

TESTIMONY
OF
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BEFORE THE SUBCOMMITTEE ON
INTELLECTUAL PROPERTY, COMPETITION AND THE INTERNET
COMMITTEE THE JUDICIARY
UNITED STATES HOUSE OF REPRESENTATIVES

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Mr. Chairman and Members of the Subcommittee, thank you for the opportunity to appear before you today to testify on issues relating to music licensing.

I currently serve as a Managing Director at Navigant Economics, a Visiting Scholar at the American Enterprise Institute and an adjunct professor at George Mason University Law School, where I teach the course on Regulated Industries. In all of these capacities, and for much of the past two decades, I have written about and taught on topics relevant to the subject of today's hearing. While some of the research upon which my testimony today is based was supported in part by the musicFIRST coalition, I am appearing today solely on my own behalf, and the views I will express are exclusively my own.

My testimony today focuses on the sound recording performance right and, in particular, on what is commonly referred to as the digital performance right.¹ As the Subcommittee knows well, until recently, owners of sound recording performance rights were granted reproduction and distribution rights, but – unlike the holders of musical work rights – were not granted a performance right. Thus, copyright holders of sound recordings could monetize the copying and distribution of their recordings, but could not charge for “performances,” such as when radio stations (or webcasters) played copyrighted music. In the absence of such a property right, naturally, there was no market for sound recording performances.

Beginning with passage of the Digital Performance Right in Sound Recordings Act (DPRA) in 1995,² Congress has moved gradually in the direction of both creating performance rights and putting in place the conditions to allow such rights to be traded at market (that is, economically efficient) rates. The DPRA established the first sound recording performance right in the form of the digital performance right. Then, in the 1998 Digital Millennium Copyright Act (DMCA), Congress established the principle that license terms and royalty rates would either be negotiated directly between the parties or, in the case of rights subject to a compulsory license, would “represent the rates and terms that would have been negotiated in the marketplace between a willing buyer and a willing seller.”³ Twice in recent years, this subcommittee has passed

¹ I have recently authored a study on the sound performance recording right which addresses many of the issues discussed herein. It is included in this written statement as Attachment A.

² *Digital Performance Right in Sound Recordings Act of 1995*, Pub. L. No. 104–39.

³ 17 U.S.C. § 114(f)(2)(B).

legislation that would have further advanced market-based principles by extending the sound performance right to the over-the-air broadcasts of terrestrial broadcasters.⁴

The central point of my testimony today is that Congress should continue to move in the direction of using market-based mechanisms for setting the terms and rates by which sound recording performance rights are licensed among rights holders and users. Equally important, it should resist entreaties to backslide by passing legislation that would replace the current market-based standard for royalty rates with one designed to tilt the playing field in such a way as to subsidize a particular class of copyright users.

I am referring, of course, to the proposed Internet Radio Fairness Act (IRFA, H.R. 6480/S. 3609). While the IRFA contains a number of provisions designed to tilt the rate-setting process in favor of copyright users and against copyright holders, at its core is its proposal to replace the market-oriented willing buyer/willing seller standard with the uneconomic, four-part standard under Section 801(b)(1) of the Copyright Act of 1976 (the “801(b) standard”). To do so would represent a significant step in the wrong direction, both because the rates likely to emerge from the rate setting process would be below those that would emerge from a competitive market, and thus reduce economic welfare, and because the “non-disruption” standard contained in Section 801(b)(1)(D) would create perverse incentives that are fundamentally at odds with the innovative, dynamic nature of the market for online music.

Specifically, replacing the willing buyer/willing seller standard with the 801(b) standard and making the other changes proposed by the IRFA would harm consumers for four primary reasons.

- (1) Market-based rates result in the efficient – i.e., consumer-welfare-maximizing – allocation of society’s resources, and the willing buyer/willing seller standard embodies the principle of market-based rates.
- (2) The lower rates that would result from the IRFA are not necessary to preserve a vibrant, growing market for online music, and would harm the market for content creation.
- (3) The non-disruption standard contained in Section 801(b)(1)(D) is fundamentally inconsistent market-based incentives for efficiency and innovation, especially in a dynamic market such as the market for digital music.
- (4) Adoption of the IRFA would distort the rate setting process and likely result in the further politicization of rate setting for sound performance rights.

Let me expand briefly on each reason.

First, market-based rates maximize consumer welfare by ensuring that society’s resources are directed to their highest valued uses. In a market-based economy like ours, prices serve as the key signaling mechanism telling economic actors how capital and labor should be directed to

⁴ See The Performance Rights Act of 2007 (H.R. 4789/S. 2500) and its successor, The Performance Rights Act of 2009 (H.R. 848/S. 379).

produce the products and services valued most highly by consumers at the lowest possible cost. Prices set above market-clearing levels result in too many resources being directed towards production, while at the same time too little of the resulting output is demanded by consumers. Prices set below market clearing levels have the opposite effect – too little is produced, and consumers are unable to procure the amount, or the quality, of products they desire.

As I detail in Attachment A, the willing buyer/willing seller standard has been implemented in such a way as to produce royalty rates consistent with those that would likely result from a freely functioning market. In particular, the arbitration bodies that have set rates in the major Webcaster proceedings have based their determinations on freely negotiated rates for analogous products, e.g., the rates for interactive services, which are not subject to a compulsory license. While no rate setting process is perfect, the procedures followed by the Copyright Arbitration Royalty Panel (in *Webcaster I*) and by the Copyright Royalty Board (in *Webcaster II* and *Webcaster III*) – which include opportunities for all sides to fully present their positions, supported by expert economic and industry testimony, as well as both administrative and judicial review – have likely yielded rates that reasonably approximate those that would have resulted from voluntary negotiations in a freely operating market, and thus are presumptively consumer-welfare-maximizing.

Second, while IRFA would almost certainly produce the lower royalty rates its supporters seek, there is no valid economic or public policy basis for forcing content providers to subsidize webcasters by charging them below-market rates. The market for online music is intensely vibrant and growing rapidly. Tens of thousands of new listeners are signing up to services like Pandora and Spotify every week, and existing listeners are using the services more and more intensely every year. Online advertising revenues are growing 30 percent per year, new firms are entering the market at a rapid pace, and existing firms are garnering billion dollar market valuations.

IRFA's leading supporter, Pandora, makes much of the fact that content acquisition accounts for a large proportion of its revenues, but in fact its content costs as a proportion of revenues are comparable to other, similar firms. For example, as I detail in the attachment, the proportion of revenues accounted for by content costs for Netflix and Pandora have been nearly identical over the last three years (2009-2011) for which data is available from both firms; indeed, for each of the last two years, Netflix has paid a higher proportion of its revenues for content acquisition than has Pandora.

Moreover, and crucially, the ratio of Pandora's content costs to its revenues is well within Pandora's control: To raise its revenues, it need only choose to sell additional advertising. As *The New York Times* reported recently, "Throughout the music industry there is a wide belief that Pandora could solve its financial problems ... by simply selling more ads."⁵

⁵ See Ben Sisario, "Proposed Bill Could Change Royalty Rates for Internet Radio," *The New York Times* (September 23, 2012) (available at <http://www.nytimes.com/2012/09/24/business/media/proposed-bill-could-change-royalty-rates-for-internet-radio.html>). See also Richard Greenfield, "Congress Should be Working to Raise Royalty Rates on Pandora, Not Lower Them," *BTIG Research* (September 24, 2012) (available at <http://www.btigresearch.com/2012/09/24/congress-should-be-working-to-raise-royalty-rates-on-pandora-not-lower-them/>) ("[T]he reason why companies such as Pandora pay such high royalty rates as a percentage of revenues is because they severely limit audio advertising to protect the user experience and keep people on the platform. If Pandora ran several minutes of audio ads per hour (the way terrestrial radio does) vs. just a few 15 sec. spots, the %

Third, the Section 801(b)(1)(D) non-disruption standard would fundamentally distort the rate setting process by granting users a *de facto* right to perpetual profitability based on their current business models. Indeed, as I detail in the attachment, experts testifying on behalf of copyright users in the current *SDARS II* proceeding have argued that the non-disruption standard not only requires rates to be set so as to guarantee copyright users profits on their initial investments, apparently in perpetuity, but even to ensure that they can “recover the financial cost of capital for forward-looking investments,” since rates that fail to give users incentives to *continue* investing in their businesses would be “disruptive.”

In the dynamic world of online content delivery – in which new and improved business models are constantly replacing old, obsolete ones – the creation of what licensees argue is a *de facto* right to perpetual profitability is a recipe for technological and marketplace stagnation.⁶

Fourth, and finally, both the act of passing the IRFA and a number of its specific provisions would distort the rate setting process and likely result in the further politicization of rate setting for sound recording performance rights. As I detail in the attachment, a number of the IRFA’s specific provisions, including the changes it would make to the appointment process and qualifications of the copyright royalty judges, would threaten to reduce the objectivity and independence of the CRB.

More broadly, it is a truism that all market participants would prefer to pay lower prices for their inputs – car manufacturers would like to pay less for steel, gas stations less for gas and soft drinks, aluminum plants less for electricity. In the absence of market failures, however, market forces ensure that the prices paid for such inputs are, to paraphrase Goldilocks, neither too high nor too low, but “just right.” The politicization of pricing decisions, on the other hand, results in prices which favor the actors with the greatest capacities for political influence. In this case, Congress should not allow the fact that webcasters have the demonstrated capacity to generate a large volume of emails from their listeners to lead to a result that would, in the end, harm those very same consumers by retarding innovation and destroying incentives for content creation.

* * *

Mr. Chairman and Members of the Subcommittee, that completes my testimony. I look forward to any questions you may have.

of revenues paid out as royalties would be dramatically lower and would be more in line with satellite radio or cable TV. Interestingly, Spotify’s radio product runs substantially more advertising per hour than Pandora.”).

⁶ By contrast, as the D.C. Circuit explained in reviewing the *Webcaster II* decision, the willing buyer/willing seller standard does not require rates to be set so as to preserve inefficient business models. See *Intercollegiate Broadcast System v. Copyright Royalty Board* 574 F. 3d 748, 761 (D.C. Cir. 2009) (“[I]t was not error for the Judges to reject the small commercial webcasters’ pleas that paying per performance would wreck their inefficient business models. The Judges made clear they could not ‘guarantee a profitable business to every market entrant.’ *The Judges are not required to preserve the business of every participant in a market.*”) (emphasis added).

The Sound Recording Performance Right at a Crossroads: Will Market Rates Prevail?

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Starting in the 1990s, Federal policy has moved in the direction of a market-oriented approach towards sound recording rights, beginning with Congress' decision to create a sound recording performance copyright in 1995. In 1998, Congress provided that most statutory royalty rates, including the rates paid by webcasters like Pandora Radio, would be set using a market-based "willing buyer, willing seller" (WBWS) standard. Since then, the WBWS standard has been applied in several rate setting proceedings, but complaints from webcasters that the rates were "too high" have led to Congressional intervention and, ultimately, to adoption of rates below market levels. Now, as a new rate setting cycle is about to get underway, webcasters have begun lobbying Congress to replace the WBWS standard with a new version of the so-called 801(b) standard, which promises copyright users a right of "non-disruption." Adoption of the 801(b) standard – and the other changes favored by the webcasters – would result in rates below economically efficient levels, thereby distorting markets, slowing innovation and harming consumers. This paper examines the market for sound recording performance rights, concluding that Congress should resist webcasters' pleas for regulatory favoritism and instead continue moving towards a market-oriented approach, starting with extending the sound performance right to terrestrial radio.

| | | |
|------|--|----|
| I. | INTRODUCTION | 2 |
| II. | THE SOUND RECORDING PERFORMANCE RIGHT: A BRIEF HISTORY | 4 |
| | A. <i>The Digital Performance Rights Act</i> | 5 |
| | B. <i>The Digital Millennium Copyright Act</i> | 7 |
| III. | THE SOUND RECORDING PERFORMANCE RIGHT IN PRACTICE | 9 |
| | A. <i>Webcaster Rates and the Willing Buyer/Willing Seller Standard</i> | 10 |
| | 1. <i>Webcaster I</i> | 11 |
| | 2. <i>Webcaster II</i> | 15 |
| | 3. <i>The Webcaster Settlement Act and the 2009 Compromise</i> | 17 |
| | 4. <i>Webcaster III</i> | 18 |
| | B. <i>Section 801(b) and the "Non-Disruption" Standard</i> | 20 |
| | 1. <i>Early Interpretations of the 801(b) Standard</i> | 21 |
| | 2. <i>SDARS I</i> | 22 |
| | 3. <i>SDARS II</i> | 23 |
| IV. | BEYOND THE NON-DISRUPTION STANDARD: THE PROPOSED INTERNET RADIO FAIRNESS ACT AND THE MARKET FOR ONLINE MUSIC | 25 |
| | A. <i>The IRFA Would Dramatically Tilt the Rate Setting Process in Favor of Webcasters</i> | 25 |
| | B. <i>The IRFA is Not Necessary to Ensure a Vibrant Market for Online Music</i> | 27 |
| | C. <i>The IRFA Would Exacerbate Market Distortions, Reduce Incentives to Create Content, Slow Innovation, and Harm Consumers</i> | 36 |
| VI. | SUMMARY AND POLICY RECOMMENDATIONS..... | 38 |

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I. INTRODUCTION

Until 1995, the principal protection afforded to holders of sound recording copyrights were rights of reproduction and distribution. Thus, copyright holders of sound recordings could monetize the copying and distribution of their recordings, but could not charge for “performances,” such as when radio stations played copyrighted music. In the absence of such a property right, naturally, there was no market for sound recording performances.¹

Beginning with passage of the Digital Performance Right in Sound Recordings Act (“DPRA”) in 1995, Congress has moved gradually in the direction of both creating performance rights and putting in place the conditions to allow such rights to be traded at market (that is, economically efficient) rates. The first sound recording performance right, for certain digital performances, was created by DPRA, which also created a compulsory license for nonexempt, non-interactive, digital subscription transmissions. In 1998, Congress expanded the compulsory license to additional digital performances in the Digital Millennium Copyright Act (“DMCA”). As a result, for some rights, particularly “interactive” services, buyers and sellers bargain freely over rates and conditions. However, “non-interactive” services (i.e., radio-like “streaming” services), may take advantage of a compulsory license: Buyers and sellers have the option of negotiating voluntary agreements (which is generally done on an industry-wide basis), but if they fail to do so, sellers are required to license rights at government-determined “statutory” rates.

In this context, the criteria for setting statutory rates are obviously important. For most non-interactive services, the DMCA established a “willing buyer/willing seller” (“WBWS”) standard, which is intended to set rates at the level that would have been reached in a voluntary, marketplace negotiation. In practice, as implemented by Copyright Arbitration Royalty Panels (“CARP”) and later by the Copyright Royalty Board (“CRB”), the WBWS standard has resulted in a market-oriented approach to setting rates.

In adopting the WBWS standard, Congress chose to reject the previous, less market-oriented standard used in the DPRA, namely a four-part test under Section 801(b) of the 1976 Copyright Act. Unlike the WBWS standard, the 801(b) approach requires regulators to take into account non-market based criteria in setting royalties for statutory licenses, including specifically to set rates so as to protect licensees against any “disruptive” effects that might be caused by paying royalties – no matter how market-oriented they may be. Thus, the 801(b) standard arguably grants licensees a *de facto* right to perpetual profitability, allowing licensees to argue that they and their business models have a right to be protected from “disruption.” In the dynamic world of online content delivery – in which new and improved business models are constantly replacing old, obsolete ones – the creation of such a right has obvious negative consequences for innovation.

Fortunately, the 801(b) standard currently applies to only a handful of companies, which were “grandfathered” when the DMCA was adopted. Thus, royalties for all other sound recording performance rights are established either through direct market negotiations among the parties or, for compulsory licenses,

¹ Here and elsewhere in this paper, I use the term “property right” in the colloquial sense, that is, as the right to right to exclude others from using a good.

under the market-oriented WBWS standard. Moreover, in recent years, Congress has shown substantial interest in bringing the one significant remaining area in which property rights are lacking – over-the-air performances by terrestrial broadcasters – under a market-oriented framework, by extending the sound recording performance right to such performances. In short, the recent history of the sound recording performance right has been clearly in the direction of a more market-oriented approach.

In mid-2012, however, legislation was introduced in both the House and Senate that would reverse the pro-market trend by replacing the WBWS standard with the less-market-oriented 801(b) standard for the compulsory licenses for sound recording performances. The Internet Radio Fairness Act (“IRFA”) (H.R. 6480 in the House, S. 3609 in the Senate) – which is supported by some webcasters (e.g., Pandora) – would require copyright judges to take into account whether market-based royalty rates might “disrupt” the business models of licensees. It goes without saying that the webcasters that support the bill expect the 801(b) approach would result in lower royalties than under the current market-based standard.

The IRFA does not stop, however, at imposing the anti-disruption standard on future royalty proceedings. It contains a series of additional measures, all designed to tilt the institutional playing field to the advantage of webcasters, including prohibiting the CRB from considering certain types of evidence and forcing it to ignore relevant precedents. As if to ensure that economics will play as small a role as possible in future CRB deliberations, the Act even removes the requirement that at least one of the three CRB judges have expertise in economics.

As I explain below, the arguments offered in support of the IRFA – that it is necessary to ensure a vibrant market for digital music, or that it will “level the playing field” by subjecting all digital music distributors to the same copyright regime – are unfounded. The market for digital music is growing by leaps and bounds, and the rapid growth of online advertising and wireless broadband, ensure that it will continue to do so. Webcasters are not paying “unreasonable” rates, and they are fully capable of paying market rates in the future. Moreover, imposing the 801(b) standard on webcaster royalty proceedings would not address the most serious imbalances in the current royalty regime, including the fact that over-the-air broadcasts by terrestrial broadcasters continue to be exempt altogether from the sound recording performance right.

The remainder of this paper is organized as follows. Section II presents a brief history of the sound recording performance right. Section III reviews the implementation of the WBWS and 801(b) standards by the CARP and the CRB, and explains why, in practice, the 801(b) standard is likely to result in below-market rates. Section IV explains why the rates established for non-interactive online music services under the WBWS standard are both efficient and “reasonable,” and details the harm to innovation, competition and consumers that would result from adoption of the 801(b) standard for all statutory royalty proceedings. Section V presents a brief summary and offers a few concluding thoughts. Specifically, it recommends that Congress return to the market-oriented path it started down in the 1990s, beginning with extending the sound performance right to terrestrial radio.

II. THE SOUND RECORDING PERFORMANCE RIGHT: A BRIEF HISTORY

Under Section 102 of the Copyright Act of 1976, there are two types of copyrights associated with recorded music.² The first copyright protects the musical composition (consisting of the notes and lyrics) written by the composer.³ This “musical work” copyright is typically held by a music publisher.⁴ The second type of copyright protects subsequent recordings of a given song by a particular artist.⁵ This “sound recording” copyright is typically held by the producer of the sound recording, most often a record label.⁶

Prior to 1995, there was an important distinction between the rights enjoyed by the owners of a musical work copyright and a sound recording copyright. The owner of a musical work copyright was also granted a “performance right,” which entitled her to compensation whenever her copyrighted work was performed or broadcast publicly.⁷ The owners of sound recording copyrights, however, were not granted a performance right.⁸ For example, when a radio station publicly broadcasts a song over the air, it pays a royalty to the holder of the musical work copyright, but not to the holder of the sound recording copyright.⁹ The principal protection afforded to owners of sound recording copyrights was a reproduction and distribution right, which granted

² See e.g., Library of Congress, Copyright Royalty Judges, *Digital Performance Right in Sound Recordings and Ephemeral Recordings, Final Rule and Order*, 72 FR 24084 (May 1, 2007) (hereafter *Webcaster II*).

³ *Id.*

⁴ See Kimberly L. Craft, “The Webcasting Music Revolution Is Ready to Begin, as Soon as We Figure out the Copyright Law: The Story of the Music Industry at War with Itself,” *Hastings Communications & Entertainment Law Journal* 24:1 (2001) 1-42 at 4 (hereafter *Craft 2001*).

⁵ See *Webcaster II* at 24086. (“The term ‘musical work’ refers to the notes and lyrics of a song, while a ‘sound recording’ results from ‘the fixation of a series of musical, spoken or other sounds. A song that is sung and recorded will constitute a sound recording by the entity that records the performance, and a musical work by the songwriter.’”) See also Brian Day, “The Super Brawl: The History and Future of the Sound Recording Performance Right,” *Michigan Telecommunications and Technology Law Review*. 16 (2009) 179-212 at 183 (“Sound recording copyrights, on the other hand, are normally owned by the artist or record label and protect the originality of the recording itself as distinct from the underlying written lyrics or melody.”).

⁶ See *Webcaster II* at 24086 (“Typically, a record label owns the copyright in a sound recording and a music publisher owns the copyright in a musical work.”) (citations omitted).

⁷ See *Craft 2001* at 4 (“If a performance of the musical work happens to be broadcast over the airwaves such as by a radio station, each play is also worth money, in the form of royalties, to the songwriter and publisher.”). See also Jeremy Delibero, “Copyright Arbitration Royalty Panels and the Webcasting Controversy: The Antithesis of Good Alternative Dispute Resolution,” *Pepperdine Dispute Resolution Law Journal* 5:1 (2005) 83-114 at 85 (hereafter *Delibero 2005*) (“Within the Copyright Act, [musical] copyright owners enjoy an exclusive right of public performance. The copyright owner may recover royalties anytime a third party publicly performs the work. A public performance includes both the musical work and the sound recording.... Unlike musical works, the owner of a sound recording (usually a record label) is not automatically entitled to performance royalties under the Copyright Act.”).

⁸ See *Webcaster II* at 24086 (“The performance right is granted to all categories of copyrighted works with one exception: Sound recordings. Thus, while the owner of a musical work enjoys the performance right, the owner of a sound recording does not.”).

⁹ See *Craft 2001* at 6 (“While radio broadcasters pay royalties to publishers and writers for use of the musical work, they have, however, never had to pay any sort of royalty or licensing fee to the actual record companies for use of the sound recording.”). See also *Intercollegiate Broadcast System, Inc., et al. v. Copyright Royalty Board*, 574 F.3d 748, 753 (D.C. Cir. 2009) (“The copyright owners of musical works, but not those of sound recordings, have long enjoyed exclusive rights to public performances of their works.”) (hereafter *Webcaster II Circuit Opinion*).

compensation for the physical reproduction and sale of sound recordings (and prevented the unauthorized reproduction and distribution of recordings).¹⁰ This reproduction right was beneficial to sound recording copyright owners prior to the 1990s, when recorded songs were primarily disseminated to consumers via the sale of physical records or CDs.¹¹ Broadcasters also argued that no performance right was necessary because radio airplay helped to promote the sales of sound recordings.¹²

A. *The Digital Performance Rights Act*

In the 1990s, the emergence of digital communications technologies and the growth of the Internet dramatically altered the music landscape.¹³ In addition to purchasing cassettes or CDs, or tuning into AM/FM radio, listeners could access music via digital satellite transmissions, Internet radio (“webcasters”), or cable music services.¹⁴ As digitally broadcast music began to take root, record labels, backed by both the Copyright Office and the Patent and Trademark Office, argued that the prevailing copyright structure would not adequately compensate owners of sound recording copyrights.¹⁵ Congress was concerned that “certain types of subscription and interactive audio services might adversely affect sales of sound recordings and erode copyright owners’ ability to control and be paid for use of their work,” as well as about the potential for further erosion in the future from “pay-per-listen, audio-on-demand, or ‘dial-up’ services for a particular recording or artist” (the so-called “celestial jukebox”).¹⁶ In response to these concerns, Congress enacted the Digital Performance Right in Sound Recordings Act in 1995.¹⁷

The DPRA granted the owners of sound recordings a right to compensation for performances of copyrighted works broadcast “by means of a digital audio transmission,” often referred to as the “digital performance right.”¹⁸ “Terrestrial” broadcasters (like AM and FM radio stations) that simulcast transmissions over the Internet were exempt. Non-subscription (ad-supported) services did not exist at the time.

While DPRA required digital music services to compensate copyright holders, it treated interactive services and non-interactive services very

¹⁰ See Sound Recording Act of 1971, Pub. L. 92-140, 85 Stat. 391 (1971).

¹¹ See *Craft 2001* at 5-6 (“Traditionally, the record companies have made money by selling copies of the sound recording, in form of vinyl albums, and later cassette tapes and CDs. The record companies then pay the musical artist a percentage of these sales (i.e., the artist’s royalties).”).

¹² See e.g., *Day 2009* at 184.

¹³ See *Delibero 2005* at 86-87.

¹⁴ *Id.* See also Eldar Haber, “Copyrights in the Stream: The Battle on Webcasting,” *Santa Clara Computer & High Technology Law Journal* 28:4 (2012) 769-813 at 773 (“Webcasting is a digital transmission of creative work over a network that results in the playing of the work, without storing a permanent copy at the recipient’s end.... Put simply, webcasting is listening to music or watching a video in ‘real time,’ instead of downloading a file and viewing or listening to it after the downloading is complete or at any other time.”).

¹⁵ See U.S. Senate, Committee on the Judiciary, *Digital Performance Right in Sound Records Act of 1995* (Report 104-128, August 4, 1995) at 11-15 (hereafter *DPRA Senate Report*).

¹⁶ *Id.*, at 15.

¹⁷ Public Law 104–39, 109 Stat. 336 (1995).

¹⁸ See *Beethoven.com LLC v. Librarian of Cong.*, 394 F.3d 939, 942 (D.C. Cir. 2005); see also *Webcaster II Circuit Opinion* at 753 and *Webcaster II* at 24086.

differently.¹⁹ Because interactive services provide the ability to listen to a given song “on demand,” thus obviating the need to purchase a physical copy of a sound recording, they arguably pose a more potent threat to music sales than non-interactive services (which are more akin to radio).²⁰ Thus, Congress established an exclusive copyright for interactive services, allowing rights holders to negotiate freely in the market for such rights.²¹

For non-interactive services (i.e., radio services or “webcasters”), on the other hand, DPRA created a compulsory license granting users full access to record companies’ libraries of sound recordings.²² Royalty rates could still be voluntarily negotiated by the parties, but if they failed to agree, rates were set through binding arbitration by a Copyright Arbitration Royalty Panel convened by the Librarian of Congress, subject to his review and a right to appeal to the D.C. Circuit Court of Appeals.²³

Notably for our purposes, DPRA borrowed the substantive criteria for arbitrated royalty rates from a pre-existing four-part standard found in section 801(b)(1) of the Copyright Act of 1976. Specifically, 801(b)(1) requires that royalty rates achieve four objectives:

- (A) Maximizing the availability of creative works to the public;
- (B) Affording copyright owners a fair return for their creative work and a fair income under existing economic conditions;
- (C) Reflecting the relative roles of the copyright owner and the copyright user in the product made available to the public with respect to relative creative contribution, technological contribution, capital investment, cost, risk, and contribution to the opening of new markets for creative expression and media;
- (D) Minimizing any disruptive impact on the structure of the industries involved.²⁴

As discussed below, the first three criteria, standing alone, imply a standard that is similar to the market-based WBWS standard. However, the fourth criterion, requiring “non-disruption,” reflects a departure from the principle of

¹⁹ See Matt Jackson, “From Broadcast to Webcast: Copyright Law and Streaming Media,” *Texas Intellectual Property Law Journal* 11 (2003) 447-498 at 456 (hereafter *Jackson 2003*).

²⁰ *Id.*

²¹ *Id.* See also *Day 2009* at 185.

²² See Amy Duvall, “Royalty Rate-Setting for Webcasters: A Royal(ly) Mess,” *Michigan Telecommunications Technology Law Review* 15 (2008) 267-295 at 270, n. 20 (“The statutory license is compulsory because the user of the copyrighted work need not get individual permission from the copyright holder; their permission is automatically given if the user complies with the requirements of the statute.”) (hereafter *Duvall 2008*). The requirements of the statutory licenses included limitations on the number of songs by a single artist or from a single album that could be played per hour, as well as a prohibition on releasing an advance playlist of upcoming songs. *Id.* at 271.

²³ *Id.*, at 271.

²⁴ 17 U.S.C. 801(b)(1). See also Copyright Royalty Board, Library of Congress, *Determination of Rates and Terms for Preexisting Subscription Services and Satellite Digital Audio Radio Services: Final Rule and Order*, 73 FR 4080 (January 24, 2008) at 4082 (hereafter *SDARS I*).

market-based rates in favor of protecting licensees from potentially “disruptive” changes in royalties. Today, only a handful of services remain subject to this anachronistic standard.

B. The Digital Millennium Copyright Act

The years immediately following passage of the DPRA saw the emergence of the Internet and the rapid growth of “streaming radio.” These new services were generally non-interactive and non-subscription, relying on advertising for revenue. Because advertising-supported services were not in existence at the time DPRA was passed, they were not covered by its compulsory license.²⁵ In 1998, Congress addressed this oversight by expanding the scope of the compulsory license as part of the Digital Millennium Copyright Act (“DMCA”).²⁶ The DMCA offered these new non-interactive services the benefit of a statutory license (rather than requiring these services to negotiate licenses with individual sound recording copyright owners).²⁷

The DMCA divided non-interactive digital audio services into two groups. The first group consisted of FCC-licensed satellite digital audio services (SDARS) that existed prior to July 31, 1998 (i.e., satellite radio companies Sirius and XM) and three subscription services: DMX, Music Choice and Muzak (called Pre-Existing Subscription Services, or PSS).²⁸ Under the DMCA, PSS and SDARS were “grandfathered” under the 801(b)(1) standard, under the theory that they had relied on the standard at the time.

The second group consisted of “new” digital subscription services and services making “eligible non-subscription transmissions,” which included Internet-only radio webcasters like Pandora and simulcasts of over-the-air broadcasts.²⁹ For these services, in the absence of a voluntary agreement between copyright holders and the webcasters, the DMCA directed that the rates for

²⁵ See *Day 2009* at 187. See also *Jackson 2003* at 457 (“At the time the [DPRA] was written, webcasting was a nascent technology. By 1998, webcasting had proliferated with hundreds of radio stations and webcasters streaming music on the Internet. As Congress prepared to pass the Digital Millennium Copyright Act, the RIAA successfully lobbied to insert language to the provisions of the DPRA to close the ‘loophole’ that prevented them from licensing non-subscription webcast performances.”). See further *Craft 2001* at 12 (“The new technology, along with its various Internet applications, spread quickly. Suddenly, online-only webcasters were streaming digital music over the Internet – not merely on the envisioned subscription basis like satellite and cable companies, but also on a non-subscription basis by means of paid advertisements, like ordinary radio programming.”).

²⁶ See *Webcaster II* at 24086.

²⁷ See *Craft 2001* at 15 (“This license would ease the burden of having to locate and pay all of the individual record companies that held the sound recording copyrights to the various musical selections transmitted...”).

²⁸ See *SDARS I* at 4080, n. 3 (“Section 114(j)(11) of the Copyright Act defines the term ‘preexisting subscription service’ to mean ‘a service that performs sound recordings by means of noninteractive audio-only subscription digital audio transmissions, which was in existence and was making such transmissions to the public for a fee on or before July 31, 1998...’). DMX was subsequently liquidated and its assets purchased by another company, and therefore lost its “grandfathered” status.

²⁹ See *Duvall 2008* at 272 (“The Digital Millennium Copyright Act (DMCA) addressed royalty payments for webcasters under Section 114. The DMCA adopted the statutory license for two types of webcasting: ‘preexisting subscription services’ and ‘eligible non-subscription services.’ These two categories included terrestrial radio stations’ online rebroadcasts as well as pure webcasters, but excluded providers who allowed users to download or select music of their choice.”).

statutory licenses and royalties should be set by the CARP to “represent the rates and terms that would have been negotiated in the marketplace between a willing buyer and a willing seller” (the “willing buyer/willing seller” standard, or “WBWS”).³⁰

As discussed further below, Congress has intervened directly in the setting of webcaster royalties twice since passage of the DMCA, both times by passing legislation favorable to webcasters. In 2002, it passed the Small Webcasters Settlement Act of 2002, which “encouraged” record labels to negotiate lower rates with small webcasters than had been set by the CARP in the *Webcaster I* proceeding. Then, in 2008 and 2009, it passed (and then extended) the Webcaster Settlement Act, which again “encouraged” rights holders to negotiate lower royalty rates, this time offering all webcasters a discount from the rates set by the CRB in its 2007 *Webcaster II* decision.³¹

Notably, neither the DPRA nor the DMCA extended the sound performance rights to the most prolific users of sound recordings, terrestrial radio stations. However, in the late 2000’s, Congress considered adopting legislation, the Performance Rights Act of 2007 (H.R. 4789/S. 2500) and its successor, the Performance Rights Act of 2009 (H.R. 848/S. 379), which would have extended the sound recording right to terrestrial radio, established a compulsory license for terrestrial radio stations, and adopted a single “fair market value” standard for all terrestrial broadcasters, cable, satellite and Internet services. Specifically, as passed by both the House and Senate Judiciary Committees, Section 2 of the Performance Rights Act instructed the CRB to establish statutory rates under the first three prongs of Section 801(b)(1), but rejected Section 801(b)(1)(D), the non-disruption standard.³² Based on CRB precedent, the first three prongs of the 801(b)(1) establish a market-based standard which is similar, if not identical, to the WBWS standard. Thus, the Performance Rights Act would thus have created

³⁰ See 17 U.S.C. § 114(f)(1) (pre-existing services) and 17 U.S.C. § 114(f)(2) (eligible non-subscription services and new subscription services). With respect to the WBWS standard, Congress directed that several considerations be taken into account. See 17 U.S.C. § 114(f)(2)(B) (“In determining such rates and terms, the copyright arbitration royalty panel shall base its decision on economic, competitive, and programming information presented by the parties—including (i) whether use of the service may substitute for or may promote the sales of phonorecords or otherwise may interfere with or may enhance the sound record copyright owner’s other streams of revenue from its sound recordings; and (ii) the relative roles of the copyright owner and the transmitting entity in the copyrighted work and the service made available to the public with respect to relative creative contribution, technological contribution, capital investment, cost, and risk.”); and Committee on the Judiciary, U.S. House of Representatives, *Section-by-Section Analysis of H.R. 2281* (105th Congress, 2d Session, September 1998) at 57-59.

³¹ In addition, in 2004, Congress passed the Copyright Royalty and Distribution Reform Act, (CRDRA) (Public Law 108-419), which implemented procedural changes favored by webcasters. Among other changes, the law replaced the *ad hoc* CARP panels with a three-judge Copyright Royalty Board. See e.g., *Congressional Record* 150;26 (March 3, 2004 at h762-h772 (available at http://capitolwords.org/date/2004/03/03/H762_copyright-royalty-and-distribution-reform-act-of-2/)). See also Robin Jeweler, *The Copyright Royalty and Distribution Reform Act of 2005*, Congressional Research Service (2004) (available at http://www.ipmall.info/hosted_resources/crs/RS21512_041216.pdf).

³² See e.g., Committee on the Judiciary, *Performance Rights Act (H.R. 848)* Report 111-680 (December 14, 2010) at 14 (“The section further establishes rate standard parity among terrestrial broadcasters, cable, satellite, and Internet services, by creating one rate standard for Copyright Royalty Judges (CRJs) to consider, regardless of the platform involved. The new standard will be the old 801(b) standard minus subpart (D)...”) (available at <http://www.gpo.gov/fdsys/pkg/CRPT-111hrpt680/pdf/CRPT-111hrpt680.pdf>).

a level playing field for all users of sound performance rights with rates set either through voluntary negotiations or, where necessary, through a statutory license based on a market-based standard.

III. THE SOUND RECORDING PERFORMANCE RIGHT IN PRACTICE

Since passage of the DPRA and DMCA, sound recording performance copyright holders and licensees have engaged in multiple rounds of negotiations over digital performance royalties, sometimes arriving at voluntary agreements, but more commonly settling rates through litigated proceedings before the CARP and its successor, the CRB.³³

Since 1998, there have been three full-blown copyright royalty proceedings for non-pre-existing digital music services under the WBWS standard (known as *Webcaster I*, *Webcaster II*, and *Webcaster III*); in addition, as noted above, there have been two direct statutory interventions, the Small Webcaster Settlement Act of 2002 and the Webcaster Settlement Acts of 2008 and 2009. As detailed in the first subsection below, the formal proceedings have involved extensive economic analysis, supported by literally dozens of industry and economic experts, with multiple layers of administrative and judicial review. While the results of these proceedings have in many regards favored webcasters, webcasters have nevertheless succeeded on more than one occasion in lobbying Congress to intervene in the process in favor of still lower rates. Thus the IRFA is merely the latest in a string of efforts by webcasters to have royalties set at below-market rates.

In addition to the three *Webcaster* proceedings, there have been two formal proceedings (*PSS I* and *SDARS I*) to set rates for PSS and SDARS, and a second (*SDARS II*) is underway. Rates in these proceedings have been set under the 801(b) standard and, as discussed in the second subsection below, demonstrate that the 801(b) standard has resulted in rates below market-based levels.

Table 1 presents a brief summary of the primary *Webcaster* and *SDARS* proceedings.³⁴

³³ In the meantime, of course, rights holders have also negotiated voluntary agreements with online interactive services, such as Spotify. As discussed below, these voluntarily negotiated rates have been used by the Copyright Royalty Board as the basis for setting compulsory license rates.

³⁴ The following review addresses the central issues in these proceedings and for copyright policy going forward, namely the terms and level of royalty rates for the primary sound performance right at issue. Each proceeding has also addressed a variety of ancillary issues, such as the rates for “ephemeral” recordings (which are digital copies made for the purpose of facilitating online music distribution), minimum fees applicable to smaller webcasters, the division of certain proceeds between studios and artists, and so forth. No effort is made here to present a complete or comprehensive treatment of these ancillary issues.

TABLE 1:
SELECTED RATE PROCEEDINGS, 1998-2012

| Term | Governing Standard | Proceeding | Decision Date | Appeal Complete | Final Statutory Rate | Royalty Metric |
|--|--------------------|---|---------------|-----------------|--|-----------------------------|
| <i>Non-Interactive Services</i> | | | | | | |
| 1998-2005 ³⁵ | WBWS | Webcaster I | Feb. 2002 | Jan. 2005 | 0.07¢ (1998-2002) | Per-performance |
| 2006-2010 | WBWS | Webcaster II | May 2007 | Jul. 2009 | 0.08¢ (2006) – 0.19¢ (2010) | Per-performance |
| 2006-2015 | WBWS | Webcaster Settlement Act Pureplay Rates | Jul. 2009 | n/a | Greater of 25% of revenues or 0.08¢ (2006) – 0.14¢ (2015) | Per-performance |
| 2011-2015 | WBWS | Webcaster III | Mar. 2011 | n/a | 0.19¢ (2011) – 0.23¢ (2015) | Per-performance |
| <i>Pre-existing Services (PSS and SDARS)</i> | | | | | | |
| 1996-2000 | 801(b) | PSS I | May 1998 | May 1999 | 6.5% | Percentage of gross revenue |
| 2007-2012 | 801(b) | SDARS I | Jan. 2008 | Jul. 2009 | 6% (2007) – 8% (2012) | Percentage of gross revenue |
| 2013-2017 | 801(b) | SDARS II | Ongoing | n/a | n/a | n/a |

A. Webcaster Rates and the Willing Buyer/Willing Seller Standard

As noted above, there have been three full-blown rate proceedings to establish rates for Internet-only webcasters and simulcasters since 1998. Each time, the adjudicating body (first a CARP, then the CRB) held extensive hearings, took testimony from numerous expert economic and industry witnesses, engaged in full briefing schedules, and issued a written decision explaining the basis for the resulting rates; and, each decision has been subject to appeal before the D.C. Circuit. Nevertheless, each decision has led to complaints by webcasters, who have lobbied Congress to intervene and set lower rates. Indeed, most webcasters today are paying royalty rates negotiated pursuant to the Webcaster Settlement Act of 2009, which are below the market-based rates

³⁵ Non-subscription webcasting rates for 1998-2002 were the result of the *Webcaster I* proceeding. See 67 FR 45240 (July 8, 2002) (affirmed in *Beethoven.com v. Librarian of Congress*, 394 F.3d 939 (D.C. Cir. 2005)). Rates for non-subscription webcasting for 2003-2004, and rates for subscription webcasting for 1998-2004, were settled. See 68 FR 23241 (May 1, 2003); see also 68 FR 27506 (May 20, 2003); 68 FR 50,493 (Aug. 21, 2003); 69 FR 5693 (Feb. 6, 2004); at 69 FR 8822 (Feb. 26, 2004). Rates for 2005 were the result of an extension of the 2004 rates in the Copyright Royalty and Distribution Reform Act. See Pub. L. No. 108-419 § 6(b)(3); 70 FR 6736 (Feb. 8, 2005) (terminating pending proceedings).

established by the CRB in the *Webcaster II* proceeding. This subsection describes the process by which webcaster rates have been established since 1998.

1. *Webcaster I*

The *Webcaster I* proceeding began on November 27, 1998, after a six-month voluntary negotiation period between webcasters and the RIAA resulted in a number of agreements between individual webcasters and the record companies, but failed to produce an industry-wide agreement.³⁶ In accordance with the DMCA, a CARP was convened to establish the rates and terms for a statutory license. Its report, recommending royalty rates for the period from October 28, 1998 through December 31, 2002, was released more than three years later, on February 20, 2002.³⁷

The CARP proceeding was extensive by any standard. It included a full cycle of direct and rebuttal testimony, with 49 economic and industry expert witnesses presenting direct testimony and 26 on rebuttal, as well as oral arguments and multiple rounds of briefs.³⁸ The resulting record was “one of the most voluminous records in CARP history,” including a written transcript of over 15,000 pages, many thousands of pages of exhibits, and over 1,000 pages of post-hearing submissions” by counsel.³⁹

In reaching its decision, the CARP grappled with and resolved a number of highly technical legal and economic questions, many of which were resolved in favor of webcasters. For example, under the statute, the CARP concluded that the WBWS standard was created to set rates and terms “that would have been negotiated” been a willing buyer and a willing seller in a “hypothetical marketplace” in which no compulsory licenses existed and rates were determined by negotiations between music services and copyright holders.⁴⁰ While the parties agreed that the willing “buyers” in this context were non-interactive digital music services, they disagreed as to the identities of the hypothetical “sellers.”⁴¹

The RIAA, representing the interests of the copyright holders (i.e., record companies), asserted that the seller in the hypothetical marketplace should consist of “a single collective of sound recording copyright owners (such as RIAA), offering a blanket license” for access to the sound record libraries of its

³⁶ See United States Copyright Office, Library of Congress, *Determination of Reasonable Rates and Terms for the Digital Performance of Sound Recordings and Ephemeral Recordings*; Final Rule, 67 FR 45240 (July 8, 2002) at 45241 (hereafter *Webcaster I*) (“These proceedings began on November 27, 1998, when the Copyright Office announced a six-month voluntary negotiation period to set rates and terms for the webcasting license and the ephemeral recording license for the first license period covering October 28, 1998–December 31, 2000. 63 FR 6555 (November 27, 1998). During this period, the parties negotiated a number of private agreements in the marketplace, but no industry-wide agreement was reached. Consequently, in accordance with the procedural requirements, the Recording Industry Association of America, Inc. (‘RIAA’) petitioned the Copyright Office on July 23, 1999, to commence a CARP proceeding to set the rates and terms for these licenses.”).

³⁷ See United States Copyright Office, Library of Congress, *In the Matter of Rate Setting for Digital Performance Right in Sound Recordings and Ephemeral Recordings, Report of the Copyright Arbitration Royalty Panel*, (February 20, 2002) (hereafter *2002 CARP Report*).

³⁸ *Id.*, at 11-15.

³⁹ *Id.*, at 18.

⁴⁰ *Id.*, at 21.

⁴¹ *Id.*

members.⁴² The music services, in contrast, argued that in a hypothetical marketplace where compulsory licenses did not exist, a single RIAA-like entity could not negotiate on record companies' behalf, because the antitrust exemption granted to RIAA that allowed it to bargain on behalf of the collective was conditional on the compulsory nature of the licenses at issue.⁴³ The services contended that a single RIAA-like entity in the hypothetical marketplace would wield market power sufficient to distort negotiations.⁴⁴ Instead, the services proposed that the "sellers" in the WBWS market be comprised of a "non-trivial number" of smaller collectives, offering blanket licenses in competition with one another.⁴⁵ Ultimately, the CARP rejected both proposals, concluding instead that the appropriate "sellers" in the hypothetical marketplace were neither a single collective nor a number of smaller collectives, but rather individual record companies, offering blanket licenses for each company's particular repertory of sound recordings.⁴⁶ From the perspective of the webcasters, this was a highly favorable result, as it meant that rates were based on the assumption that all copyright owners were competing against one another in the marketplace rather than being represented jointly by bargaining agents.

In addition, the CARP concluded that the WBWS standard did not necessitate any *ex post* adjustments of the royalty rates it determined based on the "additional factors" enumerated in Section 114(f)(2)(B), finding that these factors would already be "fully reflected in any agreements *actually negotiated* between webcasters and copyright owners in the relevant marketplace."⁴⁷

In the course of this extensive proceeding, RIAA and the music services presented competing proposals for determining royalty rates, each backed by expert testimony. RIAA proposed basing rates on the agreements negotiated between the RIAA and 26 separate webcasters during the voluntary bargaining period,⁴⁸ noting that those agreements involved "the same buyer, the same seller, the same right, the same copyrighted works, the same time period, and the same

⁴² *Id.*, at 21-22.

⁴³ *Id.*, at 23 ("We recognize that the hypothetical marketplace we seek to replicate would operate more efficiently, with lower transactional costs, if a single collective designated by the services could negotiate with a single collective designated by the record companies. Even if such negotiations were non-exclusive, Congress clearly perceived antitrust concerns with such an arrangement. Congress authorized antitrust exemptions respecting such negotiations *only* within the context of compulsory licenses.") (emphasis in original).

⁴⁴ *Id.*, at 22 ("The Services' perception of the sellers, in the hypothetical marketplace envisaged by Congress, is starkly different. They assert that RIAA's vision 'would eviscerate the protections sought by the Justice Department and implemented by Congress to prevent the exercise of market power [by the RIAA or the record companies].'").

⁴⁵ *Id.*

⁴⁶ *Id.*, at 44 ("We concluded above that the... hypothetical marketplace is one where the buyers are DMCA-compliant services, the sellers are record companies, and the product being sold consists of blanket licenses for each record company's repertory of sound recordings.")

⁴⁷ *Id.*, at 35 (emphasis in original).

⁴⁸ *Id.*, at 26, 38 ("The second foundational issue relates to the type of evidence that can most reliably be used for deriving the royalty rates we must determine in this proceeding. On this issue, the two sides present starkly different viewpoints. RIAA argues that the best available evidence of the rate which willing buyers and willing sellers would agree to can be found in the 26 agreements it actually negotiated with the licensees for the rights in question. The Services, on the other hand, contend that these agreements are fatally tainted in numerous respects and that willing buyer/willing seller rates are best derived from the thoughtful, theoretical model developed and explicated by Dr. Adam Jaffe, a distinguished economist.")

medium as those in the marketplace that the CARP must replicate.”⁴⁹ Webcasters, on the other hand, proposed rates derived from a theoretical model which attempted to estimate appropriate royalty rates for the *sound recording right* based on rates for *musical work performance rights* established between music publishers and over-the-air-radio broadcasters.⁵⁰

The CARP ultimately decided that the webcasters’ theoretical model was unreliable, in part because of intrinsic differences between the musical work performance right and the sound recording performance right.⁵¹ Moreover, it concluded, “the quest to derive rates which would have been negotiated in the hypothetical willing buyer/willing seller marketplace is best based on a review of actual marketplace agreements, if they involve comparable rights and comparable circumstances.”⁵² Taking multiple factors into account, the CARP concluded that while 25 of the 26 agreements that had been negotiated by RIAA were “unreliable benchmarks,”⁵³ the freely negotiated agreement with Yahoo! was “evidence of an entirely different character,”⁵⁴ reflecting “a truly arms-length bargaining process on a level playing field between two major players of comparable skill, size, and economic power.”⁵⁵ Thus, based largely on the Yahoo! agreement, the CARP set a statutory performance royalty rate of 0.14¢ per performance for Internet-only (“IO”) webcasters.

In adopting the per performance rate structure, the CARP rejected arguments that it should set rates as a percentage of licensees’ revenues. It found that the per-performance structure was superior because (1) a per-performance metric is directly reflective of the right being licensed; (2) percentage-of-revenue models are difficult to implement because relevant webcaster revenues are complex; and, (3) many webcasters are small and do not generate much revenue, so that the adoption of a percent-of-revenue model could result in copyright owners receiving little or no compensation for the use of their material.⁵⁶

The CARP also grappled with the issue of whether webcasters promoted music sales, especially in the context of radio retransmissions (i.e., copyrighted material contained in Internet retransmissions of broadcast radio signals). Based on “undisputed testimony that traditional over-the-air radio play has a

⁴⁹ *Id.*

⁵⁰ *Id.* at 28 (“Accordingly, Webcasters calculated their proposed per-performance and per-hour sound recording performance fee by extrapolation from the aggregate fees paid to ASCAP, BMI, and SESAC by over-the-air radio stations holding blanket performance licenses.”).

⁵¹ *Id.* at 40 (“The Panel is uncomfortable with many of these assumptions and the cumulative effect casts significant doubt on the reliability of the ultimate conclusions. The Panel finds that this theoretical construct suffers serious deficiencies.”).

⁵² *Id.* at 43.

⁵³ *Id.* at 60.

⁵⁴ *Id.* at 60.

⁵⁵ *Id.* at 61. *See also Duvall 2008* at 273-274 (“To determine the rates that would have been negotiated in the marketplace under the per performance model, CARP reviewed actual royalty agreements to comply with its statutory obligations under the DMCA. It found that the RIAA/Yahoo! agreement provided an appropriate benchmark for the rate-setting because it was the only RIAA-negotiated agreement ‘to reflect a truly arms-length bargaining process on a level playing field between two major players of comparable skill, size, and economic power.’”).

⁵⁶ *See 2002 CARP Report* at 36-37. The CARP also recommended a minimum royalty fee of \$500 per annum. *Id.*, at 95 (“The Panel concurs with the Services that one purpose of the minimum fee is to protect against a situation in which the licensee’s performances are such that it costs the license administrator more to administer the license than it would receive in royalties. Another arguable purpose is to capture the intrinsic value of a service’s *access* to the full blanket license, irrespective of whether the service actually transmits any performances.”) (emphasis in original)

tremendous promotional impact on phonorecord sales,” and the lack of any basis in the record for concluding that the impact of Internet simulcasts was any less significant,⁵⁷ the CARP set a (lower) Radio Retransmission (or “RR”) rate of 0.07¢.⁵⁸

As provided for under the DPRA, the CARP’s findings were reviewed by the Register of Copyrights and the Librarian of Congress (“LOC”). In its Final Rule and Order, released on July 8, 2002,⁵⁹ the LOC – after reviewing briefs filed by both sides – upheld the CARP’s determination regarding the definition of the participants in the relevant hypothetical marketplace,⁶⁰ but ruled that the CARP erred in setting a higher royalty rates for Internet-only webcasters than for radio retransmissions.⁶¹ While the LOC accepted that the RIAA’s agreements with webcasters served as a more reasonable benchmark than the webcasters’ proposed “theoretical model,” it lowered the IO webcasting rate from 0.14¢ per-performance to 0.07¢ per-performance⁶² (to match the royalty rate for RR entities).⁶³ Thus, the LOC cut the per-performance rate set by the CARP for pureplay webcasters, which was based on the actual rate agreed to by RIAA and Yahoo!, by 50 percent.

The LOC’s decision also contained important language concerning the distinction between the 801(b) and WBWS standards. The two standards, it concluded, “are not the same.” Rather, the 801(b) standard is “policy-driven, whereas the standard for setting rates for nonsubscription services set forth in section 114(f)(2)(B) is *strictly fair market value* – willing buyer/willing seller. Thus, any argument that the two rates should be equal as a matter of law is without merit.”⁶⁴

The LOC’s ruling was upheld on appeal by the D.C. Circuit Court of Appeals.⁶⁵ However, even before the appeal was decided, Congress – heeding complaints from small webcasters that the rates (even after being cut in half by the LOC) were too high, stepped in by passing the Small Webcasters Settlement Act of 2002 (SWSA),⁶⁶ which “gave noncommercial and small commercial

⁵⁷ *Id.*, at 74-75.

⁵⁸ *Id.*, at 77.

⁵⁹ *See Webcaster I.*

⁶⁰ *Id.*, at 45244-45.

⁶¹ *Id.*, at 45243 (“After carefully considering the Panel’s report and the record in this proceeding, the Register has concluded that the rates proposed by the Panel for use of the webcasting license do not reflect the rates that a willing buyer and willing seller would agree upon in the marketplace. Therefore, the Register has made a recommendation that the Librarian reject the proposed rates (\$0.14 per performance for Internet-only transmissions and \$0.07 per performance for radio retransmissions) for the section 114 license and substitute his own determination (0.07¢ per performance for both types of transmissions), based upon the Panel’s analysis of the hypothetical marketplace, and its reliance upon contractual agreements negotiated in the marketplace.”).

⁶² *Id.*

⁶³ *See Duvall 2008* at 275-276 (“However, the Librarian disagreed with CARP and found that there was no basis for differentiating between royalty rates for Internet-only webcasters and webcasters who retransmitted radio broadcasts and that CARP’s decision to distinguish between them was arbitrary.”).

⁶⁴ *See Webcaster I* at 45244 (emphasis added).

⁶⁵ *See Beethoven.com LLC v. Librarian of Cong.*, 394 F.3d 939 (D.C. Cir. 2005).

⁶⁶ Public Law No. 107-321. *See also* Committee on the Judiciary, *The Webcaster Settlement Act of 2009* (Report 111-139, June 8, 2009) at 2.

webcasters additional time to negotiate,”⁶⁷ and expressed to copyright owners “the strong encouragement of Congress to reach an accommodation with the small webcasters on an expedited basis.”⁶⁸ Shortly thereafter, the small webcasters reached a compromise agreement with RIAA setting royalty rates that were capped as a percentage of small webcasters’ revenues or expenses rather than calculated on a per-performance basis.⁶⁹

2. *Webcaster II*

The next statutory license proceeding for webcaster royalty rates, covering the period 2006-2010, established rates through another formal rate proceeding, this one lasting more than two years, from February 2005 until May 2007,⁷⁰ this time under the purview of the Copyright Royalty Board (CRB), the successors to the CARP panel.⁷¹ The *Webcaster II*, proceeding again involved direct and rebuttal testimony from dozens of expert witnesses, including formal hearings, hundreds of motions and pleadings, and over 13,000 pages of transcripts.⁷²

As in *Webcaster I*, the CRB evaluated several proposed benchmarks for royalty rates proposed by copyright owners and webcasters, again embracing an approach based on rates for comparable rights which had been negotiated freely in the marketplace. Specifically, the CRB embraced a model proposed by SoundExchange’s economic expert, Dr. Michael Pelcovits. Termed the “Interactive Webcasting Market Benchmark,”⁷³ the model utilized the royalty rates negotiated individually between copyright owners and interactive music services (adjusted for differences in interactivity) as a basis for royalties for non-interactive services under compulsory licenses.⁷⁴ Based largely on the interactive services benchmark, the CRB set per-performance rates at 0.08¢ for 2006, rising gradually to 0.19¢ in 2010, as shown in Table 2.⁷⁵ Thus, under *Webcaster II*, the statutory rate was scheduled to reach the 0.14¢ per performance rate initially

⁶⁷ See *Day 2009* at 188-189.

⁶⁸ Public Law No. 107-321, Section 2(3) (“The representatives have arrived at an agreement that they can accept in the extraordinary and unique circumstances here presented, specifically as to the small webcasters, their belief in their inability to pay the fees due pursuant to the July 8 order, and as to the copyright owners of sound recordings and performers, the strong encouragement of Congress to reach an accommodation with the small webcasters on an expedited basis.”).

⁶⁹ See Librarian of Congress, *Notification of Agreement Under the Small Webcaster Settlement Act of 2002*, 67 FR 78510 (Dec. 24, 2002). Rates were set at 10 percent of revenues up to \$250,000, 12 percent of revenues above \$250,000, or seven percent of expenses, whichever was greater.

⁷⁰ See, generally, *Webcaster II*. See also Library of Congress, Copyright Royalty Judges, *Digital Performance Right in Sound Recordings and Ephemeral Recordings, Notice Announcing Commencement of Proceeding*, 70 FR 7970 (February 16, 2005).

⁷¹ In the interim, Congress had passed the Copyright Royalty and Distribution Reform Act in 2004 which replaced the *ad hoc* CARP panels with a permanent Copyright Royalty Board. See Public Law 108-419.

⁷² See *Webcaster II* at 24085 (“In addition to the written direct statements and written rebuttal statements, the Copyright Royalty Judges heard 48 days of testimony, which filled 13,288 pages of transcript, and 192 exhibits were admitted. The docket contains 475 entries of pleadings, motions and orders.”).

⁷³ *Id.*, at 24092.

⁷⁴ See *Duvall 2008* at 279. The CRB also concurred in the *Webcaster I* determination that the preferred metric for calculating statutory royalties is a per-performance model, as opposed to royalties based on a percentage-of-revenue. See *Webcaster II* at 24089-90.

⁷⁵ See *Webcaster II* at 24096.

recommended by the CARP (in *Webcaster I*) for 1998 in 2008 – i.e., a decade later than under the original CARP report.

TABLE 2:
STATUTORY ROYALTY RATES FOR COMMERCIAL
WEBCASTERS UNDER WEBCASTER II

| Year | Per-Performance Royalty |
|------|----------------------------|
| 2006 | \$0.0008 |
| 2007 | \$0.0011 |
| 2008 | \$0.0014 |
| 2009 | \$0.0018 |
| 2010 | \$0.0019 |

Source: 72 FR at 24096.

The CRB’s decision was appealed to the D.C. Circuit Court of Appeals, in *Intercollegiate Broadcast System v. Copyright Royalty Board*.⁷⁶ The Court upheld the CRB’s determination of royalty rates for commercial webcasters, including specifically its decision to base royalties on the market-based interactive services benchmark.⁷⁷ The Court also rejected webcasters’ assertions that the rates set by the CRB were “crushing and disproportionate,”⁷⁸ and found in any case that the WBWS standard does not require to the CRB to set rates that allow all firms in the market to earn a profit:

Finally, it was not error for the Judges to reject the small commercial webcasters’ pleas that paying per performance would wreck their inefficient business models. The Judges made clear they could not “guarantee a profitable business to every market entrant.” The Judges are not required to preserve the business of every participant in a market. They are required to set rates and terms that “most clearly represent the rates and terms that would have been negotiated in the marketplace between a willing buyer and a willing seller.” 17 U.S.C. § 114(f)(2)(B). If small commercial webcasters cannot pay the same rate as other willing buyers and still earn a profit, then the Judges are not required to accommodate them.⁷⁹

Thus, the court ruled, while webcasters are guaranteed access to sound recording performance rights under a compulsory license, Congress did not extend to them a right to perpetual profitability.

⁷⁶ See 574 F. 3d 748 (D.C. Cir. 2009).

⁷⁷ *Id.*, at 758.

⁷⁸ *Id.*, at 760. The Court did, however, vacate the \$500 minimum fee for both commercial and non-commercial webcasters, remanding those portions of the CRB’s ruling for reconsideration. *Id.*, at 762.

⁷⁹ *Id.*, at 761.

3. *The Webcaster Settlement Act and the 2009 Compromise*

As with *Webcaster I*, many webcasters reacted negatively to the *Webcaster II* decision.⁸⁰ Pandora and others claimed that the CRB's royalty rates would push webcasters to the verge of collapse,⁸¹ with Pandora asserting that the CRB rates would force it to pay almost 70 percent of its revenues in performance royalties.⁸²

As in 2002, Congress reacted sympathetically to webcasters' complaints,⁸³ this time by passing the Webcaster Settlement Act of 2008 and later the Webcaster Settlement Act of 2009 (together, the "WSAs"). Modeled on the Small Webcaster Settlement Act of 2002, the WSAs expressed to copyright owners "the strong encouragement of Congress to reach an accommodation with the webcasters on an expedited basis,"⁸⁴ and provided a window of time in which to do so.⁸⁵ Not surprisingly, rights holders entered into negotiations with webcasters over lower rates, reaching eight separate agreements (containing a total of 12 royalty schedules) with different segments of the webcasting market (e.g., non-commercial webcasters, non-commercial educational webcasters, pureplay webcasters, etc.) in late 2008 and early 2009. The new rates, which were available to qualified webcasters on an opt-in basis, overrode the market-based *Webcaster II* rates established by the CRB for webcasters that elected the alternate rates, and generally covered the 10-year period from 2006-2015.⁸⁶ Table 3 shows the alternate schedule of rates for Pureplay webcasters, which are substantially lower than the rates determined by the CRB in *Webcaster II*. For example, the royalty rate per-performance under *Webcaster II* in 2010 would have been 0.19¢, while the WSA Pureplay rate is only 0.097¢. And, the 0.014¢ originally scheduled under *Webcaster I* to take effect in 1998, and delayed under *Webcaster II* until 2008, was pushed back another seven years, until 2015.

⁸⁰ See e.g., *Duvall 2008* at 283.

⁸¹ See *Day 2009* at 190-191 ("The reaction to the CRB rates was immediate and dramatic. Small and large webcasters alike predicted the CRB rates would result in the 'end of Internet Radio.' For instance, Pandora Internet Radio ("Pandora"), the largest and most successful online music webcaster, maintained that it was 'on the verge of collapse' as a result of the new rates.").

⁸² *Id.*

⁸³ See Elahe Izadi, "Pandora Growing Up Washington Style," *National Journal* (July 9, 2012) (available at <http://influencealley.nationaljournal.com/2012/07/pandora-all-grown-up.php>).

⁸⁴ See Small Webcasters Act of 2002 as modified by Webcaster Settlement Act of 2008 (available at <http://www.copyright.gov/legislation/pl107-321.pdf>).

⁸⁵ See The Webcaster Settlement Act of 2008, Pub. L. No. 110-435, 122 Stat. 4974. The original deadline for negotiations, February 15, 2009, was extended through July 2009 by the Webcaster Settlement Act of 2009. See also statement of Senator Patrick Leahy, *Congressional Record* (June 17, 2009) at S6740 (available at <http://www.gpo.gov/fdsys/pkg/CREC-2009-06-17/pdf/CREC-2009-06-17-pt1-PgS6740-3.pdf#page=1>).

⁸⁶ See Library of Congress, *Notification of Agreements Under the Webcaster Settlement Act of 2009*, 74 FR 34796 (July 17, 2009) (hereafter *2009 Webcaster Settlement*).

TABLE 3:
ROYALTY RATES FOR PUREPLAY WEBCASTERS
UNDER THE 2009 WEBCASTER SETTLEMENT ACT COMPROMISE

| Year | Per-Performance Royalty |
|------|----------------------------|
| 2006 | \$0.00080 |
| 2007 | \$0.00084 |
| 2008 | \$0.00088 |
| 2009 | \$0.00093 |
| 2010 | \$0.00097 |
| 2011 | \$0.00102 |
| 2012 | \$0.00110 |
| 2013 | \$0.00120 |
| 2014 | \$0.00130 |
| 2015 | \$0.00140 |

Source: 74 FR at 34799.

Importantly, Congress directed the LOC to make it clear that the Webcaster Settlement Act rates were not to be interpreted as “market based.” To highlight that fact, Congress made clear in section 114(f)(5)(C) that the new rates were to be considered the result of “unique” circumstances and, specifically, were not precedential with respect to the WBWS standard:

It is the intent of Congress that any royalty rates, rate structure, definitions, terms, conditions, or notice and recordkeeping requirements, included in such agreements shall be considered as a compromise motivated by the *unique business, economic and political circumstances* of webcasters, copyright owners, and performers rather than as matters that would have been negotiated in the marketplace between a willing buyer and a willing seller....⁸⁷

Thus, the rates currently being paid by webcasters like Pandora are not “market based,” but rather the result of a compromise which set rates below those established by the CRB under the WBWS standard, and extended the term of the agreement through 2015, and required large pureplay webcasters to pay the greater of 25 percent of revenues or the agreed upon per play rates.⁸⁸

4. *Webcaster III*

While rates for 2011-2015 were established for most webcasters by the various Webcaster Settlement Act compromises, the CRB was still obliged to undertake a new royalty rate proceeding to establish statutory rates and terms for the 2011-2015 term for webcasters that were not in existence at the time of the

⁸⁷ See 2009 Webcaster Settlement at 34796 (emphasis added).

⁸⁸ *Id.*, at 34799

Webcaster Settlement Act or chose not to opt-in to one of the WSA rate schedules.⁸⁹ Despite the fact that most webcasters did not participate in the proceeding, the *Webcaster III* proceeding involved extensive direct and reply testimony by numerous experts from all sides, full briefing schedules, and so forth.

Applying the WBWS standard, the CRB once again (as in *Webcaster II*) set rates by reference to a benchmark based on the rates negotiated between rights holders and interactive digital services, which are not subject to the compulsory copyright and thus are *prima facie* market-based.⁹⁰ The CRB released its rate determinations on March 9, 2011, with rates again established on a per-performance basis, as shown in Table 4.

TABLE 4:
STATUTORY ROYALTY RATES FOR
COMMERCIAL WEBCASTERS UNDER *WEBCASTER III*

| Year | Per-Performance Royalty |
|------|----------------------------|
| 2011 | \$0.0019 |
| 2012 | \$0.0021 |
| 2013 | \$0.0021 |
| 2014 | \$0.0023 |
| 2015 | \$0.0023 |

Source: 76 FR at 13048.

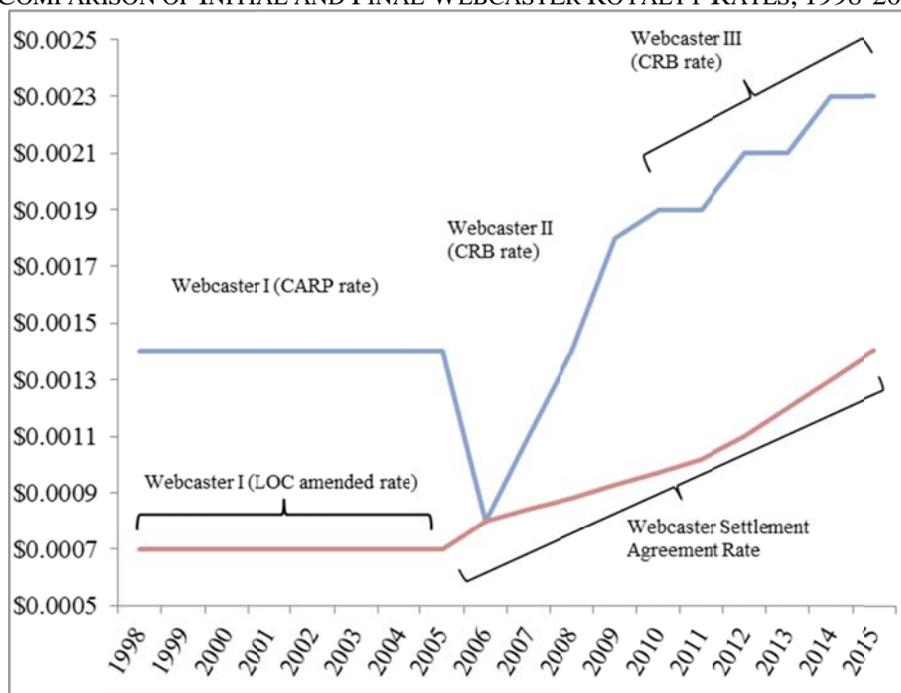
Figure 1 below illustrates the disparity between the royalty rates determined by the CARP and CRB under the WBWS standard in the *Webcaster I*, *Webcaster II* and *Webcaster III* proceedings and the royalty rates actually paid by pureplay webcasters. The blue line in Figure 1 represents the original royalty rates set by the CARP and the CRB, which applied the WBWS standard after extensive proceedings in which economic evidence was used to estimate a market-based rate. The red line represents the final royalty rates actually charged to webcasters after their appeals to the Librarian of Congress (for *Webcaster I*) and to Congress (after *Webcaster II*).⁹¹

⁸⁹ See, generally, Library of Congress, Copyright Royalty Board, *Digital Performance Right in Sound Recordings and Ephemeral Recordings, Final Rule and Order*, 76 FR 13026 (March 9, 2011) (hereafter *Webcaster III*). The *Webcaster III* proceeding began on January 9, 2009, and thus overlapped with the negotiations then under way under the Webcaster Settlement Act. Those negotiations resulted in voluntary agreements among many of the parties for which rates would otherwise have been determined under *Webcaster III*.

⁹⁰ *Id.*, at 13031.

⁹¹ Note that rates negotiated by small webcasters under the Small Webcaster Settlement Act, which were expressed as a share of revenues rather than on a per-performance basis, are not shown.

FIGURE 1:
COMPARISON OF INITIAL AND FINAL WEBCASTER ROYALTY RATES, 1998-2015



As Figure 1 shows, some pureplay webcasters (including Pandora) have secured per-performance royalty rates well below the market-based rates mandated by Congress under the DMCA.

B. Section 801(b) and the “Non-Disruption” Standard

Unlike the WBWS standard, the 801(b) standard now being advocated by webcasters is explicitly not market-based – that is, it is not designed to replicate the rates that would be achieved in a competitive market. Rather, the fourth pillar of the 801(b) standard (Section 801(b)(1)(D)) reflects Congress’ desire that rates be set so as to “minimize” any “disruptive” impact on the parties; that is, if market-based rates are determined to be disruptive for licensees, they must be lowered. From a policy perspective, the “non-disruption” standard may result in locking in place inefficient or obsolete business models, or even encouraging inefficient investments by firms which know that, under the 801(b) standard, rates will be set so as to prevent “disruption” to their business models. For licensees and their investors, such a guarantee is obviously quite valuable.

This subsection briefly reviews the application of the 801(b) standard since its adoption in the 1976 Copyright Act, focusing on proceedings involving royalty rates for SDARS services, *SDARS I* (completed in 2008) and *SDARS II*. In *SDARS I*, the non-disruption criterion played an important role, leading directly to rates lower than would have been reached under the WBWS standard. And, while the *SDARS II* proceeding is not yet complete, the expert economic testimony presented there demonstrates that, at least in the eyes of copyright

users, the non-disruption criterion amounts to a guaranteed return on investment for licensees, now and into the future.

Before addressing the two SDARS proceedings, it is useful to briefly review three prior proceedings in which the 801(b) standard was applied.

1. *Early Interpretations of the 801(b) Standard*

Prior to the creation of the Copyright Royalty Board, the 801(b) standard was applied twice by the Copyright Royalty Tribunal (CRT) in 1981, and once by Copyright Arbitration Royalty Panel (CARP) in 1997.⁹² The two CRT proceedings involved the statutory licenses for jukeboxes and for the mechanical license, i.e., the right to use a musical composition when making a copy of a sound recording. As the CRB later noted, in the 1980 Jukebox License Proceeding,⁹³ neither the CRT nor the D.C. Circuit (which reviewed the decision on appeal) dealt substantively with the 801(b) standard as such.⁹⁴ The CRT's decision in the 1981 Mechanical License Proceeding, however, did address the standard, focusing on the statutory requirement that rates be "reasonable," and suggesting that the individual 801(b) standards could be satisfied by rates lying within a "zone of reasonableness."⁹⁵ In its subsequent review, the D.C. Circuit agreed.⁹⁶

In 1997, a CARP took up the issue of royalties for PSS under the recently passed Digital Performance Right in Sounds Recordings Act.⁹⁷ When the CARP's decision came down heavily on the side of the PSS, it was reviewed and revised by the Librarian of Congress, and rates ultimately were set at 6.5 percent of revenues. However, neither the Librarian's decision nor the subsequent D.C. Court of Appeals decision (rejecting an appeal by the Recording Industry Association of America) dwelt on the proper interpretation of section 801(b).⁹⁸

⁹² See, generally, General Accounting Office, Letter from Mark Goldstein to Senator Arlen Specter, GAO-10-828R (August 4, 2010) (hereafter *GAO 801(b) Letter*).

⁹³ 46 FR 884 (January 5, 1981).

⁹⁴ See *SDARS I* at 4082 ("While the Tribunal's decision was somewhat lengthy, its consideration and application of the standard and the Section 801(b)(1) factors was not.... In reviewing the Tribunal's decision, the U.S. Court of Appeals for the Seventh Circuit gave no attention to the Section 801(b)(1) factors or the Tribunal's application of them, focusing instead on the appropriateness of the Tribunal's choice of 'marketplace analogies.'")

⁹⁵ 46 FR 10466 (February 3, 1981).

⁹⁶ See *SDARS I* at 4083, quoting *Recording Industry Ass'n. of America v. Copyright Royalty Tribunal*, 662 F.2d 1 (D.C. Cir. 1981) ("To the extent that the statutory objectives determine a range of reasonable royalty rates that would serve all these objectives adequately but to differing degrees, the Tribunal is free to choose among those rates, and courts are without authority to set aside the particular rate chosen by the Tribunal if it lies within a 'zone of reasonableness.'")

⁹⁷ See *SDARS I* at 4083 ("Unlike prior statutory licenses where the Congress fixed the initial rates within the statute, the rates for the new digital performance right license were left to resolution by a CARP. The Librarian convened a CARP in 1997 for PSS and SDARS. The SDARS settled with copyright owners and withdrew from the proceeding, and the CARP rendered a determination only with respect to the PSS. The Librarian reviewed the CARP's determination and rejected it with respect to the rate as well as to certain terms, and the U.S. Court of Appeals for the District of Columbia Circuit reviewed the Librarian's decision.")

⁹⁸ See *Recording Industry Ass'n of America, Inc. v. Librarian of Congress*, 176 F.3d 528.

2. *SDARS I*

In January 2006, the CRB initiated a rate proceeding to establish statutory royalties for PSS and SDARS for 2007/2008 through 2012.⁹⁹ The PSS services negotiated voluntary agreements, which were ratified by the CRB in late 2007,¹⁰⁰ but the SDARS services (at that time, Sirius and XM) did not, and the CRB issued statutory rates for SDARS services in January 2008. The decision, known as *SDARS I*, left no doubt that the 801(b) standard, as interpreted by the CRB and reviewed by the DC Circuit, is likely to result in rates lower than the market-based rates set under the WBWS standard.

Like the *Webcaster* proceedings, *SDARS I* was a full-blown rate proceeding, featuring dozens of economic and industry experts, direct and rebuttal testimony and so on.¹⁰¹ The CRB began its analysis by seeking to establish a benchmark based on voluntarily negotiated rates for comparable services, and ultimately chose again – as in the *Webcaster II* and *Webcaster III* proceedings – to rely on a model based on the market rates negotiated for interactive subscription services.¹⁰² Based largely on an analysis by Dr. Janusz Ordovery, the CRB determined that a royalty rate equal to 13 percent of subscriber revenue constituted a “reasonable estimate of a marketplace derived benchmark.”¹⁰³

The next step in the CRB’s analysis was to establish a “zone of reasonableness” within which the final rates – based on the 801(b) criteria – would have to lie. The Board determined that the 13 percent benchmark “marks the upper boundary of a zone of reasonableness for potential marketplace benchmarks,” that a lower boundary was established by the 2.35 percent of revenues paid by SDARS for musical works licenses, but that “based strictly on marketplace evidence, a rate close to the upper boundary is more strongly supported than one close to the lower boundary.”¹⁰⁴ Hence, prior to explicit consideration of the four 801(b) criteria, the judges had in mind a rate closer to 13 percent than to 2.35 percent.

The next step in the Board’s analysis was to determine “whether these policy objectives weigh in favor of divergence from the results indicated by the marketplace benchmark evidence.”¹⁰⁵ Looking at the first two criteria, which require, respectively, “maximizing the availability of creative works to the public” and providing a “fair return” to both copyright holders and users, the Board determined that no adjustments from market rates were necessary and,

⁹⁹ See Library of Congress, *Adjustment of Rates and Terms for Preexisting Subscription and Satellite Digital Audio Radio Services*, 71 FR 1455 (January 9, 2006); see also GAO 801(b) letter at 3-4. The PSS term started in 2008, while the SDARS term started in 2007.

¹⁰⁰ See Library of Congress, *Copyright Royalty Board, Adjustment of Rates and Terms for Preexisting Subscription and Satellite Digital Audio Radio Services, Final Rule*, 72 FR 71795 (December 19, 2007).

¹⁰¹ See *SDARS I* at 4081 (“In addition to the written direct statements and written rebuttal statements, the Judges heard 26 days of testimony, which filled over 7,700 pages of transcript, and over 230 exhibits were admitted. The docket contains over 400 pleadings, motions, and orders.”).

¹⁰² *Id.*, at 4093.

¹⁰³ *Id.*, at 4085-88. The CRB explained that, while it continues to prefer a per-performance metric to one based on a percentage of revenues, several factors made it impractical to utilize a per-performance metric in this case.

¹⁰⁴ *Id.*, at 4094.

¹⁰⁵ *Id.*

indeed, that the criteria do not as a general matter imply rates different from those set in the market.¹⁰⁶

The Board reached a different conclusion, however, with respect to the latter two criteria, section 801(b)(1)(C) (which requires an assessment of the “relative roles” of the copyright owner and user with respect to creative contribution, technological contribution, capital investment, cost, risk and contribution to the opening of new markets) and section 801(b)(1)(D), the non-disruption standard.

With respect to the “relative roles” criteria, the CRB found that the need for SDARS to make “new expenditures related to their satellite technology...might weigh in favor of a discount from the market rate.”¹⁰⁷ However, it determined that this issue was “intimately intertwined” with the non-disruption standard, and decided to “treat the potential disruptive effect of postponing investment in new satellite technology” as part of its consideration of the non-disruption standard.¹⁰⁸

In applying the non-disruption standard, the Board concluded that a deviation from market rates was justified on two grounds – profitability and investment. First, it concluded, raising rates to the market-based level would “increase costs and raise the necessary critical mass of subscribers sufficient to generate revenues that yield EBITDA profitability.”¹⁰⁹ Thus:

In order not to significantly delay the attainment and amounts of EBITDA profitability and positive free cash flow, some rate within the zone of reasonableness that is less than 13% is warranted.¹¹⁰

Second, with respect to investment, it decided that royalty rates should be set so as not to place “any undue constraint on the SDARS’ ability to successfully undertake satellite investments planned for the license period.”¹¹¹ Based on these factors, the Board found it “appropriate to adopt a rate from the zone of reasonableness for potential marketplace benchmarks that is lower than the upper boundary most strongly indicated by marketplace data.” Accordingly, it set an initial rate of six percent of revenues, rising to eight percent over the six-year (2007-2012) term of the license – roughly 50 percent below the 13 percent benchmark it had initially concluded reflected a “reasonable estimate of a marketplace derived benchmark.”¹¹²

3. SDARS II

Perhaps the best way to understand the impact of the 801(b) non-disruption standard is to examine how it is invoked in an actual proceeding, such as the one the CRB is presently engaged in to determine rates for PSS and SDARS for the

¹⁰⁶ *Id.*, at 4094-4096.

¹⁰⁷ *Id.*, at 4097.

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

¹¹¹ SoundExchange appealed the CRB’s ruling to the D.C. Circuit Court of Appeals, arguing that the royalty rates set by the CRB were too low. The Court upheld the CRB’s ruling, stating that the CRB did not act unreasonably in setting rates. The Court did not, however, make a determination on whether the rates themselves were too high or too low. *See SoundExchange v. Librarian of Congress*, 571 F.3d. 1220 (D.C. Cir. 2009).

¹¹² *Id.*

five-year term beginning in January 2013.¹¹³ In that proceeding, experts for copyright users repeatedly invoke the 801(b) standard as the basis for claiming that rates should be set below marketplace levels in order to guarantee their clients a rate of return on both past and future investments, arguing that the standard not only permits but could require the CRB to deviate from market-based rates in order to advance “social values”¹¹⁴ such as “distributive justice.”¹¹⁵

For example, one expert arguing on behalf of XM-Sirius asserts that the CRB is required to “ensure that all participants would still have voluntarily engaged in the market transactions needed to make satellite services available had they been aware of the rates when they made the decisions to enter into those transactions,”¹¹⁶ which is equivalent to requiring that rates be set so as to guarantee investors profits on their initial investments, apparently in perpetuity. Another expert testified that section 801(b) requires rates low enough that copyright users are able not only to “recover the start-up costs of entering the industry”¹¹⁷ but also to ensure that they can “recover the financial cost of capital for forward-looking investments,” since rates that failed to give users incentives to *continue* investing in their businesses would be “disruptive.”¹¹⁸

To summarize, while it is theoretically possible for the 801(b) standard to result in the same rates as under the WBWS standard,¹¹⁹ there is no question that the two standards are – as one supporter of the IRFA recently agreed – “starkly different.”¹²⁰ Nor is it surprising that, as one knowledgeable observer recently noted, “the change from the willing buyer/willing seller standard to the 801(b) standard is widely anticipated to significantly lower the royalty rates that online radio services pay.”¹²¹ As discussed further below, other elements of IRFA are also designed to ensure copyright users continue to pay below market rates in the future.

¹¹³ See United States Copyright Royalty Board, *Determination of Rates and Terms for Preexisting Subscription and Satellite Digital Audio Radio Services*, (Docket No. 2011-1 CRB PSS/Satellite II).

¹¹⁴ Written Rebuttal Testimony of Roger Noll on Behalf of Sirius-XM Radio Inc. (http://www.loc.gov/crb/proceedings/2011-1/rps/sxm_vol_3.pdf) at 6, 50.

¹¹⁵ *Id.*

¹¹⁶ Written Rebuttal Testimony of Dr. Michael A. Salinger on Behalf of Sirius-XM Radio Inc. (Docket No. 2011-1) at 16 (available at http://www.loc.gov/crb/proceedings/2011-1/rps/sxm_vol_3.pdf at 81).

¹¹⁷ Written Direct Testimony of Roger Noll on Behalf of XM-Sirius (http://www.loc.gov/crb/proceedings/2011-1/pss/sxm_wds.pdf) at 951.

¹¹⁸ *Id.*, at 1005.

¹¹⁹ See e.g., GAO 801(b) Letter at 5.

¹²⁰ Indeed, the desire to lower the “high royalty burdens” paid by webcasters is the primary rationale offered by IRFA’s proponents for its enactment. See John Villasenor, “Digital Broadcast Music Royalties: The Case for a Level Playing Field,” Center for Technology Innovation at Brookings, *19 Issues in Technology Innovation* (August 2012) 1-28 at 9 (hereafter *Villasenor*).

¹²¹ See Jodie Griffin, “The Internet Radio Fairness Act: Revamping the Online Radio Marketplace,” Public Knowledge Policy Blog (Nov. 2, 2012) (available at: <http://www.publicknowledge.org/blog/overview-internet-radio-fairness-act>).

IV. BEYOND THE NON-DISRUPTION STANDARD: THE PROPOSED INTERNET RADIO FAIRNESS ACT AND THE MARKET FOR ONLINE MUSIC

The Internet Radio Fairness Act (H.R. 6480/S. 3609)¹²² would fundamentally alter both the standards and the process by which statutory royalties are established for non-interactive webcasters like Pandora. As described in the first subsection below, the clear purpose, and the virtually certain effect, would be to tip the playing field against copyright owners in favor of the webcasters, resulting in lower royalty rates for covered webcasters – which of course is why the webcasters support it.¹²³ As explained below, there is no evidence that high royalty rates are stifling the growth of online music in general, or for that matter of Pandora in particular, or that such services would be unable to pay market based rates in the future.

Beyond simply lower rates, another argument made for IRFA is that it is necessary to create a level playing field – that is, to make webcasters like Pandora subject to the same standard that now applies to the three remaining PSS and SDARS services. The biggest problem with this argument is that non-interactive webcasters’ biggest competitors arguably are not PSS or SDARS, but rather interactive services (like Spotify), which obtain sound recording performance rights *without the benefit of a compulsory license* of any sort. Thus, what Pandora is seeking through IRFA is to *increase* the competitive advantage it already holds over interactive services by obtaining an even more attractive compulsory license. Meanwhile, IRFA would do nothing to address the other obvious imbalance in the sound recording performance right, which is the continuing exemption enjoyed by the over-the-air transmissions of terrestrial broadcasters.

The first subsection below reviews IRFA’s main provisions and explains their likely effects on the rate setting process and its results. The second subsection shows why the rates currently being paid by webcasters are not unreasonable, and why IRFA is not necessary to preserve a vibrant and growing market for online music. The third subsection explains why the uneconomic rates IRFA would produce, along with the perverse incentives inherent in the non-disruption standard, would reduce incentives for content creation, slow innovation, and harm consumers.

A. *The IRFA Would Dramatically Tilt the Rate Setting Process in Favor of Webcasters*

If one set out to write statutory language designed to favor webcasters over copyright owners in rate setting proceedings, the result would look a lot like the IRFA. While a complete exegesis is beyond the scope of this study, a partial listing of its more significant provisions provides a sense of the proposal’s scope and ambition. Among other things, the IRFA would: (a) impose a heavily-modified version of the section 801(b) criteria for royalty rates, with the modifications further favoring webcasters;¹²⁴ (b) directly intervene in the rate setting process, by extending the webcaster-friendly Webcaster Settlement Act

¹²² See H.R. 6480: Internet Radio Fairness Act of 2012.

¹²³ See e.g., *Villasenor* at 11.

¹²⁴ See H.R. 6480: Internet Radio Fairness Act of 2012, Section 3(a)(2)(bb)(II) and Section 3(a)(2)(C)(i)(I) and (II) (“In establishing rates and terms under this paragraph, the Copyright Royalty Judges shall apply the objectives set forth in section 801(b)(1).”).

rates (for small pureplay webcasters) for an extra year;¹²⁵ (c) shift the burden of proof to copyright holders to show that proposed rates do not exceed an amorphous new standard;¹²⁶ (d) prohibit copyright royalty judges from considering certain types of evidence likely to favor copyright holders;¹²⁷ (e) reverse the CRB's (economically-grounded) decision to favor "per performance" royalties over "percentage of revenue" royalties;¹²⁸ (f) prohibit the CRB from relying on some (but not other) prior decisions as precedents;¹²⁹ (g) reverse the Webcaster Settlement Act's guarantee that rates negotiated under the Act would not have precedential value for rate setting purposes;¹³⁰ (h) create a special class of antitrust liability for joint activities by copyright owners, but not copyright users;¹³¹ (i) inject politics into the process by requiring copyright judges to be confirmed by the Senate rather than appointed by the Librarian of Congress;¹³² (j) eliminate the requirement that at least one of the copyright judges be an expert in copyright, and one an expert in economics;¹³³ and, (k) subject CRB rate decisions to *de novo* review, requiring the D.C. Circuit to essentially re-hear every rate case.¹³⁴

Among the many changes proposed by IRFA, the most profound include the provisions altering the substantive standards for rate setting, specifying what evidence the CRB can consider, and changing the makeup of the CRB itself.

First, in addition to replacing the WBWS standard with 801(b), IRFA adds four additional criteria which must be considered in setting rates: (1) the public's interest in both the creation of new sound recordings of musical works and in fostering online and other digital performances of sound recordings;¹³⁵ (2) the income necessary to provide a reasonable return on all relevant investments, including investments in prior periods for which returns have not been earned;¹³⁶ (3) the value of any promotional benefit or other non-monetary benefit conferred on the copyright owner by the performance;¹³⁷ and (4) the contributions made by

¹²⁵ *Id.*, Section 3(a)(3)(E) ("The rates and terms of any settlements made pursuant to the amendments made by the Webcaster Settlement Act of 2009 (Public Law 111-36; 123 Stat. 1926) that were to expire before December 31, 2015, shall be extended through December 31, 2015, according to the rates and terms applicable to 2014.").

¹²⁶ *Id.*, Section 3(a)(2)(bb)(II) ("In any proceeding under this subsection, the burden of proof shall be on the copyright owners of sound recordings to establish that the fees and terms that they seek satisfy the requirements of this subsection, and do not exceed the fees to which most copyright owners and users would agree under competitive market circumstances.").

¹²⁷ *Id.*, Section 3(a)(2)(C)(ii) ("To the extent the Copyright Royalty Judges consider marketplace benchmarks to be relevant, the Copyright Royalty Judges shall limit those benchmarks to benchmarks reflecting the rates and terms that have been agreed under competitive market circumstances by most copyright users.").

¹²⁸ *Id.*, Section 3(a)(2)(D)(i) (the CRJs "shall not disfavor percentage of revenue-based fees.").

¹²⁹ *Id.*, Section 3(a)(2)(D)(v) (The CRJs "shall not take into account either the rates and terms provided in licenses for interactive services or the determinations rendered by the Copyright Royalty Judges prior to the enactment of the Internet Radio Fairness Act of 2012.").

¹³⁰ *Id.*, Section 3(a)(3)(b).

¹³¹ *Id.*, Section 5.

¹³² *Id.*, Section 2(1)(A).

¹³³ *Id.*, Section 2(2)(A).

¹³⁴ *Id.*, Section 6(d).

¹³⁵ *Id.*, Section 3(a)(2)(C)(i)(I).

¹³⁶ *Id.*, Section 3(a)(2)(C)(i)(II).

¹³⁷ *Id.*, Section 3(a)(2)(D)(iii).

the digital audio transmission service to the content and value of its programming.¹³⁸ Each of these criteria is favorable to webcasters, none more so than the requirement that the rates be set so as to ensure copyright users earn profits on past investments.

Further, IRFA shifts the burden of proof in rate setting proceedings to copyright owners, who would be required to establish that the fees in any statutory license do not exceed those to which “most copyright owners and users would agree to under competitive market conditions,” defined as conditions in which none of the participants have market power.¹³⁹ As a practical matter, it is likely that the only agreements that would meet this standard would be ones negotiated by the smallest independent record labels – i.e., the ones willing to accept the lowest royalty rates.

Second, in applying the new criteria, IRFA directs the CRB to ignore some evidence, but demands that other evidence be considered. Judges are prohibited from taking into account the rates and terms in licenses for interactive services (which have provided the benchmark for the market-based rates in *Webcaster II* and *Webcaster III*) or in the CRB’s previous determinations, but permitted to consider the rates set by the Copyright Royalty Tribunal in the early 1980s and the CARP/LOC 1998 *Webcaster I* decision.¹⁴⁰ In the meantime, rates negotiated under the Webcaster Settlement Act are, contrary to the Webcaster Settlement Act itself, now accorded precedential value.¹⁴¹ In short, evidence favorable to webcasters is required to be admitted, while evidence favorable to copyright owners is *a priori* inadmissible.

Third, IRFA would change the makeup of the CRB itself. Judges would no longer be appointed by the Librarian of Congress, but instead by the President with the advice and consent of the Senate – thus ensuring that the filling of every vacancy becomes a vehicle for a political contest between the interested parties. Of equal concern is that the qualifications of the judges themselves would be changed, removing the current requirement that one of the three judges have a significant knowledge of economics and another have significant knowledge of copyright law. In the future, judges would be required simply to have ten years of experience in arbitration or litigation – that is, to be process experts rather than substantive ones.¹⁴²

At the end of the day, there is no question that, as Villasenor puts it, the “obvious consequence” of imposing the 801(b) standard “would be lower rates for webcasters.”¹⁴³ As discussed below, however, forcing copyright owners to effectively subsidize webcasters through artificially low royalties is neither necessary to promote the growth of online music nor desirable from the perspective of innovation or consumer welfare.

B. The IRFA is Not Necessary to Ensure a Vibrant Market for Online Music

The market for online music is intensely vibrant and growing rapidly. Tens of thousands of new listeners are signing up to services like Pandora and Spotify

¹³⁸ *Id.*, Section 3(a)(2)(D)(iv).

¹³⁹ *Id.*, Section 3(a)(1)(B).

¹⁴⁰ *Id.*, Section 6(a)(2), Section 3(a)(2)(D)(v).

¹⁴¹ *Id.*, Section 3(a)(3)(b).

¹⁴² *Id.*, Section 2.

¹⁴³ *See Villasenor* at 13.

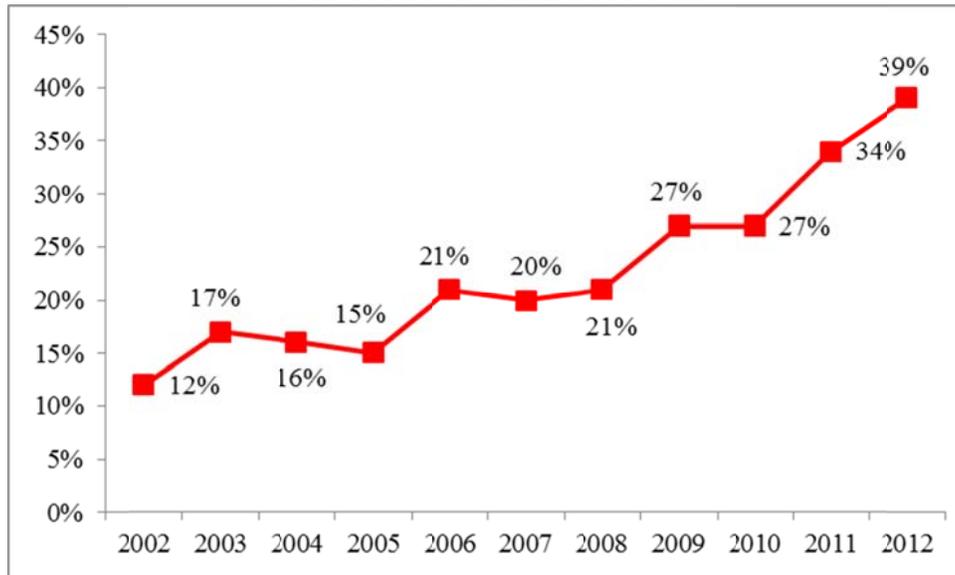
every week, and existing listeners are using the services more and more intensely every year. Online advertising revenues are growing 30 percent per year¹⁴⁴, new firms are entering the market at a rapid pace, and existing firms are garnering billion dollar market valuations. As Villasenor puts it, “The future of music distribution is clearly digital.”¹⁴⁵

Against this reality, IRFA proponents argue that webcasters need the below-market rates and guaranteed profits the legislation would provide in order to “grow and evolve.”¹⁴⁶ Moreover, they argue, the current system, is broken because the “onerous” WBWS standard can result in webcasters paying a higher percentage of their revenues in royalties than other firms, including in particular Sirius-XM.¹⁴⁷ Neither argument withstands even cursory scrutiny.

First, the current copyright regime is manifestly not preventing the online music industry from “growing and evolving” at a rapid pace. Online radio is a two-sided market, involving both listeners (who, depending on the business model, may also be subscribers) and advertisers. Both sides of the market are growing explosively.

For example, Figure 2 below shows the proportion of Americans who have listened to online radio in the past 30 days from 2002 through 2012. Growth throughout the period has been rapid but has accelerated in recent years, with listenership rising by nearly 50 percent in just the last two years.

FIGURE 2:
PERCENT OF AMERICANS WHO HAVE LISTENED TO
ONLINE RADIO IN THE LAST MONTH



Source: Edison Research, "The Infinite Dial 2012: Navigating Digital Platforms 2012," Presentation Companion, at 8.

¹⁴⁴ See Figure 4 below.

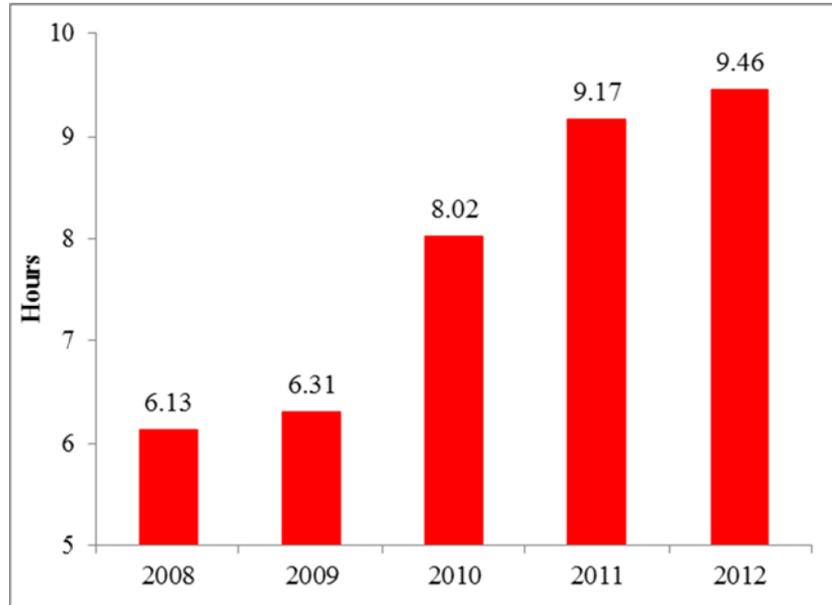
¹⁴⁵ See Villasenor at 17.

¹⁴⁶ See Edward Black, "Congress Should Pass the Internet Radio Fairness Act," *The Hill's Congress Blog* (October 25, 2012) (available at <http://thehill.com/blogs/congress-blog/technology/263915-congress-should-pass-internet-radio-fairness-act>).

¹⁴⁷ See Villasenor at 17.

As the figure shows, Edison Research/Arbitron reports that an estimated 103 million Americans, or 39 percent of the entire U.S. population aged 12 and older, now tune in to some form of online radio each month.¹⁴⁸ Similarly, the amount of time that listeners spend engaged with online radio has also increased dramatically. As shown in Figure 3, in 2012, listeners reported spending an average of 9 hours and 46 minutes per week listening to online radio, up from 6 hours and 13 minutes in 2008 (an increase of over 57 percent).¹⁴⁹

FIGURE 3:
AVERAGE WEEKLY HOURS SPENT
LISTENING TO ONLINE RADIO



Source: Edison Research, "The Infinite Dial 2012: Navigating Digital Platforms 2012," Presentation Companion, at 8.

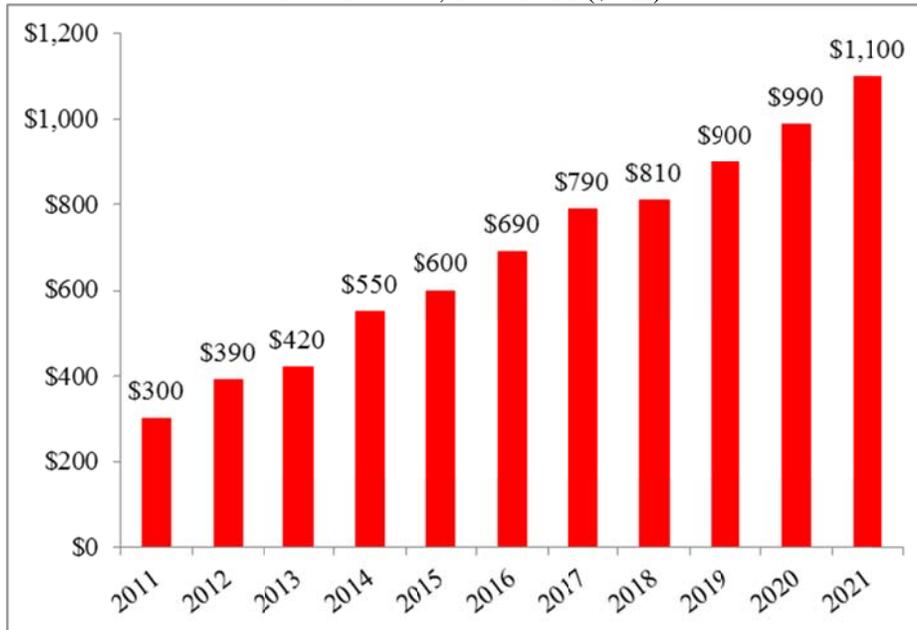
Not surprisingly, the rapid growth in listenership is leading to equally rapid growth in advertising revenues. Overall, online advertising is the fastest growing category of advertising worldwide, growing at 7.2 percent over the past year.¹⁵⁰ As shown in Figure 4 below, online radio advertising is growing even faster: According to SNL Kagan, online radio advertising revenues will approach \$400 million in 2012, and are projected to grow at a compound annual rate between 12 and 14 percent over the next decade.

¹⁴⁸ See Edison Research, "The Infinite Dial 2012: Navigating Digital Platforms 2012," Presentation Companion, at 8.

¹⁴⁹ *Id.*

¹⁵⁰ See Nielsen, *World Trends* (2012) (reporting that online advertising was the fastest growing category of advertising in the first half of 2012, up 7.2 percent compared to the same period in 2011).

FIGURE 4:
PUREPLAY INTERNET MUSIC AND RADIO AD REVENUE
PROJECTIONS, 2011-2021 (\$MIL)



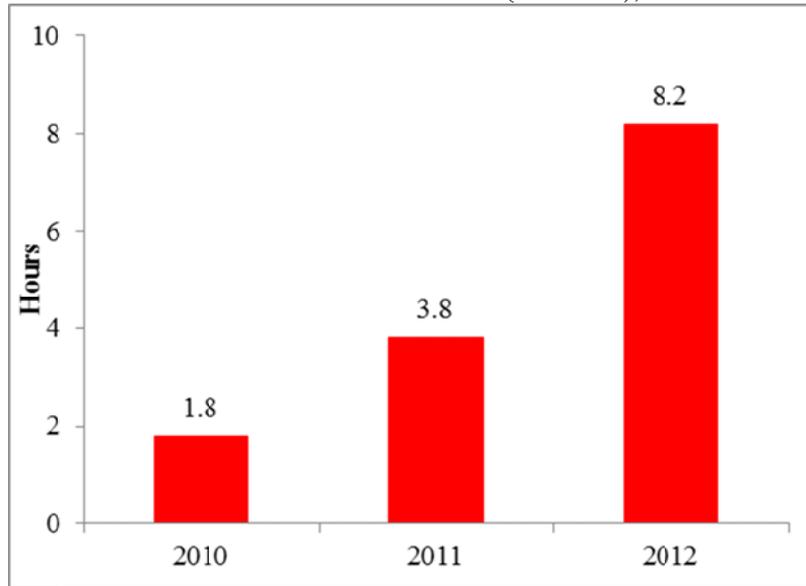
Source: SNL Kagan 2011. Includes online/mobile ad revenues from Internet Music and Radio Pureplays (i.e., AccuRadio, AOL Radio, Goom Radio, Last.fm, Live 365, MOG, Pandora, Slacker, Stitcher, Turntable.fm, Yahoo!Music, etc.).

The rapid growth of the industry has translated into financial success for existing firms and the entry of new ones. Pandora, which is by its own account the “leader in internet radio in the United States,” with a dominant market share of 69 percent, has been the biggest beneficiary.¹⁵¹ As shown in Figure 5 below, Pandora’s annual listener hours have more than quadrupled in the last two years, from 1.8 billion to 8.2 billion. Revenues over the same period have grown even faster, from \$55.2 million in 2010 to \$240.0 million in 2012.¹⁵²

¹⁵¹ See Pandora Media, Inc., 2012 Form 10K at 42 (“Pandora is the leader in internet radio in the United States, offering a personalized experience for each of our listeners. We have pioneered a new form of radio – one that uses intrinsic qualities of music to initially create stations and then adapts playlists in real-time based on the individual feedback of each listener. In January 2012, we had over 125 million registered users, which we define as the total number of accounts that have been created for our service at period end, and we added two new registered users every second on average. For the fiscal year ended January 31, 2012, we streamed 8.2 billion hours of radio and as of January 31, 2012, we had 47 million active users. According to a January 2012 report by Triton, we are one of the top 20 internet radio stations and networks in the United States and we have more than a 69% share of internet radio. Since we launched the Pandora service in 2005, our listeners have created over 2.4 billion stations.”)

¹⁵² *Id.*, at 40.

FIGURE 5:
PANDORA ANNUAL LISTENER HOURS (BILLIONS), 2010-2012

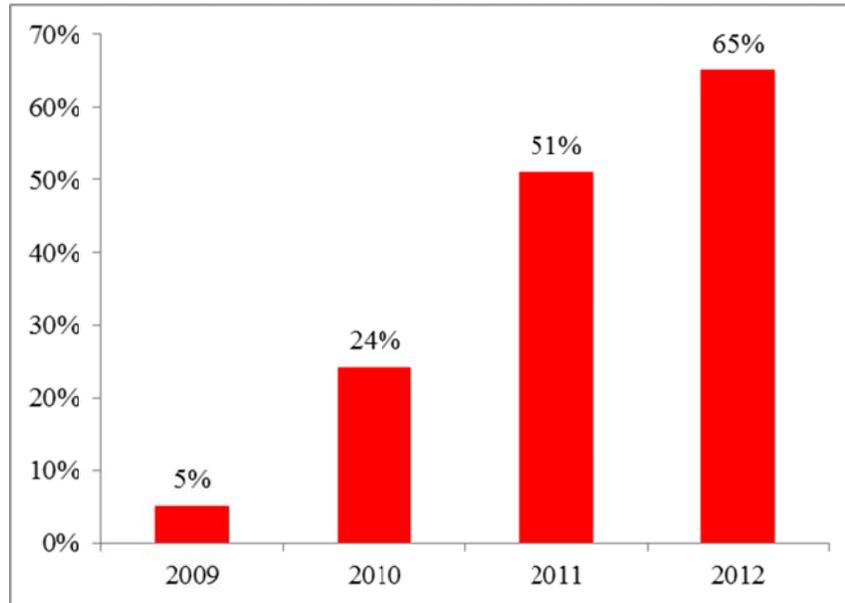


Source: Pandora Media, Inc., 2012 Form 10K, at 14.

Much of the rapid growth that has occurred in the past few years is associated with the rapid adoption of smart phones and the accompanying increase in mobile consumption of digital media. For example, as shown in Figure 6 below, Pandora reports that as of 2012, nearly two thirds of all listening hours are accounted for by mobile devices. Notably, SNL Kagan reports that in 2011, Pandora was the fifth largest U.S. mobile ad network by revenue, ranking behind only Google, Apple, Facebook and Twitter, and was growing at 476 percent annually, far faster than any of the other top 25 firms.¹⁵³

¹⁵³ See SNL Kagan, *Mobile Ad Networks by Revenue, United States* (2011) (subscription required).

FIGURE 6:
PERCENTAGE OF TOTAL PANDORA LISTENING
HOURS ACCOUNTED FOR BY MOBILE



Source: Pandora Media, Inc., 2012 Form 10K, at 14.

As a result of its rapid growth, and of market expectations that it would continue to prosper in the future, Pandora successfully “went public” in 2011, garnering large payoffs for its early investors.¹⁵⁴ The firm now trades on the New York Stock Exchange under the symbol “P.” As of mid-November 2012, Pandora was valued at \$1.3 billion.¹⁵⁵

Pandora’s defenders argue, however, that the company has not yet achieved profitability, and that “extremely high royalty burdens” are to blame, with content costs accounting for 60 percent or more of revenues.¹⁵⁶ The situation would be even worse, they warn, if Pandora and the other webcasters currently covered by the Webcaster Settlement Act agreement were forced to pay the (higher) rates determined by the CRB in *Webcaster III*.¹⁵⁷

There are several problems with these arguments. First, the fact that Pandora has not yet achieved profitability is hardly a surprise. Other successful online firms, including Facebook, Google, Vonage and many others, have taken years to achieve profitability; some have yet to do so. There is a good reason for this: Internet markets are characterized by network effects, meaning that firms compete (in what is sometimes referred to as a “land grab strategy”) to achieve critical scale. While it is thus typical for firms like Pandora to invest in customer acquisition for an initial period before becoming profitable,¹⁵⁸ there is no

¹⁵⁴ For example, in the first 11 months of 2012, Pandora cofounder Tim Westergren sold 937,000 shares of Pandora stock valued at over \$9.9 million. See <http://www.marketwatch.com/investing/stock/p/insiders?pid=78349198>.

¹⁵⁵ See Yahoo! Finance.

¹⁵⁶ See *Villasenor* at 11.

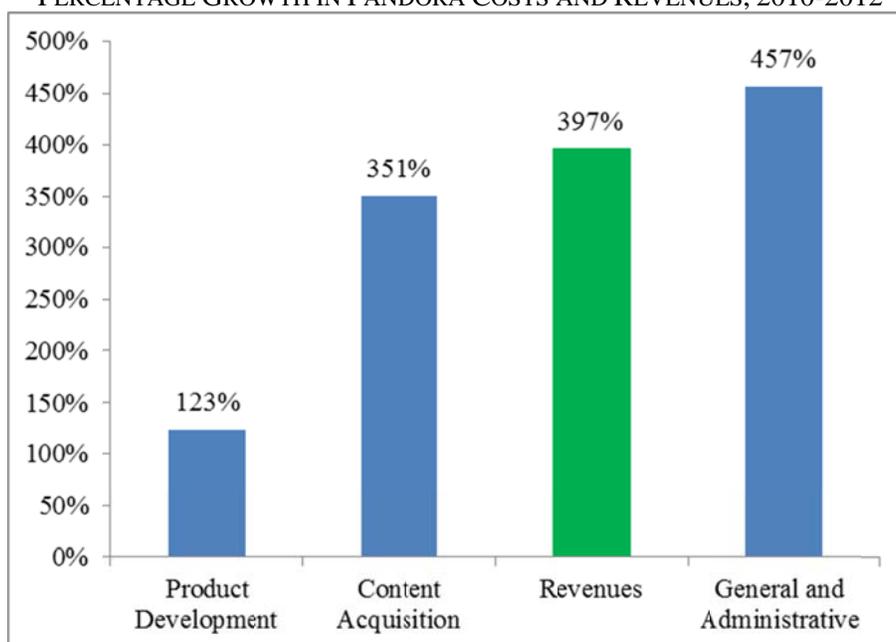
¹⁵⁷ *Id.*

¹⁵⁸ See, generally, Jeffrey H. Rohlfs, *Bandwagon Effects in High-Technology Industries* (MIT Press, 2003). See also Pandora Media, Inc., Form S-1 (February 11, 2011) at 11 (“Since our

economic or public policy rationale for forcing their suppliers to subsidize such strategies.

Second, while Pandora's content acquisition costs have indeed grown rapidly, they have not grown as rapidly its revenues or, for that matter, as its overhead. As shown in Figure 7 below, Pandora's content acquisition costs have grown by 351 percent over the past two years. However, its revenues have increased even faster, by nearly 400 percent, while its administrative and overhead expenses have grown even faster, by 457 percent over the past two years.

FIGURE 7:
PERCENTAGE GROWTH IN PANDORA COSTS AND REVENUES, 2010-2012



Source: Pandora Media Inc., 2012 Form 10-K.

Third, while Pandora makes much of the fact that content acquisition accounts for a large proportion of its revenues,¹⁵⁹ in fact its content costs as a proportion of revenues are comparable to other, similar firms. For example, while Netflix offers video rather than audio, and its revenues come more from subscriptions than from advertising, its basic business model – offering on-demand audio-video content over the Internet while minimizing its own infrastructure costs – is very similar to Pandora's.

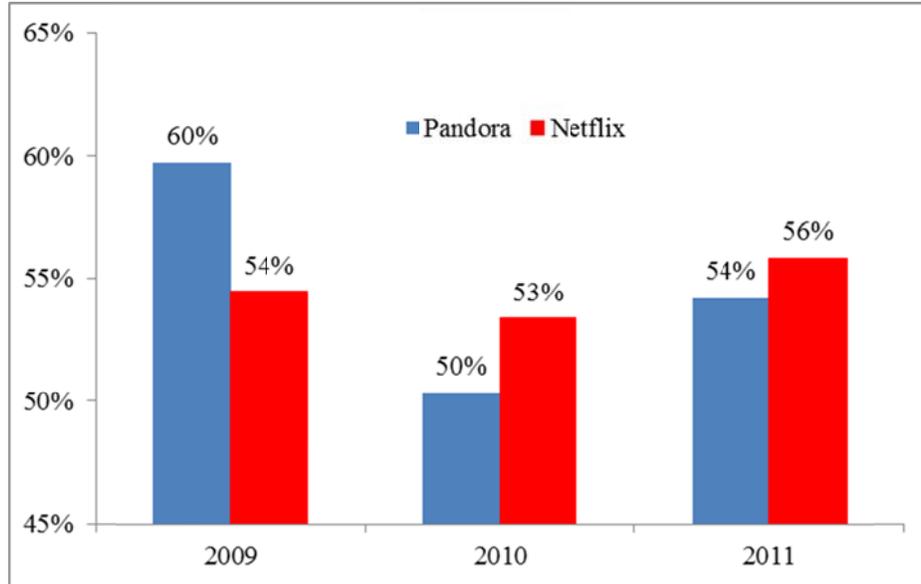
As shown in Figure 8 below, the proportion of revenues accounted for by content costs for Netflix and Pandora have been nearly identical over the last three years (2009-2011) for which data is available from both firms; indeed, for

inception in 2000, we have incurred significant net operating losses and as of October 31, 2010, we had an accumulated deficit of \$83.9 million. A key element of our strategy is to aggressively increase the number of listeners and listener hours to increase our market penetration.”).

¹⁵⁹ See e.g., Pandora Media Inc., 2012 Form 10K at 7.

each of the last two years, Netflix has paid a higher proportion of its revenues for content acquisition than has Pandora.¹⁶⁰

FIGURE 8:
CONTENT COSTS AS A PERCENTAGE OF REVENUES
PANDORA VS. NETFLIX, 2009-2011¹⁶¹



Sources: Pandora 10-K; Netflix 10-K.

It is noteworthy that, like some of Pandora's competitors in the audio market, Netflix does not benefit from a compulsory license, but instead relies on negotiating contracts with content owners on a voluntary basis. And while the firm has had some stumbles over the past year, its market capitalization in late 2012 stood at over \$4.4 billion. As of November 2012, the firm was fighting off a takeover bid by investor Carl Icahn, who believes it is undervalued, notwithstanding the fact that it pays over 50 percent of its revenues for content.¹⁶²

Fourth, and finally, Pandora's claims of impending doom with respect to content costs are belied by the fact that other firms are rapidly entering the market to compete with it. As it reports in its most recent 10-K, "the audio entertainment marketplace continues to rapidly evolve, providing our listeners

¹⁶⁰ More broadly, it is commonplace for digital music distributors of all stripes to pay 60 percent or more of their revenues for content. See e.g., Steve Knopper, "The New Economics of the Music Industry," *Rolling Stone* (October 25, 2011) (available at <http://www.rollingstone.com/music/news/the-new-economics-of-the-music-industry-20111025>).

¹⁶¹ Notes: Pandora reports "content acquisition costs" in its annual 10-K filings. According to Pandora's 2012 10-K, "Content acquisition expenses principally consist of royalties paid for streaming music or other content to our listeners. Royalties are calculated using negotiated rates documented in master royalty agreements and are based on both percentage of revenue and listener metrics." See Pandora Media, Inc., Form 10-K (Jan. 31, 2012) at 46. Netflix reports "cost of subscription" data in its annual 10-K filings. According to the company's 2012 10-K, "Cost of subscription revenues consists of expenses related to the acquisition and licensing of content, as well as content delivery costs..." See Netflix Inc., Form 10-K (Feb. 10, 2012) at 28.

¹⁶² See Greg Bensinger, "Icahn Slams Netflix 'Poison Pill,'" *The Wall Street Journal* (November 5, 2012) (available at <http://online.wsj.com/article/SB10001424052970203846804578100662260454122.html>).

with a growing number of alternatives and new media platforms.”¹⁶³ Among its competitors: Last.fm, iheartradio, Slacker Personal Radio, Rhapsody and Amazon. Recent entrants including RDIO, “a rival streaming service created by the founders of Skype,”¹⁶⁴ and Spotify, which has four million subscribers worldwide paying \$10 per month for the right to access music online¹⁶⁵ and was recently valued at \$3 billion.¹⁶⁶ As of late 2012, reports indicated that Apple was also preparing to enter the market for online radio.¹⁶⁷

The flood of new participants in the online music business is important for two reasons. First, these firms (and their investors) obviously do not share Pandora’s gloomy forecasts regarding their ability to earn a fair return on investment. Second, and at least equally important, many of these firms – including, for example, Spotify – are not eligible for the compulsory license at all, and thus have no choice but to negotiate copyright agreements in the marketplace. According to reports, Apple may choose to enter the online radio market through negotiated contracts, eschewing the compulsory license altogether.¹⁶⁸

The fact that other firms see opportunities to profit in the online music marketplace suggests to some that Pandora needs to take a closer look at its business model. As noted above, online music is a two-sided market, with some (and sometimes more or even all) of the revenues coming from advertisers. Yet, if a firm (like Pandora) is engaged in a land grab strategy designed to maximize its market share in the short run in order to capture economies of scale, too much advertising risks driving consumers to competitors. A number of analysts have noted that Pandora has failed to fully monetize its large and growing audience. As one well-respected journalist put it:

Throughout the music industry there is a wide belief that Pandora could solve its financial problems – the company, which went public a year ago, has never turned an annual profit – by simply selling more ads.¹⁶⁹

¹⁶³ See Pandora Media Inc., 2012 Form 10-K at 7.

¹⁶⁴ See Andy Fixner and Adam Satariano, “Apple’s Online Radio Service to Challenge Pandora in 2013,” *Bloomberg* (Oct. 26, 2012) (available at: <http://www.bloomberg.com/news/2012-10-25/apple-s-online-radio-service-to-challenge-pandora-in-2013.html>) (hereafter *Fixner and Satariano 2012*).

¹⁶⁵ See Peter Kafka, “Where Did Spotify’s Billion Dollars Go? Ask Netflix,” *All Things* (Nov. 11, 2012) (available at: <http://allthingsd.com/20121111/where-did-spotifys-billion-dollars-go-ask-netflix/>).

¹⁶⁶ See Evelyn M. Rusli and Jessica E. Lessin, “Spotify Seeks \$3 Billion Valuation,” *The Wall Street Journal* (November 9, 2012) (available at: <http://professional.wsj.com/article/SB10001424127887324894104578109482459713880.html>).

¹⁶⁷ See *Fixner and Satariano 2012*.

¹⁶⁸ See *Fixner and Satariano 2012*.

¹⁶⁹ See Ben Sisario, “Proposed Bill Could Change Royalty Rates for Internet Radio,” *The New York Times* (September 23, 2012) (available at <http://www.nytimes.com/2012/09/24/business/media/proposed-bill-could-change-royalty-rates-for-internet-radio.html>). See also Richard Greenfield, “Congress Should be Working to Raise Royalty Rates on Pandora, Not Lower Them,” *BTIG Research* (September 24, 2012) (available at <http://www.btigresearch.com/2012/09/24/congress-should-be-working-to-raise-royalty-rates-on-pandora-not-lower-them/>) (“[T]he reason why companies such as Pandora pay such high royalty rates as a percentage of revenues is because they severely limit audio advertising to protect the user experience and keep people on the platform. If Pandora ran several minutes of audio ads per hour (the way terrestrial radio does) vs. just a few 15 sec. spots, the % of revenues paid out as royalties

To summarize, Pandora's argument that royalties need to be reduced in order to preserve a healthy market for online music is simply not consistent with the facts. The market is vibrant and growing, and expected to continue to grow and evolve in the future. Pandora has been a major beneficiary of that growth, and while – like any firm – it would prefer to pay less for inputs into its production process, there is no public policy basis for forcing content creators to subsidize it or other webcasters by setting royalties at below-market rates.

C. The IRFA Would Exacerbate Market Distortions, Reduce Incentives to Create Content, Slow Innovation, and Harm Consumers

The IRFA is advanced by its proponents on grounds that it would create a level playing field for users of sound recording rights, increase revenues to artists and record labels, and even promote innovation. Each of these claims is incorrect. In fact, on each count, the opposite is true.

First, while it is accurate that the sound recording performance right currently does not use the same rate standard for all users and in all markets, it is entirely inaccurate to argue that IRFA would improve the situation. Currently, interactive services are subject to the sound recording performance right, but have no compulsory license, PSS and SDARS are subject to the 801(b) standard, webcasters, simulcasters and new subscription services are subject to WBWS, and terrestrial broadcasters are exempt altogether. AM/FM radio stations pay royalties when they “simulcast” sound recording performances over the Internet, but pay nothing to “broadcast” them over the airwaves.

The goal of creating a more level playing field is a desirable one, but the IRFA would hardly achieve that purpose. By lowering rates to non-market levels for non-interactive users like Pandora, it would widen the gap between firms like Pandora and interactive webcasters, like Spotify, who arguably are their closest competitors. At the same time, it would do nothing to rectify the imbalance between terrestrial broadcasters and all other users, as the former would continue to be exempt. From an economic perspective, IRFA would not ameliorate, and might well exacerbate, the economic distortions associated with the current system.

It is informative, in this regard, that IRFA's proponents are unable to proffer a policy-based, let alone an economically plausible, rationale for leaving the terrestrial exemption in place. For example, the only rationale Villasenor offers for not extending the sound recording performance right to over-the-air terrestrial broadcasters is a political one: “legislation including a provision ending the terrestrial broadcasters exemption would be likely to fail.”¹⁷⁰

Second, the argument that artists and record labels would be better off under artificially low rates fundamentally ignores the economics of two-sided markets, in which firms like Pandora act as intermediaries between consumers, advertisers and content providers. In such markets, market rates strike the correct balance between the quantities provided on each side of the market. The efficient outcome, in other words, is the one that occurs when all market participants face

would be dramatically lower and would be more in line with satellite radio or cable TV. Interestingly, Spotify's radio product runs substantially more advertising per hour than Pandora.”).

¹⁷⁰ See Villasenor at 13.

market prices. As the CRB has said, “We agree with Dr. Ordover that ‘voluntary transactions between buyers and sellers as mediated by the market are the most effective way to implement efficient allocations of societal resources.’”¹⁷¹ Indeed, even some of the IRFA’s proponents appear to recognize the flaw in this argument, acknowledging that “while rates that are too high can be punitive, so can rates that are too low, as they shortchange the content creators on which the entire music broadcasting industry depends.”¹⁷² It is crucial to remember, in this regard, that a significant proportion of performance rights royalties flow through to the performers. Thus, the cross-subsidies granted to webcasters under the IRFA would come not just from the record labels, but from the artists themselves.

Finally, the argument that IRFA – by imposing a *non-disruption criterion* on the rate setting process for a vibrant, rapidly changing digital music distribution industry -- would *enhance innovation*¹⁷³ is as misguided upon close examination as it seems upon first blush. While it is true that “[o]ne obvious consequence of broadly applying 801(b) would be lower royalty rates for webcasters,”¹⁷⁴ it does not follow that lower rates would cause webcasters to be more innovative. To the contrary, imposing a non-disruption standard would protect *incumbent* webcasters from competition and innovation by demanding that rates be set so as to provide a guaranteed profit on both previous and new investments.¹⁷⁵ This is the stuff of public utility regulation, not the dynamic Internet, and it would retard innovation, not advance it. As Dr. Janusz Ordover put it in his expert testimony in the ongoing SDARS II proceeding:

[T]he fourth policy factor ... should never be used to shield the service at issue from the full rigors of vigorous marketplace competition. Doing so is likely to harm consumers and also impede (or deter) entry and expansion of rival services.¹⁷⁶

To summarize, the primary purpose of IRFA, and one of its certain effects, would be to produce below-market royalty rates for one class of online music distributors, providing its beneficiaries with a *de facto* cross subsidy. Further, IRFA would effectively lock in the resulting profits by guaranteeing webcasters a return on both existing and future investments. The asserted public policy justifications for these proposed market interventions are without merit; indeed, the impact of IRFA would be to distort markets, retard innovation and ultimately deprive consumers of the benefits associated with competition and free markets.

¹⁷¹ See *SDARS I* at 4094.

¹⁷² See *Villasenor* at 15.

¹⁷³ See *e.g.*, *Villasenor* at 2 (“It also furnishes a strong disincentive to potential new market entrants and to the introduction of innovative new business models for delivering digital music.”)

¹⁷⁴ *Id.*

¹⁷⁵ Again, even the IRFA’s supporters acknowledge this problem. See *e.g.*, *Villasenor* at 15 (“[I]f due to technological obsolescence, poor management, or other factors, a legacy company had poorer EBITDA prospects than a new market entrant, would the fourth 801(b) factor be employed as a protectionist measure to prop up the legacy company...?”).

¹⁷⁶ Testimony of Janusz Ordover in *SDARS II* (available at: http://www.loc.gov/crb/proceedings/2011-1/pss/sx_vol_2.pdf) at 5-6. To the extent lower rates increased potential profits for non-interactive webcasters, they might attract entry. However, such entry would be of the “copycat” variety, spawned by the desire to take advantage of the arbitrage opportunity created by below-market rates.

VI. SUMMARY AND POLICY RECOMMENDATIONS

The current sound recording performance right is imperfect, most notably because of the distortions associated with the fact that it does not apply to terrestrial broadcasters.¹⁷⁷ Over the course of nearly 20 years, however, Congress has moved gradually in the direction of expanding the sound recording right and, in so doing, increasing the role of market forces in allocating the economic resources used to produce, distribute and consume musical entertainment. As long as government remains enmeshed in the process of setting rates, there will be calls from interested parties for Congress to intervene on their behalf. Such calls should be seen, however, for what they are, and resisted. There is no public policy case in favor of the IRFA, only a political one.

¹⁷⁷ For a more comprehensive treatment of the arguments in favor of the sound performance rights for terrestrial broadcasters, *see e.g.*, Sunny Noh, "Better Late than Never: The Legal Theoretical Reasons Supporting the Performance Rights Act of 2009," *Buffalo Intellectual Property Journal* 6 (Spring 2009) 83.