

PUBLIC VERSION

Before the
UNITED STATES COPYRIGHT ROYALTY JUDGES
THE LIBRARY OF CONGRESS
Washington, D.C.

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In re)	
DETERMINATION OF ROYALTY)	Docket No. 14-CRB-0001-WR (2016-2020)
RATES AND TERMS FOR)	
EPHEMERAL RECORDING AND)	
DIGITAL PERFORMANCE OF)	
SOUND RECORDINGS (<i>WEB IV</i>))	
)	

**INTRODUCTORY MEMORANDUM TO THE
WRITTEN DIRECT STATEMENT OF
PANDORA MEDIA, INC.**

Pandora Media, Inc. (“Pandora”) is pleased to present its Written Direct Statement to the Copyright Royalty Judges pursuant to 37 C.F.R. § 351.4. The details of Pandora’s rate request for the 2016-2020 license period are provided in the subsequent Tab of this submission.

SUMMARY OF TESTIMONY

Pandora, the country’s largest provider of Internet radio, launched its service in 2005 and now serves over 77 million active listeners in the United States. Pandora’s primary offering is non-interactive streaming music channels personalized according to the tastes of its listeners. The heart of Pandora’s offering is the Music Genome Project (“MGP”), a method of classifying and coding recordings – and constructing playlists – according to their musicological traits. With the help of the MGP, a Pandora listener simply enters the name of an artist, album, or song and receives a playlist of tracks with characteristics similar to that “seed” and shaped by the listener’s subsequent feedback (“thumbs up” and “thumbs down”) as he or she listens. Pandora’s unique contribution to a radio-like listening experience is to provide listeners with recorded music selections of Pandora’s choosing that reflect (and also shape) individualized listener

preference as informed by the Genome, Pandora's playlist algorithms, and listener feedback.

The accompanying testimony of Pandora founder Tim Westergren and Pandora Chief Marketing Officer Simon Fleming-Wood describes for the Judges Pandora's founding, history, primary product features, and competition in the market (chiefly terrestrial radio). Mr. Westergren's testimony also discusses the core mission that guided his founding of the company and all of Pandora's efforts since that time: to connect listeners with songs and artists they might not otherwise have encountered, and to provide a platform where artists can be exposed to new listeners, take advantage of the promotional opportunities a service of Pandora's size can offer, and advance their careers while also receiving royalty payments not available from traditional radio play.

The remainder of Pandora's presentation focuses on the appropriate level for those royalty payments – and the best benchmarks for setting them. In past webcaster proceedings, the Judges have been presented with imperfect surrogates lacking in comparability to the statutory services at issue. These inapposite benchmarks have included so-called “interactive” services (where the user selects the particular songs he or she wishes to stream on-demand), along with Webcaster Settlement Act (“WSA”) agreements negotiated not by individual record companies (the willing sellers the Judges have identified as appropriate in the hypothetical market for non-interactive services), but by SoundExchange itself, on behalf of the entire record industry. As to the first category, prior attempts to apply the rates paid by non-interactive services have involved a series of complicated adjustments (most obviously for interactivity) and unreconciled incompatibilities (*e.g.*, the predominance of subscription models for interactive services versus the free-to-the user, ad-supported nature of most non-interactive services).¹ As to

¹ The Judges identified these flaws most recently in the *Satellite II* proceeding, where they observed that “the rights licensed by interactive subscription services are not the same as those by non-interactive

the WSA agreements, the Judges were presented with agreements that raised significant questions as to the circumstances under which the agreements were negotiated, the motivations of the parties, and the parties' respective market power – with scant evidence to answer those questions.

Appreciating that the Judges must deal with the evidence that the parties present to them, the results of the prior proceedings nonetheless have been rates well above those that would be negotiated between a willing buyer and a willing seller. As the accompanying testimony of Pandora's Chief Financial Officer Michael Herring explains, Pandora, despite its size and prominence as the country's largest and most successful Internet radio service, likely would have been driven out of business long ago had it been forced to pay at the rate levels set in the *Web II* and *Web III* proceedings. Only one party, representing less than 5% of the streaming market, even *participated* in the *Web III* proceeding, *see* 70 Fed. Reg. 23102 n.5, the remainder of the industry having sought shelter from the *Web II* and *Web III* rates through privately negotiated settlements (which themselves were negotiated in "the shadow" of the statutory rates).

Against this backdrop, Pandora's written direct statement presents the Judges with evidence of a kind not presented in the *Web II* or *Web III* proceedings: a competitive, arm's-length direct license agreement between Pandora and a significant number of record companies for the very rights – public performances of sound recordings on noninteractive Internet radio and ephemeral copies made in aid of such performances – as are covered by the statutory license. That agreement is a license between Pandora and Merlin B.V. (Music and Entertainment Rights Licensing Independent Network), a global rights agency that represents thousands of leading

services such as the SDARS" and that interactive subscription streaming services did not "offer[] a foundation to support a comparable benchmark from which to begin an analysis of reasonable rates for SDARS for the upcoming license period." *See* 78 Fed. Reg. 23,065.

independent record labels. To date, some [REDACTED] labels have signed onto the deal. Participating members include such well known record companies as Merge, Beggar's, and Epitaph, providing Pandora access to hundreds of thousands of tracks featured on its service. Included among the Merlin-label repertory are Grammy winners, gold and platinum albums, and a wide range of chart-topping tracks and albums. Mr. Herring's testimony describes the key points of the Merlin agreement and identifies some of the leading labels, artists, and albums that it covers.

The testimony of Carl Shapiro, Transamerica Professor of Business Strategy at the Haas School of Business at the University of California at Berkeley, explains in detail why the Merlin agreement represents compelling evidence of rates negotiated by a willing buyer and willing sellers in a competitive market. Most notably, the Merlin agreement provides that as Pandora increases its performances of covered recordings – *i.e.*, as Pandora “steers” toward Merlin-label recordings and away from competing recordings – its effective rate drops. As Professor Shapiro explains, this feature embodies a hallmark of competition: a supplier willing to offer a lower price in an attempt to gain volume. Put in the language of the questions posed by the Judges in their notice announcing the commencement of this proceeding, *see* 79 Fed. Reg. 412, it reveals the common sense economic reality that a service with a relatively elastic demand for the works of any given supplier will be able to negotiate for a relatively lower price, because suppliers will be forced to compete for airplay or face substitution away from their works by the service.² The testimony of Stephan McBride, a member of Pandora's in-house team of data scientists, confirms that Pandora has precisely that ability to “steer” towards or away from the music of particular record companies: as he discusses, Pandora's own internal tests, conducted by Dr. McBride and his team, reveal that Pandora can increase or decrease the spins of a given label – independent

² As to the Judges' stated concerns about the relative strengths and shortcomings of per-performance and percent-of-revenue rates, Pandora's rate proposal adopts a bifurcated structure based on the greater of per-performance and percent-of-revenue rates.

and major alike – by well above [REDACTED] without out any meaningful decrease in listener hours (or, therefore, advertising revenue).

Taking such steering into account, Professor Shapiro’s testimony calculates the statutory rates that are implied by use of the Merlin agreement as a rate-setting benchmark and the rationale for those calculations, resulting in statutory rates in the range of \$0.00110 to \$0.00129 for non-subscription ad-supported streaming during the license period – well below the prevailing rates set in the *Web III* proceeding.

Unlike the interactive services used in past proceedings, application of the rates in the Merlin marketplace agreement requires only very simple adjustments, not the “crazy acrobatics” (to quote former Judge Strasser) required to convert a dissimilar interactive benchmark to a non-interactive statutory license. Professor Shapiro corroborates the reasonableness of the rates derived from the Merlin agreement by reference (with appropriate adjustment) to the rates recently established by the Judges in the *Satellite II* proceeding, which set the royalty rates paid by Sirius XM – a competitor to Pandora.

The remainder of this memorandum briefly describes the topics covered in the testimony of the fact and expert witnesses who will provide testimony in support of Pandora’s rate request.

Fact Witnesses

Timothy Westergren

Tim Westergren is Pandora’s Founder and sits on its Board of Directors. Mr. Westergren’s testimony describes the key milestones in Pandora’s early history, including the enormous effort and ingenuity required to develop the Music Genome Project, the patented music recommendation tool that forms the core of Pandora’s service to this day. Mr. Westergren further details the way in which the MGP, coupled with Pandora’s other playlist algorithms,

work to provide the optimal “lean back” radio-like listening experience for its listeners. As Mr. Westergren explains, the process of including sound recordings within the MGP’s algorithms is time- and labor-intensive work accomplished by extremely knowledgeable and credentialed musicologists with extensive experience and expertise in the field.

Mr. Westergren describes the financial struggles the Company endured as it transitioned from a business-to-business model of music recommendation to a direct-to-consumer internet radio platform. Mr. Westergren further explains the crucial role Pandora’s radio service plays in the overall music ecosystem, and Pandora’s deep commitment to supporting and promoting artists by connecting them with expanded audiences to whom they might not otherwise have had access. Mr. Westergren’s testimony illustrates that the Company’s tenacity in overcoming years of economic hardship has borne fruit, as Pandora is now by far the largest and most successful internet radio company in the industry, with some 77 million active listeners to date.

Simon Fleming-Wood

Simon Fleming-Wood is Pandora’s Chief Marketing Officer, and has held that position since he joined the Company in October 2011. Mr. Fleming-Wood’s testimony provides an overview of the functionality of Pandora’s service, the competitive landscape in which the Company operates, its future growth opportunities (including in the all-important automobile channel), and some of the promotional programs that Pandora offers to artists and labels. Mr. Fleming-Wood explains that Pandora’s simple and user-friendly interface, coupled with its lean-back, curated approach to music delivery, place it in direct competition with broadcast radio providers such as terrestrial radio and Sirius XM; Mr. Fleming-Wood testifies that Pandora also competes with other non-interactive internet radio providers such as Last.fm, iHeartRadio, Slacker Radio and iTunes Radio. As Mr. Fleming-Wood testifies, however, Pandora’s service is

in distinct from “on demand” interactive services such as Spotify and Rhapsody, which serve entirely disparate consumer desires and are, in fact, complementary to Pandora’s service.

Among Pandora’s most promising avenues for future growth, Mr. Fleming-Wood explains, is its continued expansion into the automobile, where terrestrial radio continues to dominate consumer listening. Mr. Fleming-Wood concludes that integration of Pandora with the car is an important opportunity to shift listenership from terrestrial radio, which pays no royalties to the record industry, to royalty-bearing streams from Pandora.

Michael Herring

Mike Herring is Pandora’s Chief Financial Officer, and has held that position since he joined the Company in February 2013. Mr. Herring’s testimony describes Pandora’s financial condition, explaining that despite its growth, it has suffered cumulative losses of nearly [REDACTED] million, and has yet to see its first profitable year. Mr. Herring explains that a significant contributing factor to those losses is Pandora’s staggering sound recording performance royalties, which have totaled more than \$1 billion since the Company launched in 2005. Mr. Herring’s testimony explains that, had Pandora, while maintaining its existing operations, been required to pay the rates set in the *Web II* and *Web III* proceedings, rather than the lower rates it was able to negotiate under the Webcaster Settlement Acts of 2008 and 2009, Pandora would have sustained an estimated \$800 million in additional losses through the end of 2014, and almost certainly would have been forced out of business years ago. Mr. Herring concludes that, were Pandora’s royalty obligations to be set at levels comparable to those set in the *Web III* proceeding, Pandora would need to take immediate and drastic steps to limit listening, curtail its future growth, and thereby reduce the level of royalty payments to SoundExchange’s members.

Mr. Herring's testimony also describes Pandora's enormous efforts over the last several years to create a viable internet radio advertising market. Pandora has invested tens of millions of dollars in an increasingly successful campaign to move advertising dollars from terrestrial radio (a platform that pays no royalties to the recording industry or artists) to Pandora, a platform that in 2014 expects to pay more than \$400 million in such royalties.

Finally, Mr. Herring's testimony describes Pandora's recent direct license agreement with Merlin, a global association representing thousands of independent record labels. As Mr. Herring testifies, the Merlin agreement covers the very performance rights and ephemeral reproduction rights under Sections 114 and 112 of the Copyright Act as are the subject of this proceeding.

Stephan McBride

Dr. Stephan McBride, an economist with a Ph.D. from Stanford University, is a member of Pandora's in-house science team, a position he has held since he joined the Company in April 2014. Dr. McBride's testimony describes the rigorous research methods employed by the Pandora science team in general, and the specific application of these research methods to the design and analysis of experiments that address matters directly relevant to the rate-setting task at hand. Specifically, as explained by Dr. McBride, these experiments were designed to assess: (1) whether significant increases or decreases in Pandora's reliance on the sound recordings of particular record labels will have a material impact on the Pandora listener experience (the so-called "Steering Experiments"); and (2) whether performances of sound recordings on Pandora will lead to an increase (i.e., promote) or decrease (i.e., substitute for) the sale of those sound recordings (the so-called "Music Sales Experiments").

As explained by Dr. McBride, the Steering Experiments demonstrate that Pandora can increase or decrease the spins of each of the three Major record labels by significant amounts without impacting the Pandora listener experience in any meaningful way. Accordingly, Pandora can modify its playlist selecting algorithms, should it so choose, so as to rely more heavily on the tracks of some labels at the expense of the tracks of others. Dr. McBride's testimony also describes the various Music Sales Experiments that Pandora conducted, which examined the impact that Pandora has on the sale of new music and older, more established music from both independent and major record labels. As explained by Dr. McBride, these experiments demonstrate that Pandora has a statistically significant positive impact on record sales. That is to say, when sound recordings are performed on Pandora, the sales of these songs increase. This conclusion holds with respect to sales of both independent and major record labels. These experiments are demonstrably different from, and far more rigorous than, any similar study that has been presented to the Judges in past proceedings. These experiments are not only statistically sound, but the results are generalizable: they not only demonstrate that Pandora has a promotional impact on the particular tracks examined, but that Pandora, as a general matter, is promotional of record sales.

Expert Witness

In addition, Pandora will present the testimony of the following expert witness:

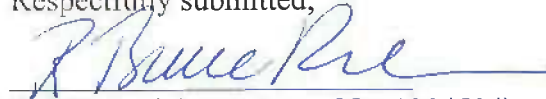
Carl Shapiro

Dr. Carl Shapiro, Transamerica Professor of Business Strategy at the Hass School of Business at the University of California at Berkley, presents testimony establishing the economic basis for the Pandora rate proposal. Professor Shapiro's primary benchmark is the direct license signed by Pandora with the licensing agent Merlin that, to date, covers the sound recordings of

approximately [REDACTED] independent record labels. This competitive market transaction suggests a market rate of the greater of 25% of revenue or a 2016 per-play rate ranging from approximately \$0.00110 to \$0.00120 for advertising-supported performances and \$0.00215 to \$0.00224 for subscription service performances. As explained by Professor Shapiro, this benchmark is ideal in the instant setting as it grants Pandora exactly the rights at issue in this proceeding, is between the same sellers (record labels) and the same buyers (a non-interactive webcaster), has the hallmarks of an agreement negotiated under competitive market conditions, and requires only minor adjustments. This direct-license benchmark is corroborated by the rate set by Judges in the *SDARS II* proceeding, which established the royalty rates paid by Sirius XM – a competitor to Pandora. When properly adjusted to account for differences in the services, the *SDARS II* rate suggests a rate for Pandora of 26% of revenue – a rate that fully corroborates the rate established by the Merlin direct license.

October 7, 2014

Respectfully submitted,

A handwritten signature in blue ink, appearing to read "R. Bruce Rich", is written over a horizontal line.

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