"Digital Disruption"

Are competitive forces in the book publishing marketplace contributing to the utility maximization of consumers' purchasing and price options for ebooks? An analysis of emerging economic models.

By

Donald Sedgwick

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Approved: Dr. Mark Raymond
Supervisor

Examiner: Dr. Mark Raymond
Associate Dean
Sobey School of Business

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The proliferation of ebooks and ebook readers is causing a digital disruption in the publishing industry as consumers alter their reading and purchasing behaviours. This research paper attempts to determine if those same consumers are being fairly served by the current pricing practices for ebooks. It also looks at the “invisible hand” of economist Adam Smith to see if there are sufficient checks and balances to create a fair and competitive environment for consumers. The thesis revolves around four fundamental questions for the book publishing industry. Is it possible to have a state of utility maximization under the current economic conditions? Are there sufficient competitive mechanisms to sustain such a state? What is the right pricing model – or models – for ebooks? More broadly, is the current publishing industry sustainable?

Keywords: ebooks, publishing, pricing models, Amazon.com

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SECTION ONE: TAXONOMY OF EBOOK PUBLISHING

1.1) Introduction & Thesis Overview

One of the most significant events of the past millennium was the invention in 1440 of the printing press by Johannes Gutenberg. By creating a device that could make multiple copies of a manuscript, Gutenberg essentially helped to create the communications industry. Great thinkers now had the opportunity to disseminate their works by being *published* (from the Latin “publicare,” which means “to make public”). Printing presses begat bookstores, which in turn promoted literacy and created a buying public for written material. Writers were now paid for their manuscripts by the printer/bookshops. Eventually, payments and copyright were also enshrined in this new publishing economy.

The second great revolution in the culture and commerce of book publishing occurred during the past decade. Once again, the event was occasioned by new technology: the ebook and its helpmate the ebook reader. This technological revolution in reading and the dissemination of information created a “digital disruption” not dissimilar to what happened in the mid-fifteenth century.

When new technologies are introduced on a worldwide scale, they have the potential to cause radical alterations at all levels of society. This phenomenon was documented by Christensen (1997) in *The Innovator's Dilemma: When New Technologies Cause Great Firms to Fail,* published by the prestigious Harvard Business School Press. Although Christensen was working in the disk-drive business when he wrote this seminal book, his analysis could just as easily refer to the ebook phenomenon. He noted how an industry crisis could involve “...changes in technology, market structure, global scope, and vertical integration" and could ultimately be "pervasive, rapid, and unrelenting" (Christensen, 1997, p. 3).

If we examine even earlier literature, we can find the roots of theoretical thinking about technological change and the reshaping of entire industries. Henderson and Clark (1990) proposed four consequences of innovation and their impact on a company or an industry: incremental innovation, modular innovation, architectural innovation, and radical innovation. Radical innovation of existing technology is not always beneficial, according to Henderson and Clark. The benefits may come at the cost of non-beneficial externalities. In the case of ebooks, Loebbecke (2010) at the University of Cologne claimed that "radical redefinition of existing technologies and the necessary intra-firm adjustments are not always beneficial" (Loebbecke, 2010, p.12). This observation was made in direct reference to Amazon.com and the introduction of "a business model built on the direct link between selling a new generation reading device and globally branded ebook content" (Loebbecke, 2011, p.12).

What are the features of an ebook that have caused this dramatic shift in our reading habits and in the way we purchase and consume electronic reading material? This question was addressed by Carreiro (2010) in her peer-reviewed article for *Publishing Research Quarterly* entitled "Electronic Books: How Digital Devices and Supplementary New Technologies Are Changing the Face of the Publishing Industry." Carreiro offered an extensive list of features that distinguish electronic books from print books, including "...media, distribution, functionality, management, quantity, copyright and fair use, information technology, cost, typology of ebooks, reading device specificity or lack thereof, pricing, accessibility, publishing model, book news and peer reviews, service model, quality assurance, standards and interoperability, user preferences, layout and paging, and contextual reading" (Carreiro, 2010, p. 220). She also offered further classification features: "Electronic books have an advantage over regular books in terms of creation, revision, dissemination, use, and access control" (Carreiro, 2010, p. 220). Many of these differentiating elements will be discussed in the pages that follow.

This changing model of the "book" has led to complex changes in the modern world of publishing. The intention here is to examine alternative economic models for the transference of intellectual property specifically through the medium of the ebook. This thesis poses the question of whether there are *sufficient economic forces in the publishing industry to ensure the utility maximization of ebook buyers.* Stated differently, is the marketplace allowing ebook buyers to purchase these products efficiently and at the best possible price? By examining a variety of pricing and distribution models, the research paper determine if the dual principles of utility maximization and equi-marginality hold true for the ebook industry. In the process, the research paper will also attempt to explain why some consumers seem unwilling to pay for information in a digital format.

A review of the academic literature produced a lengthy list of relevant articles on ebooks and the publishing industry. One of the peer-reviewed studies was "Impacting Forces on eBook Business Models Development" by Tian and Martin (2011) in *Publishing Research Quarterly*. From the abstract, it appeared to cover similar material as this research paper, but by the authors' own admission their article was merely a brief introduction to the subject. Business models for the publishing industry are a complicated subject, which they admitted has only been "introduced" in their research paper (Tian and Martin, 2011). Indeed, they suggested a follow-up paper would examine the "creation of relevant and sustainable business models...” (Tian and Martin, 2011, p. 244).

There are several other major differences between the *Publishing Research Quarterly* article and the current research paper. The authors of that article are members of the Faculty of Higher Education at the Swinburne University of Technology in Australia. As a result, they were examining the topic of ebook business models from the perspective of digital technology, whereas the current paper focuses on an economic model and is based on the writer's experience in the North American book publishing industry. It is also worth noting that ebook sales, according to Tian and Martin), represent less than 5% of industry sales in their country (Tian and Martin, 2011, p.239). This makes the phenomenon much less consequential than in North America, where ebook sales have grown exponentially and now represent almost 30% of all industry revenues. Another shortcoming of the Tian and Martin paper is that it was published before the extraordinary industry shake-up occasioned by the Department of Justice's lawsuit directed at Apple and five of the largest multinational publishers.

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The economic principle of *utility maximization* states that people act in a way that gives them satisfaction and serves their self-interest. Conversely, people try to avoid acting in any way that might diminish those results. This bold attempt to create a worldview based on the the elements of pleasure and pain was outlined by jurist Jeremy Bentham (1748-1832), who introduced the word “utility” as a framework for human activities. Bentham was best known as one of the great thinkers of the school of Utilitarianism. This line of scientific reasoning had as its basis a singular notion: collectively we should “maximize the sum of the utilities of all members of society”

(Perloff, 2007, p. 335). Stated differently, we must strive for the greatest good for the greatest number of people. By measuring the results of our efforts, we create a benchmark for deciding what is therefore good or bad, i.e., desirable or not.

Today we sometimes substitute other synonyms for "utility." As the Nobel Prize-winning economist Daniel Kahneman (2011) noted in his bestseller *Thinking, Fast and Slow,* "decision utility" or simply "wantability" are more useful points of reference (Kahneman, 2011, p. 377). This economic worldview focuses on the activity of decision-making beyond the emotional outcome of day-to-day behaviour. As a theoretical construct it helps to connect utility maximization to another important construct – the equi-marginal principle. Here we see the "mathematics" that allows economists to measure the principle of utility maximization at work. Human beings examine what they need and want, and then they determine how much they are willing to offer or sacrifice for those objects or experiences. The "mathematical" part is the tradeoff: it estimates the value of the gain versus the value of the cost in order to determine if utility has been "maximized" in the exchange.

Human beings are constantly making decisions in their lives as profit maximizers. This grand scheme is demonstrated in our purchasing decisions when we subtly calculate how much harder or longer we might have to work, for example, in order to obtain a larger house or to support a more lavish retirement. On a more immediate level, we revel in new technologies that allow us to make instant shopping comparisons of price and value. This phenomenon (viewed in derogatory terms by some retailers as "showrooming") allows consumers to stand in the aisles of a consumer electronics store making choices between products by using mobile phone apps designed specifically for this purpose. Jeremy Bentham's principles of pain and pleasure – at least in terms of modern shopping – have been reduced to emotionless clicks of a button. Marginalist economics is now a reasonably painless exercise.

The difficulty with this new world order, however, is that the *price* of a product does not necessarily equate to the *cost* of a product. The larger social, cultural, environmental and other costs or producing and selling a product result can only be fully calculated by including all of the *externalities.* These results or byproducts of these activities may or may not be intentional or even avoidable. If these costs were to be factored into the retail price of a product, however, the final price might be substantially higher. In determining the actual price of an ebook, for example, it is essential to look at both micro-economic and macro-economic parameters: efficient allocation of resources, social benefits as well as self-interest benefit, intrinsic and extrinsic incentives, and the principles of supply and demand, markets, exchange principles, and efficiencies. The key question is whether these elements are reflected in the price-tag attached to a product.

This subject was addressed directly by Loebbecke (2010): “The emergence of ebooks and ebook readers is likely to change the book industry structure and pose new opportunities and challenges for ebook publishers and vendors” (Loebbecke, 2010, p. 2). “Hardware manufacturers and Internet Service Providers (ISPs) have already entered the book industry and they may outpace the traditional industry players in the creation of new business models for digital content” (Loebbecke, 2010, p.2). Loebbecke also referenced possible lessons to be learned from the music industry, which “went digital” before the advent of ebooks. “Does another set of digital products and services suggest cross-industry 'convergence' of business models and revenue sharing structures?” she asked.

"Or will varying usage preferences, different traditional industry structures, and specific regulatory backgrounds drive conceptually different developments?" (Loebbecke, 2010, p.2).

Carreiro (2010) argued convincingly that ebooks are a disruption for the publishing industry, but they do not represent a *replacement* technology. Nevertheless, these new reading technologies are forcing an entire culture to make very difficult choices. A modern-day Jeremy Bentham might argue that the net pain of some economic decisions far outweighs the net pleasure. Indeed, Kahneman challenged the precise connection between *what* we choose and how much we might *enjoy* what we have chosen. As he pointed out in his chapter entitled "Two Selves," rational agents "are expected to know their tastes, both present and future, and they are supposed to make good decisions that will maximize these interests" (Kahneman, 2011, p. 377).

This moral imperative appears to be hanging like the sword of Damocles over the current deliberations of book publishers. The entire industry is grappling with the challenge of an evolving ebook technology. Publishers worry that the externalities of the current digital disruption may spell their own imminent demise. At the same time, a number of factors might lead to new and fair pricing models for ebooks, which in turn might support true utility maximization for consumers.

For example, this paper will show evidence of lower price trends that still create sustainable prices for publishers and authors. Part of this trend has been brought on by a backlash from consumers and certainly from independent bookstores. Both of those stakeholders have argue for the importance of "discoverability" in the book ecosystem. People need to see and explore new books *in person* before they are willing to purchase them – regardless of the delivery mode. Not surprisingly, librarians are also playing a key role in this discoverability process.

Publishers are more than pleased to support all of these interest groups. Recently their adversary has not only been the powerful force of Amazon.com, but also the United States Department of Justice and their multi-pronged collusion lawsuit. Publishers, however, have pushed backed strongly, as have writers' groups, literary agents, and other industry professionals. At the same time as ebook sales are also now starting to level off, the low barrier to entry into the ebook market has created new alternatives for the publication and distribution of this reading format. Smartphones, for example, are quickly becoming the preferred method for multiple forms of communication and information access. As a result, the popularity of the Kindle might be more short-lived than Amazon.com anticipated.

In fact, Amazon.com itself might be becoming a victim of its own success. Author disenchantment and several tactical errors by this industry giant could be softening their user base and pushing producers *and* consumers of book products to other distribution channels. Certainly the quality of some of their offerings is being challenged. In this age of instant reviews and the widespread distribution of that content, consumers may be finding that the age-old caution of "you get what you pay for" is holding true with the content offerings of Amazon.com.

Together, all of these factors are creating a challenge for everyone in the ebook business. The question is whether that challenge will be answered in a way that can sustain the publishing industry through another decade as it finds new models to satisfy consumers' reading habits.

1.2) Thesis Terms & Analytical Parameters

Are competitive forces in the book publishing marketplace contributing to the utility maximization of consumers' purchasing and pricing options for ebooks? An analysis of emerging economic models.

At this point it is important to establish our understanding of the terms, definitions, and parameters of this research paper. For the purposes of our discussion, “competitive forces” are broadly interpreted to mean all the factors that might influence the ultimate price of an ebook paid by a consumer. These strategic elements can be analyzed through a variety of matrixes, including Michael Porter's classic Five Forces model.

“Book publishing” marketplace includes what is commonly referred to in the industry as “trade books.” These are popular titles available in traditional bookstores, as opposed to works produced for academic, scholarly, scientific or professional purposes. (Anything included on a bestseller list in a newspaper or magazine, for example, would normally be a trade book.)

The “marketplace” includes all parts of the supply chain that deliver content from authors (creators) to publishers (producers) to readers (consumers). This would comprise include authors, literary agents, publishers, printers, wholesalers/distributors, bricks-and-mortar retailers, online retailers, book readers, and libraries. Additional forces at play in this broad marketplace would include industry regulators, associations, monitoring bodies (including the trade media), as well as state and federal regulators. Internationally, there are other influencing factors, although that subject is beyond the scope of this research paper.

The verb “contributing” in the thesis statement is more critical than it might appear. The central issue is whether the checks and balances of a fully functional and transparent industry are operating in an efficient manner.

"Utility maximization" refers to the "invisible hand" of economist Adam Smith, as outlined in his *Enquiry Into the Nature and Causes of the Wealth of Nations.* Is this force still silently and efficiently guiding the world of commerce? More to the point, are his three pillars – self-interest, supply-and-demand models, and competition – all in sync and serving the best interests of the consumer? By examining the emerging economic models in ebook marketing, this research paper will address these pressing issues.

"Consumers' purchasing options" may already reflect a changing paradigm for the trade book industry. Perhaps "purchasing" itself is outdated, with its notions of a fixed object that is bought and owned by a consumer. How does "purchasing" relate to an ebook that can be "rented" (or even borrowed at no cost) overnight from a "cloud" source, *improved* by the reader, and then *returned* to the "vendor" for further use?

At the centre of this study is the notion of "pricing" and equally the *costs* that must be factored into this calculation. Pricing is a reflection of the producer's fixed and variable costs, plus a calculation for acceptable rates of return on an investment. Pricing is also influenced by regulatory issues and legal statutes. All of these factors are then added to the costs and challenges of supply-and-demand variables.

"Ebooks" warrant an entire descriptive section of the thesis, along with the devices used to download and read them. This material is included in the following pages.

"Emerging models" are appearing in the marketplace almost daily as the publishing industry addresses the challenges of reinventing itself. These models are analyzed in sections 3.3 and 4.2 of this research paper.

1.3) Definition & Features of Ebooks & Ebook Readers

One of the first challenges in developing this thesis was to determine a working definition of an ebook. The fact that there was not even a standard way to *spell* the term (ebook, e-book, Ebook, etc.) indicated the nascent level of the technology. Does it refer to print-form book content that has been converted to a form that can be read on a digital device? Is an ebook limited to content that is only developed in order to be read on an e-reader? And is the content "fixed" as in static (like a printed book), or can it be an evolving text that may pass through several iterations via the author or with the assistance of writing collaborators?

Fortunately, the peer-reviewed literature has helped to build a consensus on the definition of this genre. Chris Armstrong, the managing director of Information Automation Limited, tackled the subject in an article on the evolution of the ebook and its lexicon (Armstrong, 2008). He found fault with scholars who fixate on the *form of delivery* or the *physicality* of the book, referencing in passing the *Oxford English Dictionary's* equal emphasis on the *content* of an ebook. Armstrong contended that a print book is an interface or a content holder. Ebooks are content that is simply in a different delivery mode which utilizes hardware and software (Armstrong, 2008).

Armstrong (2008) also updated the notion that ebooks are confined to print books that have been digitized. There are innumerable print books that have been converted to digital files, but there are also ebooks that are "born digital." He further encouraged readers to specify whether an ebook was in plain text or if it had some value-added features such as hypertext (Armstrong, 2008). (Other academic papers refer to "static" vs. "interactive" ebooks.)

Loebbecke (2010) reviewed the relevant literature about ebook definitions in her article entitled “The Emergence of Ebooks” and included references to Armstrong's work. Loebbecke concurred with Armstrong that an ebook is any content that is “book-like” and “...made available electronically for reference or reading on any device (handheld or desk-bound that includes a screen” (Loebbecke, 2010, p. 3). This definition clearly eliminated any content that might be an e-text.

Loebbecke (2010) noted the thirty-seven definitions examined by Vassiliou and Rowley (2008). These definitions frequently reference the printed book as a key element of an ebook. Vassiliou and Rowley (2008) condensed all of their findings into a comprehensive and workable definition as follows: “An ebook is a digital object with textual and/or other content, which arises as a result of integrating the familiar concept of a book with features that can be provided in an electronic environment” (Vassiliou and Rowley, 2008, p.363).

Publishing scholars appear to agree that an ebook is an object that *looks similar* to what we know as a traditional book, but one that has additional elements. Ebooks, of course, have developed far beyond a mere adaptation of a previously published print version of content. “Ebooks typically have in-use features such as search and cross-reference functions, hypertext links, bookmarks, annotations, highlights, multimedia objects, and interactive tools” (Loebbecke, 2010, p. 4).

One of the most informative peer-reviewed articles on the types of content that fall under the category of an ebook was by Soules (2008) in “The Shifting Landscape of E-Books” in *New World Library*, although even an article this recent is quickly out-of-date in the fast-moving realm of ebooks. Soules explained how an ebook could appear in any of the following incarnations:

- A print book that is converted to a digital file, or similarly an out-of-print book that is reissued as an ebook.
- An ebook that *could* have been issued as a traditional print book but was marketed first and directly as an ebook.
- An ebook that evolved as a result of reader contributions and/or feedback based on a previous print or ebook.
- An ebook that has a minimum of text and is focused instead on visual and audio content – yet still has the "look and feel" of a book.
- An ebook that is less of a "permanent" document and more of an ongoing "content holder" for evolving reference material (Soules, 2008, p. 8)).

The latter model was addressed by Laquintano (2010) in his peer-reviewed article entitled "Sustained Authorship: Digital Writing, Self-Publishing, and the E-book" in *Written Communication*. The title of his work referred to the process whereby an author and his/her reading audience have a continued interaction with the content of the ebook. This author-reader relationship breaks down the barrier between a content deliverer and a consumer. In the process, we lose the notion of a product that is delivered in a linear fashion and then owned by the consumer. We also lose the notion of a fixed piece of writing that is formally published in a finished format and delivered to the public through the medium of a book publisher. According to Laquintano, the "economics of digital text" are changing and we now have the potential to realize a "disintermediated relationship with readers" (2010, p. 472).

Not surprisingly, the traditional book publishing industry does not usually encourage this kind of self-publishing. Nevertheless, some authors are enjoying success and have “integrated and leveraged value from this nonmarket production” according to Laquintano (2010, p. 471). “In lieu of the capital investment of publishers,” he explained, “authors and reader/writers have manufactured valuable texts through collective literary practices, coming to a loose consensus on what constitutes a book, and working together to preserve proprietorship over texts” (2010, p. 472). These developing writing communities have been able to alter the flow of “published” material to enable texts to be “exchanged for monetary value” (2010, p.472).

In response to issues about quality control in the absence of a traditional publisher, Laquinano was quick to dismiss the criticism. He claimed that publishers' control had now morphed to peer review and communal approval. In the same way that eBay “self-polices” through public postings about buyers and sellers, the literary community is able to uphold standards of writing excellence through the posting of disinterested reviewers.

Writers who eschew Laquintano's advice can still choose to follow the traditional publishing model for ebooks in the trade book industry. In this field of study, the acknowledged expert is Mike Shatzkin, president of Idea Logical in New York. He has written extensively about this model over the past decade, and he focuses on three broad types of books and corresponding ebooks. He bases this modeling on both the content of the text and on how the text is read and consumed (Shatzkin, 2012).

The primary type of book consumption is what he calls immersive reading. In this instance, a reader wishes to purchase and consume books that are linear in terms of the presentation and in the way they are intended to be read. Examples of immersive reading material would primarily fall under the category of fiction, although narrative non-fiction would also qualify for inclusion. Not surprisingly, the most successful sales in the world of ebooks are found in genre fiction: mysteries, thrillers, science fiction, and romance. These are texts in which readers “immerse” themselves and read in a sequential fashion. In most instances, the material is intended as a means of entertainment (Shatzkin, 2012).

The second category of book, according to Shatzkin, is one he describes as “chunkable.” This is content that is *not* intended to be read in a linear fashion. Examples might be cookbooks, reference and instructional works, and travel guides. These kinds of books encourage readers to “dip” into the text rather than consume it one page after another. Here the reader relies heavily on a table of contents and/or an index in order to guide them to specific content. Although there may be a motive of entertainment in these books and ebooks, they are primarily intended as sources of information and/or education (Shatzkin, 2012).

The third type of book analyzed by Shatzkin is a format that is illustrated and/or highly designed. It may be require either immersive or chunkable text and reading, but it features proportionally more content that is visual rather than textual. (In that sense, it is not strictly immersive or linear reading content.) When books of this type are digitized and formatted for ebooks, most of the publishers (or creators in the instance of self-publishing) understandably use the elaborate technical means of the format: hypertext, bookmarking, etc. These kinds of ebooks are, in fact, only a short step away from a traditional video, with the major distinction that the content is paginated rather than continuous (Shatzkin, 2012).

Fortunately, defining an ebook *reading device* is less contentious than determining a working definition of an ebook. There are essentially four categories of ebook readers: dedicated (and usually hand-held) devices such as the Kindle, Nook, Kobo, and Sony Reader; tablet devices such as the iPad that perform other functions as well as delivering ebook content; laptop or desktop computers that offer an ebook reading function; and portable devices such as the iPhone which have ebook reading applications. An ebook reader is – broadly speaking – any device that offers a reading screen for ebook content. Depending on how "dedicated" the device is to the activity of ebook reading, it will have more or fewer applications related to the downloading, storage, and use capabilities of the ebook content.

1.4) Ebook Readers' Use & Consumption Preferences

In 1964, Marshall McLuhan penned his bestselling book *Understanding Media* in which he offered the now-famous quote "The medium is the message" (McLuhan, 1964, p. 108). McLuhan believed the *content carrier* and not the *content* itself was the most important element. He was acutely aware how a technology medium could transform our society by influencing how we see and interpret the world. Taken a step further, a new medium could also affect the way we communicate and interact with one another. If the Gutenberg press was one cornerstone of this philosophy, McLuhan might have viewed the modern ebook as the other foundation. Ebooks have literally changed the way we read, write, and communicate.

This thesis was developed at length in a peer-reviewed online article by Hillesund (2010) entitled "Digital reading spaces: How expert readers handle books, the web, and electronic paper." He described how digital reading actually changes the way we read, how we study, how we absorb information, and the types of reading ideally suited to digital devices. Hillesund said digital reading tends to be more superficial, discontinuous, less linear and more fragmented. Ebooks as a medium encourage readers to do more skimming, sampling, and bouncing around within a text. According to Hillesund, long-form reading of continuous text is best done on paper.

McLuhan would have been interested to see Hillesund's focus on the tactile notion of e-readers. He focuses on the aesthetics, weight, manual navigation, and readability as key features of a new form of reading and text consumption. Similarly, he draws our attention to key technological features, such as screen-size, reflection, contrast, adjustability of fonts, and use of the device in different circumstances (traveling, for example). For Hillesund (2010), the focus should be on the "internalization" of the reading experience.

The most extensive and reliable research on consumers' attitudes towards ebooks and their purchasing behaviour has been conducted by the Book Industry Study Group, Inc. (BISG) in New York. For the past thirty years, it has been "the U.S. Book industry's leading trade association for policy, standards and research" (BISG, 2012, aboutus). BISG is owned and operated by Bowker, which describes itself as "the world's leading provider of bibliographic information and management solutions designed to help publishers, booksellers, and libraries better serve their customers" (BISG, 2012, aboutus).

Since November, 2009, BISG has been tracking consumers' behaviour in the access, purchase and use of ebooks in the United States. Their survey results have included a different demographic of 3000 individuals each month in order to compile comprehensive and reliable statistics. Among the many consumer issues touched on in the BISG survey are the following: access, portability, readability, searchability, and affordability.

During the four years of their research, the BISG has released numerous press releases about their research findings. The following data were particularly relevant to this research paper:

- The first and most important reason that readers prefer ebooks over print books is affordability.
- Roughly 44% of survey respondents say they are buying more "units" and 34% report they are spending more on a combination of ebooks and print books.

- Ebook readers are getting more of their information about products from the retailers and less from the publishers – which was traditionally the case.
- More than 65% of survey respondents say they have moved almost exclusively to ebooks from print books.
- According to survey respondents, the two most important factors that relate to purchases are free sample materials and low retail prices.
- BISG suggests there is “the emergence of a bifurcated market, with preference for e-reading devices such as Kindle and NOOK as devices of choice for most fiction readers, while the iPad and other tablets are preferred by those engaging in more interactive types of reading that includes charts, graphs and multimedia” (BISG, 2011, p. 2).
- General fiction and mystery fiction are the two literary categories showing the fastest rate of growth. Overall, fiction accounts for more than 60% of all ebooks sold.
- Overall, the “substitutional mode” of book-buyers is indicating “an extraordinary shift in the marketplace” (BISG, 2011, p. 1).
- More than half of all ebook readers are increasing their use of apps in order to access ebook materials.
- More than one-third of ebook buyers are reducing their book purchases at national chains, and a slightly lower number are reducing their purchases at independent retailers.
- More than one-third are increasing their purchases at general online websites such

as Amazon.com. “Amazon.com continues to be the preferred source for ebook acquisition (holding steady at 70%) and ebook information (44%)” (BISG, 2011, p.1).

- Once a reader starts using ebooks, their purchases are likely to increase by more than 30%
- “Some publishers are reporting that even when overall revenue has declined, profitability – particularly for ebooks – has increased” (BISG, 2012, p.1).
- Overall, the “power buyers” are spending more. Amazon continues to dominate the online market. Ebook readers are expressing satisfaction with the reading experience on the various devices. And overall, the BISG says “many barriers to ebook reading are falling” (BISG, 2011, p.1).

One of the more interesting recent statistics was reported in the respected trade journal *Publishers Weekly* on April 4, 2012, in their coverage of the national survey of nearly 3000 readers by the Pew Research Center's Internet & American Life Project. “According to 'The Rise of E-Reading'..., the average reader of ebooks says he or she has read 24 books in the past 12 months, compared with an average of 15 books by non-ebook readers” (Albanese, 2012, p.1). This statistic is helpful as a general comparison of reading habits, but it is vitally important in terms of our analysis of ebook pricing. If a reading device needs to be “amortized” over its life and costed by factoring the price-savings over print titles, then the number of titles consumed over the device's projected lifespan is a vital statistic for these calculations.

The same study by the Pew Research Center found that ebook readers are reading

33% more books than print-only readers. If you own a dedicated ereader device, you will read 50% more books than readers without a device. (This second point is central to the discussion in section 3.4 about Amazon.com's marketing strategy vis-a-vis its Kindle devices.) Meanwhile, a survey in August of 2010 by Marketing and Research Resources Inc. had some interesting observations about early adopters of ebook technology. “Amazon.com, the biggest seller of ebooks,” noted the survey conclusion, “says its customers buy 3.3 times as many books after buying a Kindle, a figure that has accelerated in the past year as prices for the device fell” (Fowler, 2010, p.1). Megan Power in *The Chronicle Herald* said laggards “usually adopt new technology when the device increases the relative advantage to them so it is no longer worth their while to resist” (Power, 2012, p. 1).In economic terms, this relates directly to the utility maximization theory, i.e., the cost of reading devices and the value attribution models determined by consumers and producers.

That subject formed the core of a research article by Jiang (2010) entitled “The Impact of e-Book Technology on Book Retailing,” which was delivered at the 43rd Hawaii International Conference on System Sciences (Jiang, 2010). Jiang raised such key issues as versioning, content bundling, price dispersion, and the increase in social welfare resulting from multiple offerings via Amazon.com. Jiang suggested that positive utility issues brought forward by ebooks included the following features: increased access, pricing, selection assistance, viewing, speed and location of access, portability, recommendations, storage, device features, and hypertext and other reader assets (Jiang, 2010).

Jiang countered these positive features with a slighter shorter list of disutility features: cost of an ebook reader, DRM restrictions, learning curve, lack of sharing, lack of interoperability, availability of titles, “windowing” by publishers, device obsolescence, device overload, and the issue of excessive text typos (Jiang, 2010).

Jung-Yu Lai (2011) reviewed many of these same issues in a peer-reviewed article entitled “User Attitudes Toward Dedicated Ebook Readers for Reading.” The paper addressed the six key issues that contribute to the acceptance, purchase, and use of ebook readers. *Ease of use* refers to the fact that dedicated ebook readers do not require the use of a computer. Similarly, *usefulness* is an indication of how portability is frequently cited as a major benefit for users of ebooks and ebook readers. *Intention to use* is the category used to address the issues of consumer needs and wants, i.e., their motivation for behaviour. *Convenience* addresses the “anywhere/anytime” factors that have become so prevalent in the world of music. *Richness* describes the special features offered by an ebook and/or ebook reader, such as hypertext, dictionary apps, and voice-links. Lastly, *compatibility* indicates how the ebook approximates the print book experience. (This analysis by Jung-Lu appears to be based on the classic Technology Acceptance Model [TAM] developed by Fred Davis in in 1989 and further refined by Davis and other scholars in their Perceived Usefulness model and the Perceived Ease-of-Use model.)

Valuable data about ebook content and usage characteristics was presented at the “Tools of Change” Conference in New York in February, 2012. Following the lead of Mike Shatzkin, industry experts focused on the type of content being presented in ebooks (immersive or episodic), how the ebooks are consumed (via browsing or downloading), and the degree of interactivity needed in a trade book title (usually quite low). As was noted in the peer-reviewed articles above, ebooks are primarily being used for entertainment, education, and light reference purposes. For those reasons, the users and purchasers will want to be able to archive the ebooks for use at a later date.

Additional recent data on book-buying behaviour in the United States was delivered in January, 2012, at the Winter Institute, an annual industry session in New York convened to review industry developments. Each year at this meeting, Verso Digital presents its survey of consumer purchasing behaviour. This past year the findings included several highlights. First, the growth of ebooks is not a zero-sum game with regard to print books. It is more akin to "symbiosis," suggested Jack McKeown, director of business development for Verso Digital. Second, avid readers tend to be "older, female, wealthier, and better educated," he told industry journal *Shelf Awareness* (McKeown, 2012, p.13). This demographic represents approximately 30% of the U.S. population.

McKeown's third point focused on technological adoption patterns. The ebook reader world "has gone from innovator and early adopter stages into the early majority state," he suggested. "The battle is what happens with the late majority and laggards." Traditionally, these segments "convert" when there is an innovative new device that "increases the relative advantage to them so it's no longer worth their while to resist" (McKeown, 2012, p.16). In the music industry, most observers agree this tipping point was the iPod. However, there does not appear to be a similar breakthrough device on the ebook horizon.

The issue of ebook pricing, and the availability of ebooks distributed for free, are closely related – and contentious – issues. “Every institution connected to the creation of knowledge and storytelling is experiencing a revolution,” said Lee Rainie, one of the authors of the report for the Pew Internet Project (Albanese, 2012, p.1). “It's now clear that readers are embracing a new format for books and a significant number are reading more because books can be plucked out of the air” (2012, p.1). This observation is certainly substantiated by recent data. Almost 75% of survey respondents claim it is “easy to find and download free ebooks, “ notes Loebbecke in her article on “The Emergence of Ebooks” (Loebeckke, 2010, p.19). This finding is, in turn, related to another observation in her article: Only 36% of survey respondents say the current prices for ebooks are “reasonable” (Loebeckke, 2010, p. 20).

Ebooks have clearly changed the way we read and how we obtain the content we use to educate and entertain ourselves. As Marshall McLuhan predicted, the device itself can become an integral – if not essential – part of this experience. For university students, this is apparently their new reality. In a series of brief and unfiltered interviews about ebooks with MBA students at St. Mary's University in Halifax, the answers to a series of questions were dramatic but not altogether surprising. The overwhelming favourite in terms of ebook readers was the the Kindle, mostly because it offered lots of free books. The students claimed not to know anything about the economics involved in a book. Because it is “only an electronic file,” they asked why they should pay *anything* for it.

The answer to that question and many others can be found in the ecology of the book publishing industry – and in the new business models that are now emerging.

SECTION TWO: ECOLOGY OF BOOK PUBLISHING

2.1) Publishing Industry: Analog (Print) Economic Model

Until the current decade, the link between those who wrote and those who read was essentially linear and the steps involved in the process were direct. Content was created by writers and artists. It was edited and designed by literary professionals. Printers gave the material a physical form. Then the booksellers delivered the finished products to the reader. The many *functions* that facilitated this linear process comprised the book publishing industry.

The best-known analyst of this business has been Albert N. Greco, author of *The Culture and Commerce of Publishing in the 21st Century* (Greco, 2007) and *The Book Publishing Industry* (Greco, 2011). He is also the director of the Institute for Publishing Research at Fordham University in New York. Greco has always maintained that there are ten traditional functions of a book publishing company:

- Content Acquisition: Finding new authors and contracting their work.
- Content Development: Editing the content to suit the marketplace.
- Book Design: Attending to the art and craft of the physical book.
- Management of the Production Cycle: Assembling the data files in preparation for printing.
- Prepress, Printing & Binding: Creating the physical book product from paper and ink.
- Marketing: Determining the audience and the price for the book.
- Sales: Determining the optimal channels through the supply chain to the

consumer.

- Fulfilment: Processing orders and delivering inventory.
- Customer Service: Collecting revenue and handling retail and consumer enquiries.
- Rights Sales: Exploiting additional markets and revenue streams for content (Greco, 2011, p.8).

Most of the basic functions noted above are familiar to *any* manufacturing operation. An industry that creates soft-drinks has to source the ingredients, mix them to make the beverage, package and sell it through appropriate sales channels, manage the inventory and customer relations, and continually discover new opportunities to maximize revenue. Book publishing, however, has several features that are unique to the industry – and which are especially relevant to our current thesis.

The first and most problematic issue is “returnability.” During the Depression Era, publishers allowed booksellers to purchase inventory on a fully returnable basis in order to afford the retailers “protection” for unsold goods. Because most books are ordered by retailers before the products are actually created (i.e., before they are printed), there is obviously some hesitancy about the potential of those books to sell to the public. Although there might not be much risk for a bookseller in ordering the latest potential bestseller by John Grisham, even the venerable *Harry Potter* books were a tough sale when they were first presented to booksellers. Rather than risk having a retailer *only* purchase the “sure bets,” publishers therefore allow retailers to return any inventory for full refund anytime after three months on the shelves, but no later than twelve months after receipt.

The result of this practice allows and encourages retailers to support more titles from a publisher's new offerings than simply the predictable winners. At the same time, however, the practice is enormously wasteful in economic terms. Returned books account for approximately 50% of all mass-market paperbacks, and frequently 30% or more of all hardcovers and trade paperbacks. Those numbers are the *averages.* If we factor in all of the Grisham novels and *Harry Potter* sequels, the scale of the returns takes on a phenomenal cost. This expense, of course, must then be factored into the retail price of a printed book. Industry experts suggest that returnability accounts for at least 10% of the retail price of every book printed and published.

Another unique feature of book publishing is the issue of intellectual property, and more specifically the matter of supply-and-demand economics. Unlike the auto industry, for example, where there is a reasonably predictable need and demand for vehicles, the publishing industry operates more on an *inverted* supply proposition. Publishers create books and then attempt to create the equivalent demand. Millions of young adults did not know they "needed" or "wanted" *Harry Potter,* but an enterprising publisher in the U.K. named Bloomsbury took a risk, printed 5000 copies, and then promoted it extensively in the hope of "finding" a market for the content. Without the help afforded by booksellers taking a risk (and relying on the returns factor), the *Harry Potter* series would not have gone on to sell more than 500 million copies over the past fifteen years.

Part of the reason for this awkward situation re: supply-side economics is that each book is a unique product. In the realm of fiction, there may be dozens of novels by Margaret Atwood, but each one is different. Similarly in non-fiction, even though there may be hundreds of books about gardening in Canada, no two of them are the same. As a result, each book must be sold and promoted on its specific merits and publishers must convince a skeptical marketplace that the book deserves attention. (If General Motors behaved similarly, car-buyers would have thousands of vehicles to test-drive in their quest for the ideal car.) Arguably, there are no "brands" in the world of books, although there are clearly *genres* of books, and a few fortunate authors have managed to brand themselves in a way that establishes them as economically viable "product producers" in a field of other lesser-known producers.

Two features of publishing that are common to other producers of hard goods are inventory and shipping. Book publishers normally factor in approximately 5% of the retail cost of a book to account for the expense of keeping stock in a warehouse and subsequently shipping it to wholesalers and retailers. If the retailers are unable to sell the total quantity of goods received, they must pay for the shipping back to the originating publisher. (As one wag in the industry has said, "The only people who make money in this business are the trucking companies.")

The traditional wisdom in book publishing is that the retail price of a printed book is a multiple of the invested costs, and the factor is often listed as six or seven. Using this model, a typical book cost/price model would look as follows:

Hardcover Book Retail Price:	35.00
Discount to the retailer: 45% (on average).	15.75
Royalty to the author: 10%	3.50
Design Cost: 2%	.70
Production Costs: 13%	4.55

Editorial Costs: 5%	1.75
Sales & Marketing Costs: 12%	4.20
Overhead Costs: 3%	1.05
Publisher's Revenue: 10%	3.50

Historically, 60% of all books are not considered to be profitable, 30% reach a break-even position, and one book actually makes significant income. As a result, book publishing can easily be seen as – at best – a risky proposition. At its worst, book publishing is a highly vulnerable industry operating on *very* thin margins. In either scenario, the industry is offering products for which there is a limited and uncertain market in the midst of the current economic downturn. To say that the arrival of the "digital disruption" has been a challenge would be a grand understatement.

The pricing of printed books must account for – and essentially support – all of the factors listed above in the breakdown of the retail price. In addition, any slippage in the proportions of cost, market share, and especially the success of any publisher's potential bestsellers is viewed with intense nervousness and even hostility. Costing models for individual books produced by publishers must account for all the fixed and variable costs associated with every book title undertaken. Similarly, publishers must guard their star talents jealously in order to create the revenue needed for these and similar projects.

Fortunately for publishers and authors, the libraries and other educational institutions across North America have done a phenomenal job in supporting (some would say "propping up") this economic model of book publishing and the structures upon which it is founded. Libraries buy books on a broad basis, allowing publishers to produce titles that might have broad appeal but would not necessarily constitute a national bestseller. Libraries also tend *not* to return books, i.e., they do not buy titles on speculation and then return them. For reasons that publishers are often unwilling to discuss, they frequently offer libraries lower discounts that those offered to the book trade. This, in spite of the fact that libraries tend to pay all of their bills on time and in full. (As will be discussed later in this thesis, there is understandable annoyance among these institutions about the obstacles and challenges that libraries have been encountering in recent years in purchasing and circulating ebook materials.)

Greco and his colleagues at Fordham University have identified a number of significant trends that have been chipping away at the traditional edifice of book publishing and its already uncertain foundation. Four of the major industry trends noted in *The Culture and Commerce of Publishing in the 21st Century* include "changes in the channels of distribution, the marketing of books, the best-seller phenomenon, and the electronic distribution of content" (Greco, 2007, p.10). However, Greco also mentions two broader cultural changes that directly impact the publishing industry: consumer sensitivity to the pricing of books, and a concurrent atmosphere of uncertainty in the marketplace (Greco, 2007, p.10).

Various arguments will be examined in later sections of this thesis regarding the true costs of ebooks, and also about the notion of supporting the "analog" model of book publishing, so it is worth reviewing some of those issues here. There is no question that hardcover trade books are potentially the most profitable format for book publishers, notwithstanding the fact that profit is a dubious descriptor for this industry. The higher retail price allows publishers to allocate a larger proportion and/or dollar amount to their fixed costs and overhead.

At the same time, many publishers use a costing model that allocates much or all of the development costs of a book to this first edition of a publication. As a result, a subsequent edition of a former hardcover book in a new trade paperback edition (i.e., same or similar trim-size but with a soft cover) may have a better operating margin because of the now amortized development costs. If the second edition is a mass-market version of the book, that edition would also benefit from the amortized costs. This is in large part the argument we will see when critics of ebook pricing point to the “real and expected” costs and pricing of the digital format.

Regardless of how industry critics view the *rationale* for the pricing of books and ebooks, there is no question that the digital disruption of ebooks has turned the industry on its head. The supply-chain is no longer linear. Consumers have radically altered their purchasing habits. New industry “players” that are neither content creators nor traditional retailers have gained enormous power in the publishing ecosystem. Depending on one's perspective, ebooks will either save that ecosystem or herald its demise. The answer lies in our deeper understanding of the new and emerging digital publishing models.

2.2) Publishing Industry: Digital (Ebook) Economic Models

The linear supply chain for printed books was altered forever by the emergence of online retailing and the growing dominance of Amazon.com that began a decade ago in North America. Virtually all of the previously static elements of the publishing world were now freewheeling agents. In the digital book world, authors could choose their own means of making their work public. They could simply upload content to the Internet and bypass publishers and retailers altogether. Bestselling author Stephen King decided to "distribute" his novella directly to the public, for example, and sold almost half a million copies online in one day.

The traditional print publishing model (PPM) in the print/analog age was a linear model that allowed content to flow in a reasonably direct manner from the content creator (the author) through the producer (the book publisher) via the distributor (wholesaler) and the retailer (bookstore) to the consumer (reader). There was very little disintermediation in this direct-line model. In contrast, the new digital publishing model (DPM) for ebooks is best described as a web (no pun intended). This supply-chain from authors to readers now has different numbers and types of players. There are still a few straight lines in the process, but they connect different parts of the industry. And although certain elements of the supply-chain for ebooks are more simple, other elements are far more complicated.

The DPM is a stark contrast to the PPM model. Because the content is delivered in a digital fashion, the DPM does not have to factor in the physical costs of print production: paper, ink, printing and binding. In the previous section these production costs were estimated at 13% of the retail price. A second major difference in the DPM is the lack of advance payments. Digital publishers are not inclined to offer payments to authors before publication. Similarly, print publishers usually do not offer advances for the digital reprint rights (ebooks) for a print-edition book. As a result, both the costs and the risks of producing ebooks are substantially lower for an ebook publisher, or for a print-book publisher that also produces digital editions.

On the positive side for authors, the royalties being offered to ebook writers in the DPM are substantially higher than those offered in the PPM. Figures of 25%, rising sometimes to 50%, are not unusual. Another positive element is the increased frequency of accounting. Authors of print books are usually paid once or twice per calendar year. Some producers of ebooks are offering to pay royalties to authors on a monthly basis. (Meanwhile, the publisher of an ebook does not have to worry about the return of unsold inventory, so the company does not have to factor in the reserve against returns – outlined in section 2.1 – for unsold inventory from retailers.)

Amid the clamour of multinational publishers in New York, London, and Frankfurt, it is easy to forget how the great edifice of book publishing would not exist without the daily toiling of writers. The creation of content requires time, labour, and raw materials, although the "economics of writing" is almost an oxymoron. Most writers subsist on incomes at – or below – their country's poverty level. *The Manchester Guardian* offered a sobering statistic about the income of self-published authors: more than half of them earn less than $500 per year (Flood, 2012). For every J.K. Rowling of *Harry Potter* fame, there are tens of thousands of writers who are earning the equivalent of welfare checks for their creative work.

One of the underlying economic issues in this thesis concerns the externalities of new pricing models for ebooks. In the case of writers, how does their utility maximization factor into the equation? Is the true cost of their marginal contribution to the production of ebooks accounted for in the price of the finished goods? Several conclusions will be offered later in this research paper, but for the moment it is important to review the writers' unique value proposition in the supply chain of ebooks. What do they contribute to the creation of this product, and how can this contribution be evaluated and assigned a dollar figure as an asset?

Ironically, authors themselves may be part of the problem with this economic equation, especially when they appear to devalue their contribution to the cost of a book or an ebook by offering free labour. The issue of unpaid content has been hotly debated in the journal articles, blog postings, and twitters that surrounded the sale of *The Huffington Post* on February 7, 2011, to AOL for $315 million. The *HuffPo*, as writers call it, does not pay its writers, and younger journalists do not seem to care. “There now exists an entire generation of intelligent people,” said *Globe and Mail* columnist Russell Smith, “who have grown up without any expectation of compensation for imaginative work” (Smith, 2011, p.1).

This divide appears to fall partly along generational lines. Smith and some of his colleagues see their writing as a product with a quantifiable monetary value. Ideas have a fundamental value, they argue, and those who craft them for the marketplace deserve to be compensated. Many younger journalists see that notion as quaint or outdated. They have grown accustomed to finding what they want on the Internet – for free. When a paywall emerges on a particular site, they simply look for another website that delivers the content at no charge.

Some members of the publishing community agree with these young bloggers and

Twitterers. Bestselling author Sam Harris, for example, waded into the discussion in his essays on the future of the book. “Where publishing is concerned,” said Harris, “the Internet is both midwife and executioner. It has never been easier to reach large numbers of readers, but these readers have never felt more entitled to be informed and entertained for free” (Harris, 2011, p. 1). According to Harris, “the market for books is continually shifting beneath our feet” (2001, p. 1). For anyone accustomed to the notion of writing as *paid work,* the era of the Internet has been (in the words of the immortal Charles Dickens) both the best of times *and* the worst of times.

In strict economic terms, editorial content for ebooks is the raw material of the finished product. Some authors say the content cannot be assigned a specific value, because the final product would not be possible without this content. Other authors (some with stronger brand recognition) would ascribe a higher value to their content because of its potential to earn greater sales revenue. Nevertheless, depending on the degree of input from a publisher in editing, design, marketing and distribution, the author's contribution is usually “valued” as the equivalent of the author's advance payment (on contract) and the subsequent publication royalties paid by the publisher. Because an author's advance is a factor of the royalty percentage paid on the retail price, plus the number of anticipated copies sold multiplied by that percentage royalty, we can technically say the value of an author's contribution to a print book is between 6% (for a mass-market paperback) to 15% (for a bestselling hardcover).

A growing number of writers oppose the notion of *any* intermediary in the publishing equation. In pursuing that model, some of them have found considerable success as “outliers” through their self-published work. “Writers are essential. Readers are essential. Publishers are not," said iconoclast Joe Konrath, a bestselling author who *only* publishes ebooks and *only* publishes them with Amazon.com (Ingram, 2012, p.3). "Publishers,"he said emphatically, "are tied to a broken, outdated and increasingly irrelevant business model" (Lonrath, 2010).

Konrath (2010) and other authors dismiss the notion of an advance and/or a royalty and refer to it as an outdated form of indenture to a publisher. In fact, they question the entire need for a publisher in the modern world of the Internet. As Konrath said, "All publishers, small and big, need to figure out what they can offer their authors to justify taking a percentage of royalties forever. It has to be more than a cover and editing, because authors can get those on their own" (Konrath, 2010, p. 6). In stark contrast to the earlier noted findings of *The Manchester Guardian,* Konrath predicted that some of the new models (which we will review in this thesis) will ultimately be very beneficial for writers. "I believe 99.9% of writers have a better chance to make more money in this new market than they did in the old one" (Konrath, 2010, p. 6).

The challenge in the current marketplace for ebooks is one of uncertainty, and it may require almost forced experimentation on the part of authors and publishers. One of the bloggers who is monitoring these developments is Steve Peterson at 20th Level Marketing. In his writing about the pricing of digital products, he made the following observation: "I think the most important thing about ebook (and other digital product) pricing is that you can easily experiment with pricing. The ebook market is still developing and changing, so don't look for a hard and fast answer on pricing" (Peterson, 2010, p. 4).

Professor Loebeckke at the University of Cologne addressed the issue of lower-priced ebooks, following a line of thinking that echoes the economic theory of the Laffer Curve (which will be examined in a later section). Applied to ebook sales, this theory champions the notion of *more* sales at *lower* prices, with the assumption of overall greater revenue. This only works, of course, if the variable costs are held in line. "What should matter is the size of the check you put into the bank, not the price on the product," said Loebeckke (2010, p. 6). "What is important is overall profit, not your profit percentage" (2010, p. 8). At the same time, the externalities of publishing must be factored into the equestion. As Loebbecke suggested, "...the absence of commercialization turns the works of artists into a commons..., where the creation of new works is at risk when artists are not being provided a viable way to amortize their investment" (2010, pp. 8 - 9).

This radically different DPM has caused writers to rethink many of the underlying assumptions of the traditional print model regarding the *process* of being published. In a peer-reviewed article in *Computer* in 2009, writer Chris Swain (2009) posed a challenging question: *"Who needs a publisher or a retailer or a marketer?"* In the PPM, a book publisher took on the ten tasks referenced by Albert Greco at the Institute for Publishing Research. Swain asked not whether *all* of those functions are relevant, but whether *any* of them were required by a new generation of writers.

For example, the first task in print publishing is *content acquisition.* If authors can upload their digital files directly to the Internet, or use Amazon as their "publisher," the acquisition of content is a moot point. A related task is *content development.* Authors can now purchase editing services from freelance editors, corporate communications companies, ebook developers, and a host of other service suppliers. Once their book reaches the *design* stage, an author can contract independent design services. If an author's content is not moving to a print format, the type and amount of *production* expertise is severely reduced. Once again, any management of data files can be outsourced to service companies that specialize in the creation of ebooks.

When an author's book is ready for the supply-chain, the issue of *marketing* arises. If this activity involves determining the audience and the price for an ebook, an author can now perform these functions independently – or with the help of Amazon.com through their author-assistance program. The next stage – *ebook sales* – follows naturally, because the optimal sales channel for many independently published authors is clearly Amazon.com. With almost 70% of the online sales of ebooks already locked, an aspiring author using this online retailer has the best chance to reach the intended audience. The tasks of *fulfillment service* are now handled by the order, shipping, invoicing, and customer service departments of Amazon.com.

There is only one area where professional help from experts in content management and international marketing may still be required by a writer, and this is *rights sales.* Authors might still need professional assistance in order to negotiate sales of their ebooks outside of North America. However, even this aspect of book publishing may be a moot point for independent authors. Amazon.com is slowly monopolizing online ebook sales on a worldwide basis, while some entrepreneurial authors are handling these tasks independently as well.

The flaw in the arguments put forward by Swain and others is that authors do not need the services and traditional resources of the publishing industry. They say disintermediation has removed the necessity for the former linkages between various members of the book/ebook supply chain. (The same argument is being made by authors who choose to self-publlsh their books using Print on Demand technology.) In reality, many of the traditional *tasks* are still required, but they do not need to be performed by the traditional *suppliers* of those tasks. An author can take his/her digital file to a printer and return with a finished book. However, that same author still needs to arrange for the printing and then subsequently find ways to enter the marketplace in order to reach an audience. Similarly, an author can take his/her digital file to an ebook publisher such as SmashWords, Atavist, or Vook – all of whom can easily transform even a basic Word file into an ebook format.

How, then, do these new economic models for publishers' ebooks work, and how do they specifically translate into the pricing activities under scrutiny in this thesis? The most helpful approach is to review how the sales channels for ebooks have changed the dynamics of the supply chain in the publishing industry. Accurate and up-to-date information on the ebooks supply chain was presented by industry experts at The “Tools of Change” Conference in New York in February, 2012. The meeting focused attention on how the content and usage characteristics of an ebook will ultimately determine how the producer of that content will create a viable pricing and distribution model. The publishing industry has informally “agreed” on the following eleven content and usage characteristics:

- Immersive vs Episodic Content: Describes the degree to which readers “immerse” themselves in the content and tend to read it in a linear and continuous fashion. For example, a fantasy novel would require immersive reading, while a how-to book about garden perennials would suggest reading that is done in sections (episodes) and possibly with the guidance of an index.

- Consumption: Describes whether a user reads the material on the screen or needs to download all or part of it for further use or reference.
- Degree of Interactivity: Denotes the level of involvement of the reader and especially the possibility that the ebook content might change through the collaboration of the reader.
- Search Requirements: Indicates the need and level of search capability required by the user and built into the ebook.
- Annotation: Denotes the needs of readers and the capability of the ereader and the ebook regarding note-taking, excerpting, highlighting and/or annotating of the text.
- Customer: Indicates the person who is using the ebook and whether he/she is selecting the content and/or paying for it. For example, the actual reader might be a library patron, but the customer who pays for the use is the library.
- Use: Publishers typically describe three purposes for which consumers read ebooks: education, entertainment, and/or information.
- Usage Rights: References the restrictions placed on an ebook user through digital rights management (DRM) technologies.
- Metadata: Describes the presence and sophistication of descriptive bibliographic data in an ebook that might be required by a reader in order to make full use of the content.
- End-User Workflow: References how ebooks in an educational or informational

format might be formatted as an “application” rather than as static content.

- Archiving of Content: Indicates whether the content is stored somewhere in a protected format for future use or in case of disaster recovery.

In the new DPM schematic, there are numerous ways for authors to create content and engage with supply-chain models in order to deliver their content to consumers. If the author contracts with a publisher to produce an ebook, that product can then be sold directly to the public off the publisher's website. Alternatively, the ebook can flow to the consumer from the publisher via one of the retail chains. The ebook can also be distributed by a wholesaler, or a consumer could borrow an ebook from a library – which in turn could have sourced the product through the publisher or through a wholesaler. Or the author could act as their *own* publisher and then flow the ebook through many of those same distribution channels.

What, then, would be the optimal, preferred, or even fair price for an ebook? Once again, iconoclast Joe Konrath was willing to wade into the fray to advance his position. He said “$2.99 is the new ebook standard” (Konrath, 2010, p.1), although his logic was somewhat flawed. “Ebooks cost nothing to distribute or produce,” he suggested (Konrath, 2010, p.2). He was certainly correct when he criticized restrictions such as DRM and some of the proprietary formats. Both of those features, he argued, made the ebooks less valuable because consumers could not share the content, copy it, or transfer it. This is certainly a concern for consumers, but the degree of its worth may not be lowered as much as Konrath suggested.

The more pressing issue raised by Konrath was the sustainability of the print publishing industry. He said publishers should be more concerned about connecting with writers and readers, rather than worrying about selling more paper. This criticism reflected back on the issue of books being a “zero-sum game,” as was demonstrated in the music industry meltdown of the last decade. For print publishers, the concern is whether there is a limit to the discretionary purchases by readers. If the issue is *either* print books or ebooks, then one part of the industry is a winner and the other is a loser. This line of thinking, however, is part of what is paralyzing the book industry.

Aside from protecting higher prices through the Agency Model, which will be discussed at length in later sections, publishers have begun several other initiatives to protect their interests. Demanding an industry-wide use of Digital Rights Management (DMR) has been pitched by publishers to preserve their intellectual property and their sales. As noted above, however, this attempt to control usage has been extremely unpopular.

Other publisher initiatives have been more subtle. One of the strongest levers controlled by publishers has always been the distribution and sale of bestsellers. Some of the larger multinational publishers have therefore refused to release their superstar authors in an ebook format, or they have tried to “window” their books by staggering the public release. A few major titles have also been withheld from certain territories, or have been made available only on restrictive platforms. All of these efforts to control access or inflate prices have alienated some potential ebook buyers and frustrated those who are trying to embrace the new technology.

The consumer, of course, is the ultimate recipient of ebooks and the one player most affected by pricing in this financial transaction. Historically, consumers were accustomed to buying print books in retail stores and dealing with the suggested retail prices established by the industry and delivered by retailers. Bestselling print books were frequently discounted off the marked price, but otherwise the utility maximization factors for consumers related to location, availability, selection, service, and retailer promotions. The growth of online sales changed all of those utility factors. As a result, consumers were faced with the eventual monopolistic position of Amazon.com as the preeminent online bookseller in North America. With a unique delivery mechanism, the online retailer is able to address one of the fundamental economic principles of the book industry: the issue of consumer *need* vs *want.*

Penguin U.K.'s Chief Executive John Markinson addressed these economic issues in an interview with *Reuters News*. “The book industry in general is struggling to adapt to new, digital means of distribution controlled by powerful players like Amazon and Apple,” he explained (Prodhan, 2011, p. 1). “This is a business which has always been driven very much by supply rather than demand factors. Consumer taste doesn't actually change that much but what does change is the availability of books in different channels” (Prodhan, 2011, p.1). Markinson was referring to structural changes in the industry that he said “were largely outside the control of publishers” (Prodhan, 2011, p.1).

From the consumers' perspective, they have been “trained” by the music industry to change their expectations about purchasing and to demand more utility maximization. Anyone purchasing music can now expect to purchase whatever they want, whenever they want it, via whichever device they choose to purchase and/or play it, and all for a fraction of the cost of any of the previous type of technology (disk, cassette, vinyl, etc.). Consumers have also become accustomed to finding endless amounts of information for free on the web. This expectation has led to the similar belief that digital information neither "belongs" to anyone, nor does it have any intrinsic "value" – at least not to a person/creator who may have originally produced it.

In the new Digital Publishing Model (DPM), there are six factors that influence the purchasing and pricing options for consumers:

- Variety and number of sources to access an ebook.
- Price (or lack thereof) of the ebook.
- Requirement to own or purchase a device on which to read the ebook.
- Restrictions on sharing the content.
- Restrictions on repurposing the content.
- Restrictions on moving the content between devices (interoperability).

At the same time, writers and organizations are creating new economic models for transferring information. These include emerging forms of online business such as:

- Subscription: Paying for privileged information on an ongoing basis
- Advertising: Selling content by requiring readers to wade through paid messages
- Brokerage: Collecting general information as an aggregator for targeted distribution
- Affiliate: Delivering content through the support of referrals (e.g., Google ads)
- Infomediary: Collecting and distributing privileged data
- Metered Usage: Producing and distributing content with a firewall
- Merchant/Manufacturer: Creating content that resembles a product (e.g., printed material)

- Community: Distributing information for the purpose of creating a community or "tribe"

The following sections will analyze how these sometimes conflicting forces have propelled the ebook ecosystem forward – and catapulted it into the current state of digital disruption.

2.3) The Rise of Ebook Sales

In 2007, when Amazon launched the first generation of its Kindle ebook readers, the company's iconoclastic president Jeff Bezos made a grand declaration: “The vision is that you should be able to get any book – not just any book in print, but any book that's ever been in print – on this device [the Kindle] in less than one minute”(Levy, 2007, p.2). In the hyperbolic world of digital change, the media noted this pronouncement – and then moved on to the “next big thing.” Five years later, Bezos' prediction has almost come true. Equally important for Bezos, his company – Amazon.com – is not only selling the Kindle in record numbers, it is also selling the *content* for that device in equally large numbers.

As a result of the recent ruling by the Department of Justice (see section 2.4), there have been many grand pronouncements about Jeff Bezos and his online empire. The headline for *The Atlantic* on May 2, 2012, read: “The Justice Department Just Made Jeff Bezos Dictator-for-Life.” As the subhead explained, “The government's antitrust suit against Apple and five publishers will make Amazon more powerful than ever in publishing.” According to the article's author, Jordan Weissman, for the next two years “Amazon.com CEO Jeff Bezos will be free to dictate the price of ebooks across much of the publishing industry” (2012, p.1). The thesis of this research paper suggests these predictions are not entirely accurate, although the reality may depend on how we quantify the *reach* of Amazon.com's pricing control.

During the five tumultuous years since the launch of Amazon's Kindle, the publishing industry has witnessed two dramatic trends. Sales losses in bookstores of print books doubled in *decreases* from 2010 to 2011, and sales of ebooks (mostly online) doubled in *increases.* This tectonic shift in the supply-chain of content to consumers created minor chaos in the publishing industry. Meanwhile, the six publishing giants scrambled to find new economic models in order to survive. The pressing question was about the future, i.e., would this exponential growth continue, or would it flatten and stabilize?

These trends are “volatile,” according to Angela Bole, the executive director of the Book Industry Study Group (BISG). “The ebook market is developing very quickly, with consumer attitudes and behaviour changing over the course of months, rather than years,” she noted in a February, 2012, press release (BISG, 2012). Statistics from this highly respected industry source show that ebooks now account for 26% of the sales revenues for the Bix Six publishers: Random House, HarperCollins, Penguin, Hachette, Macmillan, and Simon & Schuster.

Other research confirms these findings. Sales stats from the Association of American Publishers (AAP) for January 2012 were published online by digitalbookworld on March 29 of that year. Total trade book (print and digital) revenues increased from $396 million in January 2011 to $503.5 million in 2012, up more than 27%. According to the AAP, the biggest increase was in ebooks, which grew to $128.8 million in 2012 vs. $73.2 million in 2011, an increase of more than 75%. In real dollars, however, the biggest increase was in adult ebooks. Sales in this category rose from $66.6 million to $99.5 million in 2012. This segment of the industry is now predicted to reach $1.2 billion in 2012. In line with the research quoted above, the AAP said ebooks accounted for 27% of total book sales in January 2012 and 31% of all adult trade sales (Greenfield, 2012, p.1).

Meanwhile, ebooks are making major inroads abroad, especially in India and

Brazil. Kelly Gallagher, vp at Bowker Market Research, released her company's findings at the London Book Fair in March, 2012. “The market for ebooks is experiencing exponential growth internationally, with news of new e-readers and specialist e-tailers,” she explained (bowker, 2012). Gallagher expects to see a rapid increase in ebook sales in Brazil and India. More than 50% of the respondents to Bowker's survey in those two countries indicated they would be purchasing an ebook in the coming months. This would effectively “double the number of ebook buyers in India, and triple the number of ebook buyers in Brazil” (bowker, 2012).

Ebook consumers are also increasing their overall consumption of both ebooks *and* print books, and they are purchasing them through both online and mobile apps. This last point is very significant for our current thesis. It is yet another indication of the growing number of devices through which consumers intend to access and purchase ebooks. BISG noted these trends in its press release outlining the highlights of its *Consumer Attitudes Toward Ebook Reading* on February 29, 2012. This study focused specifically on what it called the “power buyers” in this consumer market. “More than half of ebook readers increased their use of apps to purchase books and more than one-third increased their use of general retail websites such as Amazon.com,” it reported (BISG, 2012, p.1). These new power buyers were evidently “predictors of where the market is moving,” said Bole (BISG, 2012, p.1). Tablet devices and smartphones are currently making great headway. The 10% drop in the use of dedicated ereaders is exactly matched by the increase in tablet devices and smartphones.

Just prior to the “Tools of Change” conference in early 2012, industry analyst Mike Shatzkin was prepared to offer this overview: “The old publishing-distribution ecosystem is disappearing, but the new one is not built out yet. Publishers are...collecting and analyzing ebook pricing data...and building new models to work with authors and even self-publishers....” (Shatzkin, 2011, p.1). He predicted that sales of ebooks would soon reach 30%. His prognostication was accurate. Simon & Schuster CEO Carolyn Ready presented her own analysis to the industry trade journal *Publishers Weekly* in May, 2012. She said her company is looking for digital sales “to increase about 70% this year,” and she believed “digital will account for about 28% to 30% of total revenue for the full year...” (Ready, 2012, p. 1).

Of particular note was Ready's comment that “total print and digital sales seem to be growing” (2012, p.1). According to her sales figures, Simon & Schuster is not losing readers. What *is* not mentioned, however, is how publishers are losing *money.* The total unit sales of print *and* digital books may be approximating the total unit sales of earlier print-only sales, but the *dollar values* are nowhere near comparable. For writers, who exist at the bottom of this intellectual food-chain, the dollar units are dwindling at a frightening pace.

To put the original Bezos predictions in context, it is worth referencing Linda Bennett's peer-reviewed article entitled “Ten Years of Ebooks: A Review” (2011) in which she discussed the past, present, and future of the medium. “Everyone was worried about the effects of electronic publishing on the traditional supply chain – especially booksellers and publishers,” explained Bennett (2011, p. 225). Apparently, their concerns were justified. The industry recognized the *opportunity* of ebooks, she noted, but they failed to understand the long-term *sales and distribution* mechanisms.

This failure can be seen in the drama that unfolded in years leading up to the DoJ lawsuit which rocked the publishing industry. In the “Ebooks Critical Events Timeline” that follows, the issues become clear as the industry players jockey for position in a race for the consumers' attention – and pocketbook.

2.4) Ebooks Critical Events Timeline

During the past twenty years, the publishing world has changed dramatically. During the past *two* years, this industry has seen seismic shifts in how it operates as a media business. The following timeline showcases the major product innovations, business start-ups, and critical events that have led to the current crisis in the pricing and distribution of ebooks.

- **1991**
- Sony launch of the Data Discman, which can read books stored on CD's.

1993

- Design and launch of Incipid, the first electronic book reader.

1995

- Amazon.com opens for business.

1998

- Barnes & Noble Bookstores invest in NuvoMedia Inc., developers of a handheld book-reading device called the Rocket eBook Reader.
- Rocket eBook electronic e-book reader launched, followed by a similar device from SoftBook.

2000

- Stephen King's novella *Riding the Bullet* released exclusively online to the public. In less than 24 hours, 400,000 readers purchase the digital content for $2.50 per copy. Total sales climb to 1,000,000 units.

2001

- Pearson Education and O'Reilly Books join forces to create Safari Books Online.

2003

- Barnes & Noble abandons its investment in e-reading devices and ebooks.
- Borders outsources its online print-book business to Amazon.com.

2004

- Google launches the Google Books Library Project, an ambitious plan to digitize vast numbers of print books.
- Amazon begins to sell ebooks online.

2005

- Sony introduces its handheld reading device called the Sony Reader. Amazon buys MobiPocket, which will become the technology for their electronic book readers.

2007

- Introduction of the Amazon Kindle in North America.

2009

- Amazon launches the Kindle 2 and the Kindle DX in North America.
- Sony launches the Reader Pocket Edition and the Reader Touch Edition.
- Barnes & Noble launches the Nook.
- **2010**
- Apple's iPad unveiled as competition for Amazon's Kindle Ereader.
- Amazon launches the Kindle DX International Edition.

- B&N releases the NookColour.

2010

- Five of the "Big Six" publishers switch their ebook sales/marketing terms from the Wholesale Plan to the Agency Model. Random House chooses not to switch.
- Apple launches the iPad with an e-reader app called iBooks, which sells 7,000,000 copies in six months.
- Chapters/Indigo releases the Kobo in Canada and through Borders into the United States.
- Sales of ebooks at Amazon.com begin to outnumber their sales of print books.
- Google unveils plans for Google eBooks in cooperation with independent bookstores.
- Border's bookstore chain files for bankruptcy and then shuts down the company.
- Barnes & Noble launches the Simple Touch Reader, an improved version of the Nook.
- Amazon releases the Kindle Fire.

2011

- RH decides to join other major publishers and go with the Agency Model. Titles will now be available through Apple and on the iPad.
- Launch of IndieBound Reader for Android – a new "app" for phones that will assist readers in purchasing ebooks online.
- Ebook sales continue to rise dramatically, while mass-market paperback sales drop significantly.

- U.S. Department of Justice announces plans to investigate Apple and "Big Five" publishers for possible "collusion" in restrictive pricing of ebooks.
- Bookstores voice concerns about "predatory pricing practices" of Amazon, and their failure to collect and pay taxes for online sales.
- Amazon sells one million Kindle Ereaders per week. Introduces "price check app" to encourage consumers to compare prices in retail locations and then purchase identical products more cheaply online through Amazon.com.

2012

- Industry analysts predict the book industry will earn 50% of its revenues annually from digital products by 2014. Predictions then scaled back after first quarter to 30%.
- Google eBooks now being sold through independent bookstores at similar prices via the Agency Model.
- *Shelf Awareness* reports that 35% of the ebook market purchases 60% of all ebooks and accounts for 48% of the total revenue in this product category. Ebook sales in 2011 grow 117.3% over previous year to $969.9 million.
- Amazon reports a 35% increase in revenue during the previous quarter to $17.4 billion, with approximately 30% of print and digital sales for major publishers. Publishers describe dealing with Amazon as "the single biggest challenge" they face – even larger than dealing with the digital changes in the industry.
- Amazon begins officially courting authors and publishers in order to create its own content (i.e., to become a publisher as well as a wholesaler/distributor).

Amazon.com now controls 60% of all online ebook sales and 90% of all print-book sales, and shipped 3.98 million Kindle Fire PC tablets in the previous fourth quarter.

- Google announces GooglePlay access to books and music in an effort to combat market success of Amazon and Apple. Apple and Amazon offer 25-cent specials to entice online book-buyers.
- U.S. Department of Justice sues five industry multinationals: Simon & Schuster, HarperCollins, Macmillan, Penguin and Hachette. Simultaneously sues Apple, all for collusion re: the Agency Model and alleged collusion in price maintenance.
- Simon & Schuster, HarperCollins and Hachette settle lawsuit and admit culpability. Apple, Macmillan and Penguin maintain firm stance and refuse to negotiate a settlement.
- Related class-action lawsuits launched by individual states in the U.S and by several provinces in Canada. Industry insiders at the London Book Fair comment on the legal outcomes, saying "Amazon...and the most price-conscious ebook consumers have won. Everybody else in the ecosystem – authors, publishers, and other vendors – have lost."
- Amazon's publishing arm – Thomas & Mercer – continue their content-building enterprise by buying the publishing rights to all of Ian Fleming's "James Bond" novels. Print editions will be available to everyone, but ebook versions will only be available on a proprietary basis through Amazon.com and only for use on the Kindle products.

- TOR Books (owned by Macmillan) announce they will be selling their books without Digitial Rights Management (DRM) restrictions.
- Amazon continues to negotiate with Nevada and New Jersey regarding taxes. Resolution may involve the creation of warehouses for regional distribution of Amazon merchandise. Amazon sales rise in this quarter by 33.3% to $13.2 billion.
- Barnes & Noble announces joint venture between their college division and Microsoft that would allow millions of Microsoft users to have access to the B&N online bookstore. B&N stock rises by 77.6% to $24.29 on the news.
- Target announces it is dropping all Kindle (Amazon) Ereaders due to the "showrooming effect": shoppers who look at merchandise in a retail location and then purchase it online. In a related move, Target will install 25 "mini-kiosks" with Apple in their stores.
- Open letter from the American Booksellers Association to the U.S. Department of Justice decrying the decision to eliminate the Agency Model.

SECTION THREE : SUPPLY-CHAIN ECONOMICS OF BOOK PUBLISHING

3.1) Ebook Pricing Issues

Traditional marketing theories suggest there are four critical components in the selling of any goods or services: product, price, placement, and promotion. These four factors describe the content of the goods or services, the cost or price relayed to the consumer, the venue in which the item is sold, and the way the item is advertised or publicized to the consumer. In the Print Publishing Model (PPM) from section 3.1, this theory easily corresponds to the four functional components of the book industry. A book is either a hardcover or a paperback. The suggested retail price is clearly marked on the book. Until the arrival of the Internet, the book was sold in a bookstore. And the author and the book are advertised in magazines and newspapers, and publicized in print, on the radio, or occasionally on television.

In the Digital Publishing Model (DPM), *everything* has changed. The product is now digital, meaning it is no longer a physical object but has morphed into an electronic data file. This digital product can be purchased or obtained by consumers through multiple channels: direct from the publisher (usually facilitated by a third party); via a bookstore or their digital affiliate; on loan from a library; or through the last two channels, but facilitated by a wholesale operation.

Consumers of these digital products also learn about new titles, or are directed to them, by a much broader and more eclectic range of promoters. Whereas the publisher used to be the key source of new book information, today consumers are apprised of new titles via author websites, publishing bloggers, fan websites, content aggregators, bricks-and-mortar retailers, Internet retailers, and by libraries. An even more powerful source of information is the online algorithm feature of Amazon.com and its business imitators. By analyzing a consumer's buying behaviour, Amazon.com builds a consumer profile in order to select and recommend specific purchases for these online customers. In the parlance of Facebook, Amazon “friends” its clients on a daily basis in order to transform them into consistent and committed shoppers.

This kind of promotion only works, of course, if a retailer has a strong value proposition and it can offer one of the three cornerstones of sustainable market advantage: speed of delivery, uniqueness of product or service, or optimal pricing. Management theorists have posited that *one* of those three qualities can often be sufficient to capture a significant market share. If a business can manage to offer *two* of these benefits for customers, that business is certain to be a category leader. If a business could potentially offer elements of all *three* of those business virtues, this enterprise might be seen as either a category “buster” or it might have the *potential* to be a monopolist. The latter scenario will be reviewed shortly in our analysis of Amazon.com.

The fourth element of traditional marketing – product pricing – is the issue at hand. How is a retail price properly established, and which kind of pricing strategy is appropriate for a contemporary ebook? As was discussed in section 2.2, the price of an ebook can be calculated on a “cost-plus” basis. Just as a carpenter offers an estimate for building a house that is based on materials, labour, and a profit margin, publishers can create a price for ebooks based on the cost of the content and its development, plus the cost of the labour in performing all of the functions of book publishing, and then add a marginal increase to the total in order to produce a reasonable profit.

One of the many controversial issues associated with this model is the *allocation* of costs to the development of an ebook. If we apply modern managerial accounting techniques to this process, we would allow for a portion of the costs incurred in developing the original *print* edition of a book if it was then to be digitized and sold as an ebook. However, some ebooks are not simply reissues of a print book in another format; they are ebooks developed only for that publishing format. In a more contentious vein, many critics of ebook pricing say there is no rationale for basing the price of an ebook on the previous print edition. They claim an ebook is a *supplementary* product that has already earned back both its fixed and variable costs. In essence, the ebook is an *incremental* sale.

This is the argument of critics such as Adam Hodgkin at Exact Editions, who was blogging as early as 2008 about the issue of digital pricing. He suggested it was a mistake to “work back from the print price” because “...the cost of production, in the sense of 'unit cost,' has no conceivable bearing on the digital pricing....” (Hodgkin, 2012). According to Hodgkin, “Agency pricing to me seems to be as much about protecting profit margins and market share for printed books as it is about anything specifically to do with ebooks” (2012, p.3). He made a strong case for approaching ebook pricing from the opposite end, i.e., the consumer's perspective.

Industry observer John Siracusa (2009) followed a similar line of thinking in his online essay at arsstechnica.com entitled “The Once and Future E-Book: On Reading in the Digital Age.” Says Siracusa, “Pricing based on cost and demand is all well and good, but it should be the cost and demand of the actual product for sale, not another product with entirely different costs and demand!” (Siracusa, 2009, p. 4). He claimed there was another motive at play. “This makes no sense until you look at it not as a way to sell ebooks, but rather, as a way to ensure that ebook sales do not eat into hardcover sales" (Siracusa, 2009, p.4).

Now that the industry finds itself in this crisis, the key players need to find new and sustainable business models. Ironically, this task may involve going "back to the future." In *Book: A Futurist's Manifesto,* contributor Brian O'Leary (2012) referenced Theodore Levitt's seminal marketing article in the *Harvard Business Review* (1960) entitled "Marketing Myopia." Levitt called for a shift from a product-centred marketing focus to a customer-centred paradigm. Otherwise, companies easily fall into the trap of viewing their businesses too narrowly. They think only about *what* they produce and not *why* they produce it – and more especially the *customer* for whom they produce the product.

Using Levitt's theory, trains are not just for hauling raw materials; they are in the *transportation solutions* business. Similarly, publishers are not just in the business of making books from paper and ink; they are in the *content-providing* business. It is time for this industry to think more broadly and more strategically, even if this means short-term financial losses in order to secure long-term success. (This topic will be pursued further in section 3.2 of this thesis.)

If we take this theory one step further, an alternative pricing strategy would be to work "from the bottom up", i.e., not by looking at how digital prices reflect the currrent "print" model but by looking at the incremental value to a reader of a digital version of book content. Consumers do not normally consider the percentage of any retail price that is going to the writer, or the publisher, or to the printer. Consumers simply want good value for their money. Most of them believe a book – just like any other product – is "worth" what someone is willing to pay for it. The lower the price, the more willing the consumer is to take a chance on the product. Furthermore, if something is seen to be a bargain, that does not mean the product is not good. It may just means it's good value for the money.

Although this is a reasonable argument, consumers *should* know the full value of the goods they are consuming – and therefore what would constitute a price reflective of their true value. They should know that there are still a considerable number of fixed and variable costs involved in the creation and dissemination of ebooks. For example, most publishers have recently been forced to hire full-time or part-time staff in order to manage all of the technical aspects of ebook production. Another complicating factor is one mentioned earlier: the *uniqueness* of each book. No two publications are the same, regardless of whether they are in a print form or a digital form. In the realm of publishing, every single book is competing against every other book for the consumer's attention.

Industry analyst Mike Shatzkin offered a different perspective on pricing in his web posting on March 19, 2012, when he commented on the current collusion lawsuit brought forward by the U.S. Department of Justice. He summarized the problem by looking at the semantics of the discussion: the considerable difference between *fixed pricing* and *price fixing.* The former is the standard practice of establishing accepted the manufacturers' suggested retail prices and encouraging retailers to abide by those prices. Over time, most industries tend to settle on a range of prices for similar goods and services. They then compete in the marketplace on the three standard variables of speed of delivery, unique brand features, and on pricing.

This pricing variable, however, tends to be within the scale of the standard industry range. Because of the cost of goods, and federal regulations prohibiting dumping of inventory, the range of prices for similar goods would not normally reflect the enormous range currently found in the ebook industry. As will be demonstrated in later sections, the issue of price *fixing* (or collusion, according to the DofJ) is not usually at play in an industry undergoing fundamental transitions and trying to find a sustainable pricing model for new technologies.

Publishers' efforts to find these solutions are complicated when authors – the content providers – choose to bypass the book producers and distributors and take their content directly to the consumer. Self-published authors can sell their ebooks on Amazon.com for as little as 99 cents and still net 35 cents. When the authors' books sell for $2.99, they net 70% of the proceeds. Authors have also experimented with the pricing of their books online by lowering them from $2.99 to 99 cents. In some instances, sales increased by a multiple of twenty..

This form of product discounting appealed to author Joe Konrath, who was more focused on net *income* than net *prices.* "My own sales have confirmed this, numerous times," he says. "The lower the price, the more money a book earns. This is because value has nothing to do with the list price, and everything to do with how much the author earns," Konrath argued (Konrath, 2010, p. 4). "I price my ebooks at $2.99, because I've found that to be the sweet spot. If I price them higher, I make more per sale, but have fewer sales so I lose money" (Konrath, 2010, p. 4). Konrath has been a strong supporter of the supply-chain that begins and ends with Amazon.com. "Kindle owners can buy my ebooks and get them instantly, without going to the store, or without even turning on their computers. No hassle, no wait" (Konrath, 2010, p. 4). He offered this advice to authors:

"It isn't a zero sum game. You're free to price however you desire" (Konrath, 2010, p. 5).

Many self-published authors support Konrath and his supply-side economics. He is essentially arguing for a price point that maximizes the seller's revenue. Traditional book publishers, according to Konrath, are fixated on the retail price and not on the overall revenue and profits that their sales may generate. He argues that it does not matter whether an ebook is priced at $1, $10, or $100. The most important number is the quantity of products sold at any given price-point. If an author or a publisher has a choice of selling 100 copies at $10 or 10,000 copies at $1, then the choice is simple: price the product at $1.

Readers who are familiar with the principles of supply-side economics will recognize in these author pronouncements some of the principles of the Laffer Curve referred to earlier. This analytical tool invented by economist Arthur Laffer was originally applied to government taxes. He suggested that the government would actually collect more revenue if it *reduced* taxes, because this would stimulate economic growth. Consumers would able to spend more because they would have more disposable revenue as a result of these lower taxes. Similarly, authors would have more net revenue as a result of Amazon.com's lower prices because of the increased unit sales and the higher per-unit royalties. While these results may sound promising in theory, and may work well for selected authors and in selected genres, the statistics noted earlier re: the appalling revenue levels for most self-published authors should be taken as a cautionary tale.

There are additional economic externalities for authors as a result of low ebook prices. Amazon.com is essentially *reinforcing* a notion of low value for book content and, by implication, low value for the work of authors. Consumers are being conditioned to expect cheap editions of published material. Writers need to evaluate the economic tradeoff of a short-term increase in public exposure to their work versus a long-term devaluation of that same work. In simple economic terms, they need to consider the sustainability of the current economic pricing model for ebooks.

This was the dilemma put forward by author and industry analyst Joanna Penn in her industry blog entitled “Is Free Too High a Price?” (Penn, 2011). Penn said she could now “see the value in $0.99,” which she believed “has nothing to do with the value of the book” (Penn, 2011, p. 3). She wanted industry executives to reconsider the value of books as represented by their price-tag. Instead she said publishers should look at the value to an author of increasing the number of readers who were willing to purchase their books.

For most publishers, this is a serious business dilemma. They need to build the marketplace by acquiring more customers, while at the same time establishing price levels that can create the sustainability alluded to above. This task is complicated because authors who *possess* a brand have more intrinsic value than the logo of a publisher on any particular book – with Harlequin being one of the few exceptions. Readers tend to buy by author and/or subject rather than by the publisher brand. Meanwhile, it is worth noting how the *preferred* ebook prices for books from the “Big Six” publishers are in the $9.99 to $14.99 range, while the prices for self-published authors are hovering around $2.99.

In many senses, the supply chain for goods and services begins and ends with consumers. Prices determined by publishers (or directly by authors), and then reflected by retailers (both bricks-and-mortar and online), have a direct affect on consumers. However, as consumers react to these prices and make their purchasing decisions based on price, availability, delivery and convenience, their buying behaviour helps to determine those pricing models.

In the online world of instant price changes, this discussion can be immediate and ongoing. The ability to alter prices of ebooks almost instantly online can provide extraordinary insights into evolving consumer behaviour. For example, when O'Reilly Publishing tested variable pricing, they doubled the price of selected content from $4.99 to $9.99 and the volume dropped by four times. They promptly reinstated the $4.99 price. Cost and convenience clearly lead to higher sales, which is a direct reflection of utility maximization.

This transformation of consumer behaviour occurred in the world of music, and it has now occurred in the world of books and especially ebooks. Consumers demand utility maximization. Because we are an “instant” society, our buying behaviour seems to mirror the lyrics of an iconic pop song: *we want it all, and we want it now.* Everything is about convenience. The question posed in this research paper is about the *cost* of that convenience. We might want it *all* now, but we not have *any* later.

What is the right price for an ebook? Apparently it depends on which member of the supply-chain we canvas for an answer. Markets are “discussions” and there may be considerable elasticity at any given time. Tim O'Reilly offered a publisher's perspective when he said, “The right price is the one that maximizes revenue, paradoxically, because it's the one most people are willing to pay” (Bruner, 2011, p. 1). Industry analyst Jon Bruner was less declarative in his article in *Forbes* when he said, “...we don't know yet what the right price for ebooks is” (Bruner, 2011, p. 1).

3.2) Ebook Piracy & Digital Rights Management (DRM)

One of the most contentious issues in the world of intellectual property is the matter of Digital Rights Management (DRM), which hits at the core of a consumer's right to own and use a product or service they have purchased. Rights and responsibilities are clear in the laws regarding patents and trademarks. In the world of copyright, however, most industry analysts believe the current laws are outdated. The more outspoken advocates of "sharing" would go even further and suggest that copyright legislation is simply irrelevant. The current research paper will not attempt to address this issue, let alone attempt to resolve it. However, it is necessary to understand the implications of DRM – and the related issue of piracy – in order to analyze the pricing of ebooks in a competitive marketplace.

The publishing industry viewed with great alarm the demise of the record industry during the past decade. Direct piracy of content and communal file-sharing of music were seen by book producers to herald the tragic downfall of this media industry. David Choi addressed these issues in his peer-reviewed article entitled "Online piracy, innovation, and legitimate business models,"although he takes an unusual stance on the subject (Choi, 2006).

Choi said piracy could actually be a *positive* activity for the book industry. He offered four arguments. Online piracy has pioneered the use of new technologies, such as file sharing. Second, pirate communities have given us valuable insights into markets by providing data about early adopters and emerging market trends. According to Choi, online pirates have also helped to build new markets, which he sees when "Napster pirates" move to their online activity to legitimate sources such as iTunes. Lastly, online piracy has also “directly and indirectly spurred the creation of legitimate and innovative business models” (Choi, 2006, p. 6). Piracy communities in the gaming industry have been particularly interesting. They have cracked games’ basic engines and modified the games extensively to their taste. In lieu of taking legal action, however, some of the leading game developers welcomed the participation. In fact, a few of these games have actually increased in popularity as a direct result of cooperation between pirates and official gaming companies.

Requests for the inclusion of DRM mechanisms in ebooks were seen as important and natural extensions of print copyright by three sectors of the publishing supply-chain: authors, publishers, and third-party distributors. Authors were worried that the theft of the content would severely impact their revenue through lost sales and royalty payments. Publishers worried that unpoliced use of book content would also impact revenue, not to mention their obligation to protect and exploit their authors' content. Third-party requests came from vendors who also wished to maintain their control over content usage and sustain their position and viability as content disseminators.

The viewpoint of some of the younger and/or more independent-minded or market-drive authors is very different. Joe Konrath, our benchmark spokesperson for those interest groups, saw a direct link between the crisis in the music industry and the current dilemmas faced by the publishing industry. In his opinion, the central issue was one of *fear* – which was the driving force behind publishers' need to maintain DRM in ebooks. Publishers had seen what happened in the music industry as a result of Napster, and how that loophole had essentially gutted the music industry by wiping out most of the retail market for music. Some of the staff at large publishers who were now working in the ebook divisions of book publishers had actually migrated from the music industry. Konrath believed they had mistakenly brought that fear mentality to their new medium. “I've concluded that piracy hasn't hurt my sales. The way to fight piracy is with cost and convenience. Three dollar books that can be purchased and delivered with the press of a button are the ultimate in cost and convenience” (Konrath, 2010, p. 5).

Konrath's fellow writer Paulo Coelho (2012) was quoted in *Publishers Weekly* about his decision to lower the price of eleven of his ebooks to $.99. “This is a crucial decision for me. For years I have been advocating that free content is not a threat to the book business. In lowering the price of a book and equaling it to the price of a song in iTunes, the reader will be encouraged to pay for it, instead of downloading it for free” (publishersweekly.com, 2012). These authors also appreciated how interoperability (the ease with which ebook purchasers can transfer their ebooks to different devices) is only possible if the content is DRM-free. Consumers are demanding this function. Konrath, Coelho, and others are prepared to offer it.

Some publishers are now experimenting with DRM-free offerings. The science-fiction and fantasy publisher TOR/Forge will henceforth be selling all of their books without DRM. The readers of these genres tend to be more “techie,” so this is a particularly interesting marketing decision. It is also noteworthy because TOR/Forge is a imprint of Macmillan, which is still in legal discussions with the Department of Justice over their alleged participation in price collusion. In Canada, ECW Press in Toronto has also announced it will be making all of its ebooks DRM-free. Not coincidentally, many of the ECW publications are skewed to a young demographic, particularly in the areas of popular culture.

The issues surrounding DRM were reviewed in considerable detail at the “Tools of Change” industry conference in New York in February, 2012. Assembled experts agreed that the risk of lost sales were related to multiple factors. As discussed earlier, there is an overriding concern about the perceived value of the value of content in ebooks. Publishers are worried about timeliness of the content as well: what is new may be perceived as more valuable than what is old. They are also confounded by the number of formats for book content and the resulting competition for consumer sales.

As critics of the traditional Print Publishing Model (PPM) have noted well, there is a lack of revenue options for publishers beyond traditional print and ebook sales – which is why they are so protective of the content and the pricing. If some of their authors have a particularly strong promotional platform, publishers worry that these writers will bypass the PPM and go directly to their readers. (Both the author and the publisher then share the concern of interconnectedness about the reading public and the potential for file-sharing.)

DRM appears to be one more player in the chess-game of selling and marketing ebooks. Some analysts believe piracy may be a net zero gain: the number of digital thefts probably equals the number of additional copies sold because of promotional opportunities. Whether it is worth sacrificing this pawn in order to make more strategic gains is the decision facing everyone concerned about the survival of the publishing industry.

3.3) Ebook Pricing & Revenue Channel Models

In the context of ebook revenue channels, it is important to examine what the monetary exchange represents, i.e., the *terms* of the exchange. In a direct sale, the ebook recipient becomes the owner of the ebook, subject to certain restrictions on the use and sharing of the ebook. This direct sale can then be broken down into sub-categories that reflect the cost/price equation. For example, the price of a purchased ebook can be supported by advertising that is associated – or even imbedded within – a product.

A direct sale can also be part of an ongoing subscription model, whereby a fee is paid for the continuing access to an ebook or a series of ebook publications. Payment can be based on a loan model, i.e., a limited use of an ebook or a use restricted by a time-frame, platform use, copying, or sharing use. The revenue model can also be supported by a referral model whereby a sale is partially "subsidized" by revenues sent to the source that suggested the purchase to a consumer via a specific sales portal. Or the payment can be on a partial-use basis whereby the consumer only pays for what is "consumed." Another series of models can be found in libraries and educational institutions where one purchase "supports" multiple users, and the cost/price theoretically supports this single-sale/multiple-use model.

The following section is a review of several current models for channeling and pricing ebooks. In some instances, the models are already established. In a few cases, the models are merely proposed.

1) Game Model

In order to create a context for the pricing models examined in this section, we must first understand how prices are adjusted in the marketplace according to the timing of competitive entries. This subject was addressed in considerable detail in Katsamakas & Jiang (2010) when they reviewed asymmetries in the ebook marketplace. The essence of game theory pricing model (not to be confused with *video game* pricing models) is the issue of who sets the price first, and then how the other players react and use different strategies. This is really a sophisticated chess game with players and prices. According to Katsamakas and Jiang, the key issues are whether asymmetries in the two markets affect prices and readership, and whether it matters who sets the price first. Related issues include DRM and piracy, and how pricing may increase social welfare. The authors also addressed the contentious issue of monopolist behaviour in the context of DRM and piracy.

Katsamakas and Jiang suggested that the production and sale of ebooks lowers the overall production costs of book publishing, which is accurate in the sense that *any* incremental products and sales beyond the print editions are likely to lower these costs (assuming the marginal costs are less than the print editions). However, as noted in earlier sections of this thesis, the combined industry sales of print books *and* ebooks are either static or increasing slightly (depending on the market sector). The overall net revenues, however, are clearly declining. In this sense, Katsamakas and Jiang were correct in saying production costs of book publishing have declined. Regrettably, so have total revenues, and this speaks to the sustainability issues addressed later in this thesis.

2) Agency Model

The Agency Model is the industry practice that gave rise to the current DOJ federal lawsuit, which posited collusion and price-fixing on behalf of the publishers. Among the peer-reviewed articles, at least five have been particularly striking in their analysis of the core issues for the publishing industry. Linda Bennett (2011) in her article entitled “Ten years of e-books: a review” offered a valuable perspective from several players in the ebook ecosystem. “Despite paying lip-service to recognizing the need to publishers in profit, many librarians expected e-books to be much cheaper than print, or even free” (Bennett, 2011, p. 225). (In some instances, the exact opposite has happened.) “Everyone was worried about the effects of electronic publishing on the traditional supply chain – especially booksellers and publishers. Many rearguard actions were being fought to keep print the sole available format. Booksellers in particular were in denial” (Bennett, 2011, p. 225).

Bennett made the important point that both the Wholesale Model (to be reviewed in the following pages) and the Agency Model were not developed by anyone who had previously been involved in publishing, although even this observation is now outdated because Amazon has adopted a publishing role as well. “What [publishers] have addressed less satisfactorily,” said Bennett, “are sustainable pricing models for e-books. Ironically, it has taken an outsider – Apple – to point up the suicidal nature of some pricing models” (Bennett, 2011, p. 228). “Publishers are no longer the sole authors of their destiny here: the emerging shape of the supply chain will be significantly influenced by the business models favoured by the Internet giants – and by their ultimate objectives, which probably have nothing to do with publishing” (Bennett, 2011, p.229). Bennett concludes her article with a powerful warning when she urges publishers not to be bullied by the “exotic and powerful beasts who have now become part of their industry” (Bennett, 2011, p. 229).

The issues raised by Bennett were continued by Tian and Martin (2011) in their research article entitled “Impacting Forces on E-book Business Models.” They discussed the Agency Model and gave examples from mainstream and indie publishers. In addressing issues of cost and profit, Tian and Martin focused on the key issue of building a sustainable business model. They also supported the thesis of this research paper by examining the internal and external forces at play in the book marketplace (Tian and Martin, 2011).

The critical place of Amazon.com in the Agency Model will be discussed separately, but it is worth addressing elements of their activity as well. An excellent overview was offered by Isckia (2009) in “Amazon's Evolving Ecosystem: A Cyber-bookstore and Application Service Provider.” The article included an essential flow-chart and timeline of Amazon's business growth in books from 1996 until their release of the Kindle in 2007. Isckia also analyzed the “ecosystem” of Amazon and explained how and why it has dominated the online retailing world. Amazon.com has a simple but ingenious strategy: it works both ends of the supply chain by acting as a retailer and as a provider of services to retailers (Isckia, 2009, p. 341).

Early in the article, Isckia outlined an interesting model of niche players, keystones, and dominators (2009, pp. 333-334). A keystone collects and redistributes wealth within an ecosystem. It provides a leadership role through the establishment of an essential platform of services, which means it can be both a facilitator and an aggregator. Niche players can play a significant role for a keystone as they create new products and services. A dominator is a controlling hub that does not share profits. Isckia's three-player model certainly meshes with the Agency Model. Amazon.com acts as an agent to resell e-books at suggested retail prices. Amazon.com then keeps a percentage of the sales and returns the rest of the proceeds to the publishers.

According to Isckia, the three keys to Amazon.com's success are hosting services, storage capacity, and computing power. “Amazon orders most of its products only after they are sold,” explained Isckia (2009, pp. 339-340). As a result, they are working on a high turnover and low inventory basis. Amazon has also created a “key ratios” strategy that is central to their management model. With the efficiencies created by these analytical tools, Amazon.com has generated an enormous daily cash-flow. This money is then invested in sales forecasting, order processing, research and development, and inventory management.

Isckia's article concluded with a summary of Amazon's position as a cooperative organization, which may have been the situation in 2009 but is obviously not the case today. Amazon may have the appearance of helping to maximize the profits of each of the company's “partners,” but most industry analysts believe Amazon is simply helping to maximize its own profits.

3) Wholesale Model

In the Print Publishing Model (PPM) of book publishing discussed in section 2.1, wholesalers were described as the intermediaries between publishers and retailers. In the Digital Publishing Model (DP) outlined in the succeeding chapter, we saw how this element of the supply-chain changed once there was no longer a need for the storage and distribution of physical books. The retail industry, however, will probably *always* need some form of wholesale operation.

Wholesalers provide a variety of essential or optional services as part of their role in the supply chain by acting as a central buying and invoicing source for resellers.

Wholesalers aggregate content for individual purchasers as well as general retailers. They reduce shipping costs by providing regional distribution, and they also collect valuable customer data, which improves ordering efficiencies.

Wholesalers are certainly an essential part of the supply-chain for libraries. One of the most innovative alternatives in the wholesaling of ebooks is outlined in the peer-reviewed journal article by Braet (2012) entitled "Merging Publishers' and Libraries' Institutional Interests Through Business Modeling." He outlined a very interesting "solution" to the challenge of delivering e-books to a variety of end-users by analyzing a European institutional wholesaler. In Belgium, every city is forced by law to make an investment in a local library. These libraries then access their books and ebooks through a central independent wholesaling operation. This wholesaler, however, does not allow any interaction between the publisher and the end-users (Braet, 2012, p.114). Although this supply-chain model is apparently successful in Belgium, it is a cooperative venture that would be impossible to implement on a larger scale.

4) Library Model

Libraries have moved to a variety of purchasing models during the past decade, especially with the emergence of ebooks as one of the key access points for library patrons. Ebooks are seen to offer multiple benefits for librarians and their patrons. This book format provides increased content offerings due to lower unit costs. With online access, library patrons can now access more book titles and at an accelerated rate. Ironically, the increase in library purchases of ebooks creates increased shelf-space for print books. There are also increased savings for libraries due to decreased handling and cataloguing costs for ebook materials.

Vasileiou (2009) describes three models for library acquisitions of ebooks – purchase, rental, subscription – in her peer-reviewed article entitled "An overview of the e-book marketplace." All of these business models have terms that state the subsequent borrowing rights, such as 400 library patron loans per calendar year. This is essentially a "menu model" through which various reading options are acquired by librarians and then transferred to library patrons.

Vasileiou's article raises the contentious issues of the comparative costs of print and e-books in terms of development and distribution discussed in section 3.1. Vasileiou also addresses the matters of downloading, printing, sharing, and access restrictions. In spite of all these guidelines, however, she says "the success of e-books also relies on the publishing industry's ability to develop new business models and comprehend that e-books are not simply a substitute for paper books" (Vasileiou, 2009, p.189).

The concern for publishers about selling ebooks to libraries is not simply the fear of a "lost sale" but more importantly of a "lost channel" of sales. Libraries are 5% of publishers' sales, but these books represent far more than 5% of library patrons' value in a library. Publishers do not want to risk what marketers refer to as "channel conflict" by lowering the perceived value of their products. Random House is the only publisher that allows unrestricted access to its ebooks through libraries – but at considerable cost. In fact, Random House has *raised* the price of some of the "library editions" of their ebooks. (There has been considerable pushback from the South Shore Library Association in Nova Scotia on this issue.)

Publishers' fears are definitely driven by the importance of online sales. "We are headed for a single online retailer for ebooks and print online called Amazon," said Mike

Shatzkin (2012, p.1). “Publishers don't want to do anything that weakens...a commercial channel to consumers” (Shatzkin, 2012, p.1). In his analysis, he clearly included libraries in that equation. Shatzkin was worried that “giving ebook consumers ways to get what they want without paying for it weakens the other retailers” (2012, p.1). It is worth noting here how Amazon has collaborated with the wholesaler OverDrive to provide ebooks to libraries because it bolsters Amazon's overall position of lower prices and ease of access. Says Shatzkin, “I always expect an entity to act in its own self-interest, particularly when survival could be involved” (2012, p.1). The split is not between paper books and ebooks, he warns, but between books purchased in retail stores and books purchased online.

On a positive note, industry statistics demonstrate how sales, increased access, or even giveaways of ebooks appear to spur increased sales of print books. Library sales may encourage discoverability and generate word-of-mouth sales. The latter is very important as it appears to be the number one factor in the generation of buzz and sales about books. Despite this evidence, HarperCollins limits the number of library loans of their ebooks to 26. Other publishers limit the duration of the loan and not the number of times the ebooks circulate with library patrons. All of these restrictions are meant to introduce what the industry calls “friction” in the library ebook experience, i.e., factors that mitigate against the notion of “free” content. factor.

Maja Thomas (2011), a senior vp at Hachette Book Group (one of the defendants in the DoJ lawsuit) in charge of their digital division, discussed her concerns on this subject with *The New York Times* . “Selling one copy that could be lent out an infinite number of times with no friction is not a sustainable business model for us,” she contends. “To keep their overall revenue from taking a hit from lost sales to individuals, publishers heed to reintroduce more inconvenience for the borrower or raise the price for the library purchase” (Stross, 2011, p.1).

For smaller publishers without the worry of diluting the sales of their major bestsellers, libraries offer an essential venue for discovering new writers. This was the message delivered by Beth Jefferson of Bibliocommons in her speech entitled “Discoverability, Neutrality, & Early Literacy” at Book Summit in Toronto in June, 2012. She raised concerns about “too few storefronts and too much groupthink” (Jefferson, 2012). In her opinion, book choices were being pushed to far left of the shorter part of Chris Anderson's famous “long tail,” while the online platforms were actually creating a *shorter* tail by using algorithms to push *sales* rather than informed *choice*. “Public libraries encourage broader exposure,” she suggested. “There are 16,000 library screens vs. one screen for Amazon.com” (Jefferson, 2012).

5) Comic Book Model

Comic book publishers of digital editions face similar challenges as ebook publishers, although they appear to be looking more closely at pricing experiments and optimizing online opportunities. For example, older comics can be bundled with newer comics, or even given away free as a bonus or value-added benefit for purchasers of newer publications. This marketing model could be adopted by book and ebook publishers. Backlist titles that have been fully amortized need not carry the full overhead costs of newer publications.

Digital comic books are available through a wide variety of platforms and at an equally wide variety of prices. They can be purchased as an online monthly subscription service via a web browser at roughly $10 per month (half of that rate with a yearly subscription). Consumers can access comics via an iPad for $1.99 per comic. If readers want to look at entire collections, these are available on a DVD for approximately $50. Alternatively, print versions of comics are available in retail stores for $2.99 immediately on release. (Some comic-book publishers even release the digital version online *on publication day* for $1.99, which creates considerable friction in the retail sector.)

6) Cloud-Based Subscription Model

Another current and very promising development involves new curating technology. Justo Hidalgo (2011) describes these innovations in "A Cloud-Based Subscription Model for Books: The Challenges and Opportunities" in *Publishing Perspectives*. This alternative to the traditional supply-chain is essentially a "books-as-a-service" model. Cloud-based marketing allows consumers to purchase whatever they want, however they want to access and use it, at whatever time of the day or night they prefer.

This model has been incorporated into the 24symbols.com business, which is a cloud and "freemium/premium" model that allows ebook readers to access any ebook using any Internet-connected device. Consumers no longer need to have a dedicated reading device to access these kinds of services, i.e., a Kindle is not a prerequisite purchase. The other key is "access," because users are not required to download the content.

The "freemium" feature refers to content that is free because it is supported by advertising. The "premium" feature (for which there is obviously a charge) offers additional features and services, such as extra user functions and the ability to read the content while the user is offline. Like so many other Internet-based experiences, 24symbols.com also encourages users to create a "social experience" by sharing their favourite ebooks or ebook passages with friends and colleagues online.

7) Video Game Model

Arguably the most interesting experiments with selling online intellectual property are emerging from the gaming business. Ed Fries, one of the veterans of this industry, explained the state of game marketing in a 2011 interview. “We've gone from a situation where we dream up a game, we spend three years making it, we put it in a box, we hope it sells, to a situation where we're constantly modifying the game with the participation of the customers themselves” (Fries, 2011, p. 1). This notion of a two-way conversation with customers is altering the way games are marketing, and the way in which the creators of content are interacting with their audiences.

The gaming industry also takes a very different position on the “value” of piracy and the lessons and benefits that activity might have on a marketing model. For example, industry analysts suggest that game producers should closely follow what is happening online. It is possible that many of the communities pirating free content are doing so with inadequate technologies, and they might be willing to pay a modest fee to a provider that could create a more functional service. Customer satisfaction is still the key. Give the customer what they need, and not a halfway service. They want selection, search, flexibility, pricing, and customer service.

The old model used a skimming practice of releasing new products at an initially high price in order to maximize products. Prices were then gradually reduced as the life-cyle of the games reached the mature phase of its life cycle. The gaming industry is now trying to reconfigure this broken business model and instead begin to work on a new and sustainable model. Ed Fries and others are exhorting online game marketers to change their focus and build more robust communities online. The key is to segment and/or unite audiences with common interests and then market directly to them.

8) Author Self-Directed Model

This is the preferred ebook revenue channel model for authors who wish to participate in the sales and marketing activity of their e-books. As noted earlier, many of the basic tasks of producing and retailing book content (writing, editing, designing, marketing and distribution) have not changed, but the industry players have certainly evolved to a new level. For authors who wish to self-publish, the key issue is ultimately their ability to reach an audience and the need to create a sustainable revenue stream.

Amazon.com has become a dominant player in the ebook supply-chain partly through their ability to disintermediate the traditional publishing model and connect authors directly with readers. One of the other major players in the do-it-yourself market is Smashwords, which has facilitated approximately 150,000 ebook titles from 40,000 authors. Both of these ebook purveyors offer a range of services that help authors bypass publishers and (at least theoretically) reduce the costs of that model.

Amazon's e-publishing platform is called Kindle Direct Publishing (KDP). An enterprising author can take a basic Word document, format it using free software tools such as Mobipocket eBook Creator, design a book cover, and then upload the resulting ebook directly to Amazon.com. At Smashwords, an author can process their Word file and cover design through the company's formatting system (called “Meatgrinder”) and then use their website to sell the ebook or have it designated for sale through one of the major retailers of ebooks or through specific devices . At the current time, this would include the Nook, Apple's iBook, Kobo, and a host of other others entering this market.

The most important feature of this ebook channel is the self-directed pricing. Currently, those prices range anywhere from $.99 to $5.99, although $2.99 appears to be the median price. At Amazon.com, authors who format their books for the proprietary Kindle and price them between $2.99 and $9.99 retain 70% of the net price. (If a self-published author wishes to price their ebook at less than $2.99, the royalty drops to 70%.) For authors who use Smashwords to market their ebooks through that company's distribution network (Barnes & Noble, Apple, et al.), the author retains 60% of the net price, while the retailer earns 30% and Smashwords retains 10%. Pricing elasticity continues to be a hotly debated subject, although the mechanism for doing these pricing experiments is infinitely easier than in a traditional retail store.

9) Publishing "Menu" Model

O'Reilly Media in California has always been one of the most forward-thinking publishers, especially in the realm of ebook marketing. They offer an impressive menu of options for their authors in terms of distribution channels and revenue streams. O'Reilly is similar to other publishers in that it distributes ebooks via at least five channels: directly to the public through their own website, indirectly to the public through ebook retailers, indirectly to the public through ereading device manufacturers, directly to wholesalers and then indirectly to their customers, and directly to libraries for loan to library patrons.

However, O'Reilly also provides other channels of distribution and alternative revenue streams for their authors. Online purchasers can rent O'Reilly publications in order to create a customized publication. The company creates customized ebooks for corporate purchase or lease. O'Reilly will also create specialized databases of their content for use by educational institutions. Where the company excels at their value proposition is by creating a subscription-based marketing strategy. Unlike the traditional Print Publishing Model that created publications for a virtually unknown audience, O'Reilly has embraced a new mantra: building individually tailored reading solutions to meet a specific market need.

10) Academic Publishing Model

Although this sector of the publishing industry has been deliberately omitted from the current research paper, its challenges and successes in the area of ebooks revenue deserve at least a brief mention. In his article entitled "Digital Books and the Salvation of Academic Publishing," Roger Cross (2011) made a case for academic institutions and libraries to assist small academic publishers by working more cooperatively with them on purchasing agreements.

Cross decried the profits reaped by multinational publishers through their excessive pricing policies. (Academic publisher Elsevier made an operating-profit margin in 2010 of 38%.) He says we need to be "thinking outside the walls of the institutionalized library by considering the broader publishing market and market forces" (Cross, 2011, p.163). His plea for recognizing the sustainability of academic publishing in the face of large multinationals runs parallel to the concerns of this research paper. Cross drew our attention to what his colleague Glenn McQuigan (2004) was warning about in his article in the *Journal of Business and Finance Librarianship.* McQuigan was concerned about the expansion of "...an oligopoly ...in this specialized market where production is concentrated in the hands of a few large companies" (McQuigan, 2004, p.15). According to Cross, "In our era of consumer consciousness, the academic library must become an active rather than a passive consumer" (Cross, 2011, p.165).

3.4) Amazon.co: A Case Study in the Economics of Market Dominance

Scholars and industry analysts may differ on their analysis of the current digital disruption created by the ebook phenomenon, but they all agree that the vortex of the pricing storm is centred on Amazon.com. According to Loebbecke (2010), Amazon.com now has a strategic advantage in the book value chain and is working in a "nearly uncontested market." This online giant, said Loebbecke, entered "a completely new business area by developing a technical device and introducing a business model built on the direct link between selling a new generation device and globally branded ebook content" (Loebbecke, 2010, p.12). The multinational has achieved phenomenal success by leveraging three of its key strengths, explained Loebbecke. "Amazon aimed at exploiting its large customer base, its strong reputation for bookselling, and its globally known brand" (Loebbecke, 2010, p.13).

Cory Doctorow, one of the most "visible" authors in the digital age, has offered both praise and criticism for the marketing strategies of Amazon.com. "Obviously, the Kindle has brought Amazon a powerful first-mover advantage," says Doctorow (doctorow, 2010). This position, however, is not necessarily good for the ebook industry. "It is, in effect, a monopsony. Once other companies move into the red hot ebook market...publishers will have more leverage over what price their books are sold at...." (Doctorow, 2010).

In the realm of ebooks, Amazon's strategy is ingenious, although not particularly complicated. Since 2007, it has focused on the development of a series of ebook readers (see section 2.4), and simultaneously the ability to provide extensive copyright-free content and low-priced paid content via its online marketplace. More recently it has also become aggressively involved in sourcing content by purchasing publishing companies or collections of book titles, and by signing authors directly and offering to publish them exclusively through the Amazon supply-chain system. In effect, it became more vertically integrated by choosing to become a publisher as well as a distributor.

As outlined earlier, traditional economic theory suggests there are three strategies that allow a business enterprise to enter – and potentially dominate – a particular market sector: speed of delivery, lower pricing, and special feature offerings. On the first factor, there is no question that Amazon.com excels at service and delivery, at least based on their revenue results. Current statistics indicate Amazon.com is the undisputed leader in online print book sales and ebook sales. In the first quarter of 2012, Amazon.com's net sales rose 33.3% to $13.2 billion, while its shares rose 14% to $224. A considerable amount of this revenue flowed from the sale of nearly 4 million Kindle Fire reading devices in the fourth quarter of 2011.

With regard to special features, Amazon.com has created an online retail service that appears unassailable, with a specific product that is different from most other ebook readers. The Kindle operates on a Mobi platform, unlike the Nook, Kobo, et al., which use the ePub format. As a result, the ebook content provided by Amazon is inextricably tied to the device it sells and promotes. (Purchasers of competing devices must download an app in order to read anything formatted for the Kindle.) In essence, the Kindle devices lock the purchasers into the Amazon.com ecosystem, just as Apple has attempted to do (with varying degrees of success) by introducing similar proprietary devices in the field of technology.

The prices for Kindle products have ranged anywhere from $399 in the earliest versions to less than $200 in recent months. In an interesting corporate move, Amazon disregarded the traditional wisdom of the “innovation curve,” which posits a theory about innovators, early adopters, and the market segments that follow these trends. Instead, they created their own strategy for the Kindle products. According to Loebeccke (2010), “The small number of early adopters barely allowed Amazon to recoup its initial investments. By abandoning the skimming strategy and counting on economies of scale along the supply chain,” she argued, “Amazon could reduce manufacturing costs and thus lower the sales prices for the device...” (Loebbecke, 2010, p.14). Even at the lower prices, however, the margins for Amazon on their Kindle products are evidently not the driving force behind the pricing of those products. Industry analysts do not agree on the degree to which Amazon uses the Kindle Fire as a loss-leader, but estimates range from $3 and $18 per unit.

The key to understanding these pricing propositions is that Amazon.com is not necessarily focused on profit margins for individual products, nor (ironically) even on *overall* profit margins. In spite of the share-price rises noted above, and the net sales rise of 33.3%, Amazon's net income actually *dropped* by 35.2% in the first quarter of 2012. Wall Street seemed oblivious to this seeming discrepancy, because Amazon's stated intention is growth and investment, not profit margins. As a result, it can use pricing as a sustainable advantage. To many industry executives and observers, however, Amazon is using pricing more as a “weapon” and as a predatory strategy.

Critics of Amazon say the online giant has single-handedly worked to lower the price of ebooks in order to market more of Amazon's ebook readers. This theory is at the heart of the current thesis about the utility maximization of consumers. If a purchaser calculates the cost of an ebook based on its potential lifespan and the potential savings realized by ebooks over print editions, this consumer will need to see a marginal value increase in order to overcome their purchasing reluctance. In financial terms, they need to calculate the amortization factor, i.e., how quickly the accumulated savings-per-book will equal the increased cost of purchasing an ebook reader.

Alasdair White (2011) of Performance Managements Solutions offers a working model of in his article entitled "How the Amazon-Kindle Ebooks Pricing Model Really Works." According to White, an ebook reader will theoretically become obsolete in approximately three readers. If the average reader purchases and reads eight books per year, this would equate to 24 books over the span of three years. Given that the average mass-market book (admittedly the least expensive print format) is $10, this would be a total cost of $240. If an ebook reader retails for approximately $200, then each ebook purchased would need to cost roughly $1.66 in order to create the total equivalent "reading cost" for this consumer of the device and the content. Not surprisingly, this price-point bears a striking resemblance to the preferred pricing of Amazon.com's ebook offerings.

By offering 1.8 million free (i.e., copyright-free) ebooks with the purchase of a Kindle, and armed with the assurance that Kindle purchasers will be forced to purchase their platform-specific ebooks, Amazon.com creates powerful "incentives" to lock in its online clients and perpetuate low prices for the content. However, those are only two of their marketing tactics. On a less vexing level, the online company offers exceptional search capability, extraordinary depth of content, and a reading device that consistently rates high with consumers on its functionality and special features. Online customers are also offered premium service functions and perks. Price reductions, along with expedited and sometimes free shipping, all encourage customer loyalty. Meanwhile, the sophisticated algorithms of Amazon's database essentially create a customized and personalized book club experience for every consumer.

The economic externalities of Amazon, however, accrue to the debit side of this equation. Online customers do not pay sales tax when they shop online with Amazon.com, in spite of numerous state lawsuits launched across America. The state of Arizona, for example, claims that Amazon.com has racked up an unpaid tax bill with its Department of Revenue in the realm of $53 million. This obviously hurts the consumer tax base, and it clearly disadvantages local bookstores who *must* charge sales tax.

The pain is also shared by book publishers, who face a long list of challenges. For example, they are constantly being pressured to increase the discounts they offer to Amazon.com. The company makes increasing contractual demands for "co-op" advertising funds in order to promote the publishers' books. Recently, publishers have seen the costs of file conversions by Amazon.com rising precipitously. Amazon.com requires that the publisher maintain a price on the Amazon.com website that is no higher than the price on any other online site – thereby establishing them as the price "leader." Similarly, the ebook price must be no higher than 80% of the print book edition of the same book. This effectively undercuts all of the retail stores on pricing. (Not coincidentally, sales of adult trade books in bookstores last year declined by 16%.) Ironically, this policy even undercuts the price of print books sold by Amazon.com itself.

Some of the corporate bullying by Amazon has been almost unconscionable, according to industry observers. When it launched a Price Check app to encourage consumers to visit stores and comparison shop before purchasing online, retailers were outraged. A few independent bookstore owners responded with their own special offer. If a customer could prove they had closed their account with Amazon.com, the bookstore would give them an automatic discount of 15% off their purchase, plus an additional $5 rebate on any subsequent purchase.

With Amazon.com now accounting for more than half of the total online sales of some publishers' print and digital books, these terms are becoming increasingly untenable. Indeed, industry analyst Mike Shatzkin sounded a warning for publishers at “Book Summit 2012.” The current 30% figure of total online print and ebook sales may soon evolve to 50%, at which publishers may suddenly find themselves “disintermediated,” Shatzkin suggested (Shatzkin, 2012). In fact, this evolution may already be underway. Jeff Bezos, Amazon's CEO, refers to the Kindle as an “end-to-end” device, by which he means it is a technology that takes the content from the creator and delivers it directly to the user. His colleague Russell Grandinetti ,told *The New York Times:* “The only really necessary people in the publishing process are the writer and the reader” (Streitfeld, 2011).

When publishers balked at the first requests from Amazon.com to allow low prices for online ebook sales, the online retailer followed the course mentioned earlier. They went directly to the content source – authors – and aggressively courted them as an alternative to traditional publishers. For hundreds of thousands of aspiring but unpublished writers, this offer of exposure to millions of consumers was too attractive to refuse. In the process, Amazon.com cleverly added an enormous databank of inexpensive content to feed the consumers of Kindle devices.

Authors, however, are beginning to realize the pitfalls of aligning themselves with Amazon.com in its new guise as a publisher. Several bestselling authors have signed six-figure advances in order to be published by the online retailer – only to find they are subsequently shut out of other sales channels. Traditional bookstores, for example, are less than enthusiastic about selling either the print or ebook editions of works published by Amazon.com. In effect, these authors are thereby trading away 50% of their sales by "going online."

More important, these authors find they may gain high visibility *online* for their writing, but they lose the *tactile* visibility of being in the bricks-and-mortar outlets. Similarly, they lose the editing, design, and marketing experience of publishers and retailers who have been their allies for the past generation of bookselling. When Amazon.com bought the assets of publisher Marshall Cavendish, that company's authors were surprised to find their books being removed from the shelves of Barnes & Noble, the largest book retailer in America.

The lawsuit launched by the U.S. Department of Justice threatens to crown Amazon.com as the leader in slashing the price of intellectual property. Jeff Bezos and his company have been vilified in print, including a scathing article in *The Atlantic* which referred to him as "Dictator-for-Life" due to the preliminary ruling by the DoJ (Weissman, 2012). Amazon.com is now in the unique position of being able to leverage its size, technology, contracts, and technical platform – and the results could be catastrophic for the publishing community. If the online retailer and Kindle provider continues its current growth, it could become the most powerful intermediary between authors and readers in the world. Readers may find they can purchase a certain number of books at preferred prices, thus maximizing their *immediate* utility. Without sufficient competitive forces, however, their *future* utility may be jeopardized.

Barry C. Lynn addressed many of these issues in a heated article on intellectual property in *Harper's* entitled “Killing the Competition: How the New Monopolies Are Destroying Open Markets” (Lynn, 2012). He questioned the “chilling shadow of government interference” in the publishing industry. He also roundly criticized Amazon.com for “employing the most blatant forms of predatory pricing to destroy its retail competitors... And all the while, this new sovereign justifies its exercise of raw power in the same way our economic autocrats always do: it claims that the resulting 'efficiencies' will serve the interests of the consumer” (Lynn, 2012, p. 34). These sentiments were supported by Oren Teicher, who is the current head of the industry under siege – the American Booksellers Association. Lynn quotes Teicher in his *Harper's* article: “Amazon is threatening the whole ecosystem of how ideas are created, how they are developed, and how they are sold” (Lynn, 2012, p.34).

Publishers may have made some errors in implementing the Agency Model, no doubt because there was general panic over what had occurred in the music industry. They were also witnessing the drop in print sales, the decrease in bookstore sales, and the increase in ebook unit sales but at poorer margins. In spite of the poor tactics, the intention of the Agency Model was right and just. The current low prices for intellectual property may be attractive to some consumers, and enormously profitable for Amazon.com as they attempt to sell more ebook readers. The one small problem is that those low prices are probably not sustainable, and an entire industry may be collateral damage in a battle to resolve the conflict.

3.5) Antitrust Issues

The publishing industry was rocked on March 9, 2012, when *The Wall Street Journal* published an article with the ominous header and tag: “U.S. Warns Apple, Publishers: Justice Department Threatens Lawsuits, Alleging Collusion Over E-Book Pricing” (Catan and Trachtenberg, 2012, p.1). The five publishers named in the filing included almost all of the largest and most profitable multinationals in the book trade: HarperCollins Publishers Inc., a unit of Rupert Murdoch's News Corps (which also owns *The Wall Street Journal)*; CBS Corp.'s Simon & Schuster Inc.; Pearson PLC's Penguin Group (USA); Macmillan, a unit of Verlagsgruppe Georg von Holtsbrinck GmbH; and Lagardere SCA's Hachette Book Group. At issue was the way the pricing model for ebooks was altered by publishers just before Apple revealed its first iPad in the spring of 2010.

As discussed earlier in section 2.1 in the Print Publishing Model, trade books have traditionally carried a suggested retail price. Publishers sold these books either directly to retailers or through wholesalers at discounts ranging from 40 – 55% off that suggested retail price. Retailers were free to price those same books at any level they chose, but any discounting would be at the expense of lowering their own profit margins. Bestsellers, for example, were frequently discounted by as much as 30 – 50% in order to drive retail traffic and use pricing as a competitive advantage. This was especially the case with national bookstore chains and other purchasers of large quantities of books. These retailers could afford to sell these loss leaders because the stores were fairly entitled to higher discounts based on the size of their operations and the corresponding size of their book orders.

That same discounting practice, however, came back to haunt publishers when ebooks began to emerge as a significant portion of publishers' revenues. The supposed windfall of new revenue turned into a small disaster when Amazon.com chose to discount e-books heavily and claim a dominant market share in this new book format. By pricing its ebooks at $9.99 or less, Amazon was enticing its online purchasers to buy Amazon's proprietary reading device – the Kindle – rather than pay a higher price for ebooks through either the publisher or another online vendor. At the same time, this pricing was drawing book-buyers away from print copies and converting them to Amazon.com's proprietary e-reading device. More important for publishers, however, was the perceived devaluation of print-form books, and the concurrent loss of potential sales for ebooks because of the new pricing competition.

The U.S. Department of Justice was accurate in saying there were “discussions” about pricing among various industry colleagues, although this fact alone would not warrant punishment. Similarly, there were extensive “in-house” conversations about the pricing of ebooks, as would be expected. Some of those details were recently revealed in a bestselling biography of the late Steve Jobs authored by Walter Isaacson. Before Apple launched the iPad, Jobs proposed that publishers adopt the Agency Model “under which the publishers would set the price of the book and Apple would take a 30% cut” (Isaacson, 2011, p. 2). Part of that arrangement required publishers not to allow any competing retailers to sell their books at a lower price than Apple (the classic “most favoured nation” arrangement). “We told the publishers, 'We'll go to the agency model, where you set the price, and we get our 30%, and yes, the customer pays a little more, but that's what you want anyway,” Mr. Jobs was quoted as saying to Isaacson (2011, p.2).

Like many lawsuits, this one hinged on the interpretation of specific terms. What is the precise definition of "collusion," and what are the specific pricing issues on which there was supposed agreement between Apple and its publishing partners? Virtually every news agency and industry pundit had an interpretation. "If they [the publishers] agreed on anything, it was on a business model – namely, that the so-called 'agency model' that Apple's iBookstore offered was better than Amazon.com's wholesale model,"reported CNET (McCullagh and Sandoval, 2012, p.1). In economic terms, observers were saying the Agency Model was not a means of *fixing* prices but simply a means of *distributing* ebooks and a means or formula for *calculating* prices.

In its subsequent deposition to the U.S. Department of Justice, Apple said it was blameless on the charge of price collusion. In fact, Apple went beyond dismissing blame. It actually claimed it was doing *good* and not harm. Catan and Trachtenberg (2012) in their *Wall Street Journal* article quoted from Apple's legal motion: "Apple's entry created new competition in ebook distribution and a vastly larger pool of ebook consumers" (Catan and Trachtenberg, 2012, p.3). Penguin, Apple and Macmillan have steadfastly refused to admit culpability in the DoJ lawsuit. The other defendants, however, settled the lawsuit. HarperCollins, Simon & Schuster, and Hachette paid fines in excess of $50 million, and they will be prohibited from using the Agency Model in their ebook pricing strategies. Apple, Penguin, and Macmillan, however, claimed they were not in violation of antitrust laws.

News of the settlement with HarperCollins, Simon & Schuster, and Hachette surfaced at the London Book Fair in February, 2012, and was greeted with dismay by virtually all members of the publishing community. "Amazon...and the most price-conscious ebook consumers have won. Everybody else in the ecosystem – authors, publishers, and other vendors – have lost," said industry analyst Mike Shatzkin (2012, p.1). A month earlier he had already predicted how authors would "join the legion of suppliers beholden to a retailer whose mission is to deliver the lowest possible price to the consumer" (Shatzkin, 2012, p. 1).

Arguably the most respected and influential analyst and industry critic is Michael Cader, the publisher of a daily online newsletter entitled *Publishers Lunch.* In the days and weeks following the initial settlement, he provided thoughtful insights into the impact this ruling might have on the publishing industry. He offered the following predictions:

- Amazon will leap back into the marketing war and offer deep discounts on bestselling titles.
- National retailer Barnes & Noble will have to use cash to discount its ebooks rather than invest in their Nook device, improve their stores, or improve their B&N.com website. (B&N stock shares were hammered by the first DoJ ruling.)
- Ebook reader producer Kobo will have to subsidize ebook price cuts in order to match prices with Amazon.
- Google will have a harder time working with bookstores on their collaborative ebook sales. Both partners will have to work harder to compete with Amazon. Similarly, there will be tougher competitions for the margins in their new GooglePlay store launch.
- For Apple, their iBookstore model may not work. Now they will have to *set* prices rather than *respond* to the manufacturers' suggested retail price.
- Publishers will have to reverse all of their pricing and marketing models. For

smaller publishers (who did not get sued), they may have to use a hybrid model: the Wholesale Model for Amazon and the Agency Model modeling for Apple.

- Publishers may simply have to increase the base price on ebooks if they have to work on the 50% Wholesale Model.
- The real losers will be the emerging authors, who could compete on price as long as the bestsellers were set at $9.99. With lower prices, their book sales will now diminish (Cader, 2012).

Most of those warnings and predictions were supported by Readerlink (formerly Levy Home Entertainment), one of the largest book wholesalers in North America. In their letter addressed to the DoJ, Readerlink contended the ruling “sets the stage for the systematic elimination of competition....” (Readerlink, 2012,). Readerlink offers some very specific facts and figures on pricing. For example, they claim the predatory pricing of Amazon's ebooks led to the removal of *print* books from many retailers' shelves. This “reduced consumers' access to books, particularly among readers who could not afford digital reading devices” (2012). In economic terms, this was a direct reduction in utility maximization.

In a similar vein, Readerlink said the DoJ settlement would “lead to the death of many print book sellers who provide the only way to buy books for an abundance of the American book-buying public” (2012,. In response to the DoJ's contention that book prices were rising, Readerlink said “the only prices that actually rose were those on bestsellers that had been 'artificially' lowered by Amazon's below-cost pricing” (2012). Readerlink also tracked the fallout from the lack of competition in other media industries.

"Evidence of companies raising prices after killing off retail rivals has been clear in the case of Netflix, which...raised prices 60% when Blockbuster and other video stores closed...." (2012). Similarly, "iTunes raised prices on popular music tracks by 30% following the closure of Musicland and other music outlets" (2012).

The final rulings on the collusion lawsuit are expected to be tabled in June, 2013. In the meantime, the publishing industry remains in a state of digital disruption. The prevailing mood of almost everyone in the business is that letting publishers set the price of ebooks will actually *increase* competition rather than *decrease* competition. The DoJ, in their rush to save the beleaguered consumer a few dollars at the cash register, may have failed to see how bargain purchases have a hidden price-tag with a "pay later" provision.

SECTION FOUR: BEHAVIOURIAL ECONOMICS OF BOOK PUBLISHING

4.1) Consumer Behaviour & Competitive Forces

Daniel Kahneman (2011), winner of the Nobel Prize in Economics, has done ground-breaking work on decision-making, and especially on the value of using multiple frameworks for making choices. As a scientist, he values reasoning based on logic. As a student of psychology, however, he gives equal value to the power and value of intuition. What happens if the subject of ebook pricing is scrutinized using both of these frameworks?

The behavioural economic proposition might look as follows:

- Logic dictates *strict* utility maximization.
- Utility is defined as optimal price, fast delivery, and special features.
- All of these benefits are offered (in varying degrees) by Amazon.com.
- Decision rule: optimize utility.
- Decision: Purchase from Amazon.com.

Alternatively, if Kahneman's theory is used to analyze this decision, the behaviourial economic proposition might look as follows:

* Intuition requires equal consideration of externalities.

* Utility must account for *all* industry stakeholders *and* sustainability.

* Only 50% of these benefits are offered by Amazon.com.

* Decision rule: consider utility *and* externalities equally.

* Decision: Reconsider Amazon.com as a primary source for purchases.

One of the reasons why some consumers do not employ this decision framework may be explained by the theory of Time-Varying Discount, which is outlined by Perloff (2007) in *Microeconomics* (pp.561-562). Behaviourial economists believe we alter our notions of utility and benefits according to the way we view the future. Just as the Time-Value of Money theory suggests a dollar today is not the equivalent of a dollar six months from today, the perceived pain of an issue such as environmental damage *today* is not the same as the realized pain of that damage *in ten years.* Therefore, we adjust our behaviour (our "discount" rate) accordingly. We may care less because the result is so distant. In a similar way, the decision about ebook pricing appears to be focused on *immediate* utility. Any damage – if it can be seen or quantified – is deemed to be distant or minimal. Consumers need to save money today on ebooks. Anything else is therefore irrelevant.

Loebeckke (2010) arrived at a similar conclusion, although through an entirely different analysis. "Similar to the situation in music," she contended, "we expect users [will be] unable to differentiate and therefore neglect whose offer they consume" (Loebeccke, 2010, p. 23). She posed a question directed at Amazon, Google, and Apple that is central to the current thesis. "Will expertise in the fields of hardware design, electronic platform management, search, semantic matches, or even ad placements win over established book industry competencies?" (Loebeccke, 2010, p.23). Then she posed a question directed at the industry as a whole. "Clearly , economic success requires somebody willing to pay – for [the] emerging business model..." (Loebeccke, 2010, pp.23-24). pp.23-24].

The consumer obviously pays for ebooks, but will the prices of those products sustain the producers? The central argument of this research paper is the proposition that there are sufficient competitive forces at play in the marketplace for consumers to have good and fair access to ebooks. Until the recent crisis precipitated by the DoJ lawsuit, the Agency Model was supporting a sustainable framework for the publishing industry. Now there is uncertainty about the viability of this new reading format – and possibly even about the industry that has spawned the technology. The term “collateral damage” being bandied about is an appropriate metaphor for the possible results of the intermediate decision by the DoJ with regard to HarperCollins, Simon & Schuster, and Hachette.

New and fair pricing models for ebooks are likely to emerge as a result of significant developments in the industry. Many of these developments fall within the theoretical framework of Michael Porter's Five Forces model regarding competition in the marketplace. These include intra-market rivalry, the bargaining power of customers, the threat of substitute products or services, the bargaining power of suppliers, and the potential threat of new entrants to the industry. All of these issues need to be examined in the light of the current digital disruption in the the ebook world.

The multiple rules of the United States Department of Justice will certainly have a profound effect on the ebook industry. Because the DoJ has sued and settled with three plaintiffs in the collusion suit, Amazon.com now has some leeway to lower their prices. However, Random House, the largest publisher in the world, was not part of the collusion suit and is therefore not restricted by the ruling. Similarly, none of the thousands of medium-sized and small publishers will be subjected to the DoJ ruling. There is also the possibility of a different verdict in the case of Apple, Macmillan and Penguin. All of these factors may lead to a continuation – or at least a modification – of the Agency Plan, which is generally acknowledged as a good model for publishers (and, in the long term, also for consumers).

Meanwhile, changes in the ebook reader technology may also have a profound effect on how consumers purchase and interact with ebooks. Amazon's Kindle has been the preferred reading device for ebooks to this point in the technology's development. However, research by the Book Industry Study Group indicated the growth in popularity of this device is waning. (This is a predictable change, based on the traditional "innovation curve" of new products.) In fact, the latest consumer trends indicate a move towards mobile devices as the preferred means of accessing ebooks.

As noted earlier, the tradition of mass market paperbacks as a book format is slowly disappearing. At the very least, it will be reduced to the level of international bestsellers and specific genre fiction, such as romance, thrillers, fantasy and mystery. The reason is self-evident: the price-point of this format is now matched – or beaten – by ebooks. For readers of particular fiction genres and fans of specific authors, the utility of ebooks far exceeds the utility of a bookstore purchase of a disposable print genre. This change in the marketplace explains why Simon & Schuster is changing their mass-market paperback line – Pocket Star – to an ebook-only format. Pocket Star books are precisely the kind of ebook content that sells well through Amazon.com.With the substantial amount of content that will ensue, S&S may have more leverage to explore new pricing and distribution alternatives.

Independent bookstores have been the most serious casualty in this market skirmish over ebook pricing. This sector of the retail market was outraged by the Price Check app used by Amazon.com to spy on its competitors. Backlash from independent bookstores was swift, powerful, and continuous. As a result of the public outcry, the demise of the traditional bookstore may have been exaggerated. Concurrently, the importance of the discoverability of books may also have been underestimated. Consumers need to see and hold certain products in order to make informed buying decisions. They also value the personal service and the "hand-selling" advice of bookstore staff. The technical service of Amazon.com may have won over some consumers, but it is also alienated those who demand more of their retailers.

Although Amazon.com has worked assiduously to corner and control the POD market, the library and bookstore market have a marketing weapon of their own – the new and improved Espresso Book Machine. Developed by publishing veteran Jason Epstein, this technology can now produce a complete trade paperback book from a digital file in less than fifteen minutes. These machines are currently installed in selected bookstores and library venues in the United States, Canada, England, Germany and even as far afield as Egypt and the Ukraine.

Book retailers colleagues – the librarians – are also emerging as a strong voice in all of these debates. Librarians are lobbying vigorously for their status as the "third place" in consumers' lives (after the home and the workplace). With the role of libraries evolving from a storehouse of physical books to a place of information gathering and an online network for ebook access, the role of librarians as information brokers has now come of age. With the purchasing power of libraries increasing in the ebook marketplace, these information brokers will deeply influence the pricing of ebooks and will continue to lobby for the development of sustainable distribution models.

The ongoing position of the DoJ has helped to mobilize an army of industry lobbyists. Disparate sectors of the publishing world that would normally be quarreling among themselves have suddenly united as one voice in opposition to the government rulings. Fortunately, these publishing professionals know how to get "good ink," so the public is hearing that voice. Now the consumer is adding its voice to the choir. Public backlash against multinationals – and specifically Amazon.com – has been growing steadily. This is partly due to the media coverage of the so-called "collusion suit" and partly due to the lobbying of booksellers and librarians. The issues of externalities, sustainability, and author/publisher support are now major parts of the public debate.

One of the key elements of the Porter Five Forces model concerns the power of new entrants, which adds an additional level of marketing competition. As noted earlier, Smashwords is staking out a significant claim in the ebooks landscape. In fact, the number of alternatives to Amazon.com is growing exponentially. Authors now have a sizeable number of options from which to choose their distribution model – while Amazon.com may simultaneously be losing some of its former appeal. Statistics about the very low revenues averaged by self-published authors and especially ebook online sales have been a sobering lesson for many self-published authors connected to Amazon.com. Are the low prices being offered by Amazon – but essentially set by authors – really just vanity traps for writers? Critics suggest these prices are simply a clever way for Amazon.com to boost sales of the Kindle technology.

Meanwhile, an interesting situation has developed at Target, which is poised to enter the Canadian market. Target is dropping all Kindle (Amazon) e-readers and tablet products, stating several specific concerns. The first issue is "showrooming" – the problem of consumers browsing in retail stores but subsequently buying online. Not mentioned earlier was the fact that consumers were asked to turn on their geo-locating devices when they did their in-store price comparisons. For providing this instant marketing information to Amazon.com, they were rewarded with a five-dollar Amazon.com gift coupon. Target has also withdrawn support for Amazon.com because the retailer plans to set up 25 mini-kiosks for Apple in the Target stores. Target is also still recovering from the fallout from the legal wrangling over the end of the Amazon deal to run the website business for Target, which was terminated in 2011.

Although Amazon.com has an international presence, its monopolistic reach is exponential stronger in North America. The ebook reader and ebook units from Kobo are now outselling Amazon products two to one in in France, where the company is partnered with Fnac. Research from data curator and aggregator Bowker shows enormous growth potential on the international scene. Competition for this market may also mitigate against the dominance of Amazon.com. According to Bowker, "...the market for ebooks is set for a rapid increase in Brazil and India" (bowker, 2012). Data suggests the potential for new sales will "double the number of ebook buyers in India and triple the number of ebook buyers in Brazil" (bowker, 2012, p.1). Also, ebook sales in the UK last year were up 366%, to US $149 million, which was 8% of all book sales.

Another competitive factor that is influencing the pricing of ebooks and the market domination of Amazon.com is the "democratization" of book reviews. Ebay and other online sellers have a built-in self-regulation process, because buyers and sellers get to to publicly rate each other. In a similar way, book reviews are an equalizing factor in maintaining literary quality. More specifically, online reviews mitigate against the sometimes poorer quality of low-priced publications, such as the 99-cent offerings in the fiction genre at Amazon.com. These independent reviews act as a "quiet" but democratic force by sorting the quality of the ebook offerings, regardless of the price. This is one of the more subtle marketing/competitive forces at work.

The penultimate section of this research paper will examine new marketing strategies and emerging business models as publishers grapple with the challenge of technological change and its effect on the reading public.

4.2) Emerging Ebook Publishing & Pricing Models

In 2007, 80%+ of all books purchased were bought in a bricks-and-mortar bookstore. By 2017, 80%+ of all books purchased will likely be bought online (either as a print product or as a digital file). These statistics are supported by data from Pew Research, which tracks trends in the publishing industry and also report on reading habits. They have found that the number of Americans who own an e-book reader rose from 18% to 29% between December 2011 and January 2012. Coincidentally, some of the less sophisticated reading devices are now available for as little as $100 (Pew Research, 2012). We are witnessing two iconoclastic industry events: reading is shifting to *screen* reading, and store purchasing is shifting to *online* purchasing.

Unfortunately, publishers are being caught in the middle of these changes. Ebook and print publishers are finding new ways to counter the market influence of Amazon.com, all the while being cautious not to alienate what is currently their single largest and most powerful online marketer for book products. A variety of strategies are being explored. Bloomsbury Publishing has used “windowing” as one technique to control market conditions and prices. Being the publisher of the Harry Potter books gives the company special leverage in setting conditions of sale. Indeed, ebook rights were not even offered on this bestselling series. Other publishers are asking exceptionally large prices for ebook rights to their bestselling titles, which mitigates against a low retail price for the resulting version. Or they insist on pricing an ebook at the same price as the currently available print edition, i.e., at hardcover or trade paperback prices.

Another strategy that may provide relief from price-slashing is related to the content-specific branding of immersive reading, children's books, and illustrated materials outlined at the beginning of this thesis. As some publishers move to this “silo” model where they focus on specific kinds of fiction or non-fiction for a dedicated audience, they become more focused in their marketing. As industry experts at Book Summit 2012 suggested, the “new” publisher needs to create a direct relationship with the end consumer. If a publisher can develop even a modest form of brand awareness, the company can begin to market directly to a consumer.

In effect, this is the strategy being used by Amazon.com in their sophisticated use of algorithms. By tabulating the ongoing purchasers of an ebook consumer, Amazon.com can effectively “publish” for that consumer by filtering the offerings of numerous book producers and packaging the results online for the purchaser. Book publishers are now attempting to recreate this same model within their own businesses. “Branding,” said Mike Shatzkin at Book Summit 2012, “is a shortcut to consumers and book communities” (Shatzkin, 2012). He drew attention to publishers such as Random House and John Wiley, which are selling content directly to travel and business companies for their consumers via webinars, public events, and even those business's own publications. Hay House, which specializes in spiritual books and self-help materials, now packages weekend events with their authors. The company currently has the names and email addresses of more than *one million members* of their “book community.”

Content creators are exploring any new or innovative way to deliver their material to readers and consumers that might counter the effect of Amazon.com. One trend that is gaining traction is ironically the basis of the “old” magazine industry: subscription services. This model has been a mainstay for the library market for decades, but book publishers have traditionally been several steps removed from their customers because they do not own the sales portals – bookstores – for their titles. (This was not always the case. Witness the Doubleday, Scribner's, and Penguin bookstores in New York and London as just a few examples.) Publishers are now desperate to interact directly with their customers so they can market aggressively to them and build customer profiles. To this end, we now have Spain's publisher Booquo, which offers an “all you can read” subscription service for their ebooks for 9.99 pounds per month. The company has received financial backing from Bertelsmann, which is the German owner of world conglomerate Random House. Skoobe (Germany) also offers an e-book subscription service.

Interesting news surfaced at the SXSW 2012 industry conference in March, 2012, as reported by *Publishers Weekly* in “New Publishing Models and the Rise of the Referral Economy” (Reid, 2012). Wowio.com is “an online ebook retailer offering a business model downloadable ebooks-for-pay and ad-supported free content” (Reid, 2012, p.1). It is exploring new ways to deliver content and support alternative pricing models. “Wowio offers a Freemium model that lets publishers set prices (and get 100% of the price, minus a very small processing fee) for ebooks,” reported Calvin Reid in *PW.* They also offer two other models: “give them away with advertising 'tasteful' embedded and generated by Wowio,” or they offer “corporate sponsorships that also allow publishers to give away free ebooks” (Reid, 2012, p.1).

Another one of the emerging trends identified by industry analysts is that ebook readers and ebook unit sales may be reaching a plateau. Print book sales are not declining, and in the case of ebook purchasers their concurrent print book purchases are actually rising. Publishers are now reacting to this trend. In Germany, for example, Springer offers

90% of its book inventory (4500 titles) as Print-on-Demand (POD) purchases, which is a relatively new financial model. Other publishers are considering a “free-with-the-hardcover” model for “pricing” an ebook, although this move is understandably not widely popular. What most publishers *will* agree on is the notion that “e” and “p” will have to learn to accommodate each other in the marketplace.

Digital and print books are totally compatible, according to Jack McKeown, who presented the annual Verso Digital survey in New York in 2012. Many doomsayers say “the growth of ebooks and ebook readers is a zero-sum game pitting print against digital and that the book business will follow the course of the music world, where most bricks-and-mortar retailers have disappeared,” McKeown told reporters (2012). In fact, the Verso survey shows the opposite. The “new” book reality suggests “a different model,” says McKeown, “one of symbiosis mirroring the situation of species who 'depend on each other for survivability'” (2012).

McKeown and others saw indications of this potential at the “Tools of Change” conference mentioned earlier. Publishers are now looking at selling books by the chapter as ebooks, offering digital serialization of print books, financing video booksellers, and creating more “born digital” content for ebooks that can be price competitively. The conference examined platform and format potential as well, with presentations on new iPhone applications, content “mash-ups,” and online readers for iPhones, Android phones, BlackBerrys. If the reduced pricing of ebooks is creating a shortfall in cash for content development, publishers can look to Unbound in the U.K. It is using the popular online crowd-funding app “Kickstarter” to raise funds for worthy but otherwise risky publication ventures.

The key elements that must to be addressed in new and emerging business models are now clear. Publishers need to rethink the linkages between content creators, reading devices, delivery mechanisms, and the digital consumer. One of those complex models has already appeared in recent months – a joint venture between retailer Barnes & Noble and Microsoft with a unique value proposition. The new business will link B&N's college division and B&N's digital division with Microsoft. Plans are underway for a Nook app for Microsoft Windows that would allow millions of Microsoft users to gain access to the B&N online bookstore. This union of content and device may give both players a sustainable advantage as they create and distribute content into the educational marketplace.

For industry watchers, any promising sign of growth and innovation that would provide much-needed competition in this industry is a cause for celebration.

4.3) Conclusions

In this age of digital disruption, coupled with a world in economic crisis, there have been many victims and villains in the world of ebook publishing. Book publishers have seen their Traditional Publishing Model evaporate, only to be replaced by a Digital Publishing Model that appears to under attack from all sides.

Authors are struggling to find answers to questions far beyond the art and craft of their narratives. Is Amazon.com a ruthless commercial venture that is equally adept – and dispassionate – about the content and pricing of their products? The answer is probably "yes," although many observers cannot help but admire their Machiavellian tactics. Did the publishing industry err in "consulting" on an alternative means of distributing ebooks and of recommending a return to suggested retail pricing using the long-admired wholesale model? The answer is probably "yes" on the fumbled consulting, but "no" on the intent of the results.

Overall, is the consumer of ebooks well served by the results of all these industry machinations, i.e., by the actual prices and availability of ebooks? That answer depends on the reader's perspective. It is worth turning once again to Loebbecke for insight on this subject. She believes "...the industry's primary value lies in internalizing externalities between artists and consumers" (Loebeccke, 2010, p.9). That statement, in fact, is at the heart of the economic analysis of the current research paper. It points to the four central questions posed in the thesis statement:

1) *What is the right pricing model for ebooks?*
2) *Are there sufficient competitive mechanisms in the marketplace?*
3) *Is utility maximization possible?*

4) *Is the publishing industry sustainable?*

These questions have been examined from many angles in the previous pages. The "right" pricing model for ebooks is one that values the content provided by the author, returns a reasonable profit for the risk and investment of the publisher, provides an equally reasonable profit for all members of the supply chain, and ultimately provides good value for the consumer. If all of these requirements are fulfilled, then the model is "right" in that it satisfies all of the guiding principles that Jeremy Bentham first envisioned for society in 1787. Given the complexity of the modern world of technology, a "menu" of models might be a more appropriate expectation.

As for the sufficiency of competitive mechanisms, there is room for cautious optimism. In spite of the market domination of Amazon.com, there is a long list of opposing forces and entrepreneurs willing to test alternative solutions. Even if the misguided litigators in the U.S. Department of Justice fail to see the essential wrongheaded of their lawsuit, these forces and entrepreneurs will persist – and possibly succeed.

From the consumers' perspective, will utility maximization still be achieved? Here the answer must be heavily qualified. Yes, in *strict and narrow terms* the consumer will achieve utility maximization if ebooks are readily available at the lowest possible price. However, if one's view of utility maximization is broad enough to encompass some or all of the externalities to which this thesis has referred, then consumers will have to confront the exercise of "internalizing" to which Professor Loebeckke refers. In plain terms, consumers will need to address the *consequences* of their buying habits. Or, as economist Daniel Kahneman might suggest, they will have to think both *fast and slow.* Consumers will need to use not just logic but a healthy dose of deliberation and (dare one say) even *emotion* in seeing the hidden cost behind the visible price.

British author Ewan Morrison picked up this thread in his much-publicized address to the Edinburgh International Book Festival in August, 2011. The title of his speech was dour: “Are Books Dead, and Can Authors Survive?” He alluded to a long litany of industries that have “gone digital” and started on a slide known to economists as “the race to the bottom.” In this scenario, “competing corporations cut their prices in the bid to put all other competitors out of business” (Morrison, 2011, p.6). Morrison rued the day when authors would find themselves working for free and culture would be seen as a disposable commodity. At that point, book publishing would be turned into a macabre race by service providers and advertisers to build more clicks and algorithmic chatter.

At the close of Book Summit in Toronto in June, 2012, Cynthia Good, the former publisher of Penguin Canada, encouraged the audience to consider “the insurmountable opportunities” of the digital disruption facing the publishing industry. Her wry humour was not lost on the audience. Those “opportunities” for further study are the agenda for anyone willing to take up the challenge of Ewan Morrison – a challenge aimed equally at readers and especially to purchasers of books and ebooks.

“I ask you to take the long view,” pleaded Morrison (2011), “to look a generation beyond where we are now, and to express concern for the future of the book.”

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