

EUROPEAN COMMISSION STAFF WORKING DOCUMENT

Study On A Community Initiative On The Cross-Border Collective Management Of Copyright

PPL & VPL Response

The European Commission's study on cross-border collective management focuses on the online services, which, at least for music, are now growing rapidly. This is a fast evolving market and the study rightly concludes that accountability to the rightholders is the key to this growth. The Commission identifies some specific issues to be addressed, but the blanket regulatory approach proposed is in danger of holding back this emerging market. PPL¹ and VPL² therefore welcome the study on this important issue but have concerns about some of the regulatory measures that are proposed.

Summary Points

1. Online music services are growing fast, driven by the market. Sales of downloads in the new combined chart now exceed sales of physical singles.
2. Many of the problems of licensing online services stem from users' reluctance to pay. Consumers have got used to downloading music files illegally without paying and even some business users refuse to take out licences for the music they use.
3. Collective licensing is a natural monopoly driven by market forces. It delivers allocative, productive and dynamic efficiencies to rightholders and to users³.
4. The proper functioning of the online market relies on voluntary commercial agreements between rightholders and users. Collective management can facilitate this and deliver economic efficiencies but rightholders must retain the right to choose between direct and collective licensing.

¹ PPL is the UK collecting society licensing on behalf of 30,000 performers and 3,000 record companies.

² VPL is the UK collecting society licensing on behalf of 800 music video producers.

³ *Music Collecting Societies: Evolution or regulation?* PricewaterhouseCoopers LLP, June 2005

5. In order to deliver the potential economic efficiencies, collective licensing must be able to offer better return to rightholders than direct licensing. The economic conditions exist. The test is whether there are any regulatory conditions that artificially reduce the tariff below the market rate that could be obtained by direct licensing. Currently, some aspects of competition policy, tax rules and tribunal jurisdiction inhibit collective licensing.
6. The core principles outlined by the Commission broadly support the approach that rightholders should hold collecting societies to account. However, some of the proposed measures introduce accountability instead to a regulator.
7. PPL's and VPL's preferred option takes forward aspects of both Option 2 and Option 3 proposed in the Study. The Commission should issue a clear statement that allows a market framework for collective management. Specifically, the Commission should:
 - Recognise the economic benefits of collective management.
 - Ensure that Competition policy supports fair and market driven collective licensing.
 - Ensure that national copyright courts' and tribunals' rulings are based on arbitration between parties and establish fair market rates.
 - Outlaw restrictive practices in collecting societies, including national discrimination and anti-competitive cross-subsidies.
 - Confirm that cross-border licences should be based on the tariff of destination.
 - Confirm that music users must respect rights, including paying proper market rates, deploying appropriate DRM systems and accounting to rightholders or their licensors.
 - Confirm that collecting societies must account to rightholders, both direct and via reciprocal agreements, on licensing and distribution.

Online Music Market

Online music services are growing fast, driven by the market. Sales of downloads in the new combined chart now exceed sales of physical singles.

The Commission's first stated objective is opening up growth of legitimate online services in Europe. It hardly needs saying that the online music market is global, not just pan-European and licensing arrangements must reflect this reality. Already there are several UK radio stations featuring the top 20 USA simulcast stations. At the same time, many online music services emanating from the USA have a large market share in Europe. These services need multi-territorial licences which recognise the cross-border trade (eg between the USA and Europe) and which reflect the relative values of different markets (eg China compared with the UK).

Reciprocal arrangements between territories will underpin licensing these market structures. A service in the USA with listeners in Europe must be properly licensed and the rightholder remunerated for those European listeners. The reverse must also apply.

2004 was the turning point for legitimate online music services. After several years of rampant online piracy and a lack of payment and DRM systems, around 30 legitimate download and subscription services launched in the UK. Take-up was rapid, leading to the launch of a UK download chart in September 2004. Sales continued to grow exponentially and, less than a year after launch, download sales were incorporated in the new combined UK Chart⁴ in April 2005. By then, download sales had overtaken sales of physical singles. In the UK, download sales are already more than half a million a week and still rising rapidly. The online market in the USA started about a year before the UK market but the gap between the two is narrowing as the market matures.

Music has long been a key driver of online connectivity, albeit largely through illegal P2P file-sharing. Now the legitimate online music market is at the forefront of the knowledge economy, offering huge growth potential. Already, the copyright industries generate 5.3% of Europe's GDP, growing at twice the rate of the rest of the economy. Online, future growth could be even greater. This is a dynamic market, evolving fast in response to consumer demand.

Music Users

Many of the problems of licensing online services stem from users' reluctance to pay. Consumers have got used to downloading music files illegally without paying and even some business users refuse to take out licences for the music they use.

The online access market grew on the back of free music, available through illegal P2P services. Consumers therefore got used to the notion that music on the internet was free. That attitude is changing slowly now there are legitimate services and the music industry is taking action against the most persistent uploaders of music files. Recent court cases in the USA and Australia have confirmed that the software services that facilitate infringing file-sharing are themselves illegal. We do not yet enjoy that legal clarity in Europe.

A similar perception problem existed in the B2B environment. Music was seen to be free and users took advantage of its easy availability to enhance their businesses without paying the artists and record companies who created the recordings which proved so valuable. The concept of musicians and others earning royalties from each use of their music was alien to those used to traditional service models.

In the early days of the internet that misconception was perhaps understandable as formerly disjointed industries found themselves in the same value chain for the first

⁴ The UK Chart is produced by the Official Chart Company, supported by PPL's CatCo database.

time. However, some users still seem to take the attitude that music should be free. There are internet radio stations who are surprised when they are told they need to pay for the music, yet they have no difficulty in paying for bandwidth. Some go to great lengths to hide their identity or play one licensor off against another in order to avoid paying. Even some major players show a remarkable reluctance to take out a licence, despite having lobbied for a one-stop licence facility. When this was offered, via the IFPI Simulcast Agreement, one broadcaster spent many months purportedly trying to obtain licences in each individual territory at a discounted rate. Throughout this extended period, they offered a simulcast service without a licence for the sound recordings.

Downward pressure on rates by users is a constant theme. In the offline world, music users move their operations to another territory to take advantage of loopholes in copyright legislation and benefit from a lower rate. In the online world, this is even easier to do.

Fortunately, in PPL's experience the majority of music users take out a licence, pay the fee and account properly for usage. However, there is a significant minority who do not comply and they incur disproportionate costs in licensing and enforcement. In the online market, this problem is amplified because of the scale. It is crucial therefore that users account properly and that in any licensing system, there is absolute clarity of rights ownership and licensing and enforcement responsibilities. Similarly, the tariff of destination principle is critical in maintaining the proper market value of rights to the creators in cross-border licensing.

Economic Benefits of Collective Licensing

Collective licensing is a natural monopoly driven by market forces. It delivers allocative, productive and dynamic efficiencies to rightholders and to users.

The recent report by PricewaterhouseCoopers LLP *Music Collecting Societies: Evolution or regulation?* provides a valuable and possibly unique economic analysis of the collective management model. Collective licensing evolved in the music industry many decades ago to cope with the mass popularity of music. As music became available in recorded form and could be used almost anywhere, rightholders needed a way of capturing that value and generating reward for use of their creative work.

Collective licensing provided a solution that was both efficient and effective. Even major rightholders would be unable to license the myriad of uses of their music efficiently and effectively and for small rightholders - performers and independent record companies - collective licensing is absolutely essential in certain markets. PwC demonstrate the economic efficiencies clearly in their report. They also outline the economic benefits to users of collective licensing. For music users, a one-stop licence delivers productive and dynamic efficiencies to users. The single licence reduces their clearance costs and provides easy access to repertoire. The efficient distribution of royalties back to the creators acts as an incentive for and, in many cases, directly finances the new material which is most in demand from users.

The economic efficiencies of collecting societies derive from two essential features. The first is volume. The greater the volume, the greater the efficiencies in core functions such as distribution processing. The second is scope of rights. The user wants the assurance that all the rights within a particular category and a particular repertoire type can be delivered in one licence. Inefficiencies are introduced when repertoire is split or rights categories are split and uncertainties arise as to who can provide a licence.

PwC conclude in their report that collective management is an evolving market with only limited need for regulation. In their scenario of a digital world, the market pressures for collective management of rights are even greater. The primary efficiency drivers are the rightholders who demand a proper return from their creative work and economic analysis points towards greater collaboration and cooperation between collecting societies. It is proper accountability to the rightholders that will deliver the economic benefits to users and rightholders, large and small.

Direct or Collective Licensing – The Choice

The proper functioning of the online market relies on voluntary commercial agreements between rightholders and users. Collective management can facilitate this and deliver economic efficiencies but rightholders must retain the right to choose between direct and collective licensing.

Choice is at the heart of the efficiency dynamic for collective management. Rightholders in most territories have a choice between licensing direct or opting for collective management. The efficiency and effectiveness of collecting societies correlates to a large extent with the level of choice rightholders have in practice between direct and collective licensing. For smaller rightholders, even with DRM applications, it may be more difficult to exercise that choice but when allied with larger rightholders they can benefit from the efficiency drivers of the major players.

Choice is a desired outcome of competition policy and it is a crucial driver for efficiency in the market. But it is important to understand where the efficiencies are in this market and how choice can deliver them. It could be argued that choice between collecting societies is an economic driver for efficiency. Choice between collecting societies is certainly desirable in terms of competition theory and free market principles, but the PwC Report demonstrates that the natural market outcome is towards more consolidation between collecting societies as a natural monopoly. It is this natural monopoly within a right type which delivers the economies of scale and, more importantly, the legal certainty for users. When this occurs, there would still be option of choice between collecting societies, but the main driver for efficiencies is between direct and collective licensing. In these circumstances, artificially creating competition between collecting societies when the market is driving towards consolidation actually produces market inefficiencies. An analysis of the market for authors' rights in the USA would demonstrate the market inefficiencies from artificial competition between collecting societies. There should be choice between collecting societies, as well as the ability for rightholders to set up new societies, but regulators

and competition authorities should not be concerned if at a particular time, there is only one collecting society operating in a particular market. If rightholders have the option of direct licensing, that will be the most powerful incentive for the collecting society to operate efficiently and effectively.

The choice for rightholders will be made simply on an assessment of the net return that can be delivered by collective versus direct licensing. A part of that is the effectiveness and efficiency of the collecting society. How good is the governance structure in giving rightholders in general control over licensing? How accountable is the society to individual rightholders? How accurate and efficient is the distribution? What are the costs and how are they controlled? But the most significant factor is external. It is the regulatory regime which applies to collective management and which can depress the licensing rates below a proper market rate that could be obtained directly.

Regulatory Barriers to Collective Licensing

In order to deliver the potential economic efficiencies, collective licensing must be able to offer better return to rightholders than direct licensing. The economic conditions exist. The test is whether there are any regulatory conditions that artificially reduce the tariff below the market rate that could be obtained by direct licensing. Currently, some aspects of competition policy, tax rules and tribunal jurisdiction inhibit collective licensing.

One of the key objectives for the Commission is strengthening confidence of rightholders that they will be financially rewarded irrespective of where their work is exploited. The Commission also wants to improve accessibility of creative output to internet content providers, something collective and direct licensing can achieve in tandem.

To create the right market dynamic, the objective on collective management needs to go wider. Collective licensing must be able to offer better return to rightholders than direct licensing. The internal efficiencies and effectiveness of collective management are self-evident, subject to accountability to the rightholders being in place. What are less evident but more significant are the regulatory barriers that artificially reduce the tariff below the market rate that could be obtained by direct licensing. For rightholders in the UK, the key constraints that apply to collective licensing are competition policy, tax and the lack of a market led approach by the UK Copyright Tribunal. In the opinion of rightholders, these reduce the tariff that could otherwise be obtained in the market. As it is rightholders making a commercial judgement, it is their assessment which is critical in this respect.

The most significant competition statement on collective licensing was the Commission's Statement of Objections⁵ on the complaint brought by MTV against VPL. In this ruling, the major record companies were forced to withdraw from the collective licence with MTV. Their only option was direct licensing. Only the

⁵ European Commission Statement of Objections, 10 March 1994

independent companies were permitted to exercise collective management. Subsequently, MTV attempted to exploit the reduced bargaining power of the independent record companies by refusing to negotiate with the collective body, even though MTV had been properly mandated by those companies. It took considerable strength of will among the leading independent record companies to ensure their rights were licensed properly. It was only by insisting that MTV negotiate with VPL, their collecting society, that the independent record companies were able to prevent the rates being undercut⁶.

More recently, the IFPI brokered the Simulcast and Webcast Agreements between rightholders and collecting societies. That was a market driven exercise, designed to deliver one-stop licensing for users who were lobbying for just that facility. Because the agreement was collective and, by its very nature a monopoly within those right-types, the agreement had to be notified to DG Competition. Although both agreements were cleared by DG Competition, this took two years of negotiation, followed by another two years for the notification process. Although DG Competition appeared to have been pressing for agreements such as this, the delay in the regulatory process gave the opposite message to rightholders.

The MTV ruling, the notification process for the IFPI Agreements and subsequent policy statements from the competition authorities have given rightholders the impression that competition policy is aimed at driving down prices. Competition rules should of course apply to collecting societies just as they do to any economic entity but they should be applied with the aim of delivering efficiencies in the market. When a natural monopoly occurs, it is the choice between direct and collective licensing that will be the ongoing driver for efficiency.

The UK Copyright Tribunal is a member state issue but one that has a huge impact on the dynamics of the market. There is an incentive for a collecting society that is properly accountable to rightholders to achieve a market rate for music usage. If a collecting society sets a rate that is too low, the rightholders will exercise their internal control measures or choose direct licensing to achieve the right rate. If a collecting society sets a rate that is too high, users will use less music or stop using music altogether and the overall revenue will fall. Relative bargaining power could influence rates in particular circumstances, but PwC have pointed out in *Music Collecting Societies: Evolution or regulation?* that it is often the users that are more powerful than collecting societies in commercial terms⁷. The Copyright Tribunal role should then be to arbitrate between two parties as a last resort to establish the market rate. PwC outline the criteria for a market rate in their report.

The Copyright Tribunal's approach to establishing rates is critical to the proper functioning of the market and if it fails to rule in favour of proper market rates, it will depress values and lead rightholders to eschew collective licensing. PPL took part in the Leggatt Review of Tribunals in the UK and submitted that the Copyright Tribunal was not a proper party vs party arbitration, did not take heed of market rates, was too

⁶ AIM has made separate representations to the Commission on behalf of independent record companies on market abuse by music users.

⁷ The BBC alone is larger than all the European collecting societies combined.

close to the Government agency responsible for copyright policy and was too slow and too expensive.

The tax barrier is a very specific one in relation to cross-border exchange of audio-visual royalties and has been covered separately in submissions made by VPL to the UK Government.

Recommendations to the Commission

The core principles outlined by the Commission broadly support the approach that rightholders should hold collecting societies to account. However, some of the proposed measures introduce accountability instead to a regulator. PPL's and VPL's preferred option would be a clear statement from the Commission that allows a market framework for collective management.

PPL was one of the lead players in developing the IFPI simulcast and webcast agreements. These agreements pool the sound recording rights from all the major territories allowing a user to obtain a single multi-territorial licence. More importantly, the rightholders have assurances in terms of the value of the rights, through tariff of destination, and quality of service outlined in the agreement.

It is this multi-lateral agreement, in which rightholders have direct control over licensing conditions, which offers a model going forward. This agreement was drawn up by rightholders with collecting societies and is a commercial solution to online licensing. For the Commission, the key is to establish the regulatory conditions in which commercial agreements such as this can be negotiated quickly to respond to the evolving market.

The right approach builds on some of the core principles that the Commission has set out and takes forward aspects of both Option 2 and Option 3 proposed in the Study. PPL and VPL therefore recommend that the Commission issues a clear policy statement that facilitates a market framework. Specifically, the Commission should:

- Recognise the economic benefits of collective management.
- Ensure that Competition policy supports fair and market driven collective licensing.
- Ensure that national copyright courts' and tribunals' rulings are based on arbitration between parties and establish fair market rates.
- Outlaw restrictive practices in collecting societies, including national discrimination and anti-competitive cross-subsidies.
- Confirm that cross-border licences should be based on the tariff of destination.
- Confirm that music users must respect rights, including paying proper market rates, deploying appropriate DRM systems and accounting to rightholders.
- Confirm that collecting societies must account to rightholders, both direct and via reciprocal agreements, on licensing and distribution.

Such a clear policy statement from the Commission would add certainty while allowing the emerging market to evolve at a commercial pace. The Commission would then be free to address any specific behavioural issues with individual societies.

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July 2005

APPENDIX A

Analysis of the Commission's Option 3 Measures

The Commission has outlined a series of Core Principles in their Study. These are followed by a number of Measurement Proposals which would be applied to collecting societies. In general, the Core Principles assist in establishing the framework for the proper functioning of collective management. The Measurement Proposals however, tend to introduce accountability to the Commission, rather than to the rightholders who are the economic drivers in this market. Below, we add a brief analysis of each of the Core Principles and Measurement Proposals.

Commission's Core Principles

Freedom for collecting societies to provide cross-border management services.

In the online environment this is a sensible addition to the choice portfolio for rightholders.

Rightholders to be able to choose collecting society irrespective of nationality or residence.

Rightholders should have this choice. It is one of the drivers of the market.

Collecting societies rights derived direct from rightholders, rather than through reciprocal agreements.

Rightholders should have the choice of inputting their rights directly to a collecting society or using other routes such as the services made possible by reciprocal agreements. Some rightholders, particularly for example individual performers, rely on the international collection service based on reciprocal agreements.

Individual rightholders able to define precisely which rights and territories the society can license.

Clarity of rights is an essential feature of a properly functioning market and rightholders should be the drivers in defining the rights they assign to a collecting society. Rightholders should also be permitted to bundle rights if that enables them to obtain greater efficiencies from collective management.

A fiduciary duty between rightholder and society.

This is an essential feature of accountability. In PPL and VPL, this is done through a number of routes, chiefly the membership or registration agreement and Board representation. Underpinning this, both record companies and performers have legal remedies available as a last resort.

Collecting societies not able to refuse membership to foreign rightholder.

This should be an absolute condition on collecting societies.

Non-discrimination as to service provided vis-a-vis foreign and domestic rightholders.

Again, this should be an absolute condition on collecting societies.

Commission's Measurement Proposals

Removal of clauses in reciprocal agreements that restrict cross-border licensing.

This should be a matter for the rightholders through their collecting society. If rightholders choose to retain exclusivity in certain areas of licensing, they should be permitted to do so.

Increases in the number of cross-border licences issued.

This is a likely outcome of the evolving market but this measurement itself will not determine whether cross-border licensing is effective.

Number of cross-border licences compared to mono-territorial licences.

Again, this measurement itself will not determine whether cross-border licensing is effective. Some users are still structuring their businesses by territory and will want licences that reflect that.

Opinion survey on accountability, efficiency and enforcement by collecting societies.

Collecting societies should be scrutinised for accountability, efficiency and enforcement directly by rightholders (for example through an Annual General Meeting). It is only where these avenues are not functioning that additional measures should be contemplated.

Relationship between collections and distributions (inc. cost ratio).

This is a matter for rightholders. The cost ratio, for example, must be scrutinised by rightholders in relation to the service they are getting in terms of licensing effectiveness and quality and accuracy of distribution. The question is whether collecting societies provide all rightholders with full information on all these so that rightholders can see how their rights are licensed, where they are used and what royalties they receive for the uses.

Revenue collected for online users (as share of total collecting society revenue and in relation to direct licensing).

This will be a matter for the market. The revenue collected will depend on growth in the overall online market and rightholder choice between direct and collective licensing.

Number of rightholders changing society.

Rightholders should certainly be free to change society but that freedom may not translate into actual movement. Even when there is an objectively better offer available, many rightholders will remain with existing arrangements through inertia.

Changes in statutes of societies to remove national discrimination clauses.

This should be done as a matter of urgency. National discrimination clauses include membership criteria, distribution rules and internal cross-subsidy arrangements.

Share of revenue paid to foreign rightholders compared with share of use.

This is an essential measure for rightholders to determine whether they are receiving the right royalties for their music. This information should be part of the accountability requirements of collecting societies to all rightholders, whether direct or via a reciprocal agreement.

APPENDIX B

Briefing note on PPL and VPL

PPL Facts and Figures

- Licenses on behalf of 3,000 record companies and 30,000 performers.
- Licenses 200 TV channels and 300 radio stations broadcasting recorded music, as well as over 200,000 pubs, nightclubs, restaurants, shops and other places playing recorded music in public.
- Has negotiated bilateral agreements with 19 other collecting societies to collect overseas airplay royalties.
- Collects over £80m in airplay royalties for performers and record companies.
- Distributes revenue using a comprehensive track-based system - analysing over 16m uses of recorded music reported by TV and radio stations, background music suppliers and venues playing recorded music in public. All track plays are matched to PPL's repertoire database CatCo, containing information on over 7m tracks.
- Distributes to all the performers – featured artists, session musicians and backing vocalists – as well as the record companies that create the sound recordings that are played.
- Is the largest performer/record company collecting society in the world.

PPL Recent Achievements

- In 2004, achieved a 5.3% growth in net revenue for the rightholders.
- In the last four years, has increased net revenue by 40%, generating an additional £20m payable to record companies and performers, and almost halved the cost/revenue ratio.
- In 2005, PPL's CatCo was selected as the database underpinning the official combined download and singles chart.
- In 2003, distributed over £25m in back royalties based on improved information on track ownership and performer line-up.
- Signed the IFPI Simulcast Agreement in 2002 and the Webcast Agreement in 2003 paving the way for multi-territorial licences.

PPL and Performers

- In 2001, set up the Performers Forum with AURA, Equity, MPG, MU and PAMRA.
- In 2002, appointed a performer representative to the PPL Distribution Committee.
- Located several thousand artists due royalties as a result of the joint RoyaltiesReunited campaign.
- In January 2003, two performer representatives joined the PPL Board as attendees, followed a year later by a third.
- In 2003, signed two Memorandums of Understanding laying down the principles for closer cooperation.
- In 2004, PPL was appointed by the performer organisations AURA, Equity, MPG, MU and PAMRA as the single pipeline for performers' UK and overseas airplay revenue.
- At the 2004 AGM, voted to create three Performer Director positions on the PPL Board.
- In June 2004, John Smith, Nigel Parker and Sabine Schlag joined the PPL Board as the first Performer Directors, representing the interests of the entire performer community.

VPL Facts and Figures

- Represents 1,000 music video producers.
- Licenses 60 TV channels broadcasting music videos, including 25 specialist music channels.
- Licenses around 2,000 pubs, nightclubs and other places playing music videos in public.
- Collects over £8m in airplay royalties for music video producers.
- Analyses usage information from TV stations and background music services for distribution to rightholders.
- Offers a sourcing service, Music Mall, for back catalogue video clips and other footage.
- Is the largest music video collecting society in the world.

VPL Recent Achievements

- Recently concluded a licence with MTV on behalf of independent companies throughout Europe.
- In 2003, integrated management operations with PPL resulting in cost efficiencies to rightholders.

- Concluded licence arrangements for new video on demand services such as Home Choice, NTL and Telewest.
- Has licence arrangements for rapidly expanding use of music videos, including the new store forward and narrowcast services.

July 2005