Judge Roberts, *concurring* with respect to the terms of payment for the PSS and SDARS, and *dissenting* with respect to the analysis and determination of the royalty rates.

I concur with the analysis and determination of the terms for making royalty payments under the statutory licenses at issue in this proceeding, but not the definition of *Gross Revenues* to be applied to SDARS in determining the royalty fee, which I do not consider to be a term of payment.[1] I dissent, however, from the majority's evaluation and analysis of the evidence, and determination of rates for the PSS and SDARS. Rather than engage in a point-by-point discussion and disagreement with the majority's opinion, I set forth below—complete and original to me—what I believe is the proper analysis of the marketplace evidence submitted by the parties for the PSS and SDARS rates, the application of the § 801(b) factors, and the determination of the rates, including the *Gross Revenues* definition for SDARS.

I. Introduction

A. Subject of the Proceeding

This is a rate determination proceeding convened by the Copyright Royalty Judges under 17 U.S.C. § 803(b) *et seq.*, and 37 C.F.R. part 351 *et seq.*, to establish rates and terms for the digital performance of sound recordings by preexisting subscription services ("PSS") and preexisting satellite digital audio radio services ("SDARS") for the license period 2013 through 2017. The Digital Performance Right in Sound Recordings Act of 1995, as amended by the Digital Millennium Copyright Act of 1998, grants to sound recording copyright owners an exclusive right to publicly perform sound

[1] I do concur with the decision to maintain the current definition of *Gross Revenues* for the PSS for the upcoming licensing term.

recordings by digital audio transmission, subject to the statutory licenses set forth in 17 U.S.C. §§ 112(e) and 114(f)(1) of the Copyright Act. The rates and terms set forth in this Determination are for these statutory licenses.

B. Parties to the Proceeding

The parties to this proceeding are: (1) SoundExchange, Inc. ("SoundExchange"); (2) Music Choice, Inc. ("Music Choice"); and (3) Sirius XM, Inc. ("Sirius XM"). SoundExchange is a § 501(c)(6) nonprofit performance rights organization that collects and distributes royalties payable to performers and sound recording copyright owners for the use of sound recordings over satellite radio, the Internet, wireless networks, and cable and satellite television networks via digital audio transmissions. Bender WDT at 2, SX Trial Ex. 75. Music Choice (formerly Digital Cable Radio Associates) provides residential music service to subscribers of cable television. Del Beccaro Corrected WDT at 3, PSS Trial Ex. 1. Sirius XM provides satellite radio service broadcasts of music and non-music content on a subscription-fee basis throughout the continental United States. Meyer WDT at 4, SXM Dir. Trial Ex. 5.

C. Procedural History

On January 5, 2011, the Copyright Royalty Judges issued a Notice announcing commencement of this proceeding and requesting the submission of Petitions to Participate. 75 FR 455. Petitions to Participate were received and accepted from the above-described parties. When the negotiation period provided by 17 U.S.C. § 803(b)(3) failed to yield any agreements, the Judges called for the submission of written direct statements, which were received by the November 29, 2011 deadline. Hearings on the written direct testimony were conducted from June 5, 2012 through June 18, 2012. Eight

witnesses presented testimony on behalf of SoundExchange, three on behalf of Music Choice, and nine on behalf of Sirius XM.

On July 2, 2012, the participants filed their written rebuttal statements. Witness testimony in the rebuttal phase began on August 13, 2012, and concluded on August 23, 2012. Nine witnesses presented testimony on behalf of SoundExchange, two on behalf of Music Choice, and five on behalf of Sirius XM. After close of the rebuttal phase, the parties filed their proposed findings of fact and conclusions of law on September 26, 2012, and their reply findings and conclusions on October 12, 2012.

On October 16, 2012, the Judges heard closing arguments, wherein the record to this proceeding was closed. The record contains several thousands of pages of testimony, exhibits, pleadings, motions and orders.

II. The Standard for Determining Royalty Rates

Section 801(b)(1) of the Copyright Act, 17 U.S.C., provides that the Copyright Royalty Judges shall "make determinations and adjustments of reasonable terms and rates of royalty payments" for the statutory licenses set forth in §§ 114(f)(1) and 112(e). The § 114(f)(1) digital performance license for the PSS and SDARS, and the § 112(e) ephemeral license, contain similarities and important differences in their standards for setting royalty rates. Both require the determination of reasonable rates and terms; however, the digital performance license, in § 801(b)(1), requires that the rates (but not the terms) be calculated to achieve the following 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, 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.

17 U.S.C. § 801(b)(1). The § 112(e) ephemeral license requires the Judges to "establish rates that most clearly represent the fees that would have been negotiated between a willing buyer and a willing seller," and further directs that:

> [T]he Copyright Royalty Judges shall base their decision on economic, competitive, and programming information presented by the parties, including–
>
> (A) whether use of the service may substitute for or may promote the sale of phonorecords or otherwise interferes with or enhances the copyright owner's traditional streams of revenue; and
>
> (B) the relative roles of the copyright owner and the transmitting organization in the copyrighted work and the service made available to the public with respect to relative creative contribution, technological contribution, capital investment, cost, and risk.

17 U.S.C. § 112(e)(4). The ephemeral license requires adoption of a minimum fee for each type of service offered by a transmitting organization, while the digital performance license does not. 17 U.S.C. § 112(e)(3). Both licenses provide that the Judges *may* consider the rates and terms of voluntary license agreements negotiated under the licenses. 17 U.S.C. §§ 112(e)(4), 114(f)(1).

It is evident from the presentations of the parties that it is the § 114(f)(1) license that is of the greater value and concern to their interests, as it was when the Judges last

considered the two licenses in 2007. In that Determination, the Judges set forth in great detail the historical treatment of these factors by the Copyright Royalty Tribunal and the Librarian of Congress in his administration of the Copyright Arbitration Royalty Panel system, and I will not repeat them here. *See*, *SDARS-I*, 73 FR 4080, 4082-84 (Jan. 24, 2008). Consideration of this history produced the following approach:

> [T]he path for the Copyright Royalty Judges is well laid out. We shall adopt reasonable royalty rates that satisfy all of the objectives set forth in [§] 801(b)(1)(A)-(D). In doing so, we begin with a consideration and analysis of the benchmarks and testimony submitted by the parties, and then measure the rate or rates yielded by that process against the statutory objectives to reach our decision....
>
> We reject the notion, however, that [§] 801(b)(1) is a beauty pageant where each factor is a stage of competition to be evaluated individually to determine the stage winner and the results aggregated to determine an overall winner. Neither the Copyright Royalty Tribunal nor the Librarian of Congress adopted such an approach. Rather, the issue at hand is whether these policy objectives weigh in favor of divergence from the results indicated by the benchmark marketplace evidence.

Id. at 4084, 4094 (*citations omitted*). The same approach was used by the Judges in determining royalty rates for the § 115 mechanical license, the only proceeding involving the § 801(b)(1) factors decided since *SDARS-I*. *See*, *Phonorecords I*, 74 FR 4510 (Jan. 26, 2009). None of the parties in this proceeding contend that this approach is erroneous or must be abandoned.

Music Choice, however, argues that there is an additional factor that must be considered by the Judges, applicable only to the PSS rate, that operates as a limitation on the Judges' consideration of the benchmark evidence. After a lengthy discussion of the Librarian of Congress's *PSS-I* determination, and citation to the 17 U.S.C. § 803(a)(1)

proscription that the Judges must act *on the basis* of prior determinations of the Librarian of Congress, Music Choice contends that the Librarian's use of the musical works benchmark (i.e., the royalty rates paid by Music Choice to the performing rights societies—ASCAP, BMI and SESAC) in 1998 operates as legal precedent in this proceeding and must "be used in the absence of any better comparable benchmark." *Music Choice PCL* ¶ 53. Thus, under Music Choice's formulation, the Judges' benchmark analysis must begin with the current royalty fees paid by Music Choice to the performing rights societies musical works and, in the absence of a superior benchmark, employ this benchmark for framing the applicable PSS royalty fee.

I reject Music Choice's argument for several reasons. First, Music Choice does not, and cannot, point to a single statutory license rate proceeding where a court, the Librarian or the Copyright Royalty Tribunal has ruled that a set of factual marketplace observations used by the decisionmaker in formulating a royalty fee for a particular proceeding must be given *a priori* consideration in a future proceeding. Second, a plain reading of *PSS-I* makes it clear that the Librarian did not rely solely upon the musical works benchmark, but instead relied upon some unspecified combination of that benchmark and the performance royalty rate contained in a partnership agreement between Music Choice and certain cable television operators and record companies that created Music Choice. *PSS-I*, 63 FR at 25410. Even if I were inclined to accord some precedential value to the musical works benchmark in this proceeding—and I am not—I could not discern the degree to which that benchmark was influenced or altered by the Librarian's inclusion of the partnership license. *Id.* at 25404 (*"The question, however, is whether this reference point [the musical works fees paid by Music Choice] is*

determinative of the marketplace value of the performance right in sound recordings; and, as the Panel determined, the answer is no."). And, third, Music Choice's argument fails to place the *PSS-I* decision in its historical context. All that was available to the Librarian were the musical works fees paid to the performing rights societies and the partnership license agreement, an unsurprising circumstance given the newness of the statutory license, and the digital music marketplace in general. Concluding that selection of a factual market model from 1998 somehow limits the decisionmakers' consideration of the evidence in 2012 defies logic. I consider the musical works benchmark evidence offered by Music Choice in its normal course, discussed below, but it will not be given preference as a starting point, default position, or other limitation to my evaluation of the benchmark evidence.

III. Determination of the Royalty Rates

A. Application of Section 114 and Section 112

Based upon the applicable law and relevant evidence received in this proceeding, the Copyright Royalty Judges must determine rates for the § 114(f)(1) digital performance license for the only existing SDARS, Sirius XM, and the PSS.[2] The Judges also must determine rates for the § 112(e) ephemeral license for the PSS and SDARS.

With respect to the § 112(e) license, the Judges received a joint stipulation from the parties. SoundExchange and Music Choice ask for continued application of the language of 37 C.F.R. § 382.2(c), which requires a minimum fee advance payment of $100,000 per year, payable no later than January 20 of each year, with royalties paid during the year recoupable against the advance. *Joint Stipulation* at 2 (May 25, 2012).

[2] The PSS are Music Choice and Muzak. Muzak's PSS service is, apparently, only a small part of its business, and it did not participate in this proceeding. Digital Music Express, Inc., which was a PSS in *PSS-I*, ceased operation in 2000.

SoundExchange and Sirius XM ask that the same minimum fee proposal apply to Sirius XM. *Id.* For the § 112(e) license fee, all parties request that 5% of the total royalties paid by the PSS and Sirius XM be attributable to the license, consistent with the current regulations applicable to webcasters, broadcasters, SDARS and new subscription services. 37 C.F.R. §§ 380.3, 380.12, 380.22; § 382.12; and § 383.3.

I accept the stipulations of the parties regarding the § 112(e) rates, but not for the reason set forth by the majority (i.e., nothing else in the record). The stipulations in this proceeding and, for that matter, in prior proceedings involving the § 112(e) license, reflect the lack of marketplace evidence as to the value of the license *in isolation* from that of § 114. This does not mean, however, that the § 112(e) license is of no value because marketplace agreements package the rights conferred by the licenses together. The parties' stipulations represent a reasonable attempt to identify the value of the § 112(e) license if it were marketed separately to copyright users, and for that reason I find the stipulations acceptable.

I now turn to what I view should be the appropriate rate structures for the § 114(f)(1) license for the PSS and SDARS.

B. The Rate Proposals of the Parties for the Section 114 License for the PSS

Since 1998 when the decision in *PSS-I* established the initial royalty rates, Music Choice has paid a fee on a percentage basis of its *Gross Revenues*, as defined by regulation.[3] Neither Music Choice nor SoundExchange propose altering this rate structure for the 2013-2017 license period,[4] nor do they propose changes to the revenue definition. SoundExchange requests the following percentage rates for the PSS:

[3] The current regulation defining *Gross Revenues* for PSS is set forth in 37 C.F.R. § 382.2(e).

Year	Percentage
2013	15%
2014	20%
2015	25%
2016	35%
2017	45%

Second Revised Proposed Rates and Terms, at 6 (Sept. 26, 2012). SoundExchange also requests an additional aspect to the percentage of revenue metric to address what it perceives as a deliberate reduction in revenues paid to Music Choice for its residential audio service by certain cable operators that are co-owners (partners) of Music Choice. For transmissions through such a partner, SoundExchange asks that the total royalty fee not be less than the product of multiplying such partner's total number of subscribers to Music Choice's programming by the average per-subscriber royalty payment that Music Choice makes for the top five highest-paying customers of Music Choice that are not its partners. *Id.* at 7.

Music Choice requests a percentage of *Gross Revenues* of 2.6%, applicable to each of the years in the licensing period.[5] Both SoundExchange and Music Choice ask

[4] The Judges have stated a decided preference for per-performance royalty rates for statutory licenses, rather than rates as a percentage of revenue, because that metric most unambiguously relates the fee to the value of the right licensed. 73 FR at 4087. We adopted percentage-of-revenue royalty rates in *SDARS-I*, however, because of intractable problems associated with measuring usage and listenership to performances of sound recordings. *Id.* at 4088. These problems continue to exist with respect to the PSS and SDARS, and the parties agree to a percentage-of-revenue royalty fee for both § 114 licenses. Given their agreement, and lack of evidence as to an alternative, I adopt that metric.

[5] I note that these percentage rates are quite similar to the maximum rates proposed by the services and record company copyright owners in *PSS-I*. *See PSS-I*, 63 FR 25394, 25395 (May 8, 1998)(*2.0% by the services and 41.5% by the record companies*).

that the definition of *Gross Revenues*, currently set forth in 37 C.F.R. § 382.2(e), apply to the new licensing period.

C. The Rate Proposals of the Parties for the Section 114 License for SDARS

1. Proposed Rates and Structure

While SoundExchange and Music Choice are content to operate mostly the same as in prior licensing periods (with the exception of royalty rates), there is not a similar level of harmony as to the specifics of the rate structure for SDARS. SoundExchange does recommend retention of the percentage of revenue metric, but seeks expansion of the revenue base, and proposes a methodology for exclusion of the value of privately negotiated digital performance licenses from the total statutory royalty fee. *Second Revised Proposed Rates and Terms* at 3-5 (Sept. 26, 2012). Sirius XM favors maintenance of the current revenue definition and payment scheme. *Sirius XM PFF* at 203-204.

As with the PSS, SoundExchange argues for an accelerating royalty rate during the five-year license period as follows:

Year	Percentage
2013	12%
2014	14%
2015	16%
2016	18%
2017	20%

Second Revised Proposed Rates and Terms, at 2 (Sept. 26, 2012). Sirius XM counters with a royalty rate in the range of 5% to 7% of Sirius XM's monthly *Gross Revenues*, as

currently defined in 37 C.F.R. § 382.11, applicable to each month of the upcoming licensing period.

2. Proposed Definition of *Gross Revenues*

The revenue base against which the adopted royalty rates shall be applied is a matter of considerable disagreement between the parties. Sirius XM requests continuance of the current definition of *Gross Revenues* found in 37 C.F.R. § 382.11, while SoundExchange favors a considerable expansion of the revenue base. SoundExchange would like to see *Gross Revenues* redefined as follows:

> (1) *Gross Revenues* shall mean revenues recognized by the Licensee in accordance with GAAP from the operation of an SDARS in the U.S., and shall be comprised of the following:
>
> (i) All subscription, activation, subscription-related and other revenues recognized by Licensee from fees paid or payable by or for U.S. subscribers to Licensee's SDARS with respect to any and all services provided by the Licensee to such subscribers, unless excluded by paragraph (3) below;
>
> (ii) Licensee's advertising revenues, or other revenues from sponsors, if any, attributable to advertising on channels of Licensee's SDARS in the U.S. other than those that use only incidental performances of sound recordings, less advertising agency and sales commissions attributable to advertising revenues included in *Gross Revenues*; and
>
> (iii) Revenues attributable to the sale, lease or other distribution of equipment and/or other technology for use by U.S. subscribers to receive or play the SDARS service, including any shipping and handling fees therefor.
>
> (2) Gross revenues shall include such payments as set forth in paragraphs (1)(i) through (iii) of the definition of "Gross Revenues" to which Licensee is entitled but which are paid to a parent, subsidiary or division of Licensee.

(3) To the extent otherwise included by paragraph (1), *Gross Revenues* shall exclude:

(i) Royalties paid to Licensee by persons other than subscribers, advertisers and sponsors for intellectual property rights;

(ii) Revenues from the sale of phonorecords and digital phonorecord deliveries sold by Licensee (but not any affiliate fees or other payments by a third party for advertising of downloads sold by a third party);

(iii) Sales and use taxes;

(iv) Revenues recognized by Licensee for the provision of–

(A) 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, but not transmission of sound recording data), when such services are provided on a standalone basis (i.e. priced separately from Licensee's SDARS, and offered at the same price both to subscribers to Licensee's SDARS and persons who are not subscribers to Licensee's SDARS);

(B) Channels, programming, products and/or other services provided outside of the United States; and

(C) Separately licensed services, including webcasting, interactive services, transmissions to business establishments, and audio services bundled with television programming and subject to the rates provided in part 383, when such services are provided on a standalone basis (i.e. priced separately from Licensee's SDARS, and offered at the same price both to subscribers to Licensee's SDARS and persons who are not subscribers to Licensee's SDARS).

Id. at 2-3.

Jonathan Bender, CEO of SoundExchange, testified that the proposed definition will correct the inequities of the current definition and, at the same time, allow for greater

ease of administration. His premise is based upon an interpretation of the Judges' use in *SDARS-I* of Dr. Ordover's adjusted interactive subscription service benchmark to establish the upper boundary of reasonable royalty rates for an SDARS service. *SDARS-I*, 73 FR at 4093. The use of that benchmark, in Mr. Bender's view, demonstrates an intention of the Judges to use total subscription revenue as the base against which the royalty rates should apply. Bender WDT at 6, SX Trial Ex. 75. Applying this assumption to the revenues reported by Sirius XM from 2007 through the third quarter of 2011, Mr. Bender concludes that Sirius XM has paid roughly 16%-23% less in total royalty fees than intended. Bender WDT at 6-7, SX Trial Ex. 75.

SoundExchange targets for elimination several exclusions from *Gross Revenues* permitted under the current regulations. The first is paragraph (3)(vi)(B) of the current definition, which allows Sirius XM to deduct revenues received for "channels, programming products and/or services offered for a separate charge where such channels use only incidental performances of sound recordings." 37 C.F.R. § 382.11. This exclusion does not make sense for the new licensing period, according to SoundExchange, because the rates proposed by Dr. Ordover on behalf of SoundExchange *and* Dr. Noll on behalf of Sirius XM reflect that roughly half of the value of SiriusXM's SDARS service is derived from its music programming and roughly half from its non-music programming. The exclusion for non-music programming is, therefore, built into the rates and should not be double counted in revenue. *SX PFF* at 383 (¶ 838). Further, SoundExchange charges that exclusion from revenue of non-music channels encourages manipulation to reduce the royalty base in unprincipled ways. For example, Sirius XM could disaggregate its bundled subscription price of $14.49 per month into a music

package valued at $3.00 and a non-music package valued at $11.49. Sirius XM would not recognize any additional revenues from the separate packages, but could realize substantial reductions in royalty obligation. *SX PFF* at 387 (¶ 854). SoundExchange urges the Judges to prevent such arbitrary actions from occurring.

SoundExchange also submits that paragraph (3)(vi)(D) of the current definition should be eliminated. That paragraph allows for deduction of revenues received from channels and programming that are licensed outside the §§ 112 and 114 licenses. 37 C.F.R. § 382.11. Dr. Lys testified that Sirius XM excludes roughly between 10% and 15% of its subscription revenue from the royalty base for performances of pre-1972 recordings to its subscribers, thereby reducing its royalty obligation. Lys WRT at 54 (¶ 119), SX Trial Ex. 240. Yet, Sirius XM has not disclosed the process it uses to identify pre-1972 recordings, or how it calculates the deduction it takes.

SoundExchange's proposed *Gross Revenues* definition also eliminates five other exclusions permissible under the current regulations. First, under its proposed definition, revenues received from Sirius XM's webcasting service, which are currently linked to the SDARS satellite radio subscription, would come into the SDARS revenue base. Second, data services, such as Sirius XM's weather and traffic services which can be purchased on a stand-alone basis but are more commonly offered to SDARS subscribers at a discount, would be included in the revenue base. Third, revenue attributable to equipment sales or leases used to receive or play the SDARS service, would be included. Fourth, the current exclusions for credit card fees and bad debt expense would be eliminated. And, fifth, fees collected by Sirius XM for various activities related to customer account administration, such as activation fees, invoice fees, swap fees, and in

certain cases early termination fees, would be included in the revenue base. According to Sirius XM, the elimination of these deductions would, in total and based upon 2012 estimates, expand its annual revenue base, against which royalties are calculated, by over $300 million. Frear Revised WRT at ¶ 16, SX Reb. Trial Ex. 1.

3. Analysis and Conclusions

In *SDARS-I*, the parties were at loggerheads over the definition of revenue, with SoundExchange favoring an expansive reading to include "all revenue paid or payable to an SDARS service that arise from the operation of an SDARS service," SoundExchange Third Amended Rate Proposal (Aug. 6, 2007) at §38_.2(g), and the SDARS arguing for adoption of the existing *Gross Revenues* definition for PSS. XM Rate Proposal (Jan. 17, 2007) at §26_.2(d); Sirius Rate Proposal (Jan. 17, 2007) at §26_.2(d). With one exception, the Judges adopted the SDARS proposal. *See SDARS-I*, 73 FR 4080, 4087 (Jan. 24, 2008). SoundExchange's new proposal is again a request for an expansive reading of revenue. Its effort to respond to the Judges' criticism of its *SDARS-I* proposal as possessing "scant evidentiary support," is an attempt to demonstrate how Sirius XM has under-reported revenue in the current licensing period by applying a slanted interpretation of the *SDARS-I* decision. Alternatively, it is an attempt to demonstrate how Sirius XM *might* manipulate its revenue base to lower its royalty obligation. With the exception of revenue exclusions for privately licensed and pre-1972 sound recordings discussed, *infra*, both of SoundExchange's arguments lack merit.[6]

[6] Curiously, SoundExchange does not argue for expansion of the *Gross Revenues* definition for PSS, a definition which has existed since the first royalty term for the PSS digital performance license. If SoundExchange's broadened revenue definition for SDARS were acceptable, it would result in the two types of services licensed under § 114(f)(1) calculating their royalties against radically different revenue bases.

Mr. Bender's argument that Sirius XM has paid roughly 16%-23% less in royalties in the current license period than was intended by the Judges in *SDARS-I* is dependent upon the assumption that there is a direct link between the revenue definition and the adjusted interactive subscription service benchmark presented by SoundExchange's expert economist, Dr. Janusz Ordover. His reasoning is that because the Ordover benchmark was fashioned from interactive service license agreements that generally provided for inclusion of mostly all of subscriber revenue, it must be the case that the Judges intended the *SDARS-I* rates to apply to total subscription revenues. Bender WDT at 6-7, SX Trial Ex. 75. This presumed linkage between the benchmark and the revenue definition is not supported by the *SDARS-I* decision. The Judges never expressed an intention to adopt the revenue definitions contained in the subscription service license agreements used by Dr. Ordover; to the contrary, the *Gross Revenues* definition adopted in *SDARS-I* was quite different from those contained in the license agreements on the whole. Rather, in defining revenue, the Judges plainly stated that it was their intention to unambiguously relate the fee charged for a service provided by an SDARS to the value of the sound recording performance rights covered by the statutory licenses. *SDARS-I*, 73 FR at 4087. This is especially important where, as here, a proxy for use of sound recordings must be adopted because technological impediments do not permit implementation of a per-performance fee. The license agreements used in the Ordover benchmark do not provide for this connection between revenue and value under the statutory licenses, which is not surprising given that the interactive service license agreements conveyed rights beyond those granted by the § 114 license. In sum, Mr.

Bender's perceived linkage between the revenue definition and the Ordover benchmark favoring inclusion of total subscriber revenues is simply not there.

In the alternative, SoundExchange argues that an expansive revenue base is easier to administer and reduces the chances for manipulation. Dr. Lys testified that, from an accounting perspective, it is preferable to base contracts on a financial definition that is clear-cut to administer and easy to audit, and that a revenue definition that is all-inclusive satisfies this preference. Lys WRT at 54 (¶ 117), SX Trial Ex. 240. While this may be true, *SDARS-I* included only those revenues related to the value of the sound recording performance rights at issue in the proceeding. *SDARS-I*, 73 FR at 4087. I am satisfied that the exclusions permitted in the current definition of *Gross Revenues* remain proper. However, if evidence were presented to conclusively demonstrate that one or more of the exclusions produces or results in a manipulation of fees for the sole purpose of reducing or avoiding Sirius XM's statutory royalty obligation, then an amendment or elimination of the exclusion might be appropriate. SoundExchange has failed to meet this burden and has only offered speculation as to how Sirius XM *might* engage in revenue allocation to reduce its royalty obligation. With the exception of the exclusions for directly licensed and noncompensable sound recordings discussed *infra*, SoundExchange has failed to present persuasive evidence that any of the remaining exclusions it has targeted for elimination (fees received for non-music services,[7] webcasting, data services, equipment

[7] In *SDARS-I*, the Judges expressly recognized an exclusion from *Gross Revenues* for so-called non-music services, characterized as "channels, programming, products and/or other services offered for a separate charge where such channels use only incidental performances of sound recordings." *SDARS-I*, 73 FR 4102 (*citing* 37 C.F.R. § 382.11, definition of *Gross Revenues*). The Judges did this because the exclusion "unambiguously relat[ed] the fee to the value of the sound recording performance rights at issue . . ." *Id.* at 4088. SoundExchange argues that if the exclusion is allowed to continue, it will amount to a double deduction from Sirius XM's royalty obligation because Dr. Ordover's marketplace benchmarks exclude the value of non-music services, and Dr. Noll adjusted his proferred benchmarks to account for the fact that roughly half of Sirius XM's service is non-music. *SX PFF* ¶¶ 842-846. I agree with Sirius XM's counter

sales, credit card fees and bad debt expenses, and customer account fees) have, in fact, been abused or otherwise manipulated for the sole purpose of improperly reducing Sirius XM's statutory royalty obligations.

4. Deductions for Directly Licensed and Pre-1972 Recordings

Separate from the issue of exclusions from the *Gross Revenues* definition addressed above, I consider the impact to the royalty calculus of the performance by Sirius XM of sound recordings that it has directly licensed from record labels (and, therefore, does not rely upon the licenses offered by §§ 112 and 114), and the performance of sound recordings not compensable under the Copyright Act (i.e. pre-1972 recordings).

a. Directly Licensed Recordings

Both the § 112 and § 114 licenses recognize and permit the licensing of sound recordings through private negotiation. 17 U.S.C. §§ 112(e)(5), 114(f)(3). The parties concede, as they must, that directly licensed recordings are separate from those covered by the statutory licenses. At the outset, the parties did not address the treatment of such recordings in the context of this proceeding, presumably because they comprised only a small percentage of the total recordings performed by Sirius XM in a given period. However, due to the increasing instances of directly licensed recordings as a result of Sirius XM's Direct Licensing Initiative, discussed *infra*, proposals were submitted and amended up until the closing of the record. Sirius XM contends that a deduction from

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argument that Dr. Ordover's modeling allocated revenues for both the music and non-music programming for Sirius XM's standard "Select" package, "but that allocation in no way relates to the separately priced non-music packages offered by Sirius XM that are the subject of the exemption." *Sirius XM RFF* ¶ 167. The exemption, however, should be available only to the extent that the channels, programming, products and/or other services are offered for a separate charge.

Gross Revenues is necessary for directly licensed recordings; otherwise, a double payment would occur for performances of these works. *Sirius XM PFF* ¶ 425; *Proposed Rates and Terms of Sirius XM Radio, Inc.* at 3 (Sept. 26, 2012). SoundExchange acknowledges that directly licensed recordings must be accounted for, but resists a deduction from *Gross Revenues*. Instead, it proposes that the payable statutory royalty amount be determined by reducing the product of the royalty rate times Gross Revenues by a percentage approximating the value of the directly licensed usage. *Second Revised Proposed Rates and Terms,* at 4 (Sept. 26, 2012). To determine the share of performances attributable to direct licenses, SoundExchange recommends using data from Sirius XM's Internet webcasting service for music. The following calculation would then be made:

> • For each month, identify the Internet webcast channels offered by the Licensee that directly correspond to music channels offered on its SDARS that are capable of being received on all models of Sirius radio, all models of XM radio, or both (the "Reference Channels").[8]
>
> • For each month, divide the Internet performances of directly licensed recordings on the Reference Channels by the total number of Internet performances of all recordings on the Reference Channels to determine the Direct Licensing Share.

Id. at 4-5. SoundExchange requests that, if its approach is adopted, Sirius XM be required to notify SoundExchange monthly of each copyright owner from which Sirius XM claims to have a direct license and each sound recording Sirius XM claims to be excludable. SoundExchange would then be permitted to disclose this information to

[8] SoundExchange conditions the availability of its approach on the presumption that the music channels on the Internet service remain representative of the music channels offered on the SDARS service.

confirm whether the direct license exists and the claimed sound recordings are properly excludable.

Directly licensed recordings should not be a part of the calculus in determining the monthly statutory royalty obligation. To do otherwise would effectively result in a double payment for the directly licensed recordings and would discourage, if not altogether eliminate, the incentive to enter into such private licenses, contrary to § 114 which recognizes, if not encourages, private licenses. 17 U.S.C. § 114(f)(1)(B). I am not persuaded, however, by Sirius XM's position that the exclusion of directly licensed recordings should be from *Gross Revenues*, as opposed to a deduction from the total royalty obligation. As Mr. Bender correctly points out, there is no revenue recognition associated with directly licensed recordings; it is a cost to Sirius XM. Bender WRT at 3, SX Trial Ex. 239. Sirius XM has not presented a *revenue* allocation between directly licensed and statutory licensed recordings that it performs on its SDARS service; it has presented a *usage* deduction that it seeks to apply to its revenue base. Excluding usage of sound recordings from *Gross Revenues* would not comport with the Judges' approach in *SDARS-I* of unambiguously relating fees received by Sirius XM to the value of the sound recording performance rights at issue in this proceeding.

I am persuaded that the proposed methodology of SoundExchange to calculate the royalty deduction for directly licensed recordings (i.e., the "Direct License Share") is the superior approach to allowing Sirius XM to determine the percentage reduction based upon the number of plays of directly licensed recordings to total plays. Despite my request, Sirius XM and its contractor, Music Reports, Inc., were incapable of providing accurate data as to the identity and volume of directly licensed recordings on the SDARS

service. *See, SX PFF* at 399-400. Reasonable accuracy and transparency are required for calculation of the Direct License Share, and SoundExchange has demonstrated that its proposed use of the Sirius XM webcasting service better satisfies these requirements. Use of the webcasting service also better ties the value of the sound recordings used, by measuring the listenership for each performance, than Sirius XM's proposal for measuring only individual plays.

b. Pre-1972 Recordings

The performance right granted by the copyright laws for sound recordings applies only to those recordings created on or after February 15, 1972. *Sound Recording Amendment*, Pub. L. No. 92-140, 85 Stat. 391 (1971). Sirius XM makes performances of pre-1972 recordings on its SDARS service and, in the present license period, excludes a percentage of revenues from its Gross Revenues calculation for such use. The current *Gross Revenues* definition does not expressly recognize such an exclusion, which is not surprising given that there is no revenue recognition for the performance of pre-1972 works. In taking the exclusion, Sirius XM apparently relies upon paragraph (3)(vi)(D) of the *Gross Revenues* definition which permits exclusion of revenue for programming exempt from any license requirement. Dr. Lys testified that the deduction is between 10% and 15% of subscription revenue, a figure that was not disputed by Sirius XM. Lys WRT at 54, SX Trial Ex. 240. Sirius XM requests that the Judges amend paragraph (3)(vi)(D) to provide that its "monthly royalty fee shall be calculated by reducing the payment otherwise due by the percentage of Licensee's total transmission of sound

recordings during the month that are exempt from any license requirement or separately licensed." *Proposed Rates and Terms of Sirius XM Radio Inc.* at 3 (Sept. 26, 2012).[9]

As with directly licensed works, pre-1972 recordings are not licensed under the statutory royalty regime and should not factor into determining the statutory royalty obligation. But, for the same reasons described above, revenue exclusion is not the proper means for addressing pre-1972 recordings. Rather, the proper approach is deduction from the total royalty obligation to account for performances of pre-1972 recordings. The question then remains as to how the correct deduction should be calculated. Sirius XM did not offer any testimony as to how it calculated its current deduction, or how it identified what recordings performed were pre-1972, other than the obtuse assertion of Mr. Frear that the lawyers talked to the finance team to assure a proper deduction. 8/13/12 Tr. 3125:3-3126:3 (Frear). To be allowable, a deduction for pre-1972 recordings must be relatively precise and the methodology transparent. The same methodology applied to determining the Direct License Share—utilizing the Sirius XM webcasting—is appropriate to identify pre-1972 recordings.

D. The Section 114 Royalty Rates for PSS

Chapter 8 and § 114(f)(1) of the Copyright Act require the Judges to determine reasonable rates and terms of royalty payments for the digital performance of sound recordings. The rates the Judges establish under § 114(f)(1) must be calculated to achieve the objectives set forth in § 801(b)(1)(A) through (D) of the Act. Moreover, in establishing rates and terms the Judges may consider voluntary license agreements described in § 114(f)(1)(B).

[9] This is the same language that Sirius XM proposes also be applicable to directly licensed sound recordings.

As the Judges have done in prior rate proceedings where the determination standard is reasonable rates calculated to achieve the § 801(b)(1) factors, consideration of marketplace benchmarks is a useful starting point. *SDARS-I*, 73 FR 4080, 4088 (Jan. 24, 2008); *Phonorecords I*, 74 FR 4510, 4517 (Jan. 26, 2009). As discussed below, the parties disagree about what constitutes the most appropriate benchmark to guide the Judges in determining a reasonable rate. Unfortunately, there are no voluntary license agreements negotiated under § 114(f)(1)(B) for the Judges to consider, which is not surprising considering that Music Choice is the primary PSS service that continues to operate under the statutory license. Moreover, the benchmarks offered by the parties are not for similar products drawn from a marketplace in which buyers and sellers are similarly situated. I describe and discuss them below.

1. PSS Proposed Benchmarks

a. Proposed Musical Works Benchmark

As previously discussed, Music Choice argues that the annual royalties it pays to the three performing rights societies (ASCAP, BMI, and SESAC) for the right to perform musical works to subscribers of its residential audio service is, by virtue of the Librarian's determination in *PSS-I,* a precedential benchmark that establishes the upper boundary of reasonable rates in this proceeding. Although this contention has been rejected, *supra*, Music Choice offers the testimony of Mr. Del Beccaro and Dr. Crawford as corroborative of its position that the market for licensing the performance right in musical works is the most appropriate benchmark for establishing rates in this proceeding.

Music Choice pays 2.5% of revenue each to ASCAP and BMI and pays an annual flat fee to SESAC that amounts to approximately [ ] of net revenue. Del Beccaro Corrected WDT at 21-22, MC 17, MC 18 and MC 19, PSS Trial Ex. 1. The sum of those licenses amounts to [ ], which Music Choice submits should represent the upper bound of a reasonable royalty rate. Two pieces of evidence, in Music Choice's view, corroborate the use of musical works licensing as a benchmark. First, Music Choice observes an equivalence between the fees for the performance of sound recordings and musical works in Canada and Europe. Music Choice cites four decisions of the Canadian Copyright Board, involving licensing fees for commercial radio, cable television, satellite music services and radio services of the Canadian Broadcasting Corporation, wherein the Board found that royalty rates for sound recordings and musical compositions have equivalent value. Del Beccaro Corrected WDT at MC 6 at 30-33 (*commercial radio*), MC 7 at 14 (*cable television*), MC 8 at 50, 58 (*satellite music services*), MC 9 at 4, 6, 15, 17, 30 (*CBC radio services*), PSS Trial Ex. 1. SoundExchange's expert economist, Dr. George Ford, who recently submitted testimony before the Canadian Copyright Board, acknowledges that in Canada the musical composition and sound recording performance royalties are equal. 8/21/12 Tr. 4304:5-22 (Ford). In the United Kingdom, the sound recording performance royalty rates for commercial broadcasting services are less than those for the musical composition performance rights. Del Beccaro Corrected WDT at MC 11, PSS Trial Ex. 1. If Music Choice's service were transmitted through cable in the U.K., Music Choice would pay 5.25% of 85% of gross revenues for the musical works performance right, but would pay only 5% of 85% of gross revenues for the sound recording performance right. *Id.*

The second piece of evidence to corroborate use of the musical works rate as a benchmark is an economic model called the Asymmetric Nash Bargaining Framework (referred to as the "Nash Framework") offered by Dr. Crawford. Acknowledging that a perfect benchmark does not exist to determine the PSS sound recording performance rate, Dr. Crawford uses the Nash Framework to fashion solutions to bargaining problems between bilateral monopolists, in this case record labels on the one hand and PSS providers on the other. Crawford Corrected WDT at 12, PSS Trial Ex. 4. As a non-cooperative bargaining model, the Nash Framework is designed to yield predictions about how outcomes are determined when firms negotiate; that is, how two firms would split the surplus of their interaction (i.e., revenues over costs) in a hypothetical negotiation. *Id.* at 16. Three factors (the Nash factors) are analyzed to determine the split: (1) the combined agreement surplus; (2) each firm's threat point; and (3) each firm's bargaining power. *Id.* According to Dr. Crawford, the Nash factors determine sound recording performance royalties in the following way: "The royalty received by each firm in a bargain equals its threat point plus its bargaining power times the incremental surplus." *Id.* at 17. In other words, the combined agreement surplus and threat points determine the "size of the pie," while the bargaining power determines the "split of the pie."

Dr. Crawford's stated goal in applying the Nash Framework is to first establish the Nash factors for the hypothetical market (the sale of rights between one record company and one PSS provider) and compare them to the Nash factors in the actual musical works market (the sale of rights between the three performing rights societies and one PSS provider). *Id.* at 18. In the hypothetical market, Dr. Crawford determined that the threat point for the PSS provider is zero because in the absence of an agreement,

it cannot offer music and therefore cannot earn a surplus. *Id.* at 19. He determines, however, that the threat point for a record company is negative because the failure to reach an agreement has additional implications for the record company in other, non-PSS markets. Specifically, the failure to reach an agreement with the PSS provider would have substantial adverse impacts on the record company, such as on sales of compact disks, because there is a significant promotional benefit to the record company from the PSS provider. *Id.* To support this contention, Music Choice offers the testimony of Damon Williams, who testified that record company executives consider Music Choice promotional and provide artists with greater exposure. Williams WDT at 4-11, MC 28, 29, 32, PSS Trial Ex. 3. Mr. Williams offers examples of how Music Choice conducts custom promotions for artists, *id.* at 13-20, and points to a 2005 Arbitron survey in particular that he argues confirms that Music Choice's residential audio service sells records. *Id.* at 13.[10] And Mr. Williams argues that Music Choice has become more promotional since the *PSS-I* proceeding by virtue of the fact that it currently reaches more customers with more channels. *Id.* at 24.

With respect to the last Nash factor, bargaining power, Dr. Crawford assumes it to be neutral, based upon Music Choice's existing technology platform and contract, which cannot be easily replaced or replicated, and his observations of Music Choice's bargaining efforts for sound recording performance rights with respect to music videos. Crawford Corrected WDT at 15-16, PSS Trial Ex. 4.

Applying the Nash factors to the existing market for the PSS musical works performance right, Dr. Crawford determines that the threat point for a PSS provider is

[10] He also cites a 2008 survey by OTX, a 2012 survey by Experian Simmons, a 2004 Arbitron survey, a 2011 Ipsos OTX MediaCT survey, and a 2006 Sony BMG MusicLab survey.

again zero, and is again negative for the performing rights society (ASCAP, BMI or SESAC) because the loss of promotional value from the PSS provider produces loss of profits from other markets. *Id.* at 28. Dr. Crawford again assumes equal bargaining power between the PSS provider and the performing rights society, based largely upon his observations that the two possess equal patience in their negotiations. *Id.* at 29. This results in a 50/50 split of the surplus, the same conclusion he reached with respect to the hypothetical market. Because of the similarities between the Nash factors in the hypothetical market and the market for musical works, Dr. Crawford concludes that the musical works market makes for a good benchmark for the hypothetical sound recording performance right market at issue in this proceeding. *Id.* at 30.[11]

b. Proposed Alternative Surplus Splitting Analysis

As an alternative, Dr. Crawford provided a surplus splitting analysis to corroborate the reasonableness of Music Choice's rate proposal by using financial results to construct an estimate of the profits that would be shared in a royalty payment. Crawford Corrected WDT at 43, PSS Trial Ex. 4. Dr. Crawford adjusted Music Choice's 2006-2010 operating profit to remove the actual royalty paid by Music Choice for sound recording performance rights, and then applied a capital asset pricing model[12] to derive an expected rate of return on assets of 8.33%. Crawford Corrected WDT at Appendix B.4, PSS Trial Ex. 4. He then multiplied the 8.33% rate by Music Choice's average operating assets to determine cost of capital, and then subtracted cost of capital from the

[11] Dr. Crawford also concludes that the marketplace for musical works royalties might be greater than the sound recording marketplace because the performing rights society loses less than a record company in the absence of an agreement. Crawford Corrected WDT at 18, 29, PSS Trial Ex. 4.

[12] Under this model, a firm's cost of capital is based on the expected return to induce investment. Crawford Corrected WDT at ¶ 167, PSS Trial Ex. 4.

royalty-adjusted operating profits to derive the residual profits for each year. *Id.* at 47. This showed that Music Choice's cumulative returns in excess of its cost of capital, but before payment of sound recording royalties, amounts to 3.05% of Music Choice's 2006-2010 royalties. *Id.* A 50/50 split of this surplus results in a royalty payment of 1.52% of residential audio revenues. *Id.* at 48. He then applied a range of 20% to 80% of the expected surplus to determine a range of reasonable royalties from 0.61% to 2.43%, not to exceed the 3.05% expected surplus. *Id.*

2. SoundExchange Proposed Benchmarks

SoundExchange does not offer a single market benchmark to set the royalty rates to be paid by Music Choice for the sound recording performance right, and instead offers rates from over 2,000 marketplace agreements, representing a variety of rights licensed, in an effort to frame a zone of reasonable rates. Dr. Ford observes that PSS like Music Choice have certain distinctive features that make it difficult to identify a suitable benchmark market. Ford Second Corrected WDT at 12, SX Trial Ex. 79. First, Music Choice does not sell its service directly to subscribers, but rather to cable television operators who then bundle the Music Choice programming with a package of video programming for ultimate sale to subscribers. Music Choice is, therefore, an intermediary between cable operators and their subscribers, unlike any of the digital music services the Judges have previously dealt with. Ford Second Corrected WDT at 12, SX Trial Ex. 79; 6/18/12 Tr. 2810:20-2811:3 (Ford). Second, Music Choice's service is almost always bundled with a hundred or more channels of video and is almost never sold on a stand-alone basis. Ford Second Corrected WDT at 13, SX Trial Ex. 79. This

makes it difficult to determine the specific consumer value for Music Choice's programming alone. *Id.*

Given these difficulties, Dr. Ford uses an all-inclusive approach of examining royalty rates for different digital music markets: portable and non-portable interactive subscription webcasting, cellular ringtones/ringbacks, and digital downloads. *Id.* at 15-16, Table 1. Most of the over 2,000 licensing agreements he examined across these markets calculate royalties based on a "greater of" methodology that includes a per-play royalty fee, a per-subscriber fee, and a revenue-based fee. For convenience, Dr. Ford analyzed only the revenue-based fees, judging his results to be conservative because the other two payment metrics might produce a larger total royalty fee than the revenue-based calculation. 6/18/12 Tr. 2861:3-13 (Ford). His results reveal a percentage of revenue rate of 70% for digital downloads, 43% to 50% for ringtones/ringbacks, and 50% to 60% for portable and non-portable interactive subscription webcasting, respectively. Ford Second Corrected WDT at 15-16, Table 1, SX Trial Ex. 79. According to Dr. Ford, the rate proposal of SoundExchange for PSS comports well with the range established by these agreements, in that it rises above the lowest average rate (43%) only in the last year of the licensing term, and therefore can "be presumed to be a reasonable proxy for a market outcome." Ford Second Corrected WDT at 16, SX Trial Ex. 79; 6/18/12 Tr. 2831:8-15 (Ford).

3. Analysis and Conclusions Regarding the Proposed Benchmarks

Based upon the evidence put forward in this proceeding, none of the proposed benchmarks provide a satisfactory means for determining the sound recording performance royalty to be paid by Music Choice.

Turning first to Music Choice's arguments in favor of the musical works benchmark, I find them severely wanting. The fees paid to the three performing rights societies for the performance right to musical works have been offered in several other proceedings before the Judges and have been rejected consistently. *Webcasting II*, 72 FR 24084 (May 1, 2007); *SDARS-I*, 73 FR 4080 (Jan. 24, 2008); *see, also Webcasting I,* 67 FR 45240 (July 8, 2002)(*Librarian of Congress's determination*). The primary reason for the benchmark's rejection is the lack of comparability to the target market for sound recording performance rights. Dr. Crawford, who advocates the appropriateness of the musical works market, acknowledges that a benchmark market should involve the same buyers and sellers for the same rights. Crawford Corrected WDT at 24, PSS Trial Ex. 4. However, the musical works market involves different sellers (performing rights societies versus record companies) selling different rights. *See SDARS-I*, 73 FR at 4089. The fact that a PSS needs performance rights to musical works and sound recordings to operate its service does not make the rights equivalent, nor does it say anything about their values individually. Further, as in previous proceedings, the evidence establishes that the market commands higher royalty fees for the licensing of sound recordings than musical works. Aaron Harrison presented a chart demonstrating the different average royalty fees that Universal Music Group, one of the major record labels, receives for digital downloads, ringtones, on-demand music videos and portable subscription services, all of which are considerably higher than the fees received by the performing rights societies.[13] Harrison Corrected WRT at 13-14, PSS Trial Ex. 32. Dr. Ford made similar

[13] Music Choice's criticisms of the Harrison chart—that it omits synchronization and master use licenses, encompasses wholesale payments rather than specific rates, and involves some agreements that convey additional rights—do not detract from the conclusion that overall the royalty *fees* paid for sound recordings are typically significantly higher than those paid for musical works.

observations. Ford Amended/Corrected WRT at 7, SX Trial Ex. 244. I am once again led to the conclusion that use of the musical works market as a benchmark is fraught with flaws and only indicates that a reasonable rate for sound recordings cannot be as low as the musical works rate. *See*, *SDARS-I*, 73 FR at 4090.

Music Choice's efforts to corroborate the sufficiency of the musical works benchmark with a comparison to foreign rates also are unavailing. The Judges have considered before the significance of foreign countries' treatment of the licensing of exclusive rights granted by copyright. In the proceeding to set rates and terms for the reproduction of musical compositions under the § 115 license of the Copyright Act, certain licensees offered evidence of license rates in the U.K., Canada and Japan. *See Phonorecords I*, 74 FR 4510, 4521 (Jan. 26, 2009). In rejecting the foreign rate benchmarks, the Judges stated that attempts at comparison of U.S. rights with foreign rights "underline the greater concern that comparability is a much more complex undertaking in an international setting than in a domestic one. There are a myriad of potential structural and regulatory differences whose impact has to be addressed in order to produce a meaningful comparison." *Id.* at 4522. Neither Mr. Del Beccaro nor Dr. Crawford even attempt an analysis or discussion of the intricacies of Canadian and U.K. markets for performance rights for musical works and sound recordings, and Music Choice itself concedes that particular license rates in Canada and Europe "do not necessarily determine what the specific market rate in the United States should be for the sound recording right." *Music Choice PFF* ¶ 135.

Likewise, I am not persuaded that Dr. Crawford's application of the Nash Framework provides corroboration. The Nash Framework is a highly theoretical concept

whose goal is to evaluate how the surplus from a transaction might be divided among participants. As Dr. Ford points out, a problem with applying the Nash Framework to a determination of a royalty rate is that a royalty does not split surplus, it splits revenues. Ford Amended/Corrected WRT at 8, SX Trial Ex. 244. An even split of surplus, as Dr. Crawford presumes from the model, does not imply an even split of revenues. *Id.* Further, Dr. Crawford's efforts to apply the Nash Framework to royalties to be paid by Music Choice only contemplates a two-party transaction between record labels and Music Choice, even though Music Choice is the intermediary between cable operators that actually perform the sound recordings in the output market. The presence of an intermediary disrupts and complicates the Nash analysis because it introduces an additional bargain in the output market and requires that all three bargains be considered jointly. *Id.* at 15. Dr. Crawford did not take this complicating factor into consideration.

I also have serious reservations concerning Dr. Crawford's assumption that the Nash factor of bargaining power is assumed to be neutral. Mr. Del Beccaro testified that Music Choice has a number of competitors in the marketplace, meaning that record companies have other alternatives for licensing their works. Del Beccaro Corrected WDT at 36-37, PSS Trial Ex. 1. This undermines Dr. Crawford's determination of the Nash Factor threat point to the surplus received by record companies in the event no agreement is reached. If record companies have other options, then the assumed zero sum effect of the bargaining agreement under the Nash Framework is violated.

Finally, Dr. Crawford places undue reliance on the perceived promotional value of Music Choice, which is central to his application of the Nash Framework. For his conclusion to be correct–that failure to reach a bargaining agreement will result in a

substantial loss of record sales due to the absence of promotional value from Music Choice–he must demonstrate a causal relationship between Music Choice's promotion of sound recordings and the sale of those recordings. His evidence on this point, however, is mostly anecdotal and weak. The surveys relied upon by Mr. Williams do *not* confirm a causal link between listenership to Music Choice and subsequent record sales; at best, the 2005 Arbitron survey (already more than seven years old) demonstrates that there is some correlation between listenership and sales. There could be many reasons for the correlation, including the possibility that cable subscribers who listen to Music Choice are *already* inclined to purchase more music. For example, the 2010 Experian Simmons survey, cited by Mr. Williams, shows that Music Choice listeners are more likely than the average person to attend concerts, know what songs are in the top 10, read *Rolling Stone* magazine, and consume electronic and video goods at a higher rate. Williams WDT at MC 36, PSS Trial Ex. 3. Furthermore, none of the surveys cited by Dr. Crawford, including the antiquated 2006 Sony BMG Music Lab survey, offer reliable evidence as to whether Music Choice's residential audio service creates a *net* promotional or substitutional effect on the purchase of CDs or other music services. Without reliable data that quantifies the net effect of Music Choice, Dr. Crawford's conclusion regarding Music Choice's promotional effect is not sustainable.

I am not persuaded that Dr. Crawford's Nash Framework analysis confirms acceptance of the musical works benchmark for PSS, nor that royalty rates in the market for sound recordings is less than that for musical works. Likewise, I do not agree that Dr. Crawford's alternative surplus splitting analysis is probative. The Judges have previously found theoretical surplus splitting models to be of limited value, and Dr. Crawford's

analysis is no different. *See*, *Webcaster II,* 72 FR 24084, 24092-93 (May 1, 2007); *SDARS-I*, 73 FR at 4092. Although Dr. Crawford claims that his 20% to 80% range of a split of 3.05% of Music Choice's 2006-2010 revenues reflects arm's length negotiations between Music Choice and record companies, he provides no market evidence to support this contention. Crawford Corrected WDT at 49-50, PSS Trial Ex. 4. There are also methodological difficulties in the manner in which Dr. Crawford examined Music Choice's historical financial data. Specifically, he included in his cost analysis those costs associated with Music Choice's music video business in addition to the costs for the residential audio business, presumably because he was told by Music Choice personnel that it was not possible to allocate expenses between the video and audio components of the company's business. 6/12/12 Tr. 1859:21-1860:21 (Crawford). The net effect of including the music video business, which has substantial costs and not much revenue, is to drive down the surplus he proposes to be split between Music Choice and record companies. Even if I were persuaded in theory by Dr. Crawford's surplus splitting analysis—and I am not—his failure to confine his cost and revenue analysis solely to the residential audio business, which is the subject of the statutory licenses in this proceeding, prohibits its usefulness.

Turning to the music service benchmarks offered by SoundExchange and supported by Dr. Ford, one is confronted with severe theoretical and structural difficulties. Although the volume (over 2,000) of marketplace agreements examined by Dr. Ford for music products and services might suggest real usefulness in a benchmark analysis, the four markets examined—portable and non-portable subscription interactive webcasting, ringtones/ringbacks, and digital downloads—involve the licensing of

products and rights separate and apart from the right to publicly perform sound recordings in the context of this proceeding. Thus, the key characteristic of a good benchmark–comparability–is not present. *SDARS-I*, 73 FR at 4092. The buyers are different, there are different music products included (ringtones and ringbacks, digital downloads) and there are different rights licensed in the output market. Further, I do not accept Dr. Ford's contention that, as a matter of economics, it is irrelevant that different legal rights are conveyed by the benchmark agreements he examined. 6/18/12 Tr. 2819:5-10 (Ford). The agreements examined by Dr. Ford themselves suggest that the rights licensed, and the context in which they are licensed, make a great deal of importance in determining their value.

I do agree with Dr. Ford's observations that Music Choice has several distinct features, such as its intermediary role between cable systems and subscribers and the bundling of Music Choice's services with multiple channels of video and other non-music programming, that significantly dim the possibility of market comparators. This is not to say that the value of the sound recording right in the PSS market is exceedingly low, as Music Choice would have it, nor exceedingly high, as SoundExchange would have it. SoundExchange's rate proposal begins with a rate of 15% of *Gross Revenues* in the first year of the licensing term, which is endorsed by Dr. Ford as being within the range of reasonable rates for the PSS even though it is far lower than the average rates he determined in his benchmark analysis. For this reason, the 15% rate represents nothing more than the uppermost bound of the range of reasonable royalty rates for the PSS.

Based upon the above analysis, I am left with a consideration of the existing 7.5% royalty rate which is the product of settlement negotiations that occurred in *SDARS-I*

between Music Choice and SoundExchange, and is a rate for which neither party advocates. Although it is a rate that was negotiated in the shadow of the statutory licensing system and cannot properly be said to be a market benchmark, nothing in the record persuades me that 7.5% of *Gross Revenues*, as currently defined, is either too high, too low or otherwise inappropriate. *Accord*, *Phonorecords I*, 74 FR at 4522 . I now turn to the § 801(b) policy factors.

4. The Section 801(b) Factors

Section 801(b)(1) of the Copyright Act states, among other things, that the rates that the Judges establish under § 114(f)(1) shall be calculated to achieve the following 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 conditions; (C) to reflect the relative roles of the copyright owner and the copyright user in the product being made available to the public with respect to relative creative contribution, technological contribution, capital investment, cost, risk, and contribution to the opening of 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 practice. 17 U.S.C. § 801(b)(1). Based on the record evidence in this proceeding, the benchmark evidence submitted by Music Choice and SoundExchange has failed to provide the means for determining a reasonable rate for the PSS, other than to indicate the extreme ends of the range of rates. The testimony and argument of Music Choice demonstrates nothing more than to show that a reasonable rate cannot be as low as the rates paid by Music Choice to the three performing rights societies for the public performance of musical works. The benchmark

testimony of SoundExchange is of even lesser value. The proposed rate of 15% for the PSS for the first year of the licensing period, deemed reasonable by Dr. Ford (at least in the beginning of the licensing period), stands as the absolute upper bound of the range of reasonable rates. At the middle of the range is the current 7.5% rate and, based upon the record, I am are persuaded that it is neither too high, too low, or otherwise inappropriate, subject to consideration and necessary adjustment under the § 801(b) factors discussed below.

a. Maximize Availability of Creative Works

Both SoundExchange and Music Choice presented arguments as to how their proposed benchmark rates satisfy this factor, which are not relevant given that the musical works benchmark and the Ford music service benchmarks only serve the purpose of framing the absolute lower and upper bounds of reasonable rates. Rather, it is the current 7.5% rate to which the evidence presented under this factor must be applied.

Music Choice touts that it is a music service that is available in over 54 million homes, with 40 million customers using the service every month. 8/16/12 Tr. 3878:3 (Del Beccaro); Del Beccaro Corrected WDT at 4, 26, PSS Trial Ex. 1; 6/11/12 Tr. 1462:5-11, 1486:19-1487:2 (Del Beccaro). Channel offerings have increased through the years, curated by experts in a variety of music genres. Del Beccaro Corrected WDT at 3, 24, PSS Trial Ex. 1. Recent developments in technology permit Music Choice to display original on-screen content identifying useful information regarding the songs and artists being performed at any one time. *Id.* at 24; Williams WDT at 12, MC 23, PSS Trial Ex. 3; 6/11/12 Tr. 1461:14-1462: 1, 1491:1-12 (Del Beccaro). According to Music Choice, these elements, along with the promotional efforts detailed above in the context of Dr.

Crawford's Nash Framework analysis, support a downward adjustment in the rates. In any event, an upward adjustment in the rates, argues Music Choice, would not affect the record companies' bottom-line because PSS royalties are not a material revenue source for record companies. *Music Choice PFF* ¶¶ 409-417.

SoundExchange submits that a market rate incorporates considerations under the first § 801(b) factor, citing the Judges decision in *SDARS-I*, and that if PSS rates turn out to be too high and drive Music Choice from the market, presumably consumers will shift to alternative providers of digital music where higher royalty payments are more likely for record companies. Ford Second Corrected WDT at 19-20, SX Trial Ex. 79.

The current PSS rate is not a market rate so that market forces cannot be presumed to determine the maximum amount of product availability consistent with the efficient use of resources. *See SDARS-I,* 73 FR 4094. However, the testimony demonstrates that Music Choice has not, under the current rate, reduced its music offerings or contemplated exiting the business; in fact, it will be expanding its channel offerings in the near term. There is also no evidence that suggests that the output of music from record labels has been impacted negatively as a result of the current rate. There is no persuasive evidence that a higher PSS royalty rate will necessarily result in increased output of music by the record companies (major or independent), nor that a lower rate will necessarily further stimulate Music Choice's current and planned offerings. In sum, the policy goal of maximizing creative works to the public is reasonably reflected in the current rate and, therefore, no adjustment is necessary.

b. Afford Fair Return/Fair Income Under Existing Market Conditions

Music Choice submits that the Judges need not worry about the impact of a low royalty rate on the fair return to record companies and artists for use of their works because royalties from the PSS market are so small as to be virtually inconsequential to companies whose principal business is the sale of CDs and digital downloads. *Music Choice PFF* ¶¶ 420-430. With respect to Music Choice's ability to earn a fair income, however, Music Choice argues that it is not profitable under the current 7.5% rate. Mr. Del Beccaro testified that its average revenue per customer for its residential audio business has been on the decline since the early 1990's, down from $1.00 per customer/per month to [ ] per customer/per month currently. Del Beccaro Corrected WDT at 40, PSS Trial Ex. 1. He further testified that after 15 years of paying a PSS statutory rate between 6.5% and 7.5% Music Choice has not become profitable on a cumulative basis and is not projected to become so within the foreseeable future. *Id.* at 42. Cumulative loss at the end of 2011 is [ ], projected to grow to [ ] in 2012 and continue to increase throughout the 2013-2017 license period. *Id.* at 33-34; Del Beccaro Corrected WRT at MC 69 at 1, MC 70 at 1, PSS Trial Ex. 21. These losses lead Music Choice to conclude that it has not generated a reasonable return on capital under the existing rates, which it submits should be 15% in the music industry. *Music Choice PFF* ¶¶ 442-43.

Music Choice's claims of unprofitability under the existing PSS rate come from the oblique presentation of its financial data and a combining of revenues and expenses from other aspects of its business. The appropriate business to analyze for purposes of this proceeding is the residential audio service offered by Music Choice, the subject of

the § 114 license. Music Choice, however, reports costs and revenues for its residential audio business with those of its commercial business, which is not subject to the statutory license. This conflation of the data, which Music Choice acknowledges cannot be separated, *see SX PFF* at 221-222, distorts its views regarding losses. As a consolidated business, Music Choice has had significantly positive operating income during the past five years between 2007 and 2011 and has made profit distributions to its partners since 2009. Ford Amended/Corrected WRT at SX Ex. 362, p. 3, SX Trial Ex. 244; SX Trial Ex. 64 at 3; SX Trial Ex. 233 at 3. Dr. Crawford's effort to extract costs and revenues from this data for the PSS service alone for use in his surplus analysis cannot be credited because of his lack of familiarity with the data's source. 6/13/12 Tr. 1890:15-1891:10 (Crawford).[14] Music Choice has operated successfully and received a fair income under the existing statutory rate.[15]

With respect to fair return to the copyright owner, the examination is whether the existing statutory rate has produced a fair return with respect to the usage of sound recordings. During the period of the current rate and before, Music Choice provided 46 channels of music programming to the subscribers of its licensees. However, Music Choice is expanding the number of music channels dramatically in the coming licensing term, up to 300 channels by the first quarter of 2013. Del Beccaro Corrected WDT at 3-4, PSS Trial Ex. 1; 8/16/12 Tr. 3878:3 (Del Beccaro). This will result in a substantial

[14] Much was made at trial and in closing arguments regarding Dr. Crawford's supposed use of audited financial data and Dr. Ford's use of unaudited financial data in an effort to examine costs and revenues of the PSS service vis-à-vis Music Choice's other non-statutory offerings. I see no superiority to either data set, as both contain their own difficulties.

[15] It would be surprising, if not improbable, that Music Choice would be able to operate a PSS service for over 15 years with a statutory royalty between 6.5% and 7.5%, with the considerable losses that it claims, and nonetheless continue to operate, let alone intend to expand its current operation.

increase in the number of plays of music by Music Choice, even if the ultimate listenership intensity of its licensees' subscribers cannot be measured. The expansion in usage will not be reflected in increased revenues to which the statutory royalty rate is to be applied, as Music Choice has declared itself to be a mature business with no expectation of increased future revenues for its business. As a result, copyright owners will not be compensated for the increased usage of their works, underscoring the Judges' preference for a per-performance metric for royalty determinations—which is not available here—as opposed to a percentage-of-revenue metric. Dramatically expanded usage without a corresponding expectation of increased compensation suggests an upward adjustment to the existing statutory rate. Measurement of the adjustment is not without difficulty because any downstream increases in listenership of subscribers as a result of additional music offerings by Music Choice cannot be readily determined nor predicted. It is possible that listenership overall may remain constant despite the availability of 300 music channels as opposed to only 46. However, it is more reasonable to conclude that Music Choice would not make the expansion, and incur the additional expense of doing so, without reasonable expectation that subscribers will be more attracted to and will consume more of the music offerings of Music Choice. A 2% upward adjustment, phased-in during the course of the license period as described below, is sufficient to provide copyright owners with a fair return for the increased use of sound recordings by Music Choice.

c. Relative Roles of Copyright Owners and Copyright Users

This policy factor requires that the rates adopted by the Judges reflect the relative roles of the copyright owners and copyright users in the product made available with

respect to relative creative contribution, technological contribution, capital investment, cost, risk, and contribution to the opening of markets for creative expression and media for their communication. For its part, Music Choice's arguments that its creative and technological contributions, and capital investments, outweigh those of the record companies center on the same aspects of its business. First, Music Choice touts the graphic and informational improvements made to its on-screen channels, noting that what were once blank screens now display significant artist and music information. Costs for these improvements have exceeded [ ]. Del Beccaro Corrected WDT at 31-32, PSS Trial Ex. 1. Second, Music Choice offers increases in programming, staff size and facilities, along with enhancements to product development and infrastructure. Costs for these improvements have exceeded [ ]. *Id.* Regarding costs and risks, Music Choice points to its lack of profitability and the exit of other PSS from the market as evidence of its continued risk and limited opportunity for profit. *Music Choice PFF* ¶¶ 512-520. Finally, with respect to opening new markets, Music Choice touts the PSS market itself for which it remains the standard-bearer in disseminating music to the public through cable television. *Id.* at ¶ 523.

SoundExchange offers little more on the third § 801(b) factor beyond Dr. Ford's contention that he saw no evidence to support that Music Choice makes contributions to creativity or availability of music that are beyond those of the music services he included in his benchmarks, and therefore the third factor is accounted for in the market. Ford Second Corrected WDT at 21, SX Trial Ex. 79; 6/18/12 Tr. 2849:10-16 (Ford).

In considering the third factor, the Judges' task is not to determine who individually bears the greater risk, incurs the higher cost or makes a greater contribution

in the PSS market, and then make individual up or down adjustments to the selected rate based upon some unspecified quantification of these differences. Rather, the consideration is whether these elements, taken as a whole, require adjustment to the existing rate of 7.5%. Upon careful weighing of the evidence, I determine that no adjustment is necessary. Music Choice's investments in programming offerings, staff and facilities, and other related products and services are no doubt impressive, but they have been accomplished under the current rate and previous rates that are only slightly lower (the low being 6.5%). As discussed above, Music Choice has already begun to expand its channel offerings by several multiples and has allocated greater financial resources to its residential audio business. All of these undertakings, plus the investments made and costs incurred to date have been made in the shadow of the existing rate, and have not been prevented as a result of that rate. Likewise, on the other side of the ledger, SoundExchange has not offered any persuasive evidence that the existing rate has prevented the music industry from making significant contributions to or investments in the PSS market.

d. Minimize Disruptive Impact

Of the four § 801(b) factors, the parties devoted most of their attention to the last one: minimizing disruption on the structure of the industries and on generally prevailing industry practices. This is perhaps not surprising, given the role this factor played in *SDARS-I* in adjusting the benchmark rates utilized by the Judges to set the royalty fees. *See SDARS-I,* 73 FR at 4097-98. Music Choice presents a considerable volume of testimony and argument as to why the SoundExchange proposed rates would be disruptive, if not debilitating, to its business; and SoundExchange presents testimony and

argument as to why Music Choice's proposed rates would disrupt the music industry. These contentions, however, are inapposite as neither the SoundExchange nor the Music Choice benchmark analyses serve the purpose of determining a reasonable rate other than to mark the extreme ends of the boundary within which a reasonable rate can be located. Because I have identified as reasonable the rate for PSS currently in place, my analysis of the disruption factor is confined to that rate.

SoundExchange argues that the current rate is disruptive to the music industry. Dr. Ford testified that "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." Ford Second Corrected WDT at 23, SX Trial Ex. 79. This results, according to Dr. Ford, in a tilting of the competitive field for music services in favor of Music Choice, thereby disrupting the natural evolution of the music delivery industry. Dr. Ford, however, appears to ignore his own earlier assertions that the PSS market has unique and distinctive features that distinguish it from other types of music services, thereby substantially reducing the likelihood that the PSS and other music services are substitutes for one another. Further, Dr. Ford failed to present any empirical evidence demonstrating a likelihood of migration of customers from music services paying higher royalty fees to the PSS as a result of his perceived royalty imbalance.[16] Dr. Ford's conclusion that the current rate paid by the PSS for the § 114 license has caused a disruption to the music industry is mere speculation.

[16] I note that DMX's exit from the PSS market in 2000 offers an opportunity to examine how the departure of a PSS impacts consumer choices and their consumption of music, but no such analyses were presented in this proceeding.

Music Choice also contends that the current rate is disruptive, and I likewise find its argument weak and unsubstantiated. The test for determining disruption to an industry, announced by the Judges in *SDARS-I*, is whether the selected rate directly produces an adverse impact that is substantial, immediate, and irreversible in the short-run. *SDARS-I*, 73 FR at 4097. The current rate has been in place for some time and, despite Music Choice's protestations that it has never been profitable, it continues to operate *and* continues to increase its expenditures by expanding and enhancing its services in the face of the supposedly disruptive current royalty rate. Music Choice's argument that DMX's bankruptcy and Muzak's decision to limit its participation in the PSS market are evidence of the onerous burden of the current rate are without support because Music Choice has failed to put forward any evidence demonstrating a causal relationship between the actions of those services and the PSS royalty rate.

In sum, I am not persuaded by the record testimony or the arguments of the parties that the current PSS rate is disruptive to a degree that necessitates an adjustment.

5. Conclusions Regarding Section 114 Rates

Upon a careful weighing of the evidence submitted by the parties, I believe that the application of the § 801(b) factors to the rate of 7.5% of Gross Revenues requires an upward adjustment to account for the coming expanded use of music by Music Choice in the 2013-2017 licensing term. If the Judges preferred per-usage royalty metric could be applied to the PSS—which it cannot—the value of the increased usage would be captured in the metric through the measurement of listenership to the sound recordings received by Music Choice consumers through their respective cable systems. The percentage-of-revenue metric, however, will not account for the expanded use in the short term, as cable

operators will continue to pay fees for the Music Choice service in approximately the same amounts, and will only increase in the long term, presumably, if the volume of cable subscribers (or per-subscriber license rates) increases significantly. The testimony, however, suggests this possibility to be unlikely, as Music Choice itself declares the PSS market mature. 8/16/12 Tr. 3855:17-3856:7 (Del Beccaro); 8/23/12 4707:8-19 (Crawford).

The following are the rates that I believe are appropriate and supported by the evidence in this proceeding:

Year	Percentage
2013	8.5%
2014	9.0%
2015	9.5%
2016	9.5%
2017	9.5%

SoundExchange raises an additional matter with respect to the total royalty obligation of the PSS. Though not technically a rate, nor strictly an amendment of *Gross Revenues*, SoundExchange requests a means for capturing revenues from cable systems that are owners of equity or capital interests in Music Choice who do not engage in arm's length transactions with Music Choice for its product offerings. *Second Revised Proposed Rates and Terms*, at 6-7 (Sept. 26, 2012). Put another way, SoundExchange seeks to capture any price break that Music Choice offers its ownership partners for the Music Choice service. The price break to a specific partner cable system would be calculated by multiplying the total number of subscribers for the month for that system by

the average per-subscriber royalty payment of the five largest paying cable systems providing Music Choice that are not its partners. This reconciling for each partner cable system would then be added to Music Choice's *Gross Revenues* overall calculation. In support of its "Non Arm's Length Transaction" adjustment for cable partners, Dr. Ford testified that a straight percentage of revenue metric is problematic where Music Choice offers per-subscriber rate discounts to it cable partners. "I believe that, if we are going to properly compensate someone for the use of their property, we ought to be compensating them for use and not have the compensation affected by peculiar ownership structure of the entities that easily arise." 8/20/12 Tr. 4216:21-4217:8 (Ford). Over half of Music Choice's non-partner cable systems pay approximately [ ] per subscriber per month in licensing fees to Music Choice, whereas the partner cable systems pay only [ ] per subscriber per month. Ford Second Corrected WDT at 5, SX Trial Ex. 244.

I am not persuaded that a "Non Arm's Length Transaction" adjustment is warranted. Implicit in Dr. Ford's observation of Music Choice's licensing of its service to its cable partners is the assumption that the partners have the ability to exert downward pressure on Music Choice revenues so as to avoid payment of music royalties and thereby boost their own bottom-lines. Such presumed use of Music Choice as a loss leader is not borne out by the evidence in this proceeding. The partnership agreements between Music Choice and its cable operators are lengthy and complicated and vary from partner to partner. It is not surprising that the partner cable operators, which are in most instances of greater size with respect to numbers of subscribers than the non-partner licensors of Music Choice's service, would be able to negotiate lower per-subscriber licensing fees due to their ability to deliver more subscribers to the service. Further, the cable partners

represent only a third of Music Choice ownership, and do not appear to be able to influence rates any more than Music Choice's record company partners, who own one quarter of the company. 6/11/12 Tr. 1454:16-22 (Del Beccaro). SoundExchange's "Non Arm's Length Transaction" adjustment is founded upon inference and speculation and is not supported by the record evidence.

E. The Section 114 Royalty Rates for SDARS

As with the consideration of reasonable rates for the PSS, I begin my analysis for SDARS with the proffered benchmarks of Sirius XM and SoundExchange, respectively.

1. SDARS Proposed Benchmarks

a. The Direct Licenses

Beginning in the summer of 2010, Sirius XM commenced a coordinated effort to negotiate sound recording performance rights directly with individual record labels. 6/7/12 Tr. 669:8-672:9, 713:3-11, 714:11-715:4 (Frear). Dubbed the Direct License Initiative, Sirius XM first attempted to engage the four major record companies in discussions but was unsuccessful. *Id.*; 6/11/12 Tr. 1347:7-21, 1348:20-1349:4 (Karmazin). Sirius XM then enlisted the services of Music Reports, Inc. ("MRI") to formulate and execute a direct licensing strategy with as many independent record labels as possible. Together, Sirius XM and MRI developed the terms and conditions of a Direct License, the highlights of which include:

- A *pro rata* share of 5%, 6% or 7% of gross revenues, defined by reference to 37 C.F.R. § 382.11;

- A grant of rights to Sirius XM to operate all of its various services (satellite radio plus other services such as webcasting);

> •"Additional functionality" granted to Sirius XM, including elimination of the § 114 license sound recording performance complement;
>
> • Direct, quarterly payment of 100% of the royalties to the record label;
>
> • Payment of advances to the 5 largest record labels;
>
> • The possibility, but not the promise, of increased play on Sirius XM's music services.

Gertz Corrected WDT ¶ 14(a), (b), SXM Dir. Trial Ex. 5. The first Direct Licenses were executed in August of 2011 and by the time of the closing of testimony in this proceeding, Sirius XM had Direct Licenses with 95 independent record labels. 8/13/12 Tr. 3015-16-20 (Frear); 8/15/12 Tr. 3679:22-3680:1 (Gertz).

Sirius XM's expert economist, Dr. Roger Noll, advises that the 95 Direct Licenses are the best benchmark for rate setting in this proceeding because, unlike in *SDARS-I*, the Judges now have direct evidence of competitively negotiated marketplace rates for the exact service at issue in this proceeding. Noll Revised Amended WDT at 7, 11, 33-36, SXM Dir. Trial Ex. 1. Dr. Noll testified that the Direct Licenses are representative, for benchmarking purposes, of the types of sound recordings available across the industry, including those distributed by major labels. *Id.* at 39-44; *see also* 6/5/12 Tr. 261:6-262:14 (Noll)(*the 95 Direct Licensors as a group offer a scope of sound recordings comparable to those not so licensed*). The fact that the Direct Licenses represent only a small percentage of market share of music available does not alter the incentive to create demand diversion, Dr. Noll opines, because the major record labels and the independent labels signed to the Direct Licenses both seek to maximize their number of plays on Sirius XM's music services. A Direct Licensor would find a 7% license rate more

attractive than the current 8% statutory rate if the lower rate would cause an increase in the number of plays. Noll Revised Amended WDT at 40-41, SXM Dir. Trial Ex. 1. Dr. Michael Salinger, another Sirius XM expert economist, concludes that the fact that 95 record companies accepted the Direct License offer suggests that the current 8% statutory rate is, if anything, above the competitive rate for sound recordings. Salinger Corrected WRT at ¶ 28, SXM Reb. Trial Ex. 9. Further, Sirius XM argues that the number of Direct Licenses undoubtedly would have been higher but for the efforts of SoundExchange, the American Association of Independent Musicians and others to undermine and interfere with its Direct License Initiative. Sirius XM devoted considerable time and testimony in an effort to support this contention. *See, e.g., Sirius XM PFF* at 61-63.

b. The Noll Benchmark

Dr. Noll asserts that license agreements between major record labels and certain customized non-interactive webcasters provide marketplace evidence of rates that corroborate the 5%-7% rates achieved in the Direct Licenses. Noll Revised Amended WDT at 16, 72, SXM Dir. Trial Ex. 1. Focusing principally on the agreements between the digital music service Last.fm and the four major record companies,[17] Dr. Noll determined that for its non-interactive subscription streaming service, Last.fm agreed to pay:

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[17] Dr. Noll also examined agreements involving the music services Slacker and Turntable.

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Noll Revised Amended WDT at 76-79 (*footnote omitted*), Tables 2.1-2.1c and Appendices E-H, SXM Dir. Trial Ex. 1. Examining these same agreements for Last.fm's interactive on demand service—[ ] —led Dr. Noll to conclude that sound recording rights owners charge [ ] for non-interactive services than they do for interactive/on-demand services. *Id.*[18]

Using the rates gleaned from the Last.fm agreements for the non-interactive subscription streaming service, which he deemed to be the most similar to Sirius XM's satellite radio service in terms of functionality, Dr. Noll computed his reasonable royalty fee by multiplying the Last.fm revenue rate [ ] against the implicit per-subscriber price of Sirius XM's music channels ($3.00-$3.45), and then divided the resulting per-subscriber monthly fee into Sirius XM's average revenue per user ($11.38) in order to express the fee as a percentage of revenue. *Id.* at 15; 6/5/12 Tr. 285:7-293:9 (Noll). This yielded an average royalty rate as a percentage of Sirius XM revenue of 6.76%. *Id.* at 90; 6/5/12 Tr. 293:5-9 (Noll). Because this average rate fit squarely between the 5%-7% range of the Direct Licenses, Dr. Noll opines that his calculation is corroborative of the rates contained in Direct Licenses and further concludes that it represents the upper end of a reasonable royalty rate because the customized, non-

[18] Dr. Noll also found similar splits in [ ] agreements. *Id.* at Tables 2.2-2.2d and Appendices I-L.

interactive services he examined offer greater functionality and sound quality than the channels offered by Sirius XM. *Id.* at ¶¶ 14-16; 6/5/12 Tr. 292:2-14 (Noll).

2. SoundExchange Proposed Benchmarks

SoundExchange's expert economist, Dr. Janusz Ordover, offers a principal benchmark, and two alternatives, based upon his examination of market agreements for digital music between interactive subscription services streaming music and the four major record companies. Dr. Ordover chose interactive subscription services because of his belief that they represent voluntary transactions in a competitive marketplace free of regulatory overhang, provide sufficient information based on multiple buyer/seller interactions, are not distorted by the exercise of undue market power on either the buyer's or seller's side, and involve digital music services that are similar to Sirius XM. 6/14/12 Tr. 2359:11-2360:9, 2257:5-11, 2257:12-20, 2257:21-2258:2 (Ordover).

Dr. Ordover's principal benchmark is to calculate the percentage of total revenues represented by royalty payments made by interactive services to record companies, and then apply that percentage of revenue to the amount that he determined to be the retail price of a music-only satellite service in order to calculate the corresponding percentage-of-revenue for the Sirius XM service. *See generally* Ordover Third Corrected/Amended WDT at 18-25, SX Trial Ex. 74. Beginning with data from July 2010, he derived the effective percentage-of-revenue paid by each interactive service by taking the amount of royalty fees paid to the major record labels and dividing it by each service's gross subscription revenues. In other words, he relied on royalty payments made, rather than the percentage-of-revenue rates specified in the agreements which contained "greater of"

royalty formulations.[19] In calculating actual licensing fees paid, Dr. Ordover used gross subscription revenues of the interactive services without any deductions or carve-outs. Ordover Third Corrected/Amended WDT at 19, SX Trial Ex. 74. Examining the agreements, he determined that the annual payments as a percentage of gross revenues of the services ranged from 50% to 70%, and tended to cluster in a narrower range of 60% to 65%. 6/14/12 Tr. 2275:4-12 (Ordover); Ordover Third Corrected/Amended WDT at 19-21, SX Trial Ex. 74. Dr. Ordover then adjusted the benchmark to account for the fact that the Sirius XM satellite radio service, unlike interactive subscription services, transmits both music and non-music content. Reducing the percentage-of-revenue by half, principally based upon his observation of the identical $9.99 retail prices offered by Sirius XM for non-music and mostly music stand-alone subscriber packages, yielded rates for Sirius XM between 30% and 32.5% for the 2013-2017 statutory licensing period. Ordover Third Corrected/Amended WDT at 17, SX Trial Ex. 74.[20]

As his first alternative benchmark, Dr. Ordover examines per-subscriber royalty rates from interactive subscription services in an effort to account for the differences in service attributes between satellite radio and interactive subscription services. He first determined an unweighted average monthly royalty of $5.95 per subscriber (monthly licensing fees paid divided by monthly subscriber counts) for interactive services, and then adjusted this fee by the ratio of the retail price of a hypothetical music-only satellite

[19] The "greater of" metric is an amount per play, an amount per-subscriber, and a percentage of the service's revenues. 6/14/12 Tr. 2261:7-2262:4 (Ordover).

[20] Dr. Ordover's mathematical calculation is as follows: He took the $12.95 Sirius XM subscription price, and then multiplied that by 50% to obtain the music portion of the subscription price of $6.475. He then multiplied the music-only satellite radio subscription price by 60% to 65% (his effective percentage-of-royalty derived from the interactive subscription service agreements) to obtain the music royalty of $3.88 to $4.21. Finally, he divided those numbers into the Sirius XM subscription price for the Select programming package to obtain 30% to 32.5%. 8/16/12 Tr. at 3794:13-3795:9 (Salinger).

radio service (50% of the $12.95 subscription price for the Sirius XM Select programming package[21]) to the retail price for interactive subscription services ($9.99). Ordover Third Corrected/Amended WDT at 30-31, SX Trial Ex. 74. This percentage, when applied to the average per-subscriber royalty paid by interactive services ($5.95), yields $3.86 for the hypothetical music-only satellite radio service. Dividing this number by the $12.95 Sirius XM subscription price provides a percentage-of-revenue rate of 29.81%. *Id.* at 32.

Dr. Ordover's second alternative benchmark approach attempts to adjust for the presence of interactivity alone in the rates yielded by his primary benchmark under the assumption that interactivity is the material difference between interactive subscription services and satellite radio. Ordover Third Corrected/Amended WDT at 34, SX. Trial Ex. 74. To derive the value of interactivity, he compared the retail prices for interactive music streaming services with the retail prices for non-interactive music streaming services in order to obtain a ratio. He determined that interactive music streaming services are uniformly priced at $9.99 per month, while non-interactive services prices averaged $4.86. Ordover Third Corrected/Amended WDT at 31-32 Table 4, SX Trial Ex. 74; *Id.* at 33 Table 5.[22] Dr. Ordover then used the ratio to adjust the average per-subscriber royalty paid by interactive services ($5.95) to calculate an equivalent payment for satellite radio. This yielded a percentage-of-revenue royalty rate of 22.32% for

[21] The current price for this service is $14.49. Ordover Third Corrected/Amended WDT at 31 n.33, SX Trial Ex. 74.

[22] Dr. Ordover did not provide a weighted average of the non-interactive service prices because he concluded that he did not have reliable data, nor did he include, at my invitation, ad-supported non-interactive services in his calculation, deciding that such services would add undue complexity to his methodology. Ordover Amended WRT at 33, SX Trial Ex. 218.

Sirius XM, which Dr. Ordover concludes represents the lower bound of a reasonable royalty rate. 6/14/12 Tr. 2282:12-16 (Ordover).[23]

3. Analysis and Conclusions Regarding the Proposed Benchmarks

The Direct Licenses offered by Sirius XM have the surface appeal of a good benchmark in that they involve the same sellers and buyers in the target market; however, a closer examination reveals that they are fraught with problems. First, they represent a sliver of the universe of rights holders for sound recordings: 95 of over 20,100 rights holders to which SoundExchange distributes payments, Bender WDT at 4, SX Trial Ex. 75, and a subset of the 691 independent labels that Sirius XM approached in the first instance. Ordover Amended WRT at 4 n.8, and 6, SX Trial Ex. 218; SX Trial Ex. 301 at 53. Much was made by Sirius XM in this proceeding that the number of Direct Licenses would have been substantially higher but for the interference of SoundExchange. It is not within the Judges' jurisdiction to determine that SoundExchange's actions amounted to legal interference with contractual relations or otherwise frustrated Sirius XM's efforts to execute more Direct License agreements. The Direct Licenses are evaluated for what they are, not for what they might have been, and what they are is a very small percentage of the sound recording market.[24]

Second, the Direct Licenses do not include any of the major record labels whom, by virtue of their size of the music market and the popularity of their recordings,

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[23] This was calculated by multiplying the interactivity ratio of .4865 ($4.86/$9.99) to the average per-subscriber royalty payment of $5.95, yielding an equivalent satellite radio payment of $2.89. The $2.89 per-subscriber rate was then divided by the $12.95 monthly charge for the Sirius XM Select satellite radio package, resulting in the percentage-of-revenue rate of 22.32%.

[24] I note, further, that the works licensed under the Direct Licenses represent no more than 2%-4% of the total number of works performed by Sirius XM. Ordover Amended WRT at 4-5, SX Trial Ex. 218; 6/6/12 Tr. 308:3-5 (Noll).

Sirius XM cannot do without. Dr. Noll's observation that the works licensed by the Direct Licensors are representative of the kinds of sound recordings available to Sirius XM in the market is beside the point, for the Judges have concluded before that sound recordings, particularly those of the major record labels, are not readily substitutional for one another, let alone with those of independent record labels. *Phonorecords I*, 74 FR 4510, 4519 (Jan. 26, 2009); *see, generally Webcaster I,* 72 FR 24084 (May 1, 2007). The "representativeness" of the sound recordings contained in the catalogs of the Direct Licensors do not equate to their popularity,[25] an essential ingredient to Sirius XM's music offerings. 6/7/12 Tr. 836:17-22 (Gertz)(*"Sirius XM is very hits driven, and they want to have the most successful service they can, so they're going to use what's popular."*).

Third, I am troubled by the additional considerations and rights granted in the Direct Licenses that are beyond those contained in the § 114 license, thereby weakening their comparability as a benchmark. The Direct Licenses provide for payment of 100% of the royalties to the Direct Licensors, 6/6/12 Tr. 341:10-342:3 (Noll), thereby avoiding the statutory apportionment of 50% to record companies and 50% to artists and performers.[26] 17 U.S.C. § 114(g)(2). Certain of the Direct Licenses, in particular those of the largest independent labels, provide for cash advances and accelerated royalty payments, also not available under the statutory license. *See, e.g.,* Gertz Revised WRT at SXM Reb. Ex. 23, pp. 3-4, SXM Reb. Trial Ex. 8; Gertz Revised WRT at SXM Reb. Ex.

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[25] Dr. Noll's citation to Direct Licensors' catalogues containing Broadway recordings, three former hit singles, and the recordings of George Carlin, as confirmation of the popularity of the works of the Direct Licensors overall, is not persuasive.

[26] I recognize that direct payment to the Direct Licensors does not relieve them of their royalty obligations to their artists and performers; however, receipt of 100% of the royalties upfront is clearly attractive to certain record labels and was a selling point in negotiations with independent record labels. Powers WDT at 4-5, SX Trial Ex. 243.

8, pp. 3-4, SXM Reb. Trial Ex. 8. Sirius XM absorbs all of the administrative costs of the licensing process under the Direct Licenses, which under the statutory license are borne by the copyright owners, artists and performers. Eisenberg Amended/Corrected WRT at SX Ex. 313-RR, SX Trial Ex. 245. And with respect to rights granted under the Direct Licenses, Sirius XM receives a waiver of the sound recording complement of the statutory license, and the ability to perform the works of the Direct Licensors on other services not covered by the statutory license.

My concerns regarding the Direct Licenses are not cured by Dr. Noll's analyses. Dr. Noll contends that the fact the Direct License rates are lower than the current 8% statutory rate is explained by a demand diversion effect—record labels engaging in price competition aimed at increasing their market share through increased plays on Sirius XM, thereby reducing the royalty rates demanded—and represents what would happen in the market as a whole in the absence of a statutory rate. Noll Revised Amended WDT at 36-38, SXM Dir. Trial Ex. 1.[27] His demand diversion theory, however, has limited explanatory power. It may well be that independent record labels took the Direct License offer because of the valuable non-statutory benefits discussed above, and there is testimony in the record to this effect. *See, e.g.,* SX Trial Ex. 317 at SXM-CRB_DIR_00079565; 8/20/12 Tr. 4156:5-4157:3 (Powers). Further, independent labels have greater concerns than majors in securing performances of their works on services such as Sirius XM, increasing the attractiveness of a Direct License relationship. Powers WRT at 4, SX Trial Ex. 243; Eisenberg Amended/Corrected WRT at SX Ex. 329-RR, p. SXM_CRB_DIR_00042287, SX Trial Ex. 245 (*e-mail from MRI to independent label*

[27] Dr. Noll also offers his demand diversion theory as an explanation as to why SoundExchange allegedly attempted to interfere with Sirius XM's Direct License Initiative.

emphasizing that a Direct License offers the possibility of increased airplay). The incentive of increased airplay does not necessarily exist for major record labels, whose works are already performed in large numbers by Sirius XM's hits-driven programming. Harrison Corrected WRT at 9-10, PSS Trial Ex. 32.

Dr. Noll's benchmark analysis, whether considered as corroboration of the Direct Licenses or stand-alone, contains significant flaws. His reliance on the Last.fm agreements with the four major record labels, which provide the critical data to his calculations, is valid to the extent that it is representative of non-interactive subscription webcasting services. *See SDARS-I*, 73 FR at 4090. Two of the agreements, however, have expired and are no longer in effect. Ordover Amended WRT at 25, SX Trial Ex. 218. Last.fm now pays those record companies at the statutory webcasting rate, which is not a *per se* market rate. 8/14/12 Tr. 3308:8-20, 3317:10-16 (Ordover). Even if the Last.fm agreements were the *most* representative of webcasting services—and Dr. Noll has not demonstrated that they are—I would not be inclined to accept them as fully comparable to the SDARS business without some adjustment for the functional differences between webcasting and satellite radio. No persuasive adjustment was offered.

I also have reservations about Dr. Noll's determination of $3.00-$3.45 as the implicit monthly market price for Sirius XM's music channels.[28] Dr. Noll identified three methods for determining the implicit price. The first is the average retail price of $3.15 taken from Last.fm's and Pandora's non-interactive subscription services. Noll Revised WRT Table 1, SXM Reb. Trial Ex. 6. As with Last.fm, there is no adjustment to

[28] The implicit monthly price is applied to the effective percentage-of-revenue rate of [ ] from the Last.fm agreements that serve as the numerator in Dr. Noll's calculation.

account for functional differences between the Pandora webcasting service and satellite radio, whose primary use is in the automobile. The second is to derive a market price for Sirius XM using a survey conducted by Sirius XM's witness Professor John Hauser that attempts to measure the value of music to Sirius XM subscribers. Professor Hauser posited an anchor price for the Sirius XM service to his survey respondents, and then randomly removed features (such as lack of commercials, quality of sound, etc.) to determine how much the respondents would be willing to pay for the service after each feature is removed. After averaging the results, he determined that subscribers place an average value on Sirius XM's music channels of $3.24. Hauser Corrected WDT at Appendix G, SXM Dir. Trial Ex. 24. Professor Hauser's survey is of limited value. By design, the higher number of features or attributes of the Sirius XM service included in the survey, the lower the estimated value of any given service. This produces anomalous results, such as his survey showing that subscribers would pay a certain amount for ubiquitous station availability, premium sound quality and absence of commercials all without any programming content whatsoever. Ordover Amended WRT at 35, SX Trial Ex. 218.

Third, Dr. Noll sought to calculate the cost of inputs necessary for delivery of Sirius XM's programming via satellite and its subsidization/installation of radio receivers in automobiles (described as "unique" costs to the satellite radio service), to then deduct those costs from gross revenues, and allocate the remaining revenue between music and non-music content. Noll Revised Amended WDT at 81-83, 85, SXM Dir. Trial Ex. 1. After making these calculations, Dr. Noll credited 55.1%, or $3.45, to music channels. *Id.* at 88 and Table 3. Sirius XM contends that including the unique delivery costs and

investments of its service is appropriate in Dr. Noll's calculation, and cites to major record company agreements with Cricket and MetroPCS (mobile service providers that bundle telephone service and interactive music service into a single package) that reflect that a percentage royalty rate for music must be reduced by a commensurate proportion to reflect revenue collected for the non-music portion of the bundled service. *Sirius XM PFF* ¶¶ 169-173. However, SoundExchange's expert economist, Dr. Thomas Lys, explained that because most of the unique costs that Dr. Noll allocated are relatively fixed, the per-subscriber amounts vary inversely with the number of subscribers. Lys WRT at 57, SX Trial Ex. 240. Dr. Noll performed his calculation of costs using 2010 data, but had he used subscriber numbers for the years thereafter which have continued to increase and are anticipated to increase further in the coming licensing term, the analysis would show lower unique costs per subscriber and a higher value of music. Lys WRT at 57, SX Trial Ex. 240. The dependency of Dr. Noll's methodology on timing and the number of subscribers undermines its reliability for quantifying what the unique costs are likely to be in the coming rate term. *Id.* at 58. Moreover, Sirius XM's analogy to the bundled services of Cricket and MetroPCS is inapposite. Unlike those services, the success of Sirius XM is dependent upon its access to music. 6/14/12 Tr. 2270:7-2271:15 (Ordover); *see also* 6/5/12 Tr. 235:6-10 (Noll)(*"It's a bundle of services, it's a distribution system, a bunch of nonmusic content and a bunch of music content, all of which are essential. And you pull the plug on any one of them, and the whole thing collapses."*); 6/11/12 Tr. 1431:10-17 (Karmazin). The value of Sirius XM's satellite radio service is the bundling of music and non-music content with its delivery platform,

and Sirius XM has failed to present convincing evidence that its delivery platform and non-music content, alone, present a viable business.[29]

In sum, these concerns, coupled with those surrounding the Direct Licenses themselves, do not inspire confidence that the Direct Licenses are the best benchmark for rate setting in this proceeding. Rather, I believe that the rates between 5% and 7% contained in the Direct Licenses mark the lower boundary of the range of reasonable rates to be determined in this proceeding. The evidence presented establishes that reasonable rates cannot be lower. I now examine the benchmarks offered by SoundExchange and Dr. Ordover.

As an initial matter, the Judges have determined in the past that the interactive subscription service market is a benchmark with characteristics reasonably comparable with non-interactive SDARS. *SDARS-I*, 73 FR at 4093. Sirius XM, however, charges that Dr. Ordover began his analysis in the wrong place by examining rates for interactive services instead of non-interactive services. I do not agree. In saying this, I do not suggest that the market for interactive services, in and of itself, offers the best benchmark from which to begin an analysis of reasonable rates for Sirius XM's satellite radio service. Adjustments, as discussed below, are necessary for the benchmark to be at all useful. However, as a starting point, the interactive subscription service market is more illustrative of a competitive marketplace (willing buyer/willing seller) than the non-interactive subscription service market, where negotiated rates are likely influenced by the availability of the statutory licensing regime for webcasting. *See Webcasting III*, 76

[29] Likewise, Sirius XM has failed to demonstrate that it could successfully substitute away to other providers of music. If that were the case, Sirius XM could have operated its business under the Direct Licenses, for example, and avoided participation in this proceeding altogether.

FR 13026 (Mar. 9, 2011)(*citing Noncommercial Educational Broadcasting Compulsory License, Final rule and order,* 63 FR 49823, 49834 (Sept. 18, 1998))(*"[I]t is difficult to understand how a license negotiated under the constraints of a compulsory license, where the licensor has no choice to license, could truly reflect 'fair market value.'"*). Furthermore, the agreements examined by Dr. Ordover represent a more robust data source from which to consider the outcomes of marketplace negotiations, as opposed to Dr. Noll's confined use of only the Last.fm agreements.[30,31] His observation of a clustering of effective percentage of revenue rates between 60% and 65% for interactive subscription services is supported by empirical evidence and is not misleading or under inclusive.[32] Ordover Third Corrected/Amended WDT at 21 Table 1, 26, Table 2, SX Trial Ex. 74.

I am not persuaded that Dr. Ordover's perceived "failure" to incorporate the costs of Sirius XM's satellite delivery platform renders his interactive subscription services benchmark fatally flawed or in need of adjustment. Dr. Noll asserts that the Sirius XM satellite radio service should be viewed as a bundle of three inputs—music content, non-

[30] Dr. Noll identifies the non-interactive music services offered by Pandora, whom he categorizes as the "big elephant in the room," as highly comparable to the satellite radio service of Sirius XM. 6/5/12 Tr. 286:21-287:7 (Noll). While his comparison is to the compatible features of Pandora, the parties have interjected and argued the royalty rates paid by Pandora for its music services. I am expressly *not* considering the rates, terms or conditions of Pandora's royalty payments in relation to the rates in this proceeding, for to do so would violate the terms of the Webcaster Settlement Act of 2009. *See* 17 U.S.C. § 114(f)(5).

[31] Dr. Noll also considered agreements involving Slacker and Turntable, but only *used* the Last.fm agreements in his analysis. As Sirius XM acknowledges, the Slacker and Turntable services are more interactive than Last.fm, thereby weakening their comparability. *Sirius XM RFF* ¶ 64.

[32] Sirius XM makes much of the fact that rates obtained by the major record labels have dropped almost 20% since *SDARS-I* and argues that this logically must mean that music is worth less than in the prior proceeding. *Sirius XM PFF* ¶ 339. SoundExchange counters that the reason for the 20% drop is the decline in retail prices for interactive services, which SoundExchange concludes is an indication that consumers value interactivity less than before. *SX RFF* ¶ 145. Neither side provided empirical evidence to prove their point, and logic does not dictate that music is of any less, or more, value as a result of this occurrence.

music content, and the satellite platform for delivering the content—and attempts to separately value each component of the bundle. Noll Revised Amended WDT at 80, SXM Dir. Trial Ex. 1. Consumers do not value the satellite platform independent of the content it transmits, 6/7/12 Tr. 666:5-11 (Frear), and Sirius XM has not successfully demonstrated that the satellite platform can be unbundled and sold separately. *See SDARS-I*, 73 FR at 4089; *see also* Ordover Amended WRT at 33, SX Trial Ex. 218 (*Cricket license agreements reflect that its delivery system provides services that have independent value to consumers*). The value of Sirius XM's service is the end product to the consumer, as is the case with the interactive subscription service consumer, and no adjustment for the delivery mechanism is necessary.

To be sure, the rights licensed by interactive subscription services are not the same as those by non-interactive services such as the SDARS, and adjustment to the interactive benchmark is necessary to account for these differences. *See SDARS-I*, 73 FR at 4093. Dr. Ordover attempted to account for these differences by offering two alternative benchmarks. His first alternative begins with the average monthly per-subscriber fee paid by interactive services and reduces that fee in proportion to the ratio of the retail price of Dr. Ordover's hypothetical music-only satellite radio service to the retail price of interactive services. There are doubts as to whether this approach accurately adjusts the interactive service benchmark to account for differences in attributes and functionality between interactive subscription services and satellite radio, and SoundExchange backed away from advocacy of this model in its post-trial submissions. I focus, instead, on Dr. Ordover's second alternative approach, which begins with the average monthly per-subscriber fee paid by interactive services ($5.95)

and then reduces that fee in proportion to the ratio of the average retail price of non-interactive music services to the retail price of the interactive services ($4.86/$9.99). Ordover Third Corrected/Amended WDT at 34, SX Trial Ex. 74.

It is readily apparent that Dr. Ordover's interactivity adjustment to his interactive subscription services benchmark in this proceeding is *not* the same as the one he performed in *SDARS-I*. Dr. Ordover based his adjustment in *SDARS-I* on per-play rates from non-interactive video streaming services, a market that both parties concede effectively no longer exists. *SX RFF* at 164; 8/15/12 Tr. 3573:22-3574:3 (Noll). However, I am not persuaded that the difference—using retail prices for non-interactive services in this proceeding rather than per-play rates—renders his analysis invalid. A straightforward comparison of per-play rates in the interactive and non-interactive markets would be flawed, in that it would not account for differences in intensity of use (average number of plays per subscriber) between the markets, and would involve analysis of non-interactive rates from a market subject to influences of the statutory license. Comparing retail prices between the markets, as Dr. Ordover does, is a reasonable approach as the value of interactivity to consumers will likely be reflected in retail prices. 8/16/12 Tr. 3836:5-11 (Salinger).

While I find Dr. Ordover's comparison of retail prices in the interactive and non-interactive markets *conceptually* sound, his analysis is not without warts. In deriving his average non-interactive service price for the five non-interactive services he examined, Dr. Ordover's averaging technique placed greater weight on the higher-priced services.[33]

[33] The five non-interactive services selected by Dr. Ordover listed one retail price for two services, two retail prices for one service, and three retail prices for two services. Ordover Third Corrected/Amended WDT at ¶ 54, Table 5, SX Trial Ex. 74. The differing prices reflect differing duration commitments for subscribers.

A more accurate method for calculating the average price is to include a single time-frame observation—the price of a year of service—for each of the five services. This procedure reduces the average price to $4.01. Noll Revised WRT at 25, SXM Reb. Trial Ex. 6. Dr. Ordover also did not weight his average by the number of subscribers to each service to account for differences in popularity, presumably because data was not available for all five services. It exists, however, for Pandora, Last.fm and Live365. I accept Dr. Noll's weighted adjustment to $3.15 because of the unlikelihood that the other two services used by Dr. Ordover, Musicovery and Sky.fm, would significantly impact the calculation. *Id.* at 25-26.

In converting his price for non-interactive services to a price for Sirius XM, Dr. Ordover used the monthly price charged to subscribers for the Sirius XM Select package. Ordover Third Corrected/Amended WDT at 43, SX Trial Ex. 74. Dr. Noll suggests that using Sirius XM's Average Revenue Per User ("ARPU") makes more sense, stating that "I doubt that Dr. Ordover disagrees that ARPU, not sticker price, is the correct basis for calculating royalties." Noll Revised WRT at 20 n.5, SXM Reb. Trial Ex. 6. ARPU was $11.22 in the first quarter of 2011 and rose to $11.49 in the first quarter of 2012 after the Sirius XM price increase. I use $11.49 as the most current ARPU figure in the record, and the one most representative for the coming licensing term.

Making the adjustments for the price of non-interactive services and revenues for Sirius XM[34] yields a percentage-of-revenue rate for Sirius XM of 16.2%.[35] Dr. Ordover

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[34] While I am adopting these adjustments to Dr. Ordover's second alternative benchmark, I underscore that I am *not* adopting Dr. Noll's recommended use of the Last.fm non-interactive percentage rate (26.1%) for

opines that his second alternative benchmark generates a lower bound estimate of reasonable rates. Ordover Third Corrected/Amended WDT at 33, SX Trial Ex. 74. However, I am not confident that his benchmark fully adjusts for interactivity to the level of service offered by Sirius XM's satellite radio service. For example, Pandora and Last.fm allow more user control of content than Sirius XM. Noll Revised WRT at 27, SXM Reb. Trial Ex. 6. Musicovery allows users to create playlists within a social network, to ban songs and artists from certain customized channels, and to skip songs altogether, while Sky.fm permits caching for later listening. *Id.* at 28. Additionally, Dr. Ordover's use of the average per-subscriber royalty payment of $5.95, which is drawn from the 60% average royalty fee for interactive services, bakes in the interactive service royalty to his calculation by virtue of its use as a multiplier.

There are other concerns with Dr. Ordover's analysis. For example, Live 365, which charges the most of the non-interactive services that Dr. Ordover observed, offers more than 7,000 channels that are pre-programmed by independent entities and other content that does not closely resemble the Sirius XM satellite. This reduces my confidence that Dr. Ordover's 16.2% benchmark is as reliable as the one the Judges considered in *SDARS-I*. In sum, the 16.2% royalty rate marks the upper bound of reasonable rates in this proceeding, with the lower bound marked by the 5%-7% rates from the Direct Licenses. The appropriate royalty rates lie within this zone, identified by my § 801(b) policy analysis described below.

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the same reasons that a five-year old agreement with two major record labels did not make for a useful benchmark.

[35] This is calculated by multiplying the interactivity ratio of .3153 ($3.15/$9.99) to the average per-subscriber royalty payment of $5.95, yielding an equivalent satellite radio payment of $1.87. The $1.87 per-subscriber rate is then divided by Sirius XM's ARPU ($11.49), resulting in the percentage-of-revenue rate of 16.2%.

4. The Section 801(b) Factors

In *SDARS-I,* the Judges determined that an evaluation of the marketplace evidence hued in the direction of Dr. Ordover's interactivity-adjusted interactive subscription market analysis that marked the upper bound of reasonable royalty rates in that proceeding. *See* 73 FR at 4094. For the reasons stated above, the market-based evidence presented in this proceeding does not weigh in favor of either SoundExchange's or Sirius XM's presentations. Rather, reasonable rates to be paid by Sirius XM for the 2013-2017 licensing period lie along the continuum of rates marked at the lower end by 5%-7% from Sirius XM's presentation and at the upper end by 16.2% by SoundExchange's presentation. Consideration of the § 801(b) policy factors locates the appropriate royalty rates within that range.

a. Maximize Availability of Creative Works

The first policy objective set forth in § 801(b)(1) is to "maximize the availability of creative works to the public." 17 U.S.C. § 801(b)(1)(A). Sirius XM argues that application of the first factor favors adoption of rates at the lower end of the range for three reasons.[36] First, Sirius XM contends that its satellite radio service enhances the delivery and availability of sound recordings by providing nationwide transmissions of sound recordings not played elsewhere. Second, Sirius XM submits that royalties from the § 114 SDARS license are too small a portion of record companies' overall revenue to be a driving force behind decisions to produce creative works. Thus, according to Sirius XM, a lower royalty rate will not reduce record companies' incentives. Third, Sirius XM

[36] SoundExchange, citing Dr. Ordover's testimony, argues that the policy considerations of the first three factors are subsumed in the marketplace benchmarks it has proffered. *SX PFF* ¶¶ 502-507. Since I do not accept the benchmarks of either side as determinative of the rate to which § 801(b) is applied, other than their ability to define the *range* of reasonable rates, SoundExchange's argument is inapposite.

argues that the promotional effects created by its artist-themed channels, special benefits and programming exert a direct promotional impact on the sale of sound recordings thereby generating revenue for rightsholders and inducing them further to create new sound recordings. *Sirius XM RFF* ¶ 99.

I am not persuaded that any of these reasons augurs in favor of rates at the lower end of the range of reasonable rates. While it is acknowledged that Sirius XM's signal is capable of reception in locations in the United States not served by over-the-air terrestrial broadcast radio or wireless Internet service, Dr. Noll could not estimate what percentage of the population (approximately 2% in the U.S.) in these unserved areas actually subscribes to Sirius XM's satellite radio service. Noll Revised Amended WDT at 18-21, SXM Dir. Trial Ex. 1. Even for those persons in unserved areas who do subscribe to Sirius XM, there is no evidence that this group depends upon Sirius XM in order to access music. In fact, Sirius XM's own internal survey demonstrates that subscribers who deactivate their Sirius XM service typically turn to consumption of music on CDs. SX Trial Ex. 8 at 23 (SXM_CRB_DIR_00042796).

With respect to the percentage of record company revenues represented by Sirius XM's § 114 royalty payments, it is true that the percentages of the totals are low; nonetheless, there is testimony that the royalty payments contribute significantly to overall profitability. *See,* 6/13/12 Tr. 2141:1-10 (Ciongoli)(UMG); Ford Amended/Corrected WRT at 13, SX Trial Ex. 244 (Warner); PSS Trial Ex. 33 (Sony). Therefore, it cannot be said that § 114 royalty rates—whether low or high within the range—have no impact whatsoever on record companies' incentives to create new sound recordings.

Finally, there is no objective, quantifiable evidence that Sirius XM's promotional activities with respect to its music offerings, events, and surrounding programming produce a *net* positive impact on record company revenues. While these activities, viewed individually, may have promotional effect on record sales, there is insufficient evidence in the record as to the overall effect of Sirius XM's satellite radio service on all streams of record company revenues from sound recordings. Indeed, Sirius XM's witness Steven Blatter conceded that his examples of on-the-air activities showed only a correlation between airplay and record sales and nothing more. 6/8/12 Tr. 1032:20-1033:7 (Blatter). It may be that Sirius XM's use of sound recordings has an overall substitutional effect upon record company revenues, as opposed to an overall promotional effect. Sufficient and creditable evidence is not present in this record to quantify the promotional/substitutional effect of Sirius XM's service.

In sum, I find that the policy goal of maximizing the availability of creative works to the public is not, due to the paucity of the evidentiary presentations, advanced by royalty rates at either the upper bound or the lower bound of the range of reasonable rates determined from my analysis of the marketplace evidence.

b. Afford Fair Return/Fair Income Under Existing Market Conditions

The second policy objective seeks "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." 17 U.S.C. § 801(b)(1)(B). SoundExchange contends that dramatic changes in the recorded music business within the last decade have placed a greater emphasis on digital exploitation of sound recordings versus physical sales, thereby increasing the importance of revenues generated by the § 114 license. Sirius XM contends that lower

royalty rates are necessary to enable it to recover the investments in its satellite business and achieve profitability.

Charles Ciongoli, Executive Vice President and Chief Financial Officer for Universal Music Group North America ("UMG"), testified that the recorded music business' new reliance on digital revenues is the result of consumers purchasing fewer physical products as they gain more widespread access to music through digital services. As a result, companies like UMG cannot rely solely on the sale of physical products or permanent downloads, as in years past, and must obtain substantial royalty revenues from "access" services, such as Sirius XM, in order to survive. Ciongoli Corrected WDT at 4-6, SX Trial Ex. 67. *See also* Bryan Corrected WDT at 3-4, SX Trial Ex. 66; 6/13/12 Tr. 1969:21-1970:12 (Bryan). SoundExchange submits that digital royalties are even more important for independent record companies to ensure a fair return on their efforts to develop artists in the short and long terms. Van Arman WDT at 3, SX Trial Ex. 77.

Sirius XM states that the costs of its investments in the satellite business, expenses related to research, development, and permitting, and its operating losses must be measured cumulatively, not as a snapshot of annual operating costs, in considering fair return to the user under the second § 801(b) factor. *Sirius XM PFF* ¶ 263. The evidence, according to Sirius XM, demonstrates that it is a long way from earning any return on its billions of dollars of expenditures, in contrast to the record companies which have "presented no evidence that the record industry is not currently earning a fair return on its investments in the production of creative works." *Id.* at ¶ 264.

Evaluating royalty rates that would enable recovery of expenditures of Sirius XM over more than a decade of operations is not required under the second § 801(b) factor.[37] As the Judges observed 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 of a highly leveraged enterprise." *SDARS I,* 73 FR at 4095 (*footnote omitted*). During the current five-year licensing period, Sirius XM has publicly reported in its SEC filings adjusted Earnings Before Interest, Taxes, Depreciation and Amortization ("EBITDA") of positive $2.1 billion, and net income of positive $3.2 billion. Frear WDT at 7, SXM Dir. Trial Ex. 12 (2008-2010 results); Lys WRT at SX Ex. 231-RP, SX Ex. 232-RP, SX Trial Ex. 40 (2011 and 2012 first quarter results), SX Trial Ex. 240; SX Trial Ex. 217 (2012 second quarter results and 2012 full-year guidance). By the end of 2012 under the current 8% of *Gross Revenues* royalty rate, Sirius XM expects to report cumulative adjusted EBITDA of positive $2.6 billion, net income of positive $3.4 billion, and free cash flow of positive $1 billion. SX Trial Ex. 217. EBITDA results are predicted to increase in the coming years, whether the royalty rates are set beginning at 9% in 2013 and rising 1% per year to end at 13% (Morgan Stanley's "base case" scenario), or beginning at 12% in 2013 and rising by 2% per year to end at 20% (Morgan Stanley's "bear case" scenario). SXM Reb. Trial Ex. 12 at 9; *SX PFF* ¶ 568. In sum, I cannot discern how selection of any rate within the range of reasonable rates suggested by the marketplace evidence will fail to enable Sirius XM to earn a fair income in the upcoming licensing period.

With respect to fair return to the copyright owner, I accept the testimony of Mr. Ciongoli and others that revenues from the statutory licenses are of greater importance to

[37] Indeed, it is difficult to imagine royalty rates, other than perhaps those approaching zero, that might make more than a dent in the recovery of billions of dollars of cumulative losses.

record labels as a result of the changes brought about by digital distribution of music and that such revenues contribute to the overall profits. Their importance may be offset somewhat by the gains achieved by the lower costs associated with digital distribution and the efficiencies achieved by the record industry in recent years through downsizing. At best, the record testimony suggests that a royalty rate above the existing 8% of *Gross Revenues* will promote a fair return to copyright owners in the upcoming licensing term, but the evidence does not permit quantification of an increase with accuracy. Nevertheless, I am satisfied that the rates set forth below incorporate the policy considerations of fair return/fair income prescribed in the second § 801(b) factor.

c. Relative Roles of Copyright Owners and User

This policy factor requires that the rates adopted reflect the relative roles of the copyright owners and copyright user in the product made available with respect to relative creative contribution, technological contribution, capital investment, cost, risk, and contribution to the opening of markets for creative expression and media for their communication. 17 U.S.C. § 801(b)(1)(C). The majority of the evidence and arguments submitted by the parties on this factor can be generally described by a single inquiry: who spent more on their business? *Compare, SX PFF* ¶¶ 535-544 *with Sirius XM PFF* ¶¶ 278, 289-290, 294. Capital investments, costs and risk, however, are only part of the analysis required by the third § 801(b) factor. Relative creative and technological contributions, as well as contributions to opening new markets must also be considered. Sirius XM contends that it has pioneered and built a complex satellite delivery system that assures uninterrupted, nationwide availability of programming content, thereby creating a satellite radio business that did not previously exist. *Sirius XM PFF* ¶¶ 280-286.

SoundExchange counters that Sirius XM has exploited mostly existing technology, principally designed and built by WorldSpace, Boeing, PanAmSat and the United States Army. *SX RFF* ¶¶ 252-257.

As is stated with respect to the PSS, *supra*, the task is not to consider each element of the third factor separately and make unspecified, unquantified up or down adjustments to the chosen royalty rates. Rather, the task with respect to the SDARS rate is to consider the elements *as a whole* and determine whether such consideration warrants any directional change in the range of rates established by the evaluation of the marketplace evidence (i.e., 5%-7% on the lower end to 16.2% on the upper end). I conclude, upon careful weighing of the evidence, that the third § 801(b) factor does not require royalty rates that hue to either end of the spectrum of reasonable rates. In fact, little has changed in the evidentiary record relevant to this factor since *SDARS-I*. Sirius XM continues to overstate the originality of its technological contributions, as well as its exposure to risk. Elbert Designated WRT *passim*, SX Trial Ex. 410. No new markets have been opened during the current licensing term, nor is there evidence suggesting that the situation will change in the upcoming term. As was the case in *SDARS-I*, Sirius XM and the record companies continue to invest large sums in operating and advancing their businesses, as well as developing products for the future. The evidence does not indicate that the output or efforts of either side warrants a higher or lower royalty rate.

d. Minimize Disruptive Impact

The fourth policy factor under § 801(b) requires the Judges to determine rates that "minimize any disruptive impact on the structure of the industries involved and on generally prevailing industry practices." 17 U.S.C. § 801(b)(1)(D). The analytical

framework for my evaluation of this factor is well established. A royalty rate may be considered disruptive "if it directly produces an adverse impact that is substantial, immediate and irreversible in the short-run because there is insufficient time for [the parties impacted by the rate] 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*, 74 FR at 4097; *see also Phonorecords I*, 74 FR 4510, 4525 (Jan. 26, 2009).

In *SDARS-I*, it was the Judges' consideration of this factor that merited the adoption of a rate below the upper bound of the zone of reasonable market rates suggested by the interactivity-adjusted Ordover benchmark (i.e., 13%). It is, therefore, not surprising that the parties have devoted most of their argument under § 801(b) to the fourth factor. Much of this argument is inapposite here, however, because it is made in support of the parties' respective rate proposals. The task here is to evaluate rates within the 5%-7% to 16.2% zone of reasonableness and select a rate or rates, consistent with the other § 801(b) factors, that will not cause disruption. This requires consideration of the evidence on disruption presented in this proceeding, *not* the evidence that was presented or evaluated by the Judges in *SDARS-I*.

The record in this proceeding demonstrates that Sirius XM is in a far stronger financial position than it was at the time of *SDARS-I*. At the end of 2007, Sirius and XM[38] had a total of 17.3 million subscribers. SX Trial Ex. 16 at 18 (SXM_CRB_DIR_00021683). By the end of 2012, Sirius XM has announced that, with a net increase of 1.6 million subscribers this year, it will attain 23.5 million subscribers.

[38] The merger of the two companies did not occur until the following year. 6/7/12 Tr. 640:15 (Frear).

SX Trial Ex. 217 at 7. In 2007, Sirius and XM had combined revenue of only $2.1 billion, with combined adjusted EBITDA of negative $565 million. SX Trial Ex. 16 at p. 14-15 (SXM_CRB_DIR_00021680-81). By the end of 2012, Sirius XM has announced that its revenue will be $3.4 billion, and its adjusted EBITDA will be approximately a positive $900 million. SX Trial Ex. 217 at 7. A similar situation applies to free cash flow, rising from negative $505 million in 2007 to approximately positive $700 million in 2012. SX Trial Ex. 16 at 16 (SXM_CRB_DIR_00021682); SX Trial Ex. 217 at 7; *see also* Lys Corrected WDT at 18-21, SX Trial Ex. 80. In 2007, Sirius and XM faced considerable expense in the completion of their satellite builds, the failure of which, the Judges recognized, "clearly raises the potential for disruption of the current consumer service." *SDARS-I*, 73 FR at 4097. Sirius XM has no plans to launch or invest in new satellites during the 2013-2017 licensing period. Lys WRT at SX Ex. 211-RP at 44, SX Trial Ex. 240; 6/6/12 Tr. 607:18-22 (Meyer).

Despite its strong financials in 2012, Sirius XM's witnesses attempt to paint a grim picture for the upcoming licensing term. David Stowell, professor of finance at Northwestern University's Kellogg School of Management, testified that Sirius XM's financial history and substantial accumulated losses evince a threat of disruption caused by higher royalty rates that is "equal to or even greater than the one it faced at the time of the last rate proceeding." Stowell WDT at 21, SXM Dir. Trial Ex. 18. David Frear, Sirius XM's Chief Financial Officer, testified that Sirius XM's brush with bankruptcy in late 2008 (where it struggled to repay the balance due on notes that matured on February 17, 2009, until receiving a loan from Liberty Media) requires that Sirius XM maintain a cash reserve of at least $750 million to guard against future calamity. Frear WDT at 4-5,

SXM Dir. Trial Ex. 12; 6/7/12 Tr. 663:17-665:2 (Frear). Mr. Frear and Mel Karmazin, the Chief Executive Officer of Sirius XM, testified that the satellite delivery infrastructure of Sirius XM radio is inherently risky and that any number of events could seriously impact its ability to deliver programming and result in large, unanticipated expense. Frear WDT at 9, SXM Dir. Trial Ex. 12; Karmazin WDT at 17, SXM Dir. Trial Ex. 19. James Meyer, Sirius XM's President of Operations and Sales, testified that current economic uncertainty can affect the purchase of Sirius XM in automobiles and increase the number of current subscribers discontinuing service (described as the "churn rate"). 6/6/12 Tr. 566:21-568:16 (Meyer); Meyer WDT at 18-19, 29-30, SXM Dir. Trial Ex. 5. And William Rosenblatt, president of GiantSteps Media Technology Strategies, along with Messrs. Meyer, Karmazin, Frear and Professor Stowell, testified that rapidly evolving Internet-based competitors, advantaged by rapidly expanding wireless broadband capabilities and the explosion of smartphone use, present a potentially great disruptive challenge to Sirius XM during the 2013-2017 licensing period. Rosenblatt Corrected WDT *passim*, SXM Dir. Trial Ex. 17; Meyer WDT at 7-18, SXM Dir. Trial Ex. 5; Stowell WDT at 10-11, 22, SXM Dir. Trial Ex.18; 6/11/12 Tr. 1429:6-13 (Karmazin); 8/13/12 Tr. 3042:5-3043:9 (Frear).

The problem with Sirius XM's parade of horribles is that–with one exception–it is belied by the evidence and, in most instances, by Sirius XM's own public statements. Dr. Thomas Lys, SoundExchange's expert economist, presented data projecting Sirius XM's likely future EBITDA and free cash flow (two financial measures that the Judges focused on in considering the disruption factor in *SDARS-I)* using forecasts from Morgan Stanley and Sirius XM's own internal projections. Morgan Stanley projects significant positive

EBITDA and free cash flow for Sirius XM in the upcoming license period under varying scenarios with different royalty rates and economic conditions. Lys WRT at 21-31, SX Trial Ex. 240. Particularly relevant to the consideration of reasonable rates is Morgan Stanley's recent 2012 baseline projection which assumes that royalty rates will begin at 9% in 2013 and rise 1% per year to end at 13%. SXM Reb. Trial Ex. 12 at 9. Under this projection, Sirius XM's EBITDA will increase each year despite the increases in rates and will be higher than Sirius XM has achieved in the history of its company. *Id.* Furthermore, projections made using Sirius XM's own internal forecasts generally corroborate these results. Lys WRT at 11, SX Trial Ex. 240.

Sirius XM vehemently opposes consideration of either the Morgan Stanley or its own internal projections, arguing that long-term financial projections for Sirius XM are not reliable. *Sirius XM RFF* ¶¶ 118-129. It is certainly true that the longer the term of forecast, the lesser the degree of accuracy that can be expected in the latter portion of the term. However, Sirius XM does not and cannot contend that short-term projections, either its own or those of Morgan Stanley, are highly unreliable.[39] Both show substantial EBITDA profitability and positive free cash flow, even under scenarios that exceed the range of reasonable rates I have identified in this proceeding. *See* Lys Corrected WDT at 25-28, SX Trial Ex. 80. A royalty rate can be disruptive under the fourth § 801(b) factor

[39] The record in this proceeding is replete with public statements and assertions by the executive officers of Sirius XM that the company is and will be highly successful and profitable, both in the short term *and* the long term. *See, e.g.*, Lys Corrected WDT at 8, 10-11 (*quoting Mr. Karmazin from November 2011: "[W]e believe we have many, many years of subscriber growth ahead of us."*), SX Trial Ex. 80; 8/13/12 Tr. 3179:7-10 (Frear)(*Sirius XM revenue not just growing, but accelerating*); Lys WRT at 31 & SX 238-RP (*Mr. Karmazin in an April 2012 interview with Forbes magazine: "[W]e're a very profitable, successful company. If we want a performer, we can afford to pay more than anybody else because we're making more."*), SX Ex. 226-RP (*Mr. Karmazin: "Given the predictable nature of our business, we would prefer to take advantage of a prudent level of leverage, which should mean higher returns to our equity holders over time."*), SX Trial Ex. 240.

if it "produces an adverse impact that is substantial, immediate and irreversible in the short-run." *SDARS-I*, 73 FR at 4097. The Morgan Stanley and Sirius XM internal projections convincingly reveal that disruption to Sirius XM will not occur in the short run by royalty rates within the range of reasonable rates identified in this proceeding.[40]

There is also another element of Sirius XM's business operation that persuades me that rates within the reasonable range I have identified in this proceeding will not be disruptive: the Music Royalty Fee. The U.S. Music Royalty Fee was adopted by Sirius XM in July 2009, with the permission of the Federal Communications Commission, as a result of the Sirius and XM merger and in response to the royalty rates adopted in *SDARS-I*,[41] to pass through to subscribers Sirius XM's music royalty costs. After adopting the $1.98 per subscriber per month charge (it is currently $1.42), Mr. Karmazin informed investors that there was no "discernable impact on churn," meaning that the overall price increase to subscribers did not impact Sirius XM's ability to retain its subscribers. Lys WRT at 33-34, SX Trial Ex. 240. Sirius XM's long-range planning documents reveal an intention for future use of the Music Royalty Fee to recoup music licensing expenses, SX Trial Ex. 9 at 6 (SXM_CRB_DIR_00031738), and neither Messrs. Karmazin nor Frear denied that the Music Royalty Fee will continue to appear on customers' bills in some amount in the upcoming 2013-2017 licensing period. Sirius XM's demonstrated ability to pass through music licensing costs to its subscribers

[40] I find Professor Stowell's criticisms of equity analysts' forecasts flawed and unpersuasive. He ignores substantial, published research as to the improved accuracy of projections, particularly within recent years, as well as changes implemented by the Securities and Exchange Commission to eliminate analyst bias. Lys WRT at 11-12, SX Trial Ex. 240. He also ignores recent data criticizing the performance of equity analysts that follow Sirius XM, confining his analysis to only forecasts made prior to the Sirius and XM merger. *Id.* at 14.

[41] Indeed, Sirius XM originally considered calling the fee the "Copyright Royalty Board Fee" instead of the Music Royalty Fee. Lys WRT at 33 n.142, SX Trial Ex. 240.

without discernible, negative impact to its satellite radio business further belies its claims that increased royalty fees from current levels will be disruptive.[42]

Sirius XM also posits several financial risks for the upcoming license period that it claims will be exacerbated by higher royalty rates. First, Sirius XM contends that higher royalty rates will reduce available levels of free cash flow to such an extent as to impair Sirius XM's ability to account for possible downturns in any of its key performance metrics such as churn, conversion from trial to paid subscriptions, and average revenue per user over the upcoming rate term. *Sirius XM RFF* ¶ 117. Unlike consideration of the Sirius XM or Morgan Stanley forecasts, which have reasonable reliability at least in the short term, Sirius XM's suggestions of possible downturns in its satellite radio business are no more than that. While downturns are possible, Sirius XM has not presented compelling testimony that any one or more events are probable and, therefore, must be considered closely.

Second, Sirius XM contends that its "brush with bankruptcy" in the aftermath of the July 2008 merger demonstrates the risk of its debt level and difficulty in accessing credit markets, all of which will be made worse by higher royalty rates. *Sirius XM PFF* ¶¶ 313-314. The "brush with bankruptcy" argument, however, is a red herring, as it was caused by the need to refinance during a global-wide credit crisis and had nothing to do with the § 114 royalty rates. 8/20/12 Tr. 4040:14-4042:7 (Lys).[43] Professor Stowell's conclusion that Sirius XM has a "realistic possibility" of defaulting on its outstanding

[42] SoundExchange and Sirius XM disagree as to what percentage of licensing costs are passed through to subscribers in the Music Royalty Fee. SoundExchange contends 100%, Lys WRT at 32 & SX Ex. 240-RR, SX Trial Ex. 240, while Sirius XM contends 53%. Frear Revised WRT at 16, SXM Reb. Trial Ex. 1. A *substantial* portion of licensing fees is passed on to subscribers in either case, ameliorating the possibility of short-term negative effects of increased § 114 fees.

[43] The odds of another such crisis occurring during the 2013-2017 licensing period are low since that type of crisis has happened only twice in the past 80 years. 8/20/12 Tr. 4046:5-9 (Lys).

debt in the near future is speculative and not based upon the possibility of higher § 114 royalty rates, since the ratings agencies do not discuss such royalties as a primary risk of Sirius XM in assessing its credit quality and likelihood of default. Lys WRT at 23, SX Trial Ex. 240; 8/20/12 Tr. 4049:2-4050:13 (Lys). Moreover, credit rating agencies have repeatedly raised Sirius XM's credit rating over the last few years and believe that it has strong liquidity and ability to finance its debt. Lys Corrected WDT at 31-32, SX Trial Ex. 80; Lys WRT at 47-48, SX Trial Ex. 240.

Third, Sirius XM argues that higher royalty rates will disrupt its ability to recoup billions of dollars of accumulated losses. *Sirius XM PFF* ¶ 312; *see also* Frear WDT at 7, SXM Dir. Trial Ex. 12 (*discussing decrease in Sirius and XM stock prices from 2000 to 2007*). Past losses and decreases in stock prices, however, do not have relevance to a disruption analysis under § 801(b). There is no evidence that the expenditures of prior investors will have any impact on the future decision making or operation of the company. *See, e.g.,* 6/8/12 Tr. 1297:1-8 (Stowell) (*Professor Stowell acknowledging that he did not know if any pre-2008 investors are still owners of Sirius XM stock today*).

In sum, there is no persuasive evidence that an increase in royalty rates from the current level and within the range of reasonable rates identified by the analysis of market evidence will cause disruption to the operation of Sirius XM's satellite radio business in the beginning to middle of the 2013-2017 licensing period. There is, however, testimony that raises the *potential* for disruption in the latter portion of the licensing term. New Internet-based competitors, whose emergence is enabled by the explosion of wireless broadband capability and smartphone use, appear poised to offer the same advantages over terrestrial radio that Sirius XM once claimed only to itself, and without the expenses

associated with a satellite-based delivery system. Meyer WDT at 5-11, SXM Direct Trial Ex. 5; Rosenblatt Corrected WDT at 12-14, 20-38, SXM Dir. Trial Ex. 17. Such competitors can also offer their customers the added benefits of increased customization and personalization which Sirius XM is incapable of providing on its satellite radio service. Meyer WDT at 8-9, SXM Dir. Trial Ex. 5; Rosenblatt Corrected WDT at 20-31, SXM Dir. Trial Ex. 17. Many of these competitive products are being introduced already, particularly in automobiles which lie at the core of Sirius XM's satellite radio business, and *could* cause disruption by 2016 or 2017. *See* Meyer WDT at 15 (*all major car manufacturers expected to incorporate connected-car technology within the next three years*), SXM Dir. Trial Ex. 5. SoundExchange counters that Sirius XM enjoys considerable advantages over Internet radio competitors, such as a head start in integration of satellite radios into the automobile dashboard, current agreements with auto manufacturers, and current limitations on network streaming technology. *SX PFF* ¶¶ 637, 639-640, 642, 645-648. Nevertheless, SoundExchange does acknowledge that Internet-based competitors will grow, along with Sirius XM, in the coming rate term. *Id.* ¶ 650.

The evidence suggests that competition from Internet-based radio, particularly in the automobile, may cause disruption to Sirius XM's business by the final two years of the upcoming licensing period. The potential for such disruption is underscored by the limitations afforded to long-term financial projections (four and five years from now), and the relative speed in technological development demonstrated in the marketplace in recent years for delivery of music. I cannot forecast with certainty the degree to which future Internet-based competition may cause disruption in Sirius XM's business and,

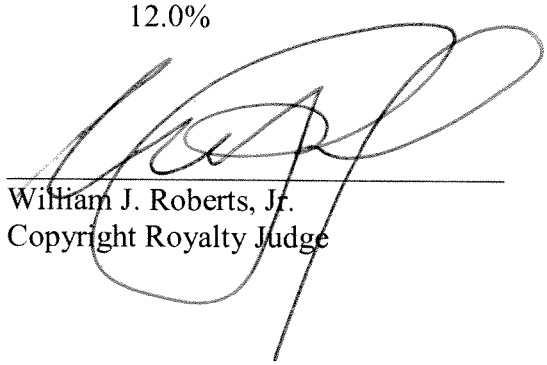
therefore, cannot determine the amount to which royalty rates may or should be reduced to prevent such disruption. However, the *potential* for disruption is suggested sufficiently by the evidence and counsels against escalation of the royalty rates in the last two years of the 2013-2017 license period.

5. Conclusions Regarding Section 114 Rates

As discussed above, analysis of the market-based evidence presented in this case yields a range of reasonable royalty rates between 5%-7% on the lower end, and 16.2% on the upper end. I have analyzed and applied the § 801(b) factors to this range of reasonable rates and conclude that only two of the factors—the second and the fourth—impact the selection of rates within the range for the upcoming 2013-2017 licensing term. The second factor (fair return/fair income under existing market conditions) suggests selection of royalty rates that are above the current 8% rate, albeit without specific quantification. The fourth factor (minimizing any disruptive impact on the structure of the industries involved and on generally prevailing industry practices) counsels against raising the royalty rates further in the final two years of the licensing term. I dissent from the rates adopted by the majority and submit that they should be as follows:

Year	Percentage
2013	10.0%
2014	11.0%
2015	12.0%
2016	12.0%
2017	12.0%

DATED: February 14, 2013



William J. Roberts, Jr.
Copyright Royalty Judge