

2. Experts on Pricing

Throughout these proceedings, CSI and RTC have endeavored to provide the Service with the information it needs to make a determination. However, the Service has consistently challenged many of the representations CSI and RTC have made and refused to accept them as true. As a consequence, CSI and RTC have found it impossible to establish facts the Service maintains are central to their exemption.

The Service's refusal to accept these representations as true violates the statutory scheme for the judicial review of adverse determination in section 7428. As discussed from F-1 to F-14 of the Protest, section 7428 provides a bifurcated system of procedural rules for determining questions of fact in exemption proceedings. In revocation proceedings like Animal Protection Institute, Inc. v. United States, 78-2 U.S.T.C. ¶ 9709 (Ct. Cl. Trial Div. 1978), the case the Service cited during the Conference in support of its position, the exempt organization is entitled to a full trial to resolve all factual and legal disputes. Both the Service and the organization are entitled to submit evidence and arguments in the case. Since both parties have the opportunity to litigate the facts and the law, the resulting decision

will collaterally estop them from relitigating the issues that were involved in the case. Consequently, in revocation cases, the Service must be sure to raise all likely issues for if it loses it cannot challenge exemption for the years that were litigated.

In initial determination cases, like the one at hand, there is no trial. Section 7428 provides only for a review of the evidence in the record. See, e.g., Houston Lawyer Referral Service v. Commissioner, 69 T.C. 570, 573 (1978); Tax Court Rule 217(a)). An applicant must furnish sufficient information to present a prima facie case that it qualifies for exemption. That is all; if the representations are complete and unequivocal, the Service cannot challenge them and must assume that they are true. See Dupaine Farms v. Commissioner, 73 T.C. 650, 664 (1980), acq. 1980-2 C.B. 1, nonacq., 1980-2 C.B. 2; Church of the Visible Intelligence that Governs the Universe v. United States, 53 A.F.T.R. 2d 406, 409 (Ct. Claims 1983). The determination and subsequent litigation must be based on the representations as made.

Unlike revocation proceedings, initial determination proceedings do not result in a judgment that collaterally estops the Service from challenging exemption for the years under issue sometime in the future. The Service's

decision in an initial determination proceeding will not bind the Service if the representations on which the Service based its determination were incomplete or false in any material respect. See, e.g., World Family Corp. v. Commissioner, 81 T.C. 958 (1983); Church of the Visible Intelligence that Governs the Universe v. United States, 53 A.F.T.R. 2d 406 (1983); S. Rep. No. 938, 94th Cong. 2d Sess. 588 (1976). Thus, even though the Service must base its initial determination on the representations as made, the Service always may subsequently test the representations and revoke exemption if they prove untrue.

In an effort to establish for once and for all the facts the Service considers critical to the issue of pricing and profits, CSI has asked five experts to analyze the methods it uses for setting prices for books, E-Meters and jewelry and determine whether the resulting prices and profits are reasonable or unreasonably high. In this way, the Service will have the assurances of expert testimony that prices are or are not set to maximize profits. The background and qualifications of these five experts are discussed below.

As their credentials amply demonstrate, each of these five experts enjoy the highest reputation throughout the country as the best in his particular field of

specialty. Their opinions -- given under penalties of perjury -- unequivocally establish that prices are not set to maximize profits. CSI and RTC trust that the Service will accept their declarations as true.

a. Experts on Book Pricing

CSI and RTC retained two experts on book pricing and publishing to examine its pricing method. Both are among the leading experts in the publishing field today and are intimately familiar with industry standards for the very details at issue here.

The first expert, Glen Ruh, is an independent book producer and publishing consultant living in Washington, D.C. Mr. Ruh provides his clients with analysis and recommendations in all major areas of publishing, including financial planning, marketing, pricing, distribution, production, and design. As an independent book producer, he is thoroughly involved in the publishing process from acquisition to production, pricing and marketing.

Mr. Ruh has worked closely with nonprofit tax-exempt organizations in the publishing field for over two decades. He began his career in publishing in 1964 as a Manuscript and Acquisitions Editor for the Gregg Division

of the McGraw-Hill Book Company in New York City. In 1967 Mr. Ruh became Special Projects Editor for the College Division of Holt Rinehart & Winston in New York, which involved him in the design and promotion of textbooks to state colleges and other high volume purchasers. In 1968 he became Managing Editor for Books for the Naval Institute Press, a nonprofit organization located in Annapolis, Maryland. The Naval Institute Press is tax-exempt under section 501(c)(3) of the Internal Revenue Code. While there, Mr. Ruh was responsible for acquiring and editing textbooks, reference books, and scholarly and special-interest books, for preparing detailed financial budgets for the Institute, and for proposing the suggested price for books.

In 1975 Mr. Ruh left the Naval Institute Press to become Associate Editorial Director of the Chilton Book Company, a nonfiction trade publishing house located in Radnor, Pennsylvania. He managed Chilton's editorial, design and production departments for general trade books and supervised a staff of approximately fifteen. He dealt with best-sellers with national media exposure and negotiated distribution and co-publishing arrangements. At Chilton, Mr. Ruh had full fiscal responsibility for establishing book prices and for program budgeting.

From 1980 through 1985 Mr. Ruh was Director of Smithsonian Books at the Direct Mail Division of the Smithsonian Institution Press. The Smithsonian Institution Press is a part of the Smithsonian Institution (and is exempt from tax under section 501(c)(3)) and is widely known as an extensive publisher of high quality books priced at the upper ranges of the market. As Director of Smithsonian Books, Mr. Ruh directed all aspects of the Smithsonian's multimillion dollar direct-mail book program and managed an editorial, production and marketing staff that developed illustrated books for sale to the Smithsonian's member and to the retail book trade. He also developed and implemented sophisticated business and marketing plans and had complete responsibility for establishing prices for direct-mail books.

The second expert, Stephen Conland, is Vice President of Moseley Associates, Inc., a management consultant to the publishing industry, and has thirty years of experience in the publishing field. Mr. Conland's career in publishing began in 1956 when he joined Berkley Publishing Corporation, a publisher of mass-market paperback books located in New York City. Three years later he acquired ownership of the company and became its publisher, which position he held until his retirement in

1977. During that period, Berkley published about 250 titles per year.

In 1965, Mr. Conland sold Berkley to G.P. Putnam's Sons. With Putnam, Berkley published hardcover books and trade paperback books in addition to mass-market paperback books. One of the hardcover best-sellers published by Berkley at that time was Plain Speaking: An Oral Biography of Harry Truman by Merle Miller. That title was a Book-of-the-Month Club selection and sold 250,000 copies. Mr. Conland's experience with best-sellers also included The Godfather.

Mr. Conland joined Moseley Associates in 1979. Moseley Associates is a nationally-known firm that specializes in providing management and consulting services to the publishers and the publishing industry in general. Moseley Associates includes some of the country's leading experts in all major areas of publishing, including organization, operations, management, expansion and financial planning, as well as appraisals. While at Moseley, Mr. Conland has had extensive experience analyzing the value, profitability, and marketing policies of numerous publishing companies.

Mr. Conland's expertise has been recognized by the government itself for many years. He has been retained by the Internal Revenue Service to prepare 197 appraisal reports of various books. He also has testified as an expert witness on behalf of the Service in five federal tax court cases involving the value and profitability of books used in tax shelters, and as an expert witness in federal court concerning the operations and costing policies of a paperback book company.

b. Experts on E-Meter Pricing

CSI also retained two experts to examine its method of pricing E-Meters. Both of these experts have extensive experience in the manufacturing industry and are eminently qualified to render an opinion on the pricing issues raised by the Service.

The first expert, Dudley Smith, has been a patent attorney and licensing executive for major U.S. manufacturing companies since the mid-1950s. In the late 1950s, Mr. Smith was appointed Manager of Licensing and Corporate Secretary for a licensing venture between Cluett, Peabody & Company (best known for their ARROW Shirts and their famous "SANFORIZED" licensing program) and West Virginia Pulp and Paper Co., known as CLUPAK.

During Mr. Smith's six years with CLUPAK, his sole daily job responsibility was licensing, i.e., formulating licensing strategy, drafting, negotiating, concluding, and administering licenses, and reporting to the Board of Directors on the CLUPAK licensing program.

In 1965, Mr. Smith was hired by Celanese Corp. as a licensing executive. His official responsibilities pertained, once again, solely to licensing. His daily work involved drafting and negotiating domestic and foreign license agreements, both as a licensee (buyer) and as a licensor (seller) of patent rights in the areas of fibers, chemicals, mechanical devices, plastics, coatings, and many diverse specialty items.

Also in 1965, Mr. Smith was afforded the opportunity to form an educational association for others involved in the licensing field. He put together a core group of individuals and formed the Licensing Executives Society, known as LES. Today, LES is the leading professional society on licensing in the world and has 21 national chapters reporting to a parent body, LES International, with over 5,000 individual members.

Since 1965 Mr. Smith has served LES in many capacities, including as President of LES US/Canada and as President of LES International. He has served on numerous

LES committees, has been a speaker and teacher on licensing at numerous annual, regional, and foreign meetings, and started the Society's publication called Les Nouvelles. Les Nouvelles has since become the most authoritative publication in the licensing field. From its founding, Mr. Smith has been a member of the editorial board, and in that capacity reviewed or participated in the review of all of the more than 1,000 licensing articles it has published.

In 1971, Mr. Smith was awarded the first LES Gold Medal, which is an award given by the LES International every few years (seven since 1965) to a worthy licensing professional executive in recognition of outstanding contributions to the profession of licensing.

During the 1970's Mr. Smith was the primary organizer, and participated as a member, of a U.S. governmental delegation to the Soviet Union to study and report to American industry on Soviet licensing practices. Subsequently, he was a United States representative on a licensing mission to the Peoples Republic of China.

The second licensing expert, Cruzan Alexander, has been a practicing patent attorney and licensing executive

for over 40 years. At the time of his retirement in 1983, he had been Chief Patent Counsel for the 3M Company for 11 years.

During Mr. Alexander's more than 40 years of practice of patent and intellectual property law, he has been extensively involved with the licensing of inventions and patents and has written and delivered numerous papers, talks, and educational seminars on various aspects of patent licensing and royalty arrangements. While at 3M he took part in or had responsibility for negotiating the majority of 3M's licensing agreements.

Mr. Alexander is past President of the Licensing Executives Society US/Canada. As the result of his extensive involvement in the field of patent and intellectual property licensing he has prepared, negotiated, and reviewed thousands of licensing agreements and has lectured extensively on the reasonableness of royalty rates in patent licensing agreements.

c. Expert on Jewelry Pricing

CSI also retained an expert to examine its pricing method for jewelry. This expert, Jack R. Revoyr, is the Licensing Administrator for the University of California,

Los Angeles ("UCLA"). UCLA is tax-exempt under section 501(c)(3). In that position he has been responsible since May of 1981 for all of UCLA's nonprofit licensing activities with respect to its name, trademarks, and merchandising properties, including jewelry products bearing the University's insignia, such as charms, bracelets, and pins.

On UCLA's behalf, Mr. Revoyr ministers more than 130 domestic and seven international licensing agreements. He is responsible for negotiating the terms of licenses (including royalty provisions), drafting contracts, reviewing products and marketing plans of UCLA's licensees (including the pricing of products), monitoring their performance and compliance with contract terms, and collecting royalties. He also prepares all reports to the UCLA's Administration on trademark and licensing matters and prepares special reports to interpret policy, anticipate future needs, and recommend policy changes. In short, Mr. Revoyr is responsible for all aspects of policy planning, management, and implementation of UCLA's extensive and successful nonprofit trademark licensing and merchandising program.

In addition to his duties at UCLA, Mr. Revoyr has been active in licensing industry affairs for many years,

and in April 1986 helped to found the Association of Collegiate Licensing Administrators, a professional educational organization with 71 university members. Mr. Revoyr also serves as consultant on trademark licensing to the Los Angeles Visitors and Convention Bureau, and designed its licensing program which operates in both the U.S. and Japan. He also advises many other universities on establishing trademark licensing programs.

3. Analysis of Pricing

CSI's objectives in setting prices and contribution rates and the review procedures through which all pricing proposals must pass. What follows, as the Service requested, is a detailed analysis of purchasing and pricing information with respect to a representative book, E-Meter and item of jewelry. This analysis, which draws from the opinions of these leading experts, establishes that prices are not set to maximize profits.

In reviewing the foregoing analysis, the Service should bear in mind that it only summarizes the basic facts and the experts' extensive analyses pertaining to the particular book, E-Meter and item of jewelry involved. The details of all facts and the complete expert analysis are contained in or attached to the affidavit each expert prepared. This information is too detailed to include in the body of the text so it is hereby incorporated by reference. CSI urges the Service to turn to these affidavits if it desires to review the actual data on which this summary is based.

CSI also would like to inform the Service of the extensive effort necessary to compile information necessary to answer the Service's questions on the pricing

and profits. The data on pricing CSI maintains is not the same as the data maintained by other for-profit and nonprofit publishing organizations. The financial system CSI and Bridge maintain to account for receipts and expenditures with respect to its books, E-Meters and jewelry is geared to reflect data related to its religious programs -- not "profits" as that term is commonly used throughout the publishing industry. For example, CSI staff and its representatives had to work with the experts extensively over a period of three to four months in order to develop figures to parallel those used by other nonprofit and for-profit publishers.

The Service's questioning, as innocuous as it may have seemed to Service representatives, in point of fact, severely disrupted the ecclesiastical management of a very important facet of the Church's religious activities. It also cost the Church a great deal of money to identify, compile and analyze the requested data. As a result, the religion of Scientology suffered a significant loss.

CSI and RTC protest this abhorrent and excessive governmental entanglement in their religious affairs. While the information requested is being provided in order

to protect, their tax exemptions, this disclosure does not constitute a waiver of their rights under the First Amendment.

a. Books

The Service asked for purchasing and pricing information for a representative book. Since CSI publishes books that fall into three general price ranges -- inexpensive, moderately priced and expensive -- CSI decided it best to provide the Service one book representative of each price range. The books selected are: Dianetics: The Modern Science of Mental Health (softcover) ("DMSMH softcover"; Exhibit G-1) for an inexpensive book, Dianetics: The Modern Science of Mental Health (hardcover) ("DMSMH hardcover"; Exhibit G-2) for a moderately-price book, and Organization Executive Course Volume 0 ("OEC"; Exhibit G-3) for an expensive book.

DMSMH softcover is a mass-market paperback. It is considered the Scientology religion's primary method of dissemination to the general public. This book also is the genesis of most of the later religious writings and developments. It introduces readers to the basic tenets and philosophy underlying the Scientology faith and the religion's sacramental services. DMSMH softcover has a

suggested list price of \$4.95. To date, over 9 million copies have been sold. Unlike almost every other Scientology book, DMSMH softcover is primarily sold to the general public through commercial bookstores located throughout the country.*/

DMSMH hardcover differs from DMSMH softcover mainly in binding, typeface and quality of paper and other material and is designed to last many years as a permanent reference book. DMSMH hardcover is a textbook (like a college textbook) and is sold primarily through Church bookstores to Scientologists enrolled in religious training courses that use it as a course text. Almost all purchasers are members of the International Association of Scientologists ("IAS") and are entitled to a 20 percent discount from the suggested list price of \$25.

OEC is the first volume of a multi-volume treatise of Scriptural issues concerning the structure and organization of Scientology churches, the religion's ecclesiastical laws, and religious policies for the administration of Scientology Churches. Volume 0 contains

*/ Bridge sells about 82 percent of all copies of DMSMH (softcover) to trade bookstores and 18 percent to Church bookstores. The only other Scientology book sold through trade bookstores is Self-Analysis, which also is considered a primary dissemination method.

basic and introductory material with respect to organizational administration. OEC is a textbook which is sold exclusively through Church bookstores and primarily to Church staff, who are members of IAS and entitled to a 20-percent discount from the suggested list price of \$90. This book also is occasionally sold by Bridge directly to Sea Org members at a 50-percent discount from the suggested list price.

All these books are published by Bridge through commercial suppliers pursuant to a sublicense with NEP, which is licensed by the author, L. Ron Hubbard. (Exhibit G-4) Bridge has published these books in the United States since 1982 pursuant to two sublicense agreements. In the first agreement, dated June 8, 1982 (Exhibit G-5), NEP granted Bridge the nonexclusive right to publish all religious literary works Mr. Hubbard had written to date in the United States, Canada and Mexico (Bridge sells directly only in the United States and Canada). In exchange, Bridge agreed to pay NEP an initial lump-sum payment of \$150,000 and royalties at sliding rates of 11 percent to 16 percent of the retail price for hardcover books (OEC and DMSMH hardcover) and 9 percent to 13 percent of the retail price for mass market paperback books (DMSMH softcover).

This agreement was superseded by a March 15, 1983 agreement (Exhibit G-6), which maintained the same sliding scale of royalty rates. Subsequently, on February 1, 1985, Bridge and NEP amended the sublicense agreement (Exhibit G-7) to change the base for the royalty rates from the retail price to the lower (20 percent) IAS discounted price. The effect of this amendment was to reduce the amount of royalties payable under the arrangement.

The primary license agreement covering these three books during the period in question was entered into between Mr. Hubbard and NEP on June 1, 1982. This agreement granted NEP the nonexclusive right to publish all religious literary works Mr. Hubbard had written to date worldwide. In exchange, NEP agreed to pay Mr. Hubbard an initial lump-sum payment of \$225,000 (of which \$150,000 is attributable to Bridge) and 92 percent of all royalties NEP received from Bridge. NEP was entitled to retain 8 percent of the royalties it collected from Bridge as compensation for its obligations under the license agreement.*/

*/ While CSI and RTC have reserved discussion of benefit to Mr. Hubbard for Part II of their Supplemental Submission, it is worthwhile to point out at this time that both Mr. Ruh and Mr. Conland concluded that Mr. Hubbard's royalty rates were either reasonable or "consistent with," "substantially less than" or "substantially lower than" standard royalty rates for the publishing industry. See Exhibit G-9 at, ¶12 and Footnotes 2, 5 and 8; Exhibit G-8 ¶18.

Bridge sells books to Churches of Scientology (at an average discount of 60 percent of the suggested list price) or to retail bookstores (at an average discount of 50 percent of the suggested list price). Church bookstores sell almost exclusively to members of the International Association of Scientologists ("IAS"), who are entitled to a 20-percent discount from the suggested list price.

The costs, prices and profits of each book are:

	<u>DMSMH (Hardcover)</u>	<u>DMSMH (Softcover)</u>	<u>OEC</u>
<u>Bridge's Receipts:</u>			
List price	\$25.00	\$ 4.95	\$ 90.00
Discount (60 or 50%)	<u>15.00</u>	<u>2.47</u>	<u>54.00</u>
Receipts (wholesale price)	<u>\$10.00</u>	<u>\$ 2.48</u>	<u>\$36.00</u>
<u>Bridge's Costs:</u>			
Plant	\$.39	\$.00	\$.60
Manufacturing	2.49	.70	7.08
Overhead	1.87	.70	7.68
Royalty	<u>4.00</u>	<u>.64</u>	<u>14.40</u>
Total costs	<u>\$ 8.75</u>	<u>\$ 2.04</u>	<u>\$29.76</u>

Bridge's Operating Profit:

Net profit	\$10.00	\$ 2.48	\$36.00
Total costs	<u>8.75</u>	<u>2.04</u>	<u>29.76</u>
Operating profit	<u>\$ 1.25</u>	<u>\$.44</u>	<u>\$ 6.24</u>
Operating profit as a percentage of list price	<u>5%</u>	<u>9%</u>	<u>7%</u>
Operating profit as a percentage of receipts	<u>12.3%</u>	<u>12.5%</u>	<u>17.3%</u>

Bookstore operating profit:

Wholesale price	\$15.00	N/A	\$54.00
IAS discount (20% of list)	5.00		18.00
Sales commission (15% of IAS price)	3.00		10.80
Average freight	- <u>.74</u>		- <u>1.81</u>
Operating profit	<u>\$6.25</u>		<u>\$23.34</u>
Operating profit as a percentage of list price	<u>25%</u>		<u>26%</u>
Operating profit as a percentage of bookstore receipts	<u>42%</u>		<u>43%</u>

The two experts who reviewed CSI's pricing method and prices for the three representative books concluded that they are not designed to maximize profits. According to Mr. Ruh, the pricing method "is reasonable in light of the standards and practices of the publishing industry,

both nonprofit and for-profit." (Exhibit G-3 at ¶20) In fact, Mr. Ruh found that Bridge computes its overhead at rates lower than rates prevalent in the publishing industry, which is "likely to cause Bridge's retail book prices and profitability to be lower" and that Bridge "could justifiably raise its retail prices." (Id. at ¶22.)

Mr. Ruh analyzed the prices through profitability to Bridge, as the publisher. He found that Bridge's average net operating profit (its profit as a percentage of list price of nine percent on DMSMH softcover) was "reasonable and consistent with publishing industry standards." (Id. at ¶23.) Mr. Ruh concluded that Bridge's net operating profits of five percent on DMSMH hardcover and seven percent on OEC "are reasonable but are at the low end of the average net operating profit range for the textbook segment of the for-profit and nonprofit publishing industries." (Id.)

Mr. Ruh also analyzed the books' prices by the return on investment method ("ROI"), which is the most common method of analyzing profits in the publishing industry. (ROI is computed by dividing net operating profits per copy by the total costs -- plant, manufacture, overhead and royalties -- per copy of each book.) Under

this method, Mr. Ruh explains, both nonprofit and for-profit publishers seek a minimum standard of 10 percent for their return on investment. Bridge's ROI is much less comparatively -- only 3 percent for DMSMH hardcover, 4 percent for DMSMH softcover, and 7 percent for OEC. Mr. Ruh concluded:

Thus, it is my opinion that the prices for these representative books are very reasonable and in fact below the price that would be set if Bridge were seeking the industry's minimum standard return on investments.

Id. at ¶24.

Mr. Ruh plainly disagrees with the Service's unfounded assertion that prices are set to maximize profits. To the contrary, he found that prices would have to be raised "by a significant amount" to maximize profits, and even then prices would "still fit well within reasonable industry practices."

If the goal of Bridge and the Church of Scientology were to maximize profits from sales of books, the retail prices of DMSMH (hardcover and softcover) and OEC could be increased by a significant amount and still fit well within reasonable industry practices.

Id.

Mr. Conland took a different tack and analyzed prices and profits in terms of Bridge's profit as a percentage of its net return on sales and the discount

structure offered Church bookstores. He found that Bridge's profit as a percentage of its net sales of DMSMH softcover, which is 12.3 percent, is "within the range of average publishing industry profits for best-selling mass market paperbacks." (Exhibit G-9 at ¶16.)^{*/} He also found that Bridge's profit as a percentage of net sales of DMSMH (hardcover) and OEC, which are 12.5 percent and 17.3 percent, respectively, "also are consistent with average profits for textbooks in the publishing industry and are not excessive." (Id.)

Mr. Conland concluded that "Bridge's profits . . . and its book prices . . . are reasonable in light of the general practices and standards of the publishing industry," and that "the prices of these books are not set at an amount designed to maximize profits from their sales." (Id. at ¶7.)

^{*/} Mr. Conland calculated Bridge's net income for DMSMH Softcover as a percentage of gross sales (rather than net sales, as is the case for the hardcover books) because industry statistics for mass market, as paperbacks are based on gross sales (Exhibit G-9 at ¶14 and Footnote 1).

b. E-Meter

The Service has asked for purchasing and pricing information for an E-Meter. Since the Mark VI E-Meter (Regular Model) (hereinafter referred to as the "E-Meter") has had the most per unit sales for the period in question, it was selected as representative of E-Meter sales in general.

The E-Meter is used by Scientologists in receiving the principal sacrament of the Scientology religion and is sold by Churches of Scientology to individual Scientologists primarily through Church bookstores. Pursuant to Church policy, the bookstores sell E-Meters only to sincere students or fully-qualified Ministers of the Scientology religion who are members of IAS. The suggested list price of the E-Meter (Regular Model) is \$3,328.88. Its IAS discounted price is \$2,663.10.

The E-Meters are manufactured by Bridge, in its own facilities, and sold pursuant to a sublicense with NEP, which is licensed by the creator of the E-Meter, L. Ron Hubbard. Bridge has manufactured and sold E-Meters in the United States since 1982 pursuant to a sublicense agreement dated August 19, 1982 (Exhibit G-10). By this agreement, NEP granted Bridge the nonexclusive right to manufacture and sell the E-Meter (as well as the Mark V E-Meter) in the United States, Canada and Mexico (though

Bridge sells directly only in the United States and Canada). In exchange, Bridge agreed to pay NEP an initial lump-sum payment of \$30,000 and a royalty at the rate of 16 percent of the retail price. On February 1, 1985, Bridge and NEP amended the sublicense agreement (Exhibit G-11) to change the base for the royalty rates from the retail price to the lower IAS discounted price. The effect of this amendment was to reduce the amount of royalties payable under the arrangement.

The primary license agreement covering E-Meters during the period in question also was entered into between Mr. Hubbard and NEP on August 19, 1982. (Exhibit G-12) This agreement granted NEP the nonexclusive right to manufacture and sell Mark V and Mark VI E-Meters worldwide. In exchange, NEP agreed to pay Mr. Hubbard an initial lump-sum payment of \$60,000 (of which \$30,000 is attributable to Bridge) and 92 percent of all royalties NEP received from Bridge. NEP was entitled to retain 8 percent of the royalties it collected from Bridge as compensation for its obligations under the license agreement.*/

*/ While CSI and RTC have reserved discussion of benefit to Mr. Hubbard for Part II of their Supplemental Submission, it is worthwhile to point out at this time that both Mr. Smith and Mr. Alexander concluded that Mr. Hubbard's royalty rates are either reasonable or are "well within, and in fact below" or "significantly less than," standard rates payable to a patent owner. See Exhibit G-13 at ¶12, 16-17; Exhibit G-14 at ¶8, 11-12.

Bridge sells E-Meters to Churches of Scientology at a discount of 50 percent of the suggested list price for bulk purchases of 10 E-Meters. Church bookstores sell almost exclusively to IAS members who are entitled to a 20-percent discount from the suggested retail price.

The costs, prices and profits of the E-Meter are:

<u>Bridge's Net Profit:</u>	<u>Discounted</u>	<u>Retail</u>
Sales price	\$2,663.10	\$3,328.88
50% bulk discount on sale of 10 E-Meters to bookstores	- <u>1,331.55</u>	- <u>1,664.44</u>
Wholesale price received by Bridge	\$1,331.55	\$1,664.44
Royalties paid to NEP	426.10	532.62
Parts	347.15	347.15
Manufacturing cost	38.87	38.87
Operating costs	- 308.47	- 308.47
Net profit retained by Bridge	\$ <u>210.96</u>	\$ <u>437.33</u>
Amortized lump-sum payment*/	- <u>1.68</u>	- <u>1.68</u>
Effective net profit retained by Bridge	\$ <u>209.28</u>	\$ <u>435.65</u>
 <u>Church Bookstore Net Profit</u>		
Sales price	\$2,663.10	\$3,328.88
Wholesale price to Bridge	- <u>1,331.55</u>	- <u>1,664.44</u>
Gross profit to bookstores	<u>1,331.55</u>	<u>1,664.44</u>
Sales commission (5%)	133.16	166.44
Average shipping and insurance	- 3.67	- 3.67
Net profit retained by bookstores**/	\$ <u>1,194.72</u>	\$ <u>1,494.33</u>

*/ If the Bridge's \$30,000 lump-sum payment to Mr. Hubbard, through NEP, is spread over the 17,900 E-Meters expected to be sold before the agreement expires in July 2001, Bridge's profit is effectively reduced by \$1.68 per unit.

**/ The actual net profit retained by COS should be somewhat lower per unit than the amounts shown because, in addition to Bridge, Church bookstores also pay for the promotion of E-Meters. However, a per unit cost figure cannot be calculated accurately because the bookstores promote E-Meters, books, tapes, etc. from a single budget and often in the same materials.

The two experts who reviewed CSI's pricing method and prices for the E-Meter concluded that "the discounted and undiscounted retail prices of the E-Meter are reasonable in light of its production and delivery costs." Exhibit G-12 at ¶12; Exhibit G-13 at ¶8.

Mr. Smith and Mr. Alexander also concluded that the list price of the E-Meter (\$3,328.88) is reasonable based upon "the common manufacturing industry practice of setting retail prices at 300% to 400% above the total per unit cost of production and delivery." Specifically, the two experts found that the list price is about 385% over the per-unit production and delivery cost of \$864.60 (based on sales at the retail price). The experts also concluded that the IAS discounted price of the E-Meter (\$2,663.10) is reasonable because it is about 320% over the per-unit production and delivery costs of \$831.32 (based upon sales at the IAS price). (Exhibit G-12 at ¶24); (Exhibit G-13 at ¶19).

c. Jewelry

The Service also asked for purchasing and pricing information for a representative item of jewelry. Since the sterling silver Clear Bracelet (medium size) (the "Clear Bracelet") is one of the best selling jewelry items in terms of unit sales, it was selected as representative of jewelry sales in general. However, like all of the jewelry items sold through the Church bookstores, it is a low volume item and has sales of only about 500 units annually.

Clear Bracelets are sold only to Scientologists who have reached the Spiritual level known as "Clear," and may be purchased only through Church bookstores. The suggested retail price of the Clear Bracelet is \$138.00.

The Clear Bracelets bear a registered trademark originally owned by Mr. Hubbard, which he assigned in 1982 to the Religious Technology Center subject to his pre-existing license to NEP and NEP's sublicense to Bridge. Clear Bracelets are manufactured for Bridge by subcontractors and sold by Bridge pursuant to a sublicense with NEP dated January 2, 1986, but effective as of June 8, 1982, by which NEP granted Bridge the nonexclusive right to sell jewelry and other items bearing Scientology

trademarks originated by Mr. Hubbard. (Exhibit G-15) In exchange, Bridge agreed to pay NEP a royalty at the rate of 11 percent of the list price.

The primary license agreement covering the Clear Bracelet during the period in question was entered into between Mr. Hubbard and NEP on May 28, 1982. (Exhibit G-16) This agreement granted NEP the nonexclusive right to sell jewelry and other items bearing Scientology trademarks originated by Mr. Hubbard worldwide. In exchange, NEP agreed to pay Mr. Hubbard the entire 11% royalty (based on the list price) received from Bridge.

Although the Hubbard/NEP license and the NEP/Bridge sublicense require the payment of a royalty of 11% of the list price of jewelry items (such as the Clear Bracelet), until March 1987 Bridge was erroneously paying NEP 16% of the IAS price, and NEP was paying Mr. Hubbard 15% of the IAS price, pursuant to earlier licenses to Bridge's and NEP's predecessors that have now been superseded. Bridge and NEP have been paying royalties at the rate of 11% of the IAS price, rather than the list price, since March

*/ While CSI and RTC have reserved discussion of benefit to Mr. Hubbard for Part II of their Supplemental Submission, it is worthwhile to point out that Mr. Revoyr concluded that Mr. Hubbard's royalty rates are reasonable. See Exhibit G-17 at 116, 11.

1987 because that is the price at which the Clear Bracelets are actually sold in Church bookstores. (Mr. Hubbard's estate will be contacted to discuss recovery of any overpayment of royalties, or possible offset of future royalties by the overpaid amount.)

Bridge sells Clear Bracelets to Churches of Scientology at a discount of 30 percent of the IAS price. Church bookstores sell the Clear Bracelets exclusively to IAS members who have reached the level of "Clear," who are entitled to a 20-percent discount from the suggested retail price.

The costs, prices and profits for the Clear Bracelet are:

Bridge's Profit:

Retail list price		\$138.00
Discount to IAS Members (20%)		- 27.60
Discounted retail price		<u>110.40</u>
Church bookstore gross receipts (30% discount)		- 33.12
Wholesale price charged by Bridge		<u>\$ 77.28</u>
Per Unit Cost	\$ 46.00	
Royalty (16%)	17.66	
Operational Overhead (estimated)	<u>5.00</u>	
Total Cost		- 68.66
Net profit		<u>\$ 8.62</u>

Church Bookstore's Profit:

Gross receipts on IAS price	33.12
Sales commission (15% of sales price)	- 16.56
Net profit	<u>\$ 16.56</u>

Jack R. Revoyr reviewed CSI's pricing method for the Clear Bracelet and concluded that "the price of the Clear Bracelet has not been set to maximize Bridge's profit." Exhibit G-17 at ¶9. According to Mr. Revoyr, Bridge's discounted and undiscounted prices for the Clear Bracelet are "substantially lower than average . . . prices for comparable items of jewelry." (Id. at ¶11)

Moreover, Mr. Revoyr concluded that Bridge's pricing method "results in an abnormally low price" for the Clear Bracelet, and that "if Bridge's goal in pricing the Clear Bracelet were to maximize profits, it could raise its price by a very significant amount." (Id.) Specifically, Mr. Revoyr observed that the IAS price for the Clear Bracelet is only about 50% over Bridge's wholesale price (\$77.28), even though "jewelry of this type is typically priced at a rate of 200-300% over the wholesale price." (Id. at ¶9)