The Emperor's New Clothes

A Submission to the Standing Committee of the Department of Canadian Heritage
on the Recent Past and the Near Future of the Book Trade in Canada.

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The Literary Press Group of Canada represents 39 Canadian owned book publishers who specialize in the genres of fiction, poetry, drama and *belles lettres*. We thank the Standing Committee on Canadian Heritage for this opportunity to present our views on the recent evolution of the book trade in Canada, and on what we see evolving in the future within that marketplace.

Prior to any discussion of the Canadian book trade it is mandatory to remember that the market for books in Canada has been and remains both a regulated and an interventionist marketplace. Without such an understanding of this context of the market's recent and future evolution, no discussion of where this market has been and where it might be going has any value or relevance to anyone.

As we understand it, this series of hearings by the Standing Committee has been convened primarily in response to submissions by the Canadian Booksellers' Association, which has alleged that since 1995, the growing presence of Chapters, and the related companies Pegasus and Chapters Online, in which Chapters Inc. has a majority and a controlling interest, have achieved, and have the ongoing potential to further achieve, a position so dominant in the Canadian book trade that their very existence has already created, and will in the future increasingly continue to create a situation wherein its competitors in that book trade will be unfairly disadvantaged; competition in the Canadian book trade will thereby be reduced; and that therefore both the availability and affordability of books for Canadian readers will ultimately be diminished.

The LPG agrees with the position that the CBA has taken on this issue, and we would like to explain to the Committee why that is so from our point of view as licensees of Canadian intellectual properties that we turn into books, which we then supply to the book market.

We wish from the outset to apologize for the length and breadth of our presentation. As editors, we know and cherish the virtues of concision and brevity. However, since we feel that both the Competition Bureau's three-year conditional approval of the merger of Coles and SmithBooks in 1995 which created Chapters Inc., and its as yet unlimited conditional approval of the creation of Pegasus Wholesale in 1999 were misinformed and misguided, we feel it mandatory that these mistakes not be made for a third time in the hearings of this Standing Committee.

1) Is the retail trade market for Canadian books a zero-sum game?

Much has been made in the populist media about how the Chapters phenomenon has "grown the book trade in Canada." We believe that such sentiments represent at best speculation, and at worst wishful thinking, since they cannot be objectively and historically quantified-they cannot be measured against any sort of historic benchmark. It is not quantitatively known, nor can it ever be quantitatively known, whether the book trade in Canada since 1995 would have grown more or less rapidly either with our without the merger of Coles, The Book Company, Classics, Librairie Smith, and SmithBooks which created Chapters Inc. in that year. What can be historically known and quantified, however, is what Chapters offered to deliver as a result of that merger to both the industry and the Competition Bureau in 1994-95, and what it has actually delivered to date since its founding in March of 1995. While it is not known to us as publishers what, if any undertakings Chapters delivered to the Competition Bureau to gain its initial three-year conditional approval of that merger, the undertakings Chapters delivered to the publishing industry during its extended period of review, with a view to gaining, if not supplier approval, then at least supplier neutrality to its ambitions, are a matter of historic record.

Senior officials of Chapters, under the leadership of Larry Stevenson, in a presentation of their plans to the Association of Canadian Publishers, offered to deliver five "products" to the Canadian retail sector, should the Competition Bureau grant its approval of their proposed merger, through a reconstitution of its brand name retailers as follows;

1) a clarification and repositioning of the “up-market” or “highbrow” series of retail outlets around the then current brand name “The Book Company;”

2) a clarification and repositioning of the “middle-market” series of retail outlets, probably around the then current brand name “SmithBooks;”

3) a clarification and repositioning of the “down-market” series of retail outlets, probably around the then current brand name of “Coles;”

and the creation of two new types of outlets;

4) some form of undefined, and as of then unnamed series of “discount outlets” to compete directly with the narrow range of highly selective and discounted bestseller and remaindered books offered by the high volume oriented warehouse discounters such as Price Club and Costco; and

5) a series of “superstores” to be brand-named “Chapters” based on the American model-big box bookstores carrying a wide selection of 100 to 150 thousand titles.

These senior officials also provided a context for the five “products” they were selling to the Canadian publishing industry. They were very clear about the fact that “some” of the formerly competing (and therefore “redundant”) Coles and SmithBooks stores located primarily in malls, and often in close proximity to each other in the same malls, would have to be closed (though, since their market repositioning was to be clearly differentiated, the question of their alleged “redundancy” seemed not quite relevant under the new plan), and some of these, even without any local competition, would have to be closed because of a decline in profitability and or leases that had become uneconomic.

Although no promises were made during this presentation, the "up-market" The Book Company brand name was presented as a potential "growth sector" clearly distinct from, and therefore not subject to, the kind of "necessary" rationalization of the Coles and SmithBooks stores.

No mention was made at all of any ambitions, or even speculative plans of Chapters entering into the book wholesale field. Any mention of such plans, if they existed at the time, would have put the lie to Chapters' chief defense against all critics of the merger, (who worried that the merger would create or quickly lead to a Chapters monopsony in the retail sector-["monopsony" is a technical term used by economists to describe a situation in which one firm controls the market because of its dominant position as a **buyer** rather than a seller]), that defense being based primarily on the assertion, by Chapters, that their merged book chains would account for only a minority portion of **the entire Canadian book trade**, and that they would therefore not dominate that market as a **seller** of books to the end-user (i.e. as a monopoly).

No mention was made at all of any possibility of Chapters entering the field of electronic commerce, although at the time this sector of the trade was practically non-existent.

No mention was made of any plans Chapters might have of entering the college bookstore sector.

This presentation of Chapters' plans to Canadian owned publishers had the effect of neutralizing any potential official collective negative position of the supply side of the industry on the merger that the Competition Bureau was in the process of ruling on. Some publishers believed a positive approach should be taken, and Chapters should be allowed to proceed in the hope that their five new "products" would "grow the industry;" others, who looked south of the border where chain owned superstores had already been a reality for several years, felt that their appearance in Canada was an "inevitability" purely as a new retail phenomenon, (if not from Chapters, then from some other player, and "at least

Chapters would be Canadian owned"); and still others, also looking south of the border, continued to worry that the new Chapters would put independent bookstores out of business, lessen competition, and, with their heightened market clout, would impose new, more onerous terms of trade on the book business in Canada.

Chapters' most recent annual report to its shareholders allows us a very clear view of what Chapters has delivered in the four years between its founding in March of 1995, and the end of its most recent fiscal year on April 3, 1999.

1) The Book Company has not proved to be a growth sector for Chapters-on the contrary, the number of "up-market" outlets has decreased much faster (by 65%) than either the Coles or the SmithBooks outlets under the Chapters umbrella: from 17 in 1994 to 6 in 2000.

2) Most of the marketing attention Chapters initially paid to its outlets other than the superstores was focused on its "middle-brow" SmithBooks brand name, where it introduced its first "customer loyalty" program, the "Avid Reader Program" as early as 1994, along with its regular mailings to the members of this program, containing paid advertising by publishers.

3) Coles stores have proven not to be significantly different from, or more "down-market" than SmithBooks. In fact, the "Avid Reader" program was extended to Coles stores in 1996.

What Chapters has really done with these three different brand-names (along with its two other related brand-names, Classic Bookstores and Librairie Smith) is to make them more, rather than less similar, and to make all of them down-market. In fact, the 1999 annual report calls all of these retail outlets "Traditional" stores, and stresses their similarities, rather than their differences.

But Chapters has done something else in the process of this consolidation of its former three brand-names into what it now calls its "Traditional" stores-it has added to those three originally separate and distinctly targeted outlets the function it first presented to the publishing industry as its "fourth product"-discounting. Thus, fully four of the five "products" Chapters first undertook to deliver to the industry have been consolidated over the last five years in what it calls its "Traditional" stores. (It is important to note that the consumer discounting Chapters Inc. has offered to date has never really been aimed at, or provided any real competition to, the discount warehouse retailers, who are usually supplied by publishers at the rate of 48% off the retail price, rather than the 45% available to Chapters. The real targets of the Chapters discounting policies, **prior to the creation of Pegasus**, have been the independent booksellers from day one, not the discount warehouse wholesalers which Chapters Inc. alone could not, until the creation of Pegasus in 1999, afford to take on in a head-to-head competition-for exactly the same main reason the independents have not been able to take on Chapters: higher discount). The 1999 Chapters Annual Report is surprisingly open and candid about this process, and deserves to be quoted extensively on these matters:

> For Chapters' traditional mall-based bookstores, fiscal 1999 was decidedly a turn-around year. In fiscal 1996 [1995-96], we began the necessary consolidation of the *Coles* and *SmithBooks* chains with 420 stores, many of them underperforming or overlapping within their markets...by the end of 1999 we had 261 locations. While there has been a natural decline in overall revenues as we reduced the number of stores and brought them in line with our national superstore rollout, traditional stores showed growth in same-store sales and profits, exceeding our projections in both cases. Even during a Christmas season that was generally soft for other retailers, our *Coles*, *SmithBooks*, *Librairie Smith*, *Classic Bookstores*, and *The Book Company* stores had their best quarter yet since the merger.

With *Chapters* superstores now in virtually every Canadian market, we have redefined the role played by our traditional stores. Located in shopping centres and other high-traffic sites, they are designed to conveniently serve book buyers who want the latest bestsellers and popular titles *but may not have the time to browse* [italics added]. Our growing success is based on our ability to offer the books people want at competitive prices, and ensuring that our inventories are replenished rapidly as books sell.

Crucial to this strategy has been a significant investment in unified information systems...We are now able to track the in-stock positions of the most popular titles in Canada, and replenish inventory with a product mix tailored to each store's specific customer preferences [the contradiction embedded in this paragraph is glossed over].

Sales also increased due to new marketing strategies implemented during the year. Through our discounted bestseller program, Chapters traditional stores now offer bestsellers at a price that is competitive with the discounts offered by non-traditional booksellers such as wholesale warehouse outlets and drug stores. Margin reductions are more than offset by increased sales, and because the bestsellers are merchandised at the front of each store, customer traffic has increased markedly. Also displayed prominently are "bargain books"-popular hardcover titles purchases as "remainders" from publishers and priced in the $7 to $10 range, considerably lower than their original sticker price. Through aggressive buying of the best available remainders and packages coupled with their display visibility, sales of these high-margin bargain books increased from 8% of total sales in fiscal 1998 to 11.5% in fiscal 1999...

Our foremost goal for fiscal 2000, now that we have almost completed our rationalization of the traditional store business, is to use our improved systems, merchandising, and tighter focus on inventory to increase sales. [pages 18 and 19]

Having merged four of its five projected "products" (actually "functions" or "services) into its "Traditional" stores, where, according to Chapters Inc., not only the stores themselves, but also their inventory has been "rationalized," it is legitimate to inquire into the performance of Chapters' one remaining "product," the superstore. This "product" is unique in the Chapters system because it currently offers more, rather than less title selection than most of those independent booksellers still left standing after five years of unequal competition with the Chapters juggernaught.

Not surprisingly, the 1999 annual report does not permit the reader to distinguish the relative performance of Chapters' superstores from that of its "Traditional" outlets. Nevertheless, the performance of the superstores as a distinct phenomenon in the Chapters organization can be easily inferred through a very simple exercise. Chapters' own summary of its "Traditional" store history tells the reader that the "necessary consolidation" of its 420 outlets at the beginning of fiscal 1995 resulted in 261 of these "Traditional" outlets remaining at the end of its fiscal 1999 (a reduction of 38% over five years). It would be reasonable to assume that the remaining 62% of these outlets would be the most, and not the least efficient of the original 420, an assumption which is reinforced by Chapters' description of the relative performance of these remaining stores over time on pages 18 and 19 of its 1999 Annual Report. But when this assumed substantial increase in efficiency in the "Traditional" store portion of its operations is combined with the overall figures for the Chapters organization as a whole, some very surprising results begin to surface. These results can be examined on **Table A**.

Table A

The First Four Years, According to Chapters Inc.

Fiscal 1996 (1995-96)	Revenues:	$379,100,000
	Total number of stores	375
	Average square feet per store	3,013
	Average revenues per square foot	$ 335.49

Fiscal 1997 (1996-97)	Revenues	$389,800,000
	Total number of stores	346
	Average square feet per store	3,613
	Average revenues per square foot	$ 311.84
Fiscal 1998 (1997-98)	Revenues	$456,600,000
	Total number of stores	335
	Average square feet per store	5,000
	Average revenues per square foot	$ 272.60
Fiscal 1999 (1998-99)	Revenues	$577,900,000
	Total number of stores	316
	Average square feet per store	6,978
	Average sales per square foot	$ 262.09

Using fiscal 1996 (Chapters' first full year of operation, at the end of which the original 420 "Traditional" outlets had already been rationalized to 371, and only 4 superstores had been created), as a base year, we find that all 375 stores together had the following characteristics:

- average square footage: 3,013
- average sales: $1,010,933
- average sales per square foot: $335.49

Four years later, with 261 "Traditional" stores, one college store, and 54 superstores, we find the following characteristics for all of Chapters' 316 stores together:

- average square footage: 6,978
- average sales: $1,828,797 (not yet adjusted downwards for inflation)
- average sales per square foot: $262.09 (not yet adjusted downwards for inflation)

These first four full years of operation for the Chapters organization demonstrate a very clear pattern, consistent in direction for each and every one of these four years: while the number of stores decreased by 15.7%, and sales overall increased by 52.4%, the average sales per square foot of space in this reduced number of stores decreased by a staggering 21.9%! Clearly, the superstores have introduced a highly inefficient type of bookselling to the "Traditional" store mix, a circumstance which these global figures significantly understate, since the efficiency of the "Traditional" stores has increased, not decreased over the same period. This growing overall inefficiency is beginning to appear on the quarterly reports as well: losses in the first quarter of fiscal 2000 are at $9.4 million, almost three times the $3.3 million loss of the first quarter of 1999.

At the end of the day, it is vital to ask where the 52.4% increase in retail volume of Chapters Inc. came from in the four years between 1995 and 1999. Prior to the merger of the Canadian chains in 1995, informal estimates in the book trade put the level of retail trade sales through chain outlets in Canada at approximately 45% of total. If **all** of the increase experienced by the Chapters organization came exclusively from business that has been redirected to the chain from the independent book retailers that Chapters Inc. has either put out of business or forced to downsize over these four years, Canadian book retailing over this period would have been a zero sum game. There exists every indication that this is exactly what happened. Assuming such a zero sum game, a 52.4% increase in dollar volume flowing through Chapters Inc. over this period would lead one to project a 68.6% retail market share for the chain by the end of 1999-exactly the percentage of market share the industry currently estimates "belongs" to Chapters. This thesis can and should have been tested by research conducted by the Competition Bureau with respect to the question of growth or decline in sales over this period by the independently owned sector of the retail book business in Canada. It is highly likely that such research would confirm what the book trade in Canada currently only "guesstimates" because, of course, the above calculation has not yet accounted for the inflation of average book prices over this same four year period, which constitutes a significant part of the Chapters Inc. 52.4% increase.

If even the **majority** of the sales increase to Chapters Inc. has come from retail business cannibalized from the independent sector, then the rapid period of apparent growth Chapters Inc. has experienced to date is about to come to an abrupt halt. With the 1999 Annual Report indicating that the rationalization of Chapters' "Traditional" stores is "almost complete" (although closures have continued apace-three more being announced in the current month alone, with a fiscal 2000 target of around 240 of the original 420 remaining open); with the *National Post* reporting that "same store sales dropped by more than five percent in the [third] quarter[of fiscal 2000]," which Larry Stevenson acknowledged can be attributed to "cannibalization" within the chain itself, as well as to online sales; with Stevenson speculating in an interview with *ROB magazine online* [Oct. 99] that "in Canada...there are some markets that are already saturated;" we are witnessing the early warnings that retail growth for Chapters' "bricks and mortar" operations will not continue as it has over the first five years of its existence. It would appear that the eagerly awaited and much touted ability of Chapters Inc. to "grow the industry" is quickly evaporating in the recognition that the Canadian retail book market may in fact not be very elastic at all.

Chapters Inc. is a publicly traded company owned by thousands of shareholders. Not all of them are illiterate and therefore incapable of conducting the simple analysis of their 1999 Annual Report outlined above. One wonders how long it will take for many of those shareholders to follow Mr. Stevenson's example in profit-taking: in 1999, he "cashed in a third of his holdings in Chapters Inc. for more than $5 million" (*ROB magazine online*[Oct. 99]).

In April of 1999, at the beginning of Chapters' current fiscal year, the organization launched Chapters.ca, "giving customers access to several million book titles, as well as music CDs, videos, and DVDs." (Chapters Inc. Backgrounder, Annual Report, April, 1999). Initial results for the first three quarters have produced less than spectacular results. In the week ending February 11, 2000, Chapters.ca, now separately incorporated and

named Chapters Online Inc., reported losses of $11.7 million on sales of $12.2 million in the last three months of 1999. This represents a loss of 96%, adding a rather ominously ironic spin to Chapters' own boast that it won the 1999 Internet World Canada's Site of the Year Award *for its impact on the lives of Canadians* [italics added].

In May of 1999, Chapters announced the formation of Pegasus Wholesale, a separately incorporated company in which Chapters Inc. holds a controlling interest (72% of shares). Initially presenting itself as a supplier to the "Traditional" stores, college store and superstores under the umbrella of Chapters Inc., as well as, potentially, to all independent booksellers in Canada, it announced the formation of its library and education market wholesale division this February, at the Ontario Library Association's Super Conference 2000, in Toronto. Pegasus Library and Educational Services (PLES) aims to capture a "significant portion of [the Canadian public and school library] market." [*Just The Fax*, February 10, 2000.] Given the original argument by Chapters to the Competition Bureau in 1994-95, that the merger of the Canadian chain stores into a single company did not constitute a "monopoly" in the entire Canadian book market, it is no accident that Chapters Inc. did not proceed with the launch of its majority owned and controlled (vertically integrated) **wholesale** operation until just over one year after the three-year conditional approval by the Competition Bureau of that original retail merger had expired, making it illegal for the various sectors in the Canadian book trade to get together and discuss the kinds of issues now being presented by those sectors to this Standing Committee.

If, as we understand it, the primary function of the Competition Act is to protect the Canadian **consumer** from a reduction of choice and availability of product, why has the closure by Chapters Inc., over the last five years, of some 180 of its own "Traditional" bookstores "in shopping centres and other high traffic areas throughout Canada," and a clearly and publicly described shrinkage of the range of product available in the 240-odd "Traditional" stores remaining in the Chapters chain by 2000, not caused the Bureau any alarm? Are these not factors which "limit access to and diversity of product to Canadian consumers?" Even worse, why have the predatory competitive practices of the Chapters Inc. superstores, which have resulted in an as yet unquantified number of independent

bookstore closures as well (again, Bureau research is needed here to quantify this) not also raised any additional alarm? Does not the systematic closure of what is by now probably well over 300 chain and independent bookstores throughout Canada since 1994, and a reduction of diversity of product in most of these stores other than Chapters' superstores, as a direct result of the business practices of Chapters Inc., constitute a very effective "limitation of access by Canadian readers to a diverse range of books?"

With Chapters Inc. now accounting for between 60 and 70% of retail sales in Canada, and with Pegasus poised to supply not only all of Chapters Inc.'s outlets, but a significant portion of independent retailers as well, along with college stores, and public and school libraries, it would seem that the argument that Chapters Inc., along with its holdings in Pegasus, does not constitute a monopsony, (if not **yet** a monopoly) in the Canadian book trade, can no longer be rationally made.

2) Will the terms of trade Chapters Inc. and Pegasus Inc. have imposed on the industry result in a net benefit to any other sector of the Canadian book trade?

In order to understand both this question and its implications, it is instructive to review the traditional formula publishers have used in a non-interventionist and unregulated market to determine the theoretical break-even point of their title budgets. The largest single portion (a maximum average of 40%) of the retail price of any trade title has traditionally gone to the bookseller. A further maximum average of 10% of that retail price has been allocated to the cost of the intellectual property (royalty and rights payments to the author[s]); 10% to marketing; and 20% to the cost of creating the physical commodity; leaving 20% of the retail price to pay for the publisher's distribution and overhead costs, and generating a net profit of zero. Using a $20.00 retail price for our sample trade book, this zero-based budgeting model is displayed in **Table B**.

Table B

Budgeting the publishing dollar

Retail Price		$20.00
Maximum average discount (40%)		8.00
Net to Publisher		$12.00
Less:	Maximum average royalty (10%)	2.00
	Maximum manufacturing budget (20%)	4.00
	Maximum marketing budget (10%)	2.00
	Maximum distribution & overhead budget (20%)	4.00
Net profit (Loss)		$ 0.00

Trade publishers' profits, if any, are derived from their ability to reduce the relative size of one or more of these cost centres. By the same token, however, should the relative size of any of these cost centres increase (should the average discount to book re-sellers-retailers and wholesalers-increase from 40% to 50% of the retail price, for example), only three things can happen:

1) the publisher will become unprofitable in direct proportion to that increase;

2) the publisher will have to accommodate that increase by a directly proportionate decrease of its other cost centres-i.e. decrease the amount spent on royalties, marketing, manufacture, distribution and or overhead; or

3) increase the retail price of the book to the consumer, who would then bear the cost of the additional discount given to the publisher's primary customers (retailers and wholesalers).

What would that new retail price be in this model? **It would be very significantly greater than 10%**. In order for the publisher to retain the same net income ($12.00 after retailer discount alone) from our sample book above, originally priced at $20.00 retail, its new suggested retail price would have to jump to $24.00, which, at an average discount of 50% would yield the same $12.00 in net sales to the publisher. If the publisher did this and **only** this, the royalty **rate** as a maximum percentage of the retail price in our break-even budget exercise would have to drop from 10% to 8.3% of $24.00 ($2.00 as a percentage of $24.00, not $20.00). Unless Canadian authors wish to join Canadian readers and begin subsidizing Chapters Inc.'s shareholders in this fashion, the maintenance of the maximum royalty rate of 10% of the retail price of the sample book (with the publisher now still retaining $10.00 in net income to pay the same dollar amount for its marketing, manufacture, distribution and overhead for our sample book) would imply a new retail price for the same book of $25.00. Thus, all things being equal, an increase in the average discount demanded by the combined retail and wholesale book trade of 10%, automatically and necessarily implies a jump in the retail prices of books of **at least** 25%. This very significant increase in the retail prices of books in Canada will have an impact on the affordability, and therefore the sales, of all books, and will make all other things not equal. In this scenario, in an unregulated marketplace, publishers would have to do one or both of two things:

1) spend more dollars on the production values, the marketing and the distribution of those books in an attempt to replace customers who can no longer afford to buy them with wealthier ones, resulting in an escalating increase in the retail price of our sample book of up to 50%, while yielding diminishing returns; and or

2) begin to reject titles that cannot be manufactured in press runs large enough to yield a manufacturing cost of significantly less than 20% of the retail price.

In an interventionist and regulated marketplace like Canada, publishers would have a third option:

3) demand more subsidy, thus involving authors, readers **and** taxpayers in a process which ultimately subsidizes Chapters Inc.'s shareholders, **and no one else**.

It is instructive, at this point, to examine why and how national book chains (including Coles and Smithbooks prior to their merger) have both "required" higher discounts than independent booksellers; and have successfully circumvented the Competition Act in obtaining them from publishers. In order to both minimize inventory holdings and, conversely, shortages caused by delays in restocking the inventory of high turnover titles **at the level of the individual store**, all national chains need to maintain a central distribution facility serving all of their retail outlets. This central distribution function adds a cost centre to the operation of any national network of book retailers (chains) which most independents do not have to contend with. The extra two to four points of discount (42 to 44%, rather than the 40% available to independents) the chains have traditionally demanded has always been justified by their need to maintain their relatively costly distribution centres. Such a practice of "discriminatory discounts" to retailers for goods supplied "in like quality and quantity" is illegal under Canadian trade law. Chains have traditionally skirted this law in two ways:

1) by ordering their books on a bill-to ship-to basis, whereby the publisher receives one invoice for a quantity of books which the publisher is obliged to drop ship to some or all of the chains' individual retail stores. This has the effect of increasing the size of the average order invoiced by the publisher to the chains (in relation to the size of the average order invoiced to the independents), justifying a larger discount to the chains; and or

2) since this type of ordering still results in a floating and therefore unpredictable discount, (albeit at a rate somewhat higher than 40%), chains have often persuaded publishers to set a fixed and predictable discount for them higher than 40%, based on their average annual volume of business, rather than the average value of individual invoices

issued (which in all cases will obviously be higher than the average annual volume of any independent bookseller, even so-called mini-chains). While this manner of doing business is much more gray than the bill-to, ship-to method, it has never been challenged under the Competition Act in Canada.

Chapters, prior to its creation of Pegasus Inc., has proven itself to be no different in this regard from other chains in the past, demanding, and getting a blanket 45% discount from its Canadian suppliers since 1995. However, in creating the vertically integrated Pegasus Inc., and offloading its internal distribution function (formerly a cost centre for Chapters Inc.) to Pegasus Inc. (where this former cost centre becomes a profit centre for Pegasus, demanding an even higher discount of 50% to finance that transformation), Chapters Inc. now finds itself in a position where, under the Competition Act, no supplier can justify any discount to Chapters higher than that available to any other book retailer in Canada (the independents). Publishers have only three options in this scenario:

1) they can refuse to continue to sell to Chapters Inc. at a discount of 45% based on anything other than an annual sales volume model, thus losing all of their Chapters business, since Chapters Inc. has indicated it will be sourcing the vast majority of its product in the future from Pegasus, and direct orders from publishers will become the exception rather than the rule;

2) they can offer a 45% discount to all other competing Canadian retailers of books, ushering in an immediate **minimum** price increase of 12.5%; and or

3) they can channel all of their former business with Chapters (along with that of a growing number of independents, public and school libraries, and educational institutions, including, but not limited to, college book stores) through Pegasus, ushering in the general shift of average discounts from the pre-Chapters 40% to the post-Chapters / Pegasus average of 50%, launching the price escalation and all of its structural implications described above.

3) Is the 50% discount contractually demanded by Pegasus Wholesale a "traditional" or "standard" wholesale discount in the Canadian book trade?

In a word: No.

Discounts of 50% or higher are still considered by most publishers in Canada to be "Distributor," not "Wholesaler" discounts. They apply to **distributors** who service specialty markets **outside the regular book trade** (like, for example, an outdoor equipment distributor who may take only that part of a publisher's list which relates to practical outdoor matters, and distribute those books to retailers who do not normally specialize in the retailing of books, but in the retailing of outdoor equipment). The types of accounts such distributors supply books to are what is known in the book trade as "non-traditional accounts," and they are perceived to exist "outside the regular book selling channels, wherein books are sold within a range of discounts beginning at none (direct sales to the consumer by mail-order or some such method) to a maximum of 48 or 49% to book wholesalers."

(There are notable exceptions to this rule. For example, *Raincoast* represents itself as a "specialty regional distributor" in British Columbia and demands the higher discount, even though it serves primarily the traditional book trade in BC. They remain exceptions, however, and not the rule. But Pegasus' targeting of these exceptions as a rationale for its demand for a 50% discount signals that Chapters Inc. and its subsidiaries are now targeting not only retailers, wholesalers and institutions, but also specialty distributors [and, by extension, any and all distributors, including those serving the "traditional" book market]-in other words, the entire book trade in Canada.)

Most traditional publisher-author contracts specify that for book sales "through the regular book selling channels," i.e. in "the book trade," the author's royalty shall be based on a percentage of the retail price of every copy sold. For the purposes of our ongoing $20.00 example, let us recall that this rate is a maximum of 10% of the retail price, yielding an author royalty of $2.00 for each copy sold through regular book selling channels, which include direct sales by the publisher to individuals, libraries, schools, institutions retailers and wholesalers.

In order to access sales "outside of the regular book selling channels," which is an exceptional circumstance for most trade book publishers, involving only a minority of their product in most cases, they may contract with distributors who specialize in, are knowledgeable about, and are therefore set up to service the different sales infrastructure of those markets which the publisher, in the normal process of carrying out its business, would otherwise not have access to.

The discounts offered to these distributors supplying these "non-traditional accounts" begin at 50%, and can go as high as 60% or more. This, normally exceptional, type of sale is accommodated in most publisher-author contracts with a provision that for books sold in Canada at a discount of 50% or more "outside the regular book trade," the basis on which the author's royalty is calculated changes from the retail price to the net price (the amount the publisher actually receives after discounting the book by 50% or more), and the rate at which it is calculated changes to a maximum of 15% of that net income to the publisher. This is done so that the extra effort and cost incurred by the publisher in its attempt to access sales outside the regular book trade is in some measure shared by the author. In our example, the $20.00 book, when sold in this fashion at the "triggering" discount of 50%, would generate a maximum royalty income of 15% of $10.00, or $1.50, (which, coincidentally, is the equivaent of 7.5% of the retail price, or 25% less than the $2.00 the author would earn on "regular" sales of his book to the trade at up to a 49% discount).

It is interesting to note that, although warehouse discounters who do sell some books, but for whom this represents a small minority of their overall business, will (though under duress-they always begin by asking for, and would prefer, a 50% discount), usually purchase books **directly from publishers** at 48% discount, generating a retail-based royalty for the author because they are not buying them at a discount of 50% or more, nor are they accessing those books through a distributor which specializes in product other than books.

What Pegasus is demanding of its suppliers is that they begin to accept a non traditional **distributors'** 50% discount as their new "standard wholesale discount in the Canadian book trade." The model it is using to do that comes from America, where, with the rise of Ingram and other wholesalers as "suppliers of choice" (rather than publishers) to the retail trade, a 50% wholesale discount (or in some cases even a 55% discount) has become "standard." All this has meant in terms of American author-publisher contracts is that the threshold at which the switch to a royalty based on the net receipts kicks in has been notched up to 55 or 60%, rather than the previous 50%. There has, however, been a tradeoff-the maximum royalty for most American trade books has become between 7.5 and 8.5% of the retail price, not 10% of that price.

Should Pegasus' demand for 50% discount become successful, and the same increase in this threshold take place within Canadian publishing, authors will ultimately receive less of the publishing dollar, in one way or another. Neither the publisher nor the consumer will benefit from this change-on the contrary, they, along with the author, will be paying for it, **for the sole benefit, once again, of Chapters / Pegasus Inc**. (And to the detriment of everyone else.)

4) **How is the book trade discount of 40% to retailers justified, and is there a difference in the way books are marketed in chains as opposed to independents?**

As can be seen on **Table B** above, the traditional retail discount of 40% to the bookselling sector constitutes by far the largest portion of the publishing dollar. Critics and analysts of the book industry in North America have often expressed astonishment at the relatively large percentage of the retail price of books going to this sector, especially since books in this market are sold on a returnable basis, thus providing the retail sector with the lowest risk factor of all sectors involved in the book trade.

The answer to this apparent conundrum is to be found in a number of point-of-purchase and reader surveys carried out by both Statistics Canada and the private sector since 1978. These surveys consistently reveal that only approximately 33% of all book purchases occur because the customer has set out to acquire the specific book actually purchased. Thus, 67% are impulse buys, whether the customer set out to buy any specific book, and found it and purchased it in the store or not. From the publishers' point of view, this means that the single most important and effective marketing tool at their disposal is the availability and display of their books in a retail outlet. It is this fact alone which justifies such a high percentage of the publishing dollar going to the retail sector. If fully two-thirds of all retail purchases are dependent on not only the books' availability in a retail outlet, but also on how they are presented or displayed there to maximize impulse buying, then how the retailers make their product presentation and display decisions, and who pays for those decisions, becomes one of the most important considerations in the book trade.

Traditionally, the majority of point-of-purchase marketing decisions (which books are displayed face-out rather than spine-out; which are placed in end-of-aisle or other feature-displays; which are placed near the front of the store; or in the store window; etc.), are made by the independent retailer's owners or management, based on a combination of their likes and dislikes, special interests, and knowledge of their customers. While, through a system of "co-op advertising," publishers often contribute to the cost of these feature displays, that cost to the publisher is relatively small, and is the exception, rather than the rule, in the visible layout of most independent bookstores or even mini-chains.

While to the uninformed consumer, a chain store layout may **look** the same as that of an independent, the exact reverse is true of the Chains. The shareholders of Chapters Inc. have no interest in indulging the personal tastes of their senior managers, much less those of their regional and individual store managers. This means that the vast majority of Chapters Inc.'s purchasing and display decisions depend on the degree to which "the publisher is prepared to back the title in the system," or on "how cheaply the retailers acquired the product"-see the growing role of "remainders" in the Chapters Inc. 1999 Annual Report above.

Just as in the grocery supermarket business (which is the exact analog here), the products featured in the chains with: customer-directed mailings; or face-out; spine out; end of aisle; front of store; etc. treatment usually receive that point-of-purchase marketing attention **because the publisher has paid for it**, not because there is an assumed interest in that book among the staff or within the community each bookstore, and especially each superstore, serves. Because so many individual stores are involved, and this cannot be done on a per-store basis, this cost to the publisher is relatively high. In addition, since the purchasing power of individual store managers and even regional managers is either non-existent or severely limited, the ability of each individual store to match its inventory to the interests of its region, much less its local community, is limited in like measure.

Titles available in most individual Chapters Inc.'s stores, at least initially, tend to reflect a "lowest common denominator" of national, and at best regional interest. While it is true that all chains try to respond quickly to the appearance of local demand for a specific title within each region, community or store, the essence of the difference in point of purchase marketing decisions, beginning with the crucial question of what gets purchased in the first place, and ending with what gets featured where and how in each individual store, is that these decisions are mainly paid for by the publishers and are reactive in a chain store; and "free" (paid for, in large part, only by the 40% discount that the retailer receives from the publisher) and are pro-active in an independent store.

If one recalls that about 67% of all book purchase decisions are made because the book is there and visible in the store, the fundamentally reactive operating style of chain bookstores tends to limit diversity of book purchases within their communities (once again the grocery supermarket analog is germane), whereas the fundamentally proactive operating style of most independent bookstores tends to increase diversity in book purchases within their communities **over time**.

There is one other respect with which point-of-purchase marketing in the chains differs from that of the independents. Consumer discounting is as endemic to Chapters Inc. as it is rare among independent booksellers. This related difference is yet again based on the hidden [to the consumer] structural differences between the two types of stores, and has nothing whatsoever to do with an alleged “lack of competitiveness” and “disregard for their customers’ price sensitivity” among the independents.

The simple facts that the chains begin with a 5% discount advantage, and then also have the majority of their point-of-sale marketing much more commonly paid for by their suppliers (**in addition** to their higher discounts), allow them to pass some of these structural advantages on to their customers in the form of consumer discounts. What those customers who have moved their purchasing from the independents to the chains in order to take advantage of these discounts do not yet realize, is that the discounts provided them today by the chains will ultimately be paid for by those same customers tomorrow, when the inevitable overall increase in book prices that Chapters / Pegasus is structurally imposing on the book trade for its own benefit, **and its own benefit alone**, begin to take effect.

5) Why did the Competition Bureau approve both the merger of Coles and SmithBooks in 1995, and then the creation of Pegasus in 1999?

In the first instance (1995), and in a word: Naiveté.

Not to personalize the issue, but rather to get directly at its ideological roots, it must be acknowledged that Larry Stevenson is nothing if not a good salesman.

He managed to sell the publishers (and their authors) on the idea that by individually focusing the market orientation of his three "Traditional" stores, Coles, SmithBooks and The Book Company, on very specific and sharply defined customer niches, and by introducing two new kinds of outlets to the retail market that it had never seen before, superstores and discounters, some, but by no means any **significant** volume would be taken away from the then current network of competing, but structurally different independents. Therefore, the appearance of Chapters Inc., in its planned five iterations, would "grow the industry." It was the classic "add-on" or "diversification" model applied to the retail (book) trade in Canada. Why wouldn't such an "opportunity" be attractive to the supply side of the industry?

He managed to sell the independents on the idea that his five new "products" would target a significantly different market from the one(s) the independents were serving, and that therefore he wouldn't actually be "stealing" their customers, **if** those independents were managed as "sound businesses," had defined their market niches, and continued to serve the readers within those niches efficiently and well. Of course, the independents rose to this not-so-implied challenge, and rested assured that in this great Darwinian exercise of competition, only those among them who "didn't deserve" to be in business in the first place would be lost, and that the overall effect of this new competition would serve to "professionalize and modernize" a retail sector which had become "complacent and moribund" over the years. How could they have reacted otherwise, without losing their self-esteem as businesses?

He managed to sell Canadian readers on the idea that they could have access to the very best of both worlds: a wider product selection **and** cheaper prices. Has any consumer, anywhere in the world, ever **not** bought into this particular promise?

Having pre-sold every sector of the book trade on the "great opportunity" he had planned for them, he successfully sold this same plan to the Competition Bureau by offering it an alternative, should their approval of the merger of Coles and SmithBooks which started all this not be forthcoming: since neither of the competing two chains, Coles and SmithBooks, were particularly profitable, the alternative to a plan which saw the merger and "rationalization" of the two chains was a scenario in which both would eventually become bankrupt, removing 420 book retail outlets from the consumer landscape of the Canadian marketplace, a phenomenon which would clearly and substantially reduce consumer access to books in Canada.

(The possible third or fourth options of: private investors taking over those of the individual chain stores which remained viable after such bankruptcies and turning them into independents; or of one chain bankrupting the other in a truly equal head-to-head competition on a level playing field and accomplishing the "necessary rationalization" of the chain store business in Canada that way, were clearly backgrounded as options in this debate, if in fact they were presented or considered at all).

And finally, the option presented by an extension of what has historically already happened so far, which is that Canada is well on the way to **losing a different mix of the same number of 420 bookstores** Canada would have lost if both chains had gone bankrupt in 1994 **anyway**, was not foreseen by anyone other than the most realistic, a tiny group of industry players which has never included the likes of either Mr. Stevenson, or any of the members of the Competition Bureau.

While recognizing that it is, after all, its job, it is to the Competition Bureau's credit that it looked upon the bright new "opportunity" Chapters Inc. offered the industry in 1995 with a somewhat more jaundiced, if not downright cynical eye than most of the industry itself did. That's why the Bureau initially approved the merger of Coles and Smithbooks which kick-started Chapters Inc. on a **conditional** basis, allowing a three-year review period during which any or all sectors of the book trade in Canada could have chal-

lenged any perceived restraint of trade effect that Chapters Inc. was having on the industry. The fact that no officially constituted part of the industry availed itself of the ample three-year opportunity offered to it by the Bureau to question and or challenge these perceived effects, is what made the Bureau's approval of Chapters Inc. permanent.

There is, however, clear evidence that in granting its conditional approval to the chain merger which created Chapters Inc., the Bureau saw it as an organization which could easily, if left unchallenged over time, become a monopsony that **might** create the effect of limiting competition, diversity and product availability (including as a function of pricing and discounting) in the Canadian book trade. This evidence is to be found in a statement made by the Bureau to the *Globe and Mail* at the time of issuing its conditional approval to Chapters Inc. It justified its decision by stating that **even if**, over time, such a negative result were to arise, "Such an organization would inevitably attract competition." And that's where the Bureau made its fatal error. While in a continentalized or even globalized free market such a statement is correct and historically demonstrable, in a regulated and interventionist market like the Canadian book trade, it is not.

In the 1970's Canada changed its interventionist policy in the Canadian book trade (designed to level the competitive playing field between Canadian publishers producing Canadian authored books for Canadian readers in a market one-tenth the size of that of its main competitors, American publishers) from a tariff on foreign published trade books (which artificially increased the retail price of those imported books) to subsidies of books published by Canadian owned publishers (which artificially buys down the cost of those domestic books so they can be priced competitively to physically similar, but cheaper, imported product). In order to minimize the open-ended potential demand which threatens all such subsidy programs, Canada also introduced an ownership policy in the Canadian book trade which limits foreign investment (i.e. Canadian-based, but foreign-owned competition) in that trade. It was in order to protect and maintain its interventionist and regulatory policies in all Canadian cultural industries, of which book publishing is merely one, that the exemption for cultural industries was inserted into both the Free Trade Agreement (FTA) and the North American Free Trade Agreement (NAFTA) in the 1980s.

What this means is that if Chapters Inc. were ever, subsequent to its approval in 1995, to begin to act in a manner that would in any way limit competition or product access or diversity in the Canadian book trade, the competition that such behavior "would inevitably attract" **could not come from foreign owned companies or investors**. In fact, Chapters Inc. attracted just such "inevitable competition" right from the earliest days of its existence, when Borders Inc., America's second largest book Chain, attempted first to enter the Canadian book market on its own, then in a majority-owned joint venture with a junior Canadian partner, Ms. Heather Reisman, who now operates the "other" Canadian Superstore chain, Indigo. Both attempts by Borders to enter the Canadian book market as a majority shareholder were disallowed by Investment Canada because of the DCH's protectionist ownership policy on investment in the Canadian book trade.

This same ownership policy does not prevent, however, a minority interest of foreign ownership in Canadian based companies. Thus, also from its earliest days, Chapters attracted a 20% investment in its operations from America's largest book chain, Barnes & Noble, an investment which has never diminished, but now constitutes only approximately 7% of the share holdings of Chapters Inc., the percentage of B&N's holdings having been diluted by subsequent share offerings by Chapters.

Because of the (twice) historically tested structural impossibility of Chapters Inc. ever attracting any foreign competition, the question then remains, is it credible, or even plausible, that Chapters Inc. will ever attract any significant **Canadian owned** competition, no matter what it does in the Canadian book trade? In a word: No. Chapters has had, from the outset, far too many advantages for any Canadian owned company to realistically or effectively compete with it, beginning, of course, with an infrastructure and cash flow from 420 already established "Traditional" bookstores throughout Canada which it had carte-blanche to "rationalize" if, when and how it saw fit, along with the management expertise of America's most successful book chain, Barnes and Noble, which was inevitably provided by B&N's minority stockholding in Chapters.

Ms. Heather Reisman's recent announcement (February, 2000) that her own superstore chain, Indigo (currently consisting of 14 superstores, no "traditional" stores, and no college stores) will not be going public, constitutes a clear acknowledgment that any serious attempt by any Canadian investor(s) to compete with Chapters Inc. on a level playing field is doomed to failure: the competitive advantages of Chapters Inc., in place from the beginning, are simply too great.

Thus, by the end of March, 1998, when the original conditional term of its approval by the Competition Bureau expired, Chapters Inc. occupied, at least potentially, a position of a state-protected monopsony in the Canadian book trade, with the door left wide open for it to vertically integrate, and begin the process of transforming itself into a state-protected monopoly in that trade. Its creation of Chapters.ca and especially Pegasus Inc. only one year later constitute two very clear steps in this direction. Which brings us directly to the baffling question of why the Competition Bureau granted conditional approval to Pegasus Inc. in 1999.

In a letter written on November 15, 1999, to Mr. Paul Davidson, the then Executive Director of the Association of Canadian Publishers, Mr. Richard Taylor, the Assistant Deputy Commissioner of Competition (Civil Matters, Division B), justified the Bureau's May, 1999 approval of the creation of Pegasus on a number of indirect grounds: i.e. because Pegasus has "not yet," (in a veritable litany of possible ways enumerated in Mr. Taylor's letter, all of which are acknowledged as potentially available to Pegasus because of the way it is structured and because of the role it will play in the Canadian book trade), acted in restraint of trade in ways which would be judged to have contravened the letter of the Competition Act in a court of law.

The only direct explanation of the Bureau's decision in the same letter is that: "The facilities used to establish Pegasus were wholly owned by Chapters before being used to form the wholesale operation. Therefore, their transfer to Pegasus, which is majority owned by Chapters, does not constitute a change in ownership that may raise an issue under the Competition Act. In short, entering into a new business does not contravene the act."

Surely, if anyone ever needed a lesson in the relation of the letter to the spirit of the law, the members of the Competition Bureau would be right up there at the top of the list. Is Mr. Taylor really saying here that the circumstance of Chapters Inc. buying a majority interest in an **existing** national wholesaler, "may [have raised] an issue under the Competition Act," but that since the physical plant that the new national wholesaler, Pegasus, moved its operations into was already owned by its majority shareholder, Chapters Inc., this **did not** raise an issue under the Act? If this were true, for what purpose, exactly, would the Competition Act exist?

Let's try to look at this position objectively for a moment. The purchase, through either a hostile or a friendly takeover of any independent national wholesaler, (presumably supplying all national retailers equally), by any national retail chain, (much less **the** national retail chain), "**might** raise an issue under the Act;" but the creation of a brand new national wholesaler by that same national retail chain on its own premises, would "**not** raise an issue under the Act!?" We would like to ask the readers of this report to tell us which of the two circumstances above they think, in their judgement, would be the **most likely** to result in the wholesaler in question acting in a manner which "might raise an issue under the Competition Act."

What is so interesting in this affair is its common denominator: the largest American book retail chain (and a minority stockholder in Chapters Inc.), Barnes & Noble, which about two years previously had made a successful bid to the shareholders of Ingram, America's largest book wholesaler, to take over their company. American antitrust legislation intervened, the issue went to court for about 11 months, and Barnes &

Noble eventually withdrew its bid to purchase Ingram. Obviously, Chapters learned something from their American junior partner in all of this, so that when it came time to make the move to vertical integration in the Canadian book trade, instead of making a bid to purchase a majority of the shares in any number of already existing Canadian book wholesalers, Chapters Inc. started its own wholesaler instead, thus avoiding "raising [the] issue under the Act" in Canada that Barnes & Noble had raised in the American courts in their attempt to acquire Ingram. Apparently, the Canadian Competition Bureau remains unaware of this history, and or doesn't consider it to have any bearing on what is clearly "a completely different set of circumstances in Canada."

While the one direct reason given for the Bureau's ruling that the creation by Chapters Inc. of Pegasus, "springing fully armed like Athena from the forehead of Zeus" did not "raise an issue under the Act" stretch the limits of credulity to the point of rupture, some of the Bureau's proposed "negative tests" for possible contravention under the Act which Mr. Taylor enumerates in the same letter are patently absurd. Take, for example, the following circumstance which the Bureau states might be, but has not yet demonstrably been, an indication that Pegasus has "raised an issue under the Act:"

-that publishers are effectively prevented by Chapters and Pegasus from supplying books to Chapters through wholesalers or distributors other than Pegasus

Now, the Competition Bureau should have discovered in its review is that the only way a publisher is going to do any significant volume of business with Pegasus is by explicitly signing a service contract, on Pegasus' terms, which are, for the book industry in Canada, a non-standard 50% discount (that's **why** the contractual relation, [which no other Canadian book **wholesaler** demands, but all Canadian **disributors** demand], is mandatory at Pegasus). If suppliers don't sign that contract, they won't do much, if any, business with Pegasus. And that's not in restraint of trade. There are, after all, for the moment, other

wholesalers operating in Canada, who will and do order books from publishers at the Canadian standard wholesale discount of 46 to 48%, and there are, also for the moment, other disributors in Canada which, **if a publisher signs on with them**, will order books from those publishers at the Canadian standard distributor discount of 50% or more.

So, we ask the reader to imagine that one day in the not-so-distant future, Chapters orders some of publisher "X's" books from Pegasus. Pegasus says to Chapters (openly, of course, so as not to engage in **another** of the Bureau's "examples" of how Pegasus might "raise an issue under the Act"-i.e. by the "strategic use of confidential information"): "Sorry, we don't have that book in stock because we don't do much business with that publisher because they don't like our terms and so haven't signed on with us." In order to protect itself under the Act, Chapters may, in this one instance, resend this order which has created a paper or an electronic trail, to another wholesaler, distributor, or even to the publisher directly. After this transaction is complete, Chapters suddenly loses interest in publisher "X's" books. It simply cannot be proved in any court of law, subsequent to this hypothetical series of events, that publisher "X" is now "effectively prevented by Chapters and Pegasus from supplying books to Chapters through wholesalers or distributors other than Pegasus," especially since any burden of proof rests with the publisher, and not with "Chapters **and** Pegasus." How, exactly, do publishers set about to prove that they have been "prevented from supplying books to Chapters" through **any** wholesaler or distributor, if Chapters simply ceases to order that publisher's books from anyone?

While the Competition Bureau's conditional approval of the original merger of Coles and SmithBooks which created Chapters Inc. **might** be excused by an alleged naiveté on the part of the Bureau, its recent approval of Pegasus cannot be excused in this way, because with Pegasus, the Bureau is no longer contemplating unknown territory. What, for example, was the 1995-98 conditional review period for, if not at least in part give the Bureau some idea of the direction of the evolution of the Chapters Inc. phenomenon? Did the Bureau actually learn nothing from either Chapters' suppliers, or their competitors, or even from Chapters' own and very public Annual Reports in those three years, or even in the year since 1998?

At the end of the day, no matter how inexplicable, irrational or even non-sensical the Bureau's refusal to stop the "rollout" of Chapters Inc.'s ongoing iterations might seem, it may very well be that the officials at the Bureau are actually doing the Canadian book trade a favour. There is, after all, "A tide in the affairs of men...," and the Bureau missed that tide in 1995, and the industry did not stick its fingers in the leaky dike holding back that tide between 1995 and 1998. It is now too late. The tide is upon us. What, for example would the Canadian book trade look like in the year 2000, without Chapters?

In a word: bankrupt.

6) Are there books after Chapters?

In 1994-95, when Larry Stevenson was first raising the straw man of the bankruptcy of both Coles and Smithbooks, what was the Canadian book trade facing?

The loss of what the industry then estimated was 45% of the retail trade flowing through those two chains, which between them had 420 bookstores located in "shopping centres and other high traffic areas." But even if both chains were **threatened** with bankruptcy back then (which there remains little if any disagreement about), how would that circumstance have "rolled out?"

First of all, it is highly unlikely that both chains would have gone bankrupt simultaneously. Thus, in the event of the bankruptcy of one of the chains, the independent booksellers through whom 55% of the retail trade was then flowing, along with the +/- 50% of the chain retail volume of the chain left standing after the first of them went down, or +/- 75% of the total retailers remaining, could have absorbed, though not without this generating some difficulty in the trade, the volume of sales which formerly had flowed through the one chain which was now bankrupt.

That scenario would have allowed the industry as a whole to carry out the "necessary rationalization" of the chain business by reducing the number of chain stores by about 200, (which, by the time Chapters Inc. gets around to "completing the necessary rationalization of its 'traditional stores'" is about exactly the same amount that Mr. Stevenson has put out to pasture) **but it also would have strengthened, not weakened the independents**. The bankruptcy of the second chain, in these circumstances, would have been a possibility so remote that it's not even worth considering because, just like Chapters today, it would not be facing any viable competition from any other chain. The one thing this scenario would have done, however, is to cause some pretty severe short term pain on the road to the eventual long term gain: the failure of some publishers whose product was very chain-reliant, and some fairly acute short term hardship to those publishers who survived. At the end of that process, however, because competitive forces would have been allowed to self-regulate and reconstitute the marketplace, the Canadian book trade as a whole, including its readers, would have been stronger, with good, healthy independents dominating that market and outnumbering the chain outlets.

In short, the Canadian book trade never needed Mr. Stevenson's "solution" to a "problem" that in fact never existed as he portrayed it in his own self interest. Had the Competition Bureau done its job at the time, and disallowed the Chapters proposal so that competitive forces could continue to work in favour of **all** of the players in the Canadian book trade, rather than in favour of just one of them, Chapters, the Canadian owned sector of the publishing industry would not be as threatened with extinction as it is today.

In fact Canadian owned publishers are more threatened by the Canadian owned Chapters today, than they ever were by all foreign owned publishers combined at the time of the first major publishing ownership crisis in Canadian history thirty years ago, in 1970.

Is that overstating the case? Let's examine both the possibility of, and the consequences of, the collapse of Chapters in the Canadian book trade, recalling that Chapters already "owns" 60 to 70% of the retail trade, and is poised, with Pegasus, to begin to own a lot more of it, in addition to the non-retail part of the trade represented by the public and

school library, and the institutional business it is courting through Pegasus PLES. By continuing to allow one company to control such an ever growing portion of **the entire Canadian book trade**, the Competition Bureau has created a situation in which, should that one company ever get into serious financial difficulty, it will take the entire industry down with it. And unlike in 1995, there will not be enough infrastructure left this time around to catch what remains of the industry in such a disastrous free-fall.

On October 29, 1999, the Globe and Mail published an article by Marina Strauss under the headline "Chapters shares fall." After describing a decline in share prices which matched a 52 week low, the article goes on to say:

"Brian Acker, president of brokerage and money manager Acker Finley Inc., said
he has serious concerns about Chapters. 'It doesn't surprise us that it [the stock] is doing what it's doing. We expect it to go a lot lower."

He said the Toronto-based Chapters has a lot of debt on its books in comparison
with its assets, because the superstores carry a lot of inventory.

'They really have to turn their inventory over quickly,' Mr. Acker said.

But Tamara Lawson, chief financial officer at Chapters, rejected Mr. Acker's view, saying the company's debt-to-equity ratio 'is not out of line at all.'

'**He obviously doesn't know that much about our company**,' Ms. Lawson said. '**Inventory is returnable**.'"

Chapters Inc. and its subsidiaries are publicly traded companies. Should at any time, and for any variety of reasonable or even irrational causes, their share prices and therefore their equity fall steeply, with their debt-to-equity ratios already stretched to the limit they will have no alternative but to return massive amounts of inventory to bring their debt-load into line.

None of which is to ascribe fault to Chapters. It's just business, after all. If Chapters Inc. were doing what it is doing to the Canadian book trade either consciously, manipulatively, secretly, or even with malicious intent, its chief financial officer, Ms. Tamara Lawson, would not be making public statements like this-they are too threatening, and too nakedly revealing of Chapters' already universal power to destroy the entire Canadian book trade, top to bottom, by doing exactly that-a wholesale return of all unsold inventory to Canadian suppliers.

7) Is there a political dimension to the Chapters / Pegasus Inc. question?

Ever since David Peterson, a former Liberal Premier of Ontario and the brother of Federal Liberal Secretary of State Jim Peterson, was first appointed as chairman of the board at Chapters Inc., there has existed some considerable degree of public speculation as to what, exactly, his qualifications for the job might have been. This circumstance has, from the beginning, created some very counter-productive political optics around the entire Chapters affair.

It is also, of course, pure coincidence the Competition Bureau's conditional approval of the merger of Coles and SmithBooks in March of 1995, primarily to "protect the industry from the imminent bankruptcy threatening both of these chains," occurred exactly one month after Finance Minister Paul Martin's cut to DCH's publishing subsidies, without even 24 hours' warning, by a staggering 55%. Certainly it is clear to everyone that after taking this huge hit in federal subsidy cuts, from which the industry is still recovering today, (even though funding for those subsidies was quietly put back in place, without explanation, one year later), publishers could not **also** have survived the bankruptcy of even one, much less both of the chains in that same year.

Almost immediately after the Competition Bureau failed to enforce the spirit of the Competition Act in its investigation into the Chapters / Pegasus affair (May, 1999), the Government of Canada **suspended the Act itself** for 90 days, in order to allow another Canadian company, Onex, to legally discuss, plan, and make a "legitimate" financial bid

to create a monopoly in the Canadian airline business. The **suspension of the Competition Act** in order to legalize the attempt by one Canadian investor to create an airline monopoly in this country; and the Competition Bureau's **failure to use the Act** to prevent another Canadian investor from creating a monopoly in the Canadian book trade, seems to demonstrates that the current Government of Canada has a policy preference for the creation of monopolies, to which it considers its own Competition Act to be merely an "irritant," (because "only in this manner can any Canadian business sector become truly competitive in a globalized marketplace").

These negative political optics were increased exponentially at precisely 11:17 AM on October 27, 1999, when "Dina@Chapters.ca" issued a press release, via E-mail (of course) announcing: "CHAPTERS ONLINE AND CANADA POST ROLL OUT E-COMMERCE ADVERTISING CAMPAIGN." What a very odd and compromising position for Canada Post to find itself in, especially since the language used in the press-release duplicated the vocabulary announcing the former Chapters superstores, which were also "rolled out" to the public after being approved by a Federal regulatory agency. As a Crown Corporation (as opposed to a private sector business), Canada Post has an explicit social mandate which overrides any and all commercial concerns it may well also have as a publicly owned commercial enterprise-to serve, **and to be seen to serve**, any and all Canadian Citizens, whether private or corporate, from a position of unassailable neutrality. Why does it have such an explicit and overriding mandate? Because its social function or purpose is to **equalize** competition between all Canadians. This is exactly why this joint advertising venture between Chapters and Canada Post was so unique and "newsworthy." At no time in Canadian history prior to this announcement had Canada Post ever conducted any advertising campaign with any private sector business, for precisely the reason of maintaining both its actual and its apparent position of competitive neutrality. That's what made this new arrangement so shockingly unique. The press release, presumably issued after, not before being vetted by Canada Post, made much of the precedent-breaking nature of this arrangement.

Again, it is not necessary, nor is it particularly intelligent to infer any explicit political favoritism within or behind this arrangement. There is a much more logical, reasonable and less conspiratorial explanation for this bold new joint venture which has gone where no Postal-person has ever gone before. The digital universe, explicitly the phenomenon of E-mail, and in the realm of parcel post, particularly the phenomenon of e-commerce, had been leaving the “snail-mail” Canada Post behind like some desperately struggling dinosaur choking on the dust of ancient history. It is no wonder, then, that Canada Post, desperate for a little bit of contemporary cachet and chic, sought some way to present itself as a viable or, even better, an **essential** partner in the e-commerce phenomenon sweeping the continent, and what better partner than the coolest, award winning e-commerce player in the country-like, for example...,Chapters Online!

8) Is there life.com after books.com?

Highly touted as last year’s “hula hoop” (the past tense will not have escaped the reader), the “e-commerce phenomenon,” as conceived, initially and coincidentally around books, by amazon.com and its many imitators, (barnes&noble.com, Chapters Online, etc.) is actually an infertile hybrid, and therefore doomed to failure. It is no accident that amazon.com and all of its imitators have yet to produce a single dollar in profit on operations, and their operating losses to date have been, and continue to be, staggering. The excuse used by all of them-that their high startup and technology costs are causing these losses, and that eventually, once those startup costs have been fully amortized, the organizations will begin to generate operating profits, have really already worn unbelievably thin, given the length of time amazon.com itself has been in this game.

The fact that this craze began at amazon.com with **books** is very useful to those of us in the book trade wishing to structurally analyze this phenomenon, and that analysis begins with the question: “What do people buy from these books.com sites, and why?” The answer is pretty straight forward, once the novelty of the process (buying something

from your home or place of business and having it show up on your doorstep several days later) wears off: they are buying books of very specific interest to them (niche-market product) in very small orders because most of them are not stocked at their local bookstore which would have to "special order" them.

The essential differences between these electronic special orders vs. physical special orders are two: at books.com the customer doesn't have to physically go anywhere to either do the ordering or to accept the delivery; and delivery times from the books.com sites are generally faster than through physical bookstores. The delivery cost to the organization providing the service in both cases is usually nil, because the bookstore simply telephones or (e-)mails the customer when the product arrives for pickup, and the books.com sites bill the customer for freight out.

But, even without consideration of the shipping costs to the customer, have special orders of this type ever been profitable for retailers? The answer, of course, is no. When it is done by retailers, it is done as a function of "loss-leader customer service" the intent of which is to keep the customer coming to the store, because the statistics say that for every specific book a customer sets out to buy from a bookstore (whether or not the store already has it in stock when the customer comes looking for it), that customer will buy, from that same bookstore, another two books by browsing. It is the statistical ability to spread the physical acquisition and handling cost of the service provider on that one special order over the sales of **at least** two other books which the retailer has already acquired much more cheaply in bulk, that allows bookstores to provide a special order service to their customers economically in the first place. That's why the product-customer match decisions of all book retailers determine, more than any other factor, their success or failure: the more specific books customers "pick and pack" for themselves from high-discount, low-handling-cost stock already present in a physical bookstore, the more profitable that bookstore will be. On the other hand, the more special ordering the bookstore does for its customers: sourcing; ordering; picking; and packing those orders at relatively smaller discounts from their suppliers (because they haven't bought them at high-volume discounts), the less profitable it will be.

The competitive problem, therefore, of any books.com site, is that "every order is a special order." Part of the function of this competitive disadvantage (the physical processing of all aspects of each small order) for the books.com sites is that they cannot achieve the same margins, even on bestsellers purchased in bulk at high discounts from their suppliers that physical booksellers can, for the simple reason that in a physical bookstore, the customers pick and pack those products for themselves, at zero handling cost to the service provider. Thus, the structurally based competitive disadvantages on the supply side of the books.com sites are alone insurmountable at standard industry discounts to resellers of books. On the demand side, the only advantage the books.com sites have successfully sold to their customers to date is a faster turnaround time for their special orders. However, this has demanded of them that they tie up a huge amount of capital in an enormously broad, often dead inventory, because, of course, if the book isn't already in stock at books.com when the customer asks for it, and it has to be special ordered from the publisher, the delivery time takes as long at books.com as it does at the corner store.

There is, of course, an answer to these competitive disadvantages that all books.com sites face. Supplier discount. Very deep supplier discount-certainly at a much deeper level than what is now available to the wholesale centrepiece embedded in the Chapters organization, Pegasus. If one takes a close look at what the books.com sites, including Chapters Online are actually doing, it looks very much more like what book clubs have been doing for years, especially specialty book clubs, than what bookstores do.

The advantage of the books.com sites have over traditional book clubs is that, because they use electronic mail, their mailing costs are much lower than those of traditional books clubs. The disadvantage they have is that they don't have the subscription-type negative billing option that traditional book clubs use. (It is interesting to note that even book clubs make their real money on their alternate selections and backlists, which, just like in a bookstore, customers almost invariably buy from in addition to, or instead of, the main selections automatically sent and billed to them unless they make the effort to stop it). And what is the typical supplier discount from the retail price which book clubs

say they need in order to operate profitably? 80%. That's why book clubs often decide to print their own editions. If the readers refer themselves, at this point, all the way back to **Table B** above, they will find, in this typical "book budget," an upper limit to the "manufacturing cost" of 20% of the suggested retail price of any trade book. That's why, **either** an 80% discount off the retail price of publisher's edition of a book, **or** the book club's own edition, at a maximum cost of 20% of the retail price of that book, works for book clubs.

Thus, in the matrix of customer service providers in the book market, books.com sites like Chapters Online, in order to ever generate any operating margin at all, will need discounts much closer to those received by book clubs than those received by chain bookstores or even book wholesalers, simply because the actual service they are providing is more analogous to what book clubs, not book retailers, provide. But if an increase in average discounts to the traditional book trade from 40% to 50% requires a minimum increase of 25% in the retail price of the book (as demonstrated above), are the books.com sites likely to get the kind of huge discount increase they need to actually begin generating an operating profit? That's not very likely. In the end, all books.com sites will fail because of their hybrid nature-they are all based on the old "bricks and mortar" distribution model inappropriately inserted in a completely virtual technology that they are in profound structural conflict with. E-commerce sites based on the amazon.com model are like concrete malls built in the middle of the electronic highway. They have no business being there. They just get in the way. And because of this, Chapters Online represents a growing threat to everything Chapters Inc. and Pegasus Wholesale is doing in the Canadian book market. It is the place where the domino-effect which takes down the entire Canadian book trade will come from.

It is our sincere hope that our rather lengthy explication of the recent history and the short-term future of the book trade in Canada will be of some help the Standing Committee.

Respectfully submitted,