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LITIGATION III, ANTITRUST DIV.
U.S. DEPT OF JUSTICE

Dear Mr. Read,

As a book publisher, I am writing to share my thoughts about the Department of Justice's complaint against Apple and five publishers, as well as the settlement agreements negotiated and now being considered by the Court.

At first glance, it might appear presumptuous of me to offer an opinion on this case. I'm neither an American citizen nor a lawyer, but rather a European businessman, holder of a Stanford MBA, and founder of LID, a publishing company that specializes in business books. Over the past nineteen years, we have published the work of 1,300 authors and have become established in six countries, including, since January 2010, the United States.

However, I believe that one of the reasons the United States is such a great country is your willingness to consider the opinions of ordinary citizens affected by the law. Therefore, I feel it's not just my right but also my duty to explain why I believe free markets, freedom of expression, and vibrant exchange of ideas are all involved in this case—and why I hope the department will reconsider its current position, which I fear may be prejudicial to these cherished rights.

In fact, I believe the department can best serve the general interest by withdrawing its current action and allowing each publisher and each retailer to conduct business as he or she sees fit. In the end, the choices of customers in a free marketplace should determine the success or failure of any particular business strategy.

Let me explain the basis for my conclusion.

The most significant impact of the department's action, if upheld, will be to effectively prohibit publishers and ebook retailers from doing business under the so-called agency model. A crucial question, then, is whether the agency model is likely, in the long run, to have a harmful or a positive effect on publishers, retailers, authors, readers, and, most important, on the free marketplace of ideas.

To answer this question, let's begin by considering the nature of the publishing business.

The publishing process begins when the publisher invests in preparing a book, normally both in print and e-book formats. Most of the cost is fixed or indirect, since the variable costs of paper, printing, and binding only amount to 5-10% of the usual retail price for the print book and nothing for the ebook.



However, the economic models of print publishing and e-book publishing are rather different. A reseller of printed books makes an investment in stock, including the expense of receiving and displaying it, and in case it is not sold of returning it (since most books are sold on terms that make them fully returnable to the publisher). By contrast, the e-book retailer makes no investment in any particular e-book, only in its sales and marketing system. The publisher gives the retailer access to the master file of the e-book, and the retailer does not buy or commit to buy any quantity of e-books. When the retailer sells an e-book, it normally gets paid immediately, then one month later informs the publisher and pays it.

It seems to me that the economic difference between these two transactions more than justifies the existence of two different business models. Most resellers rely on the right to establish their own prices because they have invested in non-returnable stock and need the ability to unload goods they've been unable to sell. This is not the case with e-books. In fact, how can someone qualify as a "reseller" when they have not bought anything in the first place?

In the e-book business, the retailer is really acting on behalf of the publisher, who is the only one that has invested in a particular e-book. Thus, it seems to me that the e-book retailer is really acting as an agent rather than as a reseller.

With this distinction in mind, let's consider some of the key issues that have arisen in this case, beginning with the importance of price.

Prices are signals to the market. It seems to me that a business person should be able to establish his or her own signals. One clothing manufacturer can decide to sell to an upscale market using retail outlets with certain characteristics, while another may choose a different path.

In the same way, a book publisher should be able to decide how to sell his or her books. When setting the recommended retail price of a particular title, a publisher compares the value of the title for the reader based in the author, the content, the prices of similar materials in his own catalog and the price of competitive books in other publishers. The publisher's goal is to maximize the profit earned from the title.

By contrast, when an e-book retailer is setting the effective price of a particular e-book, the retailer mainly compares the prices for that particular title charged by different retailers. The indirect cost of the system is reasonably high and the variable cost is only 3-5% of sales, so this is a volume business and one can expect high competition to build that volume. The retailer is not trying to maximize the sales of a given title, just to maximize the share of those sales going through that particular retailer.

The key fact here is that a system that allows the publisher to set the final price will allow the publisher to maximize his profit, while a system that allows the retailer to set up the final price will allow the retailer to do the same. The question, then, is, why should the Department of Justice decide whether in a certain trade the profit to be maximized is the publisher's or the retailer's?

Next, let's consider the question of the 30% commission set by Apple for their agency model. Is this an adequate commission?



As a businessman, I'd prefer to let the free market answer this question, but let us consider a few points. Remember that when Apple set the 30% commission for music and games it was considered very high, made possible only by the near-monopolistic dominance of its iPod device. They have kept the 30% commission when entering the book trade, probably because that is already very high.

Furthermore, with a 3-5% variable cost for credit card and digital rights management processing, one would expect a free market to gravitate toward a commission of 6-8% on sales, which, with adequate volume, would imply a return on investment of over 25% for the retailer. A retailer who can command 30% instead of 8% is in heaven.

We're now in a better position to consider how these two alternative systems for marketing books—the agency model and the reseller model—actually compare with one another.

The agency model has some practical difficulties, but the same result can be obtained by the publisher using retailers that voluntarily give up their capacity to set prices, instead following the guidelines of the publisher about the final price to the reader. The two basic alternatives, assuming the law permits them, are (1) price set by the publisher and (2) price set by the retailer.

Could a publisher use both models at the same time, thereby discriminating among retailers? Not really, because the retailers that are able to set their own prices will easily outprice the others. If the publisher wants to keep some retailers following his price strategy, it will probably have to stop selling to the retailers that do not follow it. Is that legally possible? I believe so, but that's a matter for the department to decide. I believe that a publisher should be free to decide what kind of shopping experience he wants his readers to have and therefore to choose to use some retailers while not using others—just as the clothing manufacturer can do.

Could a retailer use the two models at the same time? Theoretically yes, especially in the short term. In fact, we have seen the leading retailer doing so. In the long run, perhaps the publishers whose books are sold at full margin will realize that they are subsidizing other publishers, which may lead them to decide to stop selling to that retailer. The question then is, who gives up first? Will it be the retailer that wants to make the widest possible selection of e-books available to users of its proprietary device, or the publisher that wants its books to be available through as many retailers as possible—especially the one that has a commanding market share and a proprietary device used by millions of captive customers?

It would be interesting to see how the competition between these two models might play out in a free market over time. My own opinion is that the department should allow this to happen rather than pre-judging the outcome.

In the end, of course, the most important question is: What is better for readers and for the thriving marketplace of ideas that book publishing should serve?

No doubt there are many kinds of book readers. Some are most concerned about being able to buy books at lower prices; others are more focused on better quality or more variety. It's worth noting that there are more countries in the world that allow publishers to fix the final price to the consumer than countries, like the United States, that allow the retailers to do it. Are those countries against freedom? Perhaps they simply prefer to have a system that makes it easier for small authors, small publishers, and small retailers to survive, believing that this will enrich the marketplace of ideas in the long run.



The department's action implies that low prices for consumers are of crucial importance, which just happens to be the main selling point of the leading retailer. But there are other very important elements of freedom for the consumer—for example, not being forced to use a proprietary device that can only buy e-books from a particular vendor. The department should not assume that in cultural goods price is the commanding factor.

It's not my job to give work to the Department of Justice, but I wonder whether the practice of the leading retailer of giving a 30/70 split on book sales revenues to individual authors yet not allowing small publishers to get the deal is justified. Is there any justification in terms of service costs for that practice? It seems designed to generate a good image for the retailer among authors and to make publishers appear inefficient—all with the ultimate goal of disintermediating the publishers.

It also seems to me that a situation where a particular retailer commands more than 40% of book sales and knows exactly what each reader has bought and at what price could be a potential nightmare. If that retailer is also becoming a publisher, deciding which authors to promote and which ones to reject, then freedom of the press may ultimately be threatened.

Companies in certain other industries, such as finance, have been required to set up "Chinese walls" between practices that threaten conflicts of interest. Shouldn't a company being both the leading book retailer and a publisher at the same time raise similar concerns?—Especially when that retailer has a history of selling under cost, a strategy that could be calculated to crowd out weaker competitors in order to build a monopolistic position.

I'm not interested in using the power of government to shore up or undermine any particular industry participant. Rather, my objective, which I believe all responsible publishers share, is to defend free markets, the rights of authors and readers, and the vibrant exchange of ideas and information on which democracy itself depends. I believe this goal will be best served if the Department of Justice defends free competition, allows publishers and retailers to use the sales and marketing system each company wants, and intervenes only when unfair practices allow one company to achieve a position of dangerous dominance in the market.

If the ideas I've presented in this letter are too obvious to be worth stating, I hope you will excuse me.

Thank you for your consideration.

Sincerely,

Marcelino Elosua
Founder and Director
LID Publishing Inc.