

March 18, 2009

The Honorable Dianne Feinstein
United States Senate
331 Hart Senate Office Building
Washington, D.C. 20510

Re: Potential Changes to the Statutory License
Rate-Setting Standards in the Copyright Act

Dear Senator Feinstein:

The undersigned companies and association, which have a direct and vital interest in the structure of the statutory sound recording licenses, appreciate this opportunity to provide their views on the fee standard set forth in section 801(b)(1) of the Copyright Act. These entities and their members have created a wide array of innovative new platforms and programming services that bring performances of recorded music and other audio programming to the public and provide new opportunities for recording companies and performing artists.

Last July 29, in a hearing of the Committee on the Judiciary, you stated that your goal is to ensure that royalty rates set by the Copyright Royalty Board reflect the contributions of all parties – performers, recording companies, and programming services. We agree. We also agree with you that Congress should abandon the willing buyer-willing seller rate-setting standard and transition all sound recording royalty-setting to the 801(b)(1) standard. Unfortunately, the framework for revising the 801(b)(1) standard that was distributed by your counsel March 5 does not accomplish your goal, because it does not recognize the value of any contribution by programming services.

In this letter we document:

- (i) the inherent and longstanding balance that is provided by the current 801(b)(1) royalty standard
- (ii) the disastrous royalty-setting precedents that have resulted from so-called “market-based” statutory license rate-setting standards, each of which has triggered Congressional hearings and corrective legislation; and
- (iii) modest improvements that could be made to 801(b)(1) to ensure that your goals are consistently met.

As an initial matter, we emphasize our support for uniformly applying to sound recording performance royalties the current 801(b)(1) standard, which we believe accomplishes your goals. The 801(b)(1) standard has been in existence for decades, been repeatedly re-ratified by Congress, and has well-served diverse industries and communities, including the public interest. We do not believe the standard should be

changed or its scope diminished, and any suggestion to do so should be supported by an explanation of the need, as well as a justification of why such disruptions would be imposed on affected industries. Moreover, the burden should be on proponents of change to demonstrate how the public interest and the public benefits of the Copyright Act will be served by altering a well-balanced statutory test that has served so well in so many contexts over so many years. In the event that amendments are nevertheless contemplated, we set forth some initial views below.

We recognize your desire to assure that the 801(b)(1) royalty standard remains relevant and appropriate and have offered our views within the time constraints imposed in that spirit. At the same time, aside from the long overdue need to extend the 801(b)(1) standard to Internet radio, we believe that any substantive change in this provision must be the subject of careful review and analysis. Accordingly, any effort to amend this longstanding and manifestly reasonable statutory framework should allow full participation by the interested parties and careful consideration of their views, and we reserve the right to amplify our views as this process moves forward.

**The Balanced Section 801(b)(1) Standard, in its
Current Form, Works Well and Should Be Maintained**

Section 801(b)(1) as currently codified, is a stable, well-functioning and widely accepted rate-setting standard. It results in license fees that benefit copyright owners, copyright users and the public, alike. The key to 801(b)(1) is its balanced, policy-based approach, which expressly calls for consideration of the interests of all stakeholders and the public, and which requires recognition of the value of all contributions of licensors and licensees.

Existing 801(b)(1) also has the benefit of longstanding acceptance and ratification by Congress. Repeated amendments to the Copyright Act, even adopting new rate-setting standards and processes, have kept the standard intact and confirmed the reasonableness of its approach. *See* Title 117 Technical Corrections, Pub. L. 105-80, 111 Stat. 1529 (1997) (no change to mechanical royalty rate setting standard); Digital Millennium Copyright Act, Pub. L. 105-304, 112 Stat. 2860 (1998) (same); Copyright Royalty and Distribution Reform Act of 2004, Pub. L. 108-419, 118 Stat. 2341 (2004) (implementing wholesale changes to the rate setting process but not changing the standard to be applied in setting mechanical rates); Copyright Royalty Judges Program Technical Corrections Act, Pub. L. 109-303, 120 Stat. 1478 (2006) (amending certain processes carried out by the Copyright Royalty Judges, but not changing standard for mechanical royalty rate setting).

The 801(b)(1) standard has, in practice, proven to be far more equitable and effective and generated far less controversy than standards purportedly based on market value or “fair” value, such as the “willing buyer/willing seller” or “fair market value” standards that have been applied in other cases. The 801(b)(1) standard was adopted by Congress in 1976, and was applied to the first sound recording performance right. At that time, Congress made clear that its creation of the narrow new right was “intended to

strike a balance among all of the interests affected thereby.” S. Rep. No. 104-128, at 14 (1995). Since 1976, in each of the four proceedings that have occurred under the 801(b)(1) standard (two involving the recording industry as licensor and two involving the recording industry as licensee), the royalties awarded have been upheld by the courts, and in none of the cases have the parties felt compelled to ask Congress to remedy the determination.

**Market-Based Statutory Royalty Standards Are Well-Intended,
But Have Repeatedly Failed to Achieve Fair, Competitive Results**

On two occasions Congress has legislated market-based statutory royalty rate-setting standards. These standards have been used by copyright royalty rate-setters in three arbitrations, and each time the market-based standard has resulted in extremely high royalties. All three determinations caused industry and public outcry and required Congressional intervention to reverse or mitigate their effect.

- In 1997 a Copyright Arbitration Royalty Panel used the Congressionally-set “fair market value” standard to set royalties for satellite television distributors’ retransmissions of broadcast television programming. The resulting royalties were 11 times the amounts paid by similarly situated cable television systems for analogous rights and about three times higher than the rates Congress had previously set. In 1999 Congress reversed the result and repealed the “fair market value” standard.
- In 2002 a second CARP decision utilized the “willing buyer-willing seller” standard (a proxy for fair market value) when setting Internet radio royalties. This decision was similarly disastrous, as the arbitrators relied on a single agreement between the recording industry and Yahoo! to set royalty rates that were so high as to be the equivalent of all industry profits if the arbitrators’ royalty formula was applied to the competing broadcast radio industry. Legislation was introduced to overturn the decision, and after several hearings Congress passed the Small Webcaster Settlement Act and strongly encouraged all parties to negotiate reduced royalties.
- In 2007 the Copyright Royalty Board relied on the “willing buyer-willing seller” standard to set non-interactive webcasting rates based on a small number of record label agreements with a handful of interactive services, in which the record companies were able to exploit their substantial market power, arising out of the highly concentrated nature of the recording industry and the particular needs of those services. The resulting rates did not reflect competitive fair market value; rather, they reflected supra-competitive market power that the judges used as benchmarks to determine “willing buyer-willing seller” rates. Once again a market-based decision led to the introduction of legislation, Congressional hearings, and in this instance adoption of the Webcaster Settlement Act.

The Recording Industry Has Contradictory Opinions of the 801(b)(1) Standard and What Comprises a “Fair Market Rate”

It is notable that in the two most recent 801(b)(1) cases, respectively, the record industry approached the standard in two different ways. In the satellite radio proceeding the *licensor* recording industry argued that royalties should equal up to 23% of gross satellite radio revenues, based on what it claimed were “marketplace benchmarks,” including the rates that the four major record companies were able to extract from interactive services that admittedly needed licenses from each of the major labels. In the recently concluded Section 115 composition licensing proceeding, the *licensee* recording industry argued that rates “need not be market rates,” Proposed Conclusions of Law of the Recording Industry Association of America, Inc., Docket No. 2006-3 CRB DPRA, ¶ 26 (July 2, 2008), but that ratemaking involves “tempering the choice of any proposed [market] rate with the policy considerations underpinning the objectives of Congress in creating the license,” *id.* ¶ 62 (citing *Determination of Reasonable Rates and Terms for the Digital Performance of Sound Recordings*, 63 Fed. Reg. 25394, 25049 (May 8, 1998)).

In the 115 proceeding the recording industry was correct to seek to apply a tempered, policy-based standard; it is equally appropriate for all sound recording royalty proceedings and all statutory sound recording licensees. In the satellite radio 114 proceeding, the arbitrators fortunately rejected the recording industry’s licensor-based view that 23% royalties are fair. Similarly, Congress should reject any suggestion that “fair markets” need not be competitive markets.

Indeed, it is ironic that the recording industry has steadfastly supported application of the tempered policy-based 801(b)(1) standard to the section 115 license, in which the recording industry is the licensee, paying royalties, while opposing that standard as a “subsidy” in section 114.¹ The recording industry’s contention that the 801(b)(1) standard is a “subsidy” is also ironic because the *status quo ante* was not an unlimited sound recording performance right or a right based on fair market value, but no sound recording performance right at all.

Any Changes to Section 801(b)(1) Must Maintain a Fair Balance and Consider all Contributions to the Delivery and Programming of Sound Recording Performances

As discussed above, the keys to section 801(b)(1)’s success have been its balance and its express recognition of all contributors in the value chain. The 801(b)(1) standard has worked well in its current form; no revision is needed. If, however, revisions to the standard are considered, revisions must maintain the balance and considerations that have made the standard successful. A standard that focuses only on one side’s interest, such as

¹ We do not disagree with the recording industry’s position that 801(b)(1) should be maintained as the standard for setting royalties in the context of Section 115 mechanical licensing. In fact we are not certain as to whether your proposal to modify 801(b)(1) extends to Section 115 licensing or is limited to sound recording licensing in Sections 114 and 112.

the purported “fair market value” of the copyrighted work and “fair rate of return” to the copyright owner, without considering the contributions of programming and technology providers or the public interest, will suffer the same shortcomings as the “willing buyer/willing seller” and other “market value” standards, and will lead to the same untenable results.

If Congress is interested in changing the 801(b)(1) standard, we initially recommend the following clarifications, to correct for certain errors that have infected past decisions. As set forth above, we reserve the right – and highlight the need – to supplement and expand upon these views if amendments to the existing statutory framework are considered.

1. ***Factor (A): “To maximize the availability of creative works to the public.”*** If changed, this factor should be modified to clearly recognize that “availability” has multiple components, including not only the creation of works, but the creation and operation of technologies and services to deliver those works to the public. As the Supreme Court has made clear, “private motivation” to create new copyrighted works “must ultimately serve the cause of promoting broad public availability of literature, music, and the other arts.” *Twentieth Century Music Corp. v. Aiken*, 422 U.S. 151, 156 (1975) (emphasis supplied). “[W]idespread distribution of creative works through improved technologies” is precisely what helps to “generate audiences for emerging artists.” *Metro-Goldwyn-Mayer Studios, Inc. v. Grokster, Ltd.*, 545 U.S. 913, n.8 (2005) (citing *Eldred v. Ashcroft*, 537 U.S. 186, 223-26 (2003) (Stevens, J., dissenting)).

Thus, this factor could reasonably read: “To maximize the availability of creative works to the public, taking into account both the creation and dissemination of the works.”

2. ***Factor (B): “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.”*** This factor recognizes the interests of both the copyright owner and user, and, thus, is part of the essential balance of section 801(b)(1) and the balance that you suggested in the July 2008 hearing. If changes are to be made, it could be beneficial to modify this factor slightly in several ways.

First, it would be beneficial to clarify the disparity between “fair return” and “fair income,” which as written is difficult to explain. One reasonable approach would be to simply use “fair return” or “fair income” for both owners and users.² A second reasonable alternative would be to reverse the expressions, because in the licensing context in which section 801(b)(1) arises, the royalty provides “income” to the copyright owner and the policy interest is in providing a fair “return” on investment to the copyright user.

² The House Report on the 1976 Copyright Act used parallel language for both the owner and the user, stated the Committee’s intent that the Copyright Royalty Commission afford both owner and user “a fair income” or, “if the [owner/user] is not a person, a fair profit, under existing economic conditions.” H.Rep. 94-1476, at 174.

Second, Congress should direct that the appropriate source for statutory royalty benchmarks are marketplace licenses that result from *competitive* markets, and not from markets in which the aggregation or collective exploitation of copyrights creates market power. Exploitation of monopoly power (or even supra-competitive market power) is not in the public interest. Competitive market pricing results in better resource allocation and greater surplus for the public. Thus, for example, in the analogous context of music performance rights, the Second Circuit has recognized that setting the fair market value for “reasonable” license fees requires careful consideration of the competitive circumstances of the market. *ASCAP v. Showtime/The Movie Channel, Inc.*, 912 F.2d 563, 570 (2d Cir. 1990) (licensor’s market power is important consideration in setting rates).

This direction is necessary because the Copyright Royalty Judges have twice adopted as a market-based benchmark the non-competitive licenses issued by the four major record labels to interactive on-demand webcasting services. *Digital Performance Right in Sound Recordings and Ephemeral Recordings*, 72 Fed. Reg. 24084, 24093 (May 1, 2007) (failing to grapple with any indication of competitive imbalances in benchmark market); *Determination of Rates and Terms for Preexisting Subscription Services and Satellite Digital Audio Radio Services*, 73 Fed. Reg. 4080, 4093-94 (Jan. 24, 2008). Any revision of section 801(b)(1) should make clear that fair income and fair return are to be analyzed in the context of competitive markets.

Third, the concept of “fair income” or “fair return” requires consideration of a competitive return to all invested capital, including start-up costs. Looking only to forward costs and revenues is flawed policy, particularly for nascent industries and those that require large initial investments. For example, satellite radio companies invested billions of dollars to create innovative delivery systems and an entirely new market, with the goal of earning a return in the future as they grew. The Judges, however, did not recognize the need for any return on those investments in their recent satellite radio decision. *Determination of Rates and Terms for Preexisting Subscription Services and Satellite Digital Audio Radio Services*, 73 Fed. Reg. 4080, 4097 (Jan. 24, 2008) (completely ignoring investments expended outside of the licensing period). Failure to allow a return on those investments in the rate setting process creates an enormous financial disincentive for any investor or innovator to enter an industry that uses a statutory license for an input. The appropriate standard is whether the rate allows a competitive return on *all* investments, including the paid-in capital that has financed early cash flow losses.

Thus, if it is to be revised, this factor should state: “To afford the copyright owner a competitive, fair income for his or her creative work and the copyright user a competitive, fair return, on all of its investments, including the capital that financed start-up costs, under existing economic conditions.”

3. ***Factor (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.” This factor is part of the essential balance of section 801(b)(1), recognizing the interest of both the copyright owner and the copyright user.

Although this factor captures all of the relevant contributions, there has been some confusion about the precise meaning of “product made available to the public.” The correct policy goal should be to consider the end product, that which incorporates the contribution both of the copyright owner and the copyright user. This could beneficially be clarified by adding “For purposes of this subparagraph, the ‘product made available to the public’ includes the copyrighted works and the means of their dissemination to the public, including the contribution of the copyright owner and copyright user.”

4. **Factor (D):** *“To minimize any disruptive impact on the structure of the industries involved and on generally prevailing industry practices.”* This factor is part of the essential balance of section 801(b)(1), recognizing the interest of the copyright owner, the copyright user and the public in predictability and stability. It should not be changed.

As three recent cases illustrate, this factor benefits both copyright owners and licensees, and its absence can be disastrous.

- In the satellite radio case the licensees argued that extraordinary royalty cost increases such as those proposed by copyright owners would jeopardize already thin margins and potentially threaten the viability of their businesses. As a result, the CRB declined to immediately increase royalties by 500 percent.
- In the 115 proceeding regarding composition royalties, the recording industry asked the CRB to (a) reduce publishing royalties on a per-unit (songs sold) basis; and (b) convert the royalty from a penny-per-song to a percentage of revenue, because sound recording prices had declined markedly over the several years and these reductions were not accompanied by reductions in publishing input costs. Publishers and songwriters argued vigorously that reducing the royalty and converting it to a revenue-percentage would significantly disrupt the industry and undermine longstanding industry economics. The CRB decided to maintain current pricing for five years and to maintain the penny-rate royalty structure.
- The recent webcasting proceeding demonstrates the dangers of deciding a case without the non-disruption factor. Notwithstanding webcasters’ demonstration of the harms caused by dramatic rate increases, the CRB imposed such rate increases and the result is a significant reduction in the number of economically viable Internet radio services. Both Yahoo! and AOL have left the business; Pandora’s existence is threatened; and Live365 has dramatically reduced its streaming hours. Perhaps these outcomes would not have occurred if the non-disruption factor had been effective in this case.

Conclusion

As discussed above, the undersigned believe that the standard set forth in section 801(b)(1) has withstood the test of time and has led to the most predictable and least controversial results of any standard that has been used in setting fees under statutory licenses. The public would best be served by maintaining the current standard and applying it to all sound recording statutory licenses. No change should be undertaken without careful deliberation and study of the affected industries and constituencies, as well as the ultimate impact on consumers. The burden should be on proponents of change to demonstrate how the public interest and the public benefits of the Copyright Act will be served by altering a statutory test that has served so well in so many different contexts over so many years without alteration. We appreciate working with you as the process moves forward and thank you for your consideration of our views.

Respectfully,

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