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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)**

WRITTEN REBUTTAL 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"). I previously provided testimony during the direct phase of this proceeding.

2. I offer this rebuttal testimony to address several issues raised in the written direct statements submitted by the National Music Publishers' Association and Nashville Songwriters Association International (collectively, "Copyright Owners"). My testimony will primarily discuss two points: (1) that the *magnitude* of the Copyright Owners' proposed rate increases would [redacted]; and (2) that the *structure* of the Copyright Owners' rate proposal — namely, per-user and per-stream rates — would misalign incentives and reduce revenue to the industry. Throughout my testimony, I show that a rate structure based on percentage of revenue would maximize value for the entire

ecosystem — including not only publishers and Digital Services but also songwriters, artists, and listeners.

3. My testimony concludes by summarizing the financial effects of the various parties' rate proposals. In particular, the level and structure of the Copyright Owners' rate proposal would be counterproductive to the goals of the statutory rate. It would place tremendous financial pressure on the Digital Services to drastically change their product offerings or exit the streaming music business altogether. At a minimum, if the Copyright Owners' proposal were adopted, [redacted] and the listening public would experience limitations on the widespread availability of new music, all of which would harm artists and songwriters, both in terms of popularity and financial reward.

The Copyright Owners' Rate Proposal Would [redacted]

4. As discussed in my written direct testimony, Spotify offers a free-to-users ad-supported service and a paid subscription service. I will refer to the former as the "ad-supported" service and the latter as the "paid" or "Premium" service.

5. The Copyright Owners propose a mechanical rate that is the greater of $.0015 per play or $1.06 per end user.[1] This proposal would [redacted].

[1] Unless otherwise noted, I will use "play" and "stream" interchangeably.

6. Spotify pays three types of royalties: *mechanical* royalties to songwriters and publishers, *public performance* royalties to the same songwriters and publishers, and *sound recording* royalties to record labels and artists.

7. For the period from July 2015 to June 2016,[2] Spotify paid out approximately [redacted] of its U.S. revenue in mechanical royalties and [redacted] in public performance and sound recording royalties.

8. [redacted].[4]

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[2] [redacted].

[3] I understand the Copyright Owners believe the mere ability to access music should trigger a royalty. *See, e.g.*, Written Direct Testimony of David Israelite ("Israelite WDT") ¶ 42 ("Each end user account has an inherent value. The user is secure in knowing that all the songs offered by the Digital Service can be accessed at any time or place.").

[4] Calculations are based on the July 2015 – June 2016 period.

9. [redacted].

10. [redacted].

11. [redacted]

[5] Calculations are based on the July 2015 – June 2016 period.

[6] *E.g.*, Written Direct Testimony of Barry McCarthy ("WDT") ¶¶ 16-19

[redacted].

<u>The Ad-supported Service</u> [redacted]

12. The Copyright Owners' greater of per-stream or per-user rate would [redacted].

13. The Copyright Owners' per-user rate applies if the average user listens to 706 or fewer streams per month ($1.06 / $0.0015 = 706.7). [redacted].

14. [redacted].

[7] I understand that these figures are for the United States, using the Copyright Owners' proposed definition for a "play."

15. [redacted].

16. The Copyright Owners present some suggestions for how the Digital Services could [redacted]. But these suggestions are not only uninformed, they are blind to the economic complexities of the digital streaming market.

17. For example, the Copyright Owners assert that [redacted]. This suggestion is unrealistic, as [redacted].

18. [redacted].

19. Without any analysis of Spotify's financials, the Copyright Owners further suggest that the company could [redacted]. *See, e.g.*, Rysman WDT ¶ 101 *et seq.* This is simply not the case.

20. Spotify's paid service would [redacted]. This would have numerous negative consequences for [redacted] rights holders. As discussed below, it would shunt listeners to piracy, [redacted].

21. [redacted]. As discussed in my written direct testimony (*see* Written Direct Testimony of Barry McCarthy ("WDT") ¶¶ 12-15, 75-77), switching a terrestrial radio or piracy-using listener to Spotify's ad-supported service results in increased payments to rights holders — piracy pays no royalties and terrestrial radio pays little.[8] [redacted]

[8] I understand that Dr. Leslie Marx will include supporting calculations in her written rebuttal testimony.

[redacted]

22. The Copyright Owners' suggestion that consumers are willing to pay for interactive streaming is only partially correct.[9] Listeners have varying levels of price sensitivity, and there is a segment of listeners who are *not willing to pay at all*. These listeners will only use free-to-users options, such as terrestrial radio or piracy. It benefits both the Copyright Owners' and the Digital Services' to earn as much as possible from these users. In addition, Spotify and rights holders earn even more when [redacted]. Some users are willing to pay for interactive streaming, but only after they see the benefits through a free option that offers less functionality than the paid service. [redacted], they will not be willing to pay. The ad-supported service has strong promotional effects — approximately [redacted] of Spotify's paid subscribers in the United States were previously active on the ad-supported service. This is similar to how terrestrial radio encouraged listeners to purchase CDs. That same promotional effect applies today to digital streaming services and, particularly, to Spotify — which has introduced novel features to connect artists with their fans, promote new artists, and to enable listeners to find previously undiscovered music.

[9] *See, e.g.*, Israelite WDT ¶ 42 ("Users are willing to and do pay Digital Services for such access [to the songs offered by the Digital Service.]"); Written Direct Testimony of Peter Brodsky ("Brodsky WDT") ¶ 53 ("[C]onsumers have paid and are willing to pay for that value."); Written Direct Testimony of Gregg Barron ("Barron WDT") ¶ 29 ("Digital Services promote this access as a consumer benefit, and consumers have paid and are willing to pay for it ….").

23. [redacted].

24. Ad-supported services must balance a set of often-competing goals, such as generating revenue, attracting and retaining customers, and promoting the paid service. An ad-supported service that only prioritizes revenue could run more ads, but this might harm the service's efforts to attract and retain customers as the service becomes a less attractive alternative to radio, piracy, or other streaming services [redacted]. If users were to leave the service, ad revenue would fall as the service becomes less attractive to advertisers. Losing users would also affect how many ad-supported users could be converted to paid users, and revenue from the paid service could also fall. Balancing these goals is complicated, and the mechanical rates for ad-supported services need to take into account how these services bring in revenue to the overall pool, including revenue to paid services.

25. [redacted].

26. [redacted].

[redacted]

27. As discussed above, I understand that if we were to apply the Copyright Owners' proposal to Spotify's business [redacted]

[10] Calculations are based on the July 2015 – June 2016 period.

[11] Calculations are based on the July 2015 – June 2016 period.

[redacted].

28. [redacted].

29. [redacted].

30. [redacted].

31. [redacted]

[12] [redacted]

[13] [redacted].

[redacted].

32. [redacted].

33. [redacted].

34. [redacted]. This would [redacted] and result in less money for rights holders.

[redacted]

35. The Copyright Owners' testimony concludes that "the Copyright Owners' rate proposal will not be disruptive and will hardly be noticed." Rysman WDT ¶ 92. They suggest that [redacted]

[14] [redacted].

[redacted].

36. [redacted].

37. [redacted]. The Copyright Owners argue that Spotify prioritizes growth *at the expense of revenue*, purportedly to obtain a higher price in a sale or IPO.[15] In other words, the Copyright Owners suggest that Spotify is

[15] *E.g.*, Brodsky WDT ¶ 66 ("Even Spotify … appears to be less focused on generating revenue than on obtaining customers to increase its enterprise value …."); Written Direct Testimony of David Kokakis ("Kokakis WDT") ¶ 61 ("[Spotify] has kept subscription fees low … and has sold less advertising inventory on its free tier than it can with the apparent goal of obtaining the largest possible user base …, which will inure to the benefit of Spotify and its owners and investors when it completes its (highly-publicized) initial public offering.").

under-pricing to grow customers. But the Copyright Owners do not present any evidence that Spotify is under-pricing its services, has sold less ad inventory than it could have sold, or that either of these actions would benefit Spotify in a sale or IPO. That is because they cannot.[16] [redacted]

38. The Copyright Owners argue that "a change in market-wide royalty rates such as this would affect all participants in a similar way," suggesting that the industry as a whole could increase prices without affecting their relative price points. Rysman WDT ¶ 94. [redacted]

[16] Contrary to the Copyright Owners' assertions, Spotify constantly works to improve its advertising services and revenue on the ad-supported service. [redacted] Our service attracts top-tier brands like [redacted]

[redacted].

39. [redacted], the Copyright Owners ignore how sensible prices that promote growth can help listeners, the Digital Services, and rights holders. As discussed in my written direct testimony, student discounts illustrate this potential. [redacted]. While lower prices result in less revenue per user, they often bring in more than enough users to make up the difference. *See* WDT ¶ 53. The Copyright Owners' proposal would inhibit Spotify — and rights holders — from capturing this revenue.

40. The Copyright Owners further argue that the Digital Services could raise revenue through a tiered subscription pricing system with monthly stream caps, overage charges, and other limits (*e.g.*, $9.99 per month for 1000 streams, $14.99 for 2000 streams, an ad-supported service capped at 500 streams, etc.). *See, e.g.*, Rysman WDT ¶¶ 27, 95. They cite no evidence in support of their argument, whereas Netflix is proof that a flat rate price for unlimited

[17] http://fortune.com/2016/10/18/youtube-profits-ceo-susan-wojcicki/. A true and correct copy is attached hereto as Spotify Exhibit 1.

consumption offers a compelling value proposition — one which has propelled the growth of streaming video and resulted in very substantial consumer engagement.

41. [redacted].

42. The Copyright Owners argue that Spotify can cut costs by analogizing to SiriusXM's experience. *See* Rysman WDT ¶¶ 98-100 (stating that SiriusXM's subscriber acquisition, S&M, G&A, and R&D costs have declined as a percentage of revenue). This argument betrays a fundamental lack of understanding of SiriusXM's or the Digital Services' businesses. First, and as the Copyright Owners recognize, SiriusXM's S&M, G&A, and R&D costs declined as a percentage of revenue *as they grew their subscriber base*. *See* Rysman WDT ¶ 99. Their costs declined as they achieved scale. [redacted]. Second, Sirius Satellite Radio and XM Satellite Radio nearly bankrupted each other and merged in order to survive. This led to economies of scale as well, and the merged company had 100% market share as the only satellite radio service. Third, SiriusXM's content costs were almost entirely a

percentage of revenue [redacted], which enabled it to more easily scale.

[redacted]

43. [redacted].

44. As I explained in my written direct testimony, external financing is not an alternative to lower rates (*see* WDT ¶ 55 *et seq.*), [redacted]. [redacted].

45. In sum, the Copyright Owners' proposal would severely disrupt the streaming music industry, [redacted]

[redacted]. Moreover, as I explained in my written direct testimony:

> [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, losing money while publishers' profits are growing. [redacted].

WDT ¶ 54. [redacted].

Monetization of User Data Is Not Relevant to This Proceeding

46. The Copyright Owners' testimony throughout this proceeding suggests that they believe they deserve a cut of any monetization of Spotify's user data.

47. [redacted]

[redacted]

48. [redacted], the Copyright Owners are not entitled to revenue that is unrelated to Spotify's licensed use of musical works, just as they are not entitled to any of Billboard's, IFPI's, or a record label's revenue from their use of listener data.[18] [redacted]

49. [redacted]

[18] Should the Copyright Owners make the argument that [redacted], this would be an attempt by the Copyright Owners to get a cut of revenue that did not come from musical works. For example, Billboard does not pay musical works royalties for selling listening data, and Ticketmaster does not pay musical works royalties for selling concert tickets. This is because these activities do not require a license. [redacted] any such activities should be disregarded in setting a rate for Subpart B royalties. The Copyright Owners' references to the large sizes and deep pockets of some of the Digital Services' parent companies (*see, e.g.*, Israelite WDT ¶ 104; Rysman WDT ¶ 27) also shows their interest in tapping other revenue streams. The Copyright Owners raise the issue to suggest that [redacted], and their reasoning is essentially a demand for a cut of the parent companies' other revenue streams.

[redacted].

<u>Per-User and Per-Stream Rates Prevent Spotify from Growing the Pie for All Rights Holders</u>

50. Even ignoring [redacted], there are other problems with their proposal. Per-user and per-stream rates in general would not provide the right incentives to maximize either revenue and profits to rights holders and the Digital Services or benefits to the public. A pure percentage of revenue royalty structure would align Spotify's incentives with those of rights holders for the reasons set forth in my and others' earlier statements submitted to the Board.

<u>A Per-User Rate Would Adversely Affect Listeners and the Industry</u>

51. As discussed in my written direct testimony, the per-user floor in the current Subpart B royalty structure for Spotify's paid service misaligns incentives and leaves surplus on the table, resulting in inefficiencies and unnecessary risk. *See, e.g.*, WDT ¶ 65 *et seq*. For example, it disincentivizes Spotify and others from offering student accounts even though these accounts promote the growth of the overall pie and payments to rights holders. *See, e.g.*, WDT ¶¶ 67-69. [redacted]. In general, a varied willingness to pay among consumers means we need to target customers with different pricing levels. Any minimum inhibits our ability to target different customers based on price.

52. The Copyright Owners' proposal "doubles down" on the current per-user floor for paid services, increasing it from $0.50 to $1.06 and expanding it to ad-supported services. This is wrong for all of the reasons that the current per-user floor for paid services is wrong, such as those noted above.

53. In addition, a per-user rate for ad-supported services is counterintuitive. First, ad-supported accounts are monetized by ads, which play periodically when users listen. But account creation is unrelated to ad monetization. A user who has an account but does not listen generates no revenue.

54. Second, access is different for ad-supported services than paid services. The Copyright Owners argue that a per-user rate is appropriate because mere access is of value. *See, e.g.*, Israelite WDT ¶ 42 ("Each end user account has an inherent value. The user is secure in knowing that all the songs offered by the Digital Service can be accessed at any time or place."). This argument misses the mark. Anyone with a radio has *access* to radio stations at any time. But the stations generate ad revenue based on who is actually consuming radio content, not based on who *could be* consuming it. The "security" comes from the existence of the radio station itself, or for Spotify, the existence of the ad-supported service. It does not come from setting up a username and password, for example.

55. Third, the ad-supported tier [redacted]. Forcing Spotify to pay a monthly fee for every user

who has ever used its service makes as little sense as charging a radio station for every user who had ever tuned in.[19]

56. In sum, a per-user floor is value-destroying and should be removed from the Subpart B formula — not expanded.

A Per-Stream Rate Would [redacted]

57. As stated above, a per-stream rate applicable to both ad-supported and paid services ignores the different value propositions and monetization structures of the two services. Spotify's services are built on the "freemium" model, [redacted] — a model that has been endorsed by over 120 million users worldwide.

58. A per-stream rate would misalign incentives between Digital Services and Copyright Owners in a way that would hurt both Spotify and songwriters. [redacted] Engagement depends on the ability of a user to listen to as much music as he or she

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19 [redacted] This seems to be a solution in search of a problem.

wants. For example, there is no additional cost for a Spotify user to try out the lesser known artists and songwriters Spotify promotes. [redacted]

59. But a per-stream rate would disincentivize Spotify and other providers from encouraging listening. This would cause at least two problems: first, user engagement is a key driver of retention for access-based subscription products, such as streaming music. As engagement declines, a user's perception of the service's value declines and user attrition increases. A user who heavily uses the service (for example, by not only listening to her favorite music but also discovering new music) is much more likely to retain her subscription than a user who uses it less frequently, or who only uses it to listen to a few favorite songs. Higher churn means less money for Digital Services and rights holders. Thus, a per-stream rate, which incentivizes services to decrease engagement, effectively incentivizes them to increase churn, and as such misaligns incentives.

60. Second, if Digital Services moved away from offering music recommendation products, like Discovery Weekly, it would mean fewer streams and fewer artists and songwriters receiving exposure. As discussed by Mr. Page and Mr. Lucchese, Spotify's music discovery products result in exposure for many "long-tail" artists and songwriters who may otherwise not receive any exposure. Such rights holders would be disproportionately affected by a per-stream

rate structure, whereas the current royalty structure allows the Digital Services to grow the pie (*i.e.*, the royalty pool) as much as possible without worrying about how that pie is divided up.

61. [redacted]

62. The Copyright Owners attempt to justify a per-stream rate on the notion that "musical works have inherent value and the Digital Services should pay more when their users stream or play more music." Brodsky WDT ¶ 68. But as discussed above, a per-stream rate means higher churn, which means less money for rights holders. Rights holders would earn more total dollars under Spotify's proposal.

63. **Apple's proposal suffers from the same deficiencies.** All of the problems with a per-stream rate generally apply to Apple's proposal as well as the Copyright Owners'.

64. Apple's rate is lower than the Copyright Owners' rate, and [redacted]. However, like the Copyright Owners, Apple proposes one per-stream rate for both ad-supported and paid services.

65. [redacted]

Conclusion

66. Spotify wants to pay artists and songwriters well as part of a thriving competitive marketplace. But Spotify must also have a sustainable business in order to do so. Significant rate increases would threaten Spotify's sustainability.

67. The Copyright Owners' proposal would be highly disruptive to the streaming music industry as a whole and [redacted]. This would hamper the Digital Services' growth and destroy many of the benefits they provide to listeners and rights holders. The Copyright Owners' use of per-user and per-stream rates would misalign incentives and destroy value, even if the rates were lower.

68. It seems to me that the Copyright Owners' proposal is little more than a thinly-veiled attempt to control the retail pricing of our service by imposing a punitive cost structure on the business [redacted].

69. Apple's proposal, [redacted], would still create poor incentives due to the use of a per-stream rate. [redacted]

70. Spotify's proposal properly aligns incentives and maximizes revenue to the industry as a whole. By removing the per-user floor, Spotify's proposal enables the Digital Services to focus on growing the pie and monetizing musical works to the fullest extent possible. And it allows Digital Services to take into account various market segments' willingness to pay.

71. As I explained in my written direct testimony, "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." WDT ¶ 74. Spotify's proposal would be better for everyone, not just Spotify.

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DECLARATION OF BARRY MCCARTHY

I, Barry McCarthy, declare under penalty of perjury that the statements contained in my Written Rebuttal Testimony in the above-captioned proceeding are true and correct to the best of my knowledge, information, and belief. Executed this 15 day of February 2017 in New York, United States.

Barry McCarthy