PUBLIC VERSION

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Before the
COPYRIGHT ROYALTY BOARD
LIBRARY OF CONGRESS
Washington, D.C.

In the Matter of: Determination of Rates and Terms for Making and Distributing Phonorecords (Phonorecords III)	Docket No. 16-CRB-0003-PR (2018-2022) (Remand)

THIRD SUPPLEMENTAL WRITTEN REMAND TESTIMONY OF DR. GREGORY K. LEONARD

PUBLIC VERSION

1. I have been asked by Google to review and respond to the Additional Written Direct Testimonies ("AWDT") of Drs. Watt, Eisenach, and Spulber.

I. IT WOULD BE ECONOMICALLY INAPPROPRIATE TO USE A [redacted] SOUND RECORDING-TO-MUSICAL WORKS RATIO IN THE JUDGES' WORKING PROPOSAL

2. Both Dr. Watt and Dr. Eisenach suggest that the Judges should use the [redacted] ratio, obtained from the Gans "Shapley-inspired" model, in their Working Proposal.[1] They are incorrect for several reasons. Their argument appears to be that, because the Judges used the [redacted] ratio to derive the 15.1% musical works rate and 26.2% TCC percentage in the Final Determination, consistency dictates that the same ratio be used in the Working Proposal.[2] However, Drs. Watt and Eisenach ignore the fact that the Judges explicitly adjusted the [redacted] ratio to account for the major labels' complementary oligopoly power (yielding the 3.82:1 ratio) before calculating the musical works rate and TCC percentage. Thus, consistency in fact would dictate that the 3.82:1 ratio be used in the Working Proposal. Dr. Watt's and Dr. Eisenach's argument is also flawed because, as the Judges have recognized, the adjustment to the [redacted] ratio helps mitigate the impact of the labels' complementary market power incorporated into the statutory musical works rate.[3]

3. Additionally, Drs. Watt and Eisenach are confusing the output of Shapley models with economic outcomes in the real world. The [redacted] ratio emerges from the Gans "Shapley-inspired" model. However, real world outcomes do not correspond to the Gans model or other Shapley models due to limitations in those models, as well as the labels' complementary oligopoly power.[4] As a result of this power, the

[1] Watt AWDT ¶¶ 3, 43-44; Eisenach AWDT ¶¶ 6, 15, 22.
[2] Watt AWDT ¶¶ 3, 43-44; Eisenach AWDT ¶¶ 6, 15, 22.
[3] In my SSWRT, I explained why a ratio based on real-world benchmarks would be superior to the adjusted Gans ratio. Leonard SSWRT ¶¶ 23-25.
[4] I have previously discussed at length other shortcomings of the musical works copyright owners' experts' Shapley-based approaches. See, e.g., Leonard SSWRT ¶ 8.

labels have received more than their Shapley values in the real world. If one were to ignore this divergence between the Shapley models and the real world and use the unadjusted [redacted] ratio in the Working Proposal, the result would be to give the musical works copyright owners more than their Shapley value. For example, suppose hypothetically that a Shapley model suggests that revenue shares should be 47% for the services, [redacted]% for sound recordings, and [redacted]% for musical works (so that the latter two revenue shares are consistent with the [redacted] ratio), while, in the (hypothetical) real world, the sound recording royalty rate was 52%, well above the revenue share suggested by the Shapley model, and musical works royalty rate was 14%. If the Judges were to import those (hypothetical) real-world numbers into the Working Proposal and apply the Shapley model's [redacted] ratio to the 66% (52% + 14%) hypothetical real-world combined royalty rate, the Working Proposal would generate a statutory musical works rate of [redacted]%, which is *above* the hypothetical's Shapley value-based musical works rate of 15.1%. In other words, the failure to adjust the [redacted] rate would result in the labels' complementary oligopoly further distorting the model. Absent a one-for-one see-saw effect, which the evidence has shown does not exist (and is all but impossible on a retroactive basis), the services (and consumers) would bear the brunt of this additional distortion, an outcome that is not consistent with the 801(b)(1) factors. For example, with no see-saw, the combined royalties would increase to 70.9% (52% + 18.9%), which is well above the intended "survival rate" of 66%.

II. SOUND RECORDING RATES ARE ABOVE THE COMPETITIVE LEVEL

4. Underlying Dr. Watt's and Dr. Eisenach's claim that the [redacted] ratio should be used in the Working Proposal is the assertion that the labels do not have complementary oligopoly power.[5] This is

[5] Watt AWDT ¶¶ 50-55; Eisenach AWDT ¶¶ 35-37; Spulber AWDT ¶¶ 6-21.

contrary to the evidence and findings in this proceeding, as well as in *Web IV* and *Web V*.[6]

5. Dr. Watt and Dr. Spulber present largely theoretical arguments as to why the labels do not have complementary oligopoly power. They set up a theoretical straw man and then proceed to argue that, because the assumptions of the theoretical straw man do not hold in the interactive streaming marketplace, complementary oligopoly power *necessarily* does not exist in that marketplace.[7] However, Dr. Watt and Dr. Spulber do not actually prove that complementary oligopoly power is *impossible* outside the confines of their straw man theoretical model, nor could they. Inefficiencies can arise despite the marketplace factors they identify. And such inefficiencies are common in the real-world, including because of incomplete or imperfect information.[8]

6. Thus, whether the labels charge rates above the competitive level due to their "must have" status is ultimately an empirical question.[9] Notably, Drs. Watt and Spulber provide no empirical analysis whatsoever to support either the applicability of their theoretical arguments[10] or their conclusion that

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[6] Final Determination, *Phonorecords III*, p. 47; Dissent, Phonorecords III, p. 3; Final Determination, *Web V*, pp. 12-72; Final Determination, *Web IV*, p. 66.

[7] For example, they argue that in the interactive streaming marketplace, but not in their theoretical straw man, there is negotiation, contracting, repeated interaction, communication, less than perfect competition among services, and competition among labels. Watt AWDT ¶¶ 50-55; Spulber AWDT ¶¶ 6-21.

[8] In my testimony in this matter, I discussed how complementarities, aggregation of rights, and the resulting "must have" status have resulted in rates above the effectively competitive level and analogized this outcome to the "royalty stacking" phenomenon observed in situations where a product manufacturer requires licenses from multiple patent owners who hold rights to complementary technologies. 3/15/2017 Hearing Transcript, pp. 1191-1192, 1248-1249; 4/5/2017 Hearing Transcript, pp. 5183-5184.

[9] Dr. Watt, in particular, cannot now argue without contradicting himself that the major labels are not "must have" for the interactive streaming services. Watt Dep., pp. 225-226 ("Q. And that's because of the market power of the labels, correct? A. Yes. When they come to negotiate. They're the – Q. When they come to negotiate. A. They're the sole holder of an essential input at that point."). Moreover, it is telling that none of the major labels offers a service based on only its own catalog. The existing marketplace demonstrates that the catalogs of multiple labels are necessary. Dr. Watt tries to argue that any market power the labels have is not an "abuse" but rather valid due to their "necessity" or "critical[] importan[ce]" to the services. Watt AWDT ¶ 56-57. However, Dr. Watt fails to recognize that the major labels' "necessity" is a result of their aggregation of works. As I explained during my testimony in this matter, aggregating substitutes (here, individual sound recordings) eliminates competition among them and creates the "must have" status for the aggregate, which in turn leads to higher rates. 4/5/17 Hearing Testimony, p. 5184.

[10] For example, they do not provide any evidence that parties communicated about reducing sound recording rates to avoid the inefficiencies arising from the complementarity of the major labels' catalogs, nor do they discuss any aspects of the

sound recording royalty rates are at the competitive level.

7. In fact, the evidence suggests that sound recording rates are above the competitive level. Sound recording rates are lower in contexts where steering, and thus competition among labels, is possible.[11] However, the nature of an interactive streaming service (offering on-demand access) limits such a service's ability to steer.[12] Moreover, labels have demanded and received "anti-steering" and "most favored nations" provisions from interactive streaming services, which further limit competition among labels.[13] In the *Web V* and *Web IV* proceedings, label witnesses acknowledged the lack of price competition between labels.[14] Also, as discussed above, actual sound recording rates are well above the levels suggested by the Shapley models that have been considered in this case.

III. DR. EISENACH'S DISCUSSION OF ROYALTY RATES IS MISLEADING

8. Dr. Eisenach identifies a range of [redacted]% for the combined royalty rate the Judges should use as the "survival rate" in the Working Proposal.[15] Dr. Eisenach bases this range on combined royalties for interactive streaming services from before the *Phonorecords III* period as well as purported benchmarks such as NetFlix, iTunes, and Hulu.[16]

9. However, combined royalties from before the *Phonorecords III* period are substantially less relevant than the combined royalties from the *Phonorecords III* period. For example, [redacted]. Combined royalties at the

services' contracts with labels that would have achieved this end. They also ignore evidence that is inconsistent with the applicability of their theoretical arguments. For example, the evidence in the *Web V* proceeding suggested that the services have relatively little bargaining power relative to the labels. See Final Determination, *Web V*, pp. 16-21, 48-49.

[11] Final Determination, *Web V*, pp. 21-33.
[12] Final Determination, *Web V*, pp. 21-33.
[13] Final Determination, *Web V*, pp. 25-27.
[14] Final Determination, *Web V*, p. 24; Final Determination, *Web IV*, p. 66.
[15] Eisenach AWDT ¶¶ 28-32.
[16] Eisenach AWDT ¶ 32.

time of these renegotiations are a better gauge of the "survival rate" than royalties from an earlier time. Dr. Eisenach acknowledges that the combined royalties from the *Phonorecords III* period have been [redacted]% (including increased publishing royalties due to the vacated Initial Determination).[17] He argues that this figure is too low to be used in the Working Proposal because (1) musical works rates were being ramped up to the 15.1% level, (2) revenue was increasingly being deferred/hidden by services, and (3) greater use of student/family plans have lowered effective royalty rates.[18] Regarding the first point, under Dr. Watt's assertion as to the existence of a nearly 100% see-saw (upon which adoption of the Phonorecords III rates was premised), a ramped up musical works rate should not affect the combined royalty.[19] Regarding the second point, Dr. Eisenach provides no credible evidence to support his claim that services have manipulated revenue figures, let alone that services have increasingly done so during the *Phonorecords III* period. Finally, regarding the third point, Dr. Eisenach appears to be referring to the fact that the *Phonorecords III* rate structure calls for family plan and student plan subscribers to be weighted at less than a regular subscriber. However, this is a feature of the statutory rate structure that the Judges found to be economically rational and desirable, not a nefarious action by the services.

10. With regard to Dr. Eisenach's purported benchmarks, video streaming does not provide a sound benchmark for interactive music streaming because of the substantial differences between them in terms of the services offered, the rights at issue, the parties, and the geographic scope (he uses worldwide data from NetFlix and Hulu, whereas this case is about the United States). Dr. Eisenach does not address these differences. Similarly, Dr. Eisenach does not explain how a retailer of digital media such as iTunes is comparable in terms of its costs and the value of its contributions to an internet streaming provider.

[17] Eisenach AWDT ¶ 31.
[18] Eisenach AWDT ¶ 31.
[19] There is also no evidence suggesting that the 15.1% musical works rate was driving label decisions concerning a hypothetical survival rate at the time of negotiations with services.

IV. DR. EISENACH MISINTERPRETS MLC DATA

11. Dr. Eisenach identifies a [redacted] at the beginning of 2019 in the data Google reported to the MLC. He insinuates that this is indicative of issues with Google's reporting [redacted].[20] In fact, [redacted].[21] [redacted].

12. Dr. Eisenach also claims that mechanical royalties for the 2018-2022 period would be $[redacted] without the TCC prong.[22] But this number is largely driven by assumptions rather than actual data—particularly related to forecasting. Because he does not have actual data for 2021 and 2022 (and for some services in Q4 2020), he forecasts royalties for 2021 and 2022 (and, for some services, certain months in Q4 2020)—over 40% of the 2018-2022 period—by extrapolating based on the growth rate exhibited in the actual data between a single month at the end of 2019 and the same month in 2020.[23] Excluding Dr. Eisenach's forecasts and limiting the calculation to the period for which actual data exist, [redacted]

Gregory K. Leonard

Dated: February 24, 2022

[20] Eisenach AWDT ¶ 41.
[21] Interview of Jennifer Rosen, Head of Music Publishing Partnerships at YouTube Music, conducted by me on Feb. 23, 2022.
[22] Eisenach AWDT ¶ 43.
[23] Eisenach AWDT, fn. 53. He uses September for "Full" and "Limited" offerings and December for "Free" offerings.

Proof of Delivery

I hereby certify that on Thursday, February 24, 2022, I provided a true and correct copy of the PUBLIC_THIRD SUPPLEMENTAL WRITTEN REMAND TESTIMONY OF DR. GREGORY K. LEONARD to the following:

National Music Publishers' Association (NMPA) et al, represented by Benjamin Semel, served via ESERVICE at Bsemel@pryorcashman.com

Spotify USA Inc., represented by Richard M Assmus, served via ESERVICE at rassmus@mayerbrown.com

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Nashville Songwriters Association International, represented by Benjamin K Semel, served via ESERVICE at Bsemel@pryorcashman.com

Johnson, George, represented by George D Johnson, served via ESERVICE at george@georgejohnson.com

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Signed: /s/ David P Mattern