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Copyright Royalty Board

Before the
COPYRIGHT ROYALTY JUDGES
LIBRARY OF CONGRESS
Washington, D.C.

In the Matter of Mechanical and Digital Phonorecord Delivery Rate Adjustment Proceeding	Docket No. 2006-3 CRB DPRA

REPLY OF NATIONAL MUSIC PUBLISHERS' ASSOCIATION, INC., THE SONGWRITERS GUILD OF AMERICA AND THE NASHVILLE SONGWRITERS ASSOCIATION INTERNATIONAL TO THE PROPOSED FINDINGS OF FACT OF THE RECORDING INDUSTRY ASSOCIATION OF AMERICA, INC. AND THE DIGITAL MEDIA ASSOCIATION

July 18, 2008

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flaws, Exhibit 28 depends only on publicly available *estimates* (and extrapolations from those estimates) of music publisher royalty income, notwithstanding that Professor Teece was provided *actual* information from the music publishers. *See* 2/19/08 Tr. at 3730-33 (Teece). In any event, Exhibit 28 proves that, even in nominal dollars, current mechanical royalties are below the levels earned in 2000—a decline that would be greater if considered in real dollars adjusted for inflation. As for Bruce Benson's analysis, it too proves the point of the Copyright Owners, not the RIAA, demonstrating an overall decline in mechanical royalties. *See* RIAA PFF ¶¶ 376-77.

22. The RIAA's reliance on Ms. Santisi's analysis of mechanical royalties fares no better. Indeed, Ms. Santisi's analysis reveals that publishers are experiencing declines in mechanical royalties. In any event, Ms. Santisi's analysis is marred by her failure to account for the impact on mechanical royalty earnings of either catalog acquisitions or inflation. *See* 5/7/08 Tr. at 5216 (Santisi). The RIAA's attempts to rebut the decline in mechanical royalties evident from the HFA financials also fall short; although the RIAA has suggested that the decline is due to a decrease in HFA's share of the mechanical licensing market, a suggestion is not evidence. There is no basis in the record to conclude that the decline in HFA licensing revenue—significant in nominal dollars and even more so when adjusted for inflation—is solely attributable to the fact that publishers are granting more direct licenses.

23. The RIAA's efforts to show that songwriter mechanical income is increasing are no more successful. In support, the RIAA presents a cropped view of Professor Landes' ssongwriter study, but a view of the full seven year period he studied, shows, on average, that songwriters were earning less in 2006 than they were in 2000.

See CO PFF ¶¶ 272-73. In addition to neglecting three of the seven years of the songwriter study, the RIAA disregards all of the testimony of the songwriters attesting to the decline in mechanical royalties they have personally experienced. Finally, the RIAA asserts—contravening the 1981 CRT Decision—that this Court should ignore the troubles of struggling songwriters and focus only on the few extremely popular ones. Even then, the RIAA disregards the evidence, dismissing the testimony of each of the songwriter witnesses who appear before the Court describing today's struggles of even successful songwriters and the resulting depletion of songwriter ranks.

24. The RIAA urges the Court not to worry about mechanical compensation because the music publishers and songwriters get enough elsewhere—in the form of "psychic" satisfaction, other revenue streams and profits. *See* RIAA PFF ¶¶ 399-410, 524, 1168. But none of these alleged benefits should have any bearing in this proceeding to set the mechanical royalty rate for uses pursuant to the compulsory license provisions of Section 115.

25. Here, again, the RIAA disregards the record evidence. Although songwriters testified to their love for their craft, none testified to feeling fairly compensated from the emotional satisfaction of hearing their songs, as RIAA economist witness Daniel Slottje asked the Court to believe. *See* RIAA PFF ¶¶ 1165-70. To the contrary, the songwriters all testified to their need for mechanical royalties to be fairly compensated. *See* CO PFF ¶¶ 231-35.

26. As the evidence further shows, even though songwriters may receive other streams of revenue through non-mechanical uses of their works, such as synchronization and performance, songwriters depend heavily on mechanical royalty income. CO PFF

¶¶ 278-79. For music publishers, mechanical royalty income is no less important. And although the RIAA asserts that a comparison of music publisher revenues and record company revenues—performed by Professor Teece and again based only on his estimates—shows minimal importance of mechanical revenues, Professor Teece's comparison is far from a fair one. Although Professor Teece includes all of the publisher revenue on one side of the equation, he excludes billions of dollars of record company revenue from manufacturing and distribution operations as well as the new forms of revenue such as so-called "360 contracts" on the other.

27. The RIAA's comparison between the profits and market valuations of music publishers on one hand and record companies on the other is no more probative. In the first instance, neither has any bearing on the correct measure of the "fair return" required under Section 801(b). Equally important, as discussed above, the RIAA's characterization of the record companies as barely profitable is incorrect. And to the extent that the music publishers are more profitable, have higher valuations and have not had to endure significant restructurings, that reflects their good management as opposed the record companies' blunders.

Songwriters and Music Publishers Make Critical Contributions to Making Creative Works Available and Bear Significant Risk

28. As it did in 1980 before the CRT, the RIAA accuses music publishers of being "passive"—adding minimal value to the process of making works available to the public and taking little risk. *See, e.g.*, Kushner WDT (RIAA Trial Ex. 62) at 2. The factual evidence—as opposed to the conclusory expert testimony relied on by the RIAA—proves otherwise. As music publisher and songwriter witnesses testified, music publishers make critical contributions through assisting songwriters in the creative

process, and through promoting, licensing and administering their musical works. CO PFF ¶¶ 290-91. At bottom, the record companies' real complaint is that music publishers do not act as record companies. But turning musical works into a form the public will buy is the role of the record company, not the music publisher.

29. The RIAA's inapt comparisons of the investments of certain publishers and certain record companies are also far from persuasive. It compares companies with different market share, markets of dramatically different size and worth, and budgets in absolute dollars rather than percentages of overall revenues. In any event, any reliable comparison of investments of publishers and record companies must, but the RIAA's does not, account for their respective rates of return. As Ms. Santisi conceded at trial, when recordings are hits, the record companies earn many multiples of what publishers earn. 5/7/08 Tr. at 5233-34 (Santisi).

30. The RIAA further contends that music publishers face fewer risks than record companies because publishers attempt to recoup their advances to songwriters, but the record—in particular, the form recording artist agreements in evidence—shows that record companies are well-armed in recouping their advances. *See* CO Trial Ex. 297. The evidence also shows that advances are a risky proposition for publishers, full recoupment is rare and write-offs are frequent. CO PFF ¶¶ 313-16. And while the RIAA claimed that record companies are not as successful as publishers in recouping advances, the Court will not find a single record company financial document to support the claim.

31. The RIAA's characterizations of songwriter contributions and risks are no more accurate. Although dismissed as a low-cost contribution, songwriters make a most

critical contribution: the song that is the foundation for the sound recording. *Id.* ¶ 216. And that contribution is far from low cost; as numerous songwriters testified, it comes at great cost to them and their families. *Id.* ¶¶ 223-28. As the songwriters further testified, songwriters face enormous risk throughout their careers. *Id.* ¶¶ 231-33. That they work other jobs (whether in the music business or not) does not minimize their risk; it is, in fact, evidence of the financial risks they face. Again, the RIAA complains that songwriters do not invest in the manufacture or distribution of recorded music—a point utterly irrelevant to setting a reasonable mechanical rate.

The Record Companies' Contributions and Risks Are Overstated

32. Having understated the contributions and risks of the songwriters and music publishers, the record companies overstate their own. Although the RIAA contends that with the rise of the singer-songwriter, the record companies play a greater role in the actual writing of songs, the rise of the singer-songwriter is nothing new; indeed, the RIAA made the very same argument to the CRT in 1981. *See* RIAA PFF ¶ 354; 1981 CRT Determination, 46 Fed. Reg. at 10472. As for the argument that publishers play a lesser role in songwriting today, the evidence cited by the RIAA says it all: a conclusory statement by Professor Teece, an economist with no prior background in the music industry who conducted not a single interview of any music publisher. And as for the abundant factual evidence from the music publishers, the RIAA simply ignores it.

33. There is much more for which the record companies claim false credit. First, the RIAA exaggerates its marketing, promotion and manufacturing and distribution costs. They have decreased, not increased. Moreover, although the RIAA claims that the record companies are technology innovators, the evidence shows that they were anything

but. *See* CO PFF ¶¶ 363-66. As for their supposed "huge" and "significant" technology investments, the Court will search in vain for any quantification of those industry costs.

34. Finally, as evidence of its alleged high risk, the RIAA relies on its supposedly (but not actually) significantly volatile profit margins as an industry and specifically those of EMI. But little can be inferred from the historical EMI numbers. During years of unprecedented record label profitability, EMI stood alone, losing market share and money as a result of its admitted prior mismanagement. *See* CO PFF ¶¶ 439-48. Going forward, EMI predicts no such risk, projecting profits to rise throughout the rate period. *See* RIAA Trial Ex. 9.

Professor Landes'sMastertone and Synchronization Benchmarks are Appropriate and Sound

35. As the Copyright Owners showed, in selecting benchmarks for the determination of the mechanical royalty rate, Professor Landes sought benchmarks rooted in competitive markets in which users of music acquire the rights to both the sound recording and the underlying musical composition. Landes WDT (CO Trial Ex. 22) at 22-23. Critically, Professor Landes sought benchmarks involving transactions outside the scope of the Section 115 statutory license. *Id.*; 2/7/08 Tr. at 2080 (Landes). Professor Landes found two such benchmarks: the mastertone market and the synchronization license market. From his study of those markets, as described in detail in the Copyright Owners' Proposed Findings of Fact, Professor Landes derived a range of reasonableness for mechanical royalty rates, corroborated by the split of royalties under the Audio Home Recording Act, of between 20% (based on the mastertone market) to 50% (based on the synchronization market) of the total license fees paid for the musical composition and the sound recording. Landes WDT (CO Trial Ex. 22) at 25-26, 29. After analyzing the

Copyright Owners' proposed rates against his range of reasonableness, Professor Landes concluded that they all fell at the low end of his range. *Id.* at 46; CO PFF ¶¶ 543-56. He further determined that the Copyright Owners' proposed rates are consistent with a sound economic interpretation of the Section 801(b) statutory factors. CO PFF ¶ 484.

36. None of the RIAA's or DiMA's attempts to call Professor Landes's conclusions into doubt has support in the facts or economic theory. First, Professor Landes's analysis is not a surplus analysis like that previously rejected by the Court. *See* Landes WDT (CO Trial Ex. 22) at 22-48. It is not—as the rejected analyses were (and Professor Wildman's surplus analysis, in fact, is)—based on market assumptions; it is based on market transactions. Moreover, the breadth of Professor Landes's range of reasonableness—with a spread less than half of that the Court endorsed in the SDARS proceeding—does not remotely make it "implausible." RIAA PFF ¶ 819. (In any event, Professor Landes's testimony made clear his caution on adopting a rate at the high end of his range.). CO PFF ¶¶ 544; 2/7/08 Tr. at 2114, 2254 (Landes). Nor does Professor Landes advocate the "bargaining room" theory rejected by the CRT in 1981. *See* RIAA PFF ¶¶ 1099-1105; DiMA PFF ¶¶ 277-78. He has not endorsed a rate above that which the market can bear. Rather, he properly warned of the risks of setting the rate too low in view of the fact that the statutory rate acts as a "ceiling" above which bargaining does not occur (but bargaining below does), and opined that the statutory rate should approximate an average that would be paid by the parties in a free market. Landes WRT (CO Trial Ex. 406) at 2; Landes WDT (CO Trial Ex. 22) at 29; 2/11/08 Tr. at 2692-97 (Landes).

37. With respect to its criticisms concerning the mastertone benchmark specifically, the RIAA does no better. The RIAA tries, but fails, to show that the supply

and demand characteristics of the mastertone market differ meaningfully from the physical phonorecord and permanent download markets. RIAA PFF ¶¶ 900-07. And even if there were differences in the supply and demand characteristics of the market, they would hardly call for casting aside the mastertone benchmark, which Professor Landes has looked for assessing the relative value of the musical composition and sound recording, not to argue that the same rate should be set for mastertones, physical products and permanent downloads.

38. The evidence also does not bear out the RIAA's claim that the mastertone market is shallow and insignificant in terms of sales and revenue. The mastertone market is filled with a wide breadth of releases and today represents the third largest source of revenue for the record companies. And although the bulk of that revenue derives from a fraction of mastertones, that is no different from the rest of the hit-driven recorded music industry. CO PFF ¶ 513. Moreover, record company projections—ignored by the RIAA—put the lie to its claim that the mastertone market was considered "fleeting" at the time of the first mastertone agreements. *See* RIAA ¶¶ 918, 920-21. Internal record company documents and forecasts also debunk the assertion that the mastertone market is now in rapid decline and will soon be obsolete. *See, e.g.*, Murphy WDT (CO Trial Ex. 15), Ex. 702 at RIAA 391390; *accord* CO Ex. 731 at RIAA 28574-82. In fact, the market is projected to increase to $1.5 billion in 2012. *See* Enders WDT (Co Trial Ex. 10) Ex. C. at 5-6.

39. As the Copyright Owners' Proposed Finding of Fact also demonstrate, there is no basis on which to call into question the mastertone rates agreed to in the New Digital Media Agreements ("NDMAs") between the music publishers and the record

companies. CO PFF ¶¶ 520-22. The RIAA did no analysis to support the proposition that the pre-existing markets for monophonic and polyphonic ringtones somehow inflated the mastertone rate. Nor is there a stitch of support for the argument that the NDMAs—which require advance written approval for each song incorporated into a mastertone—are "blanket licenses." *See* Faxon WDT (CO Trial Ex. 3), Ex. 219 at 13; Firth WDT (CO Trial Ex. 24), Ex. 332 at 15.

40. Equally unavailing is the notion—floated repeatedly by the RIAA—that the mastertone rates were the product of a series of tradeoffs. The mastertone rates are not "package deals" lacking in probative value. Rather, they are consistent with prior and contemporaneous mastertone licensing activity, as well as later standalone mastertone licenses. Landes WRT (CO Trial Ex. 406) at 36-37; CO PFF ¶¶ 501-02, 506-07. Nor is there any record evidence of "concessions" on which the mastertone rates purportedly were based. As an example, despite the RIAA's argument that record companies agreed to such rates to get the DualDisc product to market, the evidence shows that the launch of the DualDisc predated the NDMAs and that the DualDisc was dead before several record companies agreed to extensions of the NDMAs at the very same rates. CO PFF ¶¶ 525-28.

41. Unable to refute the propriety of the mastertone benchmark, the RIAA argues that, if used for any product, the mastertone benchmark's 20% wholesale rate requires adjustment. But the RIAA's proposed adjustment is based on a flawed "surplus analysis" conducted by Professor Wildman and unsupported by any fact in evidence—indeed, Professor Wildman's analysis is precisely the type of surplus analysis previously rejected by the Court. Beyond being theoretically flawed, Professor Wildman's surplus

adjustment calculations are unreliable because his cost and revenue figures derive from Mr. Benson's highly suspect work. *See* 5/12/08 Tr. at 5974-77 (Wildman). Equally problematic is Professor Wildman's assumption in his analysis that the record companies have no fixed costs, and his exclusion of the costs of songwriters, including opportunity costs.

42. Turning to Professor Landes' ssynchronization benchmark—50% of the content pool—the RIAA first erroneously argues that this Court has rejected such a benchmark in its prior decisions. *See* RIAA PFF ¶¶ 831-32. But the situation in those cases is easily distinguished from that presented here. First, Professor Landes does not advance the argument that musical compositions should receive the same absolute compensation that they receive in the synchronization market when they are used in physical product, permanent downloads or ringtones. Rather, he has presented the synchronization benchmark as instructive on the *relative* value of the rights. Landes WDT (CO Trial Ex. 22) at 23, 25; 2/7/08 Tr. at 2078-80, 2083-84 (Landes). Second, the musical works benchmark put forward in Webcasting involved different sellers who were selling different rights—far from the case here.

43. Nor is there any merit to the RIAA's arguments that the dynamics of the synchronization market somehow undermine the synchronization benchmark. *See* RIAA PFF ¶¶ 851, 853, 857. The RIAA has failed to prove that any of these factors—such as the ability of licensees to acquire alternative recordings of songs—drive the equal fees for the uses. In fact, the evidence shows that there is symmetry of such pressures on both sides. Landes WRT (CO Trial Ex. 406) at 31; 5/7/08 Tr. at 5293-95 (Pascucci). And there is no evidence to support the RIAA's assertions that artists somehow drive up the

synchronization rate at the expense of the master use license. 5//7/08 Tr. at 5302 (Pascucci).

The RIAA's Proposed Effective Mechanical Rate and First Use Benchmarks Are Not Appropriate Market Benchmarks

44. The RIAA's headline proposed benchmarks are the "effective mechanical royalty rate" and the rate for the "first use" of musical compositions. RIAA PFF ¶¶ 575-667. Although the RIAA characterizes these two benchmarks as "market" benchmarks, they are, in fact, anything but. Both suffer the fundamental flaw of being derivative, not independent, of the statutory rate, a fact conceded by the RIAA's economist who sponsored these benchmarks, Professor Wildman. *See* CO PFF ¶¶ 660, 675-698; *see also* 5/12/08 Tr. at 5893-94 (Wildman). Indeed, this Court's Webcasting I Decision, on which the RIAA relies to support these benchmarks—arguing that a transaction for the exact product issue makes the best benchmark—in fact counsels that an ideal marketplace benchmark is "one in which no compulsory license exists" (a principle followed by the Court in both its Webcasting II and SDARS decisions). *See Webcasting I CARP Decision* at 21; *Webcasting I Librarian's Decision*, 67 Fed .Reg. at 45244 ("Webcasting I"); *see also SDARS*, 73 Fed. Reg. at 4090, 409, *infra* Sec. VII.B.

45. To the point, the benchmarks applied in the Webcasting I were the product of voluntary transactions that predated the proceeding and were entered into prior to the existence of a statutory rate.

46. In support of its effective rate benchmark, specifically, the RIAA argues that because mechanical royalty rates never exceed the statutory rate, the true "market" is below the statutory rate. But as economists and fact witnesses from both sides agreed, and as the CRT concluded in 1981, the statutory rate acts as a ceiling on the negotiation

of mechanical royalty rates. Landes WRT (CO Trial Ex. 406) at 39; 5/12/08 Tr. at 5900 (Wildman). The RIAA nevertheless asserts that if the "market" were higher than the statutory rate, the Copyright Owners would somehow be able to extract the statutory rate in addition to the transaction costs associated with the statutory license and that there would be significant use of the compulsory license given the Copyright Owners' demands for market rates. The record evidence—including that publishers too receive benefits from creating efficiencies through establishing a central licensing clearinghouse, which makes the licensing more attractive thereby increasing the demand for it—easily explains why neither situation occurs. Landes WRT (CO Trial Ex. 406) at 37-38.

47. Moreover, reduced mechanical rates obtained by the record companies through their use of controlled composition clauses cannot serve as evidence that the market rate is below the statutory rate. Mechanical royalty rates in controlled composition clauses are not independent market rates; they are intertwined with other financial arrangements between the record company and the recording artist, and are agreed to as part of the recording agreement, a complex multi-part contract governing a wide variety of rights. CO PFF ¶¶ 684-93. Witnesses from both sides attested to the fact that the rates in controlled composition clauses are the result of trade-offs between the record companies and the recording artists—a fact confirmed by the language of the recording agreements themselves setting forth the various financial terms of the arrangement and the CRT's 1981 Decision, which observed that singer-songwriters "freely negotiate their entire royalty packages, including both artist royalties and mechanical royalties." *See* Teece WDT (CO Trial Ex. 64) at 29; 5/12/08 Tr. at 5892-93 (Wildman); 1981 CRT Determination, 46 Fed Reg. at 10483.

48. The RIAA's reliance on mechanical rates agreed to by so-called "outside" writers who co-write their songs with singer-songwriters is equally misplaced. The "outside" rates are no more independent than those produced by controlled composition agreements because, as Professor Wildman conceded, the agreements between "outside" writers and singer-songwriters cover more than just mechanical rates.

49. Moreover, as the Copyright Owners' economist Kevin Murphy testified, if in fact controlled composition clauses had any independent market significance, the percentage reduction or cap on tracks subject to payment in those clauses should have adjusted downward over time as the statutory rate rose. K. Murphy (CO Trial Ex. 400) at 16. Professor Murphy's empirical work in that regard—unrebutted by the RIAA—demonstrates that neither adjustment occurred, compelling the conclusion that controlled composition clauses are simply derivative of the statutory rate. *See id.* at 14-17.

50. As the evidence also shows, market dynamics limit the choices of singer-songwriters to refuse to accept controlled rates. Perhaps most telling of the merits of the RIAA's claim that controlled rates are somehow market rates is the RIAA's confession that if its lower alleged "market" rate were adopted by the Court, its use of controlled composition clauses would simply be—in the words of a record company executive—"pegged to the new statutory rate," further depressing the compensation of the Copyright Owners. *See* 5/12/08 Tr. at 5744 (A. Finkelstein).

51. With respect to the non-controlled discounted licensing in the market offered by the RIAA in support of its effective rate benchmark, the evidence shows that the Copyright Owners discount only when there is sufficient reason to do so and that the overwhelming majority of HFA and direct licensing through music publishers is at the

statutory rate. 2/5/08 Tr. at 1666-68 (Peer); CO PFF ¶¶ 269-76. Indeed, as Professor Landes' sempirical analysis of discounting showed, the frequency of discounting has declined as the statutory rate has increased—demonstrating that the statutory rate is capping rates that would exceed the statutory rate in the free market. Landes WDT (CO Trial Ex. 22) at Fig. 4, 5. Finally, the RIAA's assertion that too-high transaction costs act as a barrier to obtaining below-statutory rates when appropriate has no support in empirical evidence.

52. The RIAA's "first use" benchmark is equally infirm. As even Professor Wildman conceded, because of the substitutability between first and second uses of musical works, first use rates "are not independent of the statutory rate." 5/12/08 Tr. at 5894 (Wildman). The evidence further shows that first use rates—used by singer-songwriters to launch their works into the marketplace—are inextricably linked with controlled composition clauses and thus are part of bundled agreements that preclude their use as market rates. *See* Faxon WRT (CO Trial Ex. 375) at 13; *see also* CO Trial Ex. 56 at RIAA 4575.

53. Beyond lacking a basis in fact and economic theory, the RIAA's effective mechanical rate and first use rate benchmarks cannot be supported by Professor Wildman's empirical analysis. As uncovered during Professor Wildman's cross-examination, his analysis is fundamentally flawed. Among other problems, it relies on unverified data for limited periods of time (one quarter for two of the three companies he examined) and examines only mean, not median values. *See* CO PFF ¶¶ 699-706; 5/12/08 Tr. at 5910-11, 5928 (Wildman). There is no basis to derive a market rate from the bit of empirical work that he performed.

54. In sum, there is no support in the record for the RIAA's effective rate and first use rates as market benchmarks.

The 1981 CRT Decision and Cherry-Picked International Rates Are Not Appropriate Market Benchmarks

55. The RIAA's revived reliance on an erroneously derived rate from the 1981 CRT Decision and selective international rates—its benchmarks from the direct trial seemingly abandoned on rebuttal—fare no better.

56. As the Copyright Owners demonstrated and the RIAA concedes, the recorded music market has undergone transformational change since the time of the 1980 proceeding. 2/19/08 Tr. at 3640 (Teece). In any event, Professor Teece's analysis of the 1981 CRT Decision to derive a rate is unsound. As the record reveals, he rested his analysis on a baseless assumption that all albums then were sold at the retail list price, even though the evidence before the CRT—evidence available to the RIAA and Professor Teece—was to the contrary. CO PFF ¶¶ 670-74. Thus, Professor Teece's derived rate of 7.8% of wholesale revenue has no empirical foundation.

57. As for the RIAA's selected foreign rates from the U.K. and Japan, they too have no merit as market benchmarks. In the first place, although the RIAA purports to compare the mechanical rates in the U.S. to the rates in the U.K. and Japan to support the baseless proposition that the U.S. rate is one of the highest in the world, the RIAA's "comparison" is meaningless because it applies its derived percentages in those markets to three different bases—CD prices (the U.S.), PPD (the U.K.) and retail (Japan). *Id.* ¶¶ 716-18. The only evidence in the record as to the comparability of those bases, from Copyright Owner Witness Jeremy Fabinyi, is that they cannot be compared. *Id.* ¶ 722-23; Ex. F-1, Ex. F-2.

58. Mr. Fabinyi's testimony—filling out the international field of mechanical rates that the RIAA intentionally left incomplete—further establishes that the U.S. rate is far from one of the highest in the world, instead falling far behind many countries, particularly with respect to CDs. *Id.* ¶ 722. Although the RIAA attempts to revive the attacks made on Mr. Fabinyi's knowledge and methodology in its failed effort to exclude his testimony, there is no basis in the record to question the data he presents. *Id.* ¶¶ 722-25.

59. Finally, the record evidence demonstrates the myriad fundamental differences among the markets in the U.S., U.K. and Japan—including different licensing regimes and different market conditions—which leave the RIAA's international benchmark worthy of no weight. CO PFF ¶¶ 711-18, 721.

The RIAA's Derived Demand Analysis Has No Economic Basis

60. The RIAA's "derived demand" theory deserves no credit. According to the RIAA, economic theory requires the mechanical royalty rate to decrease as the price of CDs declines because the value of inputs into a final product is "derived" from the final value of that product so a reduction in value of the final product necessitates a reduction in value of the inputs. RIAA PFF ¶¶ 545, 549-55.

61. But as Professor Murphy—hardly endorsing the RIAA's derived demand theory (as the RIAA mistakenly claims)—explained, under settled economic theory there is no valid reason for the per-copy mechanical royalty rate to decrease as the overall demand for recorded music declines. K. Murphy WRT (CO Trial Ex. 400) at 6-14. In fact, economic theory predicts the opposite: under conditions of falling revenues and sales of recorded music, compensation per unit would need to rise for songwriters, who have fixed costs of production, but not for inputs with variable costs, such as those made

by the record companies. *Id.* at 8. Professor Murphy's empirical work proved his point. Among other observations, Professor Murphy found that artist royalties had risen as a fraction of overall record company costs even as CD sales and prices fell. CO PFF ¶¶ 733-34; K. Murphy WRT (CO Trial Ex. 400) at 8-13.

62. Professor Slottje—the RIAA's own economist—provided no greater support for the RIAA's "derived demand" theory. He conceded that, unlike Professor Murphy, he had not done the empirical analysis necessary to reach a conclusion concerning how a decline in demand would affect the mechanical royalty rate. 5/8/08 Tr. at 5345-47, 5393-96 (Slottje).

DiMA Has Presented No Factual or Benchmark Support for its Rate Reduction

63. As the Copyright Owners demonstrated, there is no support in the record for the 30% reduction of the mechanical royalty rate sought by DiMA. Although DiMA argues that such a drastic reduction is necessary to allow the supposedly "nascent" digital market to evolve, to protect current providers, and to allow others to enter, the evidence shows not only that no such reduction is necessary, but also that the vibrant digital market can easily bear the Copyright Owners' proposed rates. *Id.* ¶¶ 84, 831-35.

64. Today, the permanent download market (the only segment of the market left at issue following the parties' settlement with respect to rates and terms for limited downloads and interactive streams) is thriving. Having enjoyed dramatic growth since the launch of Apple's iTunes Store in 2003, the permanent download segment of the market is projected to earn revenues reaching $2.7 billion in 2012, with the entire digital market projected to reach $5 billion in 2012. Enders WDT (CO Trial Ex. 10) at 22, Ex. C. at 4.

65. Today, Apple's iTunes Store commands 85% of the permanent download market and its success—which DiMA attempts to hide throughout its Proposed Findings of Fact—has been stunning. The iTunes Store has consistently generated a contribution margin for Apple in the range of [redacted] (putting to one side Apple's profits from the sales of iPods driven by the sale of music through iTunes). CO PFF ¶ 27. In fiscal year 2007, iTunes profits were around [redacted]. 2/25/08 Tr. at 4295 (Cue); *see also* CO Trial Ex. 85. Indeed, even if Apple (against current practice) were to absorb the Copyright Owners' proposed increase, it still would enjoy [redacted]. CO PFF ¶ 466, Table 10-E.

66. Apple is no longer the only player in the permanent download market. Numerous firms have entered the market under the current penny rate (some even under pricing Apple). *See* CO PFF ¶¶ 60, 625. DiMA did not offer a speck of financial evidence from any of them to support the claim that they cannot survive absent a rate reduction. Nor did DiMA provide any financial information from the subscription services to show their costs and expenses for permanent downloads separate from their subscription services.

67. Left with no evidence to support its rate reduction and ample evidence to support a rate increase, DiMA resorts to mischaracterizing the record. Thus, DiMA marshals evidence in support of various of its claims that has nothing to do with permanent downloads and everything to do with the limited download and interactive streaming business for which the rates have been settled. As just an example, DiMA argues for a rate reduction based, in part, on Napster's purportedly high marketing expenses. But as is made clear from the evidence, Napster, although it offers permanent

downloads to consumers, is primarily a subscription service and incurs high marketing expenses because consumers resist such services. Enders WDT (CO Trial Ex. 10) at 51. The marketing costs of the iTunes Store, by contrast, are a mere fraction of Napster's costs and are the only costs relevant here. *Id.* at 49. Simply put, DiMA's non-permanent download evidence should be afforded no weight.

68. And to the extent that DiMA hangs its rate proposal on the effects of piracy, as ample evidence from all parties shows, piracy is a threat to everyone. But it has not prevented the iTunes Store from thriving, others from entering the permanent download market, or the digital market from continuing its significant growth. *See generally*, CO PFF ¶¶ 457-66. Nor is there any merit to DiMA's persistent suggestion that consumers are price-sensitive. Neither Apple nor DiMA's economist, Margaret Guerin-Calvert, performed any price sensitivity studies or provided any empirical support for the claim. 2/26/08 Tr. at 4581-83 (Guerin-Calvert).

69. Beyond lacking factual support, DiMA's proposed rates have no support in any benchmarks. The only benchmarks presented by DiMA in its findings are the 1981 CRT Decision and the mechanical royalty rate in the U.K. and, for the reasons discussed above, they cannot carry the day. CO PFF ¶¶ 809-20.

The Penny Rate Should Remain in Place

70. The RIAA and DiMA also fall far short of carrying their heavy burden to overturn the penny rate in place for physical product and permanent downloads. Indeed, all that the RIAA and DiMA proved was precisely why the Court should not adopt a percentage of revenue rate for those products.

71. As the Copyright Owners demonstrated, the penny rate is a usage-based metric that preserves the value of the underlying musical compositions no matter how

they are used. CO PFF ¶¶ 582, 593-95; *see also* 2/7/08 Tr. at 2173 (Landes). The copyright users do not, as they cannot, dispute that critical point.

72. Rather, the RIAA and DiMA both contend that only the percentage rate will provide their members with the necessary flexibility to flourish and innovate in the marketplace. But the record evidence establishes the contrary. Neither the record companies nor the digital music companies have hit any penny-rate related obstacles in releasing product or developing services. CO PFF ¶¶ 623-33. To the extent that those companies have faced problems with their products or services, that is the fault of the products' or services' lack of attractiveness to consumers, not the penny rate. Indeed, although the Copyright Users claim that the Court should adopt a percentage-based rate because it is used in many other countries, the evidence shows that the digital market in the U.S. has far outpaced the markets in those countries and has done so under a penny rate. *Id.* ¶ 634.

73. In defense of their non-usage-based percentage metric, the RIAA and DiMA contend that the Copyright Owners need not worry because their interests are allegedly aligned with those of the Copyright Users. But again the record proves them wrong, revealing that both the record companies and the digital music companies operate to generate profit, whether or not that maximizes revenue. *Id.* ¶¶ 607-08. And as the Copyright Owners demonstrated, the revenue definitions proposed by the RIAA and DiMA—easily subject to manipulation by them—illustrate just how risky a percentage of revenue rate is for the Copyright Owners. *Id.* ¶¶ 609-23.

II. The Record Companies are Enjoying Growing Prosperity

74. Throughout the direct and rebuttal trials in this proceeding, and in their Proposed Findings of Fact, the Copyright Owners demonstrated that the record companies' cries of economic distress are unsupported by fact. Simply stated, although the record companies' top-line revenues have declined, they are enjoying banner profits, particularly as a result of rapidly growing sales of digital music products. *See, e.g.*, CO PFF ¶ 417; CO Trial Ex. 41; H. Murphy WDT (CO Trial Ex. 15), Ex. 3A.

75. Notwithstanding the ample evidence of the record companies' record profitability, the RIAA's Proposed Findings of Fact lament a purported "perfect storm" of events rocking the recorded music industry since 1999, and allegedly continuing unabated today. *See, e.g.*, RIAA PFF ¶ 178. The record companies have righted their ship through restructurings and sales of digital products (such as permanent downloads and ringtones) that feature far higher profit margins than those of physical goods have soared and continue on that path—leading to levels of profitability never before seen in the past 17 years. *See, e.g.*, CO PFF ¶¶ 398-401, 424-33. The forecast for the future is undoubtedly bright. *See, e.g., id.* ¶¶ 467-77.

76. Moreover, as explained in the Copyright Owners' Proposed Findings of Fact, the record companies drifted off course in large part because they made a series of poor business decisions. As numerous record company executives and documents concede, the record companies were unprepared to react nimbly when the "storm" first hit, because in the late 1990s, they were weighed down by excessive overhead and other out-of-whack costs. *See* CO PFF ¶¶ 398-401.

77. Indeed, a Universal Music Group presentation, reproduced in relevant part below, shows that the "perfect storm" was not simply a whirlwind of external forces, as

the RIAA claims today. Rather, it resulted from, among other things, [redacted]

[redacted]—all factors well within the control of the record companies.

[redacted]

[redacted]

Source: H. Murphy WDT (CO Trial Ex. 15), Ex. 700 at RIAA 018075.

78. By their own admission, the record companies did not take the "[redacted] that they recognized was necessary. *See id.* at RIAA 018076 (according to Universal, [redacted]. Even though the record companies have completed restructurings, overhead remains their most significant cost, both as a

percentage of revenue and in absolute dollars, and many of the record companies' other costs—hardly "cut to the bone"—have risen when viewed on a percentage of revenue basis. *See* CO PFF ¶¶ 422-23. Just as important, the evidence shows also that when the supposed storm hit, the record companies refused to embrace digital music, sinking hundreds of millions of dollars in ill-conceived services and products, and stalling the legitimate digital market, allowing the pirates to reign. *See, e.g., id.* ¶¶ 363, 367-74.

79. As telling of the true state of the record companies' health as the evidence presented by the Copyright Owners is the lack of it offered by the RIAA. In fact, the RIAA hangs its picture of the alleged woes of the entire recorded music industry on "evidence" drawn primarily from only one of the majors—EMI Music. *See, e.g.,* RIAA PFF ¶¶ 180, 207, 274-75. But as trial testimony from current and former EMI executives conclusively established, EMI is an outlier, listing in the marketplace as a direct result of poor management choices, excessive spending, loss of market share and high return rates on physical product. *See, e.g.,* CO PFF ¶¶ 447-49; RIAA Trial Ex. 9 at 4032291; 2/26/08 Tr. at 4749-50 (Munns), 2/13/08 Tr. at 3157-58 (C. Finkelstein). And notwithstanding EMI's troubles, EMI's own internal documents predict a dramatic return to growth for its recorded music division—both in revenue and profitability. *See* RIAA Trial Ex. 9 at CO 4032299.

80. The RIAA's anecdotal evidence with regard to independent record companies (Concord Music Group and Shout! Factory) is no more compelling. *See, e.g.,* RIAA PFF ¶ 222 (claiming that mechanical royalty costs are increasing for "indie labels"). The RIAA has neither established that these two companies are representative of the other "indie labels" that constitute 30% of the recorded music marketplace, nor

proven that these companies are unable to succeed under current business conditions. Indeed, Concord is thriving, earning a profit margin of over 20% in 2007. *See* CO Trial Ex. 83 (Concord P&L statement).

81. Beyond presenting conclusory statements and cherry-picked evidence, the RIAA relies on testimony and evidence that was thoroughly discredited at trial. For example, the RIAA presents Bruce Benson's profitability by format analysis absent any acknowledgment that Mr. Benson's calculations—which left out billions of dollars in record company profits from manufacturing and distribution and ignored future sales of profitable mobile products—were exposed as fatally flawed through cross-examination. *See, e.g.,* RIAA PFF ¶¶ 316-23.

82. In sum, the RIAA's "perfect storm" presentation of the record companies' alleged current economic condition is easily cleared through a comprehensive review of the record evidence.

A. The RIAA's Picture of the Record Companies' Financial Health Is Misleading

83. Throughout its proposed findings, the RIAA lodges complaints about trends in the music industry—including declining wholesale and retail revenues, reduced wholesale and retail prices, piracy, retail and radio consolidation, and the migration from albums to singles—most of which equally affect the Copyright Owners, and none of which has diminished the record companies' profits or dampened their bright future in the digital music era. *See, e.g.,* RIAA PFF ¶ 178; *see also, e.g.*, Israelite WDT (CO Trial Ex. 11) at 9-10 (piracy has "dramatically undercut the mechanical royalty stream"); Bogard WDT (CO Trial Ex. 2) at 8 ("corporate consolidation in the music industry and among radio stations" results in reduced business opportunities for songwriters); 1/29/08

Tr. at 429-30 (Faxon) (shift from a CD-album based market to a digital-single based market affects music publishers and songwriters).

1. The Record Companies Are Enjoying Record Profits

84. As the RIAA's Proposed Findings of Fact concede, profits are the most important measure of a firm's health and success in the marketplace. RIAA PFF ¶ 785. ("It is well understood in elementary economic theory that the main purpose of a firm is to earn profits.") (citing Slottje WRT (RIAA Trial Ex. 81) at 12).

85. Despite the admitted importance of profits in assessing the record companies' financial well-being, the RIAA failed to provide any empirical analysis of the record companies' profits, instead focusing on declining revenues. *See, e.g.,* RIAA PFF ¶¶ 185-200. Notwithstanding the RIAA's emphasis on revenues, however, its expert witness Professor Teece admitted that the increase in the mechanical royalty rate has not been the cause of the record companies' falling revenues. 2/19/08 Tr. at 3803 (Teece). When asked whether record companies' declining album sales in recent years were attributable to mechanical royalties, Professor Teece testified: "No. I don't think it's the mechanicals which is pushing this curve down. It's a whole set of demand-related phenomena." *Id.*

86. The RIAA ignores profitability data compiled by its own witnesses, instead erroneously contending that the record companies have only "eke[d] out slim profits in recent years." RIAA PFF ¶ 1540; *see also id.* ¶ 3 ("record companies that recently have eked out profit margins closer to 5%"); *id.* ¶ 181 (characterizing record companies' profit margins as "modest"); *id.* ¶ 216 (referring to record companies' profit margins as "small"); *id.* ¶ 696 ("record companies have eked out some profit"). The

RIAA ignores the facts for an obvious reason. The evidence in this proceeding unmistakably shows that the record companies have not been scraping by on "slim" profit margins, but have instead in recent years reaped their best profits in nearly two decades.

87. In the direct trial, the RIAA presented financial data for the major record companies for 1991-2005 through witness Linda McLaughlin. (Ms. McLaughlin's data was prepared in 2006, at the beginning of this proceeding, and this did not include financial results for any year after 2005.) As set forth in the chart below, which was created by Ms. McLaughlin, the majors earned $740 million in profits in 2005, the majors' most profitable year of the entire time period. The second most profitable year for the majors during that 15-year period was 2004, when their profits totaled $571 million. CO Trial Ex. 41 at 1.

CO Trial Ex. 41

Confidential

ALL LABELS COMBINED
BMG, EMI, POLYGRAM, SONY, SONY/EMG, UMG & WBMG

	1991	1992	1993	1994	1995	1996	1997	1998 ($Millies)	1999	2000	2001	2002	2003	2004	2005
Net Sales Revenue	3,043	3,546	3,903	4,341	4,330	4,477	4,643	5,008	5,916	5,583	5,203	5,214	4,835	5,188	5,413
Net License Income	301	343	364	452	549	523	463	627	525	564	564	520	570	624	601
Mechanical Royalties	237	279	322	374	372	367	397	495	512	428	440	471	443	487	550
Artist Royalties	555	651	742	792	831	819	912	1,120	1,228	1,143	1,078	1,209	1,051	1,218	1,270
Advances & Recording	259	223	223	252	292	333	335	392	412	331	277	350	450	304	247
Direct Marketing	493	514	569	624	710	805	899	1,035	1,024	1,119	1,153	997	832	797	892
Manufacturing	670	776	787	779	794	761	689	624	606	610	570	541	576	574	579
Distribution	414	463	524	552	559	587	615	585	629	637	621	576	541	503	434
Overhead	653	785	918	1,053	1,111	1,223	1,246	1,382	1,289	1,329	1,338	1,199	1,409	1,354	1,363
Total Costs	3,282	3,606	4,085	4,425	4,609	4,697	5,098	5,703	5,919	5,652	5,478	5,343	5,321	5,242	5,334
Total Revenue	3,345	3,894	4,362	4,793	4,932	5,000	5,111	6,235	6,442	6,147	5,832	5,734	5,404	5,812	6,074
Revenue less Costs	62	153	277	368	269	103	18	532	522	495	354	392	83	571	740
Digital Revenue														197	555

Source: CO Trial Ex. 41 (emphasis added).

88. Although Ms. McLaughlin's numbers show record profits for the majors in recent years, she actually significantly understated the total profits of these companies

because she omitted entirely from her presentation the profits generated by their manufacturing and distribution companies, at the instruction of counsel for the RIAA.

> Q: Let me just try to be clear. Am I correct that you asked counsel for the RIAA whether you should include such information relating to manufacturing and distribution . . . profits in your report, and you were told not to; isn't that correct?
>
> A: That's correct.
>
> Q: And if you had included that information, there would have been additional profits reported with respect to the U.S. recorded music companies, correct?
>
> A: Yes.

2/13/08 Tr. at 3074 (McLaughlin).

89. The majors' additional profits from manufacturing and distribution are substantial, to say the least. In 2002, Ms. McLaughlin testified to a California Senate subcommittee that over the 1991-2001 time period, the majors' "[o]perating and licensing profit, including manufacturing and distribution profit on label sales, amounted to $5 billion or 9 percent of revenues." CO Trial Ex. 43 at RIAA 8368. In stark contrast, the financial data she presented in this proceeding (and shown above), which excluded manufacturing and distribution profits, suggested that the majors profits' for the same 11-year period were only $3.2 billion, or 5.6% of total revenues. *See* CO Trial Ex. 41 at 1. In other words, Ms. McLaughlin's data left out approximately $1.8 billion—or 36%—of the majors' profits for the 1991-2001 time period.[1] Although the RIAA did not provide

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[1] The Copyright Owners' Proposed Findings of Fact state that Ms. McLaughlin testified in 2002 that "record companies earned $5 billion in profits on their manufacturing and distribution companies from 1991 to 2001." CO PFF ¶ 440. This statement should state that "record companies earned $5 billion in profits, including profits on their manufacturing and distribution companies, from 1991 to 2001."

information sufficient for the Copyright Owners to determine the amount of the majors' manufacturing and distribution profits that Ms. McLaughlin omitted from years subsequent to 2001, logic dictates that the number ends in a billion.

90. Based on Ms. McLaughlin's information, Copyright Owners' witness Helen Murphy calculated, among other things, the profit margins for the major record companies in the 1991-2005 time period. H. Murphy WDT (CO Trial Ex. 15) at Ex. 3A. Ms. Murphy's calculations show that the majors' profit margins were 12.2% in 2005 and 9.8% in 2004. *See id.* Thus, both on a percentage basis and in nominal dollars, 2004 and 2005 were the most profitable years for the major recorded music companies in the 1991-2005 time period, far outpacing record company profits in the 1990s, when wholesale revenues were rising as the CD sales grew. Ms. Murphy's chart (Ex. 3A from her written report) is reproduced below.

EXHIBIT 3A: TOTAL REVENUES, OPERATING PROFITS AND OPERATING MARGINS OF U.S. RECORDED MUSIC MAJORS

Historical, Aggregated U.S. Recorded Music Majors Financial Results

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	Sum	Average
Net Sales Revenue	3043	3546	3993	4341	4390	4477	4643	5608	5916	5583	5268	5214	4835	5188	5413	71463	4764
Net License Income	301	348	364	452	549	523	468	627	526	564	564	520	570	624	661	7661	511
Total Revenue	3344	3894	4362	4793	4939	5000	5111	6235	6442	6147	5832	5734	5405	5812	6074	79124	5275
Mechanical Royalties	237	279	322	374	372	367	397	495	512	488	440	471	443	487	550	6234	416
Artist Royalties	555	651	742	792	831	819	912	1120	1223	1148	1078	1209	1061	1218	1270	14634	976
Advances & Recording	259	223	223	252	292	333	335	392	412	331	277	350	459	304	247	4689	313
Direct Marketing	493	514	569	624	710	805	899	1035	1094	1119	1153	997	832	797	892	12533	836
Manufacturing	670	776	787	779	794	761	669	694	686	610	570	541	576	574	579	10086	672
Distribution	414	468	524	552	559	587	615	585	699	637	621	576	541	508	434	8320	555
Overhead	653	785	918	1053	1111	1223	1246	1382	1289	1329	1338	1199	1409	1354	1363	17652	1177
Total Costs	3282	3696	4085	4425	4669	4897	5093	5703	5919	5662	5478	5343	5321	5242	5334	74149	4943
Operating Profit	62	198	277	368	269	103	18	532	522	485	354	392	83	571	740		
Operating Margin	1.8%	5.1%	6.4%	7.7%	5.4%	2.0%	0.4%	8.5%	8.1%	7.9%	6.1%	6.8%	1.5%	9.8%	12.2%		
Percent of Total Revenue																MIN	MAX	AVG
Mechanical Royalties	7.1%	7.2%	7.4%	7.8%	7.5%	7.3%	7.8%	7.9%	7.9%	7.9%	7.5%	8.2%	8.2%	8.4%	9.1%	7.1%	9.1%	7.8%
Artist Royalties	16.6%	16.7%	17.0%	16.5%	16.8%	16.4%	17.8%	18.0%	19.1%	18.7%	18.5%	21.1%	19.6%	21.0%	20.9%	16.4%	21.1%	18.3%
Advances & Recording	7.7%	5.7%	5.1%	5.3%	5.9%	6.7%	6.6%	6.3%	6.4%	5.4%	4.7%	6.1%	8.5%	5.2%	4.1%	4.1%	8.5%	6.0%
Direct Marketing	14.7%	13.2%	13.0%	13.0%	14.4%	16.1%	17.6%	16.6%	17.0%	18.2%	19.8%	17.4%	15.4%	13.7%	14.7%	13.0%	19.8%	15.7%
Manufacturing	20.0%	19.9%	18.0%	16.3%	16.1%	15.2%	13.5%	11.1%	10.6%	9.9%	9.8%	9.4%	10.7%	9.9%	9.5%	9.4%	20.0%	13.3%
Distribution	12.4%	12.0%	12.0%	11.5%	11.3%	11.7%	12.0%	9.4%	10.9%	10.4%	10.6%	10.0%	10.0%	8.7%	7.1%	7.1%	12.4%	10.7%
Overhead	19.5%	20.2%	21.0%	22.0%	22.5%	24.5%	24.4%	22.2%	20.0%	21.6%	22.9%	20.9%	26.1%	23.3%	22.4%	19.5%	26.1%	22.2%
Total Costs	91.0%	87.8%	86.3%	84.5%	87.0%	90.6%	91.9%	83.5%	83.9%	84.2%	86.4%	85.0%	90.2%	81.3%	78.8%	78.8%	91.9%	86.2%

Source: RIAA 003423

Source: H. Murphy WDT (CO Trial Ex. 15), Ex. 3A (emphasis added).

91. Unable to dispute this evidence, the RIAA attempted to alter it after Ms. McLaughlin testified in the direct phase of the proceeding. To that end, Mr. Benson updated Ms. McLaughlin's work by adding financial results for 2006, and at the same time substantially revised the financial information for prior years by subtracting [redacted]. *See* CO PFF ¶¶ 449-52; *see also* Benson WRT (RIAA Trial Ex. 82) at 6, Appendix A; 5/8/08 Tr. at 5524-30 (Benson).

92. Yet, even after Mr. Benson recast the financial results for the major record companies for the 1999-2006 time period, 2004 and 2005 remained the profitable years in that time period, both in nominal dollars and on a percentage basis. RIAA PFF ¶ 191, Fig. 5. According to Mr. Benson, the majors enjoyed profits of $500 million in 2005 and $405 million in 2004, which amounted to operating margins of 8.5% and 7.0%, respectively. *See id.* The information presented by Mr. Benson suggested that profits in 2006 dipped to $300 million, or 5.6%, not far off from the industry's 1999 and 2000 numbers. *See id.*

PFF Figure 5

US Majors - Totals from 1999 to 2006

In $US Millions

	1999	2000	2001	2002	2003	2004	2005	2006	CAGR
Net Sales Revenue	5,916	5,583	5,268	5,214	4,835	5,157	5,220	4,847	-2.8%
Net License Income	526	564	564	520	570	624	630	490	-1.0%
Total Revenue	6,442	6,147	5,832	5,734	5,404	5,781	5,850	5,336	-2.7%
Mechanical Royalties	512	488	440	471	443	488	527	547	1.0%
Artist Royalties	1,228	1,148	1,078	1,209	1,061	1,217	1,229	1,104	-1.5%
Advances & Recording	412	331	277	350	459	304	234	246	-7.1%
Direct Marketing	1,094	1,119	1,153	997	832	766	843	824	-4.0%
Manufacturing	713	630	607	583	594	595	598	511	-4.6%
Distribution	816	745	741	695	628	652	601	563	-5.2%
Overhead	1,289	1,329	1,338	1,199	1,409	1,354	1,318	1,241	-0.5%
Total Costs	6,064	5,791	5,634	5,504	5,426	5,376	5,350	5,036	-2.6%
Operating profit	378	356	198	231	(22)	405	500	300	-3.2%
Operating Margin	5.9%	5.8%	3.4%	4.0%	-0.4%	7.0%	8.5%	5.6%	-0.6%

Source: RIAA PFF ¶ 191, Fig. 5 (emphasis added).

93. Put another way, even Mr. Benson's analysis—reporting doubly artificially depressed numbers—shows that from 1999 through 2003, the average profit margin for the majors was 3.7%, and that from 2004 through 2006, their average profit margin was 7.0%. The trend is clear: profits are on the rise.

94. But Mr. Benson's revisions should not be credited. Mr. Benson testified that he made adjustments to Ms. McLaughlin's work based on "new" financial data obtained from Universal subsequent to Ms. McLaughlin's testimony. Although the [redacted] Mr. Benson, by his own admission, never spoke to anyone at Universal about why any of these changes were necessary, and had no understanding as to why Universal had provided financial data that was materially different from the information that Ms. McLaughlin had sworn to be true. CO PFF ¶¶ 451-52; *see also* Benson WRT (RIAA Trial Ex. 82) at 32-33; 5/8/08 Tr. at 5524-29, 5536-39 (Benson).

95. Mr. Benson's testimony also makes clear that he reduced the majors' profits reported in his work by ignoring manufacturing and distribution profits. *See* CO PFF ¶ 454; 5/8/08 Tr. at 5555 (Benson). For example, Mr. Benson calculated that Universal lost [redacted] in 2006 even though Universal's 2006 P&L, maintained in the ordinary course of business, showed a profit [redacted] for Universal's distribution company and a total profit of [redacted] for the Universal Music Group as a whole. *See id.*; CO Trial Ex. 264. The relevant portion of Universal's 2006 P&L statement (CO Trial Ex. 264) is reproduced below:

[redacted]

[redacted]

Source: CO Trial Ex. 264 (emphasis added).

96. At trial, Mr. Benson confirmed that the profit earned by Universal in 2006 amounted to [redacted]. CO PFF ¶ 444; 5/8/08 Tr. at 5554 (Benson). Yet, as Figure 5 in the RIAA's Proposed Findings of Fact (reproduced above) shows, Mr. Benson reported that the total profits for the major record companies in 2006 were just $300 million—[redacted] lower than Universal's profits.

97. Just as significant, the majors' current record profits also debunk the record companies' claim that they earned higher profits when mechanical royalties were lower. Professor Teece has asserted that the mechanical rate was set at a more appropriate level during the 1990s, because at that time it was allegedly in line with other record company costs and wholesale prices. *See* RIAA PFF ¶¶ 223-24. But during this

nine-year period, according to the financial data provided by Ms. McLaughlin, the majors' profit margins ranged from a low of 0.4% to a high of 8.5%, and averaged only 5.0%. *See* CO Trial Ex. 41 at 1; *see also* H. Murphy WDT (CO Trial Ex. 15), Ex. 3A. Indeed, for three of these years, the majors' aggregate profit margins were 2.0% or lower. *See* H. Murphy WDT (CO Trial Ex. 15), Ex. 3A.

98. Thus, it is far from the case that the record companies enjoyed better financial results before the mechanical rate supposedly began to move "out of step" with other costs and wholesale CD prices. In stark contrast, today, the majors' profit margins stand well above years past, notwithstanding the record companies' declining wholesale revenues. Indeed, during the time period from 1991 through 1999, the CD was penetrating the market, and the major record companies' total revenues practically doubled—from approximately $3.3 billion in 1991 to $6.4 billion in 1999. *See* CO Trial Ex. 41 at 1. Yet, despite this substantial revenue growth, the average aggregate profit margin achieved by the record companies was, as shown above, 5.0%.

99. In any event, the lower profits of the 1990s did not prevent the record companies from entering into the last industry-wide agreement to raise mechanical royalties. In 1997, the record companies agreed to increase mechanical royalties from 7.1 cents per song to 9.1 cents per song over a 10-year period, even though the majors had "eked out" a profit of only 2.0% in the previous year, 1996.

100. The record evidence of the financial performance of independent record companies, although sparse, tells a similar story of improving profit margins.

101. Notably, the RIAA did not introduce any aggregate financial data for independent record companies into evidence. Mr. Benson, for instance, acknowledged

that his report presented financial information only for the majors, and that he had no information with respect to the costs, revenues or profitability of any of the independent recorded music companies, which make up 30% of the market in total. *See* CO PFF ¶ 453; *see also* 5/8/08 Tr. at 5492-93 (Benson). Nor did Ms. McLaughlin present financial results for any of the independents. In fact, the record contains the P&L statement of only one independent record company, the Concord Music Group ("Concord")—introduced into evidence by the Copyright Owners, not the RIAA. *See* CO Trial Ex. 83.

102. The Concord P&L demonstrates that, as a percentage of net record revenue, Concord's EBITDA [redacted] in 2002 to [redacted] in 2007, with a low of [redacted] and a high of [redacted]. *See id.* The information below, which can be used to calculate Concord's profit margins, is excerpted from Concord's P&L statement:

[redacted]

[redacted]

Source: CO Trial Ex. 83.

103. Although Concord's EBITDA includes the profits of a small music publishing company that it owns, Concord CEO Glenn Barros testified that this publishing company accounted for only approximately 15% of Concord's profits, meaning that the remaining 85% were generated by its recorded music business. *See* 2/21/08 Tr. at 4101 (Barros).

104. Accordingly, the record evidence shows that independent record companies—far from finding it "difficult or impossible to make the economics work" in the music business, RIAA PFF ¶ 222—may actually be more profitable than the majors. At the very least, the financial results of Concord, and the RIAA's concomitant failure to introduce the financial statements of any other independent record company into evidence, should foreclose the RIAA from arguing that independent record companies cannot be profitable under current market conditions.

2. The RIAA Has Failed To Prove that the Record Companies Are Financially Troubled

105. The RIAA has advanced three arguments in an attempt to explain away the record companies' dramatic return to profitability. None has merit.

(a) The Record Companies' Profit Margins Simply Reflect Their Business Judgments

106. First, the RIAA complains that "record company profit margins are, at best, orders of magnitude lower than the margins earned by music publishers." RIAA PFF ¶ 181. But that comparison is beside the point. As for the comparison that matters—how the record companies are doing today, as opposed to in their supposed glory days—the fact is that the major record companies' profit margins, even if lower than the publishers' margins, have dramatically improved.

107. Moreover, by all accounts, including those of record company executives, any lag in the record companies' profit margins, compared to those of the publishers, reflects the less than prudent business judgments routinely made by record company executives. *See, e.g.,* CO PFF ¶¶ 398-401, 447-49. As RIAA expert witness Daniel Slottje has observed, "[p]roducers that make good forecasts profit from their good judgment. Producers that make poor forecasts suffer economic losses and may lose all or

part of the capital that they have put at risk." RIAA PFF ¶ 784 (quoting Slottje WRT (RIAA Trial Ex. 81) at 11).

108. There is no shortage of examples of the record companies' bad business decisions in the record. During the 1990s, the major record companies squandered their resources and bloated their costs. *See* CO PFF ¶¶ 399-401. Indeed, as the Universal presentation excerpted above showed, by the late 1990s, talent, recording, marketing and overhead costs were all out of control. *See* H. Murphy WDT (CO Trial Ex. 15), Ex. 700 at RIAA 018075. The majors' mismanagement led to the significant personnel reductions that occurred during the record companies' subsequent restructurings. *See* CO PFF ¶¶ 399-401; *see also* H. Murphy WDT (CO Trial Ex. 15) at 15; 1/30/08 Tr. at 558 (Faxon).

109. Further, by their own admission, the record companies were slow to embrace the development of the digital market in the late 1990s, and waited until 2001 and 2002 to set up unwieldy subscription services that were "doomed to fail," allowing Internet piracy to explode. 2/26/08 Tr. at 4754 (Munns); *see also* CO PFF ¶¶ 364-70; 2/4/08 Tr. at 1155-57 (Enders); Enders WDT (CO Trial Ex. 10) at 11. And according to Eddy Cue, Apple's Vice President of iTunes, the major labels rebuffed Apple's attempt to enter the digital distribution market, delaying the launch of iTunes by six months to one year, during which time piracy continued to run rampant. *See* 2/25/08 Tr. at 4320-21 (Cue). (Indeed, the majors are particularly responsible for the piracy explosion, because their decision—disputed by songwriters and music publishers—not to put copy protection on CDs allowed PC-users to easily copy audio files from CDs onto their personal

computers, and then to upload them to the Internet. *See* CO PFF ¶ 362; 2/5/08 Tr. at 1397-98 (Israelite).)

110. Thus, although the RIAA bemoans the fact that "when CDs began to sharply decline in the year 1999, there was nothing to replace it: digital distribution did not begin in earnest until 2005," RIAA PFF ¶ 234, the record companies have themselves to blame. Putting aside that iTunes launched, and became an overnight success, in 2003, not 2005, the record companies, which are in the business of distributing music, made a colossal blunder when they failed to enter the digital market quickly with a product that was attractive to consumers.

111. In addition, even though growth in the recorded music industry, in the record companies' own words, will come from delivery of music over the Internet or wireless networks, see, *e.g.*, RIAA Trial Ex. 9 (Terra Firma presentation), the record companies have, nonetheless, stubbornly chosen to "expend[] significant resources in trying to develop alternative physical formats," including DualDiscs, DVD-Audio discs and Super Audio Compact Discs. RIAA PFF ¶ 1378. None of these products have caught on with consumers, as the RIAA has admitted. *See id.* The record companies' continued failure to produce successful products should have no bearing on the mechanical royalty rate—and certainly do not entitle the record companies to the drastic rate cut they have requested.

(b) There Is No Reason To Weigh Restructuring Costs Against Profits

112. The RIAA next tries to hide the record companies' profits by contending that "the major labels incurred at least $2.7 billion on restructuring costs during the 2001-2005 period. Since the total amount of profit earned by the majors over the same time

period was only about $2.1 billion, including restructuring charges in the record company P&Ls wipes that profit out and then some." RIAA PFF ¶ 181; *see also id.* ¶ 13 (same), ¶ 200 (same) and ¶ 1231 (same). But the RIAA admits, as it must, that "restructuring costs . . . do not show up on the record company P&L statements." *Id.* The RIAA further concedes—as its own expert witness, Terri Santisi, testified—that accounting principles do not call for restructuring costs to be reflected on P&L statements. *Id.* ¶ 200 ("As Terri Santisi explained, the costs of these restructuring are 'below the line' costs that do not appear on many P&Ls and ordinarily are not reflected when one attempts to calculate EBITDA or other measures of profits.") (citing Santisi WRT (RIAA Trial Ex. 78) at 37). Simply put, if the record companies do not weigh restructuring costs—to correct the record companies' wasteful business practices—against profits in the ordinary course of business, there is no reason for the Court to do so here. *See* CO PFF ¶¶ 399-401.

113. In any event, in this proceeding, the CRJs are not setting a rate for the past five years, when the restructurings occurred, but a rate that will be in effect through 2012. As the RIAA admits, "the coming years" are of critical importance. RIAA PFF ¶ 174. There is no evidence in the record to suggest that any of the majors, with the exception of EMI, are planning to conduct any further restructurings. *See id.* ¶ 204 (EMI is planning another round of restructuring). And the cause of EMI's further restructuring is the fact that EMI has been "poorly managed" and not well prepared for the digital era, according to its new owners. RIAA Trial Ex. 9 (EMI "needs to be restructured in order to embrace the digital era and to reduce costs").

> would have needed to compile your analysis such that you — neither you nor Ms. McLaughlin would have to speculate as to what the amounts might be in certain circumstances. Can you enlighten us as to why that is the case?

5/8/08 Tr. at 5613-14 (Benson).

119. Mr. Benson's answers to this question did not place the record companies in a positive light. He confessed that:

> . . . the people that ought to have this data, you would hope, would be the labels themselves: Atlantic, you know, Columbia, et cetera. And I'm sure they keep P&Ls by — or at least — you know, they want to know how a band's album did and how it did in all of its formats. And it will keep those by year necessarily because they want to just see the total impact.
>
> So I, like you, have scratched my head about this. We did ask for quite a rigorous set of numbers originally from them. And they had lots of questions about what we had asked for, even though it was very unambiguous. They said that they had certain of these line items they could not produce, could not get in the time frame needed for this trial, in my testimony. And those were the answers we got back.
>
> So I am puzzled, too. I obviously wish they did. I am used to doing these analyses with raw data and compiling them upward, as you can imagine.

5/8/08 Tr. at 5615-16 (Benson).

120. Mr. Benson further admitted that he had not spoken to any financial officer of any major label to confirm that he had reached accurate results with regard to the profitability of the record companies' products. CO PFF ¶ 453; 5/8/08 Tr. at 5518, 5604-05 (Benson).

121. Second, the data found in Mr. Benson's report is inaccurate because it is based on Ms. McLaughlin's flawed work. Ms. McLaughlin began her testimony in this

proceeding by admitting to a host of errors in her compilation of costs and revenues for the major record companies. *See* 2/13/08 Tr. at 3007-11 (McLaughlin). Specifically, she admitted that she had: misstated manufacturing costs for Polygram in 1991, *see id.* at 3008-09; omitted overhead costs for Polygram in 1991, *see id.* at 3009; misstated certain costs for Sony for 1993-1996 and 2004, *see id.* at 3010; and omitted costs for music videos for Warner in 1992 and 1993, *see id.* at 3011.

122. Even more significant than these admitted errors was Ms. McLaughlin's omission of the substantial profits—approximately $1.8 billion from 1991 through 2001—generated by the majors' manufacturing and distribution companies, as described above. Mr. Benson, too, ignored the profits from manufacturing and distribution and other sources. For example, as described above, his analysis assumes that Universal [redacted] in 2006, while Universal's P&L statement shows a profit of [redacted].

123. Third, Mr. Benson's conclusions about the profitability of digital singles and albums are not reliable because they depend on his erroneous assumption that distribution costs for digital music are 10% of revenue (or even higher). *See* CO PFF ¶¶ 433, 479. This assumption is contradicted by a white paper—reviewed and revised by Mr. Benson himself— released by his consulting firm in 2007 that acknowledged that "manufacturing, distribution and return costs . . . do not exist for digital sales." CO Trial Ex. 262.

124. More important, documents maintained by record companies in the ordinary course of business show that their digital distribution costs are at, or close to, zero. For example, EMI Music North America's digital P&L statement for year-to-date September 2007 shows that manufacturing costs were zero percent of net sales, and

distribution costs were [redacted] CO Trial Ex. 19; *see also* 2/13/08 Tr. at 3269 (C. Finkelstein). Similarly, a 2005 Sony BMG P&L [redacted]. CO Trial Ex. 20.

125. Fourth, Mr. Benson's profitability forecast ignores the effect of all of the majors' future mobile music sales. Although Mr. Benson relied on projected unit sales from a research report by Veronis Shuler Stevenson ("VSS"), he left out of his analysis that VSS had predicted that billions of dollars in mobile digital music sales (ringtones and mobile downloads) would occur over the next few years. In fact, VSS projected that 20 to 30 percent of the market would be mobile downloads by 2011. Mr. Benson admitted that his analysis applied to only CDs, digital singles and digital albums, and further conceded that he had not provided a complete forecast of the U.S. recorded music business. CO PFF ¶ 480; *see also* 5/8/08 Tr. at 5601-03 (Benson).

126. Mr. Benson's decision to disregard the majors' future profits from ringtones is particularly egregious in light of his admission that they are the most profitable product for the majors. RIAA PFF ¶ 323. And even though RIAA witness Colin Finkelstein claimed that, for EMI, ringtones are not profitable, the documentary evidence from his own files proved the opposite.

127. In his written direct statement, Mr. Finkelstein asserted that for EMI, ringtones were "completely unprofitable," due to the fact that music publishers received 20% of the wholesale price. Finkelstein WDT (RIAA Trial Ex. 57) at 21. According to a table in Mr. Finkelstein's statement, EMI [redacted] on each ringtone, which worked out to a profit margin of [redacted]. *See id.* at 23, Fig. 11. But an agreement between EMI and Ericsson, which is the provider of ringtones for Cingular, reviewed and

approved by Mr. Finkelstein and EMI's Chief Operating Officer, shows that EMI—far from [redacted] on ringtone sales—projected that the deal would provide [redacted] per ringtone, which amounted to a [redacted]. *See* 2/14/08 Tr. at 3231 (C. Finkelstein). The key difference between Figure 11 in Mr. Finkelstein's statement, which showed a loss on ringtone sales, and the financial analysis in its deal approval form, which [redacted] on ringtone sales, is that—as Mr. Finkelstein admitted—the former was prepared for litigation purposes, and the latter was prepared in the ordinary course of business. *See* 2/14/08 Tr. at 3234-35 (C. Finkelstein); *see also* CO Trial Ex. 47.

3. The Record Companies Have Failed To Contain Costs

128. Like their claim of poor financial health, the record companies' assertion that they have "cut costs to the bone," RIAA PFF ¶ 13, has no evidentiary support.

129. As the Copyright Owners' Proposed Findings of Fact established—based on the record companies' own internal documents—the record companies' costs have in many instances increased, not decreased. *See* CO PFF ¶¶ 422-23 (overhead costs increasing), ¶ 434 (artist royalties increasing). According to Mr. Benson's own percentage of revenue table, overhead costs increased over the past five years for which he presents financial results, from 23.0% of revenue in 2002 to 25.3% in 2006. RIAA PFF ¶ 220, Fig. 9. Simply put, the RIAA's claim that "[o]ver the past five years, the only record company cost increasing as a percentage of revenue is the cost of mechanical royalties," RIAA PFF ¶ 174, is false.

130. As the Copyright Owners also showed, manufacturing and distribution costs have been reduced as a result of the digital transformation, leading to higher record company profit margins. CO PFF ¶¶ 424-33.

(a) Overhead Costs Have Increased

131. Despite significant restructurings, the largest cost category for the U.S. recorded music majors is overhead, which remains on the rise. Indeed, since 1999, when the so-called "perfect storm" began, the majors have, in almost every year for which they presented financial data, spent more on overhead on an absolute number basis, not less. *See* CO Trial Ex. 41 at 1; RIAA PFF ¶ 191, Fig. 5. According to Mr. Benson's figures, overhead costs were $1.289 billion in 1999, and were higher in every subsequent year except for 2002 and 2006. In 2003, at the height of the supposed storm and during the midst of the record companies' restructurings, overhead costs jumped 16% to an all-time high of $1.409 billion. *Id.* And in 2006, overhead costs, hardly "cut to the bone," stood at approximately the same level as they were in 1999.

132. A review of the record companies' expenses as a percentage of their revenue reveals that, according to Figure 9 in the RIAA's Proposed Findings of Fact, overhead rose from 21.8% of revenue in 1999 to 25.6% in 2006 (with a high of 29.2% in 2003). *Id.* ¶ 220, Fig. 9. (The RIAA's revenue base for such calculations appears to be "Net Sales Revenue" from Figure 8 in its Proposed Findings of Fact.) Indeed, the RIAA admits that between 1999 and 2006, overhead (among other costs) "increased as a percentage of revenue." *Id.* ¶ 217.

133. Moreover, Ms. McLaughlin's data demonstrate that the long-term trend for the majors was increasing overhead on a percentage basis. According to her numbers, in 1991 overhead was 21.5% of net sales revenue. *See* CO Trial Ex. 41 at 1. According

to Mr. Benson's figures, in 2006 overhead reached 25.6% of net sales revenue. *See* RIAA PFF ¶ 220, Fig. 9.

(b) Artist Royalties Have Increased

134. Nor does the evidence support the record companies' claims that artist royalties—their only other payment aside from mechanicals made for a creative input—have been cut. According to Mr. Benson's figures, in 1999, the majors spent $1.228 billion, or 20.8% of revenue, on artist royalties, their largest category of costs next to overhead. *See* RIAA PFF ¶ 191, Fig. 5; ¶ 220, Fig. 9. For three of the next seven years, artist royalties were $1.209 billion or higher. Although artist royalties fell to $1.104 billion in 2006, they reached 22.8% of revenue—an increase from 1999, when they were 20.8% of revenue. *See* RIAA PFF ¶ 191, Fig. 5.

135. With regard to the longer-term trend, comparing Ms. McLaughlin's data and Mr. Benson's data (even though skewed in favor of the RIAA's arguments) shows that artist royalties increased from 18.2% of net sales revenue in 1991 to 22.8% in 2006. *See* CO Trial Ex. 41 at 1; RIAA PFF ¶ 220, Fig. 9.

(c) Mechanical Royalties

136. As the Copyright Owners' Proposed Findings of Fact showed, mechanical royalty costs are significantly lower, both in nominal dollars and as a percentage of revenue, than overhead and artist royalties expenses. *See* CO PFF ¶ 435. The RIAA nevertheless complains that "the cost of mechanical royalties has dramatically increased—from 8.7% in 1999 to 11.5% in 2006." RIAA PFF ¶ 220; *see also id.* at Fig. 9. But the 11.5% figure (which is ostensibly calculated based on net sales revenue) appears to be overstated. Mr. Benson reported that the majors spent $547 million on

mechanical royalties and collected net sales revenue of $4.847 billion, which amounts to 11.28% of net sales revenue, not 11.5%. *See* RIAA PFF ¶ 219, Fig. 8.

137. In any event, Mr. Benson's results are not consistent with the majors' own actual financial results, as expressed in their own internal documents. Working from documents maintained by the majors in the ordinary course of business, Copyright Owners' witness Helen Murphy calculated the majors' mechanical royalties as a percentage of total U.S. revenue over the period 1999 to 2006. *See* H. Murphy WDT (CO Trial Ex. 15), Ex. 10A. Warner showed only a modest increase, from 6.4% in 1999 to 7.7% in 2006. *See id.* Sony spent 7.8% of total revenues on mechanical royalties in 1999, while BMG spent 8.7%, and the combined Sony BMG spent 10.2% in 2006. *See id.* EMI's percentages ranged from 7.9% in 1998/1999 to 10.1% in 2006/2007. *See id.*

138. The RIAA's reliance on Professor Teece's estimates of mechanical royalties as a percentage of the recording industry's wholesale revenues is equally unavailing. *See* RIAA PFF ¶¶ 218, 219 and Fig. 7. According to Professor Teece, mechanical royalties were 11.6% of wholesale revenues in 2006, "and were expected to climb to 12.2% in 2007." *Id.* ¶ 218. These estimates, too, are inconsistent with the majors' actual results.

139. Finally, with regard to independent record companies, the evidence shows that from 2002 to 2007, Concord's mechanical royalty costs only [redacted], as the table below, taken from Concord's financial statements, shows. *See* CO Trial Ex. 83 [redacted].

[redacted]

Source: CO Trial Ex. 83.

140. In sum, as the Copyright Owners established in their Proposed Findings of Fact, notwithstanding the record companies' cost-cutting claims, many of their expenses—including overhead and artist royalties, their largest costs—are increasing, and their mechanical royalties payments have not slowed their dramatic return to profitability in the digital era. Indeed, the notion that the mechanical royalty rate is the key to the record companies' future profitability is belied by the irrefutable evidence that the mechanical royalty rate did not impact the record companies' profitability in the past.

B. The RIAA Has Failed To Prove that the Record Companies Need a Rate Cut

141. The RIAA also claims that "the money for higher mechanical royalties has to come from somewhere—either record company profits or investment in other areas. Given the small profit margins of record companies today, there is little operating profit to spare. The alternative is less investment in A&R and marketing . . . ." RIAA PFF ¶ 216. This argument is invented out of whole cloth. To begin with, the record companies' profits are not "small" today—they are higher than at any other time in almost 20 years.

142. Moreover, the notion that the record companies will invest more in artists if the mechanical royalty rate is lowered cannot be squared with the evidentiary record.

143. Although the RIAA cites Ms. Santisi on this point, Ms. Santisi admitted on cross-examination that she was not taking the position that the record companies' A&R expenditures will increase if the mechanical rate is decreased; that none of the record company executives to whom she had spoken in connection with the preparation of her report had made such a claim; that she had not seen any record company

documents indicating that mechanical royalties' savings would be reinvested in A&R; and that she had not done any empirical work to establish a correlation between the mechanical royalty rate and record label investments in A&R. *See* 5/7/08 Tr. at 5179-85, 5253 (Santisi).

144. Finally, the record companies have failed to demonstrate that an increase in the mechanical royalty rate will reduce record companies' incentives to invest in new recordings, develop new business models or fight piracy. *See, e.g.,* RIAA PFF ¶¶ 1129, 1131, 1148-56. The RIAA provides no empirical analysis on this front, only the self-serving, conclusory testimony of its witnesses. *See id.* Although the RIAA cites Mr. Benson's calculations in an attempt to establish that record companies' profit margins are too thin to support a mechanical royalty rate increase, as discussed repeatedly above, Mr. Benson's data is fundamentally flawed and deserves no weight; the majors are enjoying record profits today; and the financial data for the one independent company in the record (Concord) shows even higher profits. *See* supra Section II.A.1. Further, as explained in the Copyright Owners Proposed Findings of Fact, the record companies have been introducing a plethora of new products and business models in recent years, notwithstanding steady increases in the mechanical royalty rate. *See, e.g.,* CO PFF ¶¶ 623-33. Finally, as discussed below, the RIAA's anti-piracy budget amounts to less than one-quarter of one percent of the majors' total revenues on a yearly basis—a drop in the bucket—which undercuts any argument that a rate cut is necessary to boost anti-piracy efforts. *See infra* Section IV.E.1.

III. The Digital Future Is Bright

145. In an attempt to cloud its rising profits, the RIAA claims—in the face of overwhelming evidence to the contrary—that the future of the digital music market is not bright. *See, e.g.*, RIAA PFF ¶¶ 292-347.

146. To that end, the RIAA asserts, in clear contrast with the record companies' own internal documents, that the digital distribution of music is no less expensive than physical distribution. The RIAA further contends—relying on Mr. Benson's profitability analysis, which was irreparably impugned on cross examination—that the growing sales of digital albums are not profitable for the record companies. Neither contention has any record support or is entitled to any weight. To the contrary, the record evidence establishes that the growing digital music market will bring with it rising profitability for the record companies—a view uniformly held by the record companies themselves.

147. In addition, although the RIAA claims that the growth rate of mastertone and permanent download sales is slowing, it has introduced not a shred of evidence to undermine the forecast of the Copyright Owners' expert witness on the digital market, Claire Enders, who, consistent with numerous other forecasts, predicted that sales of mastertones and permanent downloads would rise to $1.4 billion and $2.7 billion, respectively, in 2012, and that the entire U.S. digital market would reach $5 billion. Enders WDT (CO Trial Ex. 10) Ex. C.

A. Digital Distribution Is Not as Expensive as Physical Distribution

148. The RIAA's gloomy outlook is grounded on the faulty premise that digital distribution costs just as much, or even more, than physical distribution. Thus, the RIAA asserts that "it is erroneous to assume that digital distribution costs less because it

involves no delivery of a physical product," and claims that "the suggestion that the growth of digital distribution has cut the costs of record companies is simply wrong." RIAA PFF ¶¶ 331, 332. These claims are flatly false, belied by a mountain of evidence showing that manufacturing and distribution costs are plummeting. Indeed, even Mr. Benson's data demonstrates that as the digital market has grown, the majors' aggregate manufacturing and distribution costs have fallen, from a total of $1.529 billion in 1999 to only $1.074 billion in such costs in 2006—a reduction of $455 million, or 30%. RIAA PFF ¶ 219, Fig. 8.

149. As the Copyright Owners showed in detail in their Proposed Findings of Fact, the decline in record company manufacturing and distribution costs is, in fact, largely due to the record companies' transition to digital distribution. *See, e.g.,* CO PFF ¶¶ 429-33. For example, the production of physical music products requires the manufacture of CDs, artwork for CD packaging and jewel cases, as well as the cost of warehousing and shipping goods. *See id.* ¶ 424. Moreover, record companies incur so-called "return costs" in connection with physical distribution as they allow retailers to return unsold CDs for a refund. *See id.* ¶ 425. None of these costs exist in the digital world, as record company executives have acknowledged. *See* CO PFF ¶ 428. In addition, record companies have also sold off their manufacturing plants and centralized physical distribution. *See* RIAA Trial Ex. 27 at 14.

150. If there were any doubt as to the decline in manufacturing and distribution costs in the digital world (and there is not), record company executives have conceded that digital distribution occurs at little, if any, cost to the record companies. CO PFF ¶¶ 430, 432. That admission is confirmed by the record companies' internal financial

documents. As discussed above, P&L statements for EMI and Sony show that the digital distribution costs are effectively zero. *See id.* ¶¶ 429, 431.

151. Notwithstanding the irrefutable evidence that digital manufacturing and distribution costs are minimal, the RIAA mounts a number of arguments, largely based on anecdotal evidence of EMI. All lack empirical support, and none has merit.

152. First, the RIAA protests that "in the digital world, the record companies must create far more products than they did in the world of physical products," including full-length downloads, "music videos, ringtones, ancillary content such as 'making of' documentaries and more." RIAA PFF ¶ 333. As a threshold matter, the RIAA never quantifies the amounts that any of the record companies spend to develop the "as many as 75 or 100 separate products" they claim to now make for each new album. *Id.* Moreover, when the record companies create "100 products from one piece of music," they create 100 potential revenue streams. *Id.* Of course, as the RIAA notes, there is no guarantee that all of these products "will generate enough revenue to cover the costs of production." *Id.* But the RIAA has provided no empirical analysis for the Court to conclude that the creation of dozens of digital products for each album is not a lucrative strategy. The RIAA merely notes that EMI does not break even on about [redacted]% of ringtones, but this solitary cherry-picked example from the RIAA's favorite outlier company proves nothing about the entire industry. RIAA PFF ¶ 333.

153. Second, the RIAA asserts that technology costs associated with digital distribution are substantial. RIAA PFF ¶ 336 ("Digital distribution costs have also risen because the record companies must deal with many different digital distributors, each with a different business model and different requirements.") But the RIAA does nothing

to quantify such allegedly rising costs, referring only to Mr. Munns' testimony regarding EMI's purported efforts without providing any financial data. *See id.* Next, the RIAA claims that "the record companies have found it necessary to overhaul their electronic systems to accommodate digital distribution." *Id.* ¶ 337. Again, no numbers are provided—just assertions that Mr. Munns believes this is a "very expensive process." *Id.* Although the RIAA identifies new systems that are required for digital distribution—from royalty reporting and accounting to transmission of visual graphics, art and metadata—it fails to provide any empirical analysis of the expenditures necessary to create and maintain such systems. *See id.* ¶¶ 338-39.

154. The RIAA next offers a few examples of digital costs drawn from EMI's experience in creating a global supply chain. *See* RIAA PFF ¶ 340. But it is able to muster only one number for EMI's U.S. business—[redacted] for capital expenditures in information technology from 2002 to 2006. *See id.* Not only does this figure reflect a sunk cost rather than an ongoing expense, it pales in comparison to EMI's U.S. revenues, which were over [redacted] in 2006 alone. Benson WRT (RIAA Trial Ex. 82) at 43.

155. At trial, Colin Finkelstein attempted, unsuccessfully, to establish that EMI's digital distribution costs were [redacted] or higher. *See* RIAA PFF ¶ 342. On cross-examination, however, Mr. Finkelstein admitted that although Figure 11 in his written testimony pegged digital distribution costs at [redacted], this Figure was created for litigation purposes, and an EMI digital P&L created in the ordinary course of business showed that digital distribution costs were in fact [redacted] *See* 2/14/08 Tr. at 3261-70 (C. Finkelstein).

156. Recognizing its failure of proof, the RIAA attempts to excuse its lack of evidence with the unsupported contention that "quantifying [digital] costs for the record companies has proven difficult." RIAA PFF ¶ 342. Whether difficult or not, quantifying such costs was the RIAA's responsibility, and its failure to present more precise evidence regarding their digital costs proves that no such evidence exists.

157. Third, the RIAA claims that there are "increased difficulties of marketing in a digital world." RIAA PFF ¶ 335. Again, the RIAA does not quantify any increase in marketing costs that results from such challenges. Indeed, by the RIAA's own account, marketing costs have fallen since 1999, both in nominal terms and as a percentage of revenue. *See* RIAA PFF ¶ 219, Fig. 8 (marketing costs fell from $1,094 million in 1999 to $824 million in 2006, a drop of $270 million); *id.* ¶ 220, Fig. 9 (marketing costs declined from 18.5% of net sales revenue in 1999 to 17.0% in 2006).

158. Finally, the RIAA asserts that in today's marketplace, record companies must bear the burden of two supply chains—physical and digital. *See* RIAA PFF ¶¶ 214, 341, 447. But as Mr. Munns admitted, while the record companies pay for two distribution systems, they also reap the benefit of two revenue streams—physical and digital. *See* 2/26/08 Tr. at 4744 (Munns). In any event, even though the record companies maintain two supply chains, their total manufacturing and distribution costs have nevertheless plunged by over 30% from 1999 through 2006. *See* RIAA PFF ¶ 219, Fig. 8 (record companies combined manufacturing and distribution costs fell from $1.53 billion in 1999 to $1.07 billion in 2006).

159. In sum, the RIAA's claims that digital distribution does not provide the many advantages and rising profits that record company executives have consistently and proudly touted has no support whatsoever in the evidentiary record.

B. Mr. Benson's Projections Are Unreliable

160. The RIAA's pessimistic view of the digital future is also based in part on Mr. Benson's analysis, which contends that sales of digital albums are growing, but not profitable, which will allegedly lead to negative profits for the record companies. *See* RIAA PFF ¶¶ 316-28. But as shown above, Mr. Benson's analysis is far from reliable. In reaching his flawed conclusion, Mr. Benson took several missteps.

161. First, Mr. Benson (like Ms. McLaughlin, on whose work he relied) omitted the substantial profits earned by the majors' manufacturing and distribution companies, understating the majors' profits by hundreds of millions in 2006 alone. Second, he incorrectly attributed digital distribution costs of 10% of revenue to digital products when he was well aware, given his review and publication of a white paper in 2007, that distribution costs "do not exist for digital sales." 5/8/08 Tr. at 5577 (Benson). Finally, he excluded an entire segment of the market, ignoring the record companies' expected sizeable profits from the distribution of mobile products, including ringtones and full "over-the-air" downloads. *See* supra Section II.A.2.c.

C. Forecasts Predict Strong Growth In the Digital Era

162. Industry and record company-specific forecasts reinforce the view that the digital market will continue to be a boon to the record companies. And although several record companies failed to produce in discovery, much less introduce into evidence, documents containing financial forecasts for the 2007-2012 time period, those record companies have hardly been shy about their view of the future in public statements.

163. For example, Edgar Bronfman Jr., Chairman and CEO of Warner Music Group, predicted that his company would achieve its "goal of profitable growth" in large part because it "derive[s] an operating margin advantage in digital." CO Trial Ex. 21 at 5. Eric Nicoli, former Chairman and CEO of EMI Group, stated in the company's Annual Report for 2005: "[T]he research finds that the overall effect of digital music is positive for the industry . . . . [I]t is reasonable to expect that our company will be more profitable as digital sales grow as a proportion of our business." CO Trial Ex. 45 at RIAA 0043152. Similarly, Mr. Finkelstein testified at trial that the growth engine of EMI in the future will be its digital business. 2/13/08 Tr. at 3162 (C. Finkelstein).

164. The limited forecast information in the record shows that the majors are projected to do well over the next five years, both in terms of revenues and profits. As set forth in the Copyright Owners' Proposed Findings of Fact, in 2007 Sony BMG projected that its worldwide net income would [redacted] in 2007 to [redacted] in 2008 and [redacted] in 2009, which reflects [redacted], respectively. CO PFF ¶ 476; Murphy WDT (CO Trial Ex. 15), CO Ex. 8A at RIAA 014991. And Warner predicted growth at a CAGR of [redacted] for U.S. recorded music revenues. *Id.* ¶ 477; Murphy WDT (CO Trial Ex. 15), CO Ex. 8A at RIAA 039185.

165. Even EMI's global forecast, contained in a presentation for investors created by Terra Firma, the U.K. private equity firm that purchased EMI in 2007, is bright. *See* RIAA Trial Ex. 9. This presentation shows that Terra Firma expects EMI to rocket back toward profitability, fueled by the advantages of the digital marketplace. *See id.* at CO 4032305.

166. Thus, Terra Firma's presentation (reproduced below) states that: "[d]igital will be put at the heart of EMI's revenue growth, (*id.* at 4032301)" and sets forth an undeniably favorable forecast projecting strong EBITDA growth:

Summary Financials - Terra Firma Business Plan

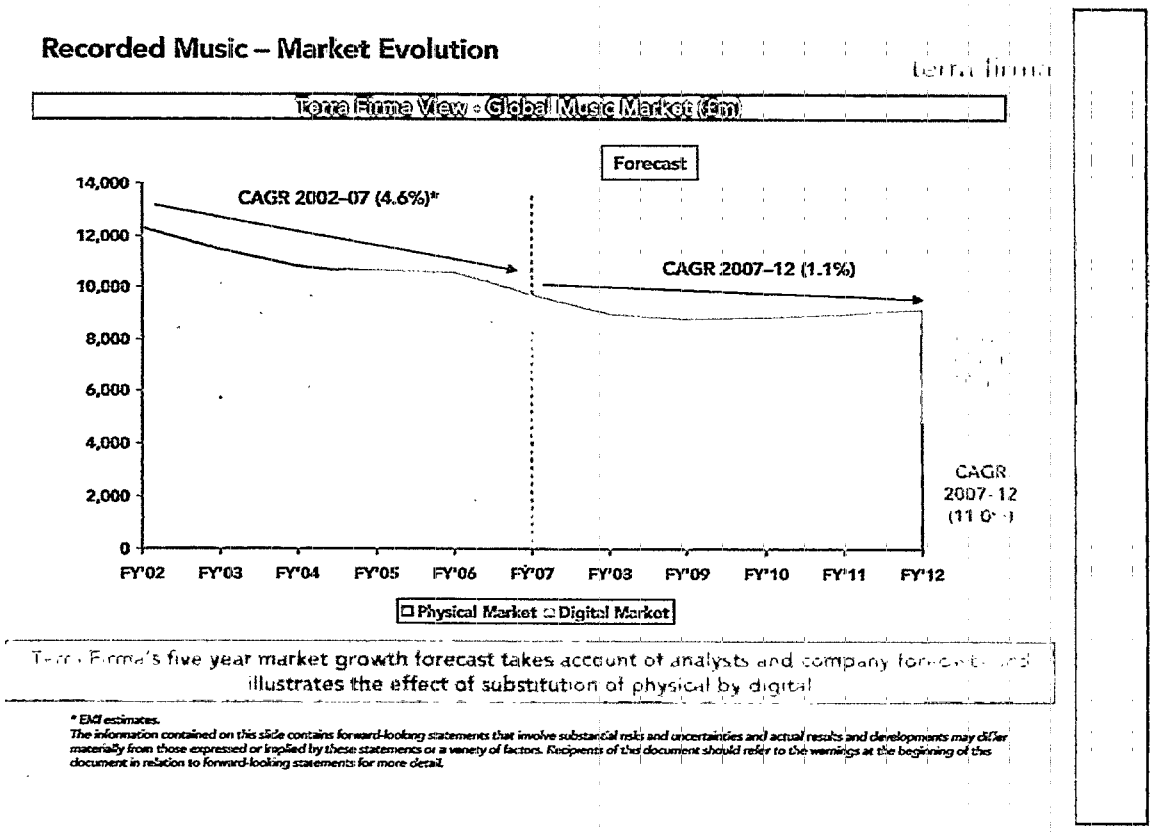
Music (£m) March Y/E	2006	2007	2008	2009	2010	2011	2012	'07-'12 CAGR
Digital	93	140	202	321	433	550	667	36.6%
Physical	1,413	1,071	902	837	806	777	749	(6.9%)
Royalties / Neighbouring Rights	155	139	129	141	154	169	183	5.6%
Organic Revenue	1,660	1,350	1,234	1,301	1,393	1,496	1,599	3.4%
Revenue from TF Initiatives	-	-	-	16	73	130	214	N.A.
Total Revenue	1,660	1,350	1,234	1,317	1,466	1,627	1,813	6.1%
Cost of Sales	(1,037)	(890)	(763)	(777)	(836)	(912)	(1,000)	2.5%
Gross Margin	573	460	471	540	630	715	805	11.0%
Overheads	(413)	(399)	(300)	(302)	(330)	(357)	(333)	(0.0%)
TF Cost Savings	-	-	6	57	90	104	106	N.A.
EBITDA	160	61	169	295	391	462	520	54.1%

Source: RIAA Trial Ex. 9 at CO 4032305 (emphasis added).

167. Indeed, Terra Firma predicts that digital revenues will increase at a CAGR of over 36%—a phenomenal growth rate in any industry. *Id.* And despite continued falling physical sales, Terra Firma expects that total revenue will rise by a CAGR of 6.1% (*id.*), demonstrating—at odds with the RIAA's repeated statements to the contrary—that rapid digital growth will, in fact, offset the decline in sales of CDs. Moreover, as shown in the chart above, Terra Firma has projected EBITDA growth for EMI at a CAGR of 54.1%.

168. In sum, Terra Firma is predicting that the digital future will lead to not only robust revenue growth, but also a stunning increase in profitability. And although the Terra Firma forecast is for EMI's worldwide operations, there is no reason to believe that EMI's U.S. operations will not share in this dramatic improvement. As EMI's CFO for North America conceded at trial, Terra Firma has not suggested that its forecast for enormous global growth is not applicable to its U.S. business. 2/13/08 Tr. at 3163-65 (C. Finkelstein).

169. In addition to its EMI-specific projections, Terra Firma's presentation also includes a forecast for the entire recorded music industry for the 2007-2012 time period, which is reproduced below. *See* RIAA Trial Ex. 9 at CO 4032299. According to Terra Firma, this forecast is based on industry analyst and company forecasts. It shows, contrary to the RIAA's unsubstantiated claims, that the industry's top line revenues are expected to stabilize during this time period as growing digital sales make up for the loss of physical sales. This is because digital sales are expected to continue to increase dramatically, at a CAGR of 30.4% and physical sales are projected to continue to decline at a CAGR of 11.0%.



Source: RIAA Trial Ex. 9 at CO 4032299.

170. As the RIAA admits in its Proposed Findings of Fact, other industry observers also expect the market to stabilize in 2009 or 2010, and even begin to expand

again. *See* RIAA PFF ¶ 298 (Merrill Lynch believes the market will "fully stabilize" in 2010); ¶ 300 (Copyright Owners' expert witness Clare Enders "predicts that overall sales may stabilize in 2009"); Teece WDT (RIAA Trial Ex. 64) at 57 (PricewaterhouseCoopers projects that retail spending will increase through 2012). Indeed, according to Warner's CEO, Mr. Bronfman, Warner's total sales have already stabilized: "The increase in [Warner's] digital recorded music revenue for the fiscal year [ended September 2006] more than offset declines in our physical recorded music revenue." RIAA Trial Ex. 27 at CO 2001085.

1. Professor Teece's Forecasts for the Industry

171. Stuck with a glowing Terra Firma forecast dated September 2007 as the most up-to-date industry-wide projection in the record, the RIAA, in trademark fashion, simply ignores it. Instead, the RIAA relies on three 2006 forecasts of retail revenues for the recording industry presented by Professor Teece—a PricewaterhouseCoopers ("PwC") forecast, a Veronis Suhler Stevenson ("VSS") outlook and an LECG "Delphi" study—as purported support for the RIAA's contention that the future will hold "continued hard times for the record companies." RIAA PFF ¶ 292. As shown below, the forecasts marshaled by Professor Teece prove nothing of the sort.

172. As an initial, but dispositive, matter, the PwC, VSS and LECG forecasts are all of limited utility. None provides projections regarding profits. Nor do they forecast wholesale revenues for the record companies; rather, they focus on total retail spending only.

173. The PwC forecast anticipates that total industry spending will increase throughout the 2008 to 2012 period. Teece WDT (RIAA Trial Ex. 64) at 57. And although the VSS and LECG forecasts project that total retail spending will decrease

during that time period, all three forecasts show strong growth in the digital market, which is the growth engine for record company profits. *Id.* at 54-56. For 2008, "the projected digital spending levels range from [redacted] to [redacted] billion, which are, respectively, [redacted] and [redacted] increases over two years. By 2012, the projected values for digital spending at retail list range from [redacted] to [redacted] billion, which are, respectively, [redacted] and [redacted] over 2006 levels." Teece WDT (RIAA Trial Ex. 64) at 56.

174. Significantly, Professor Teece did not know and thus could not share the assumptions on which the PwC or VSS forecasts were built. 2/19/08 Tr. at 3711 (Teece). In addition, Professor Teece, surprisingly, could offer little guidance with respect to the foundation of the forecast by LECG (his own company). Professor Teece could muster only a characterization of the forecast as a "Delphi approach, fairly primitive in the sense that it simply asks people in the industry what their best expectations are . . . ." *Id.* at 3705. Professor Teece testified that he did not personally participate in the preparation of the LECG forecast, that he could not name a single person whose opinion his staff had solicited, and that the information was gathered orally and never memorialized in work papers. *Id.* at 3705-07. He also made the following critical concessions:

> Q: So we don't know what information was given back from the four majors to someone on your staff to construct this forecast, correct?
>
> A: That is correct.
>
> Q: And we don't know whether the information that was given by the majors comports in any way with the actual business plans of each of those companies, correct?
>
> A: That's correct. They have been asked to give the view of the industry, not their own particular circumstance.

> Q: I understand that. But you don't know whether they have, in the ordinary course, prepared information with respect to the future of the industry?
>
> A: That's correct.
>
> Q: So we don't know who gave the information, correct?
>
> A: Yes.
>
> Q: We don't know what information was given?
>
> A: Yes.

Id. at 3709-10.

2. Claire Enders' Forecasts for the Digital Market

175. As set forth in the Copyright Owners' Proposed Findings of Fact, reliable industry forecasts project that the future of the digital market will be bright.

176. Claire Enders, the Copyright Owners' expert witness on the digital market, showed that the digital market has been dramatically on the rise. Total U.S. digital music sales (online and mobile) grew from a little more than $1 billion in 2005 to $1.859 billion in 2006 and approximately $2.7 billion in 2007. There is no decline in sight: Ms. Enders predicted that the market would reach $5 billion in 2012. *See* CO PFF ¶¶ 468-69; *see also* Enders WDT (CO Trial Ex. 10) at 22.

177. Having no answer to the vibrant forecast in Ms. Enders' report—corroborated by numerous other forecasts, *see* CO PFF ¶¶ 469-70—the RIAA tries, but fails, to discredit Ms. Enders. Specifically, the RIAA contends that a March 2007 industry report published by Ms. Enders' firm, Enders Analysis, contains statements about the future of the digital market that are "fundamentally inconsistent" with her trial testimony, because she supposedly provided a rosier view of the digital market at trial than she had in her March 2007 report. RIAA PFF ¶ 308. A review of Ms. Enders'

testimony and her March 2007 report, however, reveals no inconsistencies at all. Not only are Ms. Enders' March 2007 report and her trial testimony harmonious, they both recount what the record companies concede: there is ample reason for the recorded music companies to be optimistic about the transition to digital distribution. *See e.g.*, CO PFF ¶¶ 441-45; H. Murphy WDT (CO Trial Ex. 15) at 18.

178. Consider the consistencies between Ms. Enders' testimony and her March 2007 report. In the March 2007 report, she estimated that in 2012, online permanent download sales in the U.S. would be $2.894 billion. RIAA Trial Ex. 27 at 20. In her expert report, Ms. Enders projected that by 2012 that market would be slightly smaller, generating sales of $2.7 billion. Enders WDT (CO Trial Ex. 10), Ex. C at 4. Similarly, the March 2007 report projected that U.S. ringtone sales would "plateau at $1.8 billion or below from 2012." RIAA Trial Ex. 27 at 24. Ms. Enders' expert report in this case predicts that U.S. ringtone sales in 2012 will be $1.4 billion; again, lower than the March 2007 estimate. *See* Enders WDT (CO Trial Ex. 10) at 16, 25-26, 56-57, Ex. C at 5-6; *see also* 2/4/08 Tr. at 1266-74. Thus, there is no basis for the RIAA to claim that Ms. Enders' oral or written trial testimony was more optimistic than her March 2007 report. In fact, as with many of the RIAA's claims, the opposite is true.

179. As for the RIAA's contentions that Ms. Enders' descriptions in her expert report of "the U.S. digital market as 'thriving,' 'vibrant' and 'flourishing,'" are somehow inconsistent with statements in her March 2007 report, such as "[s]trong digital sales are far from the solution to the industry's ills," again a review of the actual evidence shows otherwise. RIAA PFF ¶ 308-09. Ms. Enders' March 2007 report is just as positive on the digital future, stating, for instance, that "[r]ising digital sales are offsetting in part the

physical market decline, and could stabilize overall sales by 2009 . . . ." RIAA Trial Ex. 27 at 1.

180. Nor does Ms. Enders' prediction in her March 2007 report that the growth rate for permanent downloads would "decline" make a dent in the integrity of her forecast. *See* RIAA PFF ¶¶ 301, 309. Given that this market has grown so rapidly since it began in 2003, it is entirely unremarkable that its growth rate would slow even as the overall market continues to expand. For example, when the market was in its infancy, unit sales of single permanent downloads grew by 163% from 2004 to 2005, but only 59.8% the following year. Enders WDT (CO Trial Ex. 10) at 23. Ms. Enders's March 2007 statement about the decline in online music sales must be considered in its full context: "We estimate the online music market grew by 67% in 2006. We anticipate continued strong growth of the format, but a decline in the growth rate to 47% in 2007 and 32% in 2008." RIAA Trial Ex. 27 at 20 (emphasis added). Such a decline in the growth rate will not reverse the expected expansion of the market.

181. In 2006, permanent download sales amounted to $878 million. Enders WDT (CO Trial Ex. 10) at 8. Given that the total market was valued at $10.9 billion, this amounts to approximately 8.1% of total sales. Ms. Enders has estimated that the U.S. permanent download market will reach $2.7 billion in 2012. CO PFF ¶ 470, *see also* Enders WDT (CO Trial Ex. 10), Ex. C.

182. Similarly, even though Ms. Enders projected that ringtone sales would level off in 2010 and amount to $1.4 billion in 2012, this estimate represents growth of $1 billion from 2005, when sales were just $356 million. *See id.* at 22-24; Enders WDT (CO Trial Ex. 10), Ex. C at 5-6.

183. Simply put, there is no forecast in the record—from Ms. Enders or any other source—that predicts a decline in the U.S. market for permanent downloads, ringtones or any other digital format between today and 2012. To the contrary, the market is expected to grow from $2.7 billion in 2007 to $5 billion in 2012.

184. Notwithstanding Ms. Enders' forecast for growth in the ringtone market, which is consistent with other industry forecasts, the RIAA contends that "mastertone sales are already in rapid decline." RIAA PFF ¶ 302. The RIAA has failed to back up this claim with sales figures from a single record company other than Sony BMG. *See id.* Notably, EMI MP has reported receiving increasing mastertone revenue in recent years, and its CEO, Roger Faxon, expects sales of mastertones to continue to rise. *See* Faxon WRT (CO Trial Ex. 375), Ex. B; 5/14/08 Tr. at 6365 (Faxon). On an industry-wide basis, the RIAA cites only to numbers provided by BMI, a performing rights society that claimed mastertone revenues have declined in the last two years. *See* RIAA PFF ¶ 302; *see also id.* ¶ 922 (citing Wildman WRT (RIAA Trial Ex. 87), RIAA Ex. 101-RP and Eisenberg WRT (RIAA Trial Ex. 89) at 6).

185. Finally, not only are ringtones, with mastertone sales topping $654 million in 2006, already a substantial and growing portion of the recorded music market, they are also very profitable for the record companies. As discussed above, Mr. Benson concedes in his written report that ringtones are the most profitable digital product, generating profits of 39 cents per sale (which amounts to a profit margin of 32%). RIAA PFF ¶ 323. Similarly, internal EMI documents—reviewed and approved by Mr. Finkelstein—show that EMI expects sizeable profits on its ringtone deals. *See* CO Trial Ex. 47 (projecting

net revenue of [redacted] per ringtone and a pre-tax margin of [redacted] for a deal with Cingular).

IV. Songwriters and Music Publishers Make Vital Contributions to the Availability of Musical Works to the Public

A. Overview

186. The Copyright Owners have presented extensive evidence of the vital work done by music publishers and songwriters. Fundamentally, songwriters create the musical works that are the foundation of sound recordings. Music publishers contribute to making these musical works available to the public by, among other things, assisting songwriters in the creative process, promoting their musical works to record companies and artists, and licensing and administering those works. *See* CO PFF ¶¶ 287-340. The Copyright Owners further established that both songwriters and music publishers depend heavily on income earned from mechanical licenses and that, despite their consistent and ongoing contributions, mechanical royalties have declined in recent years. CO PFF ¶¶ 272-81, 341-43.

187. Notwithstanding this evidence, and in clear conflict with it, the RIAA's Proposed Findings of Fact lodge a number of complaints against music publishers and songwriters. *See, e.g.,* RIAA PFF ¶¶ 351-58, 509-32. First, relying on expert data proven at trial to be fatally flawed, the RIAA asserts that mechanical royalty revenues are not declining. Second, the RIAA, ignoring the statutory parameters of the current proceeding, contends that because music publishers and songwriters enjoy other streams of revenue and songwriters receive psychic compensation for their efforts, any decline in mechanical royalties or reduction in the royalty rate should be deemed inconsequential. Third, the RIAA—again at odds with the relevant considerations of this proceeding—

argues that because the music publishing companies are more profitable than record companies, the mechanical royalty rate should be reduced. Fourth, the RIAA challenges the efforts made and risks taken by both music publishers and songwriters. According to the RIAA, music publishers do little to aid and invest in the creative process and are, therefore, entitled to only limited rewards in the form of lower mechanical royalties. Songwriters, the RIAA continues, face very few costs or risks when choosing to become songwriters and are already substantially, if not excessively, compensated. *See* RIAA PFF ¶¶ 351-541. None of the RIAA's contentions has merit.

B. Mechanical Royalties Received by Songwriters and Music Publishers Are Declining

188. The mechanical royalties earned by songwriters and music publishers have declined for a variety of reasons. Among others, CD sales have slowed, resulting in fewer mechanical royalty payments. Digital sales, while on the rise, are largely singles, not albums. CO PFF ¶ 411. Piracy has also, according to NMPA President and CEO David Israelite, "dramatically undercut the mechanical royalty stream which, at bottom, is premised on a payment for every copy of a recording of a song that is distributed to the public." Israelite WDT (CO Trial Ex. 11) at 10; *see also* CO PFF ¶¶ 236-39. And the use of controlled composition clauses limits the mechanical royalties earned by songwriters and music publishers, by either reducing the mechanical royalty paid on each song to, frequently, 75% of the statutory amount or capping the number of songs on an album for which mechanical royalties are paid at all. CO PFF ¶¶ 241-44. As a result of stunted mechanical income, many songwriters now feel that "it is getting harder and harder for professional songwriters to build a career," as NSAI President Steve Bogard testified. Bogard WDT (CO Trial Ex. 2) at 6.

189. The results of these developments are clearly reflected in the financial documents produced by a number of music publishers, which show declines in the mechanical royalties collected since 2000. CO PFF ¶¶ 257-63. Mechanical royalty totals reported by The Harry Fox Agency, Inc. ("HFA"), which collects and distributes the largest share of mechanical royalties each year, also declined significantly. *Id.* ¶ 258; *see also* CO Trial Exs. 12A, 12B. Professor Landes revealed a similar overall decline in the mechanical royalties collected by the songwriters whose compositions were administered by Universal Music Publishing Group ("UMPG") between 2000 and 2006. CO PFF ¶¶ 265-79. In the full songwriter sample of his study, average annual mechanical income fell from roughly [redacted] in 2000 to approximately [redacted] in 2006. Landes WRT (CO Trial Ex. 406) at Figure 2a. In the songwriter subgroup, average annual mechanical income fell from about [redacted] in 2000 to approximately [redacted] in 2006. *Id.* at Figure 3a.

190. The RIAA's Proposed Findings of Fact simply ignore or, when convenient, distort this evidence, claiming that for music publishers "[m]echanical royalty revenues have remained steady, thanks to the rising mechanical royalty rate, even in the face of declining overall industry revenues from music sales." RIAA PFF ¶ 359. With respect to songwriters, the RIAA claims that any evidence of financial struggle is a function of the distribution of income, not the absolute amount of money earned by the songwriting profession, because songwriters' income is growing. *Id.* ¶¶ 513, 528-32.

191. As an initial matter, the RIAA's complaints about the increase in the mechanical royalty rate since 1997, and the effects of such increases, are irrelevant in this proceeding. *See* RIAA PFF ¶¶ 360-62. The current mechanical royalty rates and their

increases from prior rates were voluntarily agreed to by both the Copyright Owners and the RIAA. *See* Israelite WDT (CO Trial Ex. 11) at CO Exs. 6, 7, 12; *see also* CO PFF ¶¶ 121-124. The rates set in 1987, and their increases, were, similarly, the result of joint negotiations. *See id.* at CO Exs. 14, 15; *see also* CO PFF ¶ 120.

192. The RIAA's charge that changes in mechanical royalty revenues have not followed changes in record company wholesale revenues and, therefore, should be reduced is similarly entitled to no weight. *See* RIAA PFF ¶ 362. The RIAA claims that "[t]ypically, one would expect that mechanical royalty revenues would largely track recording industry wholesale revenues, as those revenues are overwhelmingly generated from the very same activities." *Id.* ¶ 362 (emphasis added). This "expectation," however, does not have a speck of evidentiary support; nor could it. The RIAA's expectation would be correct only if the mechanical royalty had been set as a percentage of record company revenue, which it was not, either by the CRT in 1981 or the parties themselves in their subsequent agreements. *See* CO PFF ¶¶ 590-92.

193. In fact, as Professor Murphy testified, there is no support for the claim that declining revenues in the recorded music industry should entail a reduction in mechanical royalty rate. CO PFF ¶¶ 726-37. As he showed, both economic theory and empirical evidence gleaned from a review of the record companies' historical financial data show the RIAA's theory to be baseless. CO PFF ¶¶ 726-37.

1. Music Publishers' Mechanicals Royalties Are Declining

194. The RIAA's attempts to present a picture of mechanical royalty revenues that have "essentially remained steady" across the music publishing industry as a whole during the 1997-2007 period, rest primarily on estimates by RIAA witnesses David Teece

and Bruce Benson that were thoroughly discredited at trial and on the testimony of Terri Santisi, whose analysis, when scrutinized, actually supports the position of the Copyright Owners. *See* RIAA PFF ¶¶ 363-383.

195. The RIAA first tries to resuscitate Exhibit 28, Professor Teece's estimate of mechanical royalties and other revenue streams. *See* RIAA PFF ¶¶ 367-72, 402, PFF Figure 40. Professor Teece's analysis, however, was shown to be unreliable at trial. As Professor Teece explained, Exhibit 28 was based on publicly available information for the years 1998-2001 and extrapolated estimates for the remaining years. Teece WDT (RIAA Trial Ex. 64) at 59, Appendix C. During cross examination, it became clear that Professor Teece made no effort to update his estimates based on actual information received from the music publishers through discovery. 2/19/08 Tr. at 3730-32 (Teece). Despite noting in his written testimony that if revised data from the music publishers was produced during discovery he would "revisit this analysis," Professor Teece did no such thing. In fact, he did not even bother to check the numbers he presented with the HFA data he had been given:

> Q: Well, you know you got Harry Fox data, correct?
>
> A: I believe that there may be Harry Fox data.
>
> Q: And did you check the numbers you report for mechanical royalties in Exhibit 28 against the Harry Fox data to see if the trend line that you report with respect to growth in mechanical royalties in 2001 to 2005 is accurate?
>
> A: I haven't done any analysis on the Harry Fox data at this point because I just don't know how — what percent of the industry it represents.
>
> Q: I didn't ask you that question, sir. My question is, did you do anything with the Fox data that you have to check your numbers and the trend that you report against the actual Fox data?

A: Not yet, no.

Id. at 3732-33.

196. In any event, Professor Teece's Exhibit 28 proves the Copyright Owners' point, not the RIAA's. Even in nominal dollars, the evidence shows that recent mechanical royalty totals were below the levels earned in 2000. In "real dollars," this decline would have been even greater. *See* 5/7/08 Tr. at 5214-15 (Santisi) (nominal dollars, as opposed to real dollars, are not adjusted for inflation); *see also* CO PFF ¶ 259.

197. Mr. Benson's figures similarly understate the amount of mechanical revenues generated in the period he analyzed because he too failed to adjust for inflation. More problematic, Mr. Benson's analysis is based primarily on the initial, unreliable calculations performed by Ms. McLaughlin, with substantial, and unjustified adjustments. *See* CO PFF ¶¶ 449-53. Further, Mr. Benson's Written Rebuttal Testimony was itself substantially corrected between its initial submission and his testimony during the rebuttal hearing to account for large overstatements in the amounts certain record companies paid in mechanical royalties in certain years. Even putting aside the potential problems with his calculations, Mr. Benson's numbers do not prove the RIAA's argument because they also show an overall decline in mechanical royalties. Significantly, this decline occurred even as the mechanical royalty rate was increasing. *Id.* ¶ 121.

198. The RIAA next turns to the analysis performed by its expert Terri Santisi as purported corroboration of the trends supposedly observed by Professor Teece and Mr. Benson. RIAA PFF ¶¶ 383-385. But a closer look at Ms. Santisi's analysis of individual music publisher financials reveals that it is nothing of the sort. In fact, the

financial evidence she analyzed demonstrates that music publishers of all sizes have experienced declines in mechanical royalty revenues. *See* CO PFF ¶ 14, 259-63.

199. For example, Ms. Santisi presented mechanical royalty totals for BMG MP for 2004 and 2005, years in which, according to the RIAA, mechanical royalty earnings should have been rebounding from earlier declines. RIAA PFF ¶ 385. Yet BMG MP generated $68.7 million in mechanical royalty earnings in 2004 and only $63.9 million in 2005, a decline of almost $5 million. Santisi WRT (RIAA Trial Ex. 78) at 48.

200. Ms. Santisi also testified to a similar decline in the mechanical royalty revenues earned by Warner/Chappell 5/7/08 Tr. at 5222, 5231-32 (Santisi) (Q: And you know that Warner/Chappell's U.S. mechanical revenues declined as well because they had some problems, didn't they? A: In their publishing business, yes. Q: Yes. That's what we're talking about. Mechanicals, right? A: Uh-huh.); *see also* RIAA PFF ¶ 385.

201. EMI MP has experienced a decline in mechanical royalty revenues as well, generating [redacted]. Faxon WRT (CO Trial Ex. 375) at 2-3, Ex. A.

202. Moreover, Ms. Santisi conceded at trial—another fact simply ignored by the RIAA—that in doing her analysis, she considered neither changes in market share among the various music publishers she analyzed nor how catalog acquisitions may have masked the rate of decline in mechanical royalty revenues:

> Q: And you don't know whether the combined market share of those four publishers has increased or decreased over the period you're looking at, correct?

> A: No, I don't know specifically. They're a specific market share, but they're — you know, we now know that obviously, for example, okay, Universal Music Publishing's market share would change because it bought a major. Okay. During this period of time, no majors changed hands in terms of a major music publisher. So you have to look at the major music publishers versus the smaller music publishers.
>
> Q: Have you done any empirical analysis that would allow you to conclude anything about the market share — about the individual publishers upon whom you report in table A?
>
> A: I have not done an empirical study of market share, no.

5/7/08 Tr. at 5216, 5225-26 (Santisi).

203. Although Ms. Santisi ignored them, and the RIAA continues to, such factors can significantly influence mechanical revenues earned by music publishers. Faxon WRT (CO Trial Ex. 375) at 2; 5/14/08 Tr. at 6355-57. Mr. Faxon, for example, testified to improving EMI MP's market share through catalog acquisitions. During the rebuttal hearing, Mr. Faxon highlighted the importance of EMI MP's acquisition of the Windswept Pacific catalog and the Jobete Catalog, which contains "100 percent of all of the Motown Hits" and, in Mr. Faxon's opinion, is "the most important music publishing catalog in the world." 5/14/08 Tr. at 6356 (Faxon). According to Mr. Faxon, these acquisitions had "quite a meaningful impact on [EMI MP's] mechanical royalties," offsetting what otherwise would have been a decline in mechanical revenues. *Id.* at 6357.

204. Ms. Santisi's conclusion that mechanical royalties have not declined suffers from an additional flaw. Like Professor Teece and Mr. Benson, Ms. Santisi fails to account for inflation and its effects. As Ms. Santisi conceded when asked if inflation had factored into her analysis: "I did not inflation-adjust anything. I took them [the

numbers used] from the historical financials or the forecasts." 5/7/08 Tr. at 5215 (Santisi).

205. As a last-ditch effort to rebut what the financial evidence provided by music publishers clearly shows, the RIAA has accused music publishers of artificially depressing reported totals by inaccurately classifying ringtone and mastertone revenues. RIAA PFF ¶¶ 386-87. But as the RIAA well knows, until the Register of Copyrights issued her Ringtones Opinion in October 2006, music publishers understandably did not treat ringtone income as mechanical revenue. Indeed, the music publishers dispute that mastertones are subject to the Section 115 statutory license and have appealed the Ringtones Opinion. *See* CO PFF ¶¶ 132-33, 492-503.

206. The RIAA's attempts to disguise the decline in mechanicals collected through HFA fare no better. The RIAA acknowledged, as it must, that HFA mechanical revenues have dropped. In 2001, HFA's mechanical royalty collections were $426 million, exclusive of royalties collected through audits, but HFA's collections in 2006 were only $349 million, also exclusive of audits. CO PFF ¶ 258. Yet the RIAA contends that this decline is simply the result of decisions by the major music publishers to license their musical compositions directly, rather than through HFA. RIAA PFF ¶ 393-94. Instead of presenting evidence demonstrating and quantifying how the record companies have supposedly increased their direct licensing efforts—evidence plainly within the record companies' control—the RIAA instead relies solely on selective statistics and the general "sense" of Andrea Finkelstein, a lone business affairs executive from Sony BMG. *See* RIAA PFF ¶ 395.

207. As its sparse statistical support, the RIAA highlights limited statistics from UMG and two WMG labels, Warner Bros. and Atlantic Records. According to Ms. Santisi, HFA's share of the mechanicals paid by UMG fell from [redacted] in 2001 to [redacted] in 2007. For Warner Bros. and Atlantic Records, HFA collected [redacted] and [redacted] in 2001, respectively, and [redacted] and [redacted] in 2007. But Ms. Santisi provides no evidence that these statistics are at all representative of an industry-wide trend (she never spoke to anyone at UMG or WMG concerning those numbers), relying only on summary documentation to reach her conclusion and failing to present comparable statistics from other WMG labels, let alone other record companies. The conclusion that there has been a drastic decline in mechanical licensing through HFA cannot be reached solely on the basis of three individual statistics presented without context.

208. Further, Ms. Finkelstein's "sense," presented in lieu of comprehensive financial information, is entitled to no greater weight. *See* RIAA PFF ¶ 395. Although Ms. Finkelstein stated that she had a "sense that major publishers increasingly are asking us to license from them and pay directly rather than through HFA," she provided no concrete examples or data to support her "sense," and made no effort to quantify the supposed decline in licensing through HFA. *Id.* Again, without the presentation of such evidence, it is reasonable to infer that the RIAA cannot, in fact, back up this claim.

209. The RIAA's criticism of the Copyright Owners for failing to provide an industry-wide estimate of mechanical royalty revenues generated by music publishers is also without merit. RIAA PFF ¶ 364. The RIAA mistakenly claims that "the Copyright Owners would have been in the best position to present an industry-wide estimate of publisher mechanical royalty earnings." *Id.* However, the NMPA, as Mr. Israelite

explained during the direct hearing, "does not compile industry-wide data," focusing instead on its members and those music publishers who license their works through HFA. 2/5/08 Tr. at 1438 (Israelite). Nonetheless, the Copyright Owners provided evidence of the mechanical royalties generated by the four major music publishers as well as mechanical royalties collected by HFA, which taken together represent a substantial portion of industry-wide totals.

2. Songwriters' Mechanical Royalties Are Declining

210. For songwriters, the RIAA argues not just that mechanical royalties have held steady, but that they have, in fact, been growing. The only way to prove such a claim, however, is to completely ignore three of the six years analyzed by Professor Landes in his songwriter study as well as its overall conclusions. According to the RIAA, "[f]rom 2003 to 2006, average songwriter income from mechanicals increased by about 10% above and beyond the rate of inflation."[2] RIAA PFF ¶ 523. Nowhere in its Proposed Findings of Fact does the RIAA mention that Professor Landes began his analysis with mechanical royalties earned in 2000 or that, even with a slight rebound in the years emphasized by the RIAA, the songwriters studied were earning less in mechanical royalties, on average, in 2006 than they had been in 2000. *See* CO PFF ¶¶ 272-79.

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[2] In claiming that the mechanical royalty revenues earned by songwriters has increased faster than the rate of inflation, the RIAA ignores a critical point. As Mr. Israelite testified, if the penny rate of 2.1 cents first set in 1909 had been increased at the same rate as prices generally, as measured by the CPI, the current mechanical royalty rate, as of January 1, 2006, would have been 40.7 cents, more than four times what they receive under the current 9.1 cents rate. Israelite WDT (CO Trial Ex. 11) at 6.

211. The RIAA has not provided any analysis of the mechanical royalties earned by songwriters of its own. In fact, throughout most of the proceeding, the RIAA has ignored songwriters, notwithstanding that they are the parties with the most to gain, or lose, by the rates that will be set by this proceeding. *See id.* ¶ 6. Nonetheless, in an attempt to undermine the import of Professor Landes's systematic study of songwriter income—the only one of its kind in this proceeding—the RIAA makes a number of fundamentally flawed claims.

212. First, the RIAA claims that Professor Landes's inclusion of deceased songwriters was improper. RIAA PFF ¶ 534. But as Professor Landes explained, songwriters' incentives to produce new musical compositions are influenced not just by the potential returns over the course of their lives but also the expected returns for their heirs after the songwriters are deceased. 5/20/08 Tr. at 7299-7300 (Landes). Such an analysis is entirely consistent with copyright law, which generally grants right to creators for the term of their life plus 70 years. 17 U.S.C. § 302(a).

213. Second, the RIAA argues that it was inappropriate to include part-time songwriters in Professor Landes's analysis because the result is an understatement of the earnings of "professional" songwriters. RIAA PFF ¶ 535. But as Professor Murphy explained, the level of mechanical royalties also has clear incentive effects on part-time writers, who are splitting their time between activities. 5/15/08 Tr. at 6884-86 (K. Murphy). As he succinctly put it, economic theory predicts that "[i]f you make songwriting less attractive, people are going to switch from doing songwriting to doing something else." *Id.* at 6885.

214. Third, the RIAA claims that Professor Landes understated songwriter income because his analysis involved income from only one publisher. RIAA PFF ¶ 537. This argument neglects Professor Landes's explanation that his study focused on "the change over time" of royalty revenue, not the absolute level of those royalties. 5/20/08 Tr. at 7286 (Landes). The RIAA's argument would be relevant only if there were evidence that the trend in Universal's songwriters' royalty income were different from the trend in income for songwriters at other publishers. There is no such evidence.

215. Fourth, the RIAA claims that Professor Landes's study understates songwriter income because it does not include "income" from unrecouped advances. RIAA PFF ¶ 536. Eventually, however, the songwriter's publisher will recoup as much as possible (if not the entirety of the advance), so any apparent short-term income gains may be illusory. In any event, the RIAA has produced no evidence to indicate that the level of Universal's unrecouped advances per songwriter has increased over time—and certainly not significantly so—which is the only way that this issue could affect Professor Landes's trend analysis in any way.

216. Finally, the RIAA argues that Professor Landes "understated the earnings of songwriters, in general, because he excluded from his sample all songwriters who entered the profession after the year 2000." RIAA PFF ¶ 538. As Professor Landes explained, however, his analysis focused on the income trends for a consistent set of songwriters with reported royalty earnings in every year. Landes WRT (CO Trial Ex. 406) at 8 n.11. He did so in order to ensure that the trends were not confounded by the entry and exit of writers throughout the years, which would make it difficult to assess the lived experience of songwriters. *See* 5/19/08 Tr. at 7119-20 (Landes).

217. The RIAA has adduced no evidence to indicate that Professor Landes's trend analysis would have shown a different result if he included every writer in every year. The RIAA points only to Professor Landes's exclusion of high-earning songwriters who entered the data after 2000, RIAA PFF ¶ 538, but as Professor Landes pointed out, there are three additional groups of songwriters who were excluded that the RIAA has neglected: (1) low-earning songwriters who entered the profession after 2000; (2) songwriters with high earnings in early years who left the profession sometime in the later years; and (3) songwriters with low earnings in early years who left the profession sometime in the later years. 5/20/08 Tr. at 7310. As Professor Landes explained, there is no reason to believe that including all of these songwriters would have led to a different income trend. *Id.* at 7314-16.

218. In short, the RIAA has failed to show any reason that Professor Landes's analysis of songwriter mechanical royalty revenue over time does not show a real and declining trend in income.

219. Further, the RIAA, in addition to basing its conclusions about songwriter income almost exclusively on its cramped view of Professor Landes's data ignores the substantial testimony from the Copyright Owners' songwriter witnesses about the declines they have experienced in their mechanical royalty earnings and the struggles they continue to face. *See* CO PFF ¶¶ 235-56. For example, Steve Bogard, the President of NSAI, presented testimony about the negative effects he, and his songwriter colleagues, have felt due to the decline in mechanical royalties in recent years. According to Mr. Bogard, "[w]ith the introduction of peer-to-peer systems and the rapid

increase in music piracy, my mechanical royalty stream has dropped significantly." Bogard WDT (CO Trial Ex. 2) at 7; *see also* 1/28/08 Tr. at 258-62 (Bogard).

220. The RIAA also attempts to mask songwriters' financial struggles by arguing that, rather than a matter of the amount of money earned overall, the problem is that a substantial majority of the mechanical and other royalty income generated each year is earned by a substantial minority of extremely popular songwriters. RIAA PFF ¶¶ 528-532. Putting to one side that such an argument flies in the face of the 1981 CRT Decision, this argument overlooks the fact that even successful songwriters are struggling and feel that the current mechanical royalty rate does not fairly compensate them for their creative efforts. *See also* 1/30/08 Tr. at 827-29 (Shaw); 1/31/08 Tr. at 886-87 (Sharp).

221. Both Mr. Bogard and Ms. Shaw testified about the state of the songwriting community. According to Mr. Bogard, the Nashville community, for example, has "about half of the professional songwriters we did even five years ago. The community is basically decimated. There are so few opportunities for new writers that the community is dwindling. That's the only way I can put it." 1/28/08 Tr. at 258 (Bogard). Ms. Shaw provided a number examples of songwriters who have experienced great successes—who have won awards or written songs for major artists—but have recently been forced to work at other jobs or leave the songwriting profession entirely. 1/29/08 Tr. at 828 (Shaw). At the current rate, these songwriters do not feel that they are sufficiently compensated for their efforts and are not actually earning enough from those efforts to continue writing songs. *See* 1/30/08 Tr. at 798-801 (Galdston) (testifying that "because what we provide is so essential, it pains me to say that we're at the bottom of the totem pole in the revenue stream and revenue scale.").

222. Such testimony also disproves the RIAA's claims that that "there is absolutely no evidence that there currently is a shortage of songs or songwriters." RIAA PFF ¶ 1163; *see also id.* ¶¶ 52, 510, 640. According to the RIAA, the increasing membership numbers of the NSAI prove that songwriters ranks are growing. RIAA PFF ¶ 1195. NSAI President Steve Bogard testified that, in fact, that "the reason we have more members now is because our community is in dire straits. We have people joining like crazy." 1/28/08 Tr. at 271 (Bogard). Mr. Bogard also explained how NSAI membership numbers are unrepresentative of the true condition of the songwriting community:

> Q: So the NSAI chart shows that the number of professional songwriters appears to have remained steady and slightly increased over the last decade, am I right?
>
> A: No. It shows the number who are members of NSAI has remained stable.
>
> Q: Would you repeat that?
>
> A: It shows that the number of professional songwriters who are members of NSAI has maintained the same. It doesn't speak to the number of songwriters making a living in Nashville.
>
> Q: What is your basis for your testimony about the number of songwriters in Nashville?
>
> A: Personal experience, my presidency and our membership. If you would like to know my analysis as the president of NSAI of these numbers and why they are the same, I would be happy to tell you.
>
> Q: No. I'm trying to get your understanding of the basis for your testimony.
>
> A: The basis for my testimony is the conversations I have on a monthly basis with all the songwriters, with all the professional songwriters who are members of our organization, with absolute knowledge, personal

> knowledge of the size of the staff at Warner Chapel at the time I was a staff writing and the size of the staff now.

Id. at 269-270.

C. Other Revenues Earned by Songwriters and Music Publishers Are Not Relevant to the Determination of a Reasonable Mechanical Royalty Rate

223. Apparently recognizing the flaws in its arguments concerning the decline in mechanical royalties, the RIAA insists that music publishers and songwriters nevertheless stand in a strong financial position because they collect other forms of revenue such as performance and synchronization revenue. *See, e.g.,* RIAA PFF ¶¶ 399-411, 1270-73. According to the RIAA, these alternative revenue streams "have skyrocketed" and now insulate music publishers and songwriters from the decline in their mechanical revenues. *Id.* ¶ 355.

224. These arguments are flawed for a number of reasons. As an initial matter, and as discussed in detail in the Copyright Owners' Reply to the Conclusions of Law of the RIAA and DiMA, the revenues songwriters and music publishers earn through non-mechanical licenses are irrelevant for purposes of this proceeding. The statutory factors set out in 801(b) are provided to determine reasonable rates and terms for activities under Section 115. There is no suggestion, from either the plain text or judicial precedent, that the mechanical royalty rate should be adjusted to reflect revenues received by the Copyright Owners for activities beyond the scope of Section 115. *See* National Music Publishers' Association, Inc.'s, the Songwriters Guild of America's, and the Nashville Songwriters Association International's Motion in Limine to Exclude Evidence Relating to Revenues Generated from Non-Mechanical Licenses, Docket No. 2006-3 CRB DPRA (Jan. 7, 2008).

225. Nor should the mechanical rate be determined on the basis of the "hedonic wage theory" offered by Professor Slottje. *See* RIAA PFF ¶¶ 1164-78. The RIAA emphasizes that songwriters earn "psychic income" and a series of "non-pecuniary benefits such as the opportunity to meet famous individuals, attend parties or award shows, as well as the 'warm-glow' feeling of hearing one's song being performed." *Id.* ¶ 1168. According to the RIAA, this "revenue stream" should be factored into the determination of a reasonable royalty rate along with performance, synchronization and other pecuniary, non-mechanical royalty streams.

226. As described in detail in both the Copyright Owners Proposed Findings of Fact and Conclusions of Law, Section 801(b) does not indicate that a songwriter's "psychic income" is a valid consideration, nor is there evidentiary support for Professor Slottje's theory. *See* CO PFF ¶¶ 771-75; CO PCL ¶ 80. None of the studies cited by Professor Slottje applied a hedonic wage theory to songwriter income, and Professor Slottje conceded at trial that he has never performed any academic work relating to the recorded music or songwriting industries. *See* Slottje WRT (RIAA Trial Ex. 81) at 22-24; 5/8/08 Tr. at 5379 (Slottje). Professor Slottje also failed to consider the testimony provided by the Copyright Owners' songwriter witnesses during the direct hearing, although such testimony was clearly relevant to his analysis. 5/8/08 Tr. at 5387-88 (Slottje).

227. In fact, none of the songwriter witnesses' testimony suggested that they felt that non-monetary compensation sufficiently supplemented their mechanical royalty earnings. CO PFF ¶ 775. Notwithstanding such testimony, the RIAA attempts to twist songwriter testimony about their love of songwriting around to support that baseless

argument. *See, e.g.,* RIAA PFF ¶ 516. These arguments, again, completely ignore the testimony provided by songwriter witnesses who are most able to explain why they continue to write songs. As Ms. Shaw testified, "I love what I do. I have the best job in the world, but I take it as a job. I mean, it's — every day I work, and if I'm not writing, then I'm trying to, you know, get things recorded or networking with a writer." 1/30/08 Tr. at 824 (Shaw). Ms. Shaw left no doubt as to her view that the mechanical royalty rate should be increased because the compensation she receives from her "job" is not fair or sufficient. Shaw WDT (CO Trial Ex. 5) at 7 ("I am not being fairly compensated for the efforts I make and risks I take to continue to be a professional songwriter."); *see also* 1/30/08 Tr. at 791 (Galdston) ("Every time you step out there to write a song, what's in your heart I think is you want people to love it, and what's in your economic mind is, man, I hope they love it.").

228. Overall, the RIAA's argument that the Copyright Owners receive income from non-mechanical sources ignores how critically important mechanical royalties are to the Copyright Owners, particularly songwriters. As Professor Landes discovered through his analysis of the royalties earned by UMPG songwriters between 2000 and 2006, nearly two-thirds of the full songwriter sample received 50% or more of their total royalty income from mechanical royalties. CO PFF ¶ 278. Nearly 40% of the songwriters tracked received 75% or more from mechanical royalties. *Id.*

229. These numbers are consistent with the testimony given by songwriters such as Rick Carnes, who observed, when asked about his alternative sources of revenue, that only his most popular songs earn synchronization royalties. For Mr. Carnes, mechanical royalties are much more important because "[t]he mechanicals are for the

album cuts. That's the bulk of what you get. And that's what pays your draw ... I mean the reason why I say to keep you alive like during that dry period I had, the thing that kept me alive was mechanicals." 1/28/08 Tr. at 227 (Carnes).

230. Music publishers also depend heavily on mechanical royalties, a fact that even Ms. Santisi's figures confirm. *See* CO PFF ¶ 341-42. Corroborating testimony from the music publisher witnesses, the financial data presented in Ms. Santisi's written report indicates that for BMG MP, EMI MP, and Warner/Chappell mechanical royalties accounted for between [redacted] and [redacted] of their annual revenues in the years examined.[3] Santisi WRT (RIAA Trial Ex. 78) at 48, 49, 52. Sony/ATV's totals were slightly lower, ranging from [redacted] to [redacted] during the same period. *Id.* at 50. UMPG's figures were higher, with mechanicals accounting for no less than [redacted] and as much as [redacted] of annual revenues. *Id.* at 51.

231. Regardless of the precise range, these figures make clear how critical mechanical royalties are for music publishers, who have identified this royalty stream in particular as the most significant income stream against which their companies are able to recoup advances to songwriters. *See* 1/31/08 Tr. at 966 (Robinson); 2/5/08 Tr. at 1619 (Peer); *see also* CO PFF ¶ 342. And although the RIAA argues that publishers' non-mechanical royalty streams have grown dramatically, the numbers relied upon by Ms. Santisi do not show such increases. *See* Santisi WRT (RIAA Trial Ex. 78) at 48-52. In fact, for each of the music publishers examined, the percentage of revenue comprised of performance and synchronization revenues showed only moderate increases or held

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[3] The Warner/Chappell numbers relied on by Ms. Santisi reflect worldwide totals, rather than U.S. figures. *See* Santisi WRT (RIAA Trial Ex. 78 at 52, 56.

relatively constant. None of the companies showed growth of more than 10% for either source of revenue. *Id.*

232. Even if non-mechanical revenue streams were relevant to the determination of a reasonable mechanical royalty rate (and they are not), the RIAA's evidence presented in support of its argument that such revenues justify a mechanical royalty rate cut—estimates of other revenues collected by music publishers and the comparison between music publisher and record company revenues—is unreliable and misleading.

233. Professor Teece, as he did with respect to mechanical revenue, presents mere estimates of the alternative revenues collected by music publishers in the same table in his Written Direct Testimony described above. Teece WDT (RIAA Trial Ex. 64) at 59, Appendix C. As noted earlier, Professor Teece made no effort to update or check his numbers against actual publisher financial information produced in discovery. *See* Section I. Moreover, when asked, Professor Teece could not even clearly explain which forms of revenue he had included in his calculations, precisely how such revenues had been counted, or, most importantly, whether some revenues had been counted twice:

> Q: Let me ask you a better question. Don't you know, based on your study of this industry, that ASCAP never remits to music publishers the writer's share of performance income?
>
> A: It's my understanding that it's paid direct, yes.
>
> Q: So, in fact, then, in Exhibit 28 you've double-counted the performance and revenue income purportedly going to music publishers because half of that column was paid directly to writers, correct?
>
> A: Well, I believe I have done it consistent with what was reported publicly; otherwise, you would see a big jump in the data series, and I don't see that.

> Q: Do you know whether you excluded writers' income?
>
> A: As I sit here right now, I don't know.
>
> Q: Do you know that ASCAP and BMI collect performance income on behalf of foreign music publishers and writers?
>
> A: Yes, I'm aware of that.
>
> Q: And you didn't exclude that either, did you?
>
> A: You know, it's — unfortunately, its two years ago. I cannot tell you.

2/19/08 Tr. at 3735-77 (Teece).

234. Indeed, when asked to explain what he ultimately relied on to reach his conclusion that a reduction in the mechanical royalty rate would not be disruptive for music publishers because of other revenue sources, Professor Teece admitted that he relied more on a generalized conception of the nature of the music publishing industry rather than actual financial figures: "I'm relying basically on the structure of their costs and the nature of their business. I'm not relying ... if this number here in 2005 is off by ... $100 million, I don't think that changes anything." *Id.* at 3738. Professor Teece's "perception" is hardly competent evidence.

235. Finally, although the RIAA has emphasized that the availability of alternative revenue streams give "publishers a virtually cost-free infusion into their bottom line," a number of music publishers testified that there are, in fact, a number of expenses associated with arranging for the non-mechanical use of musical works. *See* CO PFF ¶¶ 330-32. When music publishers actively seek new licensing opportunities for the works in their catalogs, they do so at a cost. Ralph Peer, for example, testified that

Peermusic has "a staff of approximately five people dedicated to synchronization placement." Peer WDT (CO Trial Ex. 13) at 14.

236. In any event, when it comes to accounting for alternative revenue streams, the RIAA has told only part of the story. Although Professor Teece and the RIAA claim to compare all music publisher revenues with all record company revenues, the analysis presented actually weighs all music publisher revenues, including performance and synchronization, against only a slice of record company revenues, wholesale revenues, despite the fact that record companies also receive revenues from a wide variety of sources that help to insulate them from declining sales. *See* RIAA PFF ¶¶ 403-04, Figs. 40, 41.

237. The RIAA complains, for example, that music publishers have enjoyed increasing synchronization revenues. But record companies also receive revenues from the use of their sound recordings in movies or television shows, known as master use royalties. In fact, due to the standard use of most favored nation provisions, record companies almost always receive the same license fee for master use licenses as the Copyright Owners receive for synchronization licenses. Scott Pascucci, the RIAA's primary witness on the synchronization market, conceded these facts during the rebuttal hearing:

> Q: So MFN clauses often lead to synch payments and master use payments that are equal, right?
>
> A: Correct.
>
> Q: And even before a license transaction is completed, in negotiations for master use licenses the record company will often insist on being paid as much as the publisher, right?
>
> A: Correct.

> Q: And it happens vice versa as well?
>
> A: Correct.
>
> Q: And these demands for equal treatment are customary in synch and master use license negotiations, right?
>
> A: They happen with great frequency. I guess you could call that customary.

5/7/08 Tr. at 5291-92 (Pascucci); *see also* 2/26/08 Tr. at 476-57 (Munns) (discussing EMI's synch revenues); CO PFF ¶¶ 532-34. Thus, if synchronization revenues "have grown enormously in recent years" for music publishers and songwriters, then they have done the same, by definition, for record companies. RIAA PFF ¶ 399. Furthermore, to the extent that synchronization revenues are, for music publishers, insulated from piracy or a "bulwark against instability in mechanical royalty collections" and sales, so are the synchronization revenues earned by the record companies. *Id.* ¶ 355. Nevertheless, Professor Teece simply ignores this revenue stream and asserts that music publishers alone enjoy synchronization revenue.

238. The record companies also receive performance royalties from the public performance of their sound recordings. In fact, as a result of the Second Webcasting and SDARS Determinations recently issued by this Court, the record companies are poised to grow their performance royalties substantially as they begin to collect royalties for the use of their sound recordings through internet and satellite radio services. 2/26/08 Tr. at 4757 (Munns) (agreeing that record companies have developed new performance royalty streams for internet and satellite radio in recent years). Professor Teece again simply dismisses this revenue stream for record companies, and includes it only for music publishers.

239. The RIAA's revenue exclusions do not end there. As discussed in Section II above, record companies also generate substantial revenues through their manufacturing and distribution operations. Robert Emmer, the Chief Operating Officer for Shout! Factory, an independent entertainment company, testified that his company outsources distribution to Sony BMG for an annual fee of roughly [redacted] of Shout! Factory's sales. Emmer WRT (RIAA Trial Ex. 90) at 5. Sony BMG, accordingly, receives an alternative revenue stream that is independent from the sale of Sony BMG sound recordings. Mr. Emmer also testified that he believes it to be unlikely that Sony BMG will allow Shout! Factory to negotiate for lower fees under its next distribution deal, thereby maintaining Sony BMG's distribution revenues under this deal at a constant level. 5/13/08 Tr. at 6282-85 (Emmer).

240. According to its U.S. profit and loss statements from 2004, 2005 and 2006, UMG also earns substantial income from its manufacturing and distribution operations. In 2006 alone, UMG generated [redacted] in profits from those operations, CO Trial Ex. 264, more than many of the music publishers' synchronization or performance revenue totals highlighted by the RIAA in its Proposed Findings of Fact. *See* RIAA PFF ¶¶ 409-10. Yet, revenues of this sort, although substantial and dependable, are wholly ignored in Professor Teece's purported comparison.

241. Moreover, the record companies are actively attempting to develop and maximize new sources of revenue. *See* CO PFF ¶¶ 420, 744. For example, EMI and other record companies are attempting to negotiate "360 contracts" more frequently. CO PFF ¶ 420.

242. Although mentioned only in a footnote to the RIAA's proposed Findings of Fact, 360 contracts are a significant development in the industry, signaling the record companies' interest in, effectively, taking a cut of all artist revenues, including in some cases mechanical royalties. For example, Mr. Munns presented testimony concerning the 360 contract, the first of its kind, that was negotiated between EMI and Robbie Williams:

> Q: And under that 360 contract that you entered into with Robbie Williams, EMI shares in all of the revenue that Mr. Williams earns, correct?
>
> A: Yes.
>
> Q: You get a piece of his tour income, correct?
>
> A: We bought a piece of his future tour income.
>
> Q: You bought it in return for a bigger advance?
>
> A: Correct.
>
> Q: And you share in Mr. Williams' publishing income as well, correct?
>
> A: Yes.
>
> Q: So in the 360 agreements that the record companies enter into, if a songwriter receives a piece of mechanical royalties, that actually goes back — part of it goes back to the record companies?
>
> A: If that's in the deal. All 360 deals are different. They're not just a one size fits all model. If — the record company would try and access other income streams, not necessarily all of them, but as many as them as they could afford to buy ...
>
> * * *
>
> Q: And in some of the 360 agreements that EMI entered into while you were there, EMI shared in the singer/songwriter's publishing royalties, correct?
>
> A: Yes. Yes.

2/26/08 Tr. at 4759-60 (Munns). The RIAA attempts to argue that 360 contracts are a business model with uncertain prospects for success, especially in negotiations with well-established artists. Yet, EMI's first 360 contract deal was with Robbie Williams, an extremely well-established artist.

D. The Successful Management of Music Publishing Companies Does Not Justify a Reduction in the Mechanical Royalty Rate

243. The RIAA next attempts to penalize music publishers because they are more profitable, more highly valued, and have not had to engage in the corporate restructurings conducted by the major record labels. *See* RIAA PFF ¶¶ 413-15, 432-34, 497-508. But such success—the result of good management as opposed to the record companies' acknowledged mismanagement—does not justify a reduction in the mechanical royalty rate.

244. In the first place, the objective of this proceeding is not to determine rates that compensate the copyright users for their mistakes in the current rate period. Indeed, the RIAA's emphasis on the profitability and marketplace value of music publishing companies is as misplaced as its focus on alternative revenue streams described above. Under Section 801(b), the Court must set a mechanical royalty rate that will provide a fair return for the Copyright Owners and a fair income for the copyright users. *See* CO PCL ¶ 2. The ultimate value or profitability of a music publishing company is not a measure of the "fair return" owed for each use of a Copyright Owner's musical work. *See id.* ¶ 81-82. Profitability depends on a music publisher's total costs and revenues, many of which have no connection to mechanical licensing. The valuation of music publishing companies depends on a multiple of income applied by the market to the company as a

whole. Neither are relevant to the determination of the mechanical royalty rate at issue here.

1. The Profitability of Music Publishers Does Not Justify a Rate Reduction

245. The comparison between music publishers and record companies offered by the RIAA is flawed because the RIAA fails to present credible evidence that record companies are not, as claimed, profitable. In arguing that aggregate profit margins for major record labels are much lower than profits for the major music publishers, the RIAA relies on testimony from rebuttal witness Bruce Benson. RIAA PFF ¶ 414. Yet as shown above, Mr. Benson's profitability analysis cannot be trusted. *See* CO PFF ¶¶ 451-54. In contrast, a review of the financial documents actually produced by the record companies, rather than the error-filled analyses performed by Ms. McLaughlin and Mr. Benson, indicates that the profitability of many of the major record companies has improved in recent years, in some cases to record highs. *See* CO PFF ¶¶ 441-46.

246. In addition, the RIAA's featured match-up of the profit margins of EMI MP and EMI Music hardly provides an "apples to apples" comparison and cannot salvage the RIAA's argument. RIAA PFF ¶ 414. As even the RIAA has acknowledged, EMI MP was, until UMPG acquired BMG MP, the largest and most successful music publisher; it is now a close second. RIAA PFF ¶ 452; 1/29/08 Tr. at 365 (Faxon). EMI Music, on the other hand, is the least successful major record company, and an outlier among the majors in terms of its profitability, as discussed above. *See supra* Section 73; *see also* CO PFF ¶¶ 446-48. Further, EMI Music's slim profit margins are not due to the inherently unprofitable nature of record companies (as the RIAA implies), but rather to a series of poor business decisions, as both Colin Finkelstein, EMI's Chief Financial

Officer, and David Munns, formerly the Vice Chairman of EMI, acknowledged. According to Mr. Munns, "the company was a mess" when he arrived to run EMI North America in the fall of 2001, largely because his predecessors had managed the business badly and had allowed spending to get out of control. 2/26/08 Tr. at 4749-50 (Munns); CO PFF ¶ 447. Thus, the RIAA's profitability comparison is meaningless.

2. Music Publishers' Avoidance of Substantial Restructurings Does Not Justify a Rate Reduction

247. For the same reasons, the RIAA's reliance on the past restructurings made by major record companies as support for their purported instability gains them no ground in justifying a reduction in the mechanical royalty rate. *See* RIAA PFF ¶¶ 432-434. Music publishers should not be penalized for their successful and efficient corporate management. Nor should record companies be rewarded for a period of severe mismanagement.

248. As described above, and in detail in the Copyright Owners' Proposed Findings of Fact, the recorded music industry has historically experienced cyclical growth, with periods of rapid growth and great success followed by brief downturns. *See* CO PFF ¶¶ 356-61. The mechanical royalty rate has never been a casualty of these cycles. Indeed, the mechanical royalty was increased in 1981 even though the recorded music industry was in the midst of a period of contraction. *Id.* ¶¶ 119, 358.

249. And as shown above, the recent restructuring of the record industry was necessary in large part because of the record companies' own actions. *See* CO PFF ¶¶ 399-400. This is particularly true with respect to the RIAA's "case in point," EMI Music, which was restructured because "the business had become bloated and ... was overstaffed and ... its expenses were out of line with its potential revenues." 1/30/08 Tr.

at 558 (Faxon). This observation is entirely consistent with those made by Mr. Munns during the direct hearing. *See* CO PFF ¶ 447.

3. The Value of Music Publishing Companies Does Not Justify a Rate Reduction

250. Having successfully avoided many of the mistakes that forced the record companies substantially to restructure their operations, music publishers have recently become, comparatively, more valuable. RIAA PFF ¶ 357. This fact, despite the RIAA's emphasis, is irrelevant to the current proceeding. The value ascribed to a particular music publishing company depends upon the multiple applied to that company's net publisher share ("NPS"), which is the amount retained by the music publisher after payments are made to songwriters. Even the RIAA acknowledges that valuations are affected by forces outside of a music publishing company, noting that they have been "bid up" by financial investors in recent years. RIAA PFF ¶ 357. As the Copyright Owners explained in their Proposed Conclusions of Law, the critical issue in this proceeding is determining the return to an individual songwriter (and music publisher, if involved) for an individual use of a musical work. CO PCL ¶ 11. The valuation of music publishers has little, if anything, to do with the value of the musical composition or the appropriate return to an individual songwriter.

251. Further, it is problematic to justify a reduction in the current royalty rate on the valuations presented by the RIAA, as those valuations were, in fact, calculated on the basis of the current rate and the mechanical revenues expected as a result. The RIAA has presented no evidence that the current value of music publishing companies would remain stable if mechanical revenues were reduced by 40%, as they would be under the RIAA's proposal. Indeed, it is likely that such a drastic rate cut would affect both the

"stable, long-term earning potential of music publishing assets" and the precise valuation figures highlighted by the RIAA in its attempt to make this argument. RIAA PFF ¶¶ 506, 500-05.

E. Music Publishers and Songwriters Take Substantial Risks, Play Critical Roles and Should be Rewarded

252. Throughout this proceeding, both the RIAA and DiMA have repeatedly sought to discredit the critical role of music publishers and songwriters and the risks they take, in order to justify their dramatic proposed rate cuts. *See, e.g.,* RIAA PFF ¶ 358 ("music publishers have enjoyed profits and revenues out of any meaningful proportion to the risks they take and the contributions they make"). But as the overwhelming evidence shows, both songwriters and music publishers continue to make substantial contributions to the music industry and to the creative process through which musical works are made available to the public, without knowing in advance whether those contributions will result in success or financial compensation. *See generally* CO PFF ¶¶ 14-20, 287-340.

1. Music Publishers Make Critical Contributions to the Creation of Songs and the Success of the Industry

253. The RIAA has routinely criticized music publishers, claiming (just as they did in 1980 before the CRT) that publishers "are now almost entirely passive—collecting royalties on records which they did little or nothing to help create or sell." RIAA PFF ¶ 1282. Substantial evidence presented by the Copyright Owners proves the opposite.

254. Each of the four music publishers who testified during the direct hearing—Roger Faxon from EMI MP, Nicholas Firth from BMG MP, Ralph Peer from Peermusic, and Irwin Robinson from Famous Music, each a current or former CEO of a

significant music publishing company—explained in detail the wide range of functions performed by music publishers on behalf of songwriters. *See generally* Faxon WDT (CO Trial Ex. 3) at 4-12; Robinson WDT (CO Trial Ex. 8) at 10-21; Peer WDT (CO Trial Ex. 13) at 4-18; Firth WDT (CO Trial Ex. 24) at 6-20; *see also* 1/31/08 Tr. at 950-55, 957-68 (Robinson); 1/29/08 Tr. at 374-76, 387-85, 389-94, 401-10 (Faxon). Mr. Faxon testified, that music publishers are, at bottom, in a service business for songwriters, who look to publishers to "help them develop their talent [and] ... understand how better to improve their music." 1/29/08 Tr. at 370 (Faxon) (discussing the work music publishers do for songwriters). As described in the Copyright Owners' Proposed Findings of Fact, the services offered by music publishers generally include creative and financial support, promotional and licensing efforts, and administrative and ministerial functions. *See generally* CO PFF ¶¶ 295-340.

255. The testimony of the music publisher witnesses was corroborated by that of the songwriter witnesses, many of whom attribute successes in their careers to the assistance they have received over the years from music publishers. *See, e.g.,* CO PFF ¶¶ 293, 312, 322-23. Victoria Shaw, a songwriter who has written successful country and pop hits, testified, for example, that "[h]aving a publisher made all the difference in [her] career." Shaw WDT (CO Trial Ex. 5) at 2. Ms. Shaw explained in both her Written Direct Testimony and at trial that music publishers have pitched her songs to record companies and artists, have been responsible for the release of some of her biggest hits, and have allowed her to focus on writing more, and better, songs. *Id.* at 2, 6; 1/30/08 Tr. at 819-21, 830-33 (Shaw) (describing efforts made by music publishers on her behalf as well as the impact of such efforts on her career).

256. The RIAA completely ignores this first-hand, factual evidence, choosing instead to rely on unsupported, conclusory assertions made by Ms. Santisi, who has not worked at a music publishing company since 1992. Santisi WRT (RIAA Trial Ex. 78) at 2. Indeed, the RIAA even overlooks testimony given by its own witnesses that music publishers make A&R efforts similar to those of the record companies, provide advances to songwriters and, accordingly, take risks when new songwriters are signed. 2/14/08 Tr. at 3467-68 (Kushner). Ms. Santisi herself acknowledged that music publishers may sign songwriters before they have record deals or relationships with the record companies. 5/7/08 Tr. at 5235 (Santisi).

257. The RIAA also ignores the evidence that music publishers have made substantial contributions in the developing world of digital music. *See* RIAA PFF ¶¶ 1384-1390. Music publishers were integral to the creation of the ringtone market by granting early licenses for the use of their musical compositions to ringtone aggregators. CO PFF ¶ 337. More importantly, many music publishers, through NMPA, entered into a landmark 2001 agreement with the RIAA to enable online subscription services to offer limited downloads and interactive streams on a rateless basis, pending future negotiations or rate setting proceedings. *Id.* As Mr. Robinson testified, "[w]e were all interested in broadening the market for the use of music. So we agreed to give a license which didn't have a rate attached to it." 1/31/08 Tr. at 935 (Robinson); *see also* 1/29/08 Tr. at 413-14 (Faxon).

258. Music publishers have made these contributions to the growth of digital music, while also continuing to fill their longstanding roles for songwriters, in the face of widespread piracy that has significantly impacted their revenues. *See, e.g.,* CO PFF 800.

The songwriting community has made similar contributions in the face of a similar threat. *See id.* at 94, 98. Although acknowledging, as it must, that every sale lost to piracy is a lost sale for music publishers and songwriters, the RIAA then attempts to minimize piracy's true impact by citing the increases in the statutory rate and again referencing music publishers' other revenue streams. RIAA PFF ¶ 425.

259. The RIAA also ignores the record evidence when describing the substantial efforts of music publishers and songwriters that have been made to fight piracy. Again ignoring that dollar-for-dollar comparisons between music publishers and songwriters, on the one hand, and record companies, on the other, are inherently flawed, the RIAA criticizes music publishers and songwriters for assuming "only a small role in combating piracy," and spending amounts that "are a tiny fraction of the record companies' spending." RIAA PFF ¶ 1411. Music publishers have, however, been actively involved in each major high-profile piracy lawsuit, including those against Napster and Grokster. CO PFF ¶¶ 102, 800. Songwriters, for their part, have devoted great time and energy to efforts designed to fight piracy through lobbying Congress and participating in the legislative process. *Id.* ¶¶ 94, 98.

2. Music Publishers Act as Music Publishers, Not as Record Companies

260. On the basis of Ms. Santisi's testimony and a few selective documents, the RIAA argues that music publishers make smaller investments than record companies, minimize the risks associated with these limited investments in ways the record companies cannot, and ultimately recoup far more of their investments than the record companies do. The RIAA's arguments, however, ignore the basic differences between the roles of music publishers and record companies, and have no evidentiary support.

261. In an attempt to exaggerate the record companies' relative role in the making available of creative works, the RIAA mischaracterizes much of what music publishers do. Ms. Santisi correctly testified that music publishers acquire the rights to musical works in three ways—through the acquisition of existing catalogs, the negotiation of administration deals, and, last but certainly not least, the creation of new compositions through their work with active songwriters. RIAA PFF ¶¶ 442-444. Ms. Santisi is mistaken, however, in her efforts to downplay the importance of these activities or associated risks. They are not simply means by which music publishers can maximize revenue while minimizing risk. RIAA PFF ¶¶ 442-43.

262. Both the acquisition of existing catalogs and the negotiation of administration deals with small music publishers or songwriters help to maximize the availability of creative works. Catalog acquisitions are an important way in which music publishers can expand their businesses. *See* Firth WDT (CO Trial Ex. 24) at 3-5. Moreover, the acquisition of smaller or more obscure catalogs by larger music publishers, particularly the majors, who have greater resources, helps to keep existing musical works in the market. Mr. Firth testified to the particularly strong acquisition history of BMG MP. As a result of his efforts, BMG MP acquired the rights to catalogs ranging from Fleetwood Mac to Gilbert Bécaud to Ravel, Verdi and Puccini. Firth WDT (CO Trial Ex. 24) at 4-5. Once under the BMG MP umbrella, the musical works in these catalogs, and the songwriters associated with them, were able to reap the benefits of a bigger, more established infrastructure through which they could be more easily licensed for new or continued use and be more effectively made available to the public. Similar benefits

occur as a result of administration deals. Regardless of the risk involved, these efforts by music publishers benefit the industry as a whole.

263. In any event, to the extent that the acquisition of existing catalogs brings with it relatively smaller risks, the major record companies enjoy a corollary in the distribution deals they sign with independent record companies. As described above in Section IV.C, Sony BMG provides distribution services for Shout! Factory, and therefore generates additional revenues without making a creative contribution or taking any identifiable risk. *See* Emmer WRT (RIAA Trial Ex. 90) at 5; 5/13/08 Tr. at 6282-85 (Emmer). Similarly, Glenn Barros, the CEO of Concord, testified that Universal distributes all of Concord's products, both physical and digital, within the United States. 2/21/08 Tr. at 4113-14 (Barros); *see also id.* at 4201-02 (explaining that smaller independent record companies that are unable to negotiate favorable distribution rates with the majors face very high distribution costs).

264. The RIAA similarly downplays the efforts made by music publishers in their work with active songwriters to create new musical works. As described in detail in the Copyright Owners' Proposed Findings of Fact, music publishers discover songwriters, provide them with critical financial support in the form of advances, and offer creative assistance by introducing new songwriters to more experienced ones or arranging for collaborations. Music publishers also handle important administrative functions such as copyright registration, licensing, and royalty collections and distributions. *See* CO PFF ¶¶ 317-23. As a result of their integral involvement in the creation of new musical works, music publishers face the same risks as songwriters with each new song. As Mr. Peer observed, "[o]ur myriad investments in songwriters—in the

form of money, human resources and facilities—are substantial but unfortunately are no guarantee of success." Peer WDT (CO Trial Ex. 13) at 11.

3. Music Publishers Make Proportionally Substantial Investments

265. At bottom, the RIAA's complaint about music publishers—that they "play a largely passive role once the musical work has been written"—is that music publishers are not acting more like record companies. RIAA PFF ¶ 5. But music publishers are not in the business of creating or selling sound recordings. Music publishers are in the business of aiding the creation and exploitation of musical works, thereby providing a critical component of the sound recording that is ultimately delivered to the public. Music publishers invest and contribute accordingly. *See* CO PFF ¶¶ 297 (discussing music publishers' A&R budgets and expenditures), 308 (discussing amounts spent as songwriter advances), 313-14 (same), 332 (discussing promotional expenditures).

266. Simply put, "turn[ing] the musical works into a form the public will actually buy," such as CDs or digital downloads, by paying recording artists, producing sound recordings, manufacturing CDs or digital phonorecords and organizing marketing efforts, are functions of record companies, not music publishers. RIAA PFF ¶ 447. Record companies, after all, do not fulfill the role of music publishers, and neither group should be penalized for this long-standing division of labor. When asked, for example, whether music publishers are "in the business of distributing music," David Hughes, the Senior Vice President of Technology for the RIAA, testified that "distribution has primarily been done by the recording companies and their distribution partners." 2/20/08 Tr. at 4088 (Hughes).

267. The RIAA purports to prove that music publishers invest little in the creative process by comparing EMI MP's total revenues ([redacted]) and total expenses ([redacted]) from the last fiscal year. RIAA PFF ¶ 450. But this example is misleading. First, the RIAA failed to mention that of the approximately [redacted] earned in mechanical royalties, which accounted for almost half the total revenues cited, approximately 75% is passed on to songwriters, leaving EMI MP with substantially lower revenues once advances are recouped. *See* 5/7/08 Tr. at 5209-10 (Santisi) (discussing how songwriters receive the lion's share of mechanical royalties paid by the record companies to music publishers). Second, the RIAA states that songwriter royalties have also been excluded from these figures, thereby understating the total expenses actually incurred.

268. Finally, the RIAA has purposefully selected numbers from only one music publishing company—the most successful—in an unavailing attempt to prove an industry-wide contention. No evidence has been presented to show that EMI MP's financial results are representative of those across the industry. In fact, EMI MP is far from representative. Ms. Santisi's own chart, for example, indicates that Sony/ATV, another major music publisher, incurred greater expense ([redacted]) and generated far less revenue ([redacted]) in the same period. RIAA PFF ¶ 450, Table A.

269. The RIAA also attempts to prove "[t]he disparity of investments between music publishers and record companies" by comparing the investment profile of EMI MP with that of the Universal Music Group. RIAA PFF ¶ 452. This comparison suffers from similar shortcomings. Although matching financial information for "the most profitable music publisher" against that for "the largest and most financially healthy record

company" may not seem unreasonable at first blush, the two companies are hardly equivalent. At trial, Ms. Santisi could not testify that EMI MP and UMG, even though the largest companies in their respective markets, had equal market share. 5/7/08 Tr. at 5135 (Santisi) ("Q: And do they actually have the same market hare or just they're the two biggest? A: They're the two biggest in each of their sectors.").

270. What is more, the two markets are themselves dramatically different in size and worth. According to an internal EMI document, the total value of the music publishing market world-wide in CY 2006 was £2.0 billion (or approximately $4 billion), while in FY 2007, the global wholesale recorded music market was worth £9.7 billion (approximately $20 billion). RIAA Trial Ex. 9 at 8. Even with equal market shares, therefore, EMI MP and UMG would not be comparable, and the RIAA's comparison would remain unpersuasive.

271. Moreover, the RIAA exaggerated the discrepancies between the two companies by comparing absolute budget figures rather than percentages of overall revenues. The RIAA argues that EMI MP's budget of [redacted] for A&R, gross advances that average close to [redacted] per year and "expenditures on various development and promotional activities of just under [redacted] ... pale in comparison with the comparable figures from UMG." RIAA PFF ¶ 452. Yet the UMG figures offered in parallel, when taken out of the context of UMG's entire financial profile, are not suitable for comparison.

272. Indeed, the RIAA seemed to recognize this flaw, but failed to remedy it in a credible manner. At trial, Ms. Santisi attempted to offer a comparison of the advances paid by EMI MP and UMG as a percentage of revenues. As she freely admitted,

however, that analysis was not contained in her report and was in fact only done after her report had been submitted and she had been questioned about the absence of such figures at her deposition. 5/7/08 Tr. at 5189 (Santisi).

> Q: Can you show me where that [an analysis of whether EMI's advances were a larger or smaller percentage of revenues than UMG's] is in your report?
>
> A: It's not in my report.
>
> Q: Had you done that analysis at the time of your deposition ten days ago?
>
> A: I had done part of it. I had not done all of it.
>
> Q: So that's something you did because I asked you that question at your deposition, correct?
>
> A: Correct.
>
> Q: It's not an analysis that you thought you needed in order to submit your testimony to this court, correct?
>
> A: It was not something that was included in the report.

Id. at 5190-91.

273. Ms. Santisi did not provide her work papers to back up her calculations and could only explain her methodology in generalized terms. She also could not concretely establish which expenses she had considered. *Id.* at 5189 (explaining that with respect to the EMI MP numbers presented by Mr. Faxon she "believe[d] he has a certain amount of overhead in there"). Without concrete evidence establishing which numbers Ms. Santisi relied upon or how she actually performed her calculations, her untested calculations are entitled to little weight.

274. Even without such mathematical or evidentiary problems, the RIAA's argument that comparing overall investments made by music publishers and record

companies can serve as a justification for a reduction in the mechanical royalty rate is unpersuasive, largely because it fails to account for the different rates of return enjoyed by the two groups.

275. The example of Back to Bedlam, an album by singer-songwriter James Blunt, highlighted by both the RIAA and the Copyright Owners, is particularly illustrative. To the RIAA, this album is a prime example of supposedly how little EMI MP invested in Mr. Blunt in comparison to the amounts invested by Atlantic Records. RIAA PFF ¶¶ 457-58. But as Ms. Santisi conceded at trial, when records are hits, the amounts earned by the record companies are a substantial multiple of what the publisher gets. 5/7/08 Tr. at 5233 (Santisi).

276. Putting marketing costs, which, as described above, are appropriately borne by the record companies that produce and sell finished albums and have little to do with the creative process, aside, EMI MP's advances to Mr. Blunt were only approximately [redacted] less than those spent by Atlantic for Mr. Blunt's advances and recording fund. CO Trial Ex. 214. The resulting profit totals, however, were vastly different—Atlantic's profits on the record were roughly twenty times the mechanical royalties earned by EMI MP, once Mr. Blunt's songwriter share had been distributed. 5/7/08 Tr. at 5237-39 (Santisi).

277. According to the RIAA, "[n]ot only do music publishers make fewer expenditures, but they also find more ways to recoup the ones that they do. This is particular [sic] true of songwriter advances to new talent – the only significant expenditure of music publishers and therefore the only such expenditure bearing any appreciable risk." RIAA PFF ¶ 462. Ms. Santisi testified that record companies typically

recoup between 45-70% of their advances while music publishers recoup substantially more. RIAA PFF ¶ 463. These claims, however, rely on selective or incorrect evidence, and the RIAA ignores substantial testimony to the contrary. Moreover, in making this argument, the RIAA disingenuously ignores that the record companies take similar, if not more aggressive, steps to recoup their advances and minimize their own risks.

278. First, the RIAA complains that music publishers recoup more of the advances they give because they "do not give songwriter advances until a record company has gotten involved," thereby minimizing the risk. RIAA PFF ¶ 464. This claim is contrary to substantial evidence in the record. New songwriters are frequently discovered and signed by music publishers before record companies are involved, as both Mr. Robinson and Mr. Peer explained. *See* CO PFF ¶ 295; *see also* Firth WDT (CO Trial Ex. 24) at 7 (explaining how 27 of the 42 new songwriters signed by BMG MP in 2005 had not yet released a commercial record). Mr. Blunt, in fact, signed his publishing deal with EMI MP long before negotiating a record deal, as Ms. Santisi acknowledged. 5/7/08 Tr. at 5230 (Santisi); *see also* CO PFF ¶ 301. Songwriter Maia Sharp provided similar testimony, recounting how she was able to receive financial support from music publishers when record companies were not interested in her work or had withdrawn their support. Ms. Sharp described how she struggled to make ends meet after her contract with a record company ended in 1999, but that "[f]ortunately, in 2000, [she] entered into a music publishing contract with Major Bob Music and because of the advances Major Bob gave [her] that were a part of the deal, [she] was able to get out of debt." Sharp WDT (CO Trial Ex. 6) at 3.

279. Moreover, advances to songwriters are typically provided on a non-recourse basis, and songwriters are not obligated to repay them if they are unsuccessful. Given this situation, it is not unreasonable for music publishers to take some action to minimize the risk of advancing such large sums. Structuring advances so that they are not paid up front and in full is one such measure. Contrary to the RIAA's assertion, however, in most cases advances are provided as monthly salary draws or other serial payments. CO PFF ¶ 306. Conditioning the payment of advances on the release of recordings typically only occurs when a publisher is working with a singer-songwriter or producer-songwriter. *Id.*; *see also* 1/31/08 Tr. at 877 (Sharp) (describing how advances are typically paid either as lump sums or weekly or monthly payments).

280. Music publishers may also factor a songwriter's status in the industry or a songwriter's existing record deals into decisions about the amount to be paid as an advance. RIAA PFF ¶ 466; *see also* CO PFF ¶ 307. But the RIAA mistakenly implies that the existence of a record deal is the most important consideration for publishers, and ignores the other factors involved in calculating advances. As a number of music publisher witnesses testified, the genre in which a songwriter works, a songwriter's prior successes as a writer, and the opinions about a songwriter's creative potential are given as much, if not more, weight in such evaluations. CO PFF ¶ 307.

281. Given the risks that advances provided to songwriters—even those who are established, successful or who have record deals—will never be recouped, it is only sensible for advances to be higher "when there is perceived to be less risk associated with the songwriter." Peer WDT (CO Trial Ex. 13) at 7. In fact, record companies do the same. Warner Music Group, for example, explained in its 2005 Annual Report that

"[o]ur typical contract for a new artist covers a single initial album and provides us a series of exclusive options to acquire subsequent albums from the artist. Royalty rates are often increased for optional albums.... Our established artists' contracts generally provide for greater advances and higher royalty rates." CO Trial Ex. 21 at 9.

282. Second, the RIAA also complains that music publishers structure songwriter deals so that they can recoup advances against multiple streams of revenue, recoup expenses other than advances, recoup more from certain types of revenue, or manipulate recoupment percentages in an attempt to circumvent the reductions imposed by controlled composition clauses. *See* RIAA PFF ¶¶ 468-72. These claims are based almost exclusively on a single songwriter agreement between EMI MP and Metro Station. Faxon WRT (CO Trial Ex. 375), Ex. K. The RIAA presents no evidence that this contract is typical of those used by EMI MP, let alone that it is representative of agreements throughout the industry. Indeed, the RIAA fails to mention whether other music publisher contracts contain similar provisions.

283. The RIAA also claims that "music publishers continue to take large portions of songwriter income for themselves and to impose onerous contractual conditions on songwriters," and that music publishers endeavor to shift as much risk as possible to the songwriters they represent through their songwriter agreements. RIAA PFF ¶ 539-40. Similar arguments, however, were rejected in 1981, when the CRT acknowledged that, even then, the "historical split of mechanical royalties among copyright owners has increased in favor of the songwriter's share." 1981 CRT Determination, 42 Fed. Reg. at 10475.

284. These claims also ignore evidence presented by each of the music publisher witnesses that the royalty "split" between music publishers and songwriters has shifted, through marketplace transactions, in favor of the songwriter. Splits have shifted from the traditional 50:50 arrangement to, more frequently, 75:25 and, on some occasions, as high as 90:10. CO PFF ¶ 309. As a result, 75% of each mechanical royalty payment is used to recoup a songwriters' advance, and, once advances have been recouped, the songwriter receives 75% of any subsequent mechanical royalty payments. Music publishers have not reduced their investments, as described above, but now retain a smaller share of any resulting revenues.

285. It is true, as the RIAA points out, that songwriters who have entered into music publishing deals do not receive 100% of the mechanical royalties arising from sales of their musical works. RIAA PFF ¶ 541. As Mr. Faxon commented in the exchange with Judge Wisniewski quoted by the RIAA in its Findings of Fact, however, the royalty split between music publishers and songwriters is a function of the services music publishers provide for their songwriters. 5/14/08 Tr. at 6407 (Faxon). And as many of the Copyright Owners' songwriter witnesses have testified, a publisher's services can have a positive impact on a songwriter's career. CO PFF ¶¶ 322-23.

286. The dramatic reduction in mechanical royalties songwriters will experience under the RIAA's proposal "is independent of that split." 5/14/08 Tr. at 6406 (Faxon). The split negotiated between songwriters and music publishers is the result of a voluntary market transaction. It reflects the values placed on a music publisher's contributions by the parties to the contract. Such values are independent of the statutory

mechanical royalty rate and should not be forced to adjust as a result of the RIAA's proposed reduction.

287. The RIAA also ignores that record companies, too, attempt to recoup as much of their investment in recording artists as possible. Even a cursory review of the standard artist agreements used by Warner Bros./Atlantic Records and Sony BMG reveals that each record company includes a wide range of expenses, such as [redacted] and [redacted], in its definition of "Advances," thereby allowing the company to recoup far more than the RIAA has implied. *See* RIAA PFF ¶¶ 468-73. The Sony BMG agreement, for example, provides in relevant part:

[redacted]

[redacted]

CO Trial Ex. 297 at 8. The Warner Bros./Atlantic agreement has similar provisions. *See* CO Trial Ex. 56 at RIAA 45269.

289. Even with recoupment provisions, advances are a risky proposition for music publishers, complete recoupment is rare, and advances are regularly written off. CO PFF ¶ 316. As Mr. Firth testified, for example, BMG MP wrote off millions of dollars in unrecouped advances each year, and, from the company's inception in 1987, wrote off 55% of its total advances through 2005. Firth WDT (CO Trial Ex. 24) at 11-12; 2/12/08 Tr. at 2666, 2679 (Firth); *see also* Robinson WDT (CO Trial Ex. 8) at 19.

290. Even if Ms. Santisi's analysis of recoupment rates is accurate, the RIAA has failed, once again, to tell the whole story. As the RIAA emphasized repeatedly, record companies also provide advances. Other than the conclusory statements offered by Ms. Santisi at trial, however, statistics concerning the record companies' rate of recoupment—again, information easily accessible by the record companies—were not provided. When asked, Ms. Santisi admitted that, as with her information comparing advances as a percentage of revenue, her information about the respective recoupment rates enjoyed by music publishers and record companies was not contained in her report. 5/7/08 Tr. at 5191 (Santisi). Again, Ms. Santisi failed to produce the evidence on which she relied to reach her conclusions, and thus her conclusions cannot be credited.

F. Songwriters Take Severe Risks, Make Critical Investments and Should Also be Rewarded

291. The RIAA lodges similar complaints against songwriters, arguing that "[t]he 'risks' taken by songwriters also do not compare to those of the record companies." RIAA PFF ¶ 1338. Once again, this argument fails to account for the

substantial evidence, provided by the songwriters themselves, to the contrary. Numerous songwriters testified that they face substantial risks that are unavoidable in today's music industry. As Mr. Galdston put it, "[i]n choosing to be a songwriter, I chose to live with certain risks. Beginning with the most basic, in writing a song, there is a risk that it will not be recorded by an artist or licensed by a record label. Even if the song is recorded, it may not be released. If it is released, it may not be successful. If my songs are not successful, I may not have any income to provide for my family." Galdston WDT (CO Trial Ex. 4) at 4-5.

292. In attempting to group all songwriters together in this way, the RIAA also disregards the fact that different songwriters face different levels of risk, depending on the type of musical works they create. The risks faced by classical composers, especially concerning investments in time and effort, are in many respects greater than those faced by other songwriters, as Stephen Paulus, a composer of operas and other "serious" music, testified. According to Mr. Paulus, "on average, it takes [him] 13 to 14 months to write a full opera," followed by months of work with an opera company to perfect the work. Paulus WDT (CO Trial Ex. 7) at 6. Despite his tremendous effort, Mr. Paulus explained that his mechanical royalty revenues are quite low and that when it comes to mechanical royalties, "every penny . . . counts." *Id.*

293. Mr. Paulus testified that for classical composers, who often write lengthy works (such as operas), the current mechanical rate does not provide sufficient compensation. When asked to explain why he felt the mechanical royalty rate should be increased, Mr. Paulus explained that

> I just think we work long and hard on these compositions and an opera can take anywhere from 13 to 14 months to

> four years some take longer and it just gets more involved. ... An increased mechanical rate would give us some remuneration for our hard work and allow us to propagate our works out to the public. It is extremely important.

1/31/08 Tr. at 915-16 (Paulus). The Copyright Owners' proposal addresses the additional risks made by writers such as Mr. Paulus by adopting a "greater of" structure based on the playing time of a musical work. This "overtime" rate provides needed incentives to keep classical composers, among others who write works that are longer than the traditional pop song, from leaving the profession.

294. The RIAA attempts to minimize the importance of the risks songwriters face by arguing that "[l]ong after the song has been written and recorded, the songwriter and his or her heirs will continue to receive substantial income from that song." RIAA PFF ¶ 515. But record companies enjoy the same benefits. Once they have created a successful sound recording, they will continue to receive royalties from the exploitation of that sound recording for the same period of time provided for by the Copyright Act as the Copyright Owners do. Indeed, as a number of DiMA witnesses have testified, record companies are experiencing a resurgence in sales of older catalog works through various digital services, thereby allowing them to earn royalties on their sound recordings long after they were first recorded and distributed as well. *See* 2/25/08 Tr. at 4252 (Cue) (explaining the Long Tail phenomenon and noting that "a large portion of our sales [through the iTunes Store] comes from older songs").

295. The RIAA also claims that songwriters are able to minimize the risks they face by participating in other aspects of the music business or only writing songs on a part-time basis. RIAA PFF ¶¶ 520-21. But the RIAA's argument turns the songwriter testimony on its head. Songwriters do not perform, produce, tour or work as back-up

singers because they prefer to; they participate in those other activities, in many instances, because of the risks they face as songwriters, and more specifically, because they face great difficulty making a living through songwriting alone. Maia Sharp described this situation particularly well: "In addition to writing songs (for myself and others), I also sing my own material. Although I enjoy performing, songwriting is where my heart is. Generally, I split my time equally between writing songs for myself and writing songs for the purpose of pitching them to artists. Because I cannot survive on songwriting income alone, I have had to participate in many other aspects of the music business to stay financially afloat." Sharp WDT (CO Trial Ex. 6) at 1-2; *see also* CO PFF ¶ 225.

296. Although the RIAA touts the fact that many songwriters "multi-task" within the music industry, in fact, many songwriters believe that not being able to focus on their songwriting full time negatively affects the quality of the musical works they produce. *See* Bogard WDT (CO Trial Ex. 2) at 8 (testifying that when splitting time "between working at creating songs and working to pay the bills, the creative output suffers"); Sharp WDT (CO Trial Ex. 6) at 7 (noting that "[i]t is extremely difficult, if not impossible, for songwriters to produce quality songs when they are focused on how to pay the bills"); *see also* CO PFF ¶ 226.

297. Moreover, at bottom, the RIAA's attempts to use a comparison between the investments made or risks taken by songwriters with those of the record companies is as flawed as that attempted between the record companies and music publishers. *See supra* Section IV.F. Songwriters are not record companies, and they inherently make a dramatically different contribution to the creative process and the music industry. Those

differences, however, do not make the contributions of songwriters any less valuable, nor do they justify a reduction in the mechanical royalty rate.

298. In particular, the RIAA emphasizes that "[s]ongwriters do not have costs anywhere in the ballpark of the expense of record companies, or even music publishers." RIAA PFF ¶ 517. As explained above, attempting to compare costs as a measure of ultimate worth of the creative contribution is useless. The RIAA's primary support for these claims comes from Steven Wildman, who, in fact, identified a major cost faced by songwriter—the opportunity cost of being a songwriter. 5/13/08 Tr. at 6005 (Wildman).

299. The RIAA attempts to minimize such costs, but a number of songwriters explained just how great these costs could be. As Mr. Galdston testified, "[e]ven though I write many songs and have achieved great success, the way I am principally compensated—namely, through mechanical royalties—means that it is highly unlikely that I will ever make as much money as I would have had I chosen another career." Galdston WDT (CO Trial Ex. 4) at 4.

300. In fact, the risks and costs of a songwriting career have, of late, become too great for a number of established, successful songwriters. Ms. Shaw described a number of songwriters who have left the profession because songwriting is no longer sufficient to provide for their families. 1/30/08 Tr. at 827-28 (Shaw). Despite such testimony, the RIAA claims that "there is absolutely no evidence that there currently is a shortage of songs or songwriters. RIAA PFF ¶ 1163; *see also id.* ¶¶ 52, 510, 640. For the reasons described above, this claim is wrong.

V. The Record Companies' Relative Contributions Are Not Greater Than the Copyright Owners' Contributions

301. Having denigrated the contributions made and risks taken by music publishers, the RIAA exaggerates the contributions made and risks taken by the record companies. Once again, the RIAA's claims are wholly lacking in evidentiary support.

A. Recordings Are Not More Scarce Than Songs

302. As an initial matter, the RIAA's contention that "there is no shortage of songs—only a shortage of artists and record companies to record, promote, and distribute them," is completely devoid of factual support. RIAA PFF ¶ 1275. Not a single record company executive—from a major or independent label—testified about such a shortage at trial. With respect to artists, the only testimony that the RIAA offered—that the major record companies were purportedly cutting artist rosters, *see, e.g.*, *id.* ¶¶ 207-09—is inconsistent with a dearth of recorded artist talent. To the contrary, the evidence clearly shows that there are abundant artists: Professor Teece testified that 32,000 CDs are released each year. *See* RIAA PFF ¶ 619.

303. Nor is there a shortage of record companies. The record industry is not comprised solely of the four major record companies. As Glenn Barros, CEO of Concord, testified, "[t]he recorded music industry is comprised of companies of widely varying size and business models, including the four major record companies and numerous independent record companies . . . ." Barros WDT (RIAA Trial Ex. 74) at 5 (emphasis added). In fact, "independent releases account for 80-85 percent of the total of albums released each year." *Id.* at 6.

B. The RIAA Exaggerates the Record Companies' Role in the Creative Process

304. The RIAA's claims concerning the record companies' contributions to making creative works available to the public are overstated and find no support in the facts. First, the RIAA asserts that record companies today play a bigger role than the music publishers in the actual writing of songs, as a result of the rise of the singer-songwriter. *See* RIAA PFF ¶ 1278. But there is no evidence in the record that the "rise of the singer-songwriter" is a new phenomenon. Indeed, in the 1981 mechanical royalty proceeding, the RIAA made the exact same argument to the CRT about singer-songwriters as it makes to the CRJs today. 1981 CRT Determination, 46 Fed. Reg. 10466, 10472 (Feb. 3, 1981) ("[A]ccording to the recording industry, the songwriter continues to make a significant contribution, but the role of the music publisher has declined, and this has been caused by the growing importance of the singer-songwriter and the controlled publisher.").

305. In any event, in support of its argument that the role of music publishers in songwriting is dwindling, the RIAA relies first on Professor Teece, *see* RIAA PFF ¶ 1279, who clearly has no special expertise concerning the role played by music publishers in the creative process. Although Professor Teece offered his opinion on the role of publishers, he conceded that he had formed that opinion without speaking to a single music publisher. 2/19/08 Tr. at 3764 (Teece) ("I didn't interview any music publishers."). His conclusory assertion, lacking any factual basis, deserves no weight and ignores the contrary testimony of each of the music publisher and songwriter witnesses. *See, e.g.,* CO PFF ¶¶ 317-23 and *supra* Section IV.E. Nor does the record support the self-serving testimony of record company executives, such as Mr. Kushner, who claim

that artists often write songs under the supervision of record company A&R departments and that publishers "are now almost entirely passive." RIAA PFF ¶ 1282. The record is replete with examples of how the music publishers provide critical creative support to songwriters. *See, e.g.,* Faxon WDT (CO Trial Ex. 3) at 9; Robinson WDT (CO Trial Ex. 8) at 19-20; Peer WDT (CO Trial Ex. 13) at 8-11; Firth WDT (CO Trial Ex. 24) at 12-14.

C. The RIAA Exaggerates the Record Companies' Efforts to Market and Distribute Sound Recordings

306. A review of the record reveals that the RIAA also exaggerates its members' marketing and promotion investments. Although the RIAA asserts that marketing is an "enormous expense," and one that is becoming "more challenging than ever," RIAA PFF ¶ 1298, according to Mr. Benson's analysis, the majors' marketing costs—notwithstanding that record companies are engaging in a variety of new types of online marketing activities—have declined significantly in recent years, both in nominal dollars and as a percentage of revenue. *See* RIAA PFF ¶¶ 219, 200 and Figs. 8, 9 (marketing costs have declined from $1.153 billion in 2001 to $824 million in 2006, a drop from 21.9% of revenue to 17.0%).

307. The record companies' manufacturing and distribution costs have fallen too. Although the RIAA claims that physical manufacturing and distribution creates "significant costs," and that digital distribution creates "no less expense," RIAA PFF ¶¶ 1311-12, the evidence is to the contrary. As explained above, the major record companies' manufacturing and distribution costs have plummeted in recent years, due to declining physical sales and the efficiencies of digital distribution. There is overwhelming evidence in the record—both testimony from record company executives

and record company documents—showing that digital distribution leads to "less expense." Indeed, it is virtually costless. *See* CO PFF ¶¶ 424-33; CO Trial Exs. 19-21.

308. Although the RIAA accuses the Copyright Owners of not contributing to the record companies' efforts to create, promote and distribute sound recordings—asserting, for example, that "[p]ublishers have no role in marketing, providing no money and no suggestions," RIAA PFF ¶ 1310—there is no legitimate reason why music publishers and songwriters should perform such functions. Simply put, music publishers and songwriters do not have such responsibilities because they are not in the recorded music business. Indeed, the RIAA's argument boils down to the illogical complaint that music publishers and songwriters are not record companies.

309. In sum, although the record companies no doubt make contributions to the process of making creative works available to the public, the RIAA's claims that the Copyright Owners make no valuable contributions are belied by the record, which demonstrates the enormous contributions of the music publisher and the songwriter in the creation of the song, the core component of sound recordings distributed to the public.

D. The Copyright Owners' Other Revenue Streams Are Irrelevant, and Not Due to the Record Companies' Investments

310. Not content with improperly accusing the Copyright Owners of not sharing in the record companies' A&R, marketing and distribution costs, the RIAA alleges that music publishers' and songwriters' other revenue streams are "largely the result" of such investments—another claim unsupported by the record. RIAA PFF ¶ 1344. To begin with, as discussed in the Copyright Owners' Reply Proposed Conclusions of Law, the Copyright Owners' other sources of revenue are irrelevant as a matter of law, and should receive little or no weight in this proceeding. Even if the

Copyright Owners' other revenue streams are considered, the RIAA has not established that the record companies' efforts are responsible for these revenues. Take synchronization royalties, for example. As RIAA witness Scott Pascucci testified, there are occasions when a music supervisor or producer "wants to use a particular song in his project . . . because the lyrics lend special meaning to a scene or theme of the project." RIAA PFF ¶ 851. Thus, the music supervisor or producer may choose between one of several alternate recordings, seeking a lower price. *See id.* In such situations, it is clearly the songwriter's contribution of unique and memorable lyrics that drives the value of the musical composition—not the record company's investment in a particular sound recording.

E. Record Companies Are Not Technology Innovators

311. Nor is there is a stitch of evidence in the record to support the RIAA's contention that "[r]ecord companies are technology innovators." RIAA PFF ¶ 1349. To the contrary, by all accounts—including their own documents—the record companies were reluctant entrants into the digital music business. *See* H. Murphy WDT (CO Trial Ex. 15) Ex. COA 700 at RIAA 18076; RIAA Trial Ex. 9 at 4032291.

312. As the Copyright Owners showed in their Proposed Findings of Fact, instead of embracing the digital distribution of music at its infancy, the record companies resisted digital transformation, with damaging results. CO PFF ¶¶ 363. Illegal file-sharing exploded across the Internet in 1999, but the record companies did not launch their own legitimate digital music services until 2001. *See Id.* ¶¶ 365, 367. These subscription services—which were "doomed to fail," according to Mr. Munns—proved unattractive to consumers because they had limited catalogs and because they featured a rental rather than an ownership approach to music. *See id.* ¶ 368-70; 2/26/08 Tr. at 4754

(Munns); 2/4/08 Tr. at 1166-67 (Enders). In 2002, Apple approached the majors and pitched a permanent download model, but the majors initially refused to license their catalogs to Apple, stubbornly pursuing the subscription services consumers were steadily rejecting. *See* CO PFF ¶¶ 373-74. All the while, piracy became more pervasive. *See id.*

313. As for the record companies' technological investments, the RIAA has not quantified—as it cannot—the purported "significant" cost of these investments. RIAA PFF ¶ 329. Its Proposed Findings of Fact list a variety of contributions to systems that supposedly are necessary for digital distribution on an industry-wide basis, largely taken from the testimony of David Hughes, a former Sony executive and current Senior Vice President of Technology for the RIAA. *See* RIAA PFF ¶¶ 1356-71. Consistent with Mr. Hughes' trial testimony, other than stating that such systems cost "many millions," the RIAA does not provide any precise estimates of these expenses. At trial, Mr. Hughes admitted that his testimony did not contain concrete information on such costs:

> Q: In fact, in your witness statement you don't quantify the amount that any of the . . . record companies have spent on technology either, do you?
>
> A: Well, I have said that my estimate is, you know, many millions of dollars.
>
> Q: Nothing more precise than that? Is that a no?
>
> A: Nothing more precise than that appears in my testimony, no.
>
> . . .
>
> Q: And apart from saying many millions, you did not distinguish between capital expenditures and operating costs for technology, did you?
>
> A: No, I did not.

2/20/08 Tr. at 4086 (Hughes).

314. With respect to individual record companies, the vast majority of examples of the purported "high infrastructure development costs" of digital distribution offered by the RIAA are based solely on the experience of EMI, and these illustrations are almost entirely based on EMI's global business, rather than its U.S. operations. *See* generally RIAA PFF ¶¶ 329-42, 1353-54. But EMI—which has sunk to only 6% market share—is a poor vessel for illustrating the alleged condition of the entire recorded music industry. Further, even though the RIAA offers anecdotal testimony from Messrs. Munns and Finkelstein, see RIAA PFF ¶¶ 331, 333-40, it has failed to quantify what the record companies have spent on their digital supply chains.

315. And the costs that the RIAA does quantify are far from significant. As discussed above, the RIAA asserts that EMI invested approximately [redacted] in capital expenditures for digital distribution in the U.S. from 2002 to 2006, RIAA PFF ¶ 1353, but this is an insignificant amount given that EMI's North American revenues exceeded [redacted] in 2006 alone, Benson WRT (RIAA Trial Ex. 82) at 43. Although the RIAA presents additional information about EMI's capital and operational expenditures for information technology, these costs are incurred on a global basis, and are, as Mr. Finkelstein admitted, supported by "[redacted]." 2/13/08 Tr. at 3203 (C. Finkelstein). Mr. Finkelstein further testified [redacted] *Id.*

316. The same infirmities plague the Sony BMG digital distribution cost data on which the RIAA relies. The RIAA claims that Sony BMG "has spent more than $200 million over five years investing in the transition to the digital age." RIAA PFF ¶ 1352.

The RIAA also notes that "[i]n 2006, Sony BMG spent over [ ] million to manage its existing digital collection and continue to digitize new music." *Id.* According to Mr. Wilcox's witness statement, this is a "company-wide" number. Wilcox WDT (RIAA Trial Ex. 70) at 19. In any event, this cost is miniscule compared to Sony BMG's 2006 total revenue, which totaled over $ billion for North America alone. Benson WRT (RIAA Trial Ex. 82) at 44.

317. The RIAA's purported excuse for its failure of proof—that "quantifying [digital] costs for the record companies has proven difficult," RIAA PFF ¶ 342—deserves no credit. The RIAA could have introduced additional evidence with regard to the cost of digital supply chains—particularly costs for the U.S. majors—but it did not.

318. Finally, even if the RIAA had calculated the amount that record companies have spent on digital distribution—which it has not—such investments do not deserve special consideration in this proceeding. They are merely the digital equivalent of physical distribution costs, such as the expenses associated with trucks for shipping and warehouses for storing CDs. The costs of establishing a digital supply chain are simply the price of admission to the recording industry in the digital age, and are not a ground for lowering the mechanical royalty rate.

F. The RIAA Overstates the Magnitude of The Record Companies' Commitment to Anti-Piracy Activities

319. Although the RIAA claims that record companies have made a "massive expenditure of funds" to confront the problem of piracy, RIAA PFF ¶ 266, the RIAA is in fact spending less than one-quarter of one percent of the recorded music industry's total wholesale revenue on a yearly basis to fight piracy.

320. The math is simple. The RIAA claims that the RIAA's anti-piracy campaign has only cost "$174 million between 2000 and 2006, or an average of about $25 million [per year]." *Id.* ¶ 267. According to the RIAA, in 2006, the total dollar value of U.S. recorded music sales was $10.9 billion. Enders WDT (CO Trial Ex. 10) at 8 n.5. Thus, for the year 2006, the RIAA spent approximately 0.23% of the industry's total wholesale revenue on fighting the problem that the record companies claim is decimating their revenues.

321. With regard to the amount that individual record companies spend on anti-piracy efforts, the RIAA again provides information for only two of the majors—EMI and Sony BMG. *See* RIAA PFF ¶ 1407. According to the RIAA, EMI spent [redacted]—not even [redacted] percent of its total U.S. revenues—on such efforts in 2006. Similarly, the RIAA claims that Sony BMG spent $[redacted] million in 2006 on an anti-piracy program—approximately [redacted] percent of Sony BMG's total revenues for North America for that year. *See id.*; Benson WRT (RIAA Trial Ex. 82) at 43 (EMI North America financial information), 44 (Sony BMG North America financial information).

G. The RIAA Exaggerates the Record Companies' Mechanical Licensing Efforts

322. The RIAA also contends that record companies' contributions include the "administration of mechanical licenses," and claims this "is a labor-intensive enterprise that requires major investments by record companies." RIAA PFF ¶ 1415. These arguments, too, lack merit.

323. First, the RIAA complains that record companies "must obtain a separate license for each format or configuration . . . for each recording." RIAA PFF ¶ 1416. But

this is simply because, as RIAA witness Andrea Finkelstein has acknowledged, the Section 115 license is not a blanket one that covers the entire repertoire of musical works. 2/14/08 Tr. at 3371-72 (A. Finkelstein). All that the record companies are doing is what the statute requires.

324. Next, to the extent that the RIAA complains that "[a]dministering mechanical licenses is expensive," it has failed to offer proof. RIAA PFF ¶ 1417. The RIAA puts forward examples from only one company, Sony BMG, and they show costs—$3 million per year for salaries for employees in two departments, $3 million in capital expenses over five years—that are insignificant in light of Sony BMG's revenues for North America (over $[redacted] billion in 2006). *See id.*; Benson WRT (RIAA Trial Ex. 82) at 44. (Notably, the RIAA claims that the Copyright Owners bear the costs of mechanical license administration when that position suits the purposes of its flawed benchmarks. RIAA PFF ¶ 627.)

325. Finally, although the record companies may engage in mechanical license administration, the Copyright Owners do the same thing, and more of it. For example, HFA administers over 13.9 million licenses, has over 1.9 million songs in its catalog available for licensing, and issued almost 1.52 million mechanical licenses in 2007 alone. *See* CO PFF ¶ 105. HFA's expenses totaled approximately $25.8 million for 2007 alone, and these costs do not include the amounts that individual music publishers expend for mechanical license administration. *See* CO Trial Ex. 12B.

H. The RIAA's Arguments About Risk Lack Merit

326. Regarding the record companies' alleged high risk, the RIAA—without ever acknowledging the record companies' recent record profitability and forecasts for continued success in the digital era—contends that the record companies' great risk is

reflected in the supposed "significant volatility in their profit margins." RIAA PFF ¶ 1324. No support is cited, however, for the RIAA's bald assertion that a high of positive 8.5% and a low of negative 0.4% constitutes "significant volatility" for this industry. Although the RIAA again trots out EMI, this time as an example of "margin instability" "[o]n an individual company basis," *id.*, EMI's financial concerns, as noted repeatedly above, are not representative of the condition of other recorded music companies, due to, among other things, plunging market share, poor management, out-of-control spending and high return rates. *See supra* Section II. Simply stated, the record evidence shows that record company profitability is far from volatile. It is instead at its most stable in over 15 years. *See id.*

327. And, to the extent that the RIAA complains that "that it is incredibly difficult to predict which artists or sound recordings will be successful," the RIAA admits that "the record business has always been risky." RIAA PFF ¶ 1326. As for the supposed "new" risks faced by the record companies—piracy, disruption in the retail environment and "cannibalization of higher-revenue CD sales by digital singles"—the evidence shows that these risks affect record companies and the Copyright Owners equally. As discussed above, witnesses for the Copyright Owners testified at length about how these risks impact their businesses. *See, e.g.*, CO PFF ¶¶ 236-38, 240. And numerous RIAA witnesses conceded that factors such as piracy affect both copyright owners and copyright users in similar fashion. *See id.* ¶ 239.

VI. Professor Landes's Economic Analysis, Proposed Benchmarks and Empirical Work Are Sound

A. Overview

328. Virtually the entirety of the rebuttal cases of the RIAA and DiMA was devoted to attacking the economic analysis and benchmarks put forward by the Copyright Owners' principal economic expert, Professor Landes. The criticisms fall into three general categories. First, the RIAA and DiMA claim that Professor Landes's theory is either wrong, as a matter of economics, or inconsistent with this Court's precedent. Second, the Copyright Users attempt to undermine Professor Landes's mastertone and synchronization benchmarks. Third, the RIAA and DiMA each take issue with empirical studies performed by Professor Landes that show the need for a rate increase. As set forth below, the RIAA and DiMA are wrong on all counts: Professor Landes's analysis is rooted in sound economic theory, consistent with this Court's precedent and provides the Court with the only benchmarks from independent markets that can be used as a basis for a statutory mechanical rate. Further, all of the objections raised by the RIAA and DiMA with respect to Professor Landes's empirical work are meritless.

B. Professor Landes's Economic Analysis is Consistent with this Court's Precedent

329. In their failed effort to discredit Professor Landes, the RIAA and DiMA fundamentally mischaracterize the economic underpinnings of his work. DiMA claims that Professor Landes's economic framework is inconsistent with Section 801(b), even though his approach tracks almost precisely the method for setting a rate that has been explained in this Court's precedent. The RIAA and DiMA wrongly assert that he undertook a "surplus analysis" such as those that have been previously rejected by this Court when, in fact, he did not. They argue that the breadth of Professor Landes's range

of reasonableness renders it implausible on its face when, in fact, Professor Landes has himself pointed out the reasons why a rate at the high end of his range should not be adopted. And the RIAA and DiMA both maintain that Professor Landes has advocated the "bargaining room" theory rejected by the Copyright Royalty Tribunal in 1981, when he has expressly disclaimed it. *See* Landes WDT (Co Trial Ex. 22) at 29; 2/11/08 Tr. at 2592-97 (Landes).

1. Background on Professor Landes's Content Pool Analysis

330. The Copyright Owners' Proposed Findings of Fact discuss at length Professor Landes's methodology for deriving and analyzing benchmarks, and his method for assessing the Copyright Owners' rate proposal against those benchmarks. *See* CO PFF ¶¶ 481-556. We summarize some of the key elements of Professor Landes's benchmark analysis here.

331. Professor Landes sought benchmarks that are rooted in competitive markets in which users of music must acquire the rights to use both copyrighted sound recordings and musical compositions that have been recorded. Landes WDT (CO Trial Ex. 22) at 22-23. Professor Landes explained that the most probative benchmarks arise from voluntary market transactions, which provide critical information regarding market participants' willingness to buy and sell. *Id.* at 22-23; *see also* Landes WRT (CO Trial Ex. 406) at 28. Prices that are the result of voluntary market transactions tend to promote economic efficiency. 2/7/08 Tr. at 2078 (Landes). They also provide incentives for the creation of new works, take account of the returns that both buyers and sellers expect to receive from the transaction, and reflect differential costs that the parties to the transaction may have. *Id.* at 2169-71; *see also* Landes WDT (CO Trial Ex. 22) at 19.

332. Critically, Professor Landes's benchmarks involve transactions that occur outside the scope of the Section 115 statutory license and are thus uninfluenced by the statutory rate at issue in this proceeding. Landes WDT (CO Trial Ex. 22) at 22-23. The goal in identifying appropriate benchmarks is, as Professor Landes explained, to "discover rates that are the result of interactions between buyers and sellers and not the product of a statutory rate." 2/7/08 Tr. at 2080 (Landes). Benchmarks that fall within Section 115, or that are not independent of the statutory license, clearly fail this test and are of limited (if any) value when setting a rate for the Section 115 license itself. *See id.*; *see generally* CO PFF ¶¶ 675-98. Because the rights at issue in this proceeding involve the distribution of musical compositions embedded in sound recordings, an appropriate benchmark provides information regarding the *relative* valuation of the musical composition and sound recording when both rights are free from the constraint of a statutory license. *See* Landes WDT (CO Trial Ex. 22) at 23, 25; *see also* Landes WRT (CO Trial Ex. 406) at 28-29; 2/7/08 Tr. at 2078-80, 2083-84 (Landes).

333. Applying his criteria, professor Landes identified two principal market benchmarks free of the influence of a compulsory license in which copyright users obtain the rights to both sound recordings and the underlying song—the mastertone market and the synchronization license market—that he used to derive a "range of reasonableness" for appropriate mechanical royalty rates. Landes WRT (CO Trial Ex. 406) at 28-29. Professor Landes further found that the Audio Home Recording Act, 17 U.S.C. §§ 1001-1010 (2008), which divides royalties from the sale of certain digital recording devices between the copyright owners of musical compositions and sound recordings, provided additional corroboration for his range of reasonableness. Landes WDT (CO Trial Ex. 22)

at 24. All of Professor Landes's benchmarks involve the same sellers (the copyright owners of musical compositions) selling the same rights (the right to exploit musical compositions) as those at issue in this proceeding. *See* Landes WDT (CO Trial Ex. 22) at 23.

334. Professor Landes concluded that reasonable royalties under Section 115 for the Copyright Owners should fall within a range of approximately 20 to 50% of the total license fees paid for the musical composition and the sound recording. Landes WDT (CO Trial Ex. 22) at 25-26. Professor Landes referred to the sum of these license fees as the "content pool." *Id.* at 25.

335. The low end of Professor Landes's range was based on market transactions for mastertones, in which he found that Copyright Owners typically receive at least 20% of the content pool. *See* CO ¶¶ 491-507; Landes WDT (CO Trial Ex. 22) at 24-25. The upper bound of Professor Landes's range was based on market transactions for the sale of synchronization and master use licensees, in which he found that Copyright Owners almost always receive 50% of the content pool. *See* CO PFF ¶¶ 531-35; Landes WDT (CO Trial Ex. 22) at 23-24. The Audio Home Recording Act provided corroboration for Professor Landes's range of reasonableness because it provides that Copyright Owners receive one-third of the royalties collected from the sale of specified digital recording devices. *See* CO PFF ¶¶ 541-42; Landes WDT (CO Trial Ex. 22) at 24.

336. Applying his benchmarks, Professor Landes analyzed the Copyright Owners' proposed rates by determining the share of the content pool they would receive under their rates for physical phonorecords, permanent downloads and ringtones. *See* CO PFF ¶¶ 546-50 (physical phonorecords), ¶¶ 551-53 (permanent downloads), ¶¶ 554-56

(ringtones). He concluded that, in all cases, the Copyright Owners' proposed rates would provide them with a share of the content pool that fell at the low end of the range of reasonableness he derived based on free-market transactions. *See* CO PFF ¶¶ 546-50 (physical phonorecords), 551-53 (permanent downloads), 554-56 (ringtones); *see also* Landes WDT (CO Trial Ex. 22) at 46; Landes WRT (CO Trial Ex. 406) at 22. Accordingly, Professor Landes concluded that the Copyright Owners' proposed rates are all consistent with a sound economic interpretation of the four statutory factors contained in Section 801(b) of the Copyright Act.

2. Professor Landes's Analysis is Consistent with Section 801(b) and this Court's Precedent

337. In its principal attack on Professor Landes's approach, DiMA argues that Professor Landes's reliance on marketplace benchmarks for setting a statutory rate does not comport with Section 801(b) and the four statutory factors therein. DiMA PFF ¶¶ 274-76. In fact, as the Copyright Owners' Proposed Conclusions of Law showed, Professor Landes's economic interpretation of Section 801(b) is entirely consistent with the way those factors have been interpreted in previous cases. *See* CO PCL ¶¶ 68-73.

338. Professor Landes's treatment of marketplace benchmarks as central to a determination of a "reasonable" rate under Section 801(b) comports with this Court's precedent. *See* CO PCL ¶¶ 25-44. This Court recently reaffirmed the primacy of marketplace benchmarks in the SDARS proceeding, explaining that a "reasonable" royalty rate under Section 801(b) should "begin with a consideration and analysis of [marketplace] benchmarks." 73 Fed. Reg. at 4084. Professor Landes constructed a "range of reasonableness" that is on all fours with this Court's marketplace benchmarks and "zone of reasonableness." *See id.* at 4094.

339. As Professor Landes also explained, the first Section 801(b) factor, which states that the mechanical rate should "maximize the availability of creative works to the public," can be satisfied by benchmarks derived from market rates. 2/7/08 Tr. at 2170 (Landes). His economic interpretation of this factor is consistent with this Court's precedent. *See* CO PCL ¶¶ 69. Ordinarily, as the Court has explained, the maximization of creative works will be achieved by the same process that identifies market benchmarks. *SDARS*, 73 Fed. Reg. at 4094-95.

340. The second Section 801(b) factor provides that copyright owners should receive a "fair return" for their creative work and that copyright users should receive a "fair income under existing economic conditions." Professor Landes explained that market rates will take account of both sellers' and buyers' expected returns. 2/7/08 Tr. at 2170 (Landes). Such rates also ensure that creators have incentives to produce new works and that users maintain incentives to distribute works to the public. Landes WDT (CO Trial Ex. 22) at 18. Here, too, Professor Landes's economic interpretation of the factor accords with this Court's interpretation. *See* CO PCL ¶¶ 70; *see also SDARS*, 73 Fed. Reg. at 4095.

341. The third Section 801(b) factor indicates that statutory rates should "reflect the relative roles of the copyright owner and the copyright user in the product made available to the public." Professor Landes described how copyright owners' and users' relative roles are reflected "in the competitive markets themselves because to the extent there are differential costs, that would show up in the rates negotiated in a market." 2/7/08 Tr. at 2171 (Landes); *see also* Landes WDT (CO Trial Ex. 22) at 20. Thus, as a matter of economics, the third factor can be satisfied with the establishment of rates

derived from market benchmarks. This is precisely how this Court and other tribunals have approached the issue. *See* CO PCL ¶¶ 71; *see also Amusement & Music Operators, Ass'n v. Copyright Royalty Tribunal* 676 F.2d 1144, 1157 (7th Cir. 1982); *Webcasting II*, 72 Fed. Reg. at 24092.

342. Finally, the fourth Section 801(b) factor counsels that rates should "minimize any disruptive impact on the structure of the industries and on generally prevailing industry practices." As this Court has explained, marketplace considerations alone cannot address this factor. A rate can be disruptive "if it directly produces an adverse impact that is substantial, immediate and irreversible in the short-run." *SDARS*, 73 Fed. Reg. at 4097. Professor Landes's economic interpretation similarly recognized that market rates alone will not address this factor. For instance, a dramatic change in rate structure may lead to a disruptive impact on the industry that should be avoided. *See* Landes WDT (CO Trial Ex. 22) at 21. And Professor Landes acknowledged that even a rate within the market-derived range could be disruptive if it led to undue bargaining beneath it. 2/7/08 Tr. at 2114, 2254 (Landes); 2/11/08 Tr. at 2345 (Landes).

343. Thus, DiMA's claim that Professor Landes has disregarded the Section 801(b) factors is not borne out by his testimony. In fact, his economic interpretation of the four factors tracks exactly how they have been treated in this Court's precedent.

3. Professor Landes Did Not Conduct a "Surplus Analysis"

344. In an effort to discredit Professor Landes's content pool analysis, the RIAA argues that he conducted a "surplus analysis" of the sort that has been rejected by this Court twice before, in the Webcasting II and SDARS proceedings. RIAA PFF

¶¶ 816-818. This claim is untrue, as a straightforward review of the rejected surplus analyses shows.

345. In both the SDARS and Webcasting II proceedings, the record companies sought to buttress their rate proposals by presenting estimates of the share of licensees' revenues for the services at issue and then allocating a share of total content costs between copyright owners and users based on a bargaining ratio or model. *See SDARS*, 73 Fed. Reg. at 4092; *Webcasting II*, 72 Fed. Reg. at 24092. There are critical differences between Professor Landes's content pool analysis and the surplus analyses previously proffered by the record companies.

346. Most importantly, the surplus analyses in both cases were premised on theoretical rather than market-based assumptions about how the parties should divide revenue. *See SDARS*, 73 Fed. Reg. at 4092; *Webcasting II*, 72 Fed. Reg. at 24092. For example, the Brynjolfsson surplus analysis offered in the Webcasting II proceeding proposed an allocation of revenue on what this Court noted was "a questionable assumption"—namely, that there should be a 75% licensor to 25% licensee ratio in bargaining power. 72 Fed. Reg. at 24092. As this Court noted, there was "[n]o evidence" from the market to support that assumption. *Id.* Similarly, the Pelcovits surplus analysis in the SDARS proceeding relied on a cooperative game theory model to divide surplus, and as the Court observed, there was no reason to believe such a model corresponded to the real world. 73 Fed. Reg. at 4092. In both cases, this Court concluded that the analyses relied on "unsupported assumptions about market behavior." *Webcasting II*, 72 Fed. Reg. at 24092; *SDARS*, 73 Fed. Reg. at 4092.

347. Professor Landes's content pool analysis is fundamentally different because it rests on actual market transactions from the mastertone and synchronization markets, not on hypothetical numbers derived from bargaining or game theory. His benchmarks are derived from robust data concerning what Copyright Owners *actually* receive when they license their rights in conjunction with sound recording rights and without the constraint of a compulsory license. Landes WDT (CO Trial Ex. 22) at 22-26. He then analyzed the Copyright Owners' proposal to determine whether those rates would provide the Copyright Owners with a share of the content pool that corresponded to the range of reasonableness he identified based on the mastertone and synchronization markets. *Id.* at 26-48. The RIAA's effort to tie Professor Landes to the record companies' discredited surplus analyses is nothing more than an unsuccessful effort at guilt by association.

348. In fact, only one expert in this proceeding has presented a surplus analysis—Professor Wildman. And his analysis suffers from many of the infirmities that has led this Court to reject prior surplus analyses. As explained further below, Professor Wildman's surplus analysis is entitled to no more weight than the prior analyses that the record companies have offered this Court. *See infra* Section VI.C.1.g..

4. The RIAA and DiMA's Concerns Over the Breadth of Professor Landes's Range of Reasonableness Are Meritless

349. The RIAA argues that Professor Landes's range of reasonableness—20 to 50% of the content pool—"is facially implausible" due to the "breadth of the range." RIAA PFF ¶ 819. DiMA registers a similar complaint. DiMA PFF ¶ 273. These assertions, however, rest on a mischaracterization of Professor Landes's testimony.

350. Professor Landes testified that setting a rate at the high end of his range of reasonableness could create problems by introducing additional transactions costs into the market as parties negotiate below the statutory rate. *See* CO PFF ¶ 544; *see also* 2/7/08 Tr. at 2114, 2254 (Landes); 2/11/08 Tr. at 2345 (Landes). Specifically, he stated that such a rate would lead to "additional transactions costs that would be incurred as the parties negotiate more toward a competitive rate," 2/7/08 Tr. at 2114 (Landes), and that "the transactions costs involved in licensing below the statutory rate, if the rate is increased, is a factor to consider, along with the potential benefits which have to do with additional rates, providing additional income to songwriters, creating additional incentives to create new and valuable songs," *id.* at 2254 (Landes). Professor Landes made clear that he viewed this as an issue to consider under the fourth Section 801(b) factor, which counsels that reasonable mechanical royalty rates should be set with an eye toward "minimiz[ing] any disruptive impact on the structure of the industries involved and on generally prevailing industry practices." 2/11/08 Tr. at 2595 (Landes). The RIAA and DiMA's argument against Professor Landes's range of reasonableness ignores this testimony.

351. Rather than deal fairly with Professor Landes's conclusion, the RIAA creates a straw man, claiming that Professor Landes would support as "reasonable" mechanical royalties "set at both 10.5 cents and 26 cents." RIAA PFF ¶ 820. But Professor Landes nowhere endorsed a 26 cent rate. To the contrary, he clearly explained the impediments to adopting such a rate: "the added costs of dramatically changing the rate could be substantial when you move to the very high end of the benchmarks."

2/11/08 Tr. at 2345 (Landes). And, of course, the Copyright Owners are not sponsoring a 26 cent rate.

352. Finally, the fact that appropriate market benchmarks create a broad range of reasonableness is not, in and of itself, a reason for rejecting their use in deriving a statutory rate. In the SDARS proceeding, this Court adopted a "zone of reasonableness" in which the top of the range (13%) was more than 5 times the lower bound (2.35%). 73 Fed. Reg. at 4094. The spread of Professor Landes's range of reasonableness is less than half of that.

5. Professor Landes Has Not Advocated the "Bargaining Room" Theory Rejected by the CRT in 1981

353. The RIAA and DiMA both erroneously claim that Professor Landes advocates the "bargaining room" theory that was rejected by the CRT in 1981. *See* RIAA PFF ¶¶ 1099-1105; DiMA PFF ¶¶ 277-78. He does not.

354. In rejecting the "bargaining room" theory, the CRT concluded that "[a] rate that is deliberately fixed above the level the market can bear—so that a lower rate can be negotiated in the marketplace—cannot be 'reasonable.'" 46 Fed. Reg. at 10478. The Copyright Owners have not proposed, and Professor Landes has not endorsed, setting a statutory rate "above the level the market can bear." Rather, he testified that too high a rate would increase transactions costs in the market because of the large amount of bargaining that would need to occur to arrive at an appropriate rate. *See* 2/7/08 Tr. at 2114, 2254 (Landes); 2/11/08 Tr. at 2345 (Landes); *see also supra* Section VI.B.4.

355. Professor Landes did point out, consistent with the express conclusion reached by the CRT, that the statutory rate acts as a "ceiling" and, therefore, should take into account that there will be bargaining below but not above the statutory rate. 46 Fed.

Reg. at 10482. Given these market dynamics, the danger of setting a rate too low is that it would "reduce the financial benefits and hence incentives for composers to take the additional time and effort required to create new songs, even though users would value those songs by more than the cost of creating them and be willing to pay more than the statutory rate." Landes WRT (CO Trial Ex. 406) at 2; *see also* Landes WDT (CO Trial Ex. 22) at 16, 27. As Professor Murphy likewise explained, such a rate would "reduce the number of songs being supplied" and "reduce[] the quality of songs that would be supplied." 5/19/08 Tr. at 6983 (K. Murphy).

356. Rather than taking a maximalist approach, Professor Landes opined that the goal in setting a statutory rate should be to approximate an "average" rate that would be paid by parties in a free market if there were no compulsory license. Landes WDT (CO Trial Ex. 22) at 29; *see also* 2/11/08 Tr. at 2592-97 (Landes). The Copyright Owners' rate proposal is consistent with these principles. *See* CO PFF ¶¶ 543-56.

357. The RIAA also wrongly claims that Professor Landes's approach is particularly inappropriate for DPDs because "parties *may not* negotiate below the statutory rate." RIAA PFF ¶ 1100 (emphasis in original). The argument, as the RIAA well knows, is inconsistent with the statutory scheme, which precludes licensees from acquiring reduced rates through controlled composition clauses in artist contracts that postdate June 22, 1995. *See* 17 U.S.C. § 115(c)(3)(E)(i), (ii). It does not prevent licensees from applying such clauses entered into before that date. And, most importantly, the statute does not outlaw the negotiation of reduced rates on mechanical licenses for DPDs outside of the context of controlled composition clauses. *See* 2/5/08 Tr. at 1457 (Israelite); 2/14/08 Tr. at 3499-3501 (Kushner).

358. Relatedly, DiMA argues that Professor Landes has failed to understand the magnitude or nature of transactions costs in the market for HFA and direct mechanical licenses, which (according to DiMA) inhibit bargaining. DiMA PFF ¶ 287-89. The points raised in DiMA's ad hominem attack on Professor Landes's purported lack of knowledge merit little consideration. He demonstrated himself to be a fully informed witness during his lengthy direct and cross-examinations at both trials. DiMA's argument amounts to little more than a series of selective citations to Professor Landes's testimony, coupled with inaccurate descriptions of what was said.[4]

359. Professor Landes testified at length about transactions costs in this proceeding, and what he said has been borne out by independent record evidence. *See, e.g.,* Landes WDT (CO Trial Ex. 22) at 13-15; Landes WRT (CO Trial Ex. 406) at 37-39; 2/7/08 Tr. at 2112-14. As Professor Landes explained, the transactions costs in the HFA and direct licensing market are low, which has facilitated discounting that is in the mutual interests of Copyright Owners and copyright users. Landes WDT (CO Trial Ex. 22) at 13-15. The voluminous record evidence on this issue—which DiMA purports to cover in a single paragraph, DiMA PFF ¶ 288—is consistent with Professor Landes's conclusions. *See* CO PFF ¶ 557-64; *infra* Section VI.C.1.d. Yet as Professor Landes has explained on multiple occasions, it does not follow that a rate should be set artificially high on a

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[4] To take just one example: DiMA cites a portion of Professor Landes's testimony that, it says, "confirm[s] that he has no knowledge of the transactions costs under the compulsory licensing regime." DiMA PFF ¶ 287 (citing 5/20/08 Tr. at 7279:17-7280:14). In the testimony in question, Professor Landes simply explains that the evidence does not suggest that the costs of compulsory licensing are particularly high. *See infra* Section VI.C.1.a. Rather than address Professor Landes's point on the merits, DiMA mischaracterizes his testimony in an attempt to show (without even bothering to adduce evidence) that he is wrong.

"bargaining room" theory. *See* 2/7/08 Tr. at 2114, 2254 (Landes); 2/11/08 Tr. at 2345 (Landes)

C. Professor Landes's Benchmarks Should Be Accepted by this Court

360. Professor Landes's benchmarks from the mastertone and synchronization markets, as well as the Audio Home Recording Act, provide fully appropriate comparators for setting a statutory mechanical rate. None of the arguments that have been levied against Professor Landes's benchmarks provide any reason to reject them.

1. The Mastertone Benchmark is Sound

361. Professor Landes's mastertone benchmark rests on numerous voluntary marketplace agreements. In particular, Professor Landes reviewed and relied upon: (1) nearly 200 agreements between six different music publishers and third-party sellers of mastertones (either aggregators or cellular telephone companies), CO PFF ¶¶ 494-97; Landes WDT (CO Trial Ex. 22) at 40; (2) agreements between record companies and third-party sellers of mastertones, CO PFF ¶¶ 506-07; Landes WDT (CO Trial Ex. 22) at 46; (3) "New Digital Media Agreements" ("NDMAs") between several music publishers and major record companies that covered, among other rights, the licensing of musical compositions for use in mastertones, CO PFF at ¶¶ 499-501; Landes WDT (CO Trial Ex. 22) at 25 n.13; and (4) "standalone" licenses between publishers and record companies that cover mastertones only, CO PFF ¶ 502. What these myriad agreements reveal is that Copyright Owners typically receive approximately 20% of the content pool for mastertones. *See* CO PFF ¶¶ 492-507; *see also* Landes WDT (CO Trial Ex. 22) at 24-25; 2/7/08 Tr. at 2091-2104 (Landes); Landes WRT (CO Trial Ex. 406) at 36; 5/20/08 Tr. at 7519-20 (Landes).

362. The RIAA and DiMA have leveled a number of criticisms of the mastertone benchmark. As set forth below, none is persuasive or provides any reason not to adopt the benchmark here.

(a) The RIAA and DiMA Have Failed to Show that Characteristics of the Mastertone Market Undermine the Probative Value of the Mastertone Market

363. The RIAA and DiMA assert that the mastertone benchmark should not be employed because the mastertone market is insufficiently similar to the market for physical phonorecords and DPDs. First, the RIAA and DiMA claim that the ringtone market has different demand and supply characteristics. The evidence does not back up this claim. Second, the RIAA and DiMA argue that the mastertone market is populated by only a small number of recordings, but the record shows the true breadth of compositions licensed for mastertones. Third, the RIAA and DiMA assert that the mastertone market was expected to be short-lived, but the evidence, again, contradicts this claim. And finally, the RIAA argues that the mastertone benchmark is flawed because mastertones are complements to, rather than substitutes for, physical phonorecords and permanent downloads. But, as we show below, that provides no basis whatsoever for rejecting the mastertone benchmark.

(i) The RIAA and DiMA Have Not Shown that Supply and Demand Characteristics of the Mastertone Market Differ Meaningfully from the Markets for Physical Phonorecords and Permanent Downloads

364. The supply and demand characteristics of the mastertone market do not undermine the utility of the mastertone benchmark for setting a mechanical royalty rate.

365. First, the RIAA claims that music is generally "an emotional experience" while ringtones are purchased merely to "signal[] the user to answer the phone." RIAA

PFF ¶ 900. There is no competent evidence in the record to support the claim. The only support provided by the RIAA is the conclusory testimony of Professor Slottje, who conceded that he had done no empirical work to support this or any other conclusion that he offered. 5/8/08 Tr. at 5379-81 (Slottje).

366. Second, the RIAA and DiMA assert that mastertones are simply personalization products (akin to "accessories" to a cellular phone, such as wallpaper) that allow consumers to differentiate themselves. RIAA PFF ¶ 901-02; DiMA PFF ¶ 339. But the RIAA's own witnesses undermine this claim. A number of record company witnesses testified that mastertones, unlike accessories to a cell phone, are integral to the marketing of new sound recordings. Mr. Rosen of Sony BMG described mastertones as "a vital component of Sony BMG's digital business strategy." Rosen WDT (RIAA Trial Ex. 63) at 5. Mr. Kushner of Atlantic Records testified that his company "will often release a mastertone . . . several weeks before the CD in order to create a buzz." Kushner WDT (RIAA Trial Ex. 62) at 12. Mr. Wilcox likewise explained that "a lot of times we will roll out a ring tone in advance of the corresponding track download or CD album being available to help the promotional efforts with the album and the track." 2/20/08 Tr. at 4034 (Wilcox).

367. Third, the RIAA and DiMA argue that the brevity of mastertones—typically 30 or 45 seconds in length—"inherently differentiates a ringtone from a full song." RIAA PFF ¶ 903; *see also* DiMA PFF ¶¶ 337, 340. Although it is true that ringtones are shorter works, there is no dispute that they are derivative of the underlying sound recording and therefore provide an appropriate benchmark for setting the mechanical royalty rate.

368. Fourth, the RIAA also points to the differential in pricing between mastertones and permanent downloads as evidence of the supposed difference in the markets. Of course, variations in pricing in and of itself tell you nothing about the product market. Physical CDs sell for significantly higher prices than albums that are downloaded to consumers, compare Teece WDT (RIAA Trial Ex. 64) at 81 with Enders WDT (CO Trial Ex. 10) at 32; and CDs themselves sell at a broad variety of price points, see Wilcox WDT (RIAA Trial Ex. 70) at 16 (discussing variable pricing for "front-line," "mid-price" and "budget" CDs); CO Trial Ex. 348 (showing CD retail list prices ranging from [redacted]). Moreover, the argument is advanced without any regard for the evidence showing that the difference between mobile and download pricing has more to do with the portability of mastertones than anything to do with fundamental differences in the product. CO PFF ¶¶ 515-16. As Professor Wildman conceded, permanent mobile downloads (i.e., full-track downloads that can be acquired on cellular phones) sell for a retail price in excess of permanent, non-mobile downloads, even though no one would argue that such downloads constitute "wallpaper" or a cell phone accessory. 5/12/08 Tr. at 5967-68 (Wildman).

369. Nor did the RIAA or its economists give any consideration to the evidence showing that the price point for permanent downloads is set below market to drive sales of portable music players. The principal concern of Apple—which established the 99 cent price point and is the dominant player in the permanent download market with more than an 80% market share—is to sell iPods. *See* CO Trial Ex. 88 at 12 (Apple CFO explaining that the iTunes store is run with relatively low margins "because we think that selling music and now videos, helps us to sell iPods and accessories"); CO Trial Ex. 89 at

10 (Apple CFO explaining that the iTunes store is run with relatively low margins because "it helps us to sell iPods and Macs and that is really our strategy"); [redacted]; *see also* Enders WDT (CO Trial Ex. 10) at 29-30 (discussing relationship between iTunes and other Apple products). All of this testimony—which the RIAA cannot dispute—is inconsistent with rejecting the mastertone benchmark because the price of a mastertone is higher than that of a full length permanent download.

370. Fifth, DiMA misinterprets a snippet of Professor Landes's testimony in an effort to manufacture a concession that mastertones have different supply and demand characteristics. *See, e.g.*, DiMA PFF ¶¶ 283, 338. Professor Landes was asked a narrow question about whether the high royalties paid in the market to use musical compositions in mastertones provided support (by itself) for an increase in the mechanical rate for permanent downloads, on the theory that "the download of a full song is at least as valuable as a snippet," Landes WDT (CO Trial Ex. 22) at 41. Professor Landes acknowledged, "I don't think this comparison is my strongest comparison." 2/11/08 Tr. at 2481. DiMA's alchemic attempt to transform this answer into a repudiation of the mastertone benchmark fails. Professor Landes has never testified "unequivocally that ringtones have different and supply characteristics," DiMA PFF ¶¶ 283. Nor did he ever repudiate his mastertone benchmark. To the contrary, he supported its applicability through both phases of this proceeding. Landes WDT (CO Trial Ex. 22) at 24-25; Landes WRT (CO Trial Ex. 406) at 31-33.

371. Finally, even if the RIAA and DiMA had discharged their burden of demonstrating that the demand and supply characteristics of the mastertone market were distinct from CDs and full length DPDs, that would still be no reason to cast aside the mastertone benchmark. The Copyright Owners are not claiming that the statutory rates for physical products and permanent downloads should be set at the same rate as the license payments made to them for mastertones. Contrary to DiMA's claim, DiMA PFF ¶ 343, this difference in the Copyright Owners' proposed rates does not imply that the mastertone benchmark is a poor comparator. Rather, as Professor Landes has stressed, time and again, the importance of the mastertone benchmark is to demonstrate the relative value of the song to the sound recording in a market that is unconstrained by the statutory license. *See, e.g.*, Landes WDT (CO Trial Ex. 22) at 25; Landes WRT (CO Trial Ex. 22) at 28. Nothing that the RIAA and DiMA have argued explains why a composition should garner 20% of the total content cost for a mastertone but less for a permanent download or for a song included in a CD.

(ii) The Mastertone Market is Broad and Similar to the Market for Recorded Music Generally

372. The RIAA also attempts to distinguish the mastertone benchmark by claiming that mastertones are a "small subset of musical works" that often constitute the most popular sound recordings in the market. RIAA PFF ¶ 913. But the evidence does not support the notion that the mastertone market is a narrow one. *See* CO PFF ¶¶ 510-12. Nor is it noteworthy that the mastertone market is driven by "hits," *id.* ¶513, because as many record company witnesses have stated, the recorded music market, generally, depends upon the success of a small number of releases.

373. The evidence shows that the mastertone market is not as shallow as the RIAA claims. CO PFF ¶ 510. For instance, in 2006, nearly [redacted] songs earned mastertone revenue for UMPG. In 2007, that number increased to almost [redacted]. Landes WRT (CO Trial Ex. 406) at 32-33. Likewise, in 2006, approximately [redacted] songs earned ringtone royalties for EMI MP, accounting for roughly [redacted] of the songs that earned any royalties that year. *Id.* at 33. Indeed, the RIAA itself acknowledges the large "breadth of releases" that were at issue when mastertone rates were being negotiated between music publishers and record companies. RIAA PFF ¶ 954.

374. The mastertone market has also been significant in terms of revenue and sales. CO PFF ¶ 511. The RIAA's principal rebuttal economist, Professor Wildman, acknowledged that the mastertone market currently represents the third largest source of revenue for record companies. 5/12/08 Tr. at 5966 (Wildman). In 2006, across the U.S. music industry, sales of ringtones generally generated $1.04 billion in revenue. Enders WDT (CO Trial Ex. 10), Ex. C at 6. That year, Sony BMG alone earned over [redacted] from the sale of mastertones, CO Trial Ex. 77 at 2; *see also* 2/20/08 Tr. at 3994 (Wilcox), and in 2007, the company made nearly [redacted] from all forms of ringtones, including mastertones, CO Trial Ex. 338 at 2. In just the first ten months of 2007, mastertones generated [redacted] in revenue for Universal. CO Trial Ex. 17.

375. The revenue generated by mastertones has been substantial for music publishers, as well. CO PFF ¶ 512. In 2007, EMI MP earned over [redacted] from the sale of mastertones, which constituted nearly [redacted] of its total digital revenue. Faxon WRT (CO Trial Ex. 375), Ex. B. That was nearly a threefold increase over the company's mastertone revenue in 2006. *See id.* For the entire period 2003 to 2007,

revenue from ringtones and mastertones accounted for [redacted] of the company's combined income from digital uses. Faxon WRT (CO Trial Ex. 375) at 4. Mr. Faxon expects mastertone revenues to continue to rise. 5/14/08 Tr. at 6365 (Faxon).

376. Although a fraction of mastertones account for the bulk of the revenue, RIAA PFF ¶¶ 914-15; DiMA PFF ¶ 340, the mastertone market is no different from the rest of the recorded music industry. CO PFF ¶ 513. The music industry, generally, is "hit-driven"— the industry depends on a small number of recordings to drive revenues and profits. Indeed, this was a point made repeatedly by the RIAA's own witnesses. *See, e.g.,* Teece WDT (RIAA Trial Ex. 64) at 21 ("It is widely recognized that most sound recordings are not profitable . . . ."); 5/8/08 Tr. at 5342 (Slottje) ("the likelihood of any given particular song becoming a hit is low"); Kushner WDT (RIAA Trial Ex. 62) at 15 ("only one out of every ten new artists signed to major record labels will have a successful album").

(iii) The Record Does Not Support the RIAA's Claim that the Mastertone Market Was Expected to Be Short-Lived

377. The RIAA also asserts that the mastertone benchmark should be ignored because the record companies, in essence, overpaid to take advantage of the "fleeting" mastertone market. RIAA PFF ¶ 918, 920-21; *see also* DiMA PFF ¶ 342. The evidence does not bear out that claim.

378. The RIAA claims that when the first mastertone agreements were executed in 2004, record companies and publishers believed the market would be short-lived. RIAA PFF ¶ 920-21. The documentary evidence is to the contrary. First, the internal HFA 2005 forecast relied upon by the RIAA projected that the ringtone market would be worth roughly $1 billion in 2008 and that it would remain robust through 2009,

the last year of the projection. Wildman WRT (RIAA Trial Ex. 87), RIAA Ex. 103-RR at 7. Although a decline was projected, the forecast still predicted approximately $700 million in revenues for 2009, the last year for which projections were given. *Id.*

379. Internal projections of the record companies, ignored by the RIAA, are even more at odds with the claim that the mastertone market was predicted to be short-lived. A comprehensive Warner Music Group forecast created in 2005 showed [redacted] H. Murphy WDT (CO Trial Ex. 15), CO Ex. 702 at RIAA 39190; accord. CO Ex. 731 at RIAA 28574, 28582.

380. The RIAA also claims that the mastertone market is a poor benchmark because it "has been rapidly declining." RIAA PFF ¶ 922. In support of that argument, the RIAA offers testimony only from Sony BMG, a company for which mastertones continue to constitute a critical digital revenue stream. *See* CO 338 at 2; CO 77 at 2; 2/20/08 Tr. at 3994 (Wilcox) (Sony BMG earned [redacted] from sales of mastertones in 2006 and [redacted] in 2007). None of the other majors offer any corroborative evidence. And, of course, Sony BMG, Warner and Universal each entered into renewals of their NDMAs in 2007, indicating that the market remains substantial. *See* Faxon WRT (CO Trial Ex. 375) at 6-7, Ex. C. That is certainly the view on the publisher side: Mr. Faxon testified that he expects mastertone revenue of EMI MP to continue to grow. *See* Faxon WRT (CO Trial Ex. 375), Ex. B; 5/14/08 Tr. at 6365 (Faxon).

381. The RIAA's claim that the mastertone market will soon be "obsolete" finds even less support in the record. RIAA PFF ¶ 924. Not a single witness so testified.

To the contrary, Claire Enders, the Copyright Owners' expert on the state of the digital music industry, projects further increases in the U.S. ringtone market through 2012, when it will amount to nearly $1.5 billion in revenue. Enders WDT (CO Trial Ex. 10), Ex. C at 6.

(iv) Contrary to the RIAA's and DiMA's Claims, Products in a Benchmark Market Should Not Be Substitutable for Products in the Target Market When the Benchmark Involves Similar Sellers and Similar Rights

382. The RIAA and DiMA also argue that the mastertone benchmark should be discarded because mastertones are complements to, rather than substitutes for, CDs and downloads. RIAA PFF ¶¶ 926-28; DiMA PFF ¶ 338. The claim is constructed on a misreading of this Court's past decisions.

383. The RIAA asserts that the decisions in SDARS and Webcasting I require that benchmarks be drawn from markets for products that are substitutes rather than complements. *Id.* ¶ 927. But there was a critical difference between the proposed benchmarks in those proceeding and the mastertone benchmark offered by the Copyright Owners here: Each of the rejected benchmarks involved markets in which different sellers were selling different rights. In SDARS, this Court rejected benchmarks based on non-music content. *See* 73 Fed. Reg. at 4091-92 & n.28 (rejecting Stern and nonmusic content benchmarks). Similarly, in the Webcasting I proceeding, the CARP rejected a musical works benchmark on the same ground. *See Webcasting I CARP* at 41.

384. When a benchmark market involves different sellers and different rights, it is critical that the products in the benchmark market be substitutable for those in the target market. Substitutability ensures that similar market dynamics are affecting the sale of the rights being compared.

385. By contrast, it would make no sense to require substitutability when a benchmark market involves the same sellers and the same rights because such a substitute product would necessarily be priced by relationship to the statutory rate. That is precisely the reason why neither the RIAA's proposed effective rate or first use benchmarks are of any utility here.

(b) The Preexisting Monophonic and Polyphonic Ringtone Market Did Not Inflate Mastertone Rates

386. The RIAA also claims that the mastertone benchmark should be disregarded because the Copyright Owners obtained above-market rates to compensate for the opportunity cost of replacing preexisting sales of monophonic and polyphonic ringtones. The record provides no evidentiary support for a finding of such leverage. *See* CO PFF ¶¶ 520-22.

387. The critical concession came from Professor Wildman, who testified that "a complete analysis" of the issue would be "complex, involving potential growth in the marketplace, the cross-elasticity of demand between the two products, and the possibility that unit sales increased due to the introduction of mastertones." RIAA PFF ¶ 931 (citing Wildman WRT (CO Trial Ex. 87) at 20). He did no such analysis. As a result, he testified that he could not quantify what the impact would be. 5/12/08 Tr. at 5971 (Wildman). In fact, he acknowledged that it was entirely possible that publishers would have accepted a lower royalty rate for mastertones than for monophonic and polyphonic ringtones because publishers were motivated by maximizing revenue, not the rate. *See id.* at 5970-72.

(c) The RIAA Has Failed to Show that the Mastertone Rates in the NDMAs Are a Poor Benchmark for Mechanical Rights

388. Unable to dispute that the NMDAs directly support the Landes 20% mastertone benchmark, the RIAA argues that the NDMAs are "blanket licenses and thus do not comport with the hypothetical market at issue in this proceeding." RIAA PFF ¶¶ 935; *see also id.* ¶¶ 936-43. As a simple factual matter, this claim is wrong. The RIAA also asserts that the NDMAs were "package deals involving a complex trade-off of rights in which record companies agreed to pay the publishers a higher rate for sales of mastertones in exchange for concessions in other areas." *Id.* ¶ 935; *see also id.* ¶¶ 944-63. The weight of the evidence shows, however, that the inclusion of multiple rights in the NDMAs did not affect the mastertone rates.

(i) The NDMAs and the HFA/EMI Mastertone Agreement Did Not Provide "Blanket Licenses"

389. The NDMAs are not blanket licenses. A blanket license, by definition, grants the licensee immediate access to an entire repertoire of works. *See, e.g., Broadcast Music, Inc.* v. *Columbia Broad. Sys., Inc.*, 441 U.S. 1 (1979) (explaining that a blanket license "allows the licensee *immediate use of covered compositions*") (emphasis added); *United States* v. *American Society of Composers, Authors, and Publishers*, 2008 WL 1967722, at *65 (S.D.N.Y. April 30, 2008) (explaining that "a blanket license offers the flexibility of *immediate and unlimited access* to a vast and every growing repertory of compositions") (emphasis added).

390. The NDMAs, by contrast, do not provide immediate and unlimited access to the works of the publisher-licensors. Each NDMA provided the right to incorporate a song in a mastertone only "with and subject to" the publisher's "advance written

approval." *See, e.g.,* Faxon WDT (CO Trial Ex. 3), CO Ex. 219 at 13, CO Ex. 220 at 21, CO Ex. 221 Ex. A at 21; Firth WDT (CO Trial Ex. 24), CO Ex. 332 at 15 (emphasis added). No such approval is required in a blanket license; the license itself grants the right without the need to clear music on a song-by-song basis.

391. The same is true of the standalone mastertone agreement between HFA and EMI Music ("HFA/EMI Agreement"). Under that license, EMI Music is required to submit requests to publisher-principals that identify each work that the company seeks to sell or re-sell as a mastertone. *See* Israelite WDT (CO Trial Ex. 11), CO Ex. 24 at 2. That is not a blanket license.

392. In fact, the NDMAs function in the same way that mechanical licensing is generally conducted through HFA. As Ms. Finkelstein explained, licensees make license requests electronically and in bulk when seeking the statutory rate for multiple works. A. Finkelstein WRT (RIAA Trial Ex. 84) at 28. The NDMAs and the HFA/EMI agreement work essentially the same way.

(ii) There is No Evidence that the Mastertone Rates in the NDMAs Were Inflated by Trade-Offs

393. The RIAA argues that because the NDMAs were deals involving multiple rights (a "package," as the RIAA calls it), no single rate can be used in isolation as a benchmark. RIAA PFF ¶ 944. As set forth in the Copyright Owners Proposed Findings of Fact, *see* CO PFF ¶¶ 523-28, and as explained below, the RIAA's arguments are wrong as a matter of economic theory and are unsupported by the evidence.

(1) The RIAA's Application of Economic Theory is Fundamentally Flawed

394. The RIAA " package deal" argument is based on a misapplication of economic theory by two of the RIAA's economic experts, Professors Wildman and

Slottje, neither of whom studied the mastertone market in sufficient depth to offer an opinion that can be credited.

395. As Professor Landes explained, the probative value of individual terms in bundled agreements is dependent upon their consistency with external, standalone transactions. Landes WRT (CO Trial Ex. 406) at 36-37. Thus, Professor Landes observed that because the mastertone rates in the NDMAs were consistent with prior and contemporaneous licensing activity in the mastertone market, the other rights covered by the NDMAs had not affected the mastertone rates. *Id.* at 37. Indeed, if, "as the record companies claim, they conceded to the publishers' demands on the mastertone rates recited in the NDMAs in order to obtain favorable terms for the other rights licensed in those agreements, economic theory predicts that the publishers would have been able to extract more favorable mastertone terms than were contained in the standalone agreements." Landes WRT (CO Trial Ex. 406) at 37; *see also* CO PFF ¶¶ 501-02, 506-07 (describing consistency between NDMA mastertone rates and standalone mastertone rates). The rates in the NDMAs are also consistent with mastertone rates in standalone mastertone agreements between [redacted], which do not address licenses for any other products. *See* Israelite WDT (CO Trial Ex. 11), [redacted]; CO Trial Ex. 13, [redacted].

396. Neither Professor Wildman nor Professor Slottje engaged in an in-depth review of the mastertone agreements. Remarkably, each conceded that he had not seen any standalone mastertone agreements prior to offering their opinion on the invalidity of

the NDMA rates. 5/12/08 Tr. at 5955-57 (Wildman); 5/8/08 Tr. at 5445-46 (Slottje). Their failure to consider the relationship between the NDMAs and the standalone agreements undermines their testimony with respect to the NDMAs.

(2) The Mastertone Rates in the NDMAs Were Market Rates and Were Unaffected by the Terms for Other Products

397. The RIAA also claims that the mastertone rates in the NDMAs cannot be used as a benchmark because the record companies accepted above-market mastertone rates in exchange for concessions that publishers made on rates for other products, such as DualDisc, copy-protected videos, music videos and locked content. RIAA PFF ¶¶ 947-52. The record does not support this argument.

398. The Court has expressed appropriate skepticism over the admissibility and probative value of such parol evidence concerning the NDMAs. 2/20/08 Tr. at 3963 (Wilcox) (sustaining objections to questions regarding negotiations of NDMAs); 1/28/08 Tr. at 96-97 (NMPA opening statement) (Court questioning admissibility of evidence of negotiations). The NDMAs, on their face, state nothing about any agreement to pay above-market mastertone rates. If the labels "overpaid" for ringtones in the NDMAs, so did literally hundreds of third-party ringtone sellers. *See* Landes WRT (CO Trial Ex. 406) at 36; 5/20/08 Tr. at 7519-20 (Landes).

399. The RIAA's witnesses' primary argument was that the record companies agreed to inflated mastertone rates in order to gain agreement that only one mechanical per composition would be paid on DualDiscs. As Ms. Finkelstein stated, Sony BMG entered into the NDMAs "[t]o get to market with DualDiscs." Finkelstein WDT (RIAA Trial Ex. 61) at 12. Sony BMG, she claimed, "agree[d] to high rates for mastertones as the price for getting DualDiscs licensed at the statutory rate." *Id.* at 13.

400. The chronology of release of DualDiscs does not support the RIAA's claim. *See* CO PFF ¶¶ 525-28. DualDiscs were first released by Sony BMG in spring 2004, six months or more before the first NDMA was signed in November 2004. 2/20/08 Tr. at 3977 (Wilcox). Moreover, three of the major record companies extended the terms of the mastertone rates in the NDMAs in 2007, at a time when it was apparent that DualDisc had failed commercially. Faxon WRT (CO Trial Ex. 375) at 6-7; *see also* 2/14/08 Tr. at 3406 (A. Finkelstein) ("[DualDisc] was never a commercially successful product."); CO Trial Ex. 77 at 1 (showing that in Sony BMG received [redacted] in revenue from mastertones in 2006 and only [redacted] over the same time period for DualDiscs). Sony BMG entered into an extension of its NDMA with EMI MP in March 2007 that provided for a continuation of the same mastertone rates—[redacted]—through June 30, 2008. *See* Faxon WRT (CO Trial Ex. 375) at 6; CO Trial Ex. 73 at 2; Faxon WDT (CO Trial Ex. 3), CO Ex. 219 at 14-15. Universal agreed to extend through December 31, 2008 at [redacted]. Faxon WRT (CO Trial Ex. 375) at 6; CO Trial Ex. 375, Ex. C at 6. And Warner Music Group agreed to extend through August 31, 2008 at [redacted]. Faxon WRT (CO Trial Ex. 375) at 7; CO Trial Ex. 375, Ex. C at 11.[5]

401. Unable to prove its DualDisc argument, the RIAA now claims that the record companies paid higher mastertone rates in exchange for concessions on every other type of product contained in the NDMAs—copy-protected CDs, locked content and

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5 [redacted]. Faxon WRT (CO Trial Ex. 375) at 7; CO Trial Ex. 375, Ex. C at 11.

music videos. RIAA PFF ¶ 948, 955. But as Professor Landes has pointed out, if that were true, the rates paid to Copyright Owners in the NDMAs should have been higher rather than equivalent to the rates in prior mastertone agreements. Landes WRT (CO Trial Ex. 22) at 37. And while the NDMAs did grant the record companies video licensing rights that were not subject to a compulsory license, they set no rates for such products. All that the record companies gained was the right to agree or arbitrate the rate at a subsequent date. Faxon WDT (CO Trial Ex. 3), CO Ex. 219 at 20-22; *id.*, CO Ex. 220 at 31-34; *id.*, CO Ex. 221 at 41-43; Firth WDT (CO Trial Ex. 24), CO Ex. 332 at 25-27; *see also* Wilcox WDT (RIAA Trial Ex. 70) at 28. It makes no sense to conclude that the record companies overpaid for mastertones for the right to license videos at a rate "to be determined."

(3) The NDMA Extensions Demonstrate that the Mastertone Rates were Market Rates

402. The RIAA also seeks to brush off the extensions of the NDMAs that they entered into subsequent to the ruling by the Register (currently being appealed by the Copyright Owners) that mastertones are subject to compulsory licensing under 115. The weight of the evidence, however, shows that those extensions are inconsistent with the RIAA's claim that they are paying above-market mastertone rates.

403. The RIAA seeks to rationalize the NDMA extensions by attributing them to the continuation of "preferential terms on locked content and video synchronization rights under the original NDMAs." RIAA PFF ¶ 959. There is no support in the record for that claim. The RIAA's reliance on Mr. Faxon's testimony is misplaced. All that he stated was that video had become a source of revenue for record companies, not that the record companies overpaid for mastertones in return for the video license. *See* 5/14/08

Tr. at 6485 (Faxon). And the only other witness cited by the RIAA, Mr. Wilcox, also failed to provide any evidentiary support that Sony BMG paid above-market mastertone rates in return for licensing video products for a royalty subject to subsequent agreement or arbitration. 2/20/08 Tr. at 4036-37 (Wilcox), cited in RIAA PFF ¶ 959.

404. Finally, the RIAA attempts to discount the rates for mastertones in the NDMA extensions by claiming they are merely "interim rates." RIAA PFF ¶ 961. The agreements are no more interim than any others entered into by record companies. The extensions do not provide for any retroactive adjustment of the mastertone rate. The extension between Sony BMG and EMI MP provides that the mastertone rates will be operative through June 30, 2008, [redacted] Faxon WRT (CO Trial Ex. 375) at 6, Ex. C at 2-3. Similarly, the EMI MP extension with Universal extends the mastertone rates through December 31, 2008, [redacted]. Faxon WRT (CO Trial Ex. 375) at 6, Ex. C at 6. EMI MP likewise extended its Warner NDMA [redacted] Faxon WRT (CO Trial Ex. 375) at 7, Ex. C at 11.

(4) Contrary to the RIAA's Claim, Standalone Mastertone Agreements Postdating the NDMAs Show that the NDMA Rates were Market Rates

405. The RIAA has also failed to rebut the support of the mastertone benchmark provided by standalone mastertone agreements entered into subsequent to the

NDMAs. *See* CO PFF ¶ 502. These agreements, signed by two different major record labels, provide for the same mastertone rates as the NDMAs even though the agreements do not grant any rights for any other products. *See* Israelite WDT (CO Trial Ex. 11), CO Ex. 24 at 4 ([redacted]); CO Trial Ex. 13, [redacted]

406. The RIAA ignores the [redacted] agreement entirely. With respect to the HFA/EMI Agreement, the RIAA asserts "there is a high likelihood that the negotiation of this agreement . . . was affected by the fact that the NDMA rates had become a 'focal point' in the market." RIAA PFF ¶ 962. There is no factual support for the assertion. Rather, the RIAA relies for this point entirely on the testimony of Professor Wildman, who conceded that he had not even seen the HFA/EMI Music agreement prior to submitting his written testimony. *See* 5/12/08 Tr. at 5957-58 (Wildman). That would appear to disqualify him from offering probative evidence on what motivated EMI Music to enter into the agreement.

(d) Standalone Mastertone Agreements Between Music Publishers and Third-Party Ringtone Sellers Support the Mastertone Benchmark

407. The RIAA incorrectly claims that the mastertone benchmark is not supported by any of the agreements between music publishers and third-party ringtone sellers. RIAA PFF ¶¶ 986-1000. That is simply not so.

408. There are many mastertone agreements in evidence other than the NDMAs. The mastertone licenses between Copyright Owners and third-party sellers of ringtones typically include a tiered structure providing for payment at the greater of (1) a specified per-mastertone penny minimum, (2) a percentage of the retail price of the

mastertones, and/or (3) a percentage of gross revenue. *See, e.g.,* Faxon WDT (CO Trial Ex. 3), CO Ex. 218; Robinson WDT (CO Trial Ex. 8), CO Exs. 101-110, 112-119; Israelite WDT (CO Trial Ex. 11), CO Exs. 17-22; Peer WDT (CO Trial Ex. 13), CO Exs. 152, 156, 160, 161; Firth WDT (CO Trial Ex. 24), CO Exs. 252, 298, 328, 329, 351. Professor Landes's analysis included 200 such agreements from six different music publishers spanning the years 2004, 2005, and 2006. Landes WDT (CO Trial Ex. 22) at 40.

409. As Professor Landes testified, his assessment of the share of the content pool attributable to musical compositions in the mastertone market was based in part on an analysis of these agreements between publishers and third-party ringtone sellers, on the one hand, and separate agreements between record companies and third-party ringtone sellers, on the other. Landes WRT (CO Ex. 406) at 36. His analysis of these agreements revealed that publishers received 20% of the total content pool for mastertone rights when licensees separately acquired the rights to musical compositions and sound recordings. *See* 5/20/08 Tr. at 7520 (Landes).

410. Professor Landes's conclusion concerning this aspect of the mastertone market was based on a simple inference from the rates in these two sets of agreements. *See* 5/20/08 Tr. at 7520 (Landes). Professor Landes's analysis of the publishers' standalone mastertone agreements with third parties revealed an average retail percentage payable to publishers of 10.5%. *See* Landes WDT (CO Trial Ex. 22) at 41 (providing average percent-of-retail royalty rate); *id.* at Figure 9 (illustrating the distribution of percent-of-retail minima); 2/7/08 Tr. at 2131 (Landes) (143 agreements formed the basis for Figure 9). For their part, the record companies typically receive the greater of 50% of

retail or $1.00 when separately licensing their sound recordings for use as mastertones, and they have done so while undertaking the obligation to acquire and pay for publishing royalties out of their licensing revenue. Landes WDT (CO Trial Ex. 22) at 46-47. The relationship between this licensing activity—with record companies usually receiving 50% of retail revenue for their licenses (inclusive of the obligation to acquire licenses for the underlying compositions), and with publishers receiving (on average) 10.5% of retail revenue—implies a value of the rights to musical compositions of slightly over 20% of the licensing fees necessary to sell mastertones.

(e) Contrary to the RIAA's Claim, There is Nothing Unsound About Professor Landes's Application of the Mastertone Benchmark

411. The RIAA claims that "[t]here is no evidence in the record supporting Dr. Landes's decision to rely on the 20% of wholesale term in the NDMAs rather than the 10% of retail." RIAA PFF ¶ 965. The argument is the product of a fundamental misunderstanding of Professor Landes's content pool analysis.

412. As explained in further detail above, see *supra* Section VI.B.1, Professor Landes's content pool analysis is premised on the value of identifying how musical compositions are valued on a relative basis as compared to sound recordings. Professor Landes explained that this approach is sound because the rights at issue in this proceeding involve the sale of musical compositions when they are coupled with sound recordings, and thus an appropriate benchmark will provide information concerning how those rights are valued in relation to one another outside the context of Section 115. *See* Landes WDT (CO Trial Ex. 22) at 23, 25; *see also* Landes WRT (CO Trial Ex. 406) at 28-29; 2/7/08 Tr. at 2078-80, 2083-84 (Landes).

413. Such an analysis can only be conducted by comparing what is paid for each of the rights. Thus, even if the NDMAs had not provided for a wholesale tier, Professor Landes would still have concluded that they implied 20% of the content pool based on a comparison between the 10% of retail received by the publishers and the 50% received by the record companies. The 10% paid to the publishers is significant only when compared to what the record companies receive for the sound recordings.

414. The RIAA selectively cites the testimony of Mr. Faxon to suggest that he "admitted" that the mastertone market only supports "a benchmark for a 10% retail rate." RIAA PFF ¶ 966. The RIAA's characterization of Mr. Faxon's testimony is at odds with what he actually sa*id.* The questions posed to Mr. Faxon in the exchange cited by the RIAA related exclusively to the question of whether a rate for permanent downloads based on a retail percentage would be preferable to a rate based on a percentage of wholesale. *See* 1/30/08 Tr. at 627-628 (cited in RIAA PFF ¶ 966). Of course, that is not what the Copyright Owners have proposed, and Mr. Faxon was quite clear in both his written and oral testimony that he views the Copyright Owners' rate proposal as "both reasonable and necessary." Faxon WDT (CO Trial Ex. 3) at 21; *see also* 1/29/08 Tr. at 414-15 (Faxon).

(f) The RIAA Incorrectly Claims that the Mastertone Benchmark Does Not Support the Copyright Owners' Mastertone Rates

415. In addition, the RIAA argues that the rates in the mastertone agreements reviewed by Professor Landes do not support the mastertone rates being proposed by the Copyright Owners. The RIAA essentially makes two arguments, each of which is easily dispatched.

416. First, the RIAA claims that two of the tiers in the Copyright Owners' rate proposal—the content pool tier of one-third and the cents tier of 15 cents—exceed the corresponding minima that prevail in the NDMAs (20% of wholesale revenue and 10 cents). RIAA PFF ¶ 967-68. But the 20% implied by the mastertone benchmark is the bottom, not the top of the range of reasonable rates implied by Professor Landes's analysis. And a full examination of the mastertone agreements reviewed by Professor Landes—as opposed to just the NDMAs—indicates why the tiered rates proposed by the Copyright Owners are, in fact, reasonable. Publishers often receive 15 cent minima in their mastertone agreements, with some minima as high as 25 cents. *See* Landes WDT (CO Trial Ex. 22) at Figure 8. Capping the minimum at 10 cents would actually result in a rate below the rate implied by the market. *See* Landes WDT (CO Trial Ex. 22) at 45-46.

417. The RIAA also claims that the mastertone agreements reviewed by Professor Landes imply only a minimum of 12.5 cents. That cannot be the position of the RIAA, which itself has proposed an alternative (to its percentage rate) mastertone rate of 18 cents. *In the Matter of Mechanical and Digital Phonorecord Delivery Rate Adjustment Proceeding*, Amended Proposed Rates and Terms of Recording Industry Association of America, Inc., Docket No. 2006-3 CRB DPRA (April 10, 2003), at 6. Nor would it make any sense to adopt such a minimum in light of the undisputed evidence that the Copyright Owners currently receive mastertone license fees that are double the 12.5 cent rate. *See* Benson WRT (RIAA Trial Ex. 82) at 14, Figure 4f; Wildman WRT (RIAA Trial Ex. 87) at 51.

(g) Professor Wildman's "Surplus Analysis" and "Adjustments" to the Mastertone Benchmark Are Entitled to No Weight

418. The RIAA also argues that the mastertone benchmark cannot be employed without adjustment to the 20% rate. The adjustment the RIAA proposes, however, is based entirely on a hypothetical and flawed "surplus analysis" conducted by Professor Wildman that is entitled to no weight.

419. As an initial matter, Professor Wildman's theory is advanced without any empirical support. 5/12/08 Tr. at 5935-37 (Wildman). As the Copyright Owners observed in their Proposed Findings of Fact, not a single one of the 11 record company executives who testified at trial offered any facts to support Professor Wildman's theory. CO PFF ¶ 518.

420. Indeed, Professor Wildman's theory is little more than an attempt to claim that the record companies accepted a smaller share of the content pool paid for mastertones because the costs of producing the sound recordings had already been sunk at the time of creation of the mastertones. Wildman WRT (RIAA Trial Ex. 87) at 29. As the Copyright Owners explain in their Reply Conclusions of Law, this argument has been twice addressed—and rejected—by this Court at the urging of the record companies. When a similar argument was made in the 2001 Webcasting proceeding, Professor Wildman himself testified in the 2001 Webcasting proceeding that the argument "flies in the face of economic theory." 5/12/08 Tr. at 5948; *see also id.* at 5947-48 (Wildman).

(i) Professor Wildman's Calculations to Adjust the Mastertone Benchmark For Use with CDs, Digital Downloads and Mastertones Are Fatally Flawed

421. Professor Wildman testified that the mastertone benchmark could only be used after adjustment by a "surplus" calculation. RIAA PFF ¶¶ 980-83. Through this analysis, Professor Wildman purports to calculate how "surplus" above costs for CDs and permanent downloads would be divided if the record companies were to account for the costs they incur in creating sound recordings, and if the publishers were to account for their costs of providing musical compositions. *Id.* Professor Wildman defines the "surplus" as the profit to the record companies once all expenses are paid, plus artist royalties and mechanical royalties, and less costs to the publishers. *See* Wildman WRT (RIAA Trial Ex. 87) at 49-52. All of his calculations, however, are marred by empirical and conceptual flaws.

422. First, Professor Wildman's surplus calculations hinge on highly questionable cost and revenue figures. These numbers were taken—without verification—from the report of another RIAA witness, Bruce Benson. Professor Wildman admitted that his calculations were dependent upon Mr. Benson's. *See* 5/12/08 Tr. at 5974-77 (Wildman). There is substantial reason to doubt the accuracy of Mr. Benson's analysis. As explained in Section III.B above, Mr. Benson omitted all of the profits earned by the majors' manufacturing and distribution companies. He made wholesale changes in the historical cost information of the record companies without any empirical basis for accepting the changes. He also overstated the costs of digital distribution. His analysis of profitability by format—the underpinning of Professor Wildman's calculations—is entitled to no weight.

423. Second, even putting to one side the unreliability of the Benson numbers, Professor Wildman's analysis makes the implausible assumption that record companies

have no fixed costs, Wildman WRT (RIAA Trial Ex. 87) at 49. Professor Wildman conceded that reclassifying some of the variable costs as fixed would necessarily increase the surplus to be divided under his analysis. *See* 5/12/08 Tr. at 5981-82 (Wildman). But Professor Wildman did no such reclassification, instead relying on the obviously erroneous assumption that even the record company's overhead costs "are largely, if not completely, variable and responsive to the volume of record sales and the number of recordings produced." *Id.*

424. Even a cursory analysis of Mr. Benson's numbers demonstrate that it makes no sense to claim that record companies have no fixed costs. Although the record companies have seen a 17% reduction in revenue and 20% reduction in the number of CDs sold since 1999, overhead expense has remained essentially flat, dipping from $1.289 billion in 1999 to $1.241 billion in 2006. Benson WRT (RIAA Trial Ex. 82) at 7, Figure 1 (providing overhead costs); Appx. B (providing unit sales). If the costs were actually all variable, or even substantially so, there should have been a concomitant reduction in overhead. But Professor Wildman's conclusion depends entirely on the assumption that there were no fixed costs. *See* 5/12/08 Tr. at 5981-82 (Wildman).

425. Third, Professor Wildman's surplus analysis takes into account only the record companies' and the publishers' costs, but not those of the songwriters. 5/13/08 Tr. at 6004 (Wildman). Professor Wildman conceded, however, that such costs exist and include, among other things, songwriters' opportunity costs. *Id.* at 6005. By his own admission, Professor Wildman's analysis accounts for none of these costs.

426. Each of these flaws, individually and collectively, results in the conclusion that Professor Wildman's adjustment to Professor Landes's benchmarks are entitled to no

weight. The rejection of his surplus analysis would also be consistent with this Court's prior rejection of similar analyses because of the fundamental unreliability of the assumptions that were made. *See* 73 Fed. Reg. at 4092 (rejecting surplus analysis in SDARS proceeding because the analysis included only incomplete costs and underlying numbers were unreliable); 72 Fed. Reg. at 24093 (rejecting surplus analysis in Webcasting II because of "concerns over the reliability of the data.").

(ii) Professor Wildman Has No Basis for Adjusting the Mastertone Benchmark For Use With Mastertones

427. Professor Wildman also claims that if the mastertone benchmark were to be used to set mastertone rates, the Court would have to "adjust" the rate for two reasons: (1) the NDMA rate was "artificially elevated" in return for concessions made to the record companies with regard to other products; and (2) "the NDMAs granted a blanket license for the sale of mastertones." RIAA PFF ¶ 975. As explained above, the factual predicate for Professor Wildman's proposed downward adjustments are simply wrong. *See supra* Section VI.C.1.c. As a result, there is no reason to adjust the mastertone benchmark in any way whatsoever in setting mastertone rates in this proceeding.

2. The Synchronization Benchmark is Sound

428. As Professor Landes concluded, Copyright Owners virtually always receive 50% of the content pool when they license their musical compositions in conjunction with a sound recording for use in an audiovisual work such as a movie, television show or commercial. *See* CO PFF ¶¶ 532-35. The Copyright Owners' licenses are known as "synchronization licenses," and the licenses of the copyright owners of sound recordings are known as "master use licenses," Pascucci WRT (RIAA Trial Ex. 80) at 3. The RIAA seeks to dismiss the synchronization benchmark principally

by claiming that it is a reprise of the musical works benchmark rejected in the Webcasting proceedings. It is not. Rather, as already set out in the Copyright Owners' Proposed Findings, see ¶¶ 536-40, and demonstrated again below, there is a fundamental difference between the synchronization benchmark utilized by Professor Landes and the musical works benchmarks previously rejected by this Court: Here, the benchmark market involves the same sellers and the same rights. For that reason, the criticisms of the synchronization benchmark lodged by the RIAA are entitled to no weight. Nor are any of the quarrels that the RIAA and DiMA have with this independent market benchmark.

(a) Professor Landes's Use of the Synchronization Benchmark is Wholly Distinct from the Musical Works Benchmark Rejected in the Webcasting Proceedings

429. The RIAA argues that Professor Landes's synchronization benchmark has been rejected by this Court in its prior Webcasting decisions. RIAA PFF ¶ 832. This claim rests on a misreading of those decisions coupled with a misunderstanding of Professor Landes's content pool analysis.

430. First, the webcasters in prior proceedings proposed that performance rights in sound recordings should be entitled to the same absolute compensation as performance rights for musical compositions. *See Webcasting II*, 72 Fed. Reg. at 24094; *Webcasting I CARP Decision* at 40-41. Professor Landes has argued nothing of the sort. Rather, his analysis focuses on the relative valuation of sound recordings and musical compositions in the synchronization rights market in order to determine how those rights can be valued on a relative basis when musical compositions are embedded in sound recordings and used in the products at issue in this proceeding. *See* Landes WDT (CO Trial Ex. 22) at 23, 25; *see also* Landes WRT (CO Trial Ex. 406) at 28-29; 2/7/08 Tr. at 2078-80, 2083-

84 (Landes). Professor Landes has never suggested—and the Copyright Owners have not proposed—that musical compositions should receive the same absolute compensation that they receive in the synchronization market when those compositions are used in physical phonorecords, permanent downloads or ringtones.

431. Second, the musical works benchmark involved different sellers who were selling different rights. *See Webcasting IT*, 72 Fed. Reg. at 24094; *Webcasting I CARP Decision* at 40-41. The musical works benchmark looked to the level of performance royalties received by copyright owners of musical compositions, even though the right at issue in the webcasting proceedings was the performance right in sound recordings, held by the copyright owners of sound recordings. Here, the synchronization benchmark involves the same sellers (the Copyright Owners) selling the same rights (the right to use musical compositions) as those at issue in this proceeding.

432. This Court rejected a "musical works" benchmark on similar grounds in the SDARS proceeding. *See* 73 Fed. Reg. at 4089-90. That benchmark was used in the same way as it was in the Webcasting proceedings, *see id.*, and it is likewise distinct from Professor Landes's synchronization benchmark for the same reasons.

433. The RIAA also attacks the synchronization benchmark by erroneously asserting that Professor Landes "does not appear to have reviewed any synch or master use licenses at all" but rather that he relied exclusively on Karyn Ulman's testimony in the Webcasting II proceeding to support his claim that Copyright Owners and record companies typically split equally the licensee fees paid for synch. RIAA PFF ¶ 833. To support its inaccurate claim, the RIAA cites a footnote in Professor Landes's written direct testimony in which he refers to Ms. Ulman's witness statement. *Id.* (citing Landes

WDT (CO Trial Ex. 22) at 24 n.11). Emblematic of the RIAA's selective recitation of the evidence, the RIAA's Proposed Findings fail to direct this Court to the very next footnote in Professor Landes's written direct testimony, in which he explains that he "reviewed synchronization rights contracts between producers and publishers." Landes WDT (CO Trial Ex. 22) at 24 n.12.[6]

434. In any event, the RIAA's observation seems to have no point because there is no dispute in this record that Copyright Owners typically receive half of the total licensing fees paid by synchronization licensees. *See* 5/7/08 Tr. at 5291 (Pascucci) (explaining that license fees for synchronization and master use licenses are typically equal).

(b) The RIAA and DiMA's Claims about the Dynamics in the Synchronization Market are Irrelevant

435. The RIAA and DiMA also attempt to undermine the synchronization benchmark by pointing to purported differences in the use of music in the synchronization and mechanical license markets. But these purported difference are irrelevant to the purpose for which Professor Landes employed the synchronization benchmark.

(i) The Purpose for Which Music is Used in the Synchronization Market is Irrelevant to its Appropriateness as a Benchmark

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[6] A number of those agreements were in fact admitted into evidence in this proceeding and were identified in Professor Landes's list of materials reviewed in connection with his written direct testimony. *See* Landes WDT (CO Trial Ex. 22), Ex. B at 5-11 (identifying CO Exs. 251, 254, 277, 361, in evidence as part of Firth WDT (CO Trial Ex. 24)). Professor Landes likewise explained during his live testimony that he had reviewed synchronization licenses. 2/7/08 Tr. at 2084-85 (Landes) (referring to "[synchronization] agreements that I looked at").

436. The RIAA and DiMA argue that the fees paid for synchronization rights cannot be a benchmark because music is just one of multiple inputs when used for synchronization purposes. The RIAA maintains, for instance, that "[t]he purchaser of a right to include a recording and composition in a movie bears no resemblance to the purchaser at retail of a sound recording" and that "consumers ultimately pay to see the movie, not to hear the music." RIAA PFF ¶ 840.

437. The RIAA and DiMA simply miss the point of Professor Landes's benchmark analysis. The purpose of his benchmarks was to assess how licensees value musical compositions and sound recordings on a relative basis when they acquire both rights in a non-Section 115 setting. *See* Landes WDT (CO Trial Ex. 22) at 23, 25; *see also* Landes WRT (CO Trial Ex. 406) at 28-29; 2/7/08 Tr. at 2078-80, 2083-84 (Landes). That the purchaser of synchronization and master use rights is not the ultimate "consumer" is irrelevant. The critical point is how the licensee—here, the music supervisor or producer—values the relative importance of the song and the sound recording. There is no evidence that the fact that a particular recording might be used as "background music" or that there is a "larger work that consumers pay to watch" has any impact on the relative valuation of the two music inputs required to synchronize the music with the audiovisual work. *See* CO PFF ¶ 540.

438. The other purported market dynamic raised by the RIAA is even less relevant to Professor Landes's benchmark analysis. The RIAA states that music supervisors and producers "typically clear more music than they need, which pressures *record companies and music publishers* to keep their fees low"; that they "typically operate under very strict budget constraints"; and that they encourage competition among

the various owners of the solicited recordings and songs in order to get the lowest possible fees." RIAA PFF ¶ 842-43 (emphases added). Although these factors may affect the total price paid for both the synch and master use right, they do nothing to undermine Professor Landes's analysis, which depends upon the relative, not absolute, fees paid for the two music rights. As Professor Landes explained, "[e]ven though the absolute value of prerecorded music may differ across uses, the division of total content value. . . provides information about the reasonable mechanical royalty rate when rights to the sound recording are negotiated freely but the right to the mechanical is subject to compulsory licensing and rate setting." Landes WDT (CO Trial Ex. 22) at 25.

439. The RIAA also claims that the demand for a sound recording in audiovisual works differs from demand in the mechanical licensing market because demand in the synchronization market is "driven in part by its prior sales performance (which cannot exist for a new recording) in the market for recordings sold to consumers, along with its compatibility with other artistic elements of a film or program." RIAA PFF ¶ 845. This point is also irrelevant for the purposes of assessing how the musical composition is valued in relation to sound recording. Moreover, the market dynamic identified by the RIAA is not unique to the synch market. Sales of CDs or permanent downloads that are "catalog" as opposed to new releases are also "driven in part" by "prior sales performance," but even the RIAA has not suggested that the relative value of the musical composition should be different for such records.

440. In short, none of the demand characteristics of the synchronization market the RIAA purports to identify undermine the utility of the synchronization benchmark. Although these demand characteristics would have affected the "musical works"

benchmark in the Webcasting and SDARS proceedings because the sponsors of that benchmark sought to import the absolute rate attributable to musical compositions into the context of a sound recording royalty, the dynamics of the synchronization market that affect the level of compensation are, in the case of Professor Landes's synchronization benchmark, simply beside the point.

(ii) Competitive Pressures Affect Both Synchronization and Master Use License Transactions

441. The RIAA points to several dynamics in the synchronization market that purportedly undermine the bargaining leverage of record companies. In particular, the RIAA points to: (1) the ability of licensees to acquire or produce alternate recordings of songs, RIAA PFF ¶ 851; (2) the possibility that licensees will hire artists to re-record their songs, *id.* ¶ 853; and (3) the availability of songs from "production libraries," where music publishers own both the musical composition and sound recording copyrights," *id.* ¶ 857. None of these factors provide a reason for discarding the synch benchmark.

442. The RIAA has failed to prove that any of these factors drive the equal fees paid for synchronization and master use licenses. With respect to the first two points made by the RIAA, the evidence is clear that there is a symmetry of competitive pressures on both the side of the recording and the composition: Synchronization licensees can choose among many different songs and many different recordings and can substitute one for another, as the RIAA's own witness, Mr. Pascucci, testified. 5/7/08 Tr. at 5293-95 (Pascucci). In addition, as Professor Landes explained, "[f]ew songs are so unique that a commercial or movie can use only that song to convey a particular message." Landes WRT (CO Trial Ex. 406) at 31. Although the RIAA claims that frequently "there are only a limited number of compositions that would work in a given

film or television show," RIAA PFF ¶ 856, there is nothing in the record that supports that claim. Mr. Pascucci himself testified that he had no idea whether licensees had more choices for suitable recordings than compositions. *See* 5/7/08 Tr. at 5293-94 (Pascucci).

443. Moreover, just as a potential master use licensee can produce a cover recording, it can avoid the need for a synchronization license by creating a new musical composition through a work-for-hire arrangement. 2/11/08 Tr. at 2457-58 (Landes). The RIAA has provided no empirical data demonstrating that licensees prefer to record cover versions to acquiring the rights to existing master recordings. Landes WRT (CO Trial Ex. 406) at 31-32. In fact, producing a cover version "is in itself a costly enterprise" that serves to reduce licensees' incentives to pursue that course. *Id.* at 32.

444. The RIAA's suggestion that record companies' leverage is undermined by the possibility of a re-recording does not square with the evidence. In fact, record companies constrain the ability of their recording artists to engage in this activity. For instance, [redacted]; *see also* 5/7/08 Tr. at 5298-99 (Pascucci).

445. Similarly, the equal division of fees cannot be explained by the fact that some publishers have production libraries. Publishers compete with one another, so if a publisher has a production library, it will constrain the ability of record companies and other publishers to market their rights for higher prices. This necessarily follows from the fact that production libraries hold cheaper sound recordings and that the norm in the

market is for master use licenses to sell for exactly the same price as synchronization licenses. Thus, if there is a cheaper sound recording, this will push down the price of the composition, which in turn will constrain the ability of competing Copyright Owners to sell their compositions to the same music supervisor or producer at higher rates.

446. Perhaps more importantly, if the RIAA were correct that there were asymmetrical competitive pressures that sometimes disfavor record companies, then one would expect to see some meaningful variation in the market between the division of synchronization and master use fees. There is no such variation. As Mr. Pascucci put it, synchronization licenses are acquired for the same fee as master use licenses "greater than 90 percent" of the time. 5/7/08 Tr. at 5300 (Pascucci). Professor Landes's content pool analysis is based on what occurs in this vast majority of transactions—when Copyright Owners receive half of the total content fees paid by synchronization licensees—and is not affected by what occurs in marginal cases where publishers may be able to obtain more favorable divisions.

(iii) The RIAA Has Not Provided Sufficient Evidence to Conclude that Artists Inflate Synchronization Payments at the Expense of Master Use Payments

447. The RIAA further argues that "recording artists have an incentive to drive up the synch rate at the expense of the master use rate." RIAA PFF ¶ 860. This argument relies on a series of unsupported assertions.

448. First, the RIAA's argument is premised on the claim that "[m]any" artists have provisions in their recording contracts that require their consent before their recordings are used in movies, television shows and advertisements, and that "[a]rtists can use these consent rights to exert considerable control over the rates and terms of the

master use licenses." RIAA PFF ¶ 860. The RIAA relies on the testimony of Mr. Pascucci for this claim, but the evidence does not bear out his claim. Mr. Pascucci testified that, in fact, artists typically are not involved in negotiating synchronization and master use licenses. 5/7/08 Tr. at 5302 (Pascucci). [redacted]

449. Second, the RIAA argues that artists tend to recoup their advances from publishers more quickly than they recoup the advances from record companies, incentivizing them to shift their compensation to the synchronization license. RIAA PFF ¶ 861. Again, the RIAA relies on the conclusory testimony of Mr. Pascucci for this claim, but there is no independent empirical evidence in the record to support it.

(iv) The Promotional Benefits of Synchronization and Master Use Licensing Do Not Affect the Division of Fees

450. The RIAA additionally argues that record companies may "in appropriate circumstances, accept lower prices for master use licenses for individual sound recordings because of the promotional opportunities provided by the master use license." RIAA PFF ¶ 863. Like the RIAA's other arguments, this is beside the point.

451. First, the promotional benefits created by the use of a recording in a television, movie or commercial accrue to both the sound recording and the musical composition. Thus, there are incentives on both the part of the synchronization and master use licensor to have their music selected. Second, the "lower prices" that record companies might sometimes accept do not affect Professor Landes's content pool analysis. His assessment of the content pool division in the synchronization market

addresses only the vast majority of cases in which record companies receive exactly what the Copyright Owners receive.

(v) The RIAA's Argument Concerning Sunk Costs Does Not Undermine the Synchronization Benchmark

452. Finally, the RIAA continues to claim that the fees paid in the synchronization market are distorted because record companies frequently negotiate master use licenses at a time when the costs of producing a sound recording have already been sunk. RIAA PFF ¶¶ 865-70. According to the RIAA, because master use licensing "is difficult to predict," *id.* ¶ 866, the costs incurred to produce a sound recording "would not play the same role in bargaining over synch rights" as it does when record companies negotiate over mechanical rights, *id.* ¶ 867. For many of the reasons the Copyright Owners addressed in their Proposed Findings of Fact, this argument is meritless.

453. First, it bears noting that the RIAA's theory relies heavily on a "bargaining theory" proffered by its principal rebuttal economist, Professor Wildman, without any empirical support. *See* Wildman WRT (RIAA Trial Ex. 87) at 15-16; 5/12/08 Tr. at 5936-37 (Wildman). The notion advanced by Professor Wildman that record companies would "take less in the sync market," 5/12/08 Tr. at 5950 (Wildman), is unsupported by the record. Not a single record company witness offered any evidence that record companies would do anything less than seek to maximize their share of synchronization revenue. Indeed, Mr. Pascucci, the record company witness called on rebuttal expressly to attempt to rebut the utility of the synchronization benchmark, explained that when his company negotiates master use licenses, its "[p]rimary goal is maximizing revenue." 5/7/08 Tr. at 5277 (Pascucci). This testimony is expected given all of the record companies' claims about the need to generate revenue in the face of

declining CD sales. *Cf.* SDARS, 37 Fed. Reg. at 4090 (discussing record company witnesses' testimony about maximizing all revenue streams).

454. Professor Wildman's theory also conflicts with his prior testimony in the Webcasting I proceeding. There, Professor Wildman testified that it "flies in the face of economic theory" to price webcasting performance rights on the assumption that record companies have already sunk their costs by the time they generate income from that revenue stream. 5/12/08 Tr. at 5947-48 (Wildman). The RIAA attempts to reconcile the contradiction in Professor Wildman's testimony by arguing that "webcasting is different from synch rights in that it is a mode of delivery of a sound recording so its price should reflect forward-looking costs and the repeated sinking of costs." RIAA PFF ¶ 869. In essence, the RIAA asks the Court to conclude that synch is the one market where record companies are willing to "take less," 5/12/08 Tr. at 5950 (Wildman). There is no basis in the record upon which to draw such a conclusion.

3. Use of the Audio Home Recording Act as a Corroborative Benchmark is Sound

455. The Audio Home Recording Act 17 U.S.C. §§ 1001-1010 (2008) ("AHRA"), provides corroboration for Professor Landes's range of reasonableness. *See* CO PFF ¶¶ 541-42. As he explained, the AHRA provides royalties from the sale of digital recording devices to the copyright owners of musical compositions and sound recordings. Landes WDT (CO Trial Ex. 22) at 24. Passage of the law was motivated by concerns within the music industry that new digital recording devices would permit consumers to easily make high-quality digital copies of music, adversely affecting the market for audio recordings. *Id.* The AHRA provides that royalties collected from the sale of specified digital recording devices are split one-third for the "Musical Works

Fund" and two-thirds for the "Sound Recording Fund." *Id.* Based on this division, Professor Landes concluded that under the AHRA, owners of musical compositions receive one-third of the content pool. *Id.* In addition to these royalty funds, the AHRA requires digital audio recording devises to incorporate copy protection technology. 17 U.S.C. § 1002.

456. The RIAA does not appear to dispute that the royalty division embodied in the AHRA was determined through a voluntary agreement among the relevant rights holders. *See* Landes WRT (CO Trial Ex. 406) at 32. Rather, the RIAA argues that the allocation of royalties in the statute was distorted because the record companies were more interested in the copy protection than royalty provisions of the statute. RIAA PFF ¶ 876. As a result, the record companies agreed to give publishers and songwriters an "outsize share" in order to gain their agreement to the legislation. *Id.*

457. The only support cited by the RIAA is a report from the House of Representatives written just prior to passage of the AHRA. *Id.* (citing H.R. Rep. No. 102-873 (1992)). No provision of this legislative history supports the conclusion that copyright owners of musical compositions were given "an outsize share" of the royalty pool. *See* H.R. Rep. No. 102-873. Indeed, given that the fund was estimated at the time to generate $73 million in gross royalties during its first year, and $105 million the year after, H.R. Rep. No. 102-873 (II) at 6, it is unlikely that the record companies did anything less than any rational economic actor would do: seek to acquire as great a share as possible.

458. The RIAA and DiMA also criticize the AHRA on the ground that the royalty division was technically not set by a market. RIAA PFF ¶ 877; DiMA PFF ¶ 350.

Though true, the RIAA and DiMA simply overlook the testimony of Professor Landes on this point. As Professor Landes explained, although the AHRA "is not strictly the result of a voluntary exchange in a competitive market, it reflects the outcome of a compromise among competing interest groups in the legislative context and thus provides evidence of the relative value of copyrighted songs and sound recordings." Landes WRT (CO Trial Ex. 406) at 29; *see also* Landes WDT (CO Trial Ex. 22) at 24. Inferences from such legislation are fully consistent with principles of "economic analysis of law" and "scholarly work on the legislative process." 2/7/08 Tr. at 2106 (Landes).

459. In addition, the RIAA and DiMA observe that the AHRA is not related to the mechanical royalty rate. *See* RIAA PFF ¶¶ 879-80; DiMA PFF ¶ 349. Yet this is precisely why Professor Landes found it probative. As he explained, it makes little sense to look within markets covered by or related to Section 115 as evidence of the market rate for mechanical rights. *See* Landes WDT (CO Trial Ex. 22) at 22-23; 2/7/08 Tr. at 2080 (Landes). By definition, the prices in those markets will be influenced by the statutory rate.

460. Finally, the RIAA claims that there is a dearth of evidence concerning the history of the AHRA and the negotiations leading up to it. RIAA PFF ¶¶ 882-83. Professor Landes, however, first addressed the AHRA in his written direct testimony, Landes WDT (CO Trial Ex. 22) at 24, and the RIAA was free to present evidence during the rebuttal phase of this proceeding on any aspect of the AHRA concerning its relevance for setting a mechanical royalty rate. The RIAA chose not to do so. As a result, Professor Landes's testimony stands unrebutted.

D. Professor Landes's Empirical Work is Sound and Provides Support for a Rate Increase

461. The RIAA and DiMA each take issue with empirical studies performed by Professor Landes that show the need for a mechanical rate increase. The RIAA levies a series of criticisms concerning Professor Landes's study of discounted licensing through HFA, claiming that Professor Landes inappropriately excluded a large number of licenses and that his analysis understates discounting. RIAA PFF ¶¶ 1026-81. The evidence is to the contrary. For its part, DiMA claims that Professor Landes's study of songwriter income was methodologically deficient. DiMA PFF ¶¶ 290-92. But the evidence shows that the issues identified by DiMA were fully addressed at trial and provide no reason to doubt that songwriter income has been declining in real terms.

1. The RIAA's Criticisms of Professor Landes's Analysis of the HFA Licensing Data are Meritless

462. The RIAA attempts to undercut Professor Landes's testimony by taking issue with his study of discounted mechanical licensing through HFA. The RIAA claims that Professor Landes misprocessed the licensing data that he received from HFA and that his exclusions of certain licenses during his study had the effect of misrepresenting the trend in licensing under the statutory rate. RIAA PFF ¶ 1027. The record evidence does not support this conclusion.

463. The RIAA's criticism is based exclusively on testimony proffered by discredited witness David Alfaro, who the Court refused to qualify as an expert, 5/6/08 Tr. at 4976-77 (Sledge, C.J.). The record shows that the observations of Mr. Alfaro did not affect Professor Landes's work or conclusions in any way. CO PFF ¶¶ 577-81. Indeed, Professor Landes unequivocally rejected Mr. Alfaro's criticisms, testifying that

they did not affect his results whatsoever. 5/20/08 Tr. at 7514 (Landes). As Professor Landes explained to the Court, he and his staff reviewed Mr. Alfaro's testimony and found it to be inaccurate or misleading in all respects. *See* 5/20/08 Tr. at 7514, 7396-7401, 7543 (Landes). Professor Landes stood by all of the empirical work he presented, as well as the conclusions he drew from that work. *Id.* at 7514.

464. And while the RIAA purports to draw a contrary conclusion, Mr. Alfaro himself did not claim that the purported exclusions affected the results of Professor Landes's analysis. As he put it on one of several occasions: "I don't have an opinion on what should or should not have been included. I am only reporting on what was excluded and included in his analysis." 5/6/08 Tr. at 5041 (Alfaro); *see also id.* at 5014-15, 5041, 5053. As a result, Mr. Alfaro's testimony provides no basis for challenging any aspect of Professor Landes's work.

465. The record shows that the RIAA's claims are either wrong, premised on incorrect assumptions or irrelevant, and that many are based on distortions of Professor Landes's testimony.

(a) Background on Professor Landes's Study of Discounted Licensing

466. The Copyright Owners' Proposed Findings addressed Professor Landes's analysis of discounted licensing in detail. CO PFF ¶¶ 569-76. We summarize here the pertinent assumptions, parameters and conclusions.

467. Professor Landes conducted a study of HFA licensing to ascertain what current mechanical license rates imply about the appropriateness of the statutory rate. Landes WDT (CO Trial Ex. 22) at 28. Frequent discounting would indicate that the statutory rate is above the average price that would obtain in a free market. *Id.*

Conversely, infrequent discounting would suggest that the statutory rate is lower than the average rate that would be seen in a competitive market. *Id.*

468. Professor Landes analyzed the fraction of discounting below the statutory rate in the data for HFA's physical and permanent download licenses. *Id.* at 28-32, 39-40, Figures 4-5 and 6-7. The RIAA ignores the stated parameters of Professor Landes's study, repeatedly claiming—incorrectly—that Professor Landes conducted a study of "digital" licensing. *See, e.g.,* RIAA PFF ¶ 1039. As explained below, such a broad study of "digital" licensing would be both infeasible and uninformative. *See infra* Section VI.D.1.b.v.

469. Professor Landes conducted two separate studies of mechanical licensing for physical phonorecords—one that excluded licenses issued under controlled composition clauses and one that did not. He found that the fraction of non-controlled physical licenses issued below the statutory rate had been generally declining over the period 1996 to 2005. CO PFF ¶ 572; *see also* Landes WDT (CO Trial Ex. 22) at 30, Figure 4. Professor Landes saw the same declining trend in discounting when he weighted these licenses by the number of units sold. CO PFF ¶ 573; *see also* Landes WDT (CO Trial Ex. 22) at 31, Figure 5.

470. Professor Landes's rebuttal testimony reported an analysis that included both controlled and non-controlled licenses for physical products. Landes WRT (CO Trial Ex. 406) at 33-34. He found "the same pattern" he had found in the data presented in his direct testimony: "whether or not licenses for compositions subject to controlled compositions are included, the fraction of HFA licenses issued at less than the full statutory rate has declined." *Id.* at 34.

471. The decline in discounting led Professor Landes to conclude that the statutory rate is constraining the market and that the average market rate is above the statutory rate. Landes WDT (CO Trial Ex. 22) at 29-32 (study exclusive of controlled licenses); Landes WRT (CO Trial Ex. 406) at 34 (study inclusive of controlled licenses).

472. Professor Landes also analyzed HFA's licensing data for permanent downloads. He found that "the rate for virtually all permanent downloads of noncontrolled compositions is the full statutory rate." Landes WDT (CO Trial Ex. 22) at 39; *see also id.* Figure 6, Figure 7. As with the data for physical products, Professor Landes concluded that the statutory rate had acted as a ceiling on the rates that would be negotiated for permanent downloads in the absence of a statutory rate. *Id.* at 39-40.

473. Although the RIAA claims that Professor Landes's conclusions "appear to ignore the provision in the DPRA" that precludes the use of controlled composition clauses to acquire mechanical licenses below the statutory rate, RIAA PFF ¶ 1038, the RIAA ignores the fact that Professor Landes's analysis of permanent download licensing addressed only "noncontrolled licensing." Landes WDT (CO Trial Ex. 22) at 39, Figure 6, Figure 7. Nothing in Section 115 prevents the record companies from negotiating below the statutory rate for permanent downloads outside the context of controlled composition clauses. *See infra* Section VII.C.1.d. An analysis of noncontrolled licensing of permanent downloads is entirely sound and indeed highly probative of the appropriateness of the current rate. *See id.*

(b) Each of the RIAA's Criticisms of Professor Landes's Study is Baseless or Without Merit

474. The evidence as a whole demonstrates that Professor Landes's analysis is sound and provides support for an increase in the statutory rate. Nothing in Mr. Alfaro's testimony can overcome that conclusion.

(i) The RIAA Incorrectly Claims that the Inclusion of Controlled Licenses Would Have Altered Professor Landes's Conclusions

475. The RIAA claims that Professor Landes's exclusion of licenses issued pursuant to controlled composition clauses tainted the analysis in his direct testimony by overstating the trend in discounting. RIAA PFF ¶¶ 1066-71. In fact, in his rebuttal report, Professor Landes included all of HFA's controlled licenses in his study and found that they did not alter his finding that discounting had declined over the 10-year period he examined. Landes WRT (CO Trial Ex. 406) at 33-34. Mr. Alfaro claims that including these controlled licenses "would have altered Dr. Landes's conclusions about the number of licenses issued below the statutory rate." Alfaro WRT (RIAA Trial Ex. 77) at 7. His testimony is not only rebutted by Professor Landes's work, it is inconsistent with his own.

476. Mr. Alfaro's analysis shows that, since 1996, the number of licenses below the statutory rate for physical products has declined. RIAA PFF ¶ 1067, PFF Figure 60. Mr. Alfaro conceded as much when he testified. 5/6/08 Tr. at 5043 (Alfaro) ("A trend line specific to this chart over the entire period would be downward sloping."). The RIAA ignores this ten-year trend by focusing only on what happened between 2003 and 2005. RIAA PFF ¶ 1067. Thus, Mr. Alfaro's more comprehensive review of the data supports the conclusion reached by Professor Landes.

477. The RIAA further claims—incorrectly—that if controlled licenses were included in Professor Landes's first study, "it is no longer true that the average rate for physical licenses is closer to the statutory rate in later years than in early years" and "[t]o the contrary, the two increase at about the same rate, and in fact begin to diverge in 2004." RIAA PFF ¶ 1068. But the figure submitted by the RIAA to support that argument—PFF Figure 61—demonstrates the opposite. The difference between the average rate for physical licenses and the statutory rate is smaller in 2005 than in 1996. *See id.*, PFF Figure 61. Mr. Alfaro so conceded at trial, acknowledging that the gap between the average rate and the statutory rate in 2005 was "roughly half" of what it was in 1997. 5/6/08 Tr. at 5047 (Alfaro); *see also id.* at 5046 ("It appears that the gap did decrease over time."). The RIAA's Proposed Findings treat this testimony as if it never occurred.

478. The RIAA further claims that "had Dr. Landes included controlled licenses . . . the differential in the average rate would increase during the period from 2000-2005." RIAA PFF ¶ 1069. Yet this analysis merely shows that when discounting occurs, the discounts have become slightly higher. *See id.* Unlike an effective rate calculation, this does not say anything about the average statutory rate when rates in both discounted and undiscounted licenses are considered. *See* 5/6/08 Tr. at 5049-50 (Alfaro). Thus, by the RIAA's logic, if there were 500,000 licenses at 75% of the statutory rate in 1996, and just one license at 50% of the statutory rate in 2005, "the differential in the average rate would increase."

(ii) There is No Basis for the Claim That The HFA Licensing Data Contained "Substantial Gaps"

479. The RIAA claims that there were "substantial gaps in the license number sequencing maintained by HFA, suggesting that there may be a substantial amount of data missing from Dr. Landes's data pool." RIAA PFF ¶ 1046. The evidence does not support the suggestion.

480. The RIAA points only to gaps in the license numbers that HFA provided to Professor Landes. RIAA PFF ¶ 1046. Yet Mr. Alfaro conceded that he "cannot say with certainty that gaps in the license number sequencing are caused by missing HFA data." Alfaro WRT (RIAA Trial Ex. 77) at 3. He acknowledged that if HFA used different sequences of initial license numbers to represent different years when licenses are issued, then many gaps would be expected. 5/6/08 Tr. at 5013 (Alfaro). Mr. Alfaro further admitted that he had no knowledge regarding HFA's practice of voiding licenses when it is subsequently discovered that they were granted for the wrong songs. *Id.* at 5014-15. He conceded that this too could have explained the gaps he observed. *Id.* As a result, Mr. Alfaro cannot support the claim that the gaps were due to missing data. He is merely speculating.

(iii) The RIAA's Claim that Professor Landes's "Data Dictionary" Was Flawed is Baseless

481. The RIAA argues that Professor Landes's study was corrupted by a flawed "data dictionary," which the RIAA claims was "false and misleading." RIAA PFF ¶ 1053. These claims are little more than an attempt to mask the mistakes of Mr. Alfaro, who was required to submit corrected testimony because he misread the data underlying Professor Landes's work.

482. Critical to an assessment of the RIAA's claims is the evidence of Mr. Alfaro's inexperience utilizing the statistical packages that formed the basis of his

testimony. He has never written an expert report about STATA, the statistical package used by Professor Landes to produce his study. 5/6/08 Tr. at 4964 (Alfaro). Nor has he ever prepared an expert report that required the use of SQL, the statistical package that Mr. Alfaro used to analyze Professor Landes's work. *Id.* at 4965-4966. As the Court observed, Mr. Alfaro was not even in a position to legitimate the results of SQL. 5/6/08 Tr. at 4977 (Sledge, C.J.).

483. Mr. Alfaro's inexperience led to the creation of an initial report that was so riddled with errors that he was forced to submit corrected testimony prior to his appearance before the Court. 5/8/08 Tr. at 4979-85 (Alfaro). The source of these errors was Mr. Alfaro's misprocessing of a "data dictionary" that he received as backup to Professor Landes's work. 5/8/08 Tr. at 4979-85 (Alfaro). This data dictionary was used to convert raw HFA licensing data into a form that could be manipulated and analyzed by statistical software. Although Professor Landes worked with that data dictionary in the statistical package STATA, Mr. Alfaro chose to work with it in SQL. *Id.* at 5021-22; *see also* Alfaro WRT (RIAA Trial Ex. 77) at 2-3. Due to differences in how STATA and SQL handle the type of data dictionary Professor Landes employed, Mr. Alfaro's use of SQL led him to misprocess the data. *See* 5/8/08 Tr. at 5022-25 (Alfaro).[7]

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[7] As a result of his carelessness, Mr. Alfaro's initial testimony made two central claims that, by his own admission, turned out to be wrong. First, Mr. Alfaro inaccurately claimed that Professor Landes had failed to account for 144 "configuration codes," which identify in the HFA data the type of products associated with a particular license. 5/6/08 Tr. at 5034-35; *see also* Alfaro WRT (RIAA Trial Ex. 77) at 4. Second, Mr. Alfaro claimed that Professor Landes had excluded 215,000 licenses from his analysis because they lacked a configuration code. *Id.* at 5018-21. This claim was also inaccurate and, as Mr. Alfaro acknowledged, the result of his mishandling of the data. *See id.*

484. Mr. Alfaro was alerted to the flaws in his first study only through counsel for the Copyright Owners. 5/6/08 Tr. at 4984, 5030 (Alfaro). He has never spoken with anyone at HFA about any aspect of the data. *Id.* at 5010. And, notwithstanding the RIAA's claims to the contrary, RIAA PFF ¶ 1056, he failed to conduct even basic diagnostic tests that might have alerted him to the relevant differences between the statistical packages. *See id.* 5/6/08 Tr. at 5030-32 (Alfaro).

485. Rather than take responsibility for his own inexperience and error, Mr. Alfaro seeks to pin responsibility on Professor Landes, claiming that he was supplied with a "false and misleading" data dictionary. RIAA PFF ¶ 1053. He was provided with nothing of the sort. As Mr. Alfaro conceded, if he had used the STATA software that Professor Landes employed, he would have reached the exact same results. *Id.* at 5058; *see also id.* at 5022 ("There are inherent issues across programs that are undocumented."). As he acknowledged, the type of data dictionary at issue is simply processed differently in SQL than it is in STATA. *Id.* at 5022-25. Professor Landes, who did his work in STATA, would have had no reason to believe that Mr. Alfaro would have chosen to use a different program to duplicate his work.

486. The RIAA also claims that if Mr. Alfaro had used STATA rather than SQL to duplicate Professor Landes's work, he would have misclassified approximately 30,000 licenses as physical "when, in fact, they may be digital." RIAA PFF ¶ 1054. Tellingly, this claim appears nowhere in Mr. Alfaro's (corrected) report. *See* Alfaro WRT (RIAA Trial Ex. 77). It was made for the first time during his testimony before the Court. *See* RIAA PFF ¶¶ 1053-56 (citing only Mr. Alfaro's live testimony). To this day, it has never been backed up by any testable analysis by Mr. Alfaro, yet the RIAA asks the

Court to take it on faith that—this time—Mr. Alfaro has gotten it right. The RIAA is entitled to no such presumption. If Mr. Alfaro and the RIAA wanted to make this claim, they should have done it pursuant to this Court's rules—in Mr. Alfaro's written testimony. *See* 37 C.F.R. § 351.11 (requiring written rebuttal statements to be filed "in the same form and manner" as written direct statements); *id.* § 351.4 (requiring written direct statements to include "all testimony"). On the record as it stands, Mr. Alfaro's off-the-cuff testimony is entitled to no weight.

(iv) Professor Landes's Exclusion of "Orphaned Licenses" Was Justified

487. The RIAA claims that Professor Landes "excluded over five thousand licenses (5,192) ["orphaned records"] on the basis that HFA failed to identify a configuration code for them." RIAA PFF ¶ 1063. The RIAA inaccurately suggests that the absence of this information resulted in the omission of relevant data from Professor Landes's study. *See* RIAA PFF ¶ 1063.

488. In testimony the RIAA does not mention, Mr. Alfaro conceded that he had "no opinion" on whether the omission of these licenses altered Professor Landes's results. *Id.* at 5019. And with good reason: by its terms, Professor Landes's study deals only with licensing of physical products and permanent downloads. There is no way to determine for what type of product a license has been issued if it lacks such a configuration code. *See* Alfaro WRT (RIAA Trial Ex. 77) at 4.

489. Further, these 5,192 licenses accounted for just .07% of all licenses in the HFA database. Alfaro WRT (RIAA Trial Ex. 77) at 4. At trial, Mr. Alfaro conceded that this was "a very small percentage" of the nearly 8 million licenses contained in the data.

5/6/08 Tr. at 5019 (Alfaro). By definition, the omission of this tiny fraction could not have altered the results of Professor Landes's study.

490. The RIAA compounds its error by claiming that of this meager number of licenses, "most were licenses that had rates that were discounted below the statutory rate." RIAA PFF ¶ 1063. In fact, just eight of these were identified with rates of "reduced" or "controlled" and thus could reasonably have been called "discounted." Alfaro WRT (RIAA Trial Ex. 77) at Appx. B; *see also* 5/6/08 Tr. at 5051 (Alfaro). Nearly 1,000 were marked as "statutory," while the balance were marked as "Other Non-Stat / Negotiated" or, in one case, "CV TBD." Alfaro WRT (RIAA Trial Ex. 77) at Appx. B; *see also* 5/6/08 Tr. at 5051-52 (Alfaro).

491. The RIAA has no evidence to support its claim that licenses categorized with rate types of "Other Non-Stat / Negotiated" were issued below the statutory rate, only another assumption by Mr. Alfaro. *See* 5/6/08 Tr. at 5052-53 (Alfaro) ("I assume that negotiation means negotiating less than statutory"). The claim assumes that HFA licenses only Section 115 products and only at the statutory rate, but the evidence shows otherwise. For instance, HFA entered into a number of agreements prior to the Ringtones Opinion that licensed musical compositions for use as ringtones and mastertones. *See* CO Trial Ex. 11, CO Exs. 18-22, 24, 28, 29, 34, 36-39. Many of these agreements contain a minimum denominated as a percentage of revenue, but in all cases, there is a penny rate or penny minimum at or above 10 cents—above the Section 115 statutory rate. *See id.* Mr. Alfaro knew nothing about these ringtone agreements. 5/6/08 Tr. at 5052-53 (Alfaro). Nor could Mr. Alfaro rule out the possibility that HFA handles other types of

licensing for the exploitation of musical compositions for non-Section 115 uses, *id.* at 5054, which by definition need not contain rates at or below the statutory rate.

(v) Professor Landes Justifiably Excluded "Other Digital" Licenses

492. The RIAA also criticizes the exclusion from Professor Landes's study of four million licenses processed and categorized as "other digital." RIAA PFF ¶ 1064-65. Once again, there is no evidence that this was improper. In fact, Mr. Alfaro testified that he had "no opinion" about whether these licenses should have been included, 5/6/08 Tr. at 5041 (Alfaro), and the RIAA does not claim otherwise, see RIAA PFF ¶¶ 1064-65. Nor could they: the vast majority of the licenses were for "Covered Services," that is, for subscription services licensing limited downloads and interactive streams, not permanent downloads. 5/6/08 Tr. at 5040 (Alfaro). As a result of the rateless deal made by the NMPA in 2001 to launch those services, CO PFF ¶ 125, those licenses had rates denominated as "CV TBD," that is, to be determined. 5/6/08 Tr. at 5042 (Alfaro); see Israelite WDT (CO Trial Ex. 11), CO Exs. 3, 46, 47, 48 (defining subscription services as "Covered Services" and providing rateless licenses).

(vi) The RIAA's Claims About Professor Landes's Classification of Physical Licenses Are Unsupported by the Record

493. The RIAA claims that Professor Landes's classification of physical licenses is "both overinclusive and underinclusive." RIAA PFF ¶ 1079. The first claim is inaccurate; the second provides no reason to discount Professor Landes's work.

494. First, the RIAA claims that Professor Landes's physical license pool was "overinclusive because it includes licenses for formats that are actually digital formats." RIAA PFF ¶ 1080. It did not. Professor Landes explained that certain digital

configurations were classified as "physical" in an interim step in his analysis, but they were excluded from his analysis on alternative grounds—namely, that they lacked any identifiable rates. *See* 5/20/08 Tr. at 7396-7401 (Landes). As Mr. Alfaro noted, the majority of these licenses were identified with configurations for "Streaming"—licenses that contained no rates. *See* Alfaro WRT (RIAA Trial Ex. 77) at 11 (noting that these licenses had no rate descriptions); *supra* Section VI.D.1.b.v (discussing rateless licenses issued by HFA for on-demand streaming). The suggestion that Professor Landes erroneously included digital licenses in his study of discounting of physical products is "completely incorrect." 2/11/08 Tr. at 7401 (Landes).

495. Second, the RIAA claims that the physical license pool was "underinclusive" because if a license had both a configuration for a physical product and a permanent download, it was classified only as a permanent download. RIAA PFF ¶ 1081. However, had Professor Landes counted these licenses as both permanent download and physical licenses, it would have provided even further evidence that discounting is decreasing because the licenses he supposedly excluded, licenses for permanent downloads, are virtually all at the statutory rate, Alfaro WRT (RIAA Trial Ex. 77) at 9, 5/6/08 Tr. at 4999 (Alfaro), Landes WDT (CO Trial Ex. 22) at Figures 6-7.

(vii) The RIAA Incorrectly Claims that Professor Landes Improperly Excluded Over 735,000 "Discounted" Licenses From His Analysis of Physical, Non-Controlled Licenses

496. The RIAA also criticizes Professor Landes for excluding from his analysis of physical, non-controlled licenses more than 735,000 licenses "because the rate is listed as negotiated or the rate description is listed as reduced but the exact amount of the rate is not specified." RIAA PFF ¶ 1073. But it is incorrect to assume that these "negotiated"

licenses were issued for rates below the statutory rate. As result, it is incorrect to assert that their exclusion "definitively altered the outcome of Dr. Landes's analysis." *Id.* ¶ 1074. It is particularly incorrect to do so because, as the RIAA acknowledges, many of those licenses were not for physical product. RIAA PFF ¶ 1075.

(viii) Professor Landes's Study Was Based on Robust Data

497. The RIAA further claims that Professor Landes's analysis is limited because it focuses only on HFA. RIAA PFF ¶ 1030. Moreover, according to the RIAA, the declining trend in discounting may simply be attributable to HFA's declining market share because discounting occurs more frequently when copyright users license directly from Copyright Owners. *Id.* ¶¶ 1031-36.

498. The RIAA's claims overlook the undisputed fact that Professor Landes's study focuses only on HFA and that his analysis included millions of licenses that were provided to copyright users over the course of a decade. *See* 2/7/08 Tr. at 2111-12 (Landes); Alfaro WRT (RIAA Trial Ex. 77) at 6. The head of NMPA testified that HFA represents "between 65 to 85 or 90 percent of the market," including "thousands and thousands of publishers." 2/4/08 Tr. at 1384 (Israelite).

499. Moreover, the evidence does not support the claim that HFA's market share has declined significantly over the period covered by Professor Landes's study. Mr. Alfaro conceded that he did not know whether Professor Landes's study had been affected by any such decline. 5/6/08 Tr. at 5057-58 (Alfaro). In addition, the RIAA cites the purely speculative testimony about HFA's market share from Mr. Finkelstein. RIAA PFF ¶ 1033; A. Finkelstein WRT (RIAA Trial Ex. 84) at 29. The only numbers put forward by the RIAA purport to show a decline in licensing through HFA by just one

record company, Universal, but the period covered by those numbers (2001-2007), RIAA PFF ¶ 1032, is not the same as the period in Professor Landes's study (1996-2005) and cannot be used to make any inferences as a result. The RIAA also claims that WMG labels "showed a similar drop," RIAA PFF ¶ 1032, yet the decline covers an unspecified time period, rendering it even less useful. Santisi WRT (RIAA Trial Ex. 78) at 25.

500. The RIAA has not produced any data showing that Professor Landes's analysis does not hold true on an industry-wide basis. Not one of the 11 record company executives who appeared before this Court produced any data showing a decline in HFA's market share, even though such information, if it existed, would be in their possession. *See, e.g.,* 5/6/08 Tr. at 5056-57 (Alfaro). Rather, the RIAA relies on speculative testimony from fact witnesses with no empirical data, and figures from two record companies that do not cover the period addressed by Professor Landes's study.

(c) Conclusion

501. The RIAA's claims regarding Professor Landes's processing of the HFA licensing data are unsupportable. The RIAA relies exclusively on the work of Mr. Alfaro, but his ignorance of relevant facts in evidence, in conjunction with assumptions that are unsupportable, corrupt his entire testimony. Moreover, Mr. Alfaro stated repeatedly at trial that he had no opinion regarding whether Professor Landes's exclusion of the various categories of licenses was inappropriate. 5/6/08 Tr. at 5014-15, 5041, 5053 (Alfaro). Professor Landes confirmed that any such suggestion would be wholly inaccurate. 5/20/08 Tr. at 7514, 7396-7401, 7543 (Landes). In short, the RIAA's claims are meritless.

2. DiMA's Criticisms of Professor Landes's Songwriter Income Study Are Meritless

502. DiMA's Proposed Findings take issue with the songwriter income study included in Professor Landes's Written Rebuttal Testimony. DiMA PFF ¶¶ 290-92. According to DiMA, the "errors in Dr. Landes's mechanical royalty study, and his inadequate efforts to correct them at the eleventh hour, raise questions about the overall reliability of Dr. Landes's conclusions and their utility to the Court." DiMA ¶ 292. The evidence does not support this faulty inductive reasoning.

503. Professor Landes's songwriter income study is addressed in detail in the Copyright Owners' Proposed Findings of Fact. ¶¶ 265-79. We summarize here the relevant aspects of the study's methodology and Professor Landes's conclusions.

504. To assess trends in songwriter income, Professor Landes conducted a study of nearly 10,000 songwriters from Universal Music Publishing Group. Landes WRT (CO Trial Ex. 406) at 8. His data revealed that songwriter income has been declining and that a substantial number of songwriters depend heavily on income from mechanical royalties. *Id.*

505. Professor Landes analyzed both mechanical royalty income and total royalty income earned during the period 2000 to 2006 by songwriters whose compositions were administered by UMPG. *Id.* He examined two groups of songwriters: (1) a "full songwriter sample," which contained 9,438 songwriters whose songs had reported royalty earnings in every year from 2000 to 2006; and (2) a "songwriter subgroup," a group of 4,164 songwriters that remained from the full songwriter sample after excluding the 95 songwriters in the top one percent of all royalty earners (songwriters who earned on average more than $[redacted] per year) and the 5,179

songwriters who on average earned less than $[redacted] per year. *See id.* at 8-9. Professor Landes analyzed both the average and median royalty earnings of these sets of songwriters. *See id.* at 8-10.

506. Professor Landes's study yielded three principal findings. First, Professor Landes found a decline in mechanical royalty income earned by UMPG songwriters over the period 2000 to 2006. CO PFF ¶¶ 272-74; *see also* Landes WRT (CO Trial Ex. 406) at 8-9; 5/19/08 Tr. at 7214 (Landes). Second, the pattern of results for trends in total royalty income demonstrated that a reduction in mechanical royalty income would likely reduce the earnings of many songwriters. CO PFF ¶¶ 275-77; *see also* Landes WRT (CO Trial Ex. 406) at 8. Third, Professor Landes found that a large number of songwriters depend heavily on income from mechanical royalties. CO PFF ¶¶ 278-79; *see also* Landes WRT (CO Trial Ex. 406) at 11.

507. In an effort to dismiss Professor Landes's study, DiMA seizes on Professor Landes's acknowledgment of certain data processing errors that occurred during the execution of his study. DiMA PFF ¶¶ 290-92. These issues, however, were fully addressed at trial, and the evidence shows that they did not affect the trends that Professor Landes observed or the conclusions he drew. *See* 5/19/08 Tr. at 7124-31 (Landes).

508. Professor Landes testified that the issues that the RIAA identified had a "[n]egligible" impact on his original work, *id.* at 7124, and that with respect to his analysis of songwriter income over time, the principal effects of correcting the testimony would have been (a) to increase the sample sizes in his study to include songwriters who were mostly low-earners and (b) as a result, to decrease the absolute values of mean and

median songwriter income, *see id.* at 7124-31. The trends in income in his original testimony were unaffected. *See id.* Of the songwriters included in his original, admitted study, Professor Landes explained that their earnings would "increase slightly" if the RIAA's concerns were addressed, *id.* at 7125, and that this effect would only occur for the data in the years 2005 and 2006, *id.* at 7127. Professor Landes reached these conclusions by assigning proxy values for songwriters' royalty income in 2005 and 2006 in the event that their earnings fell below the threshold values required to put their songs in the top 99,999 Royalty or Income songs for those years. 2/19/08 Tr. at 7176-78.

509. DiMA suggests that Professor Landes's remediation was inadequate because he was unable to acquire the full data from UMPG. DiMA PFF ¶292. But as Professor Landes explained, the assignment of these proxy values was the most conservative method possible, which meant that in many cases Professor Landes's corrected study overstated what UMPG's songwriters earned in 2005 and 2006. 2/19/08 Tr. at 7176-78.

510. DiMA's second error is its claim that Professor Landes "acknowledged that it is impossible to determine how many songwriters (and consequently how much mechanical income) was [sic] excluded as a result of this error." DiMA PFF ¶ 291. Professor Landes clearly testified that when he reran his study with the proxy values, it resulted in the addition of approximately 750 songwriters. 2/19/08 Tr. at 7176-79 (Landes). DiMA's claim that Professor Landes could not determine "how much mechanical income" was excluded is likewise weak, because as Professor Landes explained, his remediation assumed the highest possible mechanical income for those individuals in his original and corrected studies. *See id.* at 7176-78.

511. In short, DiMA has failed to show any justification for disregarding Professor Landes's songwriter income study. The evidence shows that although minor data processing errors took place during the execution of the study, the impact of those errors was negligible and did nothing to affect Professor Landes's conclusions.

VII. The RIAA's Proposed Benchmarks Are Fundamentally Flawed

A. Overview

512. The RIAA claims that it has identified two "market" benchmarks: (1) the effective mechanical royalty rate (i.e., the rate at which mechanical licenses are actually paid in the market); and (2) the rate for the "first use" of musical compositions. *See* RIAA PFF ¶¶ 575-667. In addition, although the RIAA seemingly abandoned Professor Teece on rebuttal, it now also asserts that his interpretation of the 1981 CRT decision and the 1997 settlement between the Copyright Owners and record companies provide evidence for a reduction in the mechanical rate. *See id.* ¶¶ 662-91. And the RIAA argues that international rates are appropriate benchmarks for the U.S. mechanical royalty rate and that these too support a rate reduction. *See id.* ¶¶ 697-776. But the weight of the evidence demonstrates that each of these purported benchmarks is flawed and provides no basis for setting a statutory rate.

513. The Copyright Owners' Proposed Findings of Fact explained in detail why the effective and first use rates are inappropriate benchmarks upon which to base a statutory rate. *See* CO PFF ¶¶ 675-98. The RIAA's Proposed Findings provide no reason to conclude otherwise. Indeed, not a word in the 650 pages submitted by the RIAA comes to grips with the concession by Professor Wildman, the architect of the effective and first use rate benchmarks, that these rates are derivative rather than independent of the statutory rate. *See* 5/12/08 Tr. at 5893 (Wildman) (the effective rate

"is not independent of the statutory rate" because negotiations for licenses "take place in the context of the overhang of the statutory rate"); *id.* at 5894 (first use rates are "influenced by the statutory rate"). As a result, the effective and first use rates fail the fundamental test for any useful benchmark in this proceeding: they must be the product of a market that is not constrained by a statutory license. As the Librarian observed, it is critical to account for the "constraining effect the mechanical license has on copyright owners in setting a value on their reproduction and distribution right." In re Determination of Reasonable Rates and Terms for the Digital Performance of Sound Recordings, 63 Fed. Reg., 25394-01, 25405 (May 8, 1998) ("PSS").

514. In resurrecting its reliance on the CRT's 1981 decision, the RIAA's prolix Proposed Findings ignores completely the fundamental changes in the recorded music industry in the last 30 years that render any reliance on that decision misplaced. As Professor Teece conceded, the industry has undergone "transformational change" since 1981. 2/19/08 Tr. at 3640 (Teece). As a matter of simple logic, this concession undermines the suggestion that a decision from nearly 30 years ago can be used as a benchmark for the purposes of a proceeding today. *See* CO PFF ¶¶ 665-66. And the RIAA's Proposed Findings also completely fail to take into account that Professor Teece's derivation of a 7.8% of wholesale revenue benchmark rate from that decision is based on a flawed assumption that led him to abandon the 7.8% rate at trial. *See* CO PFF ¶¶ 667-74. As Professor Teece admitted, his derived rate should have been 8.7% of wholesale revenue, not 7.8%. 2/19/08 Tr. at 3683-84 (Teece). Similarly, Professor Teece's analysis of the 1997 settlement between the record companies and the Copyright Owners—which he claims implied a rate at the time of 7.1% of wholesale revenue, Teece

WDT (RIAA Trial Ex. 64) at 28-29—relies on the baseless assumption that the parties sought to tie the agreed-upon penny rate to the price of CDs.

515. As for international rates, the RIAA has failed to explain why rates set in different countries under different laws and different mechanical licensing regimes should provide a benchmark for setting a reasonable royalty for a compulsory license that comports with the requirements of Section 801(b). Moreover, the Copyright Owners have already shown that the markets the RIAA has chosen—the U.K. and Japan—are not appropriate comparators and that a more comprehensive review of international rates provides no support for the RIAA's claim that the U.S. mechanical rate is unusually high. *See* CO PFF ¶¶ 709-25.

516. In support of these flawed benchmarks, the RIAA's Proposed Findings make a number of claims concerning the impact of controlled composition clauses and the role of transactions costs that are unsupported by the weight of the evidence. In particular, the RIAA claims that reduced mechanical rates in controlled composition clauses are reflective of the "market rate" for mechanical rights. The RIAA ignores the other forms of consideration that songwriters receive for these reduced rates, as well as the evidence showing that controlled composition clauses are inextricably linked to the statutory rate. In addition, the RIAA argues that transactions costs in the mechanical licensing market prevent licensees from using the compulsory license (such that the statutory rate cannot truly act as a ceiling) and that such costs inhibit the ability of parties to negotiate below the statutory rate. The evidence is to the contrary. The record provides no support for the claim that the compulsory license is prohibitively burdensome. Moreover, the evidence makes clear that the transactions costs in the

mechanical licensing market do not prevent parties from agreeing to reduced mechanical rates when it is in their mutual interests to do so. *See, e.g.,* 2/5/08 Tr. at 1666-68 (Peer); 2/12/08 Tr. at 2704 (Firth); Faxon WRT (CO Trial Ex. 375) at 15.

B. The RIAA's Claim that this Court's Precedent Requires a Benchmark "In Which the Exact Same Rights Are At Issue for the Same Consumer Product" Is Wrong

517. There is a fundamental reason why the effective and first use rates fail as benchmarks: the rates are derivative of the statutory rate. *See* CO PFF ¶¶ 675-98. Having overlooked this fatal infirmity, the RIAA purports to find support for its benchmarks in the Webcasting I decision, where "the CARP and the Librarian found that a transaction for the exact product at issue—non-interactive webcasting—was the best benchmark for setting rates and terms for the statutory license at issue and needed little adjustment." RIAA PFF ¶ 559. But the RIAA's reliance on Webcasting I is misplaced and nothing in that decision counsels this Court to rely on rates that are derived from the compulsory rate.

518. The RIAA's argument ignores entirely that in Webcasting I, both the CARP and the Librarian concluded that an ideal marketplace benchmark "is one in which no compulsory license exists." Webcasting I CARP Decision at 21; *see also* Webcasting I Librarian's Decision, 67 Fed .Reg. at 45244 ("the rates should be those that a willing buyer and willing seller would have agreed upon in a hypothetical marketplace *that was not constrained by a compulsory license*") (emphasis added). As explained in Section VI.C above, the Copyright Owners have proposed the only benchmarks not influenced by the statutory rate for the compulsory license.

519. Second, although it is true that in Webcasting I, the CARP and the Librarian "found that a transaction for the exact product at issue—non-interactive

explained further below, the inferences that the RIAA draws from these elements of the market find no support in the record. With respect to the RIAA's proposed first use benchmark, the evidence is clear that first use rights are constrained by and intertwined with the statutory mechanical rate.

(a) The Statutory Rate Operates as an Effective Ceiling on the Mechanical Royalty Rate

525. The RIAA argues that because the rates paid for mechanical licenses never exceed the statutory rate, the true "market" rate for mechanical rights is below the statutory rate. Critical to this conclusion is the RIAA's claim that the compulsory license "is not a viable option" and that "it does not and cannot operate as a ceiling." RIAA PFF ¶ 623. This claim is contradicted by fact and expert testimony presented by both the Copyright Owners and the RIAA, as well as being inconsistent with the CRT's conclusion to the contrary in 1981.

526. As explained in the Copyright Owners Proposed Findings of Fact, *see* CO PFF ¶¶ 558-61, economists put forward by both the Copyright Owners and the RIAA agree that the statutory rate acts as a ceiling on the rates that can be negotiated for mechanical rights. *See* Landes WRT (CO Trial Ex. 406) at 39 (explaining that "the copyright owners cannot credibly hold out for a fee above the statutory rate, because everyone knows that statutory licenses at statutory rates are available to the record companies"); Landes WDT (CO Trial Ex. 22) at 12 (noting that "[n]o potential user will offer to pay a publisher more for the right to use a composition than he has to pay if he takes a compulsory license."); 5/15/08 Tr. at 6903-06 (K. Murphy) (testifying that because even the "most desirable songs" are available at the statutory rate through the compulsory license, the effect of the statutory rate is to allow bargaining below, but not

above, the statutory rate); 5/12/08 Tr. at 5900 (Wildman) (agreeing that the statutory rate "impose[s] a cap on what the marketplace might negotiate").

527. The economists' testimony was corroborated by fact witnesses for both the Copyright Owners and the RIAA. Andrea Finkelstein of Sony BMG—who the RIAA cites in support of its argument—testified that "[b]ecause there is the last resort of a compulsory license (*no matter how impractical*), publishers and writers almost always license use of any song at a rate no higher than the statutory rate." A. Finkelstein WDT (RIAA Trial Ex. 61) at 6 (emphasis added). Indeed, contrary to the RIAA's suggestion that the compulsory license is not a "viable option," RIAA PFF ¶ 623, Ms. Finkelstein stated clearly that if someone were to seek a rate above the statutory rate, "we would go compulsory if we had to." 2/14/08 Tr. at 3382 (A. Finkelstein); *see also* 2/14/08 Tr. at 3328 (A. Finkelstein); 2/5/08 Tr. at 1420-21 (Israelite) (explaining that "the rate serves as an artificial ceiling"). Rather than address this testimony, the RIAA simply ignores it.

528. All of this testimony, moreover, is consistent with the CRT's conclusion in 1981 concerning the impact of the statutory rate in negotiations for mechanical rights in the HFA and direct licensing market. The CRT held that copyright users "exploit the statutory rate payable under a compulsory license to keep their mechanical royalty costs as low as possible, fixing the [statutory rate] as a ceiling in all negotiations with copyright owners, even for first releases." 46 Fed. Reg. 10466 at 10482. The evidence here shows that, on this score, nothing has changed since 1981: Copyright users continue to use the statutory rate available under a compulsory license "as a ceiling" when they negotiate voluntary licenses with Copyright Owners. *See* CO PFF ¶¶ 558-64; *e.g.*, A. Finkelstein WDT (RIAA Trial Ex. 61) at 6; 2/5/08 Tr. at 1420-21 (Israelite).

529. The RIAA nonetheless argues that if the market rate for mechanical rights truly exceeded the statutory rate, there would be "some licensing above the statutory rate because Copyright Owners would be able to extract the statutory rate plus the transaction costs associated with the compulsory license" and "there would be significant use of the compulsory license because music publishers would demand market rates for voluntary licenses, forcing record companies to resort to the compulsory license." RIAA PFF ¶ 626. The RIAA's argument overlooks all of the evidence that explains why neither of these things occurs and ignores the fact that the Copyright Owners also benefit from avoiding the compulsory license.

530. First, as Professor Landes explained, it would be difficult to charge a premium for HFA and direct licensing in the form of a higher mechanical rate. Landes WRT (CO Trial Ex. 406) at 37-38. This is because any purported savings in transactions costs are incurred on a per-transaction basis, rather than on a per-copy, basis. *Id.*

531. Second, HFA and direct licensing "expands the demand for licenses." *Id.* Thus, it is in the Copyright Owners' interests to keep that process attractive and to induce additional licensing that in turn generates additional income. *Id.*

532. Third, HFA and direct licensing provide benefits not only to record companies but also to publishers, which benefit from efficiencies created through the use of a central licensing clearinghouse. *Id.* at 38. Publishers benefit when copyright users license through HFA because audits for late or unpaid royalties are easier to conduct when HFA serves as a conduit. *See id.* Alfred Pedecine, the Senior Vice President and Chief Financial Officer of HFA, testified that these audits result in the recovery of tens of millions of dollars per year on behalf of publishers. *See* Pedecine WRT (CO Trial

Ex. 394) at 7. From 1990 to 2007, HFA collected over $430 million through audits of its licensees. *Id.* at 6. Conducting these audits (and recovering these substantial sums) would be much more difficult if HFA did not induce licensing outside of the compulsory scheme. *See* Landes WRT (CO Trial Ex. 406) at 38.

533. Fourth, as Judge Roberts observed, it is in the Copyright Owners' interest to charge no more than the statutory rate because such pricing discourages copyright infringement. *See* 5/20/08 Tr. at 7283-84 (Roberts, J.). Not only does this increase compensation paid for the legitimate exploitation of musical works, it reduces the need to engage in costly anti-infringement litigation. *See id.*

534. Fifth, the RIAA asserts that the difficulties of compulsory licensing should permit Copyright Owners to extract rates above the statutory rate, by charging a premium for the savings in transactions costs that licensees see when they license through HFA or directly through publishers rather than through the Section 115 procedures. But there is no evidence that the costs associated with compulsory licensing are significant. 5/20/08 Tr. at 7280 (Landes). The witnesses put forward by the RIAA to claim the contrary conceded that they could not quantify such costs. *See* 5/12/08 Tr. at 5900-02 (Wildman); 5/12/08 Tr. at 5745-46 (A. Finkelstein). Indeed, if, as Ms. Finkelstein testified, there is always an implied threat to go compulsory if a publisher seeks more than the statutory rate, that threat could only be credible to the extent that the costs of pursuing that route are not onerous. *See* A. Finkelstein WDT (RIAA Trial Ex. 61) at 6; 2/14/08 Tr. at 3382 (A. Finkelstein).

535. In fact, the evidence that the RIAA cites to show "that the compulsory license itself is not a viable option" does not support its claim. *See* RIAA PFF ¶ 623.

Ms. Finkelstein of Sony BMG offered only the conclusion that compulsory licensing was more burdensome than HFA and direct licensing; she provided no quantitative evidence concerning the additional transactions costs that a licensee would have to incur in order to acquire a compulsory license. *See* A. Finkelstein WDT (RIAA Trial Ex. 61) at 5. Professor Wildman simply echoed the conclusory claims of Ms. Finkelstein, yet like Ms. Finkelstein, he provided no quantitative evidence of the transactions costs required by compulsory licensing. *See* Wildman WRT (RIAA Trial Ex. 87) at 31, 33; *see also* 5/12/08 Tr. at 5901-03 (Wildman) (conceding that he had done no empirical analysis of the relative costs of compulsory and HFA and direct licensing). Nor did he acknowledge (much less analyze) the benefits that accrue to publishers through HFA and direct licensing. The testimony of Mr. Emmer of Shout! Records also failed to demonstrate that compulsory licensing is "not a viable option," RIAA PFF ¶ 623. All that he said is that it is "just simpler to go to Harry Fox." 5/13/08 Tr. at 6272 (Emmer). Mr. Israelite, the last witness the RIAA cites, made a similar point: Far from claiming that compulsory licensing was infeasible, he testified that HFA made licensing easier in order "to facilitate licensing." 2/5/08 Tr. at 1301 (Israelite).

536. All of the evidence highlights the fundamental flaw of the RIAA's argument: There is no evidence to prove that the compulsory license is an unrealistic option. In fact, the RIAA's principal witness on this issue, Ms. Finkelstein, has stated just the opposite. Rather, in an effort to induce licensing for a variety of reasons, the Copyright Owners and copyright users have settled on a well-functioning, streamlined process for the administration of mechanical licenses that allows each of the parties to achieve efficiencies that might not be possible through the compulsory process. But that

is far short of a showing that the compulsory license "is not a viable option," RIAA PFF ¶ 623.

(b) The RIAA's Assertion That Publishers Bear the Exclusive Burden of Administrating Mechanical Licenses Is False

537. As further support for its claim that the market rate for mechanical licenses is below the statutory rate, the RIAA claims that "Harry Fox—and the music publishers and songwriters—exclusively bear the transaction costs when record companies obtain mechanical licenses from HFA, in the form of a commission taken from the publishers' share of the mechanical payment made by the record company." RIAA PFF ¶ 613 (emphasis in original). According to the RIAA, "[t]hat Copyright Owners have taken on this burden at no cost and significant benefit to copyright users is a reflection that the price paid for such streamlined licenses—9.1 cents—is actually above the fair market value of the rights at issue." *Id.* ¶ 615. This argument overlooks the incentives on the part of publishers to induce HFA licensing and, in fact, is contradicted by evidence that the RIAA itself put in the record about the costs to record companies of HFA and direct licensing. *See* RIAA PFF ¶ 1415-22.

538. First, it is not only the "copyright users" who benefit from HFA's system of licensing. That system provides substantial benefits to Copyright Owners. *See supra* Section VII.C.1.a. The ease of HFA licensing expands the demand for licenses, generating additional licensing income for publishers. Landes WRT (CO Trial Ex. 406) at 38. HFA's system also generates additional benefits for Copyright Owners, including but not limited to the facilitation of audits that have generated tens of millions of dollars in royalty revenue each year. *See id.*; Pedecine WRT (CO Trial Ex. 394) at 6-7. Moreover, a simple system to facilitate licensing discourages copyright infringement on

the part of copyright users who might otherwise avoid acquiring a license at all. *See* 5/20/08 Tr. at 7283-84 (Roberts, J.).

539. Second, the RIAA's claim that Copyright Owners "exclusively" bear the cost of administering mechanical licenses is undermined by the RIAA's own submission. The RIAA claims that "[t]he administration of mechanical licenses is a labor-intensive enterprise that requires major investments by record companies." RIAA PFF ¶ 1415. The RIAA describes the administration of voluntary mechanical licenses as "expensive," *id.* ¶ 1417, and claims that record companies "make significant investments in the systems necessary" for voluntary mechanical licenses. *Id.* ¶ 1422. This evidence flatly contradicts the assertion that the Copyright Owners bear the "exclusive" burden of mechanical licensing.

(c) Reduced Rates in Controlled Composition Clauses Do Not Constitute a Valid Benchmark

540. Contrary to the RIAA's claims, see RIAA PFF ¶¶ 592-608, the use of controlled composition clauses to obtain reduced mechanical rates is not evidence that the market rate is below the statutory rate. Rather, as explained in the Copyright Owners' Proposed Findings of Fact, the rates paid for licenses issued under these clauses are not independent "market" rates because they are arrived at as part of the negotiation of a series of interdependent financial arrangements between record companies and recording artists. *See* CO PFF ¶¶ 684-93.

(i) Rates Contained in Complex, Multi-Part Artist Contracts Cannot Be Used in Isolation as a Benchmark Rate

541. Controlled composition clauses are just one element of complex, multi-part artist contracts that govern a wide variety of rights. *See* CO PFF ¶¶ 686-89.

Economists for *both* the RIAA and the Copyright Owners agreed that the rates in these clauses are the result of trade-offs between other components of the agreement, as opposed to independent market rates. *See* Teece WDT (CO Trial Ex. 64) at 29 (noting that an "artist-songwriter [sic] would agree to [a controlled rate] only in exchange for other financial benefits, such as a higher 'advance' payment or a higher artist royalty rate."); 5/12/08 Tr. at 5892-93 (Wildman) (testifying that controlled composition clauses are part of artist agreements in which "a package of rights" are negotiated, including artist royalty rates, advances, recording costs and other terms); Landes WRT (CO Trial Ex. 406) at 35-36 (explaining that "[f]rom an economic standpoint, one cannot examine a single term from a package agreement that governs such a variety of issues, because parties to such agreements make trade-offs between various aspects of the agreement in order to reach a final arrangement"); K. Murphy WRT (CO Trial Ex. 400) at 15-16 (testifying that "controlled composition rates cannot be viewed in isolation because the parties to the artist agreements containing the controlled composition clauses are concerned with "the total compensation package," not optimizing each individual term). Mr. Faxon of EMI MP confirmed that trade-offs on the part of artists between various components of artist contracts are routine. *See* 5/14/08 Tr. at 6412-13 (Faxon).

542. The artist agreements produced by the record companies are entirely consistent with this testimony. The Sony BMG template recording artist contract covers not only mechanical royalties, but critical aspects of the financial relationship between the label and the artist such as [redacted]

[redacted]. CO Trial Ex. 297. The Warner Music Group artist contract covers the same matters, as well as [redacted]. CO Trial Ex. 56. Mechanical royalties are just one component of the complex web of financial arrangements between the recording artist and the label.

543. The CRT took note of precisely this fact in its 1981 decision. The Tribunal concluded that singer-songwriters "freely negotiate *their entire royalty packages*, including both artist royalties and mechanical royalties." 46 Fed. Reg. at 10483 (emphasis added). As economists on both sides in this proceeding have testified, and as Mr. Faxon confirmed as a matter of fact, it is just as true today that when artists enter into recording contracts, they are negotiating an entire package of rights—the constituents of which cannot be viewed in isolation.

544. In its Proposed Findings, the RIAA makes two arguments in its failed effort to attach independent economic significance to controlled rates.

545. First, the RIAA argues that "recording contracts are expressly severable—under the contract, each provision expressly and specifically stands on its own." RIAA PFF ¶ 644. But the severability clause that the RIAA points to is a standard contractual provision that allows the remainder of a contract to be enforced when one provision is determined to be unlawful or unenforceable. *See, e.g., Booker* v. *Robert Half Intern, Inc.*, 315 F. Supp. 2d 94, 106 (D.D.C. 2004). A severability provision does not imbue each and every provision in a complex agreement with the significance of an independent

market agreement. And no RIAA witness—including those charged with negotiating such agreements, such as Mr. Kushner—came forward to claim the contrary.

546. Other agreements in the record prove the weakness of the RIAA's claim. For example, the HFA/EMI Music mastertone agreement—covering just a single product—has a severability provision. Israelite WDT (CO Trial Ex. 11), CO Ex. 24 at 19. To be sure, the purpose of that provision was not to ensure that each rate was afforded independent significance; only one product at one rate is covered. A number of other contracts in evidence also covering just one product have severability provisions as well, further demonstrating the emptiness of the RIAA's argument. *See, e.g.,* Israelite WDT (CO Trial Ex. 11), CO Ex. 24 at 19, CO Ex. 18 at 16; Faxon WDT (CO Trial Ex. 3), CO Ex. 223 at 20; Faxon WRT (CO Trial Ex. 375), Ex. F at 17.

547. Second, the RIAA seeks to skirt around the bundled nature of their artist agreements by arguing that "the exchanges of consideration in a recording contract all relate to the compensation to be paid for one end goal—the commercialization of one or more sound recordings." RIAA PFF ¶ 644. Professor Murphy put the lie to this argument in his testimony. As he explained, when individuals negotiate multi-part contracts relating to a single product, it is in precisely those circumstances where rational economic actors will make trade-offs between various parts of the agreement. 5/15/08 Tr. at 6915-16 (K. Murphy). This is because the seller (in the case of a recording contract, the artist) is principally concerned with total compensation for the entire package of rights, not the value of any one component. *Id.* The same is not true where, as in the case of the NDMAs, parties are pricing "many different transactions." *Id.* 6915. In those situations, "there's a much greater incentive to make the [individual] prices in

that contract come close to those that would happen in the market" because "[i]f you underprice ones [sic] . . . everybody will gravitate toward buying the things that are underpriced and nobody will want to buy the things that are overpriced." *Id.* 6916.

548. In short, reduced rates in controlled composition clauses—the principal mechanism through which record companies achieve rate reductions—are not "market" rates. As economists on both sides agree, they are inextricably linked with other terms in artist contracts, and as a result, controlled rates cannot be viewed in isolation.

(ii) Controlled Rates Accepted by Co-Writers Are Not Market Rates

549. Essentially conceding that controlled rates paid to singer-songwriters are not market rates, the RIAA also seeks to rely on mechanical rates paid to "outside writers" who "regularly partner with artists and accept the same controlled rates because they understand that is what the marketplace demands if they are going to have their songs recorded." RIAA PFF ¶ 596. According to the RIAA, these agreements "focus only on mechanical royalties." *Id.* ¶ 583. The evidence is exactly to the contrary.

550. Agreements between outside writers and singer-songwriters cover more than just mechanical rates. The only RIAA witness to offer any evidence on this point conceded that other forms of consideration factor into the economics of the arrangement:

> Q: Mr. Wildman, before we leave Exhibit 313, you know, from your study of this industry over some period of time, that sometimes writers and co-writers enter into agreements, correct?
>
> A: Yes, I do.
>
> Q: And sometimes under those agreements the singer/songwriter will agree to pay advances or make some other kinds of payments to co-writers, correct?
>
> A: That's my understanding, yes.

> Q: And am I correct that the data that was provided to you by Sony does not tell you in any way whether the co-writers received any remuneration from the singer/songwriters in addition to the mechanical rights that are specified?
>
> A: No, it doesn't.
>
> Q: So if a particular contract said 7 cents per song, you don't know whether that was accompanied with a check for $100,000?
>
> A: No, I don't.

5/12/08 Tr. at 5921-22 (Wildman).

551. The RIAA's evidentiary support for its claim that co-writer agreements "focus only on mechanical royalties" does not contradict Professor Wildman's testimony and, indeed, does not support the RIAA's claim. The RIAA cites portions of Ms. Finkelstein's testimony, RIAA PFF ¶ 582, but the testimony called to the Court's attention says nothing of the sort. In fact, she said simply that controlled composition clauses are "a principal way[] that we obtain licenses." *See* 2/14/08 Tr. at 3330-3331 (A. Finkelstein). Similarly, the section of Professor Wildman's written testimony relied upon by the RIAA does not address at all the question of whether agreements between co-writers and recording artists deal only with mechanical rates. Wildman WRT (RIAA Trial Ex. 87) at 43. And his trial testimony was to the contrary.

552. Thus, the fact that co-writers accept controlled rates is no more relevant to an assessment of the market rate for mechanical licenses than the fact that singer-songwriters accept such rates in their recording contracts. In both cases, the writers' agreement to accept reduced rates is accompanied by other forms of consideration that make it impossible to isolate the independent "market" rate for mechanical rights.

(iii) The RIAA Ignores Professor Murphy's Empirical Study of Controlled Composition Clauses

553. The RIAA attempts to buttress its claim that the market rate has fallen in relation to the statutory rate by claiming that controlled composition clauses have become more onerous over time. *See* RIAA PFF ¶ 597. Specifically, the RIAA argues that "[c]ontrolled composition clauses . . . have increased in prevalence in recent years. That is precisely because the increases in the mechanical royalty rate over the last decade have so outstripped the value of the rights at issue." *Id.* Nowhere does the RIAA mention, much less rebut, the empirical study of controlled composition clauses in EMI Music recording agreements conducted by Professor Murphy that demonstrates that controlled composition clauses have not changed in response to increases in the mechanical rate.

554. As described in the Copyright Owners' Proposed Findings of Fact, *see* CO PFF ¶¶ 690-93, Professor Murphy examined actual artist contracts from EMI Music spanning the years 1953 to 2007 to test whether the rates in these contracts provided any support for the claim that controlled rates are independent, rather than derivative, of the statutory rate. K. Murphy WRT (CO Trial Ex. 400) at 14. As Professor Murphy explained, if controlled composition rates had any independent market significance, either the percentage reduction or cap on compensable songs should have adjusted downward over time as the statutory rate rose. *Id.* at 16. Neither of these things occurred. *Id.* Because the rates and caps have remained stable as the statutory rate has increased, the rates in controlled composition clauses are not indicative of an independent market rate. Rather, as Professor Murphy concluded, the rates obtained by controlled composition clauses are simply derivative of the statutory rate. *See id.* at 14-17.

555. The RIAA's claim is also inconsistent with the empirical analyses performed by Professor Wildman. His analysis of UMG, the only company for which he had data for more than one quarter, showed that 67% of the songs were licensed at the full statutory rate. 5/13/08 Tr. at 6018 (Wildman). That the largest recorded music company paid the statutory rate for the overwhelming majority of its songs in 2006 and 2007 is hardly evidence that record companies are resorting to increased use of controlled composition clauses to compensate for an above market statutory rate.

(iv) Negotiations Over Controlled Composition Clauses Are Distorted By the Absence of Meaningful Alternatives for Songwriters

556. The RIAA further claims that songwriters are free to refuse to accept controlled rates if they feel that they can acquire a better rate in the market by going to another company. RIAA PFF ¶ 604. According to the RIAA, the fact that this rarely occurs is evidence that the value of mechanical rights does not exceed the standard controlled rate (75% of the statutory rate). *See id.* The RIAA's argument, however, fails to account for the market dynamics that limit the choices of singer-songwriters.

557. As Mr. Faxon of EMI MP explained, the four major record companies account for approximately 85% of the market, reducing the leverage of songwriters to obtain artist agreements without controlled rates. Faxon WRT (CO Trial Ex. 375) at 11; *see also* 1/31/08 Tr. at 1012 (Robinson) ("[S]ince almost every record company, every major record company seems to engage in that practice, the choice is, I become an artist or I don't become an artist."). The evidence shows that three of the four majors use the same percentage rate reduction in their controlled composition clauses. *See* K. Murphy WRT (CO Trial Ex. 400) at 16 (standard controlled rate in EMI Music's artist contracts is 75% of the statutory rate); [redacted]

[redacted]. There is nothing in the evidence to suggest the UMG's practice with respect to the terms of its controlled composition clauses is any different. The claim that singer songwriters have market choices with respect to controlled composition arrangements is, therefore, illusory.

(v) A Statutory Rate Based on Controlled Composition Rates Will Not Reduce the Prevalence or Impact of Controlled Composition Clauses

558. Another flaw in the RIAA's attempt to use controlled composition rates as a benchmark for the "market rate" is that the continued use of controlled composition clauses by the record companies would ensure that Copyright Owners would never be paid that rate. *See* CO PFF ¶¶ 690-93. The evidence shows that if the mechanical rate goes down, controlled composition clauses would simply be tied to the new, lower statutory rate—further depressing what the RIAA claims is the independent "market rate" for mechanical rights.

559. This is the only conclusion to be drawn from two key pieces of evidence. As Professor Murphy showed, controlled composition rates have been historically unresponsive to changes in the statutory rate. K. Murphy WRT (CO Trial Ex. 400) at 14-17. No matter what the level of the statutory rate, these clauses have almost typically effected a reduction of 25% off the statutory rate. *See* CO PFF ¶¶ 690-93; *supra* Section VII.C.1.c.iii. Ms. Finkelstein of Sony BMG conceded the point. As she testified, if this Court accepted the RIAA's proposal for a rate reduction, her company's controlled composition rate "would just be pegged to the new statutory rate." 5/12/08 Tr. at 5744

(A. Finkelstein). The result is that the Copyright Owners would be deprived of even the below-market "market rate" urged by the RIAA. And in 2012, when the RIAA would once again argue that the "market rate" should be tied to the then-prevailing effective rate, the downward spiral caused by the RIAA's circular reasoning would be repeated to result in an even lower rate to which controlled composition clauses would continue to apply.

560. In response, all that the RIAA can say is that they would expect less discounting once a lower statutory rate were in place. RIAA PFF ¶ 646. The RIAA's sole support for this claim is speculation from Professor Wildman, who performed no empirical work to support his seat of the pants conclusion. *See* 5/12/08 Tr. at 5838-39 (Wildman). In fact, as the testimony of Professor Murphy and Ms. Finkelstein makes clear, there is no reason to believe that the record companies' quest for ever lower rates would end with the adoption of the rate that they seek.

(d) Contrary to the RIAA's Claim, the Pattern of Discounting in the HFA and Direct Licensing Markets for Mechanical Licenses Demonstrates that the Market Rate for Mechanical Rights Exceeds the Current Statutory Rate

561. The RIAA's claim that discounting in the voluntary market supports a rate reduction is at odds with the weight of the record. Although there is discounting in the market, the majority of mechanical licenses that are not governed by controlled composition clauses are struck at the statutory rate and the evidence as a whole demonstrates that the market rate for mechanical rights exceeds the statutory rate. This conclusion is buttressed by the evidence concerning the absence of discounting for permanent downloads—evidence that the RIAA attempts to brush aside by wrongly claiming that such discounting is precluded by Section 115.

562. First, the RIAA concedes that the principal mechanism for acquiring discounts from the statutory rate is through the use of controlled composition clauses. *See* RIAA PFF ¶¶ 592-608; Wildman WRT (RIAA Trial Ex. 87) at 39-41. As explained above, far from showing that the "market" rate for mechanical rights is below the statutory rate, the prevalence of licensing under controlled composition clauses simply shows that songwriters accept reduced rates when the reduced rate is accompanied with other forms of consideration. *See supra* Sections VII.C.1.c.i.; VII.C.1.c.ii.

563. Second, the record shows that licensing below the statutory rate outside of the context of controlled composition clauses occurs, *see* CO PFF ¶¶ 562-64, and that it is facilitated by the low transactions costs in the market, *see id.* ¶¶ 565-66. However, the weight of the evidence demonstrates that publishers agree to such discounts only in those circumstances when there is a good and sufficient business reason to do so. Mr. Peer, for example, explained that his company provides reduced rates for low-priced compilation albums. *See* 2/5/08 Tr. at 1666-68 (Peer). Mr. Firth noted that BMG "[f]airly often" licensed below the statutory rate when requested to do so because of the large number of tracks on an album. 2/12/08 Tr. at 2704 (Firth). And Mr. Faxon explained that EMI MP routinely grants reduced rates for "labels that specialize in compilations and/or budget products." Faxon WRT (CO Trial Ex. 375) at 15. It is also common for publishers to provide reduced rates for record clubs. *See, e.g.,* 2/12/08 Tr. at 2704 (Firth); 2/5/08 Tr. at 1667-68 (Peer).

564. The RIAA erroneously argues that this discounting is evidence that the market rate for mechanical rights is lower than the statutory rate. RIAA PFF ¶ 588. That is simply not so. The overwhelming volume of voluntary mechanical licensing occurs at

the statutory rate. On this point, there is no real dispute. The Copyright Owners have introduced systematic evidence demonstrating this to be the case. *See* CO PFF ¶¶ 569-76. The RIAA's principal rebuttal economist, Professor Wildman, examined rates in mechanical licenses as well. He found that 67% of mechanical licenses acquired by UMG were issued at the statutory rate. 5/13/08 Tr. at 6018 (Wildman). And the only comprehensive analysis of discounting, conducted by Professor Landes, showed that the frequency of discounts has declined, not increased, as the statutory rate has increased. *See* Landes WDT (CO Trial Ex. 22) at Figures 4, 5. This, he explained, demonstrated the opposite of what the RIAA claims: Professor Landes testified that the statutory rate is truncating licensing at rates that would exceed the statutory cap in a free market. *Id.* at 29-32.

565. Unable to fit the number of licenses at the statutory rate into its theory that the market rate is lower, the RIAA asserts that transactions costs defeat discounted licensing that would otherwise occur. *See* RIAA PFF ¶¶ 584-58, 616-21. Once again, the evidence points in the opposite direction.

566. There is no evidence that transactions costs in HFA and direct licensing are high. The large number of HFA and direct licenses that the record companies have entered into is evidence that transactions costs are, in fact, not a barrier to obtaining below-statutory rates when appropriate. Although it is true that licensing at the statutory rate may be easier than licensing at a discount, that is not the relevant question. The question is whether transactions costs preclude discounts when they are in the mutual interests of the record companies and the Copyright Owners. The evidence gleaned from the HFA and direct licensing that does occur is that they do not.

567. The RIAA's argument to the contrary rests on the false premise that absent transactions costs the Copyright Owners would always license at a discount. But why would they? As the CRT observed in 1981, parties are often able to "successfully bargain[] for discounts from the statutory rate," but under conditions of falling revenue, "copyright owners [will be] more insistent on receiving ceiling and near-ceiling mechanical royalty rates for their musical compositions." 46 Fed. Reg. 10466 at 10483.

568. The RIAA's claim concerning the magnitude of transactions costs to obtain voluntary discounts, RIAA PFF ¶ 619, is completely unsupported by the empirical evidence. The RIAA points to a hypothetical exercise engaged in by Professor Wildman that leads him to the indeterminate conclusion that the benefits of a rate reduction "*may well be less* than the cost of the time and talent involved in negotiating" the reduced-rate licenses. *Id.* (citing Wildman WRT (RIAA Trial Ex. 87) at 32 & n.42) (emphasis added). In the absence of empirical work that he did not perform, his speculative conclusion concerning the magnitude of transactions costs is entitled to no weight. *See* 5/12/08 Tr. at 5901-03 (testifying that he had done no empirical work on transactions costs in the mechanical licensing market). The only other evidence cited by the RIAA is that of Ms. Finkelstein, who claimed that she and her staff have issued "guidelines" discouraging the negotiation of discounts for albums that are expected to sell fewer than 50,000 copies. RIAA PFF ¶ 620 (citing Finkelstein WRT (RIAA Trial Ex. 84) at 27-28). But Ms. Finkelstein offered no evidence as to whether SONY BMG follows her "guidelines." Nor did she offer any evidence that any other record company has similar parameters for the negotiation of mechanical licensing rates.

569. The RIAA's arguments concerning discounting and the market rate for mechanical licensing are also inconsistent with the evidence concerning permanent downloads. There is no dispute on this record that licensing for permanent downloads almost always occurs at the statutory rate. *See* Landes WDT (CO Trial Ex. 22) at Figure 6, Figure 7; Alfaro WRT (RIAA Trial Ex. 77) at 9. Although Professor Wildman purported to study the activity in the mechanical licensing market, he looked only at licensing for physical products, on the flawed rationale that Section 115 does not allow licensing below the statutory rate. Wildman WRT (RIAA Trial Ex. 87) at 35. He did not look at the digital market. *Id.* Yet although the RIAA claims that Section 115 "compel[s] record companies to pay the statutory rate for digital downloads," RIAA PFF ¶ 590, the statute compels no such thing. The relevant provision precludes licensees from acquiring reduced rates through controlled composition clauses in artist contracts that postdate June 22, 1995. *See* 17 U.S.C. § 115(c)(3)(E)(i), (ii). Given the millions of songs available for download on iTunes and other services, Cue WDT (DiMA Trial Ex. 3) at 2; McGlade WDT (DiMA Trial Ex. 5) at 10, it is obvious that the statute does not prevent the application of controlled composition clauses to all permanent downloads. Indeed, Mr. Cue of Apple's iTunes testified that his service sold a large amount of "catalog or obscure stuff." 2/25/08 Tr. at 4253 (Cue); *see also* 2/4/08 Tr. at 1333-34 (Enders) (testifying that digital services seek as wide a catalog as possible).

570. Nor does Section 115 preclude record companies from negotiating for reduced rates on mechanical licenses for DPDs if it is done outside of the context of controlled composition clauses. *See* 2/5/08 Tr. at 1457 (Israelite). Mr. Kushner of

Atlantic Records explained that record companies can in fact conduct such negotiations with artists after they deliver their albums:

> CHIEF JUDGE SLEDGE: How does the restriction on contracts signed after — I think the testimony has been '95, maybe '96 – on controlled composition clauses impact that testimony?
>
> THE WITNESS: Well, the clause still exists, but the — the clause cannot be applied to digital recordings, digital masters of releases, except to the extent that the contracts were entered into prior to 1995.
>
> CHIEF JUDGE SLEDGE: Where is that in the contract?
>
> THE WITNESS: It doesn't — it's not in the contract. It's — it's by law, and we obviously have to adhere to the law. So the discussion at the time that we enter into recording agreements with people is we explain to them that under the copyright law, we cannot apply controlled composition clauses to digital releases. And we do not.
>
> With the sole exception, *Your Honor, if an artist is willing, after delivering the album, to — to alter that relationship contractually, and obviously, if there's no publisher involved who has a voice in that decision, we can agree otherwise,* and that's allowed under the law, from what I understand.

2/14/08 Tr. at 3499-3501 (Kushner) (emphasis added).

571. The fact is that the record companies do not obtain discounts for permanent downloads even though they are free to do so, either through the application of controlled composition clauses, or if precluded by Section 115, by direct negotiation. This indisputable evidence is completely inconsistent with the RIAA's claim that pervasive discounting demonstrates that the market rate is below the prevailing statutory rate. To the contrary, the evidence as a whole shows that discounting is the exception, not the norm. And, as Professor Landes has shown, discounting has become less

frequent, demonstrating that the market rate is, in fact, above the current statutory rate. Landes WDT (CO Trial Ex. 22) at 28-32.

(e) Rates for First Use Licenses Are Not Independent Market Rates

572. The RIAA also claims that rates for first use licenses provide an additional benchmark for the statutory rate. *See* RIAA PFF ¶¶ 648-53. They do not, because first use rates are not independent of the statutory mechanical rate. *See* CO PFF ¶¶ 694-98. Professor Wildman so conceded in testimony that the RIAA's Proposed Findings ignores entirely. He acknowledged that "because there's substitutability between first uses and second uses," first use rates are "not independent of the statutory rate." 5/12/08 Tr. at 5894 (Wildman). In this regard his testimony is consistent with that of Professor Landes, who made the point at both the direct and rebuttal trials that the rates for first uses are constrained by the statutory rate. *See* Landes WRT (CO Trial Ex. 406) at 40; 2/11/08 Tr. at 2387 (Landes).

573. The economists' testimony is also consistent with the conclusion reached by the CRT in 1981 that the statutory rate operates as a cap on the rates for first as well as subsequent uses. As the CRT observed, copyright users "exploit the statutory rate payable under a compulsory license to keep their mechanical royalty costs as low as possible, fixing the [statutory rate] as a ceiling in all negotiations with copyright owners, *even for first releases*." 46 Fed. Reg. 10466 at 10482 (emphasis added).

574. The RIAA's effort to sponsor a first use benchmark also neglects to take into account that first use rates are inextricably linked with controlled composition clauses, which do not distinguish between first and subsequent uses. *See* Faxon WRT (CO Trial Ex. 375) at 13; *see also* [redacted]

[redacted]. As a result, the rates paid for first uses cannot be a market benchmark because they are determined in substantial part by controlled rates that are derived from the statutory rate and set in the context of bundled agreements dealing with numerous financial arrangements between singer-songwriters and record labels. Professor Wildman again conceded the point at trial, acknowledging that a number of the first use rates he used in his study are rates specified in controlled composition clauses. 5/12/08 Tr. at 5895 (Wildman). For example, his study of Sony BMG releases showed that more than half of the first use songs were subject to controlled composition clauses. CO Trial Ex. 313 at 2 (showing that only 406 of 1033 songs were "not/out controlled"). And nowhere in his study did Professor Wildman report any rate for first uses of songs that were written by songwriters who were not subject to a controlled composition clause either directly or because they were co-writing with a singer-songwriter who was. 5/12/08 Tr. at 5916 (Wildman). As a result, he conceded that he had reported no rate solely for "pure" first uses. *Id.*; *see also* 5/12/08 Tr. at 5927 (Wildman) (conceding that for Warner Music he had done "no analysis for any song in which all of the writers are not subject to controlled comp").

575. Mr. Faxon of EMI MP provided corroborative testimony on this point. Faxon WRT (CO Trial Ex. 375) at 13 (explaining that first use licenses are typically contained in contracts with controlled composition clauses). [redacted]

576. The RIAA's claims concerning the utility of first uses as a benchmark also ignores the fact that songwriters will license first uses to get their songs into the marketplace so as to realize future earnings on subsequent uses. Mr. Faxon explained that when songwriters negotiate first use license rates, "the rate almost invariably will be at the statutory rate because, at that point, the songwriter's main objective is to get the song into the marketplace so he or she can realize future earnings." Faxon WRT (CO Trial Ex. 375) at 13. Professor Landes similarly testified that the rate set for first uses will often be set with an eye towards generating income from subsequent uses. Landes WRT (CO Trial Ex. 406) at 41; *see also* 2/11/08 Tr. at 2387-88 (Landes). A rate that is calibrated to encourage future use is not an appropriate benchmark for the statutory rate. *See* CO PFF ¶ 698. The RIAA claims Professor Landes's statements are unsupported by any data, RIAA PFF ¶¶ 651-52, but nowhere does it mention the testimony from Mr. Faxon, who provided direct support for this fact. Indeed, Mr. Faxon's testimony is uncontradicted: As the current head of EMI MP and the former CFO of EMI Group (the parent of EMI Music), Mr. Faxon is the only person in this proceeding who has testified directly, from first-hand experience, to the incentives of songwriters when they license their work for first uses.

577. Thus, the record clearly shows that first use rates cannot be considered independent market rates. As a result, the RIAA's proposal to use these rates as a benchmark is fatally flawed.

2. Professor Wildman's Empirical Work is Flawed and Cannot Be Used to Set a Statutory Rate

578. There is yet another reason why the effective and first use rates are entitled to no weight: the empirical work performed by Professor Wildman is too flawed to be relied upon. *See* CO PFF ¶¶ 699-706. The numerous issues with Professor Wildman's empirical work were addressed in his cross-examination.

579. First, Professor Wildman conceded that his colleague (the regressions were not performed by Professor Wildman) manipulated data from three record companies (he requested but could not get any data from EMI Music) without any direct communication at all with those companies. *See* 5/12/08 Tr. at 5910-11, 5928 (Wildman). All of his communications were funneled through counsel for the RIAA. *Id.* He did nothing to verify the accuracy of any of the data he received. *Id.*

580. Second, Professor Wildman's data were extremely limited: In the case of Sony BMG and Warner, he had information from only one quarter in 2006, and in the case of Universal, the data covered only 2006 and 2007. As a result, he could not opine on the representativeness of any of this data, *see* 5/12/08 Tr. at 5922-23, 5928-29, 5933 (Wildman), and because the data covered different time periods, he could not confidently perform any inter-company comparisons, *see id.* at 5844-45 (Wisniewski, J.). The limited time period for which Professor Wildman collected data also precluded a time-series analysis to assess whether effective mechanical and first use rates have, in fact, been rising over time. *See id.* at 5908-09 (Wildman). As Professor Murphy explained,

even accepting the RIAA's proposition that the effective rate could be relevant to setting the statutory rate, the critical analysis is the relationship between the effective mechanical rate and the statutory rate over time. 5/15/08 Tr. at 6906-07 (K. Murphy). Professor Wildman's data allowed for no such analysis. 5/12/08 Tr. at 5908-09 (Wildman).

581. Third, Professor Wildman reported only mean, as opposed to median, rates. The failure to report both leads to misleading results. For example, in the case of UMG, Professor Wildman found that 67% of licenses were at the statutory rate, indicating a median effective rate of 9.1 cents. *Id.* at 5998-99. Yet he provided none of this information in his written testimony, reporting only a mean overall effective rate of [redacted] cents. Wildman WRT (RIAA Trial Ex. 87) at 38.

582. Fourth, even the mean rates he reported were rates based on contractual rather than sales data. 5/12/08 Tr. at 5916-17 (Wildman). The failure to weight mechanical rates by sales rendered his conclusions even more unreliable.

583. Fifth, Professor Wildman's testimony included licensing data for co-writers who accepted reduced rates even though they were not themselves subject to controlled composition clauses. But he could not say whether any of those co-writers received additional remuneration, such as advances, in exchange for their agreement to take reduced rates. *See id.* at 5921-22, 5927-29. He failed to adjust his analysis for such payments despite the fact that he knew these exchanges often occur. *Id.* at 5921. Moreover, his data on transactions involving co-writers was extraordinarily limited. In the case of Warner, Professor Wildman reported an average payment of [redacted] cents per track, Wildman WRT (RIAA Trial Ex. 87) at 44, but nowhere in his report did he mention that this number was based on data for fewer than 43 songs, 5/12/08 Tr. at 5924-

25 (Wildman). For Sony BMG, he reported on only 405 songs that were not written by artists directly subjected to controlled composition clauses, and as to those, he did not distinguish between those songs that were written with singer-songwriters that were subject to controlled rates and those that were not. *Id.* at 5912-16. For Universal, he had no information at all about controlled composition, *id.* at 5931-32, rendering his analysis of songs written for that music label particularly non-probative.

584. Sixth, Professor Wildman undertook no study at all as to rates paid for digital uses. His stated reason was that the Digital Performance Right in Sound Recordings Act of 1995 "trumps controlled composition clauses and compels record companies to pay the full statutory rate, even if they can negotiate with singer-songwriters to pay less." Wildman WRT (RIAA Trial Ex. 87) at 35. As is shown above, however, parties are free to negotiate below the statutory rate for digital uses outside the context of controlled composition clauses. Because songwriters are licensing songs for both physical and digital distribution, the rate that is paid on physical product only tells you nothing about the effective rate actually paid to songwriters whose remuneration is determined not only by physical product but by digital as well.

585. The RIAA's Proposed Findings discuss none of this testimony. The failure to do so demonstrates the inherent weakness in benchmarks constructed on the basis of Professor Wildman's analysis.

D. Professor Teece's Testimony Concerning the 1981 CRT Decision and the 1997 Settlement is Entitled to No Weight

586. As additional support for its proposed rate cut, the RIAA points to the testimony provided by Professor Teece concerning the 1981 CRT decision and the 1997 settlement between the record companies and the Copyright Owners to set a mechanical

royalty rate for the subsequent decade. *See* RIAA PFF III.D. As is evident from his testimony at the direct trial, Professor Teece's opinion is entitled to no weight.

1. The 1981 CRT Decision is Not a Legitimate Benchmark

587. As the Copyright Owners explained in their Proposed Findings of Fact, there is no support for the use of a rate purportedly derived from the 1981 CRT decision as a benchmark in this proceeding. *See* CO PFF ¶¶ 664-76.

588. As an initial matter, it makes little sense to revert to a rate derived from a decision that is nearly 30 years old to inform the current mechanical rate, when all parties to this proceeding have testified to significant changes in the industry since then. Professor Teece himself argued that "the recording industry is in the midst of a significant and sustained disruption of its 'structure' and 'industry practices.'" Teece WDT (RIAA Trial Ex. 64) at 109. The RIAA echoes this claim in its Proposed Findings, writing that "the industry now confronts significant and sustained business challenges that are different in kind from the challenges highlighted by the CRT in 1981." RIAA PFF ¶ 671. Professor Teece further testified that "until 2000, this industry was going through what I called 'evolutionary change,' and there were ups and downs associated with new formats and business cycle issues. Now, I think we're in transformational change." 2/19/08 Tr. at 3640 (Teece). The industry today is "a completely different ball of wax," *id.*, and is undergoing a "structural shift." *Id.* at 3641. This testimony demonstrates just how inappropriate it is to rely on the rate he derived from the 1981 CRT decision.

589. In any case; the cross-examination of Professor Teece demonstrated that his analysis of the 1981 decision was too unreliable to be given any credence. The rate

he purported to derive from the 1981 decision—7.8% of wholesale revenue, Teece WDT (RIAA Trial Ex. 64) at 81—rested on a baseless assumption concerning the prevalence of discounting in 1981. As a result, Professor Teece's rate calculation was shown to be wholly unsupportable and Professor Teece himself posited the possibility that the correct rate could be 8.7% rather than the 7.8% he had sworn was a "ceiling" on an appropriate rate. 2/19/08 Tr. at 3683-84 (Teece).

590. The flaws in Professor Teece's rate calculation are fully addressed in the Copyright Owners Proposed Findings of Fact and will not be repeated at length here. *See* CO PFF ¶¶ 667-74. In short, although Professor Teece's calculation depended upon his assumption that all albums at the time of the CRT's decision were sold at retail list price, the evidence before the CRT (submitted by the RIAA itself) was to the contrary. *Id.* ¶¶ 670-76. As the RIAA puts it in its Proposed Findings, Professor Teece's calculation was expressly premised on the assumption that "[t]he 1981 CRT treated retail 'list price' ($7.98 in 1981) as the *functional equivalent* of actual retail price in its assessment of the relationship between price and the mechanical royalty rate." RIAA PFF ¶ 674; *see also* Teece WDT (RIAA Trial Ex. 64) at 80 (emphasis added); 2/19/08 Tr. at 3681-82 (Teece). At trial, the assumption was shown to be untrue.

591. The evidence before the CRT at the time of its 1981 decision demonstrates that the actual average retail price was $5.79—or 27 percent less than $7.98, the figure Professor Teece used. *See* 46 Fed. Reg. at 10477.[8] At trial, Professor Teece conceded that he had not considered this finding by the CRT before arriving at his opinion that

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[8] In its only reference to actual retail prices, the CRT cited a study by the RIAA showing that "during the period 1974-1979, the average actual selling price of LP's increased from $4.05 to $5.79." 46 Fed. Reg. at 10477.

7.8% of wholesale constituted a "ceiling" on a reasonable rate. 2/19/08 Tr. at 3780 (Teece). He also admitted that he had no knowledge of discounting practices in the industry at the time of the 1981 decision and had not seen the relevant pricing data prior to submitting his written testimony. *Id.* at 3787-88. Professor Teece's error renders his rate calculation wholly unsupportable; had Professor Teece performed the rate calculation correctly with an accurate understanding of the facts, his wholesale percentage rate would have been 38% higher than the 7.8% rate he initially proposed as a cap on reasonable rates in his testimony. *See* CO PFF ¶ 673.

592. Although Professor Teece's error was the subject of considerable testimony at trial, *see* 2/19/08 Tr. at 3772-96 (Teece), the RIAA's Proposed Findings are written as if his cross-examination never happened. Not one paragraph in the more than 1700 Proposed Findings addresses this issue. Not only has the RIAA pretended that these flaws were never uncovered, it has asked this Court—once again—to accept a benchmark rate calculation that it knows to be inaccurate and performed by an expert who swore under oath that the "ceiling" on a reasonable rate—7.8% in his written testimony, 8.7% in his live testimony—is lower than the rate that the RIAA now proposes. *See* Teece WDT (RIAA Trial Ex. 64) at 81 (stating that 7.8% is a "ceiling" on a reasonable rate); In the Matter of Mechanical and Digital Phonorecord Delivery Rate Adjustment Proceeding, Amended Proposed Rates and Terms of Recording Industry Association of America, Inc., Docket No. 2006-3 CRB DPRA (April 10, 2003), at 1-2 (proposing rate of 9% of wholesale revenue).

2. Professor Teece's Analysis of the 1997 Agreement Between Copyright Owners and Record Companies Does Not Support A Rate Decrease

593. The RIAA appears to find additional support for a reduction in the mechanical rate in the 1997 settlement between the Copyright Owners and the RIAA that resulted in the current 9.1 cent rate. Relying again on Professor Teece, the RIAA argues that this agreement, although perpetuating the historical penny rate, implied a statutory rate of approximately 7.1% of wholesale CD price, "consistent with historical norms." RIAA PFF ¶ 683. From this, the RIAA argues that the subsequent decline in wholesale CD prices requires a downward adjustment in the mechanical rate. *See id.* ¶¶ 687-91.

594. As an initial matter, the suggestion that mechanical royalties should fall as a result of the decline in wholesale CD prices is, as Professor Murphy has explained, wrong as a matter of economic theory and the application of that theory to the recorded music industry. CO PFF ¶¶ 726-37.

595. But there is an additional, fundamental reason why the RIAA's analysis of the 1997 settlement is fatally flawed: The parties never agreed that the mechanical royalty rate should be tied to the wholesale price of CDs. The agreement provided for semi-annual increases in the penny rate without any adjustment of the rate based on the price of CDs. Israelite WDT (CO Trial Ex. 11), CO Ex. 11 at 7. The suggestion on the part of the RIAA and Professor Teece that the parties sought to maintain a fixed relationship between the mechanical royalty rate and the wholesale price of CDs is merely revisionist history, unsupported by any evidence in the record.

596. Professor Teece claims that if "the parties (particularly the record companies) guessed right about the future in 1997, the agreed rates would have looked

much different." RIAA PFF ¶ 687. That may be true but cuts the opposite way from that suggested by the RIAA. As Mr. Robinson, the NMPA's longtime Chairman explained, a key assumption the Copyright Owners in concluding a deal was that that unit sales of CDs, which had been consistently increasing in the years prior to 1997, would continue to do so. Robinson WDT (CO Trial Ex. 8) at 4; *see also* Israelite WDT (CO Trial Ex. 11) at 8. As both Mr. Robinson and Mr. Israelite of NMPA testified, this assumption led the Copyright Owners to accept rates that were lower than they would have accepted had they anticipated the decline in CD sales because they expected to compensate for the lower-than-hoped-for rate by increased volume. Robinson WDT (CO Trial Ex. 8) at 4; Israelite WDT (CO Trial Ex. 11) at 8.

E. The RIAA Has Failed To Show That International Rates Support Its Proposal For a Rate Cut

597. Relying principally on the testimony of Geoffrey Taylor, the RIAA argues that the U.S. has one of the highest mechanical rates in the world. RIAA PFF ¶ 699. The RIAA purports to support its argument with a comparison of selected foreign rates expressed as a percentage of revenue with the current U.S. penny rate converted into a percentage of wholesale revenue. *Id.* ¶¶ 701-702, 748, 762. The RIAA's percentage analysis is fundamentally flawed because a comparison of percentage rates without analysis of the revenue bases against which the percentage is applied is not a comparison at all.

598. The RIAA's international math is this: the U.S. mechanical rate of 9.1 cents per song represented 12.93% of the wholesale CD price in 2005 and 14.8% in 2006. *Id.* ¶ 702. In the two countries selected by Mr. Taylor, the U.K. and Japan, the mechanical rate is 8.5% of the Published Price Dealer or PPD (U.K.) and 4.53% of retail

(Japan). *Id.* ¶ 702, PFF Figure 56. But those percentages, in and of themselves, provide no evidence of which countries have higher mechanical license fees because the percentages are applied to three different bases—CD prices, PPD and retail.

599. The RIAA's economist, Professor Teece, conceded the flaw in this type of analysis in his written testimony and at trial: "From an economic perspective when calculating royalties, any royalty rate must be applied to a corresponding royalty base. It makes no sense to set the rate independently of the base. The same dollar amount of royalties can be generated with a higher royalty rate on a smaller base or a lower royalty rate on a larger base." Teece WDT (RIAA Trial Ex. 64) at 74; 2/19/08 Tr. at 3758 (Teece).

600. No RIAA witness provided the Court with evidence from which the revenue bases in the U.S., U.K. and Japan could be compared. Professor Teece acknowledged that he had not conducted an independent analysis of the royalty bases in the U.S. and U.K. *Id.* at 3759. Mr. Taylor conceded that he did not include price in his analysis of physical rates. 2/12/08 Tr. at 2849 (Taylor). Mr. Boulton, an expert witness imported by the RIAA from a prior U.K. proceeding, testified that "PPD is not the equivalent of wholesale price...," Boulton WDT (RIAA Trial Ex. 54) at 8, but offered no testimony about how to convert the PPD rate against which U.K. rates are applied into a comparable U.S. royalty base.

601. In fact, the only evidence on the different revenue bases was provided by Mr. Fabinyi, the Copyright Owners' rebuttal witness. He testified that wholesale price could represent as much as a 40% discount from PPD. Fabinyi WRT (CO Ex. 380) at 7; 5/5/08 Tr. at 6796-6799 (Fabinyi). And although the RIAA has attempted to quibble

with the 40% figure, see RIAA PFF 725, there is no dispute on this record that PPD does not take into account any of the discounts that factor into wholesale price. Nor is there any dispute that the RIAA has offered no evidence whatsoever as to the degree of discounting that occurs in the U.K.

602. Nor did the RIAA provide the Court with any evidence as to how the various foreign percentage rates translate into actual revenue for Copyright Owners. Putting to one side the revenue base, a true comparison between the mechanical rate in the U.S. and another country would answer the question as to whether publishers and songwriters receive more or less for their compositions in that country than in the U.S. The RIAA did not even pose that question.

603. The Copyright Owners, however, did in the cross-examination of Mr. Boulton. Mr. Boulton was offered as a witness to "convert" the U.K. online rate into an equivalent U.S. wholesale figure. He testified that the U.K. permanent download rate of 8% translated into 7.7% of wholesale revenue. RIAA PFF ¶¶ 737-41. But the only relevant number is the one elicited in his cross-examination: that percentage rate results in payments to Copyright Owners for both mechanical and performance royalties of 10.4 cents per download. 2/13/08 Tr. at 2961-62 (Boulton).

604. Mr. Fabinyi filled in the evidence that the RIAA omitted from its discussion of international rates. Rather than simply report abstract percentages of revenue, he collected actual data from more than a dozen countries and computed the mechanical royalties paid to Copyright Owners per song. What his evidence shows is that the current U.S. rate of 9.1 cents is not among "the highest in the world," as the RIAA repeatedly and erroneously claims. CO PFF ¶¶ 722-23. Rather, mechanical

payments made to Copyright Owners for physical product in the United States are lower than any country he surveyed other than Canada. Fabinyi WRT (Co Trial Ex. 380), Ex. F-1. And while Copyright Owners fare somewhat better on a comparative basis for permanent downloads, the payments made solely for mechanical royalties in the U.S. still lag behind those in Denmark, Germany, Japan and Switzerland. *Id.* at Ex. F-2.

605. The RIAA's attempt to avoid the conclusions of Mr. Fabinyi's analysis center on their claim that it is inappropriate to convert foreign license payments into U.S. currency because of fluctuation in exchange rates. RIAA PFF ¶ 761. But there is no other basis on which a comparison of what is received by Copyright Owners in different countries could have been performed. And there is no evidence that Mr. Fabinyi chose the date for conversion for any improper reason. Rather, the date he selected, April 1, 2008, was the date the analysis was performed. *See* 5/15/08 Tr. at 6729 (Fabinyi). Had he done the calculations six months earlier, the results would have been the same. In November 2007, the exchange rate for the Euro was 1.4748. CO Trial Ex. 31. On April 1, 2008 the exchange rate for the Euro was 1.559. Fabinyi WRT (CO Trial Ex. 380), Exs. F-1 and F-2.

606. The RIAA further argues that differences in the manner in which European rates are promulgated make those rates inappropriate comparables. RIAA PFF ¶ 767 (acknowledging that "it is very important to understand the various legal and industry factors that influenced the setting of the rate"). Specifically, the RIAA alleges that the rates in other countries have been unilaterally promulgated by the collecting societies in the absence of regulatory oversight. RIAA PFF ¶¶ 768-69; *but see* 5/15/08 Tr. at 6802 (Fabinyi) (alleging that Japan may be an inappropriate comparator on this

basis because the Japanese rate is established pursuant to an industry agreement and has never been reviewed by an arbitrator or arbitration panel). The RIAA has it wrong.

607. As explained in the Copyright Owners Proposed Findings of Fact, the rates in Europe are not "unilaterally promulgated." CO PFF ¶ 724. In fact, both Messrs. Taylor and Fabinyi are in agreement that the current European rate was established as a result of an agreement between BIEM and IFPI. Taylor WDT (RIAA Trial Ex. 53) at 16-17; 2/12/08 Tr. at 2774-75 (Taylor). Mr. Taylor has testified that "if there has been a fair, full and free willing buyer/willing seller negotiation and both sides have agreed that a rate is appropriate, then that's fine." 2/12/08 Tr. at 2835-36 (Taylor). Moreover, as Mr. Fabinyi testified, and the RIAA has not disputed, both Germany and Switzerland—countries left out of the RIAA analysis—have a tribunal process in place. 5/15/08 Tr. 6806-07, 6829 (Fabinyi). In the absence of a formal tribunal process, most countries have anti-competition laws that prevent the unilateral promulgation of rates. CO PFF ¶ 724.

1. The Copyright Owners' Data on Mechanical Royalties Is Reliable

608. The RIAA also claims that the Copyright Owners' data on mechanical rates are unreliable and should not be given any weight. RIAA PFF ¶¶ 750-766. This argument is not new. It is a renewal of the RIAA's unsuccessful effort to exclude Mr. Fabinyi's evidence. *See* 5/15/08 Tr. at 6745-46; 6773-74 (Fabinyi). There is no more merit to the RIAA's argument now that the evidence has been admitted.

(a) Mr. Fabinyi is Knowledgeable on International Mechanical Rates

609. During the rebuttal hearing and again in its Proposed Findings of Fact, the RIAA argues that Mr. Fabinyi lacks personal knowledge about international mechanical

rates. 5/15/08 Tr. at 6745-46; 6773-74 (Fabinyi). To the contrary, virtually every job Mr. Fabinyi has ever held prepared him to give the evidence that he offered the Court.

610. Mr. Fabinyi has over 25 years of experience in the music industry. Today, he is the Managing Director of Mechanicals at the MCPS-PRS Alliance–a jointly owned operating company of two U.K. collecting societies. Prior to joining the MCPS-PRS Alliance, Mr. Fabinyi served as the Chargé de Mission for International Mechanical Rights Organization, Bureau International des Sociétés Gérant les Droits d'Enregistrement et de Reproduction Mécanique ("BIEM"), an international organization of mechanical rights societies, and Senior Consultant to the International Confederation of Societies of Authors and Composers ("CISAC"), an international trade organization of author and composer rights societies. Fabinyi WRT (CO Trial Ex. 380) at 11-12. At BIEM, Mr. Fabinyi was responsible for collecting information about mechanical rates around the world and negotiating industry agreements for the use of mechanical rights. 5/15/08 Tr. at 6704-05, 6707 (Fabinyi). Prior to that, Mr. Fabinyi worked in the record business as Group Managing Director of the Festival Group of Companies, which included Festival Records, Festival Music Publishing, Festival Studios, and Festival Mushroom Records, Australia's largest independent record company. *Id.* at 6703-04. Mr. Fabinyi is also a member of the BIEM Management Committee. *Id.* at 6710.

(b) Mr. Fabinyi's Methodology Is Not Flawed

611. The RIAA also attacks the manner in which Mr. Fabinyi collected the data on international mechanical payments that he reported to the Court. RIAA PFF ¶¶ 752-57. The RIAA argues that Mr. Fabinyi arbitrarily selected the countries to be included in his survey. What the evidence shows, however, is that Mr. Fabinyi set out "to provide a sample of information (5/15/08 Tr. at 6835 (Fabinyi))"as to "the range of . . . prices and

average number of tracks and royalties charged [by] various societies (*id.* at 6718)." Mr. Fabinyi did not attempt to do a comprehensive analysis of all mechanical license rates around the world. *Id.* at 6735 (testifying that "the intention was not to [provide] a comprehensive analysis of prices throughout the territory."). This fact does not render his review of more than a dozen countries including seven of the top 10 recorded music markets in the world "arbitrary." And there is no evidence that he omitted any countries because their rates did not fit his testimony.

612. Second, the RIAA claims that Mr. Fabinyi improperly relied on information collected by counsel for the Copyright Owners. RIAA PFF ¶¶ 753-754. The challenge rings hollow from a party which had its lawyers intermediate between its constituent record companies and its experts. 5/8/08 Tr. at 5517-18 (Benson) (testifying that he did speak to any record companies to determine if they maintained records concerning profitability by format); 5/12/08 Tr. at 5958, 65-66 (Wildman) (testifying that the NDMAs that he reviewed were presented to him by the RIAA and that he had not seen any data from the record companies concerning their view of the mastertone market in 2005). In any case, what the record actually shows is that Mr. Fabinyi was actively involved in the data collection process. He identified the most knowledgeable representatives from the various collecting societies. 5/15/08 Tr. at 6719-20 (Fabinyi). He participated in the drafting of the email inquiry that was sent to the foreign collecting societies. *Id.* at 6721. Although counsel for the Copyright Owners collected the data for Mr. Fabinyi's administrative convenience, see 5/15/08 Tr. at 6721-22 (Fabinyi), the record is clear that he reviewed the information prior to submitting his sworn statement and has vouched for its accuracy:

> Q: Okay. Now, does the entirety of the information on Exhibit F-1 come from just the e-mail inquiries?
>
> A: In terms of the PPDs of full price records, to a large extent, that's also something which I was broadly aware of, because in my time at BIEM, even though it was some time ago, it was important to keep an eye on those various — various issues. It's also worth noting that there is — even though there is a range of figures presented and that — there are many reasons why that may exist, there is also a consistency amongst them. And that makes sense as well because, in Europe, there's a principle of free movement of goods, such that if a . . . CD is publicly made available in Germany, for example, then it's legally licensed for sale in France as well. So you would imagine that between France and Germany and between the various territories, there's a lot of cross-buying of CDs. So there's very little opportunity for product which is released on an international basis . . . to have big variations in the price across various territories.

5/15/08 Tr. at 6727-28, 6749 (Fabinyi).

613. The RIAA argues that Mr. Fabinyi did not have an adequate basis to rely on the data he presented. The record shows, however, that Mr. Fabinyi collected data from expert mechanical licensing representatives with whom he routinely exchanged information in the ordinary course of business. 5/15/08 Tr. at 6723-25 (Fabinyi). For example, Mr. Fabinyi solicited and received information from the CEO of the Austrian mechanical rights organization. *Id.* at 6722. The information he received was broadly consistent across territories and with his own knowledge. *Id.* at 6766-67, 6848-49. He checked the U.K. data himself and asked each collecting society representative to confirm the accuracy of their data. *Id.* at 6729-30, 6765-66.

(c) The Rates Reflected in Mr. Fabinyi's Analysis Are Not Inflated

614. The RIAA also argues that Mr. Fabinyi "skewed" the results by relying on the average PPD only for full price albums. RIAA PFF ¶ 758-59. He did no such thing.

Rather, as Mr. Fabinyi explained, he selected the average PPD for full price albums to allow for a one-to-one comparison between the highest rate in the U.S. and the highest international rates. 5/15/08 Tr. at 6727 (Fabinyi). Moreover, his decision to select full price albums was influenced by the fact that full price albums represent the largest value and volume categories of CDs sold in the U.K. *See id.* at 6839-40.

2. Significant Differences Exist Between the Music Markets in the U.S., U.K. and Japan

615. Nothing in its Proposed Findings changes the fact that the RIAA has failed to demonstrate why this Court should look only to mechanical rates in the U.K. and Japan for guidance in setting the statutory rate. As demonstrated in the Copyright Owners' Proposed Findings and summarized below, the RIAA's fixation on the U.K. and Japan ignores fundamental distinctions between the markets, including the absence of a compulsory license in the U.K. and Japan, the prevalence of controlled composition clauses in the U.S. and the higher revenue base in the U.K. CO PFF ¶¶ 711-21.

616. There are fundamental differences between mechanical licensing in the U.S., the U.K. and Japan. *Id.* The compulsory license process in the U.S. and the prevalence of controlled composition clauses in the U.S. does not have a corollary in the U.K. or Japan. *Id.* ¶¶ 712-15. The comparison of U.S. and U.K. rates as percentage of wholesale revenue and PPD is flawed because "wholesale" in the U.S. is calculated *net* of discounts whereas PPD is calculated *before* discounts. *Id.* ¶¶ 717-18. The U.K. and Japanese markets are also distinguishable in terms of size and influence. *Id.* ¶ 721.

617. The RIAA does not refute these differences. Indeed, the RIAA's own international witnesses acknowledge the differences between the markets. *See* 2/12/08 Tr. at 2797-2802 (Taylor) (acknowledging that Japan provides less of a comparison);

2/12/08 Tr. at 2767 (Taylor), RIAA PFF ¶ 728 ("In the U.K., the Alliance has insisted on licensing only [to] music service providers and has refused to license [to] record companies where they are not the last link in the transmission of music to the users. . . . [I]n the U.S., record companies . . . generally obtain mechanical licenses and pay mechanical royalties for downloads"). Mr. Taylor testified, "it is very important to understand the various legal and industry factors that influenced the setting of the rate." RIAA PFF ¶ 767. The RIAA has failed to provide such an understanding. And Mr. Boulton testified that the comparability of international rates turns on the consideration of eight or nine factors, including the cultural significance of music, the legal regime and the nature of the copyright. 2/13/08 Tr. at 2943-44 (Boulton). There is no evidence in the record upon which such a comparison can be drawn.

618. Notably, the RIAA's own economist failed to endorse the notion that the rate in the U.K. and Japan should be used as a benchmark for setting the statutory rate. Professor Wildman specifically disclaimed that he had done any analysis that would permit him to support the U.K. rate:

> Q: Now, you're not claiming, are you, that you have done an analysis that would tell you that the rates in the U.K. are an appropriate benchmark?
>
> A: I have not.
>
> Q: You haven't studied the competitive circumstances in the U.S. and the U.K.?
>
> A: No, I haven't.
>
> Q: You haven't studied anything about demand characteristics —
>
> A: You mean comparing –
>
> Q: — in the two markets?

A: No, I have not.

Q: You haven't compared the bargaining positions in the two markets, correct?

A: No, I haven't.

Q: Similarly, you haven't done any of that analysis for the rates in Japan, correct?

A: That is true.

5/12/08 Tr. at 5987-88 (Wildman). The failure of the RIAA's own economist to endorse an international benchmark speaks volumes about the usefulness of such rates as a benchmark for the statutory rate.

VIII. The RIAA's Analysis of Derived Demand is Fundamentally Flawed

619. One of the central tenets underlying the RIAA's request for an unprecedented cut in the statutory rate is its claim that economic theory requires the mechanical license rate to go down as the price of CDs declines. *See* RIAA PFF ¶¶ 549-55. According to the RIAA's "derived demand" theory, because the value of inputs into a final product is "derived" from the final value of that product, a reduction in the value of the final product necessitates a reduction in the value of inputs. *Id.* ¶ 545. The proper application of economic theory does not support this conclusion.

620. The flaws in the RIAA's economics were exposed by Professor Murphy. Although the RIAA purports to find Professor Murphy in agreement with its claim by citing out of context snippets of his testimony, *see id.* ¶¶ 545-50, in fact, the central thesis of Professor Murphy's evidence was to the contrary; he demonstrated that a decline in the demand for recorded music does not entail a decrease in the statutory rate. *See* K. Murphy WRT (CO Trial Ex. 400) at 4-14; CO PFF ¶¶ 726-37.

621. The RIAA's reliance on its own economist, Professor Slottje, fares no better. He readily conceded that he had not done the necessary empirical work to reach a definitive conclusion concerning how a reduction in demand would affect mechanical royalties. *See* 5/8/08 Tr. at 5345-47, 5393-96 (Slottje). Professor Slottje testified that an appropriate analysis of derived demand would require an examination of how a reduction in demand had affected all of the principal inputs into recorded music, not simply the mechanical license. *See id.* at 5345-48, 5393-96.

A. Contrary to the RIAA's Claims, Professor Murphy's Explanation of Derived Demand in the Recorded Music Industry Undermines the Case for a Mechanical Rate Reduction

622. Notwithstanding the RIAA's assertion to the contrary, Professor Murphy is not an exponent of the RIAA's derived demand theory. Rather, he explained that there is no reason that the per-copy mechanical rate being set in this proceeding should decrease as the overall demand for recorded music decreases. K. Murphy WRT (CO Trial Ex. 400) at 6-14.

623. Professor Murphy's conclusion is premised on an analysis of the different types of costs associated with providing inputs into recorded music. *See* CO PFF ¶¶ 727-31. Songwriters, like recording artists, have "fixed" costs of production—i.e., the costs incurred to create a single composition do not change based on the number of units sold. K. Murphy WRT (CO Trial Ex. 400) at 6. Record companies, on the other hand, have both fixed and "variable" costs of production, such as manufacturing, distribution and marketing, that change based on the number of units sold. *Id.* at 6-7.

624. Because record companies have substantial variable costs, their incentive to supply inputs into the final product of recorded music is principally affected by a

reduction in price per unit, not the total amount of sales, because they are able to reduce their variable costs as demand decreases. The incentive to produce inputs with fixed costs of production, however, is affected by both a reduction in prices and the total number of units sold. *Id.* at 7; 5/15/08 Tr. at 6886-87 (K. Murphy). Thus, Professor Murphy demonstrated that when sales decline, "an equal reduction in the per-unit payment for the fixed cost and variable cost inputs would create a disproportionate reduction in the incentive to supply songwriting and other fixed-cost elements of the recording." K. Murphy WRT (CO Trial Ex. 400) at 7. Professor Murphy illustrated the point with an example:

> Consider what would happen if the amount paid per-recording to both the fixed and variable incentives were reduced by 10 percent, while sales per recorded song were reduced by 20 percent. The incentive to provide variable inputs (those provided on a per-unit basis) would fall by 10 percent, since they now receive 10 percent less per unit of input supplied. However, the incentive to supply songs and other fixed inputs would fall by 28 percent, because composers and others in the talent pool would now receive only 72 percent of what they received before for each song recorded (they would sell only 80 percent as many units and each unit would earn 90 percent of the amount it earned previously (0.8 times 0.9=0.72).

Id.

625. As a result, economic theory predicts precisely the opposite of what the RIAA posits: As Professor Murphy explained, under conditions of falling revenues and sales of recorded music, compensation per unit would need to rise for songwriters (and artists) but not for inputs with variable costs. K. Murphy WRT (CO Trial Ex. 400) at 8. "In the present context," with sales and prices falling, "in order to maintain the relative incentives to provide creative and distribution inputs, the relative compensation per recording for inputs in the creative step (including songwriters) must increase." *Id.*

626. Professor Murphy's proper application of economic theory is borne out by his empirical work. Professor Murphy examined the major record companies' cost and revenue information compiled by Linda McLaughlin, one of the RIAA's experts during the direct phase of this proceeding. *Id.* at 8-13. That data revealed a number of trends that confirm Professor Murphy's description of the relevant economic theory.

627. First, the percentage of the record companies' net sales revenue spent on creative inputs rose between 1991 and 2005. K. Murphy WRT (CO Trial Ex. 400) at 9; 5/15/08 Tr. at 6890-91 (K. Murphy). Professor Murphy found that artist royalties, which are likely to evolve in the same way as compensation for songwriters, had risen as a fraction of overall record company costs even as CD sales and prices fell. CO PFF ¶¶ 733-34; K. Murphy WRT (CO Trial Ex. 400) at 8-13.

628. Second, Professor Murphy examined the trends in compensation to the creative inputs exclusive of overhead costs. K. Murphy WRT (CO Trial Ex. 400) at 10; 5/15/08 Tr. at 6894-95 (K. Murphy). The data showed that artist and mechanical royalties had both increased as a share of non-overhead costs, as had the costs of royalties when combined with expenses for advances and recording (also creative costs). As Professor Murphy concluded, this is exactly what one would expect under conditions where manufacturing and distribution functions are becoming less important (due to the shift from physical to digital distribution). K. Murphy WRT (CO Trial ex. 400) at 10-11; 5/15/08 Tr. at 6894-95 (K. Murphy).

629. In making his argument, Professor Murphy drew a critical distinction—one ignored by the RIAA in its selective citation of his testimony—between compensation to songwriters on a per-song basis (i.e., the amount of royalties songwriters

receive in total for a given composition based on all of its sales) and compensation on a per-copy basis (i.e., the mechanical royalty rate). Professor Murphy explained that economic theory predicts that the Copyright Owners should receive a larger fraction of spending on recorded music when sales and prices decline, but he was careful to note that "this does not mean that their total compensation is unaffected . . . . As the number of units of recorded music falls, Copyright Owners receive less in mechanical royalties for any given royalty rate, with no corresponding reduction in their costs." *Id.* at 13. As he stated on cross-examination:

> Q: So a decrease in the demand for the final product will decrease the demand for inputs and decrease the usage and market prices of the inputs, right?
>
> A: That's right. So let's be sure — clear what we're saying here, though, because when we say that, what it means is when the demand for the final product goes down, distribution inputs will earn less. So the inputs used in the distribution phase will earn less. The inputs used in the creation phase will also get less. What that means is that if I am a copyright holder, say a songwriter, I will get less return per song. *That doesn't mean I am going to get less return per copy sold*, because if the number of copies sold goes down by 20 percent, and even if the return per copy sold went up by 15 percent, I would still take a 5 percent reduction in my compensation. And what economic theory tells us about is what's going to happen to their compensation; that is, *compensation for songwriters will go down when the market contracts. That's not synonymous with saying the rate will go down.* In fact, it's a question of whether the decline in demand pushes their compensation down more than it pushes sales. *If it pushes down sales substantially, you could very well have the rate actually rise and still have their total compensation* [*fall*].
>
> Q: You're getting ahead of me, Professor Murphy.
>
> A: Okay.
>
> Q: I am sticking with a fairly basic concept here at the moment. Okay? You would agree with me that if the

> demand for sound recordings falls, we can expect the demand for songs to fall, right?
>
> A: Yes.
>
> Q: And if the demand for songs, as an input to the sound recordings, falls, we can expect the market price for songs to fall, correct?
>
> A: The market price, yes, per song delivered, yes.

5/15/08 Tr. at 6920-22 (K. Murphy).

630. Turning this testimony on its head, the RIAA claims that Professor Murphy has endorsed their derived demand theory. Plainly, he has not. The RIAA's contrary claim is constructed by a distorted and selective quotation of his testimony that omits the core economic principles about which he testified. *See* RIAA PFF ¶¶ 547, 549 (citing 5/15/08 Tr. at 6920 (K. Murphy)); ¶ 550 (citing 5/15/08 Tr. at 6922 (K. Murphy)). The RIAA cites the last two questions and answers from the colloquy above without any citation at all of the distinction that Professor Murphy draws between per-song and per-copy prices. *See* RIAA PFF ¶ 550. But it is the per-copy, not the per-song price that is being set in this proceeding. Thus, if the RIAA is seeking support for its flawed theory that the mechanical rate must come down as the price of recorded music declines, it cannot rely on Professor Murphy.

B. Professor Slottje's Theory of Derived Demand is Entitled to No Weight

631. The RIAA's reliance on Professor Slottje is equally misplaced. *See* RIAA PFF ¶¶ 545-51. Professor Slottje testified at trial that "there's been a decrease in the demand, which has led to lower prices, and that should, Ceteris paribus, lead to a decrease in relative input prices." 5/8/08 Tr. at 5345 (Slottje); *see also* RIAA PFF ¶ 546. But Professor Slottje's conclusion depends on his assumption of "all other things being

equal." 5/8/08 Tr. at 5345-46 (Slottje). The absence of evidentiary support for his assumption fundamentally converts his conclusion concerning the relationship between demand and input pricing into unsupported speculation that is entitled to no weight.

632. Professor Slottje conceded that he had conducted no analysis of the prices for other inputs. *See* 5/8/08 Tr. at 5345-47, 5393-96 (Slottje). As he explained in response to a question from Judge Wisniewski, a decline in the demand for recorded music would not necessarily entail a reduction in the mechanical royalty rate if other inputs were appropriately considered:

> A: [O]verall, there's been a decrease in the demand, which has led to lower prices, and that should, Ceteris paribus, lead to a decrease in relative input prices. One of the input prices, of course, is the mechanical rate that goes to songwriters.
>
> Q: So all things being equal —
>
> [. . .]
>
> JUDGE WISNIEWSKI: Why does he want to hold everything equal?
>
> THE WITNESS: Because the — that's a good question. If — if the — if you assume — if you assume — as an economist, I honestly don't know the resolution to the issue if overall demand is increasing, but actual legitimate demand is decreasing, we would expect the inputs — the demand for the inputs to decline. If overall demand increases because of illegal activity and — does that mean the value of the input is higher or lower? Legally, I think you can — from the legal perspective or the legal portion of it, I think is lower. The overall, I don't know how to answer that.
>
> JUDGE WISNIEWSKI: Thank you.
>
> BY MR. SMITH:
>
> Q: So maybe to at least clarify it for me, if, in the marketplace, mechanical royalties were being set in a free

> market and the retail and wholesale value of recordings was going down because of decreased demand, what would you expect to happen to the amount of money being paid for songs in terms of mechanical royalties?
>
> A: A decline.
>
> JUDGE WISNIEWSKI: But, again, aren't you holding everything else equal, including the price of all other inputs and any other impacts on costs that could be had?
>
> THE WITNESS: *That's true.* And if — what I — *that's absolutely true.*
>
> JUDGE WISNIEWSKI: Thank you.
>
> BY MR. SMITH:
>
> Q: Well, could you explain a situation in which you wouldn't expect the — the costs of the input to decline because the cost of the output — the price of the output is declining?
>
> A: His Honor has brought up an excellent point. If there were other inputs in the production of sound recordings that were decreasing at a lower rate relative to what was happening to the mechanicals, *then the mechanical may not necessarily decline.*

5/5/08 Tr. at 5345-47 (Slottje) (emphasis added).

633. Professor Slottje acknowledged that he had conducted no study of the costs of other inputs, explaining that he did not "formalistically look at it" because he "wasn't asked to take on that task." *Id.* at 5396. In other words, Professor Slottje failed to conduct the essential analysis that was required to reach any defensible conclusion concerning the impact of a reduction in demand for recorded music on the mechanical royalty rate. *See id.* at 5357, 5393-94.

634. Professor Murphy, of course, conducted just such an analysis. K. Murphy WRT (CO Trial Ex. 400) at 4-14. He examined not just the effect of declining revenues

on mechanical royalties, but also the effects on the numerous other types of inputs that are used to produce recorded music. *Id.* What his analysis shows is that Professor Slottje's conclusions concerning the relationship between demand for music and the price of the mechanical license is not only flawed as a matter of economic theory, it is contradicted directly by the empirical evidence. *See id.*

IX. Agreements Between EMI MP and Digital Music Services Provide Further Support for the Copyright Owners' Rate Proposal

635. The RIAA levels a series of attacks on the agreements entered into between EMI MP and various digital services. RIAA PFF ¶¶ 1001-25. The RIAA cannot escape the conclusion that these agreements are evidence of market rates for musical works. The RIAA disparages these services as "scattered newcomers," ignoring the fact that collectively these services agreed to pay [redacted] in advances to EMI MP. Further, while a number of the rates in these agreements relate to products subject to the partial settlement in this matter, and one rate relates to video rights not at issue in this proceeding, the rates in these agreements are relevant to the Court's decision because they demonstrate that rights for musical works are licensed at rates far in excess of what the RIAA proposes across a variety of products (mastertones, limited downloads, on demand streams and videos) that require licenses both for musical works and sound recordings. 5/14/08 Tr. at 6487-89 (Faxon).

A. Skype

636. In April 2006, EMI MP entered into a two-year license agreement with Skype, which planned to offer a digital subscription service that includes full downloads, limited downloads and mastertones. For mastertones, the rates are the greatest of:

[redacted]

[redacted] With respect to rate tiers (i) and (ii), the agreement provides that [redacted] Faxon WDT (CO Trial Ex. 3) at 33; 1/29/08 Tr. at 460-468 (Faxon). Notably, the retail percentage in the Skype agreement ([redacted] allocated to mechanical rights) effectively exceeds the RIAA's most recent proposal for a percentage of wholesale revenue for mastertones (15%).[9]

637. The RIAA suggests the Skype agreement is not a proper benchmark because the license includes worldwide rights to EMI's U.S. and U.K. repertoire. RIAA PFF at ¶ 1007. The RIAA does not present any evidence that the U.S. rates were affected in any way by the grant of worldwide rights.

638. The RIAA also argues that Skype is a "start-up service that may have been willing to pay high prices to music publishers on a speculative basis." RIAA PFF at ¶ 1009. The RIAA does not have competent evidence to support its own speculation on this point, and the Court has been skeptical of similar evidence beyond the terms of the contract. *See* 2/20/08 Tr. at 3963 (Wilcox) (sustaining objections to questions regarding negotiations of NDMAs); 1/28/08 Tr. at 96-97 (Copyright Owners' opening statement) (Court questioning admissibility of evidence of negotiations). The RIAA has no valid grounds for disputing that the contract provides the best evidence of the value of EMI MP's musical works.

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[9] For a comparison of retail to wholesale percentages, see generally CO PFF ¶¶ 504-507.

B. Spiral Frog

639. Effective April 1, 2006, EMI MP entered into an agreement with Spiral Frog, an advertiser-supported service, that provides limited downloads and streaming at no charge to the listener. The licensee paid a [redacted] advance. Faxon WDT (CO Trial Ex. 3) at 35. Mechanical royalties for limited downloads and streams are [redacted]. *Id.*; Faxon WDT (CO Trial Ex. 3), CO Ex 223 at 11; 1/29/08 Tr. at 468-72 (Faxon).

640. As with Skype, the RIAA attacks the Spiral Frog benchmark as a "start-up service," RIAA PFF at ¶ 1012, that has had problems launching, *id.* ¶ 1013. The RIAA ignores the fact that Spiral Frog committed to pay a [redacted] advance to gain access to EMI MP's musical works. Furthermore, the evidence shows that Spiral Frog's delayed entry was due in part to the RIAA members' refusal to license the service. *See* 5/14/08 Tr. at 6515-16 (Faxon) ("Again, that service has been delayed quite considerably by being unable to license sufficient recordings, though it is operating now with Universal content.").

C. Music Net

641. On January 31, 2007, EMI MP entered into a two-year license agreement with MusicNet, Inc. ("MusicNet") for conditional downloads and on-demand streams. The agreement includes a guaranteed advance of [redacted] payable in four equal installments over 18 months and a royalty rate of [redacted] on the sale of conditional downloads embodying compositions controlled by EMI. Faxon WRT (CO Trial Ex. 375) at 9. The parties agreed that the rate for on-demand streams would be [redacted]. *Id.*

642. The RIAA's only attack on the MusicNet agreement is that royalties have yet to exceed the advance. But the RIAA cannot challenge the fact that MusicNet was willing to commit to pay a [redacted] advance to gain access to EMI MP's musical works at the noted rates. Further, EMI MP has in fact accrued royalties over [redacted] against both this $2 million advance and a [redacted] advance for use of EMI MP compositions prior to 2007. Response to Interrogatory No. 24, Responses and Objections on Behalf of NMPA, SGA, and NSAI to the RIAA and DiMA's Third Set of Interrogatories.

D. Imeem

643. On November 7, 2007, EMI MP entered into a license agreement with Imeem, Inc. ("Imeem") for on-demand video streams of label-produced videos, user-generated videos and on-demand audio streams. [redacted] Faxon WRT (CO Trial Ex. 375) at 8-9. [redacted]. Although a number of the rates in the agreement remain subject to EMI MP entering into agreements with the labels, including rates for user-generated label videos (i.e., a user creates a video but uses a sound recording released by a label), the agreement includes one rate relating to a situation in which Imeem is licensing both the musical composition and the sound recording, namely for label produced videos licensed by independent record labels. The rate payable to EMI MP for such videos is [redacted] *Id.* at 9.

644. The RIAA dismisses the Imeem agreement because it relates to videos and because EMI MP has yet to collect beyond the advance. RIAA PFF at ¶ 1018. But the

rates set in this agreement are evidence of the reasonableness of the proposed rates here: "With respect to Imeem, it was to demonstrate that the economic impact across a wide range of consumer products, some of which are implicated in this hearing and some are not, follows a — follows a pattern." 5/14/08 Tr. at 6488 (Faxon). In addition, while Mr. Faxon testified the percentage rate was equal only to [redacted] of the "content pool" of total payments for rights to musical works and sound recordings, *id.* at 6510, this percentage far exceeds what the RIAA proposes as reasonable rates.

E. QTrax

645. EMI MP entered into a license agreement with LTDnetwork for its Qtrax service in August 2006, and entered into an amendment in February 2008. The license is for "audition" downloads (i.e., conditional downloads) and "authorized" streams (i.e., on-demand streams) being offered in an advertisement-supported service. The royalty rate for these downloads is [redacted] Faxon WRT (CO Trial Ex. 375), Ex. G at 11. [redacted] Faxon WRT (CO Trial Ex. 375) at 10. Under the amendment, the rates in the agreement are extended through January 25, 2010 and [redacted]. *Id.*

646. The RIAA suggests that this market-rate contract is irrelevant. The RIAA itself elicited evidence from Mr. Faxon about the relevance of QTrax: "in Qtrax, which

is largely about conditional downloads, the — again, to the read-across between that deal and the — and the rates being set in these proceedings." 5/14/08 Tr. at 6488-89 (Faxon). As noted above with respect to other agreements, the rates in this agreement ([redacted]) exceeds even the RIAA highest proposed percentage rate of 15% of wholesale revenues for mastertones.

X. The Penny Rate Should Not Be Abandoned

647. In support of their requests that the Court abandon the penny rate—which has worked well for almost a century—in favor of a percentage of revenue system, the RIAA and DiMA recycle a variety of arguments that lack evidentiary support.

648. It is indisputable that under the penny rate, as usage of musical compositions increases, mechanical royalties increase proportionately. *See* CO PFF ¶ 593. It is equally indisputable that under the percentage of revenue structure that both the RIAA and DiMA seek, usage and mechanical royalties can become uncoupled, resulting in lower payments for more use of the Copyright Owners' work. *See id.* ¶ 594.

649. Because the RIAA and DiMA cannot dispute either of these propositions, they instead exaggerate the purported benefits of a percentage rate. But their exaggerated endorsement is insufficient to create a case for abandoning the historical penny rate and justify the disruption that would result.

A. A Percentage Rate Does Not Protect the Value of Musical Compositions

650. The RIAA contends that a "percentage rate reflects the contributions of copyright owners and copyright users automatically," whether "prices rise or fall." RIAA PFF ¶ 1503. This is simply not so. A penny rate maintains the intrinsic value of musical compositions independent of the pricing decisions of copyright users, which are beyond

the Copyright Owners' control. *See* CO PFF ¶ 598; 1/29/08 Tr. at 482 (Faxon). Indeed, as the Copyright Owners illustrated in their Proposed Findings of Fact, record companies themselves routinely take advantage of the downward price protection that usage-based rates provide. *See* CO PFF ¶¶ 598-600. Thus, record companies consistently refuse to accept payment for their sound recordings on a percentage-only basis, and instead insist on payment terms expressed in pennies or dollars in their agreements for the sale of CDs and digital products. *See id.* Indeed, all of the agreements in the record between record companies and digital music services include usage-based payment terms. *See id.* ¶ 600. In advocating a percentage rate, the record companies seek to deprive the Copyright Owners of the very protections they afford themselves.

B. A Percentage Rate Is Not Needed to Provide the Flexibility Benefits the RIAA and DiMA Claim

651. The RIAA argues that a percentage rate allows flexibility to innovate with new products, RIAA PFF ¶ 1503, and ensures that the introduction of new products will not be held up by protracted negotiations, *id.* ¶ 1513. DiMA makes the same point, arguing that a penny rate is "inflexible." DiMA PFF ¶ 226. Neither argument is persuasive.

652. In support, the RIAA cites its experience developing subscription services, as well as physical products such as DualDiscs, Super Audio CDs and Super Discs. *See* RIAA PFF ¶ 1482. The record is clear, however, that the music publishers did not delay the launch of any of these products or services. *See* 2/21/08 Tr. at 4155 (Barros). The record companies are to blame for the late arrival of subscription services, years after pirate peer-to-peer file sharing began to run rampant, as numerous record company documents and executives have confirmed. *See, e.g.,* H. Murphy WDT (CO Trial

Ex. 15), Ex. 700 at RIAA 018075 (listing reasons why record companies failed to take aggressive and decisive action to create an alternative to piracy, including "[s]urprise at speed and scope of piracy problem, "[c]oncerns over cannibalization of CD revenues" and "[b]usiness model questions"); RIAA Trial Ex. 9 (Terra Firma presentation describing the recording industry's response "to the growth in digital consumption" as "slow"). The record, in fact, confirms that music publishers helped jump start the majors' subscription service businesses with a 2001 agreement that gave the record companies the right to use musical works on a use-now, pay-later basis. 2/25/08 Tr. at 4383 (McGlade).

653. And although the RIAA continues to claim that negotiations between music publishers and record companies over mechanical royalties delayed the arrival of DualDiscs in the marketplace, the evidence shows that DualDiscs were first released by Sony BMG in the spring of 2004, prior to the execution of the first NDMA and that the negotiations over mechanical royalties did not materially delay the launch of DualDiscs. 2/20/08 Tr. 3976-77, 3981 (Wilcox).

654. The problem with each of the products the RIAA touts is that they were not attractive to consumers. *See* CO PFF ¶¶ 527-28; 2/28/08 Tr. at 3980-81 (Wilcox); 1/29/08 Tr. at 457 (Faxon). The Copyright Owners' insistence on fair compensation did not hinder the success of these products. 2/21/08 Tr. at 4155 (Barros). Moreover, sales of DualDiscs and the other physical formats that the RIAA posits would have been advantaged under a percentage of revenue system have been trivial. *See* CO Trial Ex. 77 (Sony BMG's DualDisc sales in 2006 totaled approximately $13.3 million).

655. Equally unavailing is the RIAA's argument that it needs the flexibility of a percentage rate to roll out innovative new products today. In support of this contention, the RIAA provides "case studies" of Nokia's "Comes with Music" program and "digital album cards." RIAA PFF ¶¶ 1534-41, 1544-46. But these examples prove the opposite point. Both Universal and Sony BMG have already entered into agreements with Nokia for the "Comes with Music" program, proving that the penny rate is not a hindrance to such novel business arrangements. Eisenberg WRT (RIAA Trial Ex. 89) at 13; 5/13/08 Tr. at 6052 (Eisenberg); CO Trial Ex. 352. As Mr. Eisenberg admitted, Sony BMG's agreement with Nokia is not conditioned on a percentage of revenue rate or a reduction in the penny rate. *See* CO PFF ¶ 629. Although the RIAA claims that "Nokia insisted on a bail-out provision in the event that the mechanical royalty rate is too high," RIAA PFF ¶ 1541, nothing on the face of the agreement links its termination option to mechanical royalties, CO PFF ¶ 629.

656. With respect to digital album cards, Sony BMG has already launched this new physical product in both the United States and Canada—two jurisdictions that feature penny rates for physical products. *See* Eisenberg WRT (RIAA Trial Ex. 89) at 19; 5/13/08 Tr. at 6132-33 (Eisenberg). Clearly, the penny rate did not preclude Sony BMG from introducing this product. *See id.*; CO PFF ¶ 630.

657. Nor are the RIAA's arguments that a percentage of revenue rate will give record companies the flexibility to offer consumers additional content and variable pricing at all persuasive. Although the RIAA contends that a percentage rate is necessary for "record companies to release more songs on their CD albums," particularly "catalog projects and compilations [that] require higher track counts," RIAA PFF ¶ 1555, the

undisputed testimony in the record is to the contrary. As three music publishers testified, the Copyright Owners have historically granted reductions in mechanical royalties for budget and compilation CDs, and to accommodate a large number of tracks on an album. *See* 2/5/08 Tr. at 1666-68 (Peer); 2/12/08 Tr. at 2704 (Firth); Faxon WRT (CO Trial Ex. 375) at 15. And record companies also rely on controlled composition clauses to cap mechanical royalties on albums with high track counts. CO PFF ¶ 633.

658. The RIAA also asserts that under the penny rate "the record companies may be foreclosed from introducing low price point products that would benefit the record companies and the songwriters/music publishers." RIAA PFF ¶ 1564. But as economic theory predicts, and market practice confirms, publishers and songwriters will voluntarily agree to new business models "where these new models are expected to increase the sales of [their] works." CO PFF ¶ 632 (quoting Landes WRT (CO Trial Ex. 406) at 23). Ignoring this marketplace reality, the RIAA attempts to show that for permanent downloads, the penny rate "has made lowering the price per track cost-prohibitive." RIAA PFF ¶ 1565. Yet again, the RIAA has selected an inapt example. Although 99 cents—the price set by Apple—is the standard price for permanent downloads, at least two digital music providers, Wal-Mart and Amazon, have entered the market and undersold Apple. *See* CO PFF ¶ 625. In fact, according to DiMA, the average price of Amazon's permanent downloads is 89 cents. *See id.* Accordingly, neither the penny rate structure nor its current 9.1-cent level is impeding price flexibility in today's permanent download market.

659. In short, the RIAA's "flexibility" is a one-way street: a percentage rate would shackle the Copyright Owners to the distribution decisions of copyright users

without giving the Copyright Owners any opportunity to preserve the value of their works. Further, no percentage rate could be so flexible as to eliminate disputes about whether new products were within the ambit of Section 115, as the Court has observed. *See* 2/14/08 Tr. at 3351-53 (A. Finkelstein; Roberts, J.).

660. DiMA's flexibility arguments fare no better. There is no evidence of the need for any flexibility for permanent downloads. The leading provider, Apple, has concededly "launched under a penny-rate system and achieved great success." DiMA PFF ¶ 225. DiMA's argument that iTunes' success is unique and that the penny rate is so "inflexible" that it "discourages new entrants" is also contrary to the evidence. *Id.* ¶ 226. The permanent download market is booming, and eight companies have entered it in recent years, notwithstanding the fact that the mechanical rate for permanent downloads is calculated on a penny basis. CO PFF ¶ 625.

C. The Parties Interests' Are Not Aligned

661. In their Proposed Findings of Fact, the RIAA and DiMA both repeat the claim that the interests of the Copyright Owners and the copyright users are aligned. *See* RIAA PFF ¶ 1161; DiMA PFF ¶ 204. That is simply not so.

662. First, even the record company witnesses acknowledge that the interests of owners of musical compositions and sound recordings are not necessarily aligned with those of digital music providers. CO PFF ¶¶ 594, 608. That is because digital music services may not be "in the business of selling music," but rather selling "goods and services or advertising related to other products." CO PFF ¶ 605 (quoting 5/13/08 Tr. at 6112 (Eisenberg)). Apple is a prime example. It has stated publicly that its goal is to operate its iTunes Store at breakeven to promote greater sales of profitable iPods. CO

PFF ¶ 611. This is why the record companies insist on penny minima in their agreements with Apple.

663. Nor are the interests of the record companies and the Copyright Owners necessarily aligned, which even Professor Teece concedes. RIAA PFF ¶ 608. To take one example, the interests of the parties diverge because a record company, just like a digital music service, may decide to use music as a loss leader to drive sales of another product or service. CO PFF ¶ 610. Moreover, the RIAA's proposed revenue base does not align the parties' interests, because it does not allow the Copyright Owners to share in all of the economic compensation that the record companies receive for transactions involving music. *Id.* ¶¶ 609-10. This is not a theoretical concern, as illustrated by Sony BMG's recent deal to provide music to MySpace in exchange for an equity stake in MySpace (among other things). 5/12/08 Tr. at 5716-19 (A. Finkelstein). As Ms. Finkelstein admitted at trial, the value of the equity stake that Sony BMG received from MySpace would not be included in the RIAA's proposed definition of wholesale revenue, and thus would not be shared with the Copyright Owners. *Id.* at 5718.

D. International Markets Do Not Support the Adoption of a Percentage Rate

664. The RIAA and DiMA also claim that a percentage rate is appropriate because it is used in many other countries. DiMA PFF ¶¶ 213-15; RIAA PFF ¶¶ 1587-93. That may be so, but the evidence does not bear out the RIAA's claim that a percentage rate has facilitated innovative new products in those countries that have adopted a percentage rate. To the contrary, the evidence shows that the digital market in the U.S. has grown far faster than in those countries where mechanical royalties are computed on a percentage of revenue basis. CO PFF ¶¶ 634-36. And the record

companies' November 2007 agreement to maintain and increase the penny rate for physical products in Canada further undermines the RIAA's claims that U.S. record companies cannot survive without a percentage rate. *See id.* at 637.

E. The RIAA's Rate Proposal Is Neither Simple To Apply Nor Consistent with Marketplace Practices

665. Finally, the RIAA contends that its proposed wholesale revenue base is easy to apply and consistent with existing practice in the marketplace, because that proposed revenue base is allegedly the same as the revenue base used for calculating artist royalties today. RIAA PFF ¶ 1608. Again, the RIAA's claims are contradicted by the record.

666. First, the RIAA has failed to address the undisputed fact that monitoring and auditing the copyright users' compliance with mechanical royalty obligations under a percentage of revenue regime would be more difficult and more expensive than under a penny rate. *See* CO PFF ¶ 648. This is because unlike a penny rate, which requires consideration of only two factors (units distributed and the applicable rate), a percentage rate requires, for products sold on a per-unit basis, evaluation of three factors (units distributed, the percentage rate, and the sale price for each unit). *Id.* ¶ 596 (citing 2/7/08 Tr. at 2173 (Landes)). Further, for music that is distributed as part of a bundle, pursuant to wholesale discounts or through a barter transaction, the appropriate mechanical royalty is susceptible to revenue base manipulation. *Id.* ¶ 616.

667. Moreover, although the RIAA pretends that its definition of the revenue base against which the percentage would be measured is straightforward, the evidence is to contrary. For example, when pressed by the Court to specify whether the RIAA's proposed revenue definition was the same as the revenue definition used in Sony BMG's

artist contracts, Andrea Finkelstein confessed: "I cannot say it's identical in every word." 5/12/08 Tr. at 5665 (A. Finkelstein). Further, as the Court also observed, there is no evidence in the record concerning whether the RIAA's proposed revenue definition is consistent with the terms defining the revenue base in the artist agreements used by the other three majors, much less the thousands of independent record companies that exist. *See id.* at 564-65. Indeed, when asked to identify the appropriate revenue base for the RIAA's rate proposal, Mark Eisenberg of Sony BMG was at a loss for an answer. 5/13/08 Tr. at 6136-37 (Eisenberg).

XI. DiMA Has Not Justified Its Proposed Rate Cut

A. Overview

668. As described in greater detail in the Copyright Owners' Proposed Findings of Fact, DiMA has proposed a reduction in the mechanical royalty rate for permanent downloads of approximately one-third. CO PFF ¶¶ 804-05. Such a change is unjustified and completely unsupported by the record.

669. DiMA contends, for example, that the digital music market is "nascent," and therefore needs a low mechanical royalty rate based on a percentage of revenue to encourage growth. DiMA PFF ¶¶ 1, 142, 196. Substantial evidence presented over the course of the proceeding, however, unequivocally shows that Apple's iTunes Store, the leading permanent download provider, is extremely successful and has surpassed the expectations of Apple's own executives with respect to its sales, revenue and profit figures. *See* CO PFF ¶ 383; *see also* 2/25/08 Tr. at 4245-46 (Cue). DiMA also argues that the costs and risks faced by digital services, as well as the benefits they provide to consumers, deserve credit in the form of a reduction in the mechanical royalty rate. *See generally* DiMA PFF ¶¶ 76-181. This position ignores the fact that the Copyright

Owners' contributions in the digital world are already undervalued. While the Copyright Owners recognize the critical value of legitimate digital music services, DiMA has provided no evidence—in the form of marketplace benchmarks, or otherwise—that justifies the dramatic cut in mechanical royalty rates DiMA has proposed.

670. As an initial matter, DiMA's arguments are entitled to little weight because they are, in most cases, completely unsupported by credible evidence. As DiMA acknowledged in its finding of facts, the parties reached a settlement with respect to limited downloads and interactive streaming. DiMA PFF ¶ 24. Notwithstanding the settlement, DiMA relies heavily on testimony and evidence concerning subscription services that is largely, if not completely, irrelevant to setting the rate for permanent downloads. The costs incurred in building and operating a subscription service offering limited downloads and interactive streams have nothing whatsoever do to with calculating a reasonable royalty for permanent downloads.

671. DiMA resorts to these arguments because there is nothing in the record that would otherwise support its claim for a significant reduction in the permanent download rate. Nor is there any evidence to connect DiMA's proposed rates to marketplace benchmarks. In the end, their sole expert witness, Margaret Guerin-Calvert, does not even offer a benchmark, choosing instead to offer vague admonitions to the Court concerning the degree of care it should exercise in setting a rate.

B. The Permanent Download Market is Thriving

672. The bedrock of DiMA's case is that "[d]igital music consumption is nascent." Guerin-Calvert WDT (DiMA Trial Ex. 7) at 24; *see also id.* at 3-6, 53; 2/25/08 Tr. at 465 (Guerin-Calvert); Cue WDT (DiMA Trial Ex. 3) at 3; 2/25/08 Tr. at 4264-65 (Cue). DiMA argues that "digital distribution is still a new and evolving business," and

that "[t]he future prospects of most current and potential digital music distributors are uncertain at best." DiMA PFF ¶ 138; *see also id.* ¶¶ 142, 231. The testimony was subject to challenge with respect to services offering limited downloads and interactive streaming. With respect to the permanent download business, these arguments have no bearing whatsoever.

673. The permanent download business is dominated by Apple and its iTunes Store. The entry of multiple challengers to the iTunes Store has done nothing to supplant its dominant market position. 2/4/08 Tr. at 1178 (Enders). DiMA concedes the point, noting that the digital music market can be considered "new and evolving" only if "Apple's current success with its iTunes Store" is removed from the mix. DiMA PFF ¶ 138.

674. The evidence presented over the course of the proceeding confirms Apple's success. *See* CO PFF ¶¶ 831-835. The iTunes Store launched in April 2003, over five years ago, and became an immediate success. *See* 2/25/08 Tr. at 4246, 4236 (Cue). Since that time, the iTunes store has sold over 4 billion songs globally, and over 3 billion in the U.S. alone. 2/4/08 Tr. at 1181 (Enders). In 2006, sales averaged roughly 11.0 million single track permanent downloads and 592,000 digital album permanent downloads each week. CO PFF ¶ 390. The iTunes Store currently controls approximately 85% of the permanent download market. Enders WDT (CO Trial Ex. 10) at 28; 2/4/08 Tr. at 1178-80 (Enders).

675. The iTunes Store's revenues also indicate the level of development and success experienced in the permanent download market. [redacted]

[redacted] 2/4/08 Tr. at 4292 (Cue). In 2006, revenues for the entire permanent download market reached $878 million, and accounted for about 81% of the U.S. digital music market overall. *Id.* ¶ 457; *see also* Enders WDT (CO Trial Ex. 10) at 23. The iTunes Store accounts for roughly [redacted] of this amount, generating [redacted] in revenues in 2006. Revenues from the iTunes Store grew again in 2007, totaling approximately [redacted]. 2/25/08 Tr. at 4294-95 (Cue). Revenues for the entire permanent download market are forecasted to grow to approximately $2.7 billion by 2012. Enders WDT (CO Trial Ex. 10) 23 n.46, Ex. C at 4; *see also* CO PFF ¶¶ 470, 832 . These statistics are undeniable signs not of a nascent market, but of a well-established and growing market.

676. And a profitable one. Mr. Cue, the Vice President of iTunes and DiMA's primary witness on the permanent download market, explained during the direct hearing:

[redacted]

[redacted]

2/4/08 Tr. at 4295-96 (Cue). That contribution margin has been [redacted] from quarter to quarter, earning iTunes profits in the range of [redacted]. *See* Enders WDT (CO Trial Ex. 10) at 30-31. Those profits do not take into account the orders of magnitude higher profits that Apple earns in the successful implementation of its strategy to use downloads to drive iPod and other hardware sales. *Id.* at 29-30 (noting that Apple generates profit margins in excess of 20% on iPods).

677. Seeking to divert attention from iTunes' success, DiMA claims that "[a]llowing legal digital distribution to reach its fullest potential will require new entrants." DiMA PFF ¶ 74. There is no evidence to support that assertion. In fact, the number of digital music providers selling permanent downloads is already growing. Subscription services such as Rhapsody and Napster now offer permanent download options to both subscribers and non-subscribers. Independent retailers such as Wal-Mart and Amazon have also recently begun to operate their own digital music stores, selling permanent downloads at prices lower than Apple's well-established 99 cents per track price point. CO PFF ¶ 354.

678. None of these services has been deterred by the existing mechanical royalty rate or penny rate structure. *Id.* ¶¶ 623-26. [redacted] 2/25/08 Tr. at 4296 (Cue) [redacted] DiMA has provided no evidence that other permanent

download providers have fared any differently under the current rate or penny-rate structure. DiMA offered no financial statements from Wal-Mart or Amazon or any other download service.

679. Similarly, the financial information introduced concerning subscription services such as Napster and Rhapsody tells the Court nothing about the profitability of their permanent download business, they report only revenue. Claire Enders, the Copyright Owners' expert witness on the digital music industry, for example, was able to chart the revenues earned by permanent download sales through MusicNet, Napster and RealNetworks. *See* Enders WDT (CO Trial Ex. 10) at 37-40. She was unable, however, to determine whether each service generated a profit from permanent downloads. Apart from the royalty provisions included in each service's contracts with the record companies, which outline how much each service pays the record companies for each track sold, costs were not allocated separately to permanent downloads, limited downloads or interactive streams. *See id.* at 53-55. None of these services provided any evidence as to the profitability of their permanent download business. The only complete evidence concerning the economics of permanent downloads comes from iTunes.

C. The Benefits of Digital Music Do Not Justify a Reduction in the Mechanical Royalty Rate

680. The permanent download market is thriving in large part because consumers are particularly attracted to a number of features offered by permanent downloads, especially in comparison to both CDs and subscription services. Both DiMA and the Copyright Owners have recognized that the comprehensive catalog, instant availability of music on a 24/7 basis, portability and convenience, among other features, associated with digital downloads attract consumers to digital music services and increase

the value of digital music. *See* CO PFF ¶¶ 389-92; DiMA PFF ¶¶ 81-100. The parties express different opinions, however, on the implications of these features with respect to the mechanical royalty rate. The Copyright Owners have presented ample evidence that "digital transmission increases the value of individual compositions," thereby justifying an increase in the mechanical royalty rate for permanent downloads. Landes WDT (CO Trial Ex. 22) at 38; see generally *id.* at 36-40. DiMA contends, in contrast, "legitimate digital distributors can perform these vital functions only if they are not saddled with innovation-stifling costs," and thus need a reduction in the mechanical royalty rate. DiMA PFF ¶ 77. Nothing in the record, despite DiMA's assertions, supports the conclusion that the benefits offered by digital music, to either consumers or the Copyright Owners, justify a reduction in the mechanical royalty rate.

681. DiMA cites the influence of the "long tail effect," for example, as being particularly beneficial to the Copyright Owners. According to DiMA, "[t]he 'long tail' benefits consumers and all industry participants, but the *greatest value* inures to the *songwriters and copyright owners* who would otherwise receive nothing (or nearly nothing) for relatively obscure music that legal digital distributors make available to consumers." DiMA PFF ¶ 111 (emphasis added). Permanent download providers do offer easier access to a wide range of songs. Yet every sale of a permanent download is a sale for both the Copyright Users and the Copyright Owners, as both DiMA and RIAA witnesses acknowledged. *See* CO PFF ¶ 759 (discussing testimony by Glenn Barros, of Concord Records, concerning the boost his company's niche offerings have received through digital services); *see also* 2/25/08 Tr. at 4251-53 (Cue) (discussing the impact of the long tail effect on the distribution of music sold through the iTunes Store).

682. DiMA's own evidence supports this fact. In DiMA's Proposed Findings of Fact, DiMA references the 2005 Annual Reports from the EMI Group and Warner Music Group, both of which control record companies and music publishers. These reports discuss how catalog sales of record companies are stimulated by digital distribution. DiMA PFF ¶ 103. Neither report, however, indicates that EMI MP or Warner/Chappell benefited more than their sister record companies. To the contrary, record companies, which garner roughly 61 cents out of every digital single dollar generated by the "long tail effect" are the principal beneficiaries. DiMA's member companies make these sales possible for both sides, but that fact does not justify penalizing only the Copyright Owners with a reduction in the mechanical royalty rate.

683. DiMA also attempts to rely upon the innovations in digital distribution offered by digital music services, as well as the Copyright Owners' "dependence" on such innovations, as justification for a reduction in the mechanical royalty rate. *See* DiMA PFF ¶¶ 126-35. These arguments, in essence, criticize songwriters and music publishers for not making greater efforts in the distribution of sound recordings. In doing so, they suffer from the same flaws that undermine similar arguments made by the RIAA. *See* Section IV.E. Songwriters and music publishers are not in the business of arranging for the digital distribution of music, contributing instead to the creation of musical works. An appropriate mechanical rate should no more penalize the Copyright Owners for not distributing music on the internet than it should penalize DiMA's members for not writing the songs.

D. Piracy is Not the Only Economic Condition That Should Be Considered by the Court

684. Under Section 801(b)(1)(B), the Court is charged with setting a rate that provides for fair returns to the Copyright Owners and a fair income to the Copyright Users "under existing economic conditions." 17 U.S.C. § 801(b)(1)(B). According to DiMA, the "most pressing" existing economic condition is digital piracy. DiMA PFF ¶ 40. DiMA repeatedly stresses the "singularly disruptive threat to all legitimate industry participants" that is posed by piracy, and uses this threat to justify its proposal for a dramatic reduction in the mechanical royalty rate. *Id.* ¶ 59 ("Raising mechanical rates or imposing de facto retail price regulation via unreasonable minimum penny rate fees would lead to even higher costs for digital distributors, making it more likely that digital distributors would be compelled to 'abandon the market to Internet pirates.'").

685. DiMA's stance on existing economic conditions, however, is flawed for two reasons. First, DiMA emphasizes the importance of digital piracy to the exclusion of other "existing economic conditions," such as the transition to a digital singles market, that should also be considered by the Court. Second, DiMA fails to adequately connect the impact of piracy—which affects songwriters, music publishers, record companies and digital music services alike—to any decisions made by the digital music services currently in operation or to DiMA's current rate proposal.

686. There is no dispute among the parties that digital piracy is a significant problem that negatively impacts every participant in the music industry. *See, e.g.*, CO PFF ¶¶ 237-39; DiMA PFF ¶¶ 40-45; RIAA PFF ¶ 239. However, despite sweeping allegations about the impact of piracy on the development and structure of the digital music industry, DiMA has failed to provide empirical evidence linking digital piracy to

business decisions made by permanent download providers. Piracy existed before the launch of the iTunes Store, and did not deter Apple from expanding its iTunes Jukebox software into the iTunes Store, as Mr. Cue described:

> We noticed that a lot of us were buying music and ripping them from CDs, and at the same time piracy and illegal software downloading was taking off. And we looked at the problem and said, boy, wouldn't it be great if we could buy any song that you wanted, or any album that you wanted, 24-by-7, have unlimited shelf space, and do that right within iTunes.... And so all of us really looked at that problem and said that would be, you know, a great idea to build. And this was back in 2002. Piracy, as I said, was really starting to take off. There was the Napster model of people downloading illegally. So we went to the music labels — in particular, we picked one label to go to that we started the conversations with, and we said, we're interested in doing this, and we brought the idea of how we wanted to build the music store.

2/25/08 Tr. at 4221 (Cue).

687. Piracy is still a threat, but new permanent download providers continue to enter the marketplace. CO PFF ¶ 386. Furthermore, DiMA's contentions that legitimate digital services are unable to compete with free pirate services and are, therefore, forced to exit the digital music industry, apply primarily to subscription services rather than to permanent download providers. *See, e.g.*, Guerin-Calvert WDT (DiMA Trial Ex. 7) at 29 (citing the decision of AOL/MusicNow, a subscription service, to exit the market because of "the difficulty in getting consumers to buy into the concept of legitimate digital music services where they have to pay to consumer [sic] digital music."); *see also* 2/4/08 Tr. at 1196-99 (Enders) (listing a number of subscription services that have already exited the market).

688. DiMA argues that "[p]iracy also forces legitimate digital distributors to price as low as possible so as to compete with free music." DiMA PFF ¶ 52; *see generally id.* ¶¶ 48-59. There is not a shred of empirical evidence to support that claim. DiMA's economist, Ms. Guerin-Calvert, conceded that she had performed no price sensitivity studies to measure the impact of piracy or any other factor on digital music pricing. 2/26/08 Tr. at 4581-84 (Q: And you didn't do any specific demand elasticity study for the digital music market, did you? A: Of the type I just talked about, no.). [redacted]

2/25/08 Tr. at 4332 (Cue); *see also id.* at 4266-67 ("[i]n the case of singles, again, all of our pricing has always been 99 cents, and I think the study that we continue to run is significant sales and growth; that's how we've measured whether we were being successful or not."). To the extent that DiMA is suggesting that piracy precludes any pricing above 99 cents per download, it is just that, a suggestion. No evidence supports the claim.

689. Additionally, DiMA is myopic in its arguments that piracy is "the predominant economic condition affecting the marketplace" and, thus, the only condition of which this Court should be aware. DiMA PFF ¶ 6. DiMA ignores other significant economic conditions that have resulted from the development of the digital music market, particularly the transition to a singles market.

690. According to Ms. Enders, consumers are particularly attracted to digital music because it allows them to "cherry-pick" single tracks rather than purchase an entire album. CO PFF ¶ 390; *see also* Enders WDT (CO Trial Ex. 10) at 20-21. Consumers'

desire to cherry-pick has resulted in a digital market largely driven by the sale of singles, as opposed to albums. *See* Enders WDT (CO Trial Ex. 10) at 6-7; *see also* 2/4/08 Tr. at 1248 (Enders); Landes WDT (CO Trial Ex. 22) at 6, 38-39; CO PFF ¶¶ 346, 390, 411-12. In 2006, revenues from the sales of digital singles through the iTunes Store accounted for [redacted]% of the revenue received from all permanent downloads. Landes WDT (CO Trial Ex. 22) at 39. Unit sales of single track downloads through the iTunes Store in 2006 averaged 11 million per week, while album download sales averaged only 592,000. Enders WDT (CO Trial Ex. 10) at 24.

691. The development of the digital singles market is a critical "existing economic condition" for the Court to consider. DiMA argues that it is simply "one more consumer-friendly feature among many technological innovations that, according to industry consensus, has the power to drive growth in digital sales in the years to come." DiMA PFF ¶ 121. But the evidence shows that the transition to a singles-based market has further depressed the level of mechanical license fees received by the Copyright Owners. *See, e.g.*, 1/29/08 Tr. at 429-30 (Faxon); Enders WDT (CO Trial Ex. 10) at 6-7. In fact, even the RIAA has acknowledged that the sale of singles rather than full albums means that fewer sound recordings are sold and the "shift from sales of albums to sales of singles is contributing to the decline in revenues." RIAA PFF ¶ 288; *see also* 2/4/08 Tr. at 1287-88 (Enders).

692. Moreover, the growth of the digital singles market has a substitutional effect on album sales, as consumers can now buy only the one song they want, rather than the album that contains that song. 1/29/08 Tr. at 429-30 (Faxon); *see also* 2/4/08 Tr. at 1287-88 (Enders); RIAA PFF ¶ 288 (acknowledging that "[i]n the past, if a consumer

liked a particular hit song, he or she would buy an album containing that recording. . . . Now, however, the consumer may, and frequently does, buy a digital download of the hit single, and not the physical album").

693. As Mr. Faxon testified, this has a material impact on the Copyright Owners, particularly songwriters. 1/29/08 Tr. at 429-30 (Faxon). Songwriters typically contribute more than one song to an album but do not know in advance which will be successful. In an album-based world, songwriters can, in effect, average the effort and contribution they have made to multiple songs through the compensation they receive, even if only one hit song, which is seen as more valuable to consumers, is driving the sale of the album. According to Mr. Faxon, "[n]ow when they are out there in the marketplace where each song stands completely on its own, they do not have the, if you will, the ability to have the transfer of the value across by putting another song on the album. So, they are exposed." *Id.*

694. This feature of the digital market must be considered against the backdrop of the recorded music industry's historical economic model and the current statutory rate. The current rate was set in 1997, at a time when sales of recorded music were driven by CDs, which "bundle" groups of songs, Landes WDT (CO Trial Ex. 22) at 39, and before a clear understanding of the shape of the growing digital market had developed. Israelite WDT (CO Trial Ex. 11) at 9 (explaining that the current rate for permanent downloads was "agreed to in the absence of any hard evidence of the economics of digital distribution or any clear understanding of the future of the digital distribution of music."); *see also* Robinson WDT (CO Trial Ex. 8) at 5.

695. As a result, the mechanical royalty rate was a "blended" rate or, in effect, a bundled discount, set with the understanding that consumers would buy albums that contained (from the consumers' perspectives) both high- and low-value tracks and averaging accordingly. *See* Landes WDT (CO Trial Ex. 22) at 6, 39; Enders WDT (CO Trial Ex. 10) at 61. As Ms. Enders explained, Copyright Owners could count on high-value songs to drive album sales, leading to mechanical royalties for songwriters of other tracks on the album. Enders WDT (CO Trial Ex. 10) at 61. Because that is no longer the case in the digital, singles-driven world, the current mechanical rate is, already, too low as it represents the bundled discount agreed to in an albums-driven world. This economic condition provides further support for a mechanical royalty rate increase for permanent downloads.

E. DiMA Distorts the Evidence of Costs and Risks of Legitimate Digital Distributors

696. DiMA argues that the significant investments in technology necessarily made by "legitimate digital distributors" requires all other costs, including mechanical royalties, to be kept as low as possible if those distributors are to compete with pirate music sites. *See generally* DiMA PFF ¶¶ 136-88. DiMA argues that royalty costs are already a substantial cost, and that increasing the mechanical royalty rate "will prevent [the digital music industry] from realizing its potential to stimulate growth for the music industry as a whole." *Id.* ¶ 137. However, DiMA fails to come to grips with the fact that the great majority of royalty costs are paid to the record companies, not the Copyright Owners. DiMA also claims that other costs necessitate keeping the mechanical rate as low as possible. But in making these arguments, DiMA relies almost entirely on evidence provided by witnesses from subscription services. Many of DiMA's key

arguments, if true at all, might have some relevance to the subscription market but are simply irrelevant to setting a mechanical rate for permanent downloads.

1. DiMA Conflates Mechanical and Sound Recording Licensing Costs

697. DiMA argues that royalty costs "represent a very substantial percentage of revenues" for digital music stores and "royalties take up the bulk of our product margins." DiMA PFF ¶ 153 (quoting Guerin-Calvert WDT (DiMA Trial Ex. 7) at 43; Quirk WDT (DiMA Trial Ex. 8) at ¶ 58). However, DiMA completely fails to distinguish between sound recording royalties and mechanical royalties. This omission obscures the fact that digital music companies pay substantially more in royalty rates to record companies for sound recordings than they pay to songwriters and publishers for mechanical royalties. *See* CO PFF ¶¶ 375-79.

698. Pursuant to Apple's agreements with each of the four major record companies, Warner, Sony BMG and Universal each receive the "[redacted]" from Apple each time one of their tracks is sold. *Id.* ¶ 375; *see also* CO Trial Ex. 92 at DiMA 3781; CO Trial Ex. 90 at DiMA 3632; CO Trial Ex. 93 at DiMA 3717; Enders WDT (CO Trial Ex. 10) at 48; 2/4/08 Tr. at 1228 (Enders). EMI, the fourth major record company, receives [redacted] for standard tracks. CO PFF ¶ 375; *see also* CO Trial Ex. 91 at DiMA 3463; Enders WDT (CO Trial Ex. 10) at 48; 2/25/08 Tr. at 4327-29, 4336-40, 4347-50 (Cue) (discussing Apple's agreements with each of the major record companies). Of this amount, however, the Copyright Owners only receive, at most, 9.1 cents, accounting for [redacted] of the total royalty payment.

699. Indeed, DiMA's own witnesses recognize that sound recording royalties account for the "bulk" of their content royalties, as Mr. Quirk explained during cross-examination:

> Q: Now, when you said, "Royalty rates take up the bulk of our product margins," you're not referring to mechanical royalty rates paid to songwriters and publishers, are you?
>
> A: Well, for — it depends what you're saying. We're including all royalty rates in that statement.
>
> Q: Well, the royalty rates that you're referring to in that statement are sound recording royalties paid to the record companies pursuant to the agreements you've made with them, right?
>
> A: It includes sound recording payments, yes.
>
> Q: In fact, that is the overwhelming majority of royalty payments you that make?
>
> A: They are the majority, yes.

2/26/08 Tr. at 4642 (Quirk). *See also* Cue WDT (DiMA Trial Ex. 3) at 33 ("the bulk of these royalty payments go to the record labels for the sound recording right"); 2/25/08 Tr. at 4410 (McGlade) (record companies get on average 50 percent of fees that are paid by consumers for subscription services).

700. Furthermore, DiMA argues that the need to offer the widest possible catalog results in a situation where "sound recording rights holders have substantial power over price and can extract unreasonable payment terms from digital music distributors." DiMA PFF ¶ 152. That argument might have some applicability to record companies but Copyright Owners are, of course, subject to compulsory licensing. The bargaining power, or lack thereof, of DiMA's member companies in such negotiations has no bearing on a determination of a reasonable mechanical royalty rate.

2. DiMA's Reliance on Evidence from Subscription Services Distorts its Picture of the Strength of the Digital Music Market

701. The permanent download market is thriving, because consumers easily recognize a host of characteristics that make that model of digital music attractive. CO PFF ¶¶ 389-92. Subscription services, in contrast, claimed to struggle simply to remain viable, incurring great additional expense in the process. DiMA's use of evidence related to the health and success of subscription services, therefore, distorts the picture of the digital market presented and, given its inapplicability to permanent downloads, is entitled to no weight.

702. DiMA's reliance on evidence provided by the subscription services and their representative witnesses is misplaced for a number of reasons. First, the rates and terms for limited downloads and interactive streaming, the products which comprise the overwhelming majority of the business of subscription services, are covered by the settlement between the parties concerning rates and terms for limited downloads and interactive streams. Additionally, subscription services represent less than 20% of the overall U.S. digital music market. Enders WDT (CO Trial Ex. 10) at 23. Of this, permanent downloads generate a small percentage of the revenues earned. According to figures presented by Ms. Enders, in FY 2005, permanent downloads accounted for only [redacted] of MusicNet's total revenues and [redacted] of RealNetworks' total revenues. *See* Enders WDT (CO Trial Ex. 10) at 39-40. For Napster, the third major subscription service Ms. Enders analyzed, permanent downloads generated [redacted] of total revenues in FY 2005, but only [redacted] in FY 2006. *Id.* at 36. At the time Ms. Enders submitted her report, Napster's permanent download sales had generated roughly [redacted] of the revenue earned in FY 2007. *Id.*

703. Moreover, the evidence shows that the costs of subscription services are largely attributable to the unique challenges these services face in the digital marketplace that do not apply to permanent download services. DiMA's own witnesses are well aware of this distinction. According to Timothy Quirk, the Vice President of Music Content and Programming for RealNetworks, which operates the Rhapsody service, "we face a big challenge convincing customers to try our service, because paying for access to music rather than for ownership of music requires a major mental shift." Quirk WDT (DiMA Trial Ex. 8) at 20. For subscription services, "disproving this myth" that subscription services are "music rental services" is "no small task." *Id.* at 20-21. Mr. Cue testified that Apple recognized similar challenges in the subscription services market and, instead of working to overcome them, chose to stay out of the subscription services market:

> Q: And Apple actually, subsequent to launching the iTunes Store on a download basis, actually examined the question of whether also to enter the subscription business, correct?
>
> A: We did.
>
> Q: And the conclusion that Apple reached was that the subscription business was not attractive — an attractive proposition for consumers, correct?
>
> A: That's correct.
>
> Q: Because, in Apple's view, consumers want to own their music, not rent it, correct?
>
> A: Well, given the constraints of how rental is defined, as I just defined it, that is correct.
>
> Q: So Apple is of the view that its business model is a better business model than a subscription model, correct?
>
> A: Yes, we are.

> Q: And the marketplace so far has borne out that judgment, has it not?
>
> A: Certainly -- I don't know what the exact subscription numbers are, but based on the hearsay that I have from the labels, I would agree with you.

2/25/08 Tr. at 4323-24 (Cue). However large or small, these challenges, and the additional costs it creates, are irrelevant to setting a mechanical rate for permanent downloads.

704. DiMA claims that digital music providers have particularly high marketing and content costs that must be taken into account in setting the statutory rate. *See* DiMA PFF ¶¶ 162-66. But the "illustrative" example selected by DiMA, Napster, is hardly an accidental, or appropriate, choice. *Id.* ¶ 165; Enders WDT (CO Trial Ex. 10) at 51. In 2006, Napster spent [redacted] on marketing, which was [redacted] of the year's total revenues. DiMA PFF ¶ 165; *see also* Enders WDT (CO Trial Ex. 10) at 55. In previous years, Napster spent an even greater percentage of total revenues on marketing. Enders WDT (CO Trial Ex. 10) at 55. These outsized expenditures reflect the failure of the Napster model to take hold rather than necessary costs of providing digital music. As Ms. Enders explained, "[redacted]" *Id.* at 54.

705. Indeed, DiMA's own witnesses acknowledged that marketing costs are greater for subscription businesses because the fundamental concept of a subscription music service, with its attendant usage restrictions, is unfamiliar and potentially confusing for consumers. *See* 2/25/08 Tr. at 4394-95 (McGlade) ("I think there are some

elements of a service that need explanation that they're not used to."); 5/13/08 Tr. at 6156 (Sheeran) ("We also need to invest heavily in marketing our service in order to educate consumers about our value proposition and brand."); Guerin-Calvert WDT (DiMA Ex. 7) at 34 ("Subscription music, in general, has been a difficult concept to sell to consumers."). DiMA completely ignores this distinction, choosing instead to mischaracterize testimony that applies primarily to the subscription services context. *Compare* DiMA PFF ¶ 162 (referencing testimony from Mr. Quirk for the proposition that "comprehensive marketing efforts and consumer education programs are critical to the success of legal digital distribution companies.") *with* 2/26/08 Tr. at 4615-16 (Quirk) (clarifying that Rhapsody's marketing expenses are more a result of the subscription service's need to "change the way people think about music, change the way they think about experiencing music.").

706. As Ms. Enders observed, the iTunes Store, in contrast, does not incur marketing costs of this magnitude. In fact, Apple's marketing costs for the iTunes Store are a fraction of those incurred by subscription services. [redacted]. DiMA fails to acknowledge or take these facts into account, even though the digital aspect of this proceeding is now exclusively focused on determining a rate for permanent downloads

3. Increasing the Mechanical Royalty Rate Will Not Threaten the Growth of the Digital Music Market

707. DiMA also presents a distorted view of the potential impact of the Copyright Owners' proposed mechanical royalty rates on digital music companies. As described above, the permanent download market is thriving. Sales of permanent downloads have grown steadily, and new digital music providers continue to enter the market. *See* CO PFF ¶¶ 831-32, 835. Although DiMA claims that "[t]he future prospects of most current and potential music distributors are uncertain at best" (DiMA PFF ¶ 138), the evidence shows that the permanent download market is already worth more than $1 billion dollars, 2/25/08 Tr. at 4272-73 (Cue), with sales expected to increase each year to an estimated $2.7 billion for permanent downloads alone by 2012. Enders WDT (CO Trial Ex. 10) at 22; 2/4/08 Tr. at 1246-47 (Enders); *see also* 2/25/08 Tr. at 4298 (Cue); CO Trial Ex. 86 (Apple's forecast of [redacted] in revenues for 2008).[10]

4. Apple's iTunes Music Store Will Remain Profitable, Even With an Increase in the Mechanical Royalty Rate

708. The growth of the digital music market would not exist without Apple and its eminently successful iTunes Store. Since its launch in 2003, the iTunes Store has grown steadily and now commands approximately 85% of the permanent download market. Enders WDT (CO Trial Ex. 10) at 28; 2/4/08 Tr. at 1178-80 (Enders).

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[10] To the extent that DiMA seeks to maintain the financial health of potentially unprofitable subscription services, this Court has already foreclosed that argument. In the Webcasting II Determination, the Court held that "it must be emphasized that … the Copyright Royalty Judges cannot guarantee a profitable business to every market entrant." *Digital Performance Right in Sound Recordings and Ephemeral Recordings*, 72 Fed. Reg. 24084, 24088 n.8 (May 1, 2007) ("Webcasting II Determination"); *see also* 5/13/08 Tr. at 6189 (Sheeran) (agreeing that it's "not the role of this Court" to protect an inefficient market actor).

709. Apple achieved this market position under the current penny rate structure, and it did so notwithstanding two increases in the royalty rate in 2004 and 2006. 2/25/08 Tr. at 4277-78 (Cue). Although Mr. Cue claimed in his written testimony that reduced costs were needed to increase the size and success of the digital music market, Cue WDT (DiMA Trial Ex. 3) at 39, he conceded at trial that Apple does not need a rate reduction to continue to sell permanent downloads, or sell them profitably. In fact, Mr. Cue testified that penny rates 30% higher than DiMA's current proposal had not prevented the iTunes Store from growing into an extremely profitable business. 2/25/08 Tr. at 4296 (Cue). Mr. Cue also conceded that the Copyright Owners' rate proposal would not force Apple to consider exiting the digital music business:

> Q: Is it your testimony under oath that Apple would exit the iTunes Music Store business if the margins that you're currently earning on the business would decrease?
>
> A: I think it depends on what that decrease is.
>
> Q: But you're not claiming, are you, that any decrease in your margins would cause you to leave this business in which you've sold 4 billion songs, are you?
>
> A: We certainly wouldn't do anything that would bring us to a negative. I would leave — exit immediately if it were negative.
>
> Q: Well, you know, do you not, by looking at your own P&L, that before iTunes would go negative, the mechanical rate would have to be well above 15 cents, wouldn't it?
>
> A: I do.
>
> Q: So if you sell, hypothetically, a billion songs a year, every penny increase in the mechanical rate would be $10 million, if it were passed along to Apple, correct?
>
> A: Correct.

Q: So you would need a multiple of that penny, which we can compute from the documents that are in evidence, in order to hit negative, correct?

A: Correct.

Q: But it would be above 15 cents?

A: That's correct.

Id. at 4311-12.

710. The evidence provided by Ms. Enders confirms this conclusion. *See* CO PFF ¶¶ 461-66. According to Ms. Enders, even if Apple were to fully absorb the Copyright Owners' proposed rate increase from 2007 through 2012, the iTunes Store would remain profitable. Enders WDT (CO Trial Ex. 10) at 50-51. In this scenario, iTunes would absorb the increased royalty rates while the record companies would maintain their current content licensing income levels of around [redacted] of retail. *Id.* at 50. As set forth in the table below, under such circumstances, Apple would still enjoy a [redacted], despite increased mechanical royalty costs.

Table 10-E: Forecasts for iTunes under iTunes full absorption of rate increase, 2007-2012

Calendar Year	2007e*	2008e	2009e	2010e	2011e	2012e
Revenue (m)	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Content licensing costs (m)	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Total OCOGS (m)	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Total operating expenses (m)	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Contribution margin (m)	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Contribution margin %	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

*Data for the first half of 2007 is supplied by Apple, and the second half of 2007 is an estimate of Enders Analysis.

Enders WDT (CO Trial Ex. 10) at 51.

711. In reality, the record evidence indicates that Apple is highly unlikely to bear the cost of a rate increase. Since Apple launched the iTunes Store in 2003, the mechanical royalty has already increased twice, in 2004 and 2006. CO PFF ¶ 834. On

both occasions, the rate increase came and went without any increase in costs for Apple. *See* 2/25/08 Tr. at 4277 (Cue) (testifying that he was not even aware that the rate had increased in 2004 and again in 2006). In 2004—the time of the first rate increase—Apple renegotiated its contracts with the major record companies without changing their pricing provisions. *Id.* at 4279. In 2006, Apple again renegotiated its contracts with the major record companies and again was not asked to bear the cost of the higher mechanical rate. *Id.* at 4280. Indeed, Mr. Cue testified that Apple has never made additional payments to the record companies to account for adjustments in the mechanical royalty rate. *Id.* at 4279-80. DiMA fails to provide evidence to support the view that the situation would be any different going forward.

5. DiMA Provided No Empirical Evidence Showing the That Digital Music Market is Sensitive to Price

712. In its Proposed Findings of Fact, DiMA continues to argue that the ongoing competition between legitimate digital music services and free pirate services puts significant downward pricing pressure on legitimate services. DiMA PFF ¶¶ 47-48, 52-57, 182-88. According to DiMA, the Copyright Owners are wrong that any digital distributor could successfully pass a portion of a rate increase to consumers because "higher retail prices would push increasing numbers of consumers to abandon legitimate services and turn to illegal pirates instead." *Id.* ¶ 184. These claims, however, have no factual support as not one DiMA witness presented evidence of price sensitivity studies performed on digital music services. *See* CO PFF ¶¶ 26, 836-37.

713. DiMA expert Ms. Guerin-Calvert admitted that she had no empirical basis for concluding that the digital market was sensitive to price changes, having never conducted or reviewed a demand elasticity study concerning digital music:

Q: Now, you have also expressed the view, have you not, that there is price sensitivity in the permanent download market?

A: Yes.

Q: And you have never had a conversation with anyone at Apple as to whether or not they have studied whether there is any price sensitivity, have you?

A: I have not — I have had general conversations as to the background of the industry, the pricing pressures. I have not had a specific discussion with them as to how they would change — or the basis on which change particular price points. I have not had that discussion.

Q: Has Apple shared with you any price sensitivity survey or study that it has done?

A: I'm not recalling any — of the type of study that we just talked about, any studies that were shared with me.

Q: And you, in fact, have not done a price sensitivity survey for Apple, correct?

A: Of the specific type in terms of looking specifically at what one would call an elasticity of, if they were to raise their price a specific amount, how much might they expect to lose for them...

***

Q: And you didn't do any specific demand elasticity study for the digital music market, did you?

A: Of the type I just talked about, no.

Q: Neither for downloads, correct?

A: Of the type I just talked about, no.

Q: Nor did you do a specific demand elasticity study for the subscription business, correct?

A: Of the type I talked about, no.

2/26/08 Tr. at 4581-84 (Guerin-Calvert).

723. In an attempt to preserve the usefulness of the U.K. Settlement Agreement, DiMA broadens its international focus to include evidence of the mechanical rates used in countries besides the U.K. According to DiMA, a review of other international rates indicates both that a percentage structure is more appropriate in the U.S. and that Ms. Guerin-Calvert's suggested rate of 4-6% of revenue is reasonable. *See* DiMA PFF ¶¶ 328-32. DiMA's analysis, which offers a straight-forward list of the percentage of revenues received by Copyright Owners in other countries, however, is fatally flawed because it fails to account for, or even describe, the revenue base used in each country. DiMA PFF ¶ 330, Table 1. Without evidence of the forms of revenue against which each percentage is applied, a comparison of the percentages themselves is meaningless. *See* CO PFF ¶ 819 (discussing Ms. Guerin-Calvert's failure to consider the differences between the revenue base specified in the U.K. Settlement and the definition of revenue proposed by DiMA).

2. The 1981 CRT Decision Is Not an Appropriate Benchmark

724. In her written direct testimony, Ms. Guerin-Calvert "focused [her] primary review on the 1980/81 decision because it applied the same objectives involved in this proceeding." Guerin-Calvert WDT (DiMA Trial Ex. 7) at 13. Ms. Guerin-Calvert repudiated that view during the rebuttal case hearing. DiMA, however, continues to rely on the 1981 Decision as a "useful source of analytical guidance" and a benchmark that "provides insight into an appropriate rate." DiMA PFF ¶¶ 333-34.

725. As discussed in the Copyright Owners' Proposed Findings of Fact, irrefutable evidence concerning the fundamental changes in the U.S. music market since 1981 limits, if not eliminates, the applicability of the 1981 Decision to today's

proceeding. *See* CO PFF ¶¶ 809-14. Even DiMA concedes this point. Roughly 3 sentences after emphasizing the insight offered by the CRT Decision, DiMA reverses course, explaining that "[t]he radical transformation of industry conditions since then points decidedly towards a different allocation of revenues and a lower rate compared to 1981." DiMA PFF ¶ 334.

726. Notwithstanding such contradictions, DiMA again provides no evidence to link its proposed benchmark to its proposed mechanical royalty rates. Ms. Guerin-Calvert's only calculations, through which she attempted to transform the 5% of retail revenue purportedly adopted by the CRT into 6% of applicable receipts, were based upon mistaken assumptions about the equivalency of retail list prices and average actual retail prices in 1980. CO PFF ¶¶ 811-12. When asked to defend the connection she made between the 5% royalty rate from the CRT and DiMA's current proposal, Ms. Guerin-Calvert backed away from her purported benchmark entirely:

> Q: Do you recall that in your testimony on the direct part of this case, you submitted a report that said that the '81 decision implied a 5 percent rate?
>
> A: I had a footnote that said that were one to make use of calculations and so on with the assumptions that prevailed at the time that the decision was done, it would be the equivalent of 5 percent.
>
> Q: And are you testifying that the Court should rely on the rate set in the 1981 proceeding in setting a rate in this proceeding? Can you answer that yes or no?
>
> A: No.
>
> Q: You're not?
>
> A: No.

5/6/08 Tr. at 4866 (Guerin-Calvert). Without any evidence to salvage claims such as these by its own witnesses, DiMA clearly can no longer rely on the 1981 Decision as a benchmark of any sort.

G. DiMA's Criticisms of Professor Murphy's Work Are Meritless

727. DiMA also levels a series of criticisms of Professor Murphy's work on behalf of the Copyright Owners. Although DiMA does not appear to take issue with Professor Murphy's study of controlled composition clauses, *see* CO PFF ¶¶ 690-93, DiMA attempts to undermine Professor Murphy's testimony that demonstrates that a decline in CD prices does not entail a reduction in the statutory rate. DiMA PFF ¶¶ 293-98. Some of DiMA's claims misconstrue his testimony; others appear to be based on a misunderstanding of Professor Murphy's work. None provides any basis for undermining Professor Murphy's work.

728. Professor Murphy's study has been described in detail in the Copyright Owners' Proposed Findings of Fact, *see* CO PFF ¶¶ 726-37, as well as in these Reply Findings of Fact, *see supra* Section VIII.A. In short, Professor Murphy exposed the flaw in the RIAA's argument (now adopted by DiMA) that a decline in CD prices should result in a reduction in the mechanical royalty rate. The notion that there should be a fixed relationship between CD prices and the mechanical rate finds no support in economic theory or the relevant empirical evidence. K. Murphy WRT (CO Trial Ex. 400) at 4-14. As Professor Murphy explained, under conditions of falling sales and falling prices, the relative compensation to songwriters must increase in order to maintain a steady supply of songs. *Id.* at 6-8. Similarly, the proliferation of low-cost forms of digital distribution should likewise result in an increase in relative compensation for

songwriters. As he put it, the argument "that songwriters should receive less per song when the per-unit price of recorded music declines ignores the prediction from economic theory that greater relative supply of alternative distribution methods will increase, not reduce, the market-determined compensation of songwriters and other inputs used to create the recordings relative to both record company compensation for distribution and the price of the final product." *Id.* at 5 (emphasis in original). For these reasons, Professor Murphy concluded that a percentage mechanical royalty rate would be inappropriate. At precisely the point when relative compensation for songwriters should rise, a percentage rate would create a static relationship between songwriters' remuneration and the price of music. *Id.* at 13-14.

729. DiMA attacks Professor Murphy's work on six principal grounds. None has any merit.

730. First, DiMA asserts that Professor Murphy has "done very little work with respect to the recorded music industry." DiMA PFF ¶ 294. The argument is entitled to no weight. An economist of Professor Murphy's stature and broad experience applies economic principles to different industries routinely. *See, e.g.* 5/15/08 Tr. at 6861-62 (K. Murphy) (discussing how his work "focuses on how prices are determined in markets and the way in which markets operate generally."); *Id.* at 6861-66 (discussing his experience in intellectual property matters). And the argument is particularly puzzling given that DiMA's economist, Ms. Guerin-Calvert, cited Professor Murphy's academic work on the effects of piracy in her own written testimony. *See* Guerin-Calvert WDT (DiMA Trial Ex. 7) at 22 n.27.

731. Second, DiMA argues that Professor Murphy failed to analyze "the overwhelming empirical evidence that rebuts his theory as applied in this context." DiMA PFF ¶ 294. In support of this sweeping generalization, DiMA cites just one thing: According to DiMA, Professor Murphy's opinion concerning the superiority of a penny rate to a percentage rate ignores that "the United States stands virtually alone in applying a penny rate to mechanical rights payments." *Id.* ¶ 294. There is no evidence to indicate that Professor Murphy ignored this issue, and DiMA cites none. *See id.* In fact, Professor Murphy was not asked a single question by either the RIAA or DiMA about international rates. *See* 5/15/08 Tr. at 6918-66 (K. Murphy); 5/19/08 Tr. at 6975-7021 (K. Murphy). Nor does DiMA explain how percentage rates anywhere else in the world undermine Professor Murphy's conclusions.

732. Third, DiMA claims that Professor Murphy's testimony concerning the preference for a penny rate in the current market for recorded music is "undermine[d]" by "one of the key tenets of his analysis." DiMA PFF ¶ 295. As DiMA notes, Professor Murphy testified that under current market conditions in the recorded music industry, "[l]ower distribution costs would lower product prices but would, all else equal, raise the compensation to creative inputs. However, under a percentage of revenue royalty stream, royalties would decline at the same time that the market compensation to creative inputs must rise in order to maintain the supply of songwriting." K. Murphy WRT (CO Trial Ex. 400) at 14. DiMA contends that Professor Murphy "conceded" at trial that "a penny rate suffers from the same flaw" because it is fixed and "cannot adjust alongside market fluctuations either." DiMA PFF ¶ 295. He made no such concession.

733. Simply put, DiMA's claim of concession misreads Professor Murphy's testimony. In the exchange cited by DiMA in support of its argument, he *reaffirmed* his argument that a penny rate is preferable to a percentage rate:

> Q: Now, when you refer to a fixed ratio here, you're commenting on a percentage rate structure; is that right?
>
> A: That would be the intent here, to think about what happens if you have a percent of revenue type rate structure.
>
> Q: Okay. And in this paragraph, in paragraph 13, what you're opining on here is that a percentage rate structure is flawed because it does not account for changes in the relative market values of the creation step and the distribution step over time; is that right?
>
> A: Essentially.
>
> Q: Dr. Murphy, a penny rate doesn't account for market values that change relative to each other over time either, does it?
>
> A: No, *but at least it wouldn't move it in the wrong direction.*

5/19/08 Tr. at 7015-16 (K. Murphy) (emphasis added)

734. Fourth, DiMA claims that Professor Murphy's analysis inappropriately focused on the outcome to be expected in a competitive market. DiMA PFF ¶ 296. According to DiMA, this approach disregards the statutory objectives in Section 801(b). The Copyright Owners have addressed this issue both above, *see supra* Section VI.B.2, and in their Proposed Conclusions of Law, *see* PCL ¶¶ 25-27, 68-73. DiMA's interpretation of Section 801(b) cannot be squared with this Court's precedent, which provides clear support for a market-based approach to determine a reasonable mechanical royalty rate.

735. Fifth, DiMA argues that Professor Murphy "disregard[ed] the consumer-friendly innovative contributions of legal digital distributors." DiMA PFF ¶ 297. In particular, DiMA claims that Professor Murphy "did not consider the proper valuation of—or compensation for—the newer innovative [music distribution] services." *Id.* But of course, Professor Murphy's testimony *does not purport to address* those issues. *See* K. Murphy WRT (CO Trial Ex. 400) at 3 (describing issues addressed in his report). Nor does DiMA explain how his not addressing this issue impacts the conclusions he drew.

736. Finally, DiMA claims that Professor Murphy "premised his theoretical construct on the erroneous assumption that musical compositions and distribution are economic complements" when, according to DiMA, they are "joint inputs." DiMA PFF ¶ 298. There is no basis for this criticism either.

737. DiMA's argument is based on two snippets of testimony. DiMA cites to Ms. Guerin-Calvert's view, expressed in response to Professor Landes's written direct testimony, that digital distribution is a joint input. But she never illuminated what she meant, and it is almost impossible to comprehend the product for which a song and a digital distributor such as iTunes could both be inputs. DiMA's reliance on Professor Slottje is no less opaque. He nowhere stated that that musical compositions and distribution are "joint inputs." *See* 5/8/08 Tr. at 5339-40, 5344-46 (Slottje) (cited in DiMA PFF ¶ 298).

738. In short, DiMA's arguments provide no reason to discount Professor Murphy's analysis.

XII. Ms. Finell's Testimony Establishes That The Mastertones in The Record Are "Original"

739. The RIAA does not dispute the accuracy of the evidence that the Copyright Owners presented on the creation of mastertones. Instead, the RIAA claims that the analysis performed by the Copyright Owners' expert musicologist, Judith Finell, focused on questions of "creativity and training" rather than originality, and therefore, that her testimony was inapposite "to determine whether [mastertones] are derivative works." RIAA PFF ¶¶ 1705, 1708. As explained in the Copyright Owners' Reply to the Conclusions of Law of the RIAA and DiMA, however, to be a derivative work, a work must be "original" in that it must possess a "requisite level of creativity." Feist Publ'ns, Inc. v. Rural Tel. Serv. Co., 499 U.S. 340, 346 (1991). The level "is extremely low; even a slight amount will suffice." *Id.* Moreover, creativity in the selection of what to include in a compilation or abridgment may satisfy the standard of originality. *See id.*; Waldman Publishing Corp. v. Landoll, 43 F.3d 775, 782 (2d Cir. 1994).

740. Ms. Finell's testimony is directly relevant to the issue of originality. Ms. Finell testified that creating a mastertone requires creative musical judgment, including choosing a segment of the song to incorporate into the mastertone, selecting the iteration of that segment to use, and deciding how best to edit that segment. Finell WRT ¶¶ 43-46.

741. Although the RIAA argues that in creating mastertones, there are only a few choices that a creator can make, the record evidence proves the opposite. *See, e.g.*, RIAA PFF ¶¶ 1690 ("Identification of a target excerpt requires . . . identifying which of a limited set of passages in a song should be used as a ringtone); 1699 ("there are only a few permutations of edits of the hook that are balanced and make musical sense to stand on their own"); 1701 ("[T]he location of cuts [i]s dictated by traditional musical

principles."). As Ms. Finell testified, "[i]n a 4-minute song, you will have many different possibilities" to choose from in identifying an appropriate excerpt. 5/21/08 Tr. at 7667 (Finell); Finell WRT (CO Trial Ex. 420) at 27. And, once the segment has been identified, there may be 15-20 different iterations to choose from, each of which may differ. 5/21/2008 Tr. at 7668; Finell WRT (CO Trial Ex. 420) at 27 28. Finally, in selecting the particular cuts to make, there are artistic considerations, as well as musical judgments to make about which material to include and which material to exclude. 5/21/2008 Tr. at 7669; Finell WRT (CO Trial Ex. 420) at 28. The RIAA has not rebutted this evidence (as it cannot).

742. The RIAA nevertheless argues that executing the numerous creative steps identified by Ms. Finell is "routine." RIAA PFF ¶ 1691. The only support offered for this assertion, however, is the trial testimony of Jerold Rosen. As the Copyright Owners' Proposed Findings of Fact make clear, at trial, the bulk of Mr. Rosen's written direct testimony—including every portion concerning the creative aspects of making mastertones—was struck from the record because he conceded that he did not "have an understanding currently" of the way mastertones are made. 2/14/08 Tr. at 3539, 3549-50. Thus, Mr. Rosen's conclusory opinion, unsupported by any fact, is entitled to no weight.

743. Left with nothing to argue from but the Sony BMG Guidelines (introduced into evidence by the Copyright Owners because they prove Ms. Finell's point), the RIAA claims that Sony BMG, primarily through the those Guidelines, provides "clear guidance" to its staff on the steps required to create mastertones and that the staff follows that guidance in a "routine fashion." RIAA PFF ¶1691. In support of this assertion, the RIAA again cites the discredited testimony of Mr. Rosen. But Mr. Rosen has no

knowledge of the way mastertones are made, and he denied ever having seen the Sony BMG Guidelines prior to being confronted with them at trial. *See* 2/24/08 Trial Tr. at 3527. As for the Sony BMG Guidelines, far from supporting the RIAA's argument, they themselves make clear that creating a mastertone requires more than rote judgment. Thus, the Sony BMG Guidelines—setting forth Sony BMG's judgment as to the creative characteristics Sony BMG mastertones should embody—provide that mastertone creators should strive to create mastertones that are "indivisible musical unit[s]" that are "musically balanced" and "hermetically sealed," and that do not sound like a "fragment[]" of something else. CO Trial Ex. 420, Ex. E, at RIAA 10316-17. The Sony BMG Guidelines further confirm the creative steps involved in creating mastertones, as identified by Ms. Finell. Finell WRT (CO Ex. 420) 7-8, 26-30; 5/21/08 Tr. at 7677-7680.

744. Finally, at trial, Ms. Finell explained best why the Sony BMG Guidelines are not, as the RIAA mistakenly contends (without a speck of factual support), easy to follow, and simply cannot be followed in a routine fashion:

> They're guidelines, but they're guidelines that require judgment. Given any 10 songs, all the songs have different structures, have different hooks, have different decisions that have to be made in terms of what you're trying to accomplish. That's why they're guidelines. They can't be applied without really understanding the song you're dealing with.

5/21/08 Tr. at 7694 (Finell).

XIII. The RIAA's Proposed Terms

745. The RIAA has proposed a number of terms that would dilute the requirements of the compulsory license. The RIAA seeks to change the date on which DPDs are deemed to be distributed; to water down the reporting and certification protections that Section 115 affords to the Copyright Owners; to relieve the obligation to

pay royalties on "locked content"; and to codify their view that only a single mechanical payment is due for multiple instances of the same song on a phonorecord. The RIAA has failed to adduce any evidence that would support such changes. More importantly, five of the six terms proposed by the RIAA cannot be fixed by this Court because their adoption would require modification of the express requirements established by Congress in Section 115 of the Copyright Act.

A. Accounting for Digital Phonorecord Deliveries

746. The RIAA continues to advocate a term with respect to changing the definition of when a DPD is "distributed" under Section 115 notwithstanding its belief that the term, "as a legal matter . . . is outside the scope of the Judges' jurisdiction." RIAA PFF ¶ 1765. In essence, the RIAA proposes a term that would define the word "distributed" in Section 115 as "reported."

747. Section 115(c)(2) states that "the royalty under a compulsory license shall be payable for every phonorecord made and distributed in accordance with the license." 17 U.S.C. § 115(c)(2). Again, under the terms of the statute, such payments "shall be made on or before the twentieth day of each month and shall include all royalties for the month next preceding." 17 U.S.C. § 115(c)(5). The current regulations mirror the statutory requirement. They provide that a DPD "shall be treated as a phonorecord made and distributed on the date the phonorecord is digitally transmitted." 37 C.F.R. § 201.19(a)(6).

748. The RIAA proposes that for DPDs distributed by a party other than the compulsory licensee, the Court should modify Section 201.19(a)(6) to provide that a DPD is considered made and distributed "in the accounting period in which it is reported to the compulsory licensee" instead of the month in which it was actually distributed.

no explanation why this "looser standard" (5/6/08 Tr. at 4780 (Roberts, J.)) should be adopted. Signature under oath by an officer ensures review at an appropriately senior level at the record company. It is a valuable protection for Copyright Owners which should be retained absent evidence of anything more than inconvenience to support a change.

C. Audits

753. The RIAA's proposed term amending the regulations to eliminate the required annual statement of account certified by a Certified Public Accountant suffers from the same primary deficiency as the signature term discussed above: the requirement is contained in Section 115 itself. Congress laid out the requirement that annual statements of account be "detailed," "cumulative," and "certified by a certified public accountant." 17 U.S.C. § 115(c)(5). Congress explained this obligation in 1976: "In order to increase the protection of copyright proprietors against economic harm from companies which might refuse or fail to pay their just obligations, compulsory licensees will also be required to make a detailed cumulative annual statement of account, certified by a Certified Public Accountant." H.R. Rep. No. 94-1476 at 111 (1976).

754. The RIAA ignores the statute entirely and proposes that the Court simply amend the regulations to eliminate the statutorily required certified statement of account as redundant of audits of financial statements conducted in the ordinary course of business. RIAA PFF ¶ 1774. The Court has no power to ignore the statutory requirement.

755. The RIAA argues that this Court recognized the adequacy of an independent audit in unspecified "past cases." *Id.* ¶ 1776. To the extent the RIAA is referring to Section 114 cases, the reference is irrelevant. Section 114 contains no

requirement for any kind of monthly or annual statements, much less detailed cumulative annual statements of account certified by a certified public accountant.

756. The RIAA claims that the compulsory license's annual certification is "redundant" because record companies conduct annual corporate audits and publishers audit the record companies as well. RIAA PFF ¶ 1774. First, the "annual corporate audits" conducted by the record companies are at the financial statement level. *See* A. Finkelstein WRT (CO Trial Ex. 84) at 26. They are not focused on the accuracy and completeness of specific statements of account related to particular musical works. As a result, a general corporate financial statement audit is wholly different from the work required by a CPA when certifying the cumulative statements of account particular to each musical work as required by Section 115.

757. Second, compulsory licensing is conducted on the honor system; the Copyright Owners should not be required to find and catch the cheaters. The RIAA's suggestion that certification of an annual statement is "superfluous in this day and age where the publishers are going to do an audit" (5/12/08 Tr. at 5759-60 (A. Finkelstein)) turns the system established by Congress on its head. Reliance on publishers' audits would shift the burden of ensuring the accuracy of record companies' accounts to the Copyright Owners. As Alfred C. Pedecine, Senior Vice President and Chief Financial Officer of HFA, testified, HFA does conduct time-consuming and costly Royalty Compliance Examinations to identify licensees' unpaid royalties. Pedecine WRT (CO Trial Ex. 394) at 12; *see also* 2/5/08 Tr. at 1431 (Israelite). However, the Court should not reward the record companies' delinquency by converting HFA's verification of the record companies' royalty reports into a substitute for record companies' own

verification by an independent CPA when licensees choose to avail themselves of the compulsory license. The Court recognized this responsibility of licensees in the Satellite Radio proceedings: "The responsibility of timely submitting royalty payments and statements of account rests with the statutory licensee." 73 F.R. at 4100.

758. Further, the RIAA's perceived "redundancy" simply does not exist for record companies other than the four majors. As Mr. Pedecine testified, "[f]or smaller and medium sized licensees (which are typically record companies as well), audits are not automatic, but rather are triggered by factors that suggest an RCE is necessary." Pedecine WRT (CO Trial Ex. 394) at 8. For the smaller licensees, RCEs are done "on a more judgmental basis, usually triggered by some criteria, such as whether a given licensee has a history of noncompliance with licenses [or] some empirical indicator may tell us that it might be worth looking at them." 5/19/08 Tr. at 7037 (Pedecine).

D. Locked Content

759. The RIAA proposes another modification to Section 115's definition of "distribution" in its "locked content" term. The RIAA asks the Court to modify Section 115's definition of distribution for recordings that are encrypted or degraded and then preloaded on a device or transmitted by DPD for limited previewing until the customer purchases the full, non-degraded form. RIAA PFF ¶ 1674. The RIAA argues that such "locked content" should not be considered "distributed" and therefore subject to royalty payments until the customer "unlocks" the content and is given permanent access to the recording. *Id.* ¶ 1676.

760. The Register of Copyrights recently issued a Notice of Proposed Rulemaking which confirms that the authority to adopt such a term lies with Congress and the Register, not the Court. *See* Notice of Proposed Rulemaking, Compulsory

License for Making and Distributing Phonorecords, Including Digital Phonorecord Deliveries, Docket No. RM 2000-7 (July 10, 2008) at 12-14. Moreover, the Register rejected the very proposal advanced by the RIAA here. *Id.* at 28-29. The Register noted that, "The Office takes notice that some commenters have asserted that certain DPDs, known as 'locked content' . . . should not be considered distributed until the product is 'unlocked.'" *Id.* at 28. However, under the Register's proposed definition of DPDs, "all delivered DPDs are considered distributed regardless of such so-called 'locks.'" *Id.* "Despite the presence of such technological protections, 'locked content' appears to satisfy the requirements for being both phonorecords and DPDs." *Id.* at 28-29.

E. Multiple Instances

761. The Court similarly lacks authority to adopt the RIAA's proposed "multiple instances" term because it would modify two provisions of Section 115. The RIAA proposed term would change Section 115 to provide that where multiple fixations of the same sound recording are distributed as part of a single transaction, "such fixations together shall be considered the same track." Second Amended Proposed Rates and Terms of the RIAA at 6.

762. As demonstrated in the Copyright Owners' Proposed Findings of Fact (¶¶ 886-88), the RIAA's proposed term falls outside the scope of the Court's authority because it modifies Section 115(c)(2)'s requirement that royalty be paid "for every phonorecord made and distributed." In addition, it would modify Section 115(d)'s definition of a DPD: "each individual delivery of a phonorecord by digital transmission of a sound recording which results in a specifically identifiable reproduction by or for any transmission recipient of a phonorecord of that sound recording." 17 U.S.C. § 115(d).

763. The type of "multiple fixations" proposed by the RIAA would enable the user to play the musical work "on multiple devices or at different levels of sound quality." RIAA PFF ¶ 1680. These "fixations" are therefore "specifically identifiable reproductions" under Section 115(d)(2), unlike the RIAA's analogy to the right and left stereo channels of a track. *See id.* ¶ 1681. The Court lacks the authority to modify these statutory provisions.

F. Clarification of Covered Reproductions

764. Unlike the five terms discussed above, the RIAA's proposed term clarifying the definition of covered reproductions does not contravene the express authority of the Court and the Copyright Owners do not oppose the adoption of such term.

XIV. The Copyright Owners' Proposed Terms

765. Unlike five of the six terms proposed by the RIAA, which are neither justified by the evidence nor permitted by the statute, the Copyright Owners' proposed terms fall squarely within the Court's express authority and are designed to address the specific, rampant problem of late and incomplete payments of mechanical royalties. *See* CO PFF ¶¶ 844-45. Adoption of the Copyright Owners' proposed terms would create meaningful incentives for licensees to pay in a timely and complete manner, and would achieve Section 801(b)(1)'s objective of affording Copyright Owners a fair return for their creative works.

A. 1.5% Late Payment Fee

766. The RIAA does not dispute that record companies frequently fail to make complete and timely mechanical royalty payments. Indeed, the RIAA's own witnesses conceded as much at trial. *See* 2/14/08 Tr. at 3258 (C. Finkelstein); 5/12/08 Tr. at 5692

(A. Finkelstein). The Copyright Owners presented ample evidence demonstrating the extent of the record companies' late-payment problem, including evidence that HFA spends millions of dollars a year to uncover unpaid royalties. CO PFF ¶¶ 846-48; Pedecine WRT (CO Trial Ex. 394) at 11 (Table 2). But although the RIAA acknowledges the problem of its members' late payments, it disputes the propriety of a late fee that would compensate the Copyright Owners for it. The RIAA offers seven excuses why the Copyright Owners should continue to bear the costs of the record companies' tardiness. All are attempts to distract attention from the record companies' chronic late payments and the obvious need for the same statutory remedy imposed by this Court in the Webcasting II and SDARS proceedings.

1. RIAA's Excuse #1: Late Payments Aren't That Late

767. The RIAA seeks to minimize the import of the late payment analysis performed by the HFA. That study, as Mr. Pedecine testified, shows that over 70% of the mechanical royalties received by HFA from January 1, 2000 to September 5, 2007 were, on average, 80 days late. *See* Pedecine WRT (CO Trial Ex. 394) at 5. The RIAA nonetheless argues that some of the payments were only a little late and that "a relatively large number of relatively small payments [were] received many years late." RIAA PFF ¶ 1807.[11] But that argument does not rebut the fact that 41,000 receipts totaling more

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[11] The RIAA also contends that HFA's late payment analysis should have taken into account the advances paid by record companies to HFA to cover "late payments on unlicensed uses and certain uses that have been licensed." RIAA PFF ¶ 1808. As Mr. Pedecine testified, however, HFA's late payment analysis accounted for advances by using the net cash receipts due, which takes into account the money recouped from advances. *See* 5/19/08 Tr. at 7088-90 (Pedecine).

than $2.1 billion were paid late. Pedecine WRT (CO Trial Ex. 394) at 5. As the RIAA acknowledges, some payments were received *many years late.*

768. The magnitude of late payments and the Copyright Owners' costly audits to uncover the royalties they are owed evidence a late payment problem that far exceeds those that prompted the Court to impose a 1.5% late fee in prior proceedings. In the SDARS proceedings, the record companies requested a 1.5% late fee, even though they conceded that licensees were "typically timely with their payments." SDARS Determination, 73 Fed. Reg. at 4099. The Court found that a late fee of 1.5% was "a proper incentive" to "*maintain* such timeliness." *Id.* (emphasis added). Even though the licensees had a "history of making payments in a timely manner the majority of the time," the Court was "not persuaded that a late fee of 0.5% per month provides a sufficient incentive." *Id.* In the Webcasting II proceedings, the Court imposed a 1.5% fee instead of the 2.5% proposed by the record companies because "the frequency of late payments . . . has not been so rampant as to warrant a much higher late fee." In re Digital Performance Right in Sound Recordings and Ephemeral Recordings, Final Determination of Rates and Terms, 72 Fed. Reg. 24084, 24107 n.75 (May 1, 2007) ("Webcasting II Determination"). Where a fee of 1.5% is required to maintain timeliness, it is all the more justified to remedy untimeliness.

2. RIAA's Excuse #2: Late Payments are the Fault of the Writers and Music Publishers

769. The RIAA continues to argue that the Copyright Owners' proposed late payment fee is "inappropriate" because the Copyright Owners themselves cause late payments. RIAA PFF ¶ 1793. The evidence adduced at trial proves nothing of the sort.

770. The RIAA knows that the Copyright Owners' proposed late fee would not apply to royalty payments that accrue during the period in which publishers and writers resolve copyright ownership interests (commonly referred to as "splits"). *See* A. Finkelstein WRT (RIAA Trial Ex. 84) at 10 (confirming that for the HFA physical license she attached to her statement, "I do not understand the late fee to apply before splits are worked out."). At trial, Ms. Finkelstein acknowledged that "as a practical matter" late fees would not apply to the period of time while publishers and writers resolve split ownership interests. 5/12/08 Tr. at 5685-87 (A. Finkelstein).

771. Mr. Pedecine similarly explained that a late fee would not apply until a license "gets taken" which can be up to a year after the product is released into the market. 5/19/08 Tr. at 7080 (Pedecine). Only when copyright ownership issues are resolved and a work has been licensed would the work become eligible for a late fee. *Id.*; *see also* 5/12/08 Tr. at 5687 (A. Finkelstein). Judge Roberts clarified Mr. Pedecine's explanation of the proposed late fee:

> Q: How would you categorize the situation, however, where a license is sought, but the very first payment when it becomes due is not paid timely? Is that a late payment or is that simply a license yet to be taken?
>
> A: If I understand the question correctly, I believe that would be a license yet to be taken and, in the context of the way things would work at our company, once it has been licensed and the licensee begins to report — the first quarter it's in is going to be the first time that money would be eligible for a late fee. And if they pay that quarter on time, there wouldn't be a late fee.

5/19/08 Tr. at 7080 (Pedecine). Based on the record evidence that the proposed late fee would not apply until the splits have been determined, the RIAA's excuse that the late fee

would "penalize the record companies for the Copyright Owners' own dilatory conduct" is simply untrue. *See* RIAA PFF ¶ 1804.

3. RIAA's Excuse #3: Record Companies Already Pay Advances To Cover Late Payments

772. Just as the RIAA continues to pretend that the Copyright Owners' proposed late fee would apply during the resolution of copyright splits, the RIAA also continues to maintain the fallacy that record companies pay advances to cover late payments. *See* RIAA PFF ¶¶ 1808-12. The RIAA apparently forgets that those "advances are being paid on payments pending resolution of split copyright issues." 5/12/08 Tr. at 5691 (A. Finkelstein).

773. Likewise, the RIAA appears not to have noticed Chief Judge Sledge's question for Mr. Pedecine: "the advances deal only with unlicensed usage and have no application to timeliness of payments?" or Mr. Pedecine's answer: "yes, Your Honor, because once the product would get licensed and come out of the pending, it then becom[es] available in production system of the record company to be paid in the next quarterly cycle. And if it flushes out in the next quarterly cycle and that quarterly reporting takes place on or before that 15th following the end of the quarter, there would be no late fee applied." 5/19/08 Tr. at 7072-73 (Pedecine). After the following colloquy between Judge Roberts and Mr. Pedecine, the record could not be clearer that Copyright Owners do not receive advances to cover late payments.

> Q: I just wanted to get an understanding as to what your perception was as to what role advances serve. And you're saying the role that advances serve is to pay for licenses not yet obtained?
>
> A: By and large, yes. . . . It's primarily for pending, as the term is used, pending the license. But in some instances in some of the agreements we see reference to the unmatched

> files of a particular licensee, which could be more unlicensed or, to some extent, potentially there could be some licensed in there that's hung up in their system.
>
> Q: But not works that are actually licensed for which late payment –
>
> A: That's not what it's for.
>
> Q: I understand. Thank you.

Id. at 7075-76. The record reflects that Copyright Owners are not compensated for late payments – through advances or otherwise.

4. RIAA's Excuse #4: Record Companies Don't Withhold Payments "Abusively"

774. The RIAA claims that even if the Copyright Owners were not themselves to blame for late payments, the Copyright Owners "failed to present any credible evidence that record companies hold back mechanical royalty payments *in an abusive way*." RIAA PFF ¶ 1805 (emphasis added). The Copyright Owners' proposed late fee is not designed to punish the record companies for their "abusiveness," but to compensate the Copyright Owners for the record companies' lateness.

5. RIAA's Excuse #5: The Proposed Late Fee is Inconsistent with Marketplace Practice

775. The RIAA argues that the Copyright Owners' proposed late fee is not justified because Copyright Owners do not obtain such late fees in their contracts with record companies for physical or digital product or ringtones. According to the RIAA, the Copyright Owners' proposed late fee should not be adopted because it is "contrary to marketplace norms." RIAA PFF ¶ 1785. As noted in the Copyright Owners' Proposed Findings (¶¶ 858-60), HFA's licenses are considered a "variant" of the compulsory license and, as the RIAA acknowledges, HFA encounters "marketplace resistance"

(RIAA PFF ¶ 1784) if it seeks to impose requirements more stringent than the compulsory license. Without a late fee in the statutory license, the Copyright Owners have no power to negotiate one in open-market negotiations because the record companies always have the option of "going statutory."[12]

776. In marketplace negotiations unconstrained by the statutory license, late fees are the norm. In this regard, the RIAA fails to mention to the Court that late fees most certainly are the marketplace norm for them.

777. As demonstrated in the Copyright Owners' Proposed Findings of Fact, all four major record companies receive late fees of [redacted]% per month in their contracts with Apple. CO PFF ¶ 848. In addition, all four major record companies receive late fees of [redacted]% per month in their contracts with RealNetworks. *Id.* ¶ 849.

778. Moreover, in the two prior proceedings before this Court (the Webcasting II and the SDARS proceedings) record companies, through their agent, SoundExchange, argued for and received late fees of 1.5% under Section 114 licenses. *See SDARS* Determination, 73 Fed. Reg. at 4099; Webcasting II Determination, 72 Fed. Reg. at 24107; *see also* 5/12/08 Tr. at 5698 (A. Finkelstein) (acknowledging that record companies are entitled to 1.5% late fees under Section 114).

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[12] Nevertheless, as the RIAA points out, the Copyright Owners have had some success obtaining late fees in some contracts. *See* RIAA PFF ¶¶ 1787, 1791. The agreement between HFA and Sony BMG that Ms. Finkelstein attached to her written rebuttal testimony is one example. It contains a late fee of 7% per year. *See* A. Finkelstein WRT (RIAA Trial Ex. 84), RIAA Ex. 134-RP. Famous Music Publishing's ringtone licensing agreement provides for a late payment of "the prime rate found in the Wall Street Journal . . . plus two percent (2%), compounded daily." Robinson WDT (CO Trial Ex. 8), Ex. 101 at 5. *See also, e.g., id.* at Ex. 102 at 5; Ex. 103 at 5 (additional Famous Music Publishing ringtone agreements with identical late fee provisions).

779. The Copyright Owners are merely seeking the same compensation that record companies regularly receive in their own contracts. *Cf.* 2/14/08 Tr. at 3257-58 (C. Finkelstein) (testifying that he could offer no commercial reason why the publishers should not be entitled to the same benefit of a late payment that record companies obtain in their contracts).

6. RIAA's Excuse #6: Copyright Owners Have Other Remedies

780. Rather than accept a late fee that would require the record companies to pay for their tardiness, the RIAA argues that the Copyright Owners should be content with their existing remedies of license termination and infringement litigation. RIAA PFF ¶¶ 1814-16. As demonstrated in Copyright Owners' Proposed Findings of Fact, these are costly, burdensome, and severe remedies that do not fully compensate the Copyright Owners for the lost time value of late payments. CO PFF ¶¶ 852-53. Moreover, the Copyright Owners must provide licensees with a notice and 30 days to cure before terminating licenses and bringing an infringement action. 17 U.S.C. §115(c)(6); *see also* 5/19/08 Tr. at 7049 (Pedecine).

781. As an initial matter, a late fee remedy is not, as the RIAA suggests, available only for Copyright Owners that lack the right to terminate. *See* RIAA PFF ¶¶ 1814-16. In the Copyright Royalty and Distribution Reform Act, Congress acknowledged that Copyright Owners were entitled to a late fee in addition to the right to terminate a license and bring an infringement action. Section 803(c)(7) provides that the Court's determination may include terms with respect to late payment, "but in no way shall such terms prevent the copyright holder from asserting other rights or remedies provided under this title."

782. The record evidence of late payments revealed by HFA's records and uncovered by costly audits demonstrates that the current statutory remedies do not adequately incentivize record companies to make timely payments. *See* Pedecine WRT (CO Trial Ex. 394) at 5, 11 (Table 2). And the RIAA does not deny this. Instead, the RIAA suggests that a late fee is "unnecessary" because HFA has its own audit process that is "well-known in the industry and serves as a deterrent to unauthorized and unpaid uses of musical works just as a late fee would." RIAA PFF ¶ 1814. As discussed above in Section VIII.c., the RIAA cannot shift the cost of late payments to the Copyright Owners. HFA spends an average of $2.7 million per year to uncover late and incomplete payments. Pedecine WRT (CO Trial Ex. 394) at 11. Copyright Owners already bear the burden of uncovering late and incomplete payments; they should not also have to forfeit additional money as a result of the lost time value of those payments.

783. Lastly, the 30-day cure period creates the anomalous situation where a licensee can wait to pay until presented with a notice of termination, cure without a late-payment penalty, and leave the Copyright Owners without any recourse to obtain compensation for the lost time value of money. Neither audits by HFA, nor the available termination and infringement remedies can remedy the consequences of this conduct.

7. RIAA's Excuse #7: The Court Lacks Jurisdiction to Adopt a Late Fee

784. Finally, the RIAA argues that this Court lacks jurisdiction to adopt the Copyright Owners' proposed late payment fee because it would conflict with the "detailed five-step 'formula' for calculating the 'amount of royalty payment'" set forth in 37 C.F.R. § 201.19(e)(4). RIAA PCL ¶ 237. According to the RIAA, Section 803(c)(7), which explicitly authorizes the Court to include in its determination "terms with respect

to late payment," does not mean what it says. The RIAA contends that Section 803(c)(7) allows the Court to adopt late payment terms, but only if they are not inconsistent with existing regulations. ¶ 220. There is no such limitation in Section 803(c)(7) or anywhere else in the statute. Even if such a limitation existed, it would not prevent the adoption of the proposed late payment fee because imposition of a late fee does not conflict with Section 201.19(e)(4). That regulation sets forth the method by which licensees must compute royalties that are due – not the consequences of licensees' failure to pay such royalties.

B. Pass-Through Assessment

785. The Copyright Owners' proposed 3% pass-through assessment would compensate Copyright Owners for the inability to directly audit a distributor's records and for the additional delay of royalty payments that occur when a licensee authorizes another entity to distribute works on the licensee's behalf. Pedecine WRT (CO Trial Ex. 394) at 13. The RIAA argues that Copyright Owners should not be entitled to this pass-through assessment because Copyright Owners are unable to obtain such an assessment in their HFA licenses. RIAA PFF ¶ 1818. As stated in the Copyright Owners' Proposed Findings of Fact (¶¶ 858-60), Copyright Owners rarely get terms more favorable than the compulsory license and the fact that Copyright Owners encounter "marketplace resistance" from the record companies does not obviate the need for this term.

786. The RIAA also argues that the Copyright Owners' "primary justification" for this proposed term comes from a limited number of audits that revealed that licensees report and pay digital royalties for the last month of each quarter in the following quarter. RIAA PFF ¶ 1819. The RIAA fails to acknowledge, however, that its own proposed

term, "Accounting for Digital Phonorecord Deliveries," confirms this very problem. *See* Second Amended Proposed Rates and Terms of the RIAA at 7. The RIAA's proposed term would codify the reporting and payment delays that occur in the case of pass-through licensing by modifying the definition of DPD distribution to measure the payment period from the date of "reporting" instead of the date of transmittal. *Id.* Although the Court lacks the authority to modify the statute's definition of "distribution," the RIAA's proposal itself confirms that reporting and payments are delayed in the case of pass-through licensing arrangements. The RIAA's proposed term also confirms that there is an extra layer of reporting that must occur in the case of pass-through licenses, and that additional layer precludes Copyright Owners from gaining access to the critical information they need to conduct thorough and accurate audits. *See* 5/19/08 Tr. at 7053 (Pedecine).

787. Finally, the RIAA suggests that the Copyright Owners' pass-through assessment would unfairly assess payments made during the first two months of a quarter because only the third month's payments actually get delayed until the following quarter. *See* RIAA PFF ¶1820; 5/19/08 Tr. at 7092-93 (Pedecine). The Copyright Owners' proposed term, however, would amend the regulations governing statutory licenses which are paid monthly, not HFA's licenses, which are paid quarterly. *Compare* 17 U.S.C. § 115(c)(5) (payments "shall be made on or before the twentieth day of each month and shall include all royalties for the month next proceeding") *with* RIAA Trial Ex. 29 at CO 1000847 (HFA standard DPD agreement requires payment within 45 days "after the end of each calendar quarter in which the DPDs were made and distributed").

788. Since the statute requires payments to be made monthly, because of later reporting, the delay issue would occur every month under the statutory license. That the Copyright Owners give the record companies a quarter rather than a month to pay under the HFA license is not relevant to setting terms for the statutory license.

789. The proposed assessment would only be applied to a three-month period when licensees choose to use HFA's voluntary license. *See* 5/19/08 Tr. at 7092 (Pedecine) ("It would be applied, in the case of Harry Fox with the quarterly reporting, against the entire quarter."). As the RIAA knows, Copyright Owners and licensees certainly may agree to modify the terms of the HFA license, including the period for which the pass-through assessment may apply.

C. Reasonable Attorneys' Fees

790. As a part of its proposed late payment fee term, the Copyright Owners seek compensation for the reasonable attorneys' fees they expend in the course of collecting late payments. The RIAA argues that Copyright Owners already have the right to collect attorneys' fees under Section 505. RIAA PFF ¶ 1824. But, as the Copyright Owners demonstrated in their Proposed Findings of Fact, the attorneys' fees provision of Section 505 is insufficient because it merely awards attorneys' fee to the prevailing party in a civil copyright infringement action. 17 U.S.C. § 115. In order to obtain such compensation, Copyright Owners would have to take the "draconian" step of terminating a license and instituting an infringement action. 1/30/08 Tr. at 641 (Faxon). Instituting legal action is not only expensive and time-consuming, but it damages long-term business relationships between Copyright Owners and licensees. *Id.*; 5/19/08 Tr. at 7041 (Pedecine). Therefore, Section 505 does not provide a suitable remedy to Copyright Owners who need legal assistance to collect past due royalties and late fees, but do not

wish to sever long-term business relationships by terminating a license and filing an infringement action against a licensee.

D. Clarification of the Application of Rates

791. The RIAA does not object to the Copyright Owners' requested recordkeeping clarification that the date on which the mechanical license fee is calculated is the date of distribution, not the date of manufacture. *See* RIAA PFF ¶ 1782. This term is already used in HFA's standard DPD license and should be adopted for the reasons set forth in the Copyright Owners' Proposed Findings of Fact. *See* CO PFF ¶ 867; RIAA Trial Ex. 29 at CO 1000847 (sample HFA DPD license stating that "royalty shall be the statutory rate in effect at the time each DPD is distributed").

E. Specific Licensing and Reporting

792. While the RIAA claims that the Copyright Owners' licensing and reporting term is somehow "puzzling," the proposed term is actually quite straightforward. The Copyright Owners seek a modification of the existing recordkeeping regulations to require licensing and reporting of the royalties earned for each specific configuration and, in the case of pass-through arrangements, that licensees identify the online retailer through which digital deliveries occurred. Under the existing regulations (37 C.F.R. §§ 201.18(d)(1)(v)(D), 201.19(e)(3), (f)(4)), notices and royalty reports have to provide certain information concerning the configurations in which the licensee is distributing music, but such regulations lack a requirement that licensees distinguish among permanent downloads, limited downloads and interactive streams (or any other digital format) in taking licenses or reporting under licenses. The Copyright Owners seek this additional level of detail to ensure that they are able to conduct more accurate audits with additional and critical pieces of information about what products are

being licensed. *See* Israelite WDT (CO Trial Ex. 11) at 16; Pedecine WRT (CO Trial Ex. 394) at 16.

793. The RIAA argues that "marketplace resistance prevents HFA from including such a requirement in voluntary licenses." RIAA PFF ¶ 1838. However, during her live rebuttal testimony, Andrea Finkelstein acknowledged that Sony BMG currently reports this level of detail to HFA. 5/12/08 Tr. at 5706-07 (A. Finkelstein). In addition, one of the RIAA's own exhibits shows that HFA's standard DPD license requires this level of detail as well. *See* RIAA Trial Ex. 29 at CO 1000846, 1000848.

794. The Copyright Owners simply seek to ensure that all licensees license and report in this manner. According to Mr. Pedecine, HFA has made "some progress" in gaining licensees' compliance, "but it's not immediate. It's somewhat of an uphill battle." 5/19/08 Tr. at 7105 (Pedecine).

F. Reserves

795. As noted in *Copyright Owners' Memorandum Regarding the Authority of the Copyright Royalty Judges to Set Terms*, Docket No. 2006-3 CRB DPRA, at 3 n.2 (February 22, 2008), the Copyright Owners do not propose a term with respect to reserves.

XV. There is No Need For a Rate for General DPDs

796. The Copyright Owners have proposed rates for physical phonorecords, permanent downloads and ringtones, and have entered into a settlement with regard to limited downloads and interactive streaming. Thus, there are no activities under Section 115 for which the Copyright Owners have not proposed rates in this proceeding. Nevertheless, the RIAA argues that the Copyright Owners' rate proposal is under-inclusive and fragmented. RIAA PCL ¶¶ 164-170; RIAA PFF ¶¶ 1741-1751. Not only

are the arguments advanced by the RIAA unpersuasive, but it is the RIAA's rate proposal that is inconsistent, fragmented and unnecessarily complicated.

797. For example, the RIAA's proposal provides three different definitions of the revenue base to which its percentage rates would be applied, and calls for the revenue base to differ depending on whether the Section 115 licensee is a record company selling products to a distributor, a record company selling products directly to consumers, or a digital music service. *See* RIAA Amended Proposed Rates and Terms of the Recording Industry of America, Inc., *In re Mechanical and Digital Phonorecord Delivery Rate Adjustment Proceeding*, Docket No. 2006-3 CRB DPRA (Mar. 10, 2008) at 2-4. Indeed, the RIAA's rate proposal is so confusing that RIAA witnesses could not explain how the proposed revenue definition it contains would work in the real world. *See* 5/13/08 Tr. at 6135-37 (Eisenberg).

798. The RIAA also argues that the Court must set a royalty rate for so-called "general DPDs." RIAA PCL ¶ 167. Although Section 115(c)(3) distinguishes between "incidental" DPDs and DPDs "in general," the term "general DPDs" as used by the RIAA in its rate proposal is misleading, because it refers to a miscellaneous, catch-all category of DPDs that do not yet exist, which is found nowhere in the statute. Further, no statutory requirement mandates the Court to set a general rate for DPDs. Under Section 115, the Court is directed to set rates for "activities" specified under Section 115, which on its face, permits the Court to set rates on an activity-by-activity basis.

799. The RIAA argues that the Court is nonetheless required to set a rate for general DPDs based on its misreading of the Register's review of SDARS. *See* RIAA PCL ¶ 167 (citing Review of Copyright Royalty Judges Determination, 73 Fed. Reg.

9143, 9146 (Feb. 19, 2008)). In the Register's review of SDARS, however, the Register simply determined that the Court had erred in failing to set a distinct minimum rate for incidental DPDs in accordance with the language of Section 112, which states that rates under Section 112 "shall include a minimum fee for each type of service offered by transmitting organizations." 17 U.S.C. 114(e)(4). Thus, the Register's opinion has no application here.

800. Indeed, it is worth noting that the Copyright Office has recently declined to "delineate the contours of" incidental DPDs. Notice of Proposed Rulemaking, *Compulsory License for Making and Distributing Phonorecords, Including Digital Phonorecord Deliveries*, Docket No. RM 2000-7 (July 10, 2008) at 25. ("As an initial matter, the Office is inclined to agree with the RIAA's analysis that an incidental DPD is nothing more than a subset of DPDs. However, we can find little reason to accept the invitation to delineate the contours of that subset. Whether a DPD is 'incidental' or 'general,' it is subject to the compulsory license.").

801. According to the RIAA, without a royalty rate for general DPDs, technological innovation in the industry will be stifled and new products will not come into the market. RIAA PCL ¶ 170; RIAA PFF ¶¶ 1745-46. These concerns are entirely illusory. All of the technological innovation in the music industry over the last decade occurred without a rate for general DPDs. Moreover, as demonstrated above in Section X.B, the record companies have not established that copyright users were unable to bring even a single product to market because of licensing difficulties. Similarly, the RIAA has not identified any existing products for which the Copyright Owners have not proposed a rate. Of the two products they specifically discuss, RIAA PCL ¶ 165; RIAA

PFF ¶ 1742, the first, hybrid services, does not exist in the marketplace, *see* 5/13/2008 Trial Tr. at 6128-6131 (Eisenberg), and the second, locked content, is a question for the Register, as explained in the Copyright Owners' Reply to the RIAA's Proposed Conclusions of Law.

802. Finally, disputes between the Copyright Owners and copyright users concerning whether new products are licensable under Section 115 would not be solved by setting a general rate for DPDs, as the Court has recognized. *See* 2/14/08 Tr. at 3351-53 (A. Finkelstein; Roberts, J.). For example, such a dispute arose over ringtones, with the Copyright Owners arguing, among other things, that ringtones were not within the compulsory license because they are derivative works, and the RIAA arguing that ringtones were nevertheless covered by Section 115. *See* CO PFF ¶¶ 129-134; Ringtones Opinion, 71 Fed. Reg. at 64304. A general rate for DPDs would do nothing to resolve such controversies.

XVI. Conclusion

803. For the foregoing reasons, and those set forth in their Reply to the Proposed Conclusions of Law of the RIAA and DiMA, and those set forth in their Proposed Findings of Fact and Proposed Conclusions of Law dated July 2, 2008, the Copyright Owners respectfully request that the Copyright Royalty Judges adopt the proposals set forth in the Amended Proposed Rates and Terms of National Music Publishers' Association, Inc., the Songwriters Guild of America, and the Nashville Songwriters Association International dated July 2, 2008.

Dated: July ~~18,~~ 23, 2008

Respectfully submitted,

NATIONAL MUSIC PUBLISHERS' ASSOCIATION, INC.

THE SONGWRITERS GUILD OF AMERICA

NASHVILLE SONGWRITERS ASSOCIATION INTERNATIONAL

By: _____

Jay Cohen
Jeh C. Johnson
Aidan Synnott
Lynn B. Bayard
Paul, Weiss, Rifkind, Wharton & Garrison LLP
1285 Avenue of the Americas
New York, NY 10019
Phone: (212) 373-3000
Fax: (212) 757-3990
Email: jaycohen@paulweiss.com
jjohnson@paulweiss.com
asynnott@paulweiss.com
lbayard@paulweiss.com

Of counsel:

Robert E. Bloch (DC Bar No. 175927)
Mayer Brown Rowe & Maw LLP
1909 K Street, NW
Washington, DC 20006
Phone: (202) 263-3203
Fax: (202) 263-5203
Email: rbloch@mayerbrown.com
Counsel for EMI Music Publishing

CERTIFICATE OF SERVICE

I hereby certify that on this 23rd day of July 2008, I caused true and correct copies of the public versions of the Copyright Owners' Reply to the Proposed Findings of Fact of the RIAA and DiMA, and Redaction Log, to be served in hard copy, as well as on CDs containing the same document in PDF format, via Federal Express on the following parties:

Fernando R. Laguarda
Thomas G. Connolly
Charles D. Breckinridge
Kelley A. Shields
Harris, Wiltshire & Grannis LLP
1200 Eighteenth Street, NW
Washington, DC 20036
laguarda@harriswiltshire.com
tconnolly@harriswiltshire.com
cbreckinridge@harriswiltshire.com
kshields@harriswiltshire.com
TEL: (202) 730-1300
FAX: (202) 730-1301

Steven Englund
Jared O. Freedman
Jenner & Block LLP
1099 New York Avenue, N.W.
Washington, D.C. 20001-4412
jfreedman@jenner.com
TEL: (202) 639-6879
FAX: (202) 661-4846

Robert E. Bloch
Mayer Brown LLP
1909 K Street, NW
Washington, DC 20006
rbloch@mayerbrown.com
TEL: (202) 263-3203
FAX: (202) 263-5203

I further certify that on this 23rd day of July 2008, I caused a true and correct copy of the public version of the Copyright Owners' Reply to the Proposed Findings of Fact of the RIAA and DiMA, and Redaction Log, to be served on CD in PDF format via Federal Express on the following parties:

Cindy Charles
MusicNet Digital, Inc.
845 Third Avenue
11th Floor
New York, NY 10022
ccharles@musicnet.com
TEL: (212) 704-9824
FAX: (212) 759-9783

Kyle Johnson
James D. Villa
America Online, LLC
22000 AOL Way
Dulles, VA 20166
Kylej111@ aol.com
James.Villa@corp.aol.com
TEL: (703) 265-2651
FAX: (703) 265-6480

Ajay A. Patel
Sony Connect, Inc.
1080 Center Drive
Los Angeles, CA 90045
Ajay.Patel@sonyconnect.com
TEL: (310) 981-1509
FAX: (310) 981-1570

Matt Railo
Kevin Saul
Apple Computer, Inc.
1 Infinite Loop
MS 3-ITMS
Cupertino, CA 95014
mrailo@apple.com
ksaul@apple.com
TEL: (408) 974-8849
FAX: (408) 974-9105

William B. Colitre
Royalty Logic, Inc.
21122 Erwin Street
Woodland Hills, CA 91367
bcolitre@MusicReports.com
TEL: (818) 955-8900
FAX: (818) 558-3484

George Cheeks, General Counsel
MTV Networks
1515 Broadway
New York, NY 10019
George.Cheeks@mtvn.com
TEL: (212) 846-8825
FAX: (212) 846-1849

Bob Kimball, General Counsel
Michael King, Managing Attorney
RealNetworks, Inc.
2601 Elliott Avenue
Seattle, WA 98121
bkimball@real.com
mbking@real.com
TEL: (206) 892-6121
FAX: (206) 674-2695

Steven M. Marks
Susan Chertkof Munsat
Recording Industry Association of America, Inc.
1025 F Street, N.W.
10th Floor
Washington, D.C. 20004
smarks@riaa.com
TEL: (202) 775-0101
FAX: (202) 775-7253

PAUL, WEISS, RIFKIND, WHARTON & GARRISON LLP

1285 AVENUE OF THE AMERICAS
NEW YORK, NEW YORK 10019-6064

TELEPHONE (212) 373-3000
FACSIMILE (212) 757-3990

LLOYD K. GARRISON (1946-1991)
RANDOLPH E. PAUL (1946-1956)
SIMON H. RIFKIND (1950-1995)
LOUIS S. WEISS (1927-1950)
JOHN F. WHARTON (1927-1977)

WRITER'S DIRECT DIAL NUMBER

212.373.3713

WRITER'S DIRECT FACSIMILE

212.492.0713

WRITER'S DIRECT E-MAIL ADDRESS

AGold@paulweiss.com

1615 L STREET, NW
WASHINGTON, DC 20036-5694
TELEPHONE (202) 223-7300
FACSIMILE (202) 223-7420

FUKOKU SEIMEI BUILDING
2-2 UCHISAIWAICHO 2-CHOME
CHIYODA-KU, TOKYO 100-0011, JAPAN
TELEPHONE (81-3) 3597-8101
FACSIMILE (81-3) 3597-8120

UNIT 3601, FORTUNE PLAZA OFFICE TOWER A
NO. 7 DONG SANHUAN ZHONGLU
CHAO YANG DISTRICT
BEIJING 100020
PEOPLE'S REPUBLIC OF CHINA
TELEPHONE (86-10) 5828-6300
FACSIMILE (86-10) 6530-9070/9080

12TH FLOOR, HONG KONG CLUB BUILDING
3A CHATER ROAD, CENTRAL
HONG KONG
TELEPHONE (852) 2536-9933
FACSIMILE (852) 2536-9622

ALDER CASTLE
10 NOBLE STREET
LONDON EC2V 7JU, U.K.
TELEPHONE (44 20) 7367 1600
FACSIMILE (44 20) 7367 1650

MATTHEW W. ABBOTT
MARK H. ALCOTT
ALLAN J. ARFFA
ROBERT A. ATKINS
JOHN F. BAUGHMAN
LYNN B. BAYARD
DANIEL J. BELLER
MITCHELL L. BERG
MARK S. BERGMAN
BRUCE BIRENBOIM
H. CHRISTOPHER BOEHNING
ANGELO BONVINO
RICHARD S. BORISOFF
HENK BRANDS
JAMES L. BROCHIN
RICHARD J. BRONSTEIN
SUSANNA M. BUERGEL
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JEANETTE K. CHAN
YVONNE Y. F. CHAN
DOUGLAS A. CIFU
LEWIS R. CLAYTON
JAY COHEN
KELLEY A. CORNISH
CHARLES E. DAVIDOW
DOUGLAS R. DAVIS
THOMAS V. DE LA BASTIDE III
ARIEL J. DECKELBAUM
JAMES M. DUBIN
LESLIE GORDON FAGEN
MARC FALCONE
PETER L. FELCHER
ROBERTO FINZI
PETER E. FISCH
ROBERT C. FLEDER
MARTIN FLUMENBAUM
ANDREW J. FOLEY
HARRIS B. FREIDUS
KENNETH A. GALLO
MICHAEL E. GERTZMAN
PAUL D. GINSBERG
ERIC S. GOLDSTEIN
ERIC GOODISON
CHARLES H. GOOGE, JR.
ANDREW G. GORDON
BRUCE A. GUTENPLAN
GAINES GWATHMEY, III
ALAN S. HALPERIN
CLAUDIA HAMMERMAN
GERARD E. HARPER
BRIAN S. HERMANN
ROBERT M. HIRSH
MICHELE HIRSHMAN
JOYCE S. HUANG
JEH CHARLES JOHNSON
MEREDITH J. KANE
ROBERTA A. KAPLAN
BRAD S. KARP
JOHN C. KENNEDY
ALAN W. KORNBERG
DANIEL J. KRAMER
DAVID K. LAKHDHIR
JOHN E. LANGE
DANIEL J. LEFFELL
XIAOYU GREG LIU
JEFFREY D. MARELL
JULIA TARVER MASON
MARCO V. MASOTTI
EDWIN S. MAYNARD
DAVID W. MAYO
TOBY S. MYERSON
JOHN E. NATHAN
CATHERINE NYARADY
ALEX YOUNG K. OH
JOHN J. O'NEIL
KELLEY D. PARKER
ROBERT P. PARKER*
MARC E. PERLMUTTER
MARK F. POMERANTZ
VALERIE E. RADWANER
CAREY R. RAMOS
CARL L. REISNER
WALTER RIEMAN
RICHARD A. ROSEN
ANDREW N. ROSENBERG
STEVEN B. ROSENFELD
PETER J. ROTHENBERG
RAPHAEL M. RUSSO
JEFFREY D. SAFERSTEIN
JEFFREY B. SAMUELS
DALE M. SARRO
TERRY E. SCHIMEK
KENNETH M. SCHNEIDER
ROBERT B. SCHUMER
JAMES H. SCHWAB
STEPHEN J. SHIMSHAK
DAVID R. SICULAR
MOSES SILVERMAN
STEVEN SIMKIN
JOSEPH J. SIMONS
MARILYN SOBEL
TARUN M. STEWART
ERIC ALAN STONE
AIDAN SYNNOTT
ROBYN F. TARNOFSKY
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DANIEL J. TOAL
MARK A. UNDERBERG
LIZA M. VELAZQUEZ
MARIA T. VULLO
LAWRENCE G. WEE
THEODORE V. WELLS, JR.
STEVEN J. WILLIAMS
LAWRENCE I. WITDORCHIC
JORDAN E. YARETT
KAYE N. YOSHINO
ALFRED D. YOUNGWOOD
TONG YU
TRACEY A. ZACCONE
T. ROBERT ZOCHOWSKI, JR.

*NOT ADMITTED TO THE NEW YORK BAR

July 23, 2008

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Copyright Royalty Board

By Hand

Ms. LaKeshia Brent
United States Copyright Office
101 Independence Avenue, S.E.
Washington, DC 20559-6000

In the Matter of Mechanical and Digital Phonorecord Delivery Rate Adjustment Proceeding, 2006-3 CRB DPRA

Dear Ms. Brent:

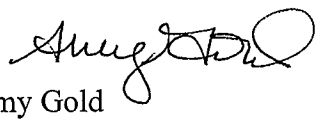
On behalf of National Music Publishers' Association, Inc., the Songwriters Guild of America and the Nashville Songwriters Association International (collectively, the "Copyright Owners"), and pursuant to the Protective Order entered in this proceeding on March 13, 2007, we enclose the following materials:

- A corrected original and five corrected copies of the Copyright Owners' Reply to the Proposed Findings of Fact of the RIAA and DiMA, as well as one electronic copy of the same document on CD in PDF format. The corrections pertain only to information marked Restricted under the provisions of the Protective Order, as we discussed yesterday, and there have been no substantive changes to the text. Counsel for the RIAA and DiMA consent to the refiling of these materials. They can be used as replacements for the versions filed last week;

- Two copies of the Copyright Owners' Reply to the Proposed Findings of Fact of the RIAA and DiMA (Public Version), as well as one electronic copy of the same document on CD in PDF format, and
- An original and five copies of a Redaction Log and Declaration and Rule 11 Certification to accompany the public version of the Copyright Owners' Reply to the Proposed Findings of Fact of the RIAA and DiMA, as well as a copy of the same document on CD in PDF format.

Please feel free to contact us if you have any questions or concerns regarding the foregoing or the enclosed materials.

Respectfully submitted,



Amy Gold

Enclosures

cc: Counsel of Record (via federal express) (with enclosures, as indicated on enclosed service list)