

**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 FINDINGS OF FACT OF
THE DIGITAL MEDIA ASSOCIATION (“DiMA”)
AND ITS MEMBER COMPANIES
AOL, LLC; APPLE INC.; MEDIANET DIGITAL, INC.;
AND REALNETWORKS, INC.**

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PUBLIC VERSION

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The Digital Media Association (“DiMA”), joined by AOL, LLC; Apple Inc. (f/k/a “Apple Computer, Inc.”); MediaNet Digital, Inc. (f/k/a “MusicNet, Inc.”); and RealNetworks, Inc., who have each filed individual notices of participation in this proceeding,¹ respectfully submit the following Reply Findings of Fact in support of DiMA’s requested rates and terms for the compulsory license pursuant to 15 U.S.C. § 115.

INTRODUCTION

1. DiMA’s Proposed Findings of Fact demonstrate that a percentage rate keyed to a practical revenue definition and backed by reasonable minima would allow the nascent legitimate digital music distribution industry to survive and expand, even as sales

¹ Napster, LLC and Yahoo!, Inc. each filed individual notices of participation and joined DiMA’s Written Direct Testimony but have since withdrawn from the proceeding. *See* DiMA PFF ¶¶ 21, 28 n.3.

of physical products continue to decline. Nothing the Copyright Owners² say about their unprecedented penny-rate hike shows it is a better alternative for achieving the objectives of Section 801(b)(1).

2. The Copyright Owners confirm that piracy still “plagues the recorded music industry.” CO PFF ¶ 798. According to the most recent statistics they cite, more than 20 billion illegal music files are downloaded annually. *See id.* ¶ 366. In light of this, selling digital music poses significant cost and pricing challenges. In these economic conditions, barely three years before this proceeding commenced, Apple launched its iTunes Music Store. *See id.* ¶ 371. As a result of these efforts and others like it, digital music sales are beginning to show growth potential industry-wide. *See* DiMA PFF § III(B)(2). But they have a long way to go, and many more challenges to overcome in the marketplace, if they are ever to compensate for sales lost due to the impact of piracy. *See id.*

3. DiMA recognizes the important contribution of songwriters. But the Copyright Owners’ contribution does not make it easier to sell music digitally in the face of widespread piracy. *See infra* §§ V, VII(C); DiMA PFF ¶¶ 255, 304. They do nothing to make the music itself more attractive than the billions of identical digital copies that are available at the click of a mouse from dozens of pirate web sites. Everything that makes paying for music on the Internet attractive to consumers is done by digital music companies like DiMA’s members, at an extraordinary cost and under severe downward price pressure. *See infra* § VII(C); DiMA PFF § IV.

² The National Music Publishers’ Association, Inc., the Songwriters Guild of America and the Nashville Songwriters Association International are referred to collectively as the “Copyright Owners.”

4. To respond to these economic conditions, these investments, and these efforts to open a new marketplace for musical works by raising costs and fixing them with a static penny rate makes absolutely no sense. Moreover, it fails to achieve the objectives as required in this proceeding. Yet this is precisely what the Copyright Owners propose.

5. To justify their demand for an inflexible penny-rate structure and a rate hike of nearly 65 percent, the Copyright Owners rely on three arguments. First, they claim more money is needed to incentivize songwriters. *See* CO PFF § IV(C). But they fail to establish the basis for this claim in light of the overwhelming historical evidence that songwriting output does not vary with the level of the mechanical rate. *See infra* §§ IV(A), IV(E). In addition, they fail to show how their proposal will result in higher revenues to songwriters given the marketplace reality of declining prices and rampant piracy. *See infra* §§ IX, XVI(C).

6. Second, the Copyright Owners claim that everything is going well for Apple and that a 65-percent rate hike is therefore justified. *See* CO PFF §§ VII, X. Repeatedly, they reference the history and success of the iTunes Store as reason enough to raise penny rates. This approach is telling. All of their analysis is pinned on a single digital distributor. Their argument is basically that because Apple pays a lot to the labels, every digital distributor should pay a lot more to the Copyright Owners. But they fail to provide any analysis to justify their demand. *See infra* §§ VI, VII(B), X. To the extent they recognize the importance of new entry into the marketplace, they make sweeping claims without any basis and assume that what works for Apple will work for everyone else. Even their analysis of the impact of their rate hike on Apple is deeply flawed.

Often, they quote their own lawyers' questions or misstate testimony to support their claims. *See, e.g., infra* ¶ 49.³ In the end, their obsession with the iTunes Store dooms their proposal. *See infra* §§ VI, VII(B), X.

7. Third, the Copyright Owners insist that the objective in this proceeding is to mirror a marketplace outcome and avoid any regulatory interference. *See, e.g.,* CO PFF ¶¶ 567-576; DiMA PFF § VIII(B)(6). Perhaps they hope that repeating this mantra will distract the Court from the plain language of Section 801(b)(1) and the incontrovertible purpose of the statutory license to lower entry barriers. But they fail to show how their proposal for increased rates will lead to more songs being made “availab[le] to the public.” 17 U.S.C. § 801(b)(1)(A). Moreover, they fail to explain how their proposal responds to existing economic conditions, or how it takes into account the innovation, risk-taking, capital investments and costs required to offer digital music to the public. *See infra* §§ IV(B), XIV.

8. To the contrary, making musical works available requires sellers to sell and buyers to buy those works. Given widespread access to pirated, free music, the price of music offerings must be low enough for sellers to attract buyers. *See infra* § VII. Buyers are attracted to innovative and ever-improving offerings, which require consistent investment and risk. *See infra* §§ V, VII(B). All of this puts pressure on margins, which in turn requires digital distributors to keep costs as low as possible. *See* DiMA PFF

³ The Copyright Owners' proposed findings are replete with misquotation and misattribution. *See, e.g.,* CO PFF ¶ 67 (incorrectly quoting David Teece); *id.* ¶ 381 (attributing counsel's statement to Eddy Cue); *id.* ¶ 618 (attributing counsel's statement to Andrea Finkelstein); *id.* ¶ 682 (attributing counsel's statement to Steven Wildman); *id.* ¶ 687 (attributing counsel's statement to Steven Wildman); *id.* ¶ 768 (attributing counsel's statement to Terri Santisi); *id.* ¶ 791 (attributing counsel's statement to David Munns).

§§ V(C), V(D). Imposing fixed penny rates in this industry – and effectively regulating prices at current levels – would impede expansion and kill nascent entry. *See infra* §§ IX, XIV(E), XVI(C).

**REPLY TO THE COPYRIGHT OWNERS’
PROPOSED FINDINGS OF FACT**

I. THE PURPOSE OF THIS PROCEEDING IS TO SET RATES FOR A LICENSE DESIGNED TO LOWER ENTRY BARRIERS IN THIS RAPIDLY EVOLVING MARKETPLACE

9. **CO PFF ¶¶ 1-4.**⁴ The Copyright Owners recognize the historic nature of this proceeding.⁵ The marketplace has undergone a fundamental evolution, as significant as moving from wax cylinders to CDs. Yet their proposal fails to recognize the sweeping technological and economic changes affecting the marketplace. *See infra* §§ V, XV(H). While prices fall, the Copyright Owners demand increased guaranteed payments per unit. They propose a rate hike when the record evidence least supports one.

10. **CO PFF ¶¶ 5-13.** DiMA in no way seeks to diminish the important role of songwriters. But the purpose of this proceeding is not to recognize songwriters; it is to

⁴ For the convenience of the Court, DiMA’s reply findings generally follow the structure of the Copyright Owners’ proposed findings and indicate the paragraph numbers used by the Copyright Owners to which a reply is being made.

⁵ The parties notified the Court that they have reached a settlement with respect to limited downloads and interactive streaming, including all known incidental DPDs. *See* DiMA PFF ¶ 24. It is DiMA’s understanding that none of the rates or terms included in the Copyright Owner or RIAA briefs apply to the subject matter of the settlement agreement among the parties, and inadvertent references to the settled issues have been withdrawn from the briefs. *See* Letter from Jay Cohen to the Copyright Royalty Judges, 2006-3 CRB DPRA (July 16, 2008); Letter from Paul M. Smith to the Copyright Royalty Judges, 2006-3 CRB DPRA (July 17, 2008). DiMA reserves the right to respond in the event either party raises these issues in their reply briefs.

determine a reasonable rate for a license Congress created. Nowhere do the Copyright Owners explain how raising the penny rate by nearly 65 percent under current economic conditions will achieve the objectives of Section 801(b)(1). Nowhere do they show how higher rates and an inflexible penny-rate structure will promote continued entry and innovation – which are needed to maximize the availability of creative works. *See infra* §§ IV(B), V, VII(B), XIV.

11. **CO PFF ¶¶ 14-20.** Selling music in the digital marketplace is difficult. *See infra* § VII. Due to pervasive piracy, consumers have free access to billions of songs. Certainly, nothing the Copyright Owners do makes it any easier to sell music under existing economic conditions. *See infra* §§ V, VII. Instead, digital music distributors must innovate and develop new business models continuously to attract consumers who could otherwise get digital music for free. *See infra* § VII(A). This is expensive and risky. Nothing in the record shows how publishers contribute to these efforts. *See infra* §§ V, VII.

12. **CO PFF ¶¶ 21-40.** The Copyright Owners admit that the marketplace has undergone a “fundamental transformation over the past decade” since rates and terms were last agreed upon for the statutory license. CO PFF ¶ 21. They recognize that the promise of digital technology and the Internet, and the perils of rampant Internet piracy, have all had a transformative impact. *See id.* ¶ 23. In this incredibly difficult competitive environment, success stories like Apple’s iTunes Store are few and far between. But one success does not establish a stable industry, and it is not a basis on which to set a rate in this proceeding. *See infra* § VII(B). This Court should not countenance the Copyright Owners’ desperate attempt to leverage the iTunes success story into a massive rate hike.

13. **CO PFF ¶¶ 41-78.** To support their aggressive rate hike, the Copyright Owners dress it up in “benchmarks” that have no relation to the statutory objectives, rely on incomparable products, and point to a resulting “range” of rates that would support almost any requested increase. *See infra* § XII. In an industry experiencing falling prices, rising costs, and crushing competition, they demand to be paid far above current rates. In an industry dependent on innovation and new entry, they demand a guaranteed return in the form of a fixed number of cents per song sold. These demands are unrealistic, unsupported by the record evidence, and incompatible with the statutory objectives.

14. **CO PFF ¶¶ 79-90.** DiMA’s proposed rates and terms are supported by the record evidence and achieve the statutory objectives. *See infra* § XVI; DiMA PFF §§ VIII(A), X. A percentage-rate structure set at 6 percent of retail revenues for permanent downloads (with reasonable minima) will encourage the expansion of digital distribution. Making comprehensive digital music catalogs available to more consumers, exposing them to more varieties of music than ever before, and providing enhanced music discovery capabilities and other innovations will boost songwriter compensation as well as compensation for all other industry participants. *See, e.g., infra* §§ IV(B), VII(B). DiMA’s proposal also allows legitimate distributors to expand legitimate sales in the face of unprecedented online music piracy – the undisputed “existing economic condition” in the marketplace. *See infra* § IV(B). Recognizing the investments and contributions that have been and must continue to be made to spur innovation and lure consumers away from illegal piracy, DiMA’s proposal helps to lower entry barriers and expand legal sales. *See infra* § XVI; DiMA PFF §§ VIII(A), X. Finally, DiMA’s proposal relies on the same

methodology used by the Copyright Owners around the world and recognized as appropriate here as well. *See infra* §§ IV(A), XIV(H).

II. THE CONTRIBUTIONS OF LEGITIMATE MUSIC DISTRIBUTORS ARE CRUCIAL

15. **CO PFF ¶¶ 91-201.** The Copyright Owners minimize the contributions that copyright users make to the digital music industry and simultaneously overstate the roles played by the members of their own coalition. They exaggerate their own contributions to fighting digital piracy, which they correctly acknowledge to be a severe scourge for the industry. While the Copyright Owners concede that promoting legitimate distribution is a powerful weapon against the growth of piracy, *see* CO PFF ¶ 102; *see also* DiMA PFF § IV(C), they offer no support for their claim that they have done anything to encourage legitimate digital distributors beyond simply licensing copyrighted works.

16. The Copyright Owners similarly exaggerate the contributions of the Harry Fox Agency (“HFA”), arguing that it “has developed a convenient and efficient system for licensing copyrighted works.” CO PFF ¶ 105. The record reveals that HFA’s system is neither of those things. To the contrary, licensing via HFA entails significant transactions costs and often requires time-consuming negotiations with the publishers holding the rights to works. *See* DiMA PFF ¶¶ 288-289.

17. Finally, the Copyright Owners present a highly simplified description of the purposes underlying the Copyright Act of 1909. They acknowledge in summary fashion that the Act was designed to prevent monopolization, but they ignore the significance of that purpose. *See* CO PFF ¶ 118. As the Copyright Royalty Tribunal

explained in 1981, Congress established the compulsory license “to prevent formation of a ‘music monopoly’ by guaranteeing to all mechanical producers full access to copyright music.” *Adjustment of Royalty Payable Under Compulsory License for Making and Distributing Phonorecords; Rates and Adjustment of Rates*, 46 Fed. Reg. 10,466, 10,483 (1981) (“1981 CRT Determination”). Avoiding monopoly requires setting a statutory rate that permits copyright users “to enter the market at will.” *Id.* at 10,480; *see also Determination of Reasonable Rates and Terms for the Digital Performance of Sound Recordings*, 63 Fed. Reg. 25,394, 25,409 (Librarian of Congress, May 8, 1998) (“[T]he mechanical license regulates the price of music to lower the entry barriers for potential users of that music.”). As DiMA has explained, the Copyright Owners’ proposals would achieve precisely the opposite result by foreclosing access for virtually all potential new entrants. *See, e.g.*, DiMA PFF ¶¶ 74, 181.

III. THE COPYRIGHT OWNERS’ PROPOSED RATES AND TERMS WOULD WREAK HAVOC ON THE INDUSTRY

A. The Copyright Owners Propose an Unprecedented and Disruptive Penny Rate for Digital Downloads While Conceding That a Percentage Rate Would Not Be Disruptive

18. **CO PFF ¶¶ 202-204.** The Copyright Owners seek a 65-percent increase in the antiquated penny-rate structure, a proposal that fails on multiple levels to achieve the statutory objectives. *See* DiMA PFF §§ V, VIII(B). In the face of constant downward price pressure, this proposal if adopted would undermine legal distributors’ ability to make the investments in the technology and innovations that consumers demand. As a result, digital distributors would be hard pressed to grow the music industry as a whole. *See id.*

19. The magnitude and unreasonableness of the Copyright Owners proposal is clear in context. They seek rates that exceed any others anywhere else in the world. *See* DiMA PFF ¶ 332; 5/15/08 Tr. 6846:15-20 (Fabinyi). Employing a penny rate for permanent downloads also would leave the United States as a global outlier. *See* DiMA PFF §§ VII(A)(5), IX(C).

20. On the other hand, a percentage-of-revenue rate structure would have no disruptive consequences. *See* DiMA PFF § VII(A)(4). Whatever disruption the Copyright Owners allege applies solely to physical products. *See infra* § XIV(H). Indeed, Roger Faxon testified that “we do not think it will be disruptive to have a percentage with a minima” for digital products. 1/29/08 Tr. 482:15-20 (Faxon) (emphasis supplied); *see also* 1/29/08 Tr. 485:20-21 (“I don’t think you need [a] penny rate for a digital download.”); DiMA PFF § VII(A)(4). Indeed, the Copyright Owners propose percentage rates for ringtones. *See* CO PFF ¶ 204. The rate structure that Mr. Faxon welcomed – a percentage rate with minima – is exactly what DiMA has proposed.

B. The Copyright Owners’ Revenue Definition Fails to Achieve the Statutory Objectives

21. **CO PFF ¶¶ 205-210.** The Copyright Owners have proposed an extraordinarily broad nine-part definition of revenue, presumably for application to their ringtone rate request (which is their only proposal based on a percentage of revenue). *See id.* ¶ 205; *see also* 5/20/08 Tr. 7456:4-7459:1 (Landes) (attempting to respond to Judge Wisniewski’s concerns about the impractical nature of the proposed definition). The proposed definition is not only vague, but purposefully overbroad. For example, the definition as proposed would capture any revenue received from advertising on any

webpage that is “in proximity to or on pages leading up to, or used to access” the sale of music. CO PFF ¶ 205(c). “Proximity” and “leading up to” are critical concepts in the Copyright Owners’ proposal, but neither is defined or explained. On its face, therefore, the proposed definition would cover all revenue from advertising on the homepage of any online retailer that decides to add the sale of digital music to its business – even if the advertising has nothing to do with music sales but merely sits in “proximity” (whatever that means) to the music-related webpages. *See id.* Applying this definition would amount to an implicit rate hike by imposing a tax on distributors’ ancillary revenue streams, which would discourage or inhibit investment and participation by new distributors. *See* 5/13/08 Tr. 6178:21-6179:14 (Sheeran).

22. The Copyright Owners’ inability to justify or explain the proposed definition underscores its impracticability. The only witness who testified about the reasonableness of their revenue definition was Dr. Landes. But he concluded that it was reasonable merely because “it tries to capture revenue attributable to music.” 5/19/08 Tr. 7251:16-18 (Landes) (emphasis supplied); *see also* 5/20/08 Tr. 7454:10-18 (Landes) (testifying that the proposed definition “tries to capture revenue . . . in one form or another from music”); *id.* 7471:2-8 (Landes) (testifying that the definition is “an effort to capture revenues attributable to music”).

23. Indeed, Dr. Landes conceded all of the definition’s fatal shortcomings. He stated, for instance, that the definition attempts to capture revenue attributable to music, *see* 5/20/08 Tr. 7251:16-18, 7452:17-21 (Landes), yet he admitted that it would be “extraordinarily difficult” to determine which revenues actually qualify under the terms of the definition. *See id.* 7453:8-18 (Landes). He acknowledged the definition’s

unworkable complexity, yet he proposed that licensees in the real world could simply hire “high-powered” lawyers and “sit down and spend a good deal of time and effort negotiating the precise contours” of this issue on a regular basis. *Id.* 7456:4-10 (Landes).

24. The failings with the Copyright Owners’ proposed definition are particularly notable in light of the ease with which EMI Music Publishing entered into a license for mechanical rights covering limited downloads with a much simpler and more practical revenue definition. *See* CO Tr. Ex. 375, attach. D, § 1(h) (Short Form License Agreement between EMI Entertainment World Inc. and MusicNet, Inc., Jan. 31, 2007).

C. The Copyright Owners Fail to Justify Any of Their Other Proposed Terms

25. **CO PFF ¶¶ 211-212.** As explained in greater detail below, *see infra* §§ XVII(A), XVII(B), the Copyright Owners completely fail to justify their proposed late fee and proposed pass-through licensing fee. In particular, they omit any justification for imposing these provisions via statute rather than by contract.

26. **CO PFF ¶¶ 213-215.** The Copyright Owners propose additional terms covering reasonable attorneys’ fees as well as specific licensing and reporting requirements. The Court should reject these proposed terms because the Copyright Owners have not presented any evidence demonstrating that they are reasonable and calculated to achieve the statutory objectives. *See infra* § XVII(C). In the event they are included in the final determination notwithstanding the lack of record support, the Court must recognize that they impose higher compliance costs on licensees, and the rate should be adjusted downward as a result.

IV. THE COYPRIGHT OWNERS' PROPOSED RATES LACK SUPPORT FROM THE RECORD EVIDENCE AS TO THE ROLE AND INCENTIVES OF SONGWRITERS

A. There Is No Empirical Evidence that a Higher Mechanical Rate Is Necessary to Prevent a Shortage of Songwriters or Songs

27. **CO PFF ¶¶ 216-234.** In their proposed findings, the Copyright Owners perpetuate their unsupported assertion that an increase in the mechanical rate is necessary to prevent a shortage of songwriters or songs. *See* CO PFF ¶¶ 222-234; *see also id.* ¶¶ 282-286. There is absolutely no empirical evidence of any such shortage, however, and no empirical evidence that an increase in the mechanical rate would assuage any such shortage even if one did exist. *See* DiMA PFF § VI; *see also* 1/29/08 Tr. 421:5-6 (Faxon) (“Songwriters write a lot of songs”). Indeed, there is no empirical evidence of any kind that the number of songwriters or the number or quality of songs written has any correlation to the mechanical rate. *See id.*

B. Every Industry Participant Makes a Valuable Contribution and Faces Risk and Financial Uncertainty

28. **CO PFF ¶¶ 235-240.** Contrary to the Copyright Owners’ assertions, DiMA has neither ignored songwriters nor discounted the value of their contributions or their hard work. *See* DiMA PFF §§ IV(B), IV(C). Indeed, as DiMA explains in its proposed findings, legitimate digital distributors offer services that provide compensation to songwriters that they would not otherwise receive. *See, e.g.,* DiMA PFF § IV(B). DiMA even presented testimony from Timothy Quirk, who is not only involved in the digital distribution business but is himself a professional songwriter who has worked with music publishers, earned mechanical royalties, and understands the music industry from

the perspective of a copyright owner. *See* DiMA PFF ¶ 106; *see also* 2/26/08 Tr. 4586:19-4591:7 (Quirk).

29. DiMA likewise has acknowledged that both songwriters and publishers have faced financial contraction since the advent of digital piracy. Far from merely “conced[ing]” that piracy hurts publishers and songwriters, CO PFF ¶ 239, DiMA has made that fact central to its proposal to achieve the statutory objectives. *See, e.g.*, DiMA PFF § III(A)(1). Although they acknowledge that piracy is a fundamental existing economic condition in the music marketplace, *see, e.g.*, CO PFF ¶¶ 236-239; DiMA PFF § III(A)(1) (noting testimony from Copyright Owner witnesses about the pervasive impact of piracy), the Copyright Owners believe that only songwriters and publishers have suffered. So they demand increased compensation. *See* CO PFF ¶¶ 230-40, 257-264, 282-286. This self-serving world view ignores the record. As the Court heard from an array of witnesses, piracy has harmed the entire industry, and it remains the fundamental existing economic condition throughout the marketplace. *See* DiMA PFF § III(A). Instead of acknowledging the state of the entire industry, the Copyright Owners mischaracterize the impact of piracy in an attempt to justify taking a greater share of a shrinking pie, and they rely on unsupported assertions to do so.

C. Controlled Composition Clauses Fail to Justify the Copyright Owners’ Unprecedented Rate Proposal

30. **CO PFF ¶¶ 241-256.** Likewise, the Copyright Owners have failed to demonstrate why controlled composition clauses, as components of voluntarily negotiated agreements, should be considered at all as a justification for an increase in the mechanical rate. The Copyright Owners assert that the “fundamental justification” for

their rate hike is to “allow both songwriters and music publishers to receive ‘compensation that is adequate to encourage their continued investments of time and creativity.’” CO PFF ¶ 349 (quoting testimony of Irwin Robinson) (emphasis supplied). But controlled composition clauses in agreements executed after June 22, 1995, generally do not apply to licenses related to digital phonorecord deliveries (“DPDs”). *See* CO PFF ¶ 252 (citing 17 U.S.C. § 115(c)(3)(E)(ii)(I)); *see also* DiMA PFF § VIII(B)(3). As a result, controlled composition clauses cannot materially affect future incentives to create digital music.

31. The Copyright Owners nonetheless attempt to make controlled composition clauses appear relevant to their proposed rate for permanent downloads by alleging that Sony BMG is improperly using a provision from its standard controlled composition clause “to reduce payments for the sales of DPDs written under artist contracts that postdate 1995.” CO PFF ¶ 255. Regardless of the merits of this allegation, this Court is not the forum in which to address it. Even if Sony BMG’s conduct violates the statutory prohibition as the Copyright Owners allege, the appropriate response is not a rate increase for all copyright users.

D. The Pervasive Flaws in Dr. Landes’s Songwriter Study Undermine Its Utility

32. **CO PFF ¶¶ 257-281.** The Copyright Owners additionally rely on Professor Landes’s “songwriter study” to justify their proposal. *See* CO PFF ¶¶ 265-279. But Professor Landes’s methodology suffered from pervasive flaws that render his results unreliable. *See* DiMA PFF ¶¶ 290-292. Even if the Court were to rely on the study, Professor Landes himself testified that technological innovation is “far more important”

to maximizing copyright owner revenue than is the mechanical rate. 2/11/08 Tr. 2153:5-14 (Landes) (emphasis supplied); *see also* DiMA PFF ¶¶ 60-61.

E. There Is No Empirical Evidence of a Correlation Between the Mechanical Rate and Songwriting

33. **CO PFF ¶¶ 282-286.** Re-hashing previous assertions, the Copyright Owners argue again that the mechanical rate should rise, this time based on songwriters’ “belie[f] that they are not fairly compensated under the current mechanical royalty rate.” CO PFF ¶ 282 (emphasis supplied). But nothing in the statutory objectives supports a rate determination based on whether some industry participants “believe” they should receive more. (Indeed, virtually any employee in any industry would answer the same way songwriters do if asked whether they deserve more pay.) The Copyright Owners further contend that failing to raise the rate will push songwriters away from the industry, resulting in a reduction in the number and quality of songs. *See* CO PFF ¶¶ 283-286. As explained above, this line of argument fails because it is contrary to historical experience and there is no empirical evidence to back it up. *See supra* § IV(A); DiMA PFF § VI.

V. NOTHING ABOUT THE ROLE OF MUSIC PUBLISHERS OR THEIR FINANCES JUSTIFIES RAISING THE MECHANICAL RATE

34. **CO PFF ¶¶ 287-349.** No one disputes that copyright owners deserve fair compensation. *See supra* § IV(B). Yet the Copyright Owners’ proposed findings overreach dramatically by inflating the role of music publishers and neglecting to acknowledge the industry-wide struggles that have ensued since digital piracy took hold.

35. Nothing in the Copyright Owners’ discussion of music publishers demonstrates that the mechanical rate should be increased. They present no evidence that their role has been undervalued in the calculation of the mechanical rate in the past or that

their role has increased since the last time the mechanical rate was set in 1997. Indeed, they admit that they do not perform any additional functions in the digital context. *See* CO PFF ¶ 294; DiMA PFF ¶¶ 255, 304. And although the Copyright Owners assert that their mechanical royalty income is declining, they ignore the fact that the entire industry has suffered as prices and sales have dropped due to piracy. *See* DiMA PFF § III(A).

36. The Copyright Owners also attempt to justify a rate hike on the ground that the value of songs has increased and that copyright owners accordingly deserve a higher mechanical rate to reflect this increased value. *See* CO PFF ¶ 349. But they offer no reliable evidentiary support, instead relying on a mischaracterization of testimony provided by Roger Faxon. While Mr. Faxon stated that songwriters are “significant contributors to [the] trend” of increased value of songs, Faxon WDT ¶ 48 (CO Trial Ex. 3), his testimony revealed that copyright owners have nothing to do with the features that he believes have increased the value:

A principal reason for this increase [in value] has been the development of various forms of digital distribution that make music more portable and accessible than it ever has been before. Consumers today can purchase music at any time of day, can put music on their computer, CD, MP3 player and phone and make digital quality copies when this is legally permitted.

Id. All of these features result from the contributions of digital distributors. Moreover, even if the Copyright Owners somehow deserved a reward for this increased value, they offer no suggestions about how to measure it. As the record reflects, the retail price for songs reflects downward pricing pressure caused by stiff competition and rampant piracy. *See* DiMA PFF §§ III(A)(2), V(D).

37. The entire music industry has suffered due to piracy, and sales and revenues have been reduced for all industry participants as a result. *See* DiMA PFF § III(A). This industry-wide crisis is not a reason to raise costs for the only entities that have the potential to grow the marketplace for the benefit of every industry participant and for music consumers. *See* DiMA PFF § III(B)(2).

38. The Copyright Owners' discussion of music publishers also undermines their arguments about songwriters' purported need for a rate increase. *See* CO PFF ¶¶ 305, 781. If nothing else, publisher advances to songwriters reveal a determination that revenues will be large enough on average to make these advance investments worthwhile. Given that the Copyright Owners themselves present evidence that songwriters receive "substantial" advances "almost without exception," *id.* ¶¶ 305, 308, it is difficult to give credence to their assertion that an increase in the mechanical royalty rate is required to ensure incentives and adequate compensation.

VI. THE COPYRIGHT OWNERS' INITIAL CHARACTERIZATION OF DIGITAL MUSIC DISTRIBUTORS IS OVERLY SIMPLISTIC

39. **CO PFF ¶¶ 350-354.** In their industry overview, the Copyright Owners present a misleadingly simplified description of several digital music companies. With respect to several providers, for instance, the Copyright Owners imply that permanent download sales are insignificant features of their overall services. In fact, MediaNet, RealNetworks, and Napster each support significant permanent download operations. *See, e.g.,* McGlade WDT ¶¶ 5, 25, 32, 36 (DiMA Tr. Ex. 5) (MediaNet sells permanent downloads); Quirk WDT ¶¶ 26, 42, 51 (DiMA Tr. Ex. 8) (RealNetworks' Rhapsody service sells permanent downloads); Enders WDT at 27, Table 6 (CO Tr. Ex. 10)

(Napster sells permanent downloads). Sales of permanent downloads account for approximately RESTRICTED of MediaNet's revenue, RESTRICTED of Rhapsody's revenue, and RESTRICTED of Napster's revenue. *See* Enders WDT at 36-39 (CO Tr. Ex. 10).

40. In addition, the Copyright Owners observe that Apple's iTunes Store has achieved success in the permanent download business, yet they remain silent with respect to the massive investment and risk that Apple has borne to achieve its success. *See, e.g.*, DiMA PFF ¶¶ 69-70. The Copyright Owners' description of Apple also ignores the fact that the iTunes Store has generated industry-wide benefits (including greater revenues for copyright owners) because it presents consumers with an attractive and viable alternative to piracy. *See* DiMA PFF ¶¶ 158-159.

VII. THE COPYRIGHT OWNERS PRESENT A MISLEADING PICTURE OF DIGITAL MUSIC DISTRIBUTION

41. **CO PFF ¶¶ 355-361.** Barely five years after the iTunes Store launched, the Copyright Owners can hardly contain their excitement about digital music distribution, and with good reason. Piracy has been undermining the recorded music business since the late 1990s. Apple took a huge risk earlier this decade and invested tens of millions of dollars to sell digital music at a time when piracy seemed unassailable. *See, e.g.*, DiMA PFF ¶ 69. But piracy has not simply gone away, and it will take more than iTunes to beat it back. The iTunes Store and other digital music distributors compete with free music and face unyielding downward price pressure. *See id.* §§ III(A)(2), V(D). For most, selling permanent downloads is still not a profitable undertaking. *See id.* § V(C). With massive up-front investments required to launch a

new offering, and the promise of continued costs and dropping prices, the environment for entering and staying in business is extremely difficult. *See id.* § V.

A. The Technological Tidal Wave of the 1990s Fundamentally Altered the Music Business

42. **CO PFF ¶¶ 362-363.** What the Copyright Owners refer to as “digital distribution of music” is actually one aspect of a technological sea-change arising from digitization, the Internet, and other systems for transmitting packets of digital information. *See* DiMA PFF ¶¶ 37-38. There is no shortage of challenges to competing in this new marketplace. With the benefit of hindsight, the Copyright Owners take the record labels to task for a host of business decisions they would have made differently. Brushing aside the difficult competitive environment, the Copyright Owners claim finances are suddenly “healthy” and the future is unquestionably “bright[.]” CO PFF ¶ 355. The record evidence says otherwise. *See* DiMA PFF § V.

43. **CO PFF ¶¶ 364-366.** Despite their cheery outlook for digital sales, the Copyright Owners do not and cannot dispute that digital music piracy became a “staggering” problem for the industry in the late 1990s, *Metro-Goldwyn-Mayer Studios, Inc. v. Grokster, Ltd.*, 545 U.S. 913, 923 (2005), “overwhelming” the marketplace, *id.* at 948 (Ginsburg, J., concurring), and “threaten[ing] copyright holders” in an unprecedented manner. *Id.* at 928-29; *see also* DiMA PFF § III(A).

44. The Copyright Owners claim that “anti-piracy efforts may be stemming the tide,” CO PFF ¶ 366, but for support they can turn only to a single statement from an IFPI report noting that illegal file-sharing has remained relatively stable. *See id.* (citing CO Tr. Ex. 29). In reality, the problem has not abated in any meaningful way. As the

Copyright Owners concede, piracy “continues to plague the music industry, causing losses of legitimate sales to record companies, music publishers and songwriters.” CO PFF ¶ 366. When “20 billion illegal files [are] downloaded” each year, *id.* (quoting from CO Trial Ex. 29 at 9008749), legitimate digital distributors have to spend more to improve their offerings and charge lower prices just to compete with the flood of free product in the marketplace. *See* DiMA PFF §§ III(A), V(D).

B. Digital Music Distribution Is An Evolving Business With High Costs And High Risks

45. **CO PFF ¶¶ 367-370.** In light of the changes wrought by digital technology and the difficult economic conditions brought about by rampant Internet piracy, it is no wonder that launching successful and sustainable digital music businesses has been a difficult undertaking. The Copyright Owners rightly point out that access to the widest possible catalog of works is essential to any such offering, and that changing consumer perceptions about music services requires a massive marketing effort. But that is precisely the sort of innovation and investment the statutory license is designed to promote. *See* DiMA PCL § I.

46. **CO PFF ¶¶ 371-374.** As an initial matter, the Copyright Owners recognize that Apple’s investments, innovations, and willingness to take risks have offered consumers a legitimate alternative to rampant Internet piracy. And the Copyright Owners point out that Apple’s iPod had already been successfully launched prior to the introduction of the iTunes Store. Indeed, making it easy to transfer music to these pre-existing devices was a selling point for the new music offering. *See* DiMA PFF ¶ 250. The Copyright Owners even concede that Apple helped to demonstrate that the only way

to compete successfully against pirated music is to invest in the technology, infrastructure and consumer awareness necessary to provide a convenient, easy-to-use, and high quality offering; that is, to make more music more attractive to more customers.

47. **CO PFF ¶¶ 375-379.** Doing so is expensive, especially because royalty costs are already so high. As the Copyright Owners recognize, the labels were able to extract very high fees from Apple because they initially refused to license their music to iTunes. *See* CO PFF ¶ 373. But these payments are not informative with respect to the rate being set in this proceeding. *See Determination of Reasonable Rates and Terms for the Digital Performance of Sound Recordings*, 63 Fed. Reg. 25,394, 25,405 (May 8, 1998) (rates for different rights “serve no practical purpose” as a benchmark where no “clear nexus” is established between them in the record). The fact that royalty costs are already high is no reason to make them even higher; under Section 801(b)(1), it is a compelling reason to set a lower percentage-of-revenue rate.

48. **CO PFF ¶ 380.** The Copyright Owners doubt this of course, and believe that Apple could simply raise the price of songs on the iTunes Store. They scoff at the absence of a formalized “price sensitivity study” to explain Apple’s choice of the 99¢ price point. Because they do not have any practical experience offering products in the marketplace, they evidently believe that anything other than formal econometric modeling to determine a price is simply “magical.” CO PFF ¶ 380. In reality, as a company with vast retailing experience, Apple carefully considered competition from others attempting to sell downloads for 79¢ to \$1.49, competition from CDs, and competition from free pirated music in determining the price at which it would sell

downloads. *See* 2/25/08 Tr. 4267:3-10 (Cue). The success of the 99¢ price point in the marketplace speaks for itself.

49. The Copyright Owners are so intent on clouding the record with respect to the 99¢ price that they quote their own lawyer’s question – but attribute it to Mr. Cue – to make it appear that a 99¢ price point was an “article of faith” for Apple from the beginning, which is not what the record reflects. *See* 2/25/08 Tr. 4315:12-16 (Mr. Cohen). Mr. Cue testified clearly about the company’s original price-selection process, which was completely devoid of “magic” or reliance on any “article of faith.” *See* 2/25/08 Tr. 4267:3-10 (Cue).

50. The Copyright Owners also try to search for nefarious motives to explain the unwillingness of digital distributors to change pricing practices that are working in the marketplace. Given downward pressure on prices, as evidenced by continued Internet piracy and pricing by new entrants at or below 99¢, *see* DiMA PFF ¶¶ 52-58, it is no wonder that digital music distributors are skeptical of demands to raise prices or make them more confusing for customers. Copyright owners make none of the investments necessary to make digital products attractive to consumers. *See* DiMA PFF ¶¶ 255, 304. And they have no track record when it comes to ideas about what makes any offering attractive in the consumer marketplace.

51. **CO PFF ¶ 381.** The fact is, as a result of Apple’s investments, innovation and willingness to take risks that no one else would, the iTunes Store has become a success story. Apple and other permanent download distributors operate in the context of the overall music marketplace, competing with CDs as well as piracy. *See, e.g., supra* ¶ 48. No one “commands” that marketplace. Without question, Apple has helped to

create a new way for consumers to purchase music, providing hundreds of millions of dollars to songwriters and artists that otherwise might never have been received. *See* Guerin-Calvert WDT ¶ 103 (DiMA Tr. Ex. 7) (discussing the “substantial spillover benefits for the industry as a whole” provided by Apple “increasing the interest and demand for digital music.”); *see also* RIAA Tr. Ex. 51 at CO05006841 (Citigroup and JP Morgan, Investment Memorandum re BMG Music Publishing, June 2006) (recognizing that the improving environment for music is driven in part by success of iTunes); CO Tr. Ex. 15, attach. 700 at RIAA0018078 (Universal Music Group Presentation, 2006) (discussing similar benefits to record labels); 1/31/08 Tr. 1071:17-1072:6 (Robinson) (same for music publishers).

52. **CO PFF ¶¶ 382-384.** Not surprisingly, after touting the success of the iTunes Store, the Copyright Owners cannot help but return to their favorite hobby horse, the iPod. Apparently they believe that music must be underpriced at 99¢ per download because otherwise it could not be such a “small part” of Apple’s total revenue. They evidently believe that the massive investments, innovation and marketplace savvy it takes to sell music in competition with free downloads should produce even higher margins than the returns the Copyright Owners themselves acknowledge to be healthy and steadily rising. *See* CO PFF ¶¶ 39, 462. And they tout Mr. Cue’s honest recognition that Apple is in synergistic lines of business as something nefarious. *See* CO PFF ¶ 382. But this synergy has served Apple well and created substantial benefits for other industry participants, including copyright owners. *See* Guerin-Calvert WDT ¶ 103 (DiMA Tr. Ex. 7); DiMA PFF § IV(B).

53. This obsessive focus on Apple and iPods is completely irrelevant and misleading. *See, e.g.*, DiMA PFF § VIII(A)(4). First, none of the activities involved in the manufacture, sale, marketing or use of an iPod (or any playback device) implicates the rights at issue here. *See* DiMA PCL ¶ 44. Nor does playback technology implicate the statutory objectives, whether it is record players, tape decks, CD players, personal computers, MP3 players, or whatever new devices may be invented tomorrow. Second, the Copyright Owners are not proposing a rate just for songs sold by Apple, nor could they by law. And finally, the Copyright Owners offer only speculation that the iTunes synergy operates exclusively in one direction, to boost sales of iPods. Statements by Apple executives defending a lower-margin line of business are completely consistent with Mr. Cue’s sworn testimony that the synergy “works both ways,” boosting sales of permanent downloads as well. 2/25/08 Tr. 4305:16-21 (Cue); *see also* DiMA PFF ¶250.

54. **CO PFF ¶ 385.** Into this mixture of baseless allegations, the Copyright Owners’ also toss the claim that Apple uses rights-protection software in its downloads to force customers to buy iPods. Again, this is totally misleading and lacks record support. Music purchased on iTunes can be burned to a CD and then played on any device. *See* Cue WDT ¶ 12 (DiMA Tr. Ex. 3). Moreover, all of Apple’s content rules and playback parameters are the result of heavy negotiations with content providers aimed at safeguarding against piracy. *See id.* ¶ 11. The “relationship” between iTunes and the iPod is not the sinister one the Copyright Owners portray.

55. **CO PFF ¶¶ 386-388.** In the end, the Copyright Owners’ singular focus on Apple alone is inappropriate because there are other digital music providers selling permanent downloads besides the iTunes Store. *See supra* § VI; *cf.* CO PFF ¶ 777

(explaining why it is improper to focus only on the most successful songwriters). Indeed, entering the marketplace requires tremendous investment and risk-taking that few are willing to bear under the current cost structure. *See* DiMA PFF § V. Microsoft’s offering is in fact provided by MediaNet. *See* 2/25/08 Tr. 4392:20-4393:12 (McGlade) (confirming that MediaNet provides the platform for Microsoft’s Zune service). Best Buy’s offering is provided through RealNetworks. *See* 5/13/08 Tr. 6157:14-17 (Sheeran). There is no evidence that Wal-Mart is any different or that it has invested in providing services on a stand-alone basis. In fact, the only evidence in the record is that Wal-Mart “offer[s] digital downloads,” nothing more. 2/4/08 Tr. 1195:9-10 (Enders). The marketplace is brutally competitive and profitability is elusive. *See id.* § V(C). The primary competition remains the pervasive availability of free, pirated product. *See id.* § III(A). The nearly 65-percent rate hike proposed by the Copyright Owners would likely kill many of these businesses. *See* DiMA PFF ¶¶ 12, 73-74, 136-137, 185-188, 258.

C. The Success of Digital Music in the Marketplace Is the Result of Efforts, Investments, And Risk-Taking by Digital Music Distributors

56. **CO PFF ¶¶ 389-392.** The Copyright Owners provide a litany of reasons to explain that digital music has the potential to grow. DiMA does not disagree that digital music companies have “expanded the availability and appeal of royalty-bearing creative works in a manner that is truly revolutionary.” Guerin-Calvert WDT ¶ 10 (DiMA Tr. Ex. 7); *see also* DiMA PFF ¶¶ 65-75. And the potential to grow is still vast. *See* 2/4/08 Tr. 1338:8-1339:3 (Enders) (80 percent of consumers have not yet purchased digital downloads). But that does not mean the risks to growth have disappeared. *See*

DiMA PFF §§ III(A), V. “With non-royalty bearing music available through illegal file-sharing, consumers must determine that there is value in paying to consume music through legitimate providers.” Guerin-Calvert WDT ¶ 89 (DiMA Tr. Ex. 7); *see also id.* ¶ 102; Guerin-Calvert WRT ¶ 7 (DiMA Tr. Ex. 10) (“Digital distributors must invest in innovative products to the user that distinguish their products from musical works available from non-legitimate sources.”). Those risks would be amplified by adoption of the Copyright Owners’ proposed rates and terms.

57. The Copyright Owners recognize and acknowledge the many attributes that “add value to music” purchased digitally, CO PFF ¶ 391, yet they fail to acknowledge that none of them has anything to do with contributions copyright owners make. *See* DiMA PFF ¶¶ 255, 304. One of those attributes – the availability of single tracks – is a by-product of that technological evolution. While the Copyright Owners contend that the availability of single tracks has reduced mechanical revenues, their own proposed findings reveal the value that singles provide to all marketplace participants. *See* CO PFF ¶ 411; *see also* DiMA PFF § IV(B)(3) (describing impact of singles sales). Moreover, Mr. Cue testified that “over 40% of tracks” sold by the iTunes Store “are sold as part of albums, rather than individually.” Cue WDT ¶ 10 (DiMA Tr. Ex. 3). The data provided by the Copyright Owners confirm this. *See* 2/4/08 Tr. 1355:3-22 (Enders); DiMA PFF ¶ 125. Indeed, from 2005 to 2006 sales of digital albums significantly outpaced growth of digital singles sales. *See* Enders WDT at 23 (CO Tr. Ex. 10); DiMA PFF ¶ 125.

58. Meanwhile, digital distributors provide access to unprecedented music catalogs that are never out of stock. *See* DiMA PFF ¶¶ 81-84. They provide powerful

searching, navigating and linking tools that enable consumers to explore songs, albums, songwriters, artists and genres with ease. *See id.* ¶¶ 85-90. They have developed easy-to-use cataloging tools. *See id.* ¶ 92. They have engineered, hosted and continually upgraded consumer-friendly websites. *See id.* ¶¶ 93-94. They offer editorial content to make music more interesting to consumers and to introduce them to new genres, artists, and songs. *See id.* ¶ 95. And they invest in the hardware, software, infrastructure, bandwidth, and staffing required to make this all available 24 hours a day, seven days a week. *See id.* ¶ 98. All of this represents major investments and costs that legitimate digital distributors have undertaken to make music more attractive to consumers who can otherwise get it easily for free. *See id.* ¶¶ 48-59. None of it represents efforts, costs, or risks undertaken by the Copyright Owners. *See id.* ¶¶ 255, 304.

59. **CO PFF ¶¶ 393-401.** No one disputes that there is growth in the digital marketplace. *See* DiMA PFF ¶¶ 65-75. But it has hardly begun to make up for the harms that piracy has dealt the industry. *See id.* ¶ 74. As Roger Faxon testified, there is little utility in “making value judgments [about] who is more harmed” by the downturn in the industry. 1/29/08 Tr. 530:14-21 (Faxon). The more important question is “who can do more to cure the problem?” *Id.* The answer is legitimate digital music distributors, but only if the rate set in this proceeding encourages continued growth and technological innovation.

VIII. THE CURRENT STATE OF THE RECORDED MUSIC INDUSTRY PRESENTS LEGITIMATE DIGITAL DISTRIBUTORS WITH HIGH COSTS AND SEVERE RISKS

60. **CO PFF ¶ 402.** The Copyright Owners paint a rosy but ultimately unsupported picture of the “flourishing” marketplace for digital music in the United

States. CO PFF ¶ 402. They assert that “[a]s U.S. consumers appear increasingly willing to pay for legitimate digital music, sales of digital music across a variety of formats are rapidly rising, further increasing the size of the U.S. digital music market and the profitability of the recorded music and digital music companies.” *Id.* But the only support they have for these claims are two pages from the Written Direct Testimony of Claire Enders. Putting aside the many problems with Ms. Enders’s predictions, *see* DiMA PFF ¶¶ 300-309, nowhere did she suggest that sales of digital music are increasing the “profitability” of multiple “digital music companies.” Indeed, the cited pages cover only subscription service revenues, ringtone sales, a list of the four major labels, and a high-level description of digital distribution models. She provided no evidence whatsoever to show that multiple “digital music companies” have turned a profit in the business.

61. Moreover, there is no relevance to the Copyright Owners’ quibble about whether the word “nascent” applies to the digital music marketplace. *See* CO PFF ¶ 402. The evidence demonstrates unequivocally that the marketplace continues to evolve. *See* DiMA PFF § V(A). The permanent download industry simply is not the “flourishing” and profitable business that the Copyright Owners describe, whether or not a business model with barely a five-year track record can be described as nascent. Indeed, the Copyright Owners readily admit that the permanent download business is “continuing to develop and evolve,” yet they suggest that in only five years the digital music business has somehow become “well-established.” CO PFF ¶¶ 831-832. That is about half as long as the digital subscription services had been in business when a rate that recognized their incipient status was set for them. *Determination of Statutory License Terms and*

Rates for Certain Digital Subscription Transmissions of Sound Recording, Docket No. 96-5 CARP DSTRA, at ¶ 49 (Nov. 12, 1997) (recognizing that the services were still “all new”) (emphasis supplied).

62. **CO PFF ¶¶ 403-416.** DiMA does not dispute the declining sales of physical product in the U.S. Nor does DiMA dispute that online music sales are growing. *See* DiMA PFF ¶¶ 65-75. But the Copyright Owners’ discussion of digital music sales is misleading and at times contradictory.

63. First, the Copyright Owners fail to acknowledge that digital music sales do not yet come close to making up for the declines in physical sales. *See* DiMA PFF ¶ 74. While legitimate digital distribution has the potential to mitigate those losses (and perhaps even make up for them entirely), that has not happened yet and would never happen under the rates the Copyright Owners have proposed. *See id.* ¶¶ 12, 73-74, 136-137, 185-188, 258. By presenting digital sales statistics that misleadingly combine figures for mobile sales, non-mobile sales, permanent downloads and subscriptions, the Copyright Owners create a false impression of the impact that digital sales have had to date, and they distort the impact of their massive proposed rate hike.

64. Second, the Copyright Owners claim that the digital single is driving the growth in digital music sales. *See* CO PFF ¶ 411. But this argument suggests that allowing customers to purchase individual songs has generated greater demand, which contrasts sharply with the Copyright Owners’ claims of harm to songwriters as a result of the transition from an albums-based format to a singles-based format. *See* CO PFF ¶¶ 20, 390; *see also* DiMA PFF § IV(B)(3) (explaining that the availability of singles attracts consumers). Further undercutting the Copyright Owners’ assertions about the impact of

digital singles is their own acknowledgment that sales of digital albums are rising, more than doubling from 2005 to 2006. *See* CO PFF ¶ 413. Indeed, Roger Faxon testified that he has worked extensively on the bundling issue, yet he acknowledged there is no evidence that gross demand for music has gone down due to the availability of unbundled tracks. *See* 1/30/08 Tr. 716:7-15 (Faxon); *see also* DiMA PFF § IV(B)(3).

IX. THE CURRENT FINANCIAL CONDITION OF THE RECORD COMPANIES HAS NO BEARING ON THE CHALLENGES THAT DIGITAL DISTRIBUTORS FACE AND THE COSTS THAT THEY INCUR

65. **CO PFF ¶¶ 417-456.** Although revenue from permanent downloads is growing, it has not offset the decreasing sales of physical recordings. *See* DiMA PFF ¶¶ 73-74. Moreover, growing digital sales do not negate the fact that the costs of digital distribution are extremely high, *see* DiMA PFF ¶¶ 147-171, and that most digital music providers have not yet become profitable and many have been forced to exit the business. *See* DiMA PFF ¶¶ 174-179. Whatever the merits of the Copyright Owners' arguments with regard to the revenues, costs, and profitability of the record companies, the truth remains that it is expensive to distribute digital music legitimately and piracy has rendered profitability difficult to achieve. *See generally* DiMA PFF §§ III(A), V. A high mechanical rate will only hinder profitability further, hasten exit, and raise entry barriers, all to the detriment of music consumers, copyright owners, record companies, and digital music providers. *See id.* ¶¶ 12, 73-74, 136-137, 185-188, 258.

X. THE COPYRIGHT OWNERS ASSUME THAT APPLE WOULD SWALLOW A 65-PERCENT RATE HIKE AND THAT NO ONE ELSE MATTERS

66. **CO PFF ¶ 457.** In a breezy description of the “current financial condition of the permanent download industry” the Copyright Owners regurgitate materials provided to them in discovery by Apple – and then commence their argument that a rate hike of nearly 65 percent could work as a matter of arithmetic if applied to the iTunes Store. A few pages earlier, they tout the presence of Wal-Mart and Best Buy and Amazon.com, but in their analysis of the impact of their proposal they provide nothing to show whether those companies would stay in the business after a 65-percent rate hike. Nor do the Copyright Owners show whether these other providers have actually invested in distributing digital music or simply affiliated with an existing provider, as is likely the case. *See supra* ¶ 55. In fact, it takes tremendous investments and ingenuity to launch and grow a successful digital music offering. *See* DiMA PFF § V.

67. While the Copyright Owners highlight the revenues generated by Napster, RealNetworks and MusicNet from the sale of permanent downloads, they remain silent about the devastating effect of their proposed rate hike on these offerings. In fact, the record evidence clearly shows that “it would be difficult” for these businesses to become profitable if the Copyright Owners’ rate were adopted. 5/13/08 Tr. 6162:4-7 (Sheeran). Mr. Sheeran testified that the Copyright Owners’ proposed fees would cut RealNetworks’ gross margins on the sale of permanent downloads by 40 percent, assuming stable prices. *See id.* 6162:14-6163:15 (Sheeran). Since prices are actually falling, the impact would be even more severe. *See id.* 6164:1-19 (Sheeran).

68. **CO PFF ¶¶ 458-460.** The Copyright Owners apparently believe that digital distributors can fund an unprecedented mechanical rate by cutting back on their royalty payments to record companies. But these content costs are a non-negotiable requirement for any digital music provider intending to stay in business. *See, e.g.*, 2/25/08 Tr. 4247:6-4248:6 (Cue) (largest possible catalog is a competitive necessity); DiMA PFF ¶152. In fact, the Copyright Owners acknowledge the importance to digital music distributors of licensing content from every record company. *See* CO PFF ¶ 368. Sound-recording rights holders have substantial negotiating power, and there is no evidence they would simply absorb higher mechanical rates rather than pass them through to digital distributors. *See* DiMA PFF ¶ 152. Someone would have to pay the higher mechanical rates; the result would be higher prices for consumers or lower investment by distributors – either of which would compel many consumers to turn to pirate sources instead. The Copyright Owners fail to show otherwise, nor do they dispute that any of these outcomes would result in decreased availability of music to consumers, fewer legitimate digital sales, and less revenue for all industry participants. None of this is consistent with the statutory objectives that must be achieved in setting the rate.

69. As Mr. Cue testified, for iTunes the choice would be whether to pass along the Copyright Owners’ massive rate hike to consumers and threaten growth of the service or to absorb the costs itself. *See* 2/25/08 Tr. 4269:2-11, 4269:20-4270:5 (Cue). Either way, Apple would have to question whether it “really want[s] to be in [the] business and, if so, . . . what kind of investments [it] want[s] to make on an ongoing basis.” *Id.* 4271:3-8 (Cue). There is no evidence in the record to support the contention that the mechanical rate could be increased so dramatically with no impact whatsoever on

digital distributors, yet this is what the Copyright Owners strenuously argue would happen.

70. **CO PFF ¶¶ 461-466.** The Copyright Owners labor mightily to show that Apple could withstand the dramatically higher penny rates they propose. But their so-called “forecast” for iTunes under steeply reduced margins neglects to address (1) whether Apple would continue to operate the iTunes Store under such conditions, (2) whether the iTunes Store would provide more than a negative return on investment, (3) whether the fixed costs of operating the iTunes Store would be recovered, and (4) whether Apple would continue to invest in the business considering alternative investment opportunities. *Cf.* DiMA PFF ¶ 247 (cataloging the Copyright Owners’ analytical failures with respect to Apple’s ability or willingness to absorb the increase they propose). Indeed, they fail to consider whether any entity not yet operating at iTunes’ sales levels – *i.e.*, every other company in the industry – could even stay in business. *See id.* All of this information is critical if the Copyright Owners’ argument is to be considered at all.

71. In the end, the Copyright Owners’ arguments are neatly summarized in their ten-paragraph overview of the industry. In essence, they claim that labels get paid a lot of money to license permanent downloads, so mechanical rates should be increased. Because they assume an increase would have no impact on the iTunes Store (an assumption they do not even bother to prove), they claim it will work for all industry participants and new entrants. Their analysis is flawed and their claims overblown. There is no record support for the massive rate hike they propose.

XI. THE COPYRIGHT OWNERS' INDUSTRY FORECASTS FOCUS ON THE SUCCESSES OF A SINGLE DIGITAL DISTRIBUTOR AND IGNORE EVERYTHING ELSE

72. **CO PFF ¶¶ 467-480.** The Copyright Owners assert that the digital music business is projected to grow in the coming years, yet they completely ignore the critical assumptions underlying those projections. Most notably, none of the sources on which they rely assessed the likely trajectory for digital music after the 65-percent rate hike they propose. In fact, the unprecedented penny rate urged by the Copyright Owners would ruin existing legal digital distributors, discourage new entrants, open the floodgates for pirate services, and stanch the legitimate revenues on which every industry participant relies. *See* DiMA PFF § V.

73. Moreover, the Copyright Owners completely disregard the fact that favorable growth projections rest on the critical assumption that “[n]ew entrants” will continue to “drive additional upside.” CO Tr. Ex. 15, attach. 731 at RIAA0028581 (Warner Music Group Presentation, 2006); *see also* DiMA PFF ¶¶ 71-75 (describing the need to encourage new entry to stimulate industry-wide growth). These projections therefore offer no support for the Copyright Owners’ position because raising the rates as the Copyright Owners propose would effectively sound the death knell for new entrants. *See* DiMA PFF ¶¶ 181, 217-218, 248.

74. The Copyright Owners’ sanguine projections for the digital music industry are based almost exclusively on the success that the iTunes Store has achieved. *See* CO PFF ¶ 471; *supra* § VII. But there is simply no basis in the statute for crafting an industry-wide rate based on the achievements of a single participant. *See, e.g.*, DiMA PFF § VIII(A)(4); *see also supra* §§ VII, X. Focusing the rate analysis on iTunes alone

would be as misleading as determining a rate by reference only to top-earning songwriters. *See* 5/20/08 Tr. 7337:7-7338:6 (Landes) (describing mechanical income for successful songwriters); *see also* DiMA PCL ¶ 69. But the Copyright Owners themselves have explained why it is improper for the rate to reflect only those success stories and not other songwriters. *See* CO PFF ¶ 777. For precisely the same reasons, the Court’s rate determination must reflect the interests of all digital music distributors – including potential new entrants – and not just the solitary successful operator. Indeed, the statutory objectives require a rate-setting approach geared toward the industry as a whole, not toward individually successful participants. *See* DiMA PCL ¶¶ 45, 69.

XII. THE COPYRIGHT OWNERS’ PROPOSED BENCHMARKS ARE LARGELY IRRELEVANT AND UNIFORMATIVE

A. Dr. Landes Selected Inappropriate Benchmarks that Offer Very Little Insight into the Permanent Download Industry

75. **CO PFF ¶¶ 481-484.** The Copyright Owners hang their entire rate proposal on the benchmarks analyzed by Dr. William Landes. As DiMA has explained in detail, however, none of Dr. Landes’s three benchmarks – ringtone agreements, synchronization agreements, or the Audio Home Recording Act (“AHRA”) – provides useful information for setting a rate for permanent downloads. *See* DiMA PFF § IX(E). Indeed, Dr. Landes admitted as much with respect to ringtone agreements and the AHRA, and the record reveals that synchronization agreements are equally dissimilar. *See id.*

76. Dr. Landes’s benchmark analysis produced a uselessly vast “range of reasonableness” that would validate any rate that amounts to 20 to 50 percent of total licensing fees. *See* DiMA PFF ¶¶ 284-285. This broad span provides no useful guidance for the Court, and it reveals the extent to which he has grasped at a group of completely

unrelated rights in an effort to bolster the Copyright Owners' unprecedented proposal.

See id.

77. Finally, the “content pool” approach Dr. Landes employed when analyzing his proposed benchmarks is utterly divorced from the requirements of the statute. Rather than assessing a rate based on relative costs as the third statutory objective requires, Dr. Landes’s “relative values” approach rests on the opposite premise that higher total licensing costs justify higher rates for mechanical licenses. *See* DiMA PFF ¶ 286.

B. Dr. Landes’s Criteria for Selecting Benchmarks Are Fundamentally Flawed

78. CO PFF ¶¶ 485-489. The Copyright Owners list the four criteria that purportedly guided Dr. Landes’s search for benchmarks. First, they claim, a benchmark should reflect voluntary market transactions. *See* CO PFF ¶ 486. But the AHRA, Dr. Landes conceded, is a legislative act, not a marketplace transaction, *see* 2/7/08 Tr. 2105:19-2106:4 (Landes); *see also* DiMA PFF ¶¶ 282, 350, so it fails as a benchmark by his own criteria.

79. Second, Dr. Landes sought benchmarks unaffected by a statutory license. *See* CO PFF ¶ 487. But ringtone agreements, Dr. Landes conceded, “were negotiated under the shadow of possible mandation” under Section 115, Landes WDT ¶ 51 (CO Tr. Ex. 22), so whether or not they could be useful in the abstract, they fail as a benchmark by his own criteria as well.

80. Third, Dr. Landes tried to locate benchmarks that provide information on the relative valuation of the sound recording and underlying composition, as reflected in

the apportionment of the total licensing “content pool.” *See* CO PFF ¶ 488. But this methodology completely inverts one of the statutory objectives. *See supra* ¶ 77. Rather than calculate a rate that reflects relative contributions and costs, *see* 17 U.S.C.

§ 801(b)(1)(C), Dr. Landes assumes that higher royalty costs for non-mechanical rights justify higher mechanical royalties as well. *See, e.g.,* 2/11/08 Tr. 2374:3-4 (Landes) (“[I]t’s a relative value that’s the key . . . not the absolute value.”); DiMA PFF ¶ 286. So this criterion is unlawful.

81. Fourth, the Copyright Owners claim that Dr. Landes sought benchmarks requiring users to obtain separate licenses for the composition and the recording, as this would ostensibly allow him to analyze the relative valuations reflected in the corresponding division of the licensing content pool. *See* CO PFF ¶ 489. This is just another way of saying he was committed to inverting the third statutory objective rather than achieving it. *See, e.g.,* DiMA PFF ¶ 286. Moreover, he provides no assurance that the relative valuation at the time these benchmark agreements were finalized is always the same, nor that they would be the same even if the rights they cover were transacted separately.

82. In addition to these serious flaws with each of the criteria he employed, Dr. Landes’s analysis suffers from a further problem. He failed to consider the importance of comparability. While the Copyright Owners acknowledge that comparability is important, *see* CO PFF ¶ 710, Dr. Landes did not. As a result, his conclusions are deeply flawed. *See infra* § XII(C). His ultimate recommendation relies on the three wholly dissimilar products that produced a worthlessly broad range that justifies any proposed rate hike with no limiting principle. *See* DiMA PFF ¶¶ 284-285.

C. Dr. Landes’s Proposed Benchmarks Provide Little Guidance to the Court with Respect to the Mechanical Rate for Permanent Downloads

83. **CO PFF ¶ 490.** As explained below, each of Dr. Landes’s three benchmarks suffers from critical flaws. As a result, none supports the Copyright Owners’ proposed rates for permanent downloads.

1. Ringtone Rights Are Not a Useful Benchmark as Presented

84. **CO PFF ¶¶ 491-530.** The Copyright Owners entered nearly 200 ringtone agreements into evidence, *see* CO PFF ¶ 494, yet they fail to explain why any of them can be used as a benchmark to set rates for permanent downloads. *See* DiMA PFF ¶ 283. Indeed, Dr. Landes himself admitted that ringtones are not his “strongest comparison” with respect to permanent downloads because they are subject to completely different supply and demand characteristics. 2/11/08 Tr. 2481:18-2482:7 (Landes).

85. Ringtones and permanent downloads are completely unrelated products, and the royalty rates applicable to the former therefore have no relevance to the latter. *See* DiMA PFF ¶¶ 336-346. Ringtones are catchy snippets of a song used to personalize a mobile phone. *See id.* ¶¶ 337-340. Ringtones are typically available only for the most popular songs, and their price points are unrelated to the price points for permanent downloads. *See id.* ¶¶ 339-340. Reflecting the products’ completely distinct supply and demand characteristics, consumers do not consider ringtones to be a substitute for permanent downloads. *See id.* ¶ 338. In addition, many ringtone agreements do not cover mastertones – the versions containing snippets from recording artists’ renditions – meaning that the copyright users participating in this proceeding had nothing to do with negotiating them. *See id.* ¶ 341. Each of these flaws applies with equal force to the

Copyright Owners’ attempt to rely on new digital media agreements as a subset of ringtone agreements. *See id.* ¶¶ 345-346. For these reasons, the Court should decline to give weight to ringtone agreements when determining the mechanical rate for permanent downloads.

2. Synchronization Rights Are Not a Useful Benchmark as Presented

86. **CO PFF ¶¶ 531-540.** Dr. Landes’s and the Copyright Owners’ reliance on synchronization licenses as a benchmark is equally misguided because the products, buyers and sellers are not comparable. *See* DiMA PFF ¶¶ 281, 347-348. A musical work is put to entirely different uses in the synchronization and mechanical contexts, as an input into a larger work in the former (*i.e.*, background music in a movie) and as a stand-alone final product in the latter. Moreover, the copyright users in the synchronization context (television and movie producers) are completely unrelated to the copyright users in the mechanical context (music retailers and distributors). *See id.* Because the products and market participants are so completely incomparable – a fact that the Copyright Owners have not even attempted to rebut – the synchronization benchmark as presented offers little useful guidance to the Court.

3. Even Dr. Landes Concedes the AHRA Is Not a Useful Benchmark

87. **CO PFF ¶¶ 541-542.** Having failed to establish its utility as a benchmark, *see* 2/7/08 Tr. 2105:19-2106:4 (Landes), Dr. Landes and the Copyright Owners now claim that the AHRA merely provides corroborative support for their analysis. But the products and royalties it covers – digital recording devices and media – are completely distinct from the products and royalties at issue in this proceeding. *See* DiMA PFF ¶¶ 282, 349-350. Even more importantly, the AHRA merely “reveals

Congress’s view” of allocating royalties for other purposes unrelated to Section 801(b)(1). Landes WDT ¶ 50 (CO Tr. Ex. 22); *see also* DiMA PFF ¶¶ 282, 350. Congress did not make a comparable legislative choice with respect to the allocation of mechanical royalties for permanent downloads. Instead, it entrusted this Court with determining rates and terms that achieve the 801(b) objectives. The AHRA thus provides little useful guidance to the Court.

D. Dr. Landes’s Broad “Range of Reasonableness” Provides No Insight Into the Suitability of the Rates the Copyright Owners Propose

88. **CO PFF ¶¶ 543-556.** The range of rates that results from Dr. Landes’s benchmark analysis is so hopelessly broad – 20 to 50 percent of the total content pool – that it does nothing to support the Copyright Owners’ proposed rates, regardless of where they may fall within the range. *See* DiMA PFF ¶¶ 284-285. Indeed, the difference between the low and high ends of the range is equivalent to more than \$1 billion in mechanical royalty payments each year, which is more than twice the volume of mechanical royalties ever paid in any year in the United States. *See* Wildman WRT at 9 (RIAA Tr. Ex. 87); *see also* DiMA PFF ¶¶ 284-285.

89. The Copyright Owners now claim that Dr. Landes was “[m]indful of the breadth of this range,” and that he took steps in his analysis to address it. CO PFF ¶ 544. None of the testimony they cite supports that characterization of his testimony, however. In the passages on which the Copyright Owners purport to rely, Dr. Landes noted only that there are transactions costs associated with negotiating a voluntary agreement below the statutory rate, *see* 2/7/08 Tr. 2114, 2254 (Landes), and he conceded that he would

have to “think more and do additional analysis” before reaching conclusions about the impact of adopting a rate at the upper end of his range. 2/11/08 Tr. 2345:14-17 (Landes).

90. With respect to permanent downloads in particular, Dr. Landes concluded that the Copyright Owners’ proposed rate would fall at the bottom end of his distended range. *See* CO PFF ¶ 551. But the Copyright Owners’ proposal for permanent downloads amounts to nearly a 65-percent increase above the current rate, *see* DiMA PFF ¶ 253, and it would result in the highest rate in place anywhere in the world. *See* DiMA PFF ¶ 332; 5/15/08 Tr. 6846:15-20 (Fabinyi). The fact that such an unprecedented rate hike falls within the lower reaches of Dr. Landes’s sweeping range only confirms that his benchmarks and methodology were deeply flawed.

XIII. THE ASSERTION THAT THE STATUTORY RATE IMPOSES A CEILING ON THE MECHANICAL ROYALTY RATE IS NEITHER SUPPORTED BY EVIDENCE NOR RELEVANT TO THE COURT’S STATUTORY ANALYSIS

91. **CO PFF ¶ 557.** The Copyright Owners’ assertion that “the statutory rate acts as a *de facto* ceiling on the mechanical royalty rates” is both unsupported in the record and irrelevant to the Section 801(b) analysis. Relying on the written testimony of Dr. Landes for the proposition that there are “relatively low transaction costs in the market,” the Copyright Owners argue that it is easy for parties to voluntarily bargain below the statutory rate. CO PFF ¶ 557. Dr. Landes’s live rebuttal testimony, however, demonstrated his complete unfamiliarity with the direct costs and transactions costs associated with the compulsory and voluntary processes. *See* DiMA PFF ¶¶ 287-289. The Court should give no weight to Dr. Landes’s conclusory assertions on this issue,

especially when faced with evidence demonstrating that transaction costs are, in fact, quite high. *See id.*

92. **CO PFF ¶¶ 558-566.** Lacking support from their own witnesses for this claim, the Copyright Owners distort the testimony of others. For example, they claim that “Professor Wildman testified that the statutory rate ‘impose[s] a cap on what the marketplace might negotiate.’” CO PFF ¶ 560 (quoting Professor Wildman). But even a cursory review of Dr. Wildman’s testimony makes clear that he does not believe the statutory rate serves as a ceiling on the mechanical royalty rate. Dr. Wildman preceded the quoted statement by saying that “[i]t’s not the statutory rate itself that’s the ceiling.” 5/12/08 Tr. 5900:7-10 (Wildman). Rather, he explained, the statutory rate plus transactions costs could impose a cap on negotiations. *See id.* 5899:13-16 (Wildman) (“You wouldn’t pay more than the compulsory fee plus the cost of using the compulsory licensing process minus the cost of negotiating independently of that.”) (emphasis supplied). Dr. Wildman testified that transactions costs (or administration costs as he calls them) are substantial, *see id.* 5900:16-22 (Wildman), and any hypothetical cap under his analysis would be substantially higher than the statutory rate.

93. **CO PFF ¶¶ 567-576.** The Copyright Owners also purport to rely on “economic theory” to bolster their unprecedented rate hike, but their theory has no place in a Section 801(b) proceeding. *See, e.g.,* DiMA PCL § II. In particular, their theory that an unjustifiably high rate determination would be “self-correcting in the marketplace,” CO PFF ¶ 567, is nothing more than a variant of the soundly rejected “bargaining room” theory. *See* DiMA PCL ¶ 43. The Copyright Owners proceed as if Section 801(b)(1) charges the Court with determining a mechanical rate that approximates the marketplace

license that would result absent the statute. *See, e.g.*, CO PFF ¶ 570. But this reasoning renders the statute superfluous. *See* DiMA PFF ¶¶ 273-279.

94. **CO PFF ¶¶ 577-581.** To the extent that the Copyright Owners attempt to defend Dr. Landes’s analysis from criticisms offered by David Alfaro, *see* CO PFF ¶¶ 577-581, DiMA has already addressed these points. In particular, DiMA explains in its proposed findings that Dr. Landes’s failure to analyze mechanical royalty data with appropriate care resulted in completely unreliable results that excluded revenues generated by approximately 37,000 songs. *See* DiMA PFF ¶¶ 290-292.

XIV. EMPLOYING A PENNY RATE FOR PERMANENT DOWNLOADS FAILS TO ACHIEVE THE STATUTORY OBJECTIVES

95. **CO PFF ¶ 582.** Nothing in the Copyright Owners’ proposed findings justifies the use of a penny rate for permanent downloads. While the Copyright Owners argue repeatedly that only a penny rate can provide “price protection,” CO PFF ¶ 582, they admit that minima offer the safety they want. Because DiMA amended its proposal to include minima to address this concern, the Copyright Owners’ arguments about “protection” merely bolster the reasonableness of the rates and terms DiMA has proposed.

96. In defense of perpetuating the penny rate, the Copyright Owners claim that it “has been in place for almost a century.” CO PFF ¶ 582. As they acknowledge elsewhere, however, the penny rate has applied to permanent downloads for only a fraction of that time. *See* CO PFF ¶¶ 121-124. Indeed, Roger Faxon admitted that the penny rate has not been incorporated into any of his company’s songwriter contracts related to permanent downloads. *See* 1/29/08 Tr. 479:2-7, 482:15-483:3 (Faxon); *see*

also DiMA PFF ¶ 210. He further admitted that there is no reason not to employ a percentage rate for permanent downloads, and he explained that doing so would not result in any disruption. See 1/29/08 Tr. 482:22-483:3, 485:11-22 (Faxon); see also DiMA PFF ¶ 210.

A. The Copyright Owners Ignore the Impact of CPI Adjustments and Distort The Parties' Proposals

97. **CO PFF ¶¶ 583-586.** In their overview of the parties' proposed rates, the Copyright Owners fail to justify their inclusion of "periodic adjustments for inflation, as measured by the [Consumer Price Index]." As DiMA explains in its proposed findings, CPI-based adjustments are flawed because they assume that the prices for the products in question – here, permanent downloads – will rise in concert with the CPI. See DiMA PFF § VIII(B)(2). The record evidence reveals, however, that legitimate digital distributors are not able to raise their prices in keeping with inflation. See DiMA PFF ¶ 259; *id.* § V(D). As a result, a CPI-based adjustment would require copyright users to pay an ever increasing share of their revenues to copyright owners in the form of mechanical royalties. See DiMA PFF ¶¶ 259-260. This would amount to an unwarranted transfer of wealth from copyright users to copyright owners. The Court should reject it.

98. **CO PFF ¶¶ 587-589.** The Copyright Owners also mischaracterize DiMA's proposal as an effort to "abolish[] the penny rate." CO PFF ¶ 587. In reality, DiMA does not propose abolishing anything. Rather, it proposes that the Court adopt a rate for permanent downloads that achieves each of the statutory objectives. A percentage rate is superior to a penny methodology in that regard for a host of reasons,

see DiMA PFF § VII, and DiMA therefore proposes that the Court adopt that methodology. *See* DiMA PFF §§ VII(A), VIII(A).

B. The History of the Penny Rate Is Largely Irrelevant to Permanent Downloads

99. **CO PFF ¶¶ 590-592.** The Copyright Owners’ description of the penny rate’s history has virtually no relevance to the Court’s determination of rates and terms for permanent downloads. Regardless of how long the penny rate has applied to physical products, the Copyright Owners admit that permanent downloads were not available before 2003, *see* CO PFF § VII(D)(1), and the recording industry did not bother to track digital sales at all until 2004. *See* DiMA PFF ¶ 143. Thus, the history of the penny rate over the last century offers no support for the Copyright Owners’ notion that it is the appropriate methodology for permanent downloads in the future.

C. The Penny Rate Suffers from a Variety of Flaws as Applied to Permanent Downloads

1. The Statutory Objectives Do Not Favor Usage-Based Metrics

100. **CO PFF ¶ 593.** The Copyright Owners launch into their defense of a penny rate by noting that it is a “usage-based metric.” But nothing in the statutory objectives favors such a metric over a percentage approach. To the contrary, the statute requires a rate that reflects relative contributions made by copyright owners and users to the final product, which undermines the supposed value of a fixed penny rate.

101. One of the Copyright Owners’ own witnesses explained this very issue. Phil Galdston bemoaned the usage-based approach because songwriters are stuck with a static revenue stream while record labels have the ability to adjust their prices to achieve greater profits for hits. *See* Galdston WDT ¶ 12 (CO Tr. Ex. 4); *see also* DiMA PFF

¶ 211. He proceeded to concede that a percentage-based methodology could resolve the compensation imbalance. *See* 1/30/08 Tr. 806:19-807:18 (Galdston); *see also* 2/26/08 Tr. 4621:9-4622:2 (Quirk) (“[I]n my own experience as a songwriter and musician[,] a percentage of revenue model works”); DiMA PFF ¶ 211.

102. **CO PFF ¶ 594.** The Copyright Owners contend that Ms. Guerin-Calvert “conceded” that a percentage methodology could result in increased use of music without a corresponding increase in royalties. *See* CO PFF ¶ 594 (mischaracterizing 1/29/08 Tr. 4503 (Guerin-Calvert)). From this they leap to the conclusion that a percentage rate does not align the interests of copyright owners and users. *See id.*

103. In reality, Ms. Guerin-Calvert simply confirmed the unremarkable proposition that total revenue and total units sold do not march in lockstep. *See* 2/25/08 Tr. 4503 (Guerin-Calvert). (Indeed, if they did, there would be no practical difference between a penny rate and a percentage rate.) The fact that they are different does not, as the Copyright Owners assert, somehow prove that a percentage rate would not align interests. To the contrary, a percentage rate is superior because it does align interests, and it does so precisely because it focuses on receipts, not units. Under a percentage structure – but not under a penny rate – the pricing decisions that benefit the labels and digital distributors provide a corresponding benefit to copyright owners. *See* DiMA PFF ¶¶ 204-206. Indeed, Mr. Galdston complained about the current usage-based regime because it prevents him from sharing in the profits that labels can generate from big hits. *See* Galdston WDT ¶ 12 (CO Tr. Ex. 4); *see also* DiMA PFF ¶ 211. A percentage rate cures that deficiency. *See* DiMA PFF ¶ 211.

104. **CO PFF ¶¶ 595-597.** The Copyright Owners further contend that a penny rate is “advantageous” because it requires application of only two factors: units distributed and rate per unit. They fail to explain, however, how this results in any advantage since a percentage rate also turns on just two factors: revenue and rate. While the Copyright Owners imply that calculating revenue would pose challenges, they fail to acknowledge the difficulties associated with promotional units or lower priced products under a penny-rate regime.

105. Moreover, DiMA has proposed a revenue definition that is reasonable, straightforward, and easy to apply in practice. *See* DiMA PFF § VIII(A)(2). In an attempt to refute the reasonableness of DiMA’s proposed revenue definition, the Copyright Owners quote selectively from Ms. Guerin-Calvert’s testimony and argue that she “struggled” to explain its application. *See* CO PFF ¶ 597. As she testified, however, and as the DiMA proposal makes clear, the proposed revenue definition applies only to revenue directly attributable to music distribution, not to revenue for devices or other ancillary products or services. *See* DiMA PFF § VIII(A)(2); Guerin-Calvert WDT ¶¶ 16(2), 114; 5/6/08 Tr. 4804:9-4807:15 (Guerin-Calvert) (explaining that a reasonable revenue definition excludes revenue from non-music sources).

2. To the Extent the Copyright Owners Deserve “Protection,”
DiMA’s Proposed Minima Provide It

106. **CO PFF ¶¶ 598-605.** The Copyright Owners repeatedly attempt to justify their penny-rate proposal by claiming it provides critical protection to copyright owners who might otherwise suffer in the event that revenues fall unexpectedly. *See, e.g.*, CO PFF ¶¶ 598, 602. In support, they note that record labels typically require protection in

the form of minima when agreeing to percentage-rate deals, and they highlight the fact that there are no percentage-only label agreements in the record. *See* CO PFF ¶¶ 598, 602. This argument is self-defeating, however, because DiMA has not proposed a percentage-only rate. To the contrary, its proposal includes precisely the type of percentage-plus-minima structure that the Copyright Owners hold up as worthy example. *See* DiMA PFF § VIII(A).

107. The Copyright Owners present testimony from Eddy Cue to demonstrate that agreements between labels and digital distributors **RESTRICTED**. *See* CO PFF ¶ 600; 2/25/08 Tr. 4328-4329 (Cue). But as explained above, *see supra* ¶ 47, those agreements provide no guidance for the Court’s ratesetting task, and in any event **RESTRICTED**. *See* 2/25/08 Tr. 4328-4329 (Cue). Mr. Cue’s testimony therefore does nothing to undermine a percentage proposal; to the contrary, it supports the percentage-and-minima structure that DiMA has proposed.

108. While DiMA’s proposed minima provide protection, it is worth noting that nothing in the statutory objectives requires targeted “protection” for copyright owners, and particularly not for the abstract “intrinsic value” of music as the Copyright Owners claim. *See* CO PFF ¶ 598; *see also* CO PFF ¶ 56 (“[A] penny rate is a usage-based metric that preserves the intrinsic value of musical compositions.”). The Copyright Owners have offered no evidence or argument explaining why the rate determination should reflect “intrinsic value,” and they have failed to present the Court with any clues as to how such a value might be ascertained. To the contrary, their own economic expert explained that the value of a song is revealed by its market price. *See* K. Murphy WRT

¶ 11 (CO Tr. Ex. 400) (“Consumers demand the delivered music product, and the economic value of the required creation and distribution inputs derives from the value that consumers place on the final product.”). There is no basis in the statute or in the record for adopting a rate that affords “protection” for some ephemeral measure of value that defies definition.

109. **CO PFF ¶¶ 606-608.** The Copyright Owners also dispute whether a percentage rate would actually align the interests of copyright owners and users. As DiMA explains in its findings, a percentage achieves general alignment because pricing decisions that benefit copyright users will benefit copyright owners as well. *See* DiMA PFF § VII(A)(2). This alignment of interests reflects the link between copyright owners and users in creating and distributing musical works. *See id.*

D. Minima Protect Against Unforeseen Revenue Shortfalls

110. **CO PFF ¶¶ 609-622.** The Copyright Owners spend several pages rehashing (again) their concern that percentage rates do not provide “protection” in the event that revenues fall below expected levels. The Copyright Owners admit, however, that percentage rates coupled with minima afford precisely the protection that they seek. *See supra* § XIV(C)(2). Since DiMA’s second amended rate proposal adheres to that structure, the Copyright Owners’ concerns are groundless. *See id.* Similarly, the Copyright Owners express concern that they would have no “protection” in the event that a licensee sets retail prices at a low level and relies on advertizing income to generate additional revenue. *See* CO PFF ¶ 610. This concern is equally unfounded. Apart from providing “protection” in the form of minima, DiMA has addressed this concern by

proposing a revenue definition that would capture advertizing revenues related directly to the sale of music. *See* DiMA PFF ¶ 237.

111. Buried within their reprised discussion about the need for “protection,” the Copyright Owners repeat another baseless mantra: the assertion that Apple operates the iTunes Store only in order to sell more iPods. *See* CO PFF ¶ 611. As DiMA has explained, there is simply no truth to that statement, and the record reveals precisely the opposite. *See* DiMA PFF ¶¶ 249-250; *see also supra* ¶¶ 52-54. The Copyright Owners’ own proposed findings confirm that the iTunes Store’s contribution margins have been increasing steadily and that [REDACTED] [REDACTED]. *See* CO PFF ¶¶ 461-463. As DiMA explains in its proposed findings, these returns refute the notion that the store is simply an offering whose success is tied to hardware sales. *See* DiMA PFF ¶ 249.

112. In a misleading effort to support their iPod argument, the Copyright Owners cite a passage from Eddy Cue’s live testimony. *See* CO PFF ¶ 611 (citing 2/25/08 Tr. 4305). In reality, Mr. Cue explained in the cited passage that [REDACTED] [REDACTED] [REDACTED] 2/25/08 Tr. 4304:18-4305:21 (Cue). There is simply nothing in his testimony that supports the Copyright Owners’ contention that Apple sacrifices music revenue to sell more iPods..

113. The Copyright Owners also attempt to make hay from the fact that Ms. Guerin-Calvert mistakenly applied DiMA’s non-bundled minimum payment to a hypothetical example involving the sale of bundled tracks. *See* CO PFF ¶¶ 614-615. Mr. Sheeran later applied the correct bundled minimum in response to a similar hypothetical.

See CO PFF ¶ 615. The Copyright Owners seize on this as evidence that DiMA’s proposal is “unclear and ambiguous.” CO PFF ¶ 616. Reviewing the actual proposal demonstrates that it is abundantly clear: a 4.8-cent minimum for single-track sales and a 3.3-cent minimum for tracks sold in a bundle. See DiMA PFF ¶ 230; CO PFF ¶ 589. The Copyright Owners’ reliance on Ms. Guerin-Calvert’s inadvertent reference to the wrong number while testifying on the stand proves nothing about the reasonableness of the proposal.

114. Similarly, the Copyright Owners cite live testimony from Timothy Quirk to support their unfounded argument that DiMA’s proposal is unclear. See CO PFF ¶ 616 (citing testimony offered on February 26, 2008). Mr. Quirk testified before DiMA had amended its proposal to include the minima described above, however, so his statements about what rate would be applicable to bundles does nothing to support the Copyright Owners’ critique.

E. Legitimate Digital Distributors Are Struggling to Survive Under The Existing Penny Rate, and Their Digital Music Business Lines Would Collapse Under the Unprecedented Rate the Copyright Owners Have Proposed

115. CO PFF ¶¶ 623-632. The Copyright Owners assert in their proposed findings that the permanent download business is “booming” under the current penny rate, and they point to the success of the iTunes Store for support. See CO PFF ¶¶ 623-625. While this line of argument completely defuses their repeated contention that Apple runs the iTunes Store as a loss leader designed to move more iPods, *see, e.g.*, CO PFF ¶¶ 382-385, 471, 516, 611, the Copyright Owners’ incessant citations to one company’s success completely fails to demonstrate that the entire industry is thriving. Indeed, the

Copyright Owners have admitted that the permanent download business as a whole continues to develop and evolve notwithstanding the iTunes Store's success. *See* CO PFF ¶ 831. Indeed, when they discuss songwriters the Copyright Owners themselves explain that focusing on successes while ignoring all others is inappropriate. *See supra* ¶ 74; *see also* CO PFF ¶ 777.

116. To support their theory that the business of selling permanent downloads is “booming,” the Copyright Owners also point to record evidence that a grand total of eight companies have sought to do so since 2003. *See* CO PFF ¶ 625. But they neglect to mention that at least two of these eight actually rely on services provided by others. *See, e.g.,* 2/25/08 Tr. 4392:20-4393:12 (McGlade) (confirming that MediaNet provides the platform for Microsoft's Zune service); 5/13/08 Tr. 6157:14-17 (Sheeran) (testifying that Best Buy's service is a partnership with RealNetworks' Rhapsody offering). They also offer no evidence indicating that any of these companies other than iTunes has generated positive margins in the permanent download business. In contrast to the rosy picture the Copyright Owners attempt to portray, many permanent download distributors actually operate with unsustainable negative margins under the current penny rate. *See* DiMA PFF § V(C). Finally, the Copyright Owners completely ignore the fact that inhospitable conditions have led to exit as well. *See, e.g.,* Guerin-Calvert WRT at 10, Table 1 (DiMA Tr. Ex. 10) (noting the departure of Yahoo Music Unlimited).

117. The Copyright Owners do not even attempt to argue that this shaky industry could withstand the nearly 65-percent increase that they seek. And with good reason; the record demonstrates unequivocally that the Copyright Owners' unprecedented

rate hike would deal digital distributors a crushing blow, leaving the industry in a shambles. *See* DiMA PFF ¶¶ 12, 73-74, 136-137, 185-188, 258.

118. **CO PFF ¶ 633.** In a bizarre twist, the Copyright Owners suggest that copyright users could reduce the high royalty costs associated with their exorbitant penny-rate proposal by employing controlled composition clauses. In other words, the Copyright Owners suggest from one side of their mouth that copyright users should use such clauses to counteract the punishing impact of an unprecedented rate increase, while arguing vigorously from the other side that the record labels’ “aggressive” use of these clauses has harmed copyright users to such an extent that a rate increase is needed. *See* CO PFF § IV(C)(2)(b)-(c). This double-speak undermines the justifications underlying the Copyright Owners’ proposal, and it reveals the extent to which they have bootstrapped support by over-spinning the role that controlled composition clauses play. *See, e.g.*, DiMA PFF § VIII(B)(3) (explaining the irrelevance of controlled composition clauses, particularly with respect to permanent downloads).

F. Evidence from International Markets Reveals Worldwide Recognition that Percentage Rates Are Superior to Penny Rates

119. **CO PFF ¶¶ 634-637.** In a departure from the record evidence, the Copyright Owners claim that an assessment of international markets somehow undermines the validity of a percentage rate. For support, they trumpet the unremarkable fact that U.S. digital music sales exceed digital music sales elsewhere in the world. From this they leap to the conclusion that the difference results from the fact that the United States employs a penny rate while the rest of the world uses percentage structures. In making this unsupported leap, however, they conspicuously ignore the actual (and

unremarkable) explanation: the U.S. digital music industry is bigger than foreign digital music industries simply because the overall U.S. music marketplace is much bigger, not because of the penny rate.

120. The Copyright Owners also point to recent events in Canada, noting that a recently-concluded agreement in that country perpetuates the penny rate for physical products. See CO PFF ¶ 637. They remain notably silent with respect to Canada's approach to permanent downloads, perhaps realizing the damage it does to their case. As their own witness testified, Canada has joined the rest of the world in employing a percentage rate for permanent downloads, leaving the United States as the notable outlier. See 5/15/08 Tr. 6730:18-6733:1 (Fabinyi) (describing percentage rate in Canada for permanent downloads). Indeed, Jeremy Fabinyi testified that he is not aware of any country other than the United States that uses a method other than a percentage rate to calculate mechanical royalties for permanent downloads. See 5/15/08 Tr. 6827:4-9 (Fabinyi). The record reveals without any ambiguity that percentage rates keyed to retail revenues are the norm around the world. See DiMA PFF § VII(A)(5); see also Fabinyi WRT, attach. F-2 (CO Tr. Ex. 380) (applying percentage rates from around the world to retail revenue).

G. The Copyright Owners' Proposed Penny Rate Is Not Easier to Administer than a Percentage Rate

121. **CO PFF ¶¶ 638-643.** The Copyright Owners contend that their proposed penny rate would be easier to administer than a percentage rate because it requires consideration of only two factors: units distributed and applicable rate. See CO PFF ¶¶ 638-639. As explained above, see *supra* ¶¶ 104-105, this argument proves nothing

because a percentage rate also turns on just two factors: revenue and rate. In reality, of course, neither method is as simple as the Copyright Owners' analysis suggests. Under a penny rate, for instance, parties must take care to exclude certain promotional copies from consideration, and they must also account for discounted rates that may apply to budget recordings and other offerings. And under a percentage rate, parties must apply the governing revenue definition to exclude revenues not subject to royalty payments. *See* DiMA PFF §§ VII(A)(7), VIII(A)(2) (describing revenue definition). Accordingly, the Copyright Owners' argument that their proposed approach necessitates consideration of only two factors is both misleading and over-simplified.

122. Moreover, there is no reason to conclude that a penny rate is simpler to administer solely because it is already in force in this country. *See* CO PFF ¶ 638. As DiMA explains in detail in its proposed findings, copyright users are thoroughly accustomed to percentage rate methodologies for royalty payments. *See* DiMA PFF § VII(A)(4). Roger Faxon testified that employing a percentage rate for permanent downloads would not disrupt his business at all. *See* 1/29/08 Tr. 482:15-20 (Faxon); *see also infra* § XIV(H).

H. Adopting a Percentage Rate For Permanent Downloads Will Not Disrupt the Industry

123. **CO PFF ¶¶ 644-648.** The Copyright Owners devote a scant five paragraphs (out of 906 in total) to arguing that a percentage rate would result in disruption. Their arguments, however, focus exclusively on the impact of adopting a percentage rate for physical products, and they therefore prove nothing about employing

a percentage rate for permanent downloads. As explained below, their own witness has endorsed the use of percentage rates for digital products.

124. The Copyright Owners commence their disruption argument by stating that the penny rate has been in place for nearly 100 years, and that adopting a percentage rate would upset a century's worth of business practices. *See* CO PFF ¶ 644. Regardless of that argument's accuracy with respect to physical products, it has no bearing whatsoever on permanent downloads. As all agree, the sale of permanent downloads barely registered in the industry until four years ago. *See, e.g.*, CO PFF § VII(D)(1); DiMA PFF ¶¶ 69, 143. The industry relationships that may have developed during the preceding 95 years are wholly irrelevant.

125. Roger Faxon explained this point concisely, although the Copyright Owners have attempted to distort his testimony by excising his discussion of digital services. They quote Mr. Faxon's testimony about the disruption he claims would result from using a percentage for physical products. *See* CO PFF ¶ 646. Yet they studiously avoid reference to his testimony that this potential disruption simply does not apply with respect to permanent downloads, as songwriter agreements for digital products are not premised on a penny rate. *See* 1/29/08 Tr. 479:2-7, 482:15-483:3 (Faxon); Faxon WDT ¶ 75 (CO Tr. Ex. 3). Indeed, Mr. Faxon confirmed that there is no reason not to employ a percentage rate for digital products, testifying that "we do not think it will be disruptive to have a percentage with a minima." 1/29/08 Tr. 482:15-20 (Faxon) (emphasis supplied); *see also* 1/29/08 Tr. 485:20-21 ("I don't think you need [a] penny rate for a digital download."); DiMA PFF § VII(A)(4).

126. In addition, the Copyright Owners completely disregard un rebutted testimony demonstrating that copyright users are completely familiar with percentage rate methodologies in their operations in the United States and abroad. Publishers employ percentage rate structures routinely for digital music. *See* DiMA PFF ¶ 209. Moreover, they earn mechanical royalties as a percentage of revenue in other countries, they receive performance royalties for digital music from ASCAP and BMI as a percentage of revenue, and their voluntary digital licensing agreements frequently call for royalty payments calculated as a percentage of revenue coupled with a penny minimum. *See id.* It therefore defies reason to suggest that using a percentage rate for mechanical royalties for permanent downloads – as they already do throughout the world – would somehow disrupt the Copyright Owners’ administrative capabilities.

I. Ringtone Agreements Have No Bearing on the Rate Applicable to Permanent Downloads

127. CO PFF ¶¶ 649-652. The Copyright Owners argue that their ringtone rate proposal reflects marketplace agreements for such products. Regardless of whether these agreements support the Copyright Owners’ proposed rate for ringtones, they have no direct relevance with respect to the mechanical rates applicable to permanent downloads. *See supra* § XII(C)(1).

XV. THE COPYRIGHT OWNERS GROSSLY MISCHARACTERIZE THE RIAA’S PROPOSED RATES AND TERMS

A. The RIAA’s Proposal for Permanent Downloads Is Not Premised on a Rate Cut

128. CO PFF ¶¶ 653-655. The Copyright Owners first attack the RIAA’s rate proposals on the ground that they “would effect a significant reduction in the current

mechanical royalty rate.” CO PFF ¶ 653. But nothing in Section 801 directs the Court to consider whether the rate it adopts is less than the current rate. Rather, the statute obligates the Court to adopt rates and terms that fulfill the objectives of Section 801(b)(1). The percentage-of-revenue rate the RIAA proposes is more likely to encourage entry and expand legitimate music consumption than the penny rate, thus increasing the revenue that copyright owners receive from mechanical royalties. *See* DiMA PFF §§ III(B)(2), V(B), V(C).

B. The Copyright Owners’ Critiques of the RIAA’s Benchmarks Are Invalid and Focus on Approximating An Unregulated Market Rather than Achieving the Statutory Objectives

129. **CO PFF ¶¶ 656-674.** As discussed in detail in DiMA’s proposed findings and in Section XVI(B) below, the Copyright Royalty Tribunal’s 1981 ratesetting decision is useful, first, as a framework to guide the Court’s analysis and, second, as it provides insight into an appropriate rate. *See* DiMA PFF § IX(D); *infra* § XVI(B).

130. **CO PFF ¶¶ 675-708.** The Copyright Owners’ critiques of the RIAA’s effective mechanical royalty and first use benchmarks demonstrate their fundamental failure to recognize that the Court’s task is not to set a rate that approximates the free market, but rather to achieve the four statutory objectives that Congress laid out in Section 801(b). *See* DiMA PCL ¶¶ 5, 17-25. While DiMA has demonstrated that controlled composition clauses completely fail to justify the Copyright Owners’ unprecedented proposed rate, *see supra* § IV(C); DiMA PFF § VIII(B)(3), DiMA does not contest the suitability of a benchmark based on the effective mechanical royalty rate, including rates resulting from application of controlled composition clauses. *See, e.g.,*

RIAA PFF § III(B)-(C) (advocating such a benchmark); DiMA PFF § IX (omitting any discussion of such a benchmark).

131. **CO PFF ¶¶ 709-725.** The Copyright Owners argue that the RIAA’s use of rates from other countries as benchmarks is inappropriate. In doing so, however, they ignore the fact that the Copyright Royalty Tribunal expressly endorsed (and relied upon) foreign benchmarks in 1981. *See* 46 Fed. Reg. at 10,484; *see also id.* at 10,483 (“We find that the foreign experience is relevant – because it provides one measure of whether copyright owners in the United States are being afforded a fair return.”) (emphasis in original). As DiMA demonstrates in its proposed findings, the mechanical rates in force for permanent downloads in virtually every other country in the world are based on a percentage of revenue. *See* DiMA PFF §§ VII(A)(5), IX(C). Not only do the Copyright Owners propose that the Court adopt a rate structure that would leave the United States as an outlier with respect to mechanical payments for digital music, their own witness conceded that their proposed rate is higher than anything adopted elsewhere in the world. *See id.* §§ VII(A)(5), IX(C).

132. Moreover, in rejecting the RIAA’s use of mechanical rates in the United Kingdom and Japan as benchmarks, the Copyright Owners state that the RIAA’s “rebuttal economist, Professor Wildman, has refused to endorse the RIAA’s position,” citing to Professor Wildman’s live testimony. CO PFF ¶ 710. A quick read of the referenced testimony makes clear that counsel for the Copyright Owners simply asked Professor Wildman if he had analyzed whether rates in the United Kingdom and Japan would be appropriate benchmarks, to which Professor Wildman responded, “I have not.”

5/12/08 Tr. 5987:20-5988:18 (Wildman). Contending that this amounts to a “refusal to endorse” them as benchmarks is a complete distortion of the record.

133. Further, the Copyright Owners’ criticisms of the U.K. Settlement Agreement apply with equal force to their own benchmarks. The Copyright Owners oppose reliance on the U.K. rates because the United Kingdom “has no compulsory license.” CO PFF ¶ 712. But the Copyright Owners themselves would argue that none of their own benchmarks is subject to a compulsory license either. *See, e.g.*, CO PFF § II(D)(2) (describing Copyright Owners’ view that ringtones are not subject to Section 115). To the extent their criticism impacts the utility of the U.K. benchmark, it undermines the Copyright Owners’ benchmarks as well. *See supra* § XII(C)(2); *see also* DiMA PFF ¶¶ 281, 347-348.

134. Finally, the Copyright Owners’ own Mr. Fabinyi testified that the Copyright Owners’ proposed rate is completely unlike anything adopted elsewhere in the world. As DiMA discusses in its proposed findings, Mr. Fabinyi acknowledged that the Copyright Owners’ proposal would result in the only penny rate among the world’s developed nations, set at a level that is higher than the comparable rate in place anywhere else in the world. *See* DiMA PFF ¶¶ 213-214, 328-332.

C. The Decline in CD Prices and Purchases Does Not Support a High Mechanical Royalty Rate

135. **CO PFF ¶¶ 726-737.** As DiMA demonstrates in its proposed findings, the Copyright Owners’ reliance on the “economic theory” presented by Professor Kevin Murphy ignores critical empirical evidence, focuses on market forces rather than

statutory objectives, and improperly disregards the value of distribution innovations. *See* DiMA PFF ¶¶ 293-298.

D. The Copyright Owners’ Claims About the Financial Condition of Permanent Download Providers Are Myopic

136. **CO PFF ¶¶ 738-742.** Regardless of the merits the Copyright Owners’ claims about the financial condition and prospects of the recording industry, there is no dispute that digital music distribution remains a risky business and digital music distributors incur huge costs to distribute music legitimately to a wide audience. *See* DiMA PFF §§ III, V. To the extent the Copyright Owners suggest that “significant investment in digital infrastructure” should not “be taken into account in determining a reasonable statutory rate,” CO PFF ¶ 740, their arguments are flatly contradicted by the plain language of the statute. The third objective directs that the rate “shall be calculated” to reflect, among other things, “technological contribution, capital investment, cost, risk, and contribution to the opening of new markets for creative expression and media for their communication.” 17 U.S.C. § 801(b)(1)(C).

137. **CO PFF ¶¶ 743-756.** To the extent the Copyright Owners imply that the labels’ purported profits and decreasing costs should be imputed to digital music providers, the Court should reject that implication as contrary to the record evidence. As DiMA explains in great detail, legitimate digital distributors bear enormous costs and risks in competing in a marketplace overshadowed by the ubiquitous availability of pirated music. *See* DiMA PFF §§ III, V.

138. **CO PFF ¶¶ 757-762.** Regardless of the accuracy of the Copyright Owners’ assertions regarding the health of independent record labels, the Copyright

Owners' claims about them highlight the contributions made by digital music distributors, not by music publishers. The Copyright Owners state that “[d]igital distribution has improved the market position of independent labels,” noting that one executive from an independent label enthused that “[t]echnology has given consumers easier access to a wider range of recordings than has ever been possible before.” *See* CO PFF ¶ 759 (quoting Barros WDT at 11 (RIAA Tr. Ex. 74)). This argument serves merely to underscore digital distribution’s potential to invigorate sales, including sales of older and relatively unknown tracks. *See* DiMA § IV(B). Adopting the extraordinary rate the Copyright Owners propose would completely eviscerate that potential. *See id.* ¶¶ 12, 73-74, 136-137, 185-188, 258.

E. The Copyright Owners Have Presented No Evidence of Any Correlation Between the Mechanical Rate and the Number or Quality of Songwriters and Songs

139. **CO PFF ¶¶ 763-778.** The Copyright Owners further attempt to minimize the RIAA’s arguments by asserting – without any empirical support – that failing to raise the mechanical rate as the Copyright Owners propose would result in reductions in the ranks of songwriters and a decline in the output and quality of songs. The problem with this argument, as DiMA has repeatedly explained, is that the Copyright Owners have not presented a shred of empirical evidence to support it. *See supra* § IV; *see also* DiMA PFF § VI.

140. Absent any empirical evidence that a mechanical rate increase is necessary to ensure the supply of songwriters and songs, the Copyright Owners are left with only one argument: their “desire for an increase in the mechanical royalty rate.” CO PFF ¶ 775 (emphasis supplied). As explained above, however, nothing in the statutory

objectives supports a rate determination based on the fact that someone wants to be paid more. *See supra* § IV(E).

F. The Copyright Owners Admit that They Do Not Perform Any Additional Functions in the Digital Context

141. **CO PFF ¶¶ 779-788.** The Copyright Owners attempt to rebut many of the RIAA's claims by asserting that Copyright Owners too make substantial contributions to the production of recorded music. Whether or not those assertions are accurate, there is no dispute whatsoever that copyright owners do not do anything differently in the digital world than in the physical, and there is likewise no dispute that they do not bear any additional expense in the digital world. *See* DiMA PFF ¶¶ 255, 304. Because everything that consumers find more appealing in the digital world results from the contributions and investments of digital distributors, *see, e.g., supra* ¶ 36; DiMA PFF § IV, there is simply no justification whatsoever for a permanent-download rate that exceeds the physical-product rate, as the Copyright Owners have proposed.

G. The Copyright Owners Conspicuously Ignore the Risks and Costs Borne by Legitimate Digital Distributors

142. **CO PFF ¶¶ 789-797.** The Copyright Owners further engage in a discussion about whether music publishing and songwriting are riskier undertakings than recording music. The glaring omission from the discussion is the risk that digital distributors bear when entering and then remaining in a marketplace characterized by rampant piracy, intense competition, and severe downward pricing pressure. As DiMA explains in its proposed findings, legitimate digital distributors face enormous costs and risks, and they must continue to invest further resources (and shoulder more risk) to roll

out the innovations that consumers demand. *See* DiMA PFF § V. The rate adopted in this proceeding must reflect those facts. *See* 17 U.S.C. § 801(b)(1)(C).

H. The Copyright Owners Disregard Piracy’s Impact on Any Industry Segment Other Than Their Own

143. **CO PFF ¶¶ 798-801.** Finally, the Copyright Owners repeat their arguments related to piracy, again focusing myopically on its impact on copyright owners and the steps they have taken to address the problem. But piracy is an industry-wide problem, and copyright owners have acknowledged that encouraging the growth of legitimate digital distribution is the most effective way to combat it. *See* DiMA PFF § III.

XVI. A LOW PERCENTAGE-OF-REVENUE RATE WITH TRUE MINIMA BEST ACHIEVES THE STATUTORY OBJECTIVES

A. The Copyright Owners Avoid The Statutory Objectives

144. **CO PFF ¶¶ 802-805.** Contrary to the Copyright Owners’ fears, DiMA’s rate proposal achieves the statutory objectives and is the best way to grow the digital marketplace to the benefit of all industry participants. *See, e.g.*, DiMA PFF § VIII(A). The Copyright Owners are stuck in the past, and for that reason they misleadingly portray DiMA’s proposal in penny-rate equivalents. They cannot show, however, that total royalty revenue would decrease as a result of DiMA’s proposal. In fact, nearly seventy years worth of empirical evidence shows that mechanical royalty revenue can increase even when the penny rate goes down in real dollar terms. *See* 2/11/08 Tr. 2513:1-14 (Landes) (technological innovation more important to the industry’s fortunes than the actual mechanical rate); *see also* DiMA PFF ¶¶ 192-193. By repeatedly converting DiMA’s proposal into a purported penny-rate equivalent based on current prices, they

avoid the real issue before the Court, which is how to achieve the Section 801(b)(1) objectives.

145. The reduction in mechanical royalties is caused by declining sales of recorded music. *See id.* ¶¶ 67-73. Consistent with the statutory objectives, the best way to slow (or even reverse) that decline is to lower entry barriers and grow the digital marketplace. *See id.* § III(B). The Copyright Owners mistakenly claim that for the Court to adopt DiMA’s proposal there must be a “guarantee” of increased royalties. They irrationally criticize DiMA for proposing reasonable minima that provide downside protection without impeding downward price movement. And they criticize DiMA for proposing a reasonable definition of revenue rather than the hopelessly overbroad definition they have offered. *See supra* § III(B). In the end, DiMA has demonstrated that its proposal achieves the statutory objectives. *See* DiMA PFF §§ VIII(A), X.

146. **CO PFF ¶¶ 806-808.** A percentage-rate structure is most suitable to ensure entry and growth of digital music services, which will provide increased returns to copyright owners. *See* DiMA PFF §§ VII(A), VIII(A). The revenue definition DiMA has proposed is carefully tailored so as not to overly regulate or create undue transactions costs. *See id.* § VIII(A)(2). The rate level DiMA has proposed will ensure fair income and fair returns under existing economic conditions, reflecting the massive investments that are required to grow the industry and the overwhelming importance of encouraging technological innovation to do so. *See id.* § VIII(A)(1). Carefully setting minimum fees so as to not discourage entry or prevent competitive pricing will minimize disruption. *See id.* §§ VII(A), VIII(A); *see also* 46 Fed. Reg. 10,466, 10,485-86 (reviewing entire record to determine royalty amount).

147. The rates and terms proposed by the Copyright Owners do not achieve the statutory objectives. *See* DiMA PFF § VIII(B). By failing to make absolutely clear that payment for the license includes all copies necessary to deliver the works to consumers, the Copyright Owners’ proposal renders the license useless. *See infra* § XVII(E). Raising the costs of doing business will make it harder for new entrants to enter the marketplace and for existing services to compete. *See id.* §§ V, VII, VIII. Likewise, refusing to recognize marketplace reality and sticking with a penny-rate structure will prevent competitive pricing and innovative offerings – precisely the opposite effect as intended by the statutory objectives. *See id.* § VII. For all of these reasons, the Copyright Owners’ proposal fails to achieve the statutory objectives.

B. DiMA Offers the Most Suitable Benchmarks

148. **CO PFF ¶¶ 809-814.** DiMA provides the Court with useful benchmarks to assist in achieving the statutory objectives and determining a reasonable rate and rate structure. *See* DiMA PFF § IX(A)-(D). Continually seeking to miniaturize the record, the Copyright Owners misrepresent DiMA’s use of the Copyright Royalty Tribunal’s 1981 ratesetting decision. *See* CO PFF § XVI(B)(1) (construing 1981 CRT Determination, 46 Fed. Reg. 10,466).

149. As DiMA explains in its proposed findings, the 1981 CRT Determination is useful for two different reasons. First, because it was the most recent contested proceeding applying the statutory objectives for the mechanical license, it serves as a useful source of analytical guidance as to the marketplace conditions most relevant to achieving the objectives. *See* DiMA PFF ¶ 333.

150. Second, it provides insight into an appropriate rate. *See id.* ¶ 334. Specifically, the original 1981 determination was equivalent to approximately 5 percent of the prevailing retail price, representing a deliberate allocation of revenues to copyright owners and users. *See* Guerin-Calvert WDT ¶ 23 (DiMA Tr. Ex. 7) (“The CRT set the compulsory rate at 4 cents per track, or approximately 5.0% of the retail price, assuming a physical album retailing at \$7.98 and 10 tracks per album.”). Not only was this decision affirmed on appeal, but the relative allocation was twice ratified by the industry through voluntary agreements in 1987 and 1997. *See, e.g.,* Landes WDT ¶ 7 (CO Tr. Ex. 22). Beginning in the late 1990s, however, legitimate music sales began to free fall. *See* DiMA PFF ¶ 67. The radical transformation of industry conditions since then points decidedly towards a different allocation of revenues and a lower rate compared to 1981. *See* Guerin-Calvert WDT ¶¶ 16, 24 (DiMA Tr. Ex. 7); Guerin-Calvert WRT ¶ 26 (DiMA Tr. Ex. 10). Thus, the Court need not rely on the 1981 “rate” so much as the analytical process underlying the determination. When viewed in the context of the rate’s subsequent history and marketplace changes, the 1981 CRT Determination provides valuable context for understanding the best benchmark in the record, which is the U.K. Settlement Agreement.

151. **CO PFF ¶¶ 815-820.** In addition to the 1981 CRT Determination, the U.K. Settlement Agreement is a relevant comparator for purposes of this proceeding because of the similarities between the recorded music industries and markets in the two countries, the parties to the agreement, and the rights involved. *See* DiMA PFF § IX(B). The fact that the rate pertains to another country does not diminish its utility; indeed, the Copyright Royalty Tribunal relied expressly on mechanical license rates from other

countries in reaching its 1981 determination, which was affirmed on appeal. *See* 46 Fed. Reg. at 10,484; *see also id.* at 10,483 (“We find that the foreign experience is relevant – because it provides one measure of whether copyright owners in the United States are being afforded a fair return.”) (emphasis in original). Thus, the Copyright Owners’ strenuous cries to turn a blind eye to the U.K. Settlement Agreement run counter to precedent.

152. Moreover, each of the objections that the Copyright Owners raise with respect to the U.K. Settlement Agreement’s suitability as a benchmark pertains to physical products. None of the objections diminishes its relevance with respect to permanent downloads. *See supra* ¶¶ 131-134.

153. To be sure, Ms. Guerin-Calvert did not testify that this benchmark could be relied upon with mathematical certainty. Most importantly, it covers rights in addition to the mechanical rights at issue in this proceeding and requires a downward adjustment to be usefully considered. But the RIAA explained how to make this adjustment. *See, e.g.,* Taylor WDT at 14 (RIAA Tr. Ex. 53); Boulton WDT ¶ 4.23 (RIAA Tr. Ex. 54); 2/13/08 Tr. 2937:11-2938:17 (Boulton) (explaining how to calculate effective mechanical payment). And the Copyright Owners themselves provided a witness who confirmed that approach. *See* Fabinyi WRT, attach. F-2 (CO Tr. Ex. 380); *see also* DiMA PFF § IX(B).

154. DiMA has also proposed a focused definition of attributable revenue that is designed to achieve the statutory objectives. *See* DiMA PFF ¶¶ 237-239. The Copyright Owners complain that it is not precisely the same as the definition in the U.K. Settlement Agreement, but they do not offer anything but an entirely unworkable alternative in its place. *See supra* § III(B).

155. **CO PFF ¶¶ 821-828.** Ms. Guerin-Calvert referred to certain agreements for mechanical rights in the United States in addition to the 1981 CRT Determination and the U.K. Settlement Agreement. This was appropriate for two reasons. First, the 1997 voluntary agreement is consistent with Ms. Guerin-Calvert’s overall recommendation for a lower rate level based on marketplace evidence in light of the statutory objectives. *See* Guerin-Calvert WDT ¶ 25 n.12 (DiMA Tr. Ex. 7). The precise rate level is less significant than the directional information it provides. Indeed, as DiMA has explained, the relevant changes in the marketplace since 1997 point decidedly towards a lower rate and a percentage structure. *See* DiMA PFF ¶¶ 333-334. Second, Ms. Guerin-Calvert relies on rateless agreements to provide relevant marketplace information, not precise rates. This is not unusual in the context of proceedings under Section 801(b)(1). *See* 63 Fed. Reg. 25,394, 25,404 (relying on license agreement that recognized value conveyed to record labels by subscription service despite the absence of an exclusive digital performance right in sound recordings). The statutory objectives do not preclude such relevant considerations. *See* 17 U.S.C. § 801(b)(1) (rates must be calculated to achieve the four objectives); *cf. Recording Indus. Ass’n of Am. v. Librarian of Congress*, 176 F.3d 528, 533 (D.C. Cir. 1999) (affirming this approach); 63 Fed. Reg. at 25,406 (any “zone” of reasonableness must be determined principally “to achieve the statutory objectives”).

156. **CO PFF ¶ 829.** Finally, the Copyright Owners criticize Ms. Guerin-Calvert because she endorses DiMA’s proposed minimum fees with caution and does not purport to derive them via a precise mathematical formula. This critique is ironic, because the Copyright Owners’ unprecedented proposal – which amounts to a fixed minimum payment – is simply a radically inflated penny rate whose derivation they

cannot explain, other than to say it comports with “benchmarks” derived without any reference to the statutory objectives. *See supra* § XII; DiMA RCL § III(A)-(C).

157. DiMA’s proposed minima avoid stifling innovation and technological investment. *See* DiMA PFF ¶¶ 221-223. DiMA’s proposed minima also recognize that prices are under severe downward pressure, *see id.* §§ III(A)(2), V(D), and they do not interfere with evolving business models. *See* Sheeran WRT ¶ 28 (DiMA Tr. Ex. 11). DiMA’s proposed minima for bundled downloads are appropriately lower than minima for single downloads. *See id.* In sum, DiMA’s proposed minima are reasonable because they achieve the statutory objectives. *See RIAA II*, 176 F.3d at 532 (the term “reasonable” in Section 801(b)(1) derives its meaning expressly from the statutory objectives).

C. The Record Evidence Demonstrates that Lower Rates and a Percentage-Rate Structure Are Essential for Achieving the Statutory Objectives

158. **CO PFF ¶¶ 830-832.** The Copyright Owners claim that the permanent download marketplace is not nascent. Yet their own “industry expert” tells a different story:

Q: Ms. Murphy, prior to 2004, were there any appreciable sales of digital music?

A: No.

2/6/08 Tr. 1770:4-6 (Murphy). Regardless of whether they think “nascent” is the proper word to describe this industry, claiming that the marketplace is not in its initial stages of development flies in the face of the record evidence. *See supra* § VIII. The massive investments undertaken to provide digital distribution of music are barely beginning to

pay off in the marketplace. *See* DiMA PFF § V. The costs and risks for legitimate digital music distributors are high, and many are struggling to survive under current economic conditions. *See id.*

159. **CO PFF ¶¶ 833-835.** In light of the state of the marketplace, increasing the mechanical rate and adhering to the penny-rate methodology will not meet any of the objectives of Section 801(b)(1): maximizing the availability of creative works, recognizing the extreme burden of current economic conditions, reflecting innovation and investment and risk-taking and creativity, and minimizing disruption. These objectives can be reconciled best in an environment that expressly promotes digital music distribution. Raising rates will kill entry, while lower rates and a percentage structure will encourage it. *See* DiMA PFF ¶¶ 12, 73-74, 136-137, 185-188, 258. And contrary to the Copyright Owners' unsupported assertion, there is no record evidence that exit has not affected the sale of permanent downloads. *See, e.g.,* Guerin-Calvert WRT at 10, Table 1 (DiMA Tr. Ex. 10) (noting the departure of Yahoo Music Unlimited); Guerin-Calvert WDT ¶ 49 (DiMA Tr. Ex. 7) (describing AOL's decision to leave to business).

160. Of course, the Copyright Owners cannot resist arguing that Apple can sustain all manner of rate increases because it has become so successful. *See, e.g., supra* §§ VII, X. But this is equivalent to construing the statutory objectives from the other side of the looking glass, as it "rewards" Apple's massive risks, costs and investments by making it even riskier and costlier to stay in business, perhaps even forcing reduced investments. *See* DiMA PFF ¶¶ 12, 73-74, 136-137, 185-188, 258.

161. Meanwhile, many of the digital distributors the Copyright Owners identify who sell permanent downloads are either companies who simply cannot absorb increased

mechanical rates (such as RealNetworks and MusicNet), or their partners (such as Microsoft and Best Buy), or other companies whose costs and investments the Copyright Owners did not bother to study. *See supra* ¶¶ 115-117. The Copyright Owners ignore the evidence about the state of less developed offerings because it suits their agenda.

162. **CO PFF ¶¶ 836-837.** Immediately after pointing to marketplace evidence that new entrants are pricing permanent downloads at less than 99¢ per track, *see* CO PFF ¶ 835, the Copyright Owners claim that consumers are not sensitive to price. *See* CO PFF ¶¶ 836-837. In fact, there is overwhelming empirical support for Ms. Guerin-Calvert’s conclusion that consumers are price sensitive when it comes to digital downloads. *See* Guerin-Calvert WDT ¶10 (DiMA Tr. Ex. 7) (industry evolving with “price sensitivity at the consumer level”); *id.* ¶ 11 (piracy poses significant pricing challenges); *see also* DiMA PFF §§ III(A)(2), V(D). As the Copyright Owners are well aware, moreover, “direct numerical calculation” of demand elasticity is not necessary where other evidence is available.⁶ Marketplace alternatives (including CDs and freely available pirated music) ensure that customers will not respond favorably to price

⁶ Such evidence can include but need not be limited to “(1) evidence that buyers have shifted or have considered shifting purchases between products in response to relative changes in price or other competitive variables; (2) evidence that sellers base business decisions on the prospect of buyer substitution between products in response to relative changes in price or other competitive variables; (3) the influence of downstream competition faced by buyers in their output markets; and (4) the timing and costs of switching products.” U.S. Department of Justice & Federal Trade Commission, HORIZONTAL MERGER GUIDELINES § 1.11 (rev. April 8, 1997). Therefore, “it is often possible to estimate the elasticity [of demand] indirectly, as antitrust lawyers, judges, and economists do all the time” by determining whether a product appears to have good substitutes at current prices. Richard A. Posner, ANTITRUST LAW at 57 (1976); *see also id.* at 114 (“The existence of potential competitors increases the elasticity of the demand facing existing sellers in the market by providing a source of supply to which consumers will be able to turn if prices rise above a competitive level.”).

increases. *See* DiMA PFF ¶¶ 52-58. The Copyright Owners’ witnesses recognized this, even if their lawyers do not. *See* 2/6/08 Tr. 1969:10-15 (H. Murphy) (digital pricing reflects “a marketplace whereby the competition was against illegal or illegitimate downloads” so prices must “compete with free”); 1/31/08 Tr. 1094:17-1095:2 (Robinson) (digital downloads compete with free, pirated music); *see also* DiMA PFF ¶¶ 57-58. Thus, the absence of an econometric study of demand elasticity does not erode Ms. Guerin-Calvert’s conclusions or undermine their importance. Specifically, the imposition of high rates, an inflexible penny structure, or high minimum fees poses substantial risks in this marketplace. *See, e.g.*, Guerin-Calvert WDT ¶¶ 113, 121 (DiMA Tr. Ex. 7).

163. **CO PFF ¶¶ 838-840.** DiMA has shown how its proposed rate and rate structure achieve the statutory objectives. *See* DiMA PFF §§ VIII(A), X. Contrary to the Copyright Owners’ complaints, the Court is not tasked with assessing a “rate cut.” Nor is it tasked with considering whether the iTunes Store alone has been able to grow. Its responsibility is to determine rates for a statutory license that achieve the objectives of Section 801(b)(1). Repeated, talismanic references to the iTunes Store cannot alter the record evidence or the statutory command. To achieve the objectives as applied to all industry participants, the rate for permanent downloads must be a low percentage of revenue, with provisions for minima to provide downside protection if necessary. *See* DiMA PFF §§ VIII(A), X. There is no evidence that the Copyright Owners’ proposed dramatic increase in the penny rate would achieve the Section 801(b)(1) objectives. Indeed, the record reveals that it would be catastrophic for the industry. *See id.* ¶¶ 12, 73-74, 136-137, 185-188, 258.

XVII. THE COPYRIGHT OWNERS' PROPOSED TERMS ARE UNREASONABLE AND DISRUPTIVE⁷

A. A Late-Payment Fee Is Unwarranted and Disruptive

164. **CO PFF ¶¶ 841-860.** The Copyright Owners have presented no evidence that imposing a late fee on all mechanical licenses is reasonable or achieves the statutory objectives. They request the imposition of a late fee ostensibly because (1) it would “encourage” timely payments from record companies and provide an alternative response to late payments other than license termination, *see* CO PFF ¶¶ 844-847, 851-857; (2) record companies have incorporated late fees into voluntary contracts with some digital music providers, *see* CO PFF ¶¶ 848-850; and (3) HFA “tr[ies] to stay very close to reflecting the terms of 115” in its license and would meet “resistance” if it sought to impose late fees via the voluntary licensing process. CO PFF ¶ 858; *see also id.* ¶¶ 859-860.

165. None of these purported justifications is valid, and none even attempts to demonstrate that a late fee somehow achieves the statutory objectives. *See, e.g.,* DiMA PFF § VIII(B)(4). As DiMA has explained, a late fee would be disruptive for the industry because it would subject all licenses to a single, exorbitant financing charge that bears no relationship to the specific license in question. *See id.* ¶ 265. Further, the Copyright Owners’ own witnesses conceded that they could achieve the same results through voluntary contractual arrangements. *See id.* ¶ 266 (citing concessions from Roger Faxon and Alfred Pedecine).

⁷ The Copyright Owners include “Section XI” twice in their proposed findings, one beginning with CO PFF ¶ 467 and the other with CO PFF ¶ 841. This section of DiMA’s reply addresses the latter.

166. It does not follow that because record companies include late fees in some voluntary contracts with digital distributors that it is reasonable to incorporate a late fee by regulatory fiat into all compulsory mechanical licenses. The record company-digital distributor agreements demonstrate only that the record companies have sufficient market power to put the provision into the contracts. *See, e.g.,* 5/13/08 Tr. 6170:2-6 (Sheeran) (explaining that labels have all the leverage in negotiations with digital music distributors). The existence of these agreements further demonstrates that such fees are more appropriately incorporated in voluntary agreements, which the Copyright Owners' witnesses have conceded they can do. *See* DiMA PFF ¶ 266. Improving HFA's bargaining position with respect to its voluntary licenses serves none of the statutory objectives and is not a reason to impose a regulation.

167. Additionally, the Copyright Owners attempt to misconstrue the statutory license through their discussion of the HFA license. The Copyright Owners' state that the HFA license differs from the compulsory license because it provides "assurance that the HFA license covers server copies." CO PFF ¶ 858. By highlighting this purported distinction, the Copyright Owners appear to take the position that the compulsory license does not cover all copies – although it is worth noting that the Copyright Owners have generally attempted to stay as noncommittal as possible on this point. *See, e.g.,* 1/31/08 Tr. 688:3-689:12 (Faxon); 2/5/08 Tr. 1709:15-1712:4 (Peer); 2/11/08 Tr. 2518:14-2520:6 (Landes). But this oblique reference to the point cannot overcome the Copyright Owners' failure to address it directly elsewhere. Notably, the Copyright Owners expressly declined to offer any response to DiMA's proposed terms, including a term addressing the inclusion of server copies and other copies necessary to effectuate the

distribution of a DPD. *See* CO PFF ¶ 889; *see also infra* ¶ 174 (addressing CO PFF ¶ 889). As DiMA discusses in detail in its proposed findings, the mechanical license would be worthless to digital distributors if it did not enable them to deliver a phonorecord to a customer. *See* DiMA PFF ¶¶ 240-241. The Copyright Office appears to agree. *See infra* ¶ 174 n.8.

B. A Pass-Through Fee is Unwarranted and Disruptive

168. **CO PFF ¶¶ 861-865.** As DiMA states in its proposed findings, the Copyright Owners’ request for a pass-through fee is unwarranted and inappropriate. First, they offer no justification for the level they propose; rather, their witness stated that they simply “felt [3 percent] was a reasonable number.” 2/5/08 Tr. 1471:9-22 (Israelite); *see also* DiMA PFF ¶ 268. In addition, they fail to explain why they could not include such a term via contract. *See* DiMA PFF ¶ 268. Moreover, the publishers’ grumblings about their “inability . . . to audit the exact users of their rights” is just a complaint about Congress’s legislative decision to allow pass-through licensing in Section 115(c)(3)(A), not a rationale for a statutory pass-through fee. CO PFF ¶ 862. It by no means justifies imposition of a pass-through licensing surcharge. The Copyright Owners also admit that any delays in pass-through royalty payments are limited to uses in the last month of each quarter, yet they inappropriately propose a disproportionate response in the form of a fee that applies to all pass-through licenses. *See* CO PFF ¶¶ 864-65; DiMA PFF ¶ 270-71. Finally, as in the case of late fees, there is no evidence that the term would achieve the statutory objectives. *See* DiMA PFF ¶ 271.

C. The Copyright Owners' Other Proposed Terms Are Not Supported By Record Evidence and Do Not Achieve the Statutory Objectives

169. **CO PFF ¶¶ 866-869.** The Copyright Owners present no evidence that any of its other proposed terms are reasonable or that they would achieve the statutory objectives in any way. Indeed, their cited support for their proposed attorneys-fee term amounts in aggregate to a single sentence, *see* CO PFF ¶ 866, in which David Israelite states that “Copyright Owners should be reimbursed reasonable attorneys’ fees for any requisite collection activities.” Israelite WDT ¶ 41 (CO Tr. Ex. 11). Needless to say, this scant support does nothing to demonstrate that the term is necessary, reasonable, or designed to achieve the statutory objectives.

170. Finally, the Copyright Owners seek a requirement that royalty records be broken down by format configuration to assist them with audits and to give HFA more negotiating leverage when it seeks to impose such requirements in its voluntary licenses. *See* CO PFF ¶¶ 868-69. But HFA’s desire for additional negotiating leverage is wholly irrelevant to this Court’s task. The Copyright Owners fail to present any evidence demonstrating that these additional burdensome requirements would achieve any of the statutory objectives. The Court should reject them.

171. These requirements, in whole, merely reflect the Copyright Owners’ pervasive strategy of treating the compulsory mechanical license as if it should reflect terms voluntarily negotiated in the marketplace instead of as a creation of Congress designed to achieve specific objectives. The Copyright Owners have provided no evidence that any of these additional terms are necessary to achieve the statutory objectives or that they would even help in doing so. Therefore, the Court should decline

to adopt them. In the event the Court chooses to adopt any of them in whole or in part, however, it should take into consideration the additional costs and burdens they will impose on copyright users, and it should lower the mechanical rate accordingly.

D. The Copyright Owners Propose a Woefully Complex and Over-Inclusive Revenue Definition

172. **CO PFF ¶¶ 870-871.** The Copyright Owners claim that they seek to define revenue so as to “include all revenue that is attributable to music.” CO PFF ¶ 870. As explained in greater detail above, however, the definition they propose is woefully complex, over-inclusive, and impractical. *See supra* § III(B). As DiMA discusses in its proposed findings, it is essential that any definition of revenue be clear and not overly broad. *See* DiMA PFF § VII(A)(7).

173. The Copyright Owners attempt to justify their proposed definition by claiming that under the RIAA’s definition of revenue, copyright owners would not be compensated for a hypothetical deal in which equity is the only consideration for the music. *See* CO PFF ¶ 871. They conveniently fail to acknowledge, however, that DiMA’s proposed definition of revenue would provide compensation in such a circumstance via operation of DiMA’s proposed minima. *See* DiMA PFF § VIII(A). Indeed, DiMA amended its rate proposal to include minima in response to concerns such as these raised at trial. *See id.* ¶ 221.

E. The Copyright Owners Have Not Disputed that the Compulsory License Covers All Copies Necessary to Deliver a Phonorecord to the End User or Any of DiMA’s Additional Proposed Terms

174. **CO PFF ¶ 889.** The Copyright Owners expressly declined to address any of DiMA’s proposed terms, most notably its proposal to ensure that the compulsory license expressly covers all reproductions necessary to effectuate a distribution:

A compulsory license under 17 U.S.C. 115 extends to, and includes full payment for, all reproductions necessary to engage in activities covered by the license, including but not limited to:

(a) the making of reproductions by and for end users;

(b) all reproductions made in the normal course of engaging in such activities, including but not limited to masters, reproductions on servers, cached, network, and buffer reproductions.

See DiMA PFF App. A, § 380.4 (Second Amended Rate Proposal of the Digital Media Association). The Copyright Owners presented no evidence that the mechanical license does not or should not cover all copies needed to deliver a phonorecord to an end user. As DiMA has explained, the statutory license would be useless if acquiring one did not convey the rights necessary to delivery a phonorecord to an end user. See DiMA PFF ¶¶ 240-41.⁸

175. DiMA also proposes terms providing for the distribution of digital music by a “licensee” or a “licensee’s carriers.” See *id.* ¶ 242. The Copyright Owners do not dispute these terms, which are important to minimize disruption to existing business arrangements that allow the distribution of downloads through distribution partners. See

⁸ The Copyright Office this week tentatively concluded that server and other intermediate copies used to create digital phonorecord deliveries are authorized by the section 115 license without additional royalty payments. See *Compulsory License for Making and Distributing Phonorecords, Including Digital Phonorecord Deliveries*, Notice of Proposed Rulemaking, Docket RM 200-7, 73 Fed. Reg. 40802, 40811 (July 16, 2008). The other issues discussed in the NPRM are not before the Court.

id. DiMA additionally proposes definitional terms, *see id.* ¶ 243, none of which the Copyright Owners dispute.

176. As there has been no dispute about any of DiMA’s proposed terms, and as DiMA has demonstrated that these terms are necessary for the mechanical license to enable the delivery of a phonorecord to an end-user and to avoid disruption in the industry, *see id.* § VIII(A)(3), the Court should adopt DiMA’s proposed terms in their entirety.

XVIII. MASTERTONES AND OTHER RINGTONES HAVE NO BEARING ON THE RATE APPLICABLE TO PERMANENT DOWNLOADS⁹

177. **CO PFF ¶¶ 890-906.** The Copyright Owners conclude their proposed findings with assertions about the creative inputs necessary for the creation of a saleable mastertone. Regardless of whether those arguments are valid, mastertones do not provide the most useful benchmark with respect to the mechanical rates applicable to permanent downloads. *See supra* § XII(C)(1); *see also* DiMA PFF § IX(E)(1).

**REPLY TO THE RIAA’S
PROPOSED FINDINGS OF FACT**

178. In these proceedings DiMA and the RIAA essentially agree that achieving the objectives set forth in Section 801(b)(1) requires the adoption of a percentage rate at a reasonable level. DiMA believes that a percentage of retail revenue is appropriate but that a percentage of wholesale is preferable to a penny rate. While the RIAA asserts that the purpose of the rate proceeding is to “achiev[e] the right balance between the

⁹ This section of DiMA’s reply responds to Section XVII from the Copyright Owners’ proposed findings. The numbering variance results from the fact that “Section XI” appears twice in the Copyright Owners proposed findings.

compensation of record companies and the Copyright Owners,” RIAA PFF ¶ 42, DiMA notes that the statute also requires the Court to consider the important role digital music distributors play. Four arguments made by the RIAA merit a brief response.

179. First, the RIAA employs the statutory objectives primarily as a method to make small adjustments to marketplace benchmarks, *see* RIAA PFF ¶¶ 542-543, rather than seeking first to determine how to achieve the objectives in light of the record evidence. Section 801(b)(1) does not require reliance upon marketplace benchmarks. *See* DiMA PCL §§ II, V(E). As DiMA points out, the central objective in this proceeding is to set a rate that achieves the goals set forth in the statute. *Id.*

180. Second, in asserting that the record companies are the “engine driving the entire music industry,” RIAA PFF ¶¶ 3, 1109, the RIAA should also acknowledge that investment and innovation by digital music distributors have provided the entire music industry with new streams of revenue and a new hope for the future. *See* DiMA PFF §§ III(B), IV(B). Without the legitimate alternatives to purchasing and enjoying music provided by DiMA members, piracy would be virtually the only option for consumers who want to obtain music through downloads. *See, e.g., id.* ¶¶ 52-54. The RIAA’s claim that record companies “laid the foundation for the new digital marketplace,” RIAA PFF ¶ 1351, does not capture the essential role played by enterprising digital music distributors.

181. Third, while the RIAA points out that the digital marketplace may not offer the same types of shopping experience as traditional bricks-and-mortar retailers, *see id.* ¶¶ 282-83, the record evidence shows that digital music distributors have invested enormous sums to provide a much larger catalog of songs available for purchase all day

every day, made accessible through customer-friendly searching and browsing tools, all in a manner that brings more works to more consumers than is possible in the physical retail environment. *See* DiMA PFF § IV(A). And digital distributors spend millions of dollars annually on marketing to bring customers to their websites to buy music. *See* DiMA PFF § V(B)(6); *see also* Cue WDT ¶¶ 47, 48 (DiMA Tr. Ex. 3); McGlade WDT ¶ 54 (DiMA Tr. Ex. 5). This is particularly important for songwriters and artists whose works are produced by independent labels that “lack the marketing muscle provided by major labels and large retail CD outlets.” Cue WDT ¶ 29 (DiMA Tr. Ex. 3); *see also* Guerin-Calvert WDT ¶ 100 (DiMA Tr. Ex. 7); *cf.* RIAA PFF ¶ 1303 (record companies provide marketing support as well); *id.* ¶ 1639 (“Record companies today do very little direct retail distribution.”). Indeed, while the record companies invest time and money in preparing digital metadata and distributing music in the digital supply chain, *see* RIAA PFF ¶ 214, digital distributors invest in that process as well. *See* DiMA PFF § V(B).

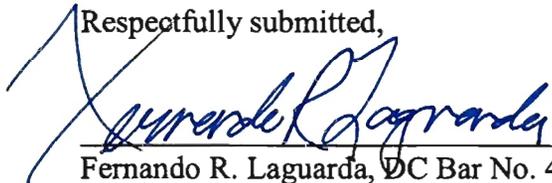
182. Finally, the RIAA suggests that digital distributors are somehow partly responsible for cannibalizing physical sales. *See* RIAA PFF ¶ 1330. But digital distributors entered the marketplace after the “bottom [had] dropped out . . . in a way that no one could have predicted.” *Id.* ¶ 684. By taking the extraordinary risk of starting businesses that sell a product otherwise available for free, and by investing heavily in technology to attract consumers, legitimate digital distributors provided a brand new revenue stream to Copyright Owners and record companies alike. *See* DiMA PFF §§ IV, V. Because of the customer-friendly features legitimate distributors have developed, consumers now pay for singles that they used to download for free. *See* DiMA PFF

§§ IV(A), IV(B)(3); cf. RIAA PFF ¶ 321 (recognizing that the sale of digital singles is profitable). And when consumers pay for music, all industry participants benefit.

CONCLUSION

183. The Copyright Owners fail to establish how their proposed rates and terms would further the purposes of Section 115 or achieve the objectives of Section 801(b)(1). For the foregoing reasons, and the reasons set forth in the accompanying Reply Conclusions of Law, the Court should adopt DiMA's Second Amended Proposed Rates and Terms.

Respectfully submitted,



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July 18, 2008

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CERTIFICATE OF SERVICE

I hereby certify that on this 21st day of July 2008, I caused a true and correct copy of the foregoing PUBLIC version of the “Reply Findings of Fact of the Digital Media Association; AOL, LLC; Apple Inc.; MediaNet Digital, Inc.; and RealNetworks, Inc.” to be served by email and overnight mail on the following:

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