
A Fair and Competitive Royalty System for Music Services

BY DANIEL CASTRO | NOVEMBER 2012

Congress has an opportunity to reform the broken music-royalty system and foster a new era of innovation in the music and broadcasting industries.

Many different platforms provide consumers access to music services, such as terrestrial radio (i.e., traditional AM/FM over-the-air radio), satellite radio, Internet radio, and subscription music services on cable TV. However, the rules used to determine which types of royalties each platform must pay and how much each has to pay vary from service to service. While the existing royalty system was created to foster innovation and facilitate fair compensation, today it achieves neither goal. The system used to determine the royalty rates for music services is antiquated and broken. It is long overdue for Congress to consider legislation to remedy this situation and create a balanced system that provides fair compensation and encourages innovation.

The purpose of this report is threefold: first, to propose a set of criteria to evaluate music royalties; second, to evaluate how the current rules and the proposed Internet Radio Fairness Act measure up to these criteria; and third, to offer an alternative solution that better meets these criteria.

CRITERIA FOR MUSIC ROYALTIES

To foster innovation in the music industry and among music services, the process used to set the rates for music royalties should be fair and the resulting markets should be competitive. Use of these criteria should not be a matter of much controversy. Unfair rate-setting processes disadvantage particular businesses or business models, and businesses may use unfair rules to protect their interests from competitors. Moreover, systematic unfairness

may depress the potential for innovation in a particular industry. Similarly, uncompetitive markets do not reward innovation or encourage new entrants. Conversely, fair processes and competitive environments give equal opportunities to both incumbents and new entrants in a particular industry and allow different technologies to compete on their merits.

Both music services and copyright owners have criticized the current music royalty rates as unfair because of how much (or how little) is paid in royalties.¹ For example, the CEO of the Computer and Communications Industry Association (CCIA) Edward Black (a supporter of legislation to reform the existing copyright royalty system) argues that the rates paid by webcasters “now can exceed 50 percent of a company’s revenues, unlike other digital broadcasting platforms.”² First, it should not be surprising that a significant portion of the revenue generated by music services goes to royalties since licensed music is their primary input. Second, comparisons with other music services, such as satellite radio, may be inappropriate since much of the programming is talk radio rather than music. Third, this criticism ignores the fact that webcasters like Pandora do not pay royalties as a percent of revenue (like, for example, SiriusXM Radio), but rather pay a rate based on the number of users they have and the amount of music they broadcast.³ This means that the percent of revenue they are paying decreases as the amount of revenue they generate per subscriber increases. If a webcaster believes it is paying too high a percentage of its revenue in royalties, it could try to remedy this by generating more revenue, through higher subscription fees or more advertising (or both).

While some of the claims about rates are likely inaccurate, it is difficult, if not impossible, to describe what a fair outcome would be for music royalties, since fairness is mostly a matter of distributive justice. Equality cannot be used as a standard of fairness because of differences in business models. A better approach would be to define fairness in terms of an equitable process for setting royalty rates (i.e., procedural fairness). First, a fair process should be transparent. This means that the decision process for setting royalty rates, including who makes the decision, the rationale for a decision, and the information used to make the decision, should be clear to all. Second, a fair process should apply uniformly to all participants. This means that the same rate-setting process should apply to all platforms, and that all platforms must pay the same type of royalties (i.e., platform parity). This does not mean that all music services would necessarily pay the same amount—there might be legitimate reasons why one platform or one company pays more or less than another. But all platforms should be subject to the same types of royalties (e.g., royalties for both sound recordings and musical compositions) and to the same rules and processes for determining royalty rates (e.g., the same rate-setting process for statutory licenses, the same evidence standard, etc.).

The process for setting rates for music royalties should also be evaluated based on whether it fosters a competitive market. Competition can be evaluated at three levels: inter-platform competition, intra-platform competition, and inter-music competition.

- Inter-platform competition is competition between different platforms, such as terrestrial radio, satellite radio, Internet radio, and cable TV music channels. Inter-platform competition would allow the best platforms to succeed based on

consumer demand and technical merits, rather than on unfair differences in royalty rates and rate-setting standards.

- Intra-platform competition is competition between companies using the same platforms, such as two local terrestrial radio broadcasters or different Internet radio webcasters. Intra-platform competition would allow the best companies to prosper based on how well they innovate or how efficiently they operate, rather than on whether certain companies were grandfathered in to lower rates.
- Inter-music competition is competition between different copyright holders, such as between competing musicians or competing song writers. In a competitive music market, musicians would be able to compete with one another when licensing to music services based not only on artistic quality but also on price.

HOW THE INTERNET RADIO FAIRNESS ACT COMPARES TO THE CURRENT MUSIC ROYALTY SYSTEM

Music royalties should be set through a fair process that results in a competitive market, and policymakers should evaluate both the existing royalty system and alternative proposals against these criteria. This section first describes the current royalty system and a legislative proposal to alter the current royalty system, the Internet Radio Fairness Act. Then, it evaluates how these two systems stack up to the criteria of fairness and competitiveness.

The Copyright Royalty System Today

Imagine a driver listening to music in his car. If he is listening to FM radio, then the artists and record labels will not receive royalties for the broadcast. If he is listening to a simulcast (i.e., a terrestrial radio broadcast that is re-transmitted online) of the exact same song over the Internet via a mobile Internet connection, then the artists and record labels will receive compensation. The reason for this discrepancy is that U.S. copyright law exempts terrestrial radio from compensating musical artists and record labels.

Music recordings have two copyrights: one for the musical composition and one for the sound recording. The musical composition copyright encompasses the notes and lyrics to a song, and the songwriter or music publisher typically owns this copyright. The sound recording consists of the actual sounds and the interpretation of the musical composition by the performing artist, and the record label usually holds this copyright. U.S. law exempts terrestrial radio from paying a performance royalty for sound recordings to the copyright owner. However, all other music services, including Internet radio, satellite radio and other digital music services must pay for this performance right.

Before 1998, both terrestrial radio and Internet radio paid royalties only to the copyright owner of the musical composition; they paid no royalties to the copyright owner of the sound recording. ASCAP, BMI and SESAC, the three performance rights organizations in the United States, collect these royalties for musical compositions. The Digital Performance Right in Sound Recordings Act of 1995 (DPR) created for copyright owners a new performance right for the digital transmissions of sound recordings. The Act defined three categories of digital transmissions: AM/FM broadcast transmissions, subscription transmissions (e.g., cable and satellite), and on-demand transmissions (e.g., Rhapsody).

The Act exempted broadcast transmissions from the performance right, thus broadcasters did not have to pay royalties to owners of sound-recording copyrights. The Act also created a statutory (or compulsory) license for subscription music services. And, it gave copyright owners full rights to negotiate licenses for the on-demand transmission of their work.

Initially the DPRA did not address how the sound recording performance copyright would apply to non-subscription, non-interactive services such as Internet radio. However, in 1998 a provision of the Digital Millennium Copyright Act (DMCA) amended the copyright law to include these services, including webcasting, as a separate category subject to the statutory license. The law continued to exempt terrestrial radio, including digital terrestrial radio (HD radio), from this statutory license even though both Internet radio and HD radio involve the digital transmission of music.⁴ The DMCA did not include simulcasts in this exemption.

The statutory license provides all entities that meet certain conditions the right to use a copyrighted work without obtaining consent from the copyright owner. For example, in the case of sound recordings, any webcaster may broadcast music if it pays the statutory royalty fee and meets the terms of the statutory license. These terms may include restrictions such as how many songs may be broadcast from a particular album or artists in a given time period. With a statutory license the webcaster does not need to negotiate a license with the copyright holder, and the copyright holder cannot deny the webcaster the right to broadcast his or her work. Internet radio companies pay the statutory license fees to SoundExchange, a non-profit industry group, which then redistributes the money to the copyright owners, featured artists and non-featured artists (such as non-featured musicians and vocalists). The Copyright Arbitration Royalty Panel (CARP) originally set rates and terms for the statutory license; however, the Copyright Royalty and Distribution Reform Act of 2004 replaced CARP with a system of three judges on the Copyright Royalty Board (CRB). Copyright owners and webcasters can set the rate for the license through voluntary negotiations; if they fail to reach an agreement, they present their case to the CRB judges, who then determine the rates and terms for the statutory license.⁵

The Internet Radio Fairness Act

Earlier this year, Reps. Jason Chaffetz (R-UT), Jared Polis (D-CO), Darrell Issa (R-CA), and Zoe Lofgren (D-CA) in the House and Sen. Ron Wyden (D-OR) in the Senate introduced H.R. 6480 and S. 3609, respectively, the Internet Radio Fairness Act of 2012 (IRFA). This legislation would amend the rate-setting process for music royalties in federal copyright law and change the standard used to set royalty rates for the compulsory license for Internet radio. The IRFA has received extensive support from the Internet Radio Fairness Coalition, a group of webcasters who are pushing for legislation to change the royalty-setting standard for Internet radio.⁶ The most vocal supporter of this legislation is Pandora, an Internet radio company that believes that the legislation, if enacted, would allow it to pay significantly less in music royalties.⁷

The IRFA contains a number of changes to the current music royalty system. Rather than use the existing “willing buyer, willing seller” standard for setting royalty rates, the IRFA would use the standard currently used to determine rates for some satellite and cable TV

music channels. This standard, found in section 801(b) of the Copyright Act, would have the CRB judges set rates based on the following four goals:⁸

- To maximize the availability of creative works to the public.
- To afford the copyright owner a fair return for his or her creative work and the copyright user a fair income under existing economic conditions.
- 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.
- To minimize any disruptive impact on the structure of the industries involved and on generally prevailing industry practices.

The IRFA would also add two additional factors to be considered when setting rates:⁹

- 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.
- The income necessary to provide a reasonable return on all relevant investments, including investments in prior periods for which returns have not been earned.

Finally, the IRFA directs the CRB judges to abide by the following conditions when establishing rates:¹⁰

- Shall not disfavor percentage of revenue-based fees.
- Shall establish license fee structures that foster competition among the licensors of sound recording performances and between sound recording performances and other programming, including per-use or per-program fees, or percentage of revenue or other fees that include carve-outs on a pro-rata basis for sound recordings the performance of which have been licensed either directly with the copyright owner or at the source, or for which a license is not necessary.
- Shall give full consideration for the value of any promotional benefit or other non-monetary benefit conferred on the copyright owner by the performance.
- Shall give full consideration to the contributions made by the digital audio transmission service to the content and value of its programming.
- 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.

The IRFA would also change other aspects of the rate-setting process, such as the

qualifications for the judges for the CRB (the IRFA would increase the years of legal experience for the judges and drop the requirement that at least one judge have significant knowledge of economics and one judge have significant knowledge of copyright law) and how the judges are selected (currently these judges are selected by the Librarian of Congress; the IRFA changes this to the President of the United States with the advice and consent of the Senate).

Finally, the IRFA would make a number of other technical changes to the Copyright Act and the rate-setting process for compulsory licenses. These include requirements about rights to make ephemeral (i.e. temporary) copies of a recording as part of operations, requirements on using Federal Rules of Civil Procedure and Federal Rules of Evidence in proceedings, and requirements for a *de novo* judicial review of the CRB's legal rulings (i.e., the court does not defer to the CRB's rulings).

Comparing the Current Royalty System to the IRFA

Clearly neither the current system nor the IRFA satisfy the fairness and competitiveness criteria outlined in the previous section. The obvious failing is that the IRFA does not address the fact that terrestrial radio pays royalties for musical composition but not for sound recordings, while other music services must pay both types of royalties. If Congress wanted to create a performance right for sound recordings, it should have done so for all technologies and not single out AM/FM transmissions for special exemption. The method of transmission should be irrelevant to decisions on whether or not to grant a performance copyright. Until all platforms are required to pay both sound recording and musical composition royalties, no amount of wrangling about the rate-setting process will address this inherent inequality. Thus, both the existing royalty system and the IRFA fail to create a fair system.

However, it may appear that the IRFA would create at least a marginally fairer system than the one in place today since it would move Internet radio services to the same 801(b) standard that is used by satellite radio and cable TV music channels (a similar argument could be applied to moving satellite and cable TV to the willing buyer-willing seller standard). In fact, this is the heart of arguments by supporters of the legislation, including Gregory Barnes at the Digital Media Association (DiMA), who complains that the willing buyer-willing seller standard is unfair because “no other form of digital radio—and in fact no other music use at all—comes under this rate-setting standard.”¹¹ However, this claim is not entirely accurate. While most of today's satellite and cable TV music channels operate under the section 801(b) standard, it is because they were grandfathered in to this other system. The Copyright Act includes a number of provisions that limit this standard to a few specific companies. For example, with regards to satellite radio, the standard does not apply to “a satellite digital audio service that is in operation, or that is licensed by the Federal Communications Commission, on or before July 31, 1998.”¹² A competitor to SiriusXM Radio would not fall under this standard. A similar clause applies to music services on cable television and grandfathers in certain services provided by companies such as Muzak and Music Choice; however, new entrants are not subject to this same standard (indeed, there are not more competitors to some of these cable TV music subscription services at least in part because new entrants would be subject to higher royalty rates).¹³

If Congress were to pass the Internet Radio Fairness Act, it would be favoring the status quo over innovation in the music and broadcasting industries.

Furthermore, in regards to competition, the IRFA does not address inter-platform competition, intra-platform competition, or inter-music competition, all of which suffer in the current royalty system. As noted above, inter-platform competition is hindered by special exemptions for different platforms and different rate-setting standards. Also as noted above, intra-platform competition is hindered by clauses that grandfathered in certain companies thus creating an uneven playing field for new entrants. Finally, inter-music competition is stymied by the statutory licensing, which values all music equally, whereas every song is *not* the same. By creating a statutory license with a single rate for all music, Congress has essentially eliminated competitive pricing for sound recordings.

Finally, some of the other proposed changes in the IRFA are cause for at least some concern. For example, the IRFA proposes that royalty rates be chosen, in part, based on the ability of music services to earn “reasonable returns” on past investments. Why should a company pay lower royalty rates because it made bad investments in the past? It is also unclear why the IRFA drops the requirements that the CRB judges should have expertise in economics and copyright law, two issues which have been most debated in past proceedings. Nor is it clear why the IRFA proposes making the CRB judges presidential appointees since this would further politicize the process.

There is also something inherently troubling about a rate-setting process that has a goal of minimizing the “disruptive impact” on industry since innovation is typically disruptive. Historically, many technological innovations have resulted in substantial disruptions in the economy and society, from the cotton gin to the automobile. Even recent examples, such as the impact of Netflix and RedBox on traditional video rental stores like Blockbuster, show the disruptive effect that innovations can have on an industry. Indeed it would seem that if Congress were to pass the IRFA, it would be favoring the status quo over innovation in the music and broadcasting industries.

Criteria	Current System	Internet Radio Fairness Act	ITIF Proposal
Do all platforms pay the same type of royalties?	No	No	Yes
Do all platforms have the same rate-setting standard?	No	No	Yes
Is there inter-platform competition?	Limited	Limited	Yes
Is there intra-platform competition?	Some platforms	Some platforms	Yes
Is there inter-music competition?	No	No	Yes

Table 1: A comparison of the current music royalty system with different alternatives

AN ALTERNATIVE PROPOSAL FOR MUSIC ROYALTIES

If Congress pursues legislation to reform copyright royalties for sound recordings, it should implement a comprehensive fix, rather than apply half measures that further reduce fairness

and competition. As noted earlier, it is nearly impossible for Congress to specify fair music royalty rates. Congress cannot set a “fair” rate for music royalties any more than it can set a “fair” rate for gasoline, movie tickets or hamburgers. What Congress can do is ensure that the rate-setting process, whether it is the free market or another process, is fair. To that end, ITIF recommends two changes.

First, Congress should uniformly apply the performance copyright for sound recordings to all broadcasts. The current system discriminates against non-terrestrial music services by imposing a performance copyright on sound recordings for all non-terrestrial radio broadcasts. Congress should promote technology-neutral policies to ensure a fair and competitive market for all forms of radio. Not only does this exemption for terrestrial radio disadvantage competing technologies, it also results in unfair compensation to the copyright holders. Congress should take an all-or-nothing approach so that terrestrial radio, Internet radio, satellite radio and other digital music services can compete fairly. In other words, everybody should pay (ideally), or nobody should pay, but the discrepancy should be eliminated. Terrestrial radio should not be the only technology platform exempt from paying royalties for performances of sound recordings.

Second, Congress should replace the broken CRB system for setting royalty rates for the statutory license with a dynamic, market-driven rate-setting system. Just as a popular band can charge more for tickets to its concert than an unpopular band, so too should musicians be able to license their music at different rates. To the end, Congress should mandate that the Library of Congress, in partnership with SoundExchange, create an electronic database of all sound recordings and allow copyright owners to determine the statutory license rate for each of their works. The database would allow copyright owners to specify separate royalty rates for different types of music services, both by type of technology (e.g., terrestrial, satellite, cable, Internet) and by status (e.g., commercial and non-commercial). In addition, Congress should rule that royalties not apply if copyright owners choose not to specify a rate. This policy would allow only those copyright owners who want to charge royalties to specify a royalty rate. These rates would be published online in an electronically accessible format for music services to access. To limit a music service’s potential liability for broadcasting a song, a maximum royalty rate or other type of safeguard should be set.

These changes would address both the fairness and competitiveness criteria while preserving the benefits of a statutory license (i.e., reduced transaction costs). With regards to fairness, this proposal would make all platforms subject to the same types of royalties and process for setting their rates. This proposal also addresses the competitiveness issue. The creation of a national database of sound recordings with corresponding performance royalty fees would allow copyright holders to set music royalty fees at competitive market rates while still allowing music services to benefit from a statutory license. Music services could make decisions about what music to play based, in part, on the published rate of particular songs, and they would no longer be subject to an artificial royalty fee that values all music equally. Copyright owners would be able to adjust fees to meet their promotional needs and, if they desire, provide reduced pricing for noncommercial music services such as non-profit college radio stations. A separate fee schedule for non-commercial music services

would allow consumers to continue to benefit from non-commercial broadcasts, while allowing copyright owners to obtain fair-market value from commercial music services.

Currently, SoundExchange must maintain a database of all sound recordings and of their corresponding copyright holders. They could extend this database to include separate statutory rates. Copyright owners must already identify their sound recordings to SoundExchange, so they could also notify SoundExchange of their preferred royalty rate. The Library of Congress should maintain an open version of this database as a valuable public resource. Just as the Library of Congress maintains useful data on published works such as title, author and subject, it could expand its services to offer similar information on sound recordings. Indeed, an authoritative database of sound recordings could be an enormous information resource for consumers. One could easily imagine how developers might use an open database such as this to create value-added services for consumers, copyright owners, and music services. For instance, a service could expand the database to allow users to tag music with keywords representative of that song and help others then find music relating to a certain genre, year, band or subject.

To keep U.S.-based Internet radio services competitive worldwide, the U.S. government should promote this system internationally. Congress should direct the Library of Congress, the Office of the United States Trade Representative (USTR), and the Intellectual Property Enforcement Coordinator to establish an international framework for sound recording copyrights based on the aforementioned model. An international agreement would help ensure that copyright holders receive fair compensation internationally and allow webcasters to broadcast globally without fear of copyright infringement. In fact, elements of this idea are already contained in the IRFA. Section seven of the legislation calls for the creation of a “global music rights database” that would “include all known or copyrighted musical works, the writers of the work, the owners of the rights, the entity on behalf of those owners who can license such rights on a territory-by-territory basis, and all known sound recording data.”¹⁴

CONCLUSION

Congress should work to modernize the music royalty system to achieve a fair royalty system that fosters competition and innovation. Unfortunately the IRFA does not achieve this goal. Instead it merely substitutes one broken system for another and repeats the history of using copyright law to give an unfair advantage to one group at the expense of another. However, interest in the IRFA gives Congress the opportunity to reform the broken music-royalty system and foster a new era of innovation in the music and broadcasting industries.

ENDNOTES

1. See for example, Ben Sisario, "Fight Builds Over Online Royalties," *The New York Times*, November 4, 2012, <http://www.nytimes.com/2012/11/05/business/media/fight-growing-over-online-royalties.html>, Jennifer Martinez, "Songwriters oppose Pandora-backed Internet royalty bill," *The Hill*, November 16, 2012, <http://thehill.com/blogs/hillicon-valley/technology/268467-songwriters-oppose-pandora-backed-internet-royalty-bill> and Austin Carr, "Pandora and SoundExchange Spar Over Royalty Fees," *Fast Company*, January 10, 2012, <http://www.fastcompany.com/1806776/pandora-and-soundexchange-spar-over-royalty-fees>.
2. Edward Black, "Congress should pass Internet Radio Fairness Act," *The Hill*, October, 25, 2012, <http://thehill.com/blogs/congress-blog/technology/263915-congress-should-pass-internet-radio-fairness-act>.
3. To be more precise, "pureplay" services like Pandora have the option of paying either the rates established by the CRB or the rates established in the webcaster settlement in 2009. Since 2009, Pandora has elected to pay the rates negotiated under the settlement. Under the settlement, Pandora pays the greater of the per performances rates or 25 percent of U.S. gross revenue. See U.S. SEC Form 10-K, Pandora Media, Inc. for fiscal year ending January 31, 2012, available at <http://sec.gov/Archives/edgar/data/1230276/000119312512120024/d280023d10k.htm>.
4. "The Digital Millennium Copyright Act of 1998: U.S. Copyright Office Summary," U.S. Copyright Office, (December 1998), 15-16, <http://www.copyright.gov/legislation/dmca.pdf>.
5. "Licensing Information," U.S. Copyright Office, <http://www.copyright.gov/carp/>.
6. Internet Radio Fairness Coalition, "About the Internet Radio Fairness Coalition," n.d., <http://internetradiofairness.com/about-us/>.
7. Pandora, "Internet Radio Fairness Act," n.d., <http://www.pandora.com/static/ads/irfa/irfa.html>.
8. See Section 801(b) of 17 U.S.C. 801 available at U.S. Copyright Office, <http://www.copyright.gov/title17/92chap8.html>.
9. Internet Radio Fairness Act of 2012, H.R. 6480, 112th Cong. (2012) http://beta.congress.gov/112/bills/hr6480/112hr6480ih_pdf.pdf.
10. Ibid.
11. Gregory Alan Barnes, "A Common Sense Approach to Internet Radio Royalties," *The Huffington Post*, November 11, 2012, http://www.huffingtonpost.com/greg-barnes/a-common-sense-approach_b_2087909.html.
12. 17 U.S.C. 114 available at U.S. Copyright Office, <http://www.copyright.gov/title17/92chap1.html#114>
13. 37 Code of Federal Regulations 383.3 available at <http://www.law.cornell.edu/cfr/text/37/383.3>.
14. U.S. House. 2012. Internet Radio Fairness Act of 2012. 112th Cong., 2nd sess. H.R. 6480, http://beta.congress.gov/112/bills/hr6480/112hr6480ih_pdf.pdf.

ACKNOWLEDGEMENTS

The author wishes to thank the following individuals for providing input to this report: Rob Atkinson. Any errors or omissions are the author's alone.

ABOUT THE AUTHOR

Daniel Castro is a Senior Analyst with the Information Technology and Innovation Foundation. His research interests include data privacy, e-commerce, e-government, electronic voting, health IT, information security, intellectual property, and accessibility. Before joining ITIF, Mr. Castro worked as an IT analyst at the Government Accountability Office (GAO) where he audited IT security and management controls at various government agencies. He has a B.S. in Foreign Service from Georgetown University and an M.S. in Information Security Technology and Management from Carnegie Mellon University.

ABOUT ITIF

The Information Technology and Innovation Foundation (ITIF) is a Washington, D.C.-based think tank at the cutting edge of designing innovation strategies and technology policies to create economic opportunities and improve quality of life in the United States and around the world. Founded in 2006, ITIF is a 501(c) 3 nonprofit, non-partisan organization that documents the beneficial role technology plays in our lives and provides pragmatic ideas for improving technology-driven productivity, boosting competitiveness, and meeting today's global challenges through innovation.

FOR MORE INFORMATION CONTACT ITIF BY PHONE AT 202.449.1351, BY EMAIL AT MAIL@ITIF.ORG, OR ONLINE AT WWW.ITIF.ORG.