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UNITED STATES COPYRIGHT ROYALTY JUDGES
The Library of Congress

In re **DETERMINATION OF ROYALTY RATES AND TERMS FOR MAKING AND DISTRIBUTING PHONORECORDS (Phonorecords III)**	**Docket No. 16-CRB-0003-PR (2018–2022) (Remand)**

INITIAL RULING AND ORDER AFTER REMAND

On October 26, 2020, the United States Court of Appeals for the D.C. Circuit (D.C. Circuit) issued its mandate vacating and remanding in part the Determination[1] issued by the Copyright Royalty Judges (Judges) in the captioned proceeding. *See Johnson v. Copyright Royalty Board,* 969 F.3d 363 (D.C. Cir. 2020). In its ruling on appeal, the D.C. Circuit found that in the Determination, the Judges (1) failed to give adequate notice to participants of their overhaul of the royalty rate structure combined with significantly increased and uncapped rates for section 115 licenses; (2) failed to explain why they rejected a benchmark based on a past settlement agreement[2] in lieu of overhauling of the rate structure and significantly increasing rates; and (3) failed to identify their legal authority to redefine a material term after they promulgated a definition of that term in the Initial Determination circulated to the participants. *See Johnson,* 969 F.3d at 367, 381; Initial Determination, *Determination of Royalty Rates and Terms for Making and Distributing Phonorecords (Phonorecords III)*, 16-CRB-0003-PR (2018-2022) (Jan. 27, 2018).

After receipt of the D.C. Circuit's ruling and mandate, the Judges consulted with the parties to the appeal and established procedures for the remand proceeding. *See* Order Adopting Schedule for … Remand (Dec. 23, 2020).[3] Each side offered opening submissions, responsive submissions, additional evidentiary filings and further supplemental briefing requested by the Judges. The parties' submissions included legal briefing and incorporated evidence from the original proceeding as well as evidence newly developed for the remand proceeding. After preliminary deliberations, the Judges asked for supplemental briefing from the parties responsive to a proposed alternative rate structure. *See* Notice and *Sua Sponte* Order Directing the Parties to

[1] *Determination of Royalty Rates and Terms for Making and Distributing Phonorecords (Phonorecords III)*, 84 Fed. Reg. 1918 (Copyright Royalty Board Feb. 5, 2019) (final rule and order) ("Determination"); *See also* Final Determination, 16-CRB-0003-PR (2018-2022) (Nov. 5, 2018) (citations to the Determination and to the Dissent in this Initial Ruling and Order after Remand (Initial Ruling) are found in this document). The Determination was issued by two of the Judges (Majority) and was accompanied by a dissenting opinion (Dissent) authored by the third Judge. The Dissent is appended to and part of the same document as the Determination.

[2] The referenced settlement agreement formed the basis for regulatory terms relating to section 115 musical works royalties and was adopted as a final rule in *Adjustment of Determination of Compulsory License Rates for Mechanical and Digital Phonorecords,* Docket No. 2011-3 CRB Phonorecords II, 78 Fed. Reg. 67938 (Nov. 13, 2013), Technical Amendment at 78 Fed. Reg. 76987 (Dec. 20, 2013). In this Initial Ruling, references to *Phonorecords II,* PR II, and PR II-based benchmark are references to this final rule.

[3] Following the original remand scheduling order, at the request of parties or on their own motion, the Judges amended the remand proceeding schedule by, *e.g.,* permitting additional briefing, changing due dates, and seeking additional input with regard to specific issues. *See, e.g.,* Order … Modifying Scheduling Orders (Dec. 13, 2021).

Provide Additional Materials (Dec. 9 Order). The Judges also sought legal analysis from the parties relating to the D.C. Circuit's directive that the Judges either provide "a fuller explanation of the agency's reasoning at the time …" or take "new agency action accompanied by the appropriate procedures." *See Johnson,* 969 F.3d at 392 (citing *Dep't of Homeland Sec. v. Regents of the Univ. of Cal.*, 140 S. Ct. 1891, 1908 (*Regents*)). On February 9, the Judges invited additional briefing on the service bundle definition issue, specifically permitting the parties to offer additional analysis of possible characterization of the Copyright Owners' motion for clarification following the Determination as a motion for rehearing under the Copyright Act, title 17, United States Code (Act) at § 803(c)(2).

At the request of the parties, the Judges agreed to forego live testimony. On March 8, 2022, all parties were afforded an opportunity to present oral argument on all remand issues.[4] Following oral argument, the Judges deliberated and now issue this Initial Ruling after Remand.

After due consideration of all of the evidence and oral argument of counsel, the Judges[5] determine[6]:

(1) With regard to the applicable rates and rate structure, the percent-of-revenue all-in headline royalty rate for the mechanical license shall be set at 15.1%, phased-in, as set forth below:

2018-2022 All-In Headline Royalty Rates

	2018	**2019**	**2020**	**2021**	**2022**
Percent of Revenue	11.4%	12.3%	13.3%	14.2%	15.1%

In all other respects, the rates and rate structure of the *Phonorecords II*-based benchmark proposed by the Services (as that benchmark is defined herein) shall constitute the rates and rate structure for the *Phonorecords III* period.[7]

To be clear: the 15.1% headline percentage rate substitutes for the headline percentage rates in subparts B and C of the Services *Phonorecords II*-based benchmark, and the definition of "Service Revenue" for bundles shall be the definition contained in 37 C.F.R. § 385.11 (subsection (5) for the "Service Revenue" definition) as proposed in the Services' *Phonorecords II*-based benchmark.

(2) The Services' *Phonorecords II*-based benchmark is the better of the benchmarks proposed by the parties and satisfies the requirements of 17 U.S.C. § 801(b)(1) in all respects. However, as noted *supra*, to be consistent with this statutory section and the

[4] Copyright Owners and Services divided the time for oral argument. George Johnson dba GEO Music Group waived oral argument.

[5] The findings and conclusions in this Initial Ruling are adopted by a majority of the Judges. One Judge dissents from the adoption of the entirety of the *Phonorecords II* rate structure (section II), though not from the exception to that benchmark with regard to the headline rate of 15.1% and the imposition of a cap on the TCC rate prong. One Judge dissents in part from the reasoning relating to adoption of the definition of Service Revenue (section V), but not from the adoption of that definition.

[6] As addressed *infra*, the Judges also order that the participants in this remand proceeding prepare and submit regulatory provisions consistent with this ruling. *See* Footnote 163.

[7] The Services include in their Joint Rate Proposal a chart summarizing the proposed rates for their offerings. That chart is attached as Appendix A to this Initial Ruling.

decision in *Johnson*, the royalty rate of 10.5% in that benchmark shall be replaced with the 15.1% rate set forth in paragraph (1) above.

(3) To reiterate for clarity, consistent with the adoption of the *Phonorecords II*-based benchmark, and for the reasons more fully developed herein, the Judges adopt the definition of "Service Revenue for Bundled Services" as it appeared in the Initial Determination in the underlying proceeding. Following are the Judges' analysis and ruling after remand.

I. Preliminary Issue: Burden of Proof

As a preliminary matter, the Judges address the issue of burden of proof raised by both parties. Pursuant to the Administrative Procedure Act (APA), "the proponent of a rule or order has the burden of proof." 5 U.S.C. § 556(d). *See also* Initial Remand Submission of Copyright Owners at 48 (Apr. 1, 2021) ("CO Initial Submission") (citing § 556(d) of the APA as setting forth "a basic rule of these rate-setting proceedings that a participant is required to provide evidence establishing the propriety of all aspects of its own proposed rates and terms, including all aspects of the participant's proposed rate structure."). Accordingly, it is clear to the Judges that the Services should continue to bear the burden of proof regarding the sufficiency of their proffered Phonorecords II-based benchmark in this remand proceeding. And, in like fashion, because on remand Copyright Owners have assumed the mantle of pursuing the vacated rate structure and rates, they bear the burden of proof with regard to their proposal.

However, Copyright Owners assert that it is *the Services* who bear the burden of proof as to Copyright Owners' proposal regarding the appropriateness, *vel non*, of an uncapped TCC rate prong. According to Copyright Owners, this burden falls on the Services because "only the Services … proposed TCC prongs at the hearing," in the form of the mix of capped and uncapped TCC prongs contained in the Services' Phonorecords II benchmark. *Id.* at 47. The Judges find that the fact that the Phonorecords II-based benchmark advanced by the Services contains this mix of capped and uncapped TCC prongs does not bear on Copyright Owners' duty, under 5 U.S.C. § 556(d), to satisfy the burden of proof with regard to the rates and rate structure they are advancing on this remand. Moreover, the D.C. Circuit has already held that the fact that some of the Streaming Services' proposals contemplated continued use of an uncapped total content cost prong for some categories "does not mean they anticipated that the [Judges] would uncap the total content cost prong *across the board* … [which] is quite different." *Johnson*, 369 F.3d at 382. The difference, according to *Johnson*, is that "[u]ncapping the total content cost prong across all categories leaves the Streaming Services exposed to potentially large hikes in the mechanical license royalties they must pay." *Id.*

Accordingly, the Judges find that Copyright Owners indeed do bear the burden of proof with regard to the appropriateness of uncapped rate structure and rates they are proposing on remand and the Services bear the burden of proof with regard to the appropriateness of the Phonorecords II-based benchmark they are continuing to advance on remand.

II. Rate Structure and Rates

A. Relevant Rulings in *Johnson*

In establishing a royalty rate structure and the rates within it in the context of this remand proceeding, the Judges are guided by the rulings in *Johnson.*

1. Percent of Revenue Prong

The D.C. Circuit noted that the Judges found the royalties in the *Phonorecords II* period were too low and that record companies were receiving a disproportionate share of the sum of the mechanical and sound recording royalties. *Johnson*, 969 F.3d at 384-85. The D.C. Circuit acknowledged that "[t]he Judges … then carefully analyzed the competing testimony and drew from it rates that were grounded in the record and supported by reasoned analysis." *Id.* at 385. The D.C. Circuit found that the Judges acted well within their discretion and not arbitrarily, relying on substantial evidence in establishing the "zone of reasonableness" for the rates. *Id.* As the D.C. Circuit noted, the Judges' process was "the type of *line-drawing and reasoned weighing of the evidence* [that] falls squarely within the [Judges'] wheelhouse as an expert administrative agency." *Id.* at 385-86 (emphasis added).

2. Uncapped TCC Prong

The D.C. Circuit found fault, however, in the Judges' determination to establish an uncapped and increased percentage-based total content cost (TCC).[8] *Id.* at 380. This approach "removed the only structural limitation on how high the [TCC] … can climb." *Id.* The D.C. Circuit reasoned that uncapping the TCC alternative rate prong across all categories of service exposed the Services to potentially large hikes in the overall mechanical royalties they must pay. *Id.* at 382. The D.C. Circuit noted: "As the [Judges] acknowledge, sound recording rightsholders have considerable market power *vis-à-vis* interactive streaming service providers …. The interactive streaming services are . . . exposed to the labels' market power and record companies could, if they so chose, put those services out of business entirely …. [B]y virtue of their oligopoly power, the sound recording copyright holders have extracted 'inflated' royalties …." *Id.* (cleaned up).

While the Services had advocated uncapping the TCC alternative rate prong for some categories of service, that "does not mean they anticipated that the [Judges] would uncap the total content cost prong *across the board*. That is quite different." *Id.* at 382. The D.C. Circuit found that the Judges "failed to provide adequate notice of the drastically modified rate structure [they] ultimately adopted." *Id.* at 381. The D.C. Circuit emphasized that the failure to provide adequate notice of their intentions "is no mere formality [because] [i]nterested parties' ability to provide evidence and argument … not only protects the parties' interests, it also helps ensure that the [Judges'] ultimate decision is well-reasoned and grounded in substantial evidence." *Id.* at 381-82.

To support their adoption of an uncapped TCC rate prong, the Judges "predicted that the sound recording copyright owners' royalty rates would naturally decline in the course of their negotiations with interactive streaming services." *Id.* at 372. The Judges found persuasive the rebuttal testimony of one of Copyright Owners' economic expert witnesses, Professor Watt, that an increase in mechanical royalties payable by the Services would lead to a corresponding decrease in the Services' sound recording royalty obligations. *See* Determination at 73-74 ("[S]ound recording royalty rates in the unregulated market will decline in response to an

[8] "TCC" refers to "Total Content Cost," and is defined as "a percentage of the royalties paid by the service … to sound recording copyright holders." *Johnson*, 969 F.3d at 370; *see also* Determination at 13 n.38 ("TCC" is an industry acronym for "Total Content Cost", a shorthand reference to the extant regulatory language describing generally the amount paid by a service to a record company for the section 114 right to perform digitally a sound recording.").

increase in the compulsory license rate for musical works [and] Professor Watt's bargaining model predicts that the total of musical works and sound recordings royalties would stay "almost the same" in response to an increase in the statutory royalty."). The Services painstakingly criticized this "see-saw" theory.

The D.C. Circuit concluded that, on remand, if and when the Judges consider the "uncapped" rate structure, they shall address all substantive challenges to that approach raised by the Services, including the issue of whether "an increase in mechanical license royalties would lead to a decrease in sound recording royalties." *Id.* at 383.

Thus, the D.C. Circuit held, the Judges erred procedurally in adopting an uncapped TCC alternative rate prong. The D. C. Circuit therefore instructed the Judges to provide the parties with the opportunity to fully address the issues regarding the uncapped TCC prong, and for the Judges to address the "substantive challenges" raised by the Services.

3. Four Itemized Statutory Objectives

The statutory standard found in section 801(b)(1) instructs the Judges to set rates that are not only "reasonable," but also reflective of four itemized objectives, or factors, which, as the D.C. Circuit stated, set forth "competing priorities." 17 U.S.C. § 801(b)(1)(A)-(D); *Johnson*, 969 F.3d at 387.[9] With regard to these four priorities, the D.C. Circuit found that the Judges properly analyzed and applied the first objective (Factor A). *Id.* at 387-88. In particular, the D.C. Circuit did not disturb the Judges' ruling that an increase in the royalty rates for mechanical licenses was necessary in order to satisfy Factor A. *Johnson*, 369 F.3d at 387-88. According to *Johnson*, in making this finding, the Judges had engaged in a "reasonable reading of the record" and had relied on "substantial evidence." *Id.* at 388. Thus, Factor A (when considered without regard to the other three objectives) indicated that the statutory rate needed to be higher than it was during the *Phonorecords II* period.[10]

With regard to the other three objectives, *Johnson* stated that "[t]he question whether the [Judges] adequately addressed factors B through D … is intertwined with the nature of the rate structure ultimately imposed by the [Judges]." *Id.* at 389. Accordingly, the D.C. Circuit concluded that it "need not … address whether the [Judges] adequately considered these remaining factors." *Id.*[11]

Within the parameters of the holdings in *Johnson*, the Judges consider the record facts and the arguments made in this remand proceeding, together with the pertinent facts and arguments made in the original proceeding.

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[9] These competing objectives are: (A) To maximize the availability of creative works to the public; (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; (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. *Id*.

[10] However, as the D.C. Circuit also noted, because the four § 801(b)(1) objectives reflect "competing priorities," *id.* at 387, the holding that Factor A militates toward a higher rate is not ultimately dispositive. Rather, it must be weighed with the other statutory factors.

[11] The phrase "intertwined with the nature of the rate structure" requires emphasis because the Majority independently considered how to weigh Factors B and C specifically as to the 15.1% revenue rate, without regard to the overall rate structure, as discussed *infra*.

B. Rate Evidence for the 33-Months from January 2018 through September 2020

After the Determination was issued, from its effective inception on January 1, 2018, through September 30, 2020—a 33-month period—the parties operated under the rates and rate structure set forth in that ruling. In light of the D.C. Circuit's decision in *Johnson*, as of October 1, 2020, the parties reverted to the *Phonorecords II* rates. The Services have asserted in this remand proceeding that, during the 33-month period when the Majority's new and higher *Phonorecords III* rates were in effect, [redacted] By contrast, Copyright Owners, on remand, looking at the same data over this 33-month period, aver that they prove the existence of the seesaw theory.

1. Services' Position

According to the Services, [redacted] Moreover, according to the Services, [redacted] The Services further maintain that, [redacted]

The Services make the [redacted] And, [redacted] Id. ¶¶ 5, 9-13, 16-19, 22-23, 26-27.

The Services claim that [redacted] More particularly, [redacted]

[redacted]

The Services' economic experts rushed to judgment upon learning of these facts, claiming that they disproved the seesaw theory. *See* Katz WDRT ¶¶ 25-27 (relying on testimonies cited *supra* and concluding that seesaw theory was disproved, based on [redacted]); Marx WDRT ¶¶ 48-

51 (relying on same testimonies and likewise finding because [redacted]); Leonard WDRT ¶ 17 ([redacted]).

2. Copyright Owners' Position

Copyright Owners analyzed the royalty data over the same 33-month period (January 2018 through September 2020) and reach the opposite conclusion. One of their economic expert witnesses, Dr. Jeffrey Eisenach, testified that [redacted] Moreover, he opined that [redacted] *See* Eisenach RWRT §2(A) & appx. C.

Based on this analysis, Professor Watt declares empirical vindication of his seesaw theory. Watt RWRT ¶¶ 41-42, 46 ("The [Judges'] bargaining theory insights about the relationship between royalty rates were correct …. [redacted] ….").

3. Analysis and Decision Regarding Evidence of Post-Determination Rates

The Judges are perplexed by the willingness of the expert economic witnesses on both sides to opine that the rate changes from January 2018 through September 2020 can serve as confirmation of their clients' respective positions. The issue to be considered empirically was whether the sound recording rate would decrease in response to the increase in the mechanical rate. That is, if the record labels had previously set royalties at a level that would allow the Services merely to survive, would the record labels agree to lower their sound recording rate if more of the Services' surplus were acquired by Copyright Owners? To answer this question, the economists on both sides applied sophisticated bargaining models and critiques to explain the nature of the negotiations that would ensue.

In the process, the economists lost track of an obvious, elementary point: The *Phonorecords III* rates were being challenged by the Services' appeal, and might not persist. Indeed, the rates were ultimately vacated and the parties returned in October 2020 to the *Phonorecords II* rates.[12] Now, the rates will be changed again by this post-remand Determination, and going forward may be subject to further potential change, consistent with the provisions of title 17. In light of such ongoing fundamental uncertainty, why would any economist or businessman assume that the sound recording companies would agree to adjust their rates in response to a change in the mechanical rate? The Judges are amazed that the

[12] There also was uncertainty as to the effective inception date of the *Phonorecords III* rate period, because the Services had appealed (ultimately unsuccessfully) the CRB Judges' finding that the period commenced, retroactively, as of January 1, 2018.

economic experts neglected even to raise this uncertainty as a complicating issue, let alone a dispositive one.[13]

Moreover, no party called as a witness any representatives of the Majors, or subpoenaed their testimony or documents, to provide the Judges with evidence of how these record companies perceived the seesaw issue, whether as a permanent phenomenon or as an uncertain matter, given the pendency of the legal proceedings regarding the ultimate mechanical rate. Any of the parties could have requested that the Judges subpoena a sound recording industry witness to give testimony and produce documents as to this issue, pursuant to 17 U.S.C. § 803(b)(6)(C)(ix), but none did so. Further, Copyright Owners, who are representing the music publishing interests of *inter alios*, Sony, Universal, Warner, and Merlin, likely could have produced such sound recording witnesses without the need for a subpoena. Witnesses from these entities who negotiated with the Services after the *Phonorecords III* rates and rate structure became effective certainly would have knowledge relevant to the testimony of the Services' witnesses [redacted] who claimed that [redacted]

Simply put, the period from period from January 2018 through September 2020 was a time the Judges construe as "33-months of uncertainty," *see* 3/8/22 Tr. 87, 91 (Closing Argument) when no party could ascertain with any assuredness the ultimate *Phonorecords III* rates and rate structure. Thus, for the economists and the parties to claim vindication for their arguments by reliance on how the record labels did or did not respond to the challenged and ever-shifting rates during this "33 months of uncertainty" reflects the elevation of adversarial zeal over objective judgment.

Accordingly, the Judges place no weight on the purported changes or stability of the sound recording rates during the *Phonorecords III* rate period.

C. Percent-of-Revenue Rate Prong

1. Copyright Owners' Position

In their initial remand submission, Copyright Owners provided no new evidence to support any aspect of the 15.1% revenue-based rate (or for that matter, any new evidence to support the rates or rate structure in the Determination), and elected to rely on the pre-remand record. In fact, in their initial remand submission, Copyright Owners do not so much as mention the 15.1% revenue rate derived by the Judges. However, in their reply remand submission (which the Judges found also to constitute, in part, a substantive *initial* submission[14]) Copyright Owners do address the 15.1% revenue rate. In the reply submission, Copyright Owners simply stated: "[T]he Circuit affirmed the Board's derivation of rate percentages, including raising the revenue rate to 15.1%." Copyright Owners' Reply Brief on Remand (in Reply Remand

[13] To place this point in the economic context of this proceeding, the Judges characterize the ongoing "legal uncertainty" as another "independent variable" to add to the economic experts' list of such variables, discussed *infra*, that affect the "dependent variable," *viz.,* the sound recording rate.

[14] *See* Order Denying in Part and Granting in Part Services' Motion to Strike Copyright Owners' Expert Testimony and Granting Services' Request to File Supplemental Testimony and Briefing at 11 (Oct. 1, 2021) (Oct. 1st Order) (The Judges found that "with one exception … the challenged testimonial evidence of Copyright Owners' economic expert witnesses serve the dual purposes of direct and rebuttal statements" and, as a consequence, "provide[d] the Services an opportunity to file supplemental testimony and briefing in opposition.

Submission of Copyright Owners, Vol. 1) at 64, n.48 (July 2, 2021) ("CO Reply"). In a subsequent submission, Copyright Owners added that "*[t]he narrow mandate on this Remand does not allow for reopening the rate percentage determination in the []Determination*." Copyright Owners' Motion for Reconsideration or Clarification at 15 & n.10 (Dec. 17, 2021) (emphasis added) (Dec. 17th Motion).

Thereafter, Copyright Owners asserted that the D.C. Circuit's affirmance of the [Judges'] revenue percentage rate calculation was "strong[]" and "detailed." Copyright Owners' Reply in Further Support of Motion for Reconsideration or Clarification at 4 (January 5, 2022). Moreover, Copyright Owners took note that the Services had relied on substantively identical language in *Johnson* to support their argument that other statements in that D.C. Circuit decision should be deemed affirmed. *See id.* at 4-5 (noting Services' reliance on *Johnson's* description of the Judges' rulings regarding student and family discounts ("*grounded in substantial record evidence … based on the weight and credibility of the evidence [and] squarely within the Judges' expertise")* as demonstrating that the D.C. Circuit had affirmed those rulings) (emphasis added); *see also* Copyright Owners' Brief in Response to the Additional Materials Orders at 2, 6-7 (Jan. 24, 2022) ("CO Additional Submission") (again asserting that "the 15.1% revenue rate … was specifically affirmed in detail by *Johnson*.").

2. Services' Position

In their initial submission after the remand, the Services objected to any continued application by the Judges of the 15.1% revenue rate because, "as the Majority acknowledged, this particular division of revenues will never happen in the real world because of the complementary oligopoly power of the record labels." Services' Joint Opening Brief (in Services' Joint Written Direct Remand Submission at Tab D) at 52 ("Services' Initial Submission") (Apr. 1, 2021). More particularly in this regard, the Services note that Professor Marx's Shapley Value Model,[15] which served as an input for the generation of the 15.1% revenue rate, also indicated that only [redacted]% of the interactive streaming revenue should be paid out as royalties to the sound recording rightsholders, with the remaining [redacted]% of these revenues retained by the interactive streaming services. *Id.* ("Both Professor Marx's and Professor Watt's models show lower combined royalties being paid by the services than are currently paid in the marketplace .... The discrepancy in total royalties between the models and the real world is explained, in part, by the absence of supranormal complementary oligopoly profits in the Shapley model, and the presence of those profits in the actual market."). *Id.* (quoting *Phonorecords III*, 84 Fed. Reg. at 1952).

By this approach, the Services maintain, "the Majority awarded the Copyright Owners the full 15.1% of revenue dictated by its model (phased in over time), and left it up to the Services to convince the complementary oligopolist major labels to dramatically lower sound recording rates." *Id.* at 54-55. The Services argue that, instead, the Majority should have applied to Professor Marx's [redacted]% total royalty obligation what they characterize as "any of the[]

[15] Generally, a Shapley Value Model is a game theory analysis. It models a hypothetical bargain that assigns each "player" the average marginal value it contributes to the bargain and (after accounting for the costs that each "player" would need to recover) the remaining "surplus" is allocated among the players according to their relative contributions. *See Johnson*, 969 F.3d at 372. For the reasons discussed *infra*, in the present case, the Shapley surplus from the streaming revenue is split essentially equally by the owners of the sound recording and musical works owners *inter se,* but the royalty rates themselves that would result from their bargaining would be different as between these two inputs, because of their differing costs. *See, e.g.*, Gans WDT ¶ 73.

real-world ratios in place of the [redacted] ratio taken from "Professor Gans' "Shapley-inspired" model. *Id.* at 54. According to the Services, these lower ratios would have reduced the revenue percentage rate well below 15.1%. *Id.*

Alternatively, the Services propose, through Professor Marx's post-remand written testimony, that the Judges now adopt "a more balanced, burden-sharing approach" to address what she described as the Majority's "imbalance" problem. *Id.* at 57; *see also* Marx WDRT ¶¶ 52-63.[16] Essentially, her proposal begins with an assumption, based on record evidence, that labels typically take specific shares of service revenue, including shares of [redacted]%, [redacted]% and [redacted]%.[17] These shares are significantly higher than the [redacted]% that Professor Marx generated from her Shapley model. Next, Professor Marx's post-remand burden-sharing approach uses as inputs the 15.1% of service revenue and the [redacted]% of service revenue that would be retained by the musical works owners and the Services respectively.[18] Putting these two factors together, she sets forth the basic math: Using her [redacted]% sound recording share as an example, she notes that there is not enough revenue for the labels to take this [redacted]% share, if the musical works owners also receive 15.1% and the Services also retain the [redacted]% derived from her model ([redacted]% + 15.1% + [redacted]% = [redacted]%, an irrational result). *See* Services' Joint Opening Brief at 57.

Professor Marx engages in an analysis based on the following math and logic (again, using the [redacted]% sound recording rate as an example of the fixed amount taken by the labels): (1) [redacted]% of the streaming revenues remain available to be split between the services and the musical works copyright owners; (2) adding the 15.1% revenue rate and her [redacted]% revenue retention percentage equals [redacted]%; and (3) the 15.1% revenue rate, as a percent of this [redacted]% , is [redacted]%; and (4) [redacted]% of the [redacted]% available for splitting between the services and the musical works copyright owners is [redacted]% (rounded). *Id.* at fig.8.

Thus, she identifies her version of a "fair" result: The Services and Copyright Owners would split the residual revenue remaining after the labels have exercised their complementary oligopoly power to take an outsized fixed share—with the split proportional to the 15.1%-to-[redacted]% revenue amounts calculated respectively by the Judges (the 15.1% musical works rate) and Professor Marx (the [redacted]% service revenue retention). *Id.* 59, table. 8.[19]

In their final post-remand submission, the Services also flatly state: "[T]he D.C. Circuit did not "affirm" the 15.1% rate—it vacated that rate." Services' Joint Rebuttal Brief Addressing the Judges' Working Proposal at 2 (Feb. 24, 2022) ("Services' Additional Submission"). However, the Services do not support that quoted statement with any citation to *Johnson*. *See id.*

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[16] Claiming consistency with the Majority's analysis, Professor Marx appears to maintain that her "burden-sharing" approach generates the statutorily-required "reasonable" rate as well as a rate that satisfies the "fair return"/"fair income" objectives of statutory Factor B. *See* Marx WDRT ¶ 52 (introducing her correction of the alleged "imbalance" problem by noting that "the "right" mechanical royalty rate is one that is "reasonable" and achieves the four objectives laid out in Section 801(b)(1)."

[17] *See* Marx WDRT, fig. 7 ([redacted]).

[18] The [redacted]% of revenue that the services would retain is based on one of Professor Marx's "Shapley Value Models." Shapley Value modeling is discussed *infra*.

[19] Using the same logic and calculation method, Professor Marx finds that the services would retain [redacted]% ÷ [redacted]%, which equals [redacted]%. Assuming again that [redacted]% of the steaming revenue is available to split (because the labels have appropriated [redacted]%), the services would retain [redacted]% ([redacted]% rounded) of the streaming revenue. *Id.*

Further, the Services assert that the 15.1% revenue rate is not immune from post-remand review and reduction because "the D.C. Circuit withheld judgment "on whether that final percentage satisfies factors B through D of Section 801(b)(1) …." *Id.* at 3.

3. Analysis and Decision Regarding 15.1% Revenue Rate Prong

The Judges determine that they are clearly bound by the D.C. Circuit's decision in *Johnson* to maintain the 15.1% revenue rate, as phased-in by the Determination. Several reasons support this decision.

First, the Judges conclude that the D.C. Circuit's decision in *Johnson* is conclusive and unambiguous regarding the revenue percentage rate. The D.C. Circuit rejected the Services' assertion that the Judges acted "arbitrarily" as to this particular issue, noting that the Services had misstated the relevant facts. *Johnson*, 969 F.3d at 385-86 (responding to Services' misdescription of Judges' analysis and explaining what Services described as "not what happened."). Moreover, the D.C. Circuit held that with regard to the construction of the 15.1% revenue rate, the Judges had "engaged in the type of line-drawing and reasoned weighing of the evidence [which] falls squarely within the [Judges'] wheelhouse as an expert administrative agency." *Id.* at 386. The D.C. Circuit further noted that the Judges "proceed[ed] cautiously" to set the 15.1% revenue rate by establishing a "zone of reasonableness" for the revenue rate. *Id.* at 385. Indeed, with regard to each aspect of this revenue rate analysis, the D.C. Circuit found that the Judges' decision making was "grounded in the record and supported by reasoned analysis" and that "[s]ubstantial evidence supports [their] judgment." *Id.* at 385.

Second, when the D.C. Circuit reviewed the Determination, it applied "the same standards set forth in the Administrative Procedure Act, 5 U.S.C. § 706." *Id.* at 375 (noting that 17 U.S.C. § 803(d)(3) cross-references 5 U.S.C. § 706); *see also id.* ("[W]e will set aside the [] Determination 'only if it is arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law, or if the facts relied upon by the agency have no basis in the record.").

Here, the D.C. Circuit explicitly found that the Judges' analysis and findings in connection with the 15.1% revenue rate are *not* arbitrary and capricious, and that the facts relied upon by the Judges have a sufficient basis in (are "grounded in") the record. It seems beyond dispute that the D.C. Circuit affirmed the Judges in their setting of the 15.1% revenue rate as a rate that is reasonable, and thus satisfies that aspect of the section 801(b)(1) standard.[20] Indeed, it would border on the Orwellian to misconstrue the D.C. Circuit's unequivocal and obvious affirmance of the reasonableness of the 15.1% revenue rate as a vacating of that finding.

Third, the Judges note that *Johnson* conspicuously declines to identify the Judges' setting of the 15.1% percent-of-revenue rate as one of the findings to be revisited on remand. Rather, *Johnson* states that the three overarching issues for resolution on remanded are the Majority's failure: (1) "to provide adequate notice of the rate structure it adopted," (2) "to explain its rejection of a past settlement agreement as a benchmark for rates going forward; and (3) "[to] identif[y] the source of its asserted authority to substantively redefine a material term after publishing its Initial Determination." *Johnson*, 369 F.3d at 367. The Majority's finding that the

[20] The CRB Judges intentionally distinguish between the "reasonable" rate standard in the initial body of section 801(b)(1) and the objectives set forth as Factors A–D of section 801(b)(1). A rate can satisfy the statutory "reasonable rate" requirement yet require adjustment (higher or lower) to reflect the balancing of the four additional factors. Accordingly, the Judges defer to a subsequent section, *infra*, a discussion of how Factors A-D should be addressed on this remand.

15.1% royalty rate is "reasonable" was not identified by the D.C. Circuit as a finding that was vacated and subject to further review and, indeed, as noted *supra*, the appellate panel credited what it characterized as the Majority's careful analysis and line-drawing in arriving at that finding.

The clarity of the D.C. Circuit's affirmance of the royalty rate of 15.1% for the percent-of-revenue prong moots the issue of whether Professor Marx's attempt, described *supra*, to correct the so-called "imbalance" problem has merit. However, the Judges note that, even if this issue had not been conclusively decided in *Johnson*, they would reject her approach as futile. That is, Professor Marx fails to acknowledge that any surplus that her approach would appear to provide to the Services would be siphoned off by the Majors, given their complementary oligopoly power.

More particularly, the sound recording royalty rates she posits ([redacted]%, [redacted]% and [redacted]%) are all functions of the sound recording companies' understanding of the Services' non-content costs (costs that the Services must recover out of retained revenues in order to remain in operation, *i.e.*, to "survive") and the then-existing musical works content (royalty) costs (comprised of the mechanical rate and the performance rate). If, as Professor Marx contemplates, the mechanical rate is reduced so that Copyright Owners "share the burden" of the complementary oligopoly effect on sound recording rates, that "burden sharing" would increase the revenues retained by the Services (that is the purpose of Professor Marx's approach!). But such an increase would raise the Services' revenue above their "survival" rate, as understood by the record labels. Thus, the record labels, given their complementary oligopoly power, would increase the Services' royalty rate above what it otherwise would have been.

Alternately stated, when Professor Marx hypothesizes a given sound recording royalty rate in column 1 of Figure 8 in her WDRT, that rate is assumed, by the logic of the complementary oligopoly theory, to have already allowed the services to cover only their non-content costs and musical works royalties, as understood by the record labels. So, her assumed rate in column 1 is not a fixed parameter, but rather an independent variable, which is a function of, *inter alia*, the costs incurred by the services, *i.e.*, their non-content costs plus their musical works royalty costs.[21] If those service costs decreased (for example, in an attempt to reduce the services' burden of bearing the full brunt of the labels' complementary oligopoly power as in Professor Marx's attempt to correct the imbalance problem), the percentage in column 1 of Figure 8 would increase, as the labels siphoned off that surplus over the services' survival revenue requirements. To find otherwise would be to refute the logic of the dynamics of the complementary oligopoly effect.[22]

Moreover, the defect in Professor Marx's attempt to remedy the so-called "imbalance" problem is a consequence of the statutory licensing and royalty scheme. To recap, the licensing of content used by the interactive services is bifurcated. The sound recording royalties paid by

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[21] The interactive services also pay a separate royalty for the performance license necessary to transmit a song. However, under the Judges' "All-In" royalty structure, that performance royalty is deducted from the "All-In" calculation to determine the mechanical royalty. Also, the performance royalty paid to the largest Performing Rights Organization (PROs) are subject to determination by federal judges in the Southern District of New York (the so-called "rate court").

[22] To be clear, the Judges are not stating that the Services' retention of only enough revenue to allow them to cover their noncontent costs and thus merely "survive" is indicia of an effectively competitive (or even healthy) market – but are merely acknowledging the state of affairs given the unregulated nature of the sound recording royalties and the complementary oligopoly power that exists in that market.

the interactive services to the record labels are not regulated, and complementary oligopoly power exists in that market, inflating sound recording royalty rates above an effectively competitive level. *See* Determination at 73 ("[T]he existence of complementary oligopoly conditions in the market for sound recordings" is the basis for "the record companies' ability to obtain most of the available surplus" generated by interactive streaming.)[23] However (and to state the obvious), the mechanical rate paid by the interactive services for musical works is regulated, pursuant to 17 U.S.C. § 115 and, until the 2018 enactment of the Music Modernization Act,[24] according to the rate standards in 17 U.S.C. § 801(b)(1). Thus, there is no statutory or regulatory impediment to prevent record labels from responding to a decrease in the mechanical rate by increasing the unregulated sound recording rate if such an increase is in their economic interest.[25]

Accordingly, any attempt by the Judges to reduce the mechanical royalty rate in order to allow the Services to retain more of the surplus would fail; it would be like pouring water into a bucket with a siphon at its base. More water would not remain in the bucket, but rather would accumulate wherever the siphon leads—in this case, to the record labels. The Judges could keep mechanical royalty rates depressed and allow this to occur, but that would harm Copyright Owners while providing no relief to the Services. And despite the old adage that "misery loves company," the Judges detect no directive under section 801(b)(1) that they harm Copyright Owners without providing a gain for the interactive streaming services—and that they provide a windfall for the record labels, to boot.

Although Professor Marx's attempt to reduce the Services' "misery" by sharing it with Copyright Owners is unavailing, the statutory scheme and market forces do appear to combine to mitigate the burden created by the complementary oligopoly power of the sound recording companies. If interactive streaming revenue were to grow over the rate period,[26] then the phase-in to the 15.1% rate will reflect fixed annual percentages of a larger base, allowing services to retain a higher dollar level of the interactive streaming revenues.[27] [redacted]

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[23] As the Judges have consistently noted, this complementary oligopoly power is generated by the concentration of ownership of sound recording licenses for "Must Have" repertoires among the three Majors (Sony Music Group, Warner Music Group and Universal Music Group), plus Merlin (a consortium of Indies sometimes referred to as "the fourth Major"), as indicated by their reported collective 85% share of Spotify's streams in 2018, the first year of the rate period at issue here. *See* https://www.midiaresearch.com/blog/smaller-independents-and-artists-direct-grew-fastest-in-2020

[24] In subsequent rate periods, the rate remains regulated, but is subject to a different standard – the "willing buyer-willing seller marketplace standard," for shorthand) under 17 U.S.C. § 115.

[25] The inverse relationship between changes in the mechanical royalty rate and changes in the sound recording royalty rate has been characterized as the "seesaw" effect, which is discussed in further detail infra, with regard to the uncapped TCC rate prong.

[26] Because this proceeding was appealed and remanded, the Judges have the benefit of knowing the "future" (beyond 2017), during which U.S. interactive streaming revenues have continued to grow, a fact that is undisputed, and as to which the Judges take administrative notice. *See, e.g.*, RIAA 2018 Year-End Music Industry Revenue Report (available at https://www.riaa.com/wp-content/uploads/2019/02/RIAA-2018-Year-End-Music-Industry-Revenue-Report.pdf; RIAA 2020 Year-End Music Industry Revenue Report (available at https://www.riaa.com/wp-content/uploads/2021/02/2020-Year-End-Music-Industry-Revenue-Report.pdf (interactive streaming revenue increased within this rate period from (approximately) $1.6 billion in 2018 to $7.7 billion in 2019 and $8.8 billion in 2020).

[27] For example, if a royalty is set at a flat rate of 15.1% when a revenue base is $1,000, then the royalty is $151, leaving $849 in revenues to cover other costs which, for this example, are held constant. If the revenue base doubles to $2,000, the same flat 15.1% royalty rate generates $302 in royalties, leaving $1,698 in revenues to cover other costs which, if constant, allow for the additional revenue ($1,698 - $849 = $849) to generate profits.

[redacted] *See, e.g.*, Diab WDRT ¶¶ 10-11 (Google agreements); Mirchandani WDRT ¶¶ 16-17 (Amazon agreements); Bonavia WDRT ¶¶ 8; 14-19 (Spotify agreements); White WDRT ¶¶ 6; 8-14; 19; 24; 27-28 (Pandora agreements). Additionally, the Services' headline sound recording rates [redacted]. *Services' Joint Remand Reply Br*ief at 40 (and record citations therein). Thus, assuming no increase in non-content costs (or increases smaller than the increases in streaming revenue), the Services will realize increased revenue above and beyond what they needed to survive.

The Services and Copyright Owners recognize the mitigation of harm to the Services generated by these facts (although they may well disagree with the Judges' application of these facts). During colloquy with counsel for Pandora and Spotify during closing arguments on remand, the Judges asked why they should in essence apply the "misery loves company" adage:

> [JUDGE STRICKLER] [T]he problem is … the sound recording [rates] are unregulated in the interactive market …. Congress did not want that to be controlled at all. So every time I see … the services' argument about how we have [to] set a rate that's fair even though there's this ability of the sound recording [companies] to take more, my margin note is always this: "Are they arguing that 'misery loves company?'" [W]hy shouldn't that misery be shared with Copyright Owners? … Isn't that really Professor Marx's argument in her proposed split … using the 15.1 percent figure …?
>
> [COUNSEL] [Regarding] Judge Strickler['s] … "misery loves company" issue. … I think … the way [Judge Strickler] put it during the trial was, even if I thought rates needed to come down, how would that help you; wouldn't the labels just take all that surplus for themselves based on their complementary oligopoly power? …. I want[] to address it right off the bat …. in open session.
>
> Relat[ed] to … the seesaw … our point is that *these label rates* are *sticky* in both directions. If you see an increase in musical works rates, *you do not see a quick decrease in label rates, and the opposite is true. These rates are sticky*.
>
> . . .
>
> *There's a lot of friction with respect to the ability of label rates to change quickly* in response to the dynamic marketplace or the dynamic for business reasons or because of regulatory changes in musical works rate. *These are multi-year contracts. They take a long time to negotiate.* They are complex, *et cetera*.
>
> *So, I do think it's right that at a minimum you can buy time where the ratio is more aligned with the 801(b) factors. In other words, you don't have to worry that the labels will take it all right away, even if you believe they will ultimately take that.*
>
> [JUDGE STRICKLER] *So you are saying we have something that reduces misery for a period of time until the misery returns?*
>
> [COUNSEL] *That's right*. And I think that would have been true in 2018 when you were sitting drafting the decision. *It's even more true today in 2022 when the label rates, as I mentioned, are effectively set, bought and paid for.*

3/8/22 Tr. 29-30, 43-46 (Closing Argument) (emphasis added).

Similarly, on this topic, Copyright Owners' counsel accurately characterized the Judges' adoption of the static 15.1% Shapley-based rate as the inevitable consequence of "regulatory lag," that requires a regulator to keep a rate constant over the statutory term because there is no sufficient data to project future rates. *Id.* at 273-75; *see generally* A. Kahn, 2 *The Economics of Regulation* at 48 (1971) "The regulatory lag [is] the inevitable delay that regulation imposes in the downward … [and] upward adjustments" to rate levels, and "thus is to be regarded not as a deplorable imperfection of regulation but as a positive advantage [because] companies can for a time keep the higher profits they reap from a superior performance….").[28]

4. Consideration of Factors A-D in Section 801(b)(1)

Finally, the Judges consider the impact of Factors A-D of section 801(b)(1) in connection with the setting of the revenue percentage rate of 15.1%.[29] Regarding Factor A, it cannot be gainsaid that the D.C. Circuit has left this issue unresolved. Rather, *Johnson* unambiguously affirmed the Majority's finding that an increase in the mechanical royalty rate was warranted. Specifically, *Johnson* states that the Majority's decision in this regard met the "test" that it be "supported by substantial evidence [and] reflect a reasonable reading of the record." *Johnson*, *supra*, at 388. Moreover, with regard to the level of the increase, the D.C. Circuit did not disturb the finding by the Majority that "[t]he rates determined by the Judges represent a 44% increase over the current headline rate, and thus satisfies the Factor A objective …." Determination at 85.[30]

With regard to Factors B and C,[31] even if *Johnson* were construed as permitting the Judges to revisit this issue, they would not adjust the 15.1% revenue rate on the basis of these

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[28] The Judges emphasize two points that mitigate any negative impact on Copyright Owners from the static nature of the 15.1% revenue rate. First, as a percent-of-revenue rate, it generates more royalty revenue in a growing market, so the quantum of revenue is not static. Second, Copyright Owners' own economic expert witness, Professor Gans, testified that the data in the "market observations" from the Goldman Sachs Report on which he relied were the result of "negotiated rates in the free market and thus "presumed to … fully consider[] ... expectations of future costs and revenues …. incorporate[ing] expectations of future values." Gans WRT ¶¶ 37-38. On this issue, it is noteworthy that both the Majority and the D.C. Circuit credited Professor Gans's reliance on these projections. *See* Determination at 70 ("The Judges … find Professor Gans' reliance on financial analysts' projections for the respective industries to be reasonable."); *Johnson*, 969 F.3d at 386 (holding that "[t]he CRB Judges' finding that Gans's … reliance on Goldman Sachs' profit projections" was "reasonable" and the] … type of line-drawing and reasoned weighing of the evidence [that] falls squarely within the [Copyright Royalty Board's] wheelhouse as an expert administrative agency.")

Thus, dynamic changes going forward in the rate term are embodied in the 15.1% revenue rate, and dynamic market expectations are incorporated in the modeling data used to establish that rate.

[29] The D.C. Circuit ruled, with regard to the "*nature of the rate structure*," that because it had "vacat[ed] and remand[ed] … for lack of notice" "[t]he question whether the [Judges] adequately addressed factors B through D is bound up with the [Judges'] analysis of sound recording rightsholders' likely responses to the new rate structure." *Johnson*, *supra,* at 389. However, the 15.1% revenue rate, viewed separately, is not bound up in the "rate structure" issue, which relates to the uncapped TCC prong and how the 15.1% revenue rate may be "intertwined" with that second rate prong. As explained *infra*, the Judges are not adopting an uncapped TCC rate prong, so the 15.1% rate is no longer "bound up" with the vacated and remanded "rate structure" issue, making moot the argument that a new post-remand analysis of Factors B through D is necessary or appropriate. However, on remand, Copyright Owners have placed in issue the "disruption" element of Factor D, claiming that the Services have not proven that the uncapped TCC rates and rate prong have or will cause disruption.

[30] The 44% figure cited by the Majority reflects the percentage increase of the headline rate, from 10.5% to 15.1%.

[31] Factors B and C are typically considered jointly, because of the overlap in the objectives of providing a "fair return" and a "fair income" to the licensors and licensees respectively (the Factor B objectives) and reflecting their relative roles in making the streamed music available to the public (the Factor C objectives). *See Johnson*, 969 at 388 (noting without criticism the joint consideration of Factors B and C; Determination at 85-86 (noting without criticism the several experts' joint consideration of Factors B and C).

two factors. In this regard, the Judges note that the Majority found that the 15.1% revenue rate was not only "reasonable," but also a "*fair* allocation of revenue between copyright owners and services." Determination at 87 (emphasis added). The Majority thus found explicitly that "with regard to Factors B and C … there is no basis to depart from [its] determination of the reasonable … rate structure and rates as set forth *supra*." *Id.* More particularly, the Majority calculated the 15.1% rate by utilizing the total royalty percentage revenue of only [redacted]% as calculated by Spotify's economic expert witness, Professor Marx, whose economic modeling intentionally reflected a conception of fairness by reducing the effect of the labels' complementary oligopoly market power. *See* Determination at 67-68 (noting that Professor Marx testified that this aspect of her model "represents a *fair outcome* in the absence of market power [and] … eliminates … market power" which … if left in the economic analysis would "render[] … the analysis incompatible with the objectives of *Factors B and C* of section 801(b)(1).)") (emphasis added).[32]

Accordingly, the Judges find it would be substantively unwarranted to engage in any new consideration on remand of the impact, if any, of Factors B and C on the otherwise reasonable 15.1% revenue rate.[33]

The final itemized statutory factor – Factor (D) – instructs the Judges to consider the "competing priority" of "minimiz[ing] any disruptive impact on the structure of the industries involved and on generally prevailing industry practices." 17 U.S.C. § 801(b)(1)(D). As with Factors B and C, even if Johnson were construed to allow the Judges to revisit this issue on remand with respect to the 15.1% revenue rate, the Judges would not change the Majority analysis or findings. In the Determination, the Judges adopted the following interpretation of this standard set forth in previous determinations:

> [T]he Judges reiterated their understanding of Factor D, concluding that a rate would need adjustment under Factor D if that rate directly produces an adverse impact that is substantial, immediate and irreversible in the short-run because there is insufficient time for either [party] to adequately adapt to the changed circumstance produced by the rate change and, as a consequence, such adverse impacts threaten the viability of the music delivery service currently offered to consumers under this license.

Determination at 86 (emphasis added).

Also, in order to minimize any economic disturbance to the Services' businesses, the Majority decided to phase-in the 15.1% rate over the five- year rate term, setting annual percent-

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[32] Additional facts support the Majority's finding that the 15.1% revenue rate is fair. The record evidence indicates that the headline percent-of-revenue sound recording rate was between approximately [redacted]% to [redacted]% in 2017. *See* Marx WDRT ¶ 58,fig 7. When the 15.1% mechanical rate is added to that rate range, the range of the total royalty obligation (based on headline rates) is [redacted]% to [redacted]%. (Plus, given the phase-in of the rates expressly to avoid disruption, the total royalty obligation would be even lower before 2022, at current sound recording rates.) The evidence pre-remand indicated that the Services were "surviving" while incurring noncontent costs of approximately [redacted]% of revenue, leaving about [redacted]% of revenue available to pay royalties while still remaining in business. *See* Eisenach WRT ¶ 79 (Copyright Owners' expert economic witness); McCarthy WDT ¶¶ 28-29 (Spotify's Chief Financial Officer). Thus, even if the Judges were to engage in a *de novo* analysis of the potential applicability of Factors B and C to the 15.1% rate, they would not find any basis sufficient to warrant a downward rate adjustment, beyond the phase-in adopted in the Determination.

[33] However, the Judges take note of their further observation, discussed *supra*, that the combined impact of "sticky" sound recording royalty rates and the inevitable regulatory lag provide an additional modicum of fairness with regard to the mechanical royalty rate.

of-revenue rates as follows: 11.4% in 2018; 12.3% in 2019; 13.3% in 2020; and 14.2% in 2021, before the full 15.1% rate became effective in 2022 the final year of the rate term. *Id*. at 87-88.

On remand, the Services have not made any argument that the rate structure or rates set by the Majority were "disruptive under this standard."[34] In sum, there is insufficient basis for the Judges to change the Majority's application of Factor (D) to the 15.1% revenue rate finding by the Majority.[35]

5. Conclusion Regarding the 15.1% Revenue Rate

For the forging reasons, the Judges do not disturb the Majority's finding that the percent-of-revenue rate at 15.1%, phased-in annually over the rate period, constitutes a "reasonable" rate under section 801(b)(1) to be used as the statutory rate for the 2018 to 2022 period.[36]

D. Uncapped TCC Rate Prong

1. Two Post-Remand Rationales for Uncapped TCC Rate Prong

The Determination set forth the following two primary reasons for adopting a "greater-of" rate structure that also included an uncapped TCC rate prong:

> First, the use of an uncapped TCC metric is the most direct means of implementing a key finding … by the experts for participants on both sides in this proceeding: the ratio of sound recording royalties to musical works royalties should be lower

[34] The Judges further discuss the Factor D "disruption issue *infra* in connection with their analysis of the uncapped TCC prong.

[35] Additional facts further support the Majority's finding that the 15.1% revenue rate is would not be disruptive under Factor D. The record evidence indicates that the headline percent-of-revenue sound recording rate was between approximately [redacted]% to [redacted]% in 2017. *See* Marx WDRT ¶¶ 14, 19. When the 15.1% mechanical rate is added to that rate range, the range of the total royalty obligation (based on headline rates) is [redacted]% to [redacted]%. (Plus, given the phase-in of the rates expressly to avoid disruption, the total royalty obligation would be even lower before 2022, at current sound recording rates.) The evidence pre-remand indicated that the Services were "surviving" while incurring noncontent costs of approximately [redacted]% of revenue, leaving about [redacted]% of revenue available to pay royalties while still remaining in business. *See* Eisenach WRT ¶ 79 (Copyright Owners' expert economic witness); McCarthy WDT ¶¶ 28-29 (Spotify's Chief Financial Officer). Thus, even if the Judges were to engage on remand in a *de novo* analysis of the potential applicability of Factor D to the 15.1% rate, they would not find any disruption sufficient to warrant a downward rate adjustment, beyond the phase-in adopted in the Determination.

[36] The Services' assert that the Judges previously found that the reasonableness of the 15.1% rate was subject to revision on remand. In support of this position, the Services cite to the Judges' Order Granting in Part and Denying in Part Copyright Owners' Motion for Reconsideration or, in the Alternative, Clarification at 3, 4 n.7 (January 6, 2022) (Jan. 6th Order). But the Judges said in that interlocutory proposal merely that Copyright Owners were incorrect in their extreme assertion that the Judges could not make an "alternative rate and rate structure finding … except for the re-adoption of the vacated rate and rate structure approach in the *Phonorecords III Determination* [because] … [t]hat … would … be inconsistent with *Johnson* [and] … would render the D.C. Circuit's vacating and remanding of the proceeding without force or effect." *Id.* at 4, n.7. That did not mean that certain elements of the D.C. Circuit's ruling could be ignored. Further, when the Judges provided the parties with the Judges' *explicitly tentative* "Working Proposal," they did not declare that the 15.1% revenue rate calculation could be revisited. Rather, the Judges "express[ed] a *concern*, not that the foregoing calculations could be *overridden*, but rather that this analysis … is '*incomplete*' …." Jan. 6th Order at 6 (emphasis added). The parties' submissions in response to the Judges' "Working Proposal" demonstrated that the 15.1% revenue rate calculation was not "incomplete" in the manner that had raised the Judges' concern. Nothing the Judges said in this interlocutory and tentative "Working Proposal" constituted a definitive statement regarding the Judges' view of what was and was not subject to review on remand. *See generally merriam-webster.com (defining the adjective "working" in this context as "*assumed or adopted to permit or facilitate further work or activity … a working draft."). Indeed, a primary purpose of the "Working Proposal" was to allow the Judges and the parties to address potential issues and resolutions, without prejudice going forward.

> than it is under the current rate structure. Incorporating an uncapped TCC metric into the rate structure permits the Judges to influence that ratio directly.
>
> Second, an uncapped TCC rate prong effectively imports into the rate structure the protections that record companies have negotiated with services to avoid the diminution of revenue.

Determination at 35-36.[37]

2. Copyright Owners' Position

Copyright Owners claim that the uncapped TCC prong should be adopted. They contend that the D.C. Circuit remand was merely "procedural" rather than substantive, and the Judges thus are not precluded from readopting the uncapped TCC prong in this remand proceeding. CO Initial Submission at 35-38 (and record citations therein).

They further contend that the uncapped TCC prong was adopted to provide protection against revenue deferment and displacement occasioned by the Services choosing to elevate the growth of subscribers and other listeners over revenue maximization. *Id.* at 38-43 (and record citations therein). The uncapped TCC prong was first proposed by Google to persuade the Judges to reject Copyright Owners' proposed "greater-of" rate structure containing a per-play prong and a per subscriber prong. *Id.* at 43-46 (and record citations therein).

Copyright Owners argue that the uncapped TCC prong should be adopted because: (1) the Services have not shown any actual or threatened "disruption" or other harm resulting from the uncapped TCC prong during the 33-month period; (2) the Services actually experienced "unprecedented growth and profit" during this period; and (3) the Services paid lower percentages of revenues in mechanical and total royalties when the uncapped TCC prong was in effect. Copyright Owners' Reply Brief on Remand at 34-48 (and record citations therein).

Relatedly, according to Copyright Owners the Services' argument that the "see-saw" effect is unsupported by empirical evidence has collapsed, given the evidence relating to market performance. Further Copyright Owners maintain that this argument is irrelevant to the rate structure issue. *Id.* at 48-50 (and record citations therein).

3. Services' Position

The Services argue on remand that the uncapped TCC rate prong must be rejected. The Services reject the "seesaw" theory claiming it is disproved by the experience of the parties during the 33-month period. Services' Joint Opening Brief at 48-49; Services' Joint Supplemental Brief at 7-13 (Nov. 15, 2021) (and record citations therein). The Services further contend that Copyright Owners have disavowed the "seesaw" theory as understood by the

[37] The Majority added two other reasons that are not germane to this remand. In particular, the Majority stated that, compared to the *Phonorecords II* benchmark proposed by the Services, the "greater-of" structure with the uncapped TCC rate prong was "simpler" to understand than the "Rube Goldberg-esque" nature of the *Phonorecords II* rate structure. *Id.* at 36. This issue apparently was not raised on appeal, as it was not mentioned in *Johnson*, and Copyright Owners have not raised the issue on remand. *See* CO Initial Submission, *supra*. (However, the Judges do consider this issue in their analysis of the PR II-based benchmark*, infra*.) The final reason provided by the Majority was that its adoption of an uncapped TCC rate prong was supported by evidence of Google's agreements with labels that included an uncapped rate structure, on which Google had relied to propose, post-hearing, the same greater-of rate structure. *Id*. However, the D.C. Circuit found that Google's proposal was distinguishable, as it was based on a far lower TCC rate (15%) as well as a far lower percent-of-revenue rate (10.5%). The D.C. Circuit thus declined to rely on the Google-based approach as support for the uncapped TCC rate prong. *Johnson*, 969 F.3d at 383.

Majority. The Services allege that Copyright Owners now claim that the theory was nothing more than "a nod" to certain "core principles" of bargaining theory, rather than a specific prediction of a commensurate inverse relationship between increases in the mechanical royalty rate and decreases in the sound recording royalty rate. Services' Joint Supplemental Brief at 2, 5-7 (and record citations therein).

With regard to the uncapped TCC rate prong, the Services assert that Copyright Owners have not even attempted to demonstrate—nor could they demonstrate—that the uncapped TCC rate prong is consistent with all four statutory objectives set forth in section 801(b)(1). Services' Joint Reply Brief at 1, 3-4, 33-34 36 (July 2, 2021) ("Services' Reply"); *see also* Services' Joint Opening Brief at 44-64 (and record citations therein). The Services claim that "yoking" the mechanical rate to the "complementary oligopoly rates extracted by the labels is plainly unreasonable." Services' Joint Opening Brief at 44-46. The Services argue that the existence, *vel non*, of any "disruptive impact" arising from the uncapped TCC rate prong, is misguided and not dispositive, because it is only one of the four separately itemized factors and, as this factor relates to Copyright Owners' proposed uncapped TCC prong, they bear the burden of proof. Services' Reply at 35-37.

Finally, the Services contend that Copyright Owners have failed to explain their self-contradictory pre-remand argument that "an uncapped TCC prong 'does nothing to protect Copyright Owners from the Services' revenue displacement and deferment.'" Services' Reply at 43.

4. Application of *Johnson* Findings Regarding Uncapped TCC Rate Prong

The Judges conclude that the D.C. Circuit affirmed the Majority's *derivation and calculation* of the 26.1% TCC rate, but vacated and remanded the Judges' *application and inclusion* of that rate prong in the rate structure. The D.C. Circuit noted that, on appeal, the Services contended that "it was arbitrary and capricious for the [Judges] to rely on information drawn from different expert analyses in calculating the mechanical royalty rates." *Johnson*, 969 F.3d at 384. Thus, the Services were making the same "information"-based argument in opposition to the calculation of both aspects of the mechanical royalty rates – the revenue percentage prong and the TCC prong. *See also id.* ("the Streaming Services separately leveled objections to the particular percentages adopted by the Copyright Royalty Board to calculate the revenue *and total content cost prongs*.") (emphasis added)

In fact, both rate prongs were indeed derived from the same analyses. *See* Determination at 75 (table) (showing that both 15.1% revenue rate and 26.2% TCC rate derived from same data—Professor Marx's model showing total royalties as high as [redacted]% [Majority's lower bound] and Professor Gans's "Shapley-inspired" model showing TCC percent should be [redacted]%.)[38]

It is also clear from *Johnson* that the D.C. Circuit found that the Majority had reasonably derived and calculated the 26.2% TCC rate:

> When it came to … the ratio of sound recording to musical work royalties that Gans derived from his analysis the [CRB Judges] specifically found … reasonable Gans' equal value assumption [for dividing the Shapley surplus … between sound recording and musical works owners] and his reliance on Goldman Sachs' profit

[38] The reciprocal of Professor Gans's [redacted] ratio of sound recording:musical works royalties is [redacted], or [redacted]%.

> projections. *That type of line-drawing and reasoned weighing of the evidence falls squarely within the Board's wheelhouse as an expert administrative agency.*

*See Johnso*n, 969 F.3d at 385-86 (cleaned up) (emphasis added). Accordingly, because the identical analysis was performed by the Judges to derive the 26.2% TCC rate as was done to derive the 15.1% revenue rate, the Majority's finding with regard to the *derivation and calculation* of the TCC rate likewise is not subject to further consideration on remand by the Judges.

However, it is equally clear that the D.C. Circuit *vacated* and remanded the Majority's *application and inclusion* of *the 26.2% TCC rate* in a separate "greater-of" TCC prong. The defect that generated the vacating on this issue was *procedural*— "the Streaming Services had no notice that they needed to defend against and create a record addressing such a significant, and significantly adverse, overhaul of the mechanical license royalty scheme…." *Id.* at 382. The consequence of the D.C. Circuit's action, however, was *substantive*. The D.C. Circuit stated:

> This is no mere formality. Interested parties' ability to provide evidence and argument bearing on the essential components and contours of the [Judges'] ultimate decision not only protects the parties' interests, it also helps ensure that the [Judges'] ultimate decision is well-reasoned and grounded in substantial evidence.
>
> . . .
>
> The Streaming Services separately challenge the uncapped rate structure as *arbitrary* and *capricious*. In particular, they argue that the rate structure formulated by the [Judges] failed to account for the sound recordings rightsholders' market power. They also object that the [Judges] failed to provide a 'satisfactory explanation, or root in substantial evidence, [their] conclusion that an increase in mechanical license royalties would lead to a decrease in sound recording royalties [the "inverse relationship" a/k/a the "seesaw" effect].

Id. at 381-83 (cleaned up) (emphasis added). Thus, the D.C Circuit explicitly declined to address these substantive issues, because of the deficient procedure. Instead, the D.C. Circuit remanded these substantive issues back to the Judges. *Id.* Simply put, *Johnson* found that the absence of notice here could be outcome-determinative. Thus, the Judges categorically reject Copyright Owners' assertion that the remand as to the uncapped TCC rate structure was merely "procedural." The Judges do not accept the notion that the Majority simply committed some ministerial *faux pas* that could be summarily corrected so that the uncapped TCC rate structure could be rubber-stamped on remand. Rather, the Judges' error rendered it impossible for them to consider the pros and cons of such a rate structure without the necessary input from the Services (and, for that matter, Copyright Owners as well).

Because the procedural infirmity precluded the D.C. Circuit from deciding whether the Majority's decision was "well-reasoned and grounded in substantial evidence," there also can be no substantive presumption of the appropriateness of the uncapped TCC rate prong, as suggested by Copyright Owners. To the contrary, the D.C. Circuit's opinion makes it clear that on remand the Judges must engage in a fresh consideration of the statutory appropriateness, *vel non*, of the uncapped TCC rate prong, by weighing and contextualizing the *competing* evidence and testimony entered into the record both before and after the remand.

Accordingly, although Copyright Owners correctly assert that *Johnson* did not find the uncapped TCC rate structure to be "unfair, unreasonable or inequitable," *Johnson* just as clearly did *not* find that structure to be "fair, reasonable or equitable." Rather, the purpose of the remand was for the Judges to make these determinations. Accordingly, the Judges next examine whether setting the statutory mechanical rate as an uncapped TCC rate is "reasonable," as required by section 801(b)(1).[39]

5. Determining Whether Uncapped TCC Rate Prong is "Reasonable"

a. Rejection of First Rationale for Including Uncapped TCC Rate

Two substantive issues are implicated raised with regard to the issue of reasonableness: (1) whether the "seesaw" theory is valid; and (2) if it is valid, whether there exist sufficient data to support the phased-in 26.2% uncapped TCC rate.[40] To demonstrate that this uncapped TCC rate prong and the (phased-in) 26.2% rate are reasonable, Copyright Owners rely on the combined application of two economic models—the Shapley Value model and a Nash Bargaining Model. Accordingly, it is necessary to consider how these two models relate to each other and how these models and their interrelationship impact the setting of the statutory rate.

The D.C. Circuit described the Shapley Value Model methodology:

> The Shapley methodology is a game theory model that seeks to assign to each market player the average marginal value that the player contributes to the market. This methodology first determines the costs that each player should recover, then divides the "surplus" among the players in proportion to the value of their contributions to the worth of the hypothetical bargain that would be struck.

Johnson, 969 F.3d at 372. The Judges provided a consistent but more detailed definition:

> The Shapley value gives each player his average marginal contribution to the players that precede him, where averages are taken with respect to all potential orders of the players. The Shapley value approach models bargaining processes in a free market by considering all the ways each party to a bargain would add value by agreeing to the bargain and then assigns to each party their average contribution to the cooperative bargain. The idea of the Shapley value is that each party should pay according to its average contribution to cost or be paid according to its average contribution to value. It embodies a notion of fairness. The Shapley model is a game theory model that is ultimately designed to model the outcome in a hypothetical 'fair' market environment. It is closely aligned to bargaining models, when all bargainers are on an equal footing in the process.

Determination at 62-63 (cleaned up).

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[39] The Judges consider *infra* whether any of the four itemized statutory factors require an adjustment to this analysis.

[40] As noted *supr*a, in the Judges' recitation of the parties' remand arguments regarding the uncapped TCC rate prong, they make other arguments as well, specifically regarding: (1)) whether it would be necessary and/or appropriate to adopt this uncapped TCC rate prong to offset revenue deferral and/or displacement by the Services; (2) whether this rate prong has caused, or would cause, economic "disruption" to the Services (under Factor D of section 801(b)(1)); (3) whether the uncapped TCC rate prong would satisfy Factors B and C of section 801(b)(1); and (4) whether this rate prong improperly imports the complementary oligopoly power of sound recording licensors. The Judges consider these issues after addressing the issues relating to the "seesaw" theory.

To apply a Shapley Value Model in a rate proceeding, the economic modeler must obtain usable cost and revenue data to be inputted into the model. More particularly for this proceeding, the modeler must identify the parties' input costs, including the Services' non-content costs, and the revenue derived from interactive streaming.[41] The difference between these revenues and the Services' noncontent costs represents the Shapley "surplus" that can be shared among the Services, the sound recording companies and Copyright Owners.

(i) The Shapley Approach of the Parties' Economic Expert Witnesses

(a) Professor Gans's "Shapley-Inspired" Model

Professor Gans, Copyright Owners' expert, utilized royalty and profit interactive streaming data for record companies and music publishers that he obtained from "a [then] recent music industry equity analysis report," namely, a Goldman, Sachs Equity Research report dated October 4, 2016 entitled "Music in the Air, Stairway to Heaven." Gans WDT ¶ 76 & n.39. As the Majority summarized Professor Gans's approach, "[h]e found that, for the music publishers to recover their costs and achieve profits commensurate with those of the record companies under his approach, *the ratio of sound recording royalties to musical works royalties derived from his Shapley-inspired analysis was* [redacted] (which attributes equal profits to both classes of rights holders and acknowledges the higher costs incurred by record companies compared to music publishers)." Determination at 69 (citing Gans WDT ¶ 77 tbl.3) (emphasis added).

Regarding Professor Gans's Shapley-inspired analysis, the Majority stated:

> [T]he Judges find the *ratio* of sound recording to musical work royalties that Professor Gans derived from his analysis to be informative. Professor Gans computed this ratio based on an assumption of equal Shapley values between musical works and sound recording copyright owners. The Judges find this assumption to be reasonable ….[42]

Determination at 70. This is part and parcel of the "line-drawing" undertaken by the Majority that the D.C. Circuit affirmed. Thus, on remand, the Judges do not find cause to reconsider the Majority's limited adoption of Professor Gans's Shapley-inspired analysis.[43]

(b) Professor Marx's Shapley Value Model

Professor Marx constructed two Shapley Value Models, one of which was relied upon by the Majority. In the model credited by the Majority, Professor Marx assumed one collective owner of sound recording copyrights and one collective owner of musical works. She also assumed the presence of a single interactive service. *See* Determination at 64-68. That approach

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[41] Identifying useful data is a vexing problem. As one of Copyright Owners' expert economic witnesses, Professor Watt, has written: "[T]he main problem with the Shapley approach … a particularly pressing problem [is] that of data availability." R. Watt, *Fair Copyright Remuneration: The Case of Music Radio*, 7 Rev. Econ. Rsch Copyright. Issues at 21, 27 (2010).

[42] The assumption of equal Shapley values is based on the understanding that a sound recording license and a musical works license are both necessary (i.e., perfect complements) in order for a service to stream a song. Determination at 69 & n.122 therein.

[43] Because the ratio of sound recording to musical works royalties that Professor Gans derived from the data and other evidence was the only portion of his testimony on which the Majority relied, and because that reliance was affirmed by the D.C. Circuit, the criticisms of other aspects of Professor Gans's modeling are no longer relevant.

yielded a total royalty obligation for sound recordings and musical works ranging between [redacted]% and [redacted]% of the hypothetical service's revenue. Dissent at 133.

Copyright Owners criticized Professor Marx's decision to assume in her model only one interactive streaming service, rather than the multiple services that actually existed. They contend that assumption reduced the market power of the licensors in her model. According to Copyright Owners' economic experts, Professor Marx's approach was a misuse of the Shapley Value Model. They aver that the Shapley Value approach is intended only to eliminate from the rate derivation the bargaining ability of a "Must Have" input supplier (like the sound recording companies and Copyright Owners) to "hold-out" and thus squeeze licensees for higher royalties. By modeling every possible "arrival ordering," they contend, the "hold-out" problem is avoided. They further contend that Professor Marx misconstrued the purpose of the Shapley approach by wrongly modeling market participants in a manner that significantly reduced the actual market power of these "Must Have" input suppliers. Determination at 66-67.

The Majority agreed with Professor Marx. The two Judges in the Majority found that her modeling reasonably "attempts to eliminate a separate factor—market power—that she asserts renders a market-based Shapley Analysis incompatible with the objectives of Factors B and C of section 801(b)(1)." *Id.* at 68.

Although the Majority ultimately relied upon Professor Marx's modeling in this regard, the Majority found that her data inputs were problematic. Determination at 65. Specifically, Professor Marx relied on 2015 data from Warner/Chappell and Warner Music Group for music publisher sound recording company noncontent costs, respectively. The Majority found that 2015 data was less probative than 2016 data and understated the percentage of revenue to be paid to the two classes of content providers. However, the Majority ultimately found only that this one-year older data served to "understate" the allocation of surplus to the upstream content providers, and thus rejected only her lower [redacted]% bound for total royalties, The Majority did decide to adopt her upper bound of [redacted]% value for total royalties, which could (and ultimately did) "constitute a lower bound for total royalties in computing a royalty rate," applied by the Majority in order to make a downward adjustment to offset the complementary oligopoly effect of "Must Have" inputs. *Id.* at 73, 75.

(c) Professor Watt's Criticisms of and Adjustments to Professor Marx's Shapley Modeling

Professor Richard Watt was called by Copyright Owners as a rebuttal witness at the hearing, for the purpose of reviewing Professor Marx's WDT. Watt WRT ¶ 3. He concluded that Professor Marx's Shapley Value Model contains important methodological and data flaws which, in his opinion, caused her to significantly understate the mechanical and overall (musical works + sound recording) royalty rates to be paid by interactive services pursuant to a proper Shapley analysis. *Id.* at ¶ 5.

Professor Watt also criticized her Shapley Value Model for failing to incorporate the fact that "the different interactive streaming companies – Spotify, Apple Music, Rhapsody/Napster, Google Play Music, Amazon, etc. – do all compete (and rather fiercely) among themselves, offering (perhaps perfectly) substitutable services." *Id.* at ¶ 25. Even more strongly in this vein, Professor Watt relied on the following description of the substitutability of the streaming services, *inter se*:

> Each [interactive streaming] service in the increasingly crowded field is working frantically to overcome the perception that the main distinction among the uniformly priced $9.99 a month offering is little more than font style, quirky playlist title and color scheme. … [M]usic platforms have long fought against the perception that they're … selling a nearly interchangeable product … You're getting sold the same car [with] just got a different lick of paint on it.”).

Id. at ¶ 32 n.19.

Professor Watt claimed that incorporating this downstream competition into the model would reduce the Shapley values of the Services and increase the Shapley values for the input suppliers, by recognizing which players provide “essential inputs” and which are in competition with other suppliers of substitutable inputs. *Id.*

He further criticized Professor Marx for including in her model “other distributors” who are not interactive streaming services. *Id.* at ¶ 27. According to Professor Watt, these other distributors “do not belong in a properly constructed Shapley Value Model because their presence would “show up” in the model as lower revenues for interactive services as their subscribers or listeners left for these other distributors (such as noninteractive services). *Id.*

Additionally, because he criticized Professor Marx’s use of 2015 data (as noted *supra*), Professor Watt re-worked Professor Marx’s model by examining how the use of 2016 data, as opposed to her 2015 data, would “better reflect[] … the reality of the market. *Id.* at ¶ 37*; see also id.* at ¶ 44. When using the (higher) 2016 revenues (and making some relatively more minor adjustments he found necessary), Professor Watt estimated that the share of streaming revenues that would be paid out in total royalties (for musical works + sound recordings) in Professor Marx’s model would range from [redacted]% to [redacted]%. *Id.* at ¶¶ 50-52.[44]

After analyzing these Shapley analyses,[45] the Majority found that the mechanical royalty rate needed to be increased in order to provide Copyright Owners with a reasonable rate as required by section 801(b)(1). As a matter of arithmetic though, if the mechanical rate increased and the sound recording rate did not decrease by a corresponding amount, then the total royalties paid by the Services would increase. That issue brings the Judges to consideration of Professor Watt’s bargaining model, on which the Majority relied to posit an inverse relationship (the seesaw effect), by which an increase in the mechanical rate would result in a commensurate reduction in the sound recording rate.

(ii) Professor Watt’s Bargaining Model.

[44] As noted *supra*, when the Majority weighed and credited Professor Watt’s entire Shapley analysis, in which his estimate of total royalties was [redacted]%, those Judges contextualized Professor Marx’s [redacted]% total royalty calculation as the lower bound of a zone of reasonable rates, and applied it as a measure that, in their analysis, would offset the complementary oligopoly effect of real-world royalties. Determination at 75 (text and tbl.).

[45] Because his testimony was made in rebuttal, leaving the Services no procedural right to file written testimony in opposition, the Majority gave little weight to Professor Watt’s total royalty projections and no weight to his proffered ratios of sound recordings-to-musical works royalties. Determination at 75.

Professor Watt's Nash Bargaining Model is the linchpin that connects: (a) the higher mechanical royalty rates generated by the Shapley Value results relied upon by the Majority with (b) the assumed lower sound recording rates—a connection that the Majority found to render "reasonable" and "fair" its uncapped TCC prong. *See* Determination at 73-74 ("As to the issue of applying a TCC percentage to a sound recording royalty rate that is artificially high as a result of musical works rates being held artificially low through regulation, the Judges rely on Professor Watt's insight (demonstrated by his bargaining model) that sound recording royalty rates in the unregulated market will decline in response to an increase in the compulsory license rate for musical works."). Alternately stated, Professor Watt's bargaining model result, *i.e.*, the seesaw effect, if sufficiently supported in the record, is the phenomenon that would allow the Judges on remand to apply the Shapley results by increasing the mechanical rate, without unduly exposing the Services to the risk of higher total royalties.

More particularly, the Majority recognized a potential problem that those Judges would have to resolve before utilizing the Shapley Value approach to create an uncapped TCC prong: "This is problematic because the sound recording rate against which the TCC rate would be applied is inflated . . . both by … complementary oligopoly [market] conditions … and the record companies' ability to obtain most of the available surplus due to the music publishers' absence from the bargaining table." Determination at 73.[46] But the Majority found that Professor Watt had provided a rationale which permitted them to resolve the second problem:

> As to the issue of applying a TCC percentage to a sound recording royalty rate that is artificially high as a result of musical works rates being held artificially low through regulation, the Judges rely on Professor Watt's insight … that sound recording royalty rates in the unregulated market will decline in response to an increase in the compulsory license rate for musical works. 3/27/17 Tr. 3090 (Watt) ("[T]he reason why the sound recording rate is so very high is because the statutory rate is very low. And if you increase the statutory rate, the bargained sound recording rate will go down.").

Determination at 73-74; *see also* Watt WRT ¶ 23 n.13 ("[I]in my Appendix 3, I show that … if the musical works rate is increased to what would be a realistically fair and reasonable rate, then the negotiated fee for sound recordings would decrease almost dollar for dollar …."); *see also id.* at ¶ 36 ("The statutory rate for mechanical royalties … is significantly below the predicted fair rate, and the statutory rate effectively removes the musical works rightsholders from the bargaining table with the services. Since this leaves the sound recording rightsholders as the only remaining essential input, bargaining theory tells us that they will successfully obtain most of the available surplus.").[47]

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[46] The other problem the Majority needed to resolve was how to deflate the market-based sound recording royalty rates to mitigate the complementary oligopoly effect in those rates. *Id.* As discussed *supra*, the Judges resolved this problem by applying the low total royalty payment sum, [redacted]%, from Professor Marx's Shapley Value Model.

[47] In full detail, Professor Watt concluded:

> [F]or every dollar that the statutory rate for musical works undercuts a fair and reasonable rate, the freely negotiated rate for sound recordings will increase by an estimated [redacted] cents. That is, if the musical works rate is increased to what would be a realistically fair and reasonable rate, then the

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To repeat: *This inverse relationship is what has been described as the "seesaw" effect.* The question in this regard on remand is whether the record proves that the seesaw theory is valid and measurable going forward. Alternately stated, does the record prove that Professor Watt's bargaining model serves as the linchpin that would allow the Judges to apply the Shapley results by increasing the mechanical rate, without unduly exposing the Services to the risk of higher total royalties?

To resolve this issue, the Judges examine this bargaining model dispute in detail, as it bears on whether the uncapped TCC rate structure can be incorporated into the statutory rate.

(a) Bargaining Model Dispute

Professor Watt utilized a general Nash Bargaining Model.[48] In his particular application, Professor Watt modeled the streaming services and the labels each as a "single unit," asserting (as is common in Shapley analyses) that this single-unit modeling was done "for simplicity." Watt WRT, appx. 3 at 10. Applying this and other modeling assumptions, Professor Watt posited: "If there were to be no successful deal, then each of these two bargainers [the assumed "single" interactive service and "single" label] would earn 0, since in that case the interactive streaming service could not operate." *Id*.

In his *oral* testimony at the hearing, Professor Watt did not opine as to whether changes in variables *other than musical works royalties* would also have an impact on the level of sound recording royalty rates, even as higher musical works rates would otherwise place virtually 1:1 downward pressure on the sound recording rate. However, in his *written* rebuttal hearing testimony, *i.e.,* his WRT, Professor Watt *did* make varying assumptions regarding the changes in the Services' non-content costs, by which he did change the total revenue share for content providers. Watt WRT ¶¶ 50-52. He concluded from this varying replication of Professor Marx's Shapley model "*that the results that it delivers are very dependent upon the amount of total*

> negotiated fee for sound recordings would decrease almost dollar for dollar, with only a minor change in the total royalty rate for all copyrights combined.
>
> *Id.* at ¶ 23, n.13; see also *id*., appx. 3 at 12.

[48] The Nash Bargaining Model is one type of game-theoretic approach used by economists to model the distribution of "gains from trade" between two parties "in a manner that reflects 'fairly' the bargaining strength of the different agents. Marx WDRT ¶ 28 n.33 (citing A. Mas-Colell, M. Whinston, and J. Green, *Microeconomic Theory* 838 (1995)). To understand the parties' modeling dispute, it is necessary to appreciate the essential elements of the Nash Bargaining Model, as previously summarized by the Judges:

> In the Nash Framework three fundamental factors determine how two firms would "split a pie" in a hypothetical negotiation: … (1) the Joint Agreement Profits; (2) each firm's Threat Point [a/k/a "Disagreement Payoff" or "Disagreement Point"]; and (3) each firm's bargaining power. Joint Agreement Profits are the combined profits to both the upstream and downstream firms in the market under study from reaching an agreement. … The Threat Point [a/k/a "disagreement payoff"] for each firm is the profit it would receive when no agreement is reached. The difference between the Joint Agreement Profits and the sum of the firms' Threat Points is called the "Incremental Profits" which are the profits the firms could earn by reaching an agreement above and beyond the profits they could earn in the absence of an agreement. The profits each firm receives in a bargain equals its Threat Point plus its Bargaining Power times the Incremental Profits.

SDARS III Final Determination, 83 Fed. Reg. 65,210, 65,215 & n.32 therein (Dec. 19, 2018).

interactive streaming revenue and the fraction of that revenue that is taken up by downstream non-content costs." *Id.* at ¶ 53 (emphasis added).[49]

The Services had no procedural right under Part 351 of the Judges' regulations to proffer surrebuttal written testimony from economic witnesses to challenge Professor Watt's assertion, made for the first time in rebuttal, of the seesaw relationship between changes in the musical works royalty rate and the sound recording royalty rate paid by interactive services. Moreover, the Services and their economists also had no opportunity to weigh in on the Majority's application of same (which was not revealed until the Judges rendered their decision). *See Johnson*, 969 F.3d at 381 ("Streaming Services had no notice that they needed to defend against and create a record addressing such a significant, and significantly adverse, overhaul of the mechanical license royalty scheme.").[50] Now though, on this remand, the Services have been afforded the opportunity to present these criticisms, through their expert witnesses.

(b) Professor Katz's Principal Criticism

Pandora's economic expert, Professor Michael Katz, levied several criticisms of the bargaining model proffered by Professor Watt and applied by the Majority. The most important problem with Professor Watt's analysis, according to Professor Katz, is that the former's model assumes an "extremely unrealistic" *zero payoff* to the label in the absence of an agreement with a streaming service—an assumption which is "far from … innocuous." Written Direct Remand Testimony of Professor Michael Katz (Katz WDRT) ¶¶ 16, 20.

Professor Katz opines that this *zero payoff* assumption is equivalent to assuming, contrary to undisputed market facts, that: (1) subscribers and listeners to an interactive service would not switch to other interactive services if that service failed to reach an agreement with the labels; and (2) the interactive service is a "Must-Have" input supplier. Katz WDRT ¶¶ 17-18. In terms of Nash modeling, according to Professor Katz, Professor Watt's assumption is thus equivalent to "assum[ing] that the sound recording copyright owners have no *outside option*." Katz WDRT ¶ 127 (app. A) (emphasis added).

Moreover, not only does Professor Katz assert the indisputability that such substitution would occur, he points out that *Professor Watt himself* acknowledged in his own testimony that such substitution would occur. Katz WDRT ¶ 19.[51]

Beyond this purported inconsistency, Professor Katz finds Professor Watt's no-substitution assumption to be a serious *modeling* error because, in order to quantify accurately each Nash bargainer's contribution to the net surplus to be divided, the extent of substitutability on each side of the market must be captured by the modeling. Katz WDRT ¶ 20. That is, he

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[49] The Judges take note here of Professor Watt's presentment of alternative scenarios, because, as discussed *infra*, the Services and their economists accuse Professor Watt of changing his testimony, post-remand, by limiting the scenarios in which his "seesaw" argument would apply in order to salvage the credibility of his bargaining model.

[50] The Services could have sought leave to file surrebuttal testimony, and could have challenged the Majority's understanding of Professor Watt's testimony, after the Initial Determination, by filing a Motion for Rehearing pursuant to 37 C.F.R. § 353.1. However, a party is not required to engage in either of these procedural approaches, but rather may challenge the Determination on appeal, as has occurred here.

[51] The Judges have quoted Professor Watt's testimony in this regard *supra*.

opines that "Professor Watt's assumption that there is no substitution dramatically biases his model toward finding a large seesaw effect and renders his analysis unreliable … lead[ing]to a prediction that the share of an increase in musical works royalties that will fall on the streaming services is approximately *eight times* larger than Professor Watt's prediction. *Id.* at ¶ 21.

As a matter of music business dynamics, Professor Katz interprets Professor Watt's substitutability error as follows.

> The assumption that a label receives a zero payoff if it does not reach agreement with a streaming service is equivalent to assuming that, if a streaming service shut down, none of the consumers who would otherwise have used that streaming service will switch to alternative streaming services or other sources of licensed music. The two forms of the assumption are equivalent because, when the services are substitutes, failure to reach an agreement with one service will not drive a label's payoffs from interactive streaming to zero. It will not result in the loss of all of the benefits that could be enjoyed by reaching an agreement. Instead, many consumers would engage in substitution and choose other streaming services, which will allow the label to earn profits from the additional royalties that would be paid to it by those other services.

Id. at ¶ 18.

Professor Katz attempts to adjust Professor Watt's Nash Bargaining Model to account for this substitution effect. In his Appendix A, Professor Katz—acknowledging the reality of multiple interactive services—changes Professor Watt's assumed single label's payoff (designated as parameter "A" in the Nash Bargaining Model) from a value of zero to a value equal to "the share of revenues that would be diverted to other streaming services" multiplied by "the royalty rate that the label receives from the other interactive streaming services." *Id.* ¶¶ 119, 127. Professor Katz asserts that the diversion to other streaming services represents an "outside option" available to a label. *Id.* ¶ 127. Professor Katz incorporates this "outside option" in his revised version of Professor Watt's Nash Bargaining Model.

In addition, Professor Katz asserts that Professor Watt's modeling is unreliable because "his prediction of the size of the see-saw effect is very sensitive to the assumed values of various other parameters." *Id.* at ¶ 23. For example, Professor Katz asserts that a change in the royalty rate paid to the labels could materially affect the balance or even the existence of the seesaw effect. *Id.* at ¶ 127. As further support for his opinion, Professor Katz relies on the testimony of one of Copyright Owners' own economic expert witnesses, who gave testimony clearly indicating that the "seesaw" effect was not at all likely to occur. *Id.* ¶ 24, n.16 (citing Gans WRT ¶ 32).[52]

[52] In this regard, Professor Gans testified:

> When considering] the general distribution of profit when royalty rates for musical works rightsholders are increased[,] [i]n principle, those funds could come from a decrease in service profit, a decrease in sound recording royalties, or an increase in consumer pricing …. The general redistribution of profit in response to increased musical works royalties is fundamentally an empirical question ….

Gans WRT ¶ 32.

In sum, Professor Katz finds Professor Watt's Nash Bargaining Model to be unusable as a foundation to set royalty rates because, although "there are theoretical reasons to believe that a see-saw effect *may* occur, … there are complications and it is difficult to predict how big the effect will be." *Id.* ¶24 (emphasis added).

(c) Professor Watt's Rebuttal to Professor Katz

In rebuttal to Professor Katz's criticisms, Professor Watt states that "the record needs to be straight on Nash bargaining theory," in order to explain "the foundational error" committed by Professor Katz. Watt RWRT ¶ 52. This basic mistake, according to Professor Watt, is Professor Katz's erroneous assertion that the bargaining model must account for a label's "outside option." *Id.* ¶ 53. Relying on economic authority regarding bargaining theory, Professor Watt defines an "outside option" as "the best alternative that a player can command *if he withdraws unilaterally* from the bargaining process." *Id.* ¶ 59 (emphasis added); *see also id.* ¶ 53 ("An outside option is a payoff that the label would receive *if negotiations with the service do not result in an agreement*.") (emphasis added).[53]

Connecting this principle of bargaining theory to economic theory, Professor Watt explains his understanding of the relationship of the "outside option" to the more familiar economic concept of "opportunity cost":

> An outside option could also be referred to as an "opportunity cost," since it is the value of what would be foregone should a deal with the service actually be struck. It is … useful to recognize the equivalence between an outside option and an opportunity cost, because economics in general has a very long history of understanding how opportunity costs weigh in on economic decision making.

Id.

Professor Watt then opines how Professor Katz confused the "outside option" with the disagreement (a/k/a threat) point in the Nash Bargaining Model:

> [Professor] Katz claim[s] that the outside option value that the labels would enjoy should they not reach an agreement with the services should be included as part of the "disagreement point" within the bargaining model and reimbursed like a cost prior to bargaining. Doing this can dramatically alter the results of the model. It is also definitively not how such an option should be modelled. [Professor] Katz [is] guilty of misunderstanding the Nash bargaining model, and concretely, the meaning of a "disagreement point," and the way that an outside option should be brought into the model.

Id. ¶ 55.

[53] The phrase "outside option" suggests the existence of an "inside option." Indeed, a treatise cited by Professor Watt identifies the "inside option," defining it as "[t]he payoff the [bargainer] obtains while the parties *temporarily* disagree"—contrasting it with the "outside option" as (consistent with Professor Watt's testimony) "the payoff [the bargainer] obtains if she chooses to *permanently* stop bargaining, and chooses not to reach an agreement with [the counterparty]." A. Muthoo, *Bargaining Theory with Applications* at 137 (1999).

More particularly, according to Professor Watt, these outside options/opportunity costs do not belong in a Nash Bargaining Model, because they are "not the types of status quo actual financial payments that may be modelled as disagreement points." *Id.* ¶ 57. Rather, he asserts that, as Professor Katz essentially acknowledged, they are "payoffs from *substitution*, [*i.e.*,] an option *instead of* the deal, and they are not actual financial payments, but opportunity costs. *Id.*

Professor Watt then explains that an outside option/opportunity that by definition exists as an alternative to a bargain between two parties lies outside the two parties' bargain, and is thus out-of-place within a proper Nash Bargaining Model:

> In the case at hand, if the parties never stop negotiating and never take up substitute options, then no joint enterprise is offered and there is no surplus to share, so each necessarily gets a payoff equal to 0, just as I assumed in my model.
>
> . . .
>
> [A]gainst this backdrop, an outside option (a potential payoff that is not directly related to a share of the surplus that is being negotiated) … comes in [to the model] as a constraint upon the set of feasible deals that could be struck, exactly as an opportunity cost would be treated.

Id. ¶¶ 57-58.

(d) Dr. Leonard's Criticisms of Professor Watt's Bargaining Model

According to Google's economic expert witness, Dr. Gregory Leonard, the Majority wrongly relied on Professor Watt's bargaining model because it is "highly stylized" and theoretically "simplified" in ways that make it unable to predict that "an increase in the musical works royalty would be offset nearly dollar-for-dollar by a decrease in the sound recording royalties (the "seesaw effect"), thus leaving the services virtually unaffected by the proposed increase in musical works royalties." Leonard WDRT ¶ 8.

Pointedly, Dr. Leonard criticizes Professor Watt's bargaining model as comprised of a "veneer of 'complexity' … mathematical formulas and [a] reference to John Nash," adopted to provide a rationalization for adoption of his Shapley Value modeling that would significantly increase the mechanical royalty rate." *Id.* ¶ 16. These modeling deficiencies, Dr. Leonard asserts, are not merely "simplifying assumptions [that] better focus on the specific question the model is meant to address," but rather "simplify away economic characteristics … entirely abstract[ing] away economic characteristics … central to the question at hand." *Id.* ¶ 18.

In particular, Dr. Leonard avers that Professor Watt's bargaining model materially abstracts away from, *inter alia*: (1) the nature of consumer demand for streaming services and competing forms of music; (2) how services decide to enter or exit the streaming market; (3) the nature of the oligopolistic interaction among the labels; (4) the nature and timing of the bargaining between each label and each service; (5) the potential for "hold-up"[54] by labels that perceive the services to be in a vulnerable bargaining position due to their previous industry-specific investments made under their assumption that the pre-existing statutory structure would be maintained; and (6) the failure of Professor Watt's bargaining model to grapple with the complementary oligopoly structure of the sound recording market. *Id.* ¶¶ 18, 20.

These factors, he posited, are "important for determining how sound recording royalties would *actually* change in response to a change in the statutory musical works royalty." *Id.* Professor Leonard concludes that, by not modeling these factors, Professor Watt's "prediction of a virtual dollar for dollar decrease in sound recording royalties is unreliable as a basis for formulating policy." *Id.* ¶ 20.

Regarding the complementary oligopoly structure of the market and its impact on the bargaining process, Professor Leonard emphasizes that an important "real-world hurdle" assumed away by Professor Watt's modeling of a single label entity is that "each label would prefer to have the other labels lower their sound recording royalties while maintaining its own royalties at pre-existing levels …." *Id.* ¶ 21. More particularly, Dr. Leonard explains that "even if a label were to recognize that it is more efficient for overall sound recording royalties to be lower, the label may not be willing to lower its royalty rate without assurance that the other labels will do the same," a result which he asserts "is unlikely to happen absent some form of collusive behavior." *Id.* Thus, Dr. Leonard maintains that the existence and size of any "seesaw"-induced decrease in sound recording royalties remains indeterminate, and it remains "within the realm of theoretical possibility that the labels do not agree to *any* reduction in sound recording royalties even if a reduction in overall royalties would be economically efficient. *Id.*

(e) Professor Watt's Rebuttal to Dr. Leonard's Criticisms

Professor Watt replies with a spirited defense of economic modeling in general and his economic bargaining model in particular. He begins by pointing out that models are not supposed to be "perfect representations of reality [but rather] are intended to isolate what is important, in order to expose a useful insight on some issue of relevance." Watt RWRT ¶ 105. He adds that economic models (not merely his bargaining model) "*do not necessarily deliver predictions* of situations that are immune to changes in variables outside the model, but rather the results inform conclusions about the relationships between the variables and parameters within the model, [which is] by nature *a crude representation[] of reality*, but the lessons and insights that they provide can be very relevant to real-world applications." *Id.* ¶¶ 106-07 (emphasis added).

With particular regard to his bargaining model, Professor Watt takes issue with Dr. Leonard's assertion that in the former's model the surplus is a "fixed constant." *See* Watt RWRT ¶¶ 110-111. Rather, Professor Watt avers that his bargaining model assume[s] that when

[54] A hold-up problem occurs when: (1) parties to a future transaction must make specific investments prior to the transaction in order to prepare for it; and (2) the exact form of the optimal transaction (*e.g.,* how many units if any, what quality level, the time of delivery) cannot be specified with certainty *ex ante*. W. Rogerson, *Contractual Solutions to the Hold-Up Problem*, Rev. Econ. Stud. 777 (1992). Here, the interactive services may need to commit to paying for long-term investments, even though they cannot know the level of their largest costs (content royalties) beyond a single rate term.

the surplus … *whatever value it takes* … is to be shared, the parties understand that the amount to be shared is, *at that moment, given*." *Id.* ¶ 111 (emphasis added).

Turning to Dr. Leonard's critique regarding the purported distortionary effect of Professor Watt's modeling assumption of a single label and a single interactive service, Professor Watt responds by acknowledging that, if he had modeled multiple labels and services in the bargaining process, that would be "not particularly enlightening *vis-à-vis* the single bargain setting, as it will not lead to different insights than those distilled by the [Majority]." *Id.* ¶ 113.[55] Further, Professor Watt characterizes this criticism as "empty," because under either his two-player Nash model or Dr. Leonard's posited multi-player (Nash-in-Nash) model, the labels will not respond to a musical works royalty increase *ipso facto* with a reduction in the sound recording royalty (*i.e.*, the seesaw effect will not occur if there is "a change in some other variable."). *Id.* ¶ 114.

(f) Professor Marx's Criticisms of Professor Watt's Bargaining Model

Professor Marx criticizes Professor Watt's application of the Nash Bargaining Model because, in her opinion, its "precise prediction" of the nearly one-to-one seesaw relationship "depends critically on the assumptions that he makes and the numerical inputs that he uses." Marx WDRT ¶ 33. First, criticizing his modeling *assumptions*, like Professor Katz, she criticizes his decision to abstract from reality by positing a single label and a single interactive streaming service. She opines that his one label/one service modeling assumption ineluctably leads to his conclusion that each of these two parties "has a 'disagreement payoff' of zero [meaning that] each party ends up with nothing in the absence of a deal." *Id.* ¶ 34. But this zero "disagreement payoff" is merely a product of Professor Watt's abstraction from reality, according to Professor Marx, because "[i]n reality, if interactive streaming went away, a share of the music listening that had occurred through interactive streaming services would migrate to other forms of music distribution, generating revenues for the label … *meaning that the disagreement payoff would be positive for the label*). *Id.* (emphasis added).[56] Consistent with Professor Katz, she maintains that Professor Watt himself acknowledged the presence of this substitution effect when he testified that "[t]he existing interactive streaming companies do not hold an essential input, as first they compete with the non-interactive services. . .." *Id.* ¶ 35, n.43 (citing Watt WRT, app. 3).

More particularly, Professor Marx maintains, a record label's disagreement payoff must be considered realistically "in any accounting of what would happen if record labels and interactive streaming services failed to reach an Agreement …." Marx RWDT ¶ 35. And, she

[55] Professor Watt describes Dr. Leonard's multiple simultaneous negotiations in a bargaining model as a "Nash-in-Nash" model, but the former does not explain why he concludes that this approach "will not lead to different insights" than those the Majority distilled from his two-party Nash model.

[56] Professor Marx's reference to a substitution from a shutdown interactive service to "other forms of music distribution" is different from, but analytically analogous to, Professor Katz's assertion that the shutdown of any one interactive service would result in migration of its subscribers and other users to the remaining interactive services. These analogous critiques are complementary. *See* Marx WDRT ¶ 37 ("One would expect the same decrease in the estimated see-saw effect by including a second, competing interactive streaming service in the market instead of just the one that Professor Watt uses. In that case, if no deal is reached, users would migrate to an even closer substitute—a competing interactive streaming service—resulting in an even higher degree of profit migration and thus an even lower estimated see-saw effect").

opines, when this real-world substitution effect is taken into account, the seesaw effect that Professor Watt estimates is reduced dramatically, because "[t]he greater … the substitution between streaming and other forms of distribution, the greater is the revenue that the record label can capture in the event of disagreement and the lower is the estimated see-saw effect." *Id.*[57]

Professor Marx opines that modeling the bargaining process without these real-world particulars diminishes the value of Professor Watt's Nash model in several significant ways. First, because his model fails to incorporate the presence of three major record labels, "each with substantial complementary oligopoly power," it fails to capture the fact that "each record label does not fully internalize the impact of its rates on the viability of the industry." *Id.* ¶ 39. She points to the Judges' Final Determination in *Web IV*, where the Judges note how this aspect of complementary oligopoly compromises the value of a rate as a useful benchmark. *Id.* ¶ 39 n.45 (quoting *Web IV* Final Determination). More particularly, she opines that when, as here, "there are multiple negotiations between multiple record labels and multiple services," sound recording rates can be affected "by the order of negotiations" among the several label:service negotiating pairs—a factor that Professor Watt's bargaining model fails to capture. Marx WRDRT ¶ 41.

Next, Professor Marx avers that Professor Watt's bargaining model "does not explain how or over what time frame the market would move to a new equilibrium." *Id.* ¶ 40. More particularly, she testifies, because interactive services' "agreements with record labels often contain multi-year terms and can take many years to negotiate … there may be little incentive or practical ability for both sides to move to a new rate before the contract expires". *Id.* ¶ 41. She takes note that this point was established at the hearing during questioning of Professor Watt from the bench:

> JUDGE STRICKLER: What of the situation . . . that the . . . time period for the existing agreements between the … labels and the interactive streamers is such that they've already locked in a particular rate and then we set a rate that's higher for the mechanical to reflect the fact that the sound recording royalty should drop, but it's locked in for a period of time? Are we running the risk, then, of disrupting the market by having a total royalty that's greater than what is indicated by your Shapley testimony, simply because of the disparity of times in which the rates are … implemented?
>
> PROFESSOR WATT: That's a very fair point. And I didn't even think of that until you've mentioned it . . . [T]he model I have done is . . . assuming that . . . the bargained thing happens at the same time as the—or in the same general period of time as a change in the statutory rate. You're absolutely correct.

3/27/17 Tr. 3091-92 (Watt); *see* Marx WRDRT ¶ 42, n.46

[57] In the context of the bargaining model, Professor Marx identifies Professor Watt's choice of "a market structure that is completely symmetric between record labels and services not reflective of the real world" as forcing his model "to attribute[] all the … surplus division to … bargaining power … and none of it to the market structure." *Id.* ¶ 38.

Third, Professor Marx points out that Professor Watt's Nash model does not attempt to capture the effects of the heterogeneous and asymmetric distribution of information relevant to the bargain available to each party at the time of negotiation. *Id.* ¶ 41.

Lastly, Professor Marx avers that Professor Watt's Nash Bargaining Model fails to address, on a more general basis beyond informational issues, other "asymmetries among record labels and among services." Marx WDRT ¶ 41.

In sum, Professor Marx concludes that these foregoing real-world points all preclude the Judges from relying on Professor Watt's testimony to identify a stable relationship between changes in the mechanical royalty rate and the sound recording royalty rate because they all share a common defect—they "lie outside Professor Watt's model." Marx WRDT ¶ 41.

To be clear, Professor Marx does not criticize Professor Watt for neglecting to include these points in his bargaining model; rather, she acknowledges that "[t]hese are difficult features to capture in a tractable equilibrium model." *Id.* Indeed, she urges *the Judges* to appreciate that relying on such a necessarily limited model, as the Majority did, can have "dramatic effects" on the royalty rates derived. *Id.* Professor Marx emphasizes that all of these inherent modeling deficiencies are especially pernicious, if the bargaining model is applied yet again on remand, to set specific rates *over a five-year period*, when other variables will have independent effect on royalty rates. *Id.*

(g) Professor Watt's Rebuttal to Professor Marx

Because Professor Marx's criticisms are of a similar nature to Professor Katz's criticisms, Professor Watt responds to Professor Marx as he did to Professor Katz. To summarize, Professor Watt responds to Professor Marx's points as follows:

- Her criticism is centered on what he characterizes as her "bogus" argument that he supposedly had predicted almost a "dollar for dollar" sound recording rate reduction in response to an increase in the musical works rate (the seesaw effect). Watt RWRT ¶ 19. Professor Watt finds this argument "particularly disheartening," because Nash bargaining theory explains why the seesaw would apply to the splitting of the surplus based on the available data, and that "there are quite apparent reasons why available surplus may not decrease even if the musical works rate increased, *because of simultaneous changes to other variables in the model*." *Id.* ¶ 34 (emphasis added).

- Professor Marx implicitly contradicts her own reliance on the complementary oligopoly power of the Major labels by modifying his bargaining model through the insertion of a lower value for their bargaining power. *Id.* ¶¶ 19, 22-24, 26.

- Professor Marx misconstrues the purpose of his Nash model, which was to serve "as a reply" to Professor Marx's direct testimony, and "to show bargaining insights that bore upon aspects of the case." *Id.* ¶ 29.

- Professor Marx, like Professor Katz, improperly includes in her bargaining model a potential payoff for the label arising from an "outside option," *i.e.*, from an alternative that the label can choose only if the Nash bargaining terminates. *Id.* ¶¶ 53 - 68.

(h) Professor Marx's Reply to Professor Watt's Criticism[58]

In her supplemental remand testimony, Professor Marx challenged several of Professor Watt's criticisms contained in his remand testimony. First, she takes issue with what he identified as two "core" economic principles of bargaining: (1) that all of the available net surplus will be shared; and (2) that neither of the two bargainers will demand a share such that more than the total net surplus is shared. Marx WSRT ¶¶ 7-8.

As an initial matter, she disputes the notion that these are "core" principles of bargaining. *Id.* ¶ 8. More particularly, she states that, in the present case, because "the label does not know with exactitude the precise maximum that a service would be willing to pay (*i.e.*, its "survival" rate), and the service likewise does not know the exact minimum that the label would be willing to accept," the simple bargaining model must be expanded to address "the potential for delay and/or bargaining breakdown." *Id.*

As a further criticism, Professor Marx avers that "[i]n the real world, the negotiated royalty outcomes do not involve just two parties, but rather a sequence of overlapping, interrelated, bilateral bargains involving multiple competing services and multiple record labels with complementary oligopoly power." *Id.* ¶ 12.[59] This complication, she opines, exacerbates the informational deficit noted in the immediately preceding paragraph, such that negotiations within the several pairings of labels and services "are affected by uncertainty and private information and … Professor Watt's discussion of bargaining theory [thus] does not support any particular real-world see-saw outcome." *Id.*

(iii) Resolution of the Bargaining Dispute

(a) Professor Watt's Nash Bargaining Model does not Support Adoption of Uncapped TCC Rate

The purpose of Professor Watt's Nash Bargaining Model was to allay the Judges' concern that increasing the mechanical rate would lead to higher total royalties for the Services. His bargaining model was understood by the Majority to show that such higher total royalties would not result, because the model demonstrated the "seesaw" effect, whereby the sound recording rate would fall almost dollar-for-dollar with the increase in the mechanical rate. *See* Determination at 73-74 ("[T]he Judges rely on Professor Watt's insight … *demonstrated by his bargaining model* that sound recording royalty rates in the unregulated market will decline in response to an increase in the compulsory license rate for musical works. … Professor Watt's

[58] The Judges found that Professor Watt's remand testimony, denoted as "rebuttal," also provided *de facto* "direct" testimony, to which the Services could respond with supplemental testimony and argument. Oct. 1st Order at 11-12. Professor Marx's response in the following text was set forth in Spotify's permitted supplemental testimony.

[59] In like manner, Professor Marx opines that Professor Spulber's discussion of bargaining theory is irrelevant to any assessment of "the complexities affecting real-world negotiations" and the presence, *vel non*, of a seesaw outcome. *Id.* ¶ 13.

bargaining model *predicts* that the total of musical works and sound recordings royalties would stay 'almost the same' in response to an increase in the statutory royalty.") (emphasis added).[60]

On the surface, the economic experts on both sides appear to be at loggerheads regarding the existence and applicability of the seesaw relationship. However, as discussed below, on further analysis of their respective positions, in light of Professor Watt's remand testimony regarding *a key assumption* in his bargaining model, their disagreement narrows considerably and—in an important respect—vanishes completely.[61]

To recap: In his WRT, Professor Watt stated

> [W]ith an appropriately modelled bargaining analysis … in my Appendix 3 … I show that for every dollar that the statutory rate for musical works undercuts a fair and reasonable rate, the freely negotiated rate for sound recordings will increase by an estimated [redacted] cents.
>
> That is, if the musical works rate is increased to what would be a realistically fair and reasonable rate, then the negotiated fee for sound recordings would decrease almost dollar for dollar, with only a minor change in the total royalty rate for all copyrights combined.

Watt WRT ¶ 23 & n.13. But nowhere in his WRT did he qualify this statement by explicitly acknowledging that in his bargaining model there are certain assumptions lurking, *i.e.*, that his "concrete" analysis is subject to the "*ceteris paribus*" constraint—that all other things are held constant (*i.e.*, equal before and after the change in the musical works rate) other things being equal).[62]

It is only in his later remand testimony—after the D.C. Circuit's remand had compelled him to confront criticism from adverse economists—that Professor Watt expresses this assumption overtly, making explicit the "understanding" that he had theretofore only tacitly assumed:

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[60] Copyright Owners note the Majority's recognition that, regardless of the rate structure, *i.e.*, uncapped TCC or otherwise, Professor Watt's "insight" from "bargaining theory" would still apply. *See* Determination at 74, n.138. That being the case, the Majority's first rationale for adopting an uncapped TCC rate is undermined.

[61] This is unsurprising. The difference of opinion among economists often lies in their assumptions, which may be left unstated or opaque (intentionally or not). Once those assumptions are laid upon the table, their differences often evaporate. As the esteemed economist Fritz Machlup noted more than sixty years ago:

> The most prolific source of disagreement lies in differences of factual assumptions. It is not customary for experts to state all the assumptions that underlie their conclusions; it would be much too cumbersome. But when they have reached very different conclusions, then we are forced to go back and find out what implicit assumptions they have made.

F. Machlup, *Why Economists Disagree*, 109 Proceedings of the American Philosophical Society 1, 3 (1965). In the modern world of more formal economic modeling as well, the obfuscation of assumptions continues to be an important source of dispute, according to a book written by a leading game theorist upon which Professor Watt relies in his testimony. A. Rubinstein, *Economic Fables* at 20 (2012) ("[T]he model's formal mantle enables economists … to conceal from the layman the assumptions the model uses."); *see* J. Schlefer, *The Assumptions Economists Make* at 29 (2012) ([S]ome assumptions made by economists capture important insights, others are insane. All you have to do is decide which capture insights, which are insane, and in which situations.")

[62] In his oral testimony, Professor Watt likewise did not qualify his opinion by taking note of his *ceteris paribus* assumption. See 3/27/17 Tr. 3026 *et seq.* (Watt).

> In other words, a model in which only the two copyright rates are permitted to change … as was the *understanding* in my original model, allows the system to derive a clear relationship between those two rates, and that relationship is that an increase in one leads to a decrease in the other, that is, the 'see-saw effect.' But if … something else changes along with the musical works rate … then *the net effect does not predict that the negotiated rate of the labels will decrease*."

Watt RWRT ¶ 35 (emphasis added).

Indeed, as noted *supra*, Professor Watt *did* give a nod to the relaxing of his implied *ceteris paribus* assumption in his WRT, by identifying varying "scenarios" in which he considered the impact of potential changes in service revenues and service non-content costs, leading to different percentages of royalties paid to content providers. Watt WRT ¶¶ 45-52. Professor Watt then used these several assumptions and scenarios to opine as follows: "The message that should be taken from this exercise … is that the results … are very dependent upon the amount of total interactive streaming revenue and the fraction of that revenue that is taken up by downstream non-content costs." *Id.* ¶ 53.[63]

Professor Spulber, on behalf of Copyright Owners, likewise emphasizes on remand the importance of the *ceteris paribus* assumption in economic modeling:

> [A]long with an increase in the compulsory license rate, *all other things being equal*, we would expect to see a decrease in sound recording royalty rates.
>
> . . .
>
> "All other things being equal" (*ceteris paribus* in Latin), is a central principle for economic modelling. This economic analysis of bargaining highlights an important relationship between two content cost variables. However, that relationship does not exist in a vacuum. *Many other variables affect the bargaining situation and, for any given period, the net effect of all of the different variables may be different than the effect of the modeled variable alone.* Thus, this economic analysis of bargaining will not assure that a streaming service will not face disruption in the real world for any reason.
>
> . . .
>
> Economic modeling is supposed to simplify the situation in order to distill useful principles and teachings.

Spulber RWRT ¶¶ 26-28 (emphasis added).

[63] Further, in his remand testimony, Professor Watt points out that Professor Katz made clear in his testimony that he applied the "all else equal" assumption expressly in his own Nash bargaining analysis at the hearing. Watt RWRT ¶ 20 (quoting Katz WRT ¶ 67).

The Judges agree that the *ceteris paribus* principle[64] is a fundamental principle in economic analysis and modeling. Professor Watt succinctly makes this point, quoting the Nobel laureate economist James Buchanan, for the following proposition:

> At the heart of any analytical process lies simplification or abstraction, the whole purpose of which is that of making problems scientifically manageable. In the economic system we recognize, of course, that 'everything depends on everything else,' and also that 'everything is always changing.

Watt RWRT ¶ 32 (*quoting* J. Buchanan, *Ceteris paribus: Some Notes on Methodology*, 24 *So. Econ. J.* 259, 259 (1958).

However, Professor Watt does not quote another portion of Professor Buchanan's article that makes a point that looms large in the present proceeding, *to wit*, the *limitations* inherent in applying the necessary *ceteris paribus* condition:

> Real problems require the construction of models, and the skill of the scientist is reflected in the predictive or explanatory value of the model chosen. We simplify reality to construct these models, but the fundamental truth of interdependence must never be forgotten. … [However,] *[f]ew, if any, meaningful results may be achieved by using ceteris paribus to eliminate the study of large numbers of variables.* If such variables are closely related, they must be studied simultaneously; there is no escape route open.

Id. at 259-60 (emphasis added); *see also* A. Rubinstein, *Comments on Economic Models, Economics, and Economists: Remarks on Economics Rules by D. Rodrik*, 55 J. Econ. Lit.162, 167 (2017) "[W]hat matters to the empirical relevance of a model is the realism of its *critical* assumptions") (emphasis added).[65]

This is not to say that Professor Watt was unaware of this caveat. As noted *supra*, he recognizes the difficulty of extrapolating from a *ceteris paribus* world to the real world. The present panel of Judges likewise recognizes this. However, the Majority missed this distinction in the Determination when it applied Professor Watt's correct but *ceteris paribus* "insight" for a constant real-world relationship between sound recording and musical works royalty rates. Again, not a single economist made this improper analytical leap or proposed an uncapped TCC rate in order to set a TCC ratio across the entire rate term. Indeed, on careful inspection, no economist states in his or her remand testimony that Professor Watt's bargaining model provides economic support for the uncapped TCC rate prong.

With the foregoing testimony in mind, the Judges see particularly relevant several additional points in Professor Watt's *remand* rebuttal testimony that pertain to the appropriateness, *vel non*, of a TCC rate prong. Referring to the application of his bargaining

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[64] The phrase is often translated into English as "all other things *equal*." However, that is somewhat ambiguous. Equal to what? Not to other things. Rather, every "thing" (*i.e.*, every other independent variable) whose effects are not being measured remain "constant," or "controlled," *i.e.*, "equal" to their measure prior to the change of the independent variable being examined. *See* W. Nicholson, *Microeconomic Theory: Basic Principles and Extensions* at 649 (9th ed. 2005) (defining "*ceteris paribus"* as "[t]he assumption that all other relevant factors are held constant when examining the influence of one particular variable in an economic model").

[65] The Judges note now that Professor Watt did not claim that his bargaining model generated any *predictions*, but rather that it explained the splitting of the Shapley surplus by the sound recording and musical works copyright owners, respectively, and the impact of that split on royalty rates, *given the assumptions and the data in his model.*

model to the present case, Professor Watt made these crucial statements regarding the lack of a seesaw effect that would generate decreases in sound recording rates when the mechanical rate is increased:

> [T]he actual effects one would expect to see several years later would be based on the actual data at that time. Moreover, I would expect many other variables to have a larger effect on the bargains than the relatively small changes in the musical works rate. … [U]nderstanding actual market outcomes requires understanding these variables.
>
> . . .
>
> [A]n attempt to capture all aspects of the real world is too complex for a simple statistical exercise involving an econometric regression. There is no obvious data to actually use for some of the independent variables, such as consumer demand equations, costs of entry and exit, a measure of oligopolistic interaction, different timings of different rate bargains, and the actual values of outside options.

Watt WRWT ¶¶ 6(iv), 118.[66]

Although Professor Watt was hardly transparent in *disclosing* his *ceteris paribus* assumption in his original testimony, it seems clear that he always *understood* its presence, and that, when this assumption was relaxed, "the actual effects … several years later would be based on the *actual data at that time* [and] *many other variables [with] a larger effect on the bargains than the relatively small changes in the musical works rate.*" *Id.* ¶ 6(iv) (emphasis added).

Professor Spulber likewise opined that the absence of an explicit statement of these assumptions in Professor Watt's testimony was unremarkable and appropriate:

> [A]ll other things being equal'… should be generally read into economic modeling conclusions or predictions, whether or not the words are repeated in each instance. Economists do not typically repeat these words in each place where they apply, since it would lead to constant repetition.

Spulber RWRT ¶ 46, n.8.

Regardless of whether economists invariably identify the existence of implicit assumptions lurking in each other's models, Professor Watt overlooked a cardinal rule of communication: *Know your audience*. Here, his audience is comprised of three Judges, only one of whom is also an economist.[67] Failing to appreciate Professor Watt's implied *ceteris paribus* assumption, the Majority transformed his limited (albeit important) "insight" regarding the equal

[66] In the language of econometrics, Professor Watt describes this problem as the "almost sure[] impossibil[ity] of "introduce[ing] a control variable for each and every possible aspect that could potentially impinge upon the relationship [that] could easily lead to such a low R^2, and/or statistically insignificant key coefficients, as to make the regression meaningless." *Id.* ¶ 118.

[67] The dissenting Judge (the only economist on the panel) warned that the seesaw effect was rife with assumptions that rendered it too speculative to be relied upon to support the uncapped TCC rate prong. *See* Dissent at 7-8.

split of the Shapley surplus between the two classes of rights holders—and the seesaw effect that would have if the mechanical rate were increased when the split was imposed—*into a justification for the imposition of an uncapped TCC rate prong over the five-year rate term*. The Majority's language reveals this point clearly:

> As to the issue of applying a TCC percentage to a sound recording royalty rate that is artificially high as a result of musical works rates being held artificially low through regulation, the Judges rely on Professor Watt's insight … **demonstrated by his bargaining model** that sound recording royalty rates in the unregulated market **will decline in response to an increase in the compulsory license rate for musical works.** *See* 3/27/17 Tr. 3090 (Watt) ("[T]he reason why the sound recording rate is so very high is because the statutory rate is very low. And **if you increase the statutory rate, the bargained sound recording rate will go down.")**
>
> Professor Watt's bargaining model ***predicts*** that the total of musical works and sound recordings royalties would stay "almost the same" in response to an increase in the statutory royalty. *Id*. at 3091.

Determination at 73-74 (emphasis added).

Making the point ever so plainly, Professor Watt *now* expressly acknowledges that his "'see-saw effect' was never really a '*prediction*" at all! Watt RWRT ¶ 117. Rather, he now cautions the present panel of Judges, that, "to make the jump from the model to the actual real-world effects, one cannot ignore the words that are omnipresent in all economic modeling, that predictions about causal relationships are understood to be "all else equal." *Id.* ¶ 32.

Without the benefit of these caveats regarding an extrapolation of the "seesaw" theory to the real-world, and with absence of an explicit statement of the *ceteris paribus* assumption, the Majority misapplied his testimony as a basis to adopt a fixed TCC rate, based upon data from a snapshot in time (2016) to cement that rate relationship for the entire five-year period.[68] The Majority misapplied Professor Watt's *correct* insight from bargaining theory regarding the use of a fixed ratio for the equal division by two "Must Have" input suppliers of the Shapley surplus to set royalty rates in a period, by using that insight *incorrectly* to establish a fixed ratio of royalty rates over the rate term.[69]

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[68] The importance of Professor Watt's failure to make explicit the *ceteris paribus* assumption in his WRT is demonstrated by his need to make it explicit in his RWRT. But even now, rather than acknowledge that the Majority missed the point, he claims that the Services' are wrongly blaming the Majority for failing to understand this assumption: "The Services' testimony on this remand seems primarily focused on creating a "straw man" argument … accus[ing] the [Majority] of something that the [Majority] did not do—that is, rely on a guarantee of a particular decrease in sound recording royalty rates—and the Services then attack the Board's determination by claiming that the decrease did not occur." Watt RWRT ¶ 5. As shown *supra*, however, this is precisely how the Majority interpreted Professor Watt's "insight." The Judges understand that, as a matter of tact and tactics, Copyright Owners may be reluctant to acknowledge that the error lies in the combination of their witness's opaque testimony and the Majority's lack of understanding of the assumptions economists make. Copyright Owners might prefer to cast the Majority as the victims of the Services' incorrect accusation. But the plain language of the Determination belies Copyright Owners' characterization as to how the confusion arose.

[69] The forgoing analysis as applied to the uncapped TCC rate needs to be contrasted with the application of Professor Watt's bargaining model to increase the percent of-revenue rate to 15.1%. That higher rate was set by the Majority after its consideration of the same Shapley approaches, pursuant to the Judges' combination of inputs from Professor Gans model (his [redacted] round recording-to-musical works ratio) and the Shapley Value Model of Professor

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Additionally, an examination of the expert economists' testimony reveals that their facial disagreements vanish once the necessary assumptions are laid bare. Professor Watt and the Services' three economists all identify the following independent variables that will impact the relative levels of sound recording and musical works rates paid by interactive services:

(1) the level of downstream consumer demand;
(2) entry costs;
(3) exit costs;
(4) oligopolistic interaction;
(5) the timing of sound recording agreements *vis-à-vis* statutory rate setting; and

Professor Watt and the three Service economists agree with regard to the relevancy of these six independent variables. *Compare* Watt RWRT ¶¶ 6(iv), 118 (identifying all five independent variables) *with* Leonard WDRT ¶ 18 (identifying independent variables 1-4 above); Marx WDRT ¶¶ 4-5, 42; (identifying independent variables 1-5 above); Katz WDRT ¶¶ 127, 134 n.115 (identifying independent variables 4 and 6 above). Accordingly, the remand record shows a consensus as to the lack of modeling of independent variables that would be important to estimate an uncapped TCC royalty ratio that could be utilized by the Judges to lock-in a ratio over the rate term.

Indeed, as noted *supra*, a careful reading of the remand testimony by Copyright Owners' economists, Professors Watt and Spulber, reveals that neither of them actually testifies that there is sufficient theoretical and empirical evidence to support the uncapped TCC rate prong and the 26.2% TCC rate phased in on that prong. Rather, those two witnesses testify to something far narrower: the alleged correctness of Professor Watt's "seesaw" theory as demonstrating an equal splitting of the surplus between the two "Must Have" input suppliers, and the effect of that split when all other relevant independent variable are held constant.

In this regard, it is noteworthy that none of Copyright Owners' several economic experts in this proceeding (Dr. Eisenach, Professor Gans, Dr. Rysman, or Professor Watt) ever *proposed* an uncapped TCC rate prong in any form, let alone within a greater-of formulation. Such a proposal would have been improper, because, as the expert testimony described above makes clear, the *ceteris paribus* assumption, reasonable for modeling purposes to provide insight as to the surplus split, lacks the input of the omitted variables that the experts on both sides find relevant to the application of economic modeling in this proceeding. A further review of

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Marx that adjusted for complementary oligopoly power by establishing a lower total royalty level ([redacted]%). But the difference is that the 15.1% revenue rate was set by applying the Shapley results *based on actual and projected market data*, *see* Gans WRT ¶ 38, whereas the uniform uncapped TCC rate (26.2%) was based on the *ceteris paribus* assumption that held constant the actual data regarding the aforementioned independent variables. As explained above though, Professors Watt and Spulber make it clear that the "insight" from bargaining theory did not have implications to allow for a "prediction" of rates in future periods.

Thus, when the Majority engaged in its analysis and "line-drawing" to apply the data and market projections relied upon by Dr. Gans's data, the Majority was operating – to use the D.C. Circuit's phrase – in its "wheelhouse," making a finding that withstood appeal. *Johnson*, *supra*, 969 F.3d at 385-86; *see also* Determination at 69-70 ("Professor Gans utilized data from projections in a Goldman Sachs analysis to identify the aggregate profits of the record companies and the music publishers, respectively. … The Judges also find Professor Gans's reliance on financial analysts' projections for the respective industries to be reasonable.").

Copyright Owners' economic expert witness testimony on remand—the first time any of them had occasion to weigh-in on the appropriateness of the uncapped TCC prong—reveals that they also *have not endorsed* the uncapped TCC rate prong as a proper form of rate setting. To be sure, they strongly endorse the insight first described by Professor Watt in his WRT that the Nash surplus would be split essentially evenly between the two suppliers of essential content, given his simplifying assumptions. But such endorsement is hardly the same as endorsement of the uncapped rate prong itself.

For these reasons, the Judges find erroneous the Majority's identification of a fixed relationship between the sound recording and mechanical royalty rates that could serve as a basis for the Majority's first rationale for yoking the mechanical rate to an uncapped TCC rate prong.

(b) The Services Have Not Rebutted Copyright Owners' *Prima Facie* Showing that Professor Watt's Model Demonstrates a More Limited "Seesaw" Effect

The foregoing analysis and decision related to the absence of a fixed relationship between the sound recording and mechanical royalty *rates*. A *separate* fixed relationship—the one Professor Watt has clarified he was demonstrating all along—is that if the Judges increase the mechanical royalty rate, the Shapley surplus realized by the labels will decrease almost dollar-for-dollar with the increase in the mechanical rate. The Services' economists aver that even this version of the seesaw is defective.

According to Professors Katz and Marx, the Nash Bargaining Model constructed by Professor Watt is deficient because it fails to properly characterize the "disagreement payoff" to the sound recording company when it and an interactive service fail to reach an agreement. More particularly, as explained *supra*, they assert that Professor Watt's model omits the value of "outside options" available to the sound recording company. This criticism relates to the issue of whether the seesaw effect would occur as posited in Professor Watt's model. That is, the increase in the sound recording company's "disagreement payoff" (a/k/a "threat point") would lead to a higher royalty in the Nash bargain between the sound recording company and the interactive service than needed to generate the seesaw effect to offset the higher mechanical royalty rate.

As the several experts' positions in this regard, discussed *supra*, make clear, however, each side has a different understanding of whether an "outside option" is properly included in the definition and calculation of the "disagreement payoff." On the one hand, Professors Katz and Marx claim that the existence and value of "outside options" should be included in the "disagreement payoff." However, they provide no economic authority for that assertion.

By contrast, Professor Watt cites to multiple economic game theory publications and authorities for the proposition that the presence and value of "outside options" are not to be included in the "disagreement payoff" contained in a Nash Bargaining Model. *See* A. Muthoo, *Bargaining Theory with Applications* at 105 1999) ("I thus emphasize that *the outside option point does not affect the disagreement point*."); M. Osborne & A. Rubinstein, *Bargaining and Markets* at 88 (1990) ("it is definitely *not* appropriate to take as the disagreement point an outside option.…"); K. Binmore, A. Rubinstein & A. Wolinsky, *The Nash Bargaining Solution in Economic Modeling*, 17 RAND J. Econ. 176, 185 (1986) ("An outside option is defined to be the best alternative that a player can command if he withdraws unilaterally from the bargaining process.”).

According to Professor Watt and these authorities, the reason for excluding “outside options” from the Nash Bargaining Model is fundamental to the nature of the model itself. In the Nash approach, the negotiating parties are bargaining with each other only over the surplus *their deal* can generate, and they are attempting to agree upon an allocation of that surplus that exists within the bounds of their respective “disagreement payoffs.” Each may have “inside options,” which are alternatives available to them *while bargaining is ongoing and they temporarily disagree*. *See Muthoo, supra*, at 137. However, “outside options” are available to a Nash bargaining party *only* in lieu of continuing the Nash bargaining with the original counterparty if it “withdraws” from the Nash bargaining process. *See Binmore et al.*, *supra*. Professor Watt characterizes the distinction as follows:

> [T]he Nash bargaining model [is] designed as [a] self-contained portrayal[] of negotiating behavior…. Given a surplus to share, the Nash model … provide[s] allowance for *financial* payments that a party is *actually* receiving, only while negotiations are *ongoing*, *without* walking away for another option, and that would cease as a result of the deal, to be factored into modelling as a cost in some situations.”)
>
> …
>
> [A]n outside option (a potential payoff that is not directly related to a share of the surplus that is being negotiated) … comes in as a constraint upon the set of feasible deals that could be struck ….”

Watt RWRT ¶¶ 56, 58.[70]

The Services never sought to introduce further testimony regarding this important dispute. This is particularly striking because the Services filed a motion to strike certain portions of the CO Reply, or for leave to file supplemental testimony responsive to those itemized portions. The portions the Services identified in their motion *did not include Professor Watt’s criticisms as to the inclusion of “outside options” in their experts’ Nash modeling*. Further, after the Judges granted the Services’ motion by providing them leave to file supplemental testimony—consistent with the designations in their motion—the supplemental testimonies did not address this “outside options” issue.

In the course of discussions among the parties and the Judges regarding remand procedures, the Judges invited the parties to produce witnesses for a hearing, at which one or more of the Services’ economic expert witnesses could have addressed this “outside options” issue. However, the Services (and Copyright Owners) waived the opportunity to produce witnesses at a hearing. Rather, they offered, and the Judges agreed, that they would stand on their written testimonies and proceed to closing arguments by counsel.

[70] Professor Marx in fact cites several of these authorities (for other points), without noting the distinction they make between the appropriate inclusion of “inside options” and exclusion of “outside options” in Nash modeling. *See id.* ¶ 59.

In the closing arguments, each side argued numerous points of controversy and provided the Judges with dozens of demonstrative aids summarizing record evidence and the parties' arguments, but none of those arguments or demonstrative aids so much as mentioned this "outside options" dispute. Moreover, when the Judges inquired during closing arguments as to whether Services' counsel would be addressing any of the experts' "modeling disputes," counsel said that they were resting on their papers. 3/8/22 Tr. 86-87 (Closing Argument). Similarly, when the Judges inquired of Copyright Owners' counsel whether he would be addressing the modeling "dust-up" between Professors Watt and Katz, counsel demurred, stating that although he would "love to engage on it but … "there would be too many slides …." *Id.* at 262-64.

Simply put, the Services' economic experts made an assertion regarding the need for Professor Watt to have included "outside options" in his Nash Bargaining Model, but Professor Watt presented authority clearly stating that such inclusions would be improper. Thus, Copyright Owners made a *prima facie* showing that in a Nash Bargaining Model, the surplus generated by the streaming surpluses acquired by the content providers would be split equally as between the sound recording licensors and musical works licensors, and that, *ceteris paribus*, an increase in the mechanical rate to provide Copyright Owners more of the surplus (per the Shapley-based results relied on by the Majority) would be essentially offset through a nearly 1:1 reduction in the sound recording rate. In response to Copyright Owners' *prima facie* case, the Services stood mute in response to the rebuttal argument claiming that their experts misapprehended the Nash modeling distinctions between "inside options" and "outside options."[71]

[71] The third economic expert for the Services, Dr. Leonard, did not utilize the "outside option" phraseology to describe his critiques. Rather, he first criticized Professor Watt for assuming the existence of a "fixed surplus." Leonard WDRT ¶ 16. However, as discussed *supra*, that assumption came from the Majority's extrapolation from Professor Watt's hearing testimony. His explicit statement regarding the *ceteris paribus* assumption makes clear that he was not assuming a "fixed surplus." Watt RWRT ¶¶ 110-11. (Again, the only "fixed" surplus was not "assumed," but rather *quantified*, in order to establish the Majority's percent-of-revenue prong royalty rate of 15.1%.)

Dr. Leonard next claims that Professor Watt's assumption that the labels would bear virtually the entirety of an increase in the statutory rate, because they previously "have captured almost all" [the] surplus," has been contradicted by the evidence. Specifically, he refers to the 33-month period in which the Phonorecords III rates were effective (January 2018 through September 2020). Leonard WDRT ¶ 16. However, as the Judges find in this Determination, that 33-month period was marked by significant uncertainty with regard to the ultimate rates and rate structure (and the rates were being phased-in), so no findings could reliably be made based on sound recording rate changes during that period.

The remainder of Dr. Leonard's critique concerns issues that would make a fixed TCC ratio inappropriate over the rate term. The Judges agree with those criticisms as previously discussed, but they do not pertain to this narrower issue of whether the *surplus* generated by interactive streaming would be split in a manner consistent with Professor Watt's Nash Bargaining Model.

Accordingly, the Judges find that the Services' criticisms in this regard are insufficient to rebut Copyright Owners' *prima facie* showing that Professor Watt's Nash Bargaining Model properly identified and valued the "disagreement payoff."[72, 73]

b. Rejection of Second Rationale for Including Uncapped TCC Rate Prong

In the Determination, as noted *supra*, the Majority also justified the adoption of the uncapped TCC rate prong because it had the effect of "import[ing] into the rate structure the protections that record companies have negotiated with services to avoid the undue diminution of revenue through the practice of revenue deferral." Determination at 36; *see also Johnson*, 369 F.3d at 372 ("By pegging the mechanical license royalties to an uncapped total content cost prong, the Board sought to ensure that owners of musical works copyrights were neither undercompensated relative to sound recording rightsholders, *nor harmed by the interactive streaming services' revenue deferral strategies*….") (emphasis added).

(i) Parties' More Specific Arguments

Copyright Owners likewise argue that the uncapped TCC rate structure should be "adopted to provide protection against revenue deferment and displacement in a revenue-based rate structure." CO Initial Submission at 38; *see also id*. at 40 (describing uncapped TCC rate prong as "critical backstop in a revenue-based rate structure.").

Whereas Copyright Owners echo the Majority, the Services adopt the reasoning of the Dissent. They argue as follows:

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[72] To be clear, the Judges' ruling is narrow; they make no finding beyond crediting this *prima facie* showing and the failure of the Services to rebut sufficiently that showing. It might be the case that the existence and definition of "outside options"—and their relationship to "inside options"—have other implications *vis-a-vis* a Nash Bargaining Model applied in the context of a rate setting proceeding. However, the Judges may not introduce and rely on analytical approaches not developed by the parties. *See Johnson*, 969 F.3d at 381 (the Judges must not "procedurally blindside[]" the parties with an "approach … first presented in the determination and not advanced by any participant."). *See generally* P. Wald, *Limits on the Use of Economic Analysis in Judicial Decisionmaking*, 50 J. L. & Contemporary Problems 225, 228 (1987) (" judicial analysis, economic or otherwise, takes place only in the context of lawsuits between two or more parties imposes a practical constraint on the judge's ability to use economic analysis.").

[73] Professor Katz also criticizes Professor Watt's assumption that "a label's non-content costs are proportional to licensing revenues." Katz WDRT ¶ 22. More particularly, Professor Katz claims that this is not "plausible" because "the royalty rate does not directly affect the sound recording copyright owners' non-content cost." *Id.* ¶ 133. The effect of eliminating this assumption, according to Professor Katz, is to reduce the seesaw effect in Professor Watt's model of [redacted] slightly further away from a 1:1 ratio, to .92. *Id.*

In rebuttal, Professor Watt says this criticism is inconsistent with Professor Katz's own analysis, because the latter also "sets the cost equal to a fraction of revenue …." Watt ¶ 82 n.31 (referring apparently to a comparison of Katz WDRT ¶ 129 with *id.* ¶ 133). Professor Watt concludes that not only does "[Professor] Katz's own model contain the same feature that he is critical of in my model," it is also "not a flaw in the bargaining model." Watt ¶ 82. As a substantive matter, Professor Watt defends the assumption that non-content costs would rise with royalty income, because "[g]reater revenue should be directly equated with a larger scale of business" and "the additional royalty income would have to be managed (*i.e.*, distributed to those who need to be paid from it, such as artists), implying higher administration costs." *Id.* ¶ 79.

The Judges find that the common use by both experts of this assumed proportionality of a label's non-content costs to licensing revenues alone blunts Professor Katz's criticism of Professor Watt's modeling. Further, Professor Watt reasonably posits that higher revenue would imply a larger scale of business with associated general cost increases. (But the Judges do no agree that it was reasonable for Professor Watt to assume that distribution and administrative costs in particular would increase merely because of an increase in royalty rates; simply paying more money, *ceteris paribus,* is not self-evidently associated with an increase in costs.)

> [A] rate structure with a capped TCC prong, like the *Phonorecords II* settlement, achieves the same goal of protecting the Copyright Owners from any potential revenue deferral through a "structure that provides alternate rate prongs and floors, below which the royalty revenue cannot fall," … and does so *without allowing Copyright Owners to impermissibly share in the labels' complementary oligopoly power*. … [T]he streaming industry has twice concluded, after extensive negotiations, that the appropriate way to address any concerns regarding revenue deferral is to have a rate structure that includes a capped TCC prong. *Phono I*, 74 Fed. Reg. 4510; *Phono II*, 78 Fed. Reg. 67,938.

Services' Joint Opening Brief at 62 (quoting *Dissent*, 84 Fed. Reg. at 1990) (emphasis added).

In their Reply, Copyright Owners argue that the Majority maintained the benefits of price discrimination contained in the prior *Phonorecords II* framework, but balanced that goal with added protection against Service revenue deferral and displacement. Copyright Owners' Reply Brief on Remand at 49 ("In adopting a rate structure with [an uncapped] TCC for all service offerings, the [Majority] balanced its concerns about fostering price discrimination while also protecting against proven revenue diminution by the Services.").

The Services, in their Reply, take note that pre-remand, Copyright Owners had strenuously objected to any yoking of the mechanical royalty rate to the sound recording rate, maintaining that, although the Copyright Owners now advocate for an uncapped TCC rate to protect against revenue displacement and diminution:

> [I]n their [pre-remand] reply proposed findings, the Copyright Owners had expressed a very different view, arguing that an uncapped TCC prong "does nothing to protect Copyright Owners from the Services' revenue displacement and deferment" [and] Copyright Owners have not even tried to explain away their complete about-face on this issue.

Services' Reply at 43.

(ii) Analysis and Decision Regarding Revenue Diminution or Deferral

The Judges find that the second rationale put forth to support an uncapped TCC rate does not justify the adoption of that rate prong. Several reasons support this finding.

First, there is insufficient evidence to show how the sound recording companies contractually structure their own royalty rates, which would constitute the rate base for an uncapped TCC rate for the mechanical royalty. The sound recording royalty rate, when proffered for use as a mechanical royalty rate base, is analogous to pegging the value of a foreign currency to the U.S. dollar. That is no mere benchmark. The Judges must have the benefit of sufficient record evidence to demonstrate that the pegging (or, to use the D.C. Circuit's word in *Johnson*, "yoking") of a statutory rate to an unregulated rate serves the statutory purposes for the rate at issue, here, the mechanical rate.

But Copyright Owners presented virtually no evidence regarding how the sound recording companies structure their interactive service royalties. Indeed, in the hearing, Dr. Eisenach acknowledged that the "relative value of sound recording [to] musical works licenses may depend on a variety of factors," but he intentionally eschewed unnecessary "assumptions, complexities and uncertainties associated with theoretical debates" as to why the particular market ratios existed. *See* Determination at 44. Indeed, the Majority found fault with Dr. Eisenach's willful ignoring of these issues, agreeing with the Services' criticism that Dr. Eisenach's "use of sound recording royalties paid by interactive services embeds within his analysis the inefficiently high rates that arise in that unregulated market through the complementary oligopoly structure of the sound recording industry and the Cournot Complements inefficiencies that arise in such a market. *See* Determination at 47. The uncapped TCC rate advocated now by Copyright Owners suffers from the same affliction.

The only reference to such sound recording rate formulae in Copyright Owners' voluminous PFF after the hearing was its statement that the effective revenue calculations in two of the Major labels' agreements with the services was based on [redacted]. *See* Copyright Owners' PFF ¶¶ 72, 91 (cited post-remand at Copyright Owners' Motion for Reconsideration or Clarification at 25, n.14). On remand, the Services have provided a further summary of the types of [redacted] *See* White WDRT ¶¶ 6-7, 14-15, 20, 24-26, 28-29 ([redacted]); Bonavia WDRT ¶¶ 15-17 ([redacted]); Mirchandani WDRT ¶¶ 16, 21-24 ([redacted]). Clearly, the levels of [redacted] would have to be weighed and the impact of complementary oligopoly power would need to be identified in order to adjust the rate prongs to account for that power. But the record is devoid of such details.

Second, compounding this problem, because the uncapped TCC rate is embedded in a "greater-of" rate structure, the labels can exploit their complementary oligopoly power when creating *the switching points that toggle royalty payments between and among rate prongs.* As the Judges have explained previously, in declining to import a "greater of" structure from the unregulated interactive market, this structure[it] is based on "agreements [which] were all negotiated in a market characterized by the lack of effective competition, and that *the lack of competition would affect the structure* as well as the level of rates." *SDARS III*, 83 Fed. Reg. 65,210, 65,228 (Dec. 19, 2018) (emphasis added). Further, the Judges held therein that the "advantageous" nature of a "greater-of" structure to sound recording licensors "may well represent an example of what licensors can and would obtain when they exploit their ''must have'' status for a special competitive advantage." *Id.; see also* Dissent at 47 (in absence of testimony explaining how greater-of structure is consonant with effective competition, use by licensor suggests a game of "heads I win tails you lose.)."

Thus, there is insufficient evidence or testimony that would permit the Judges to make any adjustment for the complementary oligopoly power that may be built into each prong of the sound recording royalty rate structures.

Third, as the Services note, Copyright Owners pre-remand, opposed the *identical rate structure*—consisting of a percent-of-revenue prong and an uncapped TCC prong—before Copyright Owners were in favor of it, post-remand.[74] Although Copyright Owners took a 180-degree turn on this issue, they never stated they were wrong to oppose it previously. Indeed, the *Dissent* relied upon Copyright Owners' strenuous objection to an uncapped TCC rate, quoting it verbatim:

> Copyright Owners rightly note that they obtain no legal protection under such a TCC prong. In making this argument regarding displacement and deferral of revenue, Copyright Owners lay out comprehensively *all the problems* inherent in an uncapped TCC prong set in a greater of rate structure, such as adopted in the majority opinion:
>
> > The notion that [the] TCC prong will provide protection from revenue gaming, deferral and displacement, and other revenue prong problems is unsupported and speculative. **Relying on just the TCC to solve those admitted problems leaves the Copyright Owners' protection from such problems entirely outside the statute** …. the per-user rates in the label deals are what protects the Copyright Owners from price-slashing by the services. **What is left unanswered …is … how can it be reasonable to ask the Judges to set a rate that does not itself provide for a fair return … but simply puts the Copyright Owners' fair return in the hands of the labels to negotiate terms that will adequately protect the publishers and songwriters as well? The labels do not have a mandate to ensure that the Services provide a fair return to the Copyright Owners, and cannot be directed to ensure such.** Indeed, labels may not have the same incentives as songwriters and publishers to negotiate such protections in their deals. To wit, a label could make an agreement with a service that includes only a revenue prong in exchange for equity or some other consideration that it may never include in the applicable revenue subject to the TCC. … [W]hat if Google purchased one or more record labels and did not have to pay **any** label royalties? Or what if Spotify chose to avail itself of the compulsory license to create its own master recordings embodying musical works—which it is already doing … and chose to compensate itself for its use of the master recordings on a sweetheart basis (or not at all)? Or what if one or more labels decided to enter the interactive streaming market and did not have to pay themselves royalties? In each case, the Copyright Owners' protection—the protection that the Services admit the Copyright Owners need and is provided by the TCC—would be gone.

[74] When Copyright Owners opposed the concept of an uncapped TCC rate prong in a greater-of structure, the proposed uncapped TCC rate was Google's 15% (and its proposed percent-of-revenue rate was 10.5%). Determination at 13. But after the Majority set the uncapped TCC rate at 26.2%--a *75% increase over the 15% TCC rate*—Copyright Owners became zealous converts to the concept of an uncapped TCC rate proper.

Dissent at 5-6 (quoting Copyright Owners' RPFF-Google at 39-41) (emphasis added). To make the identical point post-remand, *but from the Services' perspective*, Pandora's economic expert witness, Professor Katz, simply utilizes Copyright Owners' verbatim language (bolded above), but substitutes the word "Services" for "Copyright Owners" (and "income" for "return") to highlight how reliance on the sound recording royalty rate is improper:

> What is left unanswered …is … how can it be reasonable to ask the Judges to set a rate that does not itself provide for a fair income … but simply puts the Services' fair income in the hands of the labels to negotiate terms that will adequately protect the Services as well? The labels do not have a mandate to ensure that the Copyright Owners provide a fair income to the Services, and cannot be directed to ensure such.

Katz WDRT ¶ 71.

The Judges find this argument persuasive, both in its own right and in the fact that it has been advanced by Copyright Owners and the Services alike.[75]

Fourth, the Judges note that the Majority did not find that revenue diminution, via displacement, deferral, or otherwise was pervasive, as Copyright Owners aver. *Compare* CO Initial Submission at 40 ("The record overwhelmingly established that the percent of revenue prong *often* results in musical works royalties that are too low … drive[n] [by] …. revenue deferral [and] revenue displacement") *with* Determination at 21 ("The Judges agree that there is *no support for any sweeping inference that cross-selling has diminished the revenue base*.") (emphasis added) *and* 36 ("The Judges find that the present record indicates that the Services do seek to engage *to some extent* in revenue deferral in order to promote their long-term growth strategy.") (emphasis added).

Given that the Majority found revenue diminution through displacement and/or deferral exists only "to some extent" and is not a "sweeping" issue, the Judges on remand find that the uncapped TCC rate structure creates the potential for unbalanced harm. As noted *supra*, the only protection against runaway mechanical rates, the seesaw hypothesis, cannot justify yoking the mechanical rate to a fixed ratio with the *unregulated* sound recording rate.[76] By contrast, and as

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[75] At Closing Arguments on remand, Judge Strickler queried counsel for Copyright Owners regarding their prior *rejection of an uncapped TCC prong* within a "greater-of" rate structure. Counsel's response was that an uncapped TCC doesn't provide *enough* protection against revenue diminution: "It provides more than the *Phonorecords II* rates, but not as much as we want," although "still better than" the negotiated *Phonorecords II* approach. 3/8/22 Tr. 240-41(Closing Argument). But Copyright Owners have neither distinguished nor disavowed their persuasive legal point quoted in the text above, to wit that an uncapped TCC rate would be unreasonable if the "protection" it affords lies "entirely outside the statute." Whether the "protection" relates to Copyright Owners' concern over revenue diminution or to the Services' concern over uncapped mechanical rates, the legal defect is the same – the unreasonableness of leaving the purported protection "entirely outside the statute."

[76] Even Google, the party that, post-hearing, broached in its PFF the idea of an uncapped TCC prong, candidly identified the risk arising from an uncapped TCC: "Having no cap on TCC … leaves the services exposed to the labels' market power, and *would warrant close watching if adopted* …." Google PFF ¶ 73 (emphasis added). But as the Dissent noted, there is no satisfactory way to monitor an uncapped TCC rate prong:

> *Who* would do the "watching"? *When* would such watching occur? Congress directed the Judges to be the "watchers," and Congress instructed that the "watching" should occur only through rate proceedings ….

Dissent at 4 (emphasis in original).

discussed *infra*, the *Phonorecords II*-based benchmark approach, despite its own imperfections, is superior in this regard, because its series of alternate rate prongs and floors represents a negotiated compromise (negotiated by trade associations with countervailing power) between the potential for revenue diminution that would harm Copyright Owners, on the one hand, and the potential for runaway mechanical rates (yoked to the sound recording companies' complementary oligopoly power) that would injure the Services, on the other.

(iii) Distinction between the "Reasonable" Rate Statutory Standard and the Factor (D) Objective to Minimize "Disruptive Impact"

The Judges next consider an issue emphasized by Copyright Owners: whether the Services have demonstrated that the uncapped TCC rate prong would cause a "disruptive impact" as set forth in Factor (D) of section 801(b)(1).[77]

Section 801(b)(1) provides that one of the competing priorities of the Judges in setting the mechanical rate is:

> To minimize any disruptive impact on the structure of the industries involved and on generally prevailing industry practices.

17 U.S.C. § 801(b)(1)(D). In *Johnson*, the D.C. Circuit did not identify any argument by the Services that was predicated on a claim that this statutory form of "disruption" had occurred, or was likely to occur, as a consequence of the Majority's rates and rate structure. Additionally, the D.C. Circuit did not ground its decision to vacate and remand the Judges' uncapped TCC rate and rate structure rulings based on the potential that these rulings would be disruptive to the Services, let alone would cause a statutory "disruptive impact."

After the D.C. Circuit's ruling, an argument regarding "disruption" was first made by Copyright Owners, not the Services. Copyright Owners argued that the vacated rates should nonetheless be maintained as interim rates, during the pendency of the remand proceeding. Motion of Copyright Owners to Adopt Interim Rates and Terms Pending the Remand Determination, *passim* (Nov. 2, 2020). Copyright Owners argued that reverting to the rates that existed before the Determination would constitute a "disruption" and self-servingly predicted that the Services would attempt to argue that the uncapped TCC rate and rate structure were themselves "disruptive." Copyright Owners opined that such an argument would be a "hollow

[77] Separate and apart from the "disruptive impact" argument made by Copyright Owners, there is no need to consider how this prong would relate to Factor D, because the Judges find the uncapped TCC rate prong with the (phased-in) 26.2% rate to be "unreasonable." If it were necessary to separately consider the four itemized factors, the Judges would confirm that Factor A is satisfied, because, as the D.C. Circuit found, the Majority reasonably found that rates should increase from the *Phonorecords II* period, and the 15.1% revenue rate represents a 44% increase. The Judges would also find Factors B and C to be satisfied without a separate uncapped TCC rate prong. The reason is that, under the section 801(b)(1) standard, the "reasonableness" standard filters out more statutorily infirm rates than the fairness objectives. By contrast, when a rate does satisfy the "reasonableness" standards under section 801(b)(1), the Judges must also consider the rate through the finer "fairness" filter. *Cf.* Determination at 68 & n.120 (distinguishing between: (1) a Shapley Value analysis that filters out *unreasonable* rates by reducing licensors' ability to *abuse* market power by threatening or exercising their refusal to license ("hold-out or "hold-up" power); and (2) a Shapley Value analysis that further filters out *unfair* rates by going beyond eliminating *abuse* of market power to also make a "market power *adjustment*" explicitly to address Factors B and C). Finally, as the text *infra*, explains, the Judges also find no basis under Factor D to alter their analysis

exercise." *Id.* at 12, n.5; *see id.* at 2-3, 9 (claiming absence of disruption from uncapped TCC rate and structure despite absence of such argument by Services).

In response to that motion, the Services did *not* assert that the Majority's uncapped TCC rates and rate structure would constitute disruption or have disruptive impact, whether under statutory Factor D or otherwise. *See* Services' Opposition to the NMPA and NSAI's "Interim Rates Motion" (Nov. 18, 2020). In reply, Copyright Owners shifted from anticipating a "disruption" argument to misinterpreting *Johnson*, asserting, *without citation*: "With respect to the TCC prong, *the remand directs only that services be given opportunity to offer evidence of disruption* from rates that have now been in effect for three years without any disruption." Copyright Owners' Reply in Support of Motion to Adopt Interim Rates at 7-8 (Nov. 25, 2020) (emphasis added).

On December 10, 2020, the Services submitted to the Judges their Proposal for Remand Proceedings, in which they made *no argument* that the uncapped TCC rates and rate structure (or, for that matter, any aspect of the Determination) would cause disruption or have a disruptive impact, whether under statutory Factor D or otherwise. By contrast, in their remand proposal, Copyright Owners reference twelve times that, for the Judges to reject the uncapped TCC rates and structure, the Services must show the presence of "disruption" arising from the Majority's uncapped TCC rates and structure. Copyright Owners made this argument notwithstanding that the "reasonable" rate standard is separate from the "disruptive impact" issue, which is an itemized objective (one of four) to be considered as an adjustment to what would otherwise constitute a "reasonable" rate. *See* Proposal of Copyright Owners for the Conduct and Schedule of the Resolution of the Remand at 2, 7-8, 22-24 (Dec. 10, 2020).[78]

In the CO Initial Submission, Copyright Owners assert, *without citation to any of the Services' filings*: "The Services contend that, had they been given such an opportunity [at the hearing], they supposedly could have established that an "uncapped" TCC *is disruptive* because the market for sound recordings is not effectively competitive." *Id.* at 5. Copyright Owners further aver that the Services must "provide evidence, consistent with the [CRB Judges'] well-established disruption standard, that because of the labels' supposed market power, the TCC structure adopted by the Board has *actually*, *substantially*, *immediately* and *irreversibly* threatened the continued viability of the interactive streaming industry" in a manner that will "threaten the viability of the music delivery service currently offered to consumes under [the] license." *Id.* at 7, 56 (citations omitted).

Copyright Owners then assert that *the Services* bear the burden of proving disruption under Factor D from the uncapped rates and rate structure embodied within the rate proposal (even though only Copyright Owners are pursuing this approach on remand). Further, Copyright Owners assert that the Services' objection to the uncapped rates and rate structure must fail

[78] When Copyright Owners do address an argument that the Services *actually* made (on appeal) regarding the uncapped TCC rates and structure, they note *not* that the Services had made a "disruption" argument, but rather that "the Services appealed for the reversal of the TCC prong as *substantively unreasonable*." *Id.* at 22 (emphasis added). But Copyright Owners then assert, coyly, that "this request was not granted by the Circuit" (citing *Johnson*, 969 F.3d at 383), when in actuality, the D.C. Circuit did not rule against the Services on this point, but rather stated only that it was not addressing substantive arguments made by the Services "[b]ecause we have vacated the rate structure devised by the [Judges] for lack of notice …." *Id.*

unless they can show that such a disruptive impact occurred during the 33-month period (from January 2018 through September 2020) when the *Phonorecords III* rates were in effect. *Id.* at 56.

In their initial substantive remand briefing, the Services once more *did not* assert that the Determination's uncapped TCC rates and structure would cause disruption pursuant to Factor D of section 801(b)(1), or even assert a non-statutory disruption arising therefrom. Rather, the Services directly attacked this rate approach as inconsistent with the statutory "reasonable" rate requirement, maintaining that "[t]ying the mechanical rates directly to the complementary oligopoly sound recording rates in the manner of the Majority's uncapped TCC rates and rate structure is plainly *unreasonable*." Services' Joint Opening Brief at 46 (Apr. 1, 2021) (emphasis added). The Services also asserted that the uncapped TCC rates and rate structure are "unreasonable" because they do not promote the statutory objectives of Factor B ("fair income" to the copyright user) and Factor C (reflecting the copyright users' itemized role in making the musical works "available to the public."). *Id. a*t 45, 50-51, 55.[79]

In the Services' Reply, the Services attack Copyright Owners' "singular focus on the disruptive impact of the uncapped TCC prong." Services' Reply at 35. In particular, the Services argue:

1. they have maintained and demonstrated that Copyright Owners' uncapped rates and rate structure are "*unreasonable*," separate and apart from demonstrating that this uncapped approach also fails to satisfy the four itemized statutory factors;

2. the burden of proof with regard to Factor D disruption lies with Copyright Owners, because they are the ones who are advocating for the uncapped TCC rates and rate structure;

3. the presence of Factor D disruption, *vel non*, is not dispositive, because section 801(b)(1) and *Johnson* require the Judges to apply the entirety of the statutory standard (which consists of the "reasonable rate" requirement and consideration of all four itemized Factors; and

4. the "full extent of the disruption to the Services from an uncapped TCC prong was never tested in the marketplace [because] [t]he Majority set escalating rates,

[79] The Services' only references to the concept of "disruption" relate to their argument that their own benchmark premised on the prior *Phonorecords II* rate structure and rates would not be disruptive. *Id.* at 4, 24, 29-30. That argument is properly made by Services in this context, because a party seeking to persuade the Judges to adopt its proposal bears the burden of proof, pursuant to section 556(d) of the APA, regarding the consonance of its proposal with all the standards contained in section 801(b)(1). The Judges do note that one of the Services' expert witnesses, Professor Katz, found the Majority's attempt to avoid disruption by phasing-in the new rate provisions insufficient "to mitigate the risk of short-term market disruption". That testimony does not constitute a direct reliance by the Services on the statutory disruption objective in Factor D, but rather emphasizes the Majority's own concern with such disruption and the witness's concern that the phase-in did not prevent the disruptive effect that the Majority itself had contemplated. In any event, Professor Katz, as an economist, cannot make a *legal* argument regarding the applicability of the Factor D objective, the Services did not rely on his testimony in that regard and, as noted, the Services made no legal Factor D "disruption" argument on remand. Thus, the Judges do not give any weight to Professor Katz's testimony in this regard.

> and the [] Determination was vacated before the significant hike in rate levels was fully implemented."

Id. at 35-36.

In their Remand Reply, with regard to the issue of "disruption," Copyright Owners assert:

1. The Services have "completely abandoned" their appellate argument asserting disruption, and admit to having no evidence that the Board's adopted rate structure has any materially disruptive impact. Copyright Owners' Reply Brief on Remand at 5 (July 2, 2021).

2. The Services have not even attempted to show any Factor D related effect or other disruption from the adopted rates and structure. *Id.* at 15, n.9.

3. The failure of the Services to provide evidence of disruption or to pursue the argument that disruption had occurred was inconsistent with their prior assertions that the uncapped TCC rates and rate structure created "a real risk of economic harm" and the "impact" or "harm' that the uncapped approach generated. *Id.* at 35.

4. Each of the Services, in response to Copyright Owners' discovery requests, acknowledges that it was not offering new evidence regarding the "impact" of the Phonorecords III rates and rate structure. *Id*. at 36-38.

5. The Services did not merely suffer no disruption, they experienced unprecedented growth and profit under the uncapped TCC rate prong. *Id.* at 45.[80]

6. The Services on remand have attempted to replace their prior "disruption" assertion with a claim of "unreasonableness." *Id.* at 50, n.36.

(iv) Analysis and Decision Regarding "Disruption" Issue

The full Factor D "disruption" standard, as set forth by the Judges, states that an adjustment is warranted by Factor D if the rate analysis made by the Judges would otherwise:

> directly produce[] an adverse impact that is substantial, immediate and in the short-run because there is insufficient time for either [party] to adequately adapt to the

[80] The Judges allowed the Services to make a supplemental filing in response to Copyright Owners' remand reply, because those papers contained direct as well as reply materials. In their supplemental filing, the Services argued that they had not "thrived," that the financial data on which Copyright Owners' relied did not isolate revenue attributable to interactive services, was not limited to U.S. generated revenue, and used changes in the market capitalization of Amazon and Alphabet (Google's parent corporation) as a proxy for the economic fortunes of their interactive services. Services' Joint Supplemental Brief at 13-15. As explained *supra*, the Judges find the permanency of the *Phonorecords III* rate structure during the 33-month period from January 2018 through September 2020 to have been in question, pending the appeal that resulted in the vacating and remanding of the Determination and the reversion back to the *Phonorecords II* rates and rate structure. Given that uncertainty, the Judges find it wholly inappropriate to draw any conclusions from the change or stasis in the sound recording rates or the total royalty payments by a Service over that period.

> changed circumstance produced by the rate change and, as a consequence, such adverse impacts threaten the viability of the music delivery service currently offered to consumers under this license.

Determination at 87. Factor D is not applicable, particularly as proposed by Copyright Owners. Thus, the Judges reject Copyright Owners' assertion that the uncapped TCC prong should be adopted because of the absence of evidence of "disruptive impact" proffered by the Services. This rejection is based on several findings of fact and conclusions of law.

First, the issue of "disruptive impact" pertains here to the proposal advanced by Copyright Owners, not the Services. Thus, the burden of proving that this uncapped TCC rate prong proposal satisfies the elements, including Factor D, of the section 801(b)(1) standard in a sufficient manner lies with Copyright Owners, not the Services. *See* 5 U.S.C. § 556(d). Accordingly, the fact that the Services did not affirmatively assert an argument of "disruptive impact" is of no consequence. Moreover, as the review of the Services' filing makes clear, *the Services never abandoned that argument, because they never made it*. Rather, they have consistently argued that the uncapped TCC rate prong was *unreasonable*, not that it was statutorily "disruptive" as that standard has been applied by the Judges.

Second, Copyright Owners did not demonstrate with sufficient evidence or testimony that the uncapped TCC rate would be consistent with Factor D. To be clear, by this the Judges do not mean that Copyright Owners were obliged to prove a negative. Rather, they needed to prove, and indeed attempted to do so, that it was unlikely that their rates would cause a "disruptive impact."

In this regard, as an *empirical* matter, Copyright Owners proffered the testimony of an economic expert witness, Dr. Eisenach, who opined that the Services' [redacted]. Eisenach WRT ¶¶ 12-41 ([redacted]); CO Reply at 40-41. However, as the Judges discuss *supra*, that period reflected "33 months of uncertainty," during which no one could predict the final mechanical rate and structure that would be adopted by the Judges and/or the D.C. Circuit after appeals. Accordingly, that factual evidence is unpersuasive.

Further, as a *theoretical* matter, Copyright Owners rely on Professor Watt's testimony regarding the "seesaw" effect. In that regard, and as discussed *supra*, the Majority took comfort in what it understood to be Professor Watt's "prediction" that increases in mechanical royalties would be offset almost dollar-for-dollar by reductions in the sound recording royalty. However, as also discussed *supra*, Professor Watt has now clarified on remand that he never made such a "prediction," and that his testimony regarding the so-called "seesaw" was limited to shifts in the share of the surplus to Copyright Owners and from sound recording companies as a consequence of an increase in the mechanical rate, holding all other factors unchanged (the *ceteris paribus* assumption).

Moreover, Professor Watt further explained that many other factors would likely impact the sound recording rate together with an increase in the mechanical rate, including "a measure of oligopolistic interaction, different timings of different rate bargains, and the actual values of outside options." Watt RWRT ¶ 118. Professor Watt candidly acknowledged that he has not modeled these independent variables, and he further notes that the data may not exist to allow for such modeling. *Id.* But the inability to model the impact of independent variables does not mean that their potential to cause disruption can be ignored.

In particular, the purpose of the "seesaw" contention was that it prevented economic harm to the Services in connection with a rise in the mechanical rate. Although not of Professor Watt's design, that connection is intentionally built into the Majority's uncapped TCC rate. *See* Determination at 35 ("Incorporating an uncapped TCC metric into the rate structure permits the Judges to influence that ratio directly.") But the "measure of oligopolistic interaction" referenced by Professor Watt was the very concern expressed by the Dissent, which cautioned that there was no evidence that the sound recording companies would be compelled to maintain the same industry structure and accept the loss of substantial royalty income. *See* Dissent at 4 ("[T]he record companies may decide to keep their rates high despite the increase in mechanical rates, or decide it is in their interest to avoid a reduction in royalty revenue by creating a completely different paradigm for streaming, by which the record companies move the streaming service in-house and effectively destroy the existing services.").[81]

Also, the "different timings of different rate bargains," another independent variable identified in Professor Watt's remand testimony, was an issue raised to him at the hearing by Judge Strickler. Professor Watt candidly agreed that the Judge was "absolutely correct" that there is a "risk, then, of *disrupting the market* by having *a total royalty* that's greater than what is indicated by your Shapley testimony, simply because of *the disparity of times* in which the rates are … implemented." 3/27/17 Tr. 3091-92 (Watt) (emphasis added). However, this *admitted risk of disruption* was not addressed by sufficient record evidence.[82]

Third, disruption in the narrow sense of Factor D as applied by the Judges previously is not relevant to the present problem. An increase in total royalties is not a short-run immediate issue, but rather an ever-present possibility that the seesaw analysis does not sufficiently address. Rather, the uncapped nature of the TCC rate prong renders it unreasonable rather than narrowly disruptive.

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[81] The Dissent noted that this risk was speculative in nature because there was no evidence proffered at the hearing regarding the reactions of the sound recording companies. But no such evidence was forthcoming in the remand proceeding either, and, as noted *supra*, the burden of proof in this regard falls on Copyright owners as the proponents of the uncapped TCC rate prong. In fact, because the major publishers who are members of the NMPA (a constituent of Copyright Owners) are part of the same corporate structure as the sound recording Majors, the burden of producing evidence would fall on Copyright Owners as well regarding the sound recording companies' reaction to the "seesaw" effect.

[82] As noted *supra*, Copyright Owners did not call any sound recording industry witnesses, or provide evidence from sound recording companies, indicating that labels would even be amenable to considering such renegotiated rate reductions. Instead, at the hearing, Professor Watt merely *speculated* that the sound recording companies might renegotiate their rates downward to reflect the seesaw effect when mechanical rates increased. Tr.3/27/17 3093-94 (Watt) ("I'm not able to comment on how, you know, how possible it is to take an agreement that's in force and then change it."). Not only was that mere speculation, it was provided by an economist who is neither a music industry executive nor an attorney, and the witness did not testify that he had spoken to anyone who would have industry knowledge regarding whether a label would even be amenable to considering such rate reductions.

Balancing the foregoing considerations, the Judges find that Copyright Owners' disruption-based argument lacks merit.

6. Conclusion Regarding Uncapped TCC Rate Prong

For the foregoing reasons, the Judges decline to adopt the uncapped TCC rate tier proposed on remand by Copyright Owners.

III. Rejection of *Phonorecords II* Settlement as a Benchmark

A. D.C. Circuit Ruling

Each of the Streaming Services advanced somewhat different rate plans, but all four proffered a benchmark that "broadly sought to maintain the *Phonorecords II* rate structure," while lowering or eliminating the mechanical floor.[83] *Johnson,* 969 F.3d at 371. With regard to the Services' proposed benchmark based on the *Phonorecords II* rates, rate structure, and terms (hereinafter, PR II-based benchmark),[84] the Judges are guided by several rulings in *Johnson.*

In particular, the D.C. Circuit found the Judges' treatment of the PR II-based benchmark to be "muddled." *Johnson,* 969 F.3d at 387. The D.C. Circuit emphasized that the Judges "failed to explain" their rejection of the PR II-based benchmark. *Id.* at 367. *See also id.* at 376 (Judges "failed to "reasonably explain" rejection).

In the appeal, Copyright Owners attempted to defend the Judges' reliance on the absence of evidence of the settling parties' subjective intent in reaching the *Phonorecords II* terms. *Id.* at 387. The D.C. Circuit dismissed Copyright Owners' *post hoc* attempt, noting that "nowhere does the [] Determination explain why evidence of the parties' *subjective intent* in negotiating the *Phonorecords II* settlement is a prerequisite to its adoption as a benchmark." *Id.* at 387 (emphasis added).

The D.C. Circuit also criticized the attempt by the Judges' appellate counsel to "change tack" and argue that their rejection of the PR II-based benchmark was reasonable because: (1) evidence showed that the prior rates had been set far "too low" and (2) it was "outdated". The D.C. Circuit found that those arguments also were "nowhere to be found in the [] Determination's discussion" of the appropriateness of the *Phonorecords II* settlement as a potential benchmark. *Id.* at 387 (emphasis added).[85] In the end, the D.C. Circuit agreed with the Streaming Services that, *inter alia,* the Judges failed to reasonably explain their rejection of the

[83] The "mechanical floor" refers to an alternative rate calculation. "If the All-In Rate calculation results in a dollar royalty payment below the stated Mechanical Floor rate, then that floor rate would bind." Determination at 26 n.59.

[84] *See* Services' Joint Rate Proposal (in Services' Joint Written Direct Remand Submission at Tab C) (Apr. 1, 2021). According to the Services, their rate proposal in this proceeding is meant to "update the *Phonorecords II* terms to include terms of the Determination, as amended during the implementation of the Music Modernization Act, that were upheld in *Johnson* … including terms relating to student and family plan products, or that were not challenged by either the Copyright Owners or the Services." *Id.* at 2. The Services include in their Joint Rate Proposal a chart summarizing the proposed rates for their offerings. That chart is attached as Appendix A to this Initial Ruling.

[85] In the present remand ruling, the Judges do not rely on their appellate counsel's *ad hoc* arguments that the D.C. Circuit found to be absent from the Determination. The Judges note though (as discussed in more detail *infra*) that in this Initial Ruling they are increasing the 10.5% royalty rate in the *Phonorecords II* rates by 44% to 15.1% (as phased–in by the Determination), thus addressing appellate counsel's *ad hoc* assertion that the *Phonorecords II* rates were "too low." Similarly, as discussed *infra*, the Judges address the notion that the PR II-based benchmark is outdated.

benchmark and, for all of the reasons cited, vacated and remanded the adopted rate structure and percentages for further proceedings. *Id.* at 381.

B. Remand Procedure Regarding the PR II-Based Benchmark

On December 15, 2020, subsequent to the D.C. Circuit's decision, the Judges entered an Order Regarding Proceedings on Remand, in which the Judges stated:

> The Judges accept the parties' proposals to resolve the issues concerning the use of the Phonorecords II settlement as a benchmark….
>
> . . .
>
> The Services and Copyright Owners also agree that the Judges should resolve this issue based on the existing record, after receiving two rounds of additional briefing from the parties.

Remand Order at 1-2.

Based on the ruling in *Johnson* the Judges reject Copyright Owners' position that they need not engage in a full analysis of the issue. The Judges conclude that they must engage in, and fully articulate, a reasoned analysis that adequately addresses *"the issues concerning the use of the Phonorecords II settlement as a benchmark." Id.* (emphasis added). If the Judges determine that the Majority properly rejected the Services' proposed use of the PR II-based benchmark, the rejected portions will play no part in the Judges' remand ruling. On the other hand, if the Judges find, after engaging in that analysis, that the PR II-based benchmark was not properly rejected then, as a matter of law and logic, the Judges must weigh the Services' PR II-based benchmark for application, in whole or in part.

The Judges reject Copyright Owners' reading of *Johnson* as holding that the Judges cannot fully consider the PR II-based benchmark on remand. Copyright Owners argue that the D.C. Circuit "did not suggest the [Judges] substantively erred" in rejecting that benchmark, or that they "needed to reconsider [their] decision," but had "merely remanded for a 'reasoned analysis' … as to why it did so." CO Initial Submission at 10; *see also* Copyright Owners' Reply Remand Brief at 7-8. Because *Johnson* ruled that the Majority's reasoning was muddled, indiscernible, unexplained and lacking in reason, the D.C. Circuit obviously neither accepted nor rejected the Majority's disregard for the PR II-based benchmark – thus requiring the CRB Judges to take a comprehensive look at that benchmark. In this regard, the Judges agree with the Services that, pursuant to apposite case law, if the outcome of the remand as to this issue was preordained pending the further "reasoned analysis," the D.C. Circuit would have expressed a desire simply to remand *without vacating* as to this issue. Services' Joint Remand Reply Brief at 7-8 (citing *Allied-Signal, Inc. v. NRC,* 988 F.2d 146, 150-51 (D.C. Cir. 1993) ("The decision whether to vacate depends on the seriousness of the order's deficiencies (and thus the extent of doubt whether the agency chose correctly) and the disruptive consequences of an interim change that may itself be changed.").[86]

Because *Johnson* held that the Majority's reasoning was muddled, indiscernible, unexplained, and lacking in reason, the D.C. Circuit obviously neither accepted nor rejected the

[86] However, the Judges note that section 803(d)(3) may require the D.C. Circuit to remand rather than reverse when the issue concerns more than rates alone. Thus, the statute appears to require a remand in order for the Judges to apply their statutory authority and expertise *in toto*.

Majority's disregard for the PR II-based benchmark. Thus, the Judges take a comprehensive look at that benchmark's rates and rate structure to evaluate its usefulness in this proceeding.

Relatedly, the Judges also reject Copyright Owners' assertion that the Judges can only consider on remand the *Phonorecords II rates*, and cannot consider on remand the relative strengths and weaknesses of the *structure* in which those rates are embedded. *See* Copyright Owners' Reply Brief on Remand at 14. This distinction is impractical and unworkable. If the (non-"headline" rates[87]) themselves can be reviewed and found acceptable (as they are *infra*) into what structure would they be placed? There are multiple provisions in the *Phonorecords II* rate structure providing for different rates, designed to balance (1) the ability of services to attract consumers with a low Willingness-to-Pay and/or a low Ability-to-Pay (the price discriminatory and differentiated features[88]) with (2) the revenue diminution protections for which Copyright Owners had successfully negotiated. Moreover, the D.C. Circuit has vacated the Determination, and in doing so did not make any rulings critical of the rate structure in the *Phonorecords II*-based benchmark that would suggest the cramped review advocated by Copyright Owners. Indeed, the D.C. Circuit explicitly stated, *without distinguishing between rates and structure*, that it "agree[s] with the Streaming Services that the [Judges] … failed to reasonably explain [their] rejection of the Phonorecords II settlement as a benchmark …" *See Johnson*, 969 F.3d at 376; *see also id.* at 389 (issues relating to "rates" and "rate structure" are "intertwined").

Further, the Judges emphasize that the rate structure of the PR II-based benchmark provides protection *sought by Copyright Owners* against revenue diminution by the Services—*protection they would otherwise lose*—because in this Initial Ruling the Judges are not adopting the vacated uncapped TCC prong for which Copyright Owners are now advocating, and which they claim would have protected them in that regard. *Cf.* CO Additional Submission at 4-6 (acknowledging PR II-based benchmark provided some TCC provisions, allowing for protection against revenue diminution). Thus, the Judges' remand rulings on the PR II-based benchmark rates and on the uncapped TCC rate prong are inextricably interlaced. *See Johnson*, 969 F.3d at 381 (absence of "reasoned explanation" for rejecting PR II-based benchmark was problematic because it occurred "*when*" Judges adopted an alternative proposal that called for "setting … total content cost and revenue rates.") (emphasis added).

The Judges weigh each benchmark's *intrinsic* strengths and weaknesses, as well as its *comparative* advantages and disadvantages *vis-à-vis* other proffered benchmarks. On remand, the interrelationships of the competing benchmarks are of particular importance, given Copyright Owners' need for the aforementioned protections against revenue diminution via price discrimination.[89]

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[87] As explained elsewhere in this Initial Ruling, the Judges are increasing the "headline" rate from 10.5% to 15.1%.

[88] Specifically, the PR II-based benchmark would incorporate the price discriminatory features for product differentiation as between: (1) subscription vs. ad-supported services; (2) portable and non-portable services; and (3) unbundled vs. bundled services. *See* Determination at 10; Dissent at 26. The third category—bundled vs. unbundled—is discussed *infra* in the context of the Bundled Revenue definition.

[89] The Judges categorically reject Copyright Owners' assertion that the PR II-based benchmark cannot be considered because the parties agreed in the *Phonorecords II* settlement that any future statutory mechanical rate determination would made "*de novo" vis-à-vis* that settlement determination. In fact, the industrywide representatives (NMPA and DiMA) who entered into the settlement conspicuously did not agree that the existing rate structure or rates could not be considered as the bases for future rate determinations. By contrast, the *Phonorecords I* settlement agreement

continued on next page

Through this approach, the Judges ultimately may adopt only one of the parties' benchmarks or other methodologies, or they may modify the proposals by combining them, provided such a modification is "within a reasonable range of contemplated outcomes … piecing together a rate structure, the economic and policy consequences of which had already been explored and developed by the parties in the record." *Johnson*, 369 F.3d at 382.

In their consideration of the PR II-based benchmark, the Judges are not suggesting that this benchmark is the optimal tool to use in order to identify rates and terms among all approaches that *might* have been proffered (but were not). But the Judges are cabined by the evidence they receive. *See* 17 U.S.C. §803(a)(1) ("the Judges shall act … on the basis of a written record …."); *see also* P. Wald, *supra*, (noting that parties' economic proposals made in an action "impose[] a practical constraint" on judge who will, "for the most part, be limited by what the parties serve up to her."). Based upon the available record evidence, the Judges find that the Services' PR II-based benchmark – although not necessarily perfect – is more than sufficient to satisfy the legal requisites for application, as well as a practical benchmark, when used in conjunction with the 15.1% headline revenue rate advocated by Copyright Owners. *See generally Nat'l Cable Television Ass'n v. Copyright Royalty Tribunal,* 724 F.2d 176, 182 (D.C. Cir. 1983) (rate-setting is an intensely practical affair).

C. Parties' Remand Arguments Regarding PR II-Based Benchmark[90]

1. Services' Arguments

The Services maintain that their PR II-based benchmark satisfies the "reasonable" rate requirement and is consistent with the four itemized factors set forth in section 801(b)(1). They make several arguments in favor of this position.

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expressly stated "[s]uch royalty rates shall not be cited, relied upon, or proffered as evidence or otherwise used in the [Phonorecords II] Proceeding." Trial Ex.6013, Ph*onorecords I* Agreement at § 3. *Compare* Trial Ex. 6014, *Phonorecords II* Agreement at § 5.5 (omitting clause precluding reliance on evidentiary value of *Phonorecords II* royalty rates and including full-integration clause). This change objectively demonstrates that the parties to the 2012 settlement understood the evidentiary value of the *Phonorecords II* settlement in the next section 115 proceeding, *i.e., this proceeding*. *See* Dissent at 15-16.

On the other hand, the Judges reject the Services' argument that the *Phonorecords II* rates and structure should be retained merely because the Services relied on their continuation to make investments in their business models. As Copyright Owners note, the applicable regulations provide that "[i]n any future proceedings the royalty rates payable for a compulsory license shall be established *de novo*." 37 C.F.R. § 385.17; *see also* 37 C.F.R. § 385.26. A party may feel confident that past is prologue and that the parties will agree to roll-over the extant rates for another period; a party could be sanguine as to its ability to make persuasive arguments as to why the rates should remain unchanged; a party might even conclude that the mechanical rate is such a small proportion of the total royalty obligation that its increase would be unlikely to alter long-term business plans. But for sophisticated commercial entities to claim that they *simply assumed* the rates would roll-over—without the reasonable possibility of significant adjustment or outright abandonment—strikes the Judges as so irrational and reckless as to raise serious doubts about the credibility of that position. (If the Services had made a persuasive argument that certain fixed cost investments were "sunk" and had useful lives that substantially exceeded the five-year rate term, then such costs could be considered under Factor C of section 801(b)(1), but they did not make a persuasive argument in this regard. *Cf. SDARS II*, 78 Fed. Reg. 23,054, 23,069 (Apr. 17, 2013) (adjusting rates downward under Factor C, and distinguishing *internet* music transmissions, to reflect that—because Sirius XM needed to make "unique and substantial" investments in the form of "sunk" costs paid for satellites with a useful life of l2-15 years—"it is not unreasonable for Sirius XM to expect to recoup a certain amount of those costs over the expected useful life of the [s]atellites," which exceeded the five-year rate term.)

[90] The parties made arguments both in the original hearing and in this remand proceeding regarding the Services' proffer of the PR II-based benchmark. Each party's pre-remand and post-remand arguments overlap to some extent. Examination of the pre-remand arguments is also necessary because of the findings in *Johnson* and because the parties agreed that the evidentiary record on this remanded issue would not be enlarged.

First, they aver that their PR II-based benchmark possesses all the characteristics of an "ideal" benchmark. Services' Joint Opening Brief at 19. In this regard, they argue that their proffered benchmark "involves the same sellers, the same or similar buyers, and the same rights as at issue in this proceeding," and that there has been "no material change in the economic circumstances of the marketplace that would warrant adjusting the rate levels or rate structure in the benchmark." *Id.* at 20.

Applying the facts to these benchmark characteristics, the Services assert that the first three elements – same sellers (here, licensors), same buyers (here, licensees) and same rights (the mechanical license for interactive streaming) are satisfied. In particular, they note that the majority of the participants in the present proceeding either directly participated in the *Phonorecords II* settlement process or were active in the market contemporaneous with that settlement. *Id.* at 20-21.

Turning to the next benchmark characteristic – the absence of a "material change in the economic circumstances of the marketplace that would warrant adjusting the rate levels or rate structure in the benchmark" – they emphasize that the PR II-based benchmark contains different rate levels for different product offerings, to account for (a) consumers' varying willingness-to-pay (WTP) and (b) the zero marginal physical cost of digital reproductions of sound recordings containing musical works. *Id.* at 21-22 (citing multiple experts).

Next, the Services point to the fact that the "headline"[91] royalty rate is based on a percent-of-revenue, so that revenue growth (or decline) on this rate prong allows for royalty payments to directly adjust in tandem. *Id.* Further, the Services assert that the importance of streaming as "the future of the music industry" was known to the *Phonorecords II* negotiators, as evidence by the then-recent launch in the United States of the popular Spotify service. *Id*. at 23.

Beyond these benchmark requisites, the Services also emphasize that the PR II-based benchmark is the product of a settlement whose *negotiated* features burnish the value of this benchmark as reflective of effective competition. Specifically, they note:

- The settlement was negotiated in the same statutory context, concerning the identical rate standard and factors as applicable to the present proceeding.
- Neither side would have accepted a deal materially worse than what it expected from a section 115 proceeding applying the Section 801(b)(1) considerations.
- The statutory alternative diminishes any additional licensor-side negotiating power arising from "Must-Have" complementary oligopoly of the licensors of the musical works publishers.

Id. at 22. Moving from the negotiating context to market performance under this standard, the Services aver that this approach has borne fruit for the industry as a whole. They point to the

[91] The Judges and the parties characterize the percent-of-revenue of revenue rate as the "headline" rate. *See Johnson*, 969 F.3d at 383 n.10.

evidence of the licensors' consistent profitability and the licensees' ability to "benefit" from the *Phonorecords II* approach. *Id.* at 23.

The Services also maintain that the *Phonorecords II* structure "addresses any concerns with bundling and the potential for revenue deferment." *Id.* at 24.[92] They assert that these issues were specifically addressed by Copyright Owners during the *Phonorecords II* negotiation, because "multiproduct firms such as Yahoo and Microsoft" that offered streaming services had the capacity to make bundled offerings to consumers. These concerns were addressed in the *Phonorecords II* rate structure, the Services note, through the use of "multiple rate prongs, minima and floors," ensuring that "the total musical works royalty for certain types of offerings does not fall below a specified level," thereby "mitigat[ing] the effect of any potential revenue deferrals and appropriately address[ing] any concerns with bundling." *Id.*[93]

Finally, the Services maintain that "[d]irect agreements between Copyright Owners and Services also support adoption of the PR II-based benchmark." *Id.* at 34. In particular, they note that many of the royalty rates (and terms) in these direct agreements apply the *Phonorecords II* rates. Moreover, the Services maintain, because these direct agreements are in the nature of blanket license of a publisher's entire catalog, they provide an added "access" value in the form of full-repertoire licensing. These direct agreements do not include a rate above *Phonorecords II* levels; thus, the Services contend, they underscore the reasonableness of the *Phonorecords II* rates. *Id.*[94]

Finally, the Services aver that the PR II-based benchmark satisfies the itemized four Section 801(b)(1) factors. With regard to Factor A, they maintain that: (1) the *Phonorecords II* framework has corresponded with an increase in the supply of musical works; (2) the PR II-based benchmark will increase the likelihood that the Services will increase subscriber counts, generating profitability, which will make streaming available to more listeners; and (3) the price discriminatory aspects of this royalty rate structure allows the Services to afford to offer streamed music to listeners with a low willingness (or ability)-to-pay, at lower rates or through ad-supported services. Services' Joint Opening Brief at 25-27.

Regarding Factors B and C (the "fair return" and "relative contributions" objectives), the Services emphasize that the PR II-based benchmark satisfies these statutory elements because it: (1) was the result of negotiations between industrywide representatives who had every incentive to obtain a "fair" return and to receive recompense for their "contributions" to streaming; and (2) allowed interactive streaming to become "a significant means for consumers to listen to music" while simultaneously generating growth in annual royalties for Copyright Owners." *Id.* at 27-29.

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[92] The issue of bundling is addressed in this Initial Ruling *infra*, in connection with the Judges' definition of Service Revenue generated through the offering of sound recordings as part of a bundle containing other goods or services.

[93] The Services also reiterate their pre-remand argument that the *Phonorecords III* settlement of subpart A rates for sales of physical and digital download phonorecords (now reorganized in subpart B) confirms the appropriateness of the Phonorecords II-based benchmark. However, any further reliance by the Services on that argument is moot, because the D.C. Circuit affirmed the Majority's analysis of the subpart A rates. *Johnson*, 969 F.3d at 386 (noting that the Majority adequately explained treatment of the subpart A rates as "'at best' a floor" below which the mechanical royalty rates paid by the Services for interactive streaming cold not fall).

[94] Under section 115—prior to the effective date of the 2008 Music Modernization Act—an interactive service was required to serve a "Notice of Intent" to use the copyright license (NOI) with the owner of a copyright for each musical work before streaming the sound recording embodying that musical work. By contrast, a direct license with a publisher covers more than an individual musical work by providing "access" value to an entire catalog, without the transaction cost burden of filing multiple individual NOIs.

Lastly on the subject of the statutory factors—regarding Factor D (minimizing disruptive impact)—the Services make a succinct argument: "By renewing the rate levels and structure of *Phonorecords II*, there is minimal risk of disruption." *Id.* at 29-30.

The Services also address several further criticisms of the PR II-based benchmark contained in the Determination. Focusing first on an issue specifically addressed in *Johnson*, they assert the irrelevancy of the "subjective intent" of the parties that negotiated the *Phonorecords II* settlement – a factor on which the Majority relied in deciding not to adopt the PR II-based benchmark. In this regard, the Services are also responding to the D.C. Circuit's concern regarding this issue. *See Johnson*, 969 F.3d at 387 ("In rejecting that settlement as a possible benchmark, the [Judges] faulted the Streaming Services for failing to explain why the parties to the *Phonorecords II* settlement agreed to the rates in that settlement … [b]ut nowhere does the [] Determination explain why evidence of the parties' subjective intent in negotiating the *Phonorecords II* settlement is a prerequisite to its adoption as a benchmark.").

The Services note that no benchmark evidence presented by any party is proffered with supporting evidence of the subjective intent of the bargainers who negotiated the benchmark. Moreover, they note that the Majority in fact acknowledged that "[r]elying on a benchmark as *objectively* useful without [the need for] further inspection" is "typical and appropriate for the benchmarking method." *Id.* at 35 (quoting Determination at [55] & n.106 (emphasis added)).

With regard to other criticisms of the Majority's failure to use the PR II-based benchmark, the Services argue that the Majority misapplied their previous rulings that they "cannot and will not set rates to protect any particular streaming service business model." *Id.* at 37 (quoting *Phonorecords III*, 84 Fed. Reg. at 1945). The Services find this principle inapposite, because their point is that the multiple price-discriminatory aspects of the *Phonorecords II* approach made it "a valuable benchmark … because it had allowed for different service types to emerge and grow, which benefits the entire market." *Id.* at 37. The Services also take issue with the Majority's assertion that the *Phonorecords II* rate structure was too complex, deriding it as a "Rube-Goldberg-esque" contraption. *Id.* at 38. Rather, the Services maintain that the structure was as complex as necessary to effectuate the parties' needs, particularly the price discriminatory features and the protections against revenue diminution. *Id.* at 38-39. Further, the Services note that the record is devoid of any testimony or evidence indicating any actual confusion caused by the *Phonorecords II* rate structure. *Id.* at 39. Finally in this regard, the Services maintain that the rate structure adopted by the Majority is essentially as complex as the structure in *Phonorecords II*, with the only major change being the replacement of the capped TCC rates with uncapped TCC rates.[95] *Id.*

The Services address another criticism—that the rates in the PR II-based benchmark are too low. This issue is largely moot, as the D.C. Circuit's affirmance of the Majority's expert "line-drawing" and "reasoned weighing of the evidence" confirmed that a rate increase was necessary. In this Initial Ruling, the Judges have acknowledged specifically the appropriateness

[95] As discussed *infra*, the relative complexity or simplicity of the rate structure is not a statutory factor, nor is it a decisive element of a reasonable rate structure, when the details of that structure effectuate price discriminatory configurations that would increase the availability of music and streaming revenues and otherwise satisfy the statutory criteria.

of the 15.1 % revenue rate—a 44% increase over the 10.5% headline rate in the PR II-based benchmark.[96]

2. Copyright Owners' Arguments

Copyright Owners assert that the record evidence overwhelmingly supports the Judges' rejection of the PR II-based benchmark. At the outset, they maintain that the Judges found—and the D.C. Circuit affirmed—that a rate increase was required in the *Phonorecords III* terms. CO Initial Submission at 13. (As noted, an increase in the headline rate by 44%, to 15.1%, is adopted in this Initial Ruling.)

Next, Copyright Owners maintain that the evidence established that "market conditions" were "radically different" at the time of the *Phonorecords III* proceeding compared with when the parties entered into their 2012 industrywide agreement in *Phonorecords II*. *Id.* at 17. In particular, Copyright Owners point to testimony describing the streaming industry as "nascent" in 2012, with fewer streams, subscribers, services, and choices of music; operating in a consumer environment when download purchases and Pandora's noninteractive service were the predominant means for consumers to listen digitally to music. *Id.* at 18-21. In sum, Copyright Owners maintain, that streaming was "economically insignificant" to the music industry when the PR II provisions were adopted. *Id.* at 20.

Copyright Owners particularly emphasize the substantial increase in streaming revenue during the *Phonorecords II* period. They point out that while "total streaming revenue had ranged from approximately $150 million in 2005 to $212 million in 2010, … after 2012[,] annual [streaming] revenue exploded to reach approximately $1.6 billion by 2015." *Id.* at 23. Further, they note there is no evidence that the music publishers or anyone else had predicted this substantial rise in streaming and the revenues it generated, and that in no way could it be inferred that those rates had "baked-in" future growth. In fact, Copyright Owners assert at the hearing that the PR II rates were merely "experimental"—consistent with the relatively nascent stage of the streaming industry. *Id.* at 25.

Additionally, Copyright Owners maintain that the identities of the parties involved in the *Phonorecords III* proceeding are different from those who established the *Phonorecords II* framework. Although they acknowledge the presence of current interactive services Spotify and Rhapsody in this market prior to the *Phonorecords II* framework agreed to by the trade associations for the interactive services and the music publishers, they point out that "[n]one of the other participants in this proceeding even entered the streaming business until after the *Phonorecords II* settlement." *Id.* at 21.

Next, Copyright Owners assert that the Services' evidence is inadequate to support a finding that the rates in their PR II-based benchmark are suitable for use in setting royalty rates in this proceeding. First, they echo the Determination, which stated that the Services (1) did not examine in detail the particular rates within the existing rate structure; (2) relied on the 2012

[96] The Judges characterize this issue as largely moot because the PR II-based benchmark includes on its "lesser of" prongs price discriminatory rates, discussed *infra*. But those "lesser of" rates are overridden by the "greater" 15.1% rate. As also discussed *infra*, Mechanical Floors continue to bind at lower mechanical royalty levels (without reducing the songwriters' "All-In" musical works royalty that includes the performance royalties), because these floors were retained in the Determination and were not the subject of appeal.

rates as objectively useful without further inspection; and (3) did not call witnesses to testify regarding the 2012 settlement negotiations. *Id.* at 27 (citing Determination, 84 Fed. Reg. at 1944 & n.106). Because of the absence of the foregoing evidence, Copyright Owners assert that the Services were left with "no evidence explaining how the particular rates and percentages in those settlements were calculated or derived, how they were negotiated, or how they were reasonable in light of the explosive growth in the streaming marketplace between the time of those settlements and the *Phonorecords III* proceeding." *Id.* at 28. The absence of such evidence, according to Copyright Owners, meant that the Services had failed to carry their burden of proof under 5 U.S.C. § 556(d) with respect to their proposal, a burden Copyright Owners assert the Services acknowledged they bore. *Id.* at 29-30.

Additionally, Copyright Owners claim that the D.C. Circuit found "validity" in Copyright Owners' assertion that the subjective intent of the parties to the *Phonorecords II* settlement is relevant because it would have revealed whether the agreed-upon rates were based on economic realities or instead were driven by other considerations. *Id.* at 30-31 (citing *Johnson*, 969 F.3d at 387). However, Copyright Owners acknowledge that, because this was not a reason given by the Majority, it carried no weight with the D.C. Circuit on appeal. *Id.* at 31.

3. Analysis and Decision Regarding PR II-Based Benchmark[97]

a. PR II-Based Benchmark Meets Most of the Requisites for a Useful Benchmark

The four classic characteristics of an appropriate benchmark are:

> (1) the degree of comparability of the negotiating parties to the parties contending in the rate proceeding,
>
> (2) the comparability of the rights in question,
>
> (3) the similarity of the economic circumstances affecting the earlier negotiators and the current litigants, and
>
> (4) the degree to which the assertedly analogous market under examination reflects an adequate degree of competition to justify reliance on agreements that it has spawned.

In re Pandora Media, 6 F.Supp.3d 317, 354 (S.D.N.Y. 2014, *aff'd sub nom Pandora Media Inc. V. ASCAP*, 785 F.3d 73 (2d. Cir. 2015). As discussed below, the PR II-based benchmark meets criteria (1), (2) and (4), but requires adjustment to fully satisfy criterion (3).

[97] The setting of statutory royalty rates involves to a significant degree the application of economic analysis. Accordingly, the Judges find it appropriate to set forth certain key aspects of microeconomics that guide the application of the section 801(b)(1) standard in the present proceeding. That guidance is set forth more fully in the Dissent at 29-39.

First, the PR II-based benchmark obviously pertains to the same rights at issue in this proceeding, as it reflects the licensing provisions from the immediately preceding mechanical license proceeding.

Second, the licensors (songwriters and music publishers) and licensees (interactive streaming services) are comparable (albeit not identical). While Copyright Owners emphasize the different identities and market involvement of the licensees, particularly the greater market penetration of Amazon, Apple, and Google, the Services note that even prior to the more significant entry of these three entities, similar multiproduct firms, such as Yahoo and Microsoft, were active licensees. The Judges find that the changing identities of the large multiproduct technology firms does not demonstrate the absence of comparability between and among such firms in the *Phonorecords II* and *Phonorecords III* rate periods. The shifting market entries, exits, strategies, successes and setbacks of otherwise comparable firms are expected occurrences in a dynamic capitalist market system and are not factors that materially diminish the necessary comparability of the parties for benchmarking purposes.

Third, important economic fundamentals of the marketplace are sufficiently similar in crucial respects. First, the heterogeneity of the willingness-to-pay among subscribers and listeners in the downstream market continues to support price discrimination and thus differentiated royalty rates upstream pursuant to the concept of "derived demand." *See* Determination at 19 (and record citations therein) ("Weighing all the evidence and based on the reasoning in this Determination, the Judges conclude that a flexible, revenue-based rate structure is the most efficient means of facilitating beneficial price discrimination in the downstream market."); Dissent at 32, 51, 86, 121, 126 (and record citations therein).[98] Second, the items being licensed for transmission—"second copies" of sound recordings (with embedded musical works)—have a marginal physical cost of zero, a critical economic point on which the experts for both parties concur, and as to which the Majority and the Dissent repeatedly and significantly rely. *See* Determination at 18, 21, 36, 59, 80 (and record citations therein); Dissent at 30-31, 33-34, 37, 47, 49-50, 59, 122, 127-128 (and record citations therein).[99]

Copyright Owners are clearly correct, however, in noting a substantial change in economic circumstances that distinguished the *Phonorecords II* negotiations from the current proceeding; *viz., the dramatic growth of interactive streaming revenues*.[100] The economic impact of this revenue growth is incorporated into the experts' Shapley Value Models and the

[98] The Determination asserts that it includes a price discriminatory feature because a revenue percentage-based rate is itself price discriminatory, in that it does not set royalties on a per-play basis. Determination at 35 n.71. But that "blunt" form of price discrimination does not capture the granular discriminatory features that the parties had negotiated. There is no sufficient basis for the Judges to substitute their own blunt conception of the appropriate form and extent of price discrimination for the structure generated in negotiations by the market participants. *See* Dissent at 37.

[99] It bears emphasis that the fact "second copy" reproductions are physically costless does not even suggest that the market price should be zero. Rather, in this "second-best" economic context, pricing above marginal physical costs is imperative in order for Copyright Owners to recover their "first copy" costs, avoid "opportunity costs," and earn profits. *See* Dissent at 36-38.

[100] Copyright Owners also cite data demonstrating the increase in listeners and the number of streams. The Judges find those data to be causal for the key point in rate setting in this proceeding—the significant increase in revenues.

Judges' analysis of same. This analysis has generated the 44% increase in the headline royalty rate, from 10.5% to 15.1% (as phased-in by the Majority and again in this Initial Ruling).[101]

Simply put, three economic principles co-exist. First, the downstream interactive streaming market remains differentiated among listeners with different willingnesses and abilities to pay, based on varied preferences (utility) and disparities in income. Second, streaming of the "second copy" of the sound recordings (with embedded musical works) remains physically costless (but generates potential "opportunity costs"). But, third, streaming revenues have grown substantially. There is no incompatibility or inconsistency in the simultaneity of these economic principles. Each of them must be taken into account and they are in this Initial Ruling.

This economic context refutes the arguments made during oral argument at the D.C. Circuit that the PR II-based benchmark should be rejected *in toto* because it was supposedly "outdated." The heterogeneity of the downstream demand of listeners and the zero physical cost of "second copies" are enduring features that affect the upstream market via the principle of derived demand. The substantial growth of streaming revenues, however, necessitated an increase in the headline rate from 10.5% to 15.1% (as phased-in), for the reasons discussed in the Judges' analysis in this Initial Ruling of the interrelationship among: (1) Shapley Value modeling; (2) Nash Bargaining; (3) complementary oligopoly power; and (4) effective competition.

Further, the foregoing analysis also undermines the pre-remand argument made by Copyright Owners that the PR II-based benchmark reflects a market that was not yet "mature," or was only "experimental." Markets are not "mature" as opposed to, say, "adolescent." Indeed, the metaphor is strained because all economic models are subject to revision if the salient facts have changed, without rendering the prior models mere "experiments." Markets simultaneously exhibit enduring characteristics—here, heterogeneous customers and zero marginal physical costs and dynamic change—here, significant revenue increases.[102]

And yet, Copyright Owners seek to deny the idea that these principles could exist simultaneously. In an attempt to disqualify the application of the PR II-based benchmark, Copyright Owners complain:

[101] At first blush it may seem that the increase in interactive revenues is not an economic fundament that would support an increase in a percentage-of-revenue based royalty formula. However, as more fully discussed herein, under the Shapley Value approach, the increase in revenues has generated an increased "Shapley Surplus" (roughly analogous to interactive streaming industry profits), which the two "Must Have" input suppliers (record companies and Copyright Owners) will essentially split equally. If this surplus increases faster than the interactive services' non-content costs (or if those costs remain stable or fall), the increased revenues would flow disproportionately to theses input suppliers, thus causing the increase in revenues to support an increase in the royalty rate, all other things held constant. And, because the "Must Have" input suppliers have complementary oligopoly power, the Majority relied on a Shapley model constructed by Spotify's expert, Professor Marx, that adjusted for this market power.

[102] If one were to indulge the "maturity" metaphor, the ongoing creative destruction in the streaming industry has only reinforced the fact that, according to one of Copyright Owners' own economic expert witnesses, the interactive streaming market (as of the *Phonorecords III* hearing) was not yet mature, but rather remained "a relatively new enterprise." Watt WRT ¶¶ 39-40. Thus, it is hardly clear from the record that interactive streaming has "matured" in a manner that would render anachronistic the enduring marketplace characteristics.

> [W]hile streaming activity and revenues grew under the Phonorecords II royalty rates, the [redacted]. For example … [redacted]

CO Initial Submission at 15-16 (emphasis added).

But as the Services explained, the economic defect in Copyright Owners' analysis, is that it ignores the principle of price discrimination and its beneficial effects:

> [A]s [Professor] Hubbard explained, it is "meaningless" to compare growth in streams to growth in royalties in the context of Prime Music in particular because the record showed that Prime Music brings "new people into the market." … If not for the flexibility (and beneficial price discrimination) the existing Service Provider Revenue definition and rate structure facilitated, the Copyright Owners "would have gotten zero" from those new listeners. … "So they're better off by that amount" of royalty growth. … The undisputed fact that [redacted]—reflects that the existing rule enables beneficial price discrimination that expands the total royalty pool and benefits Copyright Owners.

Services' Reply at 58-59.

This rebuttal by Professor Hubbard is an example of the important distinction between "increases in demand" (when the demand curve shifts outward) and movements "down the demand curve" (when sellers use price discrimination to generate more revenue without additional cost to attract buyers with a lower willingness or ability to pay). The parties' otherwise dueling economists agreed on this point. *Compare* 4/3/17 Tr. 4373-74 (Rysman) (Copyright Owners' witness acknowledging that under the current rate regime overall revenues might be increasing because of movements "down the demand curve" (*i.e.*, changes in quantity demanded in response to lower prices), rather than because of, or in addition to, an outward shift of the demand curve (*i.e.,* increase in demand at every price) *with* 3/13/17 Tr. 701 (Katz) (the Services' witness who likewise noted that the present structure enhances variable pricing that allows streaming services "to work[][their]way down the demand curve.").

Moreover, Copyright Owners baldly cherry-pick the data they present. [redacted] CO Initial Submission at 15-16. So, by their own data, presented in their own brief, they acknowledge that [redacted] *See*

Services' Reply at 57-58 (Copyright Owners have proven the "opposite" of what they intended). This is precisely what beneficial price discrimination is designed to accomplish.[103]

The appropriateness of adopting the price discriminatory rate provisions of the PR II-based benchmark is further underscored by Copyright Owners' candid acknowledgement at the hearing that they were essentially urging the Judges to adopt what is known as the "Bargaining Room" approach to rate setting. *See* Dissent at 24 (and record citations therein).[104]

In the present proceeding, the appropriateness, *vel non*, of the Bargaining Room approach boils down to the following:

> Copyright Owners emphasize the inability of the Judges (or anyone) to identify present market rates precisely, let alone over the five-year rate period because the compulsory license set by the Judges cannot possibly contemplate every single business model that may develop in the ensuing time.… If the statutory rate is set *below* market rates, then the parties will *never* negotiate upward toward the market rates, because the licensees will always prefer to invoke the right to use the licensed work at the below-market statutory rates. However, if the Judges set the statutory rate *above* what they find to be market rates, different licensees who each have a maximum willingness to pay (WTP) *below* such a statutory rate would seek to negotiate lower rates with the licensors. In response to such requests to negotiate, according to this argument, Copyright Owners would respond by negotiating various lower rates for those licensees, provided lower rates were also in the self-interest of Copyright Owners.

Dissent at 24-25 (and record citations therein).

The Judges find no reason to depart from the policy decision in *Phonorecords I* that the rate setting policies made explicit in section 801(b)(1) are best discharged if the Judges eschew the Bargaining Room approach and continue to identify rate structures and rates that reflect the standards set forth in the statutory provision. To supplant the statutory factors with a Bargaining Room approach would essentially be to adopt a purely market-based rate-setting approach that is inconsistent with section 801(b)(1) and with the Judges' application of that statute to set rates, rate structures, and terms consonant with effective competition.

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[103] Further, [redacted] because: (1) the marginal physical cost of "second-copy" streams is zero; (2) royalties were calculated [redacted]; and (3) Copyright Owners' original proposed a per-play (*i.e.*, per-stream) metric, which was rejected by all three of the Judges.

[104] The Bargaining Room approach was first proposed for incorporation into the statutory license standard in 1967 by the NMPA, to be included in the predecessor section, later reorganized in § 801(b)(1) that governs this proceeding. *See* Dissent at 22-24 (and citations therein). Ultimately, Congress punted on the Bargaining Room approach, and adopted into law the four-factor language set forth in section 801(b)(1). A subsequent attempt by NMPA to have the Copyright Royalty Tribunal (CRT) (a predecessor to the Judges) adopt the Bargaining Room theory was rejected by the CRT, a rejection that was affirmed on appeal. *See Recording Industry Ass'n. of America v. Copyright Royalty Tribunal,* 662 F.2d 1, 37 (D.C. Cir. 1981), *aff'g* Adjustment *of Royalty Payable under Compulsory License for Making and Distributing Phonorecords*, 46 Fed. Reg. 10,466, 10,478 (1981). *See generally,* F. Greenman & A. Deutsch, *The Copyright Royalty Tribunal and the Statutory Mechanical Royalty: History and Prospect*, 1 Cardozo Arts & Ent. L.J. 1, 53, 64 (1982).

With this background in mind, the Judges turn specifically to the interrelationship between the price discrimination aspects of the rates in the PR-II benchmark and the Bargaining Room approach.

Copyright Owners have demonstrated (albeit tacitly) their understanding that, if the statutory provisions did not contain a price discriminatory rate structure to reflect the varying WTP, *they would have to invent it*. This finding is apparent from their advocacy for the adoption of a Bargaining Room approach to rate-setting. *See, e.g.,* 4/3/17 Tr. 4390, 4431 (Rysman) lauding bargaining room approach as reflecting "economical element of *price discrimination*… the [licensor] is picking its price*s* carefully.") (emphasis added); *id.* at 4431 (explaining that under this approach, when negotiating with Spotify regarding a rate for ad-supported service, "Must Have" music publishers would "have the right … to set that price."); 4/4/17 Tr. 483-45 (Eisenach) (acknowledging Copyright Owners' approach was consistent with Bargaining Room theory because they were seeking rates so high as to force would-be licensees to negotiate for the "Must Have" mechanical license.).

Thus, the Judges find there to be no real dispute as to *whether* there is a market-based need for an upstream discriminatory rate structure.[105] Rather, the parties appear to be in disagreement as to *who* shall be in control of the setting of rates, the Judges, through their application of *law*, or Copyright Owners, through the exercise of their complementary oligopoly *power*. The resolution of this choice is clear; the Judges, not the licensors, are statutorily-charged with establishing provisions that are reasonable and otherwise properly reflect the itemized objectives of section 801(b)(1).

<u>Fourth</u>, the PR II-based benchmark reflect a rate structure with an adequate degree of competition, because there was a balance of bargaining power between the two negotiating industrywide trade associations, offsetting the complementary oligopoly effects in place when a "Must Have" licensor bargains separately with each licensee. Recently, the Judges discussed in detail how the presence of countervailing bargaining power generates royalty rates at effectively competitive levels. *See Web V*, 86 Fed. Reg. 59,452, 59,457 (Oct. 27, 2021).

Further with regard to this fourth point, the parties have been operating over the past ten years under this basic rate structure, with profits accruing to the licensors and admittedly tolerable losses befalling the licensees. Moreover, after experience with these rates and this rate structure in the *Phonorecords I* period, they renewed and expanded this structure for use in the

[105] The *Majority* recognized this point as well when – regarding the "increase the total revenue that price discrimination enables – they ask (and answer) rhetorically: "How could Copyright Owners and their economic experts argue against a rate structure that inures to their benefit as well? The answer is: They do not. … [T]hey advocate for a rate set under the bargaining room theory, through which mutually beneficial rate structures can still be negotiated, but not subject to the "reasonable rate" and itemized factor analysis required by law." Determination at 85 & n.153. The Judges also note that Copyright Owners' acknowledgement that they too would set price discriminatory rates and structures is not simply a feature of *this* market. Rather, "discriminatory pricing … is the normal attribute of equilibrium … in a broad range of market types and conditions where consumers can be separated into distinct groups with different demand elasticities." W. Baumol, *Regulation Misled by Misread Theory: Perfect Competition and Competition-Imposed Price Discrimination* at 2 (2002). *See also* Dissent at 38, n.74. Given the ubiquity of discriminatory pricing, the Judges also find that the adoption into the statutory license of such pricing is not – as Copyright Owners contend – simply the inappropriate favoring of a particular business model, but rather a necessary reflection of the fundamental nature of market demand, particularly, the varied WTP among listeners.

Phonorecords II period, when the alternative of a statutory rate proceeding was available to licensors and licensee alike. Their mutual willingness to continue in this manner is important evidence of the workability and reasonableness of this approach.

b. Evidence of Subjective Intent not Prerequisite to Partial Adoption of the PR II-Based Benchmark[106]

The Judges rely on the PR II-based benchmark as an *objective* benchmark. Thus, the absence of testimony regarding what went through the minds of the negotiators of the *Phonorecords II* agreement (and the predecessor *Phonorecords I* agreement) does not diminish the objective value of this benchmark. The Judges view the provisions of the PR II-based benchmark as they would any benchmark, in the context of the requisite benchmarking elements identified and discussed *supra*. This approach allows the factfinder to analyze the benchmark through the lens of its service in the marketplace as an objective model for the market at issue, the *Phonorecords III* market. *See, e.g.*, 3/13/17 Tr. 550-51, 566 (Katz) (knowledge of why parties negotiated specific provisions is unnecessary, because objective results demonstrate satisfactory performances of market).

Both Professors Katz and Hubbard noted that the current rate structure remains useful, not based on consideration of the parties' subjective understandings at the time of its creation, but because the market has not since changed in a manner that would create a basis for departure. Katz WDT ¶ 80 ("My analysis has identified no changes in industry conditions since then [2012] that would require changing the fundamental structure of the percentage-of-revenue prong."); 4/13/17 Tr. 5977-78 (Hubbard) (changes in market are "not uncorrelated with the structure that was in place" in 2012).[107]

In this regard, it bears emphasis that Copyright Owners' own witness, Dr. Eisenach, relied on several potential approaches that the Majority characterized as benchmarks for his rate analysis, without attempting to examine the subjective intent of the parties who negotiated those agreements. Indeed, the Majority found that the PR II Rates were properly considered as an objective benchmark, in the same manner as Dr. Eisenach's proffered benchmarks:

> The Services do not examine in detail the particular rates within the existing rate structure. Rather, they treat the rates within that structure as benchmarks, *i.e.,* generally indicative of a sufficiently analogous market that has "baked-in" relevant economic considerations in arriving at an agreement. Dr. Eisenach did not analyze *why* he chose the levels for the rates and ratios on which he relied as benchmarks

[106] At the outset, the Judges reject Copyright Owners' contention that the D.C. Circuit found "validity" in their assertion that there was merit in Copyright Owners' assertion of the "subjective intent issue." Rather, on this issue, *Johnson* first held: "[N]owhere does the [] Determination explain why evidence of the parties' subjective intent in negotiating the Phonorecords II settlement is a prerequisite to its adoption as a benchmark." *Johnson*, 969 F.3d at 387. Then, when Copyright Owners' appellate counsel attempted to cure that failure by making their own "subjective intent" argument, the D.C. Circuit responded to that "subjective intent" argument with a single word: "*Perhap*s." *Id.* (emphasis added). This does not in any way suggest that *Johnson* found "validity" in the "subjective intent" argument, but rather was a non-committal response, consistent with the D.C. Circuit's ruling finding that the Determination had not explained this point.

[107] As noted *supra*, the relevant material change since the *Phonorecords II* agreement was reached is the significant growth in streaming revenues. That change is reflected in the Judges' application of the Shapley Value analyses, by which the Judges increased the headline royalty rate by 44%, from 10.5% to 15.1% (phased-in).

> or consider the subjective understandings of the parties who negotiated his benchmarks. Similarly, the Services' economists elected to rely on the 2012 rates as objectively useful without further inspection.
>
> This point is not made to be critical of Dr. Eisenach's approach, but rather to show that the Services' reliance on the 2012 settlement as a benchmark shares this similar analytical characteristic, typical and appropriate for the benchmarking method. (The factual wrinkle here is that, hypothetically, the Services could have called witnesses and presented testimony regarding the negotiations that led to the 2012 (and 2008) settlements, but did not, rendering the 2012 benchmark similar to other benchmarks taken from other markets.)

Determination at 55 & n.106.[108]

Copyright Owners also aver that they entered into the *Phonorecords II* settlement simply to avoid litigation costs. Copyright Owners' Reply Brief on Remand at 29. At the hearing, this assertion was presented by David Israelite, NMPA's President. Israelite WRT ¶ 28; 3/29/17 Tr. 3649-52 (Israelite) (claiming NMPA lacked financial position to fund rate litigation). The Services countered by noting that there was no evidence to support Mr. Israelite's testimony in this regard, or how it may have impacted the NMPA decision to participate. And, the Services pointed out, notwithstanding his testimony regarding financial constraints, NMPA had incurred the expense of a year-long negotiation with the Services to seek higher rates, create new service categories in Subpart C, and change the TCC calculations. *Id.* at 159, 161-64; 3/29/17 Tr. 3856 (Israelite).

Further, as a general principle, a party's mere assertion that the *Phonorecords II* approach was the product of a settlement that was predicated on the avoidance of litigation costs savings does not invalidate its use as a benchmark in proceedings before the Judges, especially because, by statute, the Judges are authorized to consider such agreements. *See Music Choice v. Copyright Royalty Board,* 774 F.3d 1000, 1014-15 (D.C. Cir. 2014) (testimony alleging agreement was reached to avoid litigation costs does not invalidate evidentiary use of that agreement for rate setting purposes, absent other evidence demonstrating settlement was involuntary or otherwise unreasonable.). Thus, the Judges find that the evidentiary record does not support Copyright Owners' position that this "litigation cost avoidance" assertion constituted a separate, idiosyncratic value that diminishes the Judges' partial reliance on the PR II Rates in this Initial Ruling.

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[108] Copyright Owners do not deny that they did not offer evidence of subjective intent for Dr. Eisenach's benchmarks. Rather, they assert Dr. Eisenach's reliance on benchmarks without examining the subjective understandings of the negotiators of the benchmarks is irrelevant because: (1) Copyright Owners were not seeking the adoption *in toto* of the rates contained in any specific benchmark cited by Dr. Eisenach; (2) Dr. Eisenach analyzed multiple benchmarks to derive a reasonable range of rates; (3) his benchmarks were not adopted; and (4) his benchmarks and are not at issue on this remand. Copyright Owners Reply Brief on Remand at 28 n.19. But Copyright Owners confuse evidentiary *standards* with evidentiary *application*. Benchmarks are subject to the same evidentiary standards, regardless of the breadth of purpose for which they are proffered and regardless of whether they were adopted or rejected. Further, the fact that Dr. Eisenach's chosen benchmarks are "not at issue on this remand" does not render Copyright Owners' reliance on purely objective benchmarks uninformative as to their own understanding of the irrelevancy of the subjective thoughts of benchmark negotiators. *See generally Web IV*, 81 Fed. Reg. at 26,370 (proposed benchmark adjustment based on alleged "additional value" should be supported by "record evidence … to provide a basis for such for such an adjustment.").

Copyright Owners also mistakenly rely on the fact that the Services bore the burden of proof regarding the absence of any subjective idiosyncratic factors that hypothetically could have diminished the useful value of the PR II-based benchmark. *Id.* at n.21. The Services indeed bore the burden of *proof* (*i.e., persuasion*) with regard to their proffered benchmark PR II Rates, and they presented adequate objective evidence and testimony that this approach has worked in the marketplace to serve as *prima facie* proof to support the Judges'(partial) use of this benchmark in this remand proceeding. And, as explained above, such subjective intent was not a necessary element of their benchmark proofs. But, with regard to Copyright Owners' *rebuttal* to those proofs, Copyright Owners bore the burden of *production*, to present sufficient evidence and/or testimony that the Judges could rely on to reject the (partial) use of the PR II-based benchmark. This Copyright Owners failed to do.[109]

In fact, given Copyright Owners' reliance on the subjective intent of the parties to a benchmark, the Judges attempted to identify potential subjective evidence of how the capped TCC rates in the PR II-based benchmark[110] were derived, during the examination of Dr. Eisenach at the hearing:

> [JUDGE STRICKLER] Do you discuss, Dr. Eisenach, … in your written direct or written rebuttal testimony how the parties arrived … at the ratios for sound recording to musical works in [witness interrupts]
>
> [DR. EISENACH] That process is opaque to me, Your Honor.
>
> [JUDGE STRICKLER] Did you [witness interrupts]
>
> [DR. EISENACH] I know -- I know there was a 2008 negotiation. I know there was a 2012 negotiation. I wasn't … present, and I'm not privy to any of the details.
>
> [JUDGE STRICKLER] You were not informed by your client or by any other source of information as to how they arrived at those particular ratios?
>
> [DR. EISENACH] *When I've asked the question, I've found people chuckle* and -- and there doesn't seem to have been too much system-- systematic thought that went into it, *but I don't really know that*. I just -- when I ask the question, people say: *Nobody really knows*. … Someone may know, but that's what I've been told.

4/4/17 Tr. 4611 (Eisenach) (emphasis added). The Judges find it perplexing, to say the least, that Copyright Owners would "chuckle" when asked by their expert witness for the very subjective evidence which they claim to be relevant. But of perhaps greater relevance is Dr. Eisenach's further testimony, quoted above, that he was also told by Copyright Owners that "nobody really knows" how the parties arrived at those rate ratios. Copyright Owners' "chuckle," in response to its expert's critical inquiry as to the derivation of rates—and that expert's understanding that his client *simply did not know how those rates were derived*—undercut Copyright Owners' claim

[109] As described in this Initial Ruling, the Judges identified this same distinction between the burden of proof and the burden of production to find in favor of Copyright Owners' proffered expert testimony in support of their Nash Bargaining analysis, testimony which constituted *prima facie* proof that was not adequately rebutted by the production of sufficient testimony from the Services' expert economic witnesses.

[110] The "capped" TCC rates are elements of the *Phonorecords II* rates.

that subjective understanding of those rates could undermine their usefulness in the benchmark.[111]

c. Substantial Evidence Demonstrates that PR II Rates, other than the Headline Rate, are Not "Too Low"

As noted *supra*, one reason the D.C. Circuit vacated and remanded the Determination was because it declined to entertain the argument made only by appellee's counsel that "the prior rates had been set far too low, thus negating the usefulness of the prior settlement as a benchmark." *Johnson*, 969 F.3d at 387. The Judges have noted throughout this Initial Ruling their adoption of the Shapley Value modeling analysis undertaken by the Majority, and raised the headline royalty rate by 44% from 10.5% to 15.1% (as phased-in), rendering moot appellate counsel's suggestion regarding the rate level.

Here, the Judges further consider whether other rates within the PR II-based benchmark are reasonable, not only because they are part and parcel of the workable structure of that benchmark, but also to determine if they are supported by record evidence. To put this issue in context, those rates would apply on the second prong of the "greater-of" rate structure in the PR II-based benchmark. The first prong in the PR II-based benchmark rates is the 10.5% revenue rate—increased to 15.1% (as phased-in) by this Initial Ruling. The second prong consists of the "lesser of" a TCC rate or a per subscriber rate.[112] For certain delivery configurations, these rates also cannot fall below any applicable Mechanical Floor. *See Johnson*, 969 F.3d at 370.[113]

The Services describe the key feature of these non-headline rates as the fostering of beneficial price discrimination, *i.e.*, the adoption of "different rate levels for different product offering," in order [t]to account for consumers' different willingness to pay [WTP] for music. Services' Joint Opening Brief (on Remand) at 21. As an example of how these price discriminatory rates impacted the market, the Services compare and contrast two Amazon offerings, Amazon Music Unlimited (for Echo) and Amazon Prime Music.

Amazon Music Unlimited, with more than 30 million available songs as of the *Phonorecords II* proceeding period, *see* Mirchandani WDT ¶ 41, [redacted]

[111] The Judges also find Copyright Owners' assertion that they did not know how those rates were established is not credible, given that they and their representatives negotiated those rates.

[112] This second prong contains only a TCC rate (*i.e.*, an uncapped rate) for: (1) the ad-supported the service, because there are no subscribers to such a service; and for (2) bundled subscription service, for which there is a $0.25 per month floor but no per-subscriber cap, and Service Revenue for such bundles is calculated pursuant to 37 C.F.R. § 385.11 ("Service Revenue" definition, ¶ 5).

[113] As *Johnson* explained, the CRB Judges "retained the mechanical floor" because, like so much of the PR II-based benchmark, it "'appropriately balances the [streaming service providers'] need for the predictability of an All-In rate with publishers' and songwriters' need for a failsafe to ensure that mechanical royalties will not vanish[.]" *Id.* at 371-72. It is noteworthy that Copyright Owners urged the Judges (successfully) to maintain the Mechanical Floor provisions, which are the product of the *Phonorecords II* (and *Phonorecords I*) negotiations. Thus, it seems apparent that Copyright Owners as well as the Services consider provisions from the negotiated rates and rate structure to be in the nature of benchmarks, although differing as to which elements such be included or excluded. (The Services unsuccessfully argued for the elimination of the Mechanical Floors.) This perspective underscores the correctness of the Judges' decision on remand to treat the PR II-based benchmark as useful.

[redacted].[114] By contrast, Amazon Prime Music, calculated as a "bundled subscription" configuration, makes available only an abridged repertoire of 2 million songs, see Mirchandani, supra, and [redacted] *See id.* at § 385.13(a)(4).

Thus, Amazon pays [redacted] for listening by the more casual consumers who use the limited catalog Prime Music service at no additional charge beyond their Prime membership fee, compared to consumers who want the full repertoire provided by Amazon Music Unlimited on their Echo devices. *See* Services' Joint Opening Brief at 71. These royalty obligations demonstrate the combination of price discrimination, product differentiation and "derived demand" in action; that is, the [redacted] are derived from the lower demand of consumers of the limited Amazon Prime Music service compared with subscribers to Amazon Music Unlimited on their Echo devices, which in turn drive higher revenues.

It is also important to note that these differential rates on the second prong of the "greater-of" structure of the PR II Rates are overridden by the revenue percentage rate on the first prong if that first prong rate generates more revenue. For example, [redacted], *see* Dissent at 29 (Table) and 116; *see also* [redacted] With the headline rate now increased on a phased-in basis, the price discriminatory royalty generated by this [redacted]

It is noteworthy that *Johnson* affirmed the Majority's setting of other price discriminatory features, *e.g.*, the family and student plan provisions, based on the Judges' reliance on the Services' expert testimony regarding the benefits of "having a way … where low willingness to pay consumers can still access music in a way that still allows more monetization of that provision of that service." *Johnson*, 969 F.3d at 392-93. In similar fashion, the multi-tiered rates in the PR II-based benchmark likewise were supported by the same type of testimony; indeed, from expert testimony proffered by both parties, as considered below.

First, Professor Katz notes that the existing rate structure captures two important aspects of the economics of the interactive streaming market: (1) the variable WTP among listeners; and (2) the corollary variable demand for streaming services. *See* 3/13/17 Tr. 586-87 (Katz); *see also* Marx WRT ¶ 239 *et seq.*; 4/7/17 Tr. 5568 (Marx) (noting that the present structure serves differentiated products offered to customer segments with a variety of preferences and WTP). In more formal economic terms, Professor Katz notes that the present structure enhances variable pricing that allows streaming services "to work [their] way down the demand curve," *i.e.*, to engage in price discrimination that expands the market, providing increased revenue to the Copyright Owners as well as the Services. 3/13/17Tr. 701 (Katz).

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114 [redacted]

Second, in similar testimony, Professor Hubbard captures the interrelationship between the economics of this market and the existing rate structure:

> [F]rom an economic perspective, you can think of this market and this industry as being composed of different customer segments by tastes and preferences and willingness to pay. And so no rate structure can really work without understanding that, and no business model can really work without understanding that.
>
> [I]n terms of rate structures, the *Phonorecords II* framework from the previous proceeding does offer a benchmark to start because it provides for differences in distinct product categories in terms of music service offerings, pricing possibilities, and so on. And it has encouraged a very diverse digital music offering set from actual competitors.

3/21/17 Tr. 2175-76 (Hubbard). Moreover, Professor Hubbard [redacted] 4/13/17Tr. 5978 (Hubbard); *see also* Hubbard WDT ¶4.7 (the 2012 rate structure provides the "necessary flexibility to accommodate the underlying economics of Amazon's various digital music service offerings."). *See also* 3/15/17 Tr. 1176 (Leonard) (notwithstanding changes and growth in the streaming marketplace over current rate period, underlying economic structure of marketplace, which made percent-of-revenue based royalty appropriate, has not changed).

Third, the Services' experts further assert that the multiple pricing structures necessary to satisfy the WTP and the differentiated quality preferences of downstream listeners relate directly to the upstream rate structure to be established in this proceeding. For example, Professor Marx opines that the appropriate *upstream* rate structure is derived from the characteristics of downstream demand. 3/20/17 Tr. 1967 (Marx) (agreeing that rate structure upstream should be derived from need to exploit willingness to pay of various users downstream via percentage of revenue because downstream listeners have varying willingness to pay that should be exploited for mutual benefit of copyright licensees and licensors). Professor Marx further acknowledged that this upstream:downstream consonance in rate structures represents an application of the concept of "derived demand," whereby the demand upstream for inputs is dependent upon the demand for the final product downstream. *Id.* Moreover, Dr. Leonard notes that reliance on the Services to identify segmented demand and develop price discriminatory approaches is appropriate because "the downstream company is going to have a lot more information about … the business, about what makes sense." 4/6/17 Tr. 5238 (Leonard).

Regarding a comparison of revenue growth to streaming growth, Professor Hubbard dismisses as economically "meaningless" Copyright Owners' argument that they have suffered *relativ*e economic injury under the current rate structure simply because the increase in their revenues from interactive streaming has been proportionately less than the growth in the number of interactive streams, leading mathematically to a lower implicit or effective per stream royalty rate. That is, he notes there is no evidence to rebut this *prima facie* indication of beneficial price discrimination, *i.e.*, no contrary evidence indicating that, if the Services had sought to increase the price of the services available to these low to zero WTP listeners because of higher royalties, they would have paid the higher price, rather than declined to utilize a royalty-bearing interactive streaming service. *See* 4/13/17 Tr. 5971-73 (Hubbard); *see also Dissent* at 52.

The Services also link their price discrimination argument to the fact that the marginal physical cost of streaming is zero to the need for a flexible rate structure such as now exists. In this regard, Professor Hubbard notes that, because "[t]he marginal production cost at issue here is – is zero. … it's not clear why it's not better to bring new customers into the market on which royalties would be paid and, of course, zero marginal cost incurred." 4/13/17 Tr. 5917-18 (Hubbard). *See also* Marx WDT ¶ 97 ("Setting the price of marginal downstream listening at its marginal cost of zero induces more music consumption and variety than per-song or per-album pricing.").

Professor Marx makes the same argument as to the salutary nature of price discrimination in this context with regard to Spotify's ad-supported approach. Focusing on the first purpose, Spotify is attracting ad-supported listeners who have a relatively low WTP, whether they have low incomes, (a budget constraint) or low interest in music (low "utility," in the parlance of economists). These listeners, and the advertising revenue they generate are real and reflect the WTP of a large swath of all interactive listeners. *See* Marx WRT ¶ 115-16 & Fig. 9 ("While I agree that one aspect of the ad-supported service is to provide an on-ramp to paid services, it also has another important aspect, namely to serve low WTP customers …. Copyright Owners' economists err in not calculating the impact of the Copyright Owners' proposal on ad-supported services. Ad-supported services currently make up a majority of subscribers and [redacted]% of all streams in the industry.").

Accordingly, a separate tier for an ad-supported service accounts for the different nature of the downstream listenership, allowing the upstream royalty to be based on that characteristic. This differentiation was essentially acknowledged by Copyright Owners late (*too late*, actually) when they proposed in their post-hearing filing that "if the Judges intend to include the Spotify ad-supported service in the rate structure and rate calculations, that they do so by establishing separate *rates and terms* for the ad-supported service. *See* COPCOL (Corrected) ¶ 228 & n.34. But the PR II-benchmark already incorporates separate rates for free/ad-supported services![115]

Another important evidentiary factor buttressing the need for price discriminatory rates and structures was the testimony of the Services' survey expert, Mr. Robert Klein, Chair and co-founder of Applied Marketing Systems, Inc. Mr. Klein surveyed 2,101 people (the Klein Survey) who were listeners to streamed music and found, *inter alia*, that: (1) the majority of listeners would not pay for a monthly streaming subscription; and (2) for those who do subscribe, their demand was elastic, with increases in subscription prices causing overall greater percentage reductions in quantity demanded, moving customers to free, ad-supported and non-streaming alternatives. *See Klein* WRT ¶¶ 60-67. By contrast, Copyright Owners did not present any survey testimony. The Determination fully credited the Klein Survey, finding as follows:

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[115] Copyright Owners also belatedly proposed that the Judges establish specific functionality limits on a separate ad-supported prong to avoid cannibalization of subscriber-based streaming with fuller functionality. *Id.* [redacted]

> It is important to note that Copyright Owners' attacks on the Klein Survey are not levelled by any witnesses, nor contradicted by their own survey expert, because Copyright Owners elected not to proffer such an expert in their direct (or rebuttal) cases. Rather, Copyright Owners elected to make a descriptive argument regarding the elasticity of demand among different segments of the market, as opposed to a survey-based or econometric study of price elasticity.
>
> [Although] Copyright Owners attack the Klein Survey on several fronts[,] [t]he arguments made by Copyright Owners are insufficient … to seriously weaken the probative value of the Klein Survey. In the end, the Judges are not persuaded by the Copyright Owners' revenue bundling arguments not to adopt a flexible, revenue-based royalty rate.

Determination at 22-23 & n.53; *see also* Dissent at 64-67 (including point-by-point rejection of Copyright Owners' non-expert criticisms of Klein Survey).

The Services also note that the existing rate structure has produced generally positive practical consequences in the marketplace. Their joint accounting expert, Professor Mark Zmijewski, testified that the [redacted] from the sale of product under (former) Subpart A since 2014 has been [redacted] over the same period. Expert Report of Mark E. Zmijewski February 15, 2017 ¶¶ 38, 40 (Zmijewski WRT); 4/12/17 Tr. 5783 (Zmijewski); *see also* 4/13/17 Tr. 5897 (Hubbard) ("the evidence that I reviewed suggests that the copyright holders have actually benefitted from this structure ….").

More particularly, Professor Zmijewski testified that:

- Total revenues reported by the NMPA for NMPA members from all royalty sources [redacted] Zmijewski WRT ¶ 41.
- This [redacted] *Id.*
- The [redacted] *Id.*
- Mechanical royalty revenue for the sale of downloads and physical phonorecords [redacted]

> [redacted] *Id.* ¶ 38.[116]

In sum, the foregoing analysis demonstrates the economic reasonableness and appropriateness of the price discriminatory *Phonorecords II rate structure* and its negotiated safeguards to address the real possibility of revenue diminution. As discussed below, the record evidence also supports royalty *rates* within the PR II-based benchmark.[117]

The PR II-based benchmark contain several alternate rates explicitly calculated as a percentage of payments made by interactive streaming services to the record companies for sound recording rights. *See* Appendix A to this Initial Ruling. In the Subpart relating to streaming, the (former) subpart B category, the TCC is 22% for ad-supported services and 21% for portable subscriptions. *Id.*; *see also* 37 C.F.R. § 385.13(b)(2) and (c)(2). These percentage figures correspond to sound recording: musical works royalty ratios of 4.55:1 and 4.76:1, respectively.

With regard to these ratios, Copyright Owners' economic expert witness, Dr. Eisenach, stated: "In my opinion, the evidence … indicates that the relative valuation ratios implied by the current Section 115 compulsory license … represent *an upper bound on the relative market valuations* of the sound recording and musical works rights." *Id.* ¶ 92 (emphasis added). (As an "upper bound," these ratios would represent the *lower bound on the relative market valuations* of the reciprocal percentage of the value musical works rights relative to sound recording rights, again, 22% and 21 %.[118]) Thus, there appears to be consensus between Copyright Owners' witness and the Services (who advocate for applying these rates on the price discriminatory tier

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[116] By contrast, Copyright Owners assert that the appropriate approach would only consider interactive service payment of mechanical royalties, and exclude performance royalties. On that basis, revenue, for the sale of digital downloads and physical phonorecords mechanical royalty revenue [redacted] from [redacted] in 2014 to [redacted] (as noted in (4) above, whereas mechanical royalty from streaming [redacted] from [redacted] in 2014 to [redacted] in 2015. Thus, the [redacted] in mechanical royalty revenue from streaming [redacted] in mechanical royalty revenue from the sale of digital and physical phonorecords. The Judges do not agree with Copyright Owners. Performance royalty and mechanical royalty payments made by the Services are for perfect complements – neither license has any value to the Services unless they acquire both. Indeed, that is a critical reason why the mechanical rate is calculated on an "All-In" basis. Thus, it makes sense to make the comparison in the manner undertaken by Professor Zmijewski.

[117] Again, to be clear, the Judges are substituting the 15.1% revenue rate for the 10.5% revenue rate as the headline rate in the "greater-of" structure of the *Phonorecords II* benchmark. Thus, the price discriminatory royalty rates discussed below would apply only if they generated a "greater" level of revenue than the headline 15.1% revenue rate. And, although the Mechanical Floor rate is not tied *directly* as an alternative to the "greater-of" revenue rate (now 15.1% as phased-in), it is not a floor that ignores the effect of that "greater of" rate. For example, assume the popular standalone portable subscription streaming service that people access on their mobile phones would pay an "All-In" musical works royalty of 15.1% based on the application of the two "greater-of" prongs. However, assume also the "Performance Royalty" that must be subtracted is 12%. That would leave 3.1% of service revenue attributable to the mechanical right. However, if that revenue rate of 3.1% yielded mechanical royalty revenue that was less than the royalty revenue generated by the applicable monthly mechanical floor of $0.50 per subscriber, then the mechanical floor would control. This application, like any other application of the mechanical floor, does not diminish the value of the 15.1% right, but rather limits *its reduction* under the "All-In" calculation. Recall also that the Determination, Dissent and *Johnson* do not disturb the All-In and Mechanical Floor features of the *Phonorecords II* benchmark.) And finally, with regard to the actual per subscriber monetary values in the mechanical floors, no party suggested changes from rate levels in the PR II-based benchmark, including in the mechanical floor rates. The Judges recognize, as did Dr. Katz, Pandora's economic expert witness, that alternate values might have been preferable for rates contained in the PR II-based benchmark, but none were in the record. *See* 4/15/17 Tr. 5056-58 (Katz).

[118] 1÷4.55= .219, or 22% (rounded); 1÷4.76= .210 (21%).

of their benchmark) that these rates constitute "relative *market* valuations" (even if they are not Dr. Eisenach's preferred market valuations within the bounded zone of such values).

Dr. Eisenach's testimony regarding the "bounds" of useful market valuations is noteworthy because his acknowledgement is consonant with judicial precedent. The Judges' setting of reasonable rates often requires them to identify a "zone of reasonableness," within which they identify appropriate statutory rates. *See, e.g.*, *Intercollegiate Broadcasting System, Inc. v. Copyright Royalty Board*, 684 F.3d 1332, 1340 (D.C. Cir. 2012) (The CRB Judges' rate setting can necessitate the finding of a "zone of reasonableness [because] "[s]tatutory reasonableness is an abstract quality represented by an area rather than a pinpoint.").

The 21% and 22% TCC rates within section 115 identified by Dr. Eisenach as generating the "lower bound on the relative market valuations" imply certain approximate percent-of-revenue rates, *i.e.*, percent of total service revenue (not percent of sound recording revenue). *See Dissent* at 91, n.133 (sound recording rates clustered between [redacted]% and [redacted]% of revenue). For example, if the sound recording royalty rate for interactive streaming is [redacted]% of revenue, then the musical works rate would be calculated as 0.21 x [redacted], which equals [redacted]%, (or as .22 x [redacted] which equals [redacted]%). At the low end of the range, if the sound recording royalty rate is [redacted]%, then, applying these TCC figures, the implied musical work royalty rate would be calculated as [redacted]% (.21 x [redacted]) or [redacted]% (.22 x [redacted]).[119]

It is important to emphasize and detail the context of these price discriminatory rates. These capped TCC rates are on the "greater of prong" that is compared with the headline 15.1% revenue rate (phased-in) that the Judges are also adopting in this Initial Ruling. As phased in, the headline rate is greater than all the capped TCC-based rates identified in Dr. Eisenach's testimony, *supra*, [redacted]. For 2019, the phased-in headline percentage rate, 12.3%, is [redacted] the [redacted]% and [redacted]% revenue rates derived if the sound recording rates was [redacted]%. For 2018, the phased-in headline percentage rate, 11.4%, is [redacted] all the rates derived from the capped TCC rates Dr. Eisenach identified as "market valuations" (albeit the lower bound in his opinion). But that is of no negative consequence for Copyright Owners, because they would get paid on the "greater-of" metric (capped TCC or headline rate) under the *Phonorecords II*-based rate structure the Judges are adopting (For the portable subscriptions, even though the 80 cents/subscriber "lesser-of" portion of the non-headline prong would apply on that prong if it was lower than the capped TCC rate, the actual rate could not be lower than the phased-in headline rate.)

Dr. Eisenach also examined direct agreements between record companies and interactive streaming services that contain rates for sound recordings and mechanical royalties, respectively. *See, e.g., id.* ¶¶ at 84-91. In such cases, the ratio of sound-recording to musical-works royalties

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[119] Dr. Eisenach's identification of the 21%-22% TCC as within the bounds of market valuations may appear surprising at first in light of the higher 26.2% uncapped TCC rate pursued (unsuccessfully) on remand by Copyright Owners. But in the context of his testimony, Dr. Eisenach's opinion is understandable. The former headline rate of 10.5%, when sound recording rates ranged from approximately [redacted]% to [redacted]% of streaming revenues, yielded TCC rates between [redacted]% and [redacted]%. Thus, Dr. Eisenach was identifying a market valuation [redacted] (at his lower bound) between [redacted]% (the difference between 21% and [redacted]%) and [redacted]% (the difference between 22% and [redacted]%). Again, for context, this Initial Ruling raises the percentage rate by *44%* when fully phased-in (based on the experts' Shapley analyses, significantly above the TCC rates advocated by Dr. Eisenach, even assuming the [redacted]%-[redacted]% sound recording rates on which he relied.

ranged tightly between [redacted] and [redacted], closely tracking the regulatory ratios implicit in the section 115 TCC. *Id.* ¶ 92. (The [redacted] ratio equates to a TCC rate of [redacted]%, and the [redacted] ratio equates to a mechanical rate of [redacted]%.). He concluded, as he did with regard to the actual section 115 license rates: "In my opinion, the evidence presented … indicates that the relative valuation ratios implied by the … negotiations under [the statutory] shadow – ranging from [redacted] [[redacted]%%] to [redacted][[redacted]%]—represent an *upper bound on the relative market valuations of the sound recording and musical works rights*." Eisenach WDT ¶ 92. (emphasis added).

Dr. Eisenach also identified several additional useful benchmarks. First, he identified what was coined the "Pandora Opt-Out Agreement" benchmark,[120] which reflected a ratio of [redacted] of sound-recordings to musical-works in a comparable benchmark setting. This ratio translates to a TCC percent of [redacted]%. With sound recording royalty rates of approximately [redacted]% to [redacted]%, this TCC reflects an effective percentage of total revenue equal to [redacted]% to [redacted]%.

Second, Dr. Eisenach identified YouTube agreements with music publishers that relate to the combination of a commercial sound recording and a "static image." The YouTube agreements contain an explicit royalty of [redacted].[121] That [redacted]% royalty is a denominator in the ratio concept utilized by Dr. Eisenach, and the numerator is the [redacted] sound recording royalty paid to the record companies. YouTube had agreed to pay [redacted]% of its revenues, and had agreed to pay [redacted] and other record companies [redacted]% of revenues. The [redacted] ratio reduces to [redacted], implying a TCC ([redacted]) of [redacted]%. The [redacted] ratio reduces to [redacted], implying a TCC ([redacted]) of [redacted]%. *See* Dissent at 101-102.

These additional rates identified in Dr. Eisenach's testimony further confirm the reasonableness of the non-headline rates within the PR II-based benchmark.

Finally, the Judges look at the effective rates paid by Spotify, the largest interactive streaming service in terms of in terms of the number of subscriber-months and the number of plays. *See* Marx WRT ¶¶ 37-38 & Figs. 8 & 9. Under the PR II based benchmark, Spotify paid on its *subscription* service an effective "All-In" royalty rate of [redacted]% of its total revenues. *See* Dissent at 80, 115, 149 (and record citations therein). Spotify paid this effective percent-of-

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[120]Pandora was only a noninteractive service at that time, and thus only paid the performance right royalty, not the mechanical right royalty, for the right to use musical works. Because the parties agree that the performance right and the mechanical right are perfect complements, Pandora's payments for the performance right are thus relevant and probative, as they reflect the full value of the musical works royalty to a noninteractive service. These factors became relevant because major music publishers had negotiated direct licensing agreements with Pandora for its *noninteractive* service covering the period from 2012 through 2018. Eisenach WDT ¶ 103. They negotiated these direct agreements after certain publishers had decided to "opt-out," *i.e.*, to withdraw their digital music performance rights from PROs, and asserted the right to negotiate directly with a digital streaming service. Pandora thus negotiated several such "Opt-Out" Agreements with an understanding that the rates contained in those direct agreements might not be subject to rate court review and thus could reflect market-based rates. Given this unique circumstance, and given that the markets and parties involved in the Pandora Opt-Out agreements are somewhat comparable to the markets and parties at issue in this proceeding, Dr. Eisenach concluded that *these agreements provided* "significant insight into the relative value of the sound recording and musical works rights in this proceeding." *Id.* (emphasis added). (The Judges did not adopt Dr. Eisenach's speculation that this performance royalty would continue to grow after 2018. *See* Determination at 51; Dissent at 102-103).

[121] Dr. Eisenach preferred to use YouTube agreements that included [redacted], but the Judges relied on [redacted] as more comparative. Determination at 50; Dissent at 102.

revenue rate [redacted]. *See id.* at 29 (Table).

Turning to Spotify's free/ad-supported offering (and as noted *supra*), Spotify paid royalties under the PR II Rates at an effective "All-In" royalty rate of [redacted]%. Spotify paid this effective percent-of-revenue rate [redacted]. *See id.* When Spotify's two tiers are blended and averaged, the effective percent-of-revenue rate is [redacted]% of revenue. *See id.* at 116. The average rate has salience in this proceeding because Spotify's two tiers are interrelated, in that free/ad-supported listeners constitute a pool of potential converts to the subscription tier under this "freemium" model, even as this offering generates royalties under the PR II-based benchmark.

d. Copyright Owners' Concern Regarding Revenue Diminution is Insufficient to Reject the PR II-Based Benchmark

Copyright Owners argue that what the Services tout as beneficial price discrimination generates an "incredible" level of revenue diminution, including displacement, resulting in a "major problem" that reduces reportable revenues and thus the royalty base. *See, e.g.*, 3/7/22 Tr. 193 (Copyright Owners' counsel). This argument is based upon documents and evidence that demonstrated the following:

- [redacted]
- [redacted]
- [redacted]
- [redacted]
- [redacted]
- [redacted]
- [redacted]

- [redacted]

- [redacted]

- Copyright Owners' expert, Dr. Rysman, testified that interactive services often elect to forgo current profit maximization, *e.g.*, by charging lower prices, in order to build a customer base and greater long-run profitability or value, from selling music and non-music products or services to its customers.

CO Initial Submission at 40-42 (and record citations herein).

The Services' economic experts do not ignore the fact that there can be revenue attribution problems when interactive streaming is combined with other products or services. They acknowledge that, even absent any wrongful intent with regard to the identification and measurement of revenue, attribution of revenue across product/service lines of various services can be difficult and imprecise. *See, e.g.,* 4/5/17 Tr. 5000 (Katz) (problem of measuring revenue "certainly a factor that goes into thinking about reasonableness.").

However, Professor Katz testified that the existing rate structure agreed to by the parties accommodates these bundling, deferral, and displacement issues via the use of an alternative rate prong that would be triggered if the royalty revenue resulting from the headline rate of 10.5% of streaming revenue fell below the royalty revenue generated by that second prong. Katz WDT ¶¶ 82-83; 3/13/17 Tr. 670 (Katz). Moreover, Professor Katz concluded that, because the marketplace appears to be functioning (in the sense that publishers are earning profits and new and existing interactive streaming services continue to operate despite accounting losses), these revenue-measurement issues are being adequately handled by the alternative rate prong, even if an altered second prong might work better. *Id.* at 738-39. More generally, Professor Katz further noted that, the existing rates within the PR II-based benchmark were performing well, and even if alternative minima might be preferable, no such alternative rates were in the record. *See* 4/15/17 Tr. 5056-58 (Katz) (under the PR II-based benchmark "the industry … was performing well," but "if someone had a proposal [with] a specific reason why we should adjust this minimum that's something I would have examined,"). But Copyright Owners did not propose alternative rates or minima within the PR II-based benchmark, but instead urged the Judges to disregard the benchmark *writ large*. Accordingly, there were no alternative rates or minima in the record.

Professor Katz further noted that the PR II-based benchmark rates were established when "ecosystem" entities such as Yahoo—akin to Amazon, Apple, and Google—were in the marketplace. 4/5/17 Tr. 5055-57 (Katz); see also Determination at 31 (and record citations therein) (noting the presence of Microsoft as well as Yahoo as licensees in the interactive market during the *Phonorecords II* negotiations).

More broadly, the Services' position regarding the use of the two prongs and their alternate rates to ameliorate the revenue-measurement problems is summed up by Professor Katz as follows:

> [T]he primary reason [for the two rate prongs] … is because of the measurement issues that can come up when having royalties based on a … percentage of revenues because there can be issues about how to appropriately assign revenues to a service. And so I think the minim[a] can play an important role when those – you know, when those measurement problems are severe, you can turn to the minimum instead. … [W]hat I have in mind, right, is that what would happen if you could imagine an entrepreneur coming along and saying we want to have a service and have some incredibly low price and not a very good monetization model, where a copyright owner would say -- in an effectively competitive market, would say, wait a minute, I don't want to license to you on those terms. It's -- I just think the possibility of getting a return is so low, I'm not going to do it, even though you, as an entrepreneur, are willing to try this. I as the copyright owner want some sort of, you know, return on it. And that's what the minimum also helps to do.

3/13/17 Tr. 599 (Katz.); *see also* 3/20/17 Tr. 1900-01 (Marx) (minima protect against revenue measurement problems); 4/7/17 Tr. 5584 (Marx) (statutory minima play "two roles" – *protecting the Copyright Owners* from "revenue mismeasurement" by creating the "greater of" prong ," but incorporating per subscriber rate prong in "lesser of" component *to protect services* from the record companies' use of their market power to engage in "manipulation of the sound recording royalties" on which the TCC prong is calculated).

After considering the record, the Judges determine that the Majority had not found – as Copyright Owners claim – that the activities and strategies by the Services were "incredible" or a "major problem. Rather, the Majority's characterization was measured, stating repeatedly that the Services engaged "*to some extent*" in revenue diminution because they "*might* focus on long-term profit maximization to promote their long-term growth strategy, which occurs "even absent wrongful intent." Determination at 20-21, 36, 90; *accord,* Dissent at 59. In fact, the Majority specifically stated: "The Judges agree that there is *no support for any sweeping inference that cross-selling has diminished the revenue base*." *Id.* at 21 (emphasis added). The Majority (and the Dissent) thus acknowledged the reasonableness of both sides of this issue, recognizing both the Services' use of price discriminatory approaches that can lower per user or per-stream revenues but grow royalties, market share and revenue, as well as Copyright Owners' concomitant desire to protect themselves from reductions in the royalty revenue base, however limited in extent, that would only serve to diminish royalties.

One way the input supplier can avoid this impact is to refuse to accept a percent of revenue form of payment and move to a fixed per-unit input price. This is what Copyright Owners originally and unsuccessfully sought in this proceeding, subject to a bargaining room approach by which they could switch back to the old approach (or any other approach) through purely market-based negotiations, unbounded by the statutory and regulatory standards of "fairness" and "effective competition." *See* Dissent at 60.

The Judges must reconcile the parties' competing considerations. A way by which they are both accommodated is through a pricing structure with alternate rate prongs and floors, below which the royalty revenue cannot fall. This is precisely the bargain struck between Copyright Owners and services in 2008 and 2012, and that has been the rate structure through 2017. And, because the Majority and the Dissent found that revenue diminution occurred only "to an extent," rather than in the pervasive (sweeping") manner averred by Copyright Owners, there is no sufficient reason in the record to depart from the bargained-for multi-tiered rate structure in *Phonorecords II* that allows for price discrimination but tempers its impact on royalties through the use of minima and floors.

e. Copyright Owners' Claim of "Inherent" Economic Value is Belied by the Record, including their Own Arguments

Pre-remand, Copyright Owners approached this rate setting process with an overarching premise: A musical work has an "inherent value" that must be reflected in the royalty rates. As the NMPA's president, Mr. Israelite testified, when asked how "inherent" value is defined:

> [W]hoever owns an individual copyright is the one to define it. I think that would be the most appropriate definition of it. What someone is willing to license it for would be that inherent value to that owner … That would be market value.

3/29/17 Tr. 3707 (Israelite).

If the market for musical works was as atomistic as the above quote assumes, the songwriter of an individual musical work could indeed set his or her own royalty rate, and refuse to license to any streaming service or other distributor who refused to pay that royalty. But that is not how the licensing market works.[122] Songwriters typically assign their licensing rights to music publishers (to avoid ruinous transaction costs). These music publishers control huge "Must Have" repertoires that are offered under blanket licenses to streaming services. (The musical works market of course is subject to a compulsory license, but this is precisely how the unregulated market works for the licensing of sound recordings by labels to interactive streaming services.) It is acknowledged even by Copyright Owners' own expert witness, Professor Watt that the creation of these large collectives generates market power that necessitates rate regulation. *See* R. Watt, *Copyright and Economic Theory: Friends or Foes* at 163, 190 (2000) (quoted in Dissent at 35).

Further, this "inherent" market value notion is antiquated as a matter of economics. Although an individual Copyright Owner can announce his or her "asking" royalty, that is not sufficient to generate a "market" royalty, unless and until a licensee agrees to pay it. In market-based economics. that is to say, the economic consensus that has governed economics since the "marginal revolution" in the mid to late 19th century, value is ascertained through the intersection of supply and demand, with the price established at the margin representing the market value of

[122] The record does not include evidence of self-marketing by songwriters through social media or via negotiation of individual royalty contracts by the exercise of overwhelming star power, whether through traditional payment mechanisms or new methods, such as the murky mechanism of non-fungible tokens (NFTs). The absence of incidents of such self-marketing from the record evidence in this proceeding suggests that they likely constitute but a small segment of the songwriter/publisher market. Accordingly, such self-marketing and individual negotiations do not impact the Judges' setting of statutory rates in this proceeding.

the good or service bought and sold.[123] If there is no demand for a product, be it a musical work or anything else, it has no economic value. Even though costs have been incurred to produce the product, those costs cannot be recovered (or profit earned) absent a sufficient WTP in the market. And, as noted *supra*, the product being offered and at issue here is comprised of "second copies" of sound recordings (with embedded musical works), which are costless to reproduce for streaming purposes. Of course, these "second copies" do have actual value when they are in demand, and the royalties that their licensing generates must cover: (1) the first copy (creative) costs; (2) the "opportunity cost" (measured by the next best alternative for royalty earnings if the "second copies" could have been supplied through another distribution channel that paid higher royalties to attract the end-user/consumer at issue); and (3) profits to induce the creation of musical works.

Second, the fact that Copyright Owners originally proposed a per-subscriber alternative rate to their per-play rate itself belies their conviction that some "inherent" economic value exists. When the metric of value switches from "per-play" to "per-subscriber," the focus of value likewise shifts from an emphasis on producer value to consumer value. That is, if there is truly an "inherent" value for a product or service, that singular value cannot divide into two distinct values with the "greater-of" the two controlling. Such an argument gives away the game, so to speak, demonstrating, perhaps unsurprisingly, that economic arguments (not unlike legal advocacy) are often situational—designed to support maximalist positions and the exercise of market power, however acquired. *See also* Determination at 28 n.64 (rejecting the "inherent value" argument).

f. PR II-Based Benchmark Not "Too Complex"

Copyright Owners and the Majority complained that the PR II-based benchmark is too complex. *See* Copyright Owners' PFF ¶ 12 (criticizing complexity of PR II Rates as lacking "transparency"); Determination at 36 (characterizing parties' negotiated, renewed, and expanded rate structure as Rube-Goldberg-esque in complexity and impenetrability.")

After considering this issue on remand, the Judges disagree. If some songwriters or lyricists have been confused by their royalty statements, their confusion of course should be resolved. However, one of the benefits of a collective is that it possesses the expertise and resources to identify and explain how royalties are computed and distributed. Moreover, this

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[123] As one scholar has summarized the 19th century transition from classical to neoclassical economics:

> By the early 1870s, economics reached a tipping point, and it ushered in a revolution in thought, signaling the beginning of the "modern," or "neoclassical" era. Marginalists flipped classical economics on its head. Instead of focusing on the production side of economics, they turned to consumption. It is the satisfaction of the wants of consumers that matters for value, not the labor required for production. What established the overall value of a good is the value fetched by the final unit of that item on the market. As more units of a good are produced, the marginal value of the last unit tends to decrease…. According to marginal utility, the consumer, not the producer, therefore drives the valuation process.

J. Wasserman, *The Marginal Revolutionaries* at 28 (2019). This transformation reflected the abandonment of the "labor theory of value" – the cornerstone of Marxian economics. *See* E.R. Canterbury, *A Brief History of Economics* at 111 (2001) ("Marx's devotion to a labor theory of value was complete."). It initially appears as irony that Copyright Owners espouse a Marxian approach to value while preaching the virtues of unregulated markets. The initial whiff of irony dissipates when one appreciates that a collective licensor with the market power of control over a "Must Have" input has every incentive to urge a pricing or valuation method that takes the focus away from the force of consumer demand in an effectively competitive market, which is a hallmark of neoclassical economics.

claim of complexity cannot serve as a basis to override the multi-part negotiated benchmark that the parties, through their respective trade associations, negotiated and implemented. As the Dissent stated: "There is no good reason why the rate structure that is consonant with the parties' ten-year history and with the relevant economic model should be sacrificed on the slender argument that "simpler is better than complicated." Dissent at 88.[124]

Further, section 801(b)(1) does not identify "simplicity" as a statutory goal for the setting of rates, rate structure, and terms. Although there is certainly no need for gratuitous complexity, the price discriminatory structure and the associated levels of rates in the PR II-based benchmark that were eliminated by the Majority (while maintaining all the remaining complexity) were most certainly not gratuitous, but rather designed, after negotiations, to establish a structure that would expand the revenues and royalties to the benefit of Copyright Owners and Services alike, while also protecting Copyright Owners from potential revenue diminution by the Services. Moreover, when the market itself is complex—in that the WTP across consumer groups is heterogeneous and the offerings reflect that fact—it is unsurprising that the regulatory provisions would resemble the complex terms in a commercial agreement negotiated in such a setting. For the Judges to demand simplicity in this context would be to sacrifice the specificity that an effectively competitive market requires. *See* Dissent at 88 (rejecting the simplicity argument by invoking the advice attributed to Albert Einstein that "[e]verything should be made as simple as possible, *but no simpler*."

g. So-Called Statutory "Shadow" Does Not Diminish Value of the PR II-Based Benchmark Rates

Copyright Owners maintain that the rates in the PR II-based benchmark are infirm because, like any benchmark for which a statutory rate is the default, they are not actual market rates. That is, such a rate is said to exist in the so-called "shadow" of the statutory rate. *See* Dissent at 70 (and citations therein).

The Judges reject this argument for several reasons. First, the argument is undercut by the explicit language of section 115 of the Copyright Act:

> In addition to the objectives set forth in section 801(b)(1), in establishing such rates and terms, the Copyright Royalty Judges may consider rates and terms under voluntary license agreements described in subparagraphs (B) and (C).

17 U.S.C. § 115(c)(3)(D). Subparagraphs (B) and (C), respectively, refer to agreements on "the terms and rates of royalty payments under this section" by "persons entitled to obtain a compulsory license under [17 U.S.C. § 115](a)(1)]; and "licenses" covering "digital phonorecord deliveries." *Id.* Thus, it is beyond dispute that Congress has authorized the Judges, in their discretion, to consider such agreements as evidence, irrespective of—or perhaps because of—the shadow cast by the compulsory license. Thus, the appropriate question is *how much weight* the Judges, in their discretion, should afford such benchmarks in any particular proceeding.

[124] Copyright Owners' concern for transparency has apparently evaporated in connection with its eagerness to adopt the proffered uncapped TCC rates. Under that approach, the definition of revenue, the handling of bundled products and the exclusion of certain consideration from the royalty base will remain opaque to songwriters—and to the Judges.

There is no basis to find, as Copyright Owners suggest, that statutorily-based or influenced benchmarks, including specifically the PR II-based benchmark in this proceeding, are *per se* inferior to other benchmarks or alternative economic evidence (e.g., from models, surveys or experiments) that may be unaffected by the shadow. Those other benchmarks or forms of evidence will also be subject to their own imperfections and incompatibilities with the target market and must be identified and weighed accordingly.[125] Thus, the Judges must not only consider (i) the importance, *vel non*, of any potential so-called "shadow-based" distortionary effects from a benchmark derived from a *regulated* statutory benchmark market, but also (ii) how any such purported "shadow" effects compare to any distortions generated by other proffered benchmarks and competing alternative economic evidence, *e.g.*, distortions based on complementary oligopoly power, bargaining constraints and product differentiation in other benchmarks, models, surveys or experiments.[126]

The Services' experts discount the foregoing shadow-based criticism. Moreover, the Services laud a statutorily-influenced benchmark in general, and the specific PR II-based benchmark in particular, because the latter reflects more equal bargaining power between licensors and licensees. In this regard, one of the Services' economic expert witnesses, Professor Katz, points out that rates set voluntarily by the parties in a settlement under the "shadow" provide two important benefits. First, with a statutory rate-setting proceeding as a backstop, large licensors cannot credibly threaten to "hold out" and "walk away" from the negotiations without an agreement, thereby negating their ability to use their "must have" status to obtain rates above effectively competitive levels. Second, when, as here, such negotiations are conducted with *all the parties* at the figurative table—including here, trade associations—no single party has disproportionate market power in the negotiations. *See* 3/13/17 Tr. 661 (Katz).

The Judges agree that settlement agreements reached in the statutory shadow are useful. Although imperfect when considered in *isolation*, in that the statutory proceeding is the default backstop, in *context* they negate the power of any entity simply to refuse to strike a deal. The negation of that power blunts the complementary oligopoly power of licensors of "Must Have" repertoires (whether musical works or sound recordings), making a benchmark agreement reached in the so-called "shadow" advantageous in establishing an effectively competitive rate. *See Web IV, supra*, 26,316, 26,330-31 (May 2, 2016) (noting counterbalancing effect of statutory license in establishing effectively competitive rates). Further, when such settlement agreements are industrywide, they tend to eliminate disproportionate market power, *See* Dissent at 72; *Web III*, 79 Fed. Reg. 23,102, 23,111 (Apr. 25, 2014), *aff'd Intercollegiate Broad. Sys., Inc. v. Copyright Royalty Bd.*, Case No. 14–1098 (D.C. Cir. Aug. 11, 2015) (relying on two settlement agreements).

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[125] It has been famously and wisely said that "all models are wrong, but some are useful." G. Box & N. Draper, *Empirical Model-Building* at 424 (1987). Benchmarks, Shapley, and Nash models, surveys and experiments are all models, in that "[a] model is a representation of something beyond itself … being used as a representative of that something, and in prompting questions of resemblance between the model and that something … substitute systems … directly examined … to indirectly acquire information about their target systems."). U. Maki, *Models are Experiments, Experiments are Models*, 12 J. Econ. Meth. 303 (2005).

[126] It is also important to note that the reasonable rate and rate structure identified under the section 801(b)(1) standard (before considering the four itemized statutory factors) need not be a market-based rate, as discussed *infra*.

Nonetheless, Copyright Owners are correct to note that, hypothetically, some licenses might have otherwise been negotiated at rates higher than the settlement rate that was affected by the so-called shadow. But that is simply the tradeoff that the statutory scheme makes in its identification of settlement rates as evidentiary benchmarks. Such a theoretical problem cannot serve to override the salutary aspects of benchmark settlement agreements. *See Web IV*, *supra* at 26,630 (rejecting same argument as speculative and "too untethered from the facts to be predictive or useful in adjusting for the supposed shadow of the existing statutory rate.").

Lastly, with regard to a benchmark affected by the so-called "shadow," the Judges find that, with regard to the application of the itemized factors in section 801(b)(1), they have the same duty to independently weigh those factors as they do for all otherwise reasonable rates. Thus, the Judges reject the idea that rates and terms reached through a settlement must be understood to supersede—or can be *assumed* to embody—the Judges' current thinking as to the application of the statutory elements set forth in section 801(b)(1). The Judges are obliged to conduct the four-factor analysis anew when considering a previously adopted settlement in a subsequent proceeding – and they do so *infra*. Of course, if on such further analysis, the Judges find that the provisions in an otherwise useful benchmark agreement (including those in a benchmark influenced by the so-called "shadow") *do* appropriately reflect the four itemized statutory factors in section 801(b)(1), then the Judges may adopt the provisions of that settlement without a factor-based adjustment.

h. Conclusion regarding PR II-Based Benchmark

Accordingly, the Judges find the PR II Rates to be a useful benchmark. However, this benchmark is modified by the Judges' substitution of the 15.1% headline percentage rate for the 10.5% headline percentage rate in the benchmark.

D. Precedent Permits Judges to Apply Elements of PR II Rates, Rate Structure and Terms Even if Those Are Not Proffered as Benchmarks

The D.C. Circuit has previously held that the Judges have the authority to adopt elements from the existing rate provisions, if they find that those prevailing provisions better satisfy the statutory requisites than any other proposed structures and rates discernible from the record evidence. *Music Choice v. Copyright Royalty Bd*., 774 F.3d 1000, 1009 (D.C. Cir. 2014). This authority exists even when no party has proffered those provisions in the form of a benchmark.

In *Music Choice* (concerning the setting of satellite radio royalty rates under the same section 801(b)(1) standard), the CRB Judges rejected the parties' proffered benchmarks and instead relied on a percent-of-revenue rate (13%) that was neither a benchmark nor even the prior statutory rate, but merely "a component of a prior determination." *Id.* at 1009. The licensor-party, SoundExchange, argued, like Copyright Owners here, that this component of a prior rate was "stale," "outdated," or "obsolete." Rejecting this argument as "erroneous," the D.C. Circuit stated that "the Judges did not consider the 13% rate as a current benchmark," but rather used it to "bridge the gap" caused by the inadequacies of the parties' rejected benchmarks. *Id.* In so doing, the D.C. Circuit held that the Judges properly resolved "serious problems" with the licensor's proposal, even as it had "partially credited it" and also "used permissible indicia of reasonableness to help fix the rate." *Id.*

Music Choice is highly instructive. Here, on remand, the Judges adopt a modified version of the prior rate structure and rates in *Phonorecords II*. The fact that it was also proffered as a benchmark, in another modified form by the Services, does not render *Music Choice* inapposite. Rather, because the *Phonorecords II* provisions were proffered as benchmark evidence, these provisions were placed squarely into the record, allowing the parties and the Judges to address the relative merits. *A fortiori*, *Music Choice* underscores the propriety of the Judges approach in this proceeding. That is, even if the Services had not proffered this approach as a benchmark, *Music Choice* allows the *Phonorecords II* approach to serve as a guidepost for establishing the rates and rate structure in this proceeding.

Further, here the Judges are adopting actual elements from the prior rate provisions, rather than, as in *Music Choice*, a mere "component" used to generate the prior rate. *A fortiori* yet again, *Music Choice* allows the Judges to prudently utilize the prior rate and rate structure regulations to synthesize a determination in this proceeding. The analogous nature of *Music Choice* is also seen in the Judges' use in the present case of the "headline" 15.1% revenue rate proposed by Copyright Owners on remand *combined with* elements from the PR-II regulatory provisions, including its price discriminatory rates. In *Music Choice*, the Judges likewise "partially credited" the licensor's proposal, which, as noted *supra*, the D.C. Circuit affirmed.

Finally, the Judges take note that *Music Choice* also addressed the Judges' findings regarding the setting of another statutory license, for Preexisting Subscription Services (PSS), by using a rate in a settlement from a prior period. This context is also analogous here, because Copyright Owners object to the use of the *Phonorecords II* rate structure and rates as the product of a settlement. It is instructive to consider how the arguments of the licensor (SoundExchange) in *Music Choice* mirror those of Copyright Owners in this proceeding:

- SoundExchange notes that this rate "is *the product of settlement negotiations* that occurred in *SDARS I* between Music Choice and SoundExchange."

- SoundExchange argues that the Judges arbitrarily rejected … more recent data points in favor of the "outdated" settlement rate.

- SoundExchange maintains that the Judges conceded that the prevailing rate had limited value, as the settlement rate "was negotiated in the shadow of the statutory licensing system and cannot properly be said to be a market benchmark rate."

- SoundExchange also argues that simply reciting that "nothing in the record persuades the Judges" that the prevailing rate is unreasonable … does not show that [it] is reasonable, or that it is supported by the written record.

- [G]iven the lack of creditable benchmarks in the record, the Judges did not err when they used the prevailing rate as the starting point of their Section 801(b) analysis.

- The Copyright Act contemplates that the Judges would … consider "prior determinations" and rates established "under voluntary license agreements."

> • [T]he Judges did not err when relying on the settlement rate. The Judges conceded that the settlement rate does not represent a market rate. … But … the relevant portion of the Copyright Act does not use the term "market rates," nor does it require that the term "'reasonable rates" be defined as market rates. … The Act authorizes the Judges to consider rates set "under voluntary license agreements."
>
> • Music Choice complains that it agreed to a higher rate to avoid litigation costs, but has not introduced evidence that the settlement was involuntary or otherwise unreasonable. It was not arbitrary, then, for the Judges to consider the voluntary settlement rate.

Music Choice, 774 F.3d at 1012-15. These aspects of *Music Choice* are highly instructive, considering the Judges' parallel findings regarding the same and similar arguments as discussed *supra* regarding prior settlement agreements and the so-called "shadow" of the statutory rates.

In sum, *Music Choice* provides ample support for the conclusion that, even if the Services had not proffered their PR II-based benchmark, the Judges would have acted well within their authority to give the same weight to the PR II rates and structure as they have in this Initial Ruling.[127]

E. Four Itemized Factors in Section 801(b)(1)

The Judges have considered the application of the four itemized statutory factors A through D, in connection with their application of the 15.1% revenue rate and their partial use of the PR II-based benchmark.

1. Factor A

The Judges have explained *supra* that price discrimination is a "win-win" for Copyright Owners and the Services. By serving low WTP listeners, it brings in new listeners and subscribers who increase royalty payments as well as revenues. Any licensor would prefer to increase its royalties, rather than "leave money on the table," and a rate structure that effects such an increase (through the concept of "derived demand") is appropriate. Moreover, for purposes of applying Factor A, a rate structure that increases royalties, *ceteris paribus*, would induce more production of musical works, a result that Copyright Owners should desire.

This point appears to raise a question: How could Copyright Owners and their economic experts object to a rate structure that inures to their benefit as well? The answer is: They do not object. They are not economic naifs. As stated *supra*, they advocate for a rate set under the bargaining room theory, through which rate structures can still be negotiated, but not subject to

[127] This ruling is in no way conflicts with the Judges' duty to set rates, rate structures, and terms *de novo* in each rate proceeding, as discussed supra. The *de novo* process requires the Judges to weigh new evidence regarding potential new rates, rate structures, and terms, but that is not inconsistent with the Judges' ability, as explicated by the D.C. Circuit in *Music Choice*, to adopt prior rates, rate structures, and terms in whole or in part if, in their discretion, the new evidence is deficient. *See Music Choice*, *supra*, at 1012 ("The Judges were under no obligation to salvage benchmarks they found to have fundamental problems.").

the "reasonable rate" and itemized factor analysis required by law. In those negotiations, as Dr. Eisenach candidly acknowledged, Copyright Owners would have a different threat point to use in order to obtain better rates and terms. 4/4/17 Tr. 4845-46 (Eisenach).

Second, given a heterogeneous downstream WTP, it would not be more profitable simply to equate "availability" with a higher rate. As noted *supra*, any product that is priced beyond the WTP of a significant portion of the public is *unavailable* to that segment.[128] Royalties that are aligned with the varying WTP of different classes of listeners will make downstream price discrimination more affordable to the services, driving new revenue and royalties—precisely as the PR II-based benchmark allows.[129] In this regard, Copyright Owners have taken a cramped and unrealistic view of such incentives. In particular, the Judges disagree with Copyright Owners' expert economic witness, Professor Rysman, who startlingly asserted in response to a hypothetical from the bench that even a $10,000 per month subscription price would increase "availability." 4/3/17 Tr. 4397 (Rysman).

The Judges find Professor Rysman misapprehends the nature of a price signal. If the price is so high as to eliminate or reduce total revenue to creators, in no way will higher rates simply induce the supply of creative works over time. Indeed, even monopolists do not seek the highest price possible, but rather seek to maximize profits. *See* E. Mansfield & G. Yohe, *Microeconomics* at 362-63 (11th ed. 2004) ("Monopolies maximize profits by producing where marginal cost equals marginal revenue."). Thus, even monopolists, who have the most market power, are constrained in their pricing by the demand curve and the marginal revenue it creates. Simply put, although a higher royalty *rate* might have an immediate superficial appeal, if the consequence will be lower revenues, the high per-play rate would reveal itself as a form of fool's gold.

In sum, the Judges find that the Factor A objective of "maximizing the availability of creative works" is furthered by an upstream rate structure that contains multiple royalty rates reflective of and derived from downstream variable WTP, because it will facilitate beneficial price discrimination. Such price discrimination allows for access to be afforded "down the demand curve," making musical works available to more members of the public. However, there is no evidence to suggest that the price discriminatory rates should be changed, in order to address the connection between price discrimination and the objective of Factor (A). Accordingly, the Judges find no basis to adjust either the rate structure or the rates based on Factor (A).

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[128] The concept of willingness-to-pay (WTP) as used by economists is an antiseptic phrase, because it includes not merely people who do not value a music streaming subscription highly, but also individuals and families who are "income constrained" (yet another antiseptic phrase, read "low income" people and families) who lack the "ability-to-pay" for an interactive subscription. That segment of the population likely reflects a significant portion of the nation, because "40% of Americans would struggle to come up with even $400 to pay for an unexpected bill," let alone pay for a music streaming service. See https://www.minneapolisfed.org/article/2021/what-a-400-dollar-emergency-expense-tells-us-bout-the-economy. When the royalty rates paid by interactive services enable streaming services to satisfy the demand of these low-income consumers (through the principle of "derived demand") that segment of American society can enjoy the benefits of listening to interactive streamed music, even if the offerings they can afford lack the large catalogs and "bells and whistles" of a pricier service.

[129] To be sure, royalties will not increase in equal proportions with increases in the number of streams or listeners, but that is a feature of price discrimination, not a bug. The goal is to generate revenues from low WTP listeners who otherwise would be lost as sources of revenues and royalties to both the interactive services and Copyright Owners.

2. Factors B and C

The concepts of "fair income," "fair return" and recompense for costs and other contributions was considered in connection with the setting of the 15.1% revenue rate. In that context, the Judges analyzed the Shapley Value modeling that was designed to generate "fair" rates that allowed the parties to recover their costs and to share the surplus (over and above costs) in a manner that: (1) prevented the "Must Have" Input Suppliers (the record companies and Copyright Owners) from using the essential aspect of their inputs to engage in hold-up by threatening to withhold their respective repertoires; and (2) allocated surplus shares according to each party's contribution to the surplus (as calculated though the "arrival orderings" in the Shapley model).[130]

The PR II-based benchmark was the product of an *industrywide* negotiation, with the music publishers represented by the NMPA and the interactive streaming services represented by DiMA, their respective trade associations. As explained in the Dissent, *supra*, at pp. 137-39, when an industrywide settlement is reached, particularly when the default procedure is a contested rate proceeding before the Judges, it contains the same benefits with regard to the avoidance of the "hold-out" effect and the equalizing of bargaining power as produced by Professor Marx's Shapley value modeling. *See* 3/13/17 Tr. 577 (Katz) ("I think of the shadow as balancing the bargaining power between the two parties."); Katz CWRT 136, n.236 ("there are market forces that promote the achievement of the statutory objectives in private agreements, such as the 2012 Settlement, when the parties are equally matched (it was an industry-wide negotiation) and the negotiations are conducted in the shadow of a pending rate-setting proceeding that can be expected to set reasonable rates in the event that the private parties do not reach agreement.").

Accordingly, this benchmark already incorporates the dynamics of a negotiation between parties with mutually countervailing power (although those dynamics required updating of the headline rate to 15.1% to account for the higher revenues, as undertaken by the Majority's Shapley analysis). *See Web V*, 86 Fed. Reg. 59,452, 59,456 (Oct. 27, 2021) ("the licensor-side complementary oligopoly power could be ameliorated by the ''*countervailing power*'' of a licensee").

Therefore, the Judges do not make any adjustment in their application of the PR II-based benchmark pursuant to Factors B and C.

3. Factor D

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[130] As noted elsewhere in this Initial Ruling, Professor Marx, Spotify's economic expert witness, reduced the relative market power of the input suppliers in her model which she claimed would be consonant with the "fairness" objectives in Factor B. On behalf of Copyright Owners, Professor Watt disagreed, arguing that the Shapley approach takes the existing market power as reflective of the parties' market contributions, and thus needs no adjustment. The Majority utilized Professor Marx's Shapley-based calculation of a total royalty payment of [redacted]% of service revenue in setting a 15.1% revenue rate (phased-in), which the Judges are adopting in this Initial Ruling. The Majority also used Professor Marx's calculation to find that Factors B and C were satisfied without further adjustment. *See* Determination at 68 & n.120, 75, 86-87. But this issue is not relevant to the present discussion of Factors B and C with regard to the application of the PR II-based benchmark.

As noted *supra*, the Judges understand that a Factor D adjustment is warranted if the rate the Judges would otherwise establish

> directly produces an adverse impact that is substantial, immediate and irreversible in the short-run because there is insufficient time for either [party] to adequately adapt to the changed circumstance produced by the rate change and, as a consequence, such adverse impacts threaten the viability of the music delivery service currently offered to consumers under this license.

Determination at 87.

There is no record evidence to suggest that the Services' PR II-based benchmark, as utilized by the Judges in this Initial Ruling, would create the requisite "adverse impact" to trigger Factor D. The Services certainly do not assert that their own proffered benchmark would be disruptive. With regard to Copyright Owners, the Judges cannot identify any aspect of the PR II-based benchmark that would cause the type of disruption that can serve as an adjustment under the statutory language of Factor D or the Judges' application of same, as quoted above. The Judges understand Copyright Owners' complaint to be principally that [redacted] during the *Phonorecords II* period, [redacted] the number of musical works streamed via sound recordings performed on interactive services. However, that is most certainly not any sort of disruption, let alone a disruption cognizable under section 801(b)(1) and under the Judges' application of that provision.

F. Subpart C Offerings Covered by Foregoing Analysis

The *Phonorecords II* parties also negotiated several new service types—paid locker services, purchased content locker services, mixed service bundles, music bundles and limited offerings. These service configurations were described in subpart C of 37 C.F.R. § 385 under the *Phonorecords II* regulatory provisions.[131] Parness WDT ¶ 13; Levine WDT ¶¶ 38-39; Israelite WDT ¶¶ 28-30. These negotiations spanned more than a year. *See* 3/29/17 Tr. 3652-55 (Israelite) (involved protracted bargaining, in which NMPA rejected some categories, while others were accepted and became part of subpart C). *Id.* at 3654-56. The parties ultimately agreed on a structure for subpart C that resembled the subpart B structure, including a headline percentage of revenue royalty rate and per-subscriber and TCC minima. Parness WDT ¶ 14; *see also* 37 C.F.R. § 385.22. As with the bundling negotiations relating to subpart B, the parties negotiated and created a bundled service category under subpart C (with certain adjustments to the definition of "revenue.") 3/8/17 Tr. 161-64 (Levine); 37 C.F.R. § 385.21.

Copyright Owners urge the elimination of the subpart C provisions as essentially obsolete because locker services for "purchased content" (new download purchases) and for "paid" downloads (already owned) have largely disappeared, as listeners transitioned away from ownership models to access models. *See* 3/8/17 Tr. 159-160 (Levine); 3/16/17 Tr. 1458-1461 (Mirchandani); Mirchandani WDT ¶ 33; 3/22/17 Tr. 2523 (Dorn). Copyright Owners also re-assert the same arguments with respect to subpart C as they have for interactive streaming in subpart B. *See* CORPFF-JS at p.2.

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[131] The interactive steaming (and limited download) provisions that are the principal subject of this proceeding were contained in subpart B of the *Phonorecords II* (and *Phonorecords I*) regulations. (These subparts were reorganized pursuant to the now vacated Determination.)

The Services argue that Copyright Owners do not point to any evidence to show that locker services have *completely* disappeared, emphasizing that Apple and Amazon continue to offer locker service. Joyce WDT ¶ 5; Mirchandani WDT ¶¶ 16-17; 3/22/17 Tr. 2523-25 (Dorn); Ramaprasad WDT, Table 3. More generally, the Services urge the Judges to use the subpart C rate structure as the benchmark for rates in the forthcoming period for the same reasons as they urge the use of the subpart B rates as an appropriate benchmark. *See* Mirchandani WDT ¶¶ 58-62.

The Judges find no reason on remand to treat the subpart C offerings differently than the manner in which they are treating the subpart B interactive streaming offerings, for the reasons set forth in the Dissent at 118-119. That means, however, that the various "headline" rates for these subpart C offerings must also adjust to 15.1%,[132] whereas the alternative rates (identified in subpart C as "minima" and "subminima)" rates shall remain unchanged.

IV. Change in Definition of Service Revenue for Bundles[133]

The Judges analyze the definition of "Service Revenue" for bundled offerings in the context of the partial adoption of the PR II-based benchmark. As discussed *supra*, the Judges have found that the PR II-based benchmark is a useful benchmark, particularly because of its features that incentivize beneficial downstream price discrimination that generates more listeners, revenues, and royalties.

A. Background

In their Initial Determination, the Judges adopted a definition of "Service Revenue" (*i.e.*, a royalty base) for a "Bundle"[134] that provided, in pertinent part:

> Service Revenue shall be the revenue recognized from End Users for the Bundle less the standalone published price for End Users for each of the other component(s) of the Bundle …

Initial Determination, Attachment A at 7 (section 382.2 therein).[135]

[132] Accordingly, in the PR II-based benchmark, the subpart C "headline" rates that shall adjust to 15.1% are: 11.35% for Mixed Service Bundles; 11.35% for Music Bundles; 10.5% for Limited Offerings; 12% for Paid Locker Services; and 12% for Purchased Content Locker Services. *See* 37 C.F.R. § 385.22(a)(1) (*Step 1*); 385.23(a)(1)-(5).

[133] Judge Strickler disagrees with the *procedural* analysis of a different majority by which they readopt the Bundled Revenue definition from the Initial Determination, and he dissents on that specific issue. However, Judge Strickler concurs and joins with the Majority regarding the *substantive* re-adoption of that definition from the Initial Determination. Judge Strickler has drafted a separate opinion on this Bundled Revenue issue.

[134] For interactive streaming, the Judges' Initial Determination defined a "bundle" (in pertinent part) as an offering which combined the delivery of streamed music:

> together with one or more non-music services … or non-music products … as part of one transaction without pricing for the music services or music products separate from the whole offering ….

Initial Determination, Attachment A at 2 (section 385.2 therein).

[135] The definition added: "[I]f there is no standalone published price for a component of the Bundle, then the Service shall use the average standalone published price for End Users for the most closely comparable product or service in the U.S. or, if more than one comparable exists, the average of standalone prices for comparables." *Id.* at 7-8.

After the Judges issued their Initial Determination, Copyright Owners submitted a Motion for Clarification or Correction of Typographical Errors and Certain Regulatory Terms which disclaimed any intent to seek rehearing, but sought "clarification or correction" of certain regulatory terms to conform them to what Copyright Owners claimed to be the apparent intent of the Initial Determination. (Motion for Clarification).[136] Copyright Owners purported to bring their motion under the Judges' general regulations governing motions. *See* 37 C.F.R. § 303.3-.4 (formerly codified at 37 C.F.R. § 350.3-.4).

The Motion for Clarification argued, among other things, that the definition of Service Revenue as applied to bundled offerings should be reworked. Copyright Owners argued that defining the revenue as the total price of the bundle, minus the standalone published prices for the non-streaming offerings in the bundle, undervalued the revenue created by the streaming offerings. They proposed that "Service Revenue" for bundled offerings be defined as the standalone price of the offering (or comparable offerings).

The Services objected to Copyright Owners' styling of their motion as something other than a motion for rehearing. The Services also objected that Copyright Owners had not previously proposed a definition of "Service Revenue" for bundled offerings, and that their "late-proposed" definition was unsupported by the record.

On October 29, 2018, the Judges issued an Order concluding neither party had met the exceptional standard for granting rehearing motions,[137] stating that the parties had failed to present "even a *prima facie* case for rehearing under the applicable standard". Amended Order Granting in Part and Denying in Part Motions for Rehearing (Order on Rehearing) (Jan. 4, 2019).[138]

The Judges explained that they nevertheless found it appropriate to resolve the issues that the parties had raised. Order on Rehearing at 2. The Judges added that, to the extent such resolution could be considered a rehearing under 17 U.S.C. § 803(c)(2), the Judges resolved the motions on the papers without oral argument. *Id*.

Regarding the definition of "Service Revenue" for bundled offerings, the Judges summarized the parties' competing arguments:

> Copyright Owners presented evidence that the existing approach led, *in some cases*, to an inappropriately low revenue base—but did so in service to their argument that the Judges should reject revenue-based royalty structures. *They did not present evidence to support a different measure of bundled revenue* because their rate proposal was not revenue-based. The Services rely on the fact that the approach to bundled revenue in the extant regulations is derived from the 2012 Settlement. The Judges have, however, *declined to rely on the 2012 Settlement as a benchmark*, as the basis for the rate structure, or, therefore, as regulatory guidance.

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[136] Streaming Services submitted a motion for rehearing that was limited to fixing clerical errors and clarifying existing ambiguities in the proposed regulatory terms appended to the Initial Determination.

[137] The standard is set forth in the Order on Rehearing at 2 n.3. The Judges discuss and apply this standard *infra*, pursuant to *Johnson*, and in the context of this remand proceeding.

[138] Judge Strickler, who had dissented from the Initial Determination and the Determinations, did not join in this Order on Rehearing.

> The Services have observed *correctly* that the evidentiary records in *Web IV* and *SDARS III* differ from the record in this proceeding.[139]

Order on Rehearing at 17 (emphasis added).

Despite these arguments, the Judges found that neither party presented evidence adequate to support the approach advocated in post-determination filings, because "the 'economic indeterminacy' problem inherent in bundling" remained unresolved." *Id.*[140] The Judges stated that the Services were the party in possession of the relevant information, and concluded that the Services bore the burden of providing evidence that might mitigate the "indeterminacy problem" inherent in bundling. Because the Judges concluded that the Services had not met that burden, they ruled that they must adopt an approach to valuing bundled revenue that is in line with what the Copyright Owners proposed. As a result, the Judges discarded the formula in the Initial Determination and ruled, instead, that streaming service providers will use their own standalone price (or comparable) for the music component (not to exceed the value of the entire bundle) when allocating bundled revenue. *Id*. at 16-18.

Consistent with the Judges' Order on Rehearing, the Judges' replaced the definition of "Service Revenue" for a "Bundle" that they had included in the Initial Determination with a new definition in the Determination. The final definition provided, in pertinent part:

> Service Revenue shall be the lesser of the revenue recognized from End Users for the bundle and the aggregate standalone published prices for End Users for each of the component(s) of the bundle that are Licensed Activities…[or] if there is no [such] standalone price, then the average standalone … price … for the most closely comparable product or service … or … the average of standalone prices for comparables.

Determination, Attachment A at 8.

The Services, Copyright Owners and George Johnson appealed the Judges' Determination to the D.C. Circuit. *See Johnson*, 969 F.3d 363. The Services challenged both the Judges' legal authority and the substantive soundness of the decision to reformulate the definition of "Service Revenue" for bundled offerings, after the Judges had issued the Initial Determination.

The D.C. Circuit examined several authorities under which the Judges may revisit and amend a determination. It addressed the three ways identified in the statute: "(i) order rehearing

[139] In Web IV and SDARS III, unlike under the Phonorecords II-based benchmark, there were no minima or floors to provide licensors with royalties in the event bundled offerings would otherwise fail to generate royalties.

[140] The "economic indeterminacy" problem was described in SDARS III:

> [S]uch bundling is a common form of price discrimination that increases revenue. … [S]ellers can induce buyers/subscribers to reveal their Willingness to Pay (WTP) and pay more through bundling. [If] retailers pay for their inputs on a per unit basis, bundled retail pricing is benign, because input suppliers would be indifferent to downstream pricing and bundling. However, when the input suppler, as here, is paid as a percent of retail revenue, and the bundled revenue consists of some revenue attributable to the royalty base and other revenue excluded from the royalty base, the economic indeterminacy of the revenue attributable to each bucket creates a measurement problem, absent further information regarding the WTP of buyers/subscribers to the bundle.

SDARS III, 83 Fed. Reg. at 65,264. As discussed in this Initial Ruling, this indeterminacy problem was addressed by the Phonorecords II-based benchmark through negotiated alternative royalty provisions for bundled offerings.

'in exceptional cases' in response to a party's motion, 17 U.S.C. § 803(c)(2)(A); (ii) correct 'technical or clerical errors,' *id.* § 803(c)(4); and (iii) 'modify the terms, but not the rates' of a royalty payment, 'in response to unforeseen circumstances that would frustrate the proper implementation of [the] determination.'" *Johnson,* 969 F.3d at 390. The D.C. Circuit found that the Judges' reformulation of the definition of "Service Revenue" fit none of those categories.

The D.C. Circuit noted that the Judges were explicit that they did not treat the Motion for Clarification as a motion for rehearing under 17 U.S.C. § 803(c)(2). *Id.* Furthermore, the D.C. Circuit noted the Judges' own findings that the Motion for Clarification did not meet the exceptional standard for granting rehearing motions under section 803(c)(2) and that the Copyright Owners failed to make even a *prima facie* case under the rehearing standard.

In *Johnson*, the D.C. Circuit found that the change to the definition of Service Revenue for bundled offerings was not an exercise of the Judges' authority under section 803(c)(4) to "correct any technical or clerical errors in the determination[.]" 17 U.S.C. § 803(c)(4). The D.C. Circuit observed the substantive nature of the change to the definition and determined that there was nothing technical or clerical about the amendment. The D.C. Circuit found that the Judges did not even purport to modify the terms in response to unforeseen circumstances that would frustrate the proper implementation of the Initial Determination. The D.C. Circuit observed that the Judges never mentioned section 803(c)(4) or unforeseen circumstances as the basis for revamping the Service Revenue definition.

Beyond the explicit statutory authorities for amendments to determinations, the D.C. Circuit addressed arguments for inherent authority to make *sua sponte* any appropriate substantive or fundamental changes after the Initial Determination. The D.C. Circuit foreclosed reliance on inherent authority, finding that Congress's decision to limit rehearing to exceptional cases, and to confine other *post hoc* amendments to cases involving technical or clerical errors, would be a nullity if the Judges also had plenary authority to revise their determinations whenever they thought appropriate. The D.C. Circuit noted that the Judges' decision to amend the definition said nothing of the sort, and prior decisions are silent on that topic.

In sum, the D.C. Circuit found that the Judges failed to explain the legal authority for reformulating the definition of "Service Revenue." In relevant part, the D.C. Circuit ruled

> we must vacate the [] Determination's bundled offering Service Revenue definition and remand for the [Judges] … either to provide 'a fuller explanation of the agency's reasoning at the time of the agency action[,]' or to take 'new agency action' accompanied by the appropriate procedures.

Id. at 392 (citing *Regents*, 140 S.Ct. at 1908).

Because the D.C. Circuit determined that the Judges failed to identify any legal authority for adopting the new Service Revenue definition, it found no occasion to address the Streaming Services' separate argument that the definition was arbitrary, capricious, or unsupported by substantial evidence. *Id*.

The Services and Copyright Owners agreed that the Judges should resolve the definitional issue based on the existing record, after receiving two rounds of additional briefing from the parties.[141] *See* Services' Proposal for Remand Proceedings (Dec. 10, 2020) (Services' Proposal) at 5-6, 9-10; Proposal of the Copyright Owners for Conduct and Resolution of the Remand (Public) (Dec. 10, 2020) (Copyright Owners' Proposal) at 4-6. The Judges issued an Order Regarding Proceedings on Remand, which, in part, opened briefing on the issue of the adoption of a revised definition of "service revenue" for bundled offerings between issuing the Initial Determination and the Determination. Order Regarding Proceedings on Remand (Dec. 15, 2020). The Judges received the following relevant briefing.

- CO Initial Submission
- Services' Initial Submission
- CO Reply
- Services' Reply

On December 9, 2021, the Judges requested additional briefing. Dec. 9 Order. The Dec. 9 Order sought additional briefing setting forth the parties' views on whether this proceeding constitutes the type of new agency action addressed by the D.C. Circuit, which would allow adoption of a Service Revenue definition without limitation to the definition expressed in the Initial Determination. Additionally, the Judges requested additional evidence that the parties might offer to support adoption of the Service Revenue definitions expressed in either the Initial Determination or the Determination. In response to the Dec. 9 Order, the Judges received the following relevant briefing.

- CO Additional Submission
- Services' Additional Submission

On February 9, 2022, the Judges solicited further briefing on "Whether the D.C. Circuit's *Johnson* decision permitting the Judges to engage in new agency action in this remand proceeding allows the Judges to engage in new agency action through a reconsideration of Copyright Owners' February 12, 2018 Motion for Clarification as a Motion for 'rehearing' pursuant to 17 U.S.C. § 803(c)(2)(A) and 37 C.F.R. § 353.1." *Sua Sponte* Order Regarding Additional Briefing (Feb. 9 Order). In response to the Feb. 9 Order, the Judges received the following relevant briefing.

- Copyright Owners' Brief Responding to Judges' February 9, 2022 *Sua Sponte* Order Regarding Additional Briefing on New Agency Action Question, and Replying to Services' New Agency Action Arguments in their Joint Supplemental Brief Addressing the Judges' Working Proposal (in Additional Materials Rebuttal Submission of Copyright Owners at Tab B) (Feb. 24, 2022) ("CO Further Briefing")
- Services' Joint Response to the Judges' February 9, 2022 *Sua Sponte* Order Regarding Additional Briefing and Rebuttal Regarding "New Agency Action" (Feb. 24, 2022) ("Services' Further Briefing")

B. Authority for Modification to the Initial Determination

1. Copyright Owners' Position

[141] As indicated below, during the remand proceedings, the Judges solicited two rounds of additional briefing addressing specific issues.

Copyright Owners assert that this remand proceeding offers a straightforward path to take new agency action and that the law makes clear that new agency action can consist of issuing a new determination on remand. CO Initial Submission at 71. Copyright Owners maintain that:

> [T]the new agency action here is a determination after remand proceedings, the Board is largely free to chart its own procedural course, and the Board has done so in its December 15 Order. The Board is not required to undertake any of the procedural steps set forth in 17 U.S.C. § 803(b) in order to take such "new agency action." See 17 U.S.C. § 803(d)(3) (requiring only that on remand further proceedings be taken "in accordance with subsection (a)"); 37 C.F.R. § 351.15; *Intercollegiate Broad. Sys., Inc*., 796 F.3d at 125 ("[N]either the Copyright Act nor the Board's regulations prescribe any particular procedures on remand.") The Circuit's instruction that the action be "accompanied by the appropriate procedures[,]" *Johnson*, 969 F.3d at 392, does not dictate what those "appropriate procedures" must be but instead plainly refers to these flexible rules. See also *Oceana, Inc*., 321 F. Supp. 3d at 136 (explaining that when remanding to an agency, a court generally "may not dictate to the agency the methods, procedures, or time dimension, for its reconsideration").

CO Initial Submission at 71, FN 33.

Copyright Owners acknowledge the Services' position that the asserted procedural error is an "absence of authority" that can never be cured. *Id.* at 74 (citing Services' Proposal for Remand Proceedings at 10). They note that the D.C. Circuit did not say the Judges lacked the authority to revisit the service revenue definition for bundles on remand. Nor, they observe, did it say the Judges have no authority to review the record evidence and the parties' arguments and reach the same conclusion or a different conclusion on remand. Copyright Owners opine that if the only possible outcome were for the Judges to reinstate a definition that lacked any explanation or evidentiary support solely because it was present in the Initial Determination, then the D.C. Circuit would not have remanded the issue but would have simply reversed and reinstated the Initial Determination definition. But instead, they note, the D.C. Circuit remanded and said the Judges could take new agency action precisely to cure the asserted procedural defect. Copyright Owners assert that the remand allowed the parties to present the record evidence and their arguments so that the Judges can address the definition "afresh" in the remand determination. *Id.* at 74.

Copyright Owners argue that 17 U.S.C. § 803(d)(3) states only that proceedings on remand must be in accordance with 17 U.S.C. § 803(a). They contend that remand proceedings need not be confined to procedures the Services claim are too late in the game for the Judges to follow. The Copyright Owners point to the D.C. Circuit's ruling in *Intercollegiate Broad. Sys., Inc. v. Copyright Royalty Bd.*, that "neither the Copyright Act nor the Board's regulations prescribe any particular procedures on remand." 796 F.3d 111, 125 (D.C. Cir. 2015) (citing 17 U.S.C. § 803(a), (d)(3)). Accordingly, they argue, the Judges can reaffirm the adopted bundled service revenue definition following their review of the parties' submissions without regard to section 803(c)(2) or 803(c)(4). CO Reply at 65-66.[142]

[142] Copyright Owners reiterate this argument in the CO Additional Submission. Copyright Owners added that the parties in this remand were afforded the opportunity for further briefing and, if they wished, to submit additional

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Copyright Owners further argue that the Judges may properly justify the changed definition under section 803(c) as a fuller explanation of the agency's reasoning at the time it was made. They urge that the Judges could explain that, especially in light of the evidence of how the Services misused the prior definition to make service revenue completely disappear, carrying over the prior bundle service revenue from *Phonorecords II* into the Initial Determination was unintended and inadvertent.[143] CO Reply at 69. Copyright Owners also assert that the Judges could explain that Copyright Owners had, in their Motion for Clarification, identified an "exceptional case" under section 803(c)(2) because the prior definition failed to comport with Judges' precedent and economic principles, and was unsupported by evidence.[144] In addition,

Copyright Owners note that the Judges reheard the evidence and legal arguments as presented in the parties' briefs on the issue and, as a result, may choose to adopt the revised definition. Copyright Owners maintain that for the Judges to do so would not be impermissible *post-hoc* reasoning, because the D.C. Circuit remanded precisely because the Judges did not provide any reason in the Determination for revising the bundle revenue definition. CO Reply at 69-71.

2. Services' Position

The Services assert that the D.C. Circuit found only "three ways in which the Board can revise Initial Determinations" and that the Judges had failed to establish that the change to the service revenue definition fit any of those three categories. Services' Initial Submission at 64-65 (citing *Johnson* at 390).

According to the Services the *first* way the Judges may revise an Initial Determination is to "order rehearing 'in exceptional cases' in response to a party's motion, 17 U.S.C. § 803(c)(2)(A)." Services' Initial Submission at 65 (citing *Johnson* at 390).[145] The Services argue that the D.C. Circuit held in *Johnson* that the Judges' "material revision of the 'Service Revenue' definition for bundled offerings does not fall within the Board's rehearing authority under section 803(c)(2)(A)" because "the Board itself . . . was explicit that it 'did not treat the [Copyright Owners'] motion[ ]' … 'as [a] motion[ ] for rehearing under 17 U.S.C. § 803(c)(2).'" The D.C. Circuit also noted that "as the Board found, the Copyright Owners' motion did 'not meet [the] exceptional standard for granting rehearing motions' under section 803(c)(2)." *Id.* (citing *Johnson* at 390). The Services assert that the Judges were not able to make "a volte-face" and justify on appeal their revision to the definition as an exercise of rehearing authority. As the D.C. Circuit held, agency action must be justified by "reasons invoked by the agency at the time

evidence on this issue, thus providing broader opportunity for submission than in *Fisher v. Pension Benefit Guaranty Corp.*, 994 F.3d 664, 670 (D.C. Cir. 2021), in which the D.C. Circuit upheld new agency action after remand even though the agency did not provide appellant the opportunity to submit new briefing or exhibits. CO Additional Submission at 35-36; 38.

[143] Copyright Owners assert that the definition in the Initial Determination conflicted with, the Board's findings in the Initial Determination, including its findings that the adopted rates and terms would afford copyright owners a fair return for their creative works, thereby satisfying factor B of the 801(b) standard and thus needed to be revised so as to not "frustrate the proper implementation of" the Final Determination. CO Reply at 69 (citing 17 U.S.C. §§ 801(b) and 803(c)(4)).

[144] In response to an Order by the Judges, Copyright Owners provided additional briefing regarding reconsideration of the motion for clarification as a motion for "rehearing" which is addressed separately *infra*.

[145] In response to an Order by the Judges, the Services provided additional briefing regarding reconsideration of the motion for clarification as a motion for "rehearing" which is addressed separately *infra*.

it took the challenged action," and post-hoc rationalizations are insufficient. *Id*. (citing *Johnson* at 390).

The Services add their view that the Judges cannot revisit the decision to deny rehearing without engaging in impermissible *post-hoc* reasoning. They note that the Supreme Court has explained that, while an agency may "elaborate later" on its "initial explanation" of the reason (or reasons) for its action, it "may not provide new ones." Services' Initial Submission at 66 (citing *e.g*., *Regents,* 140 S. Ct. at 1908). The Services offer that the Judges, having stated that they did not consider the Copyright Owners' motion to revise the definition to be a motion for rehearing, cannot now conclude that the motion qualified as one for rehearing and that the Judges in fact engaged in rehearing. Id.

The Services add that under section 803(c)(2)(A), the Judges can only use their rehearing authority "'in exceptional cases' in response to a party's motion." *Id*. (citing *Johnson* at 390). The Services argue that the Motion for Clarification cannot be found to have satisfied that standard. The Copyright Owners did not argue that their motion satisfied the "exceptional cases" standard before the Judges or the D.C. Circuit, and have therefore waived that argument. *Id*.

According to the Services, the *second* way the Judges may revise an Initial Determination, *viz.* action to correct a technical or clerical error under section 803(c)(4), cannot be used now to justify any modification of the Service Revenue definition in the Initial Determination. The Services note that The D.C. Circuit held specifically that the Judges' change to the Service Revenue definition could not be construed as correcting a technical or clerical error because it involved a substantive rewrite of the Service revenue definition. *Id*. at 67 (citing *Johnson* at 391).

The Services aver that the *third* way the Judges may revise the terms in an Initial Determination is in response to unforeseen circumstances that would frustrate the proper implementation of the determination. *Id.* at 67. The Services note that the D.C. Circuit held in *Johnson* that this authority did not justify the Judges' change to the Service Revenue definition because the Judges did not invoke this authority and "the need to ground the original definition in the record" could not credibly be described as "an unforeseen circumstance." *Id*. (citing *Johnson* at 391).

The Services also note that the D.C. Circuit rejected the argument that the Judges have "inherent authority" to make changes to the Initial Determination. The D.C. Circuit explained that the specific restrictions Congress placed on the Judges' authority in section 803 "would be a nullity if the Board also had plenary authority to revise its determinations whenever it thought appropriate." *Id*. (citing *Johnson* at 391-92). The Services add that even if the Judges offered a new source of authority capable of justifying substantive changes to the Service Revenue definition now, the Judges would be unable to rely on this "uninvoked authority" without engaging in impermissible *post-hoc* reasoning. *Id*.

The Services counter Copyright Owners' position that the Judges need not respond to the error the D.C. Circuit identified with this aspect of the Determination and that the Judges' "new agency action" may consist of issuing a new determination on remand. The Services argue that failure to address the legal and factual issues on which the D.C. Circuit remanded would violate the D.C. Circuit's order and would result in a second remand. The Services surmise that the issue of authority to make the changes to the Initial Determination are particularly important in this context, where the D.C. Circuit recognized that the Copyright Act places limits on the

Judges' authority to alter an initial determination by defining conditions for rehearing and the types of changes that are permitted absent a rehearing. In this regard, the Services maintain that the Judges cannot do on remand what they lacked authority to do in the first instance. The Services assert that the Judges must resolve the legal question whether there is authority to alter the revenue definition in the Initial Determination. They urge that the remanded issue is not what the substance of the service revenue definition should be as a matter of first impression, but instead is whether the Judges have properly exercised authority to alter the Initial Determination's definition. Services Reply at 52-54.[146]

The Services assert that the Judges have two paths available to them: (1) to provide a "fuller explanation" of the prior conclusion that the Judges had legal authority to revise the Service Revenue definition in the Initial Determination or (2) answer that threshold question through new agency action. The Services maintain that, if they pursue the "fuller explanation" path, the Judges are limited to elaborating on what they said previously, and that they cannot add new reasons they did not initially provide. With regard to what may constitute new agency action, the Services assert that path gives the Judges freedom to consider new reasons that the Copyright Act provided the Judges with the authority to make this change to the Initial Determination. The Services argue, however, that undertaking a new agency action does not, as Copyright Owners claim, obviate the need for the Judges to identify proper legal authority before substantively changing the Initial Determination, such authorities being limited to the authority of section 803(c)(4) or the rehearing authority of section 803(c)(2). *Id*. at 54-55.

The Services address Copyright Owners' position that if the only possible outcome were for the Judges to reinstate a definition that lacked any explanation or evidentiary support solely because it was present in the Initial Determination, then the D.C. Circuit would not have remanded the issue but would have simply reversed and reinstated the Initial Determination definition. The Services urge that the D.C. Circuit could not reverse because the Department of Justice raised for the first time on appeal new justifications for the Judges' decision to change the Initial Determination. Instead, the Services maintain, the D.C. Circuit had to remand and give the Judges the opportunity to address the Department of Justice's new justifications in the first instance, as the D.C. Circuit could not rule them out given the posture of the appeal. *Id*. at 56.

In the Services' Additional Submission, they concede that this remand proceeding is new agency action and that the Judges have provided the parties with sufficient procedural opportunities to present any new evidence and raise any additional arguments regarding the question the D.C. Circuit remanded. Services' Additional Submission at 38. But the Services still insist that the Judges may not alter the Service Revenue definition without first identifying legal authority in the Copyright Act for modifying the Initial Determination. In the Services' view the new agency action avenue provided by the D.C. Circuit merely offers a singular path beyond the Judges' ability to offer a "fuller explanation" of their previous reasoning for revisiting the definition in the Rehearing Order. According to the Services' argument, the new agency action provided for in this remand only offers the additional opportunity to offer new reasons supporting any legal authority for altering the Initial Determination's Service Revenue definition, beyond those that were raised in the appeal. Services' Additional Submission at 38-42

[146] The Services agree that this remand proceeding qualifies as "new agency action" but again urge that failure to address the legal and factual issues on which the court remanded would nonetheless violate the D.C. Circuit's order. Services' Additional Submission at 38-42.

C. Reconsideration of Motion for Clarification as Motion for "Rehearing"[147]

1. Copyright Owners' Position

Copyright Owners argue that the Judges have the authority to engage in new agency action in this remand proceeding through a reconsideration of the Motion for Clarification as a motion for rehearing, pursuant to 17 U.S.C. § 803(c)(2)(A) and 37 C.F.R. § 353.1. Copyright Owners urge, however, that proceeding in that fashion would add an entirely unnecessary and complicating step. They again suggest that there is no need to reconsider or recharacterize the Motion for Clarification as a motion for rehearing because the remand itself affords the opportunity for the Judges to take new agency action, which, as in a rehearing, permits them to reconsider evidence and arguments, but, unlike a rehearing, is not limited by the constraints of section 803(c)(2). CO Further Briefing, Tab B at 7-8.

Copyright Owners posit that if the Judges engage in new agency action to reconsider the Motion for Clarification as a motion for rehearing under 803(c), and to decide that motion based on all of the evidence in the record supporting the adopted bundle revenue definition and showing the prior bundle revenue definition to be unsupported and unreasonable, they may properly do so. They assert that the while they did not make a request for rehearing on the face of the Motion for Clarification, that is not the same as a finding that the standard could not have been met. The Judges may consider whether, based on the evidence in the record, the rehearing standard has been satisfied on this remand. In Copyright Owners' view, the Judges could conclude, revisiting on remand the question of whether the rehearing standard has now been met, that Copyright Owners have satisfied the "exceptional case" standard for granting rehearing motions under section 803(c)(2). Copyright Owners note that if the Judges do engage in new agency action that reconsiders the Motion for Clarification as a motion for rehearing, the Judges should fully explain their reasoning. *Id*. Tab B at 8-10.[148]

2. Services' Position

The Services assert that the Judges cannot invoke their rehearing authority by construing the Motion for Clarification as a rehearing motion. They maintain that the D.C. Circuit expressly found that the revision of the Service Revenue definition for bundled offerings does not fall within the Judges' rehearing authority under section 803(c)(2)(A). The Services assert that Copyright Owners did not satisfy either prong of section 803(c)(2)(A), which authorizes rehearing only "upon motion of a participant" and "in exceptional cases." They note that the D.C. Circuit agreed with the Judges' decision not to treat Copyright Owners' motion as one for rehearing and that the D.C. Circuit also agreed with the Judges' further finding that "Copyright Owners' motion did not meet the exceptional standard for granting rehearing motions." Services' Further Briefing at 7 (citing *Johnson* at 390).

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[147] The Judges consider the briefs filed in response to the Feb. 9, 2022 Order only to the extent that they are responsive to the Feb. 9, 2022 Order, which requested briefing on the specific matter of whether the D.C. Circuit's *Johnson* decision permitting the Judges to engage in new agency action in this remand proceeding allows the Judges to engage in new agency action through a reconsideration of Copyright Owners' February 12, 2018 Motion for Clarification as a Motion for "rehearing," pursuant to 17 U.S.C. § 803(c)(2)(A) and 37 C.F.R. § 353.1.

[148] With regard to the obligation to fully explain their reasoning for any reconsideration, the Copyright Owners point to *United Food & Com. Workers Union, Loc. No. 663 v. U.S. Department of Agriculture.*, 532 F. Supp. 3d 741, 769 (D. Minn. 2021) ("When an agency takes a new course of action, it must 'display awareness that it is changing position' and 'show that there are good reasons for the new policy.'"), quoting *FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 515 (2009) (emphasis in original).

The Services add their view that the Judges are bound by the D.C. Circuit's conclusions on this issue. They maintain that because the Judges' section 803(c)(2)(A) rehearing authority is among the grounds that *Johnson* addressed and determined, the Judges cannot rely on that authority on remand. *Id*. at 8-9. The Services urge that the Judges already correctly concluded that the Motion for Clarification was not a motion for rehearing, and note that Copyright Owners never presented their motion as one for rehearing. The Services add that because Copyright Owners did not challenge that decision on appeal, it is too late for them to do so now.[149] *Id*. at 9-10.

The Services argue that Copyright Owners' Motion did not make any attempt to satisfy the exceptional cases standard set out in 17 U.S.C. § 803(c)(2)(A). They argue that Copyright Owners did not purport to identify any new evidence, new legal authority, or even a substantive error in the Judges' reasoning in the Initial Determination, but instead the motion asserted that the Judges' inclusion of the definition of service revenue in the Initial Determination was supposedly inadvertent. The Services add that Copyright Owners did not identify any specific evidence in the *Phonorecords III* record or any aspect of the Initial Determination that suggested the inclusion of this definition was a mistake. *Id*. at 10.

The Services point out that Copyright Owners' motion did not comply with the procedural requirements for a motion for rehearing. They then urge that the Judges cannot invoke their section 803(c)(2)(A) authority by rewriting a participant's motion to say it is seeking rehearing when that participant specifically and unambiguously disclaimed any intent to seek rehearing. *Id*. at 11.

The Services note that the Judges previous conclusion that even if the Motion for Clarification had requested rehearing, that motion would not and does not meet that exceptional standard for granting rehearing and failed to make even a *prima facie* case for rehearing. The Services observe that the Judges apply a strict standard to rehearing motions to prevent parties from using the rehearing process to seek a second bite at the apple by advancing theories and arguments that could have been advanced earlier during the proceeding. *Id*. at 12. The Services reiterate their view that Copyright Owners' motion did not point to any evidence in the *Phonorecords III* record at all, and, that the only evidence in the *Phonorecords III* record concerning bundles supports the longstanding definition of Service Revenue which has been effective in encouraging the Services to offer bundles that benefit Copyright Owners by growing the market for music streaming services. *Id*. at 14.

The Services finally assert that this is not an extraordinary case where a party has identified an error that, if left uncorrected, would result in manifest injustice. *Id*. at 15-16. The Services conclude by urging that given this procedural history and the unchanged state of the record since the initial hearing, any claim that Copyright Owners have somehow now satisfied the exceptional case standard would be clear error. *Id*. at 17.

D. Record Evidence Regarding Definition of Service Revenue

1. Copyright Owners' Position

[149] In fact, the issue of whether to recharacterize the Motion for Clarification as a motion for rehearing is not one raised by Copyright Owners, but by the Judges *sua sponte.* The Services' estoppel argument as to the Copyright Owners cannot apply to the Judges' action.

Copyright Owners assert that the prior bundle revenue definition (published in the Initial Determination) failed to address the "'economic indeterminacy' problem inherent in bundling" appropriately and in a way consistent with Judges' precedent. CO Initial Submission at 75 (citing Order on Rehearing at 16-18). Copyright Owners proceeded to cite several portions of testimony from the Services' economic experts who acknowledged this problem. *Id*. They then point to hearing testimony in which Copyright Owners repeatedly raised the "economic indeterminacy" problem and demonstrated what they characterized as the absurd results to which the prior definition had led. *Id*. at 76. They point out that under the prior definition, service revenue for bundled subscriptions started with revenues recognized from the bundle (*i.e.*, the price paid by the subscriber) and subtracted "the standalone published price" for all non-music components of the bundle. [redacted] *Id*.

Copyright Owners point out that the Judges already found with respect to other licenses that such an approach is not only fundamentally unfair, but "absurd." *Id*. (citing 81 Fed. Reg. 26,316, 26,382 (May 2, 2016) (webcaster licenses)); *see also* 83 Fed. Reg. 65,210, 65,264 (Dec. 19, 2018) (SDARS licenses) (rejecting proposed deductions by service for bundle revenues because of the "acknowledged 'economic indeterminacy' problem inherent in bundling"). The Copyright Owners concur with the Judges' correct conclusion that the same reasoning applies to *Phonorecords III*. *Id*. at 76-77 (citing Order on Rehearing at 18) ("the 'economic indeterminacy' problem inherent in bundling is common to all three proceedings."). The Copyright Owners offer that Spotify conceded to this flaw in the definition in the Initial Determination, but offered an alternative that contained the same loophole. *Id.* at 77-78.

Copyright Owners point out that the proponent of a term bears the burden of proof as to adoption. The Judges made clear that the licensee who wishes to offer bundles must bear the burden of providing evidence that might mitigate the acknowledged economic indeterminacy problem inherent in bundling, because any such evidence would be in its possession, not in the possession of the licensors. *Id*. at 79 (citing *SDARS III* Determination, 83 Fed. Reg. 65,210, 65,264) ("bundling [is] undertaken to increase [the Services'] revenues and it would be reasonable to assume that [the Services have] information relevant to the economic allocation of the bundled revenue."). The Copyright Owners contend they presented unrebutted evidence showing the unreasonableness of the Services' proposed definition while the Services offered no evidence to support their definition. *Id*. at 78, 79 (citing Order on Rehearing at 18). Copyright Owners maintain that no Service offered evidence concerning the separate values of the constituent parts of the bundles, or any other evidence concerning the economic allocation of bundled revenue, let alone the reasonableness of the definition in the Initial Determination. *Id*. at 80. Copyright Owners assert that in the absence of evidence to support the proposed definition, the Judges may adopt or fashion a definition of service revenue for bundled offerings that comports with the record evidence, which is precisely what the Judges did and can, through new agency action, do again. *Id*. at 81.

Copyright Owners dispute the Services' assertion that there is support for the *Phonorecords II* approach to bundles in the record of this proceeding. Instead, Copyright Owners argue, the Services' purported evidence at most supports the benefits of the practice or strategy of bundling. They maintain that the strategy of bundling covered music services with other products or services has nothing to do with whether the Services should be free to reduce the revenue allocable to music to zero. They offer that the definition in the Initial Determination has nothing to do with such benefits, and that those benefits may be equally served by a definition that ensures value is apportioned to the music component in the bundle. CO Reply at 73-76.

2. Services' Position

The Services argue that the evidence in the existing written record addressing bundles shows both that this definition is supported by the *Phonorecords II* benchmark and that it has proven, industry-wide benefits. Services' Initial Submission at 68. They offer that the Copyright Owners did not propose an alternative definition of service revenue until after the Judges issued the Initial Determination and that any definition they propose now would fail the basic requirement that the Judges must adopt rules "on the basis of a written record." *Id*. (citing 17 U.S.C. §§ 803(a)(1) and § 803(c)(3)).

Addressing the merits of the definition contained in the Initial Determination, the Services argue that it best serves the goals of the Copyright Act; that as a bright-line, easily administered rule, it continues the broad industry agreement from *Phonorecords II.* The Services contend the prior definition increases output and incentivizes beneficial price discrimination to reach listeners who would otherwise not pay for music. They argue that the record evidence confirms that the prior treatment of bundles enabled experimentation and variation in the distribution of music with long-term benefits for all parties. They state that Copyright Owners' argument that Services [redacted] also demonstrates the broad benefits of the definition of Service Revenue in *Phonorecords II* because the record showed that arrangement enabled funneling of many of listeners into full-priced, full-catalog services—such treatment of bundles enabled the flexibility and price discrimination that yielded beneficial growth of the royalty pool.[150] The Services allege that Copyright Owners also ignore the extensive royalties that were generated. They add that with the per-subscriber minimum guarantees that the Copyright Owners will still be paid a fair royalty. The Services then cite several portions of testimony from various Services' economic experts who point out the realization of an expanded royalty pool, which the Services offer as proving a functioning marketplace. *Id*. at 68-74.[151]

The Services then assert that no other definition of service revenue for bundles that has been before the Judges combines both the administrative simplicity of the Initial Determination's definition and the broad price discrimination benefits of promoting discounted bundles. They maintain that while neither the Services nor Copyright Owners submitted evidence specifically addressing the way that customers, Services, or Copyright Owners might value the component parts of bundles, such subjective valuations are unnecessary for the Judges to find ample support for the *Phonorecords II* approach to bundles in the record. *Id*. at 75-76.

The Services also argue that while the Judges' decision in *SDARS III* did involve valuation of the music and non-music components of a bundle, the resolution in *SDARS III* is

[150] Notably, the Services do not deny that the former definition did, in fact, [redacted].

[151] The Services' Reply reiterates this point and offers that the testimony cited by the Copyright Owners also shows why the Initial Determination's Service Revenue definition works for bundles and grows royalties. Services Reply at 57-58.

inapposite because, here, the rate structure has a way of ensuring that Copyright Owners are fairly compensated for bundles: the statutory minimum payment. Services Reply at 62.

E. Analysis and Conclusions Regarding Definition

1. Remand Proceeding as New Agency Action

Having considered the entirety of the record of this proceeding, a majority of the Judges (Definition Majority) conclude that this remand constitutes "new agency action" and meets all of the criteria to qualify as new agency action. The Judges thus have the opportunity to consider the issue afresh consistent with their procedural rules regarding remands.

The Definition Majority finds that it is unnecessary to attempt to distinguish new "agency action" from "new agency action." Neither approach is endorsed clearly by the varied judicial interpretations of a new agency action. *See* R.J. Krotoszynski, Jr., *Administrative Law Discussion Forum: "History Belongs to the Winners": the Bazelon-Leventhal Debate and the Continuing Relevance of the Process/Substance Dichotomy in Judicial Review of Agency Action,* 58 Admin. L. Rev. 995 (Fall 2006). As noted by Judge Bazelon, the D.C. Circuit "believed in process-based review, [but] he argued that it was improper for judges to prescribe specific procedures." *Id.* at 1001. Judge Bazelon's remand orders focused on providing "genuine opportunities to participate in a meaningful way" and "genuine dialogue" with interested parties, while leaving the agency "free to decide which specific procedures to undertake." *Id.*

Several reported cases point to new action as an alternative to a fuller explanation. But few define "new agency action" other than to say, as did the *Johnson* court, that the agency must take it "accompanied by the [unspecified] appropriate procedures." *Johnson,* 969 F.3d at 392. Parties to the original action, already familiar with the issue and the factual and legal background, recognized that the D.C. Circuit identified the adoption of a modified definition in the Determination as one of three issues on remand. In repeated rounds of remand submissions, both the Services and the Copyright Owners included the definition issue. The Judges were not satisfied with the parties' lack of focus on the issue, however, and ordered expressly further briefing on the new agency action issue and sub-issues relating to the adoption of a definition of Service Revenue as it relates to bundled service offerings. *See* (Dec. 9 Order) at 4; *Sua Sponte* Order Regarding Additional Briefing (Feb. 9, 2022).

New agency action is not synonymous with justification, or confirmation, of the prior action. New agency action is a procedural mechanism for reconsideration of the record, reopening the record for additional evidence and argument, and adoption of a conclusion based on the expanded record. In this instance, the presentations, written and oral, of participants on remand, together with a re-examination of the original record, support reversion to the definition originally announced in the Initial Determination. Ultimately, given repeated opportunities for legal analysis on the issue, both sides agreed that the remand proceeding itself, with ample notice and multiple opportunities for input was sufficient to constitute new agency action. *See* CO Further Briefing at 3, 7.

The Services argued, however, that notwithstanding this appropriate new agency action, the Judges remained without authority to adopt the revised definition as a term governing the royalty rates determined in this proceeding. Their arguments regarding procedures undertaken in the Determination are superseded by the Judges' conduct of extensive remand proceedings.[152] The gravamen of the Administrative Procedure Act is transparency in agency[153] rulemaking. Agencies must publish notice of their intentions, provide opportunities for interested parties to comment and object, and finalize regulations only after reconciling objections with the policies and purposes of proposed regulations. The adjudication of this remand proceeding was conducted openly. Interested parties had ample opportunity to object, to comment, and to brief legal and factual issues relating to the Judges' approach to promulgating an appropriate definition of bundled service revenue.

The present analytic approach merely takes the position that the Judges engaged in new agency action by conducting a fully open and broadly explored remand proceeding. Unlike a rehearing or exercise of continuing jurisdiction, this remand proceeding is not limited by the constraints of sections 803(c)(2) or 803(c)(4). Contrary to the Services' assertion, the Judges address the issue on which the D.C. Circuit remanded, the need to exercise authority within the lines drawn by the authorizing statute. This remand proceeding does not, therefore, violate the D.C. Circuit's order.

The *Johnson* opinion clearly states the two paths by which the Judges may address the issues presented to them on remand; they may either (1) provide "a fuller explanation of the agency's reasoning at the time of the agency action[,]" *or* (2) to take "new agency action" accompanied by the appropriate procedures. *Johnson*, 369 F.3d at 392. The Judges chose to pursue the second option: this new agency action. The Judges reiterate: the Services concede that, through this proceeding the Judges have provided the participants with adequate procedural opportunities to present any new evidence on the proper Service Revenue definition for bundles. The Judges also acknowledge, but disagree with, the Services' position that that they must return to the issues as they were presented after issuance of the Initial Determination, regardless of the admittedly complete and valid remand procedure, which constitutes new agency action.

The Judges (the majority on this issue) determine that any confining action on remand to the provisions of sections 803(c)(2)(A) or 803(c)(4) would misconstrue the clear expression of the "new agency action" alternative presented by the D.C. Circuit,[154] as well as chapter 8 of title 17. As the Copyright Owners correctly observed, in a remand proceeding, the Judges are not required to undertake any of the procedural steps set forth in section 803(b) nor are the Judges compelled to consider or be limited by sections 803(c)(2)(A) or 803(c)(4). The statute only requires that the Judges' remand proceedings are in accordance with section 803(a).[155]

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[152] Furthermore, the issue of the Judges' authority to take an action in issuing the Determination is moot. The Judges, after new agency action, have chosen not to defend the definition in the Determination but rather to conclude, following that new agency action, that the definition in the Initial Determination is more appropriate in these circumstances. Whether the Judges had the authority in the first instance is not at issue, as they are not repeating the former action.

[153] The proceedings of the Copyright Royalty Board (CRB) are subject to the standards of the Administrative Procedure Act. *See* 17 U.S.C. § 803(a)(1).

[154] The case that the D.C. Circuit points to for the new agency action path clarifies that "An agency taking this [new agency action] route is not limited to its prior reasons but must comply with the procedural requirements for new agency action." *Regents*, 140 S. Ct. at 1908).

[155] "The court [United States Court of Appeals for the District of Columbia Circuit] may also vacate the determination of the Copyright Royalty Judges and remand the case to the Copyright Royalty Judges for further proceedings in accordance with subsection (a)." 17 U.S.C. § 803(d)(3)

The D.C. Circuit observed that the Judges have "considerable freedom to determine [their] own procedures." *SoundExchange v. CRB*, 904 F.3d 41 at 61. The D.C. Circuit also cautions that such flexibility must be exercised within the lines drawn by the authorizing statute. Here, the Judges operate within the lines drawn with respect to remand proceedings set forth in chapter 8 of title 17.

2. "Fuller Explanation" of Modification to Initial Determination

Case law regarding development of a "fuller explanation" of an agency's action emphasizes that the agency cannot adopt *post hoc* reasoning on the same record. *See, e.g., SEC v. Chenery Corp.,* 332 U.S. 194, 201 (1947) (after remand, agency bound to "deal with the problem afresh …."). Certainly, adopting a *post hoc* argument of appellate counsel, just because it offers a rationale for the agency's original action is impermissible.[156] On the other hand, if the record in the initial proceeding is sufficiently robust to support a reinterpretation or additional reasoning, the agency may justify its initial action with that "fuller explanation" without considering any new evidence. *See, Fisher v. Pension Benefit Guar. Corp.,* 468 F.Supp.3d 7, 20 (D.C.D.C. 2020), aff'd *Fisher v. Pension Benefit Guar. Corp.,* 994 R.3d 664 (D.C. Cir. 2021), rehearing *en banc denied, Fisher v. Pension Ben. Guar. Corp.,* 2021 U.S. App. LEXIS 18793 (D.C. Cir., June 23, 2021) (requirement of new evidence a "novel proposition of law" without precedent). On remand, an agency may elaborate on its prior reasoning, but it may not provide new reasons for the original decision. *Fisher*, 994 F.3d at 669. If the Judges had chosen in this remand to rest on their Determination regarding the service revenue definition, they might have done so only if they could elaborate on the existing record.[157] In the alternative, the Judges issue a new decision after new agency action. *Id.*

The Judges, having engaged in new agency action to settle on the definition of service revenue for bundled offerings, do not find a need to address the statutory avenues or the confines that are provided for rehearing or continuing jurisdiction, nor do the Judges pursue the propriety of reconsideration of the Motion for Clarification as a motion for rehearing.[158]

3. Substantive Analysis of Dueling Definitions of Bundled Revenue

The fundamental difference between the impact of the two alternative definitions is simply stated:

Under the Initial Determination:

> downstream bundling and its price discriminatory effect *would* be incentivized by a royalty structure that reflects the lower WTP of consumers who subscribe by paying for a Bundle;

Under the Determination:

[156] A rationalization is not *post hoc* simply because it is iterated by counsel. Denomination of a rationalization as *post hoc* is a matter of timing, not of the offeror.

[157] In this instance, had the Judges decided to keep the definition in the Determination, they probably could have given a fuller explanation based on the record in the underlying proceeding. Because the Judges have opted to rely on the fresh-look approach in the "new agency action" alternative and because the prior definition is appropriate given adoption of the PR II rate structure, development of that fuller explanation based on the record is unnecessary.

[158] The Judges also find no need to consider any inherent authority that may remain for consideration.

> downstream bundling and its price discriminatory effect *would not* be incentivized by a royalty structure that reflects the lower WTP of consumers who subscribe by paying for a Bundle.

To explain this difference, the Judges find it helpful to describe (as in the Determination and Dissent) how bundling facilitates price discrimination and how lower royalties for bundled streaming services incentivize such bundling.

Price discrimination occurs when a seller offers different units of output at different prices. *See*, *e.g.*, H. Varian, *Intermediate Economics* at 462 (8th ed. 2010). The benefit to the seller arises from attempting to "charge each customer the maximum price that the customer is willing to pay for each unit bought." R. Pindyck & D. Rubinfeld, *Microeconomics* at 401 (8th ed. 2013). For all goods, and intellectual property goods such as copyrights in particular,[159] the social benefit is that price discrimination more closely matches the quantity sold with the competitive quantity as the seller or licensor better aligns the price with the WTP of different categories of buyers or licensees. *See* W. Fisher, *Reconstructing the Fair Use Doctrine*, 101 Harv. L. Rev. 1659, 1701 (1988).

A seller can engage in price discrimination in several ways. One form is known as "second-degree price discrimination," by which buyers self-sort the packages and quantities they purchase.[160] *See* W. Adams & J. Yellen, *Commodity Bundling and the Burden of Mo*nopoly, 90 Q. J. Econ. 470, 476 (1976) (the profitability of bundling "stem[s] from its ability to sort customers into groups with different reservation price [WTP] characteristics."). Bundling, *i.e.*, the "practice of selling two or more products as a package," *Pindyck & Rubinfeld*, *supra* at 419, is thus a type of second-degree price discrimination. *See* A. Boik & H. Takahashi, *Fighting Bundles: The Effects of Competition on Second Degree Price Competition*, 12 Am. Econ. J. 156, 157 (2020).

The applicability of these basic economic principles was understood and explained by the parties' experts at the hearing. *See*, *e.g.*, 3/15/17 Tr. 1224-25 (Leonard) (Google's economic expert testifying that price discrimination through bundling is "very, very common … even by pretty competitively positioned firms … to sort out customers into willingness-to-pay groups."); 3/30/17 Tr. 3983 (Gans) (Copyright Owners' economic expert acknowledging that bundling is a form of price discrimination); *see also* Dissent at 69 (same).

How does this downstream (retail level) benefit of price discrimination impact the setting of upstream royalty rates? As the Majority explained (in summarizing the Services' expert testimony) the linkage is explained by the economic concept of "derived demand":

> [M]ultiple pricing structures necessary to satisfy the WTP and the differentiated quality preferences of downstream listeners relate directly to the upstream rate structure to be established in this proceeding. Professor Marx opines that the appropriate *upstream* rate structure is derived from the characteristics of

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[159] Streamed copies of intellectual property, such as musical works and sound recordings, have a marginal production cost of essentially zero, making price discrimination particularly beneficial, because charging any positive price, even to a buyer with the lowest WTP, still exceeds the zero marginal production costs. *See* Dissent at *passim*.

[160] "First-degree" price discrimination is a hypothetical construct by which a seller can identify the WTP of every buyer. "Third-degree" price discrimination occurs when the seller offers different prices to buyers based on their different characteristics (*e.g.*, a senior citizen discount). *See Pindyck & Rubinfeld*, *supra*, at 402, 404-05.

> downstream demand. 3/20/17 Tr. 1967 (Marx) (rate structure upstream should be derived from need to exploit WTP of users downstream via a percentage of revenue). This upstream to downstream consonance in rate structures represents an application of the concept of "derived demand," whereby the demand upstream for inputs is dependent upon the demand for the final product downstream. *Id.*; *see* P. Krugman & R. Wells, *Microeconomics* at 511 (2d ed. 2009) ("[D]emand in a factor market is … *derived demand* … [t]hat is, demand for the factor is derived from the [downstream] firm's output choice").

Determination at 19; *accord* Dissent at 32 (noting that "the upstream demand of the interactive streaming services for musical works (and the sound recordings in which they are embodied) – known as "factors" of production or "inputs" – is derived from the downstream demand of listeners to and users of the interactive streaming services ... This interdependency causes upstream demand to be characterized as "derived demand.").

In the present proceeding, the PR II-based benchmark embodies the parties' negotiated definition of Bundled Revenue for purposes of calculating royalties on bundled interactive offerings. This is definition in the Initial Determination. Copyright Owners' preferred definition for Bundled Revenue – the Determination's definition – would not only ignore this agreed-upon definition, but would also de-link the royalty rate from the WTP of purchasers of bundles.[161] The Judges recognize that Copyright Owners have expressed concern the Services could use such bundling in order to diminish revenue otherwise payable on a higher royalty tier. However, the Majority noted that the evidence indicated such diminishment only occurred "in some cases." Clarification Order at 17. Thus, the Judges find that eliminating the incentive for price discrimination via bundling would be a disproportionate response and inconsistent with the broad price discriminatory PR II-based benchmark they find useful in this proceeding.

Expert testimony in this regard is "substantial evidence" on which the Judges can rely. For example, the D.C. Circuit also relied in *Johnson* on the testimony of the same witness, Spotify's economic expert witness, Professor Marx, who explained how a downstream "lower willingness (or ability) to pay" among some cohorts of consumers supports definitional terms, for student and family subscribers, that lower royalty rates in order to further "economic efficiency" in a manner that "still allows more monetization of that provision of that service." *Johnson* at 392-93. Broadening her lens, Professor Marx also explained that this price discriminatory approach is appropriate "across all types of services and subscribers," as in "[t]he current law [and in the PR II-based benchmark]" which "accommodates … ad-supported

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[161] To see the incentivizing effect of the link between the royalty level and variable WTP, consider the following example. Assume a hypothetical bundle consists of a subscription to the "Acme" interactive music streaming service and the sports service NFL Sunday Ticket. Assume also that Acme and NFL Sunday Ticket have standalone monthly subscription prices of $9.99/month and $149.99/month respectively, so that purchasing both separately would cost $159.98/month. But assume the bundle price is only $140/month. Acme's purpose in bundling its interactive music streaming service subscription offering with NFL Sunday Ticket would be to attract customers who had a WTP for the standalone Acme service below $9.99/month, but a WTP at or above the $140/month for the bundle.

Under the definition in the Determination, royalties would be paid on the standalone $9.99/month Acme price. But the purpose of the bundling was to attract subscribers *who would not pay the standalone $9.99/month price*, so no such would-be subscribers would sign-up, and *no royalties would be generated by them*.

By contrast, under the Initial Determination, the standalone price of NFL Sunday Ticket, $159.98/month, would be subtracted from the $140/month bundle price. Although that would preclude a payment of royalties on a *revenue* prong, *royalties still would be paid, under a different tier or on the mechanical floor.*

services … and '*bundled services*' through different rate provisions." Marx WRT ¶ 41 (emphasis added). *See also* 3/21/17 2182-83 (Hubbard) (Amazon's expert witness testifying that "Prime Music, which is *bundled* with an Amazon Prime service … sort[s] out customers' willingness to pay, with an idea of trying to maximize the number of customers," and agreeing that this approach constitutes "sorting by way of bundling.") (emphasis added). Further, Professor Hubbard opined that, given the revenue attribution "measurement problem" associated with bundled products, the "Phonorecords II" approach "with the different categories and the minima" … address this sort of problem [in] a very good way." 3/15/17 Tr. 1221 (Hubbard).

As in the case of family and student price discrimination, the beneficial effect of such differential pricing was supported by industry witnesses as well as expert witnesses. *See, e.g.,* Mirchandani WDT ¶ 71 (Amazon executive citing the Phonorecords II-based benchmark provisions regarding bundling that "allowed Amazon to bundle Prime Music with Amazon Prime, enabling Amazon to bring a limited catalog of music [redacted]"). In sum, the same type of witness testimony that the D.C. Circuit found sufficient to support price discriminatory student and family plans also supports the use of the price discriminatory bundled definition contained in the Initial Determination.

Given the overall benefits from price discrimination, at first blush it is curious that Copyright Owners would risk "leaving money on the table" by removing the royalty-based incentive for price discrimination via bundling. The Judges have identified this problem earlier in this Initial Ruling, in connection with the broader issue of the overall beneficial price discriminatory structure of the PR II-based benchmark. As the Judges noted in that general price discrimination context, Copyright Owners' own expert economic witnesses acknowledged that they would not irrationally "leave money on the table." In fact, Copyright owners' aim, according to that testimony, is to create an unregulated space—per the Bargaining Room theory—and to use their complementary oligopoly power to negotiate price discriminatory rates (in bundles or otherwise), which would free them from the section 801(b)(1) requirements of reasonableness and fairness.

The Judges further find that their prior ruling on this issue in *SDARS III* is distinguishable. There, a proffered bundled revenue definition eliminated the payment of any royalty at all. Copyright Owners quite correctly describe that result as "absurd," but that is not the result here. Rather, in the present case, the parties' negotiated an approach that the Judges adopted in the Initial Determination requiring royalties to be paid on interactive services bundled with other products or services.

Even more distinguishable is Copyright Owners' assertion that *Web IV* provides support for their preferred definition of service revenue. The argument is immediately suspect, because *Web IV* involved per-play royalty rates – not percent-of-revenue rates, making the definition of revenue wholly inapposite. Further, the discussion of the price of an "ice cream cone" in *Web IV* – on which Copyright Owners rely – had nothing to do with bundling or isolating the WTP for different products or services. Rather, there the Judges criticized a bizarre argument made by a licensee (who had a quantity discount for plays steered in its direction), that was tantamount to arguing that if a vendor sells one ice cream cone for $1.06 but a buyer could buy two for $1.06, that the market price of an ice cream cone is thus only $.06. This argument was indeed fallacious, because the price of an ice cream cone would be the average of the total cost for the two cones, *i.e.*, $.53/cone. Here, the issue is how to address the WTP of different classes of buyers with heterogeneous WTP, not the pricing of a discount for all purchasers buying the same quantity. The parties utilized the Bundled Revenue definition from the PR II-based benchmark (and in the Initial Determination) to address the indeterminacy inherent in the variable WTP among purchasers of the bundles, by setting floors and minima, rather than attempt to sort out the WTP of individual (or individual blocs) of subscribers.[162]

For the foregoing reasons, the Judges find that the definition in the Initial Determination (unlike the definition in the Determination) is consistent with the Judges' other substantive rulings herein. That is, just as the Majority abandoned its Bundled Revenue definition in its Initial Determination because it refused to credit the PR II-based benchmark (even as "guidance"), the Judges here do partially rely on the PR II-based benchmark, and thus find that it supports the Bundled Revenue definition contained in the Initial Determination.

4. Application of Four Itemized Statutory Factors

As the forgoing analysis explains, bundling is a form of price discrimination. Accordingly, the Judges' explanation of how price discriminatory rates in the PR II-based benchmark interrelate with the Factor (A) through (D) objectives in section 801(b)(1) are equally applicable here. Accordingly, the Judges incorporate by reference their discussion of those four factors set forth *supra* in connection with the PR II-based benchmark, and find that there is no basis pursuant to those four factors to adjust the PR II-based benchmark definition of Bundled Revenue.

V. Conclusion

On the basis of the foregoing analyses, and in consideration of the entirety of the record, the Judges make the following determination relating to the issues on remand from the D.C. Circuit.

As noted at the outset, the headline rate for all offerings throughout the *Phonorecords III* period shall be as follows:

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[162] Accordingly, Copyright Owners' assertion that the Services did not satisfy their burden of proof with regard to the Bundled Revenue definition misses the point. The Services' burden was to show the reasonableness of utilizing the Bundled Revenue definition in the PR II-based benchmark, not to show that their proffered approach measured the WTP of individual subscribers (or blocs of subscribers). Such an alternative approach might have had merit but no alternative approach was presented to the Judges.

To be clear, the Judges are not declaring that an alternative Bundled Revenue definition and/or alternative rates and structures for bundle, might not have been preferable. *See* 4/15/17 Tr. 5056-58 (Katz) ("[I]f someone had a proposal [with] a specific reason why we should adjust this minimum that's something I would have examined"); *see also* 3/15/17 Tr. 1227-28 (Leonard) (Google's economic expert testifying that "if somebody had … suggest[ed] … a different sort of bucket that should be created ... that's a good idea."). But Copyright Owners did not propose such alternatives at the hearing, and the alternative in their Motion for Clarification simply eviscerated the "derived demand"-based link between royalties and bundled offerings. As the Judges have noted *supra*, in the words of Judge Patricia Wald, all judges are cabined by the record evidence introduced by the parties. Therefore (in the absence of a way in which to synthesize the parties' proposals in a manner that does not "blindside" the parties) the Judges must choose between the proposals that are in the record, not potentially superior proposals that are not in the record. Here, the Judges favor the Bundled Revenue definition in the Initial Determination that was negotiated by the parties, incentivizes price discrimination and pays royalties on the bundled music, over the substituted definition in the Determination pursued by Copyright Owners that would eliminate price discrimination, except under the terms Copyright Owners could impose via their complementary oligopoly power, and without regard to the statutory requirements of a "reasonable rate" and a "fair income" for the Services.

2018-2022 All-In Headline Royalty Rates

	2018	**2019**	**2020**	**2021**	**2022**
Percent of Revenue	11.4%	12.3%	13.3%	14.2%	15.1%

In all other respects, the rates and rate structure of the PR II-based benchmark shall be effective as the rates and structure throughout the *Phonorecords III* period.

The definition of Service Revenue for bundled offerings throughout the *Phonorecords III* period shall be the definition contained in the Initial Determination.

VI. Order

In light of the foregoing analyses and conclusions, the Judges hereby **ORDER** that the participants in this remand proceeding prepare and submit regulatory provisions consistent with this ruling.[163] The participants shall file agreed regulatory language within ten days of the date of this ruling.

The Judges **FURTHER ORDER** that if the participants cannot agree on a joint submission, the Judges will accept separate submissions respectively from (1) Copyright Owners and (2) Services, jointly. In absence of an agreed submission, the participants shall file separate submissions not later than 15 days after the date of this ruling.[164]

The Judges **FURTHER ORDER** that parties shall not file, and the Judges shall not consider, briefing or legal argument beyond necessary explanatory notes to the proposed language, section by section, not to exceed 250 words per proposed section.[165] The Judges specifically admonish the parties that they shall not use these submissions as a basis to object to this Initial Ruling, either explicitly or implicitly by proposing regulatory provisions inconsistent with this Initial Ruling.

The Judges **FURTHER ORDER** that, within 30 days of the date of this Initial Ruling and the attendant dissenting documents, the parties shall file an agreed redacted version of this Initial Ruling, and the dissents, for PUBLIC viewing.

After the Judges have reviewed the parties' regulatory submissions, the Judges shall adopt and format the necessary regulatory language format terms relevant to this ruling and issue a RESTRICTED Initial Determination after Remand, which shall embody their determination of rates and terms. The parties will have an opportunity to suggest redactions from the Initial Determination after Remand before it is issued as a public version.

The parties shall not file any motions seeking rehearing or reconsideration of this Initial Ruling. Subsequent to the Judges' issuance of their Initial Determination after Remand as

[163] The Judges adopt this process in order to avoid a dispute regarding the regulatory provisions issued in connection with their ruling. Because this is a remanded proceeding, the Judges are not restricted to the procedures that would control in an original proceeding, and are exercising their authority to "make any necessary procedural … rulings in any proceeding under this chapter." 17 U.S.C. § 801(c).

[164] In their agreed upon or separate submissions, the parties shall address the issue identified in note 135 *infra*, regarding Copyright Owners' assertion that the Services omitted from their proposed subpart C rates a portion of the *Phonorecords II* rates.

[165] A section of the regulations is designated by a number following the decimal after the part number, for example, § 385.5. The regulations relevant to this proceeding are found in part 385.

identified in the immediately preceding paragraph, any party may file a Motion for Rehearing within 15 days of the issuance of said Initial Determination after Remand.

After ruling on any and all Motions for Rehearing as identified in the immediately preceding paragraph, the Judges shall issue a Final Determination after Remand.

SO ORDERED.

Steve Ruwe Digitally signed by Steve Ruwe Date: 2022.07.01 14:59:15 -04'00'

Stephen S. Ruwe
Copyright Royalty Judge

David Strickler Digitally signed by David Strickler Date: 2022.07.01 15:04:29 -04'00'

David R. Strickler
Copyright Royalty Judge

Digitally signed by Suzanne Barnett Date: 2022.07.01 14:54:59 -04'00'

Suzanne M. Barnett
Chief Copyright Royalty Judge

Dated: July 1, 2022

APPENDIX A

Offering	% of Service Provider Revenue	TCC % or TCC Amount	"Mechanical-Only" Royalty Floor
Standalone Non-Portable Subscription Offering—Streaming Only	10.5%	The lesser of 22% of TCC for the Accounting Period or 50 cents per subscriber per month	15 cents per subscriber per month
Standalone Non-Portable Subscription Offering—Mixed	10.5%	The lesser of 21% of TCC for the Accounting Period or 50 cents per subscriber per month	30 cents per subscriber per month
Standalone Portable Subscription Offering	10.5%	The lesser of 21% of TCC for the Accounting Period or 80 cents per subscriber per month	50 cents per subscriber per month
Bundled Subscription Offering	10.5%	21% of TCC for the Accounting Period	25 cents per month for each Active Subscriber during that month
Mixed Service Bundle	11.35%	21% of TCC for the Accounting Period	n/a
Limited Offering	10.5%	21% of TCC for the Accounting Period	n/a
Paid Locker Service	12%	20.65% of TCC for the Accounting Period	n/a
Purchased Content Locker Service	12%	22% of TCC for the Accounting Period	n/a
Free nonsubscription/ad-supported services free of any charge to the End User	10.5%	22% of TCC for the Accounting Period	n/a

Proof of Delivery

I hereby certify that on Monday, August 01, 2022, I provided a true and correct copy of the Initial Ruling and Order After Remand (PUBLIC) to the following:

Johnson, George, represented by George D Johnson, served via E-Service at george@georgejohnson.com

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

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

Google LLC, represented by David P Mattern, served via E-Service at dmattern@kslaw.com

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

Pandora Media, LLC, represented by Benjamin E. Marks, served via E-Service at benjamin.marks@weil.com

Signed: /s/ Scott Angstreich