The Impact of Parallel Importing on Publishing in New Zealand

Report to Australian Publishers Association

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Table of Contents

Appendices

Tables

Figures

Boxes

Executive Summary

Australia is reviewing its copyright legislation, and in particular deregulation of territorial copyright law to permit parallel importing. The Australian Publishers Association has asked Castalia to investigate the effect of deregulation on New Zealand producers and consumers of books to inform the debate in Australia. The New Zealand experience has been referenced by both the supporters and opponents of parallel importing into Australia. New Zealand changed its copyright laws to allow parallel importing in 1998.

Our analysis suggests that New Zealand may not be quite the poster boy for the success of parallel importing as it is often presented. We find that any changes in the price gap between New Zealand and the US and UK over the past 10 years have been within the margin of error. This view is supported by the evidence that there has been little actual parallel importing. In part, this may be because the price gap reflects actual differences in handling and production costs.

At the same time, it appears that the threat of parallel importing has made domestic publishers more risk averse and less committed to production in New Zealand. There is no doubt that if the effects of parallel importing become more pronounced, publishers would reduce the domestic titles they publish. In particular, we find that the number of commercially published New Zealand titles has been growing very slowly. The number of New Zealand titles published by the top five publishers increased less than one percent annually for the last 10 years. This growth has been considerably slower than the growth trend in other markets. By contrast, in Australia, the number of titles on legal deposit has grown by approximately 2.5 percent per year over the same period.

Analytical Framework

In addition to empirical research, this report develops a clear analytical framework. We believe it is impossible to interpret book market developments in New Zealand over the past 10 years without a robust theoretical underpinning.

At the time the deregulation of territorial copyright was debated in New Zealand, there was an assumption that the production of New Zealand titles was not in any way related to the returns earned by international copyright owners in New Zealand.

Since then, the analytical framework has evolved to reflect the consolidation of the book publishing market and the fact that almost 90 percent of New Zealand titles are produced by international copyright owners. Conceptually, parallel importing (or the threat of parallel importing) might affect domestic publishing in three areas:

- Undermining the international copyright owners' ability to cover their common costs. The presence of common costs between marketing international and domestic titles can create interdependence between different lines of business. A reduction in the profitability of one operation (say, international titles), will reduce the contribution from that operation towards the common costs of the business. As a result the profitability of the business as a whole falls, reducing the firm's ability to fund the production of domestic titles

- Increasing the riskiness of a publisher's portfolio. Every publisher holds a portfolio of books—among both domestic and imported titles some will be more successful and others less. Parallel importers have access to the most profitable portion of the portfolio. They are likely to focus on the international titles which are global bestsellers, effectively capping the revenue available from successful international titles to international copyright owners. Hence, parallel importing skews the risk profile of the portfolio held by the publisher in New Zealand. Economic theory would predict that this would induce the owner of the portfolio to act to restore their preferred risk profile. This would be achieved by dropping off the more risky titles from the portfolio, for example, titles by unknown local authors, specialist local titles, or non-mainstream materials

- Reducing publishers' willingness to invest, given the presence of irreversible costs. The presence of irreversible costs increases the cost of "getting it wrong" and so tends to make investors more risk averse than they would be otherwise. We would expect any increase in business risk form parallel importing will make publishers more cautious about new investment, in particular about any investment in expanding publishing or distribution infrastructure.

Hence, economic theory would predict that:

- We should observe convergence of New Zealand book prices towards prices in the cheapest market internationally
- We should see some retrenchment in the production of New Zealand titles. Such retrenchment would be from the baseline of the underlying global growth in the number of titles.

Empirical Evidence

For this report, we:

- Reviewed price comparisons between New Zealand and the US and UK for a sample of international titles.
- Interviewed all international copyright owners operating in New Zealand (which account for 90 percent of New Zealand titles) to establish trends in the production of New Zealand titles.

The observed price gap between New Zealand and the US was a key justification for allowing parallel importing in 1998. At the time, NZIER found that a sample of international titles was around 35 percent more expensive in New Zealand than in the US. In 2004, NECG did a similar exercise (with a larger sample), and found that the price gap had fallen to around 20 percent. For this exercise, we experiment with a range of exchange rates: books are launched in different markets at different times, and pricing decisions are more likely to be based on medium-term exchange rate trends rather than on current rates. We find that for a similar sample of titles in 2009, the price gap between New Zealand and the United States remains somewhere between 10 percent and 29 percent, depending on the exchange rate used. Applying similarly plausible historical exchange rates to NZIER and NECG prices, we find that the historical price gap falls into the same range. In other words, one can not say with any certainty whether parallel importing has had any impact on domestic prices.

However, we find that the threat of parallel importing appears to have had a negative effect on domestic book production. While growth in the number of titles continues, the rate of growth in New Zealand is slower than in markets with territorial copyright.

1 What is the Purpose of this Report?

The Productivity Commission is currently reviewing copyright legislation in Australia. One of the proposals before the Commission is the deregulation of territorial copyright law in Australia to permit parallel importing of copyrighted works.

To inform the debate in Australia, Australian Publishers Association has asked Castalia to review the New Zealand experience following the introduction of parallel importing, to answer the question:

> *What has been the impact of parallel importing on the New Zealand publishing sector, and what could be the lessons for Australia?*

The aim of this report is to answer this question by:

- Considering the economics of the publishing business to understand the mechanisms by which parallel importing might affect book prices and supply of domestic titles
- Reviewing the available data to determine what evidence exists for the conceptual propositions.

1.1 Parallel Importing in New Zealand

Parallel importing is where genuine copyrighted goods may be imported without the authority of the copyright owner in that country. Significantly these goods are not pirated goods in the sense that they are produced and legitimately sold in a third country with the permission of the original copyright owner.[1]

New Zealand deregulated territorial copyright laws by passing the Copyright (Removal of the Prohibition on Parallel Importing) Act 1998. As a result, the original copyright owner no longer has control on who can import copyright products into New Zealand. In general, parallel importing is regarded as a success in New Zealand, leading to lower prices and greater choices from consumers. The threat of parallel imports has also forced copyright owners to improve their after sale service.

However, the reason for this perception of success is that New Zealand produces relatively few copyrighted consumer goods. Where parallel importing further pushed domestic producers from the market, the disappearance of New Zealand producers was generally regarded as part of an accepted trend. The effects of parallel importing occurred during the period of a sustained commodity boom, when preservation of local employment was not seen as an issue.

Parallel importing, however, did raise concerns about domestic production of books and music—cultural items where domestic production is valuable in its own right. Over the past 10 years, the New Zealand Government provided increasing funding to the creative industries to offset market developments.

This report focuses on the book market in New Zealand. To interpret market data, we start by developing an analytical framework based on the standard economic theory of intellectual property rights. Territorial copyright allows copyright owners to set different prices in different national markets. Price discrimination enables owners of intellectual property rights to capture a greater share of consumer surplus, without imposing deadweight loss. This would be achieved by setting prices in each market to reflect demand elasticity in that market. Economic theory holds that a firm with market

[1] NECG, *The Impact of Parallel Imports on New Zealand's Creative*, 2004

power—such as market power derived from the exclusive ownership of a book title which can not be substituted for other titles—would produce greater output if it is allowed to discriminate.

Parallel importing undermines the ability of copyright owners (such as publishers) to maintain artificially high prices for books in New Zealand. If the price of a particular book is substantially higher in New Zealand than elsewhere, a third party could profitably import the book and undercut the price charged by the copyright holder. As a result, since parallel importing has been allowed in New Zealand we would expect prices for copyrighted works to have equalised with prices in large international markets (with some margin to reflect the cost of transport).

With 10 years of experience to draw on, the expectation is that New Zealand should provide a useful case study in examining the impact of parallel importing on the publishing sector and should provide empirical data to the Productivity Commission on what could happen in Australia.

1.2 Our Approach

To answer the questions identified above, we have focussed on three measures:

- Prices: Are consumers better off in terms of book prices, when compared to prices in other countries in the past 10 years? Is so, by how much?
- The number of New Zealand titles published: Has there been a decline in the number of unsubsidized New Zealand titles brought out? The focus here is on purely commercial titles—we want to exclude titles which are subsidised in any form (such as university presses) or are procured by the government (school readers and textbooks)
- The extent of publishing infrastructure: Has there been any roll-back in publishing infrastructure in New Zealand?

1.3 Outline of this Report

This section outlines the remainder of this report:

- The next section puts our question into an economic context, by examining from a theoretical standpoint why it is reasonable to assume that parallel importing will not benefit consumers in every aspect—there are downside effects when deregulating the publishing industry. In particular, we explain how parallel importing may affect the publication of domestic titles
- Sections 3 reviews New Zealand's experience following the introduction of parallel importing, focusing on changes in prices, the number of New Zealand titles published and publishing infrastructure
- Section 4 interprets the empirical evidence found in Section 3 and explains the reasons behind the empirical evidence
- Section 5 brings our finding together and focuses on the lessons that can be learnt by the Productivity Commission from the NZ experience.

2 Why Would Parallel Importing have any Impact on Domestic Publishing?

This section examines the ways that parallel importing could reduce the publication of domestic titles. In 1998, the NZIER report[2] argued that the production of New Zealand titles was not in any way related to the returns earned by international copyright owners in New Zealand. At first glance this looks right. Parallel importing should only place downward pressure on prices for those titles that are available internationally. Domestic titles are produced locally, and so the commercial viability of domestic publishing should not be affected. There is some concern that remaindered copies of New Zealand titles sold overseas could be re-imported to undermine domestic sales, but there is little evidence of this occurring. The NECG report[3] in 2004 supported this approach by arguing that it found no evidence of publication of domestic title being affected by parallel importing.

We should point out that the authors of this report also wrote the 1998 NZIER report. We now believe that the analytical framework used in that report did not fully reflect what economists now understand about the economics of the firm. This has become particularly important, as due to market consolidation, international copyright owners now produce 90 percent of New Zealand titles. Hence, it has become critically important to understand how a multinational publishing business operates in any jurisdiction.

From the point of view of a multi-product firm operating across international markets, parallel importing (or the threat of parallel importing) might affect domestic publishing in the following ways:

- Undermining the business's ability to cover its common costs
- Increasing the riskiness of a publisher's portfolio
- Reducing publishers' willingness to invest, given the presence of irreversible costs

We discuss each of these below.

2.1 Publisher's Ability to Recover Common Costs

Common cost is expense a firm incurs as a whole, and which cannot be assigned directly to any particular department, product, or segment of the business. Publishing businesses generally have high common costs, such as staff salaries, warehousing and sales and marketing costs.

The presence of common costs can create an interdependence between different lines of business. To illustrate, let's assume that a publishing house has two operations: international and domestic titles. Assume also that the revenue generated by one operation is independent of other operations—a reduction in the revenue generated by international titles has no impact on the revenue from domestic titles. On the face of it therefore, a reduction in revenue from international titles should have no impact on how many domestic titles the business produces. However, publishing businesses are characterised by high fixed costs that are hard to allocate between different operations. The different lines of business each contribute to the firm's common costs, and so to the overall profitability of the firm.

[2] NZIER, *Parallel Importing: A Theoretical and Empirical Investigation,* 1998

[3] See footnote 1

Once we introduce common costs into the picture, we find that these two operations are interdependent. A reduction in the profitability of one operation (say, international titles), will reduce the contribution from that operation towards the common costs of the business. As a result the profitability of the business as a whole falls, reducing the firm's ability to fund the production of domestic titles. We illustrate this impact in Figure 2.1

Figure 2.1: Impact of International Profitability on Domestic Investment Decisions

Initial position

Common costs	100
Profit from international publications	50
Profit from domestic publications	50
Shortfall	**0**

After change in international profitability

Common costs	100
Profit from international publications	30
Profit from domestic publications	50
Shortfall	**20**

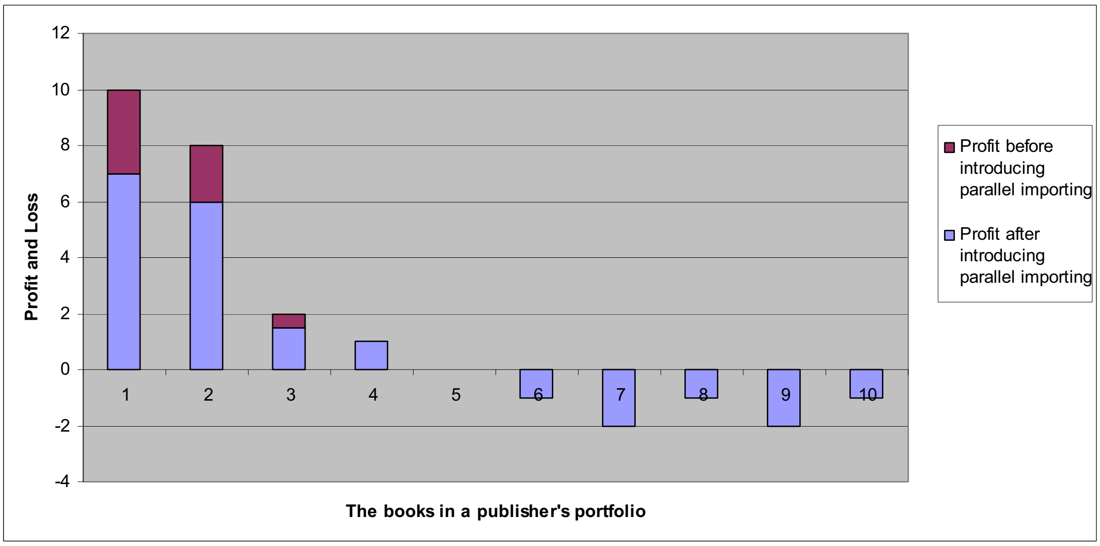
The figure shows a hypothetical publishing business that produces both international and domestic titles. In the initial position profit from both business lines is sufficient to cover the firm's common costs of $100. However once the profitability from international titles drops, the overall viability of the business is threatened. Even though the profitability from domestic publications is unchanged, the firm is unable to cover its overall costs. As a result it will need to cut costs to restore its profitability, for example through staffing cuts, reduction in warehousing capacity, or reduced investment in marketing and sales support activities. Any of these actions would, in turn, reduce the firm's capacity to produce domestic titles. It is plausible that, in the extreme, the firm may withdraw entirely from the country concerned.

This interdependence effect is distinct from arguments about cost allocation for the purpose of price setting, or for determining the profitability of different business lines. Rather this is about the practical reality that the overall profitability of a publishing business, and its ability to grow, or to continue in business, depends on the profitability of all of its individual lines of business.

2.2 Riskiness of a Publisher's Portfolio

Publishing, like many other copyright sectors, is characterized by uncertainty in advance as to the revenue any given (international or domestic) title will generate. In general only a small proportion of titles will be highly successful revenue earners. Effectively, each publishing house holds a portfolio of titles and this portfolio allows them to diversity the risk across all the titles they are publishing. Figure 2.2 shows an example of a publisher's portfolio, and the impact of parallel importing on portfolio risk. The 10 books are used as a representation of the total number of books the publishing house publishes in a year, including both international titles and domestic titles. It is impossible for a publisher to predict with certainty which titles will be winners. In order for the business overall to make a profit, it needs to earn sufficient revenue from successful titles ("best sellers") to cover the cost of "failed" titles—those for which revenue earned does not cover publication costs.

Figure 2.2: The Publisher's Portfolio



Source: Castalia

Very importantly, to maximise profit and have certainty with sales, parallel importers will only focus on the successful international titles such as book 1, 2 or 3 shown in Figure 2.2. Lifting the ban on parallel importing gives parallel importers access to the most profitable part of a publisher's portfolio. This significantly reduces the value of the overall portfolio that each publisher is managing. In the example shown in Figure 2.2, the expected return of the portfolio is 14 before parallel importing in introduced and only 8.5 afterwards..

The threat of parallel importing increases the business risk for publishers, even if no actual parallel importing takes place, by increasing the bargaining power of publishers' customers. For example one publisher we spoke to had received a threat from a major retailer that they would parallel import a particular title if the publisher did not agree with the terms of supply the retailer proposed.

As a result, parallel importing skews the risk profile of the portfolio. Economic theory predicts that the owner of the portfolio will act to restore their preferred risk profile. This is achieved by dropping the more risky titles from the portfolio, for example, unknown author, specialist title, or non-mainstream materials. In small countries such as New Zealand (and probably Australia), domestic titles will tend to be concentrated towards the more risky end of the portfolio risk distribution.

We make a clear distinction between portfolio management by publishers and explicit cross-subsidy. The argument that parallel importing will not affect domestic production is based on the view that copyright owners will not deliberately cross-subsidise unprofitable domestic titles, and hence any domestic production must be profitable on a stand-alone basis. The crucial difference between cross-subsidy and portfolio management is that when a company decides to cross-subsidise, it knows before hand which business is profitable and which business line is being subsidised. This is not the case in the book publishing industry. Before a book is published, no one knows with absolute certainty which book will be successful and therefore no one knows which books need to be subsidised by successful titles. Publishers manage this risk by using clear selection criteria, and managing a diversified portfolio (that is, publishing a sufficient number and range of titles). While after the fact this may look like publishers using successful titles to cross subsidise less successful titles, this is the outcome of strategies to manage risk across the publisher's whole portfolio.

In this sense, book publishing is most akin to oil and other minerals exploration. Many wells have to be drilled, and one has to accept a mix of dry and successful wells. In the oil industry, it is generally accepted that any policy measure which undermines the returns from successful wells, will increase the riskiness of the overall portfolio, and reduce drilling.

2.3 Willingness to Invest and Irreversible Costs

Irreversible costs are costs of an investment that cannot be recovered if the project fails. These are also known as "sunk costs" (See Box 2.1 for a hypothetical example).

Box 2.1: Example of an Irreversible Investment Cost

The irreversible cost of an investment is the amount of the investment can no longer be recovered if the management changes its mind and decides not to pursue the project. For example, a transportation company decided to expand its operation and buy more trucks. If the company subsequently decided that the expansion is a bad idea, it can sell the trucks on the second hand market and may obtain, say, 45 percent the value of the truck—a loss of 55 percent on the truck's original value. This 55 percent loss is the irreversible cost of the investment

The presence of irreversible costs increases the cost of "getting it wrong" and so tends to make investors more risk averse than they would be otherwise. Thus, any increase in business risks will make firms less willing to invest. To put it another way, businesses with greater sunk costs tend to be more sensitive to perceptions of risk than businesses where initial investment can be reversed, for example by selling buildings and machinery for other uses.

The publishing industry appears to have a particularly high proportion of sunk costs. Publishing houses face irreversible costs both in deciding whether to publish a particular title, take on a new author, or invest in expanding total production and distribution capacity.

When publishing a book, publishers need to dedicate substantial resources upfront. This many include editors' time, cash to pay the author in advance, and irreversible printing costs. If the publisher changes its mind halfway through the publication process, these costs are generally not recoverable. Decisions to expand publishing or distribution capacity are particularly risky, as they require long term commitments such as hiring more staff and leasing or buying additional warehousing space.

We would expect any increase in business risk form parallel importing will make publishers more cautious about new investment, in particular about any investment in expanding publishing or distribution infrastructure. This is especially critical in New Zealand as small and medium publishers rely on distribution infrastructure provided by the larger multinational publishing houses to distribute their books.

3 How has the Publishing Sector in New Zealand Changed since 1998

As discussed in section1, the purpose of this report is to assess the impact of parallel importing on the New Zealand publishing sector, and in particular on the publication of New Zealand titles. We have focused on three measures to assess the impact of parallel importing:

- The margin between book prices in New Zealand and in other key markets internationally
- The number of New Zealand titles published
- Investment in publishing infrastructure in New Zealand.

Below, we review the available data on each of these measures in turn.

3.1 Gap in Prices between New Zealand and Other Markets

The difference in price between books sold in New Zealand and those same titles in other English speaking countries (the "price gap") is the most relevant measure of the impact of parallel importing. Trends in book price over time are not informative, as the book price in a country can be affected by many factors such as inflation, labour and transportation cost (oil prices). A price comparison between multiple countries removes those variations as it is likely that all countries are affected in a similar way by the same factor.

In an open market, when books are priced higher in New Zealand than in overseas markets, parallel importers can make a profit by importing from the market that offers the lowest price, and undercutting the local copyright holder. As a result, we would expect the price of the books in New Zealand to converge to the cheapest price available internationally (plus the cost of shipping and duties and taxes).

To see whether this is the case, we have calculated the price gap between book prices in New Zealand and those in the United States and United Kingdom. We have compared our findings to previous studies to see how price margins have changed since 1998—are book prices in New Zealand more in line with these in other jurisdictions?

Table 3.1shows how the average price margin between New Zealand and the United States has changed since 1997. Only the price comparison between New Zealand and United States is listed because the price margin between book prices in New Zealand and the prices in United States is the largest for NZIER report in 1998, NECG report in 2004 and our study.

Table 3.1: New Zealand / United States Price Margin—Changes Since 1997

	1997	2004	2009
Average price margin	33%–38%[4]	22%[5]	10–28.8%

Note: Between late 2008 and early 2009, New Zealand dollar depreciated substantially against US dollar and this is the cause of the 18.8% range in 2009

Source: NZIER, NECG, Castalia

3.1.1 Previous studies

Two previous studies have looked at the margin between book prices in New Zealand and other English speaking countries.

[4] See footnote 2

[5] See footnote 1

In 1998, before New Zealand modified its copyright law, the New Zealand Institute of Economic Research (NZIER) undertook a theoretical and empirical review of the likely impact of lifting the ban on parallel importing[6]. In this study, NZIER took a sample of 100 books from New Zealand, and compared this booklist with 40 books from United Kingdom, 66 from United States and 95 from Australia. The study used average exchange rates for the months of September and December 1997. The study found that book prices in New Zealand were 0 to 10% higher than in the United Kingdom, 33 – 38% higher than prices in the United States and 10 – 12% higher than in Australia, depending on exchange rate used.

Following the introduction of parallel importing, NECG conducted a further price study in 2004. NECG chose "Top 100" books of all time in New Zealand and compared the prices with a slightly smaller sample from Australia and the United States (some of the books on the list were not sold in those countries). The exchange rate used was the average exchange rate in September 2004. This study found that New Zealand book price were about 5.2 percent higher than the price in Australia and 22% higher than the price in United States. Based on the evidence, NCEG argued that the price gap has reduced from 33% to 22%.

The results of the NECG study are highly dependent on the exchange rate assumption. For example, during the six month period staring three months before the study (May 2004) and finishing three months after the study (January 2005), the New Zealand dollar moved from US 61.73c to US70.64 (the September rate used for the study was US 65.92 cents). Since the retail prices remained largely invariable during that period, the measured margin would have varied between 14.3 percent and 30.8 percent. In other words, any change in the price gap between the NZIER study and the NECG study is statistically insignificant.

3.1.2 Price margins in 2009

To calculate current price margins, we have selected 12 books from New York Times best sellers list, and compared the New Zealand price for those books with prices in the United States and United Kingdom, using average exchange rates from the months of October 2008 and February 2009. This is to reflect that the books were launched at different time and the pricing decision is based on medium-term exchange rate. Table 3.2 sets out the average price differential for the 12 titles reviews for different time periods. The variation in the price differential reflects fluctuations in exchange rates. The titles, exchange rates used and the calculations are in Appendix A.

Table 3.2: The Average Price Margin between New Zealand, United States and United Kingdom

Price Margins	February 2009	October 2008
US Comparison	9.9%	28.7%
UK Comparison	12.4%	12.4%

[6] See footnote 2

3.2 The Number of New Zealand Books Published

To find out how the number of New Zealand titles being published has changed over the last 10 years, we interviewed senior manages of the five largest publishers in New Zealand: Macmillan, Random House, Harper Collins, Penguin and Hachette. These five publishers represent 90 percent of New Zealand's domestic publications and therefore the data obtained is representative for the whole industry. In this study, we have attempted to focus on "unsubsidised" titles and excluded the following titles:

- All subsidised titles (i.e. textbooks commissioned by the Ministry of Education, or the products of university presses)
- Export-oriented educational titles. In recent years, a number of New Zealand companies have been successful in providing English language and literacy services internationally, and the publishing industry has supported that growth with appropriate titles. We exclude those titles because they are not sold in New Zealand, and, ironically, enjoy the full benefits of territorial copyright in other markets.

In summary, the five firms published around 314 New Zealand titles in 1998 and around 340 in 2008—an average growth rate of less than one percent annually. Two companies significantly increased the number of New Zealand titles they publish; two companies' domestic publications remained flat while one company significantly reduced its publication of New Zealand titles.

It is instructive to compare the New Zealand publishing trend to Australia. The table below shows the number of new Australian titles submitted into the legal deposit (excluding government titles). The annualised growth rate in Australia is 2.47 percent.

Table 3.3:

	Legal deposit
1998-99	10,260
1999-00	11,666
2000-01	10,348
2001-02	10,567
2002-03	11,798
2003-04	11,336
2004-05	12,301
2005-06	12,767
2006-07	11,224
2007-08	12,819

Source: National Library of Australia

In contrast to overall domestic titles, the number of New Zealand children's titles published decreased very significantly. We are told this is due to parallel importing of remainders from international markets[7].

3.3 Extent of Publishing Infrastructure in New Zealand

We found in section 2 that there are plausible reasons from an economic point of view for parallel importing to contribute to a reduction in domestic publishing infrastructure.

[7] This finding is consistent with previous studies done by NECG, see footnote 1

To recap we would expect parallel importing to reduce the profitability of successful international titles compared to a situation where parallel importing is not permitted. This in turn reduces the contribution of international titles to the common costs of the business and the overall value of the publisher's portfolio, therefore reducing the overall viability of the business and its ability to invest in domestic publications. Thus we believe that it is plausible that, in theory, parallel importing could cause publishing businesses to roll back their publishing infrastructure.

We tested this hypothesis against New Zealand's experience. From our interviews with publishers, we found that all publishers are very cautious about the potential impacts of parallel importing, and shareholders are certainly considering reducing their investment in New Zealand. Hachette and Penguin withdrew their distribution operations from New Zealand about five years ago and now their books are solely distributed from Sydney. If the extent of parallel importing activity increased substantially, other publishers have indicated they might follow suit.

4 What is the impact of Parallel Importing on Publishing in New Zealand

In the previous section we looked at how publishing has changed in New Zealand over the past ten years. From the results shown in the last section, we can see that

- The price differential between New Zealand and other English speaking countries is relatively unchanged
- The number of New Zealand titles published has declined relative to the trend in other English speaking countries
- There is evidence that at least some publishers have rolled back their infrastructure in New Zealand.

In this section we interpret those findings. In particular we consider to what extent parallel importing, or the threat of parallel importing may have had an impact on prices, publication of New Zealand titles, or publishing infrastructure.

We find that territorial deregulation of copyright protections does not necessarily deliver benefits to everyone. In addition, our findings suggest that the full impact of parallel importing has not yet been felt in New Zealand.

4.1 Impact on Price

Table 3.1shows that the price margins between the book prices in New Zealand and United States fluctuate over the last 10 years. We believe this fluctuation is mainly caused by variations in exchange rates and consumers did not receive any material benefits in terms of book price in the past 10 years.

To take into account the exchange rate fluctuation, we experimented with two average exchange rates 4 months apart—October 2008 and February 2009. A range of exchange rate is chosen because the books in the sample are likely to be launched at different times. There is also a lag between the time when a publisher purchases them from the printers to the time when the books are being sold on the shelf. Furthermore, books are priced based on medium term exchange rate rather than the current rates. The price study done by NECG took the average exchange rate in September 2004. We believe that this does not remove the fluctuation of the volatile New Zealand dollar. As a result, NECG's 2004 conclusions that consumers have clearly benefited from parallel importing through lower prices should be treated with caution.

The results from the three studies, NZIER in 1998, NECG in 2004 and this study, are consistent with the ACCC to the Productivity Commission. The evidence shows that the price gap between Australia and the US for a sample of international titles fluctuated widely from period to period. The gap, which periodically negative can only be mostly influenced by the exchange rate cycle (Parallel importing was not allowed in the period interested by ACCC).

Parallel importers demand additional price premium to compensate for the additional risk they are taking. Therefore the price will not converge to lowest international price plus transportation cost. Whenever a retailer decides to parallel import, it bears more risks including the right to return unsold books, the cost to distribute the books, the exchange rate risk and the transportation cost. In the past 10 years, the exchange rate has been highly volatile. The exchange rate between New Zealand dollar and the US dollar fluctuated between 40c to 80c.

Furthermore, when large retailers decide to parallel import rather than buying from local publishers, they lose the pre-sale and after-sale support from the publishers. Pre-sale support includes sales and marketing, author tours. After-sale support includes "sale and return" which allows the publishers to return the books to publishers if they can not sell them.

4.2 Impact on Infrastructure

Infrastructure refers to the publisher's ability to publish and distribute books. The infrastructure normally includes staff, distribution network, warehousing and the ability to train and develop authors. Due to the nature of the business, the infrastructure is shared between publishing international titles and domestic titles. When a publisher cannot make enough revenue from the international titles, it is very likely that the publisher will cut back on its infrastructure such as reducing warehouse size and the number of staff it hires.

New Zealand is a very small market, when the division is not making enough profit or when the operating environment is too risky, the shareholders are likely to reduce or withdraw the operation from this country. Currently, Hachette and Penguin have withdrawn its distribution network from New Zealand and books are solely distributed by the Australian office. While there may be a number of reasons for this withdraw, the threat of parallel importing appears a factor.

When the publishers reduces the infrastructure, it is harder for domestic authors to have their books published and therefore reduce the financial incentive to write (we acknowledge that many writers write for reasons other than financial incentives).

4.3 Impact on Publication of Domestic Titles:

The number of New Zealand titles published has remained broadly the same. However, this has to been seen against the strong up-trend experienced in other English speaking countries. To put the number of titles in New Zealand into context, Australia publishes approximately 3,500 general interest domestic titles a year (out of a total of almost 10,000 titles, with the majority being educational). New Zealand's population is about one fifth of Australia. Hence, New Zealand could be proportionately expected to publish around 700 titles a year for domestic consumption. The actual New Zealand production is around half of that.

5 What Lessons can be Learnt from the New Zealand Experience

In section 2, we explained, in theory, there are three ways in which parallel importing could affect the production of domestic titles, by:

- Undermining the business's ability to cover its common costs
- Increasing the riskiness of a publisher's portfolio
- Reducing publishers' willingness to invest, given the presence of irreversible costs

Our review of actual experience in New Zealand shows that

- The price gap between New Zealand and the United States has remained relatively constant over the last 10 years—between 10% to 28.7% (the range is due to exchange rate volatility).
- The number of New Zealand titles published by the top five publishers increased less than one percent annually for the last 10 years and
- Some publishers have rolled back their infrastructure.

With 10 years of experience to draw on, the expectation is that New Zealand should provide a useful case study in examining the impact of parallel importing on the publishing sector and should provide empirical data to the Productivity Commission on what could happen in Australia. However, from our study, we believe that the Productivity Commission needs to be cautious about what conclusion to draw from the New Zealand experience. This is mainly because New Zealand publishers have not yet felt the full impact of parallel importing and therefore whatever is observed in New Zealand can only give limited guidance to what potentially could happen in Australia.

From the New Zealand experience, we recognise that exchange rate volatility plays a very important role in the price gap between New Zealand and other English speaking countries. Hence, price data should be treated with great caution. We believe that any study showing the gap is reducing should be treated with caution. There are genuine economic reasons for the gap to fluctuate, and little chance of it going to zero. This is due to the transportation cost and a premium to compensate the additional risks that the importers need to take.

Further, any policy must recognise that publishing is a risky business, and publishers actively manage the overall risks they are exposed to. When the business environment is more risky, publishers will act in more risk adverse ways. As a result, they will reduce the risky domestic titles they publish and be very cautious about the expansion of their publishing capacity. In extreme cases, publishers would roll back their publishing capacity and withdraw investment.

Appendix A Book Sample and Exchange Rate

This appendix lists the information we have acquired to perform the study about price margins between New Zealand and the United Kingdom and the United States. Table A.1 lists the exchange rate we used. Table A.2 lists the titles and the price we have used in our study. Table A.3 translates all the currency in New Zealand dollar and performs the margin calculation.

Table A.1: Exchange Rate between New Zealand, United States and United Kingdom

	February 2009	October 2008
NZD to USD	0.5162	0.6046
NZD to GBP	0.3574	0.3574

Table A.2: The List of Titles and Prices

TITLE	AUTHOR	PUBLISHER	US HARDBACK RRP	UK HARDBACK RRP	NZ HARDBACK RRP
The Associate	John Grisham	Doublday	$ 27.95	£18.99	$54.95
Run For Your Life	James Patterson	Little Brown	$ 27.99	£18.99	$59.95
The Host	Stephanie Meyer	Little Brown	$ 25.99	£14.99	$53.00
Fool	Christopher Moore	Morrow	$ 26.99	£18.66	$59.95
True Colours	Kristin Hannah	St Martins	$ 25.95	£17.94	$57.95
The Guernsey Literary & Potato Peel Pie Society	Mary Ann Shaffer and Annie Barrows	Dial	$ 22.00	£12.99	$35.00
Plum Spooky	Janet Evanovich	St Martins	$ 27.95	£18.99	$70.00
Agincourt	Bernard Cornwell	Harper	$ 25.99	£19.35	$54.99
The Women	T C Boyle	Viking	$ 27.95	£12.99	$59.99
Black Ops	W E B Griffin	Putnam	$ 26.95	£19.99	$59.95
A Darker Place	Jack Higgins	Putnam	$ 26.95	£17.99	$59.95
Scarpetta	Patricia Cornwell	Putnam	$ 27.95	£18.99	$60.00

Source: Bookscan, Castalia

Table A.3: Translation into New Zealand Dollar and Calculation of the Margin

				US Comparison		UK Comparison	
The Associate	Price in US (NZD)	Price in UK (NZD)	Price in NZ (NZD)				
Feb-09	54.15	53.13	54.95	1.014855		1.034182728	
Oct-08	46.23	53.13	54.95		1.18865		1.034182728
Run For Your Life							
Feb-09	54.22	53.13	59.95	1.105616		1.128284887	
Oct-08	46.30	53.13	59.95		1.294954		1.128284887
The Host							
Feb-09	50.35	41.94	53.00	1.052659		1.263655771	
Oct-08	42.99	41.94	53.00		1.232928		1.263655771
Fool							
Feb-09	52.29	52.21	59.95	1.14658		1.148238478	
Oct-08	44.64	52.21	59.95		1.342933		1.148238478
True Colours							
Feb-09	50.27	50.20	57.95	1.152747		1.154477703	
Oct-08	42.92	50.20	57.95		1.350157		1.154477703
The Guernsey Literary & Potato Peel Pie Society							
Feb-09	42.62	36.35	35.00	0.821227		0.962971517	
Oct-08	36.39	36.35	35.00		0.961864		0.962971517
Plum Spooky							
Feb-09	54.15	53.13	70.00	1.292809		1.317430226	
Oct-08	46.23	53.13	70.00		1.514204		1.317430226
Agincourt							
Feb-09	50.35	54.14	54.99	1.092183		1.01568093	
Oct-08	42.99	54.14	54.99		1.279221		1.01568093
The Women							
Feb-09	54.15	53.13	59.99	1.107937		1.129037704	
Oct-08	46.23	53.13	59.99		1.297673		1.129037704
Black Ops							
Feb-09	52.21	55.93	59.95	1.148282		1.071842421	
Oct-08	44.57	55.93	59.95		1.344927		1.071842421
A Darker Place							
Feb-09	52.21	53.13	59.95	1.148282		1.128284887	
Oct-08	44.57	53.13	59.95		1.344927		1.128284887
Scarpetta							
Feb-09	54.15	53.13	60.00	1.108122		1.129225908	
Oct-08	46.23	53.13	60.00		1.297889		1.129225908
			Average:	1.099275	1.287527	1.12360943	1.12360943

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