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# Remuneration for the use of copyright material - comment on the ACCC draft guidelines

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## 1. Executive Summary

This report comments on the draft guidelines prepared by the Australian Competition and Consumer Commission ('the ACCC') on the pricing of voluntary copyright licences and licence schemes.

In developing these guidelines the ACCC has omitted to address a number of issues that are relevant to the pricing of copyright material namely:

- § the role of alternative revenues sources that are available to the creators of original works;
- § the availability of substitutes to copyright material and the constraint that these substitutes place on the pricing of copyright material;
- § consideration of the ability and willingness of consumers to pay for the copyright material;
- § the role of comparable market transactions in assisting to determine the appropriate licence fees to charge; and
- § the potential to transfer monopoly power from the collecting societies to the users of copyright material if due consideration of the above matters is not taken into account.

The basis for these conclusions is addressed in detail in the remainder of this report.

## 2. Introduction

This report has been prepared by NERA Economic Consulting ('NERA') following a request by Minter Ellison to provide comments on draft guidelines prepared by the ACCC on copyright licensing. The ACCC's draft guidelines, entitled "Copyright licensing and collecting societies: a guide for copyright licensees" ('the draft guidelines') were released for public consultation in November 2006.

Specifically, NERA has been asked to comment from an economic perspective on section 8.3 of the draft guidelines entitled "Pricing of copyright material", which appears at pages 35-37. The stated purpose of this section of the draft guidelines is to articulate:

*.....some broad principles it [the ACCC] considers relevant to the pricing of copyright material<sup>1</sup>*

The development of these principles is particularly important since under the recently amended terms of the *Copyright Act 1968* ('the Act'):

- § in applying the provisions of the Act as they relate to the pricing of voluntary copyright licences and licence schemes, the Copyright Tribunal ('the Tribunal') may have regard to guidelines made by the ACCC;<sup>2</sup> and
- § the Tribunal may make the ACCC a party to a proceeding before it, if the ACCC applies and the Tribunal considers it appropriate.

The remainder of this paper is structured so as to address each of the main comments that we have on the draft guidelines.

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<sup>1</sup> Australian Competition and Consumer Commission, Copyright licensing and collecting societies: a guide for copyright licensees, Draft for comment, November 2006, page 35

<sup>2</sup> This applies to voluntary licences and licence schemes only. When considering statutory licences, other factors may be relevant.

### 3. Context for pricing of copyright material

The ACCC provides a helpful discussion of the context for the pricing of copyright material at the commencement of section 8 of the draft guidelines. It reminds the reader<sup>3</sup> that collecting societies bring together parties that would normally compete with each other and that this gives rise to a degree of market or monopoly power in setting the licence fees and conditions for the use of copyright material over which a collecting society has control.

The draft guidelines note that the Tribunal originated from concern at the monopoly power of collecting societies. In counterbalancing that monopoly position, the determination by the Tribunal of reasonable charges and conditions for the use of copyright material has regard to the wider public interest, where this is taken to include the effects of competition in markets.

The wider public interest is served in two main ways by these collecting societies:

- § it gives rise to an improvement in efficiency through a reduction in transaction costs; and
- § it prevents the transfer of monopoly power from one market to another.

A reduction in transaction costs arises because people wanting to make use of copyright material do not individually have to seek out and negotiate with each owner of the relevant copyright. Rather, each user simply needs to approach the relevant collecting society to obtain access to a range of copyright material. The alternative, involving negotiations with each owner of copyright would often be an onerous task since there are a range of works with a range of owners and often the copyright rights in a work will be held by a number of different individuals or organisations. For example, a piece of music is not only subject to the copyright held by the composer and songwriter, but also the copyright in relation to the musical recording and the printed sheet music. The creation of collecting societies eliminates the need for users to contact each different owner of the relevant copyright, and the need for each copyright owner to negotiate with a vast number of potential users.

The formation of collecting societies also helps to prevent the leveraging of monopoly power created in one market into another. As recognised by the draft guidelines, the collecting societies possess a degree of market power. The requirement that all members of the same class of consumers be provided access to the material at the same price stops the collecting societies from using their monopoly power effectively to determine who will have access to the copyright material. Without this requirement, copyright owners (by charging monopoly prices and/or refusing to supply certain potential customers) could effectively lock out potential users of copyright from gaining access to the material. This could conceivably allow copyright owners to limit the number of users of copyright material, thereby giving rise to the potential to distort related markets that use copyright material as an input for their products. Such limitations on access to copyright material can lead to a reduction in competition or, in some situations, a substandard product.

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<sup>3</sup> *Ibid*, page 34

The draft guidelines proceed to discuss the pricing of copyright material principally by reference to the public interest, which the ACCC describes in economic terms as the “socially optimal level”<sup>4</sup> of production of copyright works.

We very much agree that the socially optimal level of production is the correct reference point in economic terms from which to consider the pricing of copyright material. We also agree that the fact that the additional cost of producing an extra unit (‘the marginal cost’) of copyright material is often near zero lies at the heart of the problem of determining prices for such material that will encourage the socially optimal level of production. The near zero price that a ‘text book’ economic analysis would normally call for is unlikely to deliver a socially optimal production of copyright works.

Notwithstanding the ACCC’s correct identification of the problem of pricing copyright material, in our opinion its discussion in the draft guidelines of the issues arising does not give sufficient recognition to two important aspects of the market for copyright material. These are that:

- § first, the sources of revenue for the creation of original works are not limited to licence fees generated by means of the collecting societies – and so the incentives for the production of new copyright material do not depend on licence fee revenue alone; and
- § second, in determining the socially optimal level of production, of no less importance than the costs of this production (and whether or not producers are able to recover that cost) is the demand side of the market – this amounts to addressing the question of whether or not users are willing and able to meet those costs, thereby ensuring that the creation of original works is not artificially curtailed by prices that are ‘too high’.

The omission of these two considerations in its assessment of the market for copyright material means that the draft guidelines do not give sufficient weight to matters that should cause the ACCC to qualify the principles or conclusions that it draws in discussing the pricing of copyright material.

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<sup>4</sup> *Ibid*, page 36

## 4. Role of alternative revenue sources

The draft guidelines correctly point out that, in markets that are characterised by effective competition, prices reflect the marginal cost of production and that this is generally sufficient to ensure that production will tend towards the socially optimal level, particularly over the long run. However, the marginal cost of producing another unit of copyright material (once the original work has already been developed) is often very low or close to zero.

It follows that a short run perspective on marginal cost is not a viable basis on which to set prices for copyright material, because of its implications for the creation of new material. Unless there is some form of incentive (means of payment) to create copyright material, this form of production will fall below the socially optimal level.

Whilst these sentiments are correct as a matter of principle, in our opinion the draft guidelines over-emphasise the importance of copyright licences administered by collecting societies (as opposed to licences granted by copyright owners individually) in determining the strength of this incentive to create new copyright material. The draft guidelines make the statement<sup>5</sup> that:

*Setting total remuneration [by means of collecting society administered copyright licence fees] equal to the short-run marginal cost would not provide an incentive for further creation of original works, and the production of such works would fall below the socially optimal level.*

The draft guidelines further state<sup>6</sup> that:

*To provide incentive for investment in the production of new copyright material, the sum of remuneration paid [by means of collecting society administered copyright licence fees] by all users of the material should also cover the cost of creating new material.*

It is important to recognise that these statements are correct only to the extent that income collected by means of the collecting societies is the *sole source of revenue* to the creators of original works.

In practice, the creators of original works are likely to have access to a number of different potential sources of income, in addition to the licensing of copyright in their works by collecting societies. Such alternative or additional sources of income may include, for example:

- § in relation to musical works, revenues earned from the licensing of 'Grand Rights', the licensing of works for use in films and the publishing of print music;
- § in relation to books, revenues arising from the sale of books in either electronic or print form; and

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<sup>5</sup> *Ibid*, page 36

<sup>6</sup> *Ibid*, page 36



§ in relation to sound recordings, revenues earned from the sale of CDs and music online.

Given that copyright licensing revenues administered by collecting societies are but one source of potential income to the creators of original works, it follows that even if licensing fees were set equal to their marginal cost, the incentive to create original works would not be eliminated, as the draft guidelines suggest. Rather, a more balanced assessment would recognise that the incentives for the creation of original works would risk falling below the socially optimal level where *income from all potential sources* was insufficient to cover the costs of production.

One consequence of this omission is that the discussion in the draft guidelines of the conceptual attractiveness of determining the remuneration of copyright owners by reference to the cost of creating the relevant material needs to be qualified. In our opinion the draft guidelines should acknowledge that, in determining the appropriate remuneration of copyright owners, income from all other sources would need to be netted off from any measure of total production cost before the amount to be recovered from licences administered by collecting societies could be determined.

The absence of any acknowledgement of the role of alternative or additional sources of revenue for the creators of original works means that the draft guidelines tend to overstate the incentive problems arising from setting remuneration by means of copyright licensing fees at marginal cost. Given the existence of other sources of revenue and so alternative forms of incentive for the creators of original works, it is too strong to say that marginal cost pricing of collecting society administered copyright licence fees would result in production *well* below the socially optimal level - unless one had some indication of the percentage of revenue from collecting society sources as opposed to other sources.

The above observation does not detract from the important role of collecting societies in ensuring the sustainable creation of original works. Our point is simply that the ACCC has overstated the role of copyright licences and the positive incentives they give rise to by suggesting that the full cost of production should be recouped from such licensing fees. Application of such a principle is likely to over-compensate the creators of original works, and lead to a greater than socially optimal amount of production.

Given the difficulty in quantifying the costs and the amount earned from other sources of revenue, the use of comparable market transactions should be considered to help determine the appropriate price. This is discussed in greater detail in section 6.

## 5. Role of potential substitutes and the consumer

### 5.1. Potential substitutes

In determining the appropriate level of remuneration for copyright material, it is also important to take account of the nature and extent of available substitutes. As indicated above, the creators of original works are likely to be in a position to earn revenue from sources other than copyright licences administered by collecting societies. Such forms of revenue represent potential substitutes from the perspective of the creator of original works.

Importantly, substitutes for the use of copyright works also arise from the perspective of the consumer. For example, a nightclub would be subject to copyright licensing fees for the playing of recorded music. However, one alternative open to that nightclub would be to hire a live band to perform. Likewise, a pharmaceutical company could obtain a licence directly from the publisher of a scientific textbook, rather than paying licensing fees to the relevant collecting society for the photocopying of material from the book.

The availability of such substitutes puts a constraint on what people are willing to pay for the use of copyright works and so puts a constraint on the amount that is able to be charged in the form of licensing fees. As the price of licences becomes greater, users are likely to seek alternative means of meeting their needs that involve either a more limited form of licence or none at all. Such responses by copyright users will cause less original works to be produced, thereby also giving rise to the risk of sub-optimal outcomes from a societal perspective.

### 5.2. Role of consumer demand

The consideration of available substitutes amounts to making an assessment of the demand side of the market for the use of copyright material. However, in its draft guidelines the ACCC focuses exclusively on the circumstances surrounding the supply of copyright works and the costs associated with this supply. The draft guidelines involve no discussion of the role of the demand side of the market, which is likely to place a constraint on how much is supplied and its cost.

In assessing the demand for the use of copyright material, the alternatives or substitutes available to consumers need to be taken into account. The existence of substitutes will place a constraint on the amount that can be charged. Whilst collecting societies have a virtual monopoly on the licensing of copyright in original works, some works may no longer be subject to copyright or may not be eligible for copyright originally. These works will provide a substitute or alternative to the copyrighted works.

By way of example, the performance of a Shakespearean play will no longer be subject to copyright protection whereas the performance of a play by David Williamson will be subject to copyright. Those works that are no longer subject to copyright represent an alternative to using copyright works and so act as a constraint on the amount that can be charged for the use of copyright works.

Of course, in some circumstances there may be no effective substitute available to the organisation wishing to use the copyright material. For example, a radio station seeking a blanket licence for its airing of popular music would not realistically be able to seek out

licences with each and every relevant copyright owner - its only real alternative would be to move to a 'talk format'. In this situation, substitutes may not place an effective constraint on the licence fees able to be charged by the collecting societies and due account needs to be taken of the users' willingness and ability to meet the cost of copyright licence fees.

Without consideration of these issues, collecting societies may effectively 'lock out' those users that are unable or unwilling to pay the higher licence fees. Excessive prices may provide the collecting societies with the potential to transfer their monopoly power to certain users of copyright material with the ability to pay these higher fees. Further, prices that are 'too high' from the consumers' perspective will lead to lesser production of original works, and so sub-optimal outcomes from a social welfare perspective.

The ACCC's draft guidelines make no reference either to the constraints that substitutes form on the price that can be charged for the use of copyright material, or to the role of consumer preferences more generally. For the creation of any copyright work to be socially optimal, it is a requirement that some consumers must be willing to pay to experience the benefits of that work.

In giving explicit consideration only to the supply side of the market for the creation of original works, the draft guidelines effectively assume that:

- § there is a end-market for all relevant works that has a sufficient number of consumers willing and able to pay for the relevant material; and
- § that there is an absence of substitutes for the relevant copyrighted works.

Both of these demand-side considerations will act to constrain the price charged for the use of copyright material and should be explicitly acknowledged in the draft guidelines. As a matter of principle, socially optimal production cannot be achieved through consideration only of the supply side of a market. What consumers want, the alternatives available to them, and how much they are willing to pay, form important constraints on any production-orientated assessment of the appropriate price in a market.

## 6. Role of market transactions

The draft guidelines give due recognition to the difficulties associated with measuring supply costs in the context of determining the equitable remuneration of copyright owners. However, they provide little in the way of practical assistance for overcoming this hurdle. In part, this would seem to be a consequence of the exclusive focus of the draft guidelines on the supply side of the market for the relevant copyright material.

In our opinion, it would be helpful if the draft guidelines were to give explicit recognition to the potential role of transactions that have already taken place for the use of the same or similar rights as those the subject of the copyright licence in question.

An important attribute of prior transactions for the same or similar rights is that they encapsulate information from both the supply and demand sides of the relevant market. If exchange has taken place, it can be assumed that both parties to such transactions were willing participants – since, if not, either the copyright owner would have refused to make the right available or the relevant consumer would have declined to make the purchase.

## **7. Price discrimination and licence fee structure**

### **7.1. Price discrimination**

In our opinion the underlying economic principles in the section of the draft guidelines entitled ‘price discrimination and licence fee structure’ are sound. In circumstances where the supplier of a good or service has market power, the ability to price discriminate will tend to improve efficiency and is more likely to deliver a socially optimal outcome.

However, there is some risk that the draft guidelines place too much emphasis on the ability and use of price discrimination. In order for price discrimination to improve social outcomes it is necessary to be able to identify those segments of the field of consumers that have differing levels of price elasticity and in some cases to quantify these values. This is an extremely difficult analysis to achieve in practice. If this distinction cannot be made then the efficiency enhancement potential for price discrimination is doubtful.

The ability to discriminate in terms of price also presupposes the absence or limitation of substitutes. If price discrimination leads to certain customer segments being charged too much, those consumers will switch to an alternative product or producer. Substitutes again impose a cap on the amount that can be charged to any consumer. Although price discrimination is an efficient way to price goods and services for which there are limited alternatives, we believe in principle, its likely role in the context of copyright licensing is given too much emphasis in the draft guidelines.

### **7.2. Licence fee structure**

The draft guidelines are correct to state that collecting societies have to strike an appropriate balance between the advantages of charging different prices to different consumers whilst also providing for the ease of administration of their licensing function. The draft guidelines also provide examples of metrics that could be used as an approximation of the use of copyright material by different users, and illustrate relatively simple and more complex methodologies for calculating the fees depending on the circumstances in which the copyright material is to be used.

In our opinion, it is important to recognise that no one method can or should be endorsed for use in all circumstances. There may be a range of suitable charging metrics for each circumstance. Rather, the most important task is to ensure that the guidelines are flexible enough to allow different methods to be used in different circumstances, taking account of the principles that are well described in the final paragraph of the pricing section of the draft guidelines.

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