

Testimony of  
Joe Kennedy

July 29, 2008

U.S. Senate Committee on the Judiciary

Hearing on

"Music and Radio in the 21st Century:  
Assuring Fair Rates and Rules across Platforms"

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President and Chief Executive Officer

Pandora Media, Inc.

Chairman Leahy, Senator Specter, and Members of the Committee:

On behalf of Pandora and the Digital Media Association, thank you for inviting me to testify today regarding music and radio in the 21st century. I particularly appreciate the opportunity to discuss the hardships that Congress and the Copyright Royalty Board have imposed on Internet radio, as we seek to realize the potential of this new form of radio. Unencumbered by the spectrum limitations of traditional broadcast radio, Internet radio enables the full range of America's wonderful diversity of music and artists to be enjoyed.

As the Committee considers alternative approaches to revising the Copyright Act with respect to sound recording performance rights, Pandora and DiMA urge you to ensure fair and equitable treatment for all participants in the music industry ecosystem by:

(a) Establishing a level playing field by legislating royalty parity across all forms of radio, so that the government is not picking winners and losers when broadcast, cable, satellite and Internet radio compete.

(b) Adopting for all radio services the one royalty-setting standard - found at 17 U.S.C. 801(b)(1) - that has consistently yielded reasonable results for sound recording producers, artists, songwriters, music publishers, and radio services.

(c) Protecting recording artists and copyright owners from radio services that promote and profit from consumer recording of their programming, but not imposing uncertain, burdensome and expensive technology mandates on services that are simply using the Internet to deliver radio.

(d) Resolving the longstanding dispute over the meaning of "interactive service" so that consumers, online radio services and recording artists can maximize the benefits of blending Internet technology and radio programming.

If these goals are accomplished, Pandora and the Internet radio industry will continue to innovate, grow, and deliver new opportunities for tens of thousands of artists and record companies that historically were stifled by media and distribution bottlenecks.

Legislation like I have described will unleash substantial value for creators and the public alike, just as our Constitutional framers hoped.

What is Pandora?

Pandora is an Internet radio service that listeners enjoy on their personal computers, through Internet-connected home entertainment devices, and on mobile phones. We are located in an enterprise zone in Oakland, California and employ 140 people.

Pandora is powered by a unique music taxonomy, called the Music Genome Project, developed by our team of university-degreed musicologists. They have identified hundreds of musical attributes, and when analyzing a song they assign values to each attribute in that song. When applied across hundreds of thousands of songs, these analyses literally connect the dots between songs and artists that have something - often quite subtle things - in common. This enables Pandora to offer listeners - quickly and easily - radio stations that play music that matches their taste if the listener simply tells us the name of one favorite song or artist.

The result is remarkable. More than 15 million registered Pandora listeners enjoy a better radio experience. As a result they listen to more music, re-engage with it, and find new artists whose recordings they purchase and whose live performances they attend. In only three years Pandora has become the largest Internet radio service in America and among the top promotional partners of iTunes and Amazon.com. But the real winners are music fans, artists, record companies, songwriters and music publishers.

A distinct feature of Pandora is that all music wins and loses audience in a purely democratic process. If listeners vote "thumbs up" then a song and artist are added to more station playlists, their exposure is greater, and more people can offer opinions about that music. If listeners vote "thumbs down" then the song is performed and heard less.

Equally unique is the breadth of our playlist. Pandora musicologists will analyze any CD that is delivered to us, and in most cases will enter it into our database and make it available to millions. Pandora's collection includes well over half a million songs across the genres of Pop, Rock, Jazz, Electronica, Hip Hop, Country, Blues, R&B, Latin and Classical. These encompass songs from the most popular artists to the completely obscure. Seventy percent our recordings, representing 60,000 artists, are not affiliated with a major record label, and many recordings were delivered on homemade CDs by unsigned artists - yet they are reviewed on par with CDs received from major labels. Most important, all artists are treated equally because we rely only on musical relevance to connect songs and create radio playlists. As a result, independent music is likely heard more on Pandora than on any other popular radio service. More than 50 percent of Pandora radio performances are from independent musicians, compared to less than 10 percent on broadcast radio.

It is also worth noting that Pandora and our DiMA colleague Live365 may be the last of a dying breed - the strong and financially independent Internet radio service. Between us we have fewer than 200 employees, but we compete fiercely with Clear Channel, MTV, Yahoo, CBS Radio and other large media companies. So many of our independent competitors - as well as some of our competitors within big media companies - have shut down or stopped growing because they are crushed by backbreaking royalties. We need this Committee's help to fix digital radio laws quickly so that our successful radio services can also become successful businesses.

## 1. Legislate Royalty Parity - A Matter of Basic Fairness to Creators and Digital Radio Competitors

Since 1998 Pandora and other DiMA members have paid tens of millions of dollars in royalties to recording companies and artists. In part, these payments reflect widespread consumer adoption of Internet radio, which is regularly enjoyed by tens of millions of Americans. However, the fact of and the amount of these payments underscores how the Copyright Act discriminates against Pandora and Internet radio solely because we deliver music radio via the Internet, rather than using broadcast, cable or satellite technologies.

As you know, traditional broadcasters do not pay sound recording royalties, but cable, satellite and Internet radio do pay. You may not be aware that Internet radio has the smallest of all radio revenue streams, but we pay proportionately the highest royalties. While we have made great progress as a 3 year old company in monetizing our service and plan to achieve \$25 million in revenue this year, based on the dramatic rate increases established by the Copyright Royalty Board we are facing the prospect of

paying \$18 million in sound recording royalties in 2008, over 70 percent of our anticipated \$25 million in revenue. This is simply a crushing amount which will put us out of business if it is not remedied.

It is important to note that we also pay royalties to songwriters through our licenses with ASCAP, BMI and SESAC. However, these royalties are set at a level that is consistent with that historically paid by broadcast and other forms of radio--just over 3% of revenue--further highlighting the absurdity of the sound recording rates established by the Copyright Royalty Board.

Almost as egregious is a comparison to satellite radio, because if XM Radio and Sirius Satellite radio were to have revenue of \$25 million, their 2008 sound recording royalties would equal only \$1.6 million, or 6.5 percent of their revenue.

How are these disparities possible? Because broadcast radio services benefit from a statutory exemption to sound recording performance rights and royalties so they pay zero, and cable and satellite radio services benefit from a statutory royalty standard very different from that applied to Internet radio, which historically has resulted in royalties that equal between 6 and 15% of those services' revenue.

It is for these reasons that Pandora and the entire Internet Radio industry thank Senator Brownback, the lead cosponsor of the Internet Radio Equality Act (IREA), and Senator Feinstein, sponsor of the PERFORM Act. Both bills would equalize the standards that govern cable, satellite and Internet radio royalties. IREA would also resolve this industry crisis by reversing the Copyright Royalty Board's recent rate-setting decision and setting royalties at a reasonable 7.5% of revenue.

Under the CRB decision Internet music radio is economically unsustainable; it is not even a close call. Pandora has skyrocketed from a standing start to 15 million listeners in three years. We were within sight of cash-flow positive operations under the old royalty rates, but now we are back under water with no hope of ever emerging as the royalty rates continue to increase. Today, we still are hopeful and we believe that some combination of Congress, the courts, or a negotiated resolution with SoundExchange will favorably resolve this threat. But if we conclude that the CRB royalty rates are not going to be rectified, Pandora would shut down immediately and our 140 employees would be out of work.

Which royalty standard is correct?

From 1976 until 1998 a four-factor test codified at Section 801 of the Copyright Act was the basis of royalty decisions associated with compulsory and statutory licenses. In 1998, however, at the request of the recording industry, Congress imposed a new standard only with respect to Internet radio sound recording performance royalties - a standard that directed rate-setters to determine what a willing

buyer would pay a willing seller for the performance rights subject to the statutory license. Unfortunately for Internet radio, this rate-setting standard has been an abysmal failure, as both royalty arbitrations that have utilized it have resulted in extraordinarily high royalties that have massively destabilized our industry.

In 2001 testimony DiMA provided the Committee with detailed analysis of why the willing buyer-willing seller standard fails to protect against monopoly pricing, as Congress intended when it created a statutory sound recording performance rights license that has only one seller - SoundExchange - controlling all the rights. DiMA stands by that legal analysis, but perhaps more to the point I offer the following anecdotal support: There is no possible way that Pandora or our sophisticated investors would be a "willing buyer" of sound recording performance rights at a cost equaling nearly 70% of our revenue - because that royalty level is simply unsustainable and will bankrupt us and force the layoff of our 140 employees. Pandora has been more successful than any other Internet radio service in growing its revenues - but this royalty decision pays far too much of those revenues to copyright owners.

Fortunately the time-tested four-factor royalty standard remains viable, and in the last two years it has been the basis for two industry arbitrations and several successful industry negotiations. Under this standard - which the Internet Radio Equality Act would extend to Internet radio - the Copyright Royalty Board determined that satellite radio royalties should be between 6 and 8% of revenue. An arbitration to determine how much recording companies and digital music services will pay music publishers' was also concluded recently, but no decision has been rendered yet. Additionally several cable radio services operating under the 801(b) 4-factor test have concluded royalty agreements with the record companies, and these agreements are expected to be in the 12-17% of revenue range. All these figures are much more reasonable than the results for Internet radio under the willing buyer-willing seller standard.

Senator Feinstein's PERFORM Act proposes a new "fair market value" standard to apply to all sound recording performance royalties. This standard sounds reasonable at first blush, but determining "fair market value" in a single-seller marketplace is a very complex undertaking, and the Copyright Royalty Board could require several proceedings before getting comfortable with a new standard and its application to different business models. Instead, it seems prudent to rely on the traditional four-factor test that has served so well for so long, and which seems to balance all the competing interests fairly.

## 2. Legislate Content Protection Obligations, But Only on Those Whose Business Activities are Problematic.

Record companies and Internet radio companies agree that consumer recording of radio programming is a time-honored tradition that is generally not harmful to either of our interests. Similarly, record companies and Internet radio companies would be concerned if consumers' personal recordings from

radio were disaggregated into individual song files and thereby replaced on a significant scale consumers' need to purchase music or continue listening to the radio.

Since 1998 Internet radio services have been required to use content protection technology in situations where it is essentially incorporated into a service's chosen streaming technology - which is often the case. For example, Microsoft and RealNetworks, in their streaming technologies that are used by many Internet radio services, include a cost-free copy-protection technology that works reasonably well.

However, the PERFORM Act proposes much stronger content protection obligations, presumably in response to (a) the availability of software that enables listeners to record Internet radio and then divide the programming into individual song files for storage and playback as they choose, and (b) satellite radio services' development of affiliated devices and software that enable consumers to accomplish essentially the same result.

DiMA views these two situations as justifying different rules. First, DiMA agrees that services that affirmatively authorize or promote consumer digital recording of radio programming should also inhibit consumers from disaggregating and permanently storing individual songs. Services that protect content in this manner should pay performance royalties each time the recorded programming is enjoyed, but because they have protected against the consumer recording substituting for sales the recording should not obligate distribution royalties nor should the affiliated devices obligate Audio Home Recording Act royalties. In essence, those that enable "portable" digital radio by caching large blocks of programming for future enjoyment as presented by the service (and not as re-ordered or refined by the listener), should pay performance royalties in association with all performances of that music but should not pay distribution royalties or AHRA royalties for merely enabling consumers' further enjoyment of non-interactive radio.

In contrast, Congress should not require digital radio services to police against consumers' use of independent software or devices to record digital radio. This obligation would require radio services to engage in software development cat-and-mouse games against unlimited numbers of potentially conflicting 3rd party software providers, and would make an already difficult business financially impossible.

Internet radio companies succeed by maintaining continuing relationships with listeners and encouraging them to return frequently to our services. We have no incentive to promote consumer recording and in fact our incentives are aligned with the record companies. It is for this reason that DiMA agreed with SoundExchange almost one year ago to form a joint industry committee to consider the recording industry's concerns about "streamripping" and to jointly review technologies that could perhaps inhibit harmful consumer recording. DiMA members doubt that "streamripping" is a problem but are very open to evidence that the problem exists, and have committed to work with the recording

industry and SoundExchange if evidence proves otherwise. It is notable, however, that in the eleven months since this Agreement was signed, SoundExchange has not suggested that this Committee actually form or that an initial meeting actually be scheduled.

There is no reason, therefore, and certainly no compelling justification, for imposing technology mandates that will create financial and technological burdens on Internet radio services that are in the business of programming and promoting music, not consumer recording.

### 3. Resolve "Interactive Service" Confusion, which Inhibits Innovation, Stunts Internet Radio Growth and Reduces Recording Artists' Royalties.

Congress enacted the statutory Internet radio license to promote the growth of Internet radio as an innovative, competitive medium. Whether a particular Internet radio service qualifies for the statutory license is dependent on several factors, including that the service is not "interactive" as defined in the law.

Unfortunately current law is ambiguous, and whether an Internet radio service is "consumer-influenced" and qualifies for the statutory license, or is "interactive" and does not qualify has been the subject of nearly a decade of litigation and a Copyright Office proceeding, and still remains a question that vexes lawyers, product managers and investors.

The problem is fairly simple: In the 1995 Digital Performance Right in Sound Recordings Act and its 1998 amendments, Congress sought to promote Internet radio as a competitive consumer-friendly medium that benefits the recording industry by generating royalties and promoting sales of sound recordings. The 1995 Act imposed programming restrictions on the radio services (e.g., limiting how many times a single artist can be played in a 3-hour period) and - in an effort to ensure that Internet radio promoted (rather than substituted for) sales of sound recordings - disqualified "interactive" programming that provided on-demand or near-on-demand service. There was no uncertainty or any litigation regarding this standard.

The 1998 amendments modified the definition of "interactive" service, changing it from a fairly straightforward and objective test to one requiring a complex subjective analysis. Typically American law is comfortable with "reasonableness" standards and balancing tests, but in the copyright environment where there is strict liability with high statutory damages, uncertainty can chill innovation and destroy the entrepreneurial spirit.

The Register of Copyrights and the RIAA (in public filings and its licensing practices) have agreed that services can benefit from the statutory license even if they permit consumers to express preferences as to genre, artists and specific songs. But the recording industry's litigation position has been markedly different, going so far in one instance as to assert that webcasters are not permitted to allow any level of individual consumer influence over a program to qualify for the compulsory license. Such a view would destroy the potential of the Internet to surface all of America's wonderful diversity of music and artists. In fact it is consumer-influenced programming that enables the introduction of new music and artists to radio listeners. It is because we know something of our listeners' tastes that Pandora can offer the music of 60,000 artists each day, promote their music directly to listeners more likely to enjoy and purchase it, and pay royalties to all of those artists every month. The 60,000 artists played on Pandora every week contrasts dramatically with the dozens of artists heard on most broadcast stations in a given week or even a month.

In furtherance of fully-licensed litigation-free online music, DiMA urges the Subcommittee to amend the "interactive service" definition to ensure that programming based on user preferences falls squarely within the statutory license, so long as the generally applicable programming restrictions for the statutory license are not violated and so long as users are not permitted to control how much a particular artist is heard, or when a particular song might be played. DiMA companies want to focus our energy on developing exciting services that surprise and delight listeners and promote great music, not on lawyers and litigation.

#### 4. Performance Royalty Inequity is Exacerbated by the "Aberrant" Ephemeral Sound Recording Reproduction Royalty that is Imposed only on Internet Radio.

As the Copyright Office noted in a 2001 Report to Congress, there is an imbalance between the legal and financial treatment of so-called ephemeral copies of compositions in the broadcast radio context, and similar copies of sound recordings utilized by Internet radio.

Since 1976 broadcast radio has enjoyed a statutory exemption to make reproductions of compositions so long as the reproduction remains within the radio station's possession and is used solely to facilitate licensed performances of the same music. Internet radio services also require ephemeral recordings to enable their webcasts, but while broadcast radio typically requires a single ephemeral copy, webcasters require several copies to accommodate competing consumer technologies (e.g., RealNetworks or Windows Media formats), services and access speeds (e.g., dial-up or broadband Internet access). Each of a webcaster's ephemeral recordings functions precisely like the copy exempted for radio broadcasts, but Internet radio is saddled with having to license and pay for these copies, rather than enjoying the benefit of an exemption. In the first Internet radio CARP, the recording industry was awarded nearly a 9 percent bonus on top of the performance royalty for the making of these ephemeral copies which add no independent value. They are simply a by-product of modern technology.



In its 2001 Section 104 Report to Congress, the Copyright Office stated that the compulsory license for sound recording ephemerals, found in Section 112(e) of the Copyright Act, "can best be viewed as an aberration" and that there is not "any justification for imposition of a royalty obligation under a statutory license to make copies that . . . are made solely to enable another use that is permitted under a separate compulsory license." Section 104 Report, p. 144, fn. 434. The Copyright Office urged repeal of this licensing obligation; DiMA asks the Committee to act on this request.

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Mr. Chairman and Members of the Committee, for several years DiMA has sought to equalize the royalty standards that apply to radio so that fair competition prevails and Pandora and other DiMA member companies can grow and realize the full potential that Internet radio offers.

There is a great deal of opportunity for this Committee to promote the mutual interests of creators, consumers and radio innovators. We look forward to working with you to accomplish that goal.

Thank you.