Before the
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In The Matter Of: **Determination of Royalty Rates for Digital Performance in Sound Recordings and Ephemeral Recordings (Web IV)**	**14-CRB-0001-WR (2016-2020)**

INTRODUCTORY MEMORANDUM TO THE WRITTEN DIRECT STATEMENT OF THE NATIONAL ASSOCIATION OF BROADCASTERS

The National Association of Broadcasters ("NAB") respectfully submits this Introductory Memorandum to its Written Direct Statement. This Memorandum includes a summary of NAB's Direct Case and describes the testimony of its witnesses.

Summary

The National Association of Broadcasters ("NAB") represents local radio broadcasters nationwide, many of which stream their broadcasts over the Internet and who will therefore be directly and significantly affected over the next five years by the rates set by the Judges in this proceeding.

NAB's evidence will demonstrate that the Judges should start from scratch in this case in order to set sound recording license fees for streaming that represent rates that would be agreed upon by a willing buyer and a willing seller in an "effectively competitive" market, as required by the Copyright Act. The existing rates are principally a legacy of the rates set by the Judges in the second Webcasting proceeding ("Web II") that concluded in 2007. Those rates were established based on flawed evidence and analysis of selected licenses in a market that was

decidedly not effectively competitive – the licenses granted by the major record labels to interactive on-demand services.

NAB will present economic testimony explaining that the absence of competition among the labels in the interactive services market should preclude consideration of agreements from that market as a benchmark. NAB will also show that, even on its own terms, the SoundExchange analysis of the interactive services market in Web II was fundamentally flawed, as it failed to account for significant differences between the two types of services. Among other flaws, SoundExchange's analysis failed to take into account the huge and persisting disparities in revenue per play between the exclusively subscription-based interactive services in the purported benchmark market and the overwhelmingly non-subscription (advertising supported) services in the target market. Moreover, NAB will demonstrate that the benchmark market relied upon by SoundExchange in Web II was unstable. All but one of the seven benchmark services failed to sustain their businesses at the license fees rates on which SoundExchange (and the Judges) relied.

NAB will also present evidence that NAB-SoundExchange Webcaster Settlement Act ("WSA") agreement, which was heavily influenced by the rates established by the Judges in Web II, does not represent an agreement between a willing buyer and a willing seller. Rather, as the testimony of NAB's lead negotiator of the agreement will demonstrate, following the Web II decision, which dramatically hiked streaming rates, NAB lacked any reason to believe that another litigation would lead to a better result from the same Judges. Moreover, NAB faced, in SoundExchange, a party that knew it had all of the leverage while NAB had none. Thus, the agreement was really a take-it-or-leave-it result between a monopoly seller and a buyer that had no viable alternatives.

In addition, NAB will present evidence that the prevailing rate structure, including the Web II rates and the rates established in the WSA agreement, has proven to be too far too high in practice to allow broadcasters to achieve a return on streaming. NAB will present evidence from multiple broadcasters showing that they cannot make money on streaming, despite having made significant efforts to do so. Some have reached a business decision to limit their streaming or not to stream at all, despite the potential to expand their listening audience. For all of these reasons, a significant rate reset is necessary so that streaming can be a viable business that will allow broadcasters to provide streaming services to the audiences that rely on them and benefit from them.

The Judges will hear from broadcaster witnesses that music is only a part of what a music-formatted radio station offers to its audience, and that the challenge in attracting listeners is differentiating their programming from others in the market. Music does not differentiate. Rather, broadcasters devote their resources to developing personalities who can connect with and form relationships with listeners, to producing the non-music elements of their programming, and to finding other ways to connect with and serve their audience. Broadcasters will testify that the audiences who listen to their streams are not typically looking for a music delivery service – rather, they want to maintain their connection with their local station.

Small-station broadcasters will explain that advertisers do not value and are not willing to pay for audiences that have fewer than 100 to 200 average concurrent listeners. These smaller broadcasters, thus, face economic conditions comparable to those that led the Judges to adopt a flat $500 fee for non-commercial radio stations in the remand decision of the third Webcasting proceeding ("Web III").

NAB will present evidence that radio station streaming provides significant promotional benefits to record labels and artists. As NAB's witnesses explain in their testimony, labels and artists devote immense resources to securing spins on radio. In addition, labels seek to harness the influence and relationships that radio stations and on-air personalities have built with their listeners and local communities in order to promote sound recordings. As a result of that promotional value, NAB's economic expert will testify that a lower bound of a "zone of reasonableness" for the sound recording royalty would actually approach zero.

In addition, NAB's economic expert will analyze the rate established by the Judges in the recent SDARS II case and will conclude that the 13% of revenue rate relied on by the Judges in that case, which also stemmed from an analysis of the non-competitive interactive service benchmark, is above the upper bound of a zone of reasonable rates.

Witness Testimony

The National Association of Broadcasters' direct case comprises the following witness statements and accompanying exhibits:

Michael Katz is NAB's expert economist. He holds the Sarin Chair in Strategy and Leadership at the University of California at Berkeley. He also holds a joint appointment at the Haas School of Business Administration and the Department of Economics at Berkley. He specializes in the economics of industrial organizations, which includes the study of competition and pricing, as well as antitrust and regulatory policy. He has published numerous works in the field of economics and has previously served as Chief Economist at the Federal Communications Commission and as Deputy Assistant Attorney General for the United States Department of Justice. His earned his A.B. in economics from Harvard University and his doctorate in economics from Oxford University.

Drawing on his training and experience as an economist, Dr. Katz has conducted a detailed economic analysis of critical issues in the current proceeding. He first discusses principles that should guide application of the willing-buyer/willing-seller standard. He testifies that, from the perspective of economics, the willing-buyer/willing-seller standard is most appropriately interpreted as asking what would happen in an effectively competitive market in the absence of the statutory licensing regime. Congress's decision to create a rate-determination process with a willing-seller/willing-buyer standard can best be reconciled with economic principles and common sense by interpreting willing buyers as those who have meaningful choices among competing sellers, rather than facing a single, all-or-nothing offer from a monopolist or sellers with equivalent market power.

Dr. Katz explains in his testimony that effectively competitive prices promote consumer welfare and economic efficiency. Thus, from the perspective of economics, a standard requiring royalty rates to be set at the levels that would emerge from an effectively competitive market is a sound one. Economists and public policy makers have long recognized that competition delivers benefits to consumers in the form of lower, cost-based prices, greater innovation and variety, and/or improved product and service quality. Promoting efficiency through competition is widely recognized as the most effective means in most markets to promote overall consumer welfare. And, in particular, competitive prices are recognized as providing incentives to buyers and sellers alike to behave in ways that maximize the total benefits society enjoys from available resources.

Dr. Katz notes that effectively competitive prices will both tend towards the seller's cost and will reflect any other benefits that the buyer provides to the seller. In particular, to the extent that a licensee provides valuable promotional benefits to the seller, a competitive seller will be

willing to accept a lower—and, in some cases, even negative—price in recognition of the fact that those promotional benefits are a form of compensation to the seller.

Dr. Katz testifies that a market cannot be effectively competitive in the absence of buyer choice. Competition arises only when buyers have the ability substitute the offerings of one seller for those of another. It is this possibility of substitution that drives different sellers to offer higher quality and lower prices in order to attract buyers to themselves rather than their rivals. For this reason, a market with a single, monopoly seller cannot be effectively competitive: there are no alternative suppliers to which buyers can turn for substitutes. It is also the case that a market in which suppliers offer strongly complementary products cannot be effectively competitive. These principles guide Dr. Katz's analysis of the existing rates and the benchmarks used to establish them.

Dr. Katz's central finding with respect to existing statutory rates and those benchmarks is that the rates adopted in Web II were based on a severely flawed interactive services benchmark analysis that led to rates well in excess of those that would have been negotiated by a willing buyer and willing seller in an appropriate market. Dr. Katz shows that the licenses to the major labels' catalogs were complements for interactive services providers and therefore licensors did not compete with respect to those providers; as such, the interactive services market was not effectively competitive (or competitive at all) and could not serve as a proper benchmark. In addition, the business models of interactive services providers in the purported benchmark market and the non-interactive services providers in the target market were and are substantially different. Among other distinctions, interactive services were exclusively subscription based and non-interactive services were overwhelmingly advertising supported. Revenues per play generally are far lower from advertising than from subscription. None of these differences

between the benchmark and target markets was properly considered in the analysis, nor did the analysis consider the extent to which the benchmark market was not effectively competitive or stable and mature.

Dr. Katz concludes for multiple reasons that the negotiated license fees in the NAB/SoundExchange WSA Agreement are not a valid benchmark. The unreasonably high Web II rates strongly influenced the negotiations and the resulting rates. The Web II rates established the parties' expectations and eliminated any incentive of the NAB to rely on a possible return to the Copyright Royalty Board ("CRB") to set rates for 2011 through 2015. In addition to the effects of Web II on the WSA negotiations, the NAB faced a monopoly seller in SoundExchange. Accordingly, the NAB/SoundExchange WSA Agreement cannot be considered to reflect rates that would exist in an effectively competitive market.

With respect to appropriate benchmarks for the current proceeding, Dr. Katz concludes that an analysis of the economic relationship between record companies and terrestrial radio broadcasters establishes that the lower bound for reasonable royalties to be paid by webcasters that simulcast terrestrial radio broadcasts ("simulcasters") is near zero because the evidence shows that simulcasting generates significant promotional benefits. Further, an analysis of the statutory rate established for Satellite Digital Audio Radio Services in the SDARS II proceeding, subject to appropriate adjustments, establishes that, when expressed as a percentage of a music-formatted radio station's simulcasting revenue attributable to the performance of programming featuring copyrighted sound recordings, a royalty of 13 percent or higher would be unreasonably high. In fact, percentage or per-play royalties that were equivalent to a rate near 13 percent would also be unreasonably high. Given the data available at this point in the current proceeding, Dr. Katz states that he unable to reach a conclusion as to precisely how much lower

than 13 percent the upper bound on reasonable rates for simulcasting is, but that he anticipates being able to reach such a conclusion after reviewing contracts likely to be introduced into the record by other parties.

David B. Pakman is a Partner at the capital firm Venrock, where he has worked since 2008. At Venrock, Mr. Pakman focuses on investing in, and helping build, early-stage internet, digital media, and consumer companies. He also has extensive prior experience in the digital music industry, not only as an investor, but also as the founder of a digital music services company and as a CEO and employee of others, including Apple (co-founder of the original Apple Music Group), N2K, Myplay, Inc., and eMusic. He has spent more than 14 years in the digital music industry, negotiated hundreds of licensing agreements with major and independent labels, music publishers and performing rights organizations, sold music and music-related services to millions of consumers, and built and launched multiple successful digital consumer products.

Mr. Pakman explains the negative effect that the royalty rates for digital sound recording performances have had on webcasters and other the digital music services and on investors' willingness to invest in those services. He testifies, based on his long personal experience in this industry and evaluation of potential investments while at Venrock, that the digital music services industry has fared poorly due primarily to royalty rates being too high. This is evidenced by, among other things, a high failure rate for webcasting services and a lack of investment in these services relative to other digital industries. Mr. Pakman further testifies that he is unaware of any standalone webcaster that is profitable. In that context, he also details that a number of the digital music services whose license agreements were relied upon to set rates in the second webcasting proceeding are no longer in business.

Steve Newberry is the President and Chief Executive Officer of Commonwealth Broadcasting Corporation, which is a twenty-station radio group located in Kentucky. As an owner and operator of radio stations and as a longtime veteran of the radio industry, Mr. Newberry explains that local radio serves the community of which it is a part and is not just a music service. Mr. Newberry discusses how Commonwealth's stations provide information to the community and participate in community events, and how their streams serve this same purpose of helping to create the sense of community that is the heart of local radio.

Mr. Newberry also discusses the 2009 negotiations between the NAB and SoundExchange under the Webcaster Settlement Act, in which he led the NAB negotiating team. He explains that, as a result of multiple factors, including the 2007 decision by the CRB raising rates, the lack of any plausible reason to believe that another litigation before the same judges would lead to a different and better result, the economic hardship in the radio industry during the 2008-09 recession, and a disparity in the relative bargaining positions of the parties, the resulting agreement was really between a powerful seller and a buyer that had no viable alternatives, not between a willing buyer and a willing seller.

John Dimick is the Senior Vice-President of Programming and Operations at Lincoln Financial Media Company ("LFMC"), which operates radio stations in the Atlanta, Miami/Ft. Lauderdale, Denver, and San Diego markets. He describes the economics of Internet simulcasts of LFMC's over-the-air radio broadcasts. He explains that, while LFMC has been attempting to make streaming of its music-formatted stations profitable for many years, streaming is not now profitable and it never has been. One of the major reasons for this is the cost of sound recording royalties, which are LFMC's largest streaming expense by a substantial margin. He testifies that, if a per performance rate were lowered to a fee on the order of $0.0005, streaming might be

profitable and LFMC could pursue expansion of its streaming audience more aggressively without incurring a loss.

Mr. Dimick also explains how over-the-air radio and simulcast streams provide enormous promotional value to labels and artists. He provides examples showing that labels and artists know this as well, as evidenced by their behavior. Among other things, labels and artists stay in constant contact with LFMC's programming personnel through multiple avenues (in person visits, phone calls, emails and texts, etc.), provide stations with notification and copies of new and pre-release music, engage independent third parties to promote their artists and recordings to broadcasters, and make artists available to stations for in-studio performances and appearances.

Robert Francis Kocak, who is known professionally as **Buzz Knight**, is the Vice President of Program Development at Greater Media, Inc., which is a privately owned company that operates radio stations in the Boston, Charlotte, Detroit, and New Jersey markets. Mr. Kocak's testimony describes how most successful radio stations, including most music-formatted stations, owe their success to elements other than music. He explains that successful radio stations must bring something unique and different in order to stand out and that the key to success is to build an individual brand identity for each station and to integrate that station into its local community so that it becomes prominent and well-known Among other things, that effort requires: a substantial commitment to memorable on-air talent; consistent and prominent station involvement in the community; informative and interesting on-air coverage of local issues and events; and active promotion of the station's brand, including through social media. Over time, these efforts lead to loyal listener bases, both for over-the-air broadcasts and streams. In contrast, Mr. Kocak testifies that the music that a radio station plays is not exclusive to that station, and in order to succeed at a high level, stations must do much more than play music.

Mr. Kocak also testifies that, throughout his long career in radio, record labels have sought to leverage radio stations' relationships with their listeners in order to promote their artists and recordings. Record label representatives and artists actively seek spins on Greater Media stations, including their streams, through personal visits, calls, emails, provision of recordings, and participation in promotions, including artist visits and giveaways. Record labels and artists also seek the endorsement of songs and artists by Greater Media's on-air talent, whose opinions and recommendations listeners trust.

Johnny Chiang, Program Director at Cox Media Group, testifies that record labels expend significant effort to ensure airplay and artist exposure. This includes: hiring managers and outside promoters who are in constant contact with radio stations encouraging airplay; providing radio stations with free opportunities to download music; scheduling expensive radio tours for artists; and providing free opportunities to meet artists and see them perform. Further, the labels clearly believe that radio airplay promotes the sale of music. The promoters openly talk about how radio airplay turns into sales, and have provided many documented examples of how increased sales in the Houston market resulted from increased spins on the air.

Ben Downs is Vice President and General Manager of Bryan Broadcasting Corporation, which owns and operates nine radio station formats located in and around College Station, Texas. Mr. Downs, who has over 45 years of experience as a broadcaster and has been managing these stations for nearly 25 years, discusses his company's inability to make streaming a viable business operation. He describes how the current SoundExchange royalties have outpaced the company's ability to generate streaming revenue and resulted in significant financial loss. He explains that advertisers lack interest in either the local or non-local components of his stations' streaming audiences and will not pay for broadcast ads to be

streamed. He further explains that his streaming provider has never generated more than minimal ad insertion revenues while SoundExchange fees have increased significantly.

Mr. Downs also describes how the success of his music-formatted radio stations is largely driven by non-music related factors such as the local interest content his stations broadcast, the stations' close ties to their local communities, and the listener loyalty that is created through the audience's interactions with the stations' on-air personalities. He explains how his stations support artists, who value the added exposure they get from making appearances on the stations. Finally, he testifies that the company's inability to run its streaming operations without incurring significant losses has led him to conclude that the company should seriously consider no longer providing music streaming services to its listeners unless sound recording performance fees are reduced significantly.

Julie Koehn is President and General Manager of Lenawee Broadcasting Company, the licensee of WLEN Radio, in Adrian, Michigan. Ms. Koehn explains, based on her decades of industry experience, why radio broadcasters and the programming they transmit are so important to the communities they serve. She describes the ways WLEN, in particular, fulfills this important role in the Lenawee County community by focusing on local news and local community information. She describes the local content on her station broadcasts, including local weather, community calendars, local high school and college sports, and daily shows with on-air talent who have developed listener loyalty over many years. Ms. Koehn also discusses the strong ties WLEN has with its local community and how the station has earned its listeners' loyalty not only through its unique programming but also its strong commitment to community welfare and charitable causes. She explains that these attributes, and not music content, are why listeners tune in to WLEN.

Ms. Koehn further explains that Lanawee Broadcasting made a conscious decision not to stream music on the Internet because it believes that the current rate structure for SoundExchange royalties could result in unpredictable financial losses to the company. She describes the company's concern that, if WLEN were successful in building a streaming audience as large as 100 average listeners, it could not generate sufficient additional revenues to offset the high royalty fees it would incur. She testifies that if the formula for streaming royalties becomes predictable, stable, and reasonable, Lenawee Broadcasting would reconsider its decision not to stream.

Jean-Francois Gadhoury is the Chief Technology Officer of Triton Digital, which provides streaming-related technology services to many leading radio broadcasters. Mr. Gadoury's testimony explains certain situations that can lead to overcounting of sound recording performances over a stream. In particular, Mr. Gadhoury discusses how discovery connections from a listening device can lead to two performances being recorded even when only one actual connection is being made that results in a listener hearing a performance of a sound recording. Mr. Gadhoury also explains how instability in the Internet can result in temporary lost connections followed by immediate reconnection. In these situations, which may be so brief that the listener is unaware of them, two performances may be recorded even though the listener has only heard a single sound recording.