

**The Arbitrators' Award in the WTO ruling on
Section 110(5) of the US Copyright Act:
Welfare and Strategic Implications**

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Abstract

This paper analyses the economic welfare implications of the Arbitrators' award following the WTO Panel's ruling on the exemptions contained in Section 110(5)(a) & (b) of the US Copyright Act. The WTO Panel ruled that Section 110(5)(b) – relating to copyright exemptions for the use of nondramatic music in retail outlets – was in breach of the TRIPS Agreement. Pending an amendment to the US Copyright Act in order to comply with the TRIPS Agreement, arbitrators were appointed to determine an adequate compensation level for EU rights holders who were affected by the exemption. This paper examines the extent to which the Arbitrators' award redressed the welfare costs of the exemption as defined by the analysis of the WTO Panel¹. The analytical approach of the paper is to examine both the direct impact of the ruling on affected music rights holders and also to identify the ramifications for subsequent TRIPS disputes (and IPR markets more generally) where the Arbitrators' methodology might be used as a benchmark - and as a means of choosing adequate compensation (this is particularly likely given that this was the first dispute involving copyright exemptions considered under TRIPS). Throughout it is important to bear in mind that when we refer to the Arbitrators' award we mean both the discretion taken by the Arbitrators as well as the constraints placed on their choice by the legal structure under which they were operating. Our argument is based on an understanding that welfare is affected by both influences.

The main findings of the paper indicate that from a welfare perspective (as depicted by the analysis of the WTO Panel) the Arbitrators' award does not adequately compensate rights holders for the loss of revenue that is being caused by the section 110(5)(b) exemptions. From the perspective of the conclusions of the analysis carried out by the WTO Panel, the Arbitrators' methodology would be

¹ The WTO Panel sought to redress the welfare losses caused by the exemption through the use of the following formula. Compensation would be set equal to net revenue that would have been distributed to EU rights holders had the Fairness of Music Bill had not been enacted, given current US transaction costs and performing right organisation efficiency and also assuming that the homestyle exemption had negligible effects on licensing revenues.

expected to have a detrimental affect on investment in the creation and dissemination of new musical works – to the detriment of rights holders and the net detriment of consumers.

Furthermore, the report finds that the Arbitrators' award is likely to increase the incentive for countries and consumers across the globe to introduce exemptions which fall foul of the World welfare objectives of the TRIPS Agreement. In effect, the Arbitrators' ruling implies that increasingly it will be in countries interests to replace copyright enforcement by 'exemptions plus compensation'. Furthermore, a long term incentive is created where countries can reduce future compensation levels by introducing a harsh domestic environment for copyright enforcement through pursuit of a lack of governmental support for copyrights and their enforcement - thereby raising transactions costs for rights holders.

Simultaneously, the greater the lack of revenues for creative works due to exemptions the greater the need for countries and markets who do enforce copyright to compensate for this lack of external revenues by charging higher prices and supporting extensive enforcement of copyright.

Thus, if the Arbitrators' award is used as a generic compensating methodology in other markets for intellectual property rights, it has potential to escalate the realm of welfare unjustifiable copyright exemptions. Furthermore, it has potential to ignite exemption races where countries rush to introduce an exemption while it can still be justified to some extent by revenues in markets (in other countries) where no exemption currently exists. Simultaneously, rights holders may inspire domestic regulators to retaliate to exemptions in foreign markets by introducing exemptions in home markets; thereby sparking intellectual property right trade wars.

Thus, in sum the Arbitrators' award impacts directly on a generic welfare question relating to intellectual property rights. Who actually does pay for new creative works and who should pay? In this case questions arise of whether it is justifiable that per capita EU consumers subsidise US consumers in terms of contributing more to new music creations motivated by revenues form music performance markets. Similarly, it affects issues relating to compensation across markets (even within a region). For

example, should consumers of CDs subsidise retail outlets such as bars and restaurants who use the same music?

The specific findings of the paper are as follows.

(1) The Arbitrators' award does not adequately compensate rights holders for the economic consequences of the exemptions under section 110(5)(b) because:

- They only compensate EU rights holders who at the highest estimate account for no more than 25% of the relevant affected works. Thus, the compensation entails at least a 75% reduction in the cost of music performances in US retail outlets than would be the case if the rights were enforced.
- Compensation is net of performing right society administration costs. Since monitoring costs must be incurred in order to redistribute income to the rightful owners, the effect of the award is to pass this cost on to the compensated party thereby reducing their revenue below that which would have been received had the rights been enforced.

(2) The Arbitrators focus on historic transactions costs as a means of ascertaining adequate compensation levels implies that:

- Countries intent on extending exemptions do not have an incentive to reduce transaction costs by creating a domestic environment that is actively supportive of copyright and its enforcement. Put simply, compensation levels are lower the greater the level of domestic transaction costs so countries intending to create an exemption have an incentive to promote high transaction costs.
- In the presence of an exemption, rights licensors do not have an incentive to either enter the market or become more efficient. Thus, there is no scope to introduce productivity improvements which reduce transaction costs and hence increase net revenues for exempt works.

(3) The Arbitrators' award increases the incentive for countries to introduce exemptions in cases where they are detrimental to World economic welfare.

- An 'exemption plus compensation' is always less costly to the home country than enforcing copyright (i.e. not all rights holders are compensated and home country transactions costs are avoided). This increases the incentive to introduce exemptions in many instances where it is against the global welfare interest.
- Since an exemption is more likely to be justifiable the greater the revenues for the same works from other markets, there is an incentive for countries to seek an exemption before another country does so. Thus, a stimulus for races to create exemptions is created with implications for a robust, fair and acceptable world trade environment for the international trade of intellectual property rights.
- Since an exemption contains a welfare effect of 'robbing Peter to pay Paul' – reallocating welfare benefits from one country to another - it may cause retaliation by countries whose interests are damaged in the process. Not surprisingly, one may expect other countries to challenge these exemptions (as in the case of the homestyle exemption and the Fairness of Music Bill) but where the outcome is unsatisfactory the hurt party may decide that retaliation in the form of domestic exemptions is a more effective means of rectifying welfare losses. Thus, the likelihood of intellectual property trade wars is enhanced.

In sum, a strategic arena of passing off the cost of the creation of new works to other nations and markets is created. The outcome can be damaging to welfare and unfair in terms of its impact on the distribution of the benefits of creative works across global consumers. One should not be surprised to find that it is unacceptable to countries who are the losers in this strategic win-lose environment. It is unlikely to be the basis for a robust, fair and acceptable international trade environment for creative works involving intellectual property rights.

1 Introduction

In this paper we set out to investigate the wider implications for intellectual property right (IPR) markets of the award by the Arbitrators in the WTO case EU v. US over Section 110(5) of the US Copyright Act. The Arbitrators' award is of more general interest because of the practice of jurisprudence among national and international regulatory institutions. In other words, the ruling takes on wider relevance if the Arbitrators' methodology is used as a benchmark for best practice in other disputes involving exemptions being made to authors' reproduction rights. Since the recent dispute is the first between the EU and the US over the use of imposing national exemptions for copyright invoking Article 13 of the TRIPS Agreement, it will no doubt be cited in subsequent similar cases where copyright (and conceivably other intellectual property rights) are exempted within a national jurisdiction. Indeed, one could reasonably expect the Arbitrators' award to have a bearing on the calculation of future damages in cases where the WTO perceives that an IPR has been deemed to have been breached.

It is important to note that the scope of the paper is exclusively concerned with the methodology used by the Arbitrators in order to arrive at a satisfactory compensation for EU copyright owners. We seek to investigate the economic forces which this methodology creates if it is subsequently applied in other markets for IPRs. We do not want to reopen the debate that ensued between EU and US legal counsels. Nonetheless, our analytical misgivings about the underlying economic implications of the Arbitrators' methodology dictate that from an economic welfare perspective this methodology should not go uncriticised. The basic theoretical framework for this paper has its origins in an earlier publication (Burke, 2000, *Legal Structure and Strategic Regulation of Intellectual property: Who Pays for R&D in Arts Markets? Recherches Economiques de Louvain*, vol 66(2): 193-211). The current paper builds on this framework in order to consider the wider implications of adopting the Arbitrators' methodology in this dynamic environment.

The paper is structured as follows. Section 2 provides a brief overview of the dispute and the logic behind the Arbitrator's award. This trajectory is then developed

in section 3 where we develop the theoretical framework in Burke (2000) in order to account for regulation of the form utilised by the Arbitrators. The analysis highlights how this ruling is likely to influence international regulation of IPRs. Finally, in the concluding section, the paper demonstrates some of the policy and strategic implications of the analysis.

2 The Dispute and Award of the Arbitrators

The case has its origins in a complaint to the EU Commission in 1997 by the GESAC – the music industry organisation for European performing right organisations (PROs). The initiative was spearheaded by the Irish PRO, the Irish Music Rights Organisation (IMRO) and had the unanimous support of all other EU performing right organisations. The complaint concerned an alleged loss of copyright revenues for European composers which were deemed to have been caused by the music performance right exemptions embedded in section 110(5) of the US Copyright Act. These exemptions being initiated in law 1976 and then later following the extension of these exemptions through the 1998 US Fairness of Music Licensing Act, through articles 110(5)(a) and 110(5)(b).

Prior to the 1998 amendment, section 110(5) of the 1976 US Copyright Act read:

"Notwithstanding the provisions of Section 106, the following are not infringements of copyright:

(5) communication or transmission embodying a performance or display of a work by the public reception of the transmission on a single receiving apparatus of a kind commonly used in private homes, unless:

(a) a direct charge is made to see or hear the transmission, or

(b) the transmission thus received is further retransmitted to the public."

The exemption which became known as the 'homestyle' exemption was prompted into law in 1976 following the case of Twentieth Century Fox v. George Aiken. In this case the Court ruled that George Aiken was not obliged to pay music performance rights largely because the Court did not deem that the retransmission of radio to customers on a standard radio receiver (notwithstanding 4 speakers

mounted in the ceiling) was a performance in a legal sense. A key feature of the Court's ruling was the view that revenues from this market for copyright owners would have been excessive. Namely, the Court held the view that adequate revenues were already received by authors from other copyright markets for the same intellectual property and that this market was to some extent unforeseen by the original authors of the US Copyright Act (see Burke, 2000 for a more in depth analysis).

Thus, when the 1976 US Copyright Act was drafted Section 110(5) was framed in order to preserve the implications of the Aiken ruling in law. The exemption related to music being performed in a public place on a radio or television. It explicitly specified that the music performance should only apply to a transmission operating through a single and standard TV or radio commonly used in homes. Through the courts, consideration was given to the number of speakers (as a rule of thumb not more than 4 being allowed) and the square footage of the premises when considering whether or not an outlet should be deemed exempt.

This form of exemption was not adopted in the EU and hence by contrast the homestyle exemption represented a potential pool of forgone revenue for EU composers and publishers. Specifically, it represented the elimination of potential export licensing revenue. Notably, a significant proportion of copyright holders with an interest in this revenue pool did not participate in the action. In particular, GESAC (who represented the music composition right owners) did not receive active support from the publishing divisions of the Major record labels and of which Vivendi/Universal, Bertelsmann and EMI were all European companies). We do not know exactly why these companies were not highly active in the dispute but since they were the larger beneficiaries if the EU won the case their passive role remains somewhat surprising. In contrast, other European IPR owners in non-music markets such as Pernod did actively support the GESAC initiative. We will comment on these various interests in section 4 when we highlight some of the strategic implications relating to the case.

Even while the European Union was complaining to the WTO about the homestyle exemption the United States were in the process of extending the exemption. In

1998 the US Fairness of Music Bill was brought into law and this refined and extended section 110(5) of the US 1976 Copyright Act. The new bill effectively restated the previous section 110(5) as 110(5)(a) with the inclusion of the words “except as provided in subparagraph (b)”. However, importantly, part (a) no longer applied to “nondramatic musical works” and therefore was restricted to the economically peripheral markets sector relating to musical performances in plays, musicals, operas and such like.

The decision to separate dramatic from nondramatic musical works deserves some reference. From an economic perspective, these works differ in terms of the relative revenues one may expect to generate from a bundle of copyrights. Specifically, and apart from film soundtracks, most dramatic works distinguish themselves from nondramatic works on two fronts. Firstly, a significant proportion of dramatic music compositions are in the public domain. Secondly, since the primary aim of most dramatic works is to be performed it may explain why the US Legislature was reluctant to eliminate a performance revenue stream for these acts; especially in cases of dramatic music that was not targeted at the CD consumer market. This latter feature will be revisited in section 3. However, for the present it suffices to remark that it may explain why in relation to dramatic music the authors of the Fairness of Music Bill were reluctant to extend the exemption beyond that defined in the old 1976 section 110(5). Namely, the fear that a reduction in revenue for this market segment may reduce creative effort to the detriment of the public interest.

Nondramatic musical works were now the exclusive focus of the redesigned statute in section 110(5)(b), which reads as follows.

"Notwithstanding the provisions of Section 106, the following are not infringements of copyright:

(B) communication by an establishment of a transmission or retransmission embodying a performance or display of a nondramatic musical work intended to be received by the general public, originated by a radio or TV broadcast station licensed as such by the Federal Communications

Commission, or, if an audiovisual transmission, by a cable system or satellite carrier, if -

(i) in the case of an establishment other than a food service or drinking establishment, either the establishment in which the communication occurs had less than 2,000 gross square feet of space (excluding space used for customer parking and for no other purpose), or the establishment in which the communication occurs has 2,000 or more gross square feet of space (excluding space used for customer parking and for no other purpose) and -

(I) if the performance is by audio means only, the performance is communicated by means of a total of not more than 6 loudspeakers of which not more than 4 loudspeakers are located in any 1 room or adjoining outdoor space; or

(II) if the performance or display is by audiovisual means, any visual portion of the performance or display is communicated by means of a total of not more than 4 audiovisual devices, of which not more than 1 audiovisual device is located in any 1 room, and no such audiovisual device has a diagonal screen size greater than 55 inches, and any audio portion of the performance or display is communicated by means of a total of not more than 6 loudspeakers, of which not more than 4 loudspeakers are located in any 1 room or adjoining outdoor space;

(ii) in the case of a food service or drinking establishment in which the communication occurs has less than 3,750 gross square feet of space (excluding space used for customer parking and for no other purpose), or the establishment in which the communication occurs has 3,750

gross square feet of space or more (excluding space used for customer parking and for no other purpose) and

(I) if the performance is by audio means only, the performance is communicated by means of a total of not more than 6 loudspeakers of which not more than 4 loudspeakers are located in any 1 room or adjoining outdoor space; or

(II) if the performance or display is by audiovisual means, any visual portion of the performance or display is communicated by means of a total of not more than 4 audiovisual devices, of which not more than one audiovisual device is located in any 1 room, and no such audiovisual device has a diagonal screen size greater than 55 inches, and any audio portion of the performance or display is communicated by means of a total of not more than 6 loudspeakers, of which not more than 4 loudspeakers are located in any 1 room or adjoining outdoor space ;

(iii) no direct charge is made to see or hear the transmission or retransmission;

(iv) the transmission or retransmission is not further transmitted beyond the establishment where it is received; and

(v) the transmission or retransmission is licensed by the copyright owner of the work so publicly performed or displayed."

Thus, the main effect of the Fairness of Music Bill was to extend the realm of the exemption – effectively to larger outlets. Prior to the Fairness of Music Bill, size of the venue was sometimes used as a means of assessing whether or not an exemption was justified. In such cases venues were unlikely to secure an

exemption if their size exceeded 1,500 square feet². Thus, the new Section 110(5)(b) embraced larger outlets than the original 'homestyle' exemption on two fronts. Firstly, it raised the square footage requirement to 3750 square feet for bars and restaurants, and to 2000 square feet for other outlets. Secondly, it allowed venues which exceeded these size constraints to be exempt on more lenient terms than specified in the original 1976 Act. Under the new Bill, music venues could use up to six speakers for an audio device and up to 4 televisions – terms that were less restrictive than the original 'homestyle' exemption which was generally limited to 4 speakers.

2.1 The Ruling of the Panel

In the resulting WTO dispute the EU built its case around the claim that the section 110(5) of the US copyright Act was in breach of Articles 11(1)(ii) and 11bis(1) (particularly to sub paragraph iii) of the 1971 Berne Convention. Furthermore, the EU argued that Section 110(5) was not justified given the exemption clauses covered under Articles 9 and 13 of the Berne Convention. Article 11(1)(ii) states that:

"Authors of dramatic, dramatico-musical and musical works shall enjoy the exclusive right of authorizing:

- (i) the public performance of their works, including such public performance by any means or process;
- (ii) any communication to the public of the performance of their works."

² The Panel states that "...in *Twentieth Century Music Corp. v. Aiken*, the Court held that an owner of a small fast food restaurant was not liable for playing music by means of a radio with outlets to four speakers in the ceiling. The size of the shop was 1,055 square feet (98m²), of which 620 square feet (56m²) were open to the public. In the evolution of case law, subsequent to the inclusion of the original homestyle exemption in the Copyright Act of 1976 in reaction to the *Aiken* judgement, US courts have considered a number of factors to determine whether a shop or restaurant could benefit from the exemption. These factors have included: (i) physical size of an establishment in terms of square footage (in comparison to the size of the *Aiken* restaurant)..." (Report of the Panel p.39).

Article 11*bis*(1) provides:

"Authors of literary and artistic works shall enjoy the exclusive right of authorizing:

(i) the broadcasting of their works or the communication thereof to the public by any other means of wireless diffusion of signs, sounds or images;

(ii) any communication to the public by wire or by re-broadcasting of the broadcast of the work, when this communication is made by an organization other than the original one;

(iii) the public communication by loudspeaker or any other analogous instrument transmitting, by signs, sounds or images, the broadcast of the work."

The criteria for a valid exemption are spelled out in Articles 9 and 13 of the Berne Convention and Article 13 of the TRIPS Agreement. Article 9(2) of the Berne Convention provides that exemptions to the reproduction right must not conflict with the objectives underlying the economic right

"It shall be a matter for legislation in the countries of the Union to permit the reproduction of such works in certain special cases, provided that such reproduction does not conflict with a normal exploitation of the work and does not unreasonably prejudice the legitimate interests of the author."

Article 13 of the TRIPS Agreement states things in a similar manner.

"Members shall confine limitations or exceptions to exclusive rights to certain special cases which do not conflict with a normal exploitation of the work and do not unreasonably prejudice the legitimate interests of the right holder."

Thus, the Panel proceeded by attempting to confirm whether or not the original homestyle exemption and the subsequent Fairness of Music Bill were within the confines of these articles. Both articles require 3 necessary conditions to hold. By implication they outline a 3-step test which nations should undertake in order to ascertain whether or not an exemption is within the terms of Article 9(2). The 3-step test requires that an exemption (1) applies only to special cases (2) does not conflict with the normal exploitation of the work and (3) does not unreasonably prejudice the interests of the right holders.

In terms of the Panel's view of the term 'normal exploitation of the work' they specified how this would be interpreted in law. In a prelude, the panel rejects the US argument that since work is embodied in a bundle of rights that normal exploitation must to some extent define rights in terms of their sequential economic importance. The Panel summarises the US view as follows:

"In the US view, it is necessary to look to the ways in which an author might reasonably be expected to exploit his work in the normal course of events, when one determines what constitutes a normal exploitation. In this respect, it is relevant that Article 13 does not refer to particular specific rights but to "the work" as a whole. This implies that, in examining an exception under the second condition, consideration should be given to the scope of the exception *vis-à-vis* the panoply of all the rights holders' exclusive rights, as well as *vis-à-vis* the exclusive right to which it applies. In its view, the most important forms of exploitation of musical works, namely, "primary" performance and broadcasting, are not affected by either subparagraph of Section 110(5). The business and homestyle exemptions only affect what the United States considers "secondary" uses of broadcasts, and that too, subject to size and equipment limitations. In the US view, right holders normally obtain the main part of their remuneration from "primary" uses and only a minor part from "secondary" uses." (p.45 of the Report of the Panel)

The Panel rejected this hierarchical view with reference to an argument that different investors may have acquired different sets of rights and hence one could not assume that a significant revenue stream for a particular work from one set of rights would compensate for an exemption in another right for the same work. Instead, the Panel altered the US definition to allow for this economic asymmetry and placed the justification for an exemption in the context of the incentive to invest in a work which has a composite of rights and revenue streams.

“We believe that an exception or limitation to an exclusive right in domestic legislation rises to the level of a conflict with a normal exploitation of the work (i.e., the copyright or rather the whole bundle of exclusive rights conferred by the ownership of the copyright), if uses, that in principle are covered by that right but exempted under the exception or limitation, enter into economic competition with the ways that right holders normally extract economic value from that right to the work (i.e., the copyright) and thereby deprive them of significant or tangible commercial gains. “(p. 48 of the Report of the Panel)

On the bases of these criteria, the panel takes the view that 110(5)(a) is within the confines of a special case as defined by the 3-step test while part B is not. Therefore, there would conceivably have been no necessity to subject Section 110 (5)(b) to steps 2 and 3 of the test. However, the Panel decided otherwise. They decide to consider both parts (a) and (b); perhaps with an eye towards likely arbitration which could then make use of the Panel’s analysis of 110(5)(b) under steps 2 and 3 of the test i.e. analysis dealing with the economic consequences of the exemptions.

The Panel found that 110(5)(a) was not in conflict with the normal exploitation of a work and hence passes step 2. The main reasons for this conclusion were that the Panel held that the homestyle exemption was limited enough in the first place in terms of the venues it covered. It also felt that the percentage of dramatic music played within the total repertoire of performed music would be so small as to be economically insignificant. In arriving at this view the Panel accepted the US argument that the Aiken exemption was economically limited in scope.

“The United States explains that, in considering the original homestyle exemption of Section 110(5), the US Congress found that, prior to 1976, the majority of beneficiaries of the then contemplated exemption were not licensed.³” (P51 of the Report of the Panel)

“The United States argues that the homestyle exemption of 1998 is even less capable of being in conflict with normal exploitation of works because its scope is now limited to works other than nondramatic musical works. While a collective licensing mechanism for nondramatic musical works exists in the United States, there is no such mechanism for "dramatic" musical works and there is little or no direct licensing by individual right holders of the establishments in question.” (p 56 of the Report of the Panel)

“It is our understanding that the parties agree that the right holders do not normally license or attempt to license the public communication of transmissions embodying dramatic renditions of "dramatic" musical works in the sense of Article 11*bis*(1)(iii) and/or 11(1)(ii)....In this respect, we fail to see how the homestyle exemption, as limited to works other than nondramatic musical works in its revised form, could acquire economic or practical importance of any considerable dimension for the right holders of musical works.” (p.57 of the Report of the Panel)

However, the Panel went on to find that Section 110(5)(b) did not pass step 2 of the test. Nondramatic performance rights were perceived as a significant body of rights that would normally be expected to be exploited. However, in many respects the dye had just been set for the Arbitrators' ruling - in arriving at this conclusion the Panel had also accepted the US view that the homestyle exemption did not significantly expand the effective number of exempt licences beyond the level that would have been normally licensed by PROs. Thus, had the Fairness of Music Bill not been passed, it is likely that Section 110(5) of the 1976 Copyright Act would

³ House Report (1976), Exhibit US-1.

have passed Step 2 of the test. However, The Panel did note the EU objection that European PROs' market penetration levels were far higher than their US counterparts.

“The European Communities responds that administrative difficulties in licensing a great number of small establishments do not excuse the very absence of the right, because there can be enforcement of only such rights as are recognized by law. It also points out that the use of recorded music is not covered by the exemptions. Arguing that this differentiation is difficult to justify, it contends that, to the extent the licensing of a great number of establishments meets insurmountable difficulties, then such difficulties should occur independently of the medium used. It also notes that the EC CMOs are successfully licensing a great number of small businesses without encountering insurmountable obstacles, whereas the US CMOs due to the lack of legal protection have not developed the necessary administrative structure to licence small establishments.” (p. 51 of the Report of the Panel)

In terms of the final step test relating to “not unreasonably prejudice the legitimate interests of the right holder” the Panel interprets this to mean to cause “an unreasonable loss of income to the copyright owner”.

We note that the analysis of the third condition of Article 13 of the TRIPS Agreement implies several steps. First, one has to define what are the "interests" of right holders at stake and which attributes make them "legitimate". Then, it is necessary to develop an interpretation of the term "prejudice" and what amount of it reaches a level that should be considered "unreasonable". (p. 57 of the Report of the Panel)

In interpreting the term ‘unreasonable’ the Panel refers to the economic welfare objectives of the law.

“The term "legitimate" has the meanings of

"(a) conformable to, sanctioned or authorized by, law or principle; lawful; justifiable; proper;

(b) normal, regular, conformable to a recognized standard type."

Thus, the term relates to lawfulness from a legal positivist perspective, but it has also the connotation of legitimacy from a more normative perspective, in the context of calling for the protection of interests that are justifiable in the light of the objectives that underlie the protection of exclusive rights.” (p. 58 of the Report of the Panel)

These welfare objectives of the law required the panel to consider the impact of the exemption on the optimal level of the creation and dissemination of new works. Given the difficulty in conducting such an analysis it is not surprising that the Panel did not carry it out. Nonetheless, the fact that the Panel found that section 110(5)(b) was an unreasonable prejudice against rights holders implies that they viewed it to have a welfare net detrimental effect on music creation and dissemination.

On these bases the Panel ruled that Section 110(5)(a) met the requirements of Article 13 of the Trips Agreement and hence was consistent with Articles 11*bis*(1)(iii) and 11(1)(ii) of the Berne Convention. In contrast the Panel found that Section 110(5)(b) did not meet these requirements and hence was in breach of the TRIPS agreement. As a result, the Panel recommended that the US amend its laws in order to comply with the TRIPS Agreement. However, among other things, the Panel was influenced by the fact that the burden of proof was on the United States to demonstrate that 110(5)(b) was exempt given the guidelines outlined in Article 13 of TRIPS. The Panel felt that in the process the United States did not offer concrete evidence to this effect.

2.2 The Arbitrators' Award

Both parties in the dispute subsequently agreed to move to arbitration for the purpose of identifying an adequate compensation payment for EU rights holders. The agreement was for compensation in lieu of legislative changes to US copyright. Later in December 2001, the EU and US agreed that the annual compensation identified by the Arbitrators would only hold for a three year period with the expectation that they US would subsequently amend its copyright law in order to comply with the TRIPS Agreement⁴.

The extent to which the Arbitrators' award has wider implications for other markets involving IPRs, will to a significant extent depend upon whether the US does in fact amend its law. Such an action would tend to assign a peripheral role to the Arbitrators' award in terms of deriving a long-term solution to an exemption which falls foul of the TRIPS Agreement. We now turn our attention to the Arbitrators' ruling and methodology.

A key area of concern for the Arbitrators was their desire to allow for the impact of transaction costs on social welfare when ascertaining an optimal settlement. Transaction costs associated with licensing venues for music performances consists of inputs such as policing, licensing, monitoring music use, redistributing revenue to rights holders, and prosecuting venues who infringe copyright. Transactions costs are significant and amount to around 12-20% of total PROs' revenues. In terms of their welfare implications, significant marginal transaction costs (incremental costs per licence) can imply that it is not economically viable to licence every music user. Thus, a distinction is immediately drawn between the number of outlets who *should* pay a licence if the law was to be enforced at its full potential, against the number of music users who *would* pay a licence fee in light of the fact that PROs will (in the presence of significant marginal transaction costs) not licence all venues. In light of this observation, the Arbitrators were keen to ensure that the EU was not compensated for licensing revenue that would, regardless of exemptions in the US copyright Act, not in any case be collected. They reasoned as follows.

“In this regard, the Arbitrators certainly appreciate the European Communities' point that, as a matter of US law, all users of copyright works by EC right holders *should* be licensed and *should* pay licensing fees. But is it reasonable, in the circumstances of the present dispute, for the European Communities to expect that all users of the works of EC right holders *would* be licensed and *would* pay licensing fees?” (p13 of the Award of the Arbitrators)

The Arbitrators continued.

“The United States submits that, in performing the aforementioned tasks, US CMOs incur substantial costs. The United States recalls in this respect that, in the United States, the potential base of users of copyrighted musical works - i.e., bars, restaurants and retail establishments - is wide, geographically dispersed and in almost constant change, as users continually leave and enter the market. From these considerations, the United States infers that it is not economically rational for US CMOs - which the United States says generally seek to maximize profits for the right holders they represent⁵ - to attempt to identify and obtain licences from *every* user of copyright works.” (p14 of the Award of the Arbitrators)

Of course, marginal transactions costs may also vary across firms in terms of their internal efficiency. If it could be argued that US PROs were inefficient then by definition their market penetration would be lower than EU PROs and hence by implication compensation should be higher. The Arbitrators clearly viewed this as a separate issue; arguing that the EU rights holders were at liberty to enter the US performance rights licensing market and licence their rights directly.

⁴ Mann, M. (2001) US fund to repay royalties to EU musicians, FT.Com, December 18 2001.

⁵ The United States also points out, however, that US CMOs themselves may, in some cases, be organised as non-profit organizations. The United States notes that this is true, for example, of ASCAP.

“In the view of the Arbitrators, it is clear that the exercise and enforcement of the rights conferred by Articles 11*bis*(1)(iii) and 11(1)(ii) would not be the responsibility of the United States but of EC right holders.”(p13 of the Award of the Arbitrators)

However, while one can understand the Arbitrators’ motivation it is clear that they misunderstood the long-term strategic dynamic force they were creating. As long as the Arbitrators’ compensation was ruled by the WTO as being a fair compensation for the US exemptions, there would in fact be no further incentive for the EU rights holders to enter the US market in order to licence directly. Simply, compensation, by legitimising the exemptions, eliminates scope to licence directly i.e. the compensation is in lieu of direct licensing. As a consequence, the specific market disappears! Therefore, the compensation eliminates an opportunity for European PROs to enter the US market in this licensing segment. As a result, the Arbitrators’ claim above was invalid. By definition, the Arbitrators’ ruling would eliminate scope for the EU rights holders to respond to inefficient licensing by US PROs. Furthermore, the compensation offered to the EU rights holders – which would become a permanent level for the duration of the compensation regime – would statically reflect the implicit transactions costs faced by US PROs at the time that the compensation levels are set. In other words, it not only prevents EU rights holders licensing directly but compensates them at a rate equivalent to a relatively low level of market penetration i.e. below that which they could secure had they the opportunity to licence directly⁶.

Surprisingly, these economic aspects were identified and indeed emphasised in the ruling by the Panel but seemed to have either been missed or ignored by the Arbitrators. Firstly, the Panel noted that using actual rather than potential losses ignores the likelihood that venues may switch from CD music to radio/TV in order to fall under the exemption. Therefore, estimates based on initial market share (before

⁶ This is obviously a concern given that electronic licensing will cause a major reduction in marginal transactions costs thereby enlarging the scale of venues that *would* be licensed in international markets without similar exemptions.

substitution effects have occurred) of purely Radio and TV music performances would underestimate the economic impact of the exemption (under section 110(5)(b) over a longer and more dynamic time horizon.

“Although these considerations do not render irrelevant the statistics and estimations on the numbers and percentages of establishments that may play music from different sources or no music at all, it is clear that such statistics and estimations have to be considered with the *caveat* that, although they may reflect realities at a given point in time, they do not take into account the substitution between various sources of music that is likely to take place in the longer term.” (p. 62 of the Report of the Panel)

In the second instance, the Panel emphasises the way in which an exemption based on actual losses can cause a disincentive for market entry thereby eliminating the possibility of exploiting potential revenue opportunities.

“We recall our conclusion that in the application of the three conditions of Article 13 to an exemption in national law, both actual and potential effects of that exception are relevant. As regards the third condition in particular, we note that if only actual losses were taken into account, it might be possible to justify the introduction of a new exception to an exclusive right irrespective of its scope in situations where the right in question was newly introduced, right holders did not previously have effective or affordable means of enforcing that right, or that right was not exercised because the right holders had not yet built the necessary collective management structure required for such exercise. While under such circumstances the introduction of a new exception might not cause immediate additional loss of income to the right holder, he or she could never build up expectations to earn income from the exercise of the right in question. We believe that such an interpretation, if it became the norm, could undermine the scope and binding effect of the minimum standards of intellectual property rights

protection embodied in the TRIPS Agreement.⁷ “ (p63-4 of the Report of the Panel).

We will return to the strategic incentives surrounding these issues later in sections 3 and 4.

In light of the distinction between licences that *should* and *would* be paid, the Arbitrators wanted to ensure that compensation was based on the latter calculation. This led the Arbitrators to favour the US method calculating the compensation level. The US used a top down approach, basing their calculation on the amount of revenue actually collected in the 1990s – almost 2 decades after the tenants of the homestyle exemption had been in US law. The EU attempted a bottom up approach estimating the number of venues that used music and then aggregating this to a total number of customers and then scaling this figure by both the music licence fees and estimated EU share of the US market for music performance. The Arbitrators were clearly concerned that the EU calculation method did not take on board the fact that not all outlets would be licensed due to marginal transactions costs. Therefore, they decided to rely more heavily on the US calculation method as this provided a more concrete view of the number of outlets that *would* be licensed.

“It is appropriate to start from the number of establishments actually licensed at the time of the entry into force of the 1998 Amendment because this approach offers the advantage of providing us with a starting point grounded on historical, verified facts, even if adjustments may have to be made to assess the level of benefits nullified or impaired on the date of referral of the matter to the Arbitrators.” (p22 of the Award of the Arbitrators)

However, in so doing, they give little weight to the fact that their benchmark of the number of outlets that would have be licensed was calculated for a period where the

⁷ In comparison, we recall that in relation to the second condition, we noted that a low level of licensing cannot be determinative of normal exploitation to the extent that it results from lack of legal protection or of effective or affordable means of enforcement.

homestyle exemption had been in force for over two decades. Thus, the Arbitrators used the historical information in a way which assumed that the Aiken exemption had no effect on the licensing revenues for EU music copyright owners.

“The Arbitrators note that their task is to determine the level of EC benefits nullified or impaired, not to assess the TRIPS-compatibility of any piece of US legislation. Within that framework, they also consider that the most appropriate way to assess the level of EC benefits nullified or impaired is to determine what EC right holders received before the enforcement of the 1998 Amendment – because historical figures are available with respect to that period - and adjust it as appropriate to take into account the evolution of the US market in the sector concerned.” (p23 of the Award of the Arbitrators)

The Arbitrators take some latitude in interpreting the WTO Panel’s investigation as providing clear unambiguous support for the notion that EU rights holders lost little revenue from the homestyle exemption.

“The Panel did not make any finding on the original homestyle exemption which, in any event, was no longer in force by the time it issued its report. However, in its analysis of the current Section 110(5)(A) and (B), the Panel did make a number of statements relating to the original homestyle exemption. The Arbitrators recall that the Panel noted the limited percentage of establishments covered by the original homestyle exemption, the restrictions imposed by Section 110(5) and, more specifically, the fact that "playing music by the small establishments covered by the exemption by means of homestyle apparatus has never been a significant source of revenue collection for CMOs."⁸ We note in this respect that the European Communities did not, either before the Panel or during these proceedings, sufficiently establish its claim that the economic impact of

⁸ Panel Report on *US - Section 110(5) Copyright Act*, *supra*, para. 6.271.

the original homestyle exemption was considerable.” (p.23 of the Award of the Arbitrators)

The Arbitrators interpretation is pivotal to the welfare implications that result from their ruling. We will return to this issue in the sections 3 & 4 and now continue to observe how this interpretation framed the formula used to calculate compensation for EU rights holders.

The Arbitrators’ top down formula was constructed on the basis of identifying the a share of actual US PRO licensing revenue which was at one time paid to EU rights holders for European music performances in restaurants, bars and retail outlets. The starting point for the calculation was to identify a benchmark period prior to the introduction of the Fairness of Music Bill. Since the Bill did not come into force until the 26th of January 1999, the Arbitrators use an average annual royalty revenue calculated by both ASCAP and BMI over the years 1996-98. This generated a figure of US\$55 million⁹. The next step of the calculation was to identify the share of this revenue that was attributable to the licensing categories covered by the Fairness of Music Bill. The Arbitrators achieved this in two stages. Firstly they isolated the percentage of total revenue due to the ‘general’ licensing category (18.45%) and then they ascertained the percentage of this (approximately 50%) that was due to the venues covered under the Fairness of Music Bill, namely restaurants, bars and retail outlets. They, therefore, arrive at a figure of US\$5.1 million per year.

The task now was to ascertain the percentage of this revenue that was due to the licensing category covered under the Fairness of Music Bill, namely music played through the use of radio and television.

“The next step is to determine what amount of the revenue collected from eating, drinking and retail establishments was attributable to playing radio and television music as defined in

⁹ The arbitrators took some simplifying assumptions in arriving at this figure due to data constraints caused by a lack of information from the societies.

Section 110(5)(B)...For this purpose, both parties use in their respective calculations a figure of 30.5% as representing the share of this revenue that is attributable to the use of radio and television music. This figure is based on data from the National Restaurant Association and the National Licensed Beverage Association.” (p32-33 of the Award of the Arbitrators)

Using this share, the Arbitrators arrive at an actual pre-Fairness of Music Bill licensing pool of US\$1.5 million. The final stages of the calculation then involved identifying the proportion of this revenue that would disappear as a result of the new exemptions. The Arbitrators first estimated the number of outlets that would be exempt due the size restrictions inherent in section 110(5)(b). Using a 1999 Dun and Bradstreet study they calculate that 53.9% of outlets are within the size limits for the exemption. Of the remaining 46.1% who are too large to be covered by the exemption the Arbitrators use the EU calculation that roughly 10% of these venues would use equipment which is sufficiently limited in capability so as to be covered under the terms of the exemption.

“As a result, we estimate that 58.5% of eating, drinking and retail establishments are within the scope of Section 110(5)(B), either by falling within the statutory size limits (53.9%) or, in case their size exceeds those limits, by complying with the statutory equipment limitations (4.6%), and thus benefit from the exemption contained in that Section.” (p34 of the Award of the Arbitrators).

The Arbitrators thereby arrive at their 1996-98 average annual loss of EU licensing revenue.

“This means that of the US\$1.55 million per year that EC right holders received from eating, drinking and retail establishments prior to the 1998 Amendment for the use of radio and television music, approximately US\$0.91 million was attributable to establishments that were newly exempted by that Amendment.” (p34-35 of the Award of the Arbitrators).

The last task for the Arbitrators was to index this loss in order to arrive at a compensation level appropriate for 2001. They decided to use US GDP growth rates over the intervening years 1998-2001 for the purpose.

“We have adjusted the above figure representing the hypothetical annual average of revenue that EC right holders lost as a result of Section 110(5)(B) at the level of 1997 with the annual growth rate of the US GDP. Accordingly, we calculate that the level of the EC benefits nullified or impaired as a result of Section 110(5)(B) is US\$1,1 million per year.” (p35 of the Award of the Arbitrators).

Thus, the final stage of the compensation measure is to compensate the EU at an amount exactly equal to the losses which the Arbitrators believe they would have received had the homestyle and subsequently the Fairness of Music Bill not been in force i.e. an amount equal to €1,219,900 or US\$1,100,00 per annum. It is important to point out that, regardless of any of the peculiarities of the Arbitrators' formula, that the compensation amounts to less than the revenue that *would* have been collected had these exemptions not been in law. In other words, it is compensation equal to net revenue (after all PRO administration fees had been deducted from EU rights holders revenues) and not gross revenue which would have been collected on behalf of the EU rights holders. As a result, the US is able to eliminate the transaction costs involved in the licensing and thereby reduce its total licensing costs as a result of the exemption. Moreover, as we noted above the transactions costs are factored in at 1996-98 PRO efficiency levels so that as is expected, if PROs become more efficient – reducing transaction costs – the gains from these productivity increases are not accrued by rights holders but entirely by the music users.

The full formula used by the Arbitrators is therefore summarised as

Compensation

= net revenue that would have been distributed to EU rights holders had the Fairness of Music Bill had not been enacted, given current US transaction costs and

PRO efficiency and also assuming that the homestyle exemption had negligible effects on licensing revenues

=

Average total licensing revenue remitted to EU rights holders by ASCAP and BMI

X

General licensing revenue as a percentage of the total licensing revenue

X

Restaurants, bars and retail outlets as percentage of general licensing revenue

X

Percentage of bars, restaurants and retail outlets playing music exclusively on radio and/or television

X

Percentage of bars, restaurants and retail outlets that would be exempt under the size criteria + the percentage of the remaining bars, restaurants and retail outlets that would have been exempt under the audio equipment criteria

X

An index based on GDP growth in order to convert the compensation to a comparable 2001 level.

= US\$55m X 18.45% X 50% X 30.5% X 58.5% X USGDP growth = US1.1million.

3 The Economics Of Copyright And The Arbitrators' Underlying Model

In this section we outline the wider ramifications of the arbitrator's ruling for performance in other intellectual property right (IPR) intensive markets in general. Our approach entails 3 stages of development. Firstly we outline our framework to explain how the economics of music performance copyright markets function and the inherent strategic incentives created by regulatory methodology. In this section we also outline how the performance of these markets affects social welfare. In the next stage we then explain how the Arbitrators' ruling impacts on this model; particularly in relation to its impact on strategic incentives. Welfare and efficiency implications are spelt out too. Finally, in the third stage, we compare this method of regulation to other approaches.

The economic framework draws extensively from Burke (2000)¹⁰. The basic premise of that paper was to investigate how legal structures such as national regulatory authorities and law courts affect the regulation of intellectual property rights. The analysis used the original Aiken exemption to illustrate the theory. Thus, it provides a good framework to analyse the implications of the Arbitrators award relating to the homestyle exemption and the subsequent Fairness of Music Bill.

Social welfare is measured with reference to the economic right of copyright only. The welfare objectives inherent in moral rights – which are not already encapsulated by economic rights – are for the most part ignored. As in the case of most regulation, the Arbitrators only concerned themselves with the welfare losses underpinned by the economic right. Thus, there is no divergence between the Arbitrators' perspective and ours in this area. However, it is worth pointing out that moral rights values are not being considered as this effectively assumes that the US infringement of the authors' music performance rights either had no damaging effect

¹⁰ Burke, A.E. (2000), Legal structure and strategic regulation of intellectual property: Who pays for R&D in arts markets? *Louvain Economic Review*, vol 66(2): 193-211.

on the reputation of authors or if it did that it did not warrant compensation. Nonetheless, the core of the WTO dispute between the EU and the US was the monetary loss due to the US exemptions and not damages to EU composers' reputations. In this sense, and without prejudice to potential moral rights infringements, our analysis only pertains to this emphasis of interpretation.

The economic right creates an exclusive right where authors have the right to administer and control copies of their works. The economic motivation for the right is based on the notion that this right is necessary in order to ensure that new works are produced in the first instance and made available to the public in the second. The aim is to enhance social welfare by ensuring that the public benefit by having access to as great a variety of useful works as possible at accessible prices (and terms). The commercialisation of authors' works is an important means of ensuring the authors have an incentive to create works and simultaneously to publicise and distribute these works to consumers. As a result, the economic right in copyright attempts to ensure that authors and other parties (such as publishers, record companies, retail outlets etc.) engaged in commercialising and disseminating the work to the public have a sufficient incentive to engage in these activities. The economic right is viewed as being crucial to the continuation of this process due to the financial threat that investors face from unauthorised copying – which can free ride on the investment costs incurred by the author and other suppliers when creating, processing, publicising and distributing the work. In so doing, unauthorised copying has the effect of depriving these suppliers of revenue and hence the chance to recoup investment costs along with a margin for profit. The fundamental economic logic of the economic right is that without the incentive which it creates there would be less new useful works produced and disseminated to consumers, thereby damaging social welfare.

Excessive Pricing. The extent to which a work is disseminated to the public in turn depends on the price charged to consumers and terms upon which works are made available. As a result, the social welfare objective of the economic right implies that the right ought to be conditional on meeting this objective. Therefore, authors frequently are obliged to engage in compulsory licensing where they may not refuse to supply consumers; especially where it may cause competitive imbalances in

downstream markets. In this way copyright law clearly overlaps with competition law – in this case with clauses relating to ‘refusal to supply’. In terms of pricing, the economic right seeks a balance between the interests of the author in producing a work and those of the consumer in being able and willing to pay for access to it. Thus arises the concept of excessive and inadequate pricing.

Excessive pricing occurs when social welfare could be enhanced by reducing price within a range where the incentive for creation and commercialisation would be sufficient to generate creative works but where the reduction in price would cause a greater level of consumer utilisation of creative works. Thus, ascertaining welfare maximising prices requires a knowledge of price elasticities and the rates of return required by investors in firms involved in the commercialisation process.

Inadequate pricing could occur, for example, when firms who have already engaged in sunk (irretrievable) investment in the creation and commercialisation of new works seek to minimise losses by cutting prices in order to attract custom away from other creative works. A market that regularly engages in this type of activity reduces the prospect of securing an adequate return on investment in the creation of new works and hence can deter future creation and dissemination of works. In this way it can damage social welfare.

However, the main regulatory challenge usually occurs with excessive pricing, namely trying to ensure that rights holders do not abuse the monopoly power conferred in copyright. This social welfare value perspective was at the core of the US Congress’s motivation for introducing the 1909 copyright Act.

“The main object to be desired in expanding copyright protection accorded to music has been to give to the composer an adequate return for the value of [422 U.S. 151, 164] his composition, and it has been a serious and a difficult task to combine the protection of the composer with the protection of the public, and to so frame an act that it would accomplish the double purpose of securing to the composer an adequate return for all use made of his composition and at the same time prevent the formation of oppressive monopolies, which

might be founded upon the very rights granted to the composer for the purpose of protecting his interests.” {H.R. Rep No. 2222, 60th Cong., 2nd Sess., 7(1909)}

This view is reflected again in the values adopted by the Court when introducing the Aiken exemption which subsequently motivated section 110(5) of the 1976 US Copyright Act. The Court took the view that

“The immediate effect of our copyright law is to secure a fair return for an “author’s” creative labor. But the ultimate aim is, by this incentive, to stimulate artistic creativity for the general public good. “The sole interest of the United States and the primary object in conferring the monopoly”, this Court has said, “lie in the general benefits derived by the public from the labors of authors”....When technological change has rendered its literal terms ambiguous, the Copyright Act must be construed in light of this basic purpose.” {Twentieth Century Music Corp. v. Aiken [422 U.S. 151, 157(1975)}

The Court went on to find that

“....to hold that [422 U.S. 151, 163] all in Aiken’s position “performed” these musical compositions would be to authorize the sale of an untold number of licenses for what is basically a single public rendition of a copyrighted work. The exaction of such multiple tribute would go far beyond what is required for the economic protection of copyright owners and would be wholly at odds with the balanced congressional purpose behind 17 U.S.C. 1(e).” {Twentieth Century Music Corp. v. Aiken [422 U.S. 151, (1975)}

These type of values were behind the Panel’s judgment when it undertook the third step of the 3-Step test in terms of ascertaining what would be an ‘unreasonable’ prejudice against the interests of the rights owners. Clearly, there is a view that an exemption which prejudice’s the rights owner’s interests is not illegal per se, rather

that in certain circumstances – namely when it is counter to the public interest – it is unreasonable.

Price Discrimination. This involves charging different consumers different prices for equivalent creative works. It is a popular practice among firms because it is a means of maximising revenue from a work. However, from a welfare perspective it can have a beneficial effect if it allows a supplier to drop prices to consumer groups with low willingness/ability to pay without having to drop prices to other consumers with greater willingness to pay. The ability to avoid losing revenue from higher willingness to pay consumers gives firms an incentive to supply more (lower willingness to pay) consumers than they would choose to do so should every consumer be charged the same price. Thus, in this way price discrimination can enhance welfare over and above that obtainable from uniform pricing. However, charging different consumers different prices can cause downstream imbalances if these works are used by firms who compete with one another. Thus, in such cases the practice is often banned under competition law. Interestingly, the impact of price discrimination which causes a reallocation of welfare from consumers to firms does not impact on the welfare analysis simply because the backbone of mainstream economic welfare analysis is agnostic when it comes to the issue of the distribution of welfare¹¹.

In the WTO case the US legal council attempted to justify the exemptions using welfare arguments which rely on the analysis of price discrimination. This is not surprising because targeted exemptions are in fact a form of price discrimination – allowing one group of customers to use the service for free while simultaneously ensuring that (most) higher paying customers continue to pay for the service. The

¹¹ Some exposition argues otherwise (for example, see Tirole 1989) but the key point here is that all arguments do not try to address the key issues that marginal rates of substitution used in welfare analysis are determined by consumer budget constraints. It is this feature which from a moral perspective makes this methodology questionable; especially when considering the ability to buy products necessary for basic survival. It is possible to alter the welfare function to allow for these effects but in standard economic analysis this is rarely done due to the ensuing debate that emerges. Economists prefer the easier option of identifying how total welfare changes without addressing the analytically more demanding normative task of assessing how welfare should be distributed.

United States claimed that exemptions were justifiable on these welfare grounds because many of the venues would not have been licensed in the first instance due to high transactions costs and secondly if they were subject to a licence fee some would just 'turn off' the music.

“The economic effect of the homestyle exemption was minimal even before the passage of the 1998 Amendment, and thus caused no unreasonable prejudice to any legitimate interests of EC right holders.....As noted by ASCAP, the establishments exempted by the homestyle exemption, with small square footage and elementary sound equipment, are the least likely to be aggressively licensed by the collecting societies and licensing fees for these establishments would likely be the lowest in the range. (ASCAP's letter introduced at the Judiciary Committee Hearings). Furthermore, given their size and that the playing of music is often incidental to their services, these establishments are among those most likely simply to turn off the radio if pressed to pay licensing fees. “{Oral Statement of the US at the first meeting of the panel – 8th of November 1999: Annex to the Report of the Panel}

Thus, a uniform price rather than a combination of a segmented market with zero and a positive range of prices, would in the US view have resulted in lower social welfare. In light of this background we now address the issue of how authors rights should be preserved and regulated in order to achieve the welfare objectives inherent in the law. It is first useful to do this from an idealist perspective in order to provide a utopian benchmark.

Simultaneous International Regulation Of Copyright Markets. From a theoretical standpoint, World social welfare can be maximised by choosing a distribution of prices across regions (and markets within regions) which generate the highest welfare. The analysis shows that this usually involves two features, namely prices are lower in regions that have higher price elasticities of demand (i.e. where consumer demand is very sensitive to price) and where willingness to pay is generally low. However, note carefully, that the motivation here has nothing to do

with egalitarian values of assisting those less well off – this is purely a means of maximising total welfare¹².

From an international regulatory standpoint, the aim of maximising World social welfare in cases where price regulation is needed would imply regulatory power to set prices across all relevant international markets. In this sense we call this regulatory ideal simultaneous price regulation where an international price distribution is set in a single event. It is important to point out that that this can involve some zero regulatory prices (i.e. copyright exemptions) in instances where willingness to pay is very low and where transaction costs are high.

The key point here is to understand that the incentive to create and commercialise any new work depends on the *cumulative* net profits generated from the *bundle* of rights involving the work. Thus, conceivably, if authors and investors in the commercialisation process make sufficient profits from a subset of the bundle of rights, there is potential to enhance welfare if price sensitive consumers are allowed access to the remaining rights at either low or zero price. Obviously the less revenue authors and investors can make from these rights the greater the scope to impose a welfare enhancing exemption. In fact, this is precisely the argument put forward by the United States. Namely, they simultaneously argued that there was no inconsistency in allowing exemptions and having a copyright system which effectively promoted creativity.

“The United States has one of the strongest systems of intellectual property protection in the world. Under the U.S. copyright system, copyright holders are granted a "bundle" of exclusive rights.

¹² In fact, if the optimal price structure involves zero prices in some regions then from a welfare perspective it is likely to be welfare maximising to give the ‘free’ products in the areas which have the highest willingness to pay (i.e. to consumers who derive the highest rate of marginal substitution with other products). The worrying feature from an egalitarian perspective is that low marginal rates of substitution may be due to low consumer income/wealth – especially when creative works are not necessities in terms of survival.

Specifically, Section 106 of the Copyright Act grants to right holders the exclusive right to do and authorize:

- (i) the reproduction of a copyrighted work;
- (ii) the preparation of derivative works based upon the copyrighted work;
- (iii) the distribution of copies of the copyrighted work to the public;
- (iv) in the case of literary, musical, dramatic, and choreographic works, pantomimes, and motion pictures and other audiovisual works, to perform the copyrighted work publicly;
- (v) in the case of literary, musical, dramatic, and choreographic works, pantomimes, and pictorial, graphic, or sculptural works, the right to display the copyrighted work publicly; and
- (vi) in the case of sound recordings, to perform the copyrighted work publicly by means of a digital audio transmission.

Section 110 of the Copyright Act provides for several limited exceptions to one of these exclusive rights – the public performance right. The exemptions in Section 110 include exceptions to the performance right for certain educational, charitable and religious uses, as well as the provisions challenged by the EC in this proceeding, Section 110(5)(A) and (B).” {First written submission of the United States – 26 October 1999: Annex to the Report of the Panel}

The problem of course with the ‘simultaneous regulation of copyright markets’ framework is that it does not reflect reality. In practice, no such dynamic and sufficiently resourced super-state international regulatory authority exists. The

divergence between the regulatory ideal and practice diverges on two fronts which we respectively denote as partial and sequential regulation. As we will see both of these features create strategic national incentives to regulate copyright in a way which favours the national over the global interest.

Partial regulation. The term partial regulation reflects the fact that regulatory power is largely confined to particular nations (or groups of nations such as the EU). Therefore, when it is invoked the jurisdiction of its power is nearly always limited to a subset of markets which relate to the intellectual property i.e. a subset of the relevant bundle of rights that influences (profits and hence) authors and investors' behaviour. The subset of relevant markets is a subset on two dimensions. In the first, it is a geographic subset i.e. only dealing with particular markets within the geographic jurisdiction of the regulator. Secondly, it is an sectoral subset in terms of the range of relevant markets it considers within this narrow geographic jurisdiction. For example, the regulation of a market for music performance rights will usually take the functioning of all other markets for the same rights (such as other performance markets and mechanical rights markets) as given when determining optimal regulatory action. It also takes the revenues received from music performance rights in other regions as given too. Thus, the regulator assumes that any author's income received from all the (copyright) markets outside the regulator's domain is given. Thus, in terms of regulating price in the narrow market/s under the regulator's jurisdiction, the issue becomes one of asking the question: given the income an author receives from all other markets for this creative work what remuneration (and hence price) is warranted in the market under the regulator's scrutiny? Clearly, if other markets or regions are generating sufficient profits for authors and investors then scope is created to offer a low or zero price for the use of these creative works.

Sequential Regulation. This is the second departure from the economic welfare ideal of simultaneous price regulation. It basically highlights the fact that for any given creative work the bundle of rights which determine the cumulative profits for authors and investors are regulated sequentially - some rights are not regulated at all and among those that are regulated, some are regulated before others. Which rights are regulated first depends on the activeness of the relevant regulatory

authorities and the vigilance in which consumers exploit opportunities to secure lower prices for creative works. In other words, given partial regulation, the fact that regulation occurs in a less than predetermined sequence creates strategic incentives for consumers get lower cost or free creative works. This occurs when the current profits derived by authors and investors from the remaining bundle of rights can generate sufficient profits for the creative process to continue. In other words, authors and investors are already getting reasonable (and from a welfare perspective fair) remuneration elsewhere.

In this manner, consumers and countries who vigilantly exploit this opportunity not only pass on the costs of creating, publicising and distributing new works to consumers in other markets in the same region and to other regions. In fact, if they lock consumers in these other markets into higher prices because subsequent regulation in these markets will take into account that authors and investors are receiving low or no revenue in markets which have already been regulated. Thus, they can ensure that their own consumers benefit disproportionately more from any creative work affected by the regulatory decision. Of course, if other countries mirror this practice there is danger that the incentive for authors and investors to generate new works is undermined – thereby damaging welfare. This fear was clearly in the mind of the EU Commission when deciding to take action on the Irish Music Rights Organisation’s complaint.

“Furthermore, given the allegedly unique character of the US trade practices challenged, it is in the interests of the Community to examine whether such practices constitute a dangerous precedent and example which could be adopted by other countries to the detriment of European authors and composers.” {The Official Journal of the European Communities (No. C1775, 11th June 1997)}.

The strategic element of who pays for the creation of new works and who gets these works for free is in many respects dependent on how the first mover opportunities inherent in partial and sequential regulation are exploited by consumer groups. Thus, in replies to questions by the WTO Panel, the US delegation argued that there is no clear reason why radio and television music performances should be exempt in

retail outlets while performance by CD should not. They merely point out that it only turned out this way because the *Aiken* case had effectively caused exemptions in radio and TV performances first.

“The United States does not argue that administrative difficulties in licensing small establishments are more severe with respect to broadcasts as opposed to CDs or live music. Part of the rationale for this distinction is a historical one. In the *Aiken* decision, the Supreme Court decided that a radio broadcast was not a public performance. When Congress overruled the rationale, though not the result of *Aiken*, in the 1976 Copyright Act by declaring that playing the radio was a public performance, it created an exemption to the exclusive right of public performance based on the fact pattern of the *Aiken* case (i.e., a small establishment of approximately 1055 square feet with limited receiving equipment). The equitable consideration that the copyright owner had already been compensated once is reflected in the legislative history of both Sections 110(5)(A) and (B). Congress thus determined to encourage small business by creating the exception, but at the same time limited the scope of that exemption to broadcasts. “{Responses of the United States to Written questions from the Panel – 19th of November 1999}.

Thus, the key point of the analysis is not that exemptions are not justified because as we have argued they are welfare optimal in some circumstances. The point is that partial and sequential regulation allows countries and consumer groups to successfully pass on the costs of creating and commercialising a creative work to consumers in other countries and other markets. Moreover, even if justified (i.e. there is scope from a welfare perspective to lower some prices without harming the creative process), it does so in a way which is likely to be sub-optimal from a welfare perspective. In other words, it prevents a more welfare optimal distribution of prices where other countries and regions – perhaps the poorest - share in those benefits. Thus, an exemption for music performance rights as defined in sections 110(5)(a) and (b) in the US reduces the scope to have lower prices in markets for music CDs, mechanical rights, phonographic rights, and other performance rights throughout the

World. Furthermore, it prevents the ability of countries outside of the USA to give their consumers similar welfare benefits as those conveyed in section 110(5)(a) and (b) in the USA. In sum, a strategic arena of passing off the cost of the creation of new works is promoted. We are now in a position to assess the full welfare implications of the Arbitrators' award.

4 Implications Of The Arbitrators Award For The Regulation Of IPR Markets

From a policy perspective, the aim of the Arbitrators' award and methodology should enhance welfare. The starting point of the analysis is the fact that the regulatory scrutiny of the Panel had come to the conclusion that a particular exemption was not valid under the conditions specified by Article 13 of the TRIPS Agreement. In other words, given the profits authors and other investors derive from the remaining bundle of rights for the particular set of works, the regulatory authority took the view that the creative process would be detrimentally hampered (from a welfare perspective) if the exempted rights were not reinstated. If one accepts this conclusion, then on this basis the welfare desirable effect of the Arbitrators' ruling should be twofold. Firstly it should compensate all authors and investors for the loss of profits resulting from the exemption so that the incentive to invest in the creation and commercialisation of music is restored. Secondly, it should ensure that if the Arbitrators' methodology is employed in other situations where copyright exemptions have been introduced, that it creates an incentive deter this activity or compensates authors and investors sufficiently to promote further music creation.

As stated at the outset, the scope of this paper does not entail reopening the Panel's ruling. Thus, we take the Panel's analysis of the market as correct. Therefore, we assume that the original homestyle exemption and Section 110(5)(a) are welfare optimal exemptions. Thus, the only distortion caused to the market is the reduction in the incentive to create and commercialise music as a result of Section 110(5)(b). The fall in net revenues caused by 110(5)(b) will affect all rights holders in these market segments. This includes authors and investors throughout the world (but mainly in the United States) who would have derived some net revenue from the performance of music on radio and TV in venues covered by the exemption. Therefore, the welfare objective of Arbitrators should be to try to redress the economic impact of this situation. Namely, to compensate these rights holders at a level equivalent to that which would have existed if copyright had been enforced – in the absence of section 110(5)(b).

Since the exemptions in Section 110(5)(b) were deemed to be welfare damaging by the WTO Panel then by definition the welfare costs of the exemption must exceed the actual loss incurred by all rights holders. On the basis of the Arbitrators' calculation - of 10% of the affected market being equivalent to US\$1.1 million – this implies an amount exceeding US\$11 million¹³.

Of course, the Arbitrators' award only compensates for losses suffered by EU rights holders. Therefore, by remit it can only partially redress the welfare losses identified by the Panel. Indeed the Panel noted that although the complaint was taken by the EU, their interpretation of the TRIPS Agreement was that the complaint ought to be viewed from the perspective of *all* rights holders¹⁴. This is also exactly what the economic welfare analysis would recommend. However, the means by which a move to Arbitration was facilitated by WTO legal structure implies that this welfare optimal regulation did not occur.

We can get some idea of how deficient the power of the Arbitrators was by referring to the EU rights holders' share of the markets covered by Section 110(5)(b). In the submissions to the Panel, the United States argued that the EU share of the US performance market was in the region of 5-6%. In contrast the EU claimed that it was approximately 25%. If, for example, the EU share was somewhere between these levels at 10% of the relevant markets, then on the basis of the Arbitrators' award (that EU rights holders should be compensated to the tune of US\$1.1 million per annum), it follows that there is an outstanding amount due to other rights holders

¹³ If they were equal or less than US\$11 million the exemption would be justifiable because then it would save users of music (who are exempted) by at least US\$11 million – and arguably more when one considers that licensing administration costs are passed onto consumers. Therefore, in this instance the redistribution of welfare from rights holders to music users would cause an increase in total welfare.

¹⁴ “But we cannot find any indication in the express wording of the third condition of Article 13 that the assessment of whether the prejudice caused by an exception or limitation to the legitimate interests of the right holder is of an unreasonable level should be limited to the right holders of the Member that brings forth the complaint. For such a limitation to exist, the third condition of Article 13 would have to refer exclusively to the right holders who are nationals of the complaining party, not to “the right holder” as such.” (p.60 of the Report of the Panel).

equivalent to US\$9.9 million. Alternatively, if one were to accept either the US estimate of 5.5% or the EU estimate of 25% of EU Share of the US market then the outstanding amounts would be US\$20 million and US\$4.4 million respectively. Thus, it is clear that the compensation is not adequate to correct the welfare-damaging effects of the exemption. Before we look at the strategic regulatory incentives and their associated welfare implications, we will make another observation.

The compensation level was set equal to an estimate of the royalties that would have been paid to EU rights holders had the Fairness of Music Bill not been enacted. In arriving at this estimate the Arbitrators used the *net* revenues that would have been redistributed to EU PROs. In other words, revenues which were net of the administration costs that would have been incurred by ASCAP and BMI. If in fact, the exemption did not exist and payments were made to EU PROs, then these would have been based on some sampling of US venues covered by the Fairness of Music Bill. This would in turn provide EU PROs with information concerning the relative frequency of music use which they could then use to redistribute these revenues to rights holders in proportion to music usage. Since use of net revenues removes ASCAP and BMI from the picture, it transfers the cost of assessing US music usage to EU PROs who otherwise will not know how to redistribute the revenue. Thus, licensing administration costs are transferred from the US to the EU. Since EU rights holders receive revenues net of US PRO administration costs they in turn have to bear some of these costs. Thus, since this will entail a further reduction from the revenues received (in the form of a lump sum compensation fee) it follows that in order to redistribute revenue appropriately to rights holders it implies that EU rights holders are not adequately compensated.

Combining these two features we generate some concerning welfare implications of wider use of the Arbitrators' compensation methodology.

Firstly, if a country or consumer group can replace an effective copyright by an 'exemption plus compensation for foreign rights holders' then it will always choose to do so. The saving to the market in which the exemption applies is equal to administration costs plus the

number of rights holders who are not party to the resulting complaint. In the case of the Fairness of Music bill these savings have at least exceeded 75% of the cost of effective copyright¹⁵. Thus, the Arbitrators' compensation methodology creates a huge incentive for regulators and consumer groups to seek to introduce copyright exemptions.

Secondly, noting that WTO Panel found that the music copyrights were valid for this particular set of rights (i.e. that these rights were economically valid in ensuring a welfare optimal level of music creation and commercialisation) it follows that the strength of the incentive to opt for an exemption plus compensation rather than enforce copyright is detrimental to welfare. In other words, it reduces the total revenue which affected rights holders may expect to receive from the creation and commercialisation of musical works. Therefore, if one assumes that the Panel's analysis is correct, then the Arbitrators' ruling would be expected to cause a significant increase in the number of exemptions which have detrimental consequences to the creation and commercialisation of new works.

The implication is simple. The Arbitrators' compensation methodology does not fully compensate affected rights holders for the exemption. The total revenue an investor in an affected bundle of creative works will receive is less under the 'exemption plus compensation' than in the case where copyright is enforced. If one concurs with the Panel's view that the exemptions are not compatible with the conditions (relating to valid exemptions to economic welfare) defined by Berne Convention and the TRIPS

¹⁵ One might argue part of this proposition may not always hold as other rights holders from countries outside of the EU will seek similar compensation. At the time of writing rights holders in both Argentina and Australia were following the case closely. However, it should be noted that the smaller the economic value of the rights holders in any country the less likely that national and global regulators will feel that the regulatory expense of pursuing these interests is justified. Thus, not all regulators are likely to act. In this regard, it is noteworthy that the original complaint to the EU by the Irish Music Rights Organisation was only taken up by the EU conditional on the IMRO receiving support from all the PROs in other EU Member States.

Agreement then this reduction in the return on investment will be detrimental to World economic welfare.

It is noteworthy that while it may be detrimental to World welfare the fact the benefits from the exemption are captured by the country/market creating it, implies that welfare will rise in this segment of the global population – hence the strategic nature of the exemption. Thus, the exemption causes a reallocation of World welfare towards the country or market introducing the exemption. Not surprisingly, this may trigger retaliatory responses from regulators in other territories; especially if they feel that compensation is inadequate.

Thus, one of the dangers of the Arbitrators' award – and perhaps indeed from any form of compensation that is viewed as derisory from foreign rights holders' perspective – is that it is likely to encourage escalation of the this welfare damaging practice. Furthermore, it may in addition cause retaliation in the form of exemptions in areas which might hurt the initial protagonist. Thus, the introduction of an exemption could ignite a chain reaction which undermines copyright.

Thus, it is clear that when the enforcement of copyright is welfare optimal, then enforcement is preferable to compensation that is inadequate and perhaps even in cases where it is adequate but where it is nonetheless viewed as unfair by rights holders in other nations.

This same strategic dynamic could also explain why there did not appear to be a convergence of interests across all music rights holders. It may explain why the GESAC dominated complaint to the EU Commission did not receive wide scale support from EU music publishers owned by the major record companies who appeared to have a lot to gain through enforcement of their publishing rights which were eliminated by 110(5)(b). One reason for this may stem for the fact that there is always the possibility that a set of creative works are overcompensated (from a welfare perspective) in terms of the revenues received from the bundle of rights and markets. Had the EU lost the case on the basis that music rights were overcompensated (so that the Fairness of Music Bill could have been justified under

Article 13) it may have caused similar exemptions or price regulation of other music rights (for example mechanical rights). Furthermore, the Panel's analysis might have drawn attention to the possibility that welfare could be enhanced if the distribution of prices across all relevant rights was currently sub-optimal from a welfare perspective. To put this into plain words, the analysis might have highlighted that revenue from mechanical rights markets were excessively high and were in effect subsidising music use in the performance markets. As a result, it may have opened an investigation into the possibility that welfare could be enhanced if CD prices were lowered with a concomitant compensatory trade-off of higher prices of performance rights markets. This could have been detrimental to the EU publishing houses owned by major record companies whose interests are dominated by revenues from the CD market. Hence, one could postulate that they may have been reluctant to stir up a debate relating to the welfare optimal distribution of prices across a bundle of rights for music. Thus, one of the key aspects of sequential and partial regulation – such as the Fairness of Music bill – is that it can set different rights holders against one another.

One of the dynamic objectives of the economic right in copyright is that it tends to focus creative energies in areas which are most valued by consumers. Thus, in any subsector, creative works that are used more by consumers are generally compensated proportionally more than less popular works. This is the essence of the objective (if not in most cases the practice) of PROs sampling and distribution systems. However, elimination of a market with a corresponding compensation based on revenues net of PRO administration charges implies that the discrepancy between actual frequency of music use and distribution of revenues is exaggerated. This implies that there is greater uncertainty and hence risk involved in securing income for a work which relies on compensation from an exempt use rather than from enforced copyright. It follows that investors would require greater rates of return to compensate for this risk. The Arbitrators' ruling which uses net revenues has potential to both create this crisis and not compensate for it. Thus, it creates a further economic force which is likely to reduce investment in the creation and commercialisation of new works. It is important to point out that whether or not the EU PROs can easily overcome this or not (by freely accessing TV and radio playlists from ASCAP and BMI broadcast licensing activities) does not undermine the

generality of this conclusion. Namely, that as far as the regulation of other markets for IPRs are concerned, benchmarking compensation on the Arbitrators' methodology involves the scope to ignore this potential problem.

We now move onto another strategic feature of the Arbitrators' ruling. Namely, the focus on transaction costs and the differentiation between rights that *would* have been licensed versus rights that *should* have been licensed. Economic welfare interests imply that the Arbitrators were right to consider transaction costs. However, their welfare analysis of these rights was extremely static i.e. emphasising short run effects only. As we observed above transaction costs are affected by the efficiency of the PROs (in this case ASCAP and BMI). However, they are also affected by the legal and regulatory support for copyright by governments. Consumers are more likely to agree to pay for a copyright licence when the penalties for not doing so are high and where they understand the economic role of copyright. Both of these factors are influenced by government policy toward copyright.

The penalty for breach of copyright is determined by the magnitude of the penalty along with the probability that an unauthorised music user will be caught and prosecuted successfully. Thus, a legal system which is more hostile to collective licensing by both allowing exemptions in response to some prosecutions (e.g. the Aiken case) or condemning the internal efficiency of collective licensing organisation (e.g. the condemnation of ASCAP in the Alden-Rochelle case and subjecting it to consent decrees) arguably presents an environment which can deter market licensing activity and promote consumer resistance to pay licence fees. Thus, in this type of environment licensing activity could become difficult for a PRO as it faces the risk of causing an exemption should it seek to prosecute an unauthorised music user. Furthermore, legal costs raise administration costs which in turn leave it open to further condemnation from a regulatory authority – thus further raising the risk of prosecuting an unauthorised music user.

Simultaneously, consumers realise that PROs are less enthusiastic about licensing and hence the probability of being prosecuted falls; thereby encouraging more resistance to take up licences. A scenario results where the transaction costs of licensing are raised. Cumulatively these effects can cause PROs to limit market

penetration. In effect, PROs choose to licence consumers who are more willing to pay and are large enough to cause low percentage administration costs. In contrast a country with a more supportive attitude towards copyright enforcement, a tolerance of PRO administration costs and a lower tendency to grant exemptions will create an environment where licensing is easier and cheaper. Therefore, market penetration and licensing revenue is likely to be greater for any equivalent market.

With this background, we can now see how the Arbitrators' static view of transactions costs can cause some long term incentives for public policy.

Since the Arbitrators' compensation formula emphasises who would have been licensed as against who should be licensed, it follows that a nation can in fact reduce the cost of introducing an exemption by creating a market which is difficult to licence in the first place. In other words, the lower the actual legitimate market penetration prior to the exemption the lower the compensation that would need to be paid to rights holders.

To put this starkly, if for example one is to assume that the EU is more supportive of the rights holders interests in copyright than the USA then the following asymmetry is caused. Suppose the EU introduced a similar exemption to section 110(5)(a) and (b). Then, for an equivalent use of music in an equivalent European market the EU would pay higher levels of compensation to US rights holders than the US does to the EU for the same exemption. In other words, an asymmetry results in terms of appropriate penalties each region must pay for the same welfare damaging exemption and this is caused by the asymmetry in the countries' relative support for copyright.

Thus, to recap, countries whose policies are more hostile to copyright, *ceterus paribus*, pay lower compensation to rights holders for welfare-unjustifiable (as specified in Berne and TRIPS) than a country whose policy generates a more supportive environment. Given that the Arbitrators' award already creates a bias to introduce exemptions that are damaging to welfare, this new feature implies that countries intent on introducing such exemptions will have an ability to reduce the

resulting level of compensation by altering its institutional support for copyright beforehand – further increasing the incentive to introduce welfare damaging exemptions. Thus, in doing so it also creates a further incentive to fundamentally undermine a proportion of its institutional support for copyrights that are in existence.

This whole scenario is worrying considering that compensation is only paid if exemptions are actually challenged by rights holders. Thus, for example, the US legal team cite other exemptions in other markets – demonstrating the extent to which it is possible to erode IPRs at the edges – which almost go unnoticed and hence are very unlikely to draw strategic retaliation. Thus, the payoff facing a nation is a welfare gain if the exemption goes unnoticed and now as a result of the Arbitrators' ruling, faces a welfare gain if it is noticed and challenged successfully. In sum, a scenario seems to emerge where a country's dominant strategy is to introduce exemptions which may damage world welfare but not sufficiently so in order to ensure a net welfare gain for the country itself.

As we noted earlier in the report, the Arbitrators' static view of transactions costs also in effect lock the market into these historic transactions cost levels even though entry of more efficient PROs or advances in technology could potentially cause their reduction. Thus, a temporary lapse of a specific market for copyrights into inefficiency – caused either by inefficient firms or institutional support for copyright – can become a permanent implicit feature if regulatory authorities resolve to replace copyright by exemptions and use the Arbitrators' award to compensate rights holders.

5 Conclusion

The paper analysed the economic welfare implications of the Arbitrators' award following the WTO Panel's ruling on the exemptions contained in Section 110(5)(a) & (b) of the US Copyright Act. It examined the extent to which the Arbitrators' award redressed the welfare costs of the exemption as defined by the analysis of the WTO Panel. The analytical approach of the paper was to examine both the direct impact of the ruling on affected music rights holders and also to identify the ramifications for subsequent TRIPS disputes (and IPR markets more generally) where the Arbitrators' methodology might be used as a benchmark - and as a means of choosing adequate compensation (this is particularly likely given that this was the first dispute involving copyright exemptions considered under TRIPS). Throughout the report we assumed that when we referred to the Arbitrators' award we meant both the discretion taken by the Arbitrators as well as the constraints placed on their choice by the legal structure under which they were operating. Our argument was based on an understanding that welfare is affected by both influences.

The main findings of the paper indicate that from a welfare perspective (as depicted by the analysis of the WTO Panel) the Arbitrators' award does not adequately compensate rights holders for the loss of revenue that is being caused by the section 110(5)(b) exemptions. From the perspective of the conclusions of the analysis carried out by the WTO Panel, the Arbitrators' methodology would be expected to have a detrimental affect on investment in the creation and dissemination of new musical works – to the detriment of rights holders and the net detriment of consumers.

Furthermore, we find that the Arbitrators' award is likely to increase the incentive for countries and consumers across the globe to introduce exemptions which fall foul of the global welfare objectives of the TRIPS Agreement. In effect, the Arbitrators' ruling implies that increasingly it will be in countries interests to replace copyright enforcement by 'exemptions plus compensation'. Furthermore, a long term incentive is created where countries can reduce future compensation levels by introducing a harsh domestic environment for copyright enforcement through pursuit of a lack of

governmental support for copyrights and their enforcement - thereby raising transactions costs for rights holders.

Simultaneously, the greater the lack of revenues for creative works due to exemptions the greater the need for countries and markets who do enforce copyright to compensate for this lack of external revenues by charging higher prices and supporting extensive enforcement of copyright.

Thus, if the Arbitrators' award is used as a generic compensating methodology in other markets for intellectual property rights, it has potential to escalate the realm of welfare-unjustifiable copyright exemptions. Furthermore, it has potential to ignite exemption races where countries rush to introduce an exemption while it can still be justified to some extent by revenues in markets (in other countries) where no exemption currently exists. Simultaneously, rights holders may inspire domestic regulators to retaliate to exemptions in foreign markets by introducing exemptions in home markets; thereby sparking intellectual property right trade wars.

Thus, in sum the Arbitrators' award impacts directly on a generic welfare question relating to intellectual property rights. Who actually does pay for new creative works and who should pay? In this case questions arise of whether it is justifiable that per capita EU consumers subsidise US consumers in terms of contributing more to new music creations motivated by revenues from music performance markets. Similarly, it affects issues relating to compensation across markets (even within a region). For example, should consumers of CDs subsidise retail outlets such as bars and restaurants who use the same music?

In sum, the paper concludes that this state of affairs causes an international strategic arena which involves the passing-off of the cost of the creation of new works to other nations and markets. The outcome can be damaging to welfare and unfair in terms of its impact on the distribution of the benefits of creative works across global consumers. One should not be surprised to find that it is unacceptable to countries who are the losers in this strategic win-lose environment. It is unlikely to be the basis for a robust, fair and acceptable international trade environment for creative works involving intellectual property rights.