Before the
UNITED STATES COPYRIGHT ROYALTY JUDGES
The Library of Congress

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

WRITTEN DIRECT TESTIMONY OF BARRY MCCARTHY

(On behalf of Spotify USA Inc.)

Introduction

1. My name is Barry McCarthy. I am the Chief Financial Officer ("CFO") of the Spotify group of companies ("Spotify") and am an employee of Spotify USA Inc. I have served as CFO of Spotify since July 2015. Prior to that, I was a member of Spotify's board of directors. I graduated with a BA in History from Williams College in 1975 and an MBA in Finance from The Wharton School at the University of Pennsylvania in 1980.

2. Before joining Spotify, I served as a Venture Partner and Executive Advisor at Technology Crossover Ventures. Before that, I was CFO of Netflix for nearly 12 years and CFO of Music Choice for 6 years.

3. My testimony will primarily focus on three points: (1) Spotify has grown rapidly, benefitting rights holders, [redacted] (2) [redacted] and (3) the current mechanical rate structure is inefficient and hurts rights holders, listeners, and Spotify.

<u>Spotify's Rapid Growth Has Benefited Rights Holders,</u>
<u>But Spotify Has Not Turned a Profit Due to High Royalty Costs</u>

<u>Spotify Has Grown Rapidly</u>

4. Spotify has grown tremendously since it launched its service in Sweden on October 7, 2008. [redacted][1]

5. Spotify's paid subscribers have also increased significantly. [redacted]

6. [redacted]

7. [redacted]

8. [redacted]

[1] Where I don't say otherwise, the user and revenue numbers I cite in my testimony are global numbers. I will indicate where I refer to U.S.-specific numbers.

<u>Spotify's Continued Growth Is Good for Spotify and Good for Rights Holders</u>

9. Spotify offers users two services: an ad-supported service that is free to users and a paid subscription service that costs $9.99 per month (assuming no discounts). I will refer to the former as the "ad-supported" service and the latter as the "paid" or "Premium" service.

10. [redacted]

11. The large increases in Spotify's user numbers have meant that Spotify pays more and more money to rights holders. This is true for both ad-supported and Premium users.

12. **Premium**. The average Spotify Premium subscriber pays more money to owners of musical works each year than the average person who buys CDs or PDDs. In 2015, for each Premium subscriber, Spotify paid approximately [redacted] per year to songwriters and publishers for public performance and mechanical royalties. (My colleague Paul Vogel explains Spotify's royalty payments in more detail in his testimony.[2]) In contrast, the average listener who buys CDs or PDDs resulted in only [redacted] per year being paid to songwriters and publishers. (My colleague Will Page discusses broader industry trends in more detail.[3]) For every CD or PDD purchaser who signs up for Spotify's Premium service, rights holders earn an additional [redacted] per year—even if the subscriber never buys another CD or PDD. And for the many people who *weren't* buying CDs or PDDs, subscribing to Spotify Premium adds even more money for rightsholders.

[2] *See* Written Direct Testimony of Paul Vogel (On behalf of Spotify USA Inc.), Nov. 1, 2016.
[3] *See* Written Direct Testimony of Will Page (On behalf of Spotify USA Inc.), Nov. 1, 2016.

13. **Ad-supported**. The growth of the ad-supported service leads to more payments to rights holders in two ways.

14. First, [redacted] And that leads to more revenue for rightsholders.

15. Second, many people simply will not pay for music—the terrestrial radio market is as large as it is because it is free. These people have a few options: terrestrial radio, piracy, and other free streaming services (such as YouTube). Terrestrial radio does not pay any mechanical royalties (or sound recording royalties). Of course piracy pays no royalties at all. Switching these listeners to Spotify results in significantly more revenue for rightsholders that was simply being left on the table. It also exposes listeners to music they otherwise might not have discovered. That leads to more royalties to songwriters who wouldn't be discovered through radio or piracy.

Despite Spotify's Growth, [redacted]

16. Despite the growth in MAU, paid subscribers, and total revenue, Spotify has not turned a profit. [redacted]

17. [redacted]

18. [redacted]

19. [redacted]

20. Spotify's growth has resulted in significant payments to rightsholders, but at a high cost to Spotify.

21. [redacted]

22. [redacted]

[4] This number represents U.S. earnings before interest and taxes ("EBIT"), defined as U.S. contribution less a pro-rata allocation of global indirect costs such as R&D, G&A, and headcount costs for content and distribution ("C&D") based on the United States' share of global revenue.

[redacted]

23. Spotify's non-royalty costs can be generally divided into four categories: (a) other cost of goods sold ("other COGS"), such as streaming delivery, ad-serving costs, payment fees (*e.g.*, for credit card processing), customer service, and headcount costs for employees working in content and distribution; (b) sales and marketing ("S&M"); (c) research and development ("R&D"); and (d) general and administrative ("G&A"), such as human resources, facilities, content administration, finance, and legal expenses.

24. [redacted]

25. [redacted]

26. [redacted]

5 [redacted]

[redacted] The U.S. is also a large[6] and competitive[7] market, and it requires more money to grow awareness in the U.S. than smaller countries. However, the fact that the U.S. is such a large market means that it holds great potential and therefore is worth the investment.

[redacted]

27. Spotify wants to pay artists and songwriters well as part of a thriving competitive marketplace. [redacted] Spotify's interests in [redacted] and paying rightsholders are aligned with each other: [redacted] Songwriters and artists would see a huge drop in revenue, and the amount of music available to the public would decrease.

28. [redacted]

[6] Consider, for example, that the population of New York state alone is roughly twice the population of Sweden. The U.S. music market is nearly one-third of the global music market. *See, e.g.*, INTERNATIONAL FEDERATION OF THE PHONOGRAPHIC INDUSTRY, GLOBAL MUSIC REPORT: MUSIC CONSUMPTION EXPLODING WORLDWIDE 9, 72 (2016). A true and correct copy of the IFPI report is attached hereto as Spotify Exhibit 1.

[7] Spotify's competition for its free ad-supported service includes, among others, YouTube, Pandora, Deezer, SoundCloud, Grooveshark, iHeartRadio, Slacker Radio, terrestrial radio, and piracy. Spotify's competition for its paid subscription service includes, among others, YouTube Red, Pandora One, Deezer Premium+, SoundCloud Go, Amazon Music Unlimited, Apple Music, Google Play Music, Napster, Tidal, and satellite radio.

29. [redacted] This means decreasing the rate for all three types of royalties: sound recording, public performance, and mechanical.

[redacted]

30. [redacted] I will discuss each area of costs in turn. [redacted]

31. **Other cost of goods sold.** [redacted]

32. [redacted]

33. [redacted]

34. [redacted]

35. **Sales and marketing costs.** Sales and marketing costs are necessary to attract users. [redacted]

36. [redacted]

37. [redacted] Fewer people using Spotify means lower royalty payments to rightsholders. And as my colleagues James Lucchese and Will Page discuss, more people using Spotify means more opportunities for rights holders to sell concert tickets and merchandise through Spotify's platform.

38. [redacted]

39. **Research and development costs.** [redacted] Other tech companies typically spend *at least* 7.5-10% globally, as shown in the table below:

Company	2015 R&D as a percentage of revenue
Facebook	26.9%[8]
Google	16.3%[9]
Netflix	9.6%[10]
Pandora	7.3%[11]

40. Conversely, Pandora, for example, spent only 5.2% on R&D in 2013 and 5.8% in 2014. [redacted].[12] (As shown in the chart above, its R&D spend is only recently catching up.)

41. R&D is not only about innovation; some R&D is necessary to have a minimally functioning product. For example, Spotify must continuously upgrade its infrastructure to handle increased workload, not only from a growing user base,[13] but also as music content and product features change and grow. Spotify must also continually update its

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[8] Facebook, Inc., Annual Report (Form 10-K), at 41 (Apr. 27, 2016), *available at* https://s21.q4cdn.com/399680738/files/doc_financials/annual_reports/2015-Annual-Report.pdf. A true and correct copy of the Facebook Inc. Annual Report (Form 10-K) is attached hereto as Spotify Exhibit 2.

[9] Alphabet Inc., Annual Report (Form 10-K), at 24 (Feb. 11, 2016), *available at* https://abc.xyz/investor/pdf/20151231_alphabet_10K.pdf. A true and correct copy of the Alphabet Inc. Annual Report (Form 10-K) is attached hereto as Spotify Exhibit 3.

[10] Netflix, Inc., Annual Report (Form 10-K), at 38 (Jan. 28, 2016), *available at* http://files.shareholder.com/downloads/NFLX/3134691943x0xS1065280-16-47/1065280/filing.pdf. A true and correct copy of the Netflix, Inc. Annual Report (Form 10-K) is attached hereto as Spotify Exhibit 4.

[11] Pandora Media, Inc., Annual Report (Form 10-K), at 68 (Feb. 18, 2016), *available at* http://investor.pandora.com/Cache/33003946.pdf. A true and correct copy of the Pandora Media, Inc. Annual Report (Form 10-K) is attached hereto as Spotify Exhibit 5.

[12] *Id*.

[13] In general, [redacted] as the number of users, artists, and songwriters using Spotify's services increases. For example, more users generate more data [redacted] My colleague Nicholas Harteau addresses the scaling of infrastructure costs further.

apps to work with the latest mobile devices and operating system updates. [redacted]

42. But a minimally viable product is not enough; Spotify must innovate to compete. This is even more true with the increasingly rapid pace of technological change. Streaming music alone is no longer enough to be competitive. Competitive products must do more, such as providing personalized music recommendations to hundreds of millions of users.

43. Despite Spotify's [redacted] it continues to be a market leader in investing in new features. [redacted]

44. [redacted]

45. **General and administrative costs.** As Spotify grows, it needs to build up support functions, such as human resources, facilities, and so on. [redacted]

46. [redacted]

47. [redacted]

[redacted]

48. [redacted]

49. Netflix [redacted]: Years ago, it was engaged in a battle for users with Blockbuster. When Netflix raised prices by a small amount, customers fled to Blockbuster, who underpriced Netflix. Netflix was forced to retreat.

50. [redacted] For example, Amazon recently launched a new music streaming service that will cost $3.99 per month for users using an Amazon Echo device [redacted], $7.99 per month for Amazon Prime members, and $9.99 per month for others.[14]

[14] A true and correct copy of the article, *Amazon's Music-Streaming Service Completes on Price and Robotic Assistance*, published on Oct. 12, 2016 (available at http://www.wsj.com/articles/new-amazon-music-streaming-service-costs-echo-speaker-owners-4-a-month-1476255600) is attached hereto as Spotify Exhibit 6.

51. [redacted] Spotify previously offered a family plan for $9.99 for the first user and $4.99 for each additional user. Apple entered the market with a family plan costing $14.99 flat for up to six users. [redacted]

52. [redacted]

53. Moreover, raising prices would not put more money in the pockets of artists or songwriters. In many cases, [redacted] through lower royalty rates actually results in *more* money for rights holders. [redacted] Just as it is often in a company's own financial interest to [redacted] On the other hand, if all of the streaming music businesses *raised* prices or discontinued free ad-supported services, it would result in fewer users of these services.

54. [redacted] Spotify's decision to continue to provide a high quality service has fueled its own growth and the growth in royalty payments to publishers and labels. However, Spotify has been shouldering the burden of providing technological contributions and bearing the risks, [redacted]

External Financing Is Not an Alternative to Lower Rates

[redacted] It Has Had to Obtain [redacted] Financing

55. [redacted]

56. [redacted].

57. [redacted]

58. Investors see startup companies such as Spotify as a high-risk investment compared to established companies or companies employing established business models, such as music publishers.

59. [redacted]

60. Spotify is using this financing to fund its operating losses.

Spotify Has Invested Money Raised from [redacted] Financing to Build a Business That Increases Access to Music

61. From January 2010 through August 2016, Spotify has invested approximately [redacted] in R&D and [redacted] in S&M to build and market a business that offers numerous benefits to artists, songwriters, and listeners.

62. One of Spotify's overarching goals in doing this has been to empower artists and songwriters. Spotify aspires to be a platform that artists can "live off" of and use to manage their careers.

[redacted]

63. Investors in Spotify, like any company, are looking for a return on their investment. To date, investors have been interested in Spotify because it has grown faster than any other streaming music businesses and because they believe it will become profitable at some point. If investors do not continue to see this potential, they will not invest.

64. [redacted] it will be increasingly difficult for Spotify to raise capital to fund its losses.

Spotify's Mechanical Royalty Structure
Results in Inefficiencies and Unnecessary Risk

The Current Structure Improperly Aligns Incentives and Leaves Surplus On the Table

65. Spotify's all-in musical composition royalties (public performance plus mechanical) in the United States have a headline rate of 10.5% of revenue. However, mechanical royalties are subject to a number of minima. [redacted]

66. The most significant of the minima is the 50 cents per user floor that applies to Spotify's paid service.[15] [redacted]

67. Per-user floors result in inefficiencies that destroy value both for Spotify, rightsholders, and potential listeners. Student discounts show this potential value. [redacted]

[15] There is a lower, 15-cent, floor for subscribers of Spotify's "Basic Desktop" service, a grandfathered product with very few users.

[redacted]

68. [redacted]

69. But while [redacted] recognize that price flexibility is in everyone's interest, the current U.S. mechanical rate structure simply ignores this benefit. As a result, [redacted] This means that the [redacted], even though they increase profit to rightsholders (both initially and when the student accounts eventually become regular accounts) and increase the overall amount of music consumed on the service.

70. [redacted]

71. [redacted] A royalty structure that is a pure percentage of revenue

[redacted] would align Spotify's incentives with those of rightsholders.

72. [redacted] If Spotify were forced to lower its prices, mechanical royalties would increase as a percentage of revenue under the current structure. My colleague Paul Vogel will provide additional details.

73. [redacted] This would decrease competition, which would harm both listeners *and* rights holders. Competition incentivizes innovations such as Discover Weekly and Fan Insights. (James Lucchese and Will Page will speak more to some of Spotify's innovative features and their benefits to songwriters.) [redacted] This would hurt songwriters, artists, and listeners.

Lower Royalty Rates Would Not Mean Lower Revenue for Rights Holders

74. Lower royalty *rates* would actually result in higher royalty *payments* to rights holders due to the fact that they would enable Spotify to grow the pie. A (slightly) smaller piece of a larger pie is better for rights holders than a larger piece of a much smaller pie.

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16 [redacted]

75. As discussed above, rightsholders are better off when listeners switch to Spotify, for both the ad-supported and paid services. This is true even when a slight decrease in royalties is what is required to get listeners to make that switch.

76. On the ad-supported side, switching a terrestrial radio or piracy-using listener to Spotify's service results in increased payments to rights holders, even at lower than current royalty rates: These other options pay little or no royalties anyway, and the ad-supported service funnels customers into the Premium service.

77. On the paid side, the royalties to songwriters and publishers from a paid subscriber are more than the royalties from a typical purchaser of CDs or PDDs over a one-year period. Even if all Spotify users only bought CDs or PDDs prior to joining, growing the paid service would mean growing the pie. This would still be true even at somewhat lower royalty rates.

78. [redacted] more flexible) royalty rates would actually grow the pie even more, because a percentage of potential customers are willing to pay *more than nothing* but *less than $9.99 per month* (for example, students). Offering these users a discounted paid subscription results in higher payments to rights holders[redacted] because they understand that [redacted] royalty rates result in [redacted] faster subscriber growth, and higher royalty payments as a result of the faster growth.

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

DECLARATION OF BARRY MCCARTHY

I, Barry McCarthy, declare under penalty of perjury that the statements contained in my Written Direct Testimony in the above-captioned proceeding are true and correct to the best of my knowledge, information, and belief. Executed this 31 day of October 2016 in New York, New York.

Barry McCarthy