PUBLIC

Before the
UNITED STATES COPYRIGHT ROYALTY JUDGES
The Library of Congress

In the Matter of **DETERMINATION OF RATES AND TERMS FOR MAKING AND DISTRIBUTING PHONORECORDS (PHONORECORDS III)**	))))))))	**Docket No. 16–CRB–0003–PR (2018–2022)**

INTRODUCTORY MEMORANDUM TO THE WRITTEN DIRECT STATEMENT OF SPOTIFY USA INC.

Spotify USA Inc. ("Spotify") hereby submits its written direct statement, pursuant to 37 C.F.R. § 351.4.

ROYALTY RATE REQUEST FOR 2018-2022 LICENSE PERIOD

Spotify requests that the Copyright Royalty Judges continue the rates and terms for royalty payments for interactive streams and limited downloads of musical works by subscription and non-subscription digital music services as codified at 37 C.F.R. § 385, Subpart B, with the following changes:

- A removal of the subscriber-based royalty floor as codified at 37 C.F.R. § 385.12(b)(3)(ii) and 37 C.F.R. § 385.13(a)(1) & (3) (for standalone non-portable subscription—streaming only and standalone portable subscription service, respectively).

- Discounts for family plans and student plans, with one family plan being treated as 1.5 subscribers per month, and one student account being treated as 0.50 subscribers per month.

- A clarification that late fees do not apply to interactive streaming services paying royalties pursuant to 37 C.F.R. § 385, Subpart B.

- An elimination of the self-audit certification obligations as codified at 37 C.F.R. § 201.19, to be replaced by an audit right for publishers (upon satisfying a minimum aggregated service share of at least 15%, *i.e.*, a "Qualifying Publisher"). Such an audit right for publishers will be subject to the following standard

limitations: (1) such audit must be conducted by a Qualified Auditor (*i.e.*, an independent CPA that is licensed in the jurisdiction in which it conducts the verification and is not an employee of a publisher); (2) a Qualifying Publisher cannot conduct an audit more than once during any 12-month period; (3) the audit would be limited to any or all of the prior three calendar years provided that no calendar year will be subject to an audit more than once; and (4) the audit may not be conducted on a contingency fee basis.

- A revision of the definition of "service revenue" as codified at 37 C.F.R. § 385.11 to include reductions for app store, carrier billing, and credit card commissions or similar payment processing charges.

SUMMARY OF TESTIMONY

As the testimony presented by Spotify shows, Spotify's uphill battle for [REDACTED] (indeed, Spotify has [REDACTED]), coupled with Spotify's costly technological infrastructure, counsels against any increases in the royalty rates for interactive streaming. Further, because a reasonable fee for the 2018-2022 rate period must also take into account the policy-based factors of 17 U.S.C. § 801(b), the Judges should eliminate the subscriber-based royalty floor and implement certain discounts for student and family plans in calculating per-subscriber minimums. Such a reasonable rate would enable Spotify to grow its listener base, thereby increasing the exposure and dissemination of creative works to the public and decreasing piracy, as well as minimize any disruption to its business. Spotify's growth would in turn grow the pie for all parties—including copyright owners.[1]

[1] Neither the Copyright Royalty Board nor its predecessor, the Copyright Arbitration Royalty Panel, has ever had an opportunity to determine royalty rates for interactive streaming services like Spotify—or, whether a mechanical license is required at all. Indeed, the current royalty rates, codified at 37 C.F.R. § 385 Subpart B, are the product of a settlement the parties entered into during the 2006 *Phonorecords* rate proceeding. There, the Judges observed that they were "mandated to adopt the determination of the settling parties," but that, in "doing so, [the Judges] observe that the provisions of the settlement do not constitute a finding of fact or a resolution of law by [the Judges]." Mechanical and Digital Phonorecord Delivery Rate Determination Proceeding, 74 Fed. Reg. 4510-01, 4515 (Jan. 26, 2009). These same rates were continued pursuant to a settlement between all participants in the *Phonorecords II* proceeding entered into, and adopted by the Judges by Order dated January 1, 2014.

An increase in royalty rates for interactive streaming is especially unjustified given that the copyright owners in this proceeding have agreed to a continuation of the rates for physical phonorecord deliveries, permanent digital downloads ("PDDs"), and ringtones (37 C.F.R. § 385, Subpart A)—continuing the rates *from those decided by the Judges a decade ago.* That the copyright owners agreed to continue the 9.1 cent rate for PDDs is especially notable given that the *retail* price of a PDD has increased over the course of the past ten years. If anything, then, the Judges, who may use market benchmarks as a starting point but must also conduct a policy-based analysis required by the 801(b) factors, should make modifications to the current rate structure of interactive streaming to eliminate inefficiencies and ensure a fair outcome for all parties, including the digital services.

<u>Benchmarks for Spotify's Mechanical Royalty Rate</u>

As Spotify's economic expert, Professor Leslie M. Marx, testifies, there are two potential benchmarks for the interactive streaming mechanical royalty rate: mechanical rates for PDDs and existing statutory interactive streaming rates.

The 9.1 Cent Permanent Digital Download ("PDD") Rate

As Professor Marx explains, the underlying principle of using PDD/CD rates as a benchmark for interactive streaming rates is that compensation to musical rights holders for

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Spotify does not suggest at this time whether or not a mechanical license is required for streaming, and indeed, courts have not addressed whether interactive streaming companies are required to obtain a mechanical license at all for tracks that are streamed online. Spotify maintains that a mechanical license is not required for tracks that are streamed online, because such streaming technology should be viewed functionally rather than formally. To give a more concrete example, Spotify is essentially a modern equivalent of the jukebox—the quintessential device for on-demand public performance of songs. Indeed, on-demand music playing services have long been described as a "celestial jukebox." *See, e.g.*, Paul Goldstein, *Copyright's Highway: From Gutenberg to the Celestial Jukebox* (2003). The Judges need not decide that question in this proceeding, because Spotify's rate proposal does not go that far. It seeks, rather, to create a vibrant market for all parties—rightsholders and digital services, alike.

comparable channels of distribution should be comparable, so that the statutory rate structure does not create artificially favored or disfavored forms of distribution out of line with underlying costs or demand.

Moreover, the 9.1 cent PDD rate is especially useful given that it is a negotiated rate agreed to by the copyright owners as part of a settlement in this very proceeding. It reflects negotiations between copyright users and the same copyright owners for the very same mechanical rights for the very same rate period. Using this benchmark yields a mechanical royalty rate of percent of revenue— Spotify's existing effective mechanical royalty rates of roughly of revenue for paid subscribers (i.e., those subscribers on Spotify's Premium tier) and of revenue for ad-supported subscribers.

The Current Statutory Rate

Likewise, the current Subpart B rate, which has been in effect for over a decade, provides a useful starting point, as it was also a negotiated rate that was entered into in 2008 by the same buyers and sellers that are in this proceeding—owners of musical works and streaming services—and continued, by agreement of all parties, in the most recent *Phonorecords II* proceeding.

However, and as Professor Marx explains, the current Subpart B rates are structured inefficiently. The flat $0.50 per-subscriber floor inefficiently discourages discounting aimed at consumer groups with lower financial ability or willingness to pay for music. In other words, removal of the per-subscriber would incentivize Spotify and others to —the undiscounted cost of a paid subscription— Revenue from this group of users would grow revenue for both Spotify and publishers. Removal of the per-subscriber floor would achieve both

a downward movement in effective rates in some cases, and an increase in efficiency from the status quo, incentivizing expansion of the streaming market to the ultimate benefit of copyright holders, copyright users, and final consumers.

As described below, application of the § 801(b) factors likewise necessitates an adjustment to the current statutory rate in the form of removal of the per-subscriber floor and discounting of per-subscriber minimums for family and student plans.

Application of the 801(b) Factors

Spotify has pioneered a business model offering a flat rate for instant, on-demand access to one of the largest music catalogs ever made available to music fans. Along the way, by means of its substantial investments in both human capital and technology, Spotify has developed new technologies and innovative products that enable its users to be exposed to new and more music. One of those innovations is Discover Weekly, which uses algorithms to help connect listeners to artists and songs Spotify is sure listeners would love, but which they likely have never heard before. In addition, Spotify collects listening data from all over the world and makes that data available to artists on its Fan Insights portal, thereby enabling access to never-before available information about their fans. The result is more fans getting to see the music they love and more artists selling more tickets and products to those fans.

As a result of these and many other unique technological developments and customized features, a rapidly growing user base is willing to pay Spotify $120 per year to access the service—far more than a typical CD or PDD purchaser spends on CDs or PDDs.[2]

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[2] [redacted] Spotify also offers an ad-supported service (with a limited ability to select songs while on the go) that allows it to provide many of these benefits to those unable or unwilling to pay, such as radio listeners or users of piracy services.

The results of Spotify's innovations have been profound. First, Spotify monetizes music better. Spotify's paid tier monetizes music better than CDs or PDDs, and Spotify's ad-supported tier monetizes music for songwriters better than radio or piracy and serves as a gateway to the paid tier. Spotify users also listen to more music than either CD/PDD purchasers or radio listeners.

Second, Spotify has led to a significant decline in piracy: studies show that Spotify has been extremely effective at luring people away from online piracy, even in the Netherlands when piracy was *legal*.

Third, Spotify's music discovery innovations and "Creator" services (services for artists and songwriters) have helped to break out a multitude of new artists and songwriters who otherwise would not be getting any play — or royalties. In fact, the evidence shows that Spotify now breaks out artists well *before* radio (and while paying higher royalties). In sum, Spotify has resulted in more users listening to more — and more varied — music, less piracy, and a reversal in a decades-long decline in revenues for the music industry that coincided with the arrival of Napster.

To create these benefits, Spotify has made substantial and necessary investments in technology, personnel, sales, and marketing. But because of the very high costs of content, [REDACTED] If Spotify is to continue providing the benefits and revenues it brings to songwriters and the music industry, it must pay rates that support Spotify's goal: to create a thriving market where artists and songwriters are paid well and music streaming is a [REDACTED] sustainable business.

The witness testimony Spotify will present goes directly to the heart of each of the 801(b) factors, as further discussed below.

Factor (A): Maximizing Availability of Creative Works to the Public

Maximizing the availability of creative works can be accomplished in two ways: through (1) *practical availability* and (2) *discoverable availability*. Practical availability reflects the sheer number of creative works available to a consumer, such as the total number of different records in a record store. Discoverable availability, on the other hand, is the amount of new and unknown creative works that a consumer could reasonably come upon and enjoy. After all, having access to the world's largest music catalog is helpful only if a consumer can find the record she is looking for or is pointed to a record she might like.

Spotify has maximized the availability of creative works to the public in both ways. First, as Spotify's Director of Economics, Will Page, and Head of Creator, James Lucchese, will testify, Spotify makes available one of the largest online music catalogues — to which it offers unlimited access. It is simply much easier for a Spotify user to jump from song to song, artist to artist, or playlist to playlist than it was for a purchaser under the old "ownership" model. The barriers to music availability in an access model are simply much lower. Second, Mr. Page and Mr. Lucchese testify to Spotify's investment in an array of music discovery products, including "Discover Weekly," "Fresh Finds," and "Release Radar". These products help listeners find artists and songwriters and songs they would not otherwise find. Ironically, lower musical works royalty rates for terrestrial radio have been traditionally justified on the grounds of its promotional effect, yet Spotify's music discovery products now help break out artists and songwriters faster and reach a global audience better. Third, Mr. Lucchese presents testimony about Spotify's Creator group, which offers products and services designed to help artists better connect with fans. For example, Spotify's "Fan Insights" feature provides artists with dashboard data that shows them

Finally, as discussed above, Professor Marx testifies how removal of the per-subscriber floor would assist Spotify in pricing efficiently This would increase the number of users with full access to Spotify's catalog and music discovery products, thereby maximizing the availability of creative works to the public.

Factor (B): Affording Copyright User Fair Income and Copyright Owner a Fair Return

Despite Spotify's contribution to the overall musical landscape, On the other hand, the growth of Spotify has corresponded with increased income to copyright *owners*. Therefore, removal of per-subscriber rates or reduction of per-subscriber minimums under this factor is warranted to enable Spotify to continue to grow, resulting in *more* money for copyright owners, not less, and a fair income to Spotify.

First, Spotify's Chief Financial Officer, Barry McCarthy, testifies to the fact that Spotify and that its losses are largely driven by high royalty costs that consume more than 70 cents of every dollar that Spotify earns. In addition, Spotify's VP, Head of Global Financial Planning and Analysis and Investor Relations, Paul Vogel, discusses how the current royalty rates have a negative effect on Spotify's financials. And finally, David Pakman, a music industry expert and partner at Venrock Associates (a venture capital firm), demonstrates with empirical data that Spotify's situation is hardly unique, and that royalty rates must go down for music streaming services to be

Second, a number of witnesses testify to facts supporting the conclusion that the growth of Spotify, and interactive streaming, results in *more* money for copyright owners, not less. Mr. Page and Mr. McCarthy testify that Spotify's paid tier monetizes music better than CDs or PDDs, and that Spotify's ad-supported tier monetizes music better than radio or piracy. Mr. Lucchese testifies that Spotify's Creator services generate ancillary revenue for rightsholders. Mr. Page and Professor Marx also testify to Spotify's tremendous impact on piracy and its stabilizing effect on the decline of an industry that was in free fall after the advent of Napster and digital music piracy. As they explain, overall music industry revenues declined since the introduction of Napster, but, thanks to streaming, have risen again.[3] An adjustment to remove inefficiencies in the royalty rates is thus warranted to enable Spotify to continue to grow and earn a fair income, and, in turn, to provide a higher return to copyright owners.

Professor Marx also describes how removal of the per-subscriber floor would assist Spotify in [REDACTED] resulting in even more money for both Spotify and copyright owners. Mr. McCarthy's testimony about Spotify's experience with offering student discounts further supports this argument. [REDACTED] Therefore, and in addition to its economic inefficiencies, any per-subscriber floor or minimums that fail to take into account plans like student discount or family plans disincentivizes Spotify from pursuing [REDACTED], like students, [REDACTED] to minimize deadweight loss—including revenue that is not captured by any party. In the absence of on-demand options, such segments may turn to piracy or low-cost services, resulting in reduced royalties for publishers.

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[3] Critically, music publishing seems not to have been affected by a decline in overall revenue, as global publisher revenues have shown steady increases year after year.

Third, Spotify presents evidence that removing the per-subscriber floor would be fair to all stakeholders. Professor Marx discusses how the Shapley value, a model of allocating the value created by interactive streaming according to relative contributions of copyright holders and copyright users, supports the idea that interactive streaming services should pay lower rates than they do currently. This model corresponds to the second and third 801(b) factors, which call for a "fair" allocation of value as between the copyright owner and the copyright user.

In sum, a modest change in current Subpart B rates is reasonable for all stakeholders as it would offer Spotify [REDACTED] while continuing to provide a fair return for copyright owners.

Factor (C): Technological Contribution, Capital Investment, Costs, Risk, and Creative Contribution

Spotify has made numerous technical contributions as well as extensive investments in innovative streaming technology. These contributions have required significant expenditures, all of which have been borne by the streaming services, while music publishers have taken on minimal financial burden or risk.

As demonstrated by the testimony of Mr. McCarthy and Nicholas Harteau (Spotify's VP of Engineering for Infrastructure), Spotify has made substantial investments in the research and development necessary to build its products and services and continues to make significant financial investments to ensure that it delivers creative works effectively and seamlessly. Mr. McCarthy also testifies to the large amount of money Spotify has spent on marketing to bring its products to market and educate consumers about, and bring them to, those products.

In short, Spotify (like other music streaming services) has created the platform and technology necessary to bring music delivery into the new era, and in turn incurred all the cost, risk, and capital associated with doing so. Publishers incur none of these costs. In support, Mr.

McCarthy and Mr. Vogel explain how the per-subscriber floor shifts risk from publishers to streaming services by ensuring that any downward pressure on price—due to an economic downturn, for example—is borne by the services. Meanwhile, and as Mr. Pakman and Mr. Page testify to, music publishing is an extremely low-risk, low-capital business, which does the same thing it has done since the invention of the piano roll. Indeed, Mr. Page and Professor Marx describe how music *publishing* seems not to have been affected by the decline in music industry revenues.

At the same time, interactive streaming has undoubtedly reshaped the music landscape for the better. It has decreased piracy, resulting in increased royalty payments to music publishers where such publishers were previously receiving zero royalties from illegal sources. As discussed above, overall music industry revenues had declined since the introduction of Napster, but, thanks to streaming, have risen again. This change is attributable to the constant innovations and contributions of the services that worked to bring an interactive streaming platform to consumers who would otherwise turn to piracy or free substitutes.

Factor (D): Minimizing Disruptive Impact on the Structure of the Industries Involved and on Generally Prevailing Industry Practices

An increase in rates would not only impede Spotify's efforts to [REDACTED] [REDACTED] If Spotify cannot [REDACTED] [REDACTED] which, as Mr. McCarthy and Mr. Harteau explain, would only create an inferior user experience, resulting in fewer customers and lower revenue. And if Spotify, and streaming as a whole, [REDACTED] due to untenably high royalty rates, then not only will the music-consuming public suffer, but so will rightsholders.

On the other hand, Spotify's rate proposal — which proposes rationalizing the structure of minimum payments to achieve greater economic efficiency, rather than actually decreasing

rates — will increase the ability of streaming services [REDACTED] And, as Mr. Pakman testifies, a thriving music industry encourages investment, creating increased competition and resulting in better products and services for all.

Therefore, Spotify's rate proposal, which mostly seeks to retain the status quo while eliminating gross inefficiencies, represents the most effective means to balance the 801(b) factors in a way that benefits all interested stakeholders, including: (i) artists, songwriters, and creators, (ii) music publishers; (iii) digital service providers; and (iv) music listeners.

In support of its royalty rate request, Spotify will present in its direct case the testimony of the following fact and expert witnesses:

Fact Witnesses

Barry McCarthy

Barry McCarthy has been the Chief Financial Officer of Spotify since he joined the company in 2015, and was previously on Spotify's Board of Directors from 2014-2015. Mr. McCarthy describes how Spotify has experienced rapid growth [REDACTED] The company's biggest cost is royalties, which consume more than 70% of its revenue. Mr. McCarthy describes how Spotify [REDACTED] Mr. McCarthy discusses the significant money Spotify has raised and invested in building its products and services, and how royalty rates affect [REDACTED]

Mr. McCarthy further discusses how a per-subscriber floor or minimum results in inefficiencies and unnecessary risk, and how a reduction in per-subscriber minimums and

removal of a floor would [redacted] thereby growing the pie for all.

Will Page

Will Page is the Director of Economics at Spotify. Mr. Page outlines how consumption habits have changed for today's music listeners, shifting from an ownership model of purchasing CDs and PDDs to an access model of streaming. Mr. Page emphasizes that, far from cannibalizing album or digital download sales—a mode of consumption that consumers would not return to even in the absence of Spotify—Spotify displaces piracy. Mr. Page supports this testimony with data showing the sharp decrease in net revenue for the music industry after the advent of Napster and then the corresponding increase in incomes after the introduction of streaming. Mr. Page also presents data showing that revenues for music publishing have steadily increased year after year, even as overall revenues for the music industry have declined. Mr. Page further provides evidence that Spotify's paid service monetizes music better than CDs or PDDs, and that Spotify's ad-supported services monetizes better than other free-to-users options such as terrestrial radio.

Mr. Page's testimony further describes the competitive landscape in which Spotify operates, including [redacted] both of which pay lower musical works royalties than Spotify. Mr. Page's testimony highlights the continued erosion between so-called "lean back" and "lean forward" services,[4] as he describes the tremendous amount of "lean back" listening (over 50%) that Spotify users engage in by listening to Spotify-curated playlists.

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[4] "Lean forward" listening is driven by the user, where she chooses exactly the song she wants to listen to, whereas "lean back" listening is where the user allows the service to drive her listening, often through the use of a service-curated playlist or the like.

Lastly, Mr. Page's testimony highlights the promotional benefits of Spotify innovations like Discover Weekly or Fan Insights, which serve not only to promote artists but also make music available to the public like never before. As Mr. Page describes, these features lower consumer search costs by pairing consumers with artists they will likely enjoy based on past listening history, in turn promoting lesser-known artists, encouraging artist discovery, and fostering greater variety in music consumed. Similarly, innovations like Daily Mix and Fresh Finds [REDACTED] lesser-streamed artists and help them "break out". Finally, Fan Insights gives artists insight into [REDACTED] in turn increasing non-streaming performance royalties for the publishing industry.

Paul Vogel

Paul Vogel is the VP, Head of Global Financial Planning and Analysis and Investor Relations. Mr. Vogel discusses the effect of the current rate structure on Spotify's business. He testifies as to the inefficiencies of the current mechanical rate structure, [REDACTED] The end result is fewer works made available to the public as a whole [REDACTED] This means a smaller pie for everybody, including reduced royalties for publishers.

Mr. Vogel's testimony further describes the effect of removing per-subscriber floors on Spotify's financials and the pricing risk introduced by the existence of floors or undiscounted per-subscriber minimums.

Nicholas Harteau

Nicholas Harteau is VP of Engineering for Infrastructure at Spotify. Mr. Harteau's testimony describes the incredibly high operational costs and enormous capital expenditures necessary for developing and maintaining Spotify's infrastructure, which must seamlessly deliver high-quality streams to consumers. Mr. Harteau describes the company's continuous innovation in the areas of personalized music recommendations and more. Mr. Harteau also describes the high costs Spotify expects to incur in the upcoming 2018-2022 rate period, including the costs associated with Spotify's substantial technological investment in the purchase of a cloud-based system to host, manage, and operate the Spotify infrastructure from Google.

James Lucchese

James Lucchese is the Head of Creator at Spotify, a group that develops products to help connect artists, songwriters, and listeners. He describes many of the unique products Spotify has developed that help users discover music and break out artists, such as Discover Weekly and Fresh Finds. Spotify's innovations have lead the democratization of music in a world where radio no longer holds a monopoly on "breaking" artists. Mr. Lucchese also describes Fan Insights, which helps artists learn about their fan bases so as to better connect with and market to them. Finally, he describes other Spotify products that help artists monetize their works, [REDACTED]

Expert Witnesses

Leslie M. Marx

Dr. Leslie M. Marx is the Robert A. Bandeen Professor of Economics at the Fuqua School of Business at Duke University. Professor Marx's testimony focuses on two benchmarks: the current interactive statutory rate, and the permanent digital download rate of 9.1 cents. Applying these benchmarks, Professor Marx determines that the "all-in" (performance and mechanical) royalty rate for musical works should lie somewhere between [redacted] of revenue. The mechanical royalty rate, then, should be between [redacted] of revenue. Her Shapley value analysis confirms that, if anything, these values represent conservative downward movement to current rates based on the 801(b) factors.

Professor Marx argues also argues that the current interactive streaming mechanical rate structure leads to inefficiencies. The $0.50 per-subscriber floor discourages discount plans such as student and family discount plans. These plans expand the market for interactive streaming services and increase public accessibility to music, benefitting both copyright holders and users as well as consumers. More generally, Professor Marx testifies to the economic inefficiencies of flat per-subscriber and per-play minimums, which discourage interactive streaming services from expanding listening. She finds that applying such minimums to ad supported services, as called for by initial proposals to some parties to this proceeding, could have a particularly dramatic impact on the viability and effectiveness of the ad supported business model, which generates value by expanding the market to consumers at the low end of what has been recognized as a strong bimodal distribution of consumers' willingness to pay.

David Pakman

David Pakman is a Partner at Venrock Associates, a venture capital firm, and an expert on the digital music industry. He describes how high royalty rates are preventing services from

achieving profitability, resulting in underinvestment in digital streaming. Mr. Pakman concludes that lower rates would encourage investment and competition in the streaming space, creating a more vibrant landscape to the ultimate benefit of copyright owners and the consuming public.[5]

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Respectfully submitted,

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[5] Mr. Pakman's testimony is submitted in conjunction with the Written Direct Statement of Google Inc., and is sponsored by Google Inc., Pandora Media, Inc., Spotify USA Inc., and Amazon Digital Services, LLC.