

**Rick and United States District Court
for the Southern District of New York**

United States v. Apple, Inc., et al., 12-cv-2826 (DLC) (SDNY).

**Comments of the Consumer Federation of America on
Proposed Final Judgment as to Defendants
Hachette, HarperCollins and Simon & Schuster**

**Mark Cooper,
Director of Research**

June 25, 2012

CONTENTS

THE CONSUMER FEDERATION OF AMERICA	1
THE PUBLIC INTEREST IN RESTORING COMPETITION TO THE EBOOK MARKET	1
THE PUBLIC INTEREST FAIRYTALE OF CARTEL AGENCY PRICING	3
ANTITRUST LAW AND PRACTICE	6
Precedent:	
The Purpose of the remedy:	
Interrupting business relationships:	
The nature of the remedy:	
ECONOMIC ANALYSIS	11
Price v. Cost, Revenue v. Profit	
Prices for Books Sold Under the Agency Cartel Pricing Model Increased	
The Colluding Publishers Profits Increased	
The Claim of the Competitive Benefits of the Cartel Agency Pricing Model	
is Dubious and Does Not Justify Cartel-based Price Collusion	
Output Expanded before the Agency Cartel Pricing Model was Adopted	
The eBook Market is Vulnerable to Anticompetitive Practices	
CONCLUSION	20

THE CONSUMER FEDERATION OF AMERICA

The Consumer Federation of America (CFA) is an association of non-profit consumer organizations that was established in 1968 to advance the consumer interest through research, advocacy, and education. Today, nearly 300 of these groups participate in the federation and govern it through their representatives on the organization's Board of Directors. CFA is a research, advocacy, education, and service organization.

CFA was one of the first consumer groups to examine the impact of the Internet on consumers, concluding in a January 1990 paper that it would be a very consumer-friendly and citizen friendly space.¹ Since then, CFA has participated in virtually every major federal regulatory, legislative and judicial proceeding in the U.S. that would significantly impact the ability of the Internet and the digital revolution to promote the consumer interest and has advanced the consumer view in policy and academic publications.²

THE PUBLIC INTEREST IN RESTORING COMPETITION TO THE EBOOK MARKET

Brick-and-mortar book stores³ and celebrity authors⁴ are adamantly opposed to the proposed consent decree claiming economic harm to brick-and-mortar outlets that undermines competition. As the Authors Guild put it:

¹ Expanding the Information Age for the 1990s: A Pragmatic Consumer Analysis, January 11, 1990.

² Mark Cooper, "Structured Viral Communications: The Political Economy and Social Organization of Digital Disintermediation," Journal of Telecommunications and High Technology Law, 9 (2011); The Central Role of Wireless in the 21st Century Communications Ecology: Adapting Spectrum and Universal Service Policy to the New Reality," Telecommunications Policy Research Conference, September 2011; "Round #1 in the Digital Intellectual Property Wars: Economic Fundamentals, Not Piracy, Explain How Consumers and Artists Won in the Music Sector," Telecommunications Policy Research Conference, September 2008; "Governing the Spectrum Commons," September 2006. Telecommunications Policy Research Conference, October 2006; "Accessing the Knowledge Commons in the Digital Information Age," Consumer Policy Review, May/June 2006; "From Wifi to Wikis and Open Source: The Political Economy of Collaborative Production in the Digital Information Age," Journal on Telecommunications and High Technology Law, 5:1, 2006; "The Economics of Collaborative Production in the Spectrum Commons," IEEE Symposium on New Frontiers in Dynamic Spectrum Access Networks, November 2005; "Independent Noncommercial Television: Technological, Economic and Social Bases of A New Model of Video Production," Telecommunications Policy Research Conference, October 2005; "Hope And Hype Vs. Reality: The Role Of The Commercial Internet In Democratic Discourse And Prospects For Institutional Change," Telecommunication Policy Research Conference, September 21, 2003; "Inequality In The Digital Society: Why The Digital Divide Deserves All The Attention It Gets," Cardozo Arts and Entertainment Law Journal, 2002; "Open Access To The Broadband Internet: Technical And Economic Discrimination In Closed, Proprietary Networks," University of Colorado Law Review, Vol. 69, Fall 2000; "Antitrust As Consumer Protection In The New Economy: Lessons From The Microsoft Case," Hastings Law Journal, 52: 4, April 2001, first presented at Conference On Antitrust Law In The 21st Century Hasting Law School, February 10, 2000; "Evolving Concepts of Universal Service," The Federalist Society, October 18, 1996; "Delivering the Information Age Now," Telecom Infrastructure: 1993, Telecommunications Reports, 1993.

³ *Comments of Barnes and Noble, Inc. On the Proposed final Judgment*, Civil Action No. 1:12-CV-2826, June 7, 2012 (hereafter, Barnes and Noble); American Booksellers Association, *Comments on the Proposed Consent Decree in United States v. Apple, Inc., et al.*, 77 Fed. Reg. 24518 (hereafter, ABA).

First, here's our view, in a nutshell: the proposed settlement is not in the public interest, because it needlessly imperils brick-and-mortar bookstores while it backs an online monopolist and discourages competition among e-book vendors and e-book device developers. The settlement needs to be rethought, and substantially modified.⁵

They add that the consent decree violates antitrust law and practice. As Barnes and Noble put it:

The proposed settlement represents an *unprecedented* effort by the Antitrust Division of the U.S. Department of Justice (the "Government" or the "Division") to reject its traditional role of ending alleged collusion and to become instead a regulator of a nascent technology industry that it little understands. The proposal is not a run-of-the-mill Tunney Act anti-collusion order.⁶

These arguments against the settlement are wrong. They are based on misrepresentations of the purpose and intent of the antitrust laws and erroneous assumptions about and faulty analysis of the economics and nature of competition in the digital era of book publishing.

The self-interested claims of brick-and-mortar retailers and celebrity authors who profit from price fixing at the expense of consumers must not mislead the court into thinking that

- (1) the public interest lies in anything short of restoring full price competition to the book publishing marketplace or
- (2) that the harm to competition inflicted by the agency cartel price-fixing for digital distribution of books at a critical moment in the nascent development of new digital business models can be repaired without a significant period of close oversight and scrutiny.

The two-year period in which the consent decree restricts the use of agency agreements by the cartel members in an effort to allow competitive, commercial relations to return to the book publishing market is dangerously short and a break with past antitrust practice. If any modification of the consent decree is needed, based on the record and past practice, it should be to lengthen the period in which behavior of the members of the cartel is restricted, not shorten it.

In these comments, the Consumer Federation of America offers economic and legal reasons why the public interest would not be served by the modification of the consent decree as recommended by the brick-and-mortar retailers and celebrity authors. In the process of rebutting

⁴ Although the authors have not yet filed comments, the Authors Guild has issued a call to arms for its members and provided a five page analysis of the consent decree making arguments that mirror the bookstore statements and are very likely to appear in author comments. Authors Guild, *The Justice Department's E-Book Proposal Needlessly Imperils Bookstores; How to Weigh In*, June 4, 2012, <http://www.authorsguild.org/advocacy/articles/the-justice-departments-e-book-proposal-needlessly.html>. (hereafter Authors Guild)

⁵ Authors Guild, p.1.

⁶ Barnes & Nobel, p. 1, emphasis added.

their arguments, we also make the case that the proposed settlement is in the public interest. As we pointed out in an analysis of digital disintermediation that we recently submitted to the Senate Committee on Antitrust, Competition Policy and Consumer Protection.

[T]his is a particularly important moment to reject gross misrepresentations of the antitrust laws... The Department of Justice action against price fixing by five major publishers underscores the ongoing effort of antitrust authorities to define the proper role for antitrust in the development of the digital economy. The economic efficiency and consumer benefit from the digital distribution of goods and services are transforming the way the market meets consumer demand. Incumbent physical space firms confronted with a more efficient business model will stop at nothing to preserve their dominance. The actions of antitrust authorities and others to ensure that incipient competition is not squelched by anticompetitive tactics should include the full range of antitrust powers that have traditionally been used to ensure that consumers and the economy enjoy the benefits of the greatest amount of competition possible – denial or conditioning of mergers and acquisitions that substantially lessen competition, reversing actions that defend or expand monopoly power by undermining competition, prevention of unilateral monopoly abuse, and blocking of collusion.⁷

THE PUBLIC INTEREST FAIRYTALE OF CARTEL AGENCY PRICING

The public interest claim of the brick-and-mortar retailers and celebrity authors rests on a carefully concocted, self-serving argument about the book business. Specialty bookstores are the center of book publishing, “vital participants in the literary ecosystem.”⁸ The only way to maintain that ecology is to allow the publishers to prop up the specialty bookstores by ending price competition and allowing collusion to set prices.⁹ The judgment of the publisher cartel replaces the marketplace in decide retail prices.

The celebrity authors acknowledge the superior efficiency of digital distribution due to its advantages in immense availability and print on demand delivery, a benefit that they claim should be restricted to the long tail – 90 percent of titles that have little demand.¹⁰

⁷ Mark Cooper and Jodie Griffin, “The Role of Antitrust in Protecting Competition, Innovation and Consumers as the Digital Revolution Matures: The Case Against the Universal-EMI Merger and E-Book Price Fixing, hearing on The Universal Music Group-EMI Merger and the Future of Online Music,” June 21, 2012, p. 1; available at <http://www.consumerfed.org/pdfs/Studies.CaseAganstUMG-EMIMerger.pdf>

⁸ Authors Guild, p. 2.

⁹ Bookstores remain critical showrooms for works by new or lesser-known authors and for entire categories of books, such as children’s picture books. Marketing studies consistently show that readers are far more open to trying new genres and new authors when in a bookstore than when shopping online (ABA, p. 2); Bookstores provide unique experiences and services to consumers: community centers that offer browsing, in-person support, and services including children’s events and literacy and education promotion (Barnes & Nobel, p. 9)

¹⁰ Online booksellers, with endlessly long bookshelves made possible by inexpensive warehouse space and on-demand printing technology, came to dominate the market for backlist and especially deep backlist titles. For nearly all backlist books, representing roughly 90% of all in-print titles, the online market had *become* the market, and amazon owned the market (Authors Guild, p. 2).

The bookstore business is focused on the top 10 percent of titles, the frontlist. People need bookstores to discover these titles. But not just any bookstores, the big box retailers won't do, it has to be the specialty bookstores.¹¹

In other words, the heart of the "literary ecosystem," lies somewhere between two much more efficient distribution models – the "long tail" and the "mass market" – a location happily occupied by the brick-and-mortar bookstores. Cartel agency price fixing is the only way to ensure that the heart will be able to continue to pump books through the ecosystem.

The value of bookstores can be demonstrated, only by giving unique meaning to some key words in the digital age. Browsing physical bookshelves is a unique function made possible by the anointed specialty bookstores. This is a function that is entirely different than browsing on the web for titles and reviews, according to the brick-and-mortar retailers and celebrity authors, which is described as a much less valuable function of search.¹²

Unfortunately for the bookstores, the readers who need the functions of the specialty bookstores don't value them enough to pay for the services they provide. Since the specialty bookstores cannot compete on price or service, cartel agency pricing is the only solution, a solution in which consumers are forced to pay a higher price,¹³ but get services that they are unwilling to pay for. Colluding publishers, not the marketplace decide what is good for consumers.

Once the publishers have set the price up, they assure us, they will then build value into the e-tailing experience. The convenience they claim to deliver is little more than what the e-tailers started with (actually, it is a little less, since consumers have to schlep to the bookstore to get the unique services the brick-and-mortar retailers claim to offer). Many of the services that they claim

¹¹ Barnes & Nobel, "Consumers will also have limited choice in where they can buy their books: online retailers such as Amazon or large, multipurpose brick-and-mortar stores such as Costco, Wal-Mart and Target, which offer only mass-market selections (p. 20).

¹² It seems to come down to browsing versus searching. Brick-and-mortar bookstores are optimized for browsing: the stores' "search engines" – their information desks – aren't what draws in customers. A reader browsing the shelves and tables of a bookstore is often hoping to discover something unexpected. Virtual bookstores, on the other hand, are optimized for search – browsing isn't the attraction. Readers behave accordingly, tending to use virtual bookstores as search engines to find books they've discovered elsewhere." (Authors Guild, p. 2).

¹³ The Authors Guild ties the salvation of the bookstores to the cartel agency model "Steven Jobs introduced Apple's iPad, with its iBooks and its proven iTunes-and-apps "agency model" for selling digital content. Five of the largest publishers jumped on with Apple's agency pricing (pp. 2-3).

to make available are already available online.¹⁴ The public, which has embraced digital technology across as wide range of markets, somehow needs to preserve the specialty bookstores e-kiosks because “brick-and-mortar stores provide training and concierge service to help customers purchase, download and read e-books.”¹⁵ These are the same consumers who are said to be free riding the specialty stores to death, by browsing in physical space and buying in cyber space.

The claim that without the cartel pricing model they could not enter these lines of business on a profitable basis to provide these valuable services to the public is a lot closer to fiction than science. The real fear is that competition was “devaluing the book”¹⁶ or as on well-known author put it, “Publishers were making money, but they were concerned that consumers would come to believe that \$9.99 was what books were worth, and they were desperate to have greater influence on prices.”¹⁷

This is a story we have heard countless times as digital disintermediation has taken hold. In fact, it is the complaint we hear whenever discounters enter the market, digital or otherwise. It is a vain attempt to preserve an inefficient distribution system and protect the interests of the incumbent physical space distributors at the expense of the public interest.

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. 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.

The examples where online distribution played an important role in transforming the distribution of goods are familiar – music, Tower Records; computers, CompUSA; electronic devices, Circuit City; video cassettes, Blockbuster; books, Borders; newspapers, too numerous to name. Rescuing the remnants of the inefficient, brick-and-mortar distribution network would be a full-time undertaking

¹⁴ “Following adoption of the Agency Model, Independent Bookstore Enter the E-book Market (ABA, p. 1)... the ability of indie bookstores to sell e-books has also led to overall increased in these bookstores’ revenue from e-commerce activity. ABA members bookstores sell physical books, sidelines and other non-book items, ticket book selling events and other goods and services over their newly invigorated e-commerce sites, adding significantly to the bottom line of these small businesses (ABA, p. 2).

¹⁵ ABA, p. 3.

¹⁶ ABA, p. 3;

¹⁷ Ken Auletta, “Paper Trail,” [The New Yorker](#), June 25, 2012, p. 36.

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.¹⁸

The argument is particularly inapplicable in the digital space precisely because digital technologies have immense efficiency advantages. They benefit from much more than economies of scale and scope and clever marketing, they fundamentally alter the economics of production, distribution and transaction. More importantly, they fill an immense void that afflicts many physical space markets – they make information readily available to consumers.

ANTITRUST LAW AND PRACTICE

Barnes and Noble claims that the consent decree is unprecedented, unnecessarily interferes with business practices and exceeds typical remedies in violation of the antitrust laws.¹⁹ That is simply not the case. On the contrary, the only thing “unprecedented” about the remedy, it is that it is of such short duration.

Precedent: Ironically, just a decade ago, the antitrust authorities confronted a situation in the recorded music business that parallels the eBook price fixing case closely,²⁰ In our analysis of digital disintermediation we demonstrated a strong parallel between the “minimum advertised price” practices of the record labels in the mid-1990s and the collusive eBook price fixing case, as follows:

In the late-2000s the publishers had the same problem as the record labels did in the mid-1990s. They were caught between two very different distribution channels – the newer low-cost, high-volume channel and the traditional higher cost, lower volume specialty shops. They had the same reaction, they fixed prices to reduce the competitive pressures. The result was to increase profits. The FTC filed identical complaints against the major labels, but alleged no collusion. It was conscious parallelism, but illegal just the same.²¹

The strategy adopted by the record labels in response to nascent competition in the 1990s was remarkably similar to the strategy adopted by the eBook publishers. The complaint in the recorded music settlement read, in part, as follows:

¹⁸ Cooper and Griffin, pp. 43..46.

¹⁹ Barnes & Nobel, p. 1.

²⁰ Cooper and Griffin.

²¹ Cooper and Griffin, 2012, p. 43.

PARAGRAPH FIVE: In the early 1990's, several large consumer electronics chains began selling compact discs and other prerecorded music products. These new entrants competed aggressively on price and offered consumers substantial savings on some prerecorded music products. A retail price war ensued and music retailers lowered their prices.

PARAGRAPH SIX: Some retailers, faced with newly invigorated price competition in the retail market, requested margin protection from BMG. In 1993, BMG, was also concerned that declining retail prices could have wholesale price effects. Thereafter, BMG decided to introduce a Minimum Advertised Pricing ("MAP") policy. In 1992 and 1993, the other major distributors adopted MAP policies. These policies set forth minimum advertised prices for most prerecorded music products. As discussed below, these MAP policies were modified between 1995 and 1996. In 1995 and 1996, retail prices increased. Since 1997, wholesale prices have also increased.

PARAGRAPH SEVEN: The MAP policy changes which occurred in 1995 and 1996 significantly tightened the programs. By February 1, 1997, each of the major distributors had implemented similar policies. The new MAP policies provided that any retailer who advertised the distributors' product below the established MAP would be subject to a suspension of all cooperative advertising and promotional funds for either 60 or 90 days.

PARAGRAPH NINE: Shortly after adopting the new MAP policies, the distributors began aggressively enforcing the policies. Several high profile enforcement actions that resulted in long periods of suspension were widely publicized by the trade press.

PARAGRAPH TEN: BMG's stricter MAP policy, in effect since January 1, 1997 and continuing to date, was implemented to eliminate aggressive retail pricing and to stabilize overall prices in the retail marketplace. This policy was successful.²²

The complaint in the eBook price fixing case reads, in part, as follows:

E-book sales have been increasing rapidly ever since Amazon released its first Kindle device in November of 2007... Amazon substantially increased the retail market for e-books. One of Amazon's most successful marketing strategies was to lower substantially the price of newly released and bestselling e-books to \$9.99...

Publishers saw the rise in e-books, and particularly Amazon's price discounting, as a substantial challenge to their traditional business model. The Publisher defendants feared that lower retail prices for e-books might lead eventually to lower wholesale prices for e-books, lower prices for print books, or other consequences the publishers hoped to avoid. Each Publisher Defendant desired higher retail prices across the industry before "\$9.99" became an entrenched consumer expectation. By the end of 2009, however, the Publisher defendants had concluded that unilateral efforts to more Amazon away from its practice of offering low retail prices would not work.... (1)

Together, Apple and the Publisher Defendants reached an agreement whereby retail competition would cease (which all the conspirators desired), retail e-book prices would increase significantly (which the Publisher Defendants desired), and Apple would be guaranteed a 30 percent "commission" on each e-book if sold (which Apple desired)....

Prior to the conspiracy, both print books and e-books were sold under the longstanding "wholesale model." Under this model, publishers sold books to retailers, and retailers, as the owners of the books, had the freedom to establish retail prices. Defendants were determined to end the robust retail price competition in e-books that prevailed, to the benefit of consumers, under the wholesale model. They therefore agreed jointly to replace the wholesale model for selling e-books with an "agency model" ...

As Apple CO Steve Jobs described this company's strategy for negotiating with the Publisher Defendants, "We'll go to [an] agency models, where you set the prices and we get our 30%, and yes, the customer pays a little more, but that's what you want anyway" ... (3-4)

Other price and non-price competition among e-book publishers and among e-book retailers also was unlawfully eliminated to the detriment of U.S. consumers.... (5)

²² In the Matter of BMG Music, Docket No. C-3973.

The Publisher Defendants were especially concerned that Amazon was well positioned to enter the digital publishing business and thereby supplant publishers as intermediaries between authors and consumers. Amazon had, in fact, taken steps to do so, contracting directly with authors to publish their works as e-books –at a higher royalty rate than the Publisher Defendants offered. Amazon’s move threatened the Publisher Defendants’ traditional position as the gate-keepers of the publishing world (10 -11).

Penguin Group CEO John Makinson conveyed the same message

Competition for the attention of readers will be most intense from digital companies whose objective may be to disintermediate traditional publishing altogether. This is not a new threat but we do appear to be on a collision course with Amazon, and possibly Google as well. It will not be possible for any individual publisher to mount an effective response, because of both the resources necessary and the risk of retribution, so the industry needs to develop a common strategy. This is the context for the development of the Project Z initiatives [joint ventures] in London and New York. (15)²³

The parallels between the two cases are important to recognize for several reasons. The mid-1990s was a time of technological change in the recorded music industry as the Compact Disc (CD) medium for recording music replaced the prior media. The new medium was both consumer friendly and distribution friendly, taking up less space, being easier to handle and use, etc. It was ideally suited for the big box, mass market distribution channel, which put pressure on the entrenched distribution channels. Technology stimulates change but entrenched incumbents fight against it; in these two cases, using illegal price fixing practices. These issues echo loudly and clearly in the ebook price fixing case.

The Purpose of the remedy: Having uncovered an illegally anticompetitive practice, the Department of Justice must ban it, as Barnes and Noble seems to concede.²⁴ The antitrust agency must also repair the harm to competition. In this case, the DOJ has imposed a short, two year period in which a practice that could be legal, agency, but has been abused, will not be available to the members of the cartel. That short period gives competitive, commercial relationships the opportunity to be restored in the product markets that have been affected by anticompetitive practices. The antitrust practice is generally to require a longer period of time for the market to heal.

²³ U. Department of Justice, Complaint, Civil Action No. 1:12-CV-2826, June 7, 2012

²⁴ Barnes & Nobel, “the broad regulations sought in the proposed settlement go far beyond what is needed to remedy the harms alleged (p.21).

Barnes & Nobel argues that because competition is nascent in the digital book space the antitrust authorities should move cautiously when they find anticompetitive practices.²⁵ We take the opposite point of view, as does antitrust practice. Nascent competition demands decisive action because anticompetitive tactics by entrenched incumbents can impact the landscape for digital business models (not just the prospects of rivals), which was the intention in this case.

Interrupting business relationships: Barnes and Noble complains that the contracts it entered into with the colluding publishers were negotiated on a bilateral basis in the normal course of business²⁶ and the DOJ is punishing an innocent third party by abrogating them, rather than the perpetrators of the offense.²⁷ The premise is incorrect. The contracts are tainted by the illegal behavior of the publishers. Barnes & Nobel was not negotiating with independent publishers, it was negotiating with members of a cartel and was the beneficiary of the collusive tactics.

The DOJ cannot leave the offending contracts in place, but tell the publishers that they cannot sign any new ones that violate the law. Failing to abrogate the contracts would allow the colluders to reap the fruit of their illegal behavior as the contracts would run their course. Moreover, without a moratorium on agency contracts for the colluding publishers, the publishers could tear up the offending contracts and immediately sign identical contracts, claiming to act individually to adopt terms and conditions that were worked out by the cartel. Such a remedy would make a mockery of antitrust law and enforcement.

Barnes & Nobel can avoid harm by negotiating lower wholesale prices from the colluding publishers. This is an outcome that might have occurred in the market, had the publishers not implemented price increasing collusion as their response to a competitive threat.

²⁵ Barnes & Nobel, p. 23.

²⁶ Barnes & Noble is a party to agency agreements, including those that it separately negotiated with each of the settling publishers. (8)

²⁷ The settlement merits close scrutiny because it will positively harm Barnes & Nobel and other brick-and-mortar stores by (1) declaring as null and void their agency contracts and forbidding the settling publishers from entering into similar contracts with Barnes & Nobel for two years except within complex regulatory exemptions; and (2) decreasing the payments that Barnes & Nobel and other brick-and-mortar stores receive when they distribute e-books, thus jeopardizing their investments in the e-book industry, encouraging free riding, and discouraging future investment and other entrants. (see also pp. 9, 19)

The nature of the remedy: Barnes and Nobles complains that the remedy gets into the details of the book publishing business, with complex compliance and reporting requirements.²⁸ To the extent that the DOJ has introduced complexity into the remedy, it is in an effort to allow legal business models that do not mimic the offending approaches used by the price fixing cartel. The remedy in the recording industry case was extensive and detailed. The remedy proposed in the eBook case is no more detailed and the period of close oversight is much shorter. The remedy in the recording industry case included, in part, the following conditions:

II. It is further ordered that for a period of seven (7) years, BMG Music, directly, indirectly, or through any corporation, subsidiary, division or other device, in connection with the offering for sale, sale or distribution of any BMG Music Product in or into the United States of America in or affecting "commerce," as defined by the Federal Trade Commission Act, shall cease and desist from directly or indirectly adopting, maintaining, enforcing or threatening to enforce any policy, practice or plan which makes the receipt of any Cooperative Advertising or Other Promotional Funds contingent upon the price or price level at which any BMG Music Product is Advertised or Promoted.

III. It is further ordered that BMG Music... shall not directly or indirectly:

Adopt, maintain, enforce or threaten to enforce any policy, practice or plan which makes the receipt of any Cooperative Advertising or Other Promotional Funds contingent upon the price at which any BMG Music Product is offered for sale or sold;

Adopt, maintain, enforce or threaten to enforce any policy, practice or plan which makes the receipt of any Cooperative Advertising or Other Promotional Funds contingent upon the price or price level of the BMG Music Product in any In-Store Promotion or Media Advertising where the Dealer does not seek any contribution from BMG Music for the cost of said Media Advertising or In-Store Promotion;

Adopt, maintain, enforce or threaten to enforce any policy, practice or plan which makes the receipt of any Cooperative Advertising or Other Promotional Funds contingent upon the price or price level of the BMG Music Product in any In-Store Promotion or Media Advertising if BMG Music's contribution exceeds 100% of the Dealer's actual costs of said Media Advertising or In-Store Promotion;

Agree with any Dealer to control or maintain the resale price at which the Dealer may offer for sale or sell any BMG Music Product;

For a period of five (5) years, announce resale or minimum advertised prices of BMG Music Product and unilaterally terminate those who fail to comply because of such failure. Notwithstanding the foregoing, nothing herein shall prohibit BMG Music from announcing suggested list prices for BMG Music Product.

IV. It is further ordered that for a period of seven (7) years:

BMG Music shall amend all Advertising Policy statements applicable to the distribution of BMG Music Product to state affirmatively that BMG Music does not maintain or enforce any plan, practice or policy of the type prohibited in Paragraph II of this Order.

²⁸ Barnes & Nobel, p. 24.

In each published full catalogue or published full price list in which BMG Music states suggested list prices or codes indicative of such prices, BMG Music shall state affirmatively that it does not maintain or enforce any plan, practice or policy of the type prohibited in Paragraph II of this Order.

VII. It is further ordered that annually for five (5) years on the anniversary of the date this Order becomes final, and at such other times as the Commission may by written notice to BMG Music require, BMG Music shall file with the Commission a verified written report setting forth in detail the manner and form in which BMG Music has complied and is complying with this Order.²⁹

Thus, the characterization of the proposed remedy as an unprecedented, draconian remedy that illegally and unnecessarily interrupts routine business practices in the sector is simply wrong and inconsistent with normal antitrust practices. The irony here is that the agency model was the exception in the book publishing sector, not the rule. Indeed, it appears that these five publishers relied primarily, of not exclusively, on a wholesale model and never applied an agency model in a legal manner. The colluding publishers will be forced back to a wholesale model for a short period, while other publishers are allowed to pursue legal agency approaches. Then the colluding publishers will be allowed to develop legal agency models for book publishing in a market where legal agency practices have had an opportunity to develop. To satisfy the Barnes & Nobel search for a punishment for the colluding publishers, we can note that for a short period of time the colluding publishers will be denied access to a business model that they have abused.

ECONOMIC ANALYSIS

Price v. Cost, Revenue v. Profit

The public interest story of the brick-and-mortar retailers and the celebrity authors rest on the claims that brick-and-mortar outlets are indispensable to a healthy book market and the offending cartel agency agreements were central to the growth of competition in the digital era.³⁰

Barnes & Nobel claims it would not have made the investment in e-book distribution without the high margin it was offered in the cartel contracts or that its investment would not have

²⁹ In the Matter of BMG Music, Docket No. C-3973.

³⁰ The agency model agreed by Barnes & Nobel and the publishers is proconsumer; it has proven to encourage and stimulate competition in a market that previously was characterized by one dominant player and a lack of competition (p.5) Under this system, pricing was controlled not by a single dominant player but by numerous competitor publishers who compete vigorously among themselves. (p. 10)

succeeded, but for those contracts,³¹ suggesting that the only way to achieve that margin is through agency agreements. Because these claims are doubtful at best, the public interest analysis of the brick-and-mortar bookstore and the celebrity authors goes astray.

Running throughout the arguments of the opponents of the proposed settlement and the defense of the price fixing cartel is a complete confusion of price, cost, revenue and profit. When an industry is undergoing significant cost-reducing technological change, it is extremely important to be precise about the differences between price, cost, revenue and profit. When costs are falling, prices and revenues may be falling, but profits can be increasing.

As we pointed in our recent analysis, there are two primary reasons that the claim that Amazon was engaged in predatory pricing fails.³² First, the predation argument tends to cite the wrong price as the predatory threshold. Second, it fails to consider the cost (and therefore the profit) of the bundle of services Amazon is selling.

The attack on the settlement is plagued by both problems, but the first is particularly important in the public interest analysis. The opponents of the settlement claim that publishers decreased their profits³³ or “left money on the table” when they colluded to set the price of e-books. The claim that money was left on the table is used in an attempt to show that price fixing was benign. The claim is wrong because cartel agency pricing pushed up prices for many books in an attempt to quell competition that was developing and putting downward pressures on prices.³⁴ The proper framing is that any money taken off the table by collusive price fixing was illegal.

³¹ Barnes and Noble, p. 9.

³² Cooper and Griffin, p. 50.

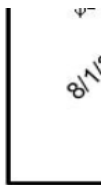
³³ The model also permitted publishers to preserve conditions for long-term competition in the distribution of their product which benefitted consumer as well as publishers, despite the immediate loss of revenue to publishers from increased payments to distributors. (p. 10; see also pp. 2, 19); Aiuletta, p. 39.

³⁴ The argument involves shifting cost recovery between hardbacks and paperbacks. *Id.* (“Moreover, in the current print model, publishers can recoup many of their costs, and start to make higher profits, on paperback editions. If publishers start a new e-book’s life at a price similar to that of a paperback book, and reduce the price later, it may be more difficult to cover costs and support new authors.”).

Prices for Books Sold Under the Agency Cartel Pricing Model Increased

It is quite clear that the intension and effect of the price fixing scheme was to increase the price of the e-books sold by the colluding publishers. The data offered by Barnes & Nobel which purports to show that average e-book prices were stable over the agency cartel pricing period, tells us nothing about the prices of the cartel controlled ebooks. In fact, the Barnes & Nobel data contradicts the claim that cartel agency prices lowered e-book prices. Upon close examination, it clearly supports the DOJ conclusion that the cartel raised prices for the ebooks sold by the colluding publishers. Prior to the execution of the cartel agency model, average eBook prices were falling. The cartel had the immediate effect of arresting the decline.

**Cartel Agency Price
Agreement Signed**



Source: Comments of Barnes and Noble, Inc. On the Proposed final Judgment, Civil Action No. 1:12-CV-2826, June 7, 2012, p. 12.

Since it is known that Amazon was forced to put up its prices for the books subject to agency cartel pricing, we can assume that the prices of competitively priced books continued to decline. The cartel agency model had the effect of increasing the price of books subject to cartel agency pricing. Our analysis of the recording industry in the 1990s shows exactly the same pattern

in which price fixing was used to arrest the decline in prices brought about by technological change and competition in the distribution channels.³⁵

The Colluding Publishers Profits Increased

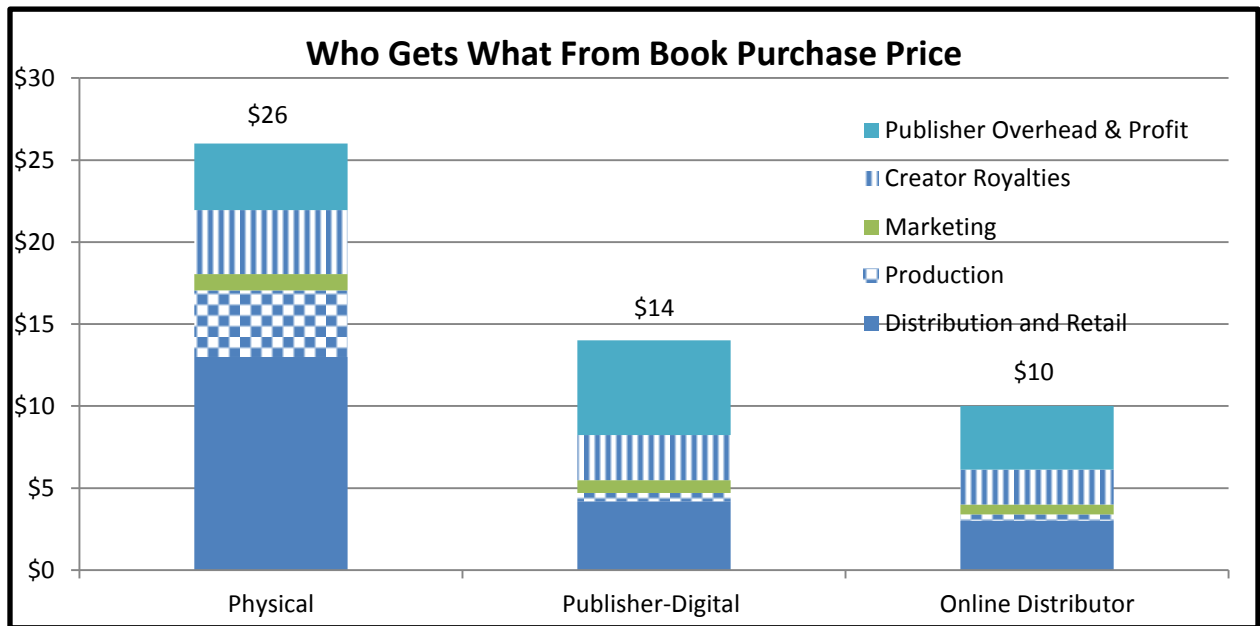
We cannot conclude how the colluding publishers fared until we know something about the cost of ebooks. In the mature, advanced industrial society of the late 20th century, distribution and transaction costs came to represent a large share of the total costs of goods and services. In the content industries, 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. 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 (higher margins).³⁶

The economic impact of digital disintermediation in the distribution of books parallels the impact on music, characterized by fierce battles over capturing rents made possible by more efficient production and distribution. The cost of production and distribution of books declined dramatically. Publishers defend high prices for digital books in the name of preserving bookstores,³⁷ but there is a widespread belief that they are also seeking to avoid downward pressure on the pricing of physical books. The cost structure in the music and

³⁵ Cooper and Griffin, Section III.

³⁶ Cooper and Griffin, Cooper, "Round #1 in the Digital Intellectual Property Wars: Economic Fundamentals, Not Piracy, Explain How Consumers and Artists Won in the Music Sector," [Telecommunications Policy Research Conference](#), September 2008.; "Governing the Spectrum Commons," September 2006. [Telecommunications Policy Research Conference](#), October 2006; "Accessing the Knowledge Commons in the Digital Information Age," [Consumer Policy Review](#), May/June 2006;

³⁷ Another reason publishers want to avoid lower e-book prices is that print booksellers like Barnes & Noble, Borders and independents across the country would be unable to compete. As more consumers buy electronic readers and become comfortable with reading digitally, if the e-books are priced much lower than the print editions, no one but the aficionados and collectors will want to buy paper books. Motoko (2010: B1) ("If you want bookstores to stay alive, then you want to slow down this movement to e-books," said Mike Shatzkin, chief executive of the Idea Logical Company, a consultant to publishers. "The simplest way to slow down e-books is not to make them too cheap.").



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

book sectors is strikingly similar in physical space.³⁸

The cost savings of digital distribution and production dramatically lowers the cost and triggers a battle over who should reap the benefits. The extent of cost savings is debated, but there is no doubt it is quite substantial. In the physical book industry, returns of unsold product alone run in the range of 30% to 50%.³⁹ Since ebook sales are on demand, there are no returns. Add in a modest cost savings of 20% and the total reduction in production cost is in the range of 50% to 70%. Since the publishers' costs are declining while their margins are rising, we should not be surprised to find, as *Time Magazine* put it "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."⁴⁰ The greater efficiency in distribution and transaction, further lowers the cost of the final digital product.

³⁸ Cooper and Griffin.

³⁹ Auletta, p. 37.

⁴⁰ Laura Owen, Hazard, 2012, "Thanks to E-Books, Flat Revenue is No Problem for Publishers," *Time*, Mar. 30, 2012.

Publishers did not leave money on the table when they illegally fixed and raised the price of e-books, they took the money that had been put on the table by technological change and put it in their pockets, money that would have ended up in the consumer's pocket in a competitive industry.

The Claim of the Competitive Benefits of the Cartel Agency Pricing Model is Dubious and Does Not Justify Cartel-based Price Collusion

The argument that a price fixing cartel was necessary to introduce competition into the ebook space is contradicted by the facts. There has been entry into and exits from the eBook space before and after the advent of the cartel agency pricing model.

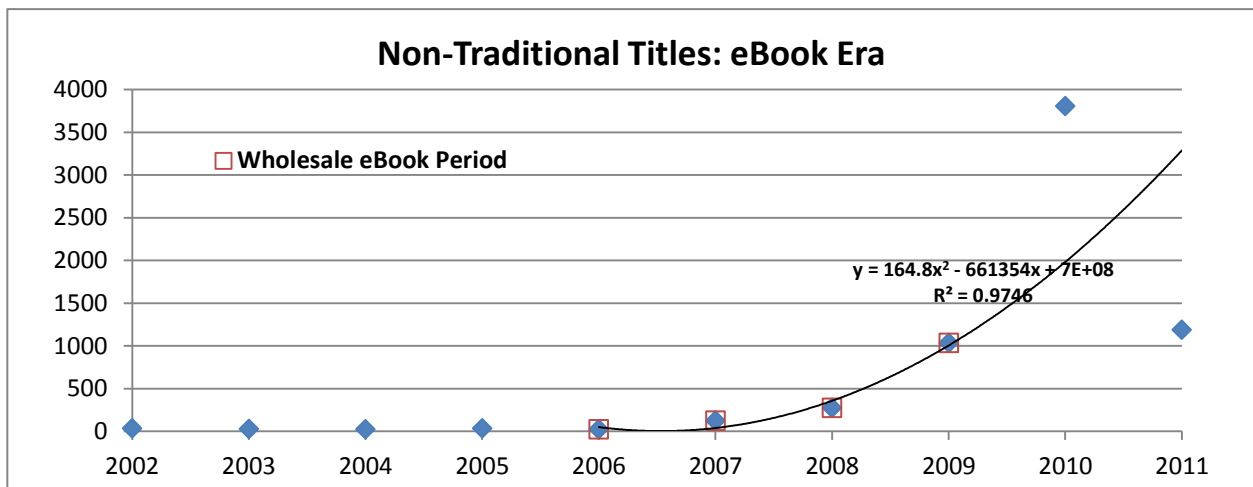
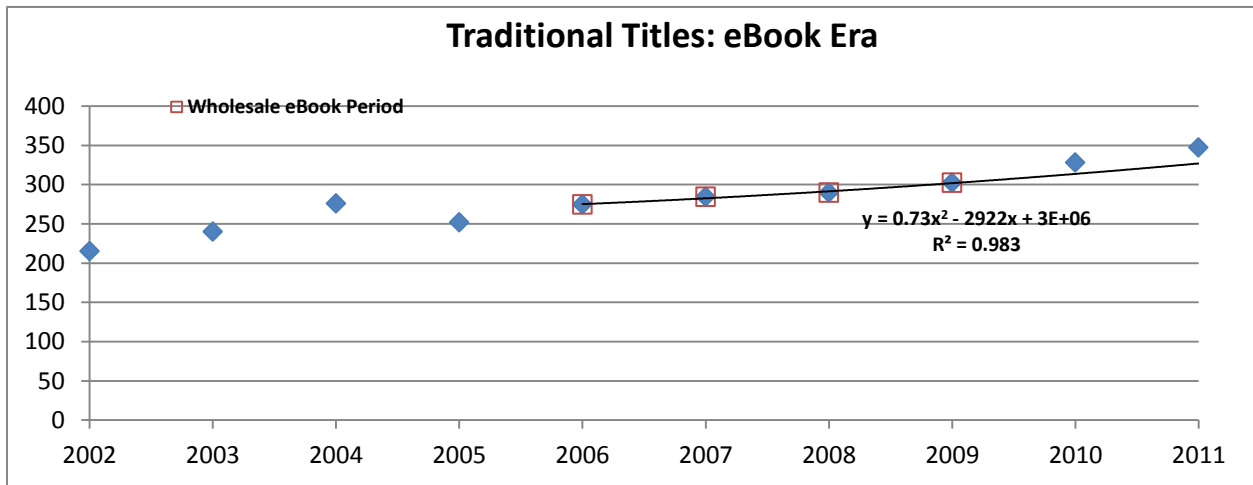
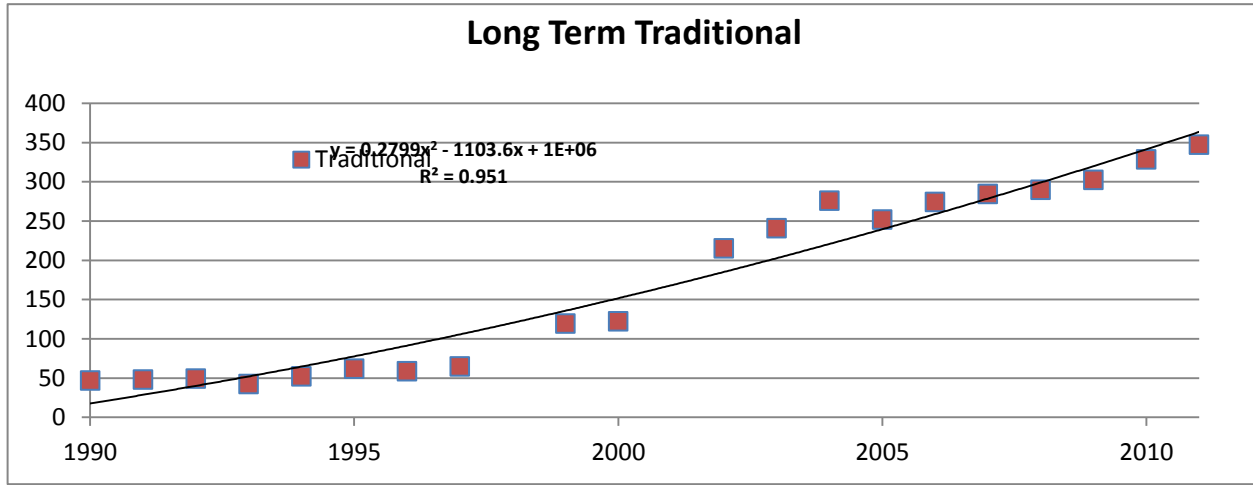
Indeed, Barnes & Nobel committed to development of an ebook reader long before the cartel came into existence and (presumably) without knowledge of the cartel (although it would be interesting to see whether there were anticompetitive terms and conditions in its contracts). Apple's vigorous efforts set up the cartel are not a demonstration that it would not have offered the iPad in the absence of the cartel. We doubt that Microsoft will now exit the ebook market, or cancel its plans to offer a tablet now that cartel agency pricing has been challenged by the antitrust authorities.

Markets in digital technologies do have a tendency to be winner-take-most, but absent anticompetitive activity, they also tend to exhibit significant entry and exit that disciplines the abuse of market power. Incumbents complaining about prices that are too low does not, and should not, receive a lot of sympathy from the public or the antitrust authorities. First and foremost, the cartel agency model served the interests of the colluders, not the public.

Output Expanded before the Agency Cartel Pricing Model was Adopted

The claim that the proposed settlement is not in the public interest is tied directly and tightly to the claim that bookstores are central to the health of the publishing industry and therefore the production and distribution of books and that cartel agency pricing is the only means to ensure the existence of bookstores. There is nothing in the long term or short term trends in either traditional or non-traditional titles to support this proposition. The publication of traditional

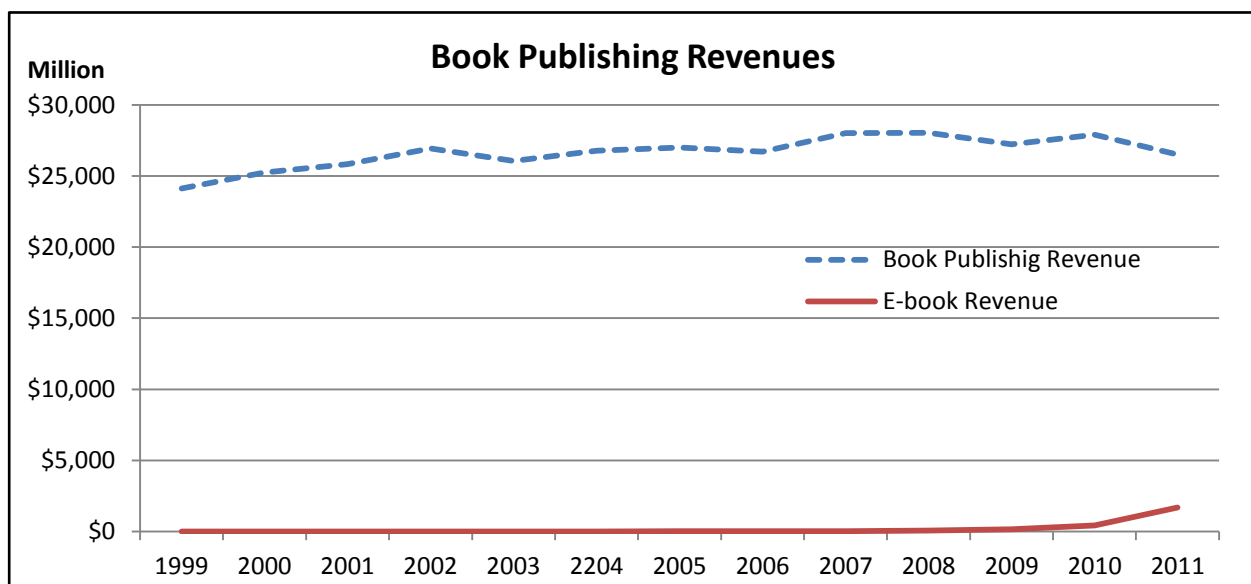
TITLES PUBLISHED PER YEAR (THOUSANDS)



Sources: Statistical Abstract, Bowker,

titles has expanded relatively steadily through the pre-eBook, wholesale eBook and cartel agency ebook eras. Non-traditional titles expanded rapidly with the introduction of ebooks, spiked in 2010 and settled down in 2011.

Over the same period, eBook revenues have increased, although total revenues are down slightly. Since the availability of eBook lowers costs and prices, the change in the number of units shipped is likely to be close to the historic trends. 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 growth of ebook distribution.



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 2011," *Digital Book World*, February 27, 2012

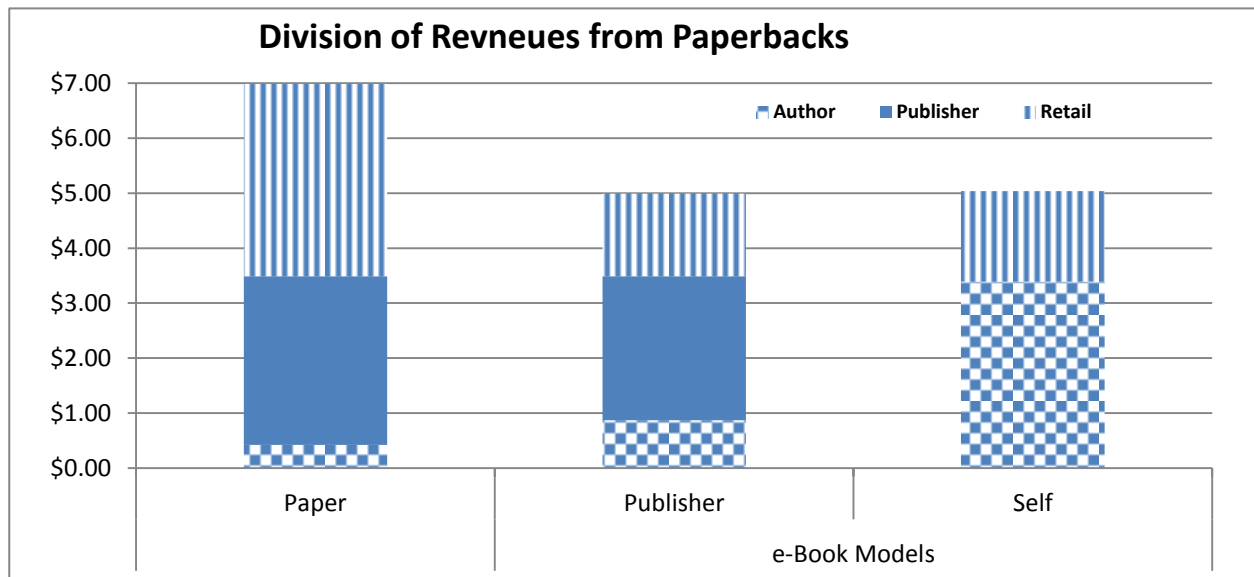
The eBook Market is Vulnerable to Anticompetitive Practices

There is tendency to assume that whenever technological change deeply affects a market there is no need to worry about antitrust, since technology tends to loosen the grasp of the incumbents. The recording industry and the publishing industry show that this assumption is wrong. The ability of the publishers to collude with a favored distributor and impose their cartel

conditions on a major digital distributor raises another important concern about the effects of the cartel agency model. The publishers have shown the ability to control the business models that can prevail in cyberspace by withholding access to marquee content. This serves as a strong reminder that anticompetitive the business practices can trump technology.

If publishers can dictate which business models flourish and which fail, consumers and authors will be worse off because the bargaining power of authors and alternative distributors will be weakened. Not only will the publishers push higher ebook prices to defend the sale of physical books, but they will also have strong preferences for digital models in which they play a larger role. They will certainly disfavor alternatives that promote self-publishing, which eliminates their role altogether.

An analysis of the split of revenues from paperbacks makes the point. Consumers and authors benefit from an e-book market in which collusion is not present, but authors benefit most if they can self-publish. One of the great fears of the publishers was that Amazon, which promoted self-publishing could encourage authors to bypass publishers altogether. Therefore they have a strong incentive to disfavor such alternatives.



Source: Andrew Zack, "Making E-books Is Harder Than it Looks," June 20, 2012.

CONCLUSION

These comments show that the claims of the brick-and-mortar bookstores and celebrity authors are incorrect. The cartel agency model was not harmless to consumers or benign for the market.

In order to defend cartel agency pricing the brick-and-mortar bookstores and celebrity authors have had to concoct a description of the market in which bookstores are squeezed between two much more efficient distribution models – big box mass marketers on the one side and long-tail e-tailers on the other. With efficiency all around, they impute massive importance to their particular function, even as it is being rapidly eroded. The story told by the brick-and-mortar bookstores and celebrity authors is nothing more or less than a “luddite” rant against change. One astute observer of the music business in the digital age concluded that “it looks like the record business is doomed. The *music* business, however, has a bright future.” Books are being devalued, literature is not.

The competitive structure built on a cartel agency pricing model increased the price to consumers and the profits of colluding publishers and selected brick-and-mortar retailers. There are no indications that the book market performed better in the aggregate under the cartel agency model than it would have if the offending practices had not been present. The proposed remedy dials back to a moment before collusion distorted the development of nascent digital books distribution. For a brief period of time, it requires the colluding publishers to return to the wholesale model on which they relied before they entered into a cartel. Far from being unprecedented or excessively regulatory, it is quite moderate and faithful to the intent and practice of the antitrust laws.

Of equal, if not greater importance, the remedy seeks to reverse anticompetitive practices that were intended to short-circuit the consumer-friendly economic thrust of the development of the digital economy. One of the most important focal points of public interest advocacy in

understanding the impact of the digital revolution on consumers is to understand on how digital disintermediation has increased efficiency in distribution and benefited consumers in many markets including digital content industries like music, e-books, newspapers, and video, as well as physical space industries.

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 online. 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 distribution of goods are familiar – music, Tower Records; computers, CompUSA; electronic devices, Circuit City; video cassettes, Blockbuster; books, Borders; 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.

The academic research into the relationship between digital and physical books yields results that are similar to the music space, although there is less of it.⁴¹ Cannibalization is less of a problem than it seems. Lower cost used books expand the market. The driver is not only price, it is also much more efficient distribution. Research on new e-books also shows that the digital and physical products are differentiated. Withholding e-books does not greatly increase sales of physical books. The loss of digital sales is much larger than the increase in physical sales. The more efficient digital production and distribution models will certainly put downward pressure on prices, but cost savings mean that more output is delivered more efficiently to the consumer.

The argument put forward in defense of collusive price fixing under the cartel agency model and now transformed into the bases for a critique of the settlement, is antithetical to the antitrust laws and the essence of digital distribution.

The Internet and the digital technology on which it rides are coming to maturity, after about 20 years of development in commercial applications.⁴² Unlike many other disputes over digital distribution of content, these do not involve claims of piracy or concerns about privacy. They are 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 these practices will send a strong signal that physical space incumbents will not be allowed to use anticompetitive practices to distort or undermine emerging digital alternatives.

The eBook price fixing cases is part of a long list of issues that antitrust authorities have faced in recent years as digital disintermediation unsettles important product markets. Access to

⁴¹ Cooper and Griffin.

⁴² Mark Cooper, 20112“Why Growing Up is Hard to Do: The “Quarter-life Crisis” of the Digital Revolution triggers a Struggle to Find 21st Century Solutions to 21st Century Challenges, Session on Multi-stakeholder Bodies and Internet Governance, The Digital Broadband Migration: The Challenges of Internet Law and Governance, Silicon Flatirons, University of Colorado Law School, February 12-13.

content for distribution in new digital models has been a prominent part of several antitrust actions, including the e-book complaint and the complaint that laid the basis for the settlement in the Comcast-NBC merger.⁴³ It also factored into the resistance of antitrust authorities to suspend the antitrust laws in order to allow newspapers to control digital distribution of news content.

These content-focused actions to preserve competition are part of an even longer list of cases in which the DOJ, the FTC, and the Federal Communications Commission have recognized the importance of stopping old-fashioned anticompetitive behavior from undermining nascent competition and the development of alternative business models online. Their efforts run the gamut from traditional concerns about horizontal concentration (AT&T-T-Mobile) and anticompetitive, most favored nation 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-ATA).

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.⁴⁴ 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.

⁴³ Acting Assistant Attorney General, Sharis A. Pozen, Remarks, Brookings Institution, April 23, 2012. The Comcast-NBC merger also demonstrated how merger conditions must be monitored and enforced to be effective in protecting competition.

⁴⁴ Cooper, 2012.

The digital world is different from the traditional models in some respects and not so different in others. Digital technologies lower costs and force incumbents to give consumers new choices. Digital technologies do not eliminate the concern about market power; if dominant incumbents have control over marquee content or bottleneck facilities, they can abuse their market power. Thus, we view vigorous action to address the anticompetitive threat of the ebook cartel agency model as an important part of the effort to reinvigorate antitrust in America and the battle to ensure that consumers get the full benefit of the digital revolution.