CFA
Consumer Federation of America
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April 9, 2012

Herbert Kohl, Chairman,
Michael S. Lee, Ranking Member
Subcommittee on Antitrust, Competition Policy and Consumer Rights
United States Senate, Committee on the Judiciary

Dear Senator Kohl,

As you are no doubt aware, recent statements by the Acting head of the Antitrust Division of the Department of Justice (DOJ) and press accounts indicate that the DOJ is taking action against the e-book pricing strategy adopted by five book publishers and Apple. The one voice that is absent in those accounts is the voice of consumers who ultimately pay the price and the one perspective that is missing is a careful consideration of the economics of digital distribution. As the name of the Committee suggests, we believe the antitrust laws are the first line of consumer protection in our economy. We also believe that the committee should give close attention to the e-book price fixing case. When it does, we are confident the Committee will find that vigorous action to stop this abusive practices is in order.

E-BOOK PRICE FIXING VIOLATES THE ANTITRUST LAWS AND HARMS CONSUMERS

Our analysis of the practices described in the publicly available accounts leads us to conclude that they constitute anticompetitive, anti-consumer collusive price fixing. Under current antitrust practice an individual firm's efforts to set a minimum retail prices is subject to a case-by-case rule of reason test. (We think it should be *per se* illegal, but that is a different issue.) Even in a case-by-case environment, collusion between firms to set minimum prices is 'slam dunk' illegal, especially when one of the first effects of the price fixing, after increasing consumer cost, has been to raise publisher profits. No self-respecting antitrust official could let this pass unchallenged.

Notwithstanding the complaints of the publishers and a few, celebrity authors, vigorous action to block the price-fixing scheme will be good for consumers and the vast majority of authors. This year the cost to consumers of e-book price fixing will likely exceed $200 million and the abuse will grow dramatically, if the Department of Justice does not take action to stop this practice. The current magnitude of harm is more than enough to merit antitrust attention.

DIGITAL "DISINTERMEDIATION"

CFA has been active across a broad range of issues that involve the digital revolution, with a particular emphasis on how "digital disintermediation" has increased efficiency in distribution and benefited consumers in many markets including digital content industries, like music, newspapers, and video, as well as physical space industries such as automobiles and the Internet of Things. We believe that the e-book price fixing comes at a crucial moment for both antitrust and the development of the digital economy.

The Internet and the digital technology on which it rides are coming to maturity, after about 20 years of development in commercial applications. Unlike many other disputes over digital distribution of content, this one does not involve claims of piracy or concerns about privacy. It is entirely about efficiency and tactics that are intended to squelch competition from a more efficient, consumer-friendly approach to the production and distribution of products. Stopping this practice will send a strong signal that physical space incumbents will not be allowed to use anticompetitive practices to distort or undermine emerging digital alternatives.

In the mature, advanced industrial society of the late 20th century, distribution and transaction costs came to represent a large share of the total costs of goods and services. In the content industries, like book publishing, music and newspapers, transaction costs are as much as 80 cents on the dollar. Digital technologies can lower production and distribution costs and give consumers much greater flexibility and choice, thereby dramatically improving the fit between what is produced and what is consumed. Digital technologies also help the great mass of content creators and artists by expanding the market and making it easier to directly reach the consumer.

Digital "disintermediation" is a powerful force for change and cost reduction that challenges the business models of the dominant incumbent firms because it dramatically reduces the need for middlemen. As technologies lower the cost of production and distribution, a scrum develops over the social surplus that is released. The sellers of information goods seem to think that because consumers were willing to pay a high price for their physical products in the past, they can keep the price high for digital products and pocket the cost savings as increased profit. However, in vigorously competitive industries (i.e. with large numbers of buyers and sellers and high elasticities of supply and demand), the vast bulk of the cost savings will be passed through to consumers. That is the why the antitrust laws are the front line of consumer protection.

In sector, after sector we see the incumbents using their market power, economic resources and political clout to try to slow and distort, if not stop, the transition to digital distribution. Their goal is to ensure they have a large role to play and capture as large a part of the cost savings as they can. The dominant incumbents are powerful, particularly in the information industries where they have disproportionate influence over the political dialogue and the content of culture. In the e-book space, the pricing fixing strategy had its intended effect, swiftly driving up the cost of e-books.

E-BOOK PRICE FIXING DOES NOT PASS THE ANTITRUST SMELL TEST

Claims that this collusive price fixing scheme is an efficiency enhancing strategy do not stand scrutiny. The publishers and authors present two classic efficiency claims to defend their practice (Scott Turow: Grim News, *The Authors Guild,* March 9, 2012). They argue that it prevents the dominant firm from pricing in a predatory manner to undermine competition, particularly from physical space book stores. They also claim that book stores are vitally necessary to preserve an efficient marketplace for books and a cross-subsidy from e-book readers to physical book readers is necessary to do so.

Discounters offer consumers economic benefits and high price incumbents always complain about them. In a sector with rapidly declining costs, falling prices reflect efficiency. Arguments against them bear a heavy burden. The publishers and celebrity authors have not come close to meeting the burden

Efficiency

Defenders of the price fixing scheme claim that the sector will be less efficient if online sales undermine the distribution of physical books. The argument is that physical book stores are vital to the functioning of the sector because it is the only way for readers to discover new books and unknown authors. The claim is that readers encounter new books when they browse the shelves in physical space book stores and it is the lucky, unknown authors who happen to be on the shelves that the browsers stumble upon.

In the digital age there is a much more efficient way for browsers to examine many more books of many more authors. They can use Internet browsers to search for books in cyberspace. Moreover, cyberspace lowers transaction costs so much that authors can, unlike in physical space, find their audiences directly, without having to rely on publishers. Needless to say, by cutting out the middleman they dramatically increase their income from selling books.

As online distribution for many goods and service has grown, physical networks have become smaller. Physical goods play a smaller part in the post-digital market and serve customers with specific needs and desires, while the vast majority of consumers benefit from digital distribution. Consumers who are willing to pay for physical goods and value the services of bookstores can and will support those stores. Publishers fixing prices is not the way to find the efficient division of labor between physical space and cyberspace distribution.

The examples where online distribution played an important role in transforming the market are familiar – music, Tower Records; computers: CompUSA; electronic devices: Circuit City; video cassettes, Blockbuster; books, Border; newspapers, too numerous to name. Rescuing the remnants of the inefficient, brick and mortar distribution network would be a full time undertaking that imposes massive costs on society. Whether these distribution networks deserve to be subsidized by the public should not be decided by anticompetitive actions of private corporations.

Predatory Pricing

A claim of price predation must show that the product is being sold below cost with the intention of driving competition out of the market (or preventing it from entering) and later increasing prices to make up the loss. Predatory pricing is an important antitrust complaint that is frequently made by high-priced incumbents against discounters and new entrants. It is difficult to prove and the remedy is not the formation of a private cartel to raise prices. For several reasons, the predatory pricing arguments offered by the publishers and celebrity authors are implausible at best, flat out wrong at worst.

First, the defenders of the price fixing scheme point to the wrong costs as the predatory threshold. They use the wholesale cost of delivering physical books to brick and mortar retailers not the cost of delivering digital books to e-tailers. The physical cost is far above the digital cost, so the publishers are pointing to a price that embodies an effort to capture a great deal of additional rent.

Second, the defenders of the price fixing scheme would have to show that the price of the bundle of e-readers and e-books, not just the e-books alone, is below the cost of the components of the bundle of hardware and software. Pricing of e-readers and e-books exhibits a strategy that is the obverse of a standard physical space marketing strategy popularized over a century ago by Gillette – selling the razor at a low price and making bigger margins on razor blades. The pricing strategy of discounting strong complements not only has a long history in our capitalist economy, it is common in the digital space.

Third, a plausible case would have to be made that there is a pricing strategy to recover any losses in a time frame that makes predation profitable. The behavior of the e-book product space does not suggest that this is likely. Prior to the price fixing scheme, anticompetitive tactics, like demanding exclusive deals or most favor nation clauses were not prevalent. Economies of scale and clever marketing are not suspect practices. Digital markets frequently manifest winner-take-most outcomes. This can be a concern, if the markets do not also exhibit rapid entry and exit and declining prices. Stable low prices for e-books and declining prices of e-readers typified the product space; at least until the price fixing scheme was instituted. This makes it difficult to execute the final leg of the predatory strategy.

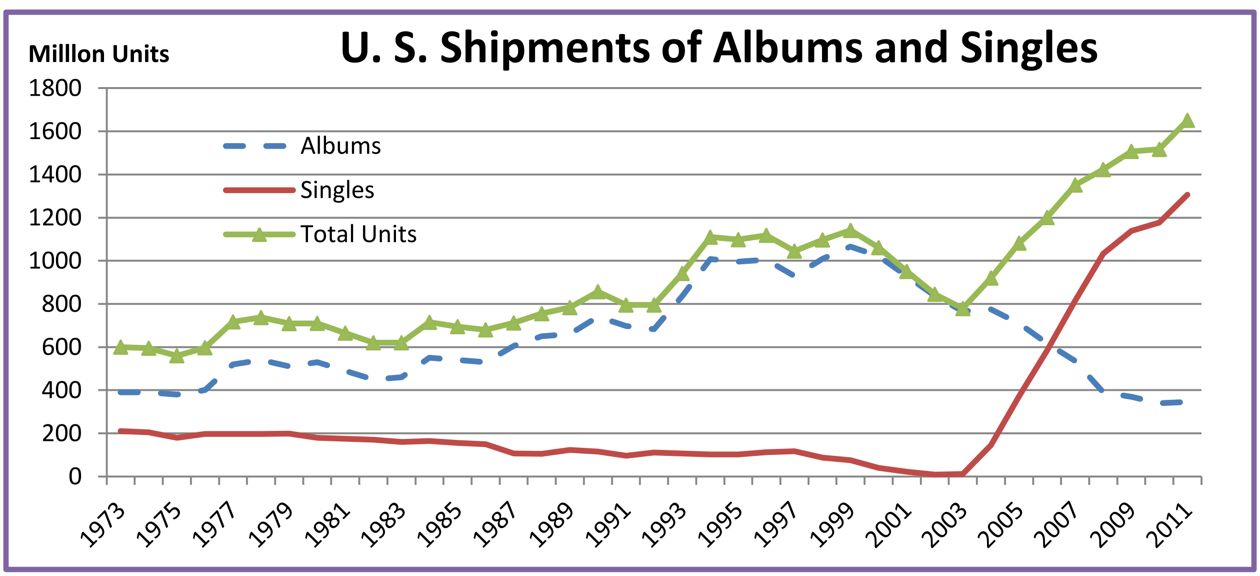
THE CONSUMER BENEFITS OF DIGITAL DISINTERMEDIATION

In sector after sector, we hear the same complaints over and over – digital distribution will eliminate physical distribution, creativity will be stifled and sales will decline. The opposite occurs. Digital distribution replaces part of physical distribution and the output expands, while efficiency squeezes the margins of intermediaries.

Digital Music

The consumer experience in the music space, the first sector that went through the process of digital disintermediation, provides evidence of the economic benefits. The dramatic explosion in sales of singles is testimony to the ability of digital technologies to deliver exactly the type of product that the consumer desires.

In the mid-1990s, record labels engaged in two practices that imposed severe harm on consumers. They adopted a price fixing scheme to keep album prices high, even though the new compact disc (CD) format dramatically lowered their costs. They eliminated the sale of singles, even though the CD was well- suited for the sale of singles. In short, they restricted output and raised prices, forcing consumers to purchase hundreds of millions more overpriced CDs to get the music that they wanted. The parallel in the e-book price fixing is clear. Publishers raise the price of e-books to prop up sales of physical books.



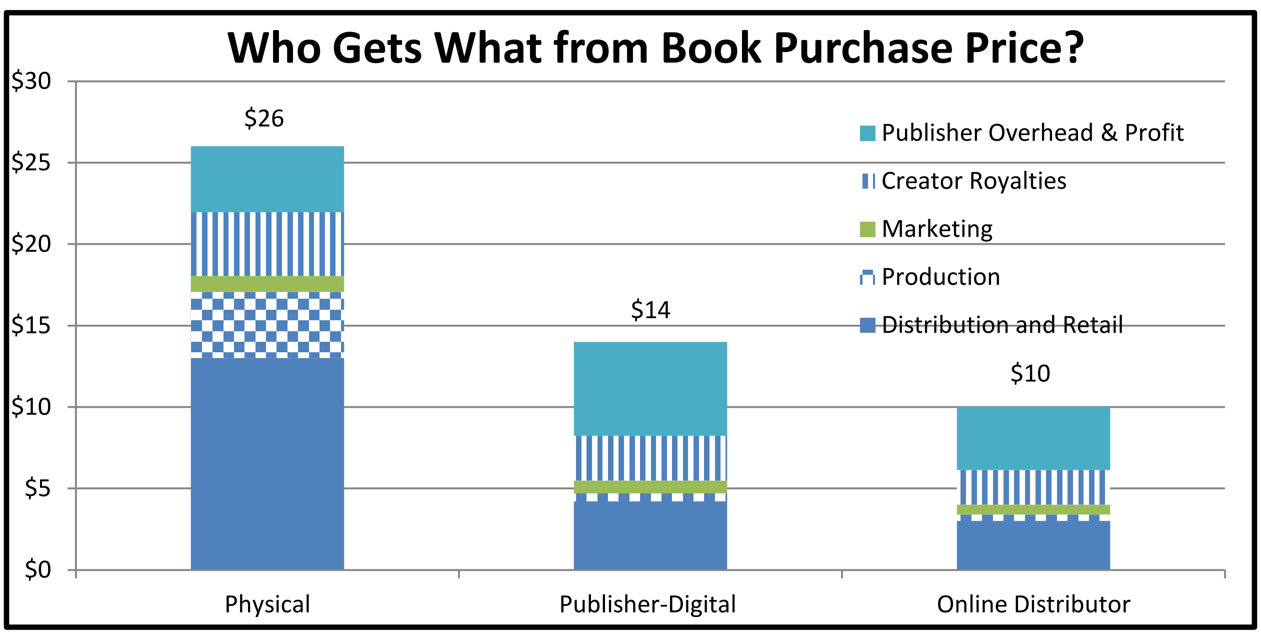
Source: Recording Industry Association of America, various years.

An antitrust consent decree ended price fixing and digital distribution made the sale of singles a compelling alternative. In 2011, consumers bought about 1.3 billion digital singles at an average of just over $1 per single, for a total cost of $1.5 billion. Since consumers typically want two or three songs per album, if the anti-consumer, anti-competitive practices of the recording industry had not been thwarted by law and technology, consumers would have been forced to buy about 500 million albums at an average cost of about $13 per CD to get the music they wanted. The total cost would have been about $6.5 billion. Digital singles allowed consumer needs to be met more efficiently at a consumer savings of more than $5 billion.

Artists have benefitted too. Millions of artists sold music on iTunes and other digital distribution services, the vast majority of whom had no way to reach the consumer in the brick and mortar world because they could not get a recording contract. Even analyzing the elite artists we find more diversity with the advent of digital distribution. Comparing Billboard's top 100 album artists in 2011 to the top 100 artists on iTunes, we find that digital sales diversify the product space. Only twenty-one artists appeared in the top 100 on both lists, while there were 53 artists that appeared only on the CD top 100 and 54 artists who appeared only on the top iTunes 100. The artists who appeared on both lists sold a disproportionate number of each of the products (41% of CDS and 37% of digital singles). However, the average number of top 100 hits per artists was the same on both lists, about 1.35 per artist. Digital and physical, singles and albums, now are part of a much more consumer and artist friendly music product space.

E-Books

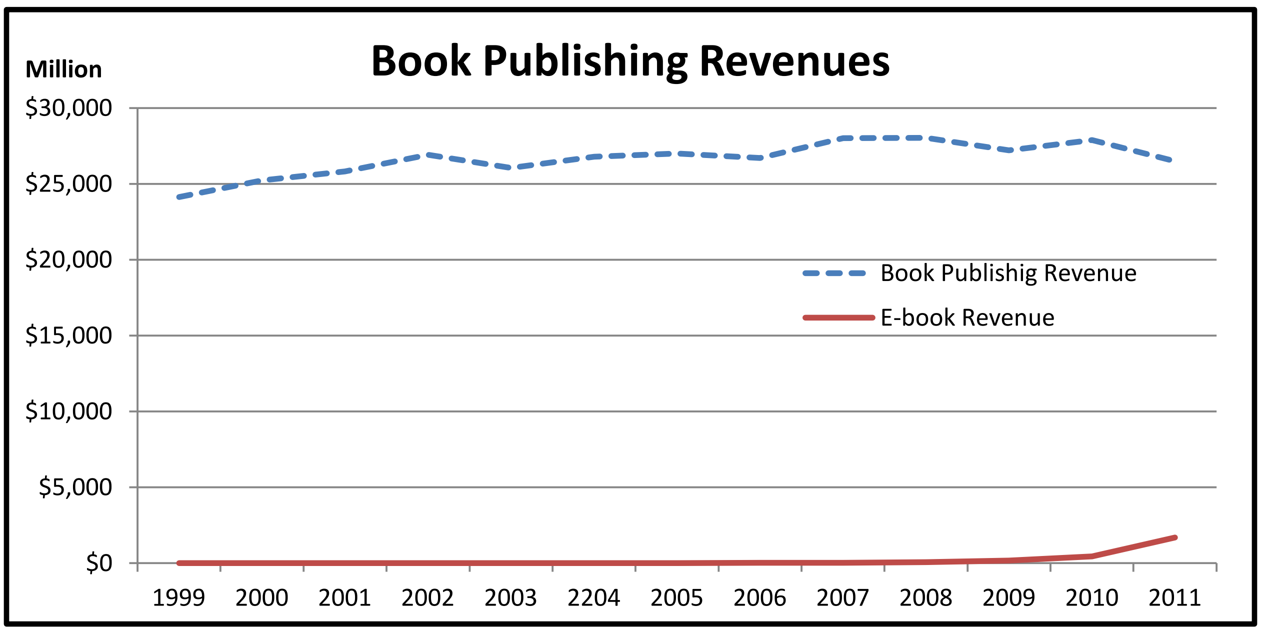
The cost structure in the music and book sectors is strikingly similar in physical space (Mark Cooper, "Structured Viral Communications: The Political Economy of Digital Disintermediation, *Journal of Telecommunications and High Technology Law,* 9:1, 2011) . Physical space distribution and retailing account for about half the price paid by the consumers. Manufacturing is about 10 percent. Labels take 20 percent for marketing and overhead. Royalties for creators are about 15 percent. Digital technologies dramatically lower the cost of books.



Sources & Nots: Average of Motoko Rich, "Math of Publishing Meets the E-Book," *New York Times,* February 28, 2010; Jeffrey A. Tractenberg, "E-Book Prices Prop Up Print Siblings," *Wall Street Journal,* September 12, 2011.

The cost savings of digital distribution and production dramatically lowers the cost and triggers a battle over who should reap the benefits. AT 9.99 for an e-book the margin before overhead for publishers equals the margin on a physical book. At 12.99 to $14.99 for an e-book the publishers' margin per book for overhead increases dramatically, 30 to 50 percent. Moreover, even if the margin did not increase, the rate of profit would likely rise because the publishers have a smaller physical business to manage, which means one might expect overhead to decline. Advertising costs also can go down with access to online advertising, especially for an online audience. Since the publishers costs are declining while their margins are rising, we should not be surprised to find, as *Time Magazine* put it (Laura Hazard Owen, "Thanks to E-Books, Flat Revenue is No Problem for Publishers," Mar. 30, 2012), "Large book publishers' most recent earnings reports reflect a new normal: Revenues are roughly flat, but profits are up—in large part due to e-books."

E-book sales are a small fraction of total book sales today and it is unclear the extent to which e-books will supplant physical books. One thing is clear; a price fixing strategy that is intended to retard the growth of the digital alternative and preserve the incumbent model must not be allowed to distort or frustrate the efficient outcome. The fact that the price fixing increases profits at the expense of the consumer makes it a blatant violation of the antitrust laws and the excuses given by the publishers and celebrity authors are no defense. While the publishers are moving to nip competition in the bud, antitrust authorities must move swiftly to protect nascent competition.



Sources: Bureau of the Census, *Statistical Abstract of the United States*, Publishing Industries, various issues; Association of American Publishers, BookStats , 2011 e-book revenue based on Ian Simpson, "One-fifth of U.S. adults read e-books as market booms: survey," *Chicago Tribune,* April 04, 2012, Citing Albert Greco on e-book sales; Assumes a 4.1 percent decline in total revenue based on Jeremy Greenfield, "New Data: U.S. E-Book Revenues up 117% in 201," *Digital Book World,* February 27, 2012

THE CRITICAL ROLE OF ANTITRUST AT A KEY MOMENT IN THE THIRD INDUSTRIAL REVOLUTION

In a series of cases the Department of Justice and the Federal Trade Commission have recognized the importance of stopping old-fashion anti-competitive behavior from undermining nascent competition and the development of alternative business models in cyberspace. Their efforts run the gamut from traditional concerns about horizontal concentration (AT&T-T-Mobile) and anticompetitive, most favored national clauses (Visa-Master Care; Blue Cross Blue Shield), to unilateral anticompetitive monopolization (Microsoft; Intel), to vertical leverage in physical space products (Ticketmaster), to vertical leverage in digital products (Google A-ATA; Comcast-NBC). The e-book case is the first example of a Sherman Act collusion case brought in the digital realm, although it harkens back to the antitrust case brought against record company price fixing in the late 1990s.

There are many more important issues and cases looming, including issues like the EMI-Universal merger, the Comcast-Verizon joint venture, enforcement of the Comcast-NBC merger conditions and the FCC network neutrality order, to name a few. This sharp increase in antitrust activity stems from two factors. On the one hand, the antitrust authorities have come back to life after a long slumber. On the other hand, the dramatic transformation of the economy driven by digital technologies is part of the "quarterlife crisis" of the third industrial revolution. The incumbent economic order is being overturned. The most powerful actors who are entrenched in the old order will use their resources to promote their interests at the expense of the public interest unless antitrust enforcement steps in.

Antitrust in the 21st century will have to be sensitive to the new economic reality, where small numbers of platforms play an important role. Large firms dominate platforms at the center of the digital economy because of the superior economics made possible by dramatic reductions in transaction costs and the ease and importance of vertical linkage in digital production. Because basic economics drive platform dominance, it becomes vitally important to ensure open competition for the complements that flow on those platforms.

The need for openness is a two edged sword. The owners of the platforms must not be allowed to leverage their market power to distort competition on the platform. The suppliers of the complements (in this case books) must not be allowed to manipulate the supply of "marque" content to distort platform competition or extract monopoly rents, especially in the name of defending inefficient, outdated physical space business models. Blatantly anticompetitive practices that are intended to frustrate efficient processes like digital disintermediation must not be tolerated. Thus, we view vigorous action to block e-book price fixing and restore competition as an important step forward in the reinvigoration of antitrust in America and the battle to ensure that consumers get the full benefit of the digital revolution.

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