Ordover
Curriculum Vitae of Dr. Janusz A. Ordover

JANUSZ ALEKSANDER ORDOVER

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New York University       Fax: (212) 995-3932
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New York, New York 10012       Mobile: (917) 815-4756
e-mail: jao@snet.net
                                                janusz.ordover@nyu.edu

EDUCATION

Graduate Department of Economics and European Institute of the School of International
Affairs, Ph.D. 1973

1967-1968 McGill University, Montreal, Canada
Departments of Economics and Political Science

1963-1966 Warsaw University, Warsaw, Poland

HONORS

1973 Columbia University: Highest distinction for the doctoral dissertation

1971-1972 Columbia University: Honorary President's Fellow

1969-1971 Columbia University: President's Fellow

1967-1968 McGill University: Honors Student

1964, 1965 Warsaw University: Award for Academic Achievement, Department of Political Economy

Who's Who in the World
Who's Who in America
Who's Who in the East
“Economist of the Year” 2010, Global Competition Review

PROFESSIONAL EXPERIENCE

June 1982 - Professor of Economics
present         Department of Economics, New York University, New York, New York

Sept. 1996 -  Director of Masters in Economics Program

Summer 1996-   Lecturer
2000          International Program on Privatization and Reform
              Institute for International Development, Harvard University, Cambridge, Massachusetts

Aug. 1991 -    Deputy Assistant Attorney General for Economics
Oct. 1992      Antitrust Division
United States Department of Justice, Washington, D.C.

Sept. 1989 -   Visiting Professor of Economics
July 1990      School of Management, Yale University, New Haven, Connecticut

Lecturer in Law
Yale Law School

Mar. 1984 -    Visiting Professor of Economics
June 1988      Universita Commerciale "Luigi Bocconi", Milan, Italy

June 1982 -    Director of Graduate Studies
Feb. 1985      Department of Economics, New York University

Sept. 1982 -   Adjunct Professor of Law (part-time)
June 1986      Columbia University Law School, New York, New York

Feb. 1982 -    Acting Director of Graduate Studies
June 1982      Department of Economics, New York University

June 1978 -    Associate Professor of Economics
June 1982      Department of Economics, New York University

Sept. 1979 -   Lecturer in Economics and Antitrust
May 1990       New York University Law School

Sept. 1977 -   Member, Technical Staff
June 1978      Bell Laboratories, Holmdel, New Jersey

Associate Professor of Economics
Columbia University

Visiting Research Scholar
Center for Law and Economics, University of Miami, Miami, Florida

Sept. 1973 -   Assistant Professor of Economics
Aug. 1977      New York University

Summer 1976    Fellow, Legal Institute for Economists,
                Center for Law and Economics, University of Miami
Summer 1976  Visiting Researcher Bell Laboratories, Holmdel, New Jersey

OTHER PROFESSIONAL ACTIVITIES

2010 – present  Member, ABA Section of Antitrust Law, Economics Task Force

2006 - present  Special Consultant, Compass Lexecon (formerly Compass)/FTI Company, Washington, D.C.

2003 - 2006  Director, Competition Policy Associates, Inc. (“Compass”), Washington, D.C.


1997 – present  Board of Editors, Antitrust Report


1998 – 2004  Senior Consultant
Applied Economic Solutions, Inc., San Francisco, California

1995 - 2000  Senior Affiliate
Cornerstone Research, Inc., Palo Alto, California

various  Testimony at Hearings of the Federal Trade Commission

1994 - 1996  Senior Affiliate
Law and Economics Consulting Group, Emoryville, California

1994 - 2000  Senior Affiliate
Consultants in Industry Economics, LLC, Princeton, New Jersey

1993 - 1994  Director
Consultants in Industry Economics, Inc., Princeton, New Jersey

1992 - 1993  Vice-Chair (*pro tempore*)
Economics Committee, American Bar Association, Chicago, Illinois

1990 - 1991  Senior Consultant

1991  Member
*Ad hoc* Working Group on Bulgaria's Draft Antitrust Law
The Central and East European Law Initiative
American Bar Association

1990 - 1991  Advisor
Polish Ministry of Finance and Anti-Monopoly Office
Warsaw, Poland

1990 - 1991  Member
Special Committee on Antitrust
Section of Antitrust Law, American Bar Association
1990 - 1991  Director and Senior Advisor  
Putnam, Hayes & Bartlett, Inc., Washington, D.C.

1990 - 1996  Member  
Predatory Pricing Monograph Task Force  
Section of Antitrust Law, American Bar Association

1989  Hearings on Competitive Issues in the Cable TV Industry  
Subcommittee on Monopolies and Business Rights of the Senate Judiciary Committee  
Washington, D.C.

1989  Member  
EEC Merger Control Task Force, American Bar Association

1988 - present  Associate Member  
American Bar Association

1987 - 1989  Adjunct Member  
Antitrust and Trade Regulation Committee, The Association of the Bar of the City of New York

1984  Speaker, "Industrial and Intellectual Property: The Antitrust Interface"  
National Institutes, American Bar Association, Philadelphia, Pennsylvania

1983 - 1990  Director  
Consultants in Industry Economics, Inc

1982  Member  
Organizing Committee  
Tenth Annual Telecommunications Policy Research Conference, Annapolis, Maryland

1981  Member  
Section 7 Clayton Act Committee, Project on Revising Merger Guidelines  
American Bar Association

1980  Organizer  
Invited Session on Law and Economics  
American Economic Association Meetings, Denver, Colorado

1978 - 1979  Member  
Department of Commerce Technical Advisory Board  
Scientific and Technical Information Economics and Pricing Subgroup

1978 – present  Referee for numerous scholarly journals, publishers, and the National Science Foundation

MEMBERSHIPS IN PROFESSIONAL SOCIETIES

American Economic Association  
American Bar Association
PUBLICATIONS

A. Journal Articles


"Redistributing Incomes: Ex Ante or Ex Post," Economic Inquiry, April 1981, 333-349.


B. Books and Monographs


Predatory Pricing, with William Green, et al., American Bar Association, Section of Antitrust Law, Monograph 22, 1996.

C. Book Chapters


D. Other Publications


"Poland: The First 1,000 Days and Beyond," Economic Times, vol. 3, no. 9, October 1992, 6-7.


"Herfindahl Concentration Index," with R.D. Willig, Memorandum for ABA Section 7 Clayton Act Committee, Project on Revising the Merger Guidelines, March 1981.


UNPUBLISHED PAPERS


GRANTS RECEIVED


Regulation of Economic Activity Program, National Science Foundation, Microeconomic Analysis of Antitrust Policy, Principal Investigator, April 1, 1983 - March 31, 1984.
Economics Division of the National Science Foundation, "Political Economy of Taxation," Principal Investigator, Summer 1982.

Sloan Workshop in Applied Microeconomics (coordinator), with W.J. Baumol (Principal Coordinator), September 1977 - August 1982.

Economics Division of the National Science Foundation, "Collaborative Research on the Theory of Optimal Taxation and Tax Reform," July 1979 to September 1980, with E.S. Phelps.


National Science Foundation Institutional Grant to New York University for Research on Taxation and Distribution of Income, Summer 1974.
## Appendix II

### Digital Audio Transmission Agreements

<table>
<thead>
<tr>
<th>Licensor</th>
<th>Licensee</th>
<th>Effective Date</th>
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<td>Guvera</td>
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<tr>
<td>EMI</td>
<td>MOG</td>
<td>08/14/09</td>
</tr>
<tr>
<td>EMI</td>
<td>Rdio</td>
<td>05/13/10</td>
</tr>
<tr>
<td>EMI</td>
<td>Rhapsody</td>
<td>04/01/10</td>
</tr>
<tr>
<td>SONY</td>
<td>Dada Entertainment</td>
<td>06/24/09</td>
</tr>
<tr>
<td>SONY</td>
<td>Spotify</td>
<td>01/19/11</td>
</tr>
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<td>UMG</td>
<td>Alltel</td>
<td>11/20/06</td>
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<td>UMG</td>
<td>Boost (Nextel)</td>
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<td>UMG</td>
<td>Claro</td>
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<td>UMG</td>
<td>ClearSky</td>
<td>08/11/06</td>
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<tr>
<td>UMG</td>
<td>Cricket Communications</td>
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<td>UMG</td>
<td>Gbox (Ika Navio)</td>
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<td>MCNE</td>
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<td>UMG</td>
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<td>Mobile Streams</td>
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<td>MOG</td>
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<tr>
<td>WMG</td>
<td>MyPlay Direct</td>
<td>03/24/10</td>
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<td>02/03/10</td>
</tr>
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<td>WMG</td>
<td>Myxer</td>
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<tr>
<td>WMG</td>
<td>Rdio</td>
<td>05/01/10</td>
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<tr>
<td>WMG</td>
<td>Rdio</td>
<td>03/15/10</td>
</tr>
<tr>
<td>WMG</td>
<td>Service Provider</td>
<td>Date</td>
</tr>
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<td>-------</td>
<td>------------------------</td>
<td>------------</td>
</tr>
<tr>
<td>WMG</td>
<td>Sprint Spectrum</td>
<td>10/03/05</td>
</tr>
<tr>
<td>WMG</td>
<td>Sprint Spectrum</td>
<td>01/11/05</td>
</tr>
<tr>
<td>WMG</td>
<td>Sprint Spectrum</td>
<td>12/04/03</td>
</tr>
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<td>T-Mobile</td>
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<td>Verizon Wireless</td>
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<tr>
<td>WMG</td>
<td>Virgin Mobile</td>
<td>05/21/10</td>
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</table>
Before the
UNITED STATES COPYRIGHT ROYALTY JUDGES
Washington, D.C.

In the Matter of:
Determination of Rates and Terms for
Preexisting Subscription Services and
Satellite Digital Audio Radio Services

Docket No. 2011-1
CRB PSS/Satellite II

TESTIMONY OF

THOMAS Z. LYS

Eric L. Kohler Chair in Accounting and Professor of Accounting and Information
Management, Kellogg School of Management, Northwestern University

Witness for SoundExchange, Inc.
Table of Contents

I. INTRODUCTION .................................................................................................................. 1
A. QUALIFICATIONS .................................................................................................................. 1
B. STATEMENT OF THE ASSIGNMENT .................................................................................. 2
C. SUMMARY OF CONCLUSIONS .............................................................................................. 3
D. ORGANIZATION OF THIS REPORT ..................................................................................... 3

II. BACKGROUND ................................................................................................................... 4
A. THE PARTIES ......................................................................................................................... 4
   1. SoundExchange .................................................................................................................. 4
   2. Sirius XM ............................................................................................................................ 4
B. COMPETITION ...................................................................................................................... 5

III. FINANCIAL PERFORMANCE OF SIRIUS XM ................................................................. 7
A. REVENUE ............................................................................................................................... 8
   1. Subscribers .......................................................................................................................... 10
   2. Products and Pricing ........................................................................................................... 12
B. EXPENSES ........................................................................................................................... 16
   1. Historical Expenses ............................................................................................................. 16
   2. Forecasted Expenses .......................................................................................................... 17
C. FREE CASH FLOW AND EBITDA ......................................................................................... 18

IV. METHODOLOGY AND RESULTS ....................................................................................... 21
A. ECONOMIC DEFINITION OF “DISRUPTION” ...................................................................... 21
B. RESULTS OF ROYALTY ANALYSIS ...................................................................................... 24
C. RISK ANALYSIS .................................................................................................................... 30
   1. Sirius XM’s debt obligations ............................................................................................... 30
   2. Equity investor assessment of Sirius XM ............................................................................. 32
   3. Sirius XM’s return on invested capital ................................................................................. 34

V. CONCLUSION ....................................................................................................................... 35

APPENDIX A: CURRICULUM VITAE

ATTACHMENTS 1-13
I. INTRODUCTION

A. Qualifications

1. My name is Thomas Z. Lys. I am the Eric L. Kohler Chair in Accounting and Professor of Accounting and Information Management at the Kellogg School of Management, Northwestern University. Kellogg is one of the leading business schools in the world.

2. I have been a faculty member at Kellogg since 1981. In addition, I have held academic positions at the Graduate School of Business at the University of Chicago (1986-87) and the Graduate School of Business at Stanford University (1997).

3. I have a Ph.D. in accounting and finance from the University of Rochester (1982), an M.S. in accounting, also from the University of Rochester (1980), and a B.S. in Economics from the University of Berne Switzerland (1976).

4. My research investigates the economic consequences of alternate financial reporting standards and financial decisions, such as changes in capital structure, changes in the money supply, and corporate disclosures. Other topics of interest include valuation, risk arbitrage, labor participation in corporate decisions, auditor liability, and financial analysts' earnings forecasts. My most recent work integrates the rational models of decision-making in economics, accounting and finance with the descriptive models of behavioral decision theory to predict the actions of various financial decision-makers.


6. Since 1988, I have served in various editorial capacities for the Journal of Accounting and Economics (a leading academic journal in financial economics), serving as one of its editors for eleven years. I have been a member of the American Accounting Association for the last 25 years.

7. At Kellogg, I teach courses in financial reporting, security analysis, and mergers and acquisitions in the regular MBA program, in Kellogg’s Executive MBA program, and in Kellogg’s International Executive MBA programs which are taught in Europe and Asia. In the latter, I also teach a course in behavioral finance. Finally, I also teach Ph.D. courses in security market research and the economic consequences of financial disclosure decisions.
8. I also teach in numerous non-degree executive programs at Kellogg. In addition, I am the director of Kellogg’s program “Corporate Governance: Effectiveness and Accountability in the Boardroom.”


10. In addition to my academic work, I have consulted for a number of leading private and public companies, including Cox Communications, Ciba Specialty Chemicals, General Electric, IBM, USX, Eastman Chemical, and Guidant Corporation.

11. My curriculum vitae is attached as Appendix A to this report, including a list of prior testimony.

B. Statement of the Assignment

12. I have been retained by counsel for SoundExchange as an expert witness in connection with the above-referenced matter.¹

13. I have been asked to evaluate whether the royalty rate schedule of 12 to 20 percent of revenues proposed by SoundExchange to be paid by Sirius XM for the period 2013 - 2017 would be disruptive to “the structure of the industries involved and on generally prevailing industry practices.”² The industries I have considered are the businesses of satellite-radio transmission of music and other programming and the recording industry more generally.³ In particular, I have focused on Sirius XM Radio Inc. (“Sirius XM”), which is the only provider of satellite digital audio radio services (“SDARS”).

14. Discovery in this matter has not yet begun, and as additional evidence becomes available, I reserve the right to amend my testimony with new information to add to or modify my analysis and the resulting conclusions.

¹ Determination of Rates and Terms for Preexisting Subscription Services and Satellite Digital Audio Radio Services, Docket No. 2011-1 CRB.


³ I have not been asked to assess the royalty rates for any other services.
C. Summary of Conclusions

15. Based on my review of the materials relied upon and the analyses I have performed, as well as my skills, knowledge, experience, education, and training, I conclude that:

- The proposed royalty rate schedule of 12 percent for 2013, 14 percent for 2014, 16 percent for 2015, 18 percent for 2016, and 20 percent for 2017 applied to Sirius XM’s revenue would not be disruptive to Sirius XM’s business. Sirius XM has achieved positive and growing financial metrics in 2010 and 2011, and this financial performance is projected to continue to improve, even after considering the effect of the proposed royalty rate schedule.

- In fact, the proposed royalty rate would have to be substantially greater (more than 31 percent starting in 2013 and more than 37 percent starting by 2017) before Sirius XM would experience negative EBITDA or negative free cash flows.

- Moreover, the proposed rate changes are likely to have a lower impact on Sirius XM’s financial performance for two reasons. First, they do not take into account the offsetting revenues that Sirius XM likely would be able to achieve by passing on all or part of the increased royalty rate to its subscribers (without a substantial decline in subscribership). If Sirius XM were to increase the U.S. Music Royalty Fee it charges its subscribers, then Sirius XM’s financial performance would be even more positive than I have calculated. Second, my analysis assumes that Sirius XM would pay the proposed royalty rates based on 100 percent of its revenue. However, I understand that, in practice, Sirius XM pays royalties based on substantially less than all of its revenue. When calculated using the percentage of revenue that Sirius XM has reported to SoundExchange in the recent past, the impact of the proposed royalty rates on Sirius XM would be even less.

D. Organization of this Report

16. In Section II, I present some relevant background facts I consider in my analysis. In Section III, I discuss Sirius XM’s financial performance. In Section IV, I discuss my analysis of SoundExchange’s proposed royalty rate schedule and its impact on Sirius XM’s expected financial performance.
II. BACKGROUND

A. The Parties

1. SoundExchange

17. SoundExchange is a non-profit organization that collects and distributes statutory royalties for the public performance of sound recordings on behalf of sound recording copyright owners and recording artists. SoundExchange previously has been designated by the Copyright Royalty Judges as the sole administrator of statutory licenses under Sections 112 and 114 of the Copyright Act.4

18. Services that publicly perform digital sound recordings pursuant to a statutory license include satellite radio, Internet radio, and cable TV music channels.

2. Sirius XM

19. Sirius XM is the result of a July 2008 merger between Sirius Satellite Radio Inc. ("Sirius Radio") and XM Satellite Radio Holdings Inc.5 Sirius Radio was originally incorporated in 1990 as Satellite CD Radio, Inc.6 XM Satellite Radio Inc. ("XM Radio") was incorporated in 1992, and XM Satellite Radio Holdings was created as a holding company for XM Radio in 1997.7 XM Radio launched its broadcasting service on November 12, 2001,8 and Sirius Radio launched its broadcasting service in February 2002.9

20. In February 2007, Sirius Radio and XM Satellite Radio Holdings agreed to a merger of equals, and the Department of Justice ceased investigating the proposed merger in March, 2008.10 The merger was completed on July 29, 2008 ("the merger").11

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21. Through proprietary satellite radio systems, Sirius XM broadcasts satellite radio on a subscription fee basis primarily to automobile-based radio receivers. Sirius XM has stated that “[a]s of December 31, 2010, satellite radios were available as a factory or dealer-installed option in substantially all vehicle makes sold in the United States.”\(^\text{12}\) Subscribers may also purchase satellite radio units in retail stores or through Sirius XM’s website, which Sirius XM markets for use in homes, cars, businesses, boats, and as portable devices.\(^\text{13}\)

22. Sirius XM offers over one hundred and forty channels of satellite radio, including seventy-one channels of commercial-free music.\(^\text{14}\) In addition to music, Sirius XM airs content consisting of radio personalities, news, talk, entertainment, and sports programming.\(^\text{15}\) As of September 30, 2011, Sirius XM had 21.3 million subscribers.\(^\text{16}\) Sirius XM offers different packages of channels that range in price from $6.99 to $19.99 per month.\(^\text{17}\)

23. Sirius XM reports that it owns nine orbiting satellites and a network of terrestrial repeaters designed to complement satellite service in areas prone to signal disruption.\(^\text{18}\)

B. Competition

24. In the company’s financial statements, Sirius XM states that it competes against a variety of

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\(^\text{12}\) Sirius XM Radio Inc., Form 10-K for the fiscal year ended December 31, 2010, p. 3.


\(^\text{16}\) Together with Canadian Broadcasting Corporation and Slaight Communications Inc., Sirius XM jointly owns SIRIUS Canada. Sirius XM also has an ownership interest in XM Canada. Although both Canadian entities offer similar services to Sirius XM, subscribers to these entities are not reported in Sirius XM subscriber counts. See Sirius XM Radio Inc. Form 10-K for the fiscal year ended December 31, 2010, p. 6. Sirius XM Radio Inc., Form 10-Q for the quarterly period ended September 30, 2011, p. 24.


other radio and audio services, including traditional AM/FM ("terrestrial") radio, HD radio, and internet radio.¹⁹ Wall Street analysts who cover Sirius XM also discuss satellite radio’s competitors.²⁰ Sirius XM also states that it competes to some extent with other distribution channels for listening to music in cars, including portable listening devices such as smartphones and iPods.²¹

25. Sirius XM’s management regularly comments on the competitive environment in earnings calls and in press releases. Many of these statements reflect management’s optimism with respect to competitive pressures. For example, in March 2011 Sirius XM’s Chief Financial Officer David Frear stated:

You know that satellite radio has had a great run, that we have faced intense competition in the 9 years since we launched the business. iPod was launched at the same time we were. Broadband has blown through the substantial majority of TV households in the country bringing the plethora of internet radio options to the public. Smartphones’ [sic] have taken the world by storm in the last couple of years. There are now over 60 million, I think, in the US alone. And those, of course, are just incredibly powerful mobile computing devices that allow people to get virtually any form of entertainment they want anyplace. So all this should sound like terrible news for SIRIUS XM Radio, except that through all this competition [we’ve] managed to grow from zero to over 20 million subscribers.... [W]e’ve done pretty well competing against a free, ad-based, curated content music service, which is what terrestrial radio is.²²

26. In Sirius XM’s earnings call for the third quarter in 2010, Mel Karmazin, CEO of Sirius XM, similarly expressed confidence that over the years, compared to terrestrial radio, Sirius XM has “provided a superior product that consumers were willing to pay for.”²³

27. In September 2011, Mr. Karmazin also expressed confidence in continued consumer demand for satellite radio:

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I mean, if you think about the way people get audio entertainment, whether it be in terrestrial radio, whether it be in Internet radio, for the most part it's free and yet today, in spite of having all this content available for free, over 21 million people decided that they want to continue to have satellite radio.24

28. Mr. Frear has also reiterated that Sirius XM's ability to retain subscribers "compares very favorably to a lot of other media platforms."25 Additionally, Mr. Karmazin has explained that subscribers who choose to deactivate do so for reasons unrelated to the service itself. He stated:

We get a report every single day on the number of people who are de-acting and why they are de-acting and a lot of the de-acts that we're getting are unrelated to us. It's their credit card, the economy that they're experiencing with. And we believe that the research that we do, customers love our service. There's no waning of that in spite of increased competition.26

29. Ultimately, though Sirius XM states that it faces competition from terrestrial, HD, and internet radio, management believes that this competition will not prevent the company from continuing to grow.27 As recently as a few weeks ago, Mr. Karmazin announced, "SiriusXM is not slowing down, and we intend to accelerate our growth next year. Our company is performing extremely well. We have a unique product that consumers demand, and we have a business model that continues to demonstrate positive economic leverage. The best is yet to come."28

III. FINANCIAL PERFORMANCE OF SIRIUS XM

30. In this section, I present information related to the historical and forecasted performance of Sirius XM. These facts will be incorporated into the analysis that I introduce in Section IV.

31. Overall, Sirius XM's financial stability and expected future financial performance have

25 Sirius XM Radio at Bank of America Merrill Lynch Credit Conference, November 18, 2010, p. 3.
improved greatly since the merger between Sirius Radio and XM Satellite Radio Holdings Inc. in mid-2008. As I discuss in more detail below, since the merger, Sirius XM has experienced steady growth in both the number of subscribers and subscriber revenues while at the same time experiencing cost reductions. As a result, the company has achieved sustainable and growing profitability. Further, in contrast to 2009, when the company restructured its debt, Sirius XM’s credit ratings and the underlying financial metrics related to its debt have improved substantially.

A. Revenue

32. In its 2010 filings with the Securities and Exchange Commission (SEC), Sirius XM reported total revenue of approximately $2.8 billion, comprising four categories: subscriber revenue, advertising revenue, equipment revenue, and other revenue. Subscriber revenue is by far the largest category; it accounted for about 86 percent of Sirius XM’s total revenue in 2010, and accounted for more than 90 percent in earlier periods.  

33. Subscriber revenue itself consists of subscription fees, activation fees and other fees, minus rebates. From 2008 to 2011, subscriber revenue has increased each year. See Attachment 1. Sirius XM’s senior management expects revenue to continue to grow in coming years. In November 2011, CEO Mel Karmazin stated:

Again, we believe we have many, many years of subscriber growth ahead of us... Growing subscribers is our primary means of growing revenue. But changes to our pricing and more effective bundling of higher-tiered packages will also boost revenue over the next few years.

34. All ten of the analyst reports that Thomson One compiles in its currently reported “Detailed Estimates” project that Sirius XM’s revenue will increase from 2011 to 2012 and in each

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29 Advertising revenue (approximately 2.3 percent of total revenue) comprises advertising sales on non-music channels, net of agency fees. Equipment revenue (approximately 2.5 percent of total revenue) includes revenue and royalties from the sale of satellite radios, components and accessories. Other revenue (approximately 9.5 percent of total revenue) comprises the U.S. Music Royalty Fee, revenue from affiliates, content licensing fees and syndication fees. See Sirius XM Radio Inc., Form 10-K for the fiscal year ended December 31, 2010, pp. 26-28, and 44-45.


As noted above, subscriber revenue accounts for about 86 percent of Sirius XM’s total

35. As noted above, subscriber revenue accounts for about 86 percent of Sirius XM’s total
revenues. In turn, subscription fees constitute 99 percent of subscriber revenue.\textsuperscript{34} I next discuss in detail the two drivers of subscription revenue: the number of subscribers and the prices they are charged.

1. Subscribers

   a) Historical Subscriber Numbers

36. At the end of Q3 2011, Sirius XM reported approximately 21.3 million subscribers,\textsuperscript{35} representing an increase of 2.3 million net subscribers, or 12.3 percent, compared to the end of Q4 2008. See Attachment 4.

37. Sirius XM obtains subscriptions primarily through automakers (referred to as OEMs or Original Equipment Manufacturers), retailers, and certain rental car companies. In late 2008, subscriptions obtained through OEMs and retailers constituted 52 percent and 48 percent of total subscribers, respectively. Since then, the share of subscriptions obtained through OEMs has steadily increased, reaching approximately 69 percent of total subscribers at the end of Q3 2011.\textsuperscript{36}

38. Sirius XM explains that OEM installations depend partially on OEM penetration rates—the percentage of new vehicles manufactured for sale in the U.S. that have a factory-installed satellite radio in the dashboard.\textsuperscript{37} During Q2 2011, Sirius XM reported an OEM penetration rate of 65 percent.\textsuperscript{38} Sirius XM has agreements with every major automaker to offer satellite radios in their vehicles. Radios are installed at factories or by dealers, depending on the agreement.\textsuperscript{39}

   b) Forecasted Subscriber Numbers

39. In August 2011, Mr. Frear stated, "[w]e've increased our guidance for net additions [in

\textsuperscript{34} The other components are activation fees and rebates. See Sirius XM Radio Inc., Form 10-K for the fiscal year ended December 31, 2010, p. F-20.
\textsuperscript{39} Sirius XM Radio Inc., Form 10-K for the fiscal year ended December 31, 2010, p. 2.
2012] to 1.6 million. This 14% increase in the face of a very challenging economic environment is testimony to our customers' passion for our service and the strength and stability of our subscriber-based business model.” Mr. Frear also noted, “[w]e will continue to grow subscribers as the OEMs are all forecasting higher auto sales in 2012.”

Sirius XM is also focused on the significant growth opportunities offered in the used car market. Sirius XM has been working with OEMs to install satellite radios in certified pre-owned cars, enabling Sirius XM to further grow subscribers and increase its penetration rate in used cars. In August 2011, Mr. Karmazin emphasized the importance of these initiatives: “I'll repeat: the previously owned market will be a very significant catalyst for our growth in the years ahead.” Analysts at Morgan Stanley agree, and “continue to expect incremental subscriber growth from the used car market.”

Wall Street analysts share management’s expectations that subscriber numbers will continue to increase in the coming years. By 2015, Morgan Stanley projects total subscribers of about 27.7 million, representing an increase of 7.5 million, or 37.3 percent, from 2010’s year-end total of 20.2 million. Figure 2 below (see also Attachment 5) illustrates this growth trend using Morgan Stanley’s estimates of Sirius XM’s future subscriber numbers.

42. Academic research shows that management forecasts are the most impactful source of information for security prices. See Beyer, Cohen, Lys, and Walther, 2010, pp. 305, 307 and 335.
2. **Products and Pricing**

42. In this section, I show that prices and fees for satellite radio subscriptions have increased over time without damaging the subscriber base.

   a) **Historical Products and Pricing**

43. In late 2001, when XM completed the national rollout of its services, XM priced its basic subscription for “as many as 100 different digital broadcast channels” at $9.95 per month. Sirius launched its satellite radio service in February 2002 and charged $12.95 per month.

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48 Morgan Stanley provides subscriber estimates through 2016, which is a longer horizon than most other analyst forecasts I have seen. However, for 2012 – 2015, Morgan Stanley’s subscriber estimates are at or below the average of subscriber forecasts provided by other investment analysts.


for a basic subscription. By 2004, XM and Sirius had each increased their offerings from 100 channels to approximately 120 channels and (still) charged $9.95 and $12.95, respectively. In April 2005, however, XM increased its basic subscription price to $12.95, matching Sirius’s then current pricing.

After the merger in July 2008, Sirius XM began to offer additional subscription packages that provided access to different combinations of existing channels for varying prices. Sirius XM stated that there were “approximately 135 channels on each of the SIRIUS platform and the XM platform; 117 channels are available to subscribers on both platforms.”

In 2009, Sirius XM increased the price of the discounted “second radio” subscription plan to $8.99 (from $6.99) per month. As of November 2011, the number of channels available under a variety of subscription types ranged from 50 to 300.

In a conference call in March 2011, Sirius XM’s CFO David Frear noted that very few subscribers choose a lower-priced, a la carte service offering 50 standard channels: “[o]ut of [our] 20 million subscribers, there are less than 30,000 that have chosen a la carte product.” According to Frear, customers are “used to a mix of music, talk, news and sports.”

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b) *The U.S. Music Royalty Fee*

47. As a condition of the merger, Sirius XM was not permitted to “raise the retail price for, or reduce the number of channels in, our basic $12.95 per month subscription package, [the] a la carte programming packages or certain other programming packages” until July 28, 2011.\(^6^3\) These price caps were extended through December 31, 2011 as part of a settlement that Sirius XM reached in a class action lawsuit filed against it, *Carl Blessing et al. v. Sirius XM Radio Inc.*\(^6^4\)

48. On July 29, 2009, Sirius XM introduced U.S. Music Royalty Fees of $1.98 for basic subscriptions (increasing the total price from $12.95 to $14.93 per month) and $0.97 for “second radio” discount plans (raising the total price from $8.99 to $9.96 per month).\(^6^5\) In December 2010, Sirius XM reduced the U.S. Music Royalty Fee that it charges subscribers from $1.98 to $1.40 per month on the base $12.95 subscription.\(^6^6\) Sirius XM states the U.S. Music Royalty Fee “is used by Sirius XM to fund its existing and anticipated royalty payments to the music industry, which includes writers and artists.”\(^6^7\) Sirius XM also notes that “Subscription packages, such as our ‘News, Sports and Talk’ package, that contain little music are not subject to the U.S. Music Royalty Fee.”\(^6^8\)

c) *Historic Effects of Price Increases*

49. In May 2001, when Sirius Radio increased its subscription fee from $9.95 per month to $12.95 per month, Sirius’s share price increased almost twenty percent.\(^6^9\) This positive market reaction occurred despite the fact that its only direct competitor at the time, XM Radio, had consistently said that its own upcoming satellite radio service would cost $9.95


per month.\textsuperscript{70, 71} In 2005, XM Radio raised its subscription price from $9.95 to $12.95 to match Sirius Radio’s pricing. Concurrently, its share price increased thirteen percent.\textsuperscript{72}

50. Sirius XM’s imposition of the U.S. Music Royalty Fee appears to have had no effect on subscriber growth rates. In an August 2011 conference call, CEO Mel Karmazin said that the U.S. Music Royalty Fee was effectively “a double-digit price increase affecting the consumer and our churn remained relatively flat.”\textsuperscript{73}

\textit{d) Forecasted Pricing}

51. In September 2011, Sirius XM reported that it planned to increase the base price of both Sirius and XM “Select” plans from $12.95 to $14.49 per month in early 2012.\textsuperscript{74} Sirius XM’s stock price increased 6.8 percent following the announcement.\textsuperscript{75, 76}

52. During an earnings call in November 2011, CEO Mel Karmazin stated that “$1.50 a month...would not really materially change DX\textsuperscript{77} for us...[s]o far, based on the noise that’s in the market, or I should say the lack of noise that’s in the market...the price increase is not in any way, shape or form egregious.”\textsuperscript{78} CFO David Frear noted that “[g]iven the

\begin{footnotesize}
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\item \textsuperscript{71} On the date of this announcement, February 28, 2005, the NASDAQ composite index (CCMP) declined by 0.66 percent, and the NASDAQ Telecommunications Index (CUTL) increased by 0.18 percent. Sirius XM Radio Inc. (SIRI) is traded on NASDAQ. (Bloomberg, L.P., CCMP NASDAQ Composite Index – Historical Prices, accessed November 27, 2011 and Bloomberg, L.P., CUTL NASDAQ Telecomm Index – Historical Prices, accessed November 27, 2011.)
\item \textsuperscript{73} “Q2 2011 Sirius XM Radio Inc Earnings Conference Call-Final.” CQ Transcriptions, LLC, August 2, 2011, p. 8.
\item \textsuperscript{74} Kell, John and Maxwell Murphy, “Update: Sirius XM Gives 2012 View, Plans Price Increases; Stock up,” Dow Jones Newswires, September 14, 2011, p. 2.
\item \textsuperscript{75} Kell, John and Maxwell Murphy, “Update: Sirius XM Gives 2012 View, Plans Price Increases; Stock up,” Dow Jones Newswires, September 14, 2011, p. 1.
\item \textsuperscript{76} On the date of this announcement, September 14, 2011, the NASDAQ composite index (CCMP) increased by 1.60 percent, and the NASDAQ Telecommunications Index (CUTL) increased by 1.11 percent. (Bloomberg, L.P., CCMP NASDAQ Composite Index – Historical Prices, accessed November 27, 2011 and Bloomberg, L.P., CUTL NASDAQ Telecomm Index – Historical Prices, accessed November 27, 2011.)
\item \textsuperscript{77} DX is often used as an abbreviation of “Quantity Demanded.”
\item \textsuperscript{78} “Sirius XM Radio Inc., Q3 2011 Earnings Call,” Capital IQ, November 1, 2011, p. 7.
\end{itemize}
\end{footnotesize}
programming we are delivering and given how long we’ve left the price unchanged, [it] just makes a lot of sense to increase it in the future.”\(^{79}\) As early as May 23, 2011, analysts at Morgan Stanley expected a $1 base rate increase in 2012.\(^{80}\)

**B. Expenses**

1. **Historical Expenses**

53. In fiscal year 2010, Sirius XM’s three largest categories of operating expenses were Revenue share and royalties, Subscriber acquisition costs, and Programming and content.\(^{81}\) The sum of operating expenses that year totaled nearly $2.4 billion compared to Total revenue of $2.8 billion.\(^{82}\) Attachment 6 illustrates Sirius XM’s (adjusted) operating expenses over the past four years. This graph shows that total operating expenses have remained relatively constant from 2009 through 2011 despite the increase in revenues for the same time period.

54. Sirius XM defines its fixed costs as satellite and transmission, programming, sales and marketing, G&A, and engineering design and development.\(^{83}\) In an earnings call for Q3 2011, Mr. Frear noted that Sirius XM had reduced fixed expenses by 31 percent since the merger while revenues had increased 25 percent over the same period. He stated:

> We continue to manage fixed expenses, that’s sales and marketing, satellite and transmission, research and development and G&A and programming, to be relatively flat despite significant growth in subscribers and revenues. Programming costs continues [sic] to decline as premerger contracts come up for their post-merger renewals in the 9 months ended September 2008. Just after the close of the merger, fixed expenses ran $936 million for the combined company. In 2009, we cut them to $658 million. We held them at that level in 2010 and reduced them further in 2011 to $649 million. That’s an aggregate reduction of 31% while revenues have increased 25% over the same period."\(^{84}\)

55. Sirius XM management calculates contribution margin as revenue net of revenue share,

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\(^{80}\) Swinburne, Benjamin and Ryan Fifital, Morgan Stanley, “Sirius XM Radio Inc. – Drive Time,” May 23, 2011, p. 6. This report also projects that subscribers and revenues will increase in 2012.


\(^{82}\) Sirius XM Radio Inc., Form 10-K for the fiscal year ended December 31, 2010, p. 50.


royalties, customer service, and building costs and cost of equipment. This calculation implies that revenue share, royalties, customer service, and building costs and cost of equipment comprise Sirius XM’s variable costs, i.e., the costs that are expected to increase more or less proportionately with increases in revenues. Over the last few years, Sirius XM has maintained a contribution margin of 70 percent or more. In a Q3 2011 earnings call, Mr. Frerar stated that the contribution margin for the quarter was 71.4 percent.

2. **Forecasted Expenses**

56. Analysts expect Sirius XM’s operating expenses to continue to decrease as a percentage of revenue. One contributing factor is that as a result of the merger, Sirius XM’s programming costs are declining. CEO Mel Karmazin stated in September 2011:

> [T]he merger has enabled us to take a great deal of costs out of the Company… Specifically, in the programming area, that has been a very important part of where our focus was in driving down costs, while we are not in any way, shape, or form taking away from our innovation in the programming side… So our peers in the cable and satellite television area are seeing a phenomenon that's very different than ours. Their programming costs are in fact going up. It's going up as a higher percentage of their revenue. Ours, the programming costs are going down and that it's going to be a lower percentage of our revenue. And deals are continuing to come up.

57. Additionally, at an investor conference in March 2011, Mr. Frerar said that he expected the underlying cost of the radio module to decrease over the next seven to eight years. He stated:

> We get smarter every year about how to build chips, how to build radios, driving costs down. Volume goes up and so the overhead factors get absorbed better. If we can get all the OEMs on a single technology platform, right? Right now

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86 “[Contribution margin] has been very consistently right around 70% before the merger, a little bit less than 70% since the merger, a little bit more than 70% -- I think 70% is a good number to think about.” Sirius XM at Bank of America Merrill Lynch Credit Conference, November 18, 2010, p. 4.


89 Sirius XM Radio Inc. at Bank of America Merrill Lynch Media, Communications and Entertainment Conference, September 14, 2011, p. 5.
they're split between two. There's the Sirius technology, the XM technology. If we can get them all onto one platform, then you've got additional volume on that platform and you can drive costs down further. So there's still -- as we look out and we plan this out over several years, I think for the next seven or eight years, that we'll drive down that the basic underlying cost of the radio module.  

58. Furthermore, Mr. Frear has said that he expects fixed costs to remain stable in absolute terms. At an investor conference in November 2010, Mr. Frear stated, “We don’t believe that there is a whole lot of reasons [sic] for fixed costs to be scaling up from here.”

59. Among other metrics, analysts at Morgan Stanley have forecasted operating revenues and costs through 2015. As shown in Attachment 7, Morgan Stanley projects that Sirius XM’s revenues will grow more quickly than Operating Expenses and Cost of Revenue, resulting in increasing Operating Income over the next four years. In August 2011, Mr. Karmazin stated, “We anticipate our revenue growth will accelerate. Our revenue will grow faster than our expenses, so there will be further margin expansion.”

60. Analysts at Morgan Stanley expect further declines in expenses due to synergies from the merger that are still materializing. The analysts stated:

While SIRI has realized significant synergies to date, we believe an incremental ~$150M of further cost synergies have been “locked up” due to long-term contracts and should be realized over the next few years. In particular, we expect programming costs to decline ~$20M this year and an additional ~$25M annual savings to be realized through 2016 as long-term programming contracts are renegotiated. Furthermore, we expect over $100M in annual cost savings to be realized as a large OEM revenue share deal is renegotiated at the end of 2013.

C. Free Cash Flow and EBITDA

61. Two important measures of financial performance are free cash flow and earnings before interest, taxes, depreciation, and amortization (“EBITDA”). Free cash flow is the measure of cash generated by a company that is not needed to fund the period’s operations or to

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91 Sirius Satellite Radio at Bank of America Merrill Lynch Credit Conference, November 18, 2010, p. 3.


reinvest in the firm’s future operations.\textsuperscript{94} In other words, the computation of free cash flow explicitly excludes the cash required to fund capital investments (e.g., facilities, satellites) that a company like Sirius XM must undertake to support its ongoing and expanded operations. Free cash flow is thus a measure of cash available to the company to deploy as it sees fit, including as payments to shareholders in the form of a dividend or stock repurchase, or to repay debt, without reducing investments in the business. As Sirius XM explains, free cash flow is a useful metric “to determine cash available for future subscriber acquisition and capital expenditures, to repurchase or retire debt, to acquire other companies and to evaluate our ability to return capital to stockholders.”\textsuperscript{95} Free cash flow is the primary measure used in (equity) valuation.

\textsuperscript{62.} EBITDA roughly measures the cash profitability of a company’s sales from an operating perspective. In deciding royalty rates for 2007 through 2012, the Copyright Royalty Board considered both EBITDA and free cash flow in assessing whether the proposed rates would be disruptive.\textsuperscript{96}

\textsuperscript{63.} Sirius XM’s management also has emphasized free cash flow and EBITDA when discussing the health of the company. In a December 2009 conference call, CFO David Frear said that “at the end of the day, we’re looking to drive EBITDA and free cash flow growth, which is ultimately what is going to drive value for shareholders.”\textsuperscript{97} CEO Mel Karmazin reiterated this view in a November 2011 earnings call: “[g]rowing EBITDA is really a precursor to driving free cash flow, which we believe is the primary driver of SiriusXM’s value.”\textsuperscript{98} See Attachment 8 for projections of Sirius XM’s EBITDA.

\textsuperscript{64.} Mr. Karmazin has noted Sirius XM’s progress with respect to both the EBITDA and free cash flow metrics. At $197 million in Q3 2011, adjusted EBITDA was “up 16% year-over-year for the quarter.”\textsuperscript{99}

\textsuperscript{95} Sirius XM Radio Inc., Form 10-Q for the fiscal quarter ended September 30, 2011, p. 32.
\textsuperscript{96} SDARS I, p. 4097.
\textsuperscript{97} “SIRI – Sirius Satellite Radio at UBS Media & Communications Conference,” Thomson Street Events, December 8, 2009, p. 7.
\textsuperscript{98} “Sirius XM Radio Inc., Q3 2011 Earnings Call,” Capital IQ, November 1, 2011, p. 3.
65. Negative free cash flow indicates that a firm must rely on external sources of financing for its operations and/or investments, while positive free cash flow implies that a firm can finance its investments internally and then have funds “free” to distribute to investors. In 2008 Sirius XM had negative free cash flow of over $550 million. In contrast, free cash flow was a positive $185 million and $210 million in 2009 and 2010, respectively. In Q3 2011, free cash flow grew 22 percent compared to Q3 2010. Sirius XM’s management predicted that free cash flow for 2011 would reach $400 million, or a 90 percent increase over 2010.

66. Mr. Karmazin expects Sirius XM’s free cash flow to continue growing in 2012:

To put it mildly, we’ve come a long way, and it gets better. Our 2011 guidance calls for our free cash flow to increase 75% next year versus 2011 to approximately $700 million, driven by improved operating results and lower capital expenditures.

Let’s put this in perspective. In 2012, we plan to grow our cash generation to nearly $2 million every day, that’s including weekends and holidays. Truly an astounding statistic, which will obviously represent the best free cash flow in the history of the company.

67. Consistent with my own analysis, analyst projections, and statements made by Sirius XM’s senior management regarding growth projections, sophisticated investors also expect that Sirius XM’s financial performance will continue to improve. For example, the College Retirement Equities Fund (CREF) Stock Account and the Vanguard Morgan Growth Fund, which hold large ownership stakes in Sirius XM common stock, both invest in U.S. companies whose revenues or earnings are expected to grow at a rate faster than that of the average firm in the market. The summary prospectus for the Vanguard Morgan Growth Fund states, “The Fund invests mainly in the stocks of mid- and large-capitalization U.S. companies whose revenues and/or earnings are expected to grow faster than those of the

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100 Sirius XM Radio Inc., Form 10-K for the fiscal year ended December 31, 2010, p. 36.
104 The CREF Stock Account and the Vanguard Morgan Growth Fund hold approximately 0.357 percent and 0.133 percent of SIRI common stock outstanding, respectively. See “Cap IQ - SIRIUS XM Radio Inc Investors by Fund.xls,” Capital IQ, retrieved on November 7, 2011.
average company in the market.” Similarly, the CREF fund’s portfolio strategy notes, “The management team focuses on companies it believes are attractively priced based on an analysis of their prospects for growth in earnings, cash flow and revenues.”

IV. METHODOLOGY AND RESULTS

A. Economic Definition of “Disruption”

68. In this section, I present an overview of the methodology I use to analyze the royalty rates proposed by SoundExchange.

69. The Copyright Royalty Judges stated in the 2007 rate proceeding that a royalty rate would clearly be disruptive if “it directly produces an adverse impact that is substantial, immediate and irreversible in the short-run.” As a matter of economics, “disruptive” does not mean that a firm or an industry could not exhibit any decline in financial performance. In addition, as a matter of economic policy, one would not want to artificially keep afloat an otherwise failing firm or industry with an unwarranted subsidy in the form of a “too low” royalty rate. Indeed, firms make business decisions in the context of competition, aware that there were certain risks inherent when the business was started, and that certain risks exist as the business matures. Thus, a disruption can occur because a royalty is set too high or too low.

70. For the purposes of my analysis here, I consider a royalty rate to be “disruptive” if it were to lead to a substantial, immediate and irreversible decline as evidenced in the financial measures that the Copyright Royalty Judges have focused on in the past, i.e., Sirius XM’s EBITDA and free cash flows.

71. The required analysis is necessarily forward-looking, that is, the analysis must project the future financial performance of Sirius XM, taking into account the proposed royalty rates. The relevant future time period is 2013 through 2017.


107 SDARS I, p. 4097.

108 SDARS I, p. 4097.
72. I perform this analysis by utilizing analyst forecasts that incorporate many elements of Sirius XM’s expected financial performance. Analyst forecasts provide a reasonable starting point for a forward-looking analysis because the estimates incorporate not only historical performance but also industry expertise, macroeconomic information that may affect future growth, and other information.

73. Using the proposed royalty rate schedule provided by counsel, I compute Sirius XM’s incremental royalty costs for each year, \( t \), from 2013 through 2017 as the difference between the proposed royalty rate for year \( t \) and the prior royalty rate of 8 percent (in 2012) times the revenue to which the proposed royalty rate applies. I make this computation under two alternative scenarios concerning revenues. First, I compute incremental royalties under the assumption that Sirius XM will pay royalties based on all of its reported revenue. In the second scenario, I assume that Sirius XM will pay royalties based on \( \Box \) percent of its reported revenue (which I understand is approximately the percentage of revenue Sirius XM has reported to SoundExchange in the recent past for purposes of calculating its royalty obligation).

74. Finally, I re-calculate the EBITDA and free cash flow components of the analyst forecasts by subtracting the incremental costs associated with the proposed royalty rates. This type of financial modeling, which focuses on the effect of a quantifiable change in underlying assumptions, is standard in finance and accounting. In this case, the quantifiable change is the increase in royalty rate from the 8 percent due to be charged in 2012 and reflected in analyst forecasts to the new rates proposed by SoundExchange.

75. For 2011 through 2016, my analysis incorporates revenue and cost projections provided by Morgan Stanley in a report dated November 3, 2011. I consider the Morgan Stanley forecasts to be a reasonable and possibly conservative starting point for my analysis because:

- The Morgan Stanley forecasts of revenues and EBITDA are at or below the average of other forecasts available during this time period. See Attachment 2

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110 If the analyst forecasts actually incorporate an expected royalty rate that is higher than 8 percent, then my approach will overstate the incremental royalty costs and understate the EBITDA and free cash flows that Sirius XM will experience.
and Attachment 8.

- The Morgan Stanley forecasts for 2011 are in line with those of Sirius XM’s management.

- In 2008, Morgan published projections for 2009 through 2011, and Sirius XM’s actual financial performance for those years has exceeded the forecasts.

None of my conclusions, however, is materially affected by relying on the specific projections made by Morgan Stanley.

76. Sirius XM’s 2011 and 2012 guidance includes projections for revenue, adjusted EBITDA, and free cash flow. Morgan Stanley’s projections are slightly greater than Sirius XM’s guidance for each of those three metrics in both years, except for free cash flow in 2011.

77. Longer-term Morgan Stanley forecasts also align with Sirius XM management’s expectations.

- The Morgan Stanley projections are consistent with Sirius XM management’s view of continued revenue growth, subscriber growth, and increased used car subscribers.

- Sirius XM management has expressed a target leverage ratio for debt-to-EBITDA of 3.0, which it expects to approach by the end of 2011. Morgan Stanley forecasts that Sirius will meet this target in early 2012.

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111 Swinburne, Benjamin and Ryan Fiftal, Morgan Stanley, “Sirius XM Radio Inc.: Reiterating OW Following 3Q Results, Outlook Unchanged,” November 3, 2011, p. 6. Morgan Stanley predicts $3,021 million and $3,372 million in revenue for 2011 and 2012, respectively. These figures are $21 million and $72 million greater than Sirius XM’s guidance for the two years, respectively. Sirius XM’s guidance for adjusted EBITDA is $20 million and $57 million lower than the Morgan Stanley projections for fiscal years 2011 and 2012, respectively. Sirius XM’s guidance for free cash flow is $41 million greater than and $42 million less than the Morgan Stanley projections for 2011 and 2012, respectively.


78. Because analyst forecasts are not available for 2017, I estimated 2017 results by assuming that Sirius XM’s revenues, EBITDA and free cash flow all would increase from 2016 levels by the growth rate forecasted for annual GDP (gross domestic product). The projected GDP growth rate for 2017 is 4.8 percent,\textsuperscript{116} which is considerably lower than the projected 2016 growth rate for Sirius XM’s revenue of 8.2 percent and the average projected growth rate for 2012 to 2016 of 9.6 percent. Therefore I consider my estimated results for 2017 to be conservative (i.e., they are likely to understate Sirius XM’s financial performance).

B. Results of Royalty Analysis

79. I understand that SoundExchange is proposing the following royalty rate schedule: 12 percent for 2013, 14 percent for 2014, 16 percent for 2015, 18 percent for 2016, and 20 percent for 2017.

80. In Attachment 9, I show the effect of the proposed royalty rate schedule on Sirius XM’s projected EBITDA, assuming that Sirius XM pays royalties based on 100 percent of its total revenues. In this analysis, I further assume that Sirius XM would completely absorb the additional expense associated with the proposed royalty rates. That is, I assume that Sirius XM would not “pass on” any of the additional royalty amounts through an increase in the U.S. Music Royalty Fee (or other new increase in subscriber prices). Under this assumption, Sirius XM’s projected EBITDA would be $917.4 million in 2012, $958.9 million in 2013 (the first year of the new royalty) and $1,321.5 million in 2017 (the fifth year of the new royalty rate). All of these figures are substantially higher than Sirius XM’s projected EBITDA for 2011 of $734.7 million. Figure 3 below illustrates graphically how Sirius XM’s EBITDA will increase dramatically over the coming rate term compared to current levels if SoundExchange’s proposed rates are adopted.\textsuperscript{117}


\textsuperscript{117} The slight decline in my EBITDA and free cash flow projections for 2017 under SoundExchange’s proposed rate, visible in Figures 3 through 7, is due in large part to my conservative revenue growth projection for that year discussed earlier in this report.
In fact, I understand that Sirius XM has historically paid royalties to SoundExchange calculated on approximately [10] percent of its total revenues. If I assume that Sirius XM will continue paying royalties on this proportion of its total revenues, then Sirius XM’s EBITDA projections are even higher: [12] million in 2013 (the first year of the new royalty) and [13] million in 2017 (the fifth year of the new royalty rate). See Attachment 10. Again, these projections are based on the assumption that Sirius XM would not “pass on” any of the additional royalty amounts through an increase in the U.S. Music Royalty Fee (or other new increase in subscriber prices). Figure 4 below illustrates graphically how Sirius XM’s EBITDA will increase over the coming rate term compared to current levels if Sirius XM applies the proposed royalty rates to [14] percent of total revenues.
Attachment 9 also shows the effect of the proposed royalty rate schedule on Sirius XM’s projected free cash flow, if royalty payments apply to 100 percent of total revenue. Again assuming that Sirius XM would not pass on any of the additional royalty amounts through an increase in the U.S. Music Royalty Fee, Sirius XM’s free cash flow would increase from $741.6 million in 2012 to $725.0 million in 2013 and to over $900 million in 2015 and 2016. For the five-year period 2013 through 2017, Sirius XM’s ratio of free cash flow to revenues would average about 20 percent, or nearly twice as high as the average ratio of 12 percent for the four-year period 2009 through 2012 (i.e., excluding the negative free cash flow of 2008). Figure 5 below illustrates graphically the increase in Sirius XM’s free cash flow over the coming rate term compared to current levels if SoundExchange’s proposed rates are adopted.
83. The free cash flow results are even stronger if I assume that Sirius XM will continue to make royalty payments on approximately [ ] percent of its total revenue. Sirius XM's free cash flow would increase from [ ] million in 2012 to [ ] million in 2013 and to [ ] million in 2017. See Attachment 10. Figures 6 below illustrates graphically Sirius XM's strong projected free cash flow over the coming rate term if Sirius XM applies the proposed royalty rates to [ ] percent of total revenues.
84. The results shown in Attachments 9 and 10 confirm that the proposed royalty rate schedule would not be disruptive to Sirius XM. Indeed, a much higher royalty rate could be enacted without causing disruption to Sirius XM. For example, assuming Sirius XM paid royalties on 100 percent of its revenues, the royalty rate in 2013 would have to be over 31 percent to cause Sirius XM’s free cash flow in that year to equal zero, and even then, free cash flow would be positive in subsequent years. The royalty rate would have to be over 37 percent to cause Sirius XM’s free cash flow in 2017 to equal zero.

85. The results presented in Attachments 9 and 10 and discussed immediately above are based on the assumption that Sirius XM would be unable to “pass on” any of the additional royalty amounts through an increase in the U.S. Music Royalty Fee (or through some other increase in subscriber prices). Of course, if Sirius XM were able to pass through some or all of the rate increases to its customers, then its financial performance would be even better than I have calculated under the more conservative assumption.\(^{118}\) For example, if

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\(^{118}\) I understand that Sirius XM had plans at some point to recover all of its music royalty fees through the U.S. Music Royalty Fee. Sirius XM, Pricing Scenarios: Draft 2 (Exhibit 44 to Motion for Summary Judgment, Declaration of James J. Sabella in Opposition, Blessing v. Sirius XM Radio Inc., 1:09-cv-10035-HB−RLE, 28
Sirius XM applies the royalty to 100 percent of revenues and is able to pass on 50 percent of the increase (without any significant decline in subscribership), then EBITDA is projected to increase as shown in Figure 7 below.

Figure 7
Sirius XM
Historical and Projected EBITDA Assuming Sirius XM Pays Royalties on 100% of Total Revenue and Passes 50% of Royalty Rate Increase to Consumers 2009-2017

86. As I discussed above, recent history indicates that Sirius XM has passed on increased royalty rates to its subscribers in the form of a $1.98 U.S. Music Royalty Fee, which was instituted in July 2009 to recoup fully the royalty increases from the last SDARS proceeding. At that time, the U.S. Music Royalty Fee amounted to a price increase of roughly 15 percent on the basic $12.95 subscription. Notwithstanding this substantial

ECF No. 102-13, p. 24, filed on May 16, 2011) (“We [Sirius XM] would evolve MRF [Music Royalty Fee] to be the full music royalty rate.”).


I note that this percentage is significantly higher than the maximum royalty rate in the 2008 CRB decision of 8 percent. As discussed above, in December 2010 Sirius XM lowered the U.S. Music Fee to $1.40, or
price increase, the number of Sirius XM subscribers grew the following two quarters (and, in fact, every quarter since then), whereas the number of Sirius XM subscribers had actually declined during the two quarters immediately prior to the institution of the Music Royalty Fee.\textsuperscript{121} This implies that Sirius XM may be able to pass on some or all future royalty increases to its customers.\textsuperscript{122}

C. Risk Analysis

87. As discussed above, research analysts, sophisticated investors, and Sirius XM’s management are optimistic about the cash flows expected by Sirius XM. It is worth noting that other measures of financial risk buttress my conclusions that the financial health of Sirius XM will not be disrupted by the royalty rate schedule proposed by SoundExchange. In this subsection, I present the results of additional research on the certainty of Sirius XM’s expected future cash flows, a process known in the finance industry as risk analysis. Like the performance metrics from financial statements, Sirius XM’s risk metrics have dramatically improved since the merger.

1. Sirius XM’s debt obligations

88. The compensation investors require when lending funds to an enterprise is reflected in the yields of that enterprise’s publicly-traded bonds. Because yield data result from market participants’ expectations, they are reliable indicators of the risk that investors assess for the companies that issued the bonds. When investors perceive low risk, they require less compensation (relative to the risk-free return) for investment in a company’s debt, which is reflected in lower yields. In contrast, when risk is elevated, investors require a higher compensation for investing in the firms’ securities, which is then reflected in higher yields.

89. In the case of Sirius XM, yields have dropped substantially since the first two months of 2009. As Attachment 11 demonstrates, Sirius XM’s debt yields stabilized in early 2010 at approximately 11 percent of the basic subscription price. I have seen no evidence that Sirius XM reduced the rate because of any concern that it was losing subscribers.


\textsuperscript{122} In order to properly analyze this question, one would first have to compute the elasticity of demand for Sirius XM’s products. Sufficient data for this computation are not currently available to me.
levels roughly 85 percent below those in early 2009, and have remained at that level (or slightly lower) since then.

90. To place Sirius XM’s debt yields into context, I compared them to the yields of the Moody’s Baa-rated Corporate Bonds index, which is Moody’s cutoff for “investment-grade” status. Over the past 90 years, an average of only 0.27 percent of Baa-rated corporate bonds have defaulted. Even in the challenging economic environment of the last five years, the corporate default rate of Baa-rated companies has remained below one percent.

91. As Attachment 11 further demonstrates, the yields of Sirius XM debt have resembled those of the Moody’s Baa-rated Corporate Bonds index for over a year. As of November 16, 2011, the weighted average yield of the Sirius XM Bonds (excluding the convertible bond) was 5.57 percent, within a half percent of the Baa index. If I include the convertible bond in the weighted average yield of Sirius XM’s debt, the average yield is below the yield of the Baa index. This indicates that investors in Sirius XM’s debt require compensation that is roughly equivalent to, or less than, the compensation required from the investment-grade companies that constitute the Baa index. In other words, the yield data indicate that investors in Sirius XM’s debt assign it a low risk, in comparison to both the company’s 2009 risk levels and the lowest-rated investment-grade companies (i.e., Baa) today.

92. I also reviewed Sirius XM’s credit ratings. Credit ratings are published by analysts assessing the likelihood of a firm’s failure to repay its general obligations. While I treat this review as a sensitivity analysis, it is a common starting point in risk analysis. Further, the relationship between credit ratings and important financial characteristics (such as systematic risk, non-systematic risk, profitability, riskiness of the profit stream, and interest coverage) has long been recognized by academics.

93. Moody’s Investors Service, a nationally-recognized statistical rating organization.

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123 From 1920 through 2010, the median percentage of defaults among Baa-rated companies was 0.000. Moody’s Investors Service, “Special Comment: Corporate Default and Recovery Rates, 1920-2010,” February 28, 2011, p. 29.


Since issuing Sirius XM a “Ca” rating in December of 2008, Moody’s has announced five consecutive upgrades to a B1 rating in May of 2011 (a rating that is still in effect).\textsuperscript{126} Historically, Ca and C-rated corporations have been twelve times more likely to default than B1-rated corporations, such as Sirius XM.\textsuperscript{127} Consistent with the yield data I analyzed above, Moody’s ratings indicate that the risk profile of Sirius XM has dramatically improved since 2009.

94. Standard and Poor’s, also an NRSRO, upgraded Sirius XM’s long term issuer rating to “BB” as recently as a month ago.\textsuperscript{128} The S&P announcement noted the potential changes in the competitive landscape that I identified above and that the Morgan Stanley Report cited above also takes into consideration. S&P stated that it expects Sirius XM to experience stable debt levels and earnings growth in 2012. The S&P announcement also cited the company’s soaring profits, record-high number of subscribers, and improved costs per subscriber.\textsuperscript{129}

95. In summary, debt-holders and credit rating agencies view Sirius XM positively. The EBITDA and free cash flow projections the company is expected to achieve even with the proposed royalty rate schedule, as shown in Attachments 9 and 10, are unlikely to change Sirius XM’s risk profile as viewed by lenders and credit rating agencies.

### Equity investor assessment of Sirius XM

96. The equity markets provide additional insight into the strength of Sirius XM’s cash flow prospects. Like investors in debt instruments, equity investors seek returns on their investments, and the performance of Sirius XM’s equity is a reflection of its overall financial health and potential for growth. The stock’s price action and performance relative to its competitors can provide valuable signals about its market prospects and investor sentiment. A strengthening equity market for Sirius XM would suggest increased confidence in the company’s ability to generate returns and sustain its growth trajectory.

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\textsuperscript{127} From 1983-2010, an average of 32.5 percent of Ca-C-rated corporations have defaulted. During that same time period, 2.7 percent of B1-rated corporations have defaulted. Moody’s Investors Service, “Special Comment: Corporate Default and Recovery Rates, 1920-2010,” February 28, 2011, p. 31.

\textsuperscript{128} This upgrade was the sixth in a series of consecutive upgrades issued by S&P, which began in early 2009. (Bloomberg, L.P., Sirius XM Radio, Inc. - Credit Profile – Standard and Poor’s – LT Local Issuer Credit, accessed November 27, 2011.)

investments. However, the nature of equity investments differs from bond investments in two ways that are relevant to this analysis.\textsuperscript{130}

97. First, equity investors ("shareholders") possess claims to the cash flows generated by a firm \textit{above and beyond} the cash needed to pay bond holders and taxes (as well as other after-debt uses of a firm's cash that occur with less regularity). Because equity investments are "residual claims" to a firm's cash flow, the risk incurred by shareholders is higher than that of creditors. The difference in risk levels is reflected in the difference between bond yields and the cost of equity.

98. Second, modern portfolio theory has established that required returns on equity investments are determined by the risk each stock introduces to a diversified portfolio. The Nobel Prize-winning works of Professors Harry Markowitz and William Sharpe demonstrated that investors evaluate the projected cash flows to equity holders in the context of risks that cannot be eliminated through diversification. The non-diversifiable risk of a stock, in this case Sirius XM, is evaluated by market participants and used to determine the stock's cost of equity. The cost of equity is the measure of compensation required to provide shareholders adequate incentive for bearing the uncertainty introduced to the shareholder's diversified portfolio by a given stock. The higher the risk incurred by shareholders, the higher the cost of equity.

99. I obtained Sirius XM's cost of equity from Bloomberg L.P. and the average cost of equity for the radio and television broadcasting industry from Ibbotson Morningstar.\textsuperscript{131} Sirius XM's cost of equity of 11.60 percent is considerably below that of the radio and television industry composite (or weighted average) cost of 15.74 percent.\textsuperscript{132} From an economic perspective, investors currently require smaller returns from shareholdings in Sirius XM

\textsuperscript{130} The interest-rate tax shield is typically another difference between the cost of equity and the cost of debt, however because Sirius XM has the advantage of not paying taxes for the next several years the other factors I describe dominate the interest-rate tax shield in terms of relevance.

\textsuperscript{131} Bloomberg, L.P., Sirius XM Radio, Inc. - Weighted Average Cost of Capital Inputs - Cost of Equity, accessed November 20, 2011. See also, "SIC 483," Ibbotson, Morningstar, September 30, 2011. Sirius XM's SIC code is 4832, \textit{Radio broadcasting}. This 4-digit SIC includes only eight other firms. Sirius XM is by far the largest of the nine, so it has a large influence on industry average or composite measures. SIC 483, \textit{Television and radio broadcasting}, is a broader category that includes 21 total firms.

\textsuperscript{132} Sirius XM's cost of equity is included in Ibbotson's calculation of the industry average. If one were to exclude Sirius XM from the composite, the difference would be even larger.
than the returns required from investing in the radio and television broadcasting industry as a whole.

3. **Sirius XM’s return on invested capital**

100. In addition to analyzing Sirius XM’s stock and bond data separately, I assessed them together through a measure known as return on (total) invested capital (“ROIC”). ROIC measures the aggregate return available to a firm’s debt and equity investors.\(^{133}\) The ROIC measure shows that Sirius XM is currently generating returns beyond those required by stock and bond holders, controlling for the company’s risk level. These returns also far exceed those generated by other firms in the radio and television broadcasting industry. These returns are projected to continue throughout the upcoming royalty period of 2013 through 2017.

101. Attachment 12 shows actual and projected ROIC under the assumption that the proposed royalty rate schedule will apply to 100 percent of Sirius XM’s revenues. Sirius XM’s weighted-average cost of capital (“WACC”) measures the returns required by the firm’s investors in aggregate. WACC is calculated by separately measuring the returns required by lenders and by equity investors, and then weighting those returns by the proportion of debt and equity in a firm’s capital structure. As Attachment 12 shows, Sirius XM’s current WACC is 9.79 percent.\(^{134}\)

102. In 2011, Sirius XM generated a return on its invested capital of 16.35 percent, well in excess of the 9.79 percent WACC. This differential indicates that Sirius XM’s activities have enhanced investors’ wealth. As Attachment 12 also shows, the projected ROIC values for Sirius XM (incorporating the effect of the proposed royalty rate schedule) exceed the current WACC. Thus, the data indicate Sirius XM’s ability to outperform the returns commensurate with its risk levels in coming years.

103. Sirius XM also outperforms the average ROIC of the radio and television broadcasting industry. The latest ROIC of radio and television broadcasting industry composite was 3.90 percent, far below Sirius XM’s ROIC of 16.35 percent and also below the industry


composite WACC of 11.54 percent. This comparison also illustrates that an ROIC below WACC is a common event and not in itself indicative of economic disruption.

104. As shown in Attachment 13, the ROIC results are even stronger if the royalty rate schedule is applied to [□] percent of Sirius XM’s total revenues.

V. CONCLUSION

105. My analysis demonstrates that the royalty rate schedule proposed by SoundExchange would not be “disruptive” to the satellite radio industry, and more particularly, to Sirius XM. I find that the EBITDA and free cash flow impacts of the proposed royalty rate schedule, which ranges from 12 percent of revenues in 2013 to 20 percent in 2017, would not introduce a sudden inability for Sirius XM to remain current in payments and sustain future operations. Indeed, my results are conservative, in that Sirius XM’s financial performance would not be disrupted by even higher royalty rates than those proposed by SoundExchange. I also base these results on the conservative assumption that Sirius XM would not pass on to its customers any of the proposed royalty rate increases.

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135 My conclusions are unchanged if I compare Sirius XM to the Radio broadcasting sub-group.
I declare under penalty of perjury that the foregoing testimony is true and correct.

Date: 11/28/2011

Thomas Z. Lys
Appendix A
Curriculum Vitae
Thomas Z. Lys
November 2011

Kellogg Graduate School of Management
Northwestern University
Evanston, Il 60208

voice: (847) 491-2673
day: (847) 467-1202
email: tlys@northwestern.edu

EDUCATION

Ph.D. Graduate School of Management, University of Rochester, 1982 (Accounting and Finance).

ACADEMIC APPOINTMENTS

Kellogg Graduate School of Management, Northwestern University (1981-present)
2006- Eric L. Kohler Chair in Accounting and Professor of Accounting and Information Management
1999-06 Gary A. Rosenberg Distinguished Professor of Real Estate Management, Professor of Accounting and Information Management, and Director, Guthrie Center for Real Estate Research.
1997-99 Gary A. Rosenberg Distinguished Associate Professor of Real Estate Management, Associate Professor of Accounting and Information Systems, and Director, Guthrie Center for Real Estate Research.
1995-97 John L. and Helen Kellogg Distinguished Associate Professor of Accounting and Information Systems
1989-95 Associate Professor of Accounting and Information Systems.
1981-89 Assistant Professor of Accounting and Information Systems.

Northwestern School of Law, Northwestern University
2000- Professor of Law (courtesy appointment).
Graduate School of Business, Stanford University (January-August, 1997): Visiting Associate Professor of Accounting.
Graduate School of Business, University of Chicago (1986-87): Visiting Assistant Professor of Accounting.

PUBLICATIONS – ARTICLES (For recent articles see: http://ssrn.com/author=23037)

PUBLICATIONS – ARTICLES (continued)


PUBLICATIONS – ARTICLES (continued)


PUBLICATIONS – BOOKS, BOOK CHAPTERS AND OTHER PUBLICATIONS


WORKING PAPERS

How Much Silence is Too Much? An Empirical Analysis of Firms Ceasing Guidance of Different Frequencies (with Gary Chen and Jie Zhou), 2011.
The Nature and Implications of Acquisition Goodwill (with Linda Vincent and Nir Yehuda), 2011.
Conservatism and analyst earnings forecast bias (with Henock Louis and Amy X. Sun), 2010.
An Examination of the Impact of the Sarbanes-Oxley Act on the Attractiveness of US Capital Markets for Foreign Firms (with Peter Hostak, N. Emre Karaoglu, and Yong (George) Yang), 2010.
Motives for and Risk-Incentive Implications of CEO Severance (with Tjomme Rusticus and Ewa Sletten), 2008.
Exceptions do not Change the Rule: Substance Overrules Form in US GAAP (with N. Emre Karaoglu), 2008.
Optimal structure of the consideration in mergers and acquisitions (with Thomas Fields), 2002.
Bridging the Gap between Value Relevance and Information Content (with Kin Lo), 2001.
Determinants and implications of the serial-correlation in analysts’ earnings forecast errors (with John Jacob), 2000.
The role of earnings levels vs earnings changes in explaining stock returns: implications from the time series properties of earnings (with K. Ramesh and S. Ramu Thiagarajan), 1999.

EDITORIAL POSITIONS


TEACHING

MBA level: Financial Accounting; Security Analysis; Financial Statement Analysis; Mergers and Acquisitions.
Executive MBA level: Financial Accounting; Security Analysis; Mergers and Acquisitions.
Executive non-degree:
  Strategies for Improving Directors’ Effectiveness (Academic Director)
  Women's Director Development Program;
  Minority Director Development Program;
  Merger Week – Creating Value through Strategic Acquisitions and Alliances;
  Biotechnology – Strategies for Growth;
Lecture capabilities in English, French, German, and Polish.
HONORS AND AWARDS

Outstanding Professor Award, Executive Masters’ Program – KR 12, 2009.
Outstanding Professor Award, Executive Masters’ Program - 46, 2000.
Outstanding Professor Award, Executive Masters’ Program - 44, 2000.
Outstanding Professor Award, Executive Masters’ Program - 38, 1998.
Outstanding Professor Award, Executive Masters’ Program - 35, 1997.
Outstanding Professor Award, Executive Masters’ Program - 32, 1996.
Notable Contribution to Accounting Literature Award Screening Committee 1987-88.
Beatrice Foods Research Chair 1984-85.
Ernst & Whinney Research Fellow 1983-84.
CHAIRED DISSERTATION COMMITTEES, DATE of COMPLETION, and FIRST PLACEMENT

Jingjing Zang (Accounting), in progress
Liang Tan (Accounting), in progress
Rafael Rogo (Accounting), in progress
Dora Altschuler (Accounting), 2011, Loyola University Chicago
Ewa Sletten (Accounting), 2007, Massachusetts Institute of Technology
Peter Hostak (Accounting), 2006, University of Massachusetts at Dartmouth
Yong (George) Yang (Accounting), 2006, The Chinese University of Hong Kong
Aiyesha Dey (Accounting), 2005, University of Chicago
Xiaohui (Gloria) Liu (Accounting), 2004, University of Houston
Daniel Cohen, (Accounting), 2004, University of Southern California
Nuri Emre Karaoglu, (Accounting), 2003, University of Southern California
Elizabeth Eccher (Accounting), 1996, Massachusetts Institute of Technology
John Jacob (Accounting), 1995, University of Colorado, Denver
Marguerite Bishop (Accounting), 1995, New York University
Linda Vincent (Accounting), 1994, University of Chicago
Sungkyu Sohn, (Accounting), 1992, CUNY, Baruch College

DISSERTATION COMMITTEES, DATE of COMPLETION, and FIRST PLACEMENT

Ann Beyer (Accounting), 2006, Stanford University
Thomas Fields (Accounting), 2004, Harvard University
Yan (Rock) Gao (Finance), 2002
Xiaoquin Hu (Finance), 2002, University of Illinois, Chicago
Stephen Brown (Accounting), 2000, Emory
Kin Lo (Accounting), 1999, University of British Columbia
Rita Czaja, 1995 (Accounting), Michigan State University
Jowell Sabino (Accounting), 1994, University of Pennsylvania
Susan Wolcott (Accounting), 1993, University of Denver
Byong Ho Kim (Accounting), 1992, Kook-min University, Seoul, Korea
Billy Soo, 1991 (Accounting), Boston College
Naveen Khanna (Finance), 1986, University of Michigan, Ann Arbor
Paula Koch, 1989 (Accounting), University of Illinois, Chicago
Young Ho Lee (Finance), 1989, Hanwha Group, Seoul, Korea

SERVICE AT KELLOGG

Personnel Committee 2001-2005; 2009-2011;
Chair Ph.D. Committee, Department of Accounting and Information Systems (1990-96);
Chair Recruiting Committee, Department of Accounting and Information Systems 1993-95 and 2002-06;
Research Computing Committee, Kellogg Graduate School of Management 1989-present, Chair 1989-92.
INVITED TALKS AND PRESENTATIONS (last ten years)

2010-11  University of British Columbia
2009-10  *Journal of Accounting and Economics* Conference
          Stanford Summer Camp
2008-09  University of Washington at Seattle,
          Massachusetts Institute of Technology
2007-08  Washington University Conference
          Accounting Symposium, London Business School
2006-07  *Journal of Accounting Research* Conference
          Pennsylvania State University,
          *Journal of Accounting and Economics* Conference (Discussant)
          University of Oklahoma Research Conference, featured speaker
          Hong Kong University of Science and Technology Summer Symposium on Accounting
          Research featured speaker
          Harvard University, 2007 Information, Markets, and Organizations Conference
2005-06  Leventhal School of Accounting, University of Southern California
          Columbia School of Business, Columbia University
2004-05  *Journal of Accounting and Economics* Conference (Discussant)
          Jerusalem School of Business Administration, Hebrew University
          American Accounting Association Annual Meeting, Orlando, Florida
          Olin School of Business, Washington University Corporate Governance Conference
2003-04  Massachusetts Institute of Technology
          University of Colorado at Bolder
          Georgetown University
          Harvard University
          London Business School
2002-03  *Journal of Accounting and Economics* Conference (Discussant)
          *Journal of Accounting and Economics* Conference
2000-01  Simon School of Business, University of Rochester
          College of Business, University of Missouri-Columbia
          Leon Recanati Graduate School of Business Administration, Tel Aviv University
          Jerusalem School of Business Administration, Hebrew University
1999-00  American Accounting Association Annual Meeting, San Diego
          A.B. Freeman School of Business, Tulane University
          Michael F. Price College of Business, University of Oklahoma
EXPERT WITNESS ASSIGNMENTS

Engagements last four years

- Testifying expert for defendant in John Hancock Life Insurance Company v. Commissioner of Internal Revenue, United States Tax Court, Docket No.: 007084-10.

- Testifying expert for Plaintiff in United States of America, v. Suntrust Bank, as personal representative of the estate of Ralph W. Hughes, The United States District Court Middle District of Florida, Tampa Division, Case No. 8:09-CV-01443-EAK-AEP.


- Testifying expert for defendant in Santa Clara Valley Housing Group, Inc and Kristen M. Bowes, v. United States of America, United States District Court Northern District of California, Complaint for Refund of Internal Revenue Taxes, Case No. C08 05097.

- Testifying expert for defendants in Napoleon Perdis Cosmetics, Inc. v Sephora USA, Inc.; and does 1-50, Superior Court Of The State of California, County of Los Angeles, Central District; Case No.: Bc391382.


- Testifying expert for plaintiff in Ventas, Inc., v.HCP, INC., United States Court for the Western District of Kentucky at Louisville; Civil Action No. 3:07-cv-238-H.

- Testifying expert for plaintiff in Moet Hennessy SNC v. Phillips Beverage Company, in the arbitration before the American Arbitration Association under the International Dispute Resolution Procedures.


Curriculum Vitae – Thomas Z. Lys

- Testifying expert for defendant in AWG Leasing Trust, et al., v. United States of America, United States District Court for the Northern District of Ohio, No. 1:07-CV-0857.

- Testifying expert for plaintiffs in Enron Corp., et al., v. Citigroup Inc., et al., United States Bankruptcy Court Southern District of New York, adversary proceeding No. 03-09266 (AJG).


Attachment 1
Sirius XM
Adjusted Total Revenue by Segment
2008 - 2011

Dollars (in millions)

2008: $2,258
2009: $2,334
2010: $2,429
2011: $2,594

Legend:
- Subscriber Revenue
- Equipment Revenue
- Advertising Revenue
- Other Revenue
Attachment 1

Sirius XM

Adjusted Total Revenue by Segment

2008 - 2011

Notes:

[1] Historical data are "pro forma" or "adjusted" as defined by Sirius XM. Adjusted revenue figures include the effect of purchase price accounting adjustments associated with the merger. Figures for 2008 include adjustments for "Predecessor Financial Information." See Sirius XM Radio Inc., Form 10-K for the fiscal year ended December 31, 2010, pp. 35, 50-52. Revenue in 2011 is calculated using "pro forma" projections for Q4 2011 as reported by Morgan Stanley, which are assumed to be in millions. See Swinburne, Benjamin and Ryan Fiftal, Morgan Stanley, "Sirius XM Radio Inc.: Reiterating OW Following 3Q Results, Outlook Unchanged," November 3, 2011, pp. 11 and 18.

[2] For the nine months ending September 30, 2011, Sirius XM generated $2,239,737,000 in adjusted total revenue, consisting of $1,926,430,000 in Subscriber Revenue, $48,392,000 in Equipment Revenue, $53,595,000 in Advertising Revenue, and $211,320,00 in Other Revenue. See Sirius XM Radio Inc., Form 10-Q for the fiscal quarter ended September 30, 2011, p. 43.

Sirius XM provides the following explanations of revenue segments (see Sirius XM Radio Inc., Form 10-K for the fiscal year ended December 31, 2010, pp. 27-28):

[3] "Subscriber Revenue includes subscription fees, activation and other fees and the effects of rebates."

[4] "Advertising Revenue includes the sale of advertising on our non-music channels, net of agency fees. Agency fees are based on a contractual percentage of the gross advertising billing revenue."

[5] "Equipment Revenue includes revenue and royalties from the sale of satellite radios, components and accessories."

[6] "Other Revenue includes the U.S. Music Royalty Fee, revenue from affiliates, content licensing fees and syndication fees."
Attachment 2  
Sirius XM  
Analyst Projections of Total Revenue  
2011 - 2015

Notes:  
[1] Analyst projections, excluding those from Morgan Stanley, are as reported by Thomson ONE. Projections from "Undisclosed" sources are excluded from this analysis.  
[3] The calculated mean is the straight average of reported projections.
Attachment 3
Sirius XM
Total Pro Forma Revenue by Segment
2008 - 2016

Notes:
[1] Revenue data are "pro forma" as reported by Morgan Stanley. Morgan Stanley figures are assumed to be in millions. See Swinburne, Benjamin and Ryan Fiffl, Morgan Stanley, "Sirius XM Radio Inc.: Reiterating OW Following 3Q Results, Outlook Unchanged," November 3, 2011, pp. 10 and 16.
[3] Morgan Stanley and Sirius XM report revenue for the same four segments: Subscriber Revenue, Equipment Revenue, Advertising Revenue, and Other Revenue. However, reported figures and their itemized designations may differ slightly between the Morgan Stanley report and Sirius XM's SEC filings due to rounding differences. Additionally, in 2008 and 2009, Morgan Stanley reports slightly less Subscriber Revenue and slightly more Other Revenue than reported by Sirius XM.
Sirius XM provides the following explanations of revenue segments (see Sirius XM Radio Inc., Form 10-K for the fiscal year ended December 31, 2010, pp. 27-28):
[4] "Subscriber Revenue includes subscription fees, activation and other fees and the effects of rebates."
[5] "Equipment Revenue includes revenue and royalties from the sale of satellite radios, components and accessories."
[6] "Advertising Revenue includes the sale of advertising on non-music channels, net of agency fees. Agency fees are based on a contractual percentage of the gross advertising billing revenue."
[7] "Other Revenue includes the U.S. Music Royalty Fee, revenue from affiliates, content licensing fees and syndication fees."
Attachment 4
Sirius XM
Quarter-End Number of Subscribers by Source
Q4 2008 - Q3 2011

July 29, 2009: Sirius XM introduced the U.S. Music Royalty Fee

Notes:
[1] From the quarter ending December 31, 2008 through the quarter ending December 31, 2010, subscriber numbers are as reported by Bloomberg, L.P. Subscriber numbers in 2011 are as reported by Morgan Stanley. See Swinburne, Benjamin and Ryan Fiftal, Morgan Stanley, "Sirius XM Radio Inc.: Reiterating OW Following 3Q Results, Outlook Unchanged," November 3, 2011, p.13
Attachment 5
Sirius XM
Year-End Number of Subscribers by Source
2008 - 2015

Subscribers (in thousands)

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<tr>
<th>Year</th>
<th>Actual</th>
<th>Projected</th>
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<td>2011</td>
<td>15,278</td>
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<td>2012</td>
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<td>5,805</td>
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<td>2013</td>
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<tr>
<td>2014</td>
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<td>4,979</td>
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<tr>
<td>2015</td>
<td>22,045</td>
<td>4,657</td>
</tr>
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Notes:
**Attachment 6**

**Sirius XM**

**Adjusted Total Operating Expenses**

2008 - 2011

---

**Notes:**


[2] Adjusted Total Operating Expenses are calculated as the sum of "Costs of Services" and "Other Operating Expenses." "Costs of Services," as calculated by Sirius XM, are the sum of "Revenue share and royalties," "Programming and content," "Customer service and billing," "Satellite and transmission," and "Cost of equipment." "Other Operating Expenses" are calculated as the sum of "Subscriber acquisition costs," "Sales and marketing," "Engineering, design, and development," "General and administrative," "Depreciation and amortization," "Restructurings, impairments and related costs," and "Share-based payment expense."
Not available
Notes:
[1] Analyst projections, excluding those from Morgan Stanley, are as reported by Thomson ONE. Projections from "Undisclosed" sources are excluded from this analysis.
[2] EBITDA projections from Morgan Stanley are "Adjusted (as defined by SIRI)," which are "pro forma." For the nine-month period ending September 30, 2011, Morgan Stanley reports EBITDA as $563,800,000. See Swinburne, Benjamin and Ryan Fifita, Morgan Stanley, "Sirius XM Radio Inc.: Reiterating OW Following 3Q Results, Outlook Unchanged," November 3, 2011, pp. 16 and 18.
[3] The calculated mean is the straight average of reported projections.
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<td>$2,436.7</td>
<td>$2,526.7</td>
<td>$2,839.9</td>
<td>$3,021.5</td>
<td>$3,372.4</td>
<td>$3,709.0</td>
<td>$4,039.2</td>
<td>$4,408.4</td>
<td>$4,771.5</td>
<td>$5,000.5</td>
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<tr>
<td>Additional Revenue from U.S. Music Royalty Passthrough</td>
<td>$0.0</td>
<td>$0.0</td>
<td>$0.0</td>
<td>$0.0</td>
<td>$0.0</td>
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<td>$1,334.1</td>
<td>$1,211.8</td>
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<td>$1,476.4</td>
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<td>$242.4</td>
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<td>$0.0</td>
<td>$0.0</td>
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<td>$-136.3</td>
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<td>$626.3</td>
<td>$734.7</td>
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<td>$1,414.0</td>
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<td>$1,886.7</td>
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<tr>
<td>Not Included</td>
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<td>$192.9</td>
<td>$359.1</td>
<td>$741.6</td>
<td>$873.4</td>
<td>$1,123.4</td>
<td>$1,279.4</td>
<td>$1,391.2</td>
<td>$1,458.0</td>
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<table>
<thead>
<tr>
<th>Net Adjustments from Change in Royalty Rate</th>
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<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
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<td>$0.0</td>
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<td>$0.0</td>
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<td>$-18.4</td>
<td>$242.4</td>
<td>$-552.7</td>
<td>$-477.2</td>
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<td>$1,458.0</td>
<td></td>
</tr>
</tbody>
</table>

Notes:
[2] Forecasts for 2017 are calculated under the following assumptions: i) revenues and free cash flow grow at the same rate as the economy as a whole (year-over-year percentage increase in nominal GDP as projected by the United States Congressional Budget Office) in 2017, and ii) the costs of revenue and EBITDA as percentages of revenue remain unchanged from the 2016 levels forecasted by Morgan Stanley. See Congres of the United States, Congressional Budget Office, "The Budget and Economic Outlook: An Update," August 2011, p. 72.
[4] I assume that 100 percent of revenues are subject to royalty payments to SoundExchange in the years 2013 through 2017.
[5] This analysis incorporates zero additional revenue from the U.S. Music Royalty Fee. Sufficient data for this computation are not currently available. Additional revenue will increase the EBITDA and FCFE at Sirius XM.
[6] Net adjustments to EBITDA and FCFE from the change in royalty rate are assumed to generate no tax savings to Sirius XM. Any tax savings generated by the increased royalty rate will increase EBITDA and FCFE at Sirius XM.
### Public Version

**Attachment 10 [RESTRICTED]**

**Sirius XM**

**Performance with Sirius XM Paying a 12 Percent Royalty Rate in 2013, 14 Percent in 2014, 16 Percent in 2015, 18 Percent in 2016, and 20 Percent in 2017 Assuming Sirius XM Completely Absorbs the Increase in Royalty Rate (Zero Percent of the Royalty Increase Passed Through to Customers)**

**Royalties Paid on 50 Percent of Revenue (Figures in $ Millions)**

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<tr>
<td>Projected and Historical Total Revenue</td>
<td>$2,436.7</td>
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<td>$2,838.9</td>
<td>$3,021.5</td>
<td>$3,372.4</td>
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<td>$0.0</td>
<td>$0.0</td>
<td>$0.0</td>
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<td>$1,334.1</td>
<td>$1,211.8</td>
<td>$1,250.3</td>
<td>$1,280.5</td>
<td>$1,385.1</td>
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<td>$1,708.7</td>
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<tr>
<td>Projected and Historical EBITDA</td>
<td>$-136.3</td>
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<td>$626.3</td>
<td>$734.7</td>
<td>$917.4</td>
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<td>$0.0</td>
<td>$0.0</td>
<td>$0.0</td>
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<td>$0.0</td>
<td>$0.0</td>
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<td>$0.0</td>
</tr>
<tr>
<td>EBITDA Incorporating Updated 2013-2017 Royalty Rate</td>
<td>$-136.3</td>
<td>$462.5</td>
<td>$626.3</td>
<td>$734.7</td>
<td>$917.4</td>
<td>$1,107.3</td>
<td>$1,414.0</td>
<td>$1,646.4</td>
<td>$1,886.7</td>
<td>$1,977.3</td>
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<tr>
<td>Projected and Historical Free Cash Flow to Equity (&quot;FCFE&quot;)</td>
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<td>$192.9</td>
<td>$359.1</td>
<td>$741.6</td>
<td>$873.4</td>
<td>$1,123.4</td>
<td>$1,279.4</td>
<td>$1,391.2</td>
<td>$1,458.0</td>
</tr>
<tr>
<td>Net Adjustments from Change in Royalty Rate</td>
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<td>$0.0</td>
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<td>FCFE Incorporating Updated 2013-2017 Royalty Rate</td>
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<td>$1,123.4</td>
<td>$1,279.4</td>
<td>$1,391.2</td>
<td>$1,458.0</td>
</tr>
</tbody>
</table>

**Notes:**

1. Historical figures and forecasts for 2008 through 2016 were obtained from the November 3, 2011 Morgan Stanley Report. Projected and Historical EBITDA is reported as "Operating Cash Flow (EBITDA) -Pre SBC" in the Morgan Stanley report.
3. Forecasts for 2017 are calculated under the following assumptions: i) revenues and free cash flow grow at the same rate as the economy as a whole (year-over-year percentage increase in nominal GDP as projected by the United States Congressional Budget Office) in 2017, and ii) the costs of revenue and EBITDA as percentages of revenue remain unchanged from the 2016 levels forecasted by Morgan Stanley. See Congress of the United States, Congressional Budget Office, "The Budget and Economic Outlook: An Update," August 2011, p. 72.
4. I assume that the Morgan Stanley report dated November 3, 2011 incorporated an eight percent royalty rate in the years 2013 through 2016.
5. I assume that percent of revenues are subject to royalty payments to SoundExchange for the years 2013 through 2017.
6. This analysis incorporates zero additional revenue from the U.S. Music Royalty Fee. Sufficient data for this computation are not currently available. Additional revenue will increase the EBITDA and FCFE at Sirius XM.
7. Net adjustments to EBITDA and FCFE from the change in royalty rate are assumed to generate no tax savings to Sirius XM. Any tax savings generated by the increased royalty rate will increase EBITDA and FCFE at Sirius XM.
Attachment 11
Sirius XM and Moody's Baa Index
Yield To Maturity of Publicly-Traded Debt
July 2008 - November 2011

ISIN Identifiers of Sirius XM Bonds and Name of Moody's Index

- US98375NAA81
- US98375NAD03
- US98375YAU01 (Convertible)
- US82967NAA63
- US82967NAD03
- US82967YAZ97
- Moody's Corporate Bonds Index: Baa

Notes:
[1] Corporate bonds are listed by ISIN number. The five bonds presented constitute Sirius XM's publicly traded series 144A debt, excluding those that have matured or that have been called. All bonds have fixed-rate coupons. Apart from the convertible bond, each of the bonds listed above is callable. US82967NAA63 and US82967NAD03 were issued by Sirius XM Radio Inc. The others were issued by XM Satellite Radio Inc. See Bloomberg, L.P.
[3] The measure of yield used for this exhibit is defined by Bloomberg as: "The yield of a bond calculated to maturity (Mid)." See Bloomberg, L.P.
[4] If no trades occur on a given day, the yield for the date of the most recent trade is carried forward.
Notes:
[1] Ibbotson defines return on invested capital (ROIC) as income before extraordinary items (IBEI) divided by total invested capital (TIC). I divide IBEI by the average of TIC for the current and prior year. IBEI is defined as "the income of a company after all expenses, including special items, income taxes, and minority interest, but before provisions for common and/or preferred stock." TIC is defined as book debt (BD) plus book value of equity (BVE). BD is the sum of book value of debt in current liabilities (STD), book value of long-term debt (LTD), and book value of preferred stock (PSTK). See "Industry Module Methodology," 2011 Ibbotson Cost of Capital Yearbook, Morningstar.
[3] Sirius XM WACC is as of November 20, 2011, using a 3 percent effective tax rate. I also considered Sirius XM's WACC with a zero percent effective tax rate; the results were not materially different. See Bloomberg, L.P.
[4] Industry composite values are based on twenty-one companies in SIC 483 as of September 30, 2011 and include Sirius XM. Composite ROIC is 3.90 percent and composite WACC is 11.54 percent. See "SIC 483," Ibbotson, Morningstar, September 30, 2011.
Notes:
[1] Ibbotson defines return on invested capital (ROIC) as income before extraordinary items (IBEI) divided by total invested capital (TIC). I divide IBEI by the average of TIC for the current and prior year. IBEI is defined as "the income of a company after all expenses, including special items, income taxes, and minority interest, but before provisions for common and/or preferred stock." TIC is defined as book debt (BD) plus book value of equity (BVE). BD is the sum of book value of debt in current liabilities (STD), book value of long-term debt (LTD), and book value of preferred stock (PSTK). See "Industry Module Methodology," 2011 Ibbotson Cost of Capital Yearbook, Morningstar.
[3] Sirius XM WACC is as of November 20, 2011, using a 3 percent effective tax rate. I also considered Sirius XM's WACC with a zero percent effective tax rate; the results were not materially different. See Bloomberg, L.P.
[4] Industry composite values are based on twenty-one companies in SIC 483 as of September 30, 2011 and include Sirius XM. Composite ROIC is 3.90 percent and composite WACC is 11.54 percent. See "SIC 483," Ibbotson, Morningstar, September 30, 2011.
Before the
UNITED STATES COPYRIGHT ROYALTY JUDGES
Washington, D.C.

In the Matter of:
Determination of Rates and Terms for
Preexisting Subscription Services and
Satellite Digital Audio Radio Services

Docket No. 2011-1
CRB PSS/Satellite II

TESTIMONY OF

J. GREGORY SIDAK

Chairman, Criterion Economics, L.L.C. and Ronald Coase Professor of Law and Economics, Tilburg Institute for Law and Economics, Tilburg University

Witness for SoundExchange, Inc.
INTRODUCTION AND EXECUTIVE SUMMARY ................................................................................................. 1

QUALIFICATIONS.......................................................................................................................................... 4

I. THE MERGER’S ECONOMIC BENEFITS TO SIRIUS XM ENABLE IT TO PAY A HIGHER ROYALTY RATE FROM 2013 TO 2017 AND STILL EARN A “FAIR INCOME” .......................................................... 8
   A. Sirius XM Has Become the Sole SDARS Provider for the Foreseeable Future ................................................................. 9
      1. The FCC Approved the Merger with Conditions ........................................ 9
      2. Sirius XM Has Exploited Its Post-Merger Market Power to Raise Prices ............................................................................. 10
   B. The Expiration of the Price Caps Will Enable Sirius XM to Increase Profits ........................................................................ 11
      1. The Price Caps Will Expire Before the Next License Period .......... 11
      2. Sirius XM Can Increase Profits by Increasing Subscription Prices ..... 12
      3. The Merger Reduced Sirius’s and XM’s Combined Costs .......... 13
      4. Tobin’s \( q \) for Sirius XM Implies an Ability to Exploit Market Power ...................................................................................... 13
   C. Barriers to Entry Will Protect Sirius XM’s Profits from 2013 to 2017 .................................................................................. 16

II. SIRIUS XM IS RELATIVELY IMPERVIOUS TO MACROECONOMIC DOWNTURNS .............................................. 17

III. SIRIUS XM CAN PAY A HIGHER ROYALTY FROM 2013 TO 2017 AND STILL EARN A “FAIR INCOME” BECAUSE IT WILL FACE LESS RISK .............................................................. 21
   A. Older Forms of Audio Entertainment Have Not Constrained Sirius XM’s Prices and Are Unlikely to Constrain Sirius XM’s Profits Further in the Coming License Period ......................................................... 23
      1. Advertiser-Supported Terrestrial Radio .............................................. 23
      2. HD Radio .......................................................................................... 26
      3. MP3s Delivered over an iPod ............................................................... 28
   B. There Is Insufficient Evidence to Conclude That, from 2013 to 2017, Sirius XM Will Face Competition from the New Technology of Mobile Internet Radio in Cars ........................................................................... 28
      1. Mobile Internet Radio Is Unlikely to Overcome Sirius XM’s Commanding Distribution Advantage with Automobile Manufacturers by 2017 .................................................................................... 29
      2. It Is Doubtful That Mobile Internet Radio in Cars Will Constrain Sirius XM’s Prices or Number of Subscribers Before 2017 .............................................................................................................. 31
         a. Technological Limitations to Data Usage and Internet Connectivity Exist in Cars ........................................................................ 31
         b. Technological and Safety Limitations Prevent the Seamlessness of Mobile Internet Radio in Cars .............................................. 32
   C. Sirius XM Will Face a Lesser Economic Cost of Technological Risk in the Next License Period Than It Has Faced in the Current License Period .............................................. 34
D. Sirius XM Will Face a Low Degree of Legal and Regulatory Risk .......................... 35

IV. A HIGHER ROYALTY RATE WILL NOT DISRUPT THE SDARS MARKET .................. 35

V. CONCLUSION .................................................................................................................. 40

APPENDIX I: CURRICULUM VITAE OF J. GREGORY SIDAK

APPENDIX II: MATERIALS RELIED UPON

APPENDIX III: CALCULATION OF SIRIUS XM’S REPLACEMENT COST
INTRODUCTION AND EXECUTIVE SUMMARY

1. I have been asked by counsel for SoundExchange to evaluate competition within the audio entertainment industry and other factors affecting Sirius XM, with a particular focus on Sirius XM’s ability to pay the rates proposed by SoundExchange and whether those rates would have a disruptive impact on Sirius XM’s operations. In the prior royalty rate proceeding, the Copyright Royalty Judges (CRJs) determined the zone of reasonable royalty rates.1 The CRJs determined that “an immediate increase to the upper boundary” of that zone that was “most strongly indicated by marketplace data” “would be disruptive,” and that a “rate within the zone of reasonableness that is less than” the upper bound was warranted.2 To avoid any disruptive impact, the CRJs established rates beginning at 6 percent with increases during the rate term to 8 percent. It is my opinion that, given Sirius XM’s improved financial performance and its advantageous position among distributors of audio entertainment, Sirius XM has, and will have, the ability to pay, without any disruptive impact to its operations, the royalty rates that SoundExchange is proposing for the period 2013 to 2017.

2. Under section 801(b)(1) of the Copyright Act, the CRJs have the authority to establish “reasonable terms and rates of royalty payments” for preexisting satellite digital audio radio services (SDARS).3 That rate “shall be calculated”4 to achieve the following four objectives:

   (A) To maximize the availability of creative works to the public.
   (B) To afford the copyright owner a fair return for his or her creative work and the copyright user a fair income under existing economic conditions.
   (C) To reflect the relative roles of the copyright owner and the copyright user in the product made available to the public with respect to relative creative contribution.

2. Id. at 4097.
4. Id.
technological contribution, capital investment, cost, risk, and contribution to the opening of new markets for creative expression and media for their communication. (D) To minimize any disruptive impact on the structure of the industries involved and on generally prevailing industry practices. My analysis focuses primarily on whether paying a higher, market-derived royalty rate within the zone of reasonableness would ensure Sirius XM a fair income under existing economic conditions and minimize any disruptive impact to the provision of SDARS to subscribers, based on the competitive and other risks that Sirius XM could face in the next license period.

3. In Part I, I explain how the Sirius-XM merger in 2008 enhanced Sirius XM’s ability to pay a higher royalty and still earn a “fair income.” Sirius XM became the only provider of SDARS through the merger. The fact that the Federal Communications Commission (FCC) approved the merger with conditions, including price caps on subscriptions, indicates that the agency believed that Sirius XM could exercise market power absent such conditions. However, once the price caps expire at the end of 2011, Sirius XM will be able to charge higher subscription prices. Economic evidence implies that consumers have a price-inelastic demand for SDARS, such that Sirius XM could raise prices profitably in the absence of a legal or regulatory constraint. Also because of the merger, Sirius XM has achieved efficiencies that have lowered Sirius XM’s costs and further enhanced its profits. Significant barriers to entry will protect Sirius XM’s supracompetitive profits from 2013 to 2017. Consequently, Sirius XM will be able to pay SoundExchange’s proposed rates.

4. In Part II, I analyze the extent to which Sirius XM is subject to macroeconomic risk, and whether that risk has risen or fallen since 2008. The low volatility and consistent

5. *Id.*
growth in Sirius XM’s subscribership that have occurred while real household income has fallen indicate that Sirius XM’s subscribership is remarkably impervious to macroeconomic adversity.

5. In Part III, I examine the risks that Sirius XM believes it will face in the next license period. Sirius XM has indicated in public filings that it may face risk related to increasing competition from other forms of audio entertainment, the integrity of its satellites (technological risk), and adverse developments in regulations or law. However, Sirius XM has significant competitive advantages over other delivery platforms for audio entertainment. Consequently, from 2013 to 2017, the entry or growth of other delivery platforms for audio entertainment is unlikely to reduce Sirius XM’s subscribership or significantly constrain its prices. Furthermore, as the sole FCC licensee to provide SDARS, Sirius XM faces little legal or regulatory risk. Finally, because Sirius XM will have completed the launch and deployment of its satellite infrastructure before the start of the next license period, Sirius XM will face considerably less technological risk from 2013 to 2017 than it will have faced from 2007 to 2012.

6. In Part IV, I explain why payment by Sirius XM of a higher, market-determined royalty would not disrupt the SDARS industry. In my opinion, a rate would clearly disrupt the SDARS industry if it forced Sirius XM to cease operating. However, the rates that SoundExchange proposes would not begin to approach that level.

7. My current curriculum vitae is attached as Appendix I to this report. The opinions contained here are based on my education, my experience, and the information I have reviewed. A list of documents that I relied upon in forming my opinions is attached as Appendix II. I have relied upon only publicly available information. I reserve the right to amend my testimony if additional information becomes available in discovery.
QUALIFICATIONS

8. My name is J. Gregory Sidak. I am the chairman of Criterion Economics, L.L.C. in Washington, D.C. I am also the Ronald Coase Professor of Law and Economics at Tilburg University in The Netherlands and a founding co-editor of the *Journal of Competition Law & Economics*, published quarterly by the Oxford University Press.


10. From 1992 through 2005, I was a resident scholar at the American Enterprise Institute for Public Policy Research (AEI), where I held the F.K. Weyerhaeuser Chair in Law and Economics. At AEI, I directed a large research initiative on telecommunications regulation that produced scores of academic conferences and publications. From 1993 to 1999, while at AEI, I was also a Senior Lecturer at the Yale School of Management, where I taught a course with Dean Paul W. MacAvoy on regulation and competitive strategy to graduate management students. From 2005 to 2007, I was a Visiting Professor of Law at Georgetown University Law Center,
where I taught courses on telecommunications regulation and antitrust law. Early in my career, I worked as a management consultant with the Boston Consulting Group.

11. Over the past thirty years, I have published six books and more than eighty articles in scholarly journals. My scholarly writings have been downloaded more than 50,000 times from the Social Science Research Network and have appeared in such journals as the *Journal of Political Economy*, the *Yale Journal on Regulation*, the *Review of Industrial Organization*, the *American Economic Association Papers & Proceedings*, *Contributions in Economic Policy Research*, *World Competition*, *Review of Network Economics*, *Industrial and Corporate Change*, the *Journal of Network Industries*, the *Columbia Law Review*, the *Stanford Law Review*, the *University of Chicago Law Review*, and the *Yale Law Journal*. Courts and regulatory commissions that have cited my writings include the Supreme Court of the United States, the Supreme Court of Canada, the European Commission, the U.S. Court of Appeals for the D.C. Circuit, the Federal Communications Commission, and various state supreme courts. I have testified before Congress on multiple occasions concerning economic aspects of regulation in the telecommunications industry and other network industries.

12. My essays have appeared in newspapers and business periodicals, including the *New York Times* and the *Wall Street Journal*. I have been interviewed and quoted by newspapers, magazines, and news organizations, including the *Asahi Shimbun*, the BBC, Bloomberg, *The Daily Telegraph*, *The Economist*, Fox News, *Forbes*, *La Reforma* (Mexico City), the *Los Angeles Times*, the Mainichi newspapers, MSNBC, *The News Hour with Jim Lehrer*, the *Nihon Keizai Shimbun* (the Nikkei), NPR’s *All Things Considered*, the *Sankei Shimbun*, and the *Wall Street Journal*. 

14. My consulting engagements have addressed economic questions concerning antitrust, patents and intellectual property, network industries (telecommunications, the Internet, electricity, natural gas, transportation, and postal delivery), international trade, entertainment and sports, mass media, public utility regulation, spectrum auctions and policy, state-owned enterprises, breach of contract, covenants not to compete, securities fraud, complex commercial litigation, damages, injunctive relief, and constitutional protection of private property and economic activity.

15. On behalf of clients, I have filed numerous expert reports with the Federal Communications Commission concerning antitrust and regulatory issues affecting operators of satellite services. In the proposed merger of the two direct broadcast satellite providers, DirecTV...
and EchoStar (DISH), I filed three reports on behalf of the National Association of Broadcasters concerning the anticompetitive consequences of the merger. In the Sirius-XM satellite merger, I filed five reports on the anticompetitive consequences of the merger and made presentations to the Assistant Attorney General and the chief economist of the Antitrust Division of the U.S. Department of Justice, as well as presentations to all Commissioners of the FCC. On behalf of the Communications Satellite Corporation (COMSAT), I submitted expert reports containing economic and competitive analysis relevant to the constitutionality of the FCC’s proposal to mandate Level 3 direct access to space segment capacity on the INTELSAT global satellite system. I have provided expert economic testimony on behalf of Disney in a contractual dispute with DISH concerning its distribution of entertainment programming by direct broadcast satellite. I have also filed various expert reports concerning spectrum policy, spectrum auctions, and competition in wireless communications. I have extensive experience in the

8. Application of EchoStar Communications Corporation, General Motors Corporation, Hughes Electronics Corporation, Transferors, and EchoStar Communications Corporation, Transferee, For Authority to Transfer Control, Federal Communications Commission, CS Dkt. No. 01-348


11. Deposition of J. Gregory Sidak, EchoStar Satellite L.L.C. v. ESPN, Inc., et al., Index No. 08-600282, Supreme Court of New York, County of New York (July 29, 2011) (on behalf of ESPN and other Disney companies) (subject to protective order).

pricing of compulsory access to private property—including patent royalties, the pricing of competitor access to unbundled elements of incumbent telecommunications networks, public utility rate making, and just compensation for government takings of property.

16. In addition to having performed consulting engagements of this nature, I served from 2002 to 2006 as a member of the U.S. Advisory Board for NTT DoCoMo, Japan’s largest wireless telecommunications company. In that capacity, I briefed DoCoMo’s chairman semiannually on the economic implications of emerging regulatory and antitrust trends.

I. The Merger’s Economic Benefits to Sirius XM Enable It to Pay a Higher Royalty Rate from 2013 to 2017 and Still Earn a “Fair Income”

17. In the 2008 proceeding, the CRJs reasoned that “[a]ffording [the SDARS] a fair income is not the same thing as guaranteeing them a profit in excess of the fair expectations of a highly leveraged enterprise. Nor is a fair income one which allows the SDARS to utilize its other resources inefficiently.” The CRJs instead concluded that “a fair income is more consistent with reasonable market outcomes.” Whether the royalty rate would diminish the SDARS’ ability to achieve profitability was deemed relevant only to the fourth statutory objective of section 801(b)(1), minimizing the “disruptive impact” of the royalty. In 2008, Sirius and XM had “not shown that their income under existing economic conditions [wa]s unfairly constrained by adoption of a rate informed by the marketplace evidence[.]”

18. In this rate proceeding, I consider whether paying higher, market-determined rates will unfairly constrain Sirius XM’s income, taking into consideration the benefits from its

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13. CRJ 2008 Final Rule and Order, supra note 1, at 4095 (internal citations omitted).
14. Id.
15. Id.
16. Id.
merger and its competitive advantage relative to other technologies for music delivery. A higher royalty rate within the zone of reasonableness would still allow Sirius XM a “fair income” for purposes of section 801(b)(1)(B). Due to the Sirius-XM merger, Sirius XM is the only provider of SDARS. It has market power—the ability to sustain supracompetitive profits. High entry barriers—including the absence of additional SDARS spectrum—will shield Sirius XM from competition and increase its ability to pay a higher royalty rate from 2013 to 2017.

A. Sirius XM Has Become the Sole SDARS Provider for the Foreseeable Future

19. Before their 2008 merger, Sirius and XM were the only two providers of content over SDARS. The merger made Sirius XM the sole provider of SDARS. Sirius XM now can raise subscription prices for consumers above the pre-merger level, thereby reaping higher profits than Sirius’s and XM’s combined profits before the merger. Consequently, Sirius XM will have a greater ability to pay sound recording royalties than Sirius and XM together had before the merger, holding other factors constant.

1. The FCC Approved the Merger with Conditions

20. The FCC approved the Sirius-XM merger with specific conditions to prevent anticompetitive harm from the merger. Most notably, the FCC required that Sirius XM cap its subscription prices.17 Thus, the FCC’s approval presumed that the merged Sirius XM would acquire market power and, in the absence of price caps, increase its profits by raising prices. This increased market power lowers Sirius XM’s expected competitive risk for the period from 2013 to 2017 compared with the period from 2007 to 2012 that Sirius and XM faced in late 2007 and early 2008 (when the CRJs last set the SDARS’ royalty rates).

2. Sirius XM Has Exploited Its Post-Merger Market Power to Raise Prices

21. When Sirius and XM filed their merger application in March 2007, they each offered one package for $12.95 per month.\(^{18}\) Since its 2008 merger, Sirius XM has raised subscription prices for a number of its packages. Sirius XM’s demonstrated ability to raise prices is economic evidence that Sirius XM’s pricing is not constrained by competition.

22. One finds evidence of price increases by Sirius XM in the record in Blessing v. Sirius XM Radio Inc.\(^{19}\) Sirius XM was the defendant in an antitrust class action lawsuit challenging the legality of its merger.\(^{20}\) The case concerned numerous price increases that Sirius XM allegedly could not have imposed on consumers had the merger not occurred.\(^{21}\) In particular, Sirius XM: (1) increased “the monthly charge per additional radio for multi-radio subscribers from $6.99 per month to $8.99;” (2) “initiat[ed] a $2.99 monthly fee for [I]nternet streaming;” (3) charged a royalty fee “between 10% and 28%;” and (4) increased “various administrative fees.”\(^{22}\) The price increase from $6.99 to $8.99 per month is an increase of 28.6 percent, which far exceeds the 2.62-percent increase in the consumer price index that occurred from July 2008 to July 2010.\(^{23}\) These price increases are economic evidence that Sirius XM acquired market power through its merger and has exercised it.

23. Blessing reveals two factors that indicate Sirius XM’s ability to pay higher royalties due to the merger. First, Sirius XM’s increased market power enables it profitably to

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\(^{18}\) Consolidated Application for Authority to Transfer Control of XM Radio Inc. and Sirius Satellite Radio Inc., MB. Dkt. No. 07-57, at 10 (Mar. 20, 2007) [hereinafter 2007 Sirius-XM Consolidated Merger Application]. In November 2011, the subscription price for the “All Access” package, which includes all channels on a Sirius, XM, or Sirius XM radio and streaming Internet radio, was $199 per year—or about $16.58 per month.\(^{19}\) Sirius XM, Our Most Popular Packages for Sirius XM, http://www.siriusxm.com/ourmostpopularpackages-sxm (last visited Nov. 22, 2011).
\(^{19}\) No. 09 CV 10035(HB), 2011 WL 1194707, 2011-1 Trade Cas. ¶ 77,468 (S.D.N.Y. Mar. 29, 2011).
\(^{20}\) Id. slip op. at *1.
\(^{21}\) Id.
\(^{22}\) Id.
sustain a price above the previous level, which suggests that SDARS consumers have relatively price-inelastic demand for SDARS. Second, Sirius XM has the ability to pay a higher royalty by passing through increases in its music royalties to subscribers. Pass through of cost increases to consumers was an enumerated exception to the FCC’s subscription price caps, and Sirius XM has indeed passed cost increases through to consumers in the form of a “Music Royalty Fee”—a monthly surcharge to any subscription that included significant music content.

B. The Expiration of the Price Caps Will Enable Sirius XM to Increase Profits

24. Sirius XM’s price caps will expire in December 2011. Sirius XM will be fully able to exploit its market power in the next license period, which it has not been able to do in the current license period. Furthermore, due to the merger, Sirius XM achieved costs savings, further enabling Sirius XM to increase profits.

1. The Price Caps Will Expire Before the Next License Period

25. The FCC’s price caps on Sirius XM expired in July 2011, and the agency declined to extend that condition. In August 2011, the parties in Blessing reached a settlement, in which Sirius XM agreed to certain price caps through December 31, 2011. The court said

24. FCC 2008 Merger Approval Memorandum Opinion and Order, supra note 17, at 12,394 ¶ 107.
27. Id.
that “evidence demonstrate[d] that Sirius XM had every intention of raising prices beginning in August of [2011], and had the go-ahead from the FCC to do so.” 29 Notably, the settlement allows Sirius XM to increase prices in 2012, as it has already announced (raising the basic subscription price 12 percent from $12.95 to $14.49), one year before the next license period begins.

26. From 2013 to 2017, neither telecommunications law nor antitrust law will prevent Sirius XM from further increasing subscription prices. Sirius XM stands to earn supracompetitive profits from 2013 to 2017 that exceed the profits that Sirius XM could have earned in the current license period or that Sirius and XM could have earned individually absent the merger.

2. Sirius XM Can Increase Profits by Increasing Subscription Prices

27. The sole supplier in a given market can extract higher profits than a firm that faces competition. When more than one firm occupies a market, firms compete with one another on price. Sirius XM has become the only firm in the SDARS market. By definition, the demand curve that a sole supplier faces is equal to the industry demand curve. In contrast, when more than one firm occupies a market, an individual firm’s demand curve is more elastic than is the overall industry demand curve. “More elastic” means that consumers are more sensitive to the firm’s price. If the sole supplier increases its price, consumers can choose only between paying the higher price and exiting the market altogether. In contrast, when multiple firms exist in a market, consumers can further choose from which firm to purchase a good. If one firm raises its price, consumers can switch to the other firm. Thus, demand at the firm level is more price-sensitive in the presence of competition.

28. Beginning in 2012, Sirius XM will be able, as the sole supplier of SDARS, to charge the unconstrained, profit-maximizing price for its service and consequently extract

29. Id. at *3.
supracompetitive profits. It is therefore reasonable to expect that, from 2013 to 2017, Sirius XM will have higher profits—and therefore will be able to pay higher royalties—than in the current license period, during which Sirius XM has been subject to the price caps that the FCC imposed and the Blessing settlement extended.

3. The Merger Reduced Sirius’s and XM’s Combined Costs

29. The Sirius-XM merger generated operational efficiencies relative to the combined costs of Sirius and XM. When Sirius and XM applied for the FCC’s approval of the merger, they claimed that they would achieve efficiencies by reducing “duplicative staffing,” “operational expenses for the infrastructure used to broadcast and transmit satellite radio programming,” “marketing and subscriber acquisition costs,” and “duplicative research and development efforts,” among other things.30 For example, fixed costs have fallen by roughly 31 percent (over $285 million) since the close of the merger.31 In addition, Sirius XM has significantly reduced its programming and content costs since the merger.32

4. Tobin’s q for Sirius XM Implies an Ability to Exploit Market Power

30. Tobin’s q is “the ratio of the market value of a firm to its value based on the replacement cost of its assets.”33 Economists have documented the relationship between a high Tobin’s q and a firm’s ability to sustain supracompetitive profits as a result of long-run market

30. FCC 2008 Merger Approval Memorandum Opinion and Order, supra note 17, at 12,391 ¶ 99.
Particularly, “for a competitive firm, one would expect $q$ to be close to one, and as [one] examine[s] firms with increasing monopoly power (increasing ability to earn above a competitive return), $q$ should increase”\(^{35}\) above one.

31. Intuitively, the market value of a firm will equal the replacement value of the firm’s assets (that is, Tobin’s $q$ will equal one) when the firm is earning enough to cover its opportunity cost of capital, but no more. Thus, a firm with a market value exceeding the replacement cost of its physical assets is earning economic profit, which can indicate the exercise of market power.\(^{36}\) If the market has barriers to entry, the incumbent will be able to earn supracompetitive profits, such that its Tobin’s $q$ will remain above one.

32. A simplified approximation for Tobin’s $q$ is the firm’s market value divided by the firm’s equity book value.\(^{37}\) This approximation assumes that the replacement cost of a firm’s assets equals the historical cost of its assets. The approximation has the formula:

$$
Tobin's \ q \approx \frac{\text{Total Market Value of the Firm}}{\text{Total Asset Value}} = \frac{\text{Market Value of Equity} + \text{Book Value of Liabilities}}{\text{Book Value of Equity} + \text{Book Value of Liabilities}}.
$$

I use the book values of Sirius XM’s equity and liabilities as of September 30, 2011, which are the most recently available quarterly data, and I calculated Sirius XM’s Tobin’s $q$ as of November 14, 2011. Over the 45-day differential, it is unlikely that inflation and depreciation changed the replacement cost of Sirius XM’s assets significantly from the book value of its


\(^{35}\) Lindenberg & Ross, supra note 34, at 2. See also THOMAS W. HAZLETT & MATTHEW L. SPITZER, PUBLIC POLICY TOWARD CABLE TELEVISION 21 (MIT Press 1997) (“An industry earning just competitive profits would be expected to demonstrate a $q \approx 1$."

\(^{36}\) See, e.g., Lindenberg & Ross, supra note 34, at 4.

assets as reported in its quarterly report. Therefore, the above formula provides a reasonable approximation of Sirius XM’s Tobin’s $q$ on November 14, 2011.

33. As of November 14, 2011, the market value of Sirius XM’s equity, which is equal to its market capitalization, was $6.3 billion. According to Sirius XM’s quarterly report for the period ending September 30, 2011, the book value of Sirius XM’s liabilities as of that date was slightly more than $6.7 billion. The book value of Sirius XM’s assets (which equals the book value of Sirius XM’s equity plus the book value of Sirius XM’s liabilities) at that time was slightly more than $7.3 billion. Using these figures, Tobin’s $q$ for Sirius XM is approximately:

$$q \approx \frac{\$6,709,825,000 + \$6,300,000,000}{\$7,324,837,000} = 1.78.$$ 

Sirius XM’s Tobin’s $q$ of 1.78 exceeds the Tobin’s $q$ that economists would expect in a competitive market. This Tobin’s $q$ implies that the value of Sirius XM as a firm is almost twice what it would cost to replace all of Sirius XM’s assets. This valuation of Sirius XM relative to Sirius XM’s “book value” indicates that the capital market views Sirius XM as being able to sustain significant profitability in the long run.

34. I conduct an alternative—and more direct—calculation of Sirius XM’s Tobin’s $q$ by estimating the replacement cost of Sirius XM’s physical assets using information on Sirius XM’s capital costs. I show the calculation of the replacement cost in Appendix III. Table 1

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40. Id.
41. My estimation of the replacement cost assumes—for simplicity and to be conservative—that the costs of satellites is not falling significantly. However, there is some indication that the cost of satellite launches has fallen over time. See Elizabeth Montalbano, DARPA Seeks Better Satellite Launch System, INFORMATIONWEEK, Nov. 11, 2011, http://informationweek.com/news/government/enterprise-architecture/231902870; Peter B. Selding, Space Forecast Predicts Satellite Production Boom, SPACE NEWS, June 15, 2009, http://www.space.com/6839-space-
shows the calculation of Sirius XM’s Tobin’s \( q \) given my estimate of Sirius XM’s replacement cost. As of November 14, 2011, Sirius XM’s market capitalization was $6.3 billion.\(^{42}\) The book value of Sirius XM’s total liabilities as of September 30, 2011, was $6.7 billion.\(^{43}\)

**Table 1: Direct Estimation of Sirius XM’s Tobin’s \( q \)**

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<thead>
<tr>
<th></th>
<th>Lower Bound</th>
<th>Upper Bound</th>
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<tbody>
<tr>
<td>Market Value + Book Liabilities</td>
<td>$13,009,825,000</td>
<td>$13,009,825,000</td>
</tr>
<tr>
<td>Replacement Cost</td>
<td>$3,473,329,000</td>
<td>$2,655,329,000</td>
</tr>
<tr>
<td><strong>Tobin’s ( q )</strong></td>
<td><strong>3.75</strong></td>
<td><strong>4.90</strong></td>
</tr>
</tbody>
</table>

*Sources: Adjustment of Rates and Terms for Preexisting Subscription and Satellite Digital Audio Radio Services, Written Direct Testimony of David J. Frear, Dkt. No. 2006-1 CRB DSTRA, at 8-10 (Oct. 30, 2006); Q3 2011 SIRIUS XM QUARTERLY REPORT, supra note 39, at 2, 11.*

Using these estimates of Sirius XM’s replacement costs, I calculated Sirius XM’s Tobin’s \( q \) to range from 3.75 to 4.90. This high range of Tobin’s \( q \) is economic evidence that the capital market believes that Sirius XM can sustain supracompetitive profits in the long run.

**C. Barriers to Entry Will Protect Sirius XM’s Profits from 2013 to 2017**

35. According to the Horizontal Merger Guidelines, a firm’s entry into a market can constrain price only if “entry would be timely, likely, and sufficient in its magnitude, character, and scope to deter or counteract the competitive effects of concern.”\(^{44}\) Sirius XM benefits from multiple barriers to entry, including high sunk costs and the unavailability of additional SDARS spectrum. Such barriers to entry will likely continue to protect Sirius XM’s supracompetitive profits for the period from 2013 through 2017.

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[43](#) Q3 2011 SIRIUS XM QUARTERLY REPORT, supra note 39, at 11.

36. The FCC licensed all the spectrum allocated for SDARS exclusively to XM and Sirius.\textsuperscript{45} Spectrum is necessary for the uplink and downlink of content delivered by SDARS. No entry is possible unless the FCC releases more frequency bands. It is unreasonable to expect that prospect to be even remotely likely in the foreseeable future. Consequently, Sirius XM will not face price pressure from any SDARS entrant from 2013 to 2017.

II. \textbf{SIRIUS XM IS RELATIVELY IMPERVIOUS TO MACROECONOMIC DOWNTURNS}

37. Sirius XM faces relatively low risk related to macroeconomic conditions. Sirius XM’s subscriptions and subscription revenue experienced little volatility during the recession of December 2007 to June 2009,\textsuperscript{46} and both metrics have continuously increased since mid-2009. Figure 1 shows Sirius XM’s end-of-quarter total number of subscribers and subscription revenue, from March 2006 to September 2011. The vertical lines mark the recession’s official start and end.


Notes: The subscriber numbers and subscription revenues are for the end of the three-month periods ending March 31, June 30, September 30, and December 31. The subscriber numbers from March 2006 to December 2007 are the combined subscriber numbers for Sirius and XM. The subscription revenues from March 2006 to September 2008 are the combined subscription revenues for Sirius and XM.

The only decline in Sirius XM’s subscribership was from the end of December 2008 to June 2009, during the last six months of the recession. One risk factor that Sirius XM disclosed in its 2010 annual report is general economic conditions:

The purchase of a satellite radio subscription is discretionary, and our business and our financial condition can be affected by adverse general economic conditions. For example, the dramatic slowdown in auto sales negatively impacted our subscriber growth in 2008 and 2009.  

However, Sirius XM’s own management has recognized that the decrease in real income has not severely reduced Sirius XM’s subscribership. During the recession, Sirius XM’s subscribership fell from 19.0 million subscribers to 18.4 million subscribers—a loss of less than 3.2 percent. By February 2011, in Sirius XM’s earnings call for its 2010 fiscal year, Mr. Frear said:

SiriusXM turned in a much better year than expected in the face of a slow improvement in the economy . . . . [U]nemployment remained high, job creation’s low, housing values haven’t improved much and consumer credit remains scarce. Nevertheless, in a clear demonstration of the strength of our subscriber based business model, SiriusXM delivered record results, solidly beating guidance we raised 3x in the course of the year, finishing a[t] 20.2 million subs, over $2.8 billion in revenue, $626 million in EBITDA and $210 million in free cash flow.  

Figure 1 shows that Sirius XM’s subscription revenue has increased at a slightly higher rate than the company’s subscriptions. Subscription revenues increased by 117.9 percent from $303.3 million in March 2006 to $660.9 million in September 2011, while subscriptions increased by 101.8 percent from 10.6 million to 21.5 million. Sirius XM’s increasing subscription revenues show that consumers are willing to pay for SDARS even during times of macroeconomic weakness.

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47. 2010 SIRIUS XM ANNUAL REPORT, supra note 32, at 13.
39. Real household income has declined dramatically since the start of the recession. Nonetheless, Sirius XM’s subscribership has grown during this period. Figure 2 shows median household income in 2010 dollars and Sirius XM’s subscribership during and after the recession.

**Figure 2: Sirius XM Subscribers and Median Real U.S. Household Income, Mar. 2006–Sept. 2011**

![Graph showing the growth of Sirius XM subscribers and median real U.S. household income from March 2006 to September 2011. The graph is divided into two sections: a blue line representing total subscribers and a red line representing median household income. Key data points include the official start of the recession in December 2007 and the official end in June 2009.]

*Note: Median household income is in 2010 dollars.*

*Sources: Subscriber numbers are from Figure 1, supra; U.S. Census Bureau, Current Population Survey, Income Statistics, Table H-5, Regions—All Races by Median and Mean Income: 1975 to 2010, available at http://www.census.gov/hhes/www/income/data/historical/household/ (last visited Nov. 17, 2011).*

40. The growth rate of Sirius XM’s subscribership has remained relatively unchanged between the period of growing household income and the period of declining household income.

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That trend indicates that Sirius XM’s subscribership is not highly sensitive to changes in real household income. Moreover, Sirius XM’s number of subscribers since 2006 has increased and has experienced little volatility. Aside from a minor drop in subscribers between December 2008 and June 2009 (of only 0.2 million subscribers), Sirius XM’s subscribership has increased in every year since 2003.\footnote{See 2010 SIRIUS XM ANNUAL REPORT, supra note 32, at 1.} In 2008, Sirius XM had 19 million subscribers.\footnote{Id.} By September 30, 2011, that number exceeded 21 million.\footnote{Q3 2011 SIRIUS XM QUARTERLY REPORT, supra note 39, at 31.} Thus, the economic evidence contradicts the proposition that macroeconomic weakness, should it be present during the next license period, would constrain Sirius XM’s ability to pay a higher royalty rate.

**III. SIRIUS XM CAN PAY A HIGHER ROYALTY FROM 2013 TO 2017 AND STILL EARN A “FAIR INCOME” BECAUSE IT WILL FACE LESS RISK**

41. The various forms of risk that Sirius XM may face are unlikely to diminish its ability to pay a higher royalty. Table 2 lists the risk factors that Sirius XM disclosed in its 2010 annual report, filed in February 2011. I categorize the risks as relating to business matters, competition (which encompasses risks related to demand), technology, legal matters, macroeconomic conditions, and costs. I order the categories by the number of factors listed by Sirius XM. The factors in Table 2 can influence Sirius XM’s business, but that influence will not necessarily impair Sirius XM’s ability to pay a royalty rate from 2013 to 2017 that is at the upper range of the zone of reasonableness.
### TABLE 2: SIRIUS XM’S RISK FACTORS REPORTED IN ITS 2010 ANNUAL REPORT

<table>
<thead>
<tr>
<th>Category</th>
<th>Risk Factor</th>
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<tbody>
<tr>
<td>Competition</td>
<td>Our business depends in large part upon automakers and demand for our service is difficult to predict</td>
</tr>
<tr>
<td>Competition</td>
<td>Higher than expected costs of attracting new subscribers or higher turnover (i.e., churn) could each adversely affect our financial performance and operating results</td>
</tr>
<tr>
<td>Competition</td>
<td>Our ability to retain subscribers and maintain our average monthly revenue per subscriber is uncertain</td>
</tr>
<tr>
<td>Competition</td>
<td>We face substantial competition and that competition is likely to increase over time</td>
</tr>
<tr>
<td>Competition</td>
<td>Rapid technological and industry changes could adversely impact our services</td>
</tr>
<tr>
<td>Business</td>
<td>Failure of other third parties to perform could adversely affect our business</td>
</tr>
<tr>
<td>Business</td>
<td>We may from time to time modify our business plan, and these changes could adversely affect us and our financial condition</td>
</tr>
<tr>
<td>Business</td>
<td>Our substantial indebtedness could adversely affect our operations and could limit our ability to react to changes in the economy or our industry</td>
</tr>
<tr>
<td>Business</td>
<td>Liberty Media Corporation has significant influence over our business and affairs and its interests may differ from us</td>
</tr>
<tr>
<td>Business</td>
<td>Our net operating loss carryforwards could be substantially limited if we experience an ownership change as defined in the Internal Revenue Code</td>
</tr>
<tr>
<td>Technology</td>
<td>Failure of our satellites would significantly damage our business and potential satellite losses may not be covered by insurance</td>
</tr>
<tr>
<td>Technology</td>
<td>Interruption or failure of our information technology and communications systems could negatively impact our result and our brand</td>
</tr>
<tr>
<td>Technology</td>
<td>Our broadcast studios, terrestrial repeater networks, satellite uplink facilities or other ground facilities could be damaged by natural catastrophe or terrorist activities</td>
</tr>
<tr>
<td>Technology</td>
<td>Electromagnetic interference from others could damage our business</td>
</tr>
<tr>
<td>Legal</td>
<td>Failure to comply with FCC requirements could damage our business</td>
</tr>
<tr>
<td>Legal</td>
<td>The unfavorable outcome of pending or future litigation could have a material adverse effect</td>
</tr>
<tr>
<td>Legal</td>
<td>Changes in consumer protection laws and their enforcement could damage our business</td>
</tr>
<tr>
<td>Legal</td>
<td>Our business may be impaired by third-party intellectual property rights</td>
</tr>
<tr>
<td>Macroeconomy</td>
<td>General economic conditions can affect our business</td>
</tr>
<tr>
<td>Costs</td>
<td>Royalties for music rights may increase</td>
</tr>
</tbody>
</table>

Note: The risk factors are direct quotes from Sirius XM’s 2010 annual report.  

42. The largest of the risks that Sirius XM identifies are competitive risks, on which I focus the majority of my analysis. Sirius XM states: “We face substantial competition and that
competition is likely to increase over time.”\(^{53}\) This disclosure restates the obvious because, for any firm, competition is always greater in the long run than in the short run.\(^{54}\) The relevant question is: To what extent will potential competitors constrain Sirius XM’s ability to raise its prices (or keep its current prices from falling) from 2013 to 2017?

### A. Older Forms of Audio Entertainment Have Not Constrained Sirius XM’s Prices and Are Unlikely to Constrain Sirius XM’s Profits Further in the Coming License Period

43. Sirius XM has considered the various preexisting delivery platforms for audio entertainment described in this section (terrestrial radio, HD Radio\(^{TM}\), MP3 devices) to be the closest competitors for its service.\(^{55}\) However, these alternative platforms have been widely available since at least the start of the current license period.\(^{56}\) To the extent that they have constrained subscriptions to or the pricing of SDARS to date (and, as noted above, Sirius XM has increased subscribers despite having raised prices), there is no reason to expect that terrestrial radio, HD Radio, and MP3 devices will suddenly start to constrain Sirius XM during the next license period.

#### 1. Advertiser-Supported Terrestrial Radio

44. Advertiser-supported terrestrial radio does not constrain Sirius XM’s prices or subscribership because of (1) Sirius XM’s lack of advertising on music channels compared with terrestrial radio’s being entirely advertiser-supported;\(^{57}\) (2) Sirius XM’s content advantages over terrestrial radio, including both the quantity of content and the range of content that regulators

\(^{53}\) 2010 SIRIUS XM ANNUAL REPORT, supra note 32, at 13.

\(^{54}\) See, e.g., CARLTON & PERLOFF, supra note 33, at 62 (“In the long run, firms can adjust their levels of capital so that they can enter [the] market.”). Consequently, competition is greater in the long run than in the short run.

\(^{55}\) 2010 SIRIUS XM ANNUAL REPORT, supra note 32, at 1.


permit Sirius XM to broadcast as compared with terrestrial radio; and (3) Sirius XM’s national distribution footprint.

45. First, terrestrial radio does not constrain Sirius XM’s prices or subscribership because of the implicit cost to listeners of advertisements on music channels. The effective price to a subscriber of advertiser-supported radio is the product of (1) the value of that subscriber’s time (as measured by the subscriber’s wage rate) and (2) the commercial time to which that subscriber would be exposed as a listener to terrestrial radio. According to Forrester Research, the success of SDARS partly reflects listeners’ desire to avoid hearing advertising on music channels.\(^5^8\) If anything, it is SDARS that constrains terrestrial radio. At the end of 2004, Clear Channel (the largest radio broadcasting company in the United States\(^5^9\)) cut its ad time and reduced the length of commercial spots from 60 seconds to 30 seconds in an attempt to “win back listeners, boost ratings, and in turn lead to higher ad rates.”\(^6^0\)

46. Even for Sirius XM subscribers willing to endure commercials on music channels, Sirius XM has significant content advantages over terrestrial radio. The number of terrestrially delivered radio stations available in any given geographic market is severely constrained compared with the number of channels available on Sirius XM. Sirius XM offers over 140 channels to its subscribers, including 71 advertisement-free music channels,\(^6^1\) compared to many fewer stations in radio markets across the country.\(^6^2\) Even in the largest radio markets, the diversity of musical genres available is quite limited. Bernstein Research said in 2005 that digital


\(^{60}\) Tom Lowry, Antenna Adjustment: Clear Channel is pulling apart its empire as it scrambles to compete in a changed media world, BUS. WK., June 20, 2005, at 64.


terrestrial radio “poses little threat to the growth in satellite radio subscriptions.” Six years later, that assessment remains valid.

47. Moreover, some content on Sirius XM would be unlawful to deliver by terrestrial radio stations. The FCC regulates “obscene, indecent, or profane language” transmitted “by means of radio communication.” It bars the terrestrial broadcast of indecent content between the hours of 6 a.m. and 10 p.m. Sirius XM is exempt from these indecency rules. A number of Sirius XM’s channels contain indecent content. Music channels marked with an “XL” on Sirius XM’s web site contain explicit lyrics. They are SiriusXM Limited Engagements, Heavy Metal, Music of Action Sports – Tony Hawk, Hip-Hop Hits, Eminem’s Uncut Hip-Hop Channel, and Old Skool Rap. Consumers cannot turn to terrestrial radio broadcasts to receive such content.

48. Finally, unlike Sirius XM, advertiser-supported terrestrial radio stations lack a ubiquitous footprint. As early as 2001, XM’s nationwide service could reach nearly 100 million listeners age twelve and over who were beyond the range of the largest 50 radio markets, as measured by Arbitron. At that time, XM estimated that, of these 100 million listeners, 36 million lived beyond the largest 276 Arbitron markets. XM also estimated that 22 million people age twelve and older received five or fewer stations. A significant percentage of radio listeners, such as truckers, routinely travelled through two or more Arbitron radio markets on a

68. Id.
70. Id. (citing census data and The Arbitron Company Fall 1999 Market Rankings).
frequent basis. Those consumers who either have access to very few terrestrial radio stations or frequently travel through multiple radio markets clearly would not perceive terrestrial radio broadcasts to be a reasonable substitute Sirius XM.

2. **HD Radio**

49. Sirius XM faces little competition from HD Radio for the same reasons that Sirius XM faces little competition from terrestrial radio broadcasters. HD Radio provides substantially the same service as terrestrial radio, with only two differences: HD Radio has higher audio quality than terrestrial radio, and HD Radio offers more content than terrestrial radio. These two differences are not significant enough for HD Radio to constrain the future profitability of Sirius XM.

50. Like terrestrial radio, HD Radio is advertiser-supported, HD Radio’s volume of content pales in comparison to that of Sirius XM, and HD radio broadcasts are subject to FCC indecency regulations. Moreover, HD Radio has an even smaller geographic coverage than traditional terrestrial radio. Not all areas that receive an analog signal also receive an HD signal. Listeners typically can use an HD radio receiver only in urban areas, where HD signals are actually broadcast.

51. HD Radio requires listeners to purchase HD Radio receivers. HD Radio’s products web page shows car stereos ranging from $129.00 to $2,000.00 and car stereo converters ranging from $99.00 to $199.95. HD Radio’s web page for home audio products

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72. *Id.* at 5.


shows receivers, tuners, and iPod docks ranging from $99.99 to $7,000.00. A subscriber to Sirius XM similarly must purchase a Sirius XM radio if the subscriber’s car does not already have a Sirius XM radio installed in it. Whether they listen to HD radio or Sirius XM, consumers must purchase stereos. Moreover, as I will describe in Part III.B, new and used cars increasingly have pre-installed Sirius XM radios and free trial subscriptions to Sirius XM.

52. Sirius and XM contended in their merger application that HD Radio would significantly threaten SDARS. For example, they said that, “[b]y some estimates, almost one-third of one million Americans already listen to HD Radio on a weekly basis, and this number is expected to increase to approximately 12 million by 2010.” The February 2007 Bridge Ratings report that Sirius and XM cited in their merger application projected that HD Radio sales would reach 1.5 million units by the end of 2007 and 12 million units by 2010. However, actual consumer adoption of HD Radio has grown much more slowly. By September 2008, HD Radio receiver sales had reached only 600,000 units. By June 2010, 3 million HD Radio receivers had been sold to consumers, which was only 25 percent of Bridge Ratings’ projection. HD Radio clearly is not the competitive threat that Sirius and XM predicted.

77. 2007 Sirius-XM Consolidated Merger Application, supra note 18, at 26-28.
3. **MP3s Delivered over an iPod**

53. MP3s delivered over an iPod or other MP3 players do not constrain the pricing for Sirius XM programming. Many U.S. consumers listen to MP3s downloaded on iPods.\(^{83}\) However, the widespread adoption of iPods and the growth in MP3 downloads does not prove that MP3s delivered over an iPod constrain Sirius XM’s ability to increase its prices or to pay a higher royalty for sound recordings. Apple released the iPod in 2001, about the same time that Sirius and XM began broadcasting. Since then, Sirius XM’s subscriberhip has increased precipitously, even as its prices have risen. It is not reasonable to expect iPods or other MP3 players to constrain Sirius XM in the next rate term more than they currently do, which is negligible.

**B. There Is Insufficient Evidence to Conclude That, from 2013 to 2017, Sirius XM Will Face Competition from the New Technology of Mobile Internet Radio in Cars**

54. Although current competition in the market for audio entertainment delivery platforms has not constrained Sirius XM’s prices, there remains the possibility that the competitive landscape could change in the coming license period. As I explained above, there is no evidence or reason to believe that the older audio entertainment delivery platforms will constrain Sirius XM any further in the coming license period than they do now. Consequently, the salient question is whether Sirius XM will face increased competition from newer forms of audio entertainment. The only identifiable competitive threat to Sirius XM is mobile Internet radio in cars.\(^{84}\) However, for the reasons that I explain below, great uncertainty exists as to

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84. In my discussion of mobile Internet radio, I am including both non-interactive webcasting services that operate under the statutory license and interactive (or “on-demand”) streaming services that offers the consumer the ability to hear exactly the song that she requests. Both the non-interactive and the interactive streaming services offer a radio-like service that streams musical content based on selected genres, artists, or user preferences. In
whether and to what extent mobile Internet radio in cars can compete effectively with Sirius XM by 2017. Two questions are relevant to assessing the competitive threat posed by mobile Internet radio in cars in the next license period. First, how widely adopted will mobile Internet radio in cars be by 2017? Second, will the adoption of mobile Internet radio in cars displace subscriptions to SDARS?

1. Mobile Internet Radio Is Unlikely to Overcome Sirius XM’s Commanding Distribution Advantage with Automobile Manufacturers by 2017

Sirius XM has a formidable distribution advantage with automobile manufacturers. Potential substitutes for Sirius XM (including mobile Internet radio in cars) pose little threat of significant competition until they can catch up with Sirius XM’s penetration of new and used cars that are pre-installed with Sirius XM. Sirius XM has agreements “with every major automaker to include satellite radios in new vehicles.” That 100-percent penetration among major automakers will help to protect Sirius XM from being displaced in the near future by audio streaming services. Satellite radio is already built into 65 percent of new cars. Sales of most of these cars include a free introductory subscription to Sirius XM.

addition, the interactive streaming services allow users to select directly a song or album they wish to hear or to play cached playlists (created by the users). These aspects of interactive streaming services, which are the primary selling points of such a service, provide an experience much more similar to an iPod, albeit without the need for a subscriber to purchase the music. With respect to these features, the ability of interactive services to constrain Sirius XM’s prices or subscribership is limited in the same way as MP3s delivered over an iPod.

85. 2010 SIRIUS XM ANNUAL REPORT, supra note 32, at 13 (emphasis added).
Moreover, satellite radios have been built into certain new cars since at least 2003; consequently, satellite radios are currently built into a large volume of used cars. The proportion of cars on the road in the United States that are equipped with Sirius XM will increase as more new cars equipped with satellite radio enter the used-car market and replace older used cars not equipped with Sirius XM. Many dealerships sell far more used cars than new cars. Many automobile manufacturers now offer a free three-month Sirius XM subscription with all used cars equipped with satellite radio that are purchased. These manufacturers include Ford, General Motors, Nissan and Infiniti, Hyundai, and others.

If manufacturers were to begin pre-installing a new technology for music delivery in cars today, it would not be reasonable to expect that the new technology would achieve by 2017 the level of penetration that satellite radio currently has. Pandora, for example, did not begin until 2009 to have agreements with automobile manufacturers to provide in-dashboard options. In contrast, Sirius XM is factory-installed in models at least as old as 2003, and a purchaser of one of these used cars can receive a free introductory subscription with her used-car

89. Sirius XM Ramps Up Used Car Market with Nissan Announcement, supra note 86.
90. Press Release of Feb. 4, 2010, supra note 87. Ford is offering the subscription on all “Ford and Lincoln Mercury Certified Pre-owned vehicles.” Id.
91. Press Release of June 20, 2011, supra note 87. General Motors is offering the subscription on all used cars that General Motors dealerships sell that are factory-equipped with satellite radio, regardless of the manufacturer. Id.
92. Press Release, Sirius XM, Nissan and Infinity Dealers to Offer 3-Month XM Subscription on All Pre-Owned Vehicles with Factory-Installed Satellite Radios (Oct. 6, 2011).
purchase. Sirius XM’s advantage in automobile distribution, particularly within used cars, will make it difficult for audio streaming to compete effectively with Sirius XM from 2013 to 2017.

2. It Is Doubtful That Mobile Internet Radio in Cars Will Constrain Sirius XM’s Prices or Number of Subscribers Before 2017

58. Currently, consumers face significant technological limitations to mobile Internet radio services through car stereos. The iPhone itself was not introduced until 2007. When a car is not smartphone-compatible, the driver faces significant technological and safety limitations to listening to mobile Internet radio. These limitations prevent mobile Internet radio in cars from constraining Sirius XM’s prices or number of subscribers.

   a. Technological Limitations to Data Usage and Internet Connectivity Exist in Cars

59. Sirius XM has a significant technological advantage over Internet radio services due to the data limitations of smartphones. Bandwidth and data-usage limitations constrain mobile Internet radio from being an adequate in-car substitute for Sirius XM. Although Pandora and other audio streaming providers offer services without a paid subscription, even these “free” services require the user to incur the cost of data usage. Moreover, with respect to interactive services, such as Spotify, mobile streaming of any sort requires the purchase of a subscription, generally priced at $9.99.

60. According to Verizon Wireless’ data-usage calculator, streaming one hour of audio on a 3G or 4G smartphone per day in a single month uses 1.76 gigabytes (GB). A 2-GB monthly data plan with Verizon Wireless costs $30 per month, and a 5-GB plan and a 4-GB plan...

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95. Press Release, Apple Inc., Apple Reinvents the Phone with the iPhone (Jan. 9, 2007).
with mobile hotspot each cost $50 per month. If a user decides to purchase a 5-GB plan instead of a 2-GB plan to accommodate her demand for mobile Internet radio, she will have paid an additional $20 per month to be able to receive a “free” mobile Internet radio. That $20 outlay exceeds Sirius XM’s current and planned monthly subscription prices. Alternatively, if the consumer purchases only the 2-GB plan, she must incur an overage charge of $10 per gigabyte if she exceeds her data limit. Mobile Internet radio thus can be substantially more expensive than a subscription to Sirius XM.

61. Internet connectivity in cars is a prerequisite for mobile Internet radio to compete effectively with Sirius XM radio. Audio streaming through a smartphone is not possible in a sparsely populated area without 3G service. In contrast, because Sirius XM has a national geographic footprint in the continental United States, a consumer can receive content from Sirius XM, at the same sound quality, in rural and urban regions alike. Even in densely populated urban areas, limitations to Internet connectivity can impair mobile Internet radio in cars and foreclose its ability to constrain Sirius XM’s pricing or number of subscribers during the next license period.\[99\]

b. Technological and Safety Limitations Prevent the Seamlessness of Mobile Internet Radio in Cars

62. Mobile Internet radio has inferior ease-of-use in cars compared with Sirius XM. One industry analyst, commenting in September 2011, put the point succinctly: “Content is no longer king, instead it is easily accessible content that is king.”\[100\] He explained that “Sirius XM


\[99\] John R. Quain, Will the Internet Kill Traditional Car Radio?, N.Y. TIMES, May 7, 2010, http://www.nytimes.com/2010/05/09/automobiles/09RADIO.html?pagewanted=all. (noting that, even in New York City, “there were occasional dead spots when the music dropped out as the cellphone searched for a signal).

works in the dashboard seamlessly along with terrestrial radio."\textsuperscript{101} In contrast, “true integration [of smartphones] in enough cars to make a material difference [to Sirius XM] is years away."\textsuperscript{102} Consequently, he concluded, “[f]or the foreseeable future Sirius XM can still thrive in the dashboard.”\textsuperscript{103} The fact that the large majority of cars on the road do not currently have seamless access to smartphone applications, and will not for the foreseeable future, limits the suitability of mobile Internet radio as a close substitute for satellite radio over the next license period.\textsuperscript{104}

63. When a car is not smartphone-compatible, audio streaming through the car stereo requires multiple steps. Pandora’s website lists numerous ways to stream music from a smartphone through a car stereo,\textsuperscript{105} most of which require purchasing additional equipment. One option is to install an in-dashboard stereo that supports Pandora. However, certain in-dashboard stereos are only compatible with certain phones. For example, the Pioneer and Alpine stereos both require an iPhone,\textsuperscript{106} leaving users with other types of smartphones, including phones with the Android operating system, unable to connect to Pandora through these in-dashboard mechanisms.

64. The other options besides an in-dashboard system require the user to use her cell phone directly, which Pandora has recognized may create a distraction and hazard.\textsuperscript{107} These

\begin{flushright}
\textsuperscript{101} Id.
\textsuperscript{102} Id.
\textsuperscript{103} Id.

\textsuperscript{104} Even cars that are “fully” compatible with audio streaming still require a connection, whether wired or wireless, to a smartphone to handle the actual music streaming. \textit{See}, e.g., Pandora, How to Listen to Pandora in the Car, http://help.pandora.com/customer/portal/articles/24523-how-to-listen-to-pandora-in-the-car (last visited Nov. 22, 2011) (“All of the currently available systems that support full integration with car stereo controls still require a smartphone to handle the actual music streaming.”).

\textsuperscript{105} Id.


\textsuperscript{107} Pandora, How to Listen to Pandora in the Car, supra note 104 (“For your safety: ONLY use your mobile device when allowed by law and conditions permit safe use. ALWAYS set up your mobile device and start Pandora before beginning to drive. Avoid interacting with your device while the vehicle is in motion. NEVER let your use of
safety considerations impede the ability of mobile Internet radio to offer consumers automobile compatibility that is as seamless as Sirius XM.

65. According to the New York Times, Pandora’s CEO expects that “there will be a gradual migration in the car to services like Pandora” and that Pandora “will not become a mainstream service until all new cars feature systems that can tap into apps.”\(^{108}\) This degree of automobile compatibility has not yet occurred. There is no reason to believe that mobile Internet radio services such as Pandora will be so widely adopted as to constrain Sirius XM’s prices or subscribership to any significant extent by 2017.

C. Sirius XM Will Face a Lesser Economic Cost of Technological Risk in the Next License Period Than It Has Faced in the Current License Period

66. Sirius XM has nine satellites in orbit.\(^{109}\) The only other satellite that Sirius XM reportedly intends to launch (Sirius FM-6) will be launched by early 2012.\(^{110}\) Sirius XM stated in its 2010 annual report that, if any satellite fails, there are multiple in-orbit spares for both the Sirius and XM satellites.\(^{111}\) Because Sirius XM has these spares, the risk that a satellite failure will cause economic harm to its operations and business is necessarily less than the risk that a satellite will fail. Moreover, Sirius XM has purchased insurance to cover significant portions of any loss from a satellite failure or disruption to a satellite’s useful life.\(^{112}\) Consequently, any risk that arises from Sirius XM’s technologies and equipment should receive less weight in this royalty rate proceeding than it did in the previous proceeding.

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\(^{108}\) Quain, supra note 99 (emphasis added) (reporting remarks of Joe Kennedy, chief executive of Pandora).

\(^{109}\) Q3 2011 SIRIUS XM QUARTERLY REPORT, supra note 39, at 9.

\(^{110}\) Id. at 36.

\(^{111}\) 2010 SIRIUS XM ANNUAL REPORT, supra note 32, at 14

\(^{112}\) See id. at 5.
D. **Sirius XM Will Face a Low Degree of Legal and Regulatory Risk**

67. Since the merger, Sirius XM has faced unremarkable legal and regulatory risk. The merger of Sirius and XM created a single licensee of SDARS spectrum, and it is not reasonable to expect that the FCC will allocate more spectrum for SDARS entrants. Starting in 2012, Sirius XM will be rid of price regulation. Consequently, it is not reasonable to expect that legal or regulatory risk will suppress Sirius XM’s profits and render it incapable of paying a higher royalty rate from 2013 to 2017.

IV. **A Higher Royalty Rate Will Not Disrupt the SDARS Market**

68. In 2008, the CRJs said that “a royalty rate that would cause the SDARS to cease operating or dramatically change the nature of its product would clearly be disruptive.” The royalty rates that SoundExchange requests would not cause Sirius XM to cease operating. Sirius XM would not cease operations unless its average subscription price fell below its average variable cost. I calculate that Sirius XM would need to pay a royalty rate of 57.8 percent of gross revenue to necessitate exiting the market. That royalty rate far exceeds what SoundExchange seeks in this proceeding.

69. For the fiscal quarter ending in September 2011, Sirius XM reported subscriber revenue of $660.8 million, and the sum of its costs of services (which I use to approximate Sirius XM’s variable cost) equaled $277.4 million, or less than half of Sirius XM’s subscriber revenue.

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113. CRJ 2008 Final Rule and Order, supra note 1, at 4097.
114. See, e.g., CARLTON & PEROFF, supra note 33, at 59-60.
115. See CHARLES T. HORngREN, GEORGE FOSTER & SRIKANT M. DATAR, COST ACCOUNTING: A MANAGERIAL EMPHASIS 61 (8th ed., Prentice-Hall, Inc. 1994). Operating cost is synonymous with “operating expenses” and consists of variable operating cost and fixed operating cost. Sirius XM’s operating expenses consist of cost of services, subscriber acquisition costs, sales and marketing, engineering, design, and development, general administrative, depreciation and amortization, and restructuring, impairments, and related costs. I use cost of services to approximate Sirius XM’s variable cost.
revenue.\textsuperscript{116} Even Sirius XM’s reported \textit{total} operating expenses of $578.1 million (which I use to approximate Sirius XM’s total cost) was less than its subscription revenue.\textsuperscript{117} Sirius XM’s operating profit margin as of September 30, 2011 was 22.0 percent.\textsuperscript{118} Consequently, Sirius XM’s existing royalty rate clearly is not threatening the company’s profitability, let alone its viability.

70. A higher royalty rate could disrupt the SDARS industry in terms of causing Sirius XM to cease supplying SDARS only if the royalty rate caused Sirius XM’s average variable cost to exceed its subscription price. An informative exercise is to determine the minimum royalty rate that would raise Sirius XM’s average variable cost above its subscription price. I refer to this royalty rate as Sirius XM’s “shutdown royalty rate.” The purpose of this exercise is not to determine a reasonable rate. It is to show what the shutdown royalty rate would be. Table 3 shows my calculation of Sirius XM’s shutdown royalty rate, using financial data that Sirius XM reported in its quarterly report for the three months ending September 30, 2011. The column “10-Q” reports Sirius XM’s actual financial results. The column “Shutdown Scenario” calculates the costs and royalties that would cause Sirius XM to make the shutdown decision and cease operating.

\textsuperscript{116} Q3 2011 SIRIUS XM QUARTERLY REPORT, supra note 39, at 1.
\textsuperscript{117} Id.
My calculation shown in Table 3 is as follows. For the three months ending September 30, 2011, Sirius XM had $660.8 million in subscriber revenues. To reach Sirius XM’s shutdown price, the new royalty rate would need to be so high as to increase Sirius XM’s total cost of services (my proxy for variable costs) to $660.8 million. Holding the other sources of cost of services constant, “revenue share and royalties” costs would need to increase to $500.5 million for Sirius XM to reach its shutdown royalty rate.

Sirius XM’s total royalties paid to SoundExchange in 2011 is 7.5 percent of Sirius XM monthly gross revenue. For the purpose of this shutdown-royalty-rate calculation, I assume that Sirius XM’s gross revenue from July 1, 2011 to September 30, 2011 equals its reported total revenue, $762.6 million. A 7.5-percent royalty rate implies that Sirius XM would pay $57.2 million in royalties over those three months (equal to 7.5% × $762.6 million). The difference between Sirius XM’s total “revenue share and royalties” cost ($117.0 million) and the $57.2 million that Sirius XM would pay in royalties to SoundExchange is $59.9 million. Holding...
those other “revenue share and royalties” cost constant, to increase Sirius XM’s “revenue share and royalties” cost to $500.5 million, Sirius XM’s royalties paid to SoundExchange would need to increase from $57.2 million to $440.7 million. That amount would yield a royalty rate equal to 57.8 percent of Sirius XM’s total reported revenue.

73. I understand that, for purposes of calculating Sirius XM’s royalty obligation to SoundExchange, regulations define Sirius XM’s revenue more narrowly than its total revenue that Sirius XM discloses in its annual report. I thus recalculated the shutdown royalty rate for the scenarios in which Sirius XM reports 60 percent, 70 percent, 80 percent, and 90 percent of its total revenues to SoundExchange for purposes of computing royalties due to SoundExchange. Figure 3 shows the shutdown royalty rates corresponding to each percentage of gross revenues reported.

**Figure 3: Shutdown Royalty Rates Depending on the Percentage of Gross Revenue that Sirius XM Reports**

Source: Q3 2011 SIRIUS XM QUARTERLY REPORT, supra note 39, at 1.

120. 37 C.F.R. § 382.11 (2007).
As Figure 3 shows, the shutdown royalty rate increases as Sirius XM reports a smaller percentage of its gross revenue for purpose of computing royalties due to SoundExchange. Thus, regardless of the percentage of gross revenue that Sirius XM reports, the lowest its shutdown royalty rate could be is 57.8 percent. Consequently, any royalty rate below 57.8 percent would not disrupt the SDARS market in the sense of causing Sirius XM to exit the market. Of course, the maximum royalty rate that SoundExchange has requested is well below a 57.8-percent shutdown royalty rate. Thus, Sirius XM can pay a higher royalty rate without any risk that the higher rate will cause it to exit the SDARS market.

74. Finally, Sirius XM’s expectations of future growth support its ability to pay a royalty rate from 2013 to 2017 that considerably exceeds its current royalty rate. Sirius XM’s management expects the company’s subscribership to increase in the near future,\textsuperscript{121} which, in the presence of economies of scale, will decrease its average variable cost further and thereby generate even larger positive margins. In 2010, Sirius XM “continued to grow revenue faster than expenses,”\textsuperscript{122} indicating that Sirius XM continues to achieve economies of scale. Furthermore, as I mentioned earlier, Sirius XM has announced increases in its subscription prices.\textsuperscript{123} Increasing subscription prices will further increase Sirius XM’s margin. Thus, from 2013 to 2017, it is reasonable to expect that Sirius XM could pay a substantially higher royalty rate without coming close to its shutdown point. The higher royalty rates requested by SoundExchange pose no credible threat of disrupting the SDARS market by shutting down Sirius XM’s operations.

\textsuperscript{121} See, e.g., Sirius XM Q3 2011 Earnings Call, supra note 31.
\textsuperscript{122} Sirius XM Q4 2010 Earnings Call, supra note 48.
V. CONCLUSION

75. Sirius XM is, and will be, more able to pay higher royalty rates in the next license period than it was in the current license period. SoundExchange’s rate proposal would not disrupt the provision of SDARS.
I declare under penalty of perjury that the foregoing testimony is true and correct.

Date: 11/23/11

[Signature]
APPENDIX I: CURRICULUM VITAE OF J. GREGORY SIDAK
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Education


Current Employment


Tilburg University, Tilburg, The Netherlands: Ronald Coase Professor of Law and Economics, 2009-present.


Employment History


Yale University, New Haven, Connecticut: Senior Lecturer, Yale School of Management, 1993-1999.


Corporate Boards

NTT DoCOMO, Tokyo, Japan: Member, U.S. Advisory Board, 2002-2006.
A U T H O R E D  B O O K S


Protecting Competition from the Postal Monopoly (AEI Press 1996), co-authored with Daniel F. Spulber.


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Bar Admissions
California (1982); District of Columbia (1989); Supreme Court of the United States (1989).

Memberships
American Law Institute

The London Court of International Arbitration, North American Users’ Council

Personal Information

November 17, 2011
**APPENDIX II: MATERIALS RELIED UPON**

**DOCUMENTS FROM THE 2008 SDARS ROYALTY RATE PROCEEDING**


**STATUTES & COURT DOCUMENTS**


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EARNINGS CALL TRANSCRIPTS


APPENDIX III: CALCULATION OF SIRIUS XM’S REPLACEMENT COST

1. Table A.1 shows Sirius XM’s capital costs as reported in the written direct testimony of Mr. David Frear, currently Sirius XM’s executive vice president and chief financial officer, filed on October 20, 2006 in the last rate proceeding (when he was Sirius’s CFO)\(^{124}\) and in Sirius XM’s quarterly report ending September 30, 2011.

**TABLE A.1: SIRIUS XM’S CAPITAL COSTS USED TO ESTIMATE SIRIUS XM’S REPLACEMENT COST**

<table>
<thead>
<tr>
<th>Item</th>
<th>Lower Bound</th>
<th>Upper Bound</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sirius satellites</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sirius FM-1</td>
<td>$259,000,000</td>
<td>$273,000,000</td>
</tr>
<tr>
<td>Sirius FM-2</td>
<td>$259,000,000</td>
<td>$273,000,000</td>
</tr>
<tr>
<td>Sirius FM-3</td>
<td>$259,000,000</td>
<td>$273,000,000</td>
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<tr>
<td>Sirius FM-4</td>
<td>$130,000,000</td>
<td>$130,000,000</td>
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<td>Sirius FM-5</td>
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<tr>
<td>Sirius FM-6</td>
<td>$260,000,000</td>
<td>$500,000,000</td>
</tr>
<tr>
<td>XM satellites</td>
<td></td>
<td></td>
</tr>
<tr>
<td>XM-1</td>
<td>$259,000,000</td>
<td>$273,000,000</td>
</tr>
<tr>
<td>XM-2</td>
<td>$259,000,000</td>
<td>$273,000,000</td>
</tr>
<tr>
<td>XM-3</td>
<td>$259,000,000</td>
<td>$273,000,000</td>
</tr>
<tr>
<td>XM-4</td>
<td>$259,000,000</td>
<td>$273,000,000</td>
</tr>
<tr>
<td>XM-5</td>
<td>$260,000,000</td>
<td>$500,000,000</td>
</tr>
<tr>
<td>Spectrum</td>
<td>$173,300,000</td>
<td>$173,300,000</td>
</tr>
<tr>
<td>Tracking, telemetry, &amp; control system</td>
<td>$57,917,000</td>
<td>$57,917,000</td>
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<tr>
<td>Terrestrial repeaters</td>
<td>$111,888,000</td>
<td>$111,888,000</td>
</tr>
<tr>
<td>Leasehold improvements</td>
<td>$43,392,000</td>
<td>$43,392,000</td>
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<tr>
<td>Broadcast studio equipment</td>
<td>$52,554,000</td>
<td>$52,554,000</td>
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<tr>
<td>Capitalized software and hardware</td>
<td>$181,712,000</td>
<td>$181,712,000</td>
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<tr>
<td>Furniture, fixtures, equipment, &amp; other</td>
<td>$64,673,000</td>
<td>$64,673,000</td>
</tr>
<tr>
<td>Land</td>
<td>$38,411,000</td>
<td>$38,411,000</td>
</tr>
<tr>
<td>Building</td>
<td>$56,952,000</td>
<td>$56,952,000</td>
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<tr>
<td>Construction in progress</td>
<td>$365,827,000</td>
<td>$365,827,000</td>
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<tr>
<td>Accumulated depreciation and amortization</td>
<td>–$1,214,289,000</td>
<td>–$1,214,289,000</td>
</tr>
<tr>
<td><strong>Total estimated replacement cost</strong></td>
<td><strong>$2,655,329,000</strong></td>
<td><strong>$3,473,329,000</strong></td>
</tr>
</tbody>
</table>


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2. Mr. Frear said in his direct testimony that the total cost of each of Sirius’s three first-generation satellites was approximately $259 million to $273 million. The total cost of Sirius’s FM-4 satellite, according to Mr. Frear, was $130 million. Each of Sirius’s next-generation satellites (the FM-5 and FM-6 satellites) cost approximately $260 million, and the total cost of the entire next-generation satellite program was $1 billion. Thus, I estimate that the replacement cost of each of Sirius’ FM-5 and FM-6 satellites is $260 million to $500 million.

3. I was not provided with information on the capital costs of XM’s satellites. Therefore, for purposes of estimating Sirius XM’s replacement cost, I have assumed that the replacement costs of the XM satellites are equivalent to those of the Sirius satellites. I approximated the replacement cost of the XM-1, XM-2, XM-3, and XM-4 satellites to be equal to $259 million to $273 million each. Because XM-5 is a next-generation satellite, I assume that its replacement cost is $260 million to $500 million.

4. The remaining, non-satellite capital costs are the costs of Sirius XM’s spectrum and property, plant, and equipment. Sirius and XM together paid a total of $173.3 million for the SDARS spectrum. According to Sirius XM’s quarterly report for the third quarter of 2011, the value of the company’s non-satellite property and equipment cost was approximately $973 million. However, Sirius XM’s accumulated depreciation and amortization costs were –$1.2

125. Id. at 8.
126. Id.
127. Id. at 9.
129. Frear 2006 Testimony, supra note 124, at 8 (stating that Sirius paid $83.3 million for its license); Adjustment of Rates and Terms for Preexisting Subscription and Satellite Digital Audio Radio Services, Direct Testimony of Gary Parsons (on behalf of XM Satellite Radio Inc.), Dkt. No. 2006-1 CRB DSTRA, at 5 ¶ 8 (Oct. 30, 2006) (stating that XM paid $90 million for its license).
130. Q3 2011 SIRIUS XM QUARTERLY REPORT, supra note 39, at 11.
The sum of Sirius XM’s total estimated replacement cost is thus $2.7 billion to $3.5 billion. 131
Before the
UNITED STATES COPYRIGHT ROYALTY JUDGES
Washington, D.C.

In the Matter of:
Determination of Rates and Terms for Preexisting Subscription Services and Satellite Digital Audio Radio Services

Docket No. 2011-1
CRB PSS/Satellite II

TESTIMONY OF

GEORGE S. FORD

President, Applied Economic Studies

Witness for SoundExchange, Inc.
My Experience and Qualifications

My name is George S. Ford. I am the President of Applied Economic Studies, a private consulting firm specializing in economic and econometric analysis, located in Birmingham, Alabama. I am also the Chief Economist of the Phoenix Center for Advanced Legal & Economic Policy Studies, a Washington, D.C.-based 501(c)(3) research organization that specializes in the legal and economic analysis of public policy issues involving the communications and technology industries. In addition, I am an Adjunct Professor at Samford University, a private university located in Birmingham, Alabama, where I teach economics in the graduate program of the business school. I serve as a member of the Alabama Broadband Taskforce upon appointment by Alabama Governor Bob Riley.

I received a Ph.D. in Economics from Auburn University in 1994. Since then, I have worked as a professional economist in both government and industry. In 1994, I became an economist in the Competition Division of the Federal Communications Commission, an organization located in the General Counsel’s Office that provided competition analysis support to the many bureaus of that organization. My primary interests were multichannel video services and broadcasting policies, though my work ranged from international policy to radio interference standards to statistical analysis. After my government tenure, I became an economist at MCI Communications, where my work focused on telecommunications policy. In April 2000, I became the Chief Economist of Z-Tel Communications in Tampa, Florida, a small competitive telephone company where I performed both regulatory and business analysis. I have been in my present employment since the Summer of 2004.

My areas of specialty in economics include Industrial Economics, Regulation, and Public Policy, with an emphasis on the communications industries, including broadcast radio and television. I have written many papers on telecommunications and media policy, and much of this work has been published in economic and law journals, including the *Journal of Law & Economics*, *Empirical Economics*, the *Journal of Business*, the *Journal of Regulatory Economics*, the *Antitrust Bulletin*, *Energy Economics*, the *Yale Journal on Regulation*, the *Federal Communications Law Journal*, and many others. I have testified before numerous public service commissions, state legislative bodies, and committees of the U.S. Congress on communications policy and rate setting. I also filed testimony before the Copyright Royalty Judges in the Matter of Distribution

Overview

The purpose of this proceeding is to establish the rates and terms for certain digital public performances of sound recordings under Section 114 of the Copyright Act and for the making of ephemeral copies in furtherance of such performances under Section 112(e) of the Copyright Act. I was engaged by SoundExchange, Inc. to provide an economic framework useful for establishing a rate for (i) the ephemeral copies paid by both the pre-existing subscription services ("PSS") and the satellite digital audio radio services ("SDARS") under the statutory license provided in Section 112(e) of the Copyright Act, and (ii) the public performance of sound recordings by the PSS, Music Choice and Muzak.

Ephemerals. With respect to the ephemeral rate, I understand that SoundExchange has proposed that the ephemeral royalty be bundled with the performance royalty and that 5% of the bundled royalty rate be allocated to the Section 112 royalty for making ephemeral copies. As I will explain below in further detail, with respect to the ephemeral copies, I have concluded that sound principles of economic theory as well as observed marketplace benchmarks firmly establish that ephemeral copies have economic value. I have also concluded on the basis of marketplace benchmarks that the economic value of ephemeral copies is properly measured as a fixed percentage of the overall value of the rights acquired by the PSS or SDARS under Sections 112 and 114. However, there exists very little in the way of traditional marketplace benchmarks to facilitate the proper computation of that percentage. This is because the hypothetical “marketplace” envisioned by Section 112 is made up of actors with very different economic interests from the marketplace that exists outside of the statutory framework.

In the unregulated marketplace, where copyright owners and services that publicly perform sound recordings freely negotiate to determine rates, the buyers and sellers are less concerned about the allocation of those royalty rates between payments for ephemeral copies and payments for public performances. However, when copyright owners and the service providers must abide by rates determined under Sections 112 and 114, the explicit allocation of
payments between those two components becomes much more relevant, because the ephemeral copy payments under Section 112(e) are made directly to copyright owners (or record companies in this case), while the performance payments under Section 114 are shared equally between copyright owners and artists. This particular division of payments is solely an artifact of the statute and does not bind or constrain market transactions.

While this division of royalties among upstream providers makes little difference to the “willing buyer” of ephemeral copies in the hypothetical unregulated marketplace — that is, the PSS and the SDARS — it makes a significant difference to the “willing seller” or “sellers,” i.e., the record companies that own the rights to the sound recordings and the artists who get a share of the royalties. Record companies and artists care about what portion of royalty payments are allocated to ephemerals because the higher the portion allocated to ephemerals, the lower the portion paid directly to artists per the terms of the Section 114 license. Record companies and artists therefore have every incentive to negotiate over the proper percentage of royalty payments that are allocated to ephemeral copies. This negotiation is precisely what one would expect to happen in a free market in which both artists and record companies are forced by statute to share 50-50 in performance royalty payments.

Such a negotiation is the basis of the rate proposal advanced by SoundExchange. SoundExchange, a collective made up of both record companies and artists, has proposed a rate that represents the result of negotiations between the artists and the record companies that make up its board. As long as the ephemeral rate is defined as a percentage subset of the total royalty payment, the “willing buyer” — the PSS and SDARS — is indifferent to the ephemeral copy rate. As such, marketplace negotiations between the “willing buyer” — the PSS and SDARS — and the “willing seller” — the copyright owner — while potentially informative, may or may not establish a specific ephemeral copy rate. From a ratemaking standpoint, it does not matter. The SoundExchange proposal is what the “willing seller” in such a marketplace would propose. Because the “willing buyer” is indifferent, the rate proposed by SoundExchange is legitimately viewed as the proper marketplace rate for ephemeral copies. The proposal resolves the problem of a non-market allocation of royalties, and is the best evidence available of the market rate of, and rate mechanism for, ephemeral copies under Section 112.
PSS. I have also been asked to provide my opinion on the reasonableness of the rates proposed by SoundExchange to be paid by the PSS (Music Choice and Muzak)\(^1\) for the performance rights for digital audio transmissions of sound recordings. The PSS are subject to the pricing standard set forth in Sections 114(f)(1) and 801(b)(1) of the Copyright Act. These sections of the Copyright Act require that the Copyright Royalty Judges establish “reasonable” royalty rates for the Section 114 license that comport with four policy objectives. In the case of the Section 112 license, a “willing buyer/willing seller” standard applies to all copyright users.

It is my understanding that SoundExchange has proposed that the PSS pay a revenue-based fee of 15% in 2013 with increases of five or ten percentage points each year to a rate of 45% in 2017. In my assessment of the reasonableness of these rates I adopt the basic economic concept that sound recording copyright owners should be comparably compensated for comparable uses of their rights at rates consistent with marketplace outcomes. This basic economic concept is consistent with, if not the foundation of, the benchmark approach commonly applied in establishing the rates for performance rights. I recognize, however, that the 801(b) statutory standard has a “broader scope”\(^2\) than does the “willing buyer/willing seller” standard for which benchmarking is commonly used. Thus, I will consider also whether the 801(b) policy objectives “weigh in favor of divergence from the results indicated by the benchmark marketplace evidence.”\(^3\)

For reasons expressed in greater detail in later sections of my testimony, I conclude the evidence implies that SoundExchange’s proposed revenue-based royalty fee of 45% is reasonable. The proposed rate is probably at or below the lower bound of a royalty rate consistent with a marketplace benchmark and by implementing the increase over a period of five years, I believe SoundExchange’s proposed rate satisfies the 801(b) statutory standard.

I. Analysis of the Section 112 License for Ephemeral Copies

\(^1\) I understand that Muzak has withdrawn from this proceeding and Music Choice is the only PSS that is still participating.


\(^3\) SDARS I at 4094.
For the Section 112 license for both the SDARS and the PSS, the Copyright Act requires that the Copyright Royalty Judges establish rates that most clearly represent those “that would have been negotiated in the marketplace between a willing buyer and a willing seller,” and that the Judges take into account two specific factors: (1) whether the use of the services may substitute for or promote the sale of phonorecords; and (2) whether the copyright owner or the service provider makes relatively larger contributions to the service ultimately provided to the consuming public with respect to creativity, technology, capital investment, cost and risk.4

In measuring the value of the Section 112(e) statutory license, just as in measuring the value of the Section 114(f)(1) license, a key consideration in setting a proper rate is the identification of proper marketplace benchmarks.5 The Copyright Royalty Judges have essentially adopted the CARP’s observations that: “[T]he quest to derive rates which would have been observed in the hypothetical willing buyer/willing seller marketplace is best based on a review of actual marketplace agreements, if they involve comparable rights and comparable circumstances.”6

As I will explain below, in reviewing the most closely analogous marketplace agreements, I come to three conclusions about the proper royalty rate for ephemeral copies under Section 112(e). First, marketplace benchmarks as well as basic economic theory demonstrate that ephemeral copies have economic value to services that publicly perform sound recordings because these services cannot as a practical matter properly function without those copies.

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5 SDARS I at 4088 (explaining that “a good starting point for the determination of what constitutes a reasonable rate encompassing the four [Section 801(b)] policy factors is to focus on comparable marketplace royalty rates as ‘benchmarks,’ indicative of the prices that prevail for services purchasing similar music inputs”). I recognize that the Section 114 standard involves a slightly “broader scope” than the “willing buyer/willing seller” standard, id., but I do not believe that the “broader scope” should materially impact the value of the Section 112(e) license.

Second, marketplace benchmarks show that the royalty rate for ephemeral copies, if directly established, is almost always expressed as a percentage of the overall royalty rate for combined activities under Sections 112 and 114. Third, because the only actors in the hypothetical three-party market established by the statute — PSS/SDARS, record companies, and artists — that have any economic interest in the measure of that allocation are the artists and the copyright owners, SoundExchange’s proposals in SDARS I and Webcasting III as to that allocation, both of which were adopted by the Judges, are the best measure of how a willing buyer and a willing seller would allocate royalty payments between performance royalties and ephemeral copies, and would value the ephemeral license in the course of a marketplace negotiation for public performances.

A. The Ephemeral License Has Economic Value

As an initial proposition, it is beyond serious question that ephemeral copies of sound recordings have economic value. This is because, as Congress recognized in enacting Section 112(e), PSS, SDARS, and other music services simply could not exist without the ability to make ephemeral copies. In fact, because PSS and SDARS must have both the ephemeral copy right as well as the performance right in order to operate their services, as a matter of economic theory one could say that the Section 114 right has zero economic value without the Section 112 right, and the Section 112 right has zero economic value without the Section 114 right. One cannot remove the Section 112(e) right from the full complement of rights required by PSS and SDARS any more than one can remove oxygen molecules from water and still have water.

This theoretical proposition is confirmed by a number of marketplace benchmarks as well as by prior precedent of the CRJs. First, in the marketplace deals between record companies and music services, such as webcasters, for non-statutory forms of licenses, it is typical for ephemeral copy rights to be expressly included among the grant of rights provided to the services. Most of these agreements do not set a distinct rate for those ephemeral copies, incorporating them instead into the overall rate that the music services pay for the combined ephemeral copy rights and performance rights. Nonetheless, economic theory teaches that rational companies do not give away something for nothing. Because these ephemeral copy rights are essential for the music providers to operate their services, it follows that the value of
ephemeral copy rights has been included in the overall rate that webcasters pay under these agreements.

Second, I am aware of several agreements over the years between record companies and services that publicly perform sound recordings that do establish specific rate mechanisms for ephemeral copies. For example, I have reviewed an agreement between a major record label and a webcaster that covered ad-supported internet radio service, subscription radio service, and on-demand streaming and recited the parties’ agreement that 10% of the royalty payments made under the agreement shall be designated as payment for ephemeral copies. Other agreements have contained similar language. For example, in SDARS I and Webcasting II the CRJs were presented with evidence of agreements negotiated by Sony BMG and by Warner Music Group which provided that 10% of the overall fees for streaming are attributable to the making of ephemeral copies.7

Third, I am also aware that, more recently, SoundExchange negotiated a number of voluntary agreements for the Section 112 and 114 rights at issue in the Webcasting III proceeding. In those agreements, the willing participants in the market agreed to structure the ephemeral reproduction rate as an allocation of the correlative performance royalty.8

7 See Webcasting II at 24101. The actual rates established in such marketplace agreements, while potentially informative, are not necessarily the best proxy for the ephemeral rate in the instant proceeding. These agreements are made without statutory constraints on how ephemeral and performance royalties are allocated between copyright owners and artists. Had these agreements been bound by such statutory conditions, then the outcomes may very well have been different. But these agreements are relevant in two important ways: First, they demonstrate that willing buyers and willing sellers do trade in ephemeral rights, which would be economically irrational if they had no value. Second, as discussed more fully in the next section below, they demonstrate that the payments for ephemeral rights, even absent regulatory constraint, employ a percent-of-total mechanism where ephemeral royalties are expressed as a percentage of payments metered on performances.

Fourth, the CRJs have recognized in prior proceedings that the ephemeral copy rights have economic value and have accordingly adopted regulations determining a value to those rights.9

B. It Is Appropriate to Express the Value of Ephemeral Copies as a Fixed Percentage of the Performance Royalty

Setting the ephemeral rate as a share of the total performance royalty fee does no injustice to economic theory. In fact, marketplace benchmarks consistently confirm that a percentage share is the appropriate measure. The marketplace has spoken with near unanimity in structuring the Section 112(e) ephemeral reproduction license as a percentage of the Section 114 performance royalty where such performance royalty is established. As discussed above, I have seen numerous voluntary agreements between willing buyers and willing sellers in which the rate for the ephemeral reproduction license was expressed as a percentage of the performance royalty. Similarly, as mentioned above, SoundExchange has previously negotiated a number of voluntary agreements concerning Section 112 and 114 rights similar to those at issue in this proceeding. There, again, the participants, although operating in the context of the statutory license, agreed to structure the ephemeral reproduction rate as an allocation of the correlative performance royalty.10

Thus, it appears that, where a rate for ephemeral copies is set in the marketplace, it is set as a percentage of overall royalties. As a structural matter, the available evidence suggests that setting the ephemeral rate as a percentage of an overall payment is consistent with marketplace negotiation. Moreover, the CRJs have accepted this view and adopted regulations setting the Section 112(e) royalties as a percentage of Section 114 performance royalty in the remand of the prior SDARS proceeding and in the Webcasting III proceeding.11

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9 See, e.g., 37 C.F.R. § 382.12; 37 C.F.R. § 380.22.

10 Although these agreements did not set the specific allocation, but left that open to future determination, the point here is that the willing buyers and willing sellers agreed to structure the ephemeral rate as an allocation of the performance rate.

11 Determination of Rates and Terms for Preexisting Subscription Services and Satellite Digital Audio Radio Services, 75 Fed. Reg. 5513 (Feb. 3, 2010); Webcasting III at 13027; see also 37 C.F.R. § 382.12; 37 C.F.R. § 380.22.
C. The Best Market Benchmark is the Agreement Between Artists and Record Companies.

Having established that the Section 112(e) ephemeral reproduction right clearly has value and is best expressed as a percentage of a bundled Section 112/114 royalty where such royalty is set, the final step in the analysis is to determine the appropriate percentage. As noted above, most agreements that set a rate for ephemeral copies specify that rate as a percentage of total royalty payments. Given the nature of the rights at issue, that is not a surprising outcome. Where performance royalties are negotiated in a free market setting, that is, outside of the Section 114 context, the copyright owner (in this case the record companies) and the service provider should have less at stake with respect to the allocation of payments between ephemeral copies and performances.

By contrast, Congress radically altered this market dynamic when it comes to the statutory licenses. There is a very significant difference between payments under the Section 112(e) compulsory license and the Section 114 compulsory license: payments under Section 114 are by law split between copyright owners and artists, while payments under Section 112(e) go entirely to copyright owners. The implication of this phenomenon is immediate. The sharing of income between record companies and artists for performances is set by law. Thus, if it is to have any relevance for the Judges, the willing buyer/willing seller market analysis suggested by Section 112(e) for ephemeral rates must reflect this statutory alteration to the market dynamics whereby the artists and the record companies jointly have a real interest in negotiating the Section 112(e) rate while the PSS and SDARS (as the willing buyers) do not.

By the very nature of the statute, the agreements reached under the constraints relevant in this proceeding will not be the same as in the unregulated market. Evidence suggests that rates agreed upon between the “willing buyer” in this hypothetical market — the PSS and SDARS — and the “willing seller” — the record companies — will either embody the ephemeral copy rate in a bundled rate or express the ephemeral rate as a percentage of the total overall royalty payment. If so, the buyer is indifferent to the allocation of payments between ephemeral copies and performance royalties. But the “willing seller” — the record companies — will not be so indifferent under the statutory division of royalties that cannot be assumed away. Under plausible conditions, only the record companies and artists are parties to the establishment of
the ephemeral rate, and these parties have arrived at a royalty rate for ephemeral copies that reflects a more market-based allocation of payments between ephemerals and performance royalties.

Because the willing buyer is disinterested with respect to that allocation, the agreement between the record companies and the artists thereby becomes the best indication of the proper allocation of royalties.

My understanding is that recording artists and record companies have determined that the royalty rate for the Section 112 license should be five percent (5%) of the bundled royalties under Section 112(e) and 114. This is the percentage that SoundExchange proposed last year in resolving the remand of the prior SDARS proceeding. The CRJs accepted and adopted that settlement. In addition, in the Webcasting III proceeding, based on the evidence in the record (which is essentially the same as the evidence set forth herein) and a stipulation between the parties, the CRJs accepted and adopted the same proposed 5% ephemeral rate.12 And of course SoundExchange is again proposing the same 5% proposal in this proceeding.

In light of the principles I have articulated above, SoundExchange’s proposal is reasonable and credibly represents the result that would in fact obtain in a hypothetical marketplace negotiation between a willing buyer and the interested willing sellers under the relevant constraints.

II. Framework for Evaluating Royalty Rates Paid by the PSS to SoundExchange

Sections 114(f)(l) and 801(b)(l) of the Copyright Act require that the Copyright Royalty Judges establish “reasonable” royalty rates for the Section 114 license that comport with four specific policy objectives:

(A) to maximize the availability of creative works to the public;
(B) to afford the copyright owner a fair return for his creative work and the copyright user a fair income under existing economic conditions;

(C) to reflect the relative roles of the copyright owner and the copyright user in the product made available to the public with respect to relative creative contribution, technological contribution, capital investment, cost, risk, and contribution to the opening of new markets for creative expression and media for their communication; and

(D) to minimize any disruptive impact on the structure of the industries involved and on generally prevailing industry practices.\(^{13}\)

It is my understanding that in only one prior case have the Copyright Royalty Judges established performance rates under the 801(b) standard – the SDARS case of 2008.\(^{14}\) In that decision, the Copyright Royalty Judges outlined a two-step procedure for setting rates under this statute. As a first step, the focus is on identifying comparable marketplace royalty rates that serve as benchmarks, and which are “indicative of the prices that prevail for services purchasing similar music inputs for use in digital programming ultimately made available to consumers.”\(^{15}\) In other words, the first step is the same willing buyer/willing seller standard that is required for setting the § 112 ephemeral rate outlined above. In the second step, the “broader scope”\(^{16}\) of Section 801(b) leads to an evaluation of whether the 801(b) policy objectives “weigh in favor of divergence from the results indicated by the benchmark marketplace evidence.”\(^{17}\) I will follow this two-step process throughout my testimony.

III. Establishing Rates by Benchmarking

In a rate-setting environment, benchmarking refers to the use of outcomes observed in market transactions – the benchmark market – to aid in establishing a rate in situations where


\(^{14}\) SDARS I at 4084. The Copyright Royalty Judges also previously affirmed a settlement agreement between the PSS and SoundExchange for the royalty that would have been set subject to the 801(b) statutory standard. Adjustment of Rates and Terms for Preexisting Subscription and Satellite Digital Audio Radio Services, 72 Fed. Reg. 71795 (Dec. 19, 2007).

\(^{15}\) SDARS I at 4088.

\(^{16}\) SDARS I at 4088.

\(^{17}\) SDARS I at 4094.
the market does not or is not permitted to operate effectively – the hypothetical target market.

Benchmarking is a common method by which to set regulated rates.

The first step in establishing the license fee for the PSS is to define the hypothetical target market, and then to find royalty rates from market transactions to serve as benchmarks for this target market. Ideally, the buyers, sellers, and rights in the benchmark market would be identical to the target market, but experience suggests that benchmarks are rarely if ever perfect. In instances where the nature of the transaction in the benchmark market differs from that in the hypothetical target market, modifications and adjustments are applied to render a more suitable rate.

A. Hypothetical Target Market

Pursuant to the statutory license, the PSS offer a non-interactive streaming music service composed of multiple, genre-based channels of diverse audio programming delivered over multichannel video systems. Each channel provides a continuous stream of music from a distinct musical genre, including genres such as “Soft Rock,” “Rap,” “Hip Hop and R&B,” “Metal,” “Pop Latino,” and so forth. Music Choice, for example, offers 46 genre-based music channels. The price charged by the PSS to the multichannel video provider for these services does not depend on the hours of programming accessed by the final consumer, and the prices paid by the final consumer also do not depend on the amount of programming accessed. The PSS are music-only services, so their revenues are for music only. But the PSS are distinctive among rights users for a number of reasons.

First, the PSS do not offer services directly to consumers. Rather, they sell their service to multichannel video providers, who then bundle the service with television channels and offer consumers subscriptions to the entire bundled service. Since the PSS offer their service only on a wholesale basis, its revenues may represent only a fraction of the retail value of its service. Some part of the value of the performance rights may be captured by the downstream multichannel video providers.

\[18\] http://www.musicchoice.com/AboutMusicChoice.aspx. Music Choice offers many other services including video and music on-demand, but such services are not relevant to this proceeding.
Second, the PSS are also somewhat unique in that their service is bundled with vast quantities of video content. It appears that only in rare cases is a PSS service sold as a stand-alone tier by cable systems, so it is difficult to determine exactly the retail value of the PSS service. Yet, the Copyright Royalty Judges have previously determined that the value of the performance right is derived from the “ultimate consumer markets.” The fact that the service is sold in audio-visual bundles, however, does not imply that the PSS are of relatively low value to the subscriber or the multichannel video industry. The sales materials of multichannel video providers suggest that Music Choice, or similar music services, is an important component of their bundled offerings.

B. Benchmark Transactions

As just detailed, the PSS provide a service of a somewhat distinctive nature. In my own review of marketplace agreements in which performance rights are sold by copyright owners to copyright users for digital transmissions, I was unable to find any contract that matched closely the peculiar nature of the PSS’s business. Nevertheless, in my opinion it is possible to use these marketplace agreements as benchmarks in order to establish a zone of reasonableness for revenue-based royalty fees. Given the variety of buyers and business plans represented in the sample of contracts, the resulting zone of reasonableness will necessarily be very wide. Still, the market-based zone of reasonableness is a useful starting point in evaluating the rate proposal offered by SoundExchange.

SoundExchange has proposed a revenue-based royalty fee for the PSS and this is helpful in two respects. First, I can largely limit my attention to the revenue-based rates from the marketplace transactions, even though these agreements typically include multiple rate elements in a “greater of” rate structure. Second, the revenue-based royalty rate is not an absolute payment as are the per-play or per-subscriber rate elements typically found in market

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19 Based on an Internet search, I was able to find two instances of a Music Choice Tier including XIT Communications ($2.75 per month) and Kalona Cooperative Telephone Company ($3.95 per month).

20 SDARS I at 4093.

21 As discussed below, the royalty payment under the “greater of” approach might be the highest payment calculated from a revenue-based fee, a per-subscriber fee, or a per-play fee.
agreements. Rather, the revenue-based rate scales the royalty payment to the revenues of the copyright user, and these revenues are determined by the value of the service offered to consumers. Therefore, in marketplace agreements, a common revenue-based royalty rate is often applied across a wide range of services, even when the per-play or per-subscriber rates differ significantly between them. Further, the transferability of revenue-based rates across services of differing values in the consumer market was embraced by the Copyright Royalty Judges in the Webcasting II and Webcasting III decisions.

Relying on analysts working under the direction of Professor Ordover (whose testimony also relies on these marketplace agreements), I reviewed the royalty rates of numerous marketplace agreements between record companies and copyright users offering digital transmissions of sound recordings. Consistently, these contracts employ a “greater of” methodology for establishing the royalty obligation. In most cases, the rate structure contains at least two of these three components: i) a revenue-based royalty fee applied to retail revenues; ii) a per-play royalty fee; and iii) a per-subscriber royalty fee. The actual royalty payment is then equal to the greatest of these calculations.

This “greater of” approach to royalty rates serves many legitimate purposes, which is why it is used in many private royalty contracts. By targeting different measures of output (revenues, subscribers, plays), it enhances the ability of the copyright owner to share in the value created by its copyrights and reduces the ability of copyright users to “game the system” in an effort to reduce royalty payments. Picking just one of the “greater of” rate elements in a statutory setting eliminates these benefits, and necessarily means that the statutory royalty payment will always be less than or equal to the payment made in corresponding marketplace transactions. Including the per-subscriber and per-play rate elements in market contracts makes it certain that copyright owners will be paid for their property even in cases in which the copyright user is unable to obtain revenues sufficient to render a reasonable revenue-based royalty payment for the performance rights. Including a revenue-based fee makes certain that the copyright owner is compensated for the option created by use of its rights (i.e., the availability of performances upon request) even if that option is not exercised (no listening occurs). Both the option and the use have market value, and the rate structure in marketplace agreements reflects this fact.
To my knowledge, the number of plays cannot be accurately measured for the PSS. As a consequence, the royalty rate structure for the PSS cannot be based directly on the number of plays. As I explained above, in the absence of a per-play rate, a percentage-of-revenue rate has benefits. But there are risks to such a rate structure that I believe are relevant in the context of the PSS. Most importantly, the use of a revenue-based royalty fee to the exclusion of other types of fees exposes copyright owners and performers to the risk of inadequate compensation for performance rights when a business plan generates little to no revenues. In *Webcasting II*, the Copyright Royalty Judges recognized that copyright owners could “receive little compensation for the extensive use of their property”\(^{22}\) under a revenue-based royalty fee. I believe this concern is very much applicable to the present case, especially with respect to the intermediary role that I discuss in detail below.\(^{23}\)

In the reviewed marketplace contracts, the range of revenue-based contract rates is 45% to 70%. Table 1 summarizes the type of service provided by the copyright user and the percentage rate applied.

<table>
<thead>
<tr>
<th>Type</th>
<th>% of Retail Revenues</th>
</tr>
</thead>
<tbody>
<tr>
<td>Permanent Audio Download</td>
<td>70%</td>
</tr>
<tr>
<td>Cellular (Ringback/Ringtone)</td>
<td>45% to 50%</td>
</tr>
<tr>
<td>Interactive Subscription (Portable)</td>
<td>60% to 65%</td>
</tr>
<tr>
<td>Interactive Subscription (Non Portable)</td>
<td>50% to 60%</td>
</tr>
</tbody>
</table>

\(^{22}\) *Webcasting II* at 24090.

\(^{23}\) Another problem with the revenue-based fee is that it has a potential practical defect in that buyers may be able to strategically shift revenues to affiliated firms or to uses that are outside the scope of the statutory license, thereby minimizing the royalty liability. In my opinion, this strategic defect is a very serious concern in this proceeding, because it is my understanding that Music Choice is owned, in part, by the nation’s largest cable television operators, including Comcast, Cox, and Time Warner Cable. This affiliation raises the possibility that the deals struck between Music Choice and much of the cable industry did not arise in arm’s length negotiations. Without more information about the ownership and control of Music Choice, it is difficult to fully analyze the impact, if any, on Music Choice’s PSS revenues.
Notably, even though the types of services differ substantially in nature – for example, permanent music downloads versus interactive webcasting -- the revenue-based fees suggest a range of revenue payable for the use of sound recordings across all uses. Even for a single user, while the per-play or per-subscriber rates may differ across the type of services offered based on retail pricing differences, the revenue-based fee is relatively uniform across such services. In marketplace transactions, it appears that the particularities of services are presumed to be reflected in revenue differences, such that the application of a uniform revenue-based rate applied across very different services is acceptable to both sellers and buyers, thereby suggesting that the differences in revenues across services adequately reflect the differences in market values. Consequently, it is reasonable to conclude that revenue-based fees are not unique to particular services, and the minimum and maximum of the market rates found in my sample of contracts -- 45% to 70% -- represent observed bounds on the zone of reasonableness for a revenue-based rate under a market-based mechanism.

SoundExchange’s proposed 45% rate is equal to the lower bound of the zone of reasonableness for a revenue-based rate, where this zone considers a broad range of digital programming services. As such, it could be presumed to be a reasonable proxy for a market outcome. However, all of the revenue-based rates from the sample of agreements summarized in Table 1 apply to retail revenues. The revenues of Music Choice are not, however, retail revenues, but only a fraction thereof. The unique features of the PSS with respect to revenue and consumer value deserve additional attention. The unique features of the PSS with respect to revenue and consumer value deserve additional attention.

1. Revenues and the Intermediary Role

The PSS are delivered to end users primarily through multichannel video programming distributors such as cable television systems. The revenues of webcasters, in contrast, reflect the market value of the music content in the ultimate consumer market. The PSS do not participate in the ultimate consumer market. Rather, the multichannel video provider retransmitting their service participates in that market. Previously, the Copyright Royalty Judges indicated the value of the music rights in the input market -- that is, the market where the rights are exchanged -- should be “driven by or derived from the ultimate consumer markets in which
these inputs are put to use.” Furthermore, the Copyright Royalty Judges expressed concern that the copyright owners could “receive little compensation for the extensive use of their property” as a consequence of particular business plans that lead to low revenues. The intermediary role played by the PSS implies that their revenues are unlikely to fully account for the value of the sound recordings in the consumer market. In fact, a share of the value of the services broadcast over cable systems is expected to be captured by the downstream video provider, not by the PSS.

The business of the multichannel video provider is to acquire and then distribute to its subscribers audio and video programming over its network, whether terrestrial or satellite, for a fee. In order to pay for the network, the video provider must mark up the incremental cost of the programming inputs, thereby creating a gross profit margin. The retail price \( P \) is equal to a markup \( M \) of incremental cost \( C \), or \( P = M \times C \). As long as a programming service generates sufficient revenue to justify its input price and to justify the assignment of potentially scarce capacity to its retransmission, then it is sensible for the multichannel video provider to include the programming service in its package. Thus, the markup is always no less than and probably greater than 1, since profits are lower if the service does not at least cover its cost. As such, the cost of the programming to the video provider, which equals the revenue of the programmer, is only a fraction (equal to the inverse of \( M \)) of the final retail price for that programming. Plainly, the intermediary role played by PSS is significant when considering the appropriate size of a revenue-based royalty rate. The royalty rates applied to retail revenues – 45% to 70% -- are too small when applied to the revenues of a programmer like the PSS, since

\[\text{SDARS I at 4093.}\]

\[\text{Webcasting II at 24090.}\]

\[\text{In the presence of a binding capacity constraint, services that have large positive margins may be excluded from the bundle because the capacity is exhausted from the retransmission of other, more profitable services.}\]

\[\text{This argument follows from the basic rule of profit maximization – programming will be added to the bundle as long as the change in revenues (marginal revenue) exceeds the change in cost (marginal cost) of doing so. The economic literature contains a wide variety of potential markup rules, most of which are based on the own-price elasticity of demand for service.}\]
the programmer’s revenue are below the retail revenues that can be attributed to the programming input. SoundExchange’s proposed rate of 45%, consequently, is, at best, at the low end of the range of reasonable rates (assuming $M = 1$) and possibly discounted even further (assuming $M > 1$) because of the intermediary nature of the PSS as compared to market agreements for similar rights where revenue-based rates are applied to retail revenues.

In the presence of a markup over incremental cost, a portion of the retail value of the performance rights is captured by entities that benefit from the statutory license but do not have to pay for the performance rights in relation to the value (i.e., the multichannel video providers). The Copyright Royalty Judges’ concern that the revenue-based rate may lead to a situation where the copyright owners could “receive little compensation for the extensive use of their property” is relevant in this case. A minimum per-subscriber fee could in principle be used to address this distortion, and discovery into the fees paid by the cable companies to the PSS may allow for the development of such a proposal in order to address the possible shortcomings of a percentage-of-revenue rate in the context of the unique features of the PSS. At a minimum, the structure of the PSS industry, wherein much of the actual retail value of the use of music is shielded from the royalty pool, supports SoundExchange’s request for a substantial increase in the royalty rate.

IV. The § 801(b) Policy Objectives

The Copyright Act requires that the Copyright Royalty Judges establish royalty rates for the PSS that comport with the four specific policy objectives of 17 U.S.C. § 801(b). Previously, the Copyright Royalty Judges concluded that implementation of the 801(b) standard requires the consideration of “whether these policy objectives weigh in favor of divergence from the results indicated by the benchmark marketplace evidence.”

28 Webcasting II at 24090.

29 SDARS I at 4094.
A. To Maximize the Availability of Creative Works to the Public

As the royalty payments for sound recordings rise, the incentives to create more recordings likewise rise. That is, the supply curve of sound recording content is upward sloping. If the goal is to maximize the availability of creative works, this logic supports higher royalty rates. However, maximizing the effective availability of creative works requires both the creation of and dissemination of such works to the public. Higher royalty rates make it more difficult for copyright users to profit from the performance of sound recordings to end users, thereby discouraging dissemination. That is, the demand for content is downward sloping, and this reality tends to support lower royalty rates to promote availability. A change in royalty rates, therefore, has two opposing effects in relation to the availability of creative works, one encouraging and the other discouraging greater availability. Some sort of balancing of these tendencies is required, and market forces are often presumed to play such a role. In the prior SDARS decision, the Copyright Royalty Judges concluded that “an effective market determines the maximum amount of product availability consistent with the efficient use of resources.”

My analysis of SoundExchange’s proposal is based on the royalty rates observed in marketplace agreements between willing buyers and willing sellers. The observed outcomes presumably reflect the balance of supply-side and demand-side considerations. As such, the 801(b)(1)(A) policy objective provides a sound basis for a change in the status quo, thereby raising the royalty rate presently paid by the PSS to a level more consistent with a market outcome, as proposed by SoundExchange. In fact, the below-market rate paid by the PSS today on revenues that do not accurately reflect the full value of the service seems to violate this policy objective. If the PSS were to cease offering their services, presumably their business and customers would shift to alternative providers of digital music. Since these alternative suppliers pay higher royalties and are evidently effective disseminators of music content, this

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30 This logic has been recognized by the Copyright Royalty Judges in the past. See, e.g., SDARS I at 4094.

31 SDARS I at 4094. “We agree with Dr. Ordover that ‘voluntary transactions between buyers and sellers as mediated by the market are the most effective way to implement efficient allocations of societal resources.’” Ordover WDT at 11.”
shift of business would lead to a higher level of availability of creative works to the public by stimulating supply, and having little to no effect on demand.

B. To Afford the Copyright Owner a Fair Return for His Creative Work and the Copyright User a Fair Income under Existing Economic Conditions

“Fairness” is not a term of art in the economics profession. In some cases, “fairness” is given economic meaning by an appeal to “willing buyer/willing seller” outcomes. In SDARS I, the Copyright Royalty Judges assigned an economic meaning to fairness, concluding that “a fair income is … consistent with reasonable market outcomes.”

Also, the 801(b)(1)(B) objective expresses concern for a “fair” outcome for both the copyright owner and the copyright user. The objective does not appear to infer favoritism to one side of the market or the other. Moreover, the economic concept of fairness does not suggest rates should be set to guarantee a particular user’s success. The marketplace offers no guarantees of success or profits. As observed by the Copyright Royalty Judges in SDARS I, “[a]ffording copyright users a fair income is not the same thing as guaranteeing them a profit in excess of the fair expectations.” From an economic perspective, this is exactly correct.

Applying the Copyright Royalty Judges’ prior conclusion that “a fair income is … consistent with reasonable market outcomes,” which is consistent with other interpretations of “fairness,” I see no reason to modify SoundExchange’s proposed rate downward to satisfy this objective. In my opinion, the 801(b)(1)(B) objectives encourage an upward adjustment to the proposed rate to reflect the fact that the PSS’s revenues grossly understate the market value of the performance rights.

Moreover, permitting certain users, even if financially troubled, to pay a royalty rate much less than their competitors may promote inefficient outcomes and subsidize particular business plans. This is a basic principle of economics. If market outcomes are the standard by which efficiency and fairness are judged, then favoritism to particular firms in a competitive market is

32 SDARS I at 4095.
33 SDARS I at 4095.
unjustified. The Copyright Royalty Judges have previously concluded that a “fair income” does not permit a copyright user to “utilize its other resources inefficiently,” and this finding is consistent with the definition of fairness that is based on market outcomes. If the user paying the lower rate takes business from the user paying a higher rate, then the income of the copyright owner is diminished, and this result hardly seems “fair,” since no seller would intentionally sabotage its own profits in an unregulated market setting.

C. To Reflect the Relative Roles of the Copyright Owner and the Copyright User in the Product Made Available to the Public with Respect to Relative Creative Contribution, Technological Contribution, Capital Investment, Cost, Risk, and Contribution to the Opening of New Markets for Creative Expression and Media for Their Communication

I see no reason to believe, and have seen no evidence to support, an argument that the PSS make a contribution to availability or creative expression that is relatively more significant than those services considered as benchmarks. Across a wide range of digital programming services, with varying level of investment and risk, marketplace evidence indicates that the royalty fee for a blanket license to sound recordings should be between 45% and 70% of retail revenues. Considering the intermediary role played by the PSS, this range should be shifted in the direction of higher rates.

D. To Minimize Any Disruptive Impact on the Structure of the Industries Involved and on Generally Prevailing Industry Practices

At present, the PSS pay a combined Section 112 and 114 royalty rate to SoundExchange of 7.25% (increasing to 7.5% in 2012) of their revenues derived from the sale of services to the multichannel video providers. Marketplace evidence is consistent with SoundExchange’s proposal for a significant rate increase.

34 SDARS I at 4095.
36 37 C.F.R. §§ 382.2(a) & (b).
The 801(b)(1)(D) objective, as I understand it, is best understood as a concern over the economic impacts of changes in rates, rate structures, or other factors influenced by the decisions of the Copyright Royalty Judges. In large part, SoundExchange’s proposal addresses such concerns. First, the proposed rate of 45% is still highly favorable to the PSS, at least relative to marketplace standards. Second, the proposed rate is revenue-based, which is a means of calculating royalties already used in the industry, and is thus familiar and consistent with prevailing industry practices, a concern the Copyright Royalty Judges have previously raised. Third, the proposal attenuates the impact of rate changes by phasing in those increases over time. SoundExchange proposes to move from the current 7.5% rate to the 45% rate incrementally over a period of five years.

That said, Section 801(b)(1)(D) is not focused just on the effects for particular copyright users, but instead contemplates disruption to the “structure of the industries involved.” In this case, industry structure is not just a matter of the PSS, however, because there are other entities providing essentially identical services under 37 C.F.R. § 383 (audio-only subscription services transmitted to residential subscribers of a television service). Certainly, a change in rates may disrupt the business of a particular copyright user, but in doing so the change may favor more efficient providers of the same service with better business plans. Shifting business to more

37 In SDARS I, the Copyright Royalty Judges provided some guidance on the economic considerations it found relevant to this objective. The Copyright Royalty Judges characterized a “disruptive” impact as one that “directly produces an adverse impact that is substantial, immediate and irreversible in the short-run because there is insufficient time for either the SDARS or the copyright owners to adequately adapt to the changed circumstances produced by the rate change and, as a consequence, such adverse impacts threaten the viability of the music delivery service currently offered to consumers under this license.” SDARS I at 4097.

38 SDARS I at 4087 (“[T]he parties have until now lived under a revenue-based regime. Therefore the parties are most familiar, and perhaps most comfortable, with the operation of a revenue-based metric. The value of such familiarity lies in its contribution towards minimizing disputes and, concomitantly, keeping transactions costs in check.”).

39 In its SDARS I decision, the Copyright Royalty Judges concluded that a royalty rate that would cause the SDARS to cease operations would be disruptive. SDARS I at 4097 (“Economic experts for both sides agree that a royalty rate that would cause the SDARS to cease operating or dramatically change the nature of its product would clearly be disruptive.”). In the case of the SDARS, however, the loss of a provider is the loss entirely of a
efficient, more innovative firms may be termed “disruptive,” but such a shift is the lifeblood of market outcomes. When consumers, whether at the wholesale or retail level, can choose among multiple sellers of the same product (as is the case here), then market outcomes, obtained on a level playing field, should be trusted in determining the success or failure of any given industry participant. The use of benchmarks, as is common in setting the rates for performance rights, intends to embrace market outcomes, not overrule them.

The current PSS royalty rates provide for payments for performance rights that are well below a level acceptable to a willing seller. Moving to a rate consistent with marketplace outcomes, particularly if done too quickly, could be disruptive. That said, in my opinion, the current practice of applying an exceedingly low rate to deflated revenues is disruptive of industry structure, especially where there are identical services already paying a higher rate.

V. Conclusion

With respect to the ephemeral rate, economic theory and marketplace evidence support SoundExchange’s proposal of a bundled royalty rate for the performance right and the ephemeral right, with 5% of the royalty attributable to the ephemeral. With respect to the PSS, marketplace evidence implies that SoundExchange’s proposal for the PSS, which ramps up to 45% of revenues in 2017 for the PSS, appears to be at the low end of the range of reasonable rates and possibly discounted even further because of the unique structure of the PSS as compared to market agreements for similar rights.

I declare under penalty of perjury that the foregoing testimony is true and correct.

Date: 11/29/11

__________________________
George S. Ford
Appendix A
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PUBLISHED RESEARCH:


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Before the
UNITED STATES COPYRIGHT ROYALTY JUDGES
Washington, D.C.

In the Matter of:

Determination of Rates and Terms for
Preexisting Subscription Services and
Satellite Digital Audio Radio Services

Docket No. 2011-1
CRB PSS/Satellite II

TESTIMONY OF

JONATHAN BENDER

Chief Operating Officer, SoundExchange, Inc.

Witness for SoundExchange, Inc.
I. Background and Qualifications

I am the Chief Operating Officer of SoundExchange, Inc. ("SoundExchange"). I have held this position since September 1, 2011. I have more than 20 years of music industry business and management expertise. Over the years, I have served in senior operational roles at Concord Music Group, Universal Music Group, and EMI Music. I was senior vice president, operations, IT and digital development at Concord Music Group, one of the fastest growing independent label groups in the world. In this role, I designed and managed a consolidated digital infrastructure to host and distribute the artist catalogs of the three combined companies: Concord Records, Fantasy Records and Telarc International. I also led the integration of all physical product operations and revamped all of the group’s online properties. Before joining CMG, I spent seven years with Universal Music Group, most recently as vice president, digital asset management and logistics. In this role, I served as team leader for building of the music industry’s first e-commerce distribution infrastructure, and converted production operations from physical assets to digital. I also spent nine years with EMI Music, one of the world’s largest music companies. As director of new technology based in London, I implemented the industry’s first worldwide transmission network for production assets, setting global standards for digital assets and metadata. I hold a bachelor’s degree from the University of North Carolina at Chapel Hill, where I was a Morehead Scholar, and an MBA from Harvard Business School.

My responsibilities as SoundExchange’s Chief Operating Officer include overseeing the processing and distribution of royalty payments for the performance of sound recordings through the various types of services eligible for statutory licensing, including the SDARS and PSS services at issue in this proceeding. I supervise SoundExchange staff who receive reports of use
from licensees, determine the amounts owed to copyright owners and performers, and process the distributions of royalties to those individuals and entities. The groups within SoundExchange that handle account services, distribution services, data management and claims all report to me. Additionally, I oversee SoundExchange’s technical involvement with licensees and assist with coordination of its systems requirements, development, and testing.

II. Overview

I am submitting this testimony to provide background information about SoundExchange and its operations; to describe SoundExchange’s processing and distribution of royalties; to explain ways in which the current SDARS definition of gross revenues has proven difficult to administer and why SoundExchange’s proposed revised definition would be preferable; to explain why SoundExchange should be the sole Collective for collecting and distributing royalties under the Section 112 and 114 licenses; and to support SoundExchange’s proposed minimum fees and terms.

III. SoundExchange’s Processing and Distribution of Royalties

A. Overview of SoundExchange

SoundExchange is a 501(c)(6) nonprofit performance rights organization established to ensure the prompt, fair and efficient collection and distribution of royalties payable to performers and sound recording copyright owners for the performance of sound recordings over, among other things, the Internet, wireless networks, cable and satellite television networks, and satellite radio services via digital audio transmissions. SoundExchange is governed by an 18-member Board of Directors that is made up of equal numbers of artist representatives and sound recording copyright owner representatives. Copyright owners are represented by board members associated with the major record companies (four), independent record companies (two), the
Recording Industry Association of America (two), and the American Association of Independent Music (one). Artists are represented by one representative each from the American Federation of Musicians (“AFM”) and the American Federation of Television and Radio Artists (“AFTRA”). There are also seven at-large artist seats, which are currently held by artists’ lawyers and managers, as well as a recording artist.

In the previous SDARS proceeding, Docket No. 2006-1 CRB DSTRA, the Judges designated SoundExchange to “serve as the Collective for the 2007-2012 license period” for the collection and distribution of royalties paid by the SDARS under the Section 112 and 114 licenses. 73 Federal Register 4,080, 4,099 (Jan. 24, 2008). SoundExchange is also the Collective for the collection and distribution of PSS royalties for the time period 2008-2012. See 37 C.F.R. § 382.3(a). In addition, the Judges have designated SoundExchange as the Collective for webcasting royalties under the Section 112 and 114 licenses for the 2011-2015 license period.

Since its founding, SoundExchange has, on behalf of artists and record labels, sought the establishment of royalties and regulations that enable the prompt, fair and efficient distribution of royalties to all those artists and copyright owners entitled to such royalties. In addition to participating in rate-setting proceedings, SoundExchange has represented artists and record labels with respect to other issues, such as notice and recordkeeping. SoundExchange also undertakes a number of measures to protect the interests of artists and copyright owners under the statutory licenses, including by conducting audits of licensees, seeking and obtaining compliance by noncompliant licensees, and engaging in other enforcement and compliance measures.
SoundExchange frequently refers to those record labels and artists who have specifically authorized us to collect royalties on their behalf as “members.” We have approximately 12,700 rights owner members (including both record labels and artists who own the copyrights in their own recordings) and 30,250 artist members. We also pay statutory royalties to non-members—copyright owners and artists alike—as if they were also members. In total, we maintain accounts for more than 20,100 rights owners and more than 45,000 artists, including members and non-members.

SoundExchange strives to minimize the administrative costs associated with royalty collection and distribution. SoundExchange has 69 full-time staff members. In 2010, our administrative rate was 6.7%. For comparison purposes, the American Society of Composers, Authors and Publishers (“ASCAP”) reported operating expenses of 14.3% for 2010 (http://www.ascap.com/about/annualReport/annual_2010.pdf).

B. SDARS and PSS Royalties

SoundExchange has collected and distributed hundreds of millions of dollars in royalties paid by the SDARS and PSS for their performances of sound recordings under the statutory licenses. For its SDARS service, Sirius XM paid [redacted] in royalties to SoundExchange in 2009; [redacted] in 2010; and [redacted] for the first nine months of 2011. The PSS pay royalties that are a small fraction of the SDARS royalties.

The SDARS pay SoundExchange on a percentage of revenue basis. The SDARS pay SoundExchange the following percentages of their “Gross Revenues,” as that term is defined in the regulations: 6.0% in 2007 and 2008; 6.5% in 2009; 7% in 2010; 7.5% in 2011; and 8.0% in 2012. However, the SDARS royalty base established by the definition of “Gross Revenues” in 37 C.F.R. § 382.12 draws distinctions among various categories of Sirius XM revenue. That
definition includes only certain subscription and advertising revenue, and then excludes some revenue such as certain equipment revenue, royalties paid to Sirius XM for intellectual property rights, money received by Sirius XM from the sale of phonorecords, revenues recognized by Sirius XM for the provision of data services offered for a separate charge, channels offered for a separate charge that use only incidental performances of sound recordings, services provided outside the United States, and services for which the performance of sound recordings is separately licensed, among other revenue.

The result of this complicated definition of gross revenues has been that Sirius XM is paying SoundExchange royalties calculated off a base that is well less than Sirius XM’s total revenues – and even less than its total subscription revenues. According to revenue data from Sirius XM’s publicly available SEC filings, its total “subscriber revenues” were $2,287,503,000 in 2009; $2,414,174,000 in 2010; and $1,922,917,000 for the first nine months of 2011. By comparison, the revenue that Sirius XM reported to SoundExchange for those same periods of time was as follows: [ ] in 2009; [ ] in 2010; and [ ] for the first nine months of 2011. Thus, the revenue base defined by “Gross Revenues” amounted to approximately [ ] of the subscriber revenues that Sirius XM reported in 2009; [ ] in 2010; and [ ] for the first nine months of 2011. Notably, the subscriber revenue that Sirius XM reports in its public filings does not encompass hundreds of millions of dollars in U.S. Music Royalty Fees and other revenue derived from Sirius XM’s SDARS subscribers (such as payments earmarked for the receivers used to listen to music). When calculated as a percentage of the total revenues (as opposed to a percentage of subscriber revenues as defined by Sirius XM in its public filings) listed in Sirius XM’s SEC filings, Sirius XM reported to
SoundExchange only [xxx] of its total revenues in 2009; [xxx] in 2010; and [xxx] for the first nine months of 2011.

In the previous SDARS proceeding, Docket No. 2006-1 CRB DSTRA, my understanding is that the Judges defined the upper bound of the zone of reasonable rates by using an “adjusted benchmark of $1.40 per subscriber per month [that] is the equivalent of 13% on a percentage of subscriber revenue basis.” 73 Fed. Reg. at 4,093. While the Judges did not set a per-subscriber rate, I understand that they did assume this relationship between a per-subscriber payment and percentage of revenues. Accordingly, I have analyzed how closely Sirius XM’s actual royalty payments have come to this expected relationship.

In the chart below, I have adjusted the $1.40 per subscriber to the relevant royalty rates (e.g., because 13% correlates to $1.40 per subscriber, then 6.5% correlates to $0.70 per subscriber) and compared that number to the per subscriber royalties actually paid by Sirius XM. I calculated the per subscriber royalty by dividing the total actual royalties paid by Sirius XM by the daily weighted average subscribers reported by Sirius XM in its public filings for the same time period and converted that number into a monthly figure. These numbers show that Sirius XM has paid well less than was contemplated by the SDARS I decision (roughly [xxx] less each year), in large part because Sirius XM has only reported to SoundExchange less than 100% of its subscriber revenues, as noted above.

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1 This methodology slightly underestimates the actual royalties paid per subscriber because the publicly available daily weighted average subscriber figures include some Internet-only and some non-music subscribers for whom Sirius XM does not pays royalties under the SDARS regulations. I do not currently have access to the number of those subscribers in order to adjust my calculations.
To relate the royalty base more nearly to the value of the sound recording rights involved, and to address uncertainty and administrative difficulties presented by the current definition of the royalty base, SoundExchange is proposing to revise the definition of “Gross Revenues.” I address this subject in detail in Part IV below.

C. Royalty Collection and Distribution

SoundExchange’s core mission is to collect and distribute statutory royalties as efficiently and accurately as possible. SoundExchange has developed sophisticated systems, business processes and extensive databases uniquely suited to the challenging task of distributing statutory royalties. For managing royalty collection and distribution, SoundExchange employs the following operational procedures.

Receipt of Payment. SoundExchange’s Royalty Administration and Distribution Services Departments receive from statutory licensees royalty payments and, ideally, two reports: (1) statements of account that reflect the licensee’s calculation of the payments for the reporting period; and (2) reports of use that, for SDARS and PSS, log plays of sound recordings. When SoundExchange receives payment from a licensee, that payment is logged into SoundExchange’s licensee database. If the licensee operates services in multiple rate categories, the royalty payments are allocated among the applicable rate categories based on the statements of account.

<table>
<thead>
<tr>
<th>Statutory Rate Set by Judges</th>
<th>Equivalent Assumed Per Subscriber Rate</th>
<th>Actual Royalties Paid per Weighted Average Subscriber</th>
<th>Actual/Expected</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011 (through Q3) 7.5%</td>
<td>$0.808</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2010 7.0%</td>
<td>$0.754</td>
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<tr>
<td>2009 6.5%</td>
<td>$0.700</td>
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<tr>
<td>2008 6.0%</td>
<td>$0.646</td>
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<td></td>
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<tr>
<td>2007 6.0%</td>
<td>$0.646</td>
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</tbody>
</table>
Loading of Reports of Use. Reports of use are associated with a service’s payments and statements of account for a particular period and loaded into SoundExchange’s system. Details of the required reporting vary among different types of services, but broadly speaking, the reports are supposed to provide information about matters such as the sound recording title, album, artist, marketing label, International Standard Recording Code and other information, as well as information about the number of plays. In some instances, services (including the PSS and SDARS) fail to accurately report identifying data for sound recordings by, for example, specifying that the artist is “Various,” a composer such as “Beethoven” or “Mozart,” or the disc jockey who played the sound recording, or simply not providing required information. Because the same songs have frequently been recorded by multiple artists, artist name is a critical piece of information for matching reported use to known sound recordings. In each of these instances, it is not possible to rely on the reported artist to do that. When we receive missing or inaccurate data, my staff has to research the partially identified sound recording in order to identify accurately the sound recording copyright owners and performers entitled to royalties.

Matching. SoundExchange’s systems seek to match the recordings reported in licensee reports of use with information in SoundExchange’s database concerning known recordings and their copyright owners and performers. Our complex log loading algorithm attempts to match identical and similar data elements and combinations of data elements from the incoming log against performance information previously received from the services or otherwise contained in SoundExchange’s database. If there is a match for a particular sound recording, then the system identifies the corresponding copyright owner and performer information. However, a reported recording might not match a known recording if, for example, the service has performed a recording by an unsigned band, or a very new, old, foreign or other obscure recording that has
not previously been reported to SoundExchange, or if the service has provided incomplete or incorrect identifying information.

**Research.** SoundExchange has built its database of sound recordings from scratch, based in part on information reported to it by the services. To the extent a reported recording does not sufficiently match a known recording, SoundExchange personnel will research the recording in an effort to determine whether it should be added to SoundExchange’s database or whether it is in the database under different identifying information. This research requires a significant amount of staff time. Such research is often required for new releases, works reported for the first time, works from small labels, compilation albums and foreign repertoire. In the case of compilation albums, for example, finding copyright ownership information is particularly time-consuming because, although the album is issued by one label, each of the sound recordings on it is often owned by a different label.

SoundExchange conducts extensive data quality assurance work to ensure the correct association of copyright owners and performers, on the one hand, and particular performances, on the other. When we receive information that is inaccurate or in conflict with other information, we conduct research to determine the copyright owner and performers for the sound recording, and we also have a process for identifying and resolving conflicts that arise between different payees.

**Account Assignment.** SoundExchange then assigns reported sound recording performances to accounts belonging to copyright owners and performers. Performances for which a copyright owner or artist account is not identifiable (e.g., because the recording reported has not yet been matched to a recording known to SoundExchange) are assigned to a suspense account for later review and research. This is often the result of poor quality data provided by
licensees, or due to artists that have not registered with SoundExchange. Performances assigned to suspense accounts are processed through the steps that follow as soon as identification is made, with the associated royalties being released in the next scheduled distribution.

Royalty Allocation. Once account assignment has occurred, a service’s royalty payments for a given distribution period are allocated to sound recordings used by that service during that period and to SoundExchange’s costs deductible under Section 114(g)(3) (sometimes referred to as SoundExchange’s “administrative fee”). SoundExchange distributes SDARS and PSS royalties to performers and copyright owners based on the reporting that the services provide to SoundExchange. If a service reports to SoundExchange that it played a recording under the statutory license, SoundExchange does not second-guess the service’s determination that it in fact performed the recording in reliance on the statutory license.

Before distribution of allocated funds, SoundExchange takes several quality assurance steps to ensure accounts are payable, address and tax identification information is complete, and performances in conflict and copyright owner conflicts are resolved (to the extent practicable).

Adjustment. Once allocations are completed, it is sometimes necessary to adjust particular accounts to rectify reporting and other errors that occurred in prior distributions. For example, if Copyright Owner A was incorrectly reported as the copyright owner of Recording X and received royalties for Recording X, but the actual owner of that recording was Copyright Owner B, then SoundExchange would need to credit Copyright Owner B in a future distribution and debit Copyright Owner A’s account for the improper distribution. Adjustments typically take the form of an additional payment or a reduced payment to an existing account in the next scheduled distribution. For copyright owners and artists who are newly identified and for whom royalties have been accruing, a new account is created and royalties attributed to the suspense
account are transferred to the new account. Adjustments are also made from suspense accounts to copyright owner and artist accounts based on registrations received during the period between distributions.

**Distribution.** This process begins with consolidating allocations across licensees’ reports of use within a license category according to earning entity,\(^2\) which are then assigned to copyright owners, artists, or certain other payees (such as a producer who an artist directs SoundExchange to pay) based on the payment instructions for each. Next, the system generates a payment file, which we transmit to our banking partner. SoundExchange generally provides each royalty-earning entity with a statement reflecting the performances – and the licenses under which the sound recordings were performed – for which the royalty payment is made. When there is a payable balance in a payee’s account above the distribution threshold, a check is mailed or funds are electronically transferred.

SoundExchange’s database containing payee information is derived from account information received from record labels and artists, and includes such payees as the copyright owners and artists themselves, management companies, production companies, estates and heirs. We must, however, verify address and other information and secure appropriate tax forms directly from each artist and label. If an earning entity fails to provide SoundExchange with tax information, then we can still distribute royalties but must withhold a portion of the royalties pursuant to applicable Internal Revenue Service guidelines.

SoundExchange presently conducts distributions four times a year for statutorily licensed uses and, at times, for non-statutorily licensed performances for which SoundExchange has collected royalties, typically from non-U.S. performing rights organizations that have money for

\(^2\) An “earning entity” is the person or entity who has earned the royalties from a tax standpoint and is not necessarily the person who receives royalties.
U.S. performers or copyright owners. The threshold for distributing royalties to a payee is $10. Distributing smaller amounts would incur significant additional transaction costs. Every payee with a balance greater than $10 receives at least an annual distribution. Payments for which SoundExchange lacks sufficient information to distribute to the appropriate copyright owner or performer are allocated to separate accounts in accordance with 37 C.F.R. § 382.7 (with respect to PSS payments) and § 382.17 (with respect to SDARS payments).

IV. SDARS Definition of “Gross Revenues”

SoundExchange proposes changes to the definition of “Gross Revenues,” which currently appears in the 37 C.F.R. § 382.11, to achieve two goals: (1) relating the royalties paid by Sirius XM more closely to the value of the rights licensed, and (2) making the definition easier to administer and less susceptible to interpretation, thus reducing transaction costs.

A. The Current Definition

With respect to the first goal, as described above, the current definition has resulted in payments to SoundExchange significantly less than appears to have been assumed in the SDARS I decision. With respect to the second goal, the current definition of “Gross Revenues” draws complicated distinctions among various categories of Sirius XM revenue that are included in or excluded from the royalty base. In practice, these distinctions have proven to be imprecise, uncertain and open to interpretation. This makes the rate structure difficult to administer, because it requires Sirius XM to make judgments about how to classify its revenues. In addition, the current definition makes it impossible for SoundExchange to determine, based on the statements of account and reports of use that Sirius XM provides, to what extent Sirius XM’s judgments about application of each of the various limitations and exclusions accounts for the discrepancy between Sirius XM’s publicly-reported total revenues and the revenues reported to
SoundExchange. While SoundExchange can conduct audits of Sirius XM to try to learn that information (in fact, an audit is currently ongoing), if SoundExchange and Sirius XM disagree about whether an inclusion or exclusion (or the amount of an inclusion or exclusion) is appropriate, SoundExchange and/or individual beneficiaries would presumably need to resort to expensive litigation to enforce their rights.

The current definition identifies two categories of revenue for inclusion in the royalty base, and nine separate categories of exclusion. The metes and bounds of each of these eleven categories are specified by regulatory language that, in most cases, is potentially subject to interpretation and susceptible to manipulation, which can lead to disputes. All together, this complicated definition greatly obfuscates Sirius XM's reporting to SoundExchange. In addition, these categories create the possibility that Sirius XM may try to label fees in ways that it may assert reduce its payments to SoundExchange while Sirius XM nonetheless realizes the revenue, and does so based at least in part on demand for the music available through its service.

For example, the current definition prescribes that the royalty base is to include “[s]ubscription revenue recognized by Licensee directly from residential U.S. subscribers for Licensee’s SDARS.” That might seem straightforward, but trying to map that concept onto Sirius XM’s publicly-reported financial statements illustrates the potential for uncertainty and disputes. Sirius XM’s Form 10-Q for the period ending September 30, 2011 reports a category of “[s]ubscriber revenue,” which it says “consists of subscription fees, revenue derived from agreements with certain daily rental fleet operators, non-refundable activation and other fees.” 10-Q at 10. Similarly, the 10-Q refers elsewhere to “activation and subscription-related fees,” which Sirius seems to view as different from “subscription fees” for purposes of its public filings. 10-Q at 25. The 10-Q notes that some of these subscriber revenues are “received from
OEMs [automakers] for subscriptions included in the sale or lease price of vehicles.” 10-Q at 10. But does Sirius XM treat activation fees and other “subscription-related fees” as “subscription revenue”? Does it view subscriptions paid for by automakers as revenues “directly from residential U.S. subscribers”? Sirius XM needs to go through this kind of classification exercise and make judgments about these kinds of questions every time it creates a new offering or establishes or renames a fee, and in the ordinary course of business SoundExchange may need to resort to an expensive audit that SoundExchange to get visibility into what Sirius has done.

As to exclusions from the royalty base, some are straightforward, such as the first part of the fourth exclusion – “sales and use taxes” – which refers to a pass-through item, not revenue. Similarly, since subscription revenue is included only when it comes from “U.S. subscribers,” the eighth exclusion – for provision of “[c]hannels, programming, products and/or other services provided outside of the United States” – seems operative only to exclude foreign ad revenue, which for some reason is to be included in the top line of the calculation before being excluded here.

Most of the exclusions, however, are more problematic. A number of them create possibilities for Sirius XM to undervalue the sound recording performance rights licensed to it by structuring payment streams to fall into those categories. In the ordinary course, the second exclusion – for “[r]oyalties paid to Licensee for intellectual property rights” – would not seem operative, because it is hard to see how license revenue could be considered subscription or advertising revenue from operation of an SDARS. However, the fact that the exclusion exists creates a possibility of Sirius XM’s trying to structure subscriber or advertiser payments as royalties. The first exclusion (sales and more licensing revenue, for equipment, “technology” and “bandwidth,” as well as “shipping and handling fees”), the balance of the fourth (more
“shipping and handling” and a variety of other obscure fees), and the sixth (data services) may permit Sirius XM to make arbitrary allocations of revenue it derives from offering bundled offerings, and practically invite Sirius XM to adopt a fee structure whereby subscribers pay more of what they are willing to spend on satellite radio in fees denominated in those ways and less in fees denominated in ways that do not qualify for an exclusion.

The fifth exclusion – bad debt expense – uniquely among these exclusions lets Sirius XM subtract one kind of cost it incurs from the revenues included in the royalty base. This subtraction seems flatly inconsistent with a revenue-based royalty related to the value of the sound recording performance rights used, because it allows Sirius XM to benefit by extending credit to subscribers who receive the full value of sound recording transmissions, and leaves copyright owners and performers to bear the risk of going uncompensated if Sirius XM makes bad lending decisions.

Finally, the seventh and ninth exclusions – for certain “[c]hannels, programming, products and/or services” that make only incidental use of sound recordings or are exempt or separately licensed – have been interpreted by Sirius XM to permit significant exclusions from the royalty base that must involve judgments by Sirius XM about what to exclude, but as to which SoundExchange has no visibility through statements of account and reports of use.

SoundExchange faces continuing administrative difficulties in trying to figure out these kinds of details for the current rate period. But SoundExchange’s experience with the current regulations demonstrates the need for a clearer gross revenues definition that is less open to interpretation. Such a definition would be easier to administer and eliminate the potential for manipulation. SoundExchange has included such a definition in its rate proposal.
B. SoundExchange’s Proposed Definition

The definition set forth in SoundExchange’s rate proposal is designed to reduce such complications and relate the royalty to the value of the sound recording performance rights by approximating Sirius XM’s total revenues from the operation of an SDARS in the U.S., except for a smaller set of more tightly-defined exclusions. Important features of SoundExchange’s proposed definition include the following:

- In clause (1)(i), the concept of subscription revenue has been refined to minimize the potential for disputes as to whether it encompasses the full range of subscriber revenues reported in Sirius XM’s public financial statements.
- In clause (1)(ii), the advertising revenues to be used in the calculation are U.S. revenues only.
- In clause (1)(iii), certain U.S. equipment revenues, previously excluded from the royalty base, are proposed to be included, because they are just another way Sirius XM makes money from providing a service that consists in large part of music.
- In clause (2), we propose largely retaining the provision concerning revenues to which the licensee is entitled but which are paid to an affiliate. However, we propose deleting the reference to “wholly-owned” subsidiaries, because there is no reason that revenue diverted to subsidiaries that are less than wholly-owned should not be treated similarly.
- In clause (3)(i), the exclusion for royalties for intellectual property rights is retained, but only where the royalties are paid by persons other than subscribers, advertisers and sponsors. As such, we believe it is merely clarifying.
• In clause (3)(ii), the exclusion for record sales is retained, except that we propose clarifying that this exclusion is for the service’s sales revenues (not, for example, advertising revenue connected to the sale of downloads).

• In clause (3)(iii), the clarification that sales and use taxes are not revenue has been retained, but the references to other arbitrary fees have been omitted, because the label that Sirius XM chooses to apply to a subscriber payment for its SDARS service should not determine whether it is included in the royalty base.

• In clause (3)(iv)(A), an exclusion for data services has been retained, but only when such services are provided on a standalone basis, so that the value attributed to use of sound recordings in an SDARS will not fluctuate based on Sirius’s accounting allocations and decisions about the relative pricing of services frequently bought together.

• In clause (3)(iv)(B), the exclusion for foreign operations has been retained, but is understood to be merely clarifying based on the limitations to U.S. operations in the categories of included revenue.

• In clause (3)(iv)(C), part of the exclusion for separately-licensed services has been retained, but only when such services are provided on a standalone basis, so that the value attributed to use of sound recordings in an SDARS will not fluctuate based on Sirius’s accounting allocations and decisions about the relative pricing of services frequently bought together.

SoundExchange’s experience with the current definition of gross revenues indicates that this more precise definition of gross revenues would more closely reflect the value of the sound recording rights used by Sirius XM, as well as produce much less uncertainty, be much less
susceptible to manipulation, and so be easier to administer, give rise to fewer disputes, and reduce transaction costs.

V. SoundExchange Should Be Designated the Sole Collective to Collect and Distribute SDARS and PSS Royalties.

In Webcasting II, the Judges found “that selection of a single Collective represents the most economically and administratively efficient system for collecting royalties under the blanket license framework created by the statutory licenses.” 72 Fed. Reg. at 24105 (May 1, 2007). In SDARS I, the Judges cited that finding, and noted that no party had submitted evidence that compelled a different conclusion or had requested the designation of multiple collectives. Indeed, SoundExchange was the only party requesting to be designated as the Collective. Based on SoundExchange’s “track record” of serving as the Collective coupled with the absence of opposition or evidence suggesting that SoundExchange not serve in that capacity, the Judges in SDARS I designated SoundExchange as the sole Collective for the 2007-2012 rate period. More recently, the Judges reached the same conclusion in the Webcasting III proceeding with respect to SoundExchange’s serving as the Collective for webcasting royalties.

I request that the Judges likewise designate SoundExchange as the sole Collective to collect and distribute statutory SDARS and PSS royalties for the 2013-2017 statutory period. SoundExchange has considerable experience and expertise in administering the statutory licenses. SoundExchange has processed billions of sound recording performances. SoundExchange has continued to increase the size of its membership and the number of record label and artist accounts it maintains. For example, whereas at the time the Webcasting II direct testimony was submitted, SoundExchange had approximately 3,000 record label members and 12,000 artist members, 72 Fed. Reg. at 24104, today SoundExchange has approximately 12,700 rights owner members and 30,250 artist members. And while SoundExchange had over 700,000
sound recordings in its database when the written direct testimony was submitted in Webcasting II, today SoundExchange has more than 4 million entries in its database of unique combinations of artist names and track titles.

I do not know whether any participant in this proceeding will propose that there be more than one collection and distribution agent, but I do know that having more than one such agent would cause significant problems. Such a system is anathema to the concept of an efficient statutory licensing system. Designating a second Collective would create greater overall costs because copyright owners and performers would have to pay for duplicative systems for license administration.

VI. Minimum Fees

I understand that the Judges are required to set a minimum fee under the Section 112 statutory license. The PSS have paid a $100,000 annual minimum fee that is creditable toward all their royalty payments. This seems sufficiently established as a feature of the statutory license that SoundExchange does not propose any change in this arrangement at this time.

There has not previously been a minimum fee for the SDARS despite the statutory requirement. To comply with the statutory requirement that the Judges set a minimum fee under the Section 112 license, we believe that one should be added at this time. We propose $100,000 because that is what the PSS have paid, creditable toward ephemerals royalty payments only. Given that Sirius XM pays considerably more than this amount in annual royalties, the ephemeral royalty component of Sirius XM’s royalty payments will far exceed $100,000 each year.
VII. License Terms and Other Regulations

A. SDARS Terms

For the SDARS, SoundExchange generally proposes continuing the same terms in this proceeding as the Judges adopted in the SDARS I proceeding, Docket No. 2006-1, subject to certain technical and conforming changes. Those terms are also in large part substantially the same as the terms currently applicable to webcasting services, as adopted in the Webcasting III proceeding, Docket No. 2009-1. I believe there is value in having consistency of terms across licenses and in allowing time to fully assess the effectiveness of those terms based on experience working under those terms. Such consistency aids SoundExchange’s administration of the licenses and makes licensees’ compliance with the terms more efficient.

In addition to the change to the definition of gross revenues discussed above, I highlight two proposed changes to the SDARS regulations:

- We propose deleting the concept of a “residential” SDARS subscriber because it is simply a confusing artifact of that term being used in the PSS regulations. The SDARS service is not primarily residential (in the sense of being delivered to homes). In the SDARS regulations, a “residential” subscriber is defined as simply a subscriber, meaning that the word “residential” in the definition does not add any value to the definition but only creates the possibility for confusion.

- In section 382.13(e)(3), we propose deleting the requirement that the signature on a statement of account be “handwritten,” because we believe it would be efficient (and hence reduce transaction costs) for both licensees and SoundExchange if SoundExchange were to automate the process of ingesting statements of account and reports of use, and this requirement can only interfere with trying to obtain such efficiencies. In contrast to
the Webcasting III proceeding, in which the Judges declined to adopt this request, dropping this requirement in this proceeding would create no issues of inconsistency among services of the same type.

B. PSS Terms

The current regulations establishing the terms for the PSS are different from the terms applicable to the SDARS and to webcasting services. The divergence between the PSS terms on the one hand, and the SDARS/webcasting terms on the other can be inconvenient, and hence produce transaction costs, for those of us that have to work with the regulations every day. As discussed above, it is impractical and inefficient to have different terms for different licenses. Accordingly, SoundExchange is proposing to conform the PSS terms to the terms for the other statutory licenses. In the following paragraphs I highlight some of the differences between the two sets of terms, and how SoundExchange proposes to conform them.

- In proposed Section 382.2, we propose collecting applicable definitions in one place for the convenience of users of the regulations. The definitions of gross revenues and licensee are relocated from Sections 382.1(d) and 382.2(e) in the current regulations, but we do not propose to change them substantively at this time. The other definitions would be new to the PSS but are used in the SDARS and webcasting regulations.

- In proposed Section 382.3(c), we have proposed allocating a combined Section 112(e)/114 royalty between Sections 112(e) and 114 in a manner equivalent to the SDARS and webcasting regulations.

- In proposed Section 382.3(d), we propose applying the late fee to a late statement of account, as in the case of SDARS and webcasting. As the Judges have found before,
SoundExchange’s need for both a payment and statement of account to be able to distribute the payment warrants applying the late fee to both.

- In proposed Section 382.4(c), we have relocated the statement of account requirement buried in the confidentiality provision of current Section 382.4(b), but adapted it to include the enumerated data elements from the SDARS regulations.

- Where current Section 382.3(c)(2) has an escheat provision that is in addition to, and a little different from, current Section 382.7, we have included in proposed Section 382.4(d)(2) a reference to the primary escheat clause, which we propose to renumber as Section 382.8.

- In proposed Section 382.5, for the sake of consistency, we propose conforming the confidentiality regulations to the SDARS regulations.

- In proposed Sections 382.6 and 382.7, we propose conforming the very different PSS audit provisions, to avoid having to maintain separate audit processes (potentially applicable to the same audited party). However, current Sections 382.5(f) and 382.6(f) provide for audit fee shifting in the case of a 5% underpayment, and the same considerations do not warrant doubling that threshold to the levels in the SDARS and webcasting regulations. The 10% threshold is high. I would much rather administer two separate fee-shifting calculations than provide incentives for services to underpay by such a large margin.

Making these changes and the other more technical ones set forth in the marked copy of the regulations included with our rate proposal would materially simplify administration of the PSS license.
I declare under penalty of perjury that the foregoing testimony is true and correct.

Date: November 28, 2011

Jonathan Bender

[Signature]
Before the
UNITED STATES COPYRIGHT ROYALTY JUDGES
Washington, D.C.

In the Matter of:

Determination of Rates and Terms for
Preexisting Subscription Services and
Satellite Digital Audio Radio Services

Docket No. 2011-1
CRB PSS/Satellite II

TESTIMONY OF

STEPHEN BRYAN

Executive Vice President of Digital Strategy and Business Development,
Recorded Music, Warner Music Group

Witness for SoundExchange, Inc.
Background and Qualifications

I am the Executive Vice President of Digital Strategy and Business Development, Recorded Music at Warner Music Group. In that role, I have direct responsibility for creating and implementing WMG’s digital strategy, developing new business models and digital products, negotiating and executing key deals, and building global relationships with strategic partners, including digital retailers, wireless carriers, handset manufacturers, ISPs and social media networks. I joined WMG in 1997 as Manager for Strategic Planning and Business Development, working to identify potential new business initiatives and strategic alliances for the company.

I hold a bachelors degree from Vanderbilt University and an MBA degree from the Wharton School of Business at the University of Pennsylvania.

About Warner Music Group

Warner Music Group Corp. (WMG) includes a collection of some of the best-known record labels in the music industry including Atlantic, Bad Boy, Elektra, Lava, Maverick, Nonesuch, Reprise, Rhino, Sire, Warner Bros. and Word. These labels feature a comprehensive roster of recording artists and a massive catalog of some of the world’s most popular sound recordings. WMG operates the Alternative Distribution Alliance (ADA), which has been the leading distributor for independent record labels in each of the past five years. Warner Music International, a leading company in national and international repertoire, operates through numerous international affiliates and licensees in more than 50 countries. Warner Music Group also includes Warner/Chappell Music, one of the world’s leading music publishers, with a catalog of more than one million musical compositions worldwide.
Until recently, WMG was publicly traded. But following the acquisition of WMG in July of 2011 by Access Industries, Inc., the company is now privately held.

Overview

My testimony seeks to explain WMG’s approach to entering into marketplace agreements for the digital distribution of our sound recordings through various channels. The main purpose of this testimony is to provide the Copyright Royalty Judges with information about how a sound recording rightsholder, such as WMG, would approach negotiations with a third party seeking a license for a satellite radio service, such as SiriusXM, outside of the context of the statutory license. I previously submitted testimony on a similar topic in the Webcasting II proceeding, in which the Judges set the rate for noninteractive webcasting services.

The Digital Distribution of Music

WMG has long been an industry leader in the digital marketplace. In fact, since the beginnings of WMG – when the Warner Bros. movie studio first entered the music business in 1929 – the company has strived to find better ways of connecting artists and fans by embracing the latest delivery technologies and the most innovative product, sales and distribution strategies. Today, WMG is a leading force in the recorded music industry's transition to digital, managing a variety of music-based content that is marketed, promoted and distributed over a wide array of online and mobile platforms.

Since I last testified before the Copyright Royalty Judges about the marketplace for distribution of music, record companies, including WMG, have expanded their efforts to embrace and advance digital distribution. As I previously testified, WMG believes that digital distribution is the key to new growth in the record industry in the coming years and WMG continues to work to transform the recorded music business from top to bottom to incorporate
digital distribution as a central part of our business strategy. Sales of CDs and other physical media have continued to decline in recent years, but revenues for digital distribution – from sales of digital downloads and albums, sales of other digital products (such as ringtones), and subscription streaming services – have increased significantly. In fact, in the second quarter of 2011, WMG reported that our digital revenue had grown to nearly 40% of our worldwide Recorded Music business, and in 2008, Atlantic Records was recognized as the first major label to achieve digital revenue in excess of 50% of its U.S. physical and digital sales revenue. We expect these numbers to continue to grow significantly over time.

Over the past decade, technological developments have enabled music lovers to enjoy music in many new ways and have provided more immediate access to music than ever before. The rise of digital services has fundamentally altered WMG’s view of how to generate revenues from distributing its sound recordings. Whereas in the past WMG was primarily concerned about the sales of physical products, such as CDs, we now view each potential distribution model in terms of its impact on all other distribution channels and seek to ensure that all of our digital distribution partners help us as a company to maximize our digital revenues. The wide range of digital services appeal to different consumers, but all have the potential to substitute for each other and WMG is vigilant in negotiating agreements in the marketplace that prevent damaging potentially more lucrative distribution channels. Simply put, some consumers prefer to “lean back” and have music provided to them, others are attracted to a more interactive “lean forward” experience where they request specific songs, artists and albums, and some consumers prefer services that combine both approaches. Regardless of the consumer experience offered by a given service, each business that WMG licenses its music to needs to provide a distinct revenue stream that either contributes meaningfully to the company’s bottom line, or helps to develop a
business model that will over time. Our experience over the past decade is that the business of
digital distribution of music has grown dramatically and will continue to grow through the
coming years. WMG executes deals only at prices that are designed to generate sustainable
revenues over the long term.

**Marketplace Agreements for Digital Distribution**

WMG has entered into a variety of agreements with various digital distribution services.
These agreements demonstrate what willing buyers and willing sellers agree to in the
marketplace when they are able to negotiate without a statutory license. Many of WMG’s
agreements are with sophisticated parties operating multiple different music services. These
agreements show the significantly higher rates and the significantly more valuable terms that
WMG receives in virtually every context outside of the statutory license when we are able to
negotiate for use of our content in a free market. A summary of relevant aspects of WMG’s
licensing strategy and of some recent WMG agreements in several distribution channels is
provided below.

A. **WMG’s basic digital distribution strategy**

Outside of the statutory licensing framework, WMG has negotiated an increasing number
of deals for the digital exploitation of WMG’s extensive catalog of copyrighted sound
recordings. As explained above, WMG negotiates each such deal with the goal of generating
substantial revenue.

In our marketplace deals, there are a few significant elements that are of particular value
to WMG, and important components of our negotiating strategy. The single most important
aspect of negotiated marketplace agreements is that they almost all feature a payment structure
based on the greater of two different amounts or the greatest of three different amounts.
Specifically, WMG almost always requires digital distribution services to pay the greatest of [ ] \[ ] . In some of our agreements, such as those with on-demand audio streaming services, the greatest-of structure depends on a calculation of WMG’s proportionate share, or the percentage of the total performances that are WMG-owned or controlled sound recordings. This approach ensures that, no matter what the business model of the licensee WMG is fairly compensated for the fact that we and our recording artists are providing the entire foundation for the service – the music – and the related commercial opportunity. Without the music, these services – whether ad-supported, free-to-the-listener or subscription streaming, permanent downloads, or mobile ringtones, whether the licensee wants to give away music for free as a loss leader, or wants to extract the maximum possible payment for it – simply would not exist. Moreover, this general deal structure ensures that if the service is tremendously successful and has significant revenues driven by the availability of WMG content, WMG shares in that success.

WMG’s marketplace agreements contain a host of additional provisions that are of significant value to the company. WMG would not enter into agreements without them or would require other consideration if some or all of them were not present. All of these deal components are designed to ensure that each digital audio distribution service functions as a distinct product, offering a distinct revenue source, and to limit the financial risk to the extent the service substitutes for other revenue sources. Moreover, none of these valuable deal components are features of the statutory license.

For example, WMG generally receives non-refundable advances on an annual and occasionally monthly basis in the context of any agreement for digital music services. These
advances, even when they are recoupable against future royalty payments, serve as minimum revenue guarantees. WMG also generally requires licensees to meet rigorous security provisions, specifies the audio quality of streams offered by a service and limits the types of devices on which music can be streamed or downloaded. For example, we generally negotiate different rates depending on whether a service offers mobile distribution or only distributes to a personal computer. WMG also negotiates extensive and uniform reporting requirements for these services, along with technical and financial auditing rights, thus allowing WMG broad oversight over the commercial distribution of its copyrighted works.

Moreover, WMG negotiates holdback rights that restrict our distribution partners from using tracks that WMG cannot provide based on restrictions in our artist agreements. WMG also negotiates holdback rights so that it can create exclusive deals for certain content, enabling WMG to derive greater value, including by way of lucrative sponsorship opportunities. Under the statutory license, non-interactive services are authorized to play not only the works that WMG authorizes other services to use, but also sound recordings that WMG cannot license for downloads or subscription services (due to contractual restrictions) and sound recordings that WMG, pursuant to holdback rights, chooses to exploit through an exclusive deal for some amount of time. If WMG were to enter into an arms-length agreement for the right to play all of WMG’s sound recordings without limitation, such an agreement would command a premium.

Finally, in our marketplace agreements, WMG generally negotiates terms of short duration. WMG will not lock itself into an unfavorable deal in the digital environment that, while maturing, is also still evolving. To the extent we would enter into a longer-term deal, we would require very significant payments to protect WMG if the digital music service becomes very successful, as well as some ability to terminate in the event the service does not perform as
hoped. The generally short term of our marketplace agreements allows us to continually reassess the viability of a given service and analyze whether any rates need to be adjusted. The long term of the statutory license – five years – means that there is no opportunity to correct for any undervaluation until the next rate-setting proceeding.

C. **On-demand services**

I understand that in each of the last three rate-setting proceedings conducted by the Judges for statutory licenses under 17 U.S.C. §§ 112 and 114 the Judges have relied heavily on the marketplace for on-demand subscription audio streaming services. As the most mature and developed freely-negotiated digital distribution channel that does not involve the purchase of permanent copies of music, I believe that the terms for these services continue to present meaningful insight into the value of sound recordings.

In the U.S., WMG’s negotiated agreements with subscription streaming services include a per-play minimum payment metric that we view as the absolute floor for our revenue and a minimum protection for the value of the recordings we provide. The [ ] represent the potential upside for our revenue. Although we negotiate the amounts of the per-play minimums, the [ ] with each streaming service, the common goal in all of these agreements is to ensure fair compensation for WMG and its recording artists for the use of our sound recordings.

Subscription, on-demand streaming services have been in existence for about a decade, and the market continues to evolve. Below, I outline the current state of that market, and highlight some of the most salient features of WMG’s agreements with these services.
1. **Marketplace structure and deal terms**

Among the most established and profitable negotiated digital distribution deals that WMG has executed are those entered into with subscription on-demand streaming services. These services offer the height of the interactive experience for a subscriber — the ability to hear exactly the song the subscriber wants to hear when he or she wants to hear it (hence, “on-demand”), as well as the more “lean-back” functionality typically offered by webcasting services. Not only can subscribers hear requested songs via audio stream online, these services also typically permit subscribers to stream or conditionally download the songs to their PC hard drive and to at least one mobile device (depending on the service and the subscription purchased). The songs that have been downloaded by a subscriber from one of these services can be played on-demand, and remain accessible on the subscriber’s hard drive or portable device for as long as the subscriber maintains his or her paid subscription.

Services like Rhapsody and Microsoft (and Napster before it was acquired by Rhapsody) have offered this type of service for years. But the retail pricing in this market has changed over time. At the time of the *Webcasting II* proceeding, a non-portable on-demand streaming subscription generally retailed for $9.99 and a portable subscription was $14.99. For the most part, the corresponding prevailing prices in today’s market are $4.99 for a non-portable subscription and $9.99 for a portable subscription. In addition to this price drop, we have observed the emergence of a new customer acquisition model for subscription, on-demand streaming services that has been dubbed “freemium.” The most prominent freemium service is Spotify, which launched in the United States in the summer of 2011, but services like MOG and Rdio, which have been around for longer, have recently adopted this model as well.
The freemium model features three tiers of service, the most basic of which provides for a limited amount of free on-demand streaming to a personal computer. But these companies aggressively seek to convert the users of the free service to more attractive (and remunerative to WMG) tiers of service that allow for unlimited non-portable streaming at $5 per month and unlimited streaming to both personal computers and mobile devices at $10 per month. This integrated service offering presents an alternative to the more traditional customer acquisition model, which offers a very limited free trial before requiring a subscription.

In our agreements with these types of services we seek to maximize the potential total revenue generated through a deal that individually prices each of the service tiers, but evaluates all of the offerings from a given service as part of an integrated agreement. These deals follow the general template I outlined above of a three-tier, greatest-of structure featuring a [ ]. Importantly, despite the drop in retail price in the interactive subscription market, [ ]. For example, in our agreement with MOG, for the subscription tiers, WMG is paid the greatest-of either:

1) [ ];

2) [ ]; and

3) [ ].

WMG believes that as these services reach scale, in terms of subscriber numbers, there may be an opportunity to seek even higher licensing fees.

Each of these services is experimenting with slightly different customer acquisition models, but all of them are working hard to build strategic distribution arrangements with mobile phone carriers. And these efforts appear to be working, as some services have been able to enter
into arrangements with mobile phone carriers to include the service on new phones and to allow for direct billing for the service through a subscriber's mobile phone bill. WMG is cautiously optimistic about the future of this business model.

3. **Radio features**

Noninteractive, statutory webcasting remains an incredibly popular music distribution platform, with services like Pandora developing substantial user bases. In light of the apparent popularity of this type of "lean-back" service, wherein the music programming is generally "pushed" toward the listener as opposed to specifically requested, many of WMG's digital distribution partners feature radio-like features on their services. Some services, like Slacker, build their service primarily around a DMCA-compliant radio offering, with increased functionality that WMG has licensed for a fee. But we also understand from some of our business partners that subscribers to on-demand services spend a substantial amount of their time using radio-like features that are bundled with on-demand services. Some of these services are preprogrammed radio offerings, while others offer customized radio offerings based on user input regarding preferred artists or genres. In all of these offerings, rather than selecting songs one-by-one subscribers are listening to sound recordings that are pushed to them. On services like Rhapsody and MOG, these radio offerings are one component of the overall subscription service, rather than freestanding services and the licensing fees for the radio component is not separately negotiated.

Services like Rhapsody and MOG have also implemented features designed to make use of their services more social. Primarily through partnering with Facebook, these services allow subscribers to share with their social network the music that they are listening to. This feature, which also allows users to share the playlists that they have created, turns music listening into an
online social experience, drives interest in the services from non-subscribers, and allows
subscribers to essentially operate as mini-broadcasters, presenting their curated musical interests
to an audience of their choosing.

D. Other digital distribution agreements

Although I believe that the subscription, mobile on-demand audio streaming services are
the best reference for setting a rate for the SDARS, I discuss below some of WMG’s other
current digital distribution agreements. These agreements demonstrate the high value that WMG
assigns to its sound recordings and the kinds of market rates that exist outside of the context of
the statutory license.

1. Permanent Downloads and “Cloud” Locker Services

The single largest contributor to WMG’s digital revenues is the sale of permanent
downloads through Apple’s iTunes Store. WMG has entered into agreements with Apple and
other services that sell permanent downloads of individual sound recordings to purchasers via an
online store. For such download services, WMG is paid pursuant to a wholesale rate card.
Currently, WMG is paid approximately [redacted] per downloaded track, or [redacted] of the retail price.
However, WMG retains the discretion to increase those rates or to [redacted]. Several services also offer
over-the-air downloads of full-track sound recordings to mobile phones. For example, the
iTunes application allows consumers to directly download songs to their mobile phones. As this
market has developed, and as mobile connectivity has increased, the retail prices and contractual
licensing fees for downloads to mobile devices have converged with the prices and fees for
downloads to personal computers. This is likely due to the fact that, unlike streaming products, a
permanent download can easily be transferred between portable and non-portable devices, such that the premium normally associated with portable services is less relevant.

A number of permanent download retailers have also recently launched so-called locker services, that allow users to store purchased music on remote servers (or in the “cloud”), as opposed to their local hard drives, and access their own music libraries from other computers or through other devices. WMG has negotiated agreements with some, but not all, of these locker services, and in our agreement with Apple for its service, we are paid the greater of [ ] and [ ]. WMG’s agreement with Apple for this service also contains stringent rules regarding access to content and robust reporting requirements.

2. **Ringtones and Ringbacks**

WMG also continues to license its sound recordings for use in connection with mobile phone personalization, for example as ringtones and ringbacks.

Ringtones are digital versions of sound recordings that serve as the ringer on a user’s cell phone. Mastertones refer to ringtones that are digital versions of a master sound recording – usually a portion of a sound recording no longer than 30 seconds. Consumers regularly pay between $2.00 and $2.99 for individual mastertones. WMG regularly requires ringtone retailers to pay wholesale prices in the amount of the greater of [ ] and [ ]. Ringtones sold by Apple are subject to the greater of [ ].

A ringback tone is a stream that a user can select to be played for a caller that is phoning the user. The ringback tone takes the place of the normal ring heard while waiting for the recipient to answer. Providers frequently charge $2 per ringback tone, plus a monthly service fee
of $1-2. WMG generally receives the greater of \[
\text{[Blank]}
\]\].

3. **Video Streaming**

WMG’s approach to music video streaming has continued to evolve since I testified in the *Webcasting II* proceeding. The market for video streaming is now dominated by two services—YouTube and Vevo. Whereas our earlier video streaming agreements sought to differentiate between on-demand and noninteractive uses of video streaming, the market has developed in such a way that noninteractive, preprogrammed video streaming is not really a relevant service. The overwhelming majority of video streaming is done by users on an on-demand basis. Thus, our current agreements with video streaming providers focus not on \[
\text{[Blank]}
\]\] rates, but rather on a \[
\text{[Blank]}
\]\] metric. In our agreement with YouTube, for example, WMG is paid between \[
\text{[Blank]}
\]\]. In terms of total dollars, these agreements have proven more attractive to WMG than earlier agreements.

Moreover, in our video streaming agreements, WMG retains significantly more control over what videos from our catalog can appear on the site and how the branding around those videos is presented. WMG does not license its entire catalog to video streaming services. WMG also has more ability on video streaming services to direct traffic to WMG-controlled websites or direct and share in advertising by, for example, \[
\text{[Blank]}
\]\] as is the case in our agreement with YouTube.
Definition of Revenue

I understand that SoundExchange has proposed revising the definition of revenue on which SiriusXM pays royalties. I believe that it would be helpful for the Judges to have a sense of how WMG approaches the definition of revenue in our marketplace agreements. When our agreements include a percentage-of-revenue metric, and most of them do, we have to negotiate both the rate and the definition of revenue to which that rate will be applied. A high percentage of revenue rate becomes illusory if the revenue base is defined too narrowly.

In defining revenue, we have a number of overarching strategic considerations. First, we strive to ensure that the revenue definition accurately captures the revenue that we believe is driven by the use of WMG’s sound recordings. We thus focus the revenue definition on the ways in which a given service generates revenue from our music. In the context of a subscription-only audio streaming service, for example, this approach would suggest a revenue definition based on subscription revenues. For services that also generate advertising revenue in conjunction with a music offering, such revenues would also likely be included in the applicable revenue definition. Where still other revenue streams are directly or indirectly attributable to the use of our music, they too should be included.

Second, we work to keep our revenue definition specific and easy to administer for our partners. A revenue definition that contains carve outs that are open to interpretation is undesirable because it may incentivize a service to “game” the definition to its advantage, and we may lack the ability to effectively prevent such gaming, absent an audit. This potential for gaming the revenue definition is also probably the single most important reason to keep the duration of our agreements short. With a short term, we can fix any deficiencies in a revenue definition and ensure that WMG is fairly compensated. From the outset, however, the more
specific a revenue definition is the less likely there are to be disputes between WMG and licensees about what revenue is properly included or excluded when calculating the applicable royalty fee. Of course, we generally reserve the right to audit licensee’s records (a right that SoundExchange also has with respect to statutory licensees), but a specific revenue definition helps minimize the likelihood that we will need to undertake an expensive audit, or to renegotiate the terms of the deal, to ensure that WMG is being properly compensated.

The Preexisting Subscription Services

Along with setting a rate for SiriusXM’s SDARS service, I understand that the Judges will be setting a rate for the preexisting subscription services (PSS), Music Choice and Muzak. These two services, which provide preprogrammed genre-based channels of non-interactive digital music on cable television systems, are not comparable to any other services that I know of in the market primarily because the PSS are not purchased directly by consumers, but are instead provided as a part of cable television subscription bundles. The PSS currently pay 7.25% of their revenue to SoundExchange under the statutory license and that rate will increase to 7.5% in 2012. Put simply, I can think of no circumstances in a free market in which WMG would agree to license its entire catalog of sound recordings to a music service like the PSS for a percentage of revenue as low as 7.5%. As I explained above, the marketplace agreements that we have negotiated for digital music services contain percentage-of-revenue rates that are in the range of 50-70% as one part of a two- or three-pronged rates structure, significantly higher than the 7.5% of revenue that the PSS will be paying next year. From WMG’s perspective, such a rate is simply not supported by the market for our sound recordings.
The Ephemeral Right

I understand that in addition to setting a rate for the public performance right for the SDARS and the PSS, the Judges must also set a rate for the ephemeral right.

In WMG’s marketplace agreements, we are careful to separately grant all of the necessary rights that a service needs to operate. In all contexts that I am aware of, the services to which we license our catalog require both an ephemeral right and either a reproduction, distribution or performance right. The ephemeral right is undeniably valuable and necessary for the operation of digital services. Despite granting these rights separately, however, we do not set different license fees for the rights. Instead, as shown above, our agreements contain blended rates that compensate WMG for all of the licensed uses of our sound recordings. To the extent that a service sought a license from WMG for just the ephemeral right, we would need to determine how to properly establish a fee for that right, outside of the bundled approach we typically use.

The only parties that I am aware of that have expressed a strong position on the value of the ephemeral right are the artist representatives within SoundExchange. My understanding is that in this proceeding, SoundExchange is proposing that 5% of the bundled royalties under Sections 112(e) and 114 should be attributed to the ephemeral. That proposal is consistent with the rate structure that was proposed by SoundExchange in Webcasting III and agreed to by SoundExchange and SiriusXM in a settlement of the ephemeral issue in SDARS I. In both cases, I understand that this rate structure was adopted by the Judges. I do not know of any reason why a different structure would be appropriate for the SDARS or the PSS in the upcoming rate term.
Role of the Collective for Statutory Licensing

WMG strongly believes that in the interest of efficiency for both the services involved in this proceeding – the SDARS and the PSS – and those who receive revenue from the statutory license, there should be one unified licensing collective and that SoundExchange should be that collective. SoundExchange, a nonprofit organization governed by an equally-weighted coalition of artists (and representatives of artist organizations) and representatives of recorded music organizations, has been repeatedly designated as the collective for statutory royalties and has done a commendable job in this role. It collects and distributes royalties from and to countless parties and persistently seeks out artists and record labels that may not be aware of monies being held for them. Based upon its track record, SoundExchange deserves to maintain its position as the only collective.
Public Version

I declare under penalty of perjury that the foregoing is true and correct.

Date: 11/22/11

Stephen Bryan
Before the
UNITED STATES COPYRIGHT ROYALTY JUDGES
Washington, D.C.

In the Matter of:

Determination of Rates and Terms for
Preexisting Subscription Services and
Satellite Digital Audio Radio Services

Docket No. 2011-1
CRB PSS/Satellite II

TESTIMONY OF

CHARLES CIONGOLI

Executive Vice President
and
Chief Financial Officer,

UNIVERSAL MUSIC GROUP NORTH AMERICA

Public Version

Witness for SoundExchange, Inc.
QUALIFICATIONS

I am Executive Vice President and Chief Financial Officer for Universal Music Group North America, a position I have held since 2003. I am ultimately responsible for all the finance activities of Universal Music Group’s North American operations, which includes seven United States record label groups, as well as music publishing and distribution operations. In my capacity as Executive Vice President and Chief Financial Officer, I have personal knowledge of, and regularly review, the finances of Universal Music Group’s record label operations in the United States (“UMG”).

I was previously Senior Vice President of Finance for Universal Music Group North America. Prior to that, I was employed as Vice President of Finance for MCA Records, and also served as Vice President and Group Controller for Records, Distribution & Manufacturing and Publishing. I began my employment with MCA in 1990 as the Group Controller for Records, Distribution & Manufacturing and Publishing which operations were part of the MCA Music Entertainment Group, which became the Universal Music Group in 1996. Prior to joining MCA in 1990, I was a Senior Manager with the international accounting and consulting firm Price Waterhouse where I provided a variety of audit, accounting and special services, including mergers and acquisitions.

I received a Bachelor’s degree in Finance and Accounting from California State University at Northridge. I am a Certified Public Accountant (CPA) in the State of California, and I am a member of the American Institute of Certified Public Accountants and the California State Society of CPAs.

1 The figures I provide in this testimony are for Universal Music Group’s operations in the United States. For purposes of this testimony, I refer to these U.S.-only operations as “UMG.”
DISCUSSION

I. Universal Music Group

The recorded music business of Universal Musical Group is the largest record company in the world and UMG had approximately [1]% share of the domestic recorded music market in 2010, including approximately [2]% market share for CD album sales in the United States and approximately [3]% market share of domestic digital sales. UMG consists of numerous acclaimed and popular record labels, including Motown Records, Universal Records, Geffen Records, Interscope Records, MCA Nashville, Island Records, and Def Jam Records. Our artist roster includes many of the biggest stars in almost all styles of music, including artists such as Andrea Bocelli, Lady Gaga, Rihanna, Sugarland, Scott McCreary, Justin Beiber, The Black Eyed Peas, and Eminem.

Our history dates back to the Music Corporation of America, which was founded in 1924. We have been a major force in the recording industry since Music Corporation of America acquired Decca Records and several other labels in the 1960’s, and then formed MCA Records in 1971. Our growth in the record industry has been steady since those days. After adding several legendary labels to its fold, including Interscope Records and Geffen Records in the 1990’s, MCA Music Entertainment Group was renamed Universal Music Group in 1996. A major addition to our company came in 1998 when we acquired the PolyGram group from Phillips N.V. UMG is an indirect, wholly-owned subsidiary of Vivendi SA, and is headquartered in Santa Monica, California.

II. The Challenges of the Transforming Music Industry

It is hardly a secret that the music industry has completely transformed over the past decade. UMG historically derived the vast majority of its revenues from the sale and distribution
of pre-manufactured physical products, such as vinyl records, cassette tapes, and CDs. Unlike music publishers who have long enjoyed a public performance right and associated revenues whenever their songs are played on the radio, we have been almost entirely dependent on the revenues generated by the sale of these physical products. Over the past decade or so, however, sales of these physical products have dropped precipitously and continue to decline each year. According to figures from the Recording Industry Association of America ("RIAA"), record manufacturers in 2000 shipped a total of 1.1 billion physical product units with a total retail value of approximately $14.3 billion. Since then, sales have declined each year such that in 2010 record manufacturers shipped only 241 million physical product units with a total retail value of approximately $3.6 billion, a decline of over 70%.

At UMG, we recognize that our business has changed dramatically over the past decade and that physical product sales will almost surely continue to decline in the future. As a result, we have adapted our business with a focus on digital exploitation, which the marketplace and consumers demand. With the transformation of the music industry, we face new challenges and market conditions. These new factors are relevant to the royalty rates and terms set in this proceeding. I explain in more detail below.

First, as the industry migrates from physical to digital exploitation, consumers are purchasing fewer and fewer physical products and are instead opting for an array of digital audio formats to consume sound recordings, including online music stores such as iTunes, streaming over the internet, and satellite radio through Sirius XM, to name a few. As a result of this substitution of digital for physical, revenues from digital exploitation of our recorded works — including those attributable to statutory and other forms of licensing activities — are now viewed as a primary source of revenues that must be maximized in order for the recorded music business
to survive. Consequently, UMG has invested heavily in the personnel and infrastructure necessary to operate a digital exploitation business. In 2010, digital revenues (inclusive of royalties received through SoundExchange) for UMG were [redacted] — about [redacted] percent of total physical and digital revenues. That is up from [redacted] (roughly [redacted] percent of total physical and digital revenues) in 2009 and [redacted] (roughly [redacted] percent of total physical and digital revenues) in 2008. Across the industry, the RIAA reports that in 2010 the total retail value from physical and digital exploitation were split almost evenly, at 53% physical to 47% digital exploitation. Only five years ago (in 2006), according to the RIAA, the split was 84% physical to 16% digital across the industry. UMG recognizes that this trend will almost surely continue into the future. As a result, we understand that if we are to survive as an organization and continue to make our substantial investment in new recorded works and artists, we must generate additional revenue from our digital exploitation.

Second, digital exploitation has altered the model for how the public consumes music. The marketplace is slowly migrating from a model based on “ownership” of music to a model based on “access” to music. Each year, UMG sees more and more of its revenue coming from services that do not “sell” music to consumers, but rather provide “access” for consumers to a wide range of music. These services include not only interactive streaming services, such as Rhapsody, Spotify, and Napster, but also non-interactive streaming services such as Pandora and satellite radio through Sirius XM. Whereas consumers previously were limited to listening to music that either (a) they owned or (b) was currently playing on the limited number of radio or music television channels they received, consumers now have the ability to “access” the music they want to hear directly through one of these services without having to purchase permanent copies of the music. For example, Sirius XM offers over 70 channels of commercial-free music,
covering the full spectrum of musical genres. It is a fair bet that when Sirius XM subscribers
tune into their satellite radios, they can “access” the type of music they want to hear when they
want hear it.

As a result of this changing model, statutory and direct licenses are becoming an
increasingly important part of UMG’s revenues and are essential to its financial performance.
While revenues from these services once accounted for only a tiny fraction of our annual
revenues, they now comprise a major source of revenue. In 2010, for example, UMG and its
featured and non-featured artists received approximately [ ] from SoundExchange in
statutory license royalties. UMG received another [ ] in direct license royalties from
other audio subscription and streaming services. This is an increase of [ ] since 2006. In
short, though UMG continues to derive much of its digital revenue from sales of recorded music
in the form of permanent digital downloads (such as through iTunes), the trend has been towards
“access” services like Sirius XM.

Digital exploitation has altered the marketplace in another way: when consumers
purchase music now under the “ownership” model, they more frequently buy a la carte songs
rather than albums. In 2010, for example, UMG sold [ ] a la carte songs (including
CD singles) and [ ] albums. In contrast, in 2000, prior to the digital distribution
revolution, UMG sold [ ] a la carte songs (including CD singles) and [ ] albums. This has hugely important implications for our business. Previously, some had argued
that radio and television were promotional of recorded music in that they could lead some
listeners to purchase albums that cost $10 or more based on the popularity of “hit” songs played
on the airwaves. To whatever extent radio and television may have been previously promotional,
the digital revolution has severely muted that promotional aspect. Moreover, as noted earlier,
many consumers simply choose to “access” music through the various services described above rather than purchasing any music at all. As a result, UMG cannot rely solely on the sale of physical products or permanent downloads to survive as a business; we must obtain substantial royalty revenues from “access” services in order to survive as a business.

Third, consumers only have a finite amount of time to consume music in a day. Sirius XM competes head-to-head with other listening formats, including CDs, iPods (or other similar devices), webcasting, and interactive services. When subscribers listen to Sirius XM, they are doing so at the expense of one of these other formats. As a result, UMG needs to obtain revenues from Sirius XM through SoundExchange that are equivalent to the revenues that it would have received through one of these other formats. The statutory license for Sirius XM should not be set lower than the license rates we regularly receive in the open market through direct licensing deals (recognizing, of course, that not all Sirius XM content is music).

In sum, UMG relies heavily on digital revenues from all sources. Digital revenue is now a primary source of revenue for our company and is necessary for us to continue investing in new sound recordings and new artists. Moreover, over the course of this rate term, I can safely say that our dependence on digital revenues and performance royalties will likely increase further.

A. The Failure of Digital Revenues to Fully Recover Lost Physical Revenues Makes It Difficult for Record Companies to Recoup Their Investment

As it currently stands, digital revenues fall far short of the revenues we have lost from physical sales over the past decade. Consequently, it has not been easy for UMG to recoup our substantial investments in the creation, marketing, and distribution of recorded music, as described in more detail below. According to figures from the RIAA, in 2000, the total retail
value of music sold in the United States was $14.3 billion. In comparison, by 2010, the total retail value of music sold (including all digital revenues) was $6.85 billion, less than half of what it was a decade earlier. Indeed, from 2009 to 2010 alone, there was a decline of nearly 11% in the value of music sold. UMG, like other record companies, must find new sources of digital revenue in order to survive.

To date, UMG’s digital revenue has failed to close the gap following the loss of traditional physical product sales over the past decade. While some have predicted for several years now that growth in digital revenue would make up this gap, digital revenues have yet to do so. According to the RIAA, in 2010 the total retail value of digital sales and licenses (including statutory and direct license revenues) was $3.2 billion. This was up narrowly from $3.1 billion in 2009. During that same time period, the total retail value of physical sales declined by $921 million. Moreover, it is plainly obvious that the growth in digital sales and licenses from essentially zero in 2000 to $3.2 billion in 2010 comes nowhere near the $10.7 billion decline in physical sales over the same time period ($14.3 billion (2000 physical retail value) – $3.6 billion (2010 physical retail value)).

Our experience at UMG is generally consistent with these nationwide trends. UMG’s domestic revenues from physical product has fallen from [redacted] in 2000 to [redacted] in 2010. Over the same period, digital revenues have risen from virtually nothing in 2000 to [redacted] in 2010 (inclusive of royalties received through SoundExchange). While our digital revenues are growing, revenues from physical sales continue to decline at a faster rate. In short, we are becoming increasingly dependent on our digital revenues for survival. We therefore seek to ensure that all avenues of digital exploitation, including the performance royalties that we receive from Sirius XM, accurately reflect the substantial value of music and
generate sufficient revenue to permit us to continue making the necessary substantial investments in creating sound recordings.

III. UMG’s Substantial Investment in and Contribution to the Creation, Marketing, and Distribution of Sound Recordings

UMG, like other record companies, makes a substantial investment in and contribution to the creation, marketing, and distribution of sound recordings each year. UMG spent a total of approximately [redacted] in 2010 in order to create, market, and distribute recorded music (including compensation to composers). Our substantial investment, and that of our fellow record companies, is vital to the functioning of the music industry. We often are involved in virtually every step of the development and distribution of recorded music, from finding and developing musical talent, to selecting and funding a creative team (including a studio, producer, and engineer) that enables the musical talent to create recorded music, to marketing and distributing that music to the public, all in the hope of transforming the musical talent into important and profitable brands. Simply stated, without the substantial investment and creative efforts of UMG and our fellow record companies, it would not be possible to bring to the marketplace all of the new recordings and new artists that the public expects.

This substantial investment yields dividends to many other industries that are dependent on the recorded music and brands that are developed and financed through our investment. These industries include radio, webcasting, and other digital services, live performance and touring, branded or sponsored merchandising, film and TV, and music publishing, to name a few. Each of these industries creates jobs and revenue for numerous parties, including the artists themselves. Our initial financing and creative efforts to record, market, and promote the recorded works provides substantial value to each of these industries.
Below I explain in detail UMG’s substantial investment of time and money into the various phases of creating, marketing, and distributing recorded works. But before I go into those details, it bears emphasizing that UMG has been cutting costs for the better part of the past decade. From 2005 to 2010, we have cut overhead costs by [ ]. This has unfortunately meant cutting jobs (our headcount has been cut by [ ]) as well as cutting other expenses whenever possible. My understanding is that our fellow record companies have similarly been cutting costs.

A. Finding the Musical Talent and Creating the Recorded Works

For UMG, the first stage in the creative process falls on the Artists & Repertoire (“A&R”) Department, which is responsible for the discovery and selection of new artists, working with artists on the recording process, and delivering a final sound recording to the label for release. UMG’s creative efforts and investment begin with finding musical talent. Musical talent is discovered through various means, but we primarily rely on members of our A&R Department who go to clubs and concerts, review thousands of demonstration recordings, scan the Internet, attend festivals, and perform market research. While our A&R Department scouts thousands of artists each year, we end up signing only a small number of new artists each year. Needless to say, finding musical talent is a laborious process, requiring uniquely skilled professionals who are able to sift through thousands of talented musicians to find the few who have true superstar potential and will be commercially viable.

Once we sign an artist, our A&R team shifts its focus to working with the artist to create the recorded music. This can include assisting the artist in selecting and developing material to be recorded, which can be a lengthy process and often involves working with the artist to develop a brand or image that will be used by the artist throughout his or her career. Our A&R
Department also may work with the artist to select a creative team, including a producer, engineer, and studio who can best help the artist reach their creative potential. In many cases, our staff is involved throughout the recording process, managing it from start to finish in a sort of executive producer role. Indeed, even after the basic recording process is complete, our A&R team often remains integrally involved in completing the finished product, overseeing the mixing and mastering of recordings as well as any re-mixing or editing of the recordings that may be required for certain markets or uses.

All told, UMG invests an enormous amount of time, energy, and money into the creation of musical works. In 2010, UMG spent approximately \([\text{xxxxxxx}]\) on recording costs, including costs paid to studios, producers, sound engineers, backup musicians, and others involved in the recording process, and advances to artists. Furthermore, UMG spent an additional \([\text{xxxxxxx}]\) to employ the A&R staff who find and work with the artists.

B. Marketing Music

After a recording is completed, we turn our attention to marketing and distributing the recorded works. In the recording industry, “marketing” is best thought of as a broad range of activities that connect our artists to their target audiences. The investment in marketing includes the cost of making music videos, consumer advertisements, Internet marketing and website development, publicity and promotional tours, promotional merchandise, designing attractive “packaging” for the recordings, and a host of other expenses. Most of these marketing costs are incurred up front, before the record company is able to generate any revenue from the music that is being marketed. UMG invests extraordinary amounts of time and money into its marketing activities. In 2010, UMG spent \([\text{xxxxxxx}]\) on marketing activities, including on our in-house staff and various other out-of-pocket expenses. Without these investments, few, if any,
recordings would become the commercial successes necessary to sustain the music industry. Indeed, even with all of our marketing efforts, the vast majority of our recordings are not commercially successful.

C. Manufacturing and Distributing Recorded Music

Even as physical sales decline and our business is shifting increasingly to digital exploitation, the costs associated with our distribution operations remain significant. In 2010, we recognized [Redacted] in manufacturing and related expenses, and [Redacted] in distribution and selling costs. These costs comprise the departments responsible for retail interaction, customer service, credit and collection, and supply chain fulfillment with both physical and digital retailers, as well as the departments responsible for the production of our inventories and various logistical operations necessary for the business.

D. Other Costs

Like any other business, UMG faces various other costs which are not directly related to the creation, marketing, and distribution of sound recordings, but which are nevertheless essential for us to function as an organization so that we can invest in new sound recordings. These expenses, which include the costs associated with our executive, legal, finance, copyright and royalties, information technology, human resources, corporate development, and administrative departments, amounted to [Redacted] for fiscal year 2010. The activities of these departments are critical to the functioning of the company and are essential to supporting the creation, marketing, and distribution of the sound recordings.

***

In total, UMG spent [Redacted] in 2010 related to its recording and distribution business. The sound recording business is thus risky and speculative. We pay enormous upfront
expenses as described earlier through various recording, marketing, and distribution costs as well as artist advances, almost all of which must be spent before we receive a single penny in revenue from the recording. In light of the myriad of challenges presented by the transforming music industry, it has been tougher and tougher for us to recoup our investments and to earn an appropriate return on our invested capital.
I declare under penalty of perjury that the foregoing is true and correct.

Date: 11/28/2011

Charles Ciongoli
In the Matter of:

Determination of Rates and Terms for Preexisting Subscription Services and Satellite Digital Audio Radio Services

Docket No. 2011-1
CRB PSS/Satellite II

TESTIMONY OF

RAYMOND M. HAIR

International President of the American Federation of Musicians of the United States and Canada

Witness for SoundExchange, Inc.
WRITTEN DIRECT TESTIMONY OF RAY HAIR

Background and Qualifications

I am a professional musician and the International President of the American Federation of Musicians of the United States and Canada, AFL-CIO ("AFM"). I have spent my entire life playing, studying and teaching music, representing musicians, and trying to improve the livelihood of professional musicians.

I began playing the drum set professionally as a youngster in Mississippi in nightclubs there before liquor was legal and before I could drive a car. At one time or another, I’ve performed every style of popular music. I was 13 years old when I performed my first professional engagement, and I became engaged as a recording musician while I was in high school. In the early 1970’s, I performed and recorded with Tommy Stuart and his group, the “Rubberband.” Our hit, “Your Man Done Gone,” moved up the Billboard charts during the summer of 1970. Over the next few years, I recorded dozens of tracks, mostly demos, in Jackson, Mississippi.

Throughout those years in Mississippi and later in Texas, I earned my way through college by performing professionally. I received an undergraduate degree in music from the University of Southern Mississippi. In 1975, I left Mississippi for Texas, where I earned a graduate degree in jazz studies from North Texas State University (now the University of North Texas). I eventually taught drum set full-time at UNT and I enjoyed teaching music to undergraduate and graduate students. I never stopped performing, though. I started my own group, Yazoo, which performed in many states of the United States and experienced the many forms of exploitation that musicians endure when they work five or six nights a week in dance
lounges nightclubs, showrooms and concert halls in city after city. I spent time in Dallas
recording studios in those years, too, doing sound recording and jingle session work.

I learned a lot of things in the studios and on the road, but the most important thing I
learned was the value of the union to a professional musician. The AFM set standards for live
performances to protect us from being ripped off, and stood by us if we had disputes with
purchasers. The AFM negotiated industry-wide rates and terms for recording musicians that
improved conditions considerably, whether recording records, television or movie soundtracks,
or commercial announcements.

Ultimately, I became very involved in the union, and in 1983 I relinquished my teaching
position and greatly reduced my performing career in order to become the President and
Secretary of the Fort Worth Professional Musicians Association, which was Local 72 of the
AFM. Later, I guided the merger of the Dallas and Forth Worth locals, and served as the
President of the merged Local 72-147 continually until 2010. At various points through those
years, I also served on the AFM’s International Executive Board, which supervises the affairs of
the entire AFM. In 2010, I was elected to my current full-time position as International President
of the AFM. As the AFM International President, I also serve as a Trustee of the AFM and
AFTRA Intellectual Property Rights Distribution Fund (“AFM/AFTRA Fund”) and the AFM
and Employers’ Pension Fund, and as a Director of the Alliance of Artists and Recording
Companies.

As a Local and International AFM officer, I’ve represented every kind of professional
musician. I’ve led or participated in negotiations for local collective bargaining agreements
covering symphony, opera and ballet orchestras and theaters, and I pioneered the free-to-attend,
continuous, multi-stage festival entertainment format in North Texas. On the national level, I
have led or participated in negotiations in the commercial announcements, television, motion picture, and recording industries.

Discussion

I understand that this proceeding is for the purpose of setting the rates and terms for the statutory license that the Copyright Act grants to certain preexisting subscription services (Muzak and Music Choice) and satellite digital audio radio services (SiriusXM). I am submitting this testimony to emphasize the importance of the statutory royalties to performing artists, and to express the AFM’s support for the designation of SoundExchange as the sole Collective to collect and distribute the royalties at issue in this proceeding for the period of 2013 through 2017.

I. AFM

The AFM is an international labor organization representing over 90,000 professional musician members in the United States and Canada through a network of more than 250 local unions. The AFM was founded in 1896 and is the oldest and largest union of musicians in the world. AFM members record music for sound recordings, film scores, radio, television and commercial announcements, as well as perform music of every genre in every sort of venue from small jazz clubs to symphony orchestra halls to Broadway and local theaters. The AFM negotiates industry-wide agreements such as the Sound Recording Labor Agreement, which sets standard working conditions for all musicians who record under it. AFM members span the full range of professional musicians, from featured recording artists who are well-known celebrities to non-featured artists who work as session musicians in the recording industry.

The traditional area of activity for labor organizations is collective bargaining, and the AFM has been negotiating an industry-wide collective bargaining agreement, the Sound
Recording Labor Agreement ("SLRA"), which governs terms and conditions for the major recording companies and hundreds of independent companies, for sixty years. But, the AFM has long served as an advocate for musicians’ interests in various other contexts, too, including specifically serving as a strong proponent of performers’ rights and copyright protection for performers.

For example, the AFM and the American Federation of Television and Radio Artists ("AFTRA") were critically important supporters of the Digital Performance Right in Sound Recordings Act in 1995, which created the rights at issue in this proceeding. The unions’ joint efforts contributed to the current structure of the Act, which requires that 50% of the royalties from the compulsory license for digital performances shall go to performers, and shall be paid by SoundExchange directly to them. I am proud that AFM and AFTRA helped secure the performance right and ensured that SoundExchange will pay 45% of the royalties from this proceeding directly to featured artists, and that it will pay 5% to the AFM/AFTRA Fund for further distribution to session musicians and vocalists.

II. The Importance of Statutory Royalties

I cannot overstate the importance of the revenue stream from the compulsory digital performance license to recording artists and musicians. In my experience as a musician and a labor leader, I know that most of us make a living by patching together revenue from many different sources. Session fees, live performing fees, royalties, teaching, you name it – they all are necessary to earn a decent living that allows you to continue to make music. Every income stream is important to a working musician, but digital performance royalties are becoming especially important as music fans change the way they consume recorded music, from purchasing CDs and downloads to listening to music on digital music services.
Traditionally, CD sales (and later, digital sales) have been a cornerstone of compensation to featured artists and session musicians. They support the industry which provides investment for artists and employment for session performers. They provide royalties to featured artists, and for session musicians, they provide payments from the union-negotiated Special Payments Fund ("SPF") under the SRLA. But I know from experience that sales have declined, and as a result we see less employment under the SRLA across the country, less investment in artists (which means reduced opportunities for them) and reduced SPF payments to musicians.

Digital performance royalties may not, by themselves, replace all the income from lost CD sales, but they are an increasingly important source of revenue to industry, artists and musicians. In October 2011, SoundExchange reported its largest distribution ever – $88 million distributed to thousands of performers and copyright owners for the third quarter of 2011 alone. In 2011, the AFM/AFTRA Fund distributed just over $9 million in digital performance royalties to non-featured musicians and vocalists. These are meaningful sums to performers. In fact, as physical product and digital download sales decline, I expect that digital performance royalties for session musicians will at some point exceed the SPF payments that they earn based on sales.

But I want to be clear. Digital performance royalties are not just important because patterns of music consumption are changing, so that “listening” is replacing “purchasing.” Their importance is more fundamental than that. The truth is that we musicians make great music. It is our talent, our training, our hard work and our passion that results in great recordings that the public across the world wants to hear. Our work is valuable. We believe that the use of sound recordings should command a fair price, and we believe that wherever and whenever our music brings financial value to a business, we ought to share in that value.
III. **Designation of SoundExchange as the Sole Collective**

In prior proceedings, the AFM has supported SoundExchange as the best entity to act on behalf of performers and copyright owners as the sole Collective for the collection and distribution of statutory royalties. For the reasons I explain below, the AFM renews its support for SoundExchange to serve as the sole designated Collective for the compulsory license fees at issue in this proceeding.

**A. SoundExchange Is Controlled by Performers and Copyright Owners.**

SoundExchange is governed by a Board of Directors that is equally composed of performer and copyright owner representatives. Thus, the very constituencies that are served by SoundExchange are also in control of its policies and operations. SoundExchange’s officers and staff are answerable to the demands of copyright owners and performers for honest, fair and efficient distributions, and for vigorous efforts to achieve fair rates that recognize the value of our music.

The nine performer representatives include artists’ attorneys and managers as well as individuals affiliated with major performer organizations – the AFM, AFTRA, the Recording Academy, the Music Manager Forum and the Future of Music Coalition – which together represent tens of thousands of performers. They bring the views and concerns of a broad range of performers to the decision-making process at SoundExchange.

I think that the level of control that performer representatives have over SoundExchange has ensured that SoundExchange is committed to serving our interests as well as the interests of copyright owners. SoundExchange has demonstrated this commitment by engaging in extensive efforts to make performers aware of the royalties they are owed, to find and enroll them, and to get royalties into their hands. These efforts include reaching out to performers and their
representatives directly, partnering with other organizations to get the word out to their members, attending conferences, earning media attention, placing print and web ads, and using social media like Facebook and Twitter. SoundExchange also serves performers’ interests by advocating for fair royalty rates, working for reporting requirements that will help get the money into the hands of as many performers as possible, and building the computer and service systems that enable it to distribute directly to performers.

Through all of its efforts, SoundExchange has earned the trust of performers and copyright owners alike. Perhaps the best evidence of SoundExchange’s commitment to the fair representation of artists and copyright owners is that tens of thousands of artists and copyright owners have registered with SoundExchange.

B. SoundExchange Is a Non-profit Organization.

The AFM firmly believes that the digital performance right was created to benefit performers and copyright owners, not to provide business opportunities for agents. It also believes that performers should receive the fullest possible benefit from the royalties, and not see their royalties reduced to pay a profit to an agent. And finally, AFM believes that the Collective’s decisions should be guided by the needs of performers and copyright owners, and not by an agent’s business needs.

As a non-profit organization, SoundExchange litigates rates, collects royalties and distributes them – all for the benefit of performers and copyright owners, not for its own financial gain. As a non-profit organization, SoundExchange’s incentives are properly aligned with the interests of royalty recipients.
C. SoundExchange Has Substantial and Unparalleled Experience Collecting and Distributing Statutory Royalties and Has Devoted Significant Resources to Developing a Distribution Infrastructure.

I understand that in prior proceedings, it has consistently been decided that the appropriate way to administer the compulsory license is through a single Collective. The AFM has always advocated for this conclusion, and remains convinced that it is the best system for performers. I also firmly believe that SoundExchange should be that single Collective.

The license at issue here is a compulsory license, and the license rate will be set by the Copyright Royalty Judges and not by competing agents who are negotiating in the marketplace. In this structure, the AFM has always thought that having one Collective to litigate rates, and collect and distribute the royalties, is by far the most efficient system. The administrative infrastructure that is required is necessarily paid for out of the royalties. Why pay for two (or more) computer systems, two (or more) staffs, two (or more) offices, two (or more) legal and technical structures? Why pay the costs that would inevitably follow from the need to coordinate between two (or more) different entities, with their differing systems? Why should the services that are subject to the license be required to make payments and file reports to two (or more) collectives, when it is simpler, more efficient and cheaper to deal only with one? Having a single Collective avoids redundancy and streamlines costs, to the benefit of performers.

The single Collective should be SoundExchange. SoundExchange has a demonstrated record of serving the interests of performers, seeking to maximize royalty payments to them, and working hard to find the thousands of potential recipients and get royalty payments to them (regardless of whether they are SoundExchange members). SoundExchange has already invested in the systems that are needed, and has developed the experience and expertise in all the complicated aspects of receiving reports of billions of digital performances, connecting them to
the proper performer and copyright owner recipients, processing the royalties, and paying them out. To choose a new Collective now would not serve the interests of artists or copyright owners, because it would simply require us to pay for the costs of a new entity getting up to speed. The best interests of the royalty recipients will be served by renewing SoundExchange as the Collective.

D. MRI Is Not an Appropriate Collective.

I understand that Music Reports, Inc. ("MRI") has indicated its intention to participate in this proceeding. I am aware that in a prior proceeding, MRI’s sister entity, RLI, sought to compete with SoundExchange to collect and distribute royalties. It is unclear to me if MRI is seeking that in this proceeding, but if it is, the AFM believes that MRI is not an appropriate entity to serve as a Collective to collect and distribute royalties, because it meets none of the criteria that the AFM believes are important for serving performers’ interests. To the best of my knowledge, MRI is a for-profit entity, and it has indicated that it is interested in royalty collection and distribution to make money; MRI’s structure does not ensure equal participation by artists in its governance; and MRI does not have SoundExchange’s deep level of investment and experience in administering the compulsory license.

If that were not enough, MRI also suffers from a conflict of interest, in my view, because it represents the interests of music licensees. MRI recently demonstrated this conflict by acting on behalf of SiriusXM to solicit direct licenses from copyright owners that would bypass the compulsory license and SoundExchange. Any entity serving as a Collective for performers and copyright owners should work on their behalf, not on behalf of services that use the statutory licenses. To my way of thinking, the choice between MRI and SoundExchange could not be clearer.
I declare under penalty of perjury that the foregoing testimony is true and correct.

Date: 11/22/11

Raymond M. Hair, Jr.
Before the
UNITED STATES COPYRIGHT ROYALTY JUDGES
Washington, D.C.

In the Matter of:
Determination of Rates and Terms for Preexisting Subscription Services and Satellite Digital Audio Radio Services

Docket No. 2011-1
CRB PSS/Satellite II

TESTIMONY OF

DARIUS VAN ARMAN

Founder, Jagjaguwar

Witness for SoundExchange, Inc.
**Background and Qualifications**

I am Darius Van Arman, founder of the independent record label Jagjaguwar, which is home to such recording artists as Bon Iver (who most recently debuted at number two on the Billboard charts with their most recent album) and Dinosaur Jr. (an iconic underground band that is still making critically acclaimed albums well into their third decade of existence). I am co-owner of the three independent record labels Dead Oceans, Jagjaguwar and Secretly Canadian, of the music distribution company SC Distribution and of the artist management company Fort William Artist Management. My companies have offices in Bloomington (Indiana), New York City and London, and we employ slightly more than forty people. I’ve been working in the music industry since 1995, solely in the independent music sector, and I’ve recently been appointed to the Presidential Advisory Committee for A2IM, the preeminent trade organization serving the independent music community in the United States.

**Independent Record Labels**

I understand the purpose of this proceeding is to set the rates that Sirius XM’s satellite radio service and certain services that stream sound recordings over satellite and cable television (Music Choice and Muzak) must pay copyright owners and performers for streaming their copyrighted sound recordings. I am providing this testimony to give the Copyright Royalty Judges the views of an independent record label.

**A. The Economics of Independent Record Labels and Their Role in Creating Sound Recordings**

While we care deeply about music and would like nothing more than to be able to only focus on releasing exceptional recordings by artists we have immense belief in, independent labels like ours are small businesses that need to proceed in a sustainable and responsible way, where our revenues are sufficient to cover our costs. Our business is in the world of the arts, and
we feel the product we release and the artists we support all make a very important cultural contribution. However, we do not receive any arts grants or rely on any indirect support from taxpayers in the form of tax breaks, local or trade-related. So, in the aggregate, we cannot afford to release albums that lose money for us. With every album we release, our plan is to generate a profit, or to at least break even, and, in fact, more than half of our albums generate a profit or break even. As a result, we are currently a profitable company.

Our approach to creating sound recordings differs slightly from the model that I understand is used by the major labels, and the scale of our operations tends to be smaller, but there are also significant similarities. Much like the major labels, we spend a great deal of time and effort seeking out recording artists to sign. We listen to demos (in fact, many of our most popular artists, such as Okkervil River, were discovered through an unsolicited demo), we actively attend showcases, shows and music festivals around the country, we read music websites and magazines, and we receive referrals from other bands, labels, managers and booking agents. We invest a significant amount of time not only identifying the kind of artists we want to work with (based on musical merits) but also conversing with the artists themselves (as well as their representatives) to gauge whether we would ultimately be compatible, both philosophically and with regards to business-related expectations. During this “getting to know each other” phase, we freely offer business advice to the prospective artists and connect them with those who can help them in ways that are beyond the scope of what we do. Additionally, for those artists who we eventually come to an agreement with, we consistently and over a long period of time devote significant resources to promoting their music and their touring.

We have not to date entered into deals with artists in which we participate in revenue from all spheres of the artist’s career, including touring, merchandising, branding, publishing and
master rights. Our approach to signing artists is to contract for only the master rights over the sound recordings. Also, in all of our agreements with artists to date, we have forgone a royalty-based way of accounting, and instead we share both costs and revenues with the artist in an even-split fashion, but where we’re the only party that covers any loss on the aggregate. It is our hope that with such a deal structure, where profits (but not losses) are shared evenly, a true feeling of partnership between us and the artist is engendered.

Because our very identity as a company is deeply rooted in this commitment to artist development (and, as per above, engaging in a true partnership with the artist), one of the challenges we face in a declining market for music sales is that, although, industry-wide, earnings from master-related exploitation is diminishing (as consumers spend less money on traditional CDs and a large number of consumers opt to illegally download music), there is no relief or reduction in the amount of work that labels like us need to do for artists. So it is very important for us to do all that we can to ensure a fair return on our energies, both for our longer-term prospects but also so that we can, right now, continue to work at a very high level for our artists and their recordings. It is our belief that this benefits consumers and the public-at-large to a great degree, as such work both directly and indirectly improves the quality of artist recordings and performances that they experience.

B. The Importance of Statutory Royalties to Independent Record Labels

The plain truth facing the recording industry is that we continue to face a challenging retail landscape. Although our labels’ market share has increased in recent years, the industry as a whole has not recovered to earlier levels. Digital distribution has become an increasingly important aspect of the recording industry and our business in particular. It is easier than ever to get our recordings to the people who want to hear them, but people are buying fewer albums. As
consumers change how they obtain music, the compensation that we receive must be fair, in order to ensure that we can continue to invest in making new records. If our companies were in a different position, where instead of recently increasing our market share, we had merely maintained it, we would be immediately facing significant pressure to release more records with the same level of staffing to attempt to maintain the same level of revenue. The attention of our staff would be diluted over more records, and as a result the quality of our work would diminish, not unlike how the education of the individual suffers when educational institutions increase student to teacher ratios in the face of funding cuts.

Based on our experience, a pattern we have noticed in the industry generally is that more established, older recording artists seem to release records that have a higher percentage of sales happen through physical products (presumably because their fan base is more accustomed to more traditional modes of purchasing music). In contrast, younger, less established artists tend to release records that earn proportionally more through digital revenues. Record labels like ours cannot rely on physical sales alone to sustain our business. Our labels tend to focus on smaller and newer artists, and we therefore fundamentally rely on strong digital revenues. Over the past 4 years, our digital revenues have grown approximately 300%, and now account for roughly 50% of our total revenues.

There is no single digital revenue stream that can sustain our business. But digital revenues in the aggregate are significant, and every digital revenue stream counts. An important component of our digital distribution is the statutory royalties that we receive from SoundExchange from services like Sirius XM. Over the past several years, royalties from SoundExchange have become an increasingly vital source of revenue. For example, the SoundExchange royalties that Jagjaguwar has received from Sirius XM’s satellite radio service
have increased from $932.92 in 2007 to $25,058.96 in 2009 and $20,237.17 in 2010, and based on the first nine months of 2011 they will likely exceed 2010 levels this year. In total, Jagjaguwar has received over $95,000 from SoundExchange (for all the services licensed through SoundExchange) since 2007. These royalties represent a meaningful contribution to our bottom line, and we hope our statutory royalty payments continue to increase in the years to come.

**Direct Licensing**

Music Reports, Inc. (MRI) has approached our three labels about entering into direct licenses with Sirius XM. We have not accepted MRI’s proposals. On September 15, 2011, Trent Smith, a Licensing Manager for MRI, emailed all three of our labels. His email attached proposed licenses from Sirius XM to license our labels’ recordings directly. I am including a copy of the email and the proposed licenses with my testimony as Exhibit SX-101DP.

Under the proposed licenses, Sirius XM would pay us directly (not through SoundExchange) at a royalty rate of “7% of gross revenue (with each label receiving its pro rata share of that amount based on its share of SXM transmissions).” The proposed licenses define the revenue base to include “[s]ubscription revenue recognized by” Sirius XM directly from subscribers in the U.S. for its digital audio service and “[a]dvertising revenues, or other monies received from sponsors, if any, attributable to advertising on channels other than those that use only incidental performances of sound recordings, less advertising agency and sales commissions.” The term of the proposed direct licenses was for 3 years, automatically renewed for successive one-year periods, unless terminated by either party.

There were a number of other notable features of the proposed direct license. For example, the license was not simply a replacement for the statutory license for Sirius XM’s
satellite radio service. Rather, Sirius XM was soliciting a license that would allow it to “enhance the service in several new and exciting ways,” that included providing subscribers the ability to record, fast forward, skip, rewind or pause programming, and cache programming for later playback. Moreover, the 7% blanket rate would apply to all “distributions of SXM’s service to business establishments, private residence (via cable and satellite television systems), and through Internet webcasts.” As Mr. Smith’s email noted, “these service platforms have been licensed separately through other statutory licenses also administered by SoundExchange.” In other words, Sirius XM was offering a direct license for all of the statutory uses of our sound recordings, along with non-statutory uses, at a rate less than the rate Sirius XM currently pays for its satellite radio service.

Mr. Smith explained Sirius XM’s position that in fact this lower royalty rate “is competitive with the 7.5% which SXM currently pays to SoundExchange under the statutory licenses for its satellite radio.” In fact, he claimed that the direct license “affords labels the opportunity of making more than they have made from SoundExchange under the statutory licenses.” He set forth three reasons for this belief. First, his email stated that while SoundExchange pays labels only 50% of the statutory license and pays the other 50% to artists, the “[r]oyalties paid by SXM under direct licenses will include both the so-called ‘featured artists share’ and the ‘non-featured artist share.’” The email explained that this would “afford[] labels the opportunity of making more than they have made from SoundExchange under statutory licenses.” Second, he claimed that there would be “potential additional royalties” from the multiple service platforms covered by the license. Third, he indicated that if we entered into direct licenses with Sirius XM, our recordings would be played more. Specifically, he stated that labels would earn more revenue under this proposal than they have made from SoundExchange
because of “SXM’s expectation that, over time, it will increase its reliance on the use of directly-licensed recordings (as opposed to non-directly-licensed recordings) in its programming.”

I did not respond to that proposal. Mr. Smith sent two follow-up emails, but our labels have not accepted MRI’s offer to direct license with Sirius XM. For us, not accepting the proposals was an easy decision. In the first place, we believe that the statutory royalty rate for satellite radio is likely to increase as a result of this proceeding, and we therefore have no interest in agreeing to a lower rate that encompasses other statutory platforms and additional non-statutory uses of our sound recordings. In addition, we have a vested interest in doing all that we can to assure that the world of satellite and internet radio continues to program its music to the extent it can based purely on the merits of the actual recordings and artists. However, MRI’s implication that in order to have our recordings played more by Sirius XM, we would need to enter into direct licenses, runs contrary to this spirit, and it feels like the beginning of a slippery slope where at the bottom of the hill is a world that looks very much like the commercial radio landscape, a world that is largely inaccessible to independent labels like us and one where very real, non-meritocratic obstacles exist. What is proposed by MRI could become a system in which Sirius XM acts as a gate-keeper and dictates whose recordings are played based not on the quality of recordings but on the deal terms of a license. We are opposed in principle to such a system.

*SoundExchange as the Sole Collective*

I also understand that MRI indicated that it may participate in this proceeding and that in the past, MRI’s affiliate Royalty Logic, Inc. (RLI), has petitioned to be recognized as a collective under the statutory license. We are opposed to the designation of MRI as a collective and support the designation of SoundExchange as the sole collective for the statutory royalties. In light of MRI’s explicit representation of Sirius XM in connection with the proposed direct
licenses that I discussed above, I believe that MRI has a fundamental conflict of interest in the context of the statutory license.

By contrast, I believe SoundExchange has earned the right to continue serving as the sole collective to collect and distribute statutory royalties for copyright owner and performers. SoundExchange is governed by and represents the interests both of recording companies – major and independent label alike – and performing artists. It is currently my belief that SoundExchange’s organizational structure ensures that the interests of all constituents are represented. It is also a non-profit organization, which ensures that the goal is to maximize royalties for recipients, and it currently has a good track record of advocating on behalf of copyright owners and performers.
I declare under penalty of perjury that the foregoing is true and correct.

Date: 1/28/2011

Darius Van Arman
<table>
<thead>
<tr>
<th>Exhibit No.</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>SX Ex. 101-DP</td>
<td>Email attaching Sirius XM Radio Inc.'s proposed sound recording catalog licenses for Dead Oceans, Jagjaguwar, and Secretly Canadian Records (Sept. 2011)</td>
</tr>
</tbody>
</table>
Hey D,

We’re just sitting back and ignoring this for the time being correct?

Best Regards,

Grant Manship

DEAD OCEANS / JAGJAGUWAR / SECRETLY CANADIAN
1499 West 2nd Street
Bloomington, IN 47403 USA
E: grant@jagjaguwar.com
V: 812.961.2571 ext 238
F: 888.678.0167

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Begin forwarded message:

From: Kathy Cook <kathy@jagjaguwar.com>
Date: October 28, 2011 4:12:13 PM EDT
To: Grant Manship <grant@jagjaguwar.com>
Subject: Fwd: Sirius XM Radio - Dead Oceans, Jagjaguwar, Secretly Canadian - Direct Licensing Opportunity

Begin forwarded message:

From: Theodora Karatzas <theodora@secretlycanadian.com>
Date: October 28, 2011 4:08:56 PM GMT-04:00
To: Kathy Cook <kathy@jagjaguwar.com>
Subject: Fwd: Sirius XM Radio - Dead Oceans, Jagjaguwar, Secretly Canadian - Direct Licensing Opportunity

Begin forwarded message:

From: Trent Smith <trent@musicreports.com>
Date: October 28, 2011 3:53:47 PM GMT-04:00
To: info@deadoceans.com, info@jagjaguwar.com, info@secretlycanadian.com
Subject: RE: Sirius XM Radio - Dead Oceans, Jagjaguwar, Secretly Canadian - Direct Licensing Opportunity

Checking in again on this still hoping we might be able to arrange an opportunity to discuss and hopefully move these licenses forward. Looking forward to hearing back from you with your availability.

Best regards,

Trent Smith
Licensing Manager
Music Reports, Inc.
21222 Erwin St.
Woodland Hills, CA 91367
tel. 818 558-1400 x7014
fax. 818558-3474
Trent@MusicReports.com

Begin forwarded message:

From: Trent Smith <trent@musicreports.com>
Sent: Wednesday, October 121 2011 2:52 PM
To: info@deadoceans.com, info@jagjaguwar.com, info@secretlycanadian.com
Subject: RE: Sirius XM Radio - Dead Oceans, Jagjaguwar, Secretly Canadian - Direct Licensing Opportunity

Checking in to see if you’ve had a chance yet to review these direct license proposals on behalf of Sirius XM and if so whether you have any questions or would like to discuss it further. SXM is eager to get these licenses in place so I’m looking forward to speaking with you at your earliest opportunity. If you’d like to set up a phone call please let me know what day and time you are most available.

Best regards,

Trent Smith
Licensing Manager
Music Reports, Inc.
21222 Erwin St.
Woodland Hills, CA 91367
tel. 818.558.1400 x7014
From: Trent Smith (mailto:trent@musicreports.com)
To: 'info(deadoceans.com'; 'info@jagjaguwar.com '; 'info@secretlycanadian.com'
Subject: Sirius XM Radio ~ Dead Oceans, Jagjaguwar, Secretly Canadian - Direct Licensing Opportunity

Dear Licensee(s): 

Attached are proposals from Sirius XM Radio Inc. ("SXM") to license the recordings in your catalogs which had previously been sent to Bank Robber Music, but they recently informed us that they do not have authority to negotiate this type of license and I should contact you directly. Historically, SXM has licensed its service through certain statutory licenses in the U.S. Copyright Act and has paid SoundExchange the royalties under these statutory licenses. For several reasons which we believe you should find of interest, SXM is now seeking to license its service programming directly from record labels.

Under the attached license agreement, SXM will pay you directly (i.e., not through SoundExchange) without any deductions. SXM will continue to rely on statutory licenses (and pay SoundExchange) for the use of recordings which are controlled by labels that do not grant SXM direct licenses but, of course, these royalties will be subject to SoundExchange deductions before the royalties are distributed. Royalties paid by SXM under direct licenses will include both the so-called "featured artists share" and the "non-feateded artists share," whereas SoundExchange, after deducting for its costs, pays only 50% of SXM royalties to its member labels, with the remaining half paid directly to the featured artists (45%) and unions (5%).

In addition, SXM intends to enhance the service in several new and exciting ways. These enhancements to the functionality of the service are described on Exhibit A of the attached license. The direct license covers all reproduction, distribution, and public performance rights necessary to operate the service, including both traditional programming functionality and these new service enhancements. In this way, labels entering into direct licenses stand to be included in, and benefit from, the full array of SXM service offerings.

In order to streamline and integrate its label licensing arrangements, the direct license also covers distribution of SXM’s service to business establishments, private residences (via cable and satellite television systems), and through internet webcasts. In the past, these service platforms have been licensed separately through other statutory licenses also administered by SoundExchange.

SXM is offering labels that enter into a direct license a royalty rate of 7% of gross revenue (with each label receiving its pro rata share of that amount based on its share of SXM transmissions), to be paid quarterly and reported on a per-play basis. We believe this rate is competitive with the 7.5% which SXM currently pays to SoundExchange under the statutory licenses for its satellite radio service and in fact affords labels the opportunity of making more than they have made from SoundExchange under statutory licenses. This is due to: (i) the potential additional royalties for the platforms described above; (ii) the absence of SoundExchange deductions from direct license royalties; and (iii) SXM’s expectation that, over time, it will increase its reliance on the use of directly-licensed recordings (as opposed to non-directly-licensed recordings) in its programming.

Please contact us if you have any questions or comments regarding the license. Otherwise, please sign each of the licenses where indicated and return them to us at the above address for counter-signature by SXM.

Best regards,

Trent Smith

Licensing Manager
Music Reports, Inc.

21122 Erwin St.
Woodland Hills, CA 91367

tel. 818-558-1400 x7014
fax. 818-558-3474

Theodora Karatzas

DEAD OCEANS / JAGJAGUWAR / SECRETLY CANADIAN

1499 W. 2nd St.
Bloomington, IN 47403
p: 812.961.2571 x-260
f: 1.888.678.0167

Kathy Cook

DEAD OCEANS / JAGJAGUWAR / SECRETLY CANADIAN

1695 W. 2nd St.
Bloomington, IN 47403
p: 812.961.2571 x-232
f: 1.888.678.0167

Kathycook@mac.com
SOUND RECORDING CATALOG LICENSE

This agreement (the “Agreement”) is entered into as of September 15, 2011 by and between SIRIUS XM RADIO INC., 1221 Avenue of the Americas, New York, New York, 10020 (collectively along with its Affiliates, “Licensee”) and DEAD OCEANS, 1499 W. Second Street, Bloomington, IN 47403 (collectively along with its Affiliates, “Label”) (each referred to as a “Party”).

WHEREAS, Label owns and/or controls certain sound recordings during the Term hereof (collectively, “Label’s Catalog”); and

WHEREAS, Licensee operates a digital audio radio service consisting of a wide variety of music and non-music (e.g., news, weather, sports and talk) programming (the “Service(s)”) in the Territory; and

WHEREAS, Licensee desires to obtain from Label a blanket license covering Label’s Catalog for the rights set forth herein, and Label is willing to grant such rights to Licensee;

NOW THEREFORE, the Parties hereto agree as follows:

1. Grant of Rights:

   (a) Service Programming: Label hereby grants to Licensee, solely in the Territory and solely during the Term, the right, through to the listener, to edit, reproduce, distribute, and publicly perform by means of digital audio transmission some or all of the sound recordings in Label's Catalog (the “Recording(s)”) solely in connection with the Service (including, without limitation, as made available to subscribers via satellite radio, the Internet, multi-channel video programming distributors, and commercial business establishment services). The grant of rights will further extend to the public performance, reproduction, and distribution of Label's Catalog on or through devices that have the functional capability set forth on Exhibit A in connection with the Service. Label will be free to grant licenses to others.

   (b) The Service operates pursuant to the statutory license at 17 U.S.C. §114(f) and 17 U.S.C. §112(e) (collectively, the “Statutory Licenses”). Label acknowledges, however, that this Agreement is a voluntary license, and Service may from time-to-time introduce product and programming features (artist-specific channels, for example) that extend beyond the Statutory Licenses. Label agrees that such features will be licensed hereunder, and that restrictions which apply under the Statutory Licenses will not apply in relation to Label’s Catalog, including but not limited to: (i) the so-called “sound recording performance complement”; (ii) the publication of advance playlists; and (iii) the six-month limit on retention of ephemeral recordings.
2. **Royalties:**

   (a) **Service Royalty Pool:** For each calendar quarter of the Term, Label’s pro-rata share of royalties for the license granted hereunder to Licensee will be determined by multiplying the “Service Royalty Pool” for that quarter by a fraction, the numerator of which is the total number of “Transmissions” of identified Recordings from Label’s Catalog in that quarter, and the denominator of which is the total number of “Transmissions” of all sound recordings performed on the Service in that quarter.

   (i) As used herein: the “Service Royalty Pool” will mean seven percent (7%) of revenue recognized by the Licensee in accordance with U.S. GAAP from:

      (A) Subscription revenue recognized by Licensee directly from subscribers in the Territory for the Service; and

      (B) Advertising revenues, or other monies received from sponsors, if any, attributable to advertising on channels other than those that use only incidental performances of sound recordings, less advertising agency and sales commissions.

   (ii) The Service Royalty Pool will exclude:

      (A) Monies or other consideration attributable to the sale and/or license of equipment and/or other technology, including but not limited to bandwidth, sales of devices that receive the Service and any taxes, shipping and handling fees therefor;

      (B) Royalties paid to Licensee for intellectual property rights;

      (C) Monies or other consideration received by Licensee from the sale of phonorecords and digital phonorecord deliveries;

      (D) Sales and use taxes, shipping and handling, credit card, invoice, and fulfillment service fees;

      (E) Bad debt expense; and

      (F) Revenues earned by Licensee for the provision of: (1) current and future data services (e.g., weather, traffic, destination information, messaging, sports scores, stock ticker information, extended program associated data, video and photographic images, and such other telematics and/or data services as may exist from time to time); (2) channels, programming, products and/or other services offered for a separate charge where such channels offer only incidental or occasional performances of sound recordings; (3) channels, programming, products and/or other services provided outside of the Territory; and (4) performances of sound recordings (and/or ephemeral recordings) that are exempt from any license requirement.
(iii) As used herein, a “Transmission” will mean each instance in which any portion of thirty seconds or more of a sound recording is publicly performed by digital audio transmission on the Sirius XM satellite radio service, but excluding performances of less than 30 seconds and performances that make no more than incidental use of sound recordings (including, without limitation, brief musical transitions in and out of commercials or program segments, brief performances during news, talk and sports programming, brief background performances during disk jockey announcements, brief performances during commercials of sixty seconds or less in duration, or brief performances during sporting or other public events).

(b) Methodology for Transmission Counts: Transmissions will be counted without respect to the number of subscribers receiving the performance of the sound recording. For example, without limitation, if a particular sound recording is transmitted on a particular channel or program only once during the reporting period, then there is one Transmission, and if the sound recording is transmitted ten (10) times on a particular channel or program during the reporting period, then there are ten (10) Transmissions.

(c) Direct, “All-In” Royalties: All royalties hereunder will be payable directly to Label and not to a "Collective" (as described in section 370.1(h) of Title 37, Code of Federal Regulations). Such royalties will be inclusive of, and Label will be responsible for paying, all amounts payable to all third parties in connection with the use of the Recordings in the Service as provided herein, including but not limited to: (i) any artist(s); (ii) any producer(s); (iii) any sample owner(s); and (iv) any union(s) (including but not limited to AFM and AFTRA). (For clarity, royalties payable to Label hereunder include, without limitation, both the so-called “copyright owner’s share(s)” and the so-called “performer’s share(s)” of royalties). Licensee will be responsible for obtaining any required licenses from the owners of the musical compositions embodied in the Recordings in connection with their use in the Service and making all payments in connection therewith.

3. Accounting:

(a) Quarterly Accountings: Commencing with the first calendar quarter accounting period, Licensee will calculate and pay any royalties due hereunder to Label quarterly, within forty-five (45) days after the end of each calendar quarter during the Term and provide accounting statements in connection therewith. All royalty payments will be in U.S. Dollars payable to Label and sent to the Label’s address as set forth above. If Label's pro rata share of royalties for a quarter is subsequently determined by Licensee to be less than the amount paid to Label for that quarter, then such payment will be deemed to be an overpayment. Label will reimburse Licensee on demand for any such overpayment. In the alternative, Licensee may deduct the amount of the overpayment from future amounts payable to Label under this or any other agreement. If Label's pro rata share of royalties for a quarter is subsequently determined by Licensee to be more than the amount paid to Label for that quarter, then such payment will be deemed to be an underpayment, and Licensee will pay the underpayment to Label during the accounting period after the accounting period in which the underpayment is determined by Licensee.
(b) **Audits**: Licensee will maintain books and records concerning the use of Label's Catalog in connection with the Service. Label will have the right, upon ninety (90) days notice to Licensee, to designate an independent certified public accountant on Label's behalf, who will not be retained on a contingency basis, to examine those books and records, at its sole cost and expense, solely for the purpose of verifying the accuracy of royalty accountings hereunder, only once per accounting statement, only once per year, and solely during Licensee’s normal business hours. Prior to commencing any such examination, Licensee, Label, and Label’s auditor will enter into a confidentiality agreement to protect the confidential information of Licensee which will be exposed during the course of the examination.

(c) **Audit Restrictions**: Each accounting statement hereunder will be binding and not subject to any objection unless Label notifies Licensee of that objection within two (2) years after the date such statement is required to be rendered hereunder (and each accounting statement will be deemed rendered on time unless Label notifies Licensee to the contrary not later than sixty (60) days after the date on which such statement is required to be rendered). Label may not commence legal action against Licensee in respect of any accounting (or failure to account) unless Label commences such legal action in accordance with Section 7(c) within two (2) years after the date the applicable accounting is required to be rendered, and the scope of any such legal action will be limited to a determination of the amount of royalties, if any, payable to Label for such accounting concerned. Label's sole and exclusive remedy in connection therewith will be the recovery of the royalties Label is adjudged to be owed hereunder, if any.

4. **Term And Territory**:

(a) **Term**: This Agreement will commence as of the date first written above and will continue for a period of three (3) years (the “Initial Period”), after which it will renew automatically for successive periods of one (1) year, each a “Renewal Period,” unless terminated by either Party as provided herein. The Initial Period, together with all Renewal Periods, if any, will constitute the “Term.” Either Party may terminate this Agreement, effective as of the end of the Initial Period or any Renewal Period, by notice to the other not less than ninety (90) days prior to the conclusion of the then-current period of the Agreement.

(b) **Territory**: The “Territory” of this Agreement will mean the United States, its territories, possessions, commonwealths and military bases.

5. **Representations and Warranties/Indemnity**:

(a) **Mutual Ability**: Each Party represents and warrants to the other that: (i) it has full right, power and authority to enter into this Agreement and to perform its obligations hereunder; (ii) this Agreement and its performance will not constitute a breach or default under any agreement to which such Party or its assets are bound; and
(iii) no consent from any party is required for the execution or performance of this Agreement.

(b) **Non-Infringement:** Label represents and warrants that the use of Label's Catalog in the Services as provided herein will not infringe the rights, including but not limited to intellectual property rights or contractual rights, of any third party.

(c) **Indemnity:** Each Party hereto will indemnify and hold the other Party harmless from any third party claim, cost, or expense (including, without limitation, legal costs and attorneys' fees) arising out of a breach by the other Party of such Party's representations or warranties hereunder.

(d) **Availability/Catalog File:**

(i) Label represents and warrants that the entirety of Label’s Catalog will be available for use by Licensee as provided herein during the Term.

(ii) Label will promptly deliver to Licensee (or Licensee’s agent) an MS Excel spreadsheet including, without limitation, complete metadata for Label’s Catalog (a “Label Metadata Spreadsheet”), inclusive of the following fields: title; artist; album; ISRC; UPC; duration; Distributing Label; Sub-Label; Label Catalog Number; and Initial Release Date. Label represents and warrants that it will similarly deliver updated Label Metadata Spreadsheets to Licensee promptly, but in no event later than once per month, during the Term.

(iii) Licensee will identify the Recording(s) in textual data by reference to the title of the Recording(s) and the featured recording artist, in a manner to permit it to be displayed to subscribers.

6. **Confidentiality:**

(a) Both Licensee and Label may disclose the existence of this Agreement, the identity of any and all Recordings subject to this Agreement, the scope of rights granted and the term and territory of the grant of rights.

(b) All other terms of this Agreement and information required to be disclosed pursuant to this Agreement will be considered confidential and may not be disclosed to third parties without the written consent of the other Party, provided, however, that:

(i) either Party may disclose such other terms of this Agreement to its employees, officers, directors, owners, agents, consultants, representatives, attorneys and auditors, in their capacity as such, on a need-to-know basis and subject to the confidentiality obligations set forth herein; and

(ii) either Party may disclose such other terms of this Agreement to third parties in the context of legal proceedings, government investigations, or compliance
with federal or state securities laws or regulations (provided reasonable prior notice of such disclosure, if permitted by law, is given to the other Party and, in each case, the disclosing Party takes all reasonable steps to prevent impermissible further disclosure by recipients authorized hereunder).

7. **Miscellaneous:**

   (a) **Definitions:** (i) “Affiliates” will mean, with respect to any specified person or entity, any other person or entity that now or in the future, directly or indirectly, through one or more intermediaries, owns or controls, is owned or controlled by, or is under common ownership or control with, such specified person or entity. As used in this definition, the term “control” of a person or entity means the ownership of at least fifty percent (50%) of the voting equity of that person or entity or possessing the power to direct or cause the direction of the management of that person or entity. (ii) “Business Day” will mean any day other than: (A) a Saturday or Sunday; and (B) a day in which the banks in New York City are authorized or required to close.

   (b) **Addresses and Notices:** All notices hereunder must be in writing and sent by certified mail, return receipt requested, to the address of the Party set forth above, in order to be effective. Notices so sent will be deemed to be effective when mailed (except for notice of change of address, which will be effective upon receipt).

   (c) **New York Law & Venue:** This Agreement will be governed by and construed in accordance with the laws of the State of New York, and the New York courts, state and federal (located in the borough of Manhattan), will have exclusive jurisdiction and venue over any disputes arising out of this Agreement.

   (d) **Notice Of Breach:** Neither Party will be deemed to be in breach of this Agreement unless the non-breaching party has notified the breaching Party of the breach with specificity, and the breaching Party has failed to cure the breach concerned within thirty (30) days.

   (e) **Merger/No Oral Amendments:** This Agreement sets forth the entire understanding between the parties with respect to the subject matter hereof, and all prior and contemporaneous agreements are merged herein. No modification of this Agreement, or waiver of any right hereunder, will be binding on either Party unless memorialized in a writing signed by the Party to be charged with such amendment or waiver.

   (f) **Counterparts:** This Agreement may be executed in counterparts, all of which, when taken together, will constitute one and the same document. Facsimile or scanned signatures hereto will be deemed original for all purposes.

   (g) **Assignment:** This Agreement may not be assigned in whole or in part by either Party without the prior written consent of the other Party. This Agreement will be binding upon the Parties and their permitted successors and assigns and will be binding
on all Affiliates of Label (including, without limitation, when they cease to remain an Affiliate of Label).

(h) **LIMITATION OF LIABILITY.** IN NO EVENT WILL ANY PARTY BE LIABLE TO THE OTHER PARTY HERUNDER FOR ANY AMOUNTS REPRESENTING ITS RESPECTIVE LOSS OF PROFITS, LOSS OF BUSINESS, INDIRECT, SPECIAL, INCIDENTAL, EXEMPLARY, CONSEQUENTIAL, OR PUNITIVE DAMAGES (EVEN IF PREVIOUSLY APPRISED OF THE POSSIBILITY THEREOF) IN CONNECTION WITH OR ARISING FROM THIS AGREEMENT OR RELATED ACTS OR OMISSIONS. NO PARTY MAKES ANY REPRESENTATIONS OR WARRANTIES WITH RESPECT TO THE SUBJECT MATTER HEREOF EXCEPT AS EXPRESSLY SET FORTH IN THIS AGREEMENT.

(i) **Severability.** If any term of this Agreement is invalid, illegal or incapable of being enforced by any rule of law or public policy, all other terms of this Agreement will nevertheless remain in full force and effect.

**ACCEPTED AND AGREED:**

DEAD OCEANS

By: ______________________________
Name (printed): ______________________
Title: ______________________________

SIRIUS XM RADIO INC.

By: ______________________________
Name (printed): ______________________
Title: ______________________________
EXHIBIT A
SERVICE ACCESS RULES

1. The Service may be accessed in any of the following ways:

   (a) Through devices and applications which are authorized by Licensee (“Authorized Devices/Applications”) which enable such subscribers to record a discrete number of individual sound recordings while listening to Service channels and retain such recordings only for so long as the user remains a subscriber;

   (b) Through Authorized Devices/Applications which automatically record a discrete number of individual sound recordings from the Service (based on subscriber preferences) and present the recordings to the subscriber, on a non-interactive basis, as a customized “channel”;

   (c) Through Authorized Devices/Applications which record subscriber-designated blocks of Service programming for later playback by the subscriber;

   (d) Through Authorized Devices/Applications which enable subscribers to select and listen to blocks of pre-recorded Service programming;

   (e) Through Authorized Devices/Applications where the Service programming concerned has been “cached” (i.e., copied locally) for access when Authorized Devices are not connected to the Service; and

   (f) Through Authorized Devices/Applications which enable one to fast-forward; skip; rewind; pause; and/or resume Service programming.

2. Notwithstanding the foregoing, Licensee will not:

   (a) Take affirmative steps to enable Service subscribers to transfer Recordings to media other than Authorized Devices/Applications; or

   (b) Take affirmative steps to enable Service subscribers to access Recordings after their subscriptions have expired or been terminated for any reason (provided that if a subscriber subsequently restores its subscription, then access to such Recordings may be re-instated).

3. For the avoidance of doubt, this Exhibit A is intended solely to illustrate the rights granted in this voluntary Agreement; it is not intended to describe the rights or limitations of the Section 112 and 114 statutory licenses, or to indicate what service offerings/features are allowed, required, or prevented or otherwise encompassed under the statutory licenses.
This agreement (the “Agreement”) is entered into as of September 15, 2011 by and between SIRIUS XM RADIO INC., 1221 Avenue of the Americas, New York, New York, 10020 (collectively along with its Affiliates, “Licensee”) and JAGJAGUWAR, 1499 W. Second Street, Bloomington, IN 47403 (collectively along with its Affiliates, “Label”) (each referred to as a “Party”).

WHEREAS, Label owns and/or controls certain sound recordings during the Term hereof (collectively, “Label’s Catalog”); and

WHEREAS, Licensee operates a digital audio radio service consisting of a wide variety of music and non-music (e.g., news, weather, sports and talk) programming (the “Service(s)”) in the Territory; and

WHEREAS, Licensee desires to obtain from Label a blanket license covering Label’s Catalog for the rights set forth herein, and Label is willing to grant such rights to Licensee;

NOW THEREFORE, the Parties hereto agree as follows:

1. Grant of Rights:

   (a) Service Programming: Label hereby grants to Licensee, solely in the Territory and solely during the Term, the right, through to the listener, to edit, reproduce, distribute, and publicly perform by means of digital audio transmission some or all of the sound recordings in Label's Catalog (the “Recording(s)”) solely in connection with the Service (including, without limitation, as made available to subscribers via satellite radio, the Internet, multi-channel video programming distributors, and commercial business establishment services). The grant of rights will further extend to the public performance, reproduction, and distribution of Label's Catalog on or through devices that have the functional capability set forth on Exhibit A in connection with the Service. Label will be free to grant licenses to others.

   (b) The Service operates pursuant to the statutory license at 17 U.S.C. §114(f) and 17 U.S.C. §112(e) (collectively, the “Statutory Licenses”). Label acknowledges, however, that this Agreement is a voluntary license, and Service may from time-to-time introduce product and programming features (artist-specific channels, for example) that extend beyond the Statutory Licenses. Label agrees that such features will be licensed hereunder, and that restrictions which apply under the Statutory Licenses will not apply in relation to Label’s Catalog, including but not limited to: (i) the so-called “sound recording performance complement”; (ii) the publication of advance playlists; and (iii) the six-month limit on retention of ephemeral recordings.
2. **Royalties:**

   (a) **Service Royalty Pool:** For each calendar quarter of the Term, Label’s pro-rata share of royalties for the license granted hereunder to Licensee will be determined by multiplying the “Service Royalty Pool” for that quarter by a fraction, the numerator of which is the total number of “Transmissions” of identified Recordings from Label’s Catalog in that quarter, and the denominator of which is the total number of “Transmissions” of all sound recordings performed on the Service in that quarter.

   (i) As used herein: the “Service Royalty Pool” will mean seven percent (7%) of revenue recognized by the Licensee in accordance with U.S. GAAP from:

   (A) Subscription revenue recognized by Licensee directly from subscribers in the Territory for the Service; and

   (B) Advertising revenues, or other monies received from sponsors, if any, attributable to advertising on channels other than those that use only incidental performances of sound recordings, less advertising agency and sales commissions.

   (ii) The Service Royalty Pool will exclude:

   (A) Monies or other consideration attributable to the sale and/or license of equipment and/or other technology, including but not limited to bandwidth, sales of devices that receive the Service and any taxes, shipping and handling fees therefor;

   (B) Royalties paid to Licensee for intellectual property rights;

   (C) Monies or other consideration received by Licensee from the sale of phonorecords and digital phonorecord deliveries;

   (D) Sales and use taxes, shipping and handling, credit card, invoice, and fulfillment service fees;

   (E) Bad debt expense; and

   (F) Revenues earned by Licensee for the provision of: (1) current and future data services (e.g., weather, traffic, destination information, messaging, sports scores, stock ticker information, extended program associated data, video and photographic images, and such other telematics and/or data services as may exist from time to time); (2) channels, programming, products and/or other services offered for a separate charge where such channels offer only incidental or occasional performances of sound recordings; (3) channels, programming, products and/or other services provided outside of the Territory; and (4) performances of sound recordings (and/or ephemeral recordings) that are exempt from any license requirement.
(iii) As used herein, a “Transmission” will mean each instance in which any portion of thirty seconds or more of a sound recording is publicly performed by digital audio transmission on the Sirius XM satellite radio service, but excluding performances of less than 30 seconds and performances that make no more than incidental use of sound recordings (including, without limitation, brief musical transitions in and out of commercials or program segments, brief performances during news, talk and sports programming, brief background performances during disk jockey announcements, brief performances during commercials of sixty seconds or less in duration, or brief performances during sporting or other public events).

(b) Methodology for Transmission Counts: Transmissions will be counted without respect to the number of subscribers receiving the performance of the sound recording. For example, without limitation, if a particular sound recording is transmitted on a particular channel or program only once during the reporting period, then there is one Transmission, and if the sound recording is transmitted ten (10) times on a particular channel or program during the reporting period, then there are ten (10) Transmissions.

(c) Direct, “All-In” Royalties: All royalties hereunder will be payable directly to Label and not to a "Collective" (as described in section 370.1(h) of Title 37, Code of Federal Regulations). Such royalties will be inclusive of, and Label will be responsible for paying, all amounts payable to all third parties in connection with the use of the Recordings in the Service as provided herein, including but not limited to: (i) any artist(s); (ii) any producer(s); (iii) any sample owner(s); and (iv) any union(s) (including but not limited to AFM and AFTRA). (For clarity, royalties payable to Label hereunder include, without limitation, both the so-called “copyright owner’s share(s)” and the so-called “performer’s share(s)” of royalties). Licensee will be responsible for obtaining any required licenses from the owners of the musical compositions embodied in the Recordings in connection with their use in the Service and making all payments in connection therewith.

3. Accounting:

(a) Quarterly Accountings: Commencing with the first calendar quarter accounting period, Licensee will calculate and pay any royalties due hereunder to Label quarterly, within forty-five (45) days after the end of each calendar quarter during the Term and provide accounting statements in connection therewith. All royalty payments will be in U.S. Dollars payable to Label and sent to the Label’s address as set forth above. If Label's pro rata share of royalties for a quarter is subsequently determined by Licensee to be less than the amount paid to Label for that quarter, then such payment will be deemed to be an overpayment. Label will reimburse Licensee on demand for any such overpayment. In the alternative, Licensee may deduct the amount of the overpayment from future amounts payable to Label under this or any other agreement. If Label's pro rata share of royalties for a quarter is subsequently determined by Licensee to be more than the amount paid to Label for that quarter, then such payment will be deemed to be an underpayment, and Licensee will pay the underpayment to Label during the accounting period after the accounting period in which the underpayment is determined by Licensee.
(b) **Audits**: Licensee will maintain books and records concerning the use of Label's Catalog in connection with the Service. Label will have the right, upon ninety (90) days notice to Licensee, to designate an independent certified public accountant on Label’s behalf, who will not be retained on a contingency basis, to examine those books and records, at its sole cost and expense, solely for the purpose of verifying the accuracy of royalty accountings hereunder, only once per accounting statement, only once per year, and solely during Licensee’s normal business hours. Prior to commencing any such examination, Licensee, Label, and Label’s auditor will enter into a confidentiality agreement to protect the confidential information of Licensee which will be exposed during the course of the examination.

(c) **Audit Restrictions**: Each accounting statement hereunder will be binding and not subject to any objection unless Label notifies Licensee of that objection within two (2) years after the date such statement is required to be rendered hereunder (and each accounting statement will be deemed rendered on time unless Label notifies Licensee to the contrary not later than sixty (60) days after the date on which such statement is required to be rendered). Label may not commence legal action against Licensee in respect of any accounting (or failure to account) unless Label commences such legal action in accordance with Section 7(c) within two (2) years after the date the applicable accounting is required to be rendered, and the scope of any such legal action will be limited to a determination of the amount of royalties, if any, payable to Label for such accounting concerned. Label’s sole and exclusive remedy in connection therewith will be the recovery of the royalties Label is adjudged to be owed hereunder, if any.

4. **Term And Territory**:

(a) **Term**: This Agreement will commence as of the date first written above and will continue for a period of three (3) years (the “Initial Period”), after which it will renew automatically for successive periods of one (1) year, each a “Renewal Period,” unless terminated by either Party as provided herein. The Initial Period, together with all Renewal Periods, if any, will constitute the “Term.” Either Party may terminate this Agreement, effective as of the end of the Initial Period or any Renewal Period, by notice to the other not less than ninety (90) days prior to the conclusion of the then-current period of the Agreement.

(b) **Territory**: The “Territory” of this Agreement will mean the United States, its territories, possessions, commonwealths and military bases.

5. **Representations and Warranties/Indemnity**:

(a) **Mutual Ability**: Each Party represents and warrants to the other that: (i) it has full right, power and authority to enter into this Agreement and to perform its obligations hereunder; (ii) this Agreement and its performance will not constitute a breach or default under any agreement to which such Party or its assets are bound; and
(iii) no consent from any party is required for the execution or performance of this Agreement.

(b) **Non-Infringement**: Label represents and warrants that the use of Label's Catalog in the Services as provided herein will not infringe the rights, including but not limited to intellectual property rights or contractual rights, of any third party.

(c) **Indemnity**: Each Party hereto will indemnify and hold the other Party harmless from any third party claim, cost, or expense (including, without limitation, legal costs and attorneys' fees) arising out of a breach by the other Party of such Party's representations or warranties hereunder.

(d) **Availability/Catalog File**:

(i) Label represents and warrants that the entirety of Label’s Catalog will be available for use by Licensee as provided herein during the Term.

(ii) Label will promptly deliver to Licensee (or Licensee’s agent) an MS Excel spreadsheet including, without limitation, complete metadata for Label’s Catalog (a “Label Metadata Spreadsheet”), inclusive of the following fields: title; artist; album; ISRC; UPC; duration; Distributing Label; Sub-Label; Label Catalog Number; and Initial Release Date. Label represents and warrants that it will similarly deliver updated Label Metadata Spreadsheets to Licensee promptly, but in no event later than once per month, during the Term.

(iii) Licensee will identify the Recording(s) in textual data by reference to the title of the Recording(s) and the featured recording artist, in a manner to permit it to be displayed to subscribers.

6. **Confidentiality**:

(a) Both Licensee and Label may disclose the existence of this Agreement, the identity of any and all Recordings subject to this Agreement, the scope of rights granted and the term and territory of the grant of rights.

(b) All other terms of this Agreement and information required to be disclosed pursuant to this Agreement will be considered confidential and may not be disclosed to third parties without the written consent of the other Party, provided, however, that:

(i) either Party may disclose such other terms of this Agreement to its employees, officers, directors, owners, agents, consultants, representatives, attorneys and auditors, in their capacity as such, on a need-to-know basis and subject to the confidentiality obligations set forth herein; and

(ii) either Party may disclose such other terms of this Agreement to third parties in the context of legal proceedings, government investigations, or compliance
with federal or state securities laws or regulations (provided reasonable prior notice of such disclosure, if permitted by law, is given to the other Party and, in each case, the disclosing Party takes all reasonable steps to prevent impermissible further disclosure by recipients authorized hereunder).

7. Miscellaneous:

(a) Definitions: (i) “Affiliates” will mean, with respect to any specified person or entity, any other person or entity that now or in the future, directly or indirectly, through one or more intermediaries, owns or controls, is owned or controlled by, or is under common ownership or control with, such specified person or entity. As used in this definition, the term “control” of a person or entity means the ownership of at least fifty percent (50%) of the voting equity of that person or entity or possessing the power to direct or cause the direction of the management of that person or entity. (ii) “Business Day” will mean any day other than: (A) a Saturday or Sunday; and (B) a day in which the banks in New York City are authorized or required to close.

(b) Addresses and Notices: All notices hereunder must be in writing and sent by certified mail, return receipt requested, to the address of the Party set forth above, in order to be effective. Notices so sent will be deemed to be effective when mailed (except for notice of change of address, which will be effective upon receipt).

(c) New York Law & Venue: This Agreement will be governed by and construed in accordance with the laws of the State of New York, and the New York courts, state and federal (located in the borough of Manhattan), will have exclusive jurisdiction and venue over any disputes arising out of this Agreement.

(d) Notice Of Breach: Neither Party will be deemed to be in breach of this Agreement unless the non-breaching party has notified the breaching Party of the breach with specificity, and the breaching Party has failed to cure the breach concerned within thirty (30) days.

(e) Merger/No Oral Amendments: This Agreement sets forth the entire understanding between the parties with respect to the subject matter hereof, and all prior and contemporaneous agreements are merged herein. No modification of this Agreement, or waiver of any right hereunder, will be binding on either Party unless memorialized in a writing signed by the Party to be charged with such amendment or waiver.

(f) Counterparts: This Agreement may be executed in counterparts, all of which, when taken together, will constitute one and the same document. Facsimile or scanned signatures hereto will be deemed original for all purposes.

(g) Assignment: This Agreement may not be assigned in whole or in part by either Party without the prior written consent of the other Party. This Agreement will be binding upon the Parties and their permitted successors and assigns and will be binding
on all Affiliates of Label (including, without limitation, when they cease to remain an Affiliate of Label).

(h) **LIMITATION OF LIABILITY.** IN NO EVENT WILL ANY PARTY BE LIABLE TO THE OTHER PARTY HEREUNDER FOR ANY AMOUNTS REPRESENTING ITS RESPECTIVE LOSS OF PROFITS, LOSS OF BUSINESS, INDIRECT, SPECIAL, INCIDENTAL, EXEMPLARY, CONSEQUENTIAL, OR PUNITIVE DAMAGES (EVEN IF PREVIOUSLY APPRISED OF THE POSSIBILITY THEREOF) IN CONNECTION WITH OR ARISING FROM THIS AGREEMENT OR RELATED ACTS OR OMISSIONS. NO PARTY MAKES ANY REPRESENTATIONS OR WARRANTIES WITH RESPECT TO THE SUBJECT MATTER HEREOF EXCEPT AS EXPRESSLY SET FORTH IN THIS AGREEMENT.

(i) **Severability.** If any term of this Agreement is invalid, illegal or incapable of being enforced by any rule of law or public policy, all other terms of this Agreement will nevertheless remain in full force and effect.

**ACCEPTED AND AGREED:**

**JAGJAGUWAR**

By: ______________________________

Name (printed): ______________________

Title: ______________________________

**SIRIUS XM RADIO INC.**

By: ______________________________

Name (printed): ______________________

Title: ______________________________
EXHIBIT A
SERVICE ACCESS RULES

1. The Service may be accessed in any of the following ways:

   (a) Through devices and applications which are authorized by Licensee ("Authorized Devices/Applications") which enable such subscribers to record a discrete number of individual sound recordings while listening to Service channels and retain such recordings only for so long as the user remains a subscriber;

   (b) Through Authorized Devices/Applications which automatically record a discrete number of individual sound recordings from the Service (based on subscriber preferences) and present the recordings to the subscriber, on a non-interactive basis, as a customized "channel";

   (c) Through Authorized Devices/Applications which record subscriber-designated blocks of Service programming for later playback by the subscriber;

   (d) Through Authorized Devices/Applications which enable subscribers to select and listen to blocks of pre-recorded Service programming;

   (e) Through Authorized Devices/Applications where the Service programming concerned has been "cached" (i.e., copied locally) for access when Authorized Devices are not connected to the Service; and

   (f) Through Authorized Devices/Applications which enable one to fast-forward; skip; rewind; pause; and/or resume Service programming.

2. Notwithstanding the foregoing, Licensee will not:

   (a) Take affirmative steps to enable Service subscribers to transfer Recordings to media other than Authorized Devices/Applications; or

   (b) Take affirmative steps to enable Service subscribers to access Recordings after their subscriptions have expired or been terminated for any reason (provided that if a subscriber subsequently restores its subscription, then access to such Recordings may be re-instated).

3. For the avoidance of doubt, this Exhibit A is intended solely to illustrate the rights granted in this voluntary Agreement; it is not intended to describe the rights or limitations of the Section 112 and 114 statutory licenses, or to indicate what service offerings/features are allowed, required, or prevented or otherwise encompassed under the statutory licenses.
SOUND RECORDING CATALOG LICENSE

This agreement (the “Agreement”) is entered into as of September 15, 2011 by and between SIRIUS XM RADIO INC., 1221 Avenue of the Americas, New York, New York, 10020 (collectively along with its Affiliates, “Licensee”) and SECRETLY CANADIAN RECORDS, 1499 W. Second Street, Bloomington, IN 47403 (collectively along with its Affiliates, “Label”) (each referred to as a “Party”).

WHEREAS, Label owns and/or controls certain sound recordings during the Term hereof (collectively, “Label’s Catalog”); and

WHEREAS, Licensee operates a digital audio radio service consisting of a wide variety of music and non-music (e.g., news, weather, sports and talk) programming (the “Service(s)”) in the Territory; and

WHEREAS, Licensee desires to obtain from Label a blanket license covering Label’s Catalog for the rights set forth herein, and Label is willing to grant such rights to Licensee;

NOW THEREFORE, the Parties hereto agree as follows:

1. Grant of Rights:

   (a) Service Programming: Label hereby grants to Licensee, solely in the Territory and solely during the Term, the right, through to the listener, to edit, reproduce, distribute, and publicly perform by means of digital audio transmission some or all of the sound recordings in Label's Catalog (the “Recording(s)”) solely in connection with the Service (including, without limitation, as made available to subscribers via satellite radio, the Internet, multi-channel video programming distributors, and commercial business establishment services). The grant of rights will further extend to the public performance, reproduction, and distribution of Label's Catalog on or through devices that have the functional capability set forth on Exhibit A in connection with the Service. Label will be free to grant licenses to others.

   (b) The Service operates pursuant to the statutory license at 17 U.S.C. §114(f) and 17 U.S.C. §112(e) (collectively, the “Statutory Licenses”). Label acknowledges, however, that this Agreement is a voluntary license, and Service may from time-to-time introduce product and programming features (artist-specific channels, for example) that extend beyond the Statutory Licenses. Label agrees that such features will be licensed hereunder, and that restrictions which apply under the Statutory Licenses will not apply in relation to Label’s Catalog, including but not limited to: (i) the so-called “sound recording performance complement”; (ii) the publication of advance playlists; and (iii) the six-month limit on retention of ephemeral recordings.
2. **Royalties:**

   (a) **Service Royalty Pool:** For each calendar quarter of the Term, Label’s pro-rata share of royalties for the license granted hereunder to Licensee will be determined by multiplying the “Service Royalty Pool” for that quarter by a fraction, the numerator of which is the total number of “Transmissions” of identified Recordings from Label’s Catalog in that quarter, and the denominator of which is the total number of “Transmissions” of all sound recordings performed on the Service in that quarter.

   (i) As used herein: the “Service Royalty Pool” will mean seven percent (7%) of revenue recognized by the Licensee in accordance with U.S. GAAP from:

      (A) Subscription revenue recognized by Licensee directly from subscribers in the Territory for the Service; and

      (B) Advertising revenues, or other monies received from sponsors, if any, attributable to advertising on channels other than those that use only incidental performances of sound recordings, less advertising agency and sales commissions.

   (ii) The Service Royalty Pool will exclude:

      (A) Monies or other consideration attributable to the sale and/or license of equipment and/or other technology, including but not limited to bandwidth, sales of devices that receive the Service and any taxes, shipping and handling fees therefor;

      (B) Royalties paid to Licensee for intellectual property rights;

      (C) Monies or other consideration received by Licensee from the sale of phonorecords and digital phonorecord deliveries;

      (D) Sales and use taxes, shipping and handling, credit card, invoice, and fulfillment service fees;

      (E) Bad debt expense; and

      (F) Revenues earned by Licensee for the provision of: (1) current and future data services (e.g., weather, traffic, destination information, messaging, sports scores, stock ticker information, extended program associated data, video and photographic images, and such other telematics and/or data services as may exist from time to time); (2) channels, programming, products and/or other services offered for a separate charge where such channels offer only incidental or occasional performances of sound recordings; (3) channels, programming, products and/or other services provided outside of the Territory; and (4) performances of sound recordings (and/or ephemeral recordings) that are exempt from any license requirement.
(iii) As used herein, a “Transmission” will mean each instance in which any portion of thirty seconds or more of a sound recording is publicly performed by digital audio transmission on the Sirius XM satellite radio service, but excluding performances of less than 30 seconds and performances that make no more than incidental use of sound recordings (including, without limitation, brief musical transitions in and out of commercials or program segments, brief performances during news, talk and sports programming, brief background performances during disk jockey announcements, brief performances during commercials of sixty seconds or less in duration, or brief performances during sporting or other public events).

(b) **Methodology for Transmission Counts:** Transmissions will be counted without respect to the number of subscribers receiving the performance of the sound recording. For example, without limitation, if a particular sound recording is transmitted on a particular channel or program only once during the reporting period, then there is one Transmission, and if the sound recording is transmitted ten (10) times on a particular channel or program during the reporting period, then there are ten (10) Transmissions.

(c) **Direct, “All-In” Royalties:** All royalties hereunder will be payable directly to Label and not to a "Collective" (as described in section 370.1(h) of Title 37, Code of Federal Regulations). Such royalties will be inclusive of, and Label will be responsible for paying, all amounts payable to all third parties in connection with the use of the Recordings in the Service as provided herein, including but not limited to: (i) any artist(s); (ii) any producer(s); (iii) any sample owner(s); and (iv) any union(s) (including but not limited to AFM and AFTRA). (For clarity, royalties payable to Label hereunder include, without limitation, both the so-called “copyright owner’s share(s)” and the so-called “performer’s share(s)” of royalties). Licensee will be responsible for obtaining any required licenses from the owners of the musical compositions embodied in the Recordings in connection with their use in the Service and making all payments in connection therewith.

3. **Accounting:**

(a) **Quarterly Accountings:** Commencing with the first calendar quarter accounting period, Licensee will calculate and pay any royalties due hereunder to Label quarterly, within forty-five (45) days after the end of each calendar quarter during the Term and provide accounting statements in connection therewith. All royalty payments will be in U.S. Dollars payable to Label and sent to the Label’s address as set forth above. If Label's pro rata share of royalties for a quarter is subsequently determined by Licensee to be less than the amount paid to Label for that quarter, then such payment will be deemed to be an overpayment. Label will reimburse Licensee on demand for any such overpayment. In the alternative, Licensee may deduct the amount of the overpayment from future amounts payable to Label under this or any other agreement. If Label's pro rata share of royalties for a quarter is subsequently determined by Licensee to be more than the amount paid to Label for that quarter, then such payment will be deemed to be an underpayment, and Licensee will pay the underpayment to Label during the accounting period after the accounting period in which the underpayment is determined by Licensee.
(b) **Audits:** Licensee will maintain books and records concerning the use of Label’s Catalog in connection with the Service. Label will have the right, upon ninety (90) days notice to Licensee, to designate an independent certified public accountant on Label’s behalf, who will not be retained on a contingency basis, to examine those books and records, at its sole cost and expense, solely for the purpose of verifying the accuracy of royalty accountings hereunder, only once per accounting statement, only once per year, and solely during Licensee’s normal business hours. Prior to commencing any such examination, Licensee, Label, and Label’s auditor will enter into a confidentiality agreement to protect the confidential information of Licensee which will be exposed during the course of the examination.

(c) **Audit Restrictions:** Each accounting statement hereunder will be binding and not subject to any objection unless Label notifies Licensee of that objection within two (2) years after the date such statement is required to be rendered hereunder (and each accounting statement will be deemed rendered on time unless Label notifies Licensee to the contrary not later than sixty (60) days after the date on which such statement is required to be rendered). Label may not commence legal action against Licensee in respect of any accounting (or failure to account) unless Label commences such legal action in accordance with Section 7(c) within two (2) years after the date the applicable accounting is required to be rendered, and the scope of any such legal action will be limited to a determination of the amount of royalties, if any, payable to Label for such accounting concerned. Label’s sole and exclusive remedy in connection therewith will be the recovery of the royalties Label is adjudged to be owed hereunder, if any.

4. **Term And Territory:**

   (a) **Term:** This Agreement will commence as of the date first written above and will continue for a period of three (3) years (the “Initial Period”), after which it will renew automatically for successive periods of one (1) year, each a “Renewal Period,” unless terminated by either Party as provided herein. The Initial Period, together with all Renewal Periods, if any, will constitute the “Term.” Either Party may terminate this Agreement, effective as of the end of the Initial Period or any Renewal Period, by notice to the other not less than ninety (90) days prior to the conclusion of the then-current period of the Agreement.

   (b) **Territory:** The “Territory” of this Agreement will mean the United States, its territories, possessions, commonwealths and military bases.

5. **Representations and Warranties/Indemnity:**

   (a) **Mutual Ability:** Each Party represents and warrants to the other that: (i) it has full right, power and authority to enter into this Agreement and to perform its obligations hereunder; (ii) this Agreement and its performance will not constitute a breach or default under any agreement to which such Party or its assets are bound; and
(iii) no consent from any party is required for the execution or performance of this Agreement.

(b) **Non-Infringement:** Label represents and warrants that the use of Label's Catalog in the Services as provided herein will not infringe the rights, including but not limited to intellectual property rights or contractual rights, of any third party.

(c) **Indemnity:** Each Party hereto will indemnify and hold the other Party harmless from any third party claim, cost, or expense (including, without limitation, legal costs and attorneys' fees) arising out of a breach by the other Party of such Party's representations or warranties hereunder.

(d) **Availability/Catalog File:**

(i) Label represents and warrants that the entirety of Label’s Catalog will be available for use by Licensee as provided herein during the Term.

(ii) Label will promptly deliver to Licensee (or Licensee’s agent) an MS Excel spreadsheet including, without limitation, complete metadata for Label’s Catalog (a “Label Metadata Spreadsheet”), inclusive of the following fields: title; artist; album; ISRC; UPC; duration; Distributing Label; Sub-Label; Label Catalog Number; and Initial Release Date. Label represents and warrants that it will similarly deliver updated Label Metadata Spreadsheets to Licensee promptly, but in no event later than once per month, during the Term.

(iii) Licensee will identify the Recording(s) in textual data by reference to the title of the Recording(s) and the featured recording artist, in a manner to permit it to be displayed to subscribers.

6. **Confidentiality:**

(a) Both Licensee and Label may disclose the existence of this Agreement, the identity of any and all Recordings subject to this Agreement, the scope of rights granted and the term and territory of the grant of rights.

(b) All other terms of this Agreement and information required to be disclosed pursuant to this Agreement will be considered confidential and may not be disclosed to third parties without the written consent of the other Party, provided, however, that:

(i) either Party may disclose such other terms of this Agreement to its employees, officers, directors, owners, agents, consultants, representatives, attorneys and auditors, in their capacity as such, on a need-to-know basis and subject to the confidentiality obligations set forth herein; and

(ii) either Party may disclose such other terms of this Agreement to third parties in the context of legal proceedings, government investigations, or compliance
with federal or state securities laws or regulations (provided reasonable prior notice of such disclosure, if permitted by law, is given to the other Party and, in each case, the disclosing Party takes all reasonable steps to prevent impermissible further disclosure by recipients authorized hereunder).

7. **Miscellaneous:**

   (a) **Definitions:** (i) “Affiliates” will mean, with respect to any specified person or entity, any other person or entity that now or in the future, directly or indirectly, through one or more intermediaries, owns or controls, is owned or controlled by, or is under common ownership or control with, such specified person or entity. As used in this definition, the term “control” of a person or entity means the ownership of at least fifty percent (50%) of the voting equity of that person or entity or possessing the power to direct or cause the direction of the management of that person or entity. (ii) “Business Day” will mean any day other than: (A) a Saturday or Sunday; and (B) a day in which the banks in New York City are authorized or required to close.

   (b) **Addresses and Notices:** All notices hereunder must be in writing and sent by certified mail, return receipt requested, to the address of the Party set forth above, in order to be effective. Notices so sent will be deemed to be effective when mailed (except for notice of change of address, which will be effective upon receipt).

   (c) **New York Law & Venue:** This Agreement will be governed by and construed in accordance with the laws of the State of New York, and the New York courts, state and federal (located in the borough of Manhattan), will have exclusive jurisdiction and venue over any disputes arising out of this Agreement.

   (d) **Notice Of Breach:** Neither Party will be deemed to be in breach of this Agreement unless the non-breaching party has notified the breaching Party of the breach with specificity, and the breaching Party has failed to cure the breach concerned within thirty (30) days.

   (e) **Merger/No Oral Amendments:** This Agreement sets forth the entire understanding between the parties with respect to the subject matter hereof, and all prior and contemporaneous agreements are merged herein. No modification of this Agreement, or waiver of any right hereunder, will be binding on either Party unless memorialized in a writing signed by the Party to be charged with such amendment or waiver.

   (f) **Counterparts:** This Agreement may be executed in counterparts, all of which, when taken together, will constitute one and the same document. Facsimile or scanned signatures hereto will be deemed original for all purposes.

   (g) **Assignment:** This Agreement may not be assigned in whole or in part by either Party without the prior written consent of the other Party. This Agreement will be binding upon the Parties and their permitted successors and assigns and will be binding
(h) **LIMITATION OF LIABILITY.** IN NO EVENT WILL ANY PARTY BE LIABLE TO THE OTHER PARTY HEREUNDER FOR ANY AMOUNTS REPRESENTING ITS RESPECTIVE LOSS OF PROFITS, LOSS OF BUSINESS, INDIRECT, SPECIAL, INCIDENTAL, EXEMPLARY, CONSEQUENTIAL, OR PUNITIVE DAMAGES (EVEN IF PREVIOUSLY APPRISED OF THE POSSIBILITY THEREOF) IN CONNECTION WITH OR ARISING FROM THIS AGREEMENT OR RELATED ACTS OR OMISSIONS. NO PARTY MAKES ANY REPRESENTATIONS OR WARRANTIES WITH RESPECT TO THE SUBJECT MATTER HEREOF EXCEPT AS EXPRESSLY SET FORTH IN THIS AGREEMENT.

(i) **Severability.** If any term of this Agreement is invalid, illegal or incapable of being enforced by any rule of law or public policy, all other terms of this Agreement will nevertheless remain in full force and effect.

**ACCEPTED AND AGREED:**

SECRETLY CANADIAN RECORDS          SIRIUS XM RADIO INC.

By: _______________________________  By: _______________________________

Name (printed):______________________  Name (printed):______________________

Title: _____________________________  Title: _____________________________
EXHIBIT A
SERVICE ACCESS RULES

1. The Service may be accessed in any of the following ways:
   
   (a) Through devices and applications which are authorized by Licensee (“Authorized Devices/Applications”) which enable such subscribers to record a discrete number of individual sound recordings while listening to Service channels and retain such recordings only for so long as the user remains a subscriber;
   
   (b) Through Authorized Devices/Applications which automatically record a discrete number of individual sound recordings from the Service (based on subscriber preferences) and present the recordings to the subscriber, on a non-interactive basis, as a customized “channel”;
   
   (c) Through Authorized Devices/Applications which record subscriber-designated blocks of Service programming for later playback by the subscriber;
   
   (d) Through Authorized Devices/Applications which enable subscribers to select and listen to blocks of pre-recorded Service programming;
   
   (e) Through Authorized Devices/Applications where the Service programming concerned has been “cached” (i.e., copied locally) for access when Authorized Devices are not connected to the Service; and
   
   (f) Through Authorized Devices/Applications which enable one to fast-forward; skip; rewind; pause; and/or resume Service programming.

2. Notwithstanding the foregoing, Licensee will not:
   
   (a) Take affirmative steps to enable Service subscribers to transfer Recordings to media other than Authorized Devices/Applications; or
   
   (b) Take affirmative steps to enable Service subscribers to access Recordings after their subscriptions have expired or been terminated for any reason (provided that if a subscriber subsequently restores its subscription, then access to such Recordings may be re-instated).

3. For the avoidance of doubt, this Exhibit A is intended solely to illustrate the rights granted in this voluntary Agreement; it is not intended to describe the rights or limitations of the Section 112 and 114 statutory licenses, or to indicate what service offerings/features are allowed, required, or prevented or otherwise encompassed under the statutory licenses.