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 REBUTTAL STATEMENT OF SPOTIFY USA INC.

Spotify USA Inc. ("Spotify") hereby submits its written rebuttal statement and First Amended Proposed Rates and Terms. Below, Spotify briefly summarizes each of its five witness and expert statements responding to the written direct statement of the National Music Publishers' Association ("NMPA") and Nashville Songwriters Association International ("NSAI", collectively, the "Copyright Owners").

INTRODUCTION

The Copyright Owners' rate proposal, if implemented, will [REDACTED] This [REDACTED], coupled with moving from a percentage-of-revenue structure to a "greater of" per-play or per-user structure, would upend the status quo and contravene the Copyright Royalty Board's preference for continuing currently-operative rate structures. Notably, not a single benchmark presented by the Copyright Owners' experts actually *contains* a per-play rate, further militating against implementation of a per-play rate here. And, as Barry McCarthy testifies, the Copyright Owners' rate proposal, which consists of a "greater of" per-user or per-stream rate, misaligns incentives and destroys value.

As Mr. McCarthy also testifies, the magnitude of the Copyright Owners' proposed rate increases [REDACTED] [REDACTED]. This is especially concerning because the Section 801(b) factors govern this proceeding, and either [REDACTED] [REDACTED] would directly contravene both the first and the fourth 801(b) factors, which militates in favor of maximizing the availability of musical works to the public and against disruption.

The Copyright Owners seem unconcerned with both these factors, noting blithely that even if a change in the royalty rate structure "somehow led some services to reduce investment, or even to exit the market entirely, it would not reduce the creative works available to the public. As long as some services are making these investments, consumers are well served."[1] In other words, the Copyright Owners are apparently satisfied so long as *some* companies [REDACTED] [REDACTED] can afford to stay in the game—likely by using music as a loss leader given streaming's negative margins and high content costs. In any event, and as the Judges will hear from non-pure-play services like Amazon, there is no guarantee even the largest companies are willing to stay in the music streaming business if there is absolutely no profit to be made from it, ever—no business has an unlimited cash flow.

Make no mistake, adoption of the Copyright Owners' rate proposal would drastically change the streaming music ecosystem. What Copyright Owners—and Apple, with a rate proposal that [REDACTED]—are advocating for is a monolithic landscape dominated by meager consumer choice, where the few who can afford or are willing to pay more than $10/month for streaming do so while others must

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[1] Written Direct Testimony of Marc Rysman ¶ 70.

resort to other means, most likely illegal piracy. This is in direct contravention of the first 801(b) factor—as well as the second factor, because a return to piracy will not provide a fair return to Copyright Owners. And, as Dr. Marx testifies, this dismissal of the importance of downstream competition is also at odds with basic economics and antitrust history and theory, all of which have found that the *degree* of competition, and not just the existence of "some" competitors, is an important predictor of the level of economic efficiency and consumer surplus produced by an industry. A vibrant competitive environment—one that maximizes the availability of creative works to the public—will necessarily consist of many players, not just the monolithic few.

The Copyright Owners' use of a "market-determined" ratio between royalty payments for sound recording rights and musical works rights—a ratio that forms the sole basis of Copyright Owners' benchmarking exercise and economic analysis of optimal mechanical royalty rates—completely obliterates the policy-based 801(b) factors that govern this proceeding. Indeed, in *Web IV*, which applied a completely different willing buyer/willing seller standard, the Judges acknowledged the inordinate amount of market power record labels held and refused to allow "such complementary oligopoly power to be incorporated into the statutory rate." 81 Fed. Reg. 26316-0179, 26367 n. 140. Notwithstanding the Judges' clear dictate, the Copyright Owners' expert, Dr. Eisenach, essentially asks the Judges to do just that: His use of a "market ratio" based on an already-inflated sound recording rate asks the Judges to mirror the record label's market power in the *statutory* mechanical rates. Likewise, the Copyright Owners' expert Dr. Gans notes that "in the context of this proceeding, a **hypothetical unconstrained market** for mechanical licenses is an appropriate analytical guide." That is, the Copyright Owners' rate proposal doesn't just contravene the 801(b) factors—it contravenes even the willing buyer/willing seller standard by asking the Judges to set a *supracompetitive* rate for musical works in a completely

unconstrained market. Such an outcome is not only a complete distortion of the statutory standard that governs this proceeding—it would be a windfall upon an industry that's already thriving in the new digital age.

The Copyright Owners' testimony obscures just how well they are doing—in fact, their testimony attempts to paint a completely different picture. According to the Copyright Owners, the state of the publishing and songwriting industry has never been bleaker. Declining physical sales and the alleged very-low rates paid by streaming services are allegedly threatening songwriters with "extinction." A history of government regulation has unfairly, in the Copyright Owners' view, depressed rates to the point where songwriters are fleeing the industry in droves.

And, according to the Copyright Owners, the digital streaming market has never been better. Spotify is, according to them, doing so well that it is imminently headed for an initial public offering, and, driven by a large influx of investor interest, is happy forgoing revenue in order to avoid its royalty obligations to songwriters.

The picture the Copyright Owners paint is far from reality. Tellingly, the Copyright Owners' WDT consists mostly of anecdotal evidence, cherry-picked data points, conclusory statements, speculation, guesswork, and sweeping generalizations. Most strikingly, the Copyright Owners entirely fail to mention that overall publishing revenue has been either consistent or *increasing* over the past decade—a far cry from the bleak publishing landscape the Copyright Owners present to the Judges. Further, and as both Dr. Marx and Will Page testify to, performance royalties are up thanks to digital streaming (which currently pays, crucially, both performance *and* mechanical royalties), mechanical royalties are steady, supply-side is increasing as BMI and ASCAP are reporting increased works in their repertoires, and a greater variety of songwriters and artists are getting paid thanks to the democratizing effect of streaming.

On the other hand, [redacted]—and indeed, [redacted]

Ultimately, publishing is a high-margin, low-risk business. As documents produced by Copyright Owners state, [redacted].[2] And as Spotify's rebuttal expert, Dr. Mark E. Zmijewski testifies, [redacted] despite the Copyright Owners' proclamations otherwise. On the other hand, streaming is a new experiment. It has only begun to reach mass-market popularity in the past few years. But new technologies beget other, more innovative technologies—that's the lesson of the new digital age. There is no telling yet [redacted], or how long the current model will work before consumers demand something new. To keep up with rapidly-changing consumer demand, Spotify must constantly evolve to meet shifting consumer needs—and that takes capital and significant investment, as well as royalty rates that are flexible enough to changing market demands. As Mr. Page states, "We should all be wary of having short memories. No one should overlook the long list of failures that lie behind us. Streaming is a difficult business. It takes a lot to get it right."

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[2] UMPG00002128, at 2 [redacted]. *See also* UMPG00001540, at 100-101 [redacted]

In contrast to the Copyright Owners' dramatically-disruptive rate proposal, what the Services are asking for is, essentially, a continuation of the current rate structure with adjustments for certain inefficiencies to better effectuate the purpose and goals of the 801(b) factors. This result benefits all parties—the Copyright Owners, the services, and the consuming public alike. As Will Page testifies, the Copyright Owners' continued focus on declining mechanicals obscures the fact that performance royalties are increasing under streaming and that, indeed, *overall* publishing revenue is up. Streaming has helped *increase* revenues to rightsholders in an industry where downloads and physical sales were devastated by *piracy*—a factor the Copyright Owners completely fail to even mention, let alone properly ascribe as the real cause of the declining ownership model. The current structure is benefiting all musical works owners, and most importantly songwriters, as 50% of performance royalties are passed through directly onto them. Any sudden disruption of that status quo could threaten the viability of streaming, which is helping the industry's recovery. Further, as Mr. McCarthy and Mr. Vogel explains, contrary to the Copyright Owners' claims, [REDACTED] [REDACTED], further supporting how Spotify is growing the pie and how streaming benefits more rightsholders.

The Judges should be wary of setting a rate that will severely disrupt an industry still evolving, yet undoubtedly positively impacting the public and rightsholders. The effects of that rate could have ripple effects throughout the entirety of the music industry landscape. Moving to either the Copyright Owners' rate proposal or adopting Apple's per-play approach will almost certainly ensure that [REDACTED] [REDACTED], that has helped the industry recover from piracy and grow the pie. Spotify's rate proposal ensures that rightsholders continue to be compensated fairly, members of

the public will continue to have legal access to the music they love, and streaming services can develop into sustainable business models that will continue to innovate and change the way we all access and enjoy the music we love.

SUMMARY OF TESTIMONY

The rebuttal witnesses Spotify offers in support of the foregoing are as follows:

Barry McCarthy

Barry McCarthy is the Chief Financial Officer at Spotify. Mr. McCarthy discusses how the magnitude of the Copyright Owners' proposed rate increases would [REDACTED] He further discusses how the *structure* of the Copyright Owners' rate proposal—namely, per-user and per-stream rates—would misalign incentives and destroy value, even if the magnitude was less.

Will Page

Will Page is the Director of Economics at Spotify. Mr. Page rebuts the Copyright Owners' argument that mechanicals from streaming should subsidize declining revenues from physical/downloads, as the argument obscures the fact that the ownership model had already been on the decline before streaming, and only with the ascendance of streaming have revenues begun to increase again. Indeed, the state of musical works appears to be doing remarkably well—ASCAP and BMI continue to add millions of new works to their repertoires on a year-on-year basis, showing that more works are being created—in sharp contrast to the apocalyptic

scenario described by the Copyright Owners.[3] Further, even *if* streaming should in effect subsidize Copyright Owners' losses from physical/downloads, comparing only mechanical revenue received from physical/downloads to mechanical revenue received from downloads is inappropriate because streaming pays both mechanical and performance royalties.

Second, Mr. Page emphasizes that the Copyright Owners' overwhelming focus on effective "per-play" rates misses the forest for the trees: overall revenue to publishers is *up* under streaming. He also rebuts the other justifications Copyright Owners set forth for their rate proposal by showing, *inter alia,* why the claim that a per-user rate is needed because Spotify is purposefully forgoing revenue in exchange for user acquisition is nothing other than pure speculation. Whereas the Copyright Owners merely speculate as to how Spotify can best run its business, Mr. Page offers testimony as to how Spotify has *actually studied how it can best run its business*, and applied these findings.

Next, Mr. Page analyzes the "risks" publishers claim to take on, noting that publishing is ultimately a low-risk, stable industry. Any "risks" taken by publishers in issuing new advances are more akin to high-interest loans than creative investment. In any event, all risk is relative—and publishers do not take on more risk or make more investment in music than the Services.

<u>Paul Vogel</u>

Paul Vogel is the Vice President, Head of Global Financial Planning and Analysis and Investor Relations at Spotify. Mr. Vogel discusses the effects of each of the parties' rate proposals on Spotify's business and the industry generally. He discusses how the Copyright

[3] Looking to the number of works in a PRO's repertoire is more indicative than measuring, say, membership of one specific organization like NSAI, which obscures the fact that music production is changing and a greater variety of musicians—not just the Nashville subset—are benefitting from the streaming model.

Owners' proposal as written would [redacted]. Mr. Vogel next discusses how Apple's proposal would unfairly penalize Digital Services with ad-supported tiers, and how it would [redacted] He concludes by discussing how the other rate proposals would result in a [redacted] and enable the Digital Services to grow the pie for all stakeholders, including the Copyright Owners.

Leslie M. Marx

Dr. Leslie M. Marx is the Robert A. Bandeen Professor of Economics at the Fuqua School of Business at Duke University. Dr. Marx testifies that the Copyright Owners' proposal represents a [redacted] in mechanical royalty rates and significant departure from the status quo. The Copyright Owners' proposal would reduce the availability of interactive streaming to consumers and disrupt current industry structure in contravention of the 801(b) factors. She estimates, that, if enacted, the Copyright Owners' proposal would [redacted] The average mechanical royalty payments for paid subscription interactive streaming services would [redacted].

Dr. Marx finds that the Copyright Owners' experts support this proposal though a misinterpretation of the 801(b) factors, a misrepresentation of the current state of the industry and distortion of the current rates services are paying, completely ignoring the effect of the "greater of" prong of the Copyright Owners' rate proposal, and an overall misapplication of economic theory. She finds that their use of a ratio between sound recording and musical works payments to determine rates in this proceeding has no economic basis and essentially asks the Judges to set a *supracompetitive* rate in this proceeding—rates that would be even higher than those under a willing buyer/willing seller standard. Dr. Marx also finds that the Copyright Owners' experts' use of Shapley value and the efficient component pricing rule (ECPR) approaches is flawed and, if correctly applied, would imply that streaming services should pay a lower, rather than higher, musical works payment.

Mark E. Zmijewski

Spotify, Google, Amazon, and Pandora are jointly presenting the expert rebuttal testimony of Professor Mark E. Zmijewski. Professor Zmijewski is the Charles T. Horngren Professor of Accounting, The University of Chicago Booth School of Business. Professor Zmijewski analyzes the financial and accounting statements produced in discovery by music publishers to test the Copyright Owners' assertions about a purportedly negative impact on music publishers' financial condition as a result of interactive streaming. Professor Zmijewski observes that that the reported declines in mechanical revenues [REDACTED]. To the contrary, when the proper comparison is made—total compensation from interactive streaming to total compensation from the sale of recorded music—it is clear that [REDACTED]

[REDACTED]. Professor Zmijewski also finds that [REDACTED]. Finally, Professor Zmijewski considers the contentions of Copyright Owner witnesses who claim that publishers will be [REDACTED] Not only are private agreements between publishers and songwriters over how to divide the royalties paid by interactive streaming services irrelevant to this proceeding, but Professor Zmijewski reports that [REDACTED]

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Respectfully submitted,

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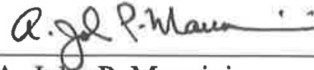

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