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Amazon: As EU Continues Scrutiny of US Tech Giants, Amazon is Increasingly Vulnerable in US to Antitrust Enforcement for Exclusionary Conduct in Books

Regulatory Update

Amazon's potential antitrust risk is wide-ranging. While Amazon operates in many markets in the U.S. and abroad, and while the company's antitrust risk is wide-ranging, this article focuses on the potential for an antitrust case in the U.S. against Amazon in the book market. Future articles will focus on both domestic and foreign antitrust risk in Amazon's Web Services business, Amazon's practice of monitoring third party sellers and undercutting them with Amazon-branded products, Amazon's role in the shipping industry, Amazon's discriminatory pricing and Amazon's role in marketplaces of ideas, including books, television, movie, music and news businesses.

Context: EU continues to lead on platform monopolies with pending Google enforcement likely ushering in global scrutiny. European enforcers are already scrutinizing Amazon. In November, Germany reportedly launched an investigation into Amazon and Apple on audiobooks, and the EU announced a formal investigation into Amazon's contracts with publishers last summer. Perhaps most importantly, we expect the EU to enforce against Google for abuse of dominance in the search market in the coming months. Recently, we conducted a conference call with Professor Alan Riley who expects EC enforcement against Google to provide a game plan for antitrust agencies across the world to step up antitrust enforcement of U.S. tech giants.

U.S. DOJ has shown interest in Amazon's role in book market and is likely to receive increased pressure from Congress in the near term. In the U.S., DOJ has met with market participants on Amazon books, but a formal investigation is still unknown. To date, DOJ's antitrust enforcement in books has been limited to its Apple e-books suit. DOJ sued Apple and publishers for price-fixing when they attempted to create an alternative to Amazon and set a $9.99 price for books to be sold by Apple. Amazon, along with other platform giants like Facebook, Apple and Google, however, is increasingly coming under scrutiny in the U.S. According to sources, key Democratic senators are circulating a letter that calls on DOJ to launch a formal investigation into Amazon, which could be released as early as this month. In two recent Senate Judiciary Committee hearings, a bipartisan group of senators has also requested stepped-up enforcement of platform monopolies [click here and here for links to hearings].

Language touting Amazon's market power not going unnoticed by policymakers. Recent statements by investors cheering Amazon's monopoly power are adding to pressure on the antitrust agencies to take a closer look. "We believe there is a multi-trillion dollar monopoly hiding in plain sight," said Chamath Palihapitiya, founder of Social Capital at the Sohn Investment Conference in early May, according to reports. Palihapitiya also reportedly described Amazon Web Services as "a tax on the internet." Although such market power may explain Amazon's stock market success despite underperforming profits, investors' public statements about the company's monopoly power make the antitrust agencies susceptible to criticism for inaction.

Analysis: DOJ likely has a solid Section 2 case against Amazon, but action only likely if political will shifts toward enforcement of monopolization law. In analysis by *The Capitol Forum*, Amazon's conduct regarding books likely supports a Section 2 monopolization case. In addition to *Capitol Forum* interviews, an event by the New America Foundation entitled "Amazon's Book Monopoly – A Threat to Freedom of Expression?" ("the Conference") brought to light facts that DOJ could utilize to bring a Section 2 case. One antitrust expert speaking at the Conference, Cadwalader Partner Jonathan Kanter, noted that bringing an antitrust case against Amazon is simply a matter of "political will." Stakeholders should monitor the presidential candidates' policy positions and close advisors, influential U.S. senators, and the departure or arrival of key personnel at the antitrust agencies to determine whether or not the agencies prioritize major Section 2 cases going forward.

In-Depth Look at Amazon's Antitrust Risk for Books Conduct

Legal standard under Section 2 for monopolization. As background, Doug Preston, President of Author's United, explained at the Conference that Amazon controls 75% of the market for online sales of physical books, 65% of the e-books market and 85% of e-books of self-published authors. Peter Hildick-Smith, the President and Founder of book industry consultancy Codex-Group LLC, told us that in April, Kindle had a 70% share of e-book sales at retail, Apple iBooks had a 10% share and Google eBookstore had a 2% share. When it comes to e-readers, Amazon Kindle has an 80% share of the market, he said.

Mere possession of monopoly power alone, however, is not illegal. Rather, Section 2 of the Sherman Act makes it illegal to acquire or maintain monopoly power through improper conduct. The test for monopolization is "(1) the possession of monopoly power in the relevant market and (2) the willful acquisition or maintenance of that power as distinguished from growth or development as a consequence of a superior product, business acumen, or historic accident."

A foundational Section 2 case, *Lorain Journal,* is illustrative. Lorain Journal was the only news publisher in a small Ohio town until a radio station entered the market. Lorain Journal refused to sell advertising space to any company that also used the radio station for local advertising. The Court enjoined the newspaper from doing so, holding that *Lorain Journal* violated the "'attempt to monopolize' clause of § 2 when it uses its monopoly to destroy threatened competition." As Christine Varney discussed in a speech when serving as AAG, "The Court found that the publisher's conduct violated Section 2 because its acts were plainly exclusionary in their ultimate effect, were not justified by any legitimate reason, and were aimed at the 'complete destruction and elimination' of the radio station."

A more contemporary example of Section 2 enforcement is DOJ's suit against Microsoft, which alleged similar exclusionary conduct. DOJ's complaint charged, "Microsoft entered into agreements with Internet Content Providers that it would give them priority placement on the Windows operating system in exchange for agreement to not pay other browsers to distribute or promote their content." (¶33)

In-Depth Look at Amazon's Exclusionary Conduct in the Self-Publishing E-Book Market

Vertical integration. According to the Conference panelists, Amazon uses its retail market power to vertically integrate into and dominate self-publishing. Journalist and author Frank Foer noted that Amazon can "crush" publishing by "deny[ing] placement in emails" and "shaft[ing] them in their algorithms if they don't agree to Amazon's terms." Amazon, he said, disfavors the authors who do not agree to its terms and puts their books at the bottom of search results. Brad Stone makes similar points in his book, "The Everything Store: Jeff Bezos and the Age of Amazon", detailing how executives play with algorithms to gain leverage over publishers and to underscore Amazon's power during negotiations.

Mark Coker, founder of indie e-book platform Smashwords, explained at the Conference how Amazon operates kindle direct publishing (KDP) for authors to self-publish through Amazon. Amazon created KDP Select, which requires authors to give an exclusive to Amazon for three months in exchange for "special merchandising advantages in the Kindle store to make them more discoverable and desirable," said Coker. KDP Select gives such authors "tremendous merchandising and sales advantage" over authors who do not give Amazon exclusivity. As a result, "thousands of authors" removed their books from competing e-book platforms, said Coker. Further, according to Coker, "Amazon punished those who refused to go exclusive." Now Amazon sells "over one million exclusive books almost entirely provided by self-published authors," said Coker.

After locking up exclusive deals, Amazon launched Kindle Unlimited, which allows Kindle users to subscribe and receive an unlimited number of books. Non-exclusive authors cannot make books available in Kindle Unlimited, said Coker. Moreover, Amazon "changed how author royalties are calculated." Rather than paying 70% of the list price, the traditional method, Amazon is effectively saying, "We don't care what your list price is," explained Coker. Amazon changed the payout to a half cent per page, said Coker, meaning that a 200-page book earns the author $1. Ordinarily, the average pay had been $2.50 per self-published e-book, so this change amounted to approximately a 60% drop in author payments, according to Coker. These low payments to authors are allowing Amazon to put "product on the market at prices that are dramatically lower" than those of books sold by other publishers and even self-published authors, he said.

"When I speak to authors who've enrolled in KDP Select," said Coker, "they hate the idea of exclusivity and resent Amazon for making them enroll, but they feel they have no choice." "They feel trapped because they are trapped," Coker added, calling Amazon's practices "a plan to bludgeon the businesses of its retailers and publisher competitors." "Amazon doesn't need to make a profit with books," he continued, noting that Amazon can "bury the non-exclusive books that dare not bend to Amazon's will." Calling it a "divide and conquer," strategy, Coker argues that Amazon is separating authors from their publishers. As a result, authors have "lost their collective bargaining power that a publisher provides. They've lost their negotiating power," said Coker.

Last month, it was reported that Amazon is meeting with professional publishers in an effort to get them to make their books available on Kindle Unlimited. With the tools Amazon has at its disposal to penalize publishers that do not adhere to its terms, publishers ultimately may have little choice in the matter. But given the loss of revenue to self-published authors when Amazon changed its pricing structure to a half cent per page, publishers have strong reason to resist joining Kindle Unlimited.

Legal Bases for a Potential Antitrust Suit Against Amazon

Section 2 monopolization case. Like the monopolistic newspaper that demanded advertisers exclusively deal with it, or Microsoft's exclusive dealing agreements with internet content providers, Amazon's requirement that self-published e-book authors deal exclusively with the company in order to be visible to customers likely violates Section 2. By advantaging its own self-publishers and excluding rival publishers and platforms, Amazon's e-book conduct falls into traditional Section 2 jurisprudence.

Although Amazon could argue that self-published e-book authors are not required to participate in KDP Select, the counterargument is that participation in KDP Select is a de facto requirement to actually sell books on Amazon and not have one's book buried in the search results behind KDP Select participants. Amazon, as a dominant platform for e-book retailing, privileging its own self-published authors in search results is analogous to the conduct that has brought antitrust trouble to Google in Europe. While the U.S. FTC did not bring antitrust charges against Google for such conduct, the leaked FTC staff memorandum on the Google investigation had many commentators questioning whether failure to bring a case was, once again, a matter of political will.

In-Depth Look at Exclusionary Conduct in the Professional E-Book and Physical Book Market

Amazon's dispute with the publisher Hachette is a pertinent case study of Amazon leveraging its retail market power against publishers. The Authors United letter sent to DOJ last summer details the conflict: "Beginning in March 2014, Amazon interfered with the sale of millions of books published by Hachette Book Group, one of the largest publishing houses in America. Amazon stopped taking preorders, delayed shipping, eliminated discounts, and used search engine modifications and pop-up windows to redirect readers to non-Hachette books." Amazon's actions reduced the sale of Hachette books by 50 to 90 percent, reducing Hachette book sales by "tens of millions" over an 8-month period and affecting "more than 8,000 titles by 3,000 authors," says the letter.

The Authors United letter also asserts that Amazon represents its rankings and recommendations as neutral. "They are not; all these services, including Amazon's search engine, are for sale, and the prime negotiating point in the Hachette/Amazon dispute was how much more money Amazon could extract from Hachette to make sure its authors were being favored instead of disfavored," maintains Authors United.

As with prioritizing the books of its exclusive self-published authors, such conduct raises the issue of platform neutrality. This issue has long plagued Google, with the EU's current enforcement against the company reflecting a view that Google's dominance requires non-discrimination and neutrality. With Amazon's market power in books approaching monopoly levels, prioritizing the books of authors and publishers that submit to its demands may similarly bring Amazon under antitrust fire. Also, to the extent Amazon has utilized discrimination in search results as a tool to willfully acquire or maintain monopoly power, bending competing retailers and publishers to its will, it is vulnerable to Section 2 enforcement.

In-Depth Look at Amazon's Practices Regarding Brick-and-Mortar Bookstores

Through discounting, Amazon priced bookstore chains out of the market during late 2000s, early 2010s. Many have pointed to Amazon's pricing structure as a determining factor, with both e-book prices and physical book prices undercutting brick-and-mortar businesses.

The e-book market took off with the introduction of Amazon's Kindle in 2007, and at one point, Amazon controlled 90 percent of the space. One of the top selling points for e-books was their lower price point compared to physical books. A study from Wharton in 2013 concluded that two-thirds of e-book sales were cannibalizing what otherwise would have been a physical sale.

Hildick-Smith said Amazon created a zeitgeist around its Kindle and associated e-books with which the physical bookstore model could not compete. He said the company created an artificial market through massive investments of more than $2 billion that saw an initial craze surrounding e-books and e-readers. The company also purchased book licenses under the wholesale model for $12.50 each, then sold them at whatever lower price point the company wanted – eating the transaction as a loss but driving consumers to the Kindle platform. Hildick-Smith said price discrepancy put the most pressure on physical bookstores.

Further, in a very granular example of Amazon's physical book pricing around the turn of the decade, a software engineer performed a non-scientific case study in 2011 while his local Borders held a going out of business sale. Even with the blanket 25 percent sale, there was a much lower-priced option available at Amazon, whether direct from the site, a partner or a used book. In fact, the blogger found he could save 45-51 percent with used options.

E-book platforms and devices have saturated the market and growth has stagnated in recent years, Hildick-Smith said, and what Amazon pitched as the future of books has proven to be more of a trend or niche. However, the lasting damage was already dealt to large, physical bookstore chains. The turn of the decade saw major contraction for physical chain locations in the U.S. who were unable to keep up with Amazon's prices. Most notably, Borders and its approximately 500 locations went out of business, and Barnes & Noble suffered setbacks and shuttered many of its stores and most of its remaining B. Dalton locations.

Amazon now plans to open multiple physical bookstores. Amazon opened its first physical bookstore called "Amazon Books" last November in Seattle. The brick-and-mortar shop uses algorithms to cycle through book titles that the company thinks will perform well with shoppers. The company has not shared its motivations to open a more traditional, physical bookstore, and CEO Jeff Bezos has called the location an experiment. Further, it seems Amazon is poised to roll out more locations, though the extent of the planned operations is still unclear. A CEO of a mall operator leaked – and later recanted – that the company plans some 300 to 400 physical locations across the U.S. More officially, the company announced a second location planned for San Diego, and Bezos reportedly told a group of investors in May that the company is "definitely going to open more stores," but would not set a specific number.

Additional Potential Bases of Antitrust Liability

Amazon could also be liable as a monopsonist. In addition to being vulnerable to a monopolization claim, Amazon could also violate Section 2 by virtue of being a dominant buyer of books that has willfully obtained or maintained that power through improper means. One indicator of monopsony power is Amazon's control of the pricing structure for self-published e-books – disregarding the book's list price and instead paying according to its own reduced half cent per page formula. Amazon's punishment of Hachette when Hachette pushed back on its pricing terms is further testament to its monopsony power. See Paul Krugman's 2014 piece, Amazon's Monopsony is Not O.K.

Amazon is also vulnerable to predatory pricing charges. At the New America Foundation Conference, best-selling author Scott Turow described pricing practices Amazon used to secure its dominance. The company "got publishers to agree that their e-books, their Kindle books, could be released at the same time that hardcover books were by promising the publishers to pay them the same thing that they would earn on a hardcover book," for e-books, said Turow. Amazon was "selling e-books at a loss between two and five dollars on every title," he added, and "that's where the Justice Department should have stepped in." Amazon was able to "permanently distort the market for books in this country," by "driving the market toward the e-book at the cost of physical books," he noted.

By selling e-books at a loss, Amazon engaged in predatory pricing that foreclosed other competitors from entering the e-book business and closed thousands of bookstores, explained Turow. Bookstores "couldn't lose two to five dollars every time they sold an e-book," he said, and "[Barnes & Noble] was hemorrhaging money trying to compete with Amazon." "Amazon aims to clear the field of anyone who stands between Amazon and the reader," Turow added. "When there's no one left, it's entirely predictable that the cost to the reader will go up."

The Authors United letter to DOJ similarly took issue with Amazon pricing books for less than the price it paid publishers, "This practice is called 'loss leading,' and it has long been used by well-capitalized corporations to drive less rich competitors from the field." "In the two decades since Mr. Bezos first explained his business plan, Amazon has sold tens or possibly hundreds of millions of physical books at or below cost," reads the letter.

Authors Untied further detailed Amazon's strategy: "The practice became more extensive in 2007, when Amazon used its (then) 90 percent share of the e-book market to dictate to publishers when to release a particular book in electronic form (i.e. the day of publication), and to impose a one-price-fits-all $9.99 sticker on all e-books, no matter how much authors and publishers had invested in those books. For years after the introduction of the Kindle, Amazon paid publishers $12 to $14 for many new e-books it sold at a loss for $9.99. …this strategy badly damaged the publishing industry by driving down the price customers were willing to pay for new books, hence reducing the amount of revenue available for publishers to invest in new books. This, over time, also harmed readers."

Amazon's pricing in the book market is analogous to Microsoft's predatory pricing in the browser market, which DOJ included in its charges against Microsoft. "Microsoft invested hundreds of millions of dollars to develop, test, and promote Internet Explorer, a product which it distributes without separate charge," reads DOJ's Microsoft Complaint (par ¶¶ 16-17) "As Paul Maritz, Microsoft's Group Vice President in charge of the Platforms Group, was quoted in the New York Times as telling executives, 'We are going to cut off their air supply. Everything they're selling, we're going to give away for free,'" continues DOJ's complaint. The complaint also quotes Bill Gates, "Our business model works even if all Internet software is free…We are still selling operating systems. What does Netscape's business model look like? Not very good."

Although prevailing on a predatory pricing claim in court is difficult under preeminent legal interpretations, Amazon's pricing practices – including its new half cent per page pricing structure – are ideal facts for a test case that could change the current legal standards. In sum, an administration that takes a broader view of antitrust rather than accepting that lower prices to consumers are always a good thing, regardless of their effects on choice, quality, innovation, the marketplace of ideas and producers, could craft a lengthy and multi-faceted antitrust complaint based on the factual groundwork laid at the Conference.

<u>Next Steps</u>

In future reports, we will discuss, among other issues:

1) Timeline of potential enforcement action against Amazon in the EU.
2) The role of the marketplace of ideas in antitrust analysis and the implications of Amazon's ever-increasing gatekeeper power in books.
3) Potential remedies and their effects on Amazon's business model of using books as loss leaders to drive sales to regular retail.
4) *Verizon v. Trinko*, a case that has arguably had a chilling effect on Section 2 enforcement, and why it is not likely to be a bar to suit against Amazon for its books conduct.
5) Amazon's antitrust risk in the AWS market.
6) Amazon's antitrust risk in its generic businesses.
7) Amazon's antitrust risk from raising prices and/or price discrimination.