Spotify, Pandora and the Changing Nature of Payments in the Music Industry

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Over the past ten years, many of my colleagues and I have campaigned for the value of music, for the right of artists and songwriters – and those who invest in them. We saw a future where access replaced ownership, where listening was more critical than owning. Whether it's in the cloud or in a crowd, people are listening more and buying less.

It was a principal reason why I fought for higher rates when we did battle with webcasters and satellite radio services that like traditional radio wanted music for free because they were "promotional." As a former recording artist, how many times was I told by a club owner or other "advisor" that I should do something for free because it was "promotional?" Now, there's nothing wrong with "promotional" if it leads to something "commercial" – a sale, a paying customer. But the mindset that a musicians' hard work, or that a songwriter doesn't need to be paid, or that a record company's investment, should be given away for free as a loss-leader for someone else's business, is frankly offensive.

When webcasting rates were initially set in 2002 every service said they'd go out of business because the rates were too high. That didn't happen. Webcasters wanted to pay a percentage of their revenue but an arbitration panel ruled they had to pay for every stream of music sent to a listener. If the webcasters had gotten their way, SoundExchange would have collected virtually nothing, Zero. Webcasters had virtually no revenue of consequence because frankly in those early years they weren't trying to monetize, they were trying to aggregate ears, to build an audience. There's nothing wrong with this approach, unless, you ask the artists and labels to subsidize it – through free or reduced royalty rates. Why should the content creators and owners subsidize a new business? Are the utility companies giving them lower rates to help them launch their business? No. Are they paying less for computers? No, again.

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If webcasters had asked content creators and owners to be partners; to have an equity interest in the business if it were to succeed, then, maybe the proposition is different. But that was not the case in the early days of webcasting. Webcasters wanted free or cheap music so that they could make more money in the long run.

In those early years, none of the webcasters had audio ads like over-the-air radio; they had banner ads or other visuals on their website. But most advertisers knew better: those internet radio listeners would launch a stream of music and then minimize the website to do work on their computers while they listened. Internet radio was generating less than $1.00 per listener per year in those early days (compared to satellite radio which generated over $100 per listener per year and over-the-air radio which was generating nearly $80 per listener per year). Not much has changed for internet radio revenue generation other than Pandora. There are only a handful of webcasters, other than Pandora, that generate significant income from their streaming services.

Traditional radio needed towers and other expensive equipment to stream music to our radios. That meant they had to make money to pay for these significant costs. The result: you as the listener were required to listen to many ads every hour so that the radio station could pay their bills and make some money.

Unlike traditional radio, many webcasters are small operations, operating on a home computer with very little overhead. These new webcasters dreamt of creating a brand, a hot service that would get swallowed up by someone larger who would pay a lot for the service. Last.fm is the classic example. They didn't monetize at all. They didn't try to. They built an audience using recordings. They built a cool factor, using music, paying almost nothing for it. When they were sold for $290 Million the artists, songwriters, music publishers and labels whose music drove the audience there, received nothing, though the site would have been worthless without the content of thousands of creators.

Finding the right rates for services isn't easy. Terrestrial radio's business model, "feels like free, but you pay by attention" has worked for songwriters for many years. Listeners get free radio, but they know in exchange for free radio, they have to listen to advertisements. Recently the ad-load on most stations has become so dense and intrusive that music listeners have turned away when possible. Still 237 Million Americans tune in each week to listen to over-the-air radio.

In fact, when you speak with many in the internet and satellite radio world, having a much smaller commercial load, to be an alternative to ad-heavy commercial radio was the intent. Internet radio and satellite radio would be different. Satellite radio, with a monthly fee for listening, doesn't have to play commercials: you pay for the channels you get in your monthly fee. And, satellite radio generates around $120 per year per customer. Over-the-air radio with its "pay by attention" ad-heavy model generates around $80 per listener per year (take total advertising revenues divided by the number of listeners). Several years ago, a study found that internet radio stations were generating about $1 per year per customer. While Pandora is probably exceeding that now, I'm not sure that any other internet radio service is even close and certainly none are anywhere close to the monetization of "free" over-the-air radio or subscription Sirius/XM.

It’s easy for a new business to say, “Consumers don’t like all of the ads on radio so we’re going to create a music service like radio without as many ads or with a different advertising formula, so that the ads aren’t as intrusive.” It’s much harder to earn dollars from advertisers when you’re advertising is visual in an aural medium. Internet radio listeners initially were quite negative about audio ads inserted into programming, where previously only banner ads had existed on the webpage. But they’ve grown to accept them in exchange for a free service. How many of Pandora’s millions of listeners have felt the need to “upgrade” to the ad-free version at $2.99 a month, essentially trading one morning’s Starbuck’s for a month’s free of ad-free music? Not many!

Pandora initially required its users to become subscribers after a certain trial period. The conversion rate from free to paid was so small (less than 1%) that they revisited their service and business model and did away with the requirement of consumers having to pay a monthly fee.

Is it fair to musicians to say, “Give us your music for very low rates because consumers will like our service better than radio?” Some artists and labels may be fine with that proposition, and they are always able to license their music directly to music services at whatever rates and terms they desire. When SoundExchange represents the entire industry in rate proceedings with webcasters or satellite radio its mission is clear: to ensure that its constituents receive fair value for the use of music. It is not to set a price that ensures that every webcaster will survive, especially those unwilling to monetize their services. Those services must ask for special favors. They must ask for permission directly from the labels and artists whose music they desire to use. Because, when you are talking about a statutory license, where all owners and artists are compelled by the government to license – where there is no opt out – the rates must be fair and based upon the most valuable of copyrights.

When Congress created the statutory license for webcasting and other digital services they compelled every label and every artist to license their work. There was no choice. Unlike the Beatles who initially said no to iTunes and no to interactive services like Rhapsody, their music was available to any webcaster or other statutory licensee. They had no right to opt out. While Coldplay can decide to hold back their recordings from Spotify for a period of time, because it is an interactive service and thus not part of the statutory license, they cannot hold back their recordings from any webcaster or digital service licensed through SoundExchange.

Every webcasting service has a choice. They can use the statutory license given to them by Congress and work with SoundExchange, the trade association created to represent artists and labels, under this compulsory license to represent everyone: majors, independents, recording artists on labels, recording artists following a DIY path. Services that want to use SoundExchange and dramatically lower their transaction costs, (one statement, one payment, instead of thousands of individual negotiations, thousands of payments, thousands of statements), can do so. The process is relatively simple.

But, Services can also go direct to every owner of a recording they want to use and enter into a “direct license”. Such licenses are negotiated between the service and the owner. The terms may vary wildly based upon the relative market power of the two parties negotiating. This same principle applies to ASCAP, an association of songwriters and music publishers. Any service is free to go around ASCAP and direct license content directly from the music publisher. But, it would take thousands of licenses to replicate the blanket license that ASCAP provides. Still, if a service thought they could save money by getting lower rates or pay nothing at all with gratis licenses, they can certainly attempt this.

But be very cautious if you decide to go down this path as a publisher, record label, artist or songwriter. Direct licensing may get you money quicker as it's paid directly to you and doesn't have to flow through the collection agent. However, will you have the resources to audit to ensure that you were paid correctly? Will you get paid as well when you lose the power of the collective? We've certainly seen that recent direct license attempts by Sirius/XM have featured very different rates for different parties. They will obviously try to pay as little as they can. When SoundExchange or ASCAP negotiates on behalf of the industry, everyone is paid at the same rate. Valuable catalogues help bring the price up for others that might be given away for little or no money. The only variable is the number of plays, or in some instances the type of plays or when it is played ("drive time" vs. overnight).

When individual copyright owners do deals with services everyone is not paid at the same rate and it is likely that those with the most valuable content, and the most content, will obtain better rates and terms than smaller entities with fewer releases and more niche releases. That is capitalism plain and simple. Your market power will influence your deal. It is no different in the artist community: artists with power will receive a greater percentage of the record company's revenue than artists who don't.

Several years ago, a major independent artist, who had previously worried that our rates were too high, sent me a note that there must be some mistake on their statement. Their SoundExchange royalty statement was around $400. The artist had received over 400,000 plays on Pandora. We did the math. 400,000 Plays times the streaming rate of approximately one tenth of a penny = $400. The artist finally understood that the rates were not too high! In fact, in 2009 the pureplay webcaster rate was nine/hundredths of a penny per play. At that rate, 800 plays on a "pureplay" webcasting service like Pandora equaled one download on iTunes for an artist who owned all of the rights to that download, including the publishing. The large webcasters and broadcasters who simulcast their signals on the internet paid roughly double the "pureplay" webcaster rate in 2009 so only 400 plays on those services were required to equal one download.

While streaming and downloading are very different activities, one much more casual than the other, if streaming leads to a decrease in downloading, artist's incomes suffer. When streams are on a service like Spotify, where you can stream the track you want when you want it, those streams are incredibly "substitutional" – they will substitute for a download sale because the consumer can access the track anytime they want to. Why own if you can access anywhere you have an internet connection? Typically, services like Spotify have paid a much higher rate for their access to music. First, they don't qualify for the statutory license from SoundExchange so they must negotiate rates with every single owner of recordings that they want to stream. This is a much more time intensive project – think about how long it took Spotify to get licenses from enough U.S. labels to launch here in the U.S. – think years, not months or weeks. When someone qualifies for the statutory license administered by SoundExchange, don't think years, months, weeks or even days. You can be licensed and streaming in a manner of minutes.

Second, because the owners and artists believe that on-demand streaming is much more "substitutional" than promotional, they typically demand higher rates (it has been reported that all labels share in one half of all revenue generated by Rhapsody from its on-demand service). In some instances, owners of content may be able to demand an equity stake in a service in order to agree to license their repertoire. If they have the market power, why shouldn't they do so? It has been reported that the major labels demanded and received such an equity stake in Spotify, in exchange for their licenses.

Substitution vs. Promotion: this argument has been going on for years. Is airplay promotional? Is it substitutional? It is likely both. Today, many artists crave airplay and think that radio play is the key to success. In the 1930's that wasn't the case. Big Band leaders didn't want radio to play their recordings. If listeners could hear their recording on the radio, they wouldn't have to buy copies, nor would they need to come down to the club and see their live show. Two Big Band leaders, Paul Whiteman and Fred Waring actually labeled their recordings, "Not Authorized For Radio Play" to keep radio stations from playing them. When radio stations persisted in playing them, these artists sued. Both won at the lower court level. Whiteman lost on appeal in the 2nd Circuit of New York. Fred Waring's decision is still law in Pennsylvania.

Most people immediately fall into the radio is promotional camp, thinking about the time they heard a song on the radio and then went out and bought it. But they don't think about the bigger picture: how much time do they spend listening to radio, in their cars, at home, at work and how many of the thousands of recording they hear do they actually buy? It is a very small percentage.

Let's think about radio as substitution. If you were in your car and you didn't have a radio and you wanted to listen to music, your only choice would be to listen to your own music collection. You would have to purchase the music you'd want to hear in the car. Remember, the battle between radio and records was just another battle of competing technologies. Would consumers buy a record player or a radio? Until RCA united the two technologies into a large apparatus that many of our grandparents and great grandparents glowingly showed off in their living rooms, it was a battle being waged in the American living room. Would you own a record player or a radio? When radio started in the 1920's one of their biggest campaigns was "Imagine how many records you'd have to buy to hear all of the music you can hear on this station for free."

When I was managing artists I remember well the focus groups we did and the radio people we talked to. One statistic stuck: about 10% of radio listeners at most are "active". These are the listeners who enter contests, buy concert tickets and perhaps a CD or download. The "passive" listeners, measured at 90% or greater, use the radio as an entertainment source but don't engage. I've always maintained that radio should be paying recording artists for that 90% of their audience that doesn't buy things and uses radio as substitution for music purchases, while getting a credit for the 10% of their audience who do engage and buy concert tickets and CD's or downloads.

During the heated battle between webcasters and SoundExchange over what rates should be charged during the CRB proceeding of 2007, Tim Westergren, founder of Pandora, and I faced off on a public radio call-in show. One caller's comments said it all. She made a plea to me to not shut down Pandora and added, "I hear lots of great new music on Pandora. I haven't bought any of it yet but I will soon."

Now, Pandora, to its credit, has always supported the notion that the artists and labels should be paid for Pandora's use of their music, our dispute has only been about how much. Obviously, any business would like to pay as little as possible for its inputs. It is also clear that a supplier wants to be paid a fair price. Our suppliers, record labels and artists, sometimes disagree as to business models, whether to give things away for free or to get paid for them and a host of other issues. Understand, every artist who controls their rights, every record company that controls their rights to content, has the right to enter into agreements with respect to their product on whatever terms they negotiate in the marketplace. But when they entrust that product to SoundExchange or when the buyer of the rights would prefer to do one deal with SoundExchange rather than thousands of deals with individual owners, we must find the right rates and terms for everyone – we can't make special exceptions. And, since no one can opt out, since the government has "compelled" everyone to license, the rates must be set based upon the most valuable copyrights, not the least.

To be sure, there are webcasters in the marketplace who have solicited artists and labels to give them their product to stream for free. Their argument is that they can't afford the rates and they want to promote artists. If an artist or labels wants to give away their product, they are free to do so. But shouldn't those artists and labels protect themselves? If the motives of the webcaster are selfless and they are doing it for love, would they have a problem building in a provision that when the service is sold to a third party, a pool from the sales price will be split between all of those artists and labels whose content has built the audience? Has created the value in that service? The next time a service asks you for a free license, ask for this kind of provision and see how they respond.

Indies and Majors – Should there be parity?

When SoundExchange negotiates rates with services or litigates rates before the Copyright Royalty Board, there is no doubt that the resulting rates are robust because all of the content is being aggregated in one place. Services can't play SoundExchange off another competing society but they can theoretically approach individual labels to offer them separate deals. We know from history that the services will try to pay less for indie content than major. This is simple economics. When listeners are streaming music, it makes no sense to differentiate between two streams, because one is on a major label it will be paid at a higher rate than another on an independent label. But in individual deals, it will happen. Some indies will give away their streams for the exposure alone!

The statutory license, administered by SoundExchange levels the playing field and every stream is valued equally, unless, an owner has granted a direct license to a service at a lower rate or for free. SoundExchange doesn't differentiate and doesn't allow the services to differentiate. SoundExchange, by law, must also divide payments equally between artists and owners (typically labels).

When the owners of master recordings direct license, the statutory fifty-fifty split between artists and owners may apply, but the owner will collect the money and will be free to recoup any unrecouped balances prior to making payments to the artist. (During the terrestrial campaign there were some provisions added to that bill that would have required labels who direct license to still run the artist portion through SoundExchange. Unfortunately, the performance rights bill did not pass and those provisions were not enacted into law. Whether or not side letters or other agreements exist between labels and artist representatives over the treatment of the artist share of direct licenses is currently an open question).

ASCAP and BMI are membership organizations of songwriters and performers that create rules that their members abide by. These rules may provide that once a song has been performed a million times it will then receive more revenue per performance than a song that's has not been performed that frequently. This type of "bonus" does not currently exist in the SoundExchange world where payment rates are set by the Copyright Royalty Board or voluntary negotiations between SoundExchange and users. Whether or not the SoundExchange Board might adopt such rules in the future for their members is an open question but unlikely. SoundExchange enjoys the transparency of a system where a play is a play and the only variable is how many plays not when it is played or where it is played or who it is played by (although a play on one service may be more valuable than a play on another service if they have different types of licenses, e.g. a non-commercial college radio station play will be much lower than a satellite radio play).

Spotify Streams

There have been reports from artists about how dismally low their streaming rate is from Spotify. It would appear from these reports that these streaming rates, for an interactive service, are lower than the rates paid by non-interactive services under the U.S. statutory license. If true, this is completely unacceptable, unless, these lower streaming rates are part of an introductory "freemium" service, whereby a listener gets to listen for a set period of time for free but has to upstream to a paid service within a certain time period, (30, 60 or even 90 days).

Were the interactive streaming rates set lower for Spotify, because of the major labels' equity interest in the service, it would eventually undermine the non-interactive rates – which should always be lower than interactive rates. Non-interactive services are arguably less substitutional than interactive services because with an interactive service you can hear the specific song you want to hear at any time, thus reducing your need to purchase it; while on non-interactive services you can't get the song you want when you want it, only something similar.

If non-interactive rates are reduced in future years due to Spotify rates of pay, would artists have a claim against those who agreed to these below-market rates? If interactive rates are no different or lower than non-interactive rates, aren't artists entitled to demand that the statutory license be expanded to include interactive streams and have SoundExchange administer them and force the industry to demand the uplift that these streams should have? Absolutely!

Recent comments by a major label executive, that Spotify play is not substitutional for sales are total garbage. All of the studies thus far on similar services have shown decreased consumer spending on CD's or downloads when they have access to a service like Spotify or Sirius/XM Satellite radio (An NPD study reported that satellite radio subscribers were now buying between 2.7 to 3 fewer CD's per year since subscribing to the service).

Digital streaming royalties, whether from interactive services like Spotify and Rhapsody or non-interactive services like Pandora, iHeart Radio or thousands of others, have been a major area of growth for the recording industry over the past decade. They have not by any stretch of the imagination made up for the huge loss of revenue from the decrease in CD purchases, but they have created a meaningful revenue stream that continues to grow as access replaces ownership. It is critical that those representing the artists and owners remain vigilant in their demand for fair payment and/or other considerations for the use of recordings, whether through the statutory license and the collective support of SoundExchange or through direct licensing of interactive services.