The causes and consequences of allocating revenue between mechanical and performing rights
Ovum view

Summary

In the analog environment, collective administration of authors’ rights was relatively straightforward: Public performance and broadcasting of non-dramatico-musical works required performing rights, soundcarrier sales used phonomechanical rights. These two distinct forms of exploitation, while coexisting, 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 that characterizes the paradigm shift from ownership to access. What once was black and white now appears an indeterminate number of shades of gray.

Earlier this year, Will Page, Director of Economics at Spotify, and David Safir, formerly Head of International Relations at PRS for Music and Vice-President, International, at ASCAP, authored a discussion paper for the annual Society for Economic Research on Copyright Issues (SERCI) conference on the causes and consequences of allocating revenue between mechanical and performing rights. The two authors have kindly given their permission for Ovum to reproduce the paper.

The 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 journey to those who earn it. While its authors recognize 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 focuses 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 that pays the collective management organization (CMO) nor the songwriter who receives the royalty knows what happens in between, resulting in asymmetric information where intermediaries know more than digital service providers (DSPs) or songwriters. Established economic theory intuitively links such asymmetric information to transaction costs, with the former driving up the latter. 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.

Lost in a maze: the challenge of tracking royalties

In the analog environment, licensing seemed simple: PROs were assigned and duly licensed, collected, and distributed broad-based performing rights, while publishers (usually through CMOs as agents) undertook to license phonomechanical (reproduction) rights.

In a digital environment that eschews the "blanket licensing" and "national treatment" that characterize 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. 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 license fees and receipt of the royalty statement. This work aims to provide clarity for songwriters, CMOs, and publishers as well as streaming services.

An International Standard Recording Code (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 International Standard Work Code (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, and components of transaction costs remain misunderstood, songwriters and publishers will lack confidence in and be suspicious of the motives of both the CMOs that 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 phonomechanical 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; SUISA).

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' CMOs; 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 Figure 1) and captures the causes of "doing the splits" in each. Although we have generalized the processes for the sake of clarity, many nuances and anomalies in CMO practices merit further study.

**Figure 1: Four processes in licensing**

![Diagram of the four processes in licensing](image)

Source: SERCI discussion paper
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 neighboring rights in the recording. Conflict of interest is unavoidable where aggregators function as licensor and licensee (and may also serve on CMO boards).

Withdrawn mandates invariably deplete the repertoire available for multiterritorial 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; moreover, it may be contracted to license and collect – but not distribute – the associated neighboring 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 license revenue between performing and mechanical rights may differ widely from the allocation of net revenue to be distributed. Absent a blanket license, prompt, accurate, and exhaustive allocation and distribution of “digital” revenue to all rights holders 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 uninvoked 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 license 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 than 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.
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Potentially far more distorting are the rarely publicized or understood differences among CMOs 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 organizations, most established PROs are compelled to allocate and distribute license 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 rights holder categories) applied to license 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 characterized as primarily the exploitation of performing rather than mechanical rights, the potential net revenue to all rights holders is limited by inherently high administration costs, and publisher-members are further constrained by the internal rules and regulations of the CMOs they are bound to use but cannot fully control.

The mechanical rights scenario

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

Subsequent steps, however, may further favor 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 characterized as primarily the exploitation of a mechanical or "making available" right, publishers had a clear incentive to maximize (directly negotiable) tariffs, minimize 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, Figure 2 takes a simple example of a CMO licensing and collecting £1,000 from a streaming service for the exploitation of a song, tracking 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
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on at a later stage. As explained above, the songwriter sees only 25% of that NDR, irrespective of any debt to the publisher.

Figure 2 offers a simplified example that deliberately ignores transaction and administration costs. Figure 3 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.

**Figure 2: License and collection payment process**

VAT varies by country; from 25% in Sweden to 0% in the USA

CMO and collects £1,000

Splits vary by country and use; in this scenario it is simply 50:50

CMO and DSP document and invoice

£500 (mechanical)

£500 (performing)

£250 (publisher)

£250 (songwriter)

£750 (publisher)

Admin costs and commission range from 5%-30%; and vary by CMO, use and contract

Publisher recoups advance

The publisher controls the flow of 75% of the net distributed revenue after transaction costs

Source: SERCI discussion paper
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### Figure 3: Following the money while doing the splits

<table>
<thead>
<tr>
<th>Gross revenue net of 20% VAT</th>
<th>£1,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less admin costs/commission of 15%</td>
<td>-£150</td>
</tr>
<tr>
<td>Net distributable revenue</td>
<td>£850</td>
</tr>
<tr>
<td>Less social and cultural deductions of 10%</td>
<td>-£85</td>
</tr>
<tr>
<td>Net revenue to be allocated</td>
<td>£765</td>
</tr>
<tr>
<td>Performing rights allocated 50%</td>
<td>£383</td>
</tr>
<tr>
<td>Creators allocated 50%</td>
<td>£191</td>
</tr>
<tr>
<td>Publishers allocated 50%</td>
<td>£191</td>
</tr>
<tr>
<td>Mechanical rights allocated 50%</td>
<td>£383</td>
</tr>
<tr>
<td>Total publisher income</td>
<td>£574</td>
</tr>
<tr>
<td>Less publisher retains 20%</td>
<td>£115</td>
</tr>
<tr>
<td>Subject to contract, creator receives</td>
<td>£459</td>
</tr>
<tr>
<td>Total income attributable to creator</td>
<td>£850</td>
</tr>
</tbody>
</table>

Source: SERCI discussion paper

### Follow the money: part II

Step 1: The CMO allocates revenue from a licensee or licensing category between rights and among classes of rights holder. 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 analog 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 analog 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 analog TV broadcasting but also in IPTV and VOD): A share of revenue attributed to a work may be deducted and diverted to pay for "broadcast mechanicals" or to acquire synchronization 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.

Figure 4 illustrates how excessive transaction costs incurred by a producer can result in a lose-lose situation for the industry, 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 for 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 digitization has typically meant lower transaction costs and made commerce easier, the opposite has occurred in the music sector as songwriters have seen the headline administrative cost 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 CMOs 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.

It is rarely clear to all parties which works belong to or are controlled by which rights holders. Service providers depend on rights holders’ information about rights ownership, while CMOs 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 these deals 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
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information by introducing new agents, thereby adding complexity, stretching resources, further increasing transaction costs, and reducing the value of a deal.

Is the split infinitive?

Too many variables and too few equations make it increasingly difficult for a songwriter tracking analog revenue to make sense of a distribution statement and navigate the maze. Nonetheless, stringent regulation ensures ever greater transparency from CMOs regarding the rules, standards, processes, and metadata that inform their operations. 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 analog and digital revenue separately (e.g. SGAE), or bespoke distribution rules compatible with the digital model have been devised (e.g. GEMA).

However, with digital exploitation characterized by non-exclusive assignment, multiterritorial licensing, inadequate metadata, and increased disintermediation, songwriters and DSPs 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.

Table of distribution splits (European CMOs)

Figure 5 (reproduced in *Music & Copyright* from CISAC in September 2014) 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 an up-to-date version is available from CISAC. Moreover, a creator or DSP may not necessarily find such information easy to interpret. 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 math. Imagine a songwriter receives a statement (from one of potentially several non-exclusive multiterritorial licensors) involving exploitation across all digital formats. Two formats (digital and streaming) are reported across 29 countries in the EU; downloads have three sub-formats (a-la-carte, ring tones, and tethered) and streaming two (on-demand and webcasting); downloads are subject to seven possible mechanical/performing splits across the 29 countries, and streaming to nine. This results in 11,513 possible splits by country, right, and format.
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### Figure 5: Download and streaming rights shares in Europe

<table>
<thead>
<tr>
<th></th>
<th>Download</th>
<th>Streaming</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>A-la-carte</td>
<td>Tethered</td>
</tr>
<tr>
<td>Austria</td>
<td>67%</td>
<td>33%</td>
</tr>
<tr>
<td>Belgium</td>
<td>67%</td>
<td>33%</td>
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<tr>
<td>Bulgaria</td>
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<td>25%</td>
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<tr>
<td>Cyprus</td>
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<tr>
<td>Czech Republic</td>
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<tr>
<td>Denmark</td>
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<td>Finland</td>
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<tr>
<td>France</td>
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<tr>
<td>Germany</td>
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<td>Greece</td>
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<td>Hungary</td>
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<td>Ireland</td>
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<td>Italy</td>
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<td>Latvia</td>
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<td>Norway</td>
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<tr>
<td>UK</td>
<td>75%</td>
<td>25%</td>
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Source: CISAC

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### Appendix

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