

# The Causes and Consequences of allocating revenue between Mechanical and Performing Rights<sup>1</sup>

– David Safir and Will Page<sup>23</sup> –

The unavoidable cause of “Doing the Splits” is that streaming is regarded either as quasi-radio or quasi-sale; the unavoidable consequence is that neither the DSP nor the creator knows or can establish what has happened to the money.

## Doing the Splits

In the analogue environment, collective administration of authors’ rights was relatively straightforward: public performance and broadcasting of non-dramatico-musical works required performing rights, sound-carrier sales used phono-mechanical rights; and these two distinct forms of exploitation, while co-existing, were rarely conflated or confused.

In the digital environment - with streaming reaching critical mass - there is a need to revisit such distinctions; since both performing and mechanical reproduction rights are required to license the streaming which characterises the paradigm shift from ownership to access. What once was black and white now appears an indeterminate number of shades of grey.

This discussion paper aims to show why authors and composers (hereinafter “songwriters”) searching for their revenue are ‘lost in a maze’, and how they might navigate their way out. It will explain not only how the rights are licensed, but how the revenue generated is distorted, diverted, delayed and diluted on its tortuous and protracted journey to those who earn it. Whilst its authors recognise the existential challenges to the music sector, this discussion paper does not seek to address or resolve macroeconomic issues such as the ‘value gap’. Rather it focusses on a seminal microeconomic issue; whether and how a songwriter can determine - given the current complexity - how much was earned from a streaming service.

Put bluntly, neither the licensee who pays the collective management organisation (CMO) nor the songwriter who receives the royalty knows what happens in between, resulting in asymmetric information where intermediaries know more than DSP’s or songwriters. Established economic theory intuitively links such asymmetric information to transaction costs, with the former driving up the latter<sup>4</sup>. After a century of collective administration, it can still take months to pay artists and years to pay songwriters, so this work is long overdue.

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<sup>1</sup> This discussion paper was prepared for the Society for Economic Research on Copyright Issues (SERCI) Annual Congress at the University of Eastern Piedmont, 10-11 July 2017.

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<sup>3</sup> Disclaimer: This material has been prepared for information purposes only: (i) The opinions expressed by David Safir in this discussion paper are, unless otherwise indicated, his own and do not necessarily constitute the view of any past or current client and (ii) the opinions expressed by Will Page in this discussion paper are, unless otherwise indicated, the author’s own and do not necessarily constitute the view of the Management or the Board of Spotify and any affiliated companies. For further enquiries, please contact: [press@spotify.com](mailto:press@spotify.com)

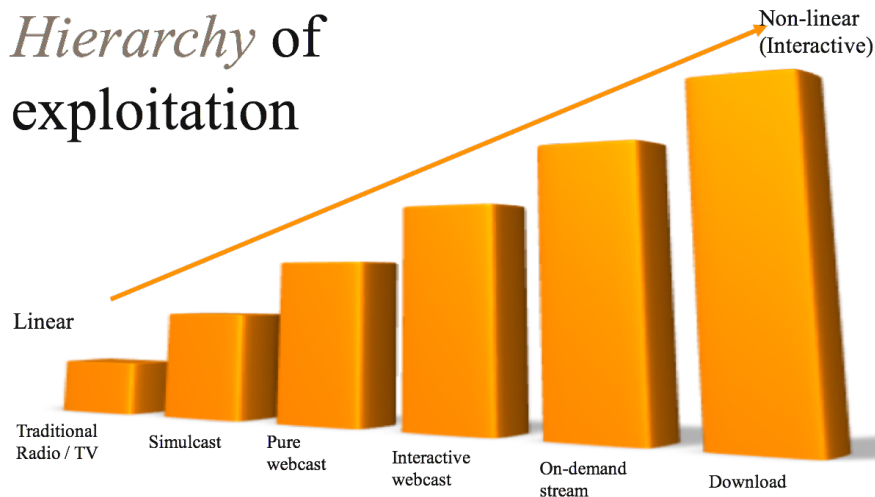
<sup>4</sup> Further reading on transaction costs and music licensing can be found in the following two publications. Heretiana Ranovoson (2013) Licensing music works and transaction costs in Europe. Heretiana Ranovoson et al (2012) The Costs of Licensing for Online Music Services: An Exploratory Analysis for European Services.

## Lost in a Maze; the daunting challenge of tracking royalties

In the analogue environment, licensing seemed simple; PRO's were assigned and duly licensed, collected and distributed broad-based performing rights; while publishers (usually through CMO's as agents) undertook to license phono-mechanical (reproduction) rights.

The far left and far right of the chart below illustrate respectively the extreme linear and extreme non-linear points on the hierarchy of exploitation of authors' rights. In a digital environment that eschews the "blanket licensing" and "national treatment" that characterise collective administration and reciprocal representation, the inherently granular nature of such exploitation makes it ever more difficult to identify what was consumed, when and by whom.

The hierarchy indicates that the more the consumer interacts with the content/product, the higher its unit value. However, while the challenges of licensing new formats are widely discussed, the difficulties of allocating and distributing their revenue are less often explored.



While the path of revenue from streaming services to performers via record labels is relatively easy to trace, the path to songwriters and their publishers is not. There are far too many 'snakes and ladders' for a songwriter to trace what happens to what he assumes is his money between the payment of licence fees and receipt of the royalty statement. This work aims to provide clarity for songwriters, CMO's and publishers as well as streaming services.

An ISRC (potentially one of many where a song has been covered and recorded in several formats across multiple territories and languages) is relatively easy to find and work with; but the uniquely appropriate ISWC and associated metadata is more elusive and more difficult to process effectively. Consequently, it is much easier for a performer to estimate and appreciate how much a streaming service has paid than it is for a songwriter or his publisher.

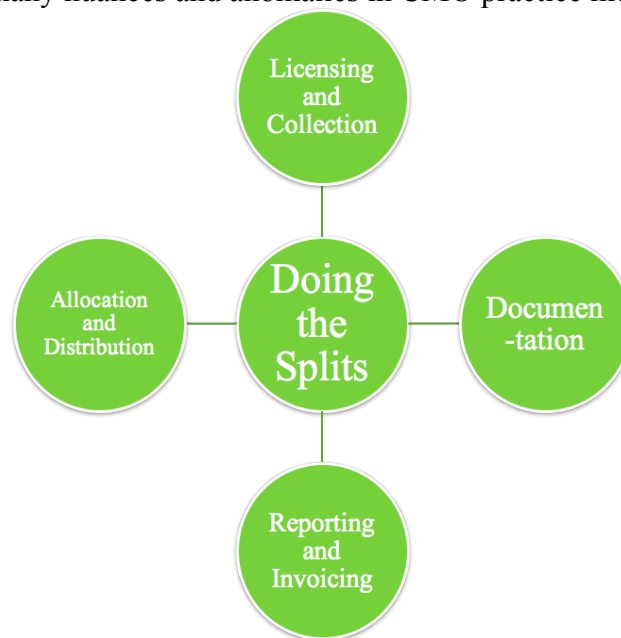
As long as (often widely different) documentation, distribution and accounting principles, processes and practices - as well as the components of transaction costs - remain misunderstood, songwriters and publishers will lack confidence in and suspect the motives of both the CMO's who represent them and the streaming services they increasingly rely upon.

## The Causes of Doing the Splits

The traditional European CMO has been constitutionally obligated to “do the splits” whether administering performing rights and phono-mechanical rights separately but under the same roof (e.g. SACEM and SDRM; BUMA and STEMRA), at arm’s length (e.g. PRS and MCPS before and since the Music Alliance) or in a fully integrated operation (e.g. SGAE; SUIISA).

With different timescales, policies, rules, regulations and processes applying at all stages (from licensing and collection through to documentation, distribution and accounting) publishers seek alternative routes to efficient and effective digital exploitation of the works they control. However, their success has been largely in inverse relation to the ongoing sustainability of their authors’ CMO’s; and, as will be explained later, the relentless upward pressure on transaction costs threatens to fragment and undermine the entire music sector.

This section explores the four processes involved in licensing (see the chart below) and captures the causes of “doing the splits” in each. Whilst we have generalised the processes for the sake of clarity, many nuances and anomalies in CMO practice merit further study<sup>567</sup>.



### Licensing and collection: too many variables, not enough equations

The predominantly non-exclusive assignment of rights fosters and encourages duplicate, direct/source and/or carve-out licensing. A publisher will customarily license and invoice a wide range of exploitation of a musical work and/or recording at different tariffs in different currencies to different licensees in different territories - but rarely all at the same time.

The performing rights and mechanical rights in the musical work are rarely licensed simultaneously with neighbouring rights in the recording. Conflict of interest is unavoidable where aggregators function as licensor and licensee (and may also serve on CMO Boards).

<sup>5</sup> Distribution Rules and Distribution Keys (splits among rightsholders) These vary significantly according to whether a CMO or jurisdiction recognises and pays the neighbouring rights in sound recordings used in TV programmes and/or commercials

<sup>6</sup> The impact of a notional composite licence has two distinct effects: (i) the effect when the split between performing and mechanical at licensing is reversed at distribution, e.g. from  $\frac{1}{2}:\frac{2}{3}$  to  $\frac{2}{3}:\frac{1}{2}$ , and (ii) the further effect of CMO Distribution Rules.

<sup>7</sup> The anomaly of “broadcast mechanicals” Some societies will allocate part of performing right revenue from broadcasters to mechanical rights before distribution. While what is being licensed is a performing right, the PRO converts and diverts a portion to mechanical rights with a consequential dilution of the amount that eventually reaches the songwriters. This evokes an interesting comparative analysis between streaming and broadcast television as compared to streaming and radio.

Withdrawn mandates invariably deplete the repertoire available for multi-territorial as against purely domestic licensing; and a CMO may license, collect and distribute for mandated repertoire while offering administrative services for the specifically withdrawn repertoire.

A PRO may license, collect and distribute repertoire for and by itself as well as through a Special Purpose Vehicle (SPV) contracting its back-office services; and, moreover, may be contracted to license and collect - but not distribute - the associated neighbouring rights.

### **Documentation of works and recordings: insufficient authenticated metadata**

While a recording of a musical work cannot precede its creation, its registration and authoritative documentation can. With multiple recordings/versions/covers in different territories, matching an ISRC to the correct ISWC is inherently difficult from territory to territory. Recently it was reported that only 20% of matches of “international” repertoire were replicated in the databases of all three leading societies ASCAP, PRS and SACEM.

The legal and financial obstacles to creating and maintaining accessible and authoritative databases have proved insurmountable, not least since metadata is constantly changing and key sponsors often exhibit inherently conflicting objectives. The adoption and application of distributed ledger technology may fragment rather than reinforce the current market model.

### **Reporting and invoicing: sharing accountability and responsibility**

What is so often overlooked is that the allocation of composite licence revenue between performing and mechanical rights may differ widely from the allocation of net revenue to be distributed. Absent a blanket licence, prompt, accurate and exhaustive allocation and distribution of "digital" revenue to all rightsholders by the CMO invariably depends on authentic and comprehensive invoicing by the licensee.

Notwithstanding the latest data access/exchange agreement between ASCAP and YouTube, far too many works remain unidentified or uninvoiced by virtue of their being assumed to have been already licensed to the DSP concerned by a third party.

In those territories where the CMO distributes and accounts mechanical rights to its authors through their publishers, the process becomes even more opaque and the route from licence fees to royalties even more tortuous, prolonged and impenetrable.

### **Allocation and distribution: what’s mine is mine and what’s yours is mine too**

Clarity is further impeded when CMO Distribution Rules “snap the tail” (i.e. pay only those works with a minimum number of “uses”), apply sampling and analogy rather a full census of reported usage; and/or revalue/devalue musical works and recordings by reference to territory, medium, context/distribution pool, time-period or licensee.

Potentially far more distorting are the rarely publicised or understood differences among CMO’s as to the allocation of digital revenue between “performing” and “mechanical” rights; as well as the further reallocation (and recoupment) that may occur when the CMO pays its authors’ mechanical rights indirectly via publishers. To cite an extreme example, until recently the Swiss CMO SUISA allocated 100% of streaming revenue to performing rights.

## **The Consequences of Doing the Splits**

Before examining the results of doing the splits, we should revisit the different licensing scenarios for the performing rights and mechanical rights that inform digital exploitation.

### **The “performing rights” scenario**

As not-for-profit membership organisations, most established PRO’s are compelled to allocate and distribute licence revenue objectively and transparently - as invariably reflected in both the composition of the Board (where neither authors nor publishers dominate) and in the Distribution Key (splits among rightsholder categories) applied to licence revenue.

After recovering administration costs of 10%-30% of revenue and (in some cases) deducting up to 10% of the net for Social and Cultural purposes, a work’s registration will usually indicate and the society’s Distribution Key require that the remainder accrue 6/12 to its authors, 6/12 to its publishers and sub-publishers. If it is a foreign work, administered under reciprocal representation, the sub-publisher may receive (but not necessarily remit) the share allocated to the original publisher.

Where new digital “use” of music is characterised as primarily the exploitation of performing rather than mechanical rights, the potential net revenue to all rightsholders is limited by inherently high administration costs; and publisher-members are further constrained by the internal rules and regulations of the CMO’s they are bound to use but cannot fully control.

### **The “mechanical rights” scenario**

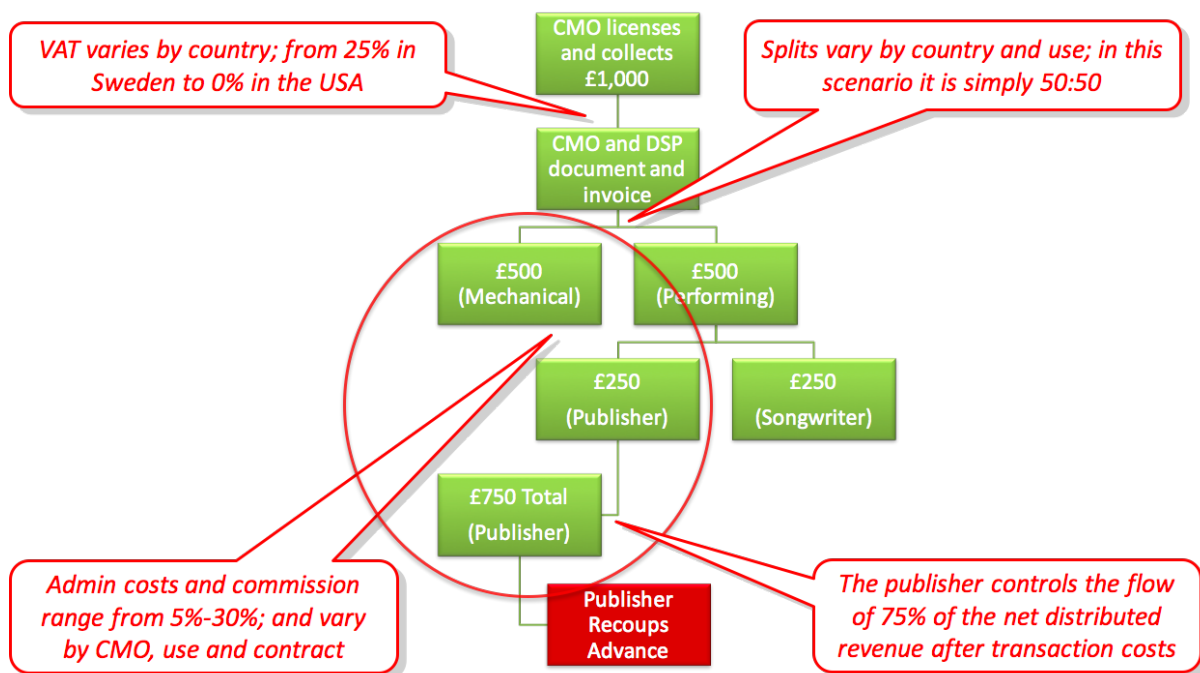
As agents, traditionally licensing phono-mechanical reproduction rights, most national mechanical rights societies (even where fully integrated or operating alongside the national PRO) charged their rightsholders a commission rather than recovering actual or notional administration costs, with such commission on national licensing rarely exceeding 10%.

Subsequent steps however may further favour the publisher, whether through a licensee’s accounting all shares directly to the publisher, by a mechanical rights society’s accepting a less equitable share split than for performing rights; or because the publisher’s agreement with the songwriter provides for the recoupment of advances from royalty income.

Insofar as downloads could be characterised as primarily the exploitation of a mechanical or “making available” right, the potential net revenue to all rightsholders was duly greater than from performing rights; and publishers had a clear incentive to maximise (directly negotiable) tariffs, minimise and control shares allocated to songwriters and benefit from lower costs. As streaming has outpaced and replaced downloads, however, the tide has turned inexorably.

### **Follow the Money Part I**

To make sense of this supply chain, the chart below takes a simple example of a CMO licensing and collecting £1,000 from a streaming service for the exploitation of a song; and tracks what happens when the allocation/split is 50:50 between mechanical and performing rights. At the end of the journey, the publisher controls 75% of the Net Distributed Revenue (NDR) to be recouped against advances or paid on at a later stage. As explained above, the songwriter sees only 25% of that NDR, irrespective of any debt to the publisher.



The chart offers a simplified example that deliberately ignores transaction and administration costs. The table below shows how administration costs, commission, Social and Cultural deductions and internal publisher accounting impact on creators' income. What is striking is that while the songwriter will initially receive directly £191 of the grand total, the remaining £459 will usually be delayed and conditional upon his publishing agreement.

#### Follow the Money, While Doing the Splits

Gross Revenue Net of 20% VAT	£1,000
Less: Admin Costs/Commission of 15%	(£150)
Net Distributable Revenue	£850
Less: Social & Cultural Deductions of 10%	(£85)
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Net Revenue to be allocated	£765
Performing Rights Allocated 50%	£383
Creators Allocated 50%	£191
Publishers Allocated 50%	£191
Mechanical Rights Allocated 50%	£383
Total Publisher Income	£574
Less: Publisher Retains 20%	(£115)
Subject to Contract, Creator Receives	£459
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Total Income Attributable to Creator	£650

#### Follow the Money Part II

Step 1: The CMO allocates revenue from a licensee or licensing category between rights and among classes of rightsholder. The process is described as distribution, but both the works that will ultimately benefit and those that will not have not yet been identified.

Step 2: (primarily but not exclusively with revenue from analogue exploitation): The CMO may - pending identification of the works performed and attribution of revenue - allocate part of such revenue either to an equivalent or in many cases unrelated “distribution pool”.

Step 3: The CMO’s Distribution Rules determine whether and how much of the revenue is distributed to a census of performances, to a statistical sample (possibly after “snapping the tail” at a revenue threshold); or by analogy to previous (invariably unrelated) distributions.

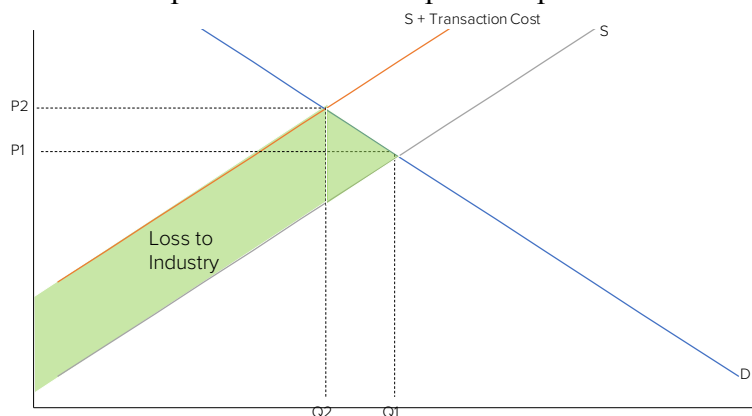
Step 4: (again primarily but not exclusively with revenue from analogue exploitation): CMO Documentation and Distribution Rules and processes may devalue or re-value otherwise identical performances of a given work by reference to objective criteria such as duration, musical genre and context and/or to subjective criteria such as originality and complexity.

Step 5 (not only in analogue TV broadcasting but also in IPTV and Video-On-Demand), a share of revenue attributed to a work may be deducted and diverted to pay for “broadcast mechanicals” or to acquire synchronisation rights in a foreign work not explicitly pre-cleared.

### Transaction Costs and Asymmetric Information

Transaction costs can undermine a potentially valuable deal. For any deal to happen, the benefits must outweigh the costs for each party. Transaction costs make valuable deals weaker and marginal deals unattractive to either or both parties. At best this reduces the sector’s value (avoidable costs are incurred); at worst, it leaves good deals on the table.

Excessive transaction costs incurred by a producer can result in a lose-lose for the industry, as illustrated below with a leftward shift in the supply curve from S to S + transaction cost. The green area captures the loss in surplus through higher prices resulting in lower utility to consumers, whereas lower output results in lower profit to producers.



Asymmetric information - where one party has less information than another - leads to market distortion and weakness. Imagine a house sale where the buyer has a price ceiling (maximum price), and the vendor a price floor (minimum price). The vendor knows the condition of the house better; and the estate agent advertises positive features rather than negative features (e.g. the buyer may not know the extent of damp or subsidence).

However, the buyer’s price ceiling may be ill-informed, leading to a deal that makes the buyer worse off and exposes the mortgagor to default risk: a clear case of asymmetric information causing market failure. Enter market regulation with buyers commissioning surveys that level the playing field, with the downside that this adds further transaction costs.

While digitisation has typically meant lower transaction costs and made commerce easier, the opposite has occurred in the music sector as songwriters have seen the headline commission rate increase from typically 7% for a CD to 14% for a stream. Key reasons for this include: licensing partners growing from a few labels to 27 CMO's in the single European market, numerous publisher breakaways; and more licensing and administration deals taking longer.

Music is an intangible and hence hard to value: and information asymmetry develops as valuations (and the reasons for them) are not shared. Technology has also increased the number of channels available for providers to publish music and consumers to listen to it, many of which are under-monetised and increase uncertainty in the value of music.

It is rarely clear to all parties which works belong to or are controlled by which rightsholders. Service providers depend on rightsholders' information about rights ownership, while CMO's and other licensors cannot always accurately identify the works they represent.

Transaction costs are to deals like friction is to movement: without transaction costs, deals would be much easier, but they are here to stay. Initiatives to reduce transaction costs aim above all to preserve and deliver value to music. A key problem is that the music sector has reacted to asymmetric information by introducing new agents - thereby adding complexity, stretching resources, further increasing transaction costs and reducing the value of a deal<sup>8</sup>.

### **Is the split infinitive? ...where do we go from here?**

Too many variables and too few equations make it increasingly difficult for a songwriter tracking analogue revenue to make sense of a distribution statement and navigate the maze. Nonetheless, stringent regulation ensures ever greater transparency from CMO's regarding the rules, standards, processes and metadata that inform their operations; and many have enabled their members to monitor the documentation and distribution of their works online.

Greater clarity and more accurate perception may result where a CMO has been re-constituted to administer analogue and digital revenue separately (e.g. SGAE) or bespoke Distribution Rules compatible with the digital model have been devised (e.g. GEMA)<sup>9</sup>

However, with digital exploitation characterised by non-exclusive assignment, multi-territorial licensing, inadequate metadata and increased disintermediation, songwriters and DSP's can hardly identify let alone engage with each other. As we confront the challenge of licensing in this confusing environment, a new approach is both essential and urgent<sup>10</sup>.

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<sup>8</sup> Further reading on transaction costs and music licensing can be found in the following two publications. Heretiana Ranovoson (2013) Licensing music works and transaction costs in Europe. Heretiana Ranovoson et al (2012) The Costs of Licensing for Online Music Services: An Exploratory Analysis for European Services.

<sup>9</sup> By acquisition or looser contractual arrangements, societies are simultaneously strengthening their operational resources and preparing to leverage authenticated data they create in-house: PRO SESAC's acquisition of mechanical rights licensor Harry Fox (HFA) and sound recording clearance specialist Rumblefish; Canadian PRO SOCAN's acquisition of composer services company Audium and works and recording clearance specialist MediaNet; the "unimaginable coupling" of SoundExchange (the US agency granting statutory licences in sound recordings) and CMRRA (the Canadian mechanical rights society); Warner-Chappell's re-assignment from ICE to SESAC and SACEM of the processing and distribution of revenues from specified directly-licensed DSP's; intensified investigation into/acquisition of IP of blockchain applications by societies (TEOSTO; ASCAP, PRS and SACEM); publishers (Kobalt) and DSP's (Spotify).

<sup>10</sup> While European societies and their Special Purpose Vehicles develop hubs and one-stop shops to administer the "international" repertoire needed for multi-national licensing of DSP's, publishers continue opportunistically to withdraw and direct-license rights. While EC Directives and commercial imperatives foster greater competition among European societies, unreformed Consent Decrees and the DoJ's attempt to enforce "100% licensing" divert and distract the major US PRO's (and, indirectly, their affiliated societies around the world) from addressing the existential challenge of greater productivity in their core competencies of licensing, collection, processing, distribution and accounting to stakeholders.



## Appendix: Table of Distribution Splits (European CMOs)

The table below (reproduced in “Music & Copyright” from CISAC’s website some years ago) outlines how CMO Distribution Rules split revenue from four essential forms of digital exploitation. It should be stressed that many splits will have since been altered several times; and moreover, a creator or DSP may not necessarily find such information easy to interpret<sup>11</sup>. However, we can use this table to illustrate just how daunting it is for a songwriter to trace royalties from a statement - after the splits - back to fees paid by a DSP.

To illustrate this, we decided to apply some maths.

Imagine a songwriter receives a statement (from one of potentially several non-exclusive multi-territorial licensors) involving exploitation across all digital formats. Two formats (digital and streaming) are reported across 29 countries in the EU; downloads have 3 sub-formats (a-la-carte, ringtones and tethered) and streaming 2 (on-demand and webcasting); downloads are subject to 7 possible mechanical/performing splits across the 29 countries, and streaming to 9; which results in 11,513 possible splits by country, right and format.

Download and streaming rights shares in Europe										
	Download						Streaming			
	A-la-carte		Tethered		Ring tones		Webcasting		On-demand	
	Mechanical	Performance	Mechanical	Performance	Mechanical	Performance	Mechanical	Performance	Mechanical	Performance
Austria	67%	33%	67%	33%	67%	33%	33%	67%	33%	67%
Belgium	67%	33%	67%	33%	67%	33%	20%	80%	33%	67%
Bulgaria	75%	25%	75%	25%	65%	35%	0%	100%	25%	75%
Cyprus	75%	25%	50%	50%	67%	33%	50%	50%	25%	75%
Czech Republic	75%	25%	75%	25%	75%	25%	33%	67%	25%	75%
Denmark	70%	30%	50%	50%	70%	30%	0%	100%	25%	75%
Estonia	70%	30%	70%	30%	70%	30%	0%	100%	30%	70%
Finland	70%	30%	50%	50%	70%	30%	0%	100%	30%	70%
France	75%	25%	75%	25%	75%	25%	25%	75%	25%	75%
Germany	67%	33%	67%	33%	67%	33%	33%	67%	33%	67%
Greece	75%	25%	75%	25%	75%	25%	25%	75%	25%	75%
Hungary	75%	25%	75%	25%	75%	25%	15%	85%	25%	75%
Ireland	75%	25%	50%	50%	75%	25%	25%	75%	25%	75%
Italy	75%	25%	75%	25%	75%	25%	25%	75%	25%	75%
Latvia	70%	30%	50%	50%	70%	30%	0%	100%	30%	70%
Lithuania	70%	30%	50%	50%	70%	30%	0%	100%	30%	70%
Luxembourg	75%	25%	75%	25%	75%	25%	25%	75%	25%	75%
Malta	75%	25%	50%	50%	67%	33%	50%	50%	25%	75%
Netherlands	75%	25%	75%	25%	75%	25%	25%	75%	25%	75%
Norway	70%	30%	50%	50%	70%	30%	30%	70%	30%	70%
Poland	65%	35%	65%	35%	65%	35%	35%	65%	50%	50%
Portugal	75%	25%	75%	25%	75%	25%	25%	75%	50%	50%
Romania	75%	25%	75%	25%	75%	25%	50%	50%	25%	75%
Slovakia	67%	33%	67%	33%	67%	33%	25%	75%	33%	67%
Slovenia	74%	26%	74%	26%	74%	26%	26%	74%	26%	74%
Spain	50%	50%	50%	50%	50%	50%	25%	75%	25%	75%
Sweden	70%	30%	50%	50%	70%	30%	30%	70%	30%	70%
Switzerland	100%	0%	100%	0%	100%	0%	33%	67%	0%	100%
UK	75%	25%	50%	50%	67%	33%	50%	50%	25%	75%

Source: National collection-societies; CISAC  
Source: Music & Copyright

## Glossary

CMO: Collective management organisation or "society", an entity administering one or more authors' rights

DSP: Digital Service Provider, a commercial entity that licenses and makes music available to consumers online and to mobile devices

ISRC: International Standard Recording Code, the unique ISO identifier of an audio or video recording of a musical work

ISWC: International Standard Work Code, the unique ISO code identifying a musical work

PRO: Performing rights organisation or "society", a CMO that administers authors' performing rights

<sup>11</sup> See: [CIS16-1059, 2016-11-03 European rights splits 2016 \(November update\)](#)