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

In re	)	
DETERMINATION OF ROYALTY RATES AND TERMS FOR EPHEMERAL RECORDING AND DIGITAL PERFORMANCE OF SOUND RECORDINGS (*WEB IV*)	)	**DOCKET NO. 14-CRB-0001-WR (2016-2020)**

TESTIMONY OF

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PUBLIC VERSION

Witness for SoundExchange, Inc.

TESTIMONY OF DENNIS KOOKER

BACKGROUND

My name is Dennis Kooker. I have been employed in the recorded music business for approximately 20 years. Since 2012, I have served as President, Global Digital Business and U.S. Sales, for Sony Music Entertainment ("Sony Music"), a wholly owned subsidiary of Sony Corporation, and currently the second largest record company in the United States. In this capacity, I am responsible for overseeing all aspects of the Global Digital Business Group and the U.S. Sales Group. The Global Digital Business Group handles business and partner development and strategy for the digital business around the world. The U.S. Sales Group oversees sales initiatives on behalf of each of Sony Music's various label groups in the United States. The areas within the organization that report to me include Business Development & Strategy, Partner Development, Digital Finance, Digital Business & Legal Affairs, U.S. Sales, and Sony Music's distribution service company, RED Distribution.

From 2007-2012, I held two different positions at Sony Music. First, I was Executive Vice President, Operations, for the Global Digital Business and U.S. Sales, and oversaw physical sales, aspects of marketing and finance for the division, new product development, and customer relationship management activities in relation to Sony Music's artist websites. I also developed and implemented key commercial strategies and policies for the physical and digital distribution of our repertoire. After that, I oversaw all aspects of the day-to-day operations of the Global Digital Business and U.S. Sales as Executive Vice President, Operations, and General Manager. During this entire period, the Digital Finance, Sales Reporting, research, and U.S. Supply Chain areas reported to me, and I had general oversight with respect to the artist website and direct-to-consumer sales groups.

From 2004 to 2007, I was Senior Vice President and Controller for Sony BMG Music Entertainment (Sony Music's corporate predecessor). Prior to that, I held a variety of positions with BMG, the music company owned by Bertelsmann AG.

I hold a Bachelor of Science in Business Administration from Shippensburg University and an MBA from St. Joseph's University.

DISCUSSION

I. Sony Music's Position in the Recorded Music Industry

Sony Music is a global recorded music company with a roster of current artists that includes both domestic and international superstars. Its record labels, including Arista Nashville, Columbia Nashville, Columbia Records, Epic Records, Kemosabe Records, Legacy Recordings, Masterworks, RCA Records, RCA Nashville, RCA Inspiration, Sony Classical, Sony Music Latin, and Syco Music, create and distribute music from every genre.

These record labels are home to a wide array of artists, including some of the most popular recording artists in the world. These include Adele, Aerosmith, Beyoncé, Kenny Chesney, Kelly Clarkson, Bob Dylan, Billy Joel, Alicia Keys, Ricky Martin, Yo-Yo Ma, Carlos Santana, Bruce Springsteen, Barbra Streisand, Justin Timberlake, Usher, and many others. Sony Music's vast catalog of recorded music—which dates back over one hundred years—comprises some of the most important recordings in history, including works from many of music's most legendary artists, such as Miles Davis, John Denver, Carole King, Johnny Cash, Frank Sinatra, Rosemary Clooney, Bing Crosby, Benny Goodman, Al Jolson, Janis Joplin, Louis Armstrong, Dolly Parton, Elvis Presley, Vladimir Horowitz, Glenn Gould, Stevie Ray Vaughn, Meatloaf, Glenn Miller, Whitney Houston, and Michael Jackson, to name a few.

Sony Music's year-to-date market share for CD albums in the U.S. is approximately 28.2% (including both owned and distributed repertoire), and its year-to-date U.S. digital market share for digital albums is approximately 26.5% (including both owned and distributed repertoire).

II. Creating, Distributing, and Marketing Recorded Music Is a Capital- and Labor-Intensive as Well as a High-Risk Business

Sony Music makes large capital investments and undertakes substantial risks to create, produce, market and distribute high quality, popular recorded music. Sony Music's investment activity starts with the discovery of talent, primarily through the legwork—literally—of members of our Artists and Repertoire ("A&R") departments. Among other things, A&R representatives go to nightclubs and music festivals throughout the country; spend countless hours listening to "demos"; and search for new artists and emerging trends on the internet. Out of the hundreds or even thousands of potential artists that our A&R departments scout, only a small handful of new artists get signed to recording contracts. In addition, Sony Music invests in third parties who find and develop talent under a range of different business arrangements, such as "label deals," joint ventures and distribution deals. This time-consuming and laborious "research and development" process involves the skills of an array of uniquely talented personnel who have a track record for finding the "next big thing."

Once an artist is signed, Sony Music spends considerable amounts of time and money identifying repertoire to be recorded, hiring producers and musicians, recording the music, honing the artist's interview and live performance skills, and working closely with the artist on the branding and imaging that the artist will use to launch their career.

Among the most significant talent-related expenses are recording costs and artist advances, which enable the artist to make the best recordings possible and subsidize the artist's

living expenses during the recording process. We advance millions of dollars each year for these purposes, including the costs of studios, equipment, background musicians and performers, sound engineers, producers, and all of the other creative talent required to make a top quality sound recording. Our total expenditures for investing in talent and recordings in our most recent fiscal year, ending in March 2014, were roughly . (This figure reflects only our out-of-pocket expenses and does not include the salaries and other overhead costs that are required to locate and sign talent and to oversee the recording process, such as the A&R staff discussed above, which account for millions of dollars more.)

Of course, making a sound recording is only the beginning of the process of bringing the artist's work to a public audience. Once a recording is made, it has to be distributed and marketed. For physical products, there are significant manufacturing costs. For example, in the fiscal year ending March 2014, we invested over in the manufacturing of physical products, including CDs.

We also spend substantial sums distributing both physical and digital product. Excluding overhead, Sony Music's costs of distributing physical products in the last fiscal year exceeded . For the same period, we invested more than to digitally distribute our content, including the costs of employees dedicated to the digital business. We also incur substantial royalty costs, including payments to songwriters and publishers in connection with our music distribution.

Our marketing and promotion costs are even higher than our manufacturing and distribution costs. Sony Music's team of marketing professionals provide world class marketing and promotion services for every Sony Music release. The marketing plan for any project will generally include a variety of components, like promotion, publicity, social media, live tour

support, video promotion, and brand sponsorship, as well as traditional media like print and TV advertising. In the most recent fiscal year alone, we invested over [REDACTED] to sell and market our recordings, including our out-of-pocket marketing expenses and our selling and marketing overhead. All told, we must invest hundreds of millions of dollars annually to connect our artists' visions to their fans.

The money that we invest in recorded music yields substantial dividends to numerous parties besides Sony Music. First, our investments inure to the benefit of individual artists. Once established, the power of an artist's brand of recorded music goes far beyond the sale or other immediate exploitation of that music. An artist's popularity typically translates into a lucrative career as a songwriter, a touring career, the potential for a career in other media (*e.g.*, film or TV), and the possibility of selling other products (everything from clothing lines to fragrance).

The artists we support and the music they create also drive the engines of many other industries, including webcasting and other digital services; satellite and terrestrial radio; live events and touring; various types of consumer electronics, online games and internet applications; merchandise sales; and music publishing, to name just a few. Each of these industries creates jobs, revenue and growth for numerous interested parties and investors. Of course, Sony Music's investments ultimately contribute to the important and unique culture of American music. Today, more than ever, music lovers expect and enjoy the constant flow of new creativity—be that from new recordings or from newly imagined or improved versions of older recordings.

All of this activity starts with the substantial capital that Sony Music and other record companies put at risk every year to find, develop, and promote new talent. As with other "R&D"

driven industries, the risks that we undertake are significant. Notwithstanding Sony Music's best efforts to control costs—particularly in this era of shrinking revenues—we still must spend considerable money to support new releases. The majority of those releases, however, do not return a profit. Most advances are eventually written off. In order for us to continue finding and developing the musical talent that the public desires, we must earn a fair return on the exploitation of our content.

III. The Recording Industry's Transformation from Physical to Digital Sales to the Rise in Music Access Services—and the Corresponding Challenges to Our Ability to Earn Returns on Investments and Make New Ones

As discussed, Sony Music's fundamental challenge is to earn a fair return on the vast sums that we must spend every year to create the music that the public consumes. We make that return by being compensated for the consumption of our content. The way that our content is consumed has undergone radical transformation over the last decade. The changes continue at a rapid pace. That transformation has wide-ranging consequences for our ability to continue to invest the millions of dollars that are required to operate our business. In this Section, I describe the nature of this transformation and the challenges that Sony Music and the entire recorded music industry face as a result.

In Section A, I describe in detail the changes in the way our content is disseminated and consumed—and how we are paid for its exploitation. In particular, music consumption is rapidly shifting from a model based on music ownership (whether physical or digital) to a model based on access to massive libraries of musical content. In a world of music access, the returns to Sony from licensing its content to online services are tied to the revenues that services generate. This means that the higher average revenue per user ("ARPU") that the service generates, the higher the returns to us. As I explain below, the highest ARPU is generated from paying subscribers of

directly licensed services. Our ability to continue to make the investments necessary to invest in new talent and new recorded music will depend on our direct licensees being able to convert free listeners to paid subscribers.

In Section B, I discuss the challenges that direct licensees face in converting free listeners to paid, high-ARPU subscribers because of head-to-head competition from statutory services, and in particular because those statutory services' functionality is rapidly converging with the functionality offered by our direct licensees.

In Section C, I discuss why statutory services do not promote, but instead substitute for, our direct licensees' high ARPU offerings.

A. The Transformation of the Recorded Music Industry

1. The Shift from Physical to Digital

Historically, Sony Music's revenues were principally derived from the sale and distribution of pre-manufactured physical products, including vinyl records, cassette tapes, and more recently, CDs and DVDs. Unlike music publishers, who have long enjoyed the revenues generated from their public performance right every time their songs get played on the radio or TV, the recorded music industry for most of its existence was almost entirely dependent on the revenues generated by the sale of these packaged goods.

Over the last decade, sales of our physical products have fallen precipitously year-over-year. This decline is the result of numerous factors, including the massive online piracy unleashed starting in 1999, advances in technology, and changing consumer preferences. Figures collected and reported by the RIAA show the dramatic decline in record industry revenues caused by the shift away from physical product. The retail value of music distributed

in the U.S. in 2013 was just under $7 billion. This was down almost 20% from $8.7 billion in 2008, and down an astonishing 52% from $14.5 billion in 1999.

Those figures can be broken out further to illustrate the downward decline in physical revenues. In 1999, U.S. manufacturers distributed CDs with a total retail value of $12.8 billion. By 2008, the retail value of CD shipments was down to $5.5 billion—a 57% drop from 1999. And revenue from physical product has only continued to decline. By 2013, the retail value of CD shipments was down to $2.1 billion—a drop of more than 60% from only five years earlier.

Consistent with the nationwide trends, Sony Music's revenue from physical distribution has fallen substantially. Sony Music's U.S. sales of physical product fell from [redacted] in the fiscal year ending March 2009 to [redacted] in the fiscal year ending March 2014.

While revenue from physical product has been shrinking, revenue from digital product has increased—though nowhere near levels sufficient to close the gap caused by plummeting physical sales. In 2013, which was a high-water mark for digital revenues for the recorded music industry, total digital revenues were $4.4 billion—well short of what would be needed to offset the $10 billion annual decline in physical sales that the industry has experienced since 1999.

As with the industry generally, while Sony Music's digital revenues have increased over the last decade, those increases have not been close to sufficient to close the gap from declining physical revenues. In the fiscal year ending March 2014, our total digital revenue was [redacted] (about [redacted] of Sony Music's total revenues). This was an increase from digital revenues five years earlier, when digital revenue for the fiscal year ending March 2009 was [redacted] (about [redacted] of Sony Music's total revenues). While this change represented a [redacted] increase in annual digital revenues by the end of the five-year period, the corresponding decline in annual physical sales was [redacted].

There are several additional observations that are important to make about the shift from physical to digital revenues in the music business generally, and at Sony Music in particular. First, the transition from physical to digital involves not only dramatic revenue reductions, but also substantial investments. There is a popular misconception that the shift from physical to digital distribution entails dramatic cost savings for a record company. In fact, we have to invest heavily in the infrastructure and personnel necessary to maintain a digital business. We have to pay for hardware and software—and continually upgrade the same—in order to digitize and store our content; to transmit it to our digital partners; and to ingest our partners' reporting activity, so that we in turn may account to our artists and other interested parties. And, of course, we have to employ personnel to make these processes run and manage all aspects of a digital business. In our last fiscal year, we expensed more than [REDACTED] in equipment, software and personnel directly related to digital distribution. And, of course, we invest hundreds of millions of dollars more each year in overhead costs that are necessary to run a digital business.

Second, digital revenues will continue to constitute even higher proportions of our revenues as compared to physical in future years. Simply stated, digital revenues—including revenues from streaming services—are and will remain the primary revenues we will depend on to continue making the substantial investments required to operate a recorded music company.

Third, the growth in digital revenue has been nowhere near sufficient to make up for the corresponding decline in physical revenues. The numbers above testify to the dramatic gap in revenues created by the transformation from physical to digital distribution. The consequences have been severe. There has been dramatic consolidation and contraction in the record business. In 1998, there were six major record companies in the U.S. (BMG, EMI, MCA, PolyGram, Sony Music, and Warner Music Group). Today, there are only three (Sony Music, Universal Music

Group and Warner Music Group), and the most recent consolidation (Universal Music Group's acquisition of EMI's recorded music business) took place only within the last two years. The substantial reduction in revenues and consequent industry contraction has led to the loss of thousands of jobs at Sony Music and across the entire music industry. Indeed, the number of Sony Music employees in the U.S. at the end of 2013 is approximately [REDACTED] of the number employed at Sony Music at the end of 2005.

At the same time that our revenues have been shrinking, music consumption has been expanding dramatically. More people are listening to more music now than ever before. But the people who invest in finding talent and bringing new musical works to market are not realizing the benefits of this increased consumption. The challenge, to which I return below, is to remedy this extreme imbalance in the digital world.

2. The Shift from Ownership to Access Models

We currently are in the midst of another major transformation of music distribution—from a digital model based on "ownership" of music to a new model of "access" to digital music. Most of Sony Music's digital revenue in the U.S. over the last decade came from sales of permanent digital downloads (through iTunes, Amazon or other similar online and over-the-air download services), which consumers purchase and store on their digital devices. The last several years, however, have witnessed an explosion in online streaming services. Streaming services represent the second largest component of the digital music business, enabling users to access millions of songs from their personal computers or mobile devices without actually buying the music.

According to a recent MIDiA consumer research survey, ██████ of people in the United States report having listened to music streamed freely online.[1] For those online services that report at least some of their user information, the growth numbers are staggering. Pandora, which operates under a statutory license at pureplay settlement rates, reported 76.2 million active users by year-end 2013—an increase of more than 16% from 65.6 million active users just one year earlier. Pandora reported that its total listener hours grew to 15.31 billion for the 11 months ended December 31, 2013, compared to 12.56 billion listener hours in 2012—an increase of nearly 22%.

A number of factors have accounted for the increasing popularity of streaming services, including the widespread availability of broadband internet connections, the huge expansion of content-delivery from "cloud" storage systems, and the massive growth in the deployment of "smartphones" and other handheld mobile devices that enable internet access from almost any location. Consumers who once bought permanent downloads to listen to remotely on iPods and other portable devices now have virtually unlimited access to music streams through smartphones and associated "apps." Services generally distribute their apps for free, and they have become extremely popular with consumers. For example, Pandora's free mobile app is the fifth most popular app on smartphones, accessed by around 69 million unique visitors.[2]

As technology has made online streaming more widely available, numerous players pursuing diverse business models have flocked to the market for streaming services. These include companies whose primary consumer offering is online streaming, such as Pandora or

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[1] MIDiA Consumer Research Survey June 2014.

[2] http://www.radiosurvivor.com/2014/08/24/internet-dj-week-youtube-becomes-youpay/. (reporting Comscore rankings of smartphone apps).

Spotify. The market also includes companies that offer both streaming and download purchases, such as Apple (which last year launched iTunes Radio). Some companies bundle online streaming with other consumer products, such as Amazon Prime Music (which is bundled with the Amazon Prime subscription service), or with wireless access, such as Cricket and Metro PCS/Rhapsody (which bundle music access offerings with mobile data plans). Other companies, such as Clear Channel (recently renamed "iHeartMedia"), offer a combination of online streaming services, some of which simulcast internet transmissions of the broadcasts from their terrestrial radio stations, and others that provide stations the user can customize based on personal preferences. In a world in which access to streamed content is increasingly dominant, the wide range of streaming services (including statutory licensees) are competing for the potential of consumer dollars that were once spent at record stores and, decreasingly, at online stores for permanent downloads.

Sony Music's revenues from streaming services reflect the shift from an ownership model to the access model. Our revenue from various streaming services has increased from around [REDACTED] in the fiscal year ending March 2009, to approximately [REDACTED] in the fiscal year ending March 2014. However, during the same five year period, Sony Music's revenues from sales of permanent downloads have flattened, and most recently have started to drop. Importantly, for the five months ending August 2014, Sony Music's revenues from download sales have decreased by [REDACTED] from the corresponding five-month period in 2013. Based on market trends, we expect the decline in permanent download sales to be permanent. The decline in permanent download revenues when compared to the increase in streaming revenue illustrates the challenge of simply maintaining a stable ARPU in the face of increased consumption through the access model.

Statistics from across the record industry show that Sony Music's experience with streaming and download revenues is no aberration. According to RIAA data, the proportion of total music industry revenue from all forms of digital streaming services grew from 4% in 2008 to 21% in 2013. Revenue from streaming services to record companies during the first half of 2014 grew by 28% over the preceding year—to $859 million from $673 million during the first six months of 2013. Revenues from the sales of permanent downloads, in contrast, decreased 12% across the same time period—from $1.486 billion at midyear 2013 to $1.305 billion at midyear 2014.

Sony Music anticipates that the movement away from ownership and toward access models will further accelerate over the course of the next statutory rate term. A significant amount of this growth in access models has been and will continue to be fueled by the rapid proliferation of streaming services operating under the statutory license created by Section 114 of the Copyright Act. Such statutory services pay significantly lower rates for our content than our direct licensees. Unsurprisingly, numerous services operating under the statutory license have entered the market seeking to take advantage of these lower rates. The result is a huge expansion of services that make use of our content and, as a consequence, a downward pull on the rates that we can charge our direct licensees. For all of these reasons, the economics of the statutory license for streaming services are of critical importance to us.

3. A Healthy Streaming Sector Relies on the Generation of Higher ARPU

Our content is the core of a streaming services' consumer offering. Without a wide array of recorded music, music streaming services have little to offer their users. If we are to continue to achieve returns on our investments and make new investments in the artists and music of

tomorrow, it is imperative that we receive returns from the services' use of our music that is proportional to the value that we contribute to those services.

We have found that streaming services cannot generate revenues sufficient to compensate us for the value of our music unless those services increase the revenues—specifically, the ARPU—they generate from the consumption of our music. Streaming services are generally unable to significantly increase their ARPU through advertising alone. While there has been some growth in recent years in advertising on streaming services, neither the amounts that advertisers pay nor the average time that services run advertisements are on par with the corresponding dollar amounts and number of ads per hour on terrestrial radio. For example, Pandora's free service runs an average of only five advertisements per hour, lasting a total of between 2.5 and 3 minutes. On its iheart.com site, iHeartMedia (formerly Clear Channel) promotes ad-free, uninterrupted listening on its custom stations. Terrestrial radio, by comparison, runs an average of 17.5 minutes of advertisements per hour.

The limited revenue from advertising on streaming services' free-listening tiers translates into ARPU that is significantly lower than ARPU from directly licensed services' subscription tiers. For example, Pandora reported advertising revenues of $489.3 million for 2013. Spread across Pandora's 76.2 million users at year-end 2013, this yields ARPU from advertising of just $6.42 annually. In contrast, many directly licensed paid subscription services generate annual ARPU of $119.88—many multiples greater than Pandora's ARPU. (Pandora reported subscription revenues for 2013 of $110.9 million. Pandora's subscription revenues do not yield market rate returns to artists and content owners. Even combining Pandora's advertising and subscription revenues yields total annual ARPU of just $7.88—which still is many multiples below the ARPU of many directly licensed paid subscription services.)

The lesson from all this is clear: our ability to continue to risk our capital and invest in new talent depends on healthy growth in paid subscriptions to our direct licensees.

B. Interactive Services Compete Head-to-Head With Statutory Services, and the Functionality the Different Services Offer Is Rapidly Converging

Unfortunately, the ability of our directly licensed partners to increase the numbers of paying subscribers is significantly hamstrung by competition from statutory services. The reality is that consumers only have a finite amount of time to consume music in a day. Sony Music has licensed its catalog to all of the major interactive streaming services operating today—Spotify, Rhapsody, Rdio, Google Play and Beats, among others. We work hard to craft deals with these partners that provide a reasonable return to Sony Music for the decades of risk and investment that went into creating the rich Sony Music catalog. Yet, all of these services compete head-to-head for listener hours with services that operate under the statutory license.

As noted, statutory licensees pay for their content at compulsory rates, and as a consequence exert downward pressure on privately negotiated rates. One of the original justifications for allowing statutory services to pay these lower rates was that the offering under the statutory license would provide a user experience similar to terrestrial radio. Statutory services could offer channels of particular musical genres, but the programming would be selected by the service. If listeners wanted to select their programming, they would have to pay for it through directly licensed services.

That fundamental distinction—between statutory services mirroring terrestrial radio and directly licensed services enabling customized music access—is rapidly disappearing. Statutory services now provide highly customized offerings to consumers. Statutory services employ sophisticated algorithms, user-interface controls, and other computer technology that allow users to communicate their preferences to the service, and the service to customize and curate

programming tailored to the individual user. Examples include interfaces that enable a user to communicate to the service whether they like or dislike content the service is streaming—"thumbs up" or "thumbs down"—and for the service to use that feedback to select the programming it will stream to that user. Through this two-way communication, the user can significantly increase or decrease (or, with enough dislikes, eliminate completely) the likelihood of hearing more music by the same artists. The result is that statutory services can and do progressively refine the individualized programs streamed to their users, thus bringing the experience of listening on statutory services ever-closer to the experience of "on-demand" listening.

Customized radio is just one way in which we have seen convergence between the experience of users of statutorily and directly licensed services. There are others. Both types of services increasingly offer other forms of functionality that are similar along a number of dimensions. For example, statutory services now stream to mobile devices, which used to be a significant incentive that direct licensees could use to migrate free listeners to higher-ARPU paid subscribers. Both types of services also offer users "curated" playlists that the services attribute to popular music "tastemakers"; integration with social media (*e.g.*, Facebook) that enables sharing of playlists with online friends; "recommendations," whereby the service suggests new songs or stations for the user to listen to; and a variety of other common functionality.

The ability of statutory services to offer customized radio and other comparable functionality provides those services considerable competitive advantages against direct licensees trying to convert listeners to higher-ARPU subscription tiers. In the first place, statutory licensees pay only the statutory royalties established for more traditional, non-interactive, non-customized streaming, whereas directly licensed services typically pay higher

rates. Statutory licensees enjoy other relative cost advantages in comparison to directly licensed services, including the fact that statutory licensees do not have to comply with reporting, security, and other requirements that our agreements require of our directly licensed partners. (I discuss these requirements in further detail in Section IV, below.) On the revenue side, statutory licensees have no legal obligation to try to transition their "free" listeners to paid tiers.

The result of all this is a further downward pull on directly licensed services' ability to generate higher ARPU for themselves, and to return higher revenues to content owners. Direct licensees find themselves competing for listeners with closely comparable services that pay substantially reduced rates and that make little or no effort to convert free listeners to paying subscribers. The overall consumer offering on a directly licensed service often will have enhanced functionality (*e.g.*, "on demand" access to particular tracks) and additional listening flexibility not found on a statutory service's offering. But it is difficult for direct licensees to convince users that the differences are worth paying for.

Users also face costs other than monetary charges when contemplating switching from free statutory services to paid subscription offerings. The inputs that users of statutory services provide to fine tune their customized offerings, their channels, and other recorded preferences are not transportable to directly licensed subscription services. The prospect to users of losing their own investments in the customized offering provides another disincentive to moving from a statutory to a directly licensed subscription service. Simply put, it is hard to compete with free—and all the more so where free has comparable functionality and users perceive costs to switching.

In sum, statutory and direct licensees have never been closer in terms of the functionality they offer to consumers. I expect that convergence will continue through the coming rate period.

I also expect that this convergence will provide significant disincentives for consumers to migrate from free to paid services, frustrating our efforts to close the gap in revenue caused by declining sales.

C. The Promotional Benefits from Statutory Streaming Services Do Not Come Close to Offsetting their Substitutional Effect

Statutory licensees frequently try to justify low compulsory rates on the ground that their free offerings promote other sources of record company revenue, such as sales of CDs and permanent downloads. Based on Sony Music's experience and my observations of the broader industry, I believe this proposition is simply untenable in light of market developments.

In the recorded music business, promotion means taking an action with some limited amount of content to incentivize broader consumer awareness and sales. Traditionally, this has meant providing access to some music for free (or at a significantly reduced price) in order to interest consumers in the same or similar products and to incentivize consumers to spend money on such products. An example of this would be a time- or quantity-limited distribution of free singles of an individual track in order to generate consumer interest in buying the album containing the single, other tracks or albums from the same artist, or other parts of our repertoire.

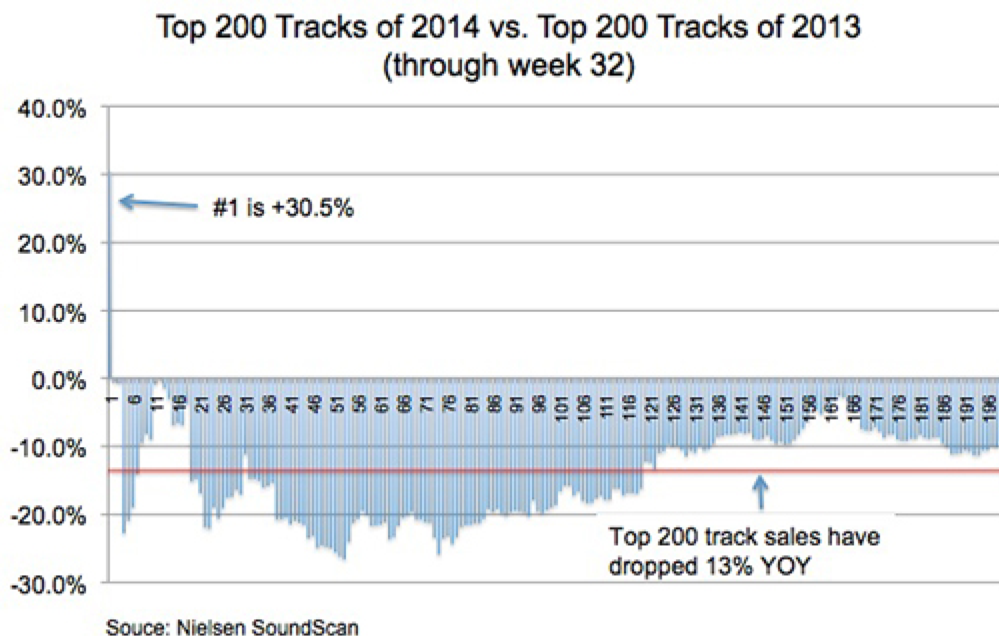
The concept of promotion is a misnomer when applied to streaming through statutory services. In a world increasingly moving to music access rather than music ownership, obtaining access to free streaming does not promote sales, but rather is an end in itself. Streaming is not promoting sales of product. It is the product. Based on Pandora's most recently announced user metrics (from May 2014), its users spent an *average* of 22.5 hours per month listening to the service (1.73 billion listening hours divided by 77 million monthly active listeners). That is a remarkably high level of monthly consumption for a service often touted as simply engaging casual listeners. Moreover, if someone is listening to 22.5 hours per month on Pandora—and

that is just the average—it decreases the likelihood they will have the additional time, interest or inclination to consider paying for music on higher-ARPU directly licensed subscription services.

Statutory services are unlike true promotional activities in many other ways. Statutory services do not make a relatively small number of our works available for free listening for limited times. Statutory services instead use enormous portions of our most popular repertoire and make those works available for free listening in perpetuity. And, as discussed above, statutory services increasingly customize and curate content for individual listeners, such that the individual user's listening experience is much closer to a station designed for one. This, in turn, provides significant *dis*incentives for users to pay for music access. If a consumer is increasingly confident that the next song they hear or the next playlist they select will be closely in synch with their musical preferences, it becomes increasingly difficult to persuade that consumer that they should buy tracks or albums.

We already are witnessing the substitutional effect that streaming services are having on download sales. As reported by *Billboard* (and illustrated in the following chart), with just one exception, every song in Billboard's "Top 200" list of download sales in 2014 through week 32 had sold *fewer* downloads than songs in the corresponding place on the same chart in 2013[3]:

[3] http://www.billboard.com/biz/articles/news/digital-and-mobile/6221778/pharrells-happy-is-a-rare-bright-spot-in-track-sales.



The one exception to this downward trend was the song "Happy," by Pharrell Williams, released on Sony Music's Columbia Records label. But for that exception, releases across our company, and the industry as a whole, have sold fewer copies in 2014 than in 2013. As discussed, our fiscal-year-to-date sales through iTunes and other online retailers of permanent downloads have fallen off from the same period in the preceding fiscal year, and we expect that decline to be permanent. We have not seen any evidence that statutory services have a significant promotional effect on the sale of physical product. Plainly, statutory services are not making a significant promotional contribution to sales of recorded music. Access is supplanting sales, and statutory services are providing access—which is the end product. Any promotional effect statutory services might have is insubstantial compared to the substitutional effect that streaming is having on sales of recorded music.

Nor have we seen evidence that statutory services are significantly promoting users to upgrade to higher-ARPU subscriptions through directly licensed services. Based on my observations of the market, I believe that statutory services have quite the opposite effect, and in

general are making it less likely that their users will pay for higher-ARPU subscription offerings through directly licensed services.

IV. How Sony Music Approaches Deals with Streaming Services

In this Section, I describe briefly some of the key components of our deals with directly licensed services. These components include both monetary and non-monetary consideration we receive for the exploitation of our repertoire. None of these valuable deal components are included in the statutory license.

One of the most important components of our direct agreements is that they generally include a payment structure based on [REDACTED]. This structure ensures that, regardless of the service's business model, Sony Music is fairly compensated for the fact that it and its artists provide the backbone—the music—that is the foundation for the service. The general deal structure further ensures that, if the service is successful and has significant revenues driven by the availability of Sony Music content, Sony Music will share in that success.

For services that include a free-listening tier, Sony Music strives to obtain deal terms intended [REDACTED], which helps to maximize the service's ARPU, and thus overall revenue to Sony Music. For example, Sony Music tries to [REDACTED]. It is generally recognized that increasing the ad-load of any service serves as an effective tool to drive consumers to convert from free to paid services.

Sony Music also requires licensees to meet rigorous security provisions, specifies the audio quality of streams offered by a service, and [redacted]

[redacted]

[redacted]. Sony Music also negotiates detailed reporting requirements, along with technical and financial auditing rights. In addition, Sony Music obtains access to various types of data, which we are able to use to understand consumer interest and to tailor our product offerings to stay current with consumer interests.

Where necessary, Sony Music negotiates holdback rights that restrict our direct licensees from streaming tracks based on restrictions in our artist agreements or for commercial purposes to drive consumer engagement. For example, Sony Music negotiates holdback rights so that it can create exclusive windows for certain content on specific platforms, enabling us to derive greater value, including by the way of lucrative sponsorship opportunities and promotional commitments. The scarcity created by these exclusive promotions proves quite useful in driving users to the services concerned. If, however, we have publicly distributed phonorecords containing the works, then the statutory license undermines our ability to create such scarcity on streaming platforms, since statutory licensees are able to start streaming works following such public distribution.

In addition, Sony Music generally negotiates short term agreements with digital services—from one to three years, depending on Sony Music's experience with the licensee. Sony Music limits the duration of its direct licenses so it is not locked into an unfavorable deal in a still-evolving digital environment. To the extent Sony Music enters into longer-term deals, Sony Music generally requires significant payments to protect it if the service becomes very successful, as well as some ability to terminate in the event the service does not perform as

hoped. The generally short term of our marketplace agreements allows us to continually reassess the viability of a given service and analyze whether any rates need to be adjusted. Five years is an eternity in the digital marketplace. The five-year term of the statutory license means that there is no opportunity to correct for any undervaluation until the next rate-setting proceeding.

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

Date: October 6, 2014

Dennis Kooker