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

In the Matter of **MECHANICAL AND DIGITAL PHONORECORD DELIVERY RATE ADJUSTMENT PROCEEDING**	)	**Docket No. 2006-3 CRB DPRA**

REBUTTAL TESTIMONY OF

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RIAA Trial Ex. 90

Written Rebuttal Testimony of Robert Emmer

Background and Qualifications

I am the Chief Operating Officer of Shout! Factory. Shout! Factory is an independent entertainment company devoted to producing, uncovering and repurposing music, movies and television shows. We release DVDs of classic, contemporary and cult TV series, sports programs, live music, animation and documentaries. We also release a wide range of CDs, with a particular focus on new releases by storied artists and enriched reissues of "deep catalog" music, which can include older music or songs that are less well known and may include unreleased songs as well.

I have worked in the music industry for over thirty years. I have a B.A. degree in journalism from the University of Southern California, and a J.D. from Loyola Law School in Los Angeles. From 1977 to 1983, I was a partner in Alive Enterprises, an entertainment management company that managed artists such as Alice Cooper and Blondie, among others. From 1983 to 1985, I was Director of Business Affairs at MGM/UA Home Video. I spent the next two years as a lawyer at the entertainment law firm Menes Law Corp. I joined Rhino Entertainment Company in 1987 as Executive Vice President, Legal and Business Affairs. After my colleagues and I sold Rhino to Warner Music Group, in 1997 I was named Senior Vice President, Business Affairs, for Warner Music Group, where I was responsible for a broad spectrum of business affairs, including acquisitions and strategic alliances. In 2003, Richard Foos, Garson Foos, and I founded Shout! Factory as a diversified, entrepreneurial, independent audio and video company devoted, on the music side, to producing quality new music and reissuing quality deep catalog music.

I am presenting testimony in this proceeding in order to rebut the rate proposal of the music publishers and songwriters. If the Copyright Royalty Judges were to adopt their proposal, it would be devastating to independent record labels like Shout! Factory and would reduce the availability of songs to the public.

I. Shout! Factory's Music Business and the Importance of Independent Record Labels

Shout! Factory's music business focuses mostly on enhanced re-issues and compilations of previously recorded and released songs. Many of the CDs that we release would simply not be released were it not for our efforts to locate, reissue, and market this music. A good example is the Tijuana Brass catalog. The Tijuana Brass was an American band created by independent record executive and artist Herb Alpert in the sixties which featured brass instruments like the trumpet and a Latin sound. Although the Tijuana Brass were very popular in their era and extraordinarily influential on other American bands like Chicago and Earth, Wind, & Fire, the last album of new Tijuana Brass music was released in 1984. In 2005, the Tijuana Brass entrusted Shout! Factory to reissue the Tijuana Brass catalog through a joint venture. We began with an album of previously unreleased tracks called *Lost Treasures* and then released deluxe versions of each of the classic albums. We also enhanced these tracks by remixing tracks from one of the band's best known albums, *Whipped Cream and Other Delights*, and releasing the enhanced content as *Whipped Cream and Other Delights Rewhipped*, which revitalized this music and made it contemporary. Albums like *Lost Treasures* and *Whipped Cream and Other Delights* feature incredible and sometimes highly obscure recordings that a major record label focused on selling high volume would never release. Without companies like Shout! Factory, this music simply would fade into history.

Shout! Factory also releases compilation albums. Compilations can include music by different artists of the same genre, or music from many different genres, and tend to include a substantially higher number of tracks than the average album. A recent example is Shout! Factory's Ultimate Grammy Collection series. In 2007, in conjunction with the National Academy of Recording Arts and Sciences and Grammy's 50th Anniversary, we released a 7-CD series encompassing Grammy winners from different genres. A compilation like our Ultimate Grammy Collection series enables music lovers to acquire a substantial number of songs that are packaged together with extras like a personal essay by music producer Quincy Jones. This type of compilation also exemplifies a goal of many compilation albums -- to stimulate album sales for each individual artist appearing on the album by exposing music lovers to many different artists on a single album.

Shout! Factory also releases new recordings. We worked with Matthew Sweet and Susanna Hoffs (of the Bangles) to produce an album of sixties cover songs, an album with The Dirty Dozen Brass Band that was their version of Marvin Gaye's *What's Going On* album, and a country album with legendary R&B artist and icon Solomon Burke. These are albums that exemplify the efforts of an independent record label focused on producing diverse offerings to the public. They might not sell millions of copies but they are a critical part of America's diverse musical landscape.

Shout! Factory also purchases other music labels' catalogs -- i.e., their master recordings and rights -- in order to release valuable repertoire that is an important part of America's musical culture and heritage. A recent example of this was the purchase of the Hightone label, which features roots music. Hightone was on the verge of insolvency and needed an independent label with Shout! Factory's skill set and positioning to come in and save their catalog of musical treasures for future consumers to enjoy. Included were bluegrass artists like Laurie Lewis, country artists like Gary Stewart and Joe Ely, rockabilly artists like Dave Alvin and Buddy and Julie Miller, and blues legend Robert Cray. Much of this music would not be available in today's audio marketplace if an independent label like Shout! did not purchase catalogs like Hightone in their entirety.

In short, Shout! Factory's music releases exemplify the importance of independent record labels. Without independents, much incredible music would fall into obscurity or simply never be released. Some of this country's greatest music emerged because independent record labels nurtured it into existence. Artists like Aretha Franklin, Etta James, Wilson Pickett, Chuck Berry, Woody Guthrie, Herb Alpert and the Tijuana Brass, and Solomon Burke got their start at independent record labels. The unique diversity of the American music scene is directly owing to its independent labels. It is commonly said that although independent record labels represent a minority of albums sold, we represent over 80% of all records released. The major record labels have infrastructure and profit needs that allow them only to focus on the most profitable music that will appeal to the most consumers. Independent labels can experiment and release music that is of incredible quality but may not sell the same quantity. As I will explain, however, these musical offerings -- and the diversity of the music market as a whole -- would be severely threatened by the mechanical rate that the publishers are seeking in this proceeding.

II. Challenges Facing Independent Record Companies Like Shout! Factory

It is simply a fact of the current music industry that sales and consumer prices have been declining. The combination of widespread music piracy and the demise of independent record stores replaced by big box retailers have hit independent record companies particularly hard. Getting shelf placement at Wal-Mart is difficult to impossible for some of our offerings, and

Wal-Mart will usually only obtain our compilation albums if they are priced at midline prices rather than frontline prices. Even though our albums often feature more tracks than the average frontline album and are often priced lower, we pay the same mechanical rate for our songs as the record companies receiving frontline wholesale pricing. The mechanical rate has been increasing as sales and wholesale prices have decreased. As a result, our margins are becoming razor thin -- only [[redacted]] of sales before overhead in 2007.

Given the current state of the music business, it is difficult or impossible to make the economics work. We have cut our expenses down to the bare minimum. As an independent record company, we must outsource our distribution to one of the major record labels (in our case, SONY BMG Music Entertainment), which charges distribution fees that represent a cost of approximately [[redacted]] of sales.[1] These are a set cost that we cannot reduce or eliminate. Our manufacturing costs represent a cost of approximately [[redacted]] of sales, and we have reduced those costs in recent years. Our royalty and profit participation payments to artists, record labels, master owners, and joint venture partners represent a cost of approximately [[redacted]] of sales. With the statutory mechanical rate at 9.1 cents, mechanicals now represent a cost to us of approximately [[redacted]] of sales.[2] Our mechanical cost is the only cost that has been increasing as wholesale revenues have gone down, in part because mechanicals are one of our only costs that is set per unit, as opposed to a percentage-of-revenue basis. Our total cost of sales is thus [[redacted]], leaving a gross margin of [[redacted]]. After deducting [[redacted]] for non-recoupable mastering, recording, and production costs and [[redacted]] for marketing and advance write-offs, our remaining

[1] Specifically, our distribution deal with SONY in 2007 was at [[redacted]] for normal retail distribution and [[redacted]] for one-way direct sales, averaging out to [[redacted]].

[2] This rate represents the rate that we are paying on revenues which carry a mechanical obligation. Some of these are payments directly to music publishers, and others are paid to other record labels when we purchase their discs on a royalty inclusive basis.

margin on new CDs is only [redacted] before overhead. As I will discuss in the next section, Shout! Factory has made every effort to cut our discretionary costs, but even having done so, the mechanical costs are now so high that the profitability of selling records is becoming questionable.

III. How Shout! Factory Has Responded to These Challenges

At Shout! Factory, we have generally responded to these challenges by rationally investing in projects that we view as profitable and declining to invest in projects where our projected margins would be too slim. We certainly have put substantial energy into our video and DVD businesses, which have been less affected by piracy and the shift to big box retailers. We have also gotten creative in lowering packaging costs, but going to India and China can only do so much and can also lead to logistical problems that are costly in terms of both time and money. Furthermore, packaging is a critical aspect of marketing reissue audio projects, especially box sets, and we are both unwilling and unable to put out a product that does not meet our standards and those of our target consumers.[3] In other words, we have cut all of our discretionary costs to the bare minimum that we can afford while still putting out quality products.

In the end, however, we have been forced to reduce our mechanicals cost by reducing the number of tracks we include on an album. Of course, we attempt to reduce the mechanicals cost by obtaining discounted mechanical licenses, but the costs of doing so are often unworkably high

[3] Releasing these albums digitally is not necessarily a viable option for us. Although we have some digital releases, most of our compilations and reissue albums are not available digitally because the recordings are licensed to us only for physical release to music lovers interested in the unique package we put together for them. Both the actual physical packaging and the combination of different types of artists or songs in a single compilation album tend to be unique to the physical album market. Because the digital music market tends to be one of singles and because there is no physical packaging for a digital album, we usually do not release these types of albums digitally.

for us. For example, a compilation CD with 18 songs will often involve negotiations with dozens of songwriters and music publishers. For independent record labels, these negotiations can be a project-killer. Cutting the number of songs is, sadly, the most pragmatic solution for an independent label like Shout! Factory.

A recent and not atypical example is an album we are releasing in 2008 by the legendary 1970's multi-platinum act Three Dog Night. The band discovered a recording of a live show of 15 of their hits performed in the vintage year of 1975. The band controlled the master rights to the show. Although artistic excitement abounded over the 15 newly discovered live tracks, we have come to realize that the CD release will have to be truncated to 13 tracks. In today's audio retail market and at the existing statutory rate ($.091 per track), the cost of two additional tracks makes the margin sufficiently slim that the project would not be profitable enough for us to pursue. The fact that we will have to release this album at a mid-line price in order to get it in retail stores further places pressure on the number of songs we can include. Our choice was to pass on the project completely or to cut tracks from the album. This forced choice does not serve the American consumer well, nor is it good for music publishers and songwriters, nor artists and record labels.

IV. The Publishers' Rate Proposal Would Have Devastating Effects on Independents Like Shout! Factory

I was shocked and appalled when I heard the publishers were seeking 12.5 cents per song for physical CDs and 15 cents per song for digital downloads as a mechanical rate, and that those rates would go up each year according to CPI. Such a rate increase could literally put Shout! Factory out of the business of selling music. The publishers would be winning the proverbial battle only to lose the war.

In 2007, we released 56 CDs and did approximately [redacted]] in CD sales.[4] As I stated earlier, mechanical royalty expenses constituted approximately [[redacted]] of sales, and our profit margin on the audio side of our business was very low -- approximately [[redacted]], or only [[redacted]] of sales before overhead. Thus, even at today's royalty rates, our music business is marginal at best and likely could not survive but for our coupling it with the more profitable DVD business with which it shares overhead (our total overhead is [[redacted]] of revenue). If the Copyright Royalty Judges were to adopt the rate proposal of the music publishers, effecting a 37% increase from the present rate of $0.091 to the publishers' proposed rate of $0.125, it would increase the cost of mechanicals as a percentage of sales from [[redacted]] to [[redacted]] of sales (and this analysis does not include the publishers' proposed CPI increase). As a result, the mechanical rate increase would lower our profit margin on CDs to [[redacted]] of sales before overhead. With a margin like that, we would literally have to get out of the business of selling music.

Take the Three Dog Night album, for example. Our projected margin -- even after cutting the number of tracks from 15 to 13 -- is only [[redacted]] before overhead. If the mechanical rate were increased to the publishers' proposed rate, however, our projected margin would fall to [[redacted]] before overhead. We could not afford to put out the album with a margin that tiny.

Take as another example a three disc set of songs by musical score composer John Williams that we have planned for 2008. This set, as planned, will include 54 tracks, encompassing Williams's entire career of iconic music from films like *Jaws*, *Star Wars*, *Indiana Jones*, and *Catch Me If You Can*. We estimate it will bring in a margin of [[redacted]] before

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[4] Shout! Factory's core business comprises both Audio and DVD. A significant portion of the DVD side is non-music, i.e. it involves no mechanical royalty payments. In order to get an accurate picture of the true cost of mechanicals, I have therefore extracted the CD business from Shout! Factory's 2007 total financials.

overhead. If the mechanical rate that applied to the project was $.125 per song, our projected margin would fall to only [[redacted]], and the mechanicals would increase from an already high and unreasonable cost of [[redacted]] of sales to a simply unbearable cost of [[redacted]] of sales. This sort of project only works if it includes a comprehensive set of tracks. With a mechanical rate of $.125, the project would not be possible.

The same is true of our albums of new music by current artists. We have an album planned for release in 2008 by a rock band called Local H. We estimate a margin of [[redacted]] before overhead at the current mechanical rate, but if the rate were increased to $.125 per song, our margin would drop to [[redacted]]. Furthermore, Local H requires the marketing model for a developing band, which means these projections -- which are only for margins on sales -- may not reflect the projected return on investment, which we would expect to be lower for a developing band. This drop may not seem make-or-break, but given the overall effect that a rate increase would have across the board on our audio projects, it very well could be. And if we did not share our overhead with our DVD business, even this album could be unprofitable.

Another consequence of the publishers' rate proposal is that Shout! Factory would not be able to purchase catalogs like the roots music catalog, Hightone. The publishers' rate request, if adopted, would make releasing albums of deep catalog artists cost prohibitive, and we would be forced out of the business of acquiring catalogs of amazing music that might not sell millions of records but that are an important part of America's musical history (and still appeal to thousands, if not millions, of music lovers today). The alternative to independent labels acquiring these catalogs is not acquisition by the majors, who are largely focused on hits and gold records. Rather, the public would simply be denied the ability to purchase this music in the future.

Ultimately, I believe that by forcing independent record companies out of the record business, a rate increase would also end up hurting the publishers. If somehow we found a way to stay in the music business, it would have to be by releasing albums with far fewer songs and/or charging a lot more for them (the viability of which is by no means clear in the current marketplace, given the way Wal-Mart and the other big box retailers have pressured prices down, not up). The publishers and the songwriters they represent would lose far more in volume than they would gain from a rate increase. I also believe that a rate increase would hurt publishers and songwriters by hastening the end of the physical music market. A rate increase would put us out of the business of releasing physical compilation CDs and consumers would be forced to buy songs digitally. Because the digital world is a singles market, it generates fewer mechanicals than an album -- especially a compilation album with many more tracks than the average album. Since the publishers themselves have argued that this shift to a singles-based digital market hurts them, I cannot understand why they would hasten that shift by asking for such a high mechanical rate.

V. A Percentage Rate Would Be Best

I also want to respond to the publishers' request for a per-song rate as opposed to a percentage rate. In my experience, independent U.S. record companies like Shout! Factory are being hurt because our mechanical rate is set as a per-track rate, while our foreign competition pays mechanicals as a percentage of sales. In the U.K., multidisc box sets routinely contain a substantially higher number of songs because the cost of copyright publishing is calculated on a fixed percentage basis instead of a per-song basis.

Because of our per-song mechanical rate, we are losing out on projects that are able to be accomplished in the UK because of their percentage rate. For example, music legend Bob Dylan currently hosts a "Theme Time Radio Hour Show." Dylan wanted to release a Double CD compilation album consisting of certain of his selections from the radio show. The album would have contained masters and songs handpicked by Dylan from a wide variety of artists. Shout! Factory would have liked to partner with him on this exciting artistic venture, which has a chance in a commercial market with a name like Bob Dylan attached. Unfortunately, no American company could make a sensible deal for this project because Dylan's concept and vision embodied 50 tracks on 2 CDs. We might have been able to make it work with 32 tracks on 2 CDs with a paltry margin, but we could not afford to pay mechanicals on 50 tracks without charging a price that no consumer would pay. Instead, Dylan went to the UK and shopped it to Ace Records, which has released it just like Dylan wanted it.

The Dylan project is only one example. Many such projects we have been actively pursuing face similar roadblocks because of mechanical license fees. One of the major labels wants to work with Shout! Factory on a more regular basis and is willing to license to Shout! Factory certain single artist compilations that would likely sell 7,000–15,000 units. One such album is for the band Sweet. There is no 2 CD retrospective that has been released for Sweet in the United States, but there is a retrospective in the UK containing 38 tracks. At best, we could release a 2 CD set with fewer tracks, but it would be an inferior product to what labels in the UK can create.

A percentage rate would be far preferable for independent record labels like Shout! Factory. If the mechanical rate were set as a percentage of wholesale revenue, we could release compilation albums with many more tracks than we can at the current per-song rate and would be able to price our albums more flexibly. With price flexibility and an increase in the number of songs being offered, I am confident that our sales would increase substantially. Thus even if the percentage rate was technically lower than the current per-song rate, publishers would make up in volume what they lose in rate reduction, and more songs would be made available to the public.

VI. Conclusion

It would be a sad day indeed if independent record labels were forced to shut their doors to artists -- singers, musicians, and songwriters -- because their margins were cut from slim to none by an increased mechanical rate. For the sake of the entire music industry, it is my sincere hope that the Copyright Royalty Judges reject the rate proposal submitted by the publishers.

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

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Robert Emmer