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# THE SOUND RECORDING PERFORMANCE RIGHT AT A CROSSROADS: WILL MARKET RATES PREVAIL?

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*Starting in the 1990s, Federal policy has moved in the direction of a market-oriented approach towards sound recording rights, beginning with Congress' decision to create a sound recording performance copyright in 1995. In 1998, Congress provided that most statutory royalty rates, including the rates paid by webcasters like Pandora Radio, would be set using a market-based "willing buyer, willing seller" ("WBWS") standard. Since then, the WBWS standard has been applied in several rate setting proceedings, but complaints from webcasters that the rates were "too high" have led to Congressional intervention and, ultimately, to adoption of rates below market levels. Now, as a new rate setting cycle is about to get underway, webcasters have begun lobbying Congress to replace the WBWS standard with a new version of the so-called 801(b) standard, which promises copyright users a right of "non-disruption." Adoption of the 801(b) standard – and the other changes favored by the webcasters – would result in rates below economically efficient levels, thereby distorting markets, slowing innovation and harming consumers. This paper examines the market for sound recording performance rights, concluding that Congress should resist webcasters' pleas for regulatory favoritism and instead continue moving towards a market-oriented approach, starting with extending the sound performance right to terrestrial radio.*

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## I. INTRODUCTION

Until 1995, the principal protections afforded to holders of sound recording copyrights were rights of reproduction and distribution.<sup>1</sup> Thus, copyright holders of sound recordings, such as record companies, could monetize the copying and distribution of their recordings, but could not charge for “performances,” such as when radio stations played copyrighted music.<sup>2</sup> In the absence of such a property right, naturally, the sound recording owner’s income was limited to sales revenue of CDs and other such phonorecords.<sup>3</sup>

Beginning with passage of the Digital Performance Right in Sound Recordings Act (“DPRA”) in 1995,<sup>4</sup> Congress has moved gradually in the direction of creating performance rights and putting in place the conditions to allow such rights to be traded at market (that is, economically efficient) rates.<sup>5</sup> The first sound recording performance right, for certain digital performances, was created by DPRA, which also created a compulsory license for nonexempt, non-interactive, digital subscription transmissions.<sup>6</sup> In 1998, Congress expanded the compulsory license to additional digital performances in the Digital Millennium Copyright Act (“DMCA”).<sup>7</sup> As a result, for some rights, particularly “interactive” services, buyers and sellers bargain freely over rates and conditions.<sup>8</sup>

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<sup>1</sup> Brian R. Day, *Collective Management of Music Copyright in the Digital Age: The Online Clearinghouse*, 18 TEX. INTELL. PROP. L.J. 195, 204 (2010); *see also* Joshua P. Binder, *Current Developments of Public Performance Rights for Sound Recordings Transmitted Online: You Push Play, but Who Gets Paid?*, 22 LOY. L.A. ENT. L. REV. 1, 11 (2001).

<sup>2</sup> Binder, *supra* note 1, at 11.

<sup>3</sup> *Id.*

<sup>4</sup> Digital Performance Right in Sound Recordings Act of 1995, Pub. L. No. 104-39, 109 Stat. 336 (codified as amended at 17 U.S.C. § 114 (2012)).

<sup>5</sup> *See* Performance Rights Act of 2009, H.R. 848, S. 379, 111th Cong. (2009) (proposing to grant sound-recording-performance rights to terrestrial broadcasters); Digital Millennium Copyright Act, Pub. L. No. 105-304, 112 Stat. 2860 (Oct. 28, 1998) [hereinafter DMCA] (adding, among other things, the “willing buyer, willing seller” standard, and expanding § 114 to cover eligible nonsubscription services).

<sup>6</sup> 17 U.S.C. § 106(6) (2012) (giving copyright owners of sound recordings the exclusive right to “perform the copyrighted work publicly by means of a digital audio transmission”); *see* 17 U.S.C. § 114(d)(2)–(3), (f) (2012) (imposing the nonexempt, noninteractive, digital subscription transmission licensing requirements); *see also* Public Performance of Sound Recordings: Definition of Service, 65 Fed. Reg. 33,266, 33,266 (May 23, 2000) (“Among the limitations on the performance was the creation of a licensing scheme for interactive digital audio services and a compulsory license for nonexempt, noninteractive, digital subscription transmissions.”).

<sup>7</sup> DMCA § 405(a)(1)(B), 17 U.S.C. § 114(d)(2); *see also* Mary Ann Lane, “Interactive Services” and the Future of Internet Radio Broadcasts, 62 ALA. L. REV. 464 (2011).

<sup>8</sup> 17 U.S.C. § 114(d)(1), (d)(2)(A)(i); *In re* Rate Setting for Digital Performance Right

However, “non-interactive” services (*i.e.*, radio-like “streaming” services), may take advantage of a compulsory license: Buyers and sellers have the option of negotiating voluntary agreements (which is generally done on an industry-wide basis), but if they fail to do so, sellers are required to license rights at government-determined “statutory” rates.<sup>9</sup>

In this context, the criteria for setting statutory rates are obviously important. For most non-interactive services, the DMCA established a “willing buyer/willing seller” (“WBWS”) standard, which is intended to set rates at “strictly fair market value.”<sup>10</sup> In practice, as implemented by Copyright Arbitration Royalty Panels (“CARP”)<sup>11</sup> and later by the Copyright Royalty Board (“CRB”),<sup>12</sup> the WBWS standard has resulted in a market-oriented approach to setting rates.

In adopting the WBWS standard, Congress chose to reject the previous, less market-oriented standard used in the DPRA—a standard that utilized the four-part test under § 801(b) of the 1976 Copyright Act.<sup>13</sup> Unlike the WBWS standard, the 801(b) standard requires regulators to take into account non-market based criteria in setting royalties for statutory licenses, including specifically to set rates so as to protect licensees against any “disruptive” effects that might be caused by paying royalties—no matter how market-oriented they may be.<sup>14</sup>

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in Sound Recordings and Ephemeral Recordings, Docket No. 2000-9 DTRA 1 & 2, at 8 (Copyright Arb. Royalty Panel Feb. 20, 2002) [hereinafter *CARP Report*] (discussing the negotiations required in order to transmit sound recordings on an interactive basis); *see* Lane, *supra* note 7, at 467; *see also* *Arista Records v. Launch Media*, 578 F.3d 148, 154 (2d Cir. 2009) (discussing the fact that the interactive services are likely to have a significant impact on traditional records sales, because of the increased options that the services give to consumers).

<sup>9</sup> Lane, *supra* note 7, at 465.

<sup>10</sup> Determination of Reasonable Rates and Terms for the Digital Performance of Sound Recordings and Ephemeral Recordings, 67 Fed. Reg. 45,240, 45,244 (July 8, 2002) (codified at 37 C.F.R. pt. 261) [hereinafter *Webcaster I*] (asserting that the “standard for setting rates for nonsubscription services . . . is strictly fair market value—willing buyer/willing seller”), *aff’d*, *Beethoven.com v. Librarian of Congress*, 394 F.3d 939 (D.C. Cir. 2005); Brian Flavin, *A Digital Cry for Help: Internet Radio’s Struggle to Survive a Second Royalty Rate Determination under the Willing Buyer/Willing Seller Standard*, 27 ST. LOUIS U. PUB. L. REV. 427, 438 (2008).

<sup>11</sup> Flavin, *supra* note 10, at 435.

<sup>12</sup> *Id.* at 438.

<sup>13</sup> DMCA § 405 (“[I]n addition to the objectives set forth in section 801(b)(1), the [CARP] may consider the rates and terms for comparable types of subscription digital audio transmission services and comparable circumstances under voluntary [negotiated] license agreements.”); *see also* 17 U.S.C. § 801(b)(1)(A)–(D) (2012).

<sup>14</sup> 17 U.S.C. § 801(b)(1)(D) (requiring, *inter alia*, that rates be calculated to “minimize any disruptive impact on the structure of the industries involved and on generally prevailing

Thus, the 801(b) standard arguably grants licensees a *de facto* right to perpetual profitability, allowing licensees to argue that they and their business models have a right to be protected from “disruption.”<sup>15</sup> In the dynamic world of online content delivery—in which new and improved business models are constantly replacing old, obsolete ones—the creation of such a right has obvious negative consequences for innovation.

Fortunately, the 801(b) standard currently applies to only a handful of companies, which were “grandfathered” when the DMCA was adopted.<sup>16</sup> Thus, royalties for all other sound recording performance rights are established either through direct market negotiations among the parties or, for compulsory licenses, under the market-oriented WBWS standard.<sup>17</sup> Moreover, in recent years, Congress has shown substantial interest in bringing the one significant remaining area in which property rights are lacking—over-the-air performances by terrestrial broadcasters—under a market-oriented framework, by extending the sound recording performance right to such performances.<sup>18</sup> In short, the recent history of the sound recording performance right has been clearly in the direction of a more market-oriented approach.

In mid-2012, however, legislation was introduced in both the House and Senate that would reverse the pro-market trend by replacing the WBWS standard with the less-market-oriented 801(b) standard for the compulsory licenses for sound recording performances. The Internet Radio Fairness Act (“IRFA”) (H.R. 6480 in the House; S. 3609 in the Senate)<sup>19</sup>—which was supported by some webcasters, like Pandora<sup>20</sup>—would have required copyright judges to

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industry practices”); see also Lauren E. Kilgore, *Guerilla Radio: Has the Time Come for a Full Performance Right in Sound Recordings?*, 12 VAND. J. ENT. L. 549, 565 (2010)

<sup>15</sup> 17 U.S.C. § 801(b)(1)(D); see also Determination of Rates and Terms for Preexisting Subscription Services and Satellite Digital Audio Radio Services, 73 Fed. Reg. 4080, 4083 (Copyright Royalty Bd. Jan. 24, 2008) [hereinafter *SDARS I*] (believing that “postponing investment in new satellite technology” would have a “potential disruptive effect”).

<sup>16</sup> Designation As a Preexisting Subscription Service, 71 Fed. Reg. 64,639, 64,641 (Nov. 3, 2006).

<sup>17</sup> Under § 114(f)(1)(B), the § 801(b)(1) standards apply to Pre-Existing Subscription Services (“PSS”) and satellite digital audio services (“SDARS”). See 17 U.S.C. § 114(f)(1)(B). Section 114(f)(2)(B) establishes the WBWS standard for eligible non-subscription services and subscription services. *Id.* § 114(f)(2)(B). Section 114(d) exempts interactive services from the statutory licensing regime. *Id.* § 114(d)(1), (d)(2)(A)(i).

<sup>18</sup> Performance Rights Act of 2009, H.R. 848, S. 379, 111th Cong.

<sup>19</sup> See generally Internet Radio Fairness Act of 2012, H.R. 6480, S. 3609, 112th Cong. (2012).

<sup>20</sup> Steve Knopper, *Pandora Clashes with Musicians over Song Payments: Singers Perform on Capitol Hill Before Hearing on Internet Radio Fairness Act*, ROLLING STONE (Dec. 3, 2012), <http://commens.org/NOqr9R>.

take into account whether market-based royalty rates might “disrupt” the business models of licensees.<sup>21</sup> It goes without saying that the webcasters who supported the bill had expected the 801(b) approach to result in lower royalties than under the current market-based standard.

The IRFA did not stop, however, at imposing the anti-disruption standard on future royalty proceedings. It contained a series of additional measures, all designed to tilt the institutional playing field to the advantage of webcasters, including prohibiting the CRB from considering certain types of evidence and forcing it to ignore relevant precedents.<sup>22</sup> As if to ensure that economics will play as small a role as possible in future CRB deliberations, the Act even removed the requirement that at least one of the three CRB judges have expertise in economics.<sup>23</sup>

As this article will explain below, the arguments offered in support of the IRFA—that it was necessary to ensure a vibrant market for digital music, or that it would “level the playing field” by subjecting all digital music distributors to the same copyright regime—are unfounded. The market for digital music is growing by leaps and bounds and the rapid growth of online advertising and wireless broadband ensure that it will continue to do so.<sup>24</sup> Webcasters are not paying “unreasonable” rates and are fully capable of paying market rates in the future. Moreover, imposing the 801(b) standard on webcaster royalty proceedings would not address the most serious imbalances in the current royalty regime, including the fact that over-the-air broadcasts by terrestrial broadcasters continue to be exempt altogether from the sound recording performance right.<sup>25</sup>

Part II of this article presents a brief history of the sound recording performance right. Part III reviews the implementation of the WBWS and 801(b) standards by the CARP and the CRB, and explains why, in practice, the 801(b) standard is likely to result in below-market rates. Part IV explains why the rates established for non-interactive online music services under the WBWS standard are both efficient and “reasonable,” and details the harm to innovation, competition and consumers that would result from adoption of the 801(b) standard for all statutory royalty proceedings. Part V presents a brief summary

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<sup>21</sup> Internet Radio Fairness Act of 2012 § 3 (replacing the “willing buyer, willing standard” with § 801(b)(1)); *see also* 158 Cong. Rec. S6628, S6628 (daily ed. Sept. 12, 2012) (statement of Sen. Wyden) (introducing the Internet Radio Fairness Act of 2012, S. 3609).

<sup>22</sup> *See* Internet Radio Fairness Act of 2012 § 3; *see also* 158 Cong. Rec. at S6628.

<sup>23</sup> Internet Radio Fairness Act of 2012 § 2.

<sup>24</sup> *See infra* Part IV.

<sup>25</sup> 17 U.S.C. § 114(D)(1)(A).

and offers a few concluding thoughts. Specifically, it recommends that Congress return to the market-oriented path it started down in the 1990s, beginning with extending the sound performance right to terrestrial radio.

## II. THE SOUND RECORDING PERFORMANCE RIGHTS: A BRIEF HISTORY

Under § 102 of the Copyright Act of 1976, there are two types of copyrights associated with recorded music.<sup>26</sup> The first copyright protects the “musical work,” which consists of notes and lyrics written by the composer.<sup>27</sup> This “musical work” copyright is typically held by a music publisher.<sup>28</sup> The second type of copyright, “sound recording,” protects subsequent recordings of a given song by a particular artist.<sup>29</sup> This “sound recording” copyright is typically held by the producer of the sound recording, most often a record label.<sup>30</sup>

Prior to 1995, there was an important distinction between the rights in a musical work copyright and a sound recording copyright. The owner of a musical work copyright was granted a “performance right,” which entitled her to compensation whenever her copyrighted work was performed or broadcast publicly.<sup>31</sup> The owner of a sound recording copyright, however, was not granted a

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<sup>26</sup> Digital Performance Right in Sound Recordings and Ephemeral Recordings, 72 Fed. Reg. 24,084, 24,086 (May 1, 2007) (codified at 37 C.R.F. pt. 380) [hereinafter *Webcaster II*] (noting that § 102 of the Copyright Act “identifies various categories of works that are eligible for copyright protection . . . these include ‘musical works’ and ‘sound recordings’”).

<sup>27</sup> *Id.*

<sup>28</sup> See Kimberly L. Craft, *The Webcasting Music Revolution Is Ready to Begin, As Soon As We Figure Out the Copyright Law: The Story of the Music Industry at War with Itself*, 24 HASTINGS COMM. & ENT. L.J. 1, 4 (2001).

<sup>29</sup> *Webcaster II*, *supra* note 26, at 24,086 (“The term . . . ‘sound recording’ results from ‘the fixation of a series of musical, spoken or other sounds. A song that is sung and recorded will constitute a sound recording by the entity that records the performance, and a musical work by the songwriter.’”); see also Brian Day, Note, *The Super Brawl: The History and Future of the Sound Recording Performance Right*, 16 MICH. TELECOMM. & TECH. L. REV. 179, 183 (2009) (“Sound recording copyrights, on the other hand, are normally owned by the artist or record label and protect the originality of the recording itself as distinct from the underlying written lyrics or melody.”).

<sup>30</sup> *Webcaster II*, *supra* note 26, at 24,086.

<sup>31</sup> Craft, *supra* note 28, at 4 (“If a performance of the musical work happens to be broadcast over the airwaves such as by a radio station, each play is also worth money, in the form of royalties, to the songwriter and publisher.”); see also Jeremy Delibero, *Copyright Arbitration Royalty Panels and the Webcasting Controversy: The Antithesis of Good Alternative Dispute Resolution*, 5 PEPP. DISP. RESOL. L.J. 83, 85 (2005) (“Within the Copyright Act, copyright owners enjoy an exclusive right of public performance. The copyright owner may recover royalties anytime a third party publicly performs the work. A public perfor-

performance right.<sup>32</sup> For example, when a radio station publicly broadcasts a song over the air, it pays a royalty to the holder of the musical work copyright, but not to the holder of the sound recording copyright.<sup>33</sup> The principal protection afforded to owners of sound recording copyrights was a reproduction and distribution right, which granted compensation for the physical reproduction and sale of sound recordings (and prevented the unauthorized reproduction and distribution of recordings).<sup>34</sup> This reproduction right was beneficial to sound recording copyright owners prior to the 1990s, when recorded songs were primarily disseminated to consumers via the sale of physical records or CDs.<sup>35</sup> Broadcasters also argued that a performance right was unnecessary because radio airplay helped promote the sales of sound recordings.<sup>36</sup>

#### A. The Digital Performance Rights Act

In the 1990s, the emergence of digital communications technologies and the growth of the Internet dramatically altered the music landscape.<sup>37</sup> In addition to purchasing cassettes or CDs, or tuning into AM/FM radio, listeners could access music via digital satellite transmissions, Internet radio (“webcasters”), or cable music services.<sup>38</sup> As digitally broadcast music began to take root, record

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mance includes both the musical work and the sound recording . . . Unlike musical works, the owner of a sound recording (usually a record label) is not automatically entitled to performance royalties under the Copyright Act.”)

<sup>32</sup> *Webcaster II*, *supra* note 26, at 24,086 (“The performance right is granted to all categories of copyrighted works with one exception: Sound recordings. Thus, while the owner of a musical work enjoys the performance right, the owner of a sound recording does not.”).

<sup>33</sup> *See* Craft, *supra* note 28, at 6 (“While radio broadcasters pay royalties to publishers and writers for use of the musical work, they have, however, never had to pay any sort of royalty or licensing fee to the actual record companies for use of the sound recording.”); *see also* *Intercollegiate Broad. Sys., Inc. v. Copyright Royalty Bd.*, 574 F.3d 748, 753 (D.C. Cir. 2009) (“The copyright owners of musical works, but not those of sound recordings, have long enjoyed exclusive rights to public performances of their works.”)

<sup>34</sup> Sound Recording Act of 1971, Pub. L. No. 92-140, 85 Stat. 391, 391 (1971).

<sup>35</sup> Craft, *supra* note 28, at 5–6 (“Traditionally, the record companies have made money by selling copies of the sound recording, in form of vinyl albums, and later cassette tapes and CDs. The record companies then pay the musical artist a percentage of these sales (i.e., the artist’s royalties).”)

<sup>36</sup> Day, *supra* note 29, at 184.

<sup>37</sup> Delibero, *supra* note 31, at 86–87.

<sup>38</sup> *Id.*; *see also* Eldar Haber, *Copyrights in the Stream: The Battle on Webcasting*, 28 SANTA CLARA COMPUTER & HIGH TECH. L.J. 769, 773 (2012) (“Webcasting is a digital transmission of creative work over a network that results in the playing of the work, without storing a permanent copy at the recipient’s end . . . Put simply, webcasting is listening to music or watching a video in ‘real time,’ instead of downloading a file and viewing or lis-

labels, backed by both the Copyright Office and the Patent and Trademark Office, argued that the prevailing copyright structure would not adequately compensate owners of sound recording copyrights.<sup>39</sup> Congress was concerned that “certain types of subscription and interactive audio services might adversely affect sales of sound recordings and erode copyright owners’ ability to control and be paid for use of their work,” as well as about the potential for further erosion in the future from “pay-per-listen, audio-on-demand, or ‘dial-up’ services for a particular recording or artist” (the so-called “celestial jukebox”).<sup>40</sup> In response to these concerns, Congress enacted the Digital Performance Right in Sound Recordings Act in 1995.<sup>41</sup>

The DPRA granted the owners of sound recordings a right to compensation for performances of copyrighted works broadcast “by means of a digital audio transmission,” often referred to as the “digital performance right.”<sup>42</sup> “Terrestrial” broadcasters, like AM and FM radio stations, that simulcast transmissions over the Internet were exempt.<sup>43</sup> Non-subscription services—that is, those services that are ad-supported—did not exist at the time.<sup>44</sup>

While DPRA required digital music services to compensate copyright holders, it treated interactive services and non-interactive services very differently.<sup>45</sup> Because interactive services provide the ability to listen to a given song “on demand,” thus obviating the need to purchase a physical copy of a sound

tening to it after the downloading is complete or at any other time.”).

<sup>39</sup> S. REP. NO. 104-128, at 11–13 (1995).

<sup>40</sup> *Id.* at 15.

<sup>41</sup> Digital Performance Right in Sound Recordings Act, Public Law 104–39, 109 Stat. 336, 336 (1995).

<sup>42</sup> *See* *Beethoven.com LLC v. Librarian of Cong.*, 394 F.3d 939, 942 (D.C. Cir. 2005); *see also* *Intercollegiate Broad. Sys., Inc., v. Copyright Royalty Bd.*, 574 F.3d 748, 753 (D.C. Cir. 2009) (“In 1995, Congress passed the Digital Performance Right in Sound Recordings Act . . . granting the owners of sound recordings an exclusive right in performance ‘by means of a digital audio transmission.’”); *Webcaster II*, *supra* note 26, at 24,086.

<sup>43</sup> S. REP. NO. 104-128, at 20.

<sup>44</sup> Digital Performance Right in Sound Recordings Act of 1995 § 3 (referring only to subscription transmissions); *CARP Report*, *supra* note 8, at 8 (discussing the dispute that arose over how to treat “webcasters who stream sound recordings on a nonsubscription basis” after DPRA was passed); S. REP. NO. 104-128, at 14 (noting that a small number of services have begun to make digital transmissions to “subscribers”); Olga Kharif, *Coming Soon to XM: More Commercials*, BUSINESSWEEK.COM (Apr. 12, 2006), <http://commcns.org/1mQTBFe>; *see also* Andrea Andelson, *Tune in Your Favorite Radio Station on Your PC, Broadcast Entrepreneurs Hope Internet Can Give Life to Staid Industry*, MILWAUKEE J. SENTINEL, Sept. 24, 1996, at 5 (explaining when non-subscription services materialized).

<sup>45</sup> *See* Matt Jackson, *From Broadcast to Webcast: Copyright Law and Streaming Media*, 11 TEX. INTELL. PROP. L.J. 447, 456 (2003).



recording, they arguably pose a more potent threat to music sales than non-interactive services (which are more akin to radio).<sup>46</sup> Thus, Congress established an exclusive copyright for interactive services, allowing rights holders to negotiate freely in the market for such rights.<sup>47</sup>

For non-interactive services (that is, radio services or “webcasters”), DPRA created a compulsory license granting users full access to record companies’ libraries of sound recordings.<sup>48</sup> Royalty rates could still be voluntarily negotiated by the parties, but if they failed to agree, rates were set through binding arbitration by a Copyright Arbitration Royalty Panel convened by the Librarian of Congress, subject to his review and a right to appeal to the D.C. Circuit Court of Appeals.<sup>49</sup>

Notably, DPRA borrowed the substantive criteria for arbitrated royalty rates from a pre-existing four-part standard found in § 801(b)(1) of the Copyright Act of 1976.<sup>50</sup> Specifically, § 801(b)(1) requires that royalty rates achieve four objectives:

- (A) To maximize the availability of creative works to the public;
- (B) To afford the copyright owner a fair return for his creative work and the copyright user a fair income under existing economic conditions;
- (C) To reflect the relative roles of the copyright owner and the copyright user in the product made available to the public with respect to relative creative contribution, technological contribution, capital investment, cost, risk, and contribution to the opening of new markets for creative expression and media for their communication; and
- (D) To minimize any disruptive impact on the structure of the industries involved and on generally prevailing industry practices.<sup>51</sup>

As discussed below, the first three criteria, standing alone, imply a standard that is similar to the market-based WBWS standard. However, the fourth crite-

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<sup>46</sup> *Id.*

<sup>47</sup> *Id.*; see also Day, *supra* note 29, at 185.

<sup>48</sup> See Amy Duvall, *Royalty Rate-Setting for Webcasters: A Royal(ty) Mess*, 15 MICH. TELECOMMS. & TECH. L. REV. 267, 270 n.20 (2008) (“The statutory license is compulsory because the user of the copyrighted work need not get individual permission from the copyright holder; their permission is automatically given if the user complies with the requirements of the statute.”). The requirements of the statutory licenses included limitations on the number of songs by a single artist or from a single album that could be played per hour, as well as a prohibition on releasing an advance playlist of upcoming songs. *Id.* at 270 n.20, 271.

<sup>49</sup> *Webcaster I*, *supra* note 10, at 45,242 (discussing the Librarians review powers under former § 802(f)–(g)); Duvall, *supra* note 48, at 271.

<sup>50</sup> 17 U.S.C. § 801(b)(1) (2012).

<sup>51</sup> *Id.*

tion, requiring “non-disruption,” reflects a departure from the principle of market-based rates in favor of protecting licensees from potentially “disruptive” changes in royalties.<sup>52</sup> Today, only a handful of services remain subject to this anachronistic standard.

#### B. The Digital Millennium Copyright Act

The years immediately following passage of the DPRA saw the emergence of the Internet and the rapid growth of “streaming radio.”<sup>53</sup> These new services were generally non-interactive and non-subscription, relying on advertising for revenue.<sup>54</sup> Because advertising-supported services were not in existence at the time DPRA was passed, they were not covered by its compulsory license.<sup>55</sup> In 1998, Congress addressed this oversight by expanding the scope of the compulsory license as part of the DMCA.<sup>56</sup> The DMCA offered these new non-interactive services the benefit of a statutory license (rather than requiring these services to negotiate licenses with individual sound recording copyright owners).<sup>57</sup>

The DMCA divided non-interactive digital audio services into two groups.<sup>58</sup> The first group consisted of FCC-licensed satellite digital audio services (“SDARS”) that existed prior to July 31, 1998 (*i.e.*, satellite radio companies

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<sup>52</sup> *Id.* § 801(b)(1)(d).

<sup>53</sup> See Richard D. Rose, *Connecting the Dots: Navigating the Laws and Licensing Requirements of the Internet Music Revolution*, 42 IDEA 313, 317 (2002).

<sup>54</sup> See, e.g., *Webcaster I*, *supra* note 10, at 45,258; Doc Searls, *Why Are So Many Internet Radio Stations Still on the Air?*, LINUX J. (July 17, 2002), <http://commcns.org/1n3Vv23>; *Growth and Development of Internet Radio*, BBC, Nov. 20, 1998, at 1; Andelson, *supra* note 44, at 5.

<sup>55</sup> See Day, *supra* note 29, at 187; see also Jackson, *supra* note 45, at 457 (“At the time the [DPRA] was written, webcasting was a nascent technology. By 1998, webcasting had proliferated with hundreds of radio stations and webcasters streaming music on the Internet. As Congress prepared to pass the Digital Millennium Copyright Act, the RIAA successfully lobbied to insert language to the provisions of the DPRA to close the ‘loophole’ that prevented them from licensing non-subscription webcast performances.”); Craft, *supra* note 28, at 5, 12 (“The new technology, along with its various Internet applications, spread quickly. Suddenly, online-only webcasters were streaming digital music over the Internet – not merely on the envisioned subscription basis like satellite and cable companies, but also on a non-subscription basis by means of paid advertisements, like ordinary radio programming.”).

<sup>56</sup> *Webcaster II*, *supra* note 26, at 24,086.

<sup>57</sup> See Craft, *supra* note 28, at 5, 15 (“This license would ease the burden of having to locate and pay all of the individual record companies that held the sound recording copyrights to the various musical selections transmitted.”).

<sup>58</sup> H.R. REP. NO. 105-796, at 33, 38–39 (1998).

Sirius and XM) and three subscription services: DMX, Music Choice and Mu-zak (called “Pre-Existing Subscription Services,” or “PSS”).<sup>59</sup> Under the DMCA, PSS and SDARS were grandfathered in under the 801(b)(1) standard, under the theory that they had relied on the standard at the time.<sup>60</sup>

The second group consisted of “new” digital subscription services and services making “eligible non-subscription transmissions,” which included Internet-only radio webcasters like Pandora and simulcasts of over-the-air broadcasts.<sup>61</sup> For these services, in the absence of a voluntary agreement between copyright holders and the webcasters, the DMCA directed that the rates for statutory licenses and royalties should be set by the CARP to “represent the rates and terms that would have been negotiated in the marketplace between a willing buyer and a willing seller” (this is the WBWS standard).<sup>62</sup>

As discussed further below, Congress has intervened directly in the setting of webcaster royalties twice since passage of the DMCA, both times by pass-

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<sup>59</sup> See *SDARS I*, *supra* note 15, at 4080 n.3 (“Section 114(j)(11) of the Copyright Act defines the term ‘preexisting subscription service’ to mean ‘a service that performs sound recordings by means of noninteractive audio-only subscription digital audio transmissions, which was in existence and was making such transmissions to the public for a fee on or before July 31, 1998.’”).

<sup>60</sup> H.R. REP. NO. 105-796, at 89.

<sup>61</sup> See Duvall, *supra* note 48, at 272 (“The Digital Millennium Copyright Act (DMCA) addressed royalty payments for webcasters under Section 114. The DMCA adopted the statutory license for two types of webcasting: ‘preexisting subscription services’ and ‘eligible non-subscription services.’ These two categories included terrestrial radio stations’ online rebroadcasts as well as pure webcasters, but excluded providers who allowed users to download or select music of their choice.”).

<sup>62</sup> See 17 U.S.C. § 114(f)(1) (pre-existing services); see also *id.* § 114(f)(2) (eligible non-subscription services and new subscription services). With respect to the WBWS standard, Congress directed that several considerations be taken into account. Section 114(f)(2)(B) says:

In determining such rates and terms, the copyright arbitration royalty panel shall base its decision on economic, competitive, and programming information presented by the parties—including (i) whether use of the service may substitute for or may promote the sales of phonorecords or otherwise may interfere with or may enhance the sound record copyright owner’s other streams of revenue from its sound recordings; and (ii) the relative roles of the copyright owner and the transmitting entity in the copyrighted work and the service made available to the public with respect to relative creative contribution, technological contribution, capital investment, cost, and risk.

*Id.* § 114(f)(2)(B); see also H. COMM. ON THE JUDICIARY, 105TH CONG., SECTION-BY-SECTION ANALYSIS OF H.R. 2281 AS PASSED BY THE UNITED STATES HOUSE OF REPRESENTATIVES ON AUGUST 4, 1998, at 57–59 (Comm. Print 1998).

ing legislation favorable to webcasters.<sup>63</sup> In 2002, it passed the Small Webcasters Settlement Act of 2002, which “encouraged” record labels to negotiate lower rates with small webcasters than had been set by the CARP in the *Webcaster I* proceeding.<sup>64</sup> Then, in 2008 and 2009, Congress passed (and then extended) the Webcaster Settlement Act, which again “encouraged” rights holders to negotiate lower royalty rates, this time offering all webcasters a discount from the rates set by the CRB in its 2007 *Webcaster II* decision.<sup>65</sup>

Notably, neither the DPRA nor the DMCA extended the sound performance rights to the most prolific users of sound recordings, terrestrial radio stations.<sup>66</sup> In the late-2000s, however, Congress considered adopting legislation—the Performance Rights Act of 2007 (H.R. 4789 and S. 2500)<sup>67</sup> and its successor, the Performance Rights Act of 2009 (H.R. 848 and S. 379)<sup>68</sup>—which would have extended the sound recording right to terrestrial radio, established a compulsory license for terrestrial radio stations, and adopted a single “fair market value” standard for all terrestrial broadcasters, cable, satellite and Internet services.<sup>69</sup> Specifically, as passed by both the House and Senate Judiciary Committees, § 2 of the Performance Rights Act instructed the CRB to establish statutory rates under the first three prongs of § 801(b)(1),<sup>70</sup> but rejected § 801(b)(1)(D), the non-disruption standard.<sup>71</sup> Based on CRB precedent, the first three prongs of §

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<sup>63</sup> See Notification of Agreement Under the Small Webcaster Settlement Act of 2002, 68 Fed. Reg. 35,008, 35,008–09 (June 11, 2003).

<sup>64</sup> Small Webcaster Settlement Act of 2002, Pub. L. No. 107-321, § 2, 116 Stat. 2780, 2780 (2002) (codified as amended at 17 U.S.C. §§ 112, 114 (2012)).

<sup>65</sup> Webcaster Settlement Act of 2009, Pub. L. 111-36, 123 Stat. 1926 (2009) (codified as amended at 17 U.S.C. § 114) (extending the Webcaster Settlement Act); Webcaster Settlement Act of 2008, Pub. L. 110-435, 122 Stat. 4974 (2008) (codified as amended at 17 U.S.C. § 114) (extending the Webcaster Settlement Act in 2009). In addition, in 2004, Congress passed the Copyright Royalty and Distribution Reform Act (“CRDRA”), which implemented procedural changes favored by webcasters and also law replaced the *ad hoc* CARP panels with a three-judge Copyright Royalty Board. Copyright Royalty and Distribution Reform Act of 2004, Pub. L. No. 108-419, § 3, 118 Stat. 2341, 2341–48 (2004) (codified at 17 U.S.C. §§ 801–02); see also ROBIN JEWELER, CRS REPORT FOR CONGRESS: THE COPYRIGHT ROYALTY AND DISTRIBUTION REFORM ACT OF 2005, at 4 (2004), available at <http://commens.org/1jNdkRD>.

<sup>66</sup> See generally Digital Millennium Copyright Act, Pub. L. 105-304, 112 Stat. 2860; Digital Performance Right in Sound Recordings Act of 1995, Pub. L. No. 104-39, 109 Stat. 336 (codified as amended at 17 U.S.C. § 114 (2012)).

<sup>67</sup> Performance Rights Act of 2007, H.R. 4789, S. 2500, 110th Cong. (2007).

<sup>68</sup> Performance Rights Act of 2009, H.R. 848, S. 379, 111th Cong.

<sup>69</sup> See generally Performance Rights Act of 2007, H.R. 4789, S. 2500, 110th Cong. § 2; Performance Rights Act of 2009, H.R. 848, S. 379, 111th Cong. § 2.

<sup>70</sup> H.R. REP. NO. 111-680, at 14–15 (2010).

<sup>71</sup> *Id.* at 14–15 (2010) (“The section further establishes rate standard parity among ter-

801(b)(1) establish a market-based standard that is similar, if not identical, to the WBWS standard. Thus, the Performance Rights Act would have created a level playing field for all users of sound performance rights with rates set either through voluntary negotiations or, where necessary, through a statutory license based on a market-based standard.

### III. THE SOUND RECORDING PERFORMANCE RIGHT IN PRACTICE

Since passage of the DPRA and DMCA, sound recording performance copyright holders and licensees have engaged in multiple rounds of negotiations over digital performance royalties, sometimes arriving at voluntary agreements, but more commonly settling rates through litigated proceedings before the CARP and its successor, the CRB.<sup>72</sup>

Since 1998, there have been three full-blown copyright royalty proceedings for non-pre-existing digital music services under the WBWS standard (known as *Webcaster I*, *Webcaster II*, and *Webcaster III*); in addition, as noted above, there have been two direct statutory interventions, the Small Webcaster Settlement Act of 2002 and the Webcaster Settlement Acts of 2008 and 2009.<sup>73</sup> As detailed in the first subsection below, the formal proceedings have involved extensive economic analysis, supported by literally dozens of industry and economic experts, with multiple layers of administrative and judicial review.<sup>74</sup> While the results of these proceedings have in many regards favored webcasters, webcasters have succeeded on more than one occasion in lobbying Congress to intervene in the process in favor of still lower rates. Thus the

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restrial broadcasters, cable, satellite, and Internet services, by creating one rate standard for Copyright Royalty Judges (CRJs) to consider, regardless of the platform involved. The new standard will be the old 801(b) standard minus subpart (D).”).

<sup>72</sup> In the meantime, of course, rights holders have also negotiated voluntary agreements with online interactive services, such as Spotify. Ben Sisario, *Google Expected to Start a Competitor to Spotify*, N.Y. TIMES, May 15, 2013, B9. As discussed below, these voluntarily negotiated rates have been used by the Copyright Royalty Board as the basis for setting compulsory license rates.

<sup>73</sup> Digital Performance Right in Sound Recordings and Ephemeral Recordings, 76 Fed. Reg. 13,025 (Mar. 9, 2011) [hereinafter *Webcaster III*]; Digital Performance Right in Sound Recordings and Ephemeral Recordings, 70 Fed. Reg. 7970 (Feb. 16, 2005); *Webcaster I*, *supra* note 10. For Congress' intervention, see the Webcaster Settlement Acts of 2002 and 2009. See Webcaster Settlement Act of 2009, Pub. L. No. 111-36, 123 Stat. 1926; Webcaster Settlement Act of 2008, Pub. L. No. 110-435, 122 Stat. 4974; Small Webcaster Settlement Act of 2002, Pub. L. No. 107-321, 116 Stat. 2780.

<sup>74</sup> See *infra* Part III.A.

IRFA was merely the latest in a string of efforts by webcasters to have royalties set at below-market rates.

In addition to the three *Webcaster* proceedings, there have been two formal proceedings (*PSS I* and *SDARS I*) to set rates for PSS and SDARS, and a second (*SDARS II*) is underway.<sup>75</sup> Rates in these proceedings have been set under the 801(b) standard and, as discussed in the second subsection below, demonstrate that the 801(b) standard has resulted in rates below market-based levels.

Table 1 presents a brief summary of the primary *Webcaster* and *SDARS* proceedings.<sup>76</sup>

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<sup>75</sup> Determination of Rates and Terms for Preexisting Subscription Services and Satellite Digital Audio Radio Services, 78 Fed. Reg. 23,053, 23,054 (Copyright Royalty Bd. Apr. 17, 2013) [hereinafter *SDARS II*]; *SDARS I*, *supra* note 15, at 4080; Determination of Reasonable Rates and Terms for the Digital Performance of Sound Recordings Services, 63 Fed. Reg. 25,394 (Copyright Arbitration Royalty Panel May 8, 1998) [hereinafter *PSS I*].

<sup>76</sup> The following review addresses the central issues in these proceedings and for copyright policy going forward, namely the terms and level of royalty rates for the primary sound performance right at issue. Each proceeding has also addressed a variety of ancillary issues, such as the rates for “ephemeral” recordings (which are digital copies made for the purpose of facilitating online music distribution), minimum fees applicable to smaller webcasters, the division of certain proceeds between studios and artists, and so forth. *See, e.g., Webcaster III*, *supra* note 73, at 13,026; *Webcaster II*, *supra* note 26, at 24,084; *Webcaster I*, *supra* note 10, at 45,240. No effort is made here to present a complete or comprehensive treatment of these ancillary issues.

TABLE 1<sup>77</sup>  
 SELECTED RATE PROCEEDINGS, 1998–2013

Term	Governing Standard	Proceeding	Decision Date	Appeal Complete	Final Statutory Rate	Royalty Metric
<i>Non-Interactive Services</i>						
1998–2005	WBWS	Webcaster I	February 2002	January 2005	0.0762¢ (1998–2002)	Per-performance
2006–2010	WBWS	Webcaster II	May 2007	July 2009	0.08¢ (2006) rising to 0.19¢ (2010)	Per-performance
2006–2015	NA (Settlement)	Webcaster Settlement Act Pure-play Rates	July 2009	n/a	Greater of 25% of revenues or 0.08¢ (2006) rising to 0.14¢ (2015)	Per-performance
2011–2015	WBWS	Webcaster III	March 2011	n/a	0.19¢ (2011) rising to 0.23¢ (2015)	Per-performance
<i>Pre-existing Services (PSS and SDARS)</i>						
1996–2000	801(b)	PSS I	May 1998	May 1999	6.5%	Percentage of gross revenue
2007–2012	801(b)	SDARS I	January 2008	July 2009	6% (2007) rising to 8% (2012)	Percentage of gross revenue
2013–2017	801(b)	SDARS II	April 2013	n/a	SDARS: 9% (2013) rising to 11% (2017) PSS: 8% (2013) – 8.5% (2014–2017)	Percentage of gross revenue

<sup>77</sup> Non-subscription webcasting rates for 1998–2002 were the result of the *Webcaster I* proceeding. See *Webcaster I*, *supra* note 10. Rates for non-subscription webcasting for 2003 to 2004, and rates for subscription webcasting for 1998–2004 were settled. See Digital Performance Right in Sound Recordings and Ephemeral Recordings, 68 Fed. Reg. 23,241 (May 1, 2003); see also Digital Performance Right in Sound Recordings and Ephemeral Recordings, 69 Fed. Reg. 8822 (Feb. 26, 2004); Digital Performance Right in Sound Recordings and Ephemeral Recordings, 69 Fed. Reg. 5693 (Feb. 6, 2004); Digital Performance Right in Sound Recordings and Ephemeral Recordings, 68 Fed. Reg. 50,493 (Aug. 21, 2003); Digital Performance Right in Sound Recordings and Ephemeral Recordings, 68 Fed. Reg. 27,506 (May 20, 2003). Rates for 2005 were the result of an extension of the 2004 rates in the Copyright Royalty and Distribution Reform Act. See Copyright Royalty and Distribution Reform Act of 2004 § 6(b)(3); Digital Performance Right in Sound Recordings and Ephemeral Recordings, 70 Fed. Reg. 6736 (Feb. 8, 2005) (terminating the pending proceedings).

### A. Webcaster Rates and the Willing Buyer/Willing Seller Standard

As noted above, there have been three full-blown rate proceedings to establish rates for Internet-only webcasters and simulcasters since 1998. Each time, the adjudicating body—first a CARP, then the CRB<sup>78</sup>—held extensive hearings, took testimony from numerous expert economic and industry witnesses, engaged in full briefing schedules, and issued a written decision explaining the basis for the resulting rates; each decision has been subject to appeal before the D.C. Circuit.<sup>79</sup> Nevertheless, each decision has led to complaints by webcasters, who have lobbied Congress to intervene and set lower rates.<sup>80</sup> Indeed, most webcasters today are paying royalty rates negotiated pursuant to the Webcaster Settlement Act of 2009, which are below the market-based rates established by the CRB in the *Webcaster II* proceeding.<sup>81</sup> This subsection describes the process by which webcaster rates have been established since 1998.

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<sup>78</sup> In 2004, Congress passed the Copyright Royalty and Distribution Reform Act of 2004, which phased out the Copyright Arbitration Royalty Panel replacing it with the Copyright Royalty Board. Copyright Royalty and Distribution Reform Act of 2004, Pub. L. No. 108-419, § 3, 118 Stat. 2341, 2341–48.

<sup>79</sup> *Intercollegiate Broad. Sys., Inc. v. Copyright Royalty Bd.*, 684 F.3d 1332 (D.C. Cir. 2012) (appealing *Webcaster III*); *Intercollegiate Broad. Sys., Inc. v. Copyright Royalty Bd.*, 574 F.3d 748 (D.C. Cir. 2009) (appealing *Webcaster II*); *Beethoven.com LLC v. Librarian of Cong.*, 394 F.3d 939 (D.C. Cir. 2005) (appealing *Webcaster I*).

<sup>80</sup> See cases cited *supra* note 79.

<sup>81</sup> See generally Notification of Agreements under the Webcaster Settlement Act of 2009, 74 Fed. Reg. 34,796 (July 17, 2009) [hereinafter *2009 Webcaster Settlement*]; Notification of Agreements under the Webcaster Settlement Act of 2008, 74 Fed. Reg. 9293 (Mar. 3, 2009) [hereinafter *2008 Webcaster Settlement*]. See David Oxenford, *Pureplay Webcasters and SoundExchange Enter into Deal under Webcaster Settlement Act to Offer Internet Radio Royalty Rate Alternative for 2006-2015*, BROADCAST L. BLOG (July 7, 2009), <http://commcns.org/1fD7BbS> (noting that the settlement by “SoundExchange and a group of webcasters that [the author] represented in the [CRB] proceeding . . . not only reaches back to set rates different, and substantially lower, than those that were arrived at by the CRB for the period from 2006–2010, but also resolves the rates for 2011-2015”); see also Manuel Roig-Franzia, *Pandora’s Keeper*, WASH. POST, Apr. 4, 2013, at C1 (“In 2007, a federal panel—the [CRB]—issued a ruling that would have raised the royalty rate paid by webcasters so high that it would have forced them out of business. Drama ensued . . . What resulted was a deal: Pandora, other music streamers, performers and the recording industry agreed to a new set of rates.”); Sarah McBride, *Royalty Plan Is Set for Online Radio*, WALL ST. J., July 8, 2009, at B8; John Timmer, *Pandora Lives! SoundExchange Cuts Deal on Webcasting Rates*, ARS TECHNICA (July 7, 2009), <http://commcns.org/1i8joa1>.



### 1. Webcaster I

The *Webcaster I* proceeding began on November 27, 1998, after a six-month voluntary negotiation period between webcasters and the RIAA resulted in a number of agreements between individual webcasters and the record companies, but failed to produce an industry-wide agreement.<sup>82</sup> In accordance with the DMCA, a CARP was convened to establish the rates and terms for a statutory license.<sup>83</sup> Its report, recommending royalty rates for the period from October 28, 1998 through December 31, 2002, was released more than three years later, on February 20, 2002.<sup>84</sup>

The CARP proceeding was extensive by any standard. It included a full cycle of direct and rebuttal testimony, with 49 economic and industry expert witnesses presenting direct testimony and 26 on rebuttal, as well as oral arguments and multiple rounds of briefs.<sup>85</sup> The resulting record was “one of the most voluminous records in CARP history,” including a “written transcript of over 15,000 pages, many thousands of pages of exhibits, and over 1,000 pages of post-hearing submissions” by counsel.<sup>86</sup>

In reaching its decision, the CARP grappled with and resolved a number of highly technical legal and economic questions, many of which were resolved in favor of webcasters. For example, under the statute, the CARP concluded that the WBWS standard was created to set rates and terms “that would have been negotiated” been a willing buyer and a willing seller in a “hypothetical marketplace” in which no compulsory licenses existed and rates were determined by negotiations between music services and copyright holders.<sup>87</sup> While the parties agreed that the willing “buyers” in this context were non-interactive digital music services, they disagreed as to the identities of the hypothetical

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<sup>82</sup> See *Webcaster I*, *supra* note 10, at 45,241.

<sup>83</sup> *Id.* at 45,240.

<sup>84</sup> *Id.* at 45,241 (discussing the CARP proceeding); Randall C. Picker, *Copyright As Entry Policy: The Case of Digital Distribution*, 47 ANTITRUST BULL. 423, 462 (2002) (discussing the February 20, 2002 report by the CARP).

<sup>85</sup> *CARP Report*, *supra* note 8, at 11–15 (describing the hearings).

<sup>86</sup> *CARP Report*, *supra* note 8, at 18; see also ROBIN JEWELER, CRS REPORT FOR CONGRESS, COPYRIGHT LAW: STATUTORY ROYALTY RATES FOR WEBCASTERS 3 (last updated Nov. 18, 2003) (“In a lengthy opinion based upon thousands of pages of testimony and evidence, the CARP recommended a public performance fee of 0.14¢ per performance and an ephemeral license fee of 9% of performance fees due for Internet transmissions by qualifying webcasters and commercial broadcasters.”).

<sup>87</sup> *CARP Report*, *supra* note 8, at 21 (internal quotation marks omitted); Allison Kidd, *The Beginning of the End of the Internet Radio Royalty Dispute*, 9 J. INTERNET L. 15, 18 (2005).

“sellers.”<sup>88</sup>

The RIAA, representing the interests of the copyright holders (*i.e.*, record companies), asserted that the seller in the hypothetical marketplace should consist of “a single collective of sound recording copyright owners (such as RIAA), offering a blanket license” for access to the sound record libraries of its members.<sup>89</sup> In contrast, the music services argued that in a hypothetical marketplace where compulsory licenses did not exist, a single RIAA-like entity could not negotiate on record companies’ behalf. This is because the antitrust exemption granted to RIAA, which allowed it to bargain on behalf of the collective, was conditional on the compulsory nature of the licenses at issue.<sup>90</sup> The Services—a collection of Webcasters, Broadcasters, and similar organizations—contended that a single RIAA-like entity in the hypothetical marketplace would wield market power sufficient to distort negotiations.<sup>91</sup> Instead, the services proposed that the “sellers” in the WBWS market be comprised of a “non-trivial number” of smaller collectives, offering blanket licenses in competition with one another.<sup>92</sup> Ultimately, the CARP rejected both proposals, concluding instead that the appropriate “sellers” in the hypothetical marketplace were neither a single collective nor a number of smaller collectives, but rather individual record companies, offering “blanket licenses for each record company’s repertory of sound recordings.”<sup>93</sup> From the perspective of the webcasters, this was a highly favorable result, as it meant that rates were based on the assumption that all copyright owners were competing against one an-

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<sup>88</sup> *CARP Report*, *supra* note 8, at 21.

<sup>89</sup> *Id.* at 21–22.

<sup>90</sup> *Id.* at 23. The CARP Report said:

We recognize that the hypothetical marketplace we seek to replicate would operate more efficiently, with lower transactional costs, if a single collective designated by the services could negotiate with a single collective designated by the record companies. Even if such negotiations were non-exclusive, Congress clearly perceived antitrust concerns with such an arrangement. Congress authorized antitrust exemptions respecting such negotiations only within the context of compulsory licenses.

*Id.*

<sup>91</sup> *Id.* at 22 (“The Services’ perception of the sellers, in the hypothetical marketplace envisaged by Congress, is starkly different. They assert that RIAA’s vision ‘would eviscerate the protections sought by the Justice Department and implemented by Congress to prevent the exercise of market power [by the RIAA or the record companies].’”). The CARP Report uses “Services” to refer to “Webcaster, Broadcasters, and the business Establishment Services.” *Id.* at 2 n.2.

<sup>92</sup> *Id.* at 22.

<sup>93</sup> *Id.* at 44.

other in the marketplace rather than being represented jointly by bargaining agents.<sup>94</sup>

In addition, the CARP concluded that the WBWS standard did not necessitate any *ex post* adjustments of the royalty rates it determined based on the “additional factors” enumerated in § 114(f)(2)(B), finding that these factors would already be “fully reflected in any agreements *actually negotiated* between webcasters and copyright owners in the relevant marketplace.”<sup>95</sup>

In the course of this extensive proceeding, RIAA and the music services presented competing proposals for determining royalty rates, each backed by expert testimony.<sup>96</sup> RIAA proposed basing rates on the agreements negotiated between the RIAA and 26 separate webcasters during the voluntary bargaining period,<sup>97</sup> noting that those agreements involved “the *same buyer*, the *same seller*, the *same right*, the *same copyrighted works*, the *same time period*, and the *same medium* as those in the marketplace that the CARP must replicate.”<sup>98</sup> Webcasters, on the other hand, proposed rates derived from a theoretical model which attempted to estimate appropriate royalty rates for the *sound recording right* based on rates for *musical work performance rights* established between music publishers and over-the-air-radio broadcasters.<sup>99</sup>

The CARP ultimately decided that the webcasters’ theoretical model was unreliable, in part because of intrinsic differences between the musical work performance right and the sound recording performance right.<sup>100</sup> Moreover, it concluded, “the quest to derive rates which would have been negotiated in the hypothetical willing buyer/willing seller marketplace is best based on a review of actual marketplace agreements, if they involve comparable rights and comparable circumstances.”<sup>101</sup> Taking multiple factors into account, the CARP concluded that while 25 of the 26 agreements that had been negotiated by

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<sup>94</sup> *Id.* at 46 (explaining that “as it meant that rates were based on the assumption that all copyright owners were competing against one another in the marketplace rather than being represented jointly by bargaining agents”).

<sup>95</sup> *Id.* at 35 (emphasis in original).

<sup>96</sup> *Id.* at 38.

<sup>97</sup> *Id.*

<sup>98</sup> *Id.* (emphasis in original) (internal quotation marks omitted).

<sup>99</sup> *Id.* at 28, 38 (“Accordingly, Webcasters calculated their proposed per-performance and per-hour sound recording performance fee by extrapolation from the aggregate fees paid to ASCAP, BMI, and SESAC by over-the-air radio stations holding blanket performance licenses.”).

<sup>100</sup> *Id.* at 40 (“The Panel is uncomfortable with many of these assumptions and the cumulative effect casts significant doubt on the reliability of the ultimate conclusions. The Panel finds that this theoretical construct suffers serious deficiencies.”).

<sup>101</sup> *Id.* at 43.

RIAA were “unreliable benchmarks,”<sup>102</sup> the freely negotiated agreement with Yahoo! was “evidence of an entirely different character,”<sup>103</sup> reflecting “a truly arms-length bargaining process on a level playing field between two major players of comparable skill, size, and economic power.”<sup>104</sup> Thus, based largely on the Yahoo! agreement, the CARP set a statutory performance royalty rate of 0.14¢ per performance for Internet-only (“IO”) webcasters.<sup>105</sup>

In adopting the per performance rate structure, the CARP rejected arguments that it should set rates as a percentage of licensees’ revenues.<sup>106</sup> The CARP found that the per-performance structure was superior because (1) a per-performance metric is directly reflective of the right being licensed; (2) percentage-of-revenue models are difficult to implement because relevant webcaster revenues are complex; and, (3) many webcasters are small and do not generate much revenue, so that the adoption of a percent-of-revenue model could result in copyright owners receiving little or no compensation for the use of their material.<sup>107</sup>

The CARP also grappled with the issue of whether webcasters promoted music sales, especially in the context of radio retransmissions (*i.e.*, copyrighted material contained in Internet retransmissions of broadcast radio signals).<sup>108</sup> The CARP could not determine whether webcasters created a net increase or net decrease in the sale of phonorecords, despite the “undisputed testimony that traditional over-the-air radio play has a tremendous promotional impact on phonorecord sales” and the absence of evidentiary support for concluding that the impact of Internet simulcasts was any less significant.<sup>109</sup> The CARP set a lower Radio Retransmission (“RR”) rate of 0.07¢.<sup>110</sup>

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<sup>102</sup> *Id.* at 60.

<sup>103</sup> *Id.*

<sup>104</sup> *Id.* at 61; *see also* Duvall, *supra* note 48, at 273–74 (“To determine the rates that would have been negotiated in the marketplace under the per performance model, CARP reviewed actual royalty agreements to comply with its statutory obligations under the DMCA. It found that the RIAA/Yahoo! agreement provided an appropriate benchmark for the rate-setting because it was the only RIAA-negotiated agreement ‘to reflect a truly arms-length bargaining process on a level playing field between two major players of comparable skill, size, and economic power.’”).

<sup>105</sup> *Webcaster I*, *supra* note 10, at 45,243.

<sup>106</sup> *Id.* at 45,243.

<sup>107</sup> *See CARP Report*, *supra* note 8, at 37. The CARP also recommended a minimum royalty fee of \$500 per annum. *Id.* at 95.

<sup>108</sup> *Id.* at 32–34.

<sup>109</sup> *Id.* at 74–75. The CARP did not conclude that there was no promotion, the CARP limited said that the evidence was insufficient to persuade them either way. *Id.* at 33–34.

<sup>110</sup> Recent Legislation, *Copyright Law—Congress Responds to Copyright Arbitration*

As provided for under the DPRA, the CARP's findings were reviewed by the Register of Copyrights and the Librarian of Congress ("LOC").<sup>111</sup> In its Final Rule and Order, released on July 8, 2002,<sup>112</sup> the LOC—after reviewing briefs filed by both sides—upheld the CARP's determination regarding the definition of the participants in the relevant hypothetical marketplace.<sup>113</sup> However, the LOC ruled that the CARP erred when the CARP set royalty rates that were higher for Internet-only webcasters than rates for radio retransmissions.<sup>114</sup> While the LOC accepted that the RIAA's agreements with webcasters served as a more reasonable benchmark than the webcasters' proposed "theoretical model," it lowered the IO webcasting rate from 0.14¢ per-performance to 0.07¢ per-performance<sup>115</sup> (to match the royalty rate for RR entities).<sup>116</sup> Thus, the LOC cut the per-performance rate set by the CARP for pureplay webcasters, which was based on the actual rate agreed to by RIAA and Yahoo!, by 50%.<sup>117</sup>

The LOC's decision also contained important language concerning the distinction between the 801(b) and WBWS standards. The two standards, it concluded, were not the same. Rather, the 801(b) standard is "policy-driven, whereas the standard for setting rates for non-subscription services set forth in § 114(f)(2)(B) is *strictly fair market value*—willing buyer/willing seller," therefore, the two rates cannot be equal as a matter of law.<sup>118</sup>

The LOC's ruling was upheld on appeal by the D.C. Circuit Court in *Beethoven.com LLC*.<sup>119</sup> However, even before the appeal was decided, Congress—heeding complaints from small webcasters that the rates (even after being cut in half by the LOC) were too high—stepped in by passing the Small Webcasters Settlement Act of 2002,<sup>120</sup> which "gave noncommercial and small commercial webcasters additional time to negotiate,"<sup>121</sup> and expressed to copyright owners "the strong encouragement of Congress to reach an accommodation with the small webcasters on an expedited basis."<sup>122</sup> Shortly thereafter, the

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*Royalty Panel's Webcasting Rates*, 116 HARV. L. REV. 1920, 1923 (2003).

<sup>111</sup> *CARP Report*, *supra* note 8, at 7.

<sup>112</sup> *Webcaster I*, *supra* note 10, at 45,240.

<sup>113</sup> *Id.* at 45,244–45.

<sup>114</sup> *Id.* at 45,243.

<sup>115</sup> *Id.*

<sup>116</sup> *See* Duvall, *supra* note 48, at 275–76.

<sup>117</sup> *See* *Webcaster I*, *supra* note 10, at 45,241, 45,243.

<sup>118</sup> *See id.* at 45,241 (emphasis added).

<sup>119</sup> *Beethoven.com LLC v. Librarian of Cong.*, 394 F.3d 939, 954 (D.C. Cir. 2005).

<sup>120</sup> H.R. REP. NO. 111–139, at 2 (2009).

<sup>121</sup> Day, *supra* note 29, at 188–89.

<sup>122</sup> Small Webcaster Settlement Act of 2002, Pub. L. No. 107-321, § 2(3), 116 Stat. 2780, 2780 ("The representatives have arrived at an agreement that they can accept in the

small webcasters reached a compromise agreement with RIAA setting royalty rates that were capped as a percentage of small webcasters' revenues or expenses rather than calculated on a per-performance basis.<sup>123</sup>

## 2. Webcaster II

The next statutory license proceeding for webcaster royalty rates, covering the period 2006–2010, established rates through another formal rate proceeding, this one lasting more than two years, from February 2005 until May 2007,<sup>124</sup> this time under the purview of the CRB, the successor to the CARP panel.<sup>125</sup> The *Webcaster II* proceeding again involved direct and rebuttal testimony from dozens of expert witnesses, including formal hearings, hundreds of motions and pleadings, and over 13,000 pages of transcripts.<sup>126</sup>

As in *Webcaster I*, the CRB evaluated several proposed benchmarks for royalty rates proposed by copyright owners and webcasters, again embracing an approach based on rates for comparable rights that had been negotiated freely in the marketplace.<sup>127</sup> Specifically, the CRB embraced a model proposed by SoundExchange's economic expert, Dr. Michael Pelcovits. Termed the "Interactive Webcasting Market Benchmark,"<sup>128</sup> the model utilized the royalty rates negotiated individually between copyright owners and interactive music services (adjusted for differences in interactivity) as a basis for royalties for non-

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extraordinary and unique circumstances here presented, specifically as to the small webcasters, their belief in their inability to pay the fees due pursuant to the July 8 order, and as to the copyright owners of sound recordings and performers, the strong encouragement of Congress to reach an accommodation with the small webcasters on an expedited basis.").

<sup>123</sup> See Notification of Agreement Under the Small Webcaster Settlement Act of 2002, 67 Fed. Reg. 78,510, 78,511 (Dec. 24, 2002) (observing that rates were set at 10% of revenues up to \$250,000, 12% of revenues above \$250,000, or seven% of expenses, whichever was greater).

<sup>124</sup> *Webcaster II*, *supra* note 26, at 24,084; see also Digital Performance Right in Sound Recordings and Ephemeral Recordings, 70 Fed. Reg. 7970, 7970 (Feb. 16, 2005) (announcing the commencement of the proceedings).

<sup>125</sup> In the interim, Congress had passed the Copyright Royalty and Distribution Reform Act in 2004, which replaced the *ad hoc* CARP panels with a permanent Copyright Royalty Board. See Copyright Royalty and Distribution Reform Act of 2004, Pub. L. No. 108-114, § 3, 118 Stat. 2341, 2341.

<sup>126</sup> *Webcaster II*, *supra* note 26, at 24,085 ("In addition to the written direct statements and written rebuttal statements, the Copyright Royalty Judges heard 48 days of testimony, which filled 13,288 pages of transcript, and 192 exhibits were admitted. The docket contains 475 entries of pleadings, motions and orders.").

<sup>127</sup> See *id.*

<sup>128</sup> *Id.* at 24,092.

interactive services under compulsory licenses.<sup>129</sup> Based largely on the interactive services benchmark, the CRB set per-performance rates at 0.08¢ for 2006, rising gradually to 0.19¢ in 2010,<sup>130</sup> as shown in Table 2. Thus, under *Webcaster II*, the statutory rate was scheduled to reach the 0.14¢ per performance rate—the very rate recommended by the CARP for Internet-only transmissions—in 2008.<sup>131</sup>

TABLE 2<sup>132</sup>  
STATUTORY ROYALTY RATES FOR COMMERCIAL  
WEBCASTERS UNDER WEBCASTER II

Year	Per-Performance Royalty
2006	0.08¢
2007	0.11¢
2008	0.14¢
2009	0.18¢
2010	0.19¢

The CRB's decision was appealed to the D.C. Circuit Court of Appeals, in *Intercollegiate Broadcast System v. Copyright Royalty Board*.<sup>133</sup> The Court upheld the CRB's determination of royalty rates for commercial webcasters, including specifically its decision to base royalties on the market-based interactive services benchmark.<sup>134</sup> The Court also rejected the webcasters' assertions that the rates set by the CRB were "crushing and disproportionate."<sup>135</sup> The

<sup>129</sup> See Duvall, *supra* note 48, at 279. The CRB also concurred in the *Webcaster I* determination that the preferred metric for calculating statutory royalties is a per-performance model, as opposed to royalties based on a percentage-of-revenue. *Webcaster II*, *supra* note 26, at 24,090.

<sup>130</sup> See *Webcaster II*, *supra* note 26, at 24,096.

<sup>131</sup> Compare *Webcaster I*, *supra* note 10, at 45,243 (rejecting the "proposed rates (\$0.14 per performance for Internet-only transmission and \$0.07 per performance for radio re-transmissions) for the section 114 license and substitut[ing] [the Librarian's] own determination ([\$0.0007] per performance for both types of transmissions)"), with *Webcaster II*, *supra* note 26, at 24,096 (setting rates at \$0.0014 for 2008).

<sup>132</sup> Adapted from information in *Webcaster II*. See *Webcaster II*, *supra* note 26, at 24,096.

<sup>133</sup> See *Intercollegiate Broad. Sys., Inc. v. Copyright Royalty Bd.*, 574 F.3d 748, 752 (D.C. Cir. 2009).

<sup>134</sup> *Id.* at 758.

<sup>135</sup> *Id.* at 760. The Court did, however, vacate the \$500 minimum fee for both commer-

court found that the WBWS standard does not require to the CRB to set rates that allow all firms in the market to earn a profit:

Finally, it was not error for the Judges to reject the small commercial webcasters' pleas that paying per performance would wreck their inefficient business models. The Judges made clear they could not "guarantee a profitable business to every market entrant." The Judges are not required to preserve the business of every participant in a market. They are required to set rates and terms that "most clearly represent the rates and terms that would have been negotiated in the marketplace between a willing buyer and a willing seller." 17 U.S.C. § 114(f)(2)(B). If small commercial webcasters cannot pay the same rate as other willing buyers and still earn a profit, then the Judges are not required to accommodate them.<sup>136</sup>

Thus, the court ruled, while webcasters are guaranteed access to sound recording performance rights under a compulsory license, Congress did not extend to them a right to perpetual profitability.<sup>137</sup>

### 3. The Webcaster Settlement Act and the 2009 Compromise

As with *Webcaster I*, many webcasters reacted negatively to the *Webcaster II* decision.<sup>138</sup> Pandora and others claimed that the CRB's royalty rates would push webcasters to the verge of collapse,<sup>139</sup> with Pandora asserting that the CRB rates would force it to pay almost 70% of its revenues in performance royalties.<sup>140</sup>

As in 2002, Congress reacted sympathetically to webcasters' complaints,<sup>141</sup> this time by passing the Webcaster Settlement Act of 2008 and later the Webcaster Settlement Act of 2009 (together, the "WSAs").<sup>142</sup> Modeled on the Small Webcaster Settlement Act of 2002, the WSAs expressed to copyright

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cial and non-commercial webcasters, remanding those portions of the CRB's ruling for reconsideration. *Id.* at 762.

<sup>136</sup> *Id.* at 761 (internal citations omitted).

<sup>137</sup> *See id.*

<sup>138</sup> Duvall, *supra* note 48, at 283.

<sup>139</sup> *See Day, supra* note 29, at 190–91 ("The reaction to the CRB rates was immediate and dramatic. Small and large webcasters alike predicted the CRB rates would result in the 'end of Internet Radio.' For instance, Pandora Internet Radio . . . maintained that it was 'on the verge of collapse' as a result of the new rates.").

<sup>140</sup> *See Day, supra* note 29 (citing a prepared statement by Pandora Media, Inc.).

<sup>141</sup> *See* Elahe Izadi, *Pandora, Growing Up Washington Style*, NAT'L J. (July 9, 2012), <http://commcns.org/1gNQ61e>.

<sup>142</sup> *See* Webcaster Settlement Act of 2008, Pub. L. No. 110-435, 122 Stat. 4974; Webcaster Settlement Act of 2009, Pub. L. No. 111-36, 123 Stat. 1926.



owners “the strong encouragement of Congress to reach an accommodation with the webcasters on an expedited basis,”<sup>143</sup> and provided a window of time in which to do so.<sup>144</sup> Not surprisingly, rights holders entered into negotiations with webcasters over lower rates, reaching eight separate agreements (containing a total of twelve royalty schedules) with different segments of the webcasting market—for example, non-commercial webcasters, non-commercial educational webcasters, and pureplay webcasters—in late 2008 and early 2009.<sup>145</sup> The new rates, which were available to qualified webcasters on an opt-in basis, overrode the market-based *Webcaster II* rates established by the CRB for webcasters that elected the alternate rates, and generally covered the ten-year period from 2006–2015.<sup>146</sup> Table 3 shows the alternate schedule of rates for Pureplay webcasters, which are substantially lower than the rates determined by the CRB in *Webcaster II*. For example, the royalty rate per-performance under *Webcaster II* in 2010 would have been 0.19¢, while the WSA Pureplay rate is only 0.097¢.<sup>147</sup> And, the 0.14¢ originally recommended by the CARP in *Webcaster I* to take effect in 1998, and delayed under *Webcaster II* until 2008, was pushed back another seven years, until 2015.<sup>148</sup>

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<sup>143</sup> See Small Webcaster Settlement Act of 2002, Pub. L. 107-321, § 2, 116 Stat. 2780, 2780.

<sup>144</sup> See Webcaster Settlement Act of 2008, Pub. L. No. 110-435, 122 Stat. 4974. The original deadline for negotiations, Feb. 15, 2009, was extended through July 2009 by the Webcaster Settlement Act of 2009, Pub. L. No. 111-36, 123 Stat. 1926. See 155 CONG. REC. S6740 (2009) (statement of Sen. Patrick Leahy).

<sup>145</sup> See 2008 Webcaster Settlement, *supra* note 81, at 9294 (listing agreements between SoundExchange and various webcasters).

<sup>146</sup> See 2009 Webcaster Settlement, *supra* note 81, at 34,798.

<sup>147</sup> *Webcaster II*, *supra* note 26, at 24,096 (setting the per-play rate applicable to Commercial Webcasters at 0.19¢ for 2010); 2009 Webcaster Settlement, *supra* note 81, at 34,799 (setting the per-play rate applicable to Commercial Webcasters at 0.097¢ for 2010).

<sup>148</sup> *Webcaster I*, *supra* note 10, at 45,273 (setting the per-play rate for all internet transmissions by Webcasters and Commercial Broadcasters at \$0.0007 per performance); *Webcaster II*, *supra* note 26, at 24,096 (setting the per play rate applicable to Commercial Webcasters at \$0.0014 for 2008); 2009 Webcaster Settlement, *supra* note 81, at 34,799 (setting the per-play rate applicable to Commercial Webcasters at \$0.0014 for 2015).

TABLE 3<sup>149</sup>  
 ROYALTY RATES FOR PUREPLAY WEBCASTERS  
 UNDER THE 2009 WEBCASTER SETTLEMENT ACT COMPROMISE

Year	Per-Performance Royalty
2006	0.08¢
2007	0.084¢
2008	0.088¢
2009	0.093¢
2010	0.097¢
2011	0.102¢
2012	0.11¢
2013	0.12¢
2014	0.13¢
2015	0.14¢

Importantly, Congress directed the LOC to make it clear that the Webcaster Settlement Act rates were not to be interpreted as “market based.”<sup>150</sup> To highlight that fact, Congress unequivocally stated in § 114(f)(5)(C) that the new rates were to be considered the result of unique circumstances and, specifically, were not precedential with respect to the WBWS standard:

It is the intent of Congress that any royalty rates, rate structure, definitions, terms, conditions, or notice and recordkeeping requirements, included in such agreements shall be considered as a compromise motivated by the *unique business, economic and political circumstances* of webcasters, copyright owners, and performers rather than as matters that would have been negotiated in the marketplace between a willing buyer and a willing seller.<sup>151</sup>

Thus, the rates currently being paid by webcasters like Pandora are not market based, but rather the result of a compromise that set rates below those es-

<sup>149</sup> 2009 Webcaster Settlement, *supra* note 81, at 34,799.

<sup>150</sup> *See id.* at 34,801 (noting that the Rates and Terms shall be considered a compromise motivated by the unique circumstances, and the Rates and Terms cannot be represented as market rates in any proceeding).

<sup>151</sup> 17 U.S.C. § 114(f)(5)(C) (emphasis added).

established by the CRB under the WBWS standard.<sup>152</sup> The compromise extends the term of the agreement through 2015.<sup>153</sup> Lastly, the compromise requires large pureplay webcasters to pay the greater of 25% of revenues or the agreed upon per play rates.<sup>154</sup>

#### 4. Webcaster III

While rates for 2011–2015 were established for most webcasters by the various Webcaster Settlement Act compromises, the CRB was still required to hold a new royalty rate proceeding to set statutory rates and terms for the 2011–2015 period that such rates would apply to webcasters that were not in existence at the time of the Webcaster Settlement Act or chose not to opt-in to one of the WSA rate schedules.<sup>155</sup> Despite the fact that most webcasters did not participate in the proceeding, the *Webcaster III* proceeding involved extensive direct and reply testimony from numerous experts from all sides, full briefing schedules, and so forth.

Applying the WBWS standard, the CRB once again (as in *Webcaster II*) set rates by reference to a benchmark based on the rates negotiated between rights holders and interactive digital services, which are not subject to the compulsory copyright and thus are prima facie market-based.<sup>156</sup> The CRB released its rate determinations on March 9, 2011,<sup>157</sup> with rates again established on a performance basis, as shown in Table 4.

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<sup>152</sup> See *2009 Webcaster Settlement*, *supra* note 81, at 34,796–99 (describing statutory rates which webcasters may elect to pay).

<sup>153</sup> *Id.* at 34,799.

<sup>154</sup> *Id.*

<sup>155</sup> See generally *Webcaster III*, *supra* note 73. The *Webcaster III* proceeding began on January 9, 2009, and thus overlapped negotiations then underway under the Webcaster Settlement Act. Those negotiated resulted in voluntary agreements among many of the parties for which rates would have otherwise been determined under *Webcaster III*.

<sup>156</sup> *Id.* at 13,031 (noting that royalty adjustments were made based on the non-interactive nature of the licenses under consideration).

<sup>157</sup> *Id.* at 13,047–48.

TABLE 4<sup>158</sup>  
 STATUTORY ROYALTY RATES FOR  
 COMMERCIAL WEBCASTERS UNDER *WEBCASTER III*

Year	Per-Performance Royalty
2011	0.19¢
2012	0.21¢
2013	0.21¢
2014	0.23¢
2015	0.23¢

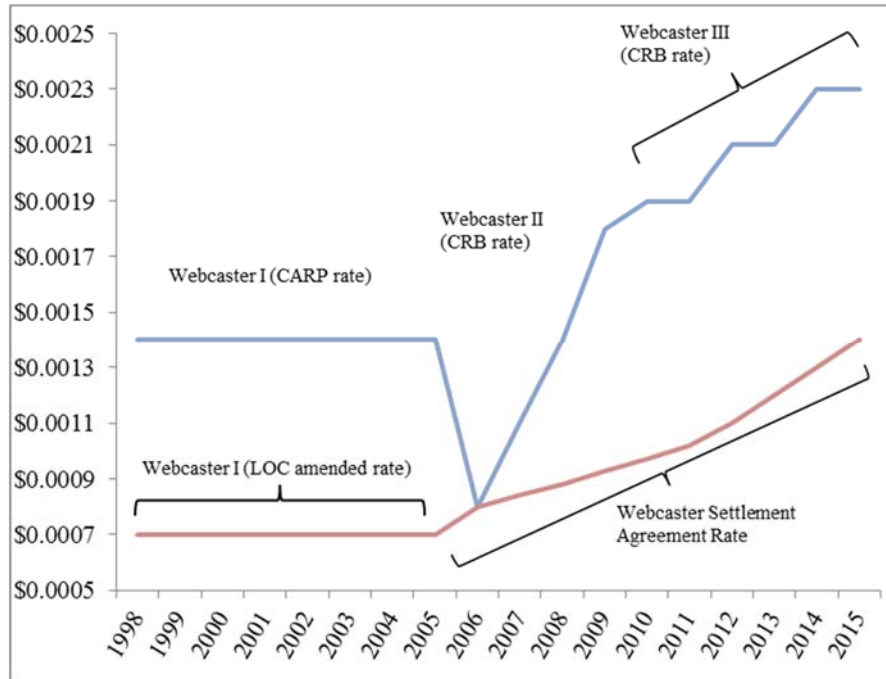
Figure 1 below illustrates the disparity between the royalty rates determined by the CARP and CRB under the WBWS standard in the *Webcaster I*, *Webcaster II* and *Webcaster III* proceedings and the royalty rates actually paid by pureplay webcasters. The blue line in Figure 1 represents the original royalty rates set by the CARP and the CRB, which applied the WBWS standard after extensive proceedings in which economic evidence was used to estimate a market-based rate. The red line represents the final royalty rates actually charged to webcasters after their appeals to the Librarian of Congress for *Webcaster I* and to Congress after *Webcaster II*.<sup>159</sup>

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<sup>158</sup> Derived from information in *Webcaster III*. See *id.* at 13,048.

<sup>159</sup> Note that rates negotiated by small webcasters under the Small Webcaster Settlement Act, which were expressed as a share of revenues rather than on a per-performance basis, are not shown.

FIGURE 1: COMPARISON OF INITIAL AND FINAL WEBCASTER ROYALTY RATES, 1998–2015



As Figure 1 shows, some pureplay webcasters (including Pandora) have secured per-performance royalty rates well below the market-based rates mandated by Congress under the DMCA.

### C. Section 801(b) and the “Non-Disruption” Standard

Unlike the WBWS standard, the 801(b) standard now being advocated by webcasters is explicitly not market-based—that is, it is not designed to replicate the rates that would be achieved in a competitive market.<sup>160</sup> Rather, the

<sup>160</sup> See Written Direct Statement of Music Choice at 13–15, *In re Determination of Rates and Terms for Preexisting Subscription and Satellite Digital Audio Radio Services*, No. 2011-1 CRB PSS/Satellite II (Copyright Royalty Bd., Nov. 29, 2011) [hereinafter *Direct Statement of Music Choice*], available at <http://commcns.org/1fD7m6s> (arguing simultaneously that current rates will result in petitioner Music Choice’s demise and that there are no similar market benchmarks on which to base royalty rate).

fourth pillar of the 801(b) standard reflects Congress' desire that rates be set so as to "minimize" any "disruptive" impact on the parties; that is, if market-based rates are determined to be disruptive for licensees, they must be lowered.<sup>161</sup> From a policy perspective, the "non-disruption" standard may result in locking in place inefficient or obsolete business models, or even encouraging inefficient investments by firms which know that, under the 801(b) standard, rates will be set so as to prevent "disruption" to their business models. For licensees and their investors, such a guarantee is obviously quite valuable.

This subsection briefly reviews the application of the 801(b) standard since its adoption in the 1976 Copyright Act, focusing on proceedings involving royalty rates for SDARS services, *SDARS I* (completed in 2008) and *SDARS II*. In *SDARS I*, the non-disruption criterion played an important role, leading directly to rates lower than would have been reached under the WBWS standard.<sup>162</sup> And, while the *SDARS II* proceeding is not yet complete, the expert economic testimony presented there demonstrates that, at least in the eyes of copyright users, the non-disruption criterion amounts to a guaranteed return on investment for licensees, now and into the future.<sup>163</sup> Before addressing the two SDARS proceedings, it is useful to review briefly the three prior proceedings in which the 801(b) standard was applied.

### 1. Early Interpretations of the 801(b) Standard

Prior to the creation of the Copyright Royalty Board, the 801(b) standard was applied twice by the Copyright Royalty Tribunal ("CRT") in 1981, and once by CARP in 1997.<sup>164</sup> The two CRT proceedings involved the statutory licenses for jukeboxes and for the mechanical license, that is, the right to use a musical composition when making a copy of a sound recording.<sup>165</sup> As the CRB

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<sup>161</sup> See 17 U.S.C. § 801(b)(1)(D) (requiring one function of the Copyright Royalty Judges while making royalty determinations is to minimize any disruptive impact on the structure of the industries involved in rate setting).

<sup>162</sup> See *SDARS I*, *supra* note 15, at 4097 (describing considerations of the analysis of the "minimizing disruption" factor).

<sup>163</sup> See *Direct Statement of Music Choice*, *supra* note 160, at 44–45 (arguing that royalties have been so disruptive as to cause the failure of competing firms, thus compelling the Board to set a lower rate).

<sup>164</sup> See generally Letter from Mark L. Goldstein, Director, Physical Infrastructure Issues, to Sen. Arlen Specter (Aug. 4, 2010), available at <http://commens.org/N0sieF>.

<sup>165</sup> 1980 Adjustment of the Royalty Rate for Coin-Operated Phonorecord Players, 46 Fed. Reg. 884, 885 (Jan. 5, 1981); Adjustment of Royalty Payable under Compulsory License for Making and Distributing Phonorecords; Rates and Adjustment of Rates, 46 Fed. Reg. 10,466, 10,467 (Feb. 3, 1981).

later noted, in the 1980 Jukebox License Proceeding,<sup>166</sup> neither the CRT nor the D.C. Circuit, which reviewed the decision on appeal, substantively dealt with the 801(b) standard as such.<sup>167</sup> The CRT's decision in the 1981 Mechanical License Proceeding, however, did address the standard, focusing on the statutory requirement that rates be "reasonable," and suggesting that the individual 801(b) standards could be satisfied by rates lying within a zone of reasonableness.<sup>168</sup> In its subsequent review, the D.C. Circuit agreed.<sup>169</sup>

In 1997, a CARP took up the issue of royalties for PSS under the recently passed Digital Performance Right in Sounds Recordings Act.<sup>170</sup> When the CARP's decision came down heavily on the side of the PSS, it was reviewed and revised by the Librarian of Congress, and rates ultimately were set at 6.5% of revenues.<sup>171</sup> However, neither the Librarian's decision nor the subsequent D.C. Court of Appeals decision to reject an appeal by the Recording Industry Association of America dwelt on the proper interpretation of § 801(b).<sup>172</sup>

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<sup>166</sup> See 1980 Adjustment of the Royalty Rate, *supra* note 165, at 888–89 (reaching a decision in light of the 801(b) standard but observing that such criteria was not contemplated for exclusive application to the determination of the jukebox rate).

<sup>167</sup> See *SDARS I*, *supra* note 15, at 4082 (noting that "[w]hile the Tribunal's decision was somewhat lengthy, its consideration and application of the standard and the Section 801(b)(1) factors was not").

<sup>168</sup> See Adjustment of Royalty Payable under Compulsory License for Making and Distributing Phonorecords, *supra* note 165, at 10,479; see also *Recording Indus. Ass'n of Am. v. Copyright Royalty Tribunal*, 662 F.2d 1, 11 (D.C. Cir. 1981).

<sup>169</sup> *Recording Indus. Ass'n of Am. v. Copyright Royalty Tribunal*, 662 F.2d at 11, 18; see *SDARS I*, *supra* note 15, at 4083 (noting that "[t]o the extent that the statutory objectives determine a range of reasonable royalty rates that would serve all these objectives adequately but to differing degrees, the Tribunal is free to choose among those rates, and courts are without authority to set aside the particular rate chosen by the Tribunal if it lies within a 'zone of reasonableness'").

<sup>170</sup> See *SDARS I*, *supra* note 15, at 4083 (noting that "[u]nlike prior statutory licenses where the Congress fixed the initial rates within the statute, the rates for the new digital performance right license were left to resolution by a CARP. The Librarian convened a CARP in 1997 for PSS and SDARS. The SDARS settled with copyright owners and withdrew from the proceeding, and the CARP rendered a determination only with respect to the PSS. The Librarian reviewed the CARP's determination and rejected it with respect to the rate as well as to certain terms, and the U.S. Court of Appeals for the District of Columbia Circuit reviewed the Librarian's decision.").

<sup>171</sup> *Recording Indus. Ass'n of Am. v. Librarian of Cong.*, 176 F.3d 528, 531 (D.C. Cir. 1999).

<sup>172</sup> See *id.* at 532–33 (finding that the Librarian's interpretation of § 802(b) was reasonable and declining to impose its own interpretation).

## 2. SDARS I

In January 2006, the CRB initiated a rate proceeding to establish statutory royalties for PSS and SDARS for 2007 and 2008 through 2012.<sup>173</sup> The PSS services negotiated voluntary agreements, which were ratified by the CRB in late 2007,<sup>174</sup> but the SDARS services (at that time, Sirius and XM) did not, and the CRB issued statutory rates for SDARS services in January 2008.<sup>175</sup> The decision, known as *SDARS I*, left no doubt that the 801(b) standard, as interpreted by the CRB and reviewed by the DC Circuit, is likely to result in rates lower than the market-based rates set under the WBWS standard.<sup>176</sup>

Like the *Webcaster* proceedings, *SDARS I* was a full-blown rate proceeding, featuring dozens of economic and industry experts, direct and rebuttal testimony and so on.<sup>177</sup> The CRB began its analysis by seeking to establish a benchmark based on voluntarily negotiated rates for comparable services, and ultimately chose again—as in the *Webcaster II* and *Webcaster III* proceedings—to rely on a model based on the market rates negotiated for interactive subscription services.<sup>178</sup> Based largely on an analysis by Dr. Janusz Ordover, the CRB determined that a royalty rate equal to 13% of subscriber revenue constituted a “reasonable estimate of a marketplace derived benchmark.”<sup>179</sup>

The next step in the CRB’s analysis was to establish a “zone of reasonableness” within which the final rates—based on the § 801(b) criteria—would have to lie.<sup>180</sup> The Board determined that the 13% benchmark “marks the upper boundary of a zone of reasonableness for potential marketplace benchmarks,” that a lower boundary was established by the 2.35% of revenues paid by SDARS for musical works licenses, but that “based strictly on marketplace evidence, a rate close to the upper boundary is more strongly supported than

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<sup>173</sup> Adjustment of Rates and Terms for Preexisting Subscription and Satellite Digital Audio Radio Services, 71 Fed. Reg. 1455 (Jan. 9, 2006); *see also* Letter from Mark L. Goldstein to Sen. Arlen Specter, *supra* note 164, at 5.

<sup>174</sup> *See* Adjustment of Rates and Terms for Preexisting Subscription and Satellite Digital Audio Radio Services, 72 Fed. Reg. 71,795 (Dec. 19, 2007).

<sup>175</sup> *See id.*

<sup>176</sup> *See id.*

<sup>177</sup> *See SDARS I*, *supra* note 15, at 4081 (stating that in addition to the written direct statements and written rebuttal statements, the judges heard 26 days of testimony, which filled over 7,700 pages of transcript, and over 230 exhibits were admitted).

<sup>178</sup> *See id.* at 4083.

<sup>179</sup> *See id.* at 4083, 4085–88 (explaining that the CRB continues to prefer a per-performance metric to one based on a percentage of revenues, because several factors made it impractical to utilize a per-performance metric in this case).

<sup>180</sup> *See id.* at 4083.



one close to the lower boundary.”<sup>181</sup> Hence, prior to explicit consideration of the four 801(b) criteria, the judges had in mind a rate closer to 13% than to 2.35%.<sup>182</sup>

The next step in the Board’s analysis was to determine “whether these policy objectives weigh in favor of divergence from the results indicated by the marketplace benchmark evidence.”<sup>183</sup> Looking at the first two criteria, which require, respectively, “maximizing the availability of creative works to the public” and providing a “fair return” to both copyright holders and users, the Board determined that no adjustments from market rates were necessary and, indeed, that the criteria do not as a general matter imply rates different from those set in the market.<sup>184</sup>

The Board reached a different conclusion, however, with respect to the latter two criteria, § 801(b)(1)(C) (which requires an assessment of the “relative roles” of the copyright owner and user with respect to creative contribution, technological contribution, capital investment, cost, risk and contribution to the opening of new markets) and § 801(b)(1)(D), the non-disruption standard.<sup>185</sup>

With respect to the “relative roles” criteria, the CRB found that the need for SDARS to make “new expenditures related to their satellite technology...may weigh in favor of a discount from the market rate.”<sup>186</sup> However, it determined that this issue was “intimately intertwined” with the non-disruption standard, and decided to “treat the potential disruptive effect of postponing investment in new satellite technology” as part of its consideration of the non-disruption standard.<sup>187</sup>

In applying the non-disruption standard, the Board concluded that a deviation from market rates was justified on two grounds—profitability and investment.<sup>188</sup> First, it concluded, raising rates to the market-based level would “increase costs and raise the necessary critical mass of subscribers sufficient to generate revenues that yield EBITDA profitability.”<sup>189</sup> Thus:

In order not to significantly delay the attainment and amounts of EBITDA profitability and positive free cash flow, some rate within the zone of reasona-

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<sup>181</sup> *Id.* at 4094.

<sup>182</sup> *Id.*

<sup>183</sup> *Id.*

<sup>184</sup> *See id.* at 4094, 4094–96.

<sup>185</sup> *See id.* at 4096.

<sup>186</sup> *Id.* at 4097.

<sup>187</sup> *Id.*

<sup>188</sup> *Id.*

<sup>189</sup> *See id.*

bleness that is less than 13% is warranted.<sup>190</sup>

Second, with respect to investment, it decided that royalty rates should be set so as not to place “any undue constraint on the SDARS’ ability to successfully undertake satellite investments planned for the license period.”<sup>191</sup> Based on these factors, the Board found it “appropriate to adopt a rate from the zone of reasonableness for potential marketplace benchmarks that is lower than the upper boundary most strongly indicated by marketplace data.”<sup>192</sup> Accordingly, it set an initial rate of 6% of revenues, rising to 8% over the six-year (2007–2012) term of the license—roughly 50% below the 13% benchmark it had initially concluded reflected a “reasonable estimate of a marketplace derived benchmark.”<sup>193</sup>

### 3. SDARS II

Perhaps the best way to understand the impact of the 801(b) non-disruption standard is to examine how it is invoked in an actual proceeding, such as the one that the CRB had engaged in to determine rates for PSS and SDARS for the five-year term beginning in January 2013.<sup>194</sup> In that proceeding, experts for copyright users repeatedly invoked the 801(b) standard as the basis for claiming that rates should be set below marketplace levels in order to guarantee their clients a rate of return on both past and future investments, arguing that the standard not only permits but could require the CRB to deviate from market-based rates in order to advance “social values”<sup>195</sup> such as “distributive justice.”<sup>196</sup>

For example, an expert who submitted a statement on the behalf of Sirius

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<sup>190</sup> *Id.*

<sup>191</sup> *Id.* SoundExchange appealed the CRB’s ruling to the D.C. Circuit Court of Appeals arguing that the royalty rates set by the CRB were too low, where The Court upheld the CRB’s ruling, stating that the CRB did not act unreasonably in setting rates. The Court did not, however, make a determination on whether the rates themselves were too high or too low. *See generally* SoundExchange, Inc. v. Librarian of Cong., 571 F.3d 1220 (D.C. Cir. 2009).

<sup>192</sup> *SDARS I*, *supra* note 15, at 4097.

<sup>193</sup> *Id.* at 4093.

<sup>194</sup> Determination of Rates and Terms for Preexisting Subscription Services and Satellite Digital Audio Radio Services, 76 Fed. Reg. 591 (Jan. 5, 2011).

<sup>195</sup> Written Rebuttal Testimony of Roger G. Noll on Behalf of Sirius XM Radio Inc. at 50, *In re* Determination of Rates and Terms for Preexisting Subscription Services and Satellite Digital Audio Radio Services, No. 2011-1 CRB PSS/Satellite II (Copyright Royalty Bd., July 2, 2012), *available at* <http://commens.org/1hHhNEO>.

<sup>196</sup> *Id.* at 6.

XM asserted that the CRB is required to “ensure that all participants would still have voluntarily engaged in the market transactions needed to make satellite services available had they been aware of the rates when they made the decisions to enter into those transactions,”<sup>197</sup> which is equivalent to requiring that rates be set so as to guarantee investors profits on their initial investments, apparently in perpetuity.<sup>198</sup> Another expert testified that, under § 801(b), rates that do not permit copyright users to recover the start-up costs of entering the industry<sup>199</sup> and ensure that they can “recover the financial cost of [future] investments” would be “disruptive,” because users must have incentives to *continue* investing in their businesses.<sup>200</sup> To summarize, while it is theoretically possible for the 801(b) standard to result in the same rates as under the WBWS standard,<sup>201</sup> there is no question that the two standards are—as one supporter of the IRFA recently agreed—“starkly different.”<sup>202</sup> Nor is it surprising that, as one knowledgeable observer recently noted, “[T]he change from the willing buyer/willing seller standard to the 801(b) standard is widely anticipated to significantly lower the royalty rates that online radio services pay.”<sup>203</sup> As discussed further below, other elements of the IRFA were also designed to ensure copyright users continue to pay below market rates in the future.

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<sup>197</sup> Written Rebuttal Testimony of Dr. Michael A. Salinger on Behalf of Sirius XM Radio Inc. at 16, *In re* Determination of Rates and Terms for Preexisting Subscription Services and Satellite Digital Audio Radio Services, No. 2011-1 CRB PSS/Satellite II (Copyright Royalty Bd., July 2, 2012), *available at* <http://commens.org/1hHhNEO>.

<sup>198</sup> *See id.*

<sup>199</sup> Written Direct Testimony of Roger G. Noll on behalf of Sirius XM Radio Inc. at 77, *In re* Determination of Rates and Terms for Preexisting Subscription Services and Satellite Digital Audio Radio Services, No. 2011-1 CRB PSS/Satellite II (Copyright Royalty Bd., Nov. 29, 2011), *available at* <http://commens.org/1eObvDj>.

<sup>200</sup> *Id.*

<sup>201</sup> *See* Letter from Mark L. Goldstein to Sen. Arlen Specter, *supra* note 164, at 5.

<sup>202</sup> *See* John Villasenor, *Digital Broadcast Music Royalties: The Case for a Level Playing Field*, 19 ISSUES TECH. INNOVATION 1, 9 (2012) (stating that the desire to lower the “high royalty burdens” paid by webcasters is the primary rationale offered by IRFA’s proponents for its enactment).

<sup>203</sup> *See* Jodie Griffin, *The Internet Radio Fairness Act: Revamping the Online Radio Marketplace*, PUB. KNOWLEDGE POL’Y BLOG (Nov. 2, 2012), <http://commens.org/1mQVeTr>.

#### IV. THE NON-DISRUPTION STANDARD: THE PROPOSED INTERNET RADIO FAIRNESS ACT AND THE MARKET FOR ONLINE MUSIC

The Internet Radio Fairness Act (H.R. 6480 and S. 3609)<sup>204</sup> would have fundamentally altered both the standards and the process by which statutory royalties were established for non-interactive webcasters like Pandora.<sup>205</sup> As described in the first subsection below, the clear purpose, and the virtually certain effect, would have been to tip the playing field against copyright owners in favor of the webcasters, resulting in lower royalty rates for covered webcasters – which of course is why the webcasters support it.<sup>206</sup> As explained below, there is no evidence that high royalty rates are stifling the growth of online music in general or, in particular, the growth of Pandora, or that such services would be unable to pay market based rates in the future.

IRFA not only sought to lower royalty rates, but also to “level the playing field” by subjecting Pandora and other webcasters to the same rate standard that now applies to PSS and SDARS services.<sup>207</sup> The biggest problem with this argument is that non-interactive webcasters’ biggest competitors are not PSS or SDARS, but rather interactive services (like Spotify), which obtain sound recording performance rights without the benefit of a compulsory license of any sort.<sup>208</sup> Thus, what Pandora is seeking through the IRFA is to increase the competitive advantage it already holds over interactive services by obtaining an even more attractive compulsory license.<sup>209</sup> Meanwhile, the IRFA would have done nothing to address the other obvious imbalance in the sound recording performance right, which is the continuing exemption enjoyed by the over-the-air transmissions of terrestrial broadcasters.<sup>210</sup>

The first subsection below reviews the IRFA’s main provisions and explains

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<sup>204</sup> See H.R. REP. NO. 6480 (2012).

<sup>205</sup> Villasenor, *supra* note 202, at 11.

<sup>206</sup> *Id.*

<sup>207</sup> *Music Licensing Part One: Hearing Before the Subcomm. on Intellectual Property, Competition, and the Internet of the H. Comm. on the Judiciary*, 112th Cong. 165 (2012) (statement of Rep. Conyers, Jr., Ranking Member, H. Comm. on the Judiciary) (“The [IRFA] seeks to facilitate a process by which all digital music services would be judged by the same rate-setting standard.”).

<sup>208</sup> LaPolt Law, P.C., *Trends & Developments in Music Licensing*, AMERICANBAR.ORG, <http://commcns.org/1dVachQ> (last visited Mar. 3, 2014); see also Eric Savitz, *Pandora Asks Users to Lobby Congress on Royalty Rates (Updated)*, FORBES (Sept. 24, 2012, 5:03 PM), <http://commcns.org/NOt1wz>.

<sup>209</sup> Savitz, *supra* note 208.

<sup>210</sup> Villasenor, *supra* note 202, at 13.

the effects that they would have had on the rate-setting process and its results. The second subsection shows why the rates currently being paid by webcasters are not unreasonable, and why the IRFA is not necessary to preserve a vibrant and growing market for online music. The third subsection explains why the uneconomic rates that the IRFA would have produced, along with the perverse incentives inherent in the non-disruption standard, would reduce incentives for content creation, slow innovation, and harm consumers.

A. The IRFA Would Dramatically Tilt the Rate Setting Process in Favor of Webcasters

If one set out to write statutory language designed to favor webcasters over copyright owners in rate setting proceedings, the result would look a lot like the IRFA. While a complete exegesis is beyond the scope of this study, a partial listing of its more significant provisions provides a sense of the proposal's scope and ambition. Among other things, the IRFA would have: (a) imposed a heavily-modified version of the § 801(b) criteria for royalty rates, with the modifications further favoring webcasters;<sup>211</sup> (b) intervened directly in the rate setting process, by extending the webcaster-friendly Webcaster Settlement Act rates (for small pureplay webcasters) for an extra year;<sup>212</sup> (c) shifted the burden of proof to copyright holders to show that proposed rates do not exceed an amorphous new standard;<sup>213</sup> (d) prohibited copyright royalty judges from considering certain types of evidence likely to favor copyright holders;<sup>214</sup> (e) reversed the CRB's (economically-grounded) decision to favor "per performance" royalties over "percentage of revenue" royalties;<sup>215</sup> (f) prohibited the

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<sup>211</sup> See Internet Radio Fairness Act of 2012 §3(a)(1)(B) ("In establishing rates and terms under this paragraph, the Copyright Royalty Judges shall apply the objectives set forth in section 801(b)(1).").

<sup>212</sup> *Id.* § 3(b)(4) ("The rates and terms of any settlements made pursuant to the amendments made by the Webcaster Settlement Act of 2009 (Public Law 111-36; 123 Stat. 1926) that were to expire before December 31, 2015, shall be extended through December 31, 2015, according to the rates and terms applicable to 2014.").

<sup>213</sup> *Id.* § 3(a)(2)(A)(ii) ("In any proceeding under this subsection, the burden of proof shall be on the copyright owners of sound recordings to establish that the fees and terms that they seek satisfy the requirements of this subsection, and do not exceed the fees to which most copyright owners and users would agree under competitive market circumstances.").

<sup>214</sup> *Id.* § 3(a)(2)(A)(iv) ("To the extent the Copyright Royalty Judges consider market-place benchmarks to be relevant, the Copyright Royalty Judges shall limit those benchmarks to benchmarks reflecting the rates and terms that have been agreed under competitive market circumstances by most copyright users.").

<sup>215</sup> *Id.* (stating that the CRJs "shall not disfavor percentage of revenue-based fees").

CRB from relying on some (but not other) prior decisions as precedents;<sup>216</sup> (g) reversed the Webcaster Settlement Act's guarantee that rates negotiated under the Act would not have precedential value for rate setting purposes;<sup>217</sup> (h) created a special class of antitrust liability for joint activities by copyright owners, but not copyright users;<sup>218</sup> (i) injected politics into the process by requiring copyright judges to be confirmed by the Senate rather than appointed by the Librarian of Congress;<sup>219</sup> (j) eliminated the requirement that at least one of the copyright judges be an expert in copyright, and one an expert in economics;<sup>220</sup> and, (k) subjected CRB rate decisions to de novo review, requiring the D.C. Circuit essentially to re-hear every rate case.<sup>221</sup>

Among the many changes proposed by the IRFA, the most profound include the provisions that alter the substantive standards for rate setting,<sup>222</sup> specify what evidence the CRB can consider,<sup>223</sup> and change the makeup of the CRB itself.<sup>224</sup>

First, in addition to replacing the WBWS standard with the 801(b) standard, the IRFA would have added four additional criteria which must be considered in setting rates: (1) "the public's interest in both the creation of new sound recordings of musical works and in fostering online and other digital performances of sound recordings";<sup>225</sup> (2) "the income necessary to provide a reasonable return on all relevant investments, including investments in prior periods for which returns have not been earned";<sup>226</sup> (3) "the value of any promotional benefit or other non-monetary benefit conferred on the copyright owner by the performance";<sup>227</sup> and (4) "the contributions made by the digital audio transmission service to the content and value of its programming."<sup>228</sup> Each of these criteria is favorable to webcasters, none more so than the requirement that the

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<sup>216</sup> *Id.* (stipulating that the CRJs "shall not take into account either the rates and terms provided in licenses for interactive services or the determinations rendered by the Copyright Royalty Judges prior to the enactment of the Internet Radio Fairness Act of 2012.").

<sup>217</sup> *Id.* § 3(b).

<sup>218</sup> *Id.* § 5(a)(1)(A)–(B).

<sup>219</sup> *Id.* § 2(1)(A).

<sup>220</sup> *Id.* § 2(2)(A).

<sup>221</sup> *Id.* § 6(d).

<sup>222</sup> *Id.* § 3(a)(2)(A)(i)(II).

<sup>223</sup> *Id.* § 6(a)(1)–(2).

<sup>224</sup> *Id.* § 2(2)(A).

<sup>225</sup> *Id.* § 3(a)(2)(A)(iv).

<sup>226</sup> *Id.*

<sup>227</sup> *Id.*

<sup>228</sup> *Id.*

rates be set so as to ensure copyright users earn profits on past investments.<sup>229</sup>

Further, the IRFA would have shifted the burden of proof in rate setting proceedings to copyright owners, who would be required to establish that the fees in any statutory license do not exceed those to which “most copyright owners and users would agree to under competitive market circumstances,” defined as conditions in which none of the participants have market power.<sup>230</sup> As a practical matter, it is likely that the only agreements that would meet this standard would be ones negotiated by the smallest independent record labels—that is, the ones willing to accept the lowest royalty rates.

Second, in applying the new criteria, the IRFA would have directed the CRB to ignore some evidence, but demands that other evidence be considered.<sup>231</sup> Judges are prohibited from taking into account the rates and terms in licenses for interactive services (which have provided the benchmark for the market-based rates in *Webcaster II* and *Webcaster III*) or in the CRB’s previous determinations, but permitted to consider the rates set by the Copyright Royalty Tribunal in the early 1980s and the CARP/LOC 1998 *Webcaster I* decision.<sup>232</sup> In the meantime, rates negotiated under the Webcaster Settlement Act are, contrary to the Webcaster Settlement Act itself, now accorded precedential value.<sup>233</sup> In short, evidence favorable to webcasters is required to be admitted, while evidence favorable to copyright owners is *a priori* inadmissible.

Third, the IRFA would have changed the makeup of the CRB itself. Judges would have no longer been appointed by the Librarian of Congress, but instead by the President with the advice and consent of the Senate,<sup>234</sup> thus ensuring that the filling of every vacancy would become a vehicle for a political contest between the interested parties. Of equal concern is that the qualifications of the judges themselves would have been changed, removing the current requirement that one of the three judges have a significant knowledge of economics and another have significant knowledge of copyright law.<sup>235</sup> In the future, judges would be required simply to have ten years of experience in arbitration or litigation—that is, to be process experts rather than substantive ones.<sup>236</sup>

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<sup>229</sup> *Id.*

<sup>230</sup> *Id.* § 3(a)(2)(A)(iv), 3(a)(3)(B) (stating the burden of proof and defining “market circumstances”).

<sup>231</sup> *Id.* §§ 3(a)(3)(B), 6(a)(1)–(2).

<sup>232</sup> *Id.* §§ 3(a)(2)(B), 6(a)(2).

<sup>233</sup> *Id.* § 3(a)(3)(b)(3)–(4).

<sup>234</sup> *Id.* § 2(2)(B)(i).

<sup>235</sup> *Id.* § 2(2)(A).

<sup>236</sup> *Id.*

At the end of the day, there is no question that, as Villasenor claims: the “obvious consequence” of imposing the 801(b) standard “would be lower rates for webcasters.”<sup>237</sup> As discussed below, however, forcing copyright owners to effectively subsidize webcasters through artificially low royalties is neither necessary to promote the growth of online music nor desirable from the perspective of innovation or consumer welfare.

#### B. The IRFA Is Not Necessary to Ensure a Vibrant Market for Online Music

The market for online music is intensely vibrant and growing rapidly.<sup>238</sup> Tens of thousands of new listeners are signing up to services like Pandora and Spotify every week, and existing listeners are using the services more and more intensely every year.<sup>239</sup> Online advertising revenues are growing 30% per year,<sup>240</sup> new firms are entering the market, and existing firms are garnering billion dollar market valuations.<sup>241</sup> As Villasenor puts it, “The future of music distribution is clearly digital.”<sup>242</sup>

Against this reality, the IRFA proponents argue that webcasters need the below-market rates and guaranteed profits the legislation would provide in order to “grow and evolve.”<sup>243</sup> Moreover, they argue, the current system is broken because the “onerous” WBWS standard can result in webcasters paying a

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<sup>237</sup> See Villasenor, *supra* note 202, at 13.

<sup>238</sup> Ryan Faughnder, *iHeartRadio, Spotify Lead User Growth as Apple Unveils Streaming*, L.A. TIMES (June 11, 2013), <http://commcns.org/1hDk7NJ>.

<sup>239</sup> *Id.*

<sup>240</sup> See *infra* Figure 4.

<sup>241</sup> Ingrid Lunden, *Digital Ads Will Be 22% of All U.S. Ad Spend in 2013, Mobile Ads 3.7%; Total Global Ad Spend in 2013 \$503B*, TECHCRUNCH.COM (Sept. 30, 2013), <http://commcns.org/1jN9BmX> (“In the U.S. . . . digital [advertising] in 2013 will account for 21.8% of all ad spend (\$109.7 billion), up from 19% the year before.”). For example, in Los Angeles, California—“the vanguard of the ad evolution”—new boutique online advertising firms are steadily setting up shop, with some quickly reaching hundreds of millions in billings. Meg James, *DIGITAL DISRUPTION; Ads in a Digital Age; Westside Firms Such as Omelet, Ignited and Blitz are Pushing Clients Beyond TV and Print and Onto the Internet, Smartphones and Tablets*, L.A. TIMES, July 8, 2012, at B1. Research suggests that the “online advertising industry trades with an average price-earnings ratio of 28.2x compared to the S&P 500’s 16.2x price-earnings ratio [and its] stocks may be as much as 74% more expensive than the average U.S. stock.” *Finding Value in the Growing Online Advertising Industry*, MARKETWATCH (Apr. 3, 2013), <http://commcns.org/MJJSzM>.

<sup>242</sup> See Villasenor, *supra* note 202, at 17.

<sup>243</sup> Edward Black, *Congress Should Pass the Internet Radio Fairness Act*, HILL’S CONGRESS BLOG (Oct. 25, 2012, 11:00 AM), <http://commcns.org/1hHiOg3>.



higher percentage of their revenues in royalties than other firms, including in particular Sirius XM.<sup>244</sup> Neither argument withstands even cursory scrutiny.

First, the current copyright regime is not preventing the online music industry from “growing and evolving” at a rapid pace. Online radio is a two-sided market, involving both listeners (who, depending on the business model, may also be subscribers) and advertisers.<sup>245</sup> Both sides of the market are growing explosively.<sup>246</sup> For example, Figure 2, below, shows the proportion of Americans who have listened to online radio in the past 30 days from 2002 through 2012. Growth throughout the period has been rapid but has accelerated in recent years, with listenership rising by nearly 44.44% in just the last two years.<sup>247</sup>

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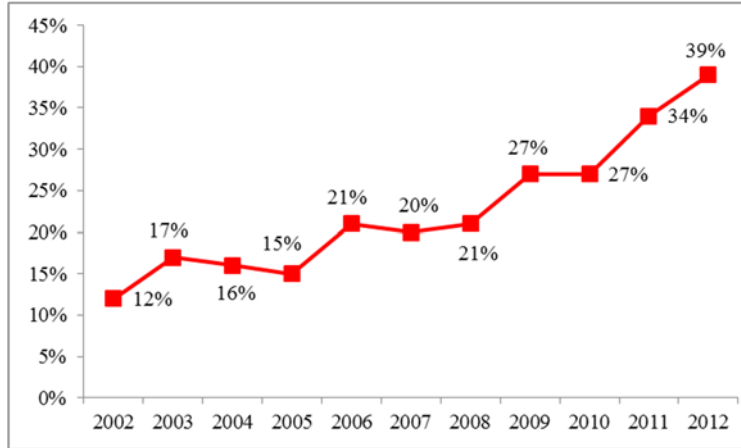
<sup>244</sup> See Villasenor, *supra* note 202, at 1–2; see Black, *supra* note 243.

<sup>245</sup> Two-sided markets “coordinate the demands of distinct groups of customers who need each other in some way. . . . [F]or example . . . magazines provide a way for advertisers to find an audience . . . .” David S. Evans, *The Antitrust Economics of Multi-Sided Platform Markets*, 20 YALE J. ON REG. 325, 325 (2003).

<sup>246</sup> “Weekly online radio reaches an estimated audience of 76 million in 2012; this 30% increase is the largest year over year spike in weekly usage we have seen since we began measuring the platform in 1998.” ARBITRON/EDISON RESEARCH, *THE INFINITE DIAL 2012: NAVIGATING DIGITAL PLATFORMS 8* (2012) [hereinafter *THE INFINITE DIAL 2012*], available at <http://commens.org/1ksNW6C>. “[T]he online advertising industry is rapidly growing . . . [as advertisers are] looking for a better return on investment [and] increasingly moving . . . to highly targeted online ads.” *Finding Value in the Growing Online Advertising Industry*, *supra* note 241.

<sup>247</sup> The percentage of American online radio listenership grew from 27% to 39% between 2010 and 2012, an increase of slightly more than 44%. *THE INFINITE DIAL 2012*, *supra* note 246, at 8.

FIGURE 2<sup>248</sup>  
 PERCENT OF AMERICANS WHO HAVE LISTENED TO  
 ONLINE RADIO IN THE LAST MONTH



As Figure 2 shows, an estimated 103 million Americans, or 39% of the entire U.S. population aged 12 and older, now tune in to some form of online radio each month.<sup>249</sup> Similarly, the amount of time that listeners spend engaged with online radio has also increased dramatically. As shown in Figure 3, in 2012, listeners reported spending an average of 9 hours and 46 minutes per week listening to online radio, up from 6 hours and 13 minutes in 2008 (an increase of over 57%).<sup>250</sup>

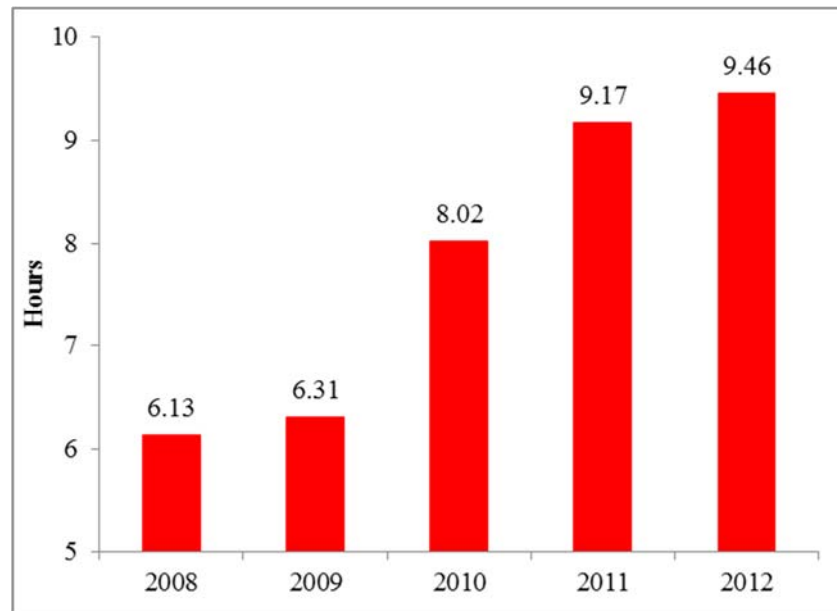
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<sup>248</sup> Adapted from information provided by Edison Research/Arbitron. *See id.*

<sup>249</sup> *Id.*

<sup>250</sup> *Id.*

FIGURE 3<sup>251</sup>  
AVERAGE WEEKLY HOURS SPENT  
LISTENING TO ONLINE RADIO



Not surprisingly, the rapid growth in listenership is leading equally to rapid growth in advertising revenues.<sup>252</sup> Overall, online advertising is the fastest growing category of advertising worldwide, growing at 7.2% over the past year.<sup>253</sup> As shown in Figure 4 below, online radio advertising is growing even faster: According to SNL Kagan, online radio advertising revenues will approach \$400 million in 2012, and are projected to grow at a compound annual rate between 12 and 14% over the next decade.<sup>254</sup>

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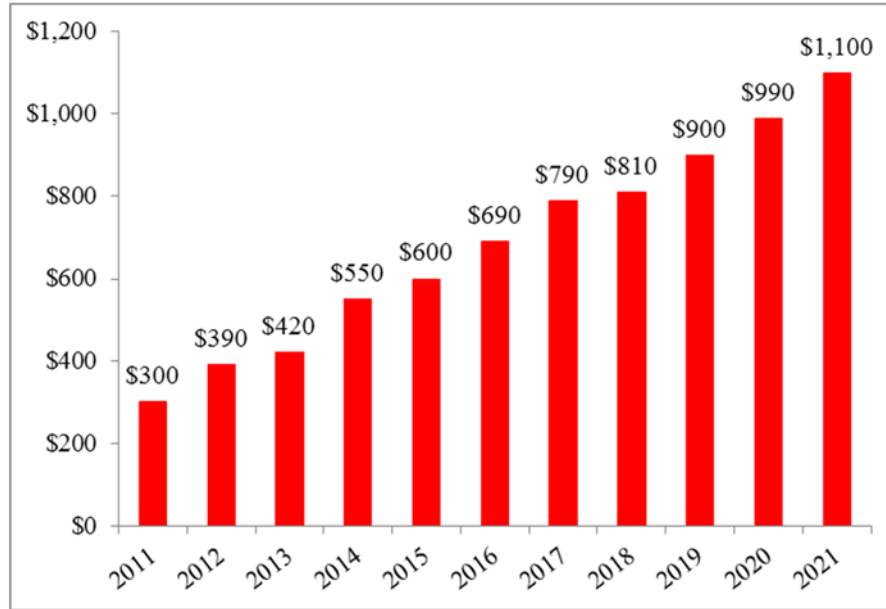
<sup>251</sup> Figure 3 is based upon information in Edison Research/Arbitron's report. *Id.*

<sup>252</sup> *Finding Value in the Growing Online Advertising Industry*, *supra* note 241.

<sup>253</sup> See NIELSEN, QUARTER 2 2012: GLOBAL ADVIEW PULSE LITE 8 (2012), available at <http://commcns.org/1diInD8> (reporting that "Online ad spend (specifically display advertising) contributed to the [advertising] growth momentum around the globe, with a +7.2 percent increase recorded globally").

<sup>254</sup> See SNL KAGAN, MOBILE AD NETWORKS BY REVENUE, UNITED STATES 98 (2011) (on file with author).

FIGURE 4<sup>255</sup>  
 PUREPLAY INTERNET MUSIC AND RADIO AD REVENUE  
 PROJECTIONS, 2011–2021 (\$ MIL)



The rapid growth of the industry has translated into financial success for existing firms and the entry of new ones.<sup>256</sup> Pandora, which is by its own account the “leader in internet radio in the United States,” with a dominant market share of 69%, has been the biggest beneficiary.<sup>257</sup> As shown in Figure 5

<sup>255</sup> Derived from information in SNL Kagan’s report, *MOBILE AD NETWORKS BY REVENUE*. See *id.* Figure 4 includes online/mobile ad revenues from Internet Music and Radio Pureplays—for example, AccuRadio, AOL Radio, Goom Radio, Last.fm, Live 365, MOG, Pandora, Slacker, Stitcher, Turntable.fm, and Yahoo! Music. *Id.*

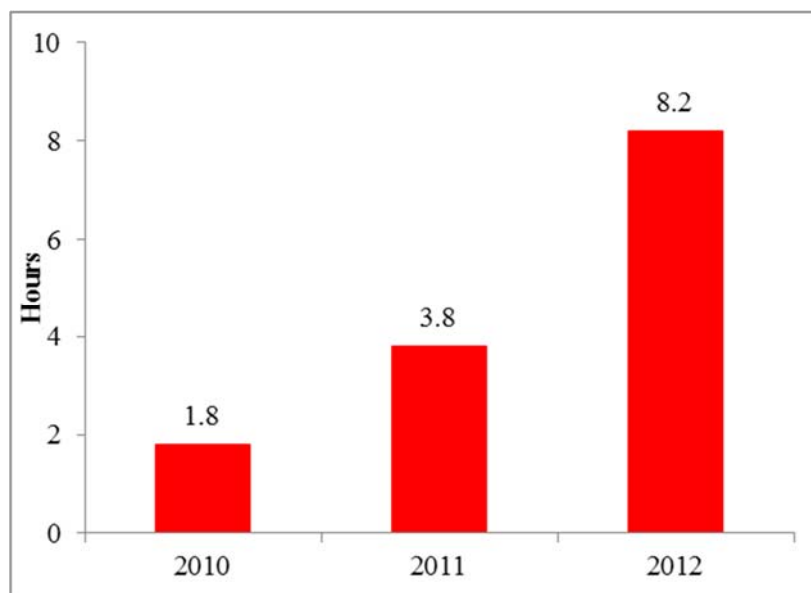
<sup>256</sup> See *Finding Value in the Growing Online Advertising Industry*, *supra* note 241.

<sup>257</sup> See Pandora Media, Inc., Annual Report (Form 10-K), at 41 (Mar. 12, 2012) [hereinafter *Pandora 2012 Form 10-K*]. Pandora states, in its 10-K, that:

Pandora is the leader in internet radio in the United States, offering a personalized experience for each of our listeners. We have pioneered a new form of radio – one that uses intrinsic qualities of music to initially create stations and then adapts playlists in real-time based on the individual feedback of each listener. In January 2012, we had over 125 million registered users, which we define as the total number of accounts that have been created for our service at period end, and we added two new registered users every second on average. For the fiscal year ended January 31, 2012, we streamed 8.2 billion hours of radio and as of Jan-

below, Pandora's annual listener hours have more than quadrupled in the last two years, from 1.8 billion to 8.2 billion.<sup>258</sup> Revenues over the same period have grown even faster, from \$55.2 million in 2010 to \$274.3 million in 2012.<sup>259</sup>

FIGURE 5<sup>260</sup>  
PANDORA ANNUAL LISTENER HOURS (BILLIONS), 2010–2012



Much of the rapid growth that has occurred in the past few years is associated with the rapid adoption of smart phones and the accompanying increase in mobile consumption of digital media.<sup>261</sup> For example, as shown in Figure 6

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uary 31, 2012, we had 47 million active users. According to a January 2012 report by Triton, we are one of the top 20 internet radio stations and networks in the United States and we have more than a 69% share of internet radio. Since we launched the Pandora service in 2005, our listeners have created over 2.4 billion stations.

*Id.*

<sup>258</sup> *Id.* at 40.

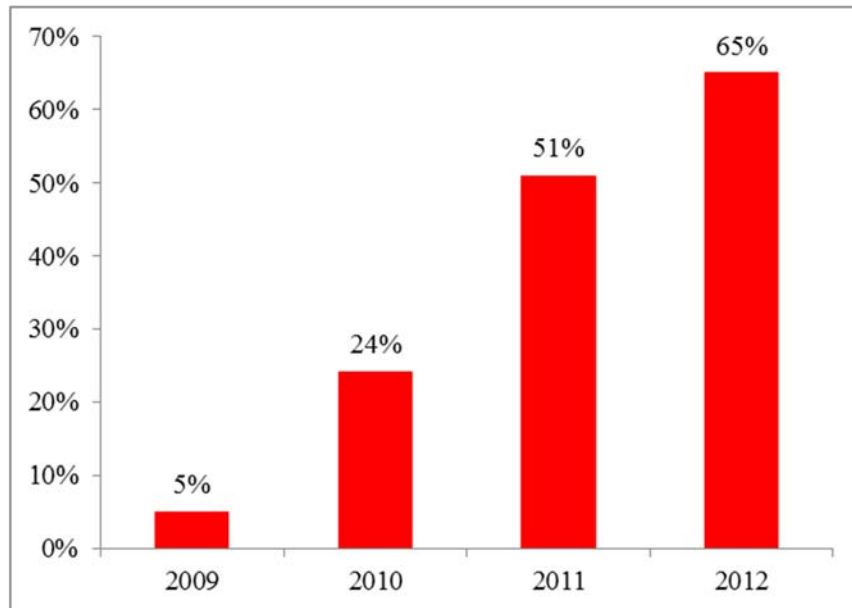
<sup>259</sup> *Id.* at 43.

<sup>260</sup> Figure 5 is based upon information in Pandora's Form 10-K, filed in 2012. *Id.* at 40.

<sup>261</sup> Pandora says that mobile devices are "an emerging phenomenon" and that the "number of listener hours on mobile devices has surpassed listener hours on traditional computers, and [it] expect[s] that this trend will continue." *Id.* at 14.

below, Pandora reports that as of 2012, nearly two thirds of all listening hours are accounted for by mobile devices.<sup>262</sup> Notably, SNL Kagan reports that in 2011, Pandora was the fifth largest U.S. mobile ad network by revenue, ranking behind only Google, Apple, Facebook and Twitter, and was growing at 476% annually, far faster than any of the other top 25 firms.<sup>263</sup>

FIGURE 6<sup>264</sup>  
PERCENTAGE OF TOTAL PANDORA LISTENING  
HOURS ACCOUNTED FOR BY MOBILE



As a result of its rapid growth, and of market expectations that it would continue to prosper in the future, Pandora successfully “went public” in 2011, garnering large payoffs for its early investors.<sup>265</sup> The firm now trades on the New

<sup>262</sup> Pandora reports that it’s “mobile listenership has experienced significant growth” and “constitute[s] approximately . . . 65% of [it’s] total listener hours for fiscal year[] . . . 2012.” *Id.*

<sup>263</sup> See SNL KAGAN, *supra* note 254, at 98.

<sup>264</sup> Figure 6 is adapted from information in Pandora’s 2012 Form 10-K. *Pandora 2012 Form 10-K*, *supra* note 257, at 14.

<sup>265</sup> In June 2011, Pandora’s stock “rose 8.9 percent [by virtue of] its debut on the New York Stock exchange,” selling “14.7 million shares . . . [and] raising \$234.9 million in its

York Stock Exchange under the symbol “P.”<sup>266</sup> As of March 2, 2014, Pandora had an Enterprise Value of \$7.04 billion.<sup>267</sup>

Pandora’s defenders argue, however, that the company has not yet achieved profitability, and that “extremely high royalty burdens” are to blame, with content costs accounting for 69% of revenues.<sup>268</sup> The situation would be even worse, they warn, if Pandora and the other webcasters currently covered by the Webcaster Settlement Act agreement were forced to pay the (higher) rates determined by the CRB in *Webcaster III*.<sup>269</sup> There are several problems with these arguments. First, the fact that Pandora has not yet achieved profitability is hardly a surprise.<sup>270</sup> Other successful online firms, including Facebook, Google, Vonage and many others, have taken years to achieve profitability;<sup>271</sup> some have yet to do so.<sup>272</sup> There is a good reason for this: Internet markets are char-

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initial public offering.” Lee Spears, *Pandora Rises in Biggest Internet IPO Boom Year Since 2000*, BLOOMBERG (June 15, 2011), <http://commcns.org/lcp8fPL>. In the first 11 months of 2012, Pandora cofounder Tim Westergren sold 935,000 shares of Pandora stock valued at over \$9.9 million. *Timothy Westergen’s Transactions*, MARKET WATCH, <http://commcns.org/1mQXvxT> (last visited Mar. 2, 2014).

<sup>266</sup> *Pandora 2012 Form 10-K*, *supra* note 257, at 37.

<sup>267</sup> See *Pandora Media, Inc. (P)—Key Statistics*, YAHOO! FIN. (Feb. 28, 2014, 7:39 PM), <http://commcns.org/1fDbhdz>.

<sup>268</sup> Villasenor, *supra* note 202, at 11.

<sup>269</sup> *Id.* at 11–12.

<sup>270</sup> For example, Pandora’s revenue is derived primarily from advertising: listener hours drive advertisement opportunities (inventory), attracting advertisers depends largely on a sufficient inventory, and revenue depends on the extent the inventory can be sold. *Pandora 2012 Form 10-K*, *supra* note 257, at 42. So although Pandora’s “total revenue has grown from \$55.2 million in fiscal 2010 to \$274.3 million in fiscal 2012[, a]t the same time, [its] total cost and expenses have grown from \$70.6 million in fiscal 2010 to \$285.3 million in fiscal 2012, principally as a result of the growth in content acquisition expenses.” *Pandora 2012 Form 10-K*, *supra* note 257, at 43.

<sup>271</sup> Online firms such as Facebook, Google, and Vonage all face highly competitive markets that demand quick and constant innovation. Facebook Inc., Annual Report (Form 10-K), at 10 (Feb. 1, 2013) [hereinafter *Facebook 2013 Form 10-K*]; Google Inc., Annual Report (Form 10-K), at 8 (Jan. 23, 2013) [hereinafter *Google 2013 Form 10-K*]; Vonage Holdings Corp., Annual Report (Form 10-K), at 8 (Jan. 31, 2013) [hereinafter *Vonage 2013 Form 10-K*]. They must build a customer base, develop their presence, and market their brand, all of which take time. See *Facebook 2013 Form 10-K*, *supra* note 271, at 13, 17; *Google 2013 Form 10-K*, *supra* note 271, at 3, 9–10, 12; *Vonage 2013 Form 10-K*, *supra* note 271, at 5, 8–9. Due to the technological nature of an online market, these online firms generally must invest significant resources into staffing, equipment, infrastructure, research and development, data management, and user privacy security—all on a continuing basis. See *Facebook 2013 Form 10-K*, *supra* note 271, at 8–11, 15–24; *Google 2013 Form 10-K*, *supra* note 271, at 3, 7–12, 14, 16–19.

<sup>272</sup> For example, Vonage has “incurred cumulative losses since [its] inception and may not achieve consistent profitability in the future. [Although it] achieved net income of [over

acterized by network effects, meaning that firms compete (in what is sometimes referred to as a “land grab strategy”) to achieve critical scale.<sup>273</sup> While it is thus typical for firms like Pandora to invest in customer acquisition for an initial period before becoming profitable, there is no economic or public policy rationale for forcing their suppliers to subsidize such strategies.<sup>274</sup>

Second, while Pandora’s content acquisition costs have indeed grown rapidly, they have not grown as rapidly its revenues or, for that matter, as its overhead.<sup>275</sup> As shown in Figure 7 below, Pandora’s content acquisition costs have grown by 351% over the past two years. Yet, its revenues have increased even faster, by nearly 400%, while its administrative and overhead expenses have grown even faster, by 457% over the past two years.<sup>276</sup>

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\$36 million in 2012, its] accumulated deficit is [over \$726 million] from [the time of its] inception . . .” *Vonage 2013 Form 10-K*, *supra* note 271, at 15.

<sup>273</sup> As the D.C. Circuit noted, “In markets characterized by network effects, one product or standard tends towards dominance, because ‘the utility that a user derives from consumption of the good increases with the number of other agents consuming the good.’” *United States v. Microsoft Corp.*, 253 F.3d 34, 49 (D.C. Cir. 2001). Continuing, the court said, “For example, ‘[a]n individual consumer’s demand to use (and hence her benefit from) the telephone network . . . increases with the number of other users on the network whom she can call or from whom she can receive calls.’” *Id.* Furthermore, the D.C. Circuit observed, “Once a product or standard achieves wide acceptance, it becomes more or less entrenched. Competition in such industries is ‘for the field’ rather than ‘within the field.’” *Id.*

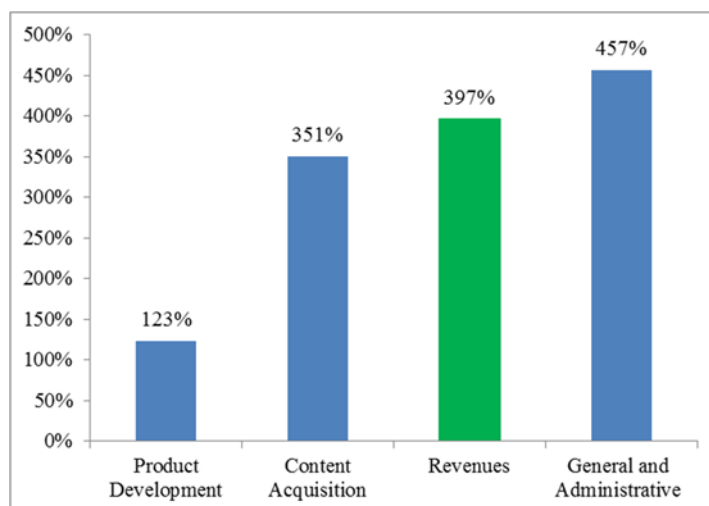
<sup>274</sup> JEFFREY H. ROHLFS, *BANDWAGON EFFECTS IN HIGH-TECHNOLOGY INDUSTRIES* 9, 14 (2003); *see also* Pandora Media, Inc., Registration Statement (Form S-1), at 17 (Feb. 11, 2011) (“Since our inception in 2000, we have incurred significant net operating losses and as of October 31, 2010, we had an accumulated deficit of \$83.9 million. A key element of our strategy is to aggressively increase the number of listeners and listener hours to increase our market penetration.”).

<sup>275</sup> *See Pandora 2012 Form 10-K*, *supra* note 257, at 47.

<sup>276</sup> *Id.*



FIGURE 7<sup>277</sup>  
 PERCENTAGE GROWTH IN PANDORA COSTS AND REVENUES, 2010–2012



Third, while Pandora makes much of the fact that content acquisition accounts for a large proportion of its revenues,<sup>278</sup> in fact its content costs as a proportion of revenues are comparable to other, similar firms.<sup>279</sup> For example, while Netflix offers video rather than audio, and its revenues come more from subscriptions than from advertising, its basic business model—offering on-demand audio-video content over the Internet while minimizing its own infrastructure costs<sup>280</sup>—is very similar to Pandora’s.<sup>281</sup>

As shown in Figure 8 below, the proportion of revenues accounted for by content costs for Netflix and Pandora have been nearly identical over the last

<sup>277</sup> Figure 7 uses information in Pandora’s 2012 Form 10-K. *Id.*

<sup>278</sup> *Id.* at 43.

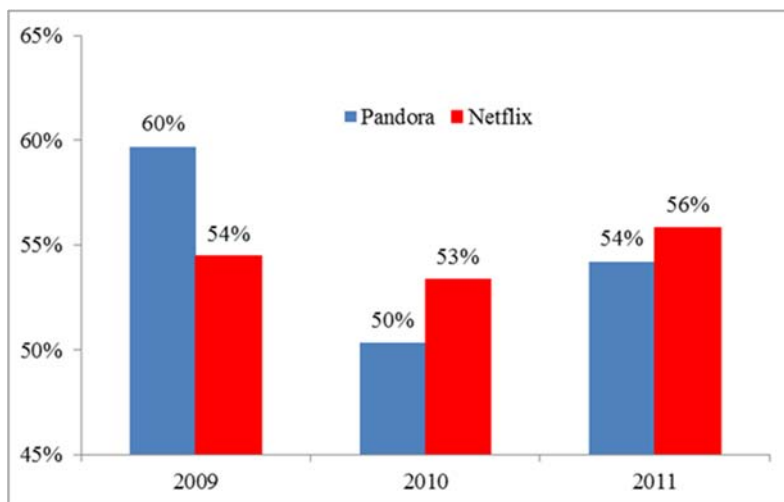
<sup>279</sup> For example, in the years 2010 and 2011, Pandora’s content acquisition expenses accounted for 60% and 50% of its revenues, respectively. *Id.* at 47. For the same years, Netflix reported its cost of revenues (the bulk of which was content acquisition expenses) as 62.6% and 61.9% of its revenues, respectively. See Netflix, Inc., Annual Report (Form 10-K), at 23–24 (Jan. 31, 2013).

<sup>280</sup> Glenn Peoples, *Pandora’s Business Model: Is It Sustainable?*, BILLBOARD (Aug. 7, 2013, 1:45 PM), <http://commcns.org/1fDbvBo>.

<sup>281</sup> *In a Dysfunctional Industry, Pandora Seeks an Algorithm for Profitability*, FORBES (Aug. 15, 2013 4:01 PM), <http://commcns.org/1ksQQjF>.

three years (2009–2011).<sup>282</sup> Indeed, for each of the last two years, Netflix has paid a higher proportion of its revenues for content acquisition than has Pandora.<sup>283</sup>

FIGURE 8<sup>284</sup>  
CONTENT COSTS AS A PERCENTAGE OF REVENUES  
PANDORA VS. NETFLIX, 2009–2011



It is noteworthy that, like some of Pandora's competitors in the audio market, Netflix does not benefit from a compulsory license, but instead relies on

<sup>282</sup> See Peoples, *supra* note 280.

<sup>283</sup> More broadly, it is commonplace for digital music distributors of all stripes to pay 60% or more of their revenues for content. See Steve Knopper, *The New Economics of the Music Industry*, ROLLING STONE (Oct. 5, 2011), <http://commcns.org/1kQaE5s>.

<sup>284</sup> Adapted from information in the Form 10-K filings of Pandora and Netflix. See *Pandora 2012 Form 10-K*, *supra* note 257; Netflix, Inc., Annual Report (Form 10-K) (Feb. 10, 2012). Pandora reports "content acquisition costs" in its annual 10-K filings. According to Pandora's 2012 10-K, "Content acquisition expenses principally consist of royalties paid for streaming music or other content to our listeners. Royalties are calculated using negotiated rates documented in master royalty agreements and are based on both percentage of revenue and listener metrics." See *Pandora 2012 Form 10-K*, *supra* note 257, at 56. Netflix reports "cost of subscription" data in its annual 10-K filings. According to the company's 2012 10-K, "Cost of subscription revenues consists of expenses related to the acquisition and licensing of content, as well as content delivery costs." See Netflix, Inc., Annual Report (Form 10-K), at 28 (2012 filing).

negotiating contracts with content owners on a voluntary basis. And while the firm has had some stumbles over the past year, its market capitalization in late 2012 stood at over \$4.4 billion.<sup>285</sup> As of November 2012, the firm was fighting off a takeover bid by investor Carl Icahn, who believes it is undervalued, notwithstanding the fact that it pays over 50% of its revenues for content.<sup>286</sup>

Fourth, and finally, Pandora's claims of impending doom with respect to content costs are belied by the fact that other firms are rapidly entering the market to compete with it. As it reports in its most recent 10-K, "the audio entertainment marketplace continues to rapidly evolve, providing our listeners with a growing number of alternatives and new media platforms."<sup>287</sup> Among its competitors: Last.fm, iHeartRadio, and Slacker Personal Radio.<sup>288</sup> Recent entrants including Rdio, "a rival streaming service created by the founders of Skype,"<sup>289</sup> and Spotify, which has four million subscribers worldwide paying \$10 per month for the right to access music online<sup>290</sup> and was recently valued at \$3 billion.<sup>291</sup> As of late 2012, reports indicated that Apple was also preparing to enter the market for online radio.<sup>292</sup>

The flood of new participants in the online music business is important for two reasons. First, these firms (and their investors) obviously do not share Pandora's gloomy forecasts regarding their ability to earn a fair return on investment. Second, and at least equally important, many of these firms—including, for example, Spotify—are not eligible for the compulsory license at all, and thus have no choice but to negotiate copyright agreements in the marketplace.<sup>293</sup> According to reports, Apple may choose to enter the online radio

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<sup>285</sup> Demitrios Kalogeropoulos & Blake Bos, *Netflix: The \$13 Billion Question*, MOTLEY FOOL (June 22, 2013), <http://commcns.org/1olw9ve>.

<sup>286</sup> See Greg Bensinger, *Icahn Slams Netflix 'Poison Pill'*, WALL ST. J., <http://commcns.org/OUMVXK> (last updated Nov. 5, 2012, 2:16 PM); see also Maxwell Meyers, *Icahn to CNBC: 'I'm Buying Netflix Because It's Undervalued'*, CNBC (Oct. 31, 2012, 8:24 PM), <http://commcns.org/1fDaVcN>.

<sup>287</sup> See *Pandora 2012 Form 10-K*, *supra* note 257, at 56.

<sup>288</sup> Bryan M. Wolfe, *Comparing iTunes to Pandora, Spotify, and Other Streaming Music Services*, APPADVICE (June 11, 2013), <http://commcns.org/1cxZMEr>.

<sup>289</sup> See Andy Fixmer & Adam Satariano, *Apple's Online Radio Service to Challenge Pandora in 2013*, BLOOMBERG (Oct. 26, 2012), <http://commcns.org/1i8pxTr>.

<sup>290</sup> See Peter Kafka, *Where Did Spotify's Billion Dollars Go? Ask Netflix*, ALL THINGS D (Nov. 11, 2012), <http://commcns.org/1eOilst>.

<sup>291</sup> See Evelyn M. Rusli & Jessica E. Lessin, *Spotify Seeks \$3 Billion Valuation*, WALL ST. J., Nov. 9, 2012, at B3.

<sup>292</sup> See Fixmer & Satariano, *supra* note 289.

<sup>293</sup> Jerry Brito, *A Free-Market Fix for Music Copyrights*, REASON (Mar. 8, 2013), <http://commcns.org/1ksRLbV>.

market through negotiated contracts, eschewing the compulsory license altogether.<sup>294</sup>

The fact that other firms see opportunities to profit in the online music marketplace suggests to some that Pandora needs to take a closer look at its business model.<sup>295</sup> As noted above, online music is a two-sided market, with some (and sometimes more or, even, all) of the revenues coming from advertisers. Yet, if a firm like Pandora is engaged in a land grab strategy designed to maximize its market share in the short run in order to capture economies of scale, too much advertising risks driving consumers to competitors.<sup>296</sup> A number of analysts have noted that Pandora has failed to monetize fully its large and growing audience.<sup>297</sup> As one well-respected journalist put it, “Throughout the music industry there is a wide belief that Pandora could solve its financial problems—the company, which went public a year ago, has never turned an annual profit—by simply selling more ads.”<sup>298</sup>

To summarize, Pandora’s argument that royalties need to be reduced in order to preserve a healthy market for online music is simply not consistent with the facts. The market is vibrant and growing, and expected to continue to grow and evolve in the future. Pandora has been a major beneficiary of that growth, and while it would prefer to pay less for inputs into its production process, there is no public policy basis for forcing content creators to subsidize it or other webcasters by setting royalties at below-market rates.

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<sup>294</sup> See Fixmer & Satariano, *supra* note 289.

<sup>295</sup> Paul Resnikoff, *Why Pandora Will Be Dead by 2018*, DIGITAL MUSIC NEWS (June 10, 2013), <http://commens.org/1hDq8tK>.

<sup>296</sup> Ryan Nakashima, *Clear Channel to Delay Inserting Ads into iHeart*, BOSTON.COM (Mar. 28, 2012), <http://commens.org/NOxDml>.

<sup>297</sup> Kyle Bylin, *Can Pandora Find a Business Model That Works*, SIDEWINDER.FM (May 10, 2013), <http://commens.org/1fDcvFN>.

<sup>298</sup> See Ben Sisario, *Proposed Bill Could Change Royalty Rates for Internet Radio*, N.Y. TIMES, Sept. 24, 2012, at B2; see also Richard Greenfield, *Congress Should Be Working to Raise Royalty Rates on Pandora, Not Lower Them*, BTIG RES. (Sept. 24, 2012), <http://commens.org/1i0CgTW> (“[T]he reason why companies such as Pandora pay such high royalty rates as a percentage of revenues is because they severely limit audio advertising to protect the user experience and keep people on the platform. If Pandora ran several minutes of audio ads per hour (the way terrestrial radio does) vs. just a few 15 sec. spots, the % of revenues paid out as royalties would be dramatically lower and would be more in line with satellite radio or cable TV. Interestingly, Spotify’s radio product runs substantially more advertising per hour than Pandora.”).

C. The IRFA Would Exacerbate Market Distortions, Reduce Incentives to Create Content, Slow Innovation, and Harm Consumers

The IRFA is advanced by its proponents on grounds that it would create a level playing field for users of sound recording rights, increase revenues to artists and record labels, and even promote innovation.<sup>299</sup> Each of these claims is incorrect. In fact, on each count, the opposite is true.

First, while it is accurate that the sound recording performance right currently does not use the same rate standard for all users and in all markets,<sup>300</sup> it is inaccurate to argue that the IRFA could improve the situation. Currently, interactive services are subject to the sound recording performance right (but have no compulsory license); PSS and SDARS are subject to the 801(b) standard; webcasters, simulcasters and new subscription services are subject to WBWS; and terrestrial broadcasters are exempt altogether.<sup>301</sup> AM/FM radio stations pay royalties when they “simulcast” sound recording performances over the Internet, but pay nothing to “broadcast” them over the airwaves.<sup>302</sup> The goal of creating a more level playing field is a desirable one, but the IRFA would hardly achieve that purpose. By lowering rates to non-market levels for non-interactive users like Pandora, it would widen the gap between firms like Pandora and interactive webcasters, like Spotify, who arguably are their closest competitors. At the same time, it would do nothing to rectify the imbalance between terrestrial broadcasters and all other users, as the former would continue to be exempt.<sup>303</sup> From an economic perspective, the IRFA would not ame-

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<sup>299</sup> 158 Cong. Rec. S6628, S6628–29 (daily ed. Sept. 12, 2012) (statement of Sen. Wyden).

<sup>300</sup> *Public Performance Rights for Sound Recordings Fact Sheet*, FUTURE MUSIC (Jan. 28, 2011) <http://commcns.org/1gNT8MI>.

<sup>301</sup> 17 U.S.C. § 114(d)(1)(A); see David Oxenford, *Copyright Royalty Board Approves Settlement for Sound Recording Royalty Rates for “New Subscription Services” - Any Hints As to What A Broadcast Performance Royalty Would Be?*, BROADCAST L. BLOG (Mar. 25, 2010), <http://commcns.org/1hHnEtN>; see also David Oxenford, *Copyright Royalty Board Releases New Rates for Sirius XM and Cable Radio - They are Going Up, Full Reasoning of the Decision to Come?*, BROADCAST L. BLOG (Dec. 17, 2012), <http://commcns.org/1g5KSWH>.

<sup>302</sup> 17 U.S.C. § 114(d)(1)(A) (providing the statutory exemption); see *Bonneville Int’l Corp. v. Peters*, 347 F.3d 485, 490 (3d Cir. 2003) (affirming the Copyright Office’s rule, which provided that “AM/FM webcasting is not an exempt transmission under § 114(d)(1)(A)”; see also *Public Performance of Sound Recordings: Definition of a Service*, 65 Fed. Reg. 77,292 (Dec. 11, 2000) (promulgating the rule at issue in *Bonneville*).

<sup>303</sup> 158 Cong. Rec. at S6628 (statement of Sen. Wyden) (“[The IRFA] would . . . treat Internet Radio, for purposes of establishing royalty rates, in the same way that satellite and cable radio are treated.”).

liorate, and might have exacerbated, the economic distortions associated with the current system.

It is informative, in this regard, that the IRFA's proponents are unable to proffer a policy-based rationale, let alone an economically plausible one, for leaving the terrestrial exemption in place. For example, the only rationale Villasenor offers for not extending the sound recording performance right to over-the-air terrestrial broadcasters is a political one: "legislation including a provision ending the terrestrial broadcasters exemption would be likely to fail."<sup>304</sup>

Second, the argument that artists and record labels would be better off under artificially low rates fundamentally ignores the economics of two-sided markets, in which firms like Pandora act as intermediaries between consumers, advertisers and content providers. In such markets, market rates strike the correct balance between the quantities provided on each side of the market. The efficient outcome, in other words, is the one that occurs when all market participants face market prices. As the CRB has said, "We agree with Dr. Ordoover that 'voluntary transactions between buyers and sellers as mediated by the market are the most effective way to implement efficient allocations of societal resources.'"<sup>305</sup> Indeed, even some of the IRFA's proponents appear to recognize the flaw in this argument, acknowledging that "while rates that are too high can be punitive, so can rates that are too low, as they shortchange the content creators on which the entire music broadcasting industry depends."<sup>306</sup> It is crucial to remember, in this regard, that a significant proportion of performance rights royalties flow through to the performers.<sup>307</sup> Thus, the cross-subsidies granted to webcasters under the IRFA would come not just from the record labels, but from the artists themselves.

Finally, the argument that the IRFA, by imposing a *non-disruption criterion* on the rate setting process for a vibrant, rapidly changing digital music distribution industry, would *enhance innovation*,<sup>308</sup> is as misguided upon close examination as it seems upon first blush. While it is true that "[o]ne obvious consequence of broadly applying § 801(b) would be lower royalty rates for

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<sup>304</sup> See Villasenor, *supra* note 202, at 13.

<sup>305</sup> See *SDARS I*, *supra* note 15, at 4094.

<sup>306</sup> See Villasenor, *supra* note 202, at 15.

<sup>307</sup> See 17 U.S.C. § 114(g)(2)(B)–(D) (mandating that 50% of statutory performance royalties for sound recordings go to the artists); see also *Public Performance Rights for Sound Recordings*, *supra* note 300.

<sup>308</sup> See Villasenor, *supra* note 202, at 1, 2 ("It also furnishes a strong disincentive to potential new market entrants and to the introduction of innovative new business models for delivering digital music.").

webcasters,”<sup>309</sup> it does not follow that lower rates would cause webcasters to be more innovative. To the contrary, imposing a non-disruption standard would protect *incumbent* webcasters from competition and innovation by demanding that rates be set so as to provide a guaranteed profit on both previous and new investments.<sup>310</sup> This is the stuff of public utility regulation, not the dynamic Internet, and it would retard innovation, not advance it. As Dr. Janusz Ordover put it in his expert testimony in the ongoing SDARS II proceeding: “[T]he fourth policy factor . . . should never be used to shield the service at issue from the full rigors of vigorous marketplace competition. Doing so is likely to harm consumers and also impede (or deter) entry and expansion of rival services.”<sup>311</sup>

To summarize, the primary purpose of the IRFA, and one of its certain effects, was to produce below-market royalty rates for one class of online music distributors, providing its beneficiaries with a *de facto* cross subsidy. Further, the IRFA would have locked in the resulting profits by guaranteeing webcasters a return on both existing and future investments. The asserted public policy justifications for these proposed market interventions are without merit; indeed, the IRFA would have distorted markets, retarded innovation, and, ultimately, deprived consumers of the benefits associated with competition and free markets.

## V. SUMMARY AND POLICY RECOMMENDATIONS

The current sound recording performance right is imperfect, most notably because of the distortions associated with the fact that it does not apply to terrestrial broadcasters.<sup>312</sup> Over the course of nearly 20 years, however, Congress

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<sup>309</sup> *Id.* at 2.

<sup>310</sup> Again, even the IRFA’s supporters acknowledge this problem. *See id.* at 15 (“[I]f due to technological obsolescence, poor management, or other factors, a legacy company had poorer EBITDA prospects than a new market entrant, would the fourth 801(b) factor be employed as a protectionist measure to prop up the legacy company.”).

<sup>311</sup> Testimony of Janusz Ordover at 5–6, *In re* Determination of Rates and Terms for Preexisting Subscription Services and Satellite Digital Audio Radio Services, No. 2011-1 CRB PSS/Satellite II (Copyright Royalty Bd., July 2, 2012), available at <http://commcns.org/OUP8m8>. To the extent lower rates increased potential profits for non-interactive webcasters, they might attract entry. However, such entry would be of the “copy-cat” variety, spawned by the desire to take advantage of the arbitrage opportunity created by below-market rates.

<sup>312</sup> For a more comprehensive treatment of the arguments in favor of the sound performance rights for terrestrial broadcasters, see Sunny Noh, *Better Late than Never: The Legal Theoretical Reasons Supporting the Performance Rights Act of 2009*, 6 BUFF. INTELL. PROP. L.J. 6, 83 (2009).

has moved gradually in the direction of expanding the sound recording right and, in so doing, increasing the role of market forces in allocating the economic resources used to produce, distribute and consume musical entertainment. As long as government remains enmeshed in the process of setting rates, there will be calls from interested parties for Congress to intervene on their behalf. Such calls should be seen, however, for what they are, and resisted. There is no public policy case in favor of the IRFA, only a political one.