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FEDERAL TRADE COMMISSION

PUBLIC WORKSHOP:
POSSIBLE ANTICOMPETITIVE EFFORTS
TO RESTRICT COMPETITION ON THE INTERNET

Tuesday, October 8, 2002
9:00 a.m.

Federal Trade Commission
6th and Pennsylvania Avenue, N.W.
Room 432
Washington, D.C.

For The Record, Inc.
Waldorf, Maryland
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P R O C E E D I N G S

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3 MR. CRUZ: Good morning, and thank you,
4 everyone, for coming. I'm Ted Cruz, I'm the Director of
5 Policy Planning here at the FTC. I'm very glad to see
6 everyone here today for this public workshop on possible
7 barriers to e-commerce.

8 Without further ado, I would like to welcome our
9 chairman, Mr. Tim Muris, to welcome everyone here for
10 the beginning of the workshop.

11 (Applause.)

12 COMMISSIONER MURIS: Thank you very much, Ted,
13 and good morning.

14 On behalf of my fellow commissioners, I'm
15 pleased to welcome you here to the Federal Trade
16 Commission's Workshop on Possible Anticompetitive
17 Efforts to Restrict Competition on the Internet. I
18 would like to extend a particular welcome to our
19 regional offices who are watching by video conference.

20 When the Internet first began to grow, many
21 thought that e-commerce would serve as an expansive free
22 market, spawning creativity and self expression. The
23 Internet was the wave of the future. It offered
24 consumers new freedom and businesses new ways to deliver
25 goods and services. Some of these predictions are, in

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1 fact, coming to pass.

2 For example, retail e-commerce sales increased
3 24 percent in the second quarter of this year to \$10.2
4 billion, while retail sales generally increased only 2.5
5 percent. Despite these impressive gains, some observers
6 have suggested that this perception of unfettered
7 competition may be inaccurate.

8 These observers contend that some businesses use
9 government to prevent online competition from new
10 entrants and to hamstring existing companies that want
11 to sell online. In a number of instances and in a
12 number of states, pre-existing regulatory regimes are
13 being extended to the Internet. Through these
14 regulatory regimes, many states now limit online
15 competition for products ranging from cars to caskets to
16 contact lenses, and for professional services ranging
17 from law to medicine to real estate.

18 Protecting consumers, our other sound public
19 policy interest, may drive some of these restrictions.
20 It bears examining, however, whether particular regimes
21 are pro-competitive and pro-consumer, and whether they
22 eliminate cost savings and convenience without
23 sufficient benefits to justify the losses.

24 We have four principal goals for this workshop.
25 First to enhance our understanding of these issues;

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1 second to educate policy makers about the effects on
2 competition and consumers of restrictive state
3 regulation; third, to help educate private entities
4 about the types of business practices that may or may
5 not be viewed as problematic; and fourth, to learn of
6 additional avenues to promote competition through
7 e-commerce.

8 Let me talk briefly about each goal in turn.
9 First, we want to enhance our understanding of these
10 issues. I have long believed that the FTC can protect
11 consumers, in part, by gathering information and
12 studying competing perspectives. Toward this end, in
13 August of last year, we formed an Internet Task Force to
14 evaluate regulations and business practices that could
15 potentially impede e-commerce.

16 The task force grew out of our already-formed
17 State Action Task Force, which had been analyzing the
18 antitrust doctrine concerning state regulations
19 generally, and out of the FTC's long-standing interest
20 in e-commerce.

21 Over the past year, the Internet Task Force has
22 reviewed the relevant literature and has met with dozens
23 of industry participants and observers, including
24 e-retailers, trade associations and leading scholars.
25 This workshop represents the next stage in the process.

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1 We hope to gain a comprehensive overview of possible
2 barriers to greater e-commerce, while at the same time
3 learning about specific issues in specific industries.

4 I should reiterate that the FTC is very much in
5 a learning mode. We do not know whether particular
6 restrictions are or are not on balance pro-competitive
7 and pro-consumer, nor have we decided what, if anything,
8 should be done about any possible restrictions that may
9 harm consumers.

10 The workshop's second goal is to help educate
11 policy makers about the effects of state regulations.
12 We are delighted to have with us this morning
13 Congressman Cliff Stearns who chairs the House of
14 Representatives Energy and Commerce Committees
15 Subcommittee on Commerce, Trade and Consumer Protection.
16 Two weeks ago, his committee held a hearing on state
17 impediments to e-commerce that addressed many of these
18 same issues. Chairman Stearns was kind enough to invite
19 us to testify. I commend him for his leadership on
20 these important issues of competition in e-commerce, and
21 we're delighted to have him address us this morning.

22 We're also delighted that Dr. Randall Kroszner,
23 a member of the White House Council of Economic
24 Advisors, will address the workshop later this morning.
25 Through Chairman Stearns, Dr. Kroszner and the many

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1 others here, we hope that this workshop will help policy
2 makers design effective policies to further expand
3 online commerce. We also hope that the workshop will
4 help educate state policy makers in particular about
5 effective e-commerce policies and that the states will
6 continue educating us about their views.

7 Many of our industry-specific panels will
8 include representatives of state governments. Our final
9 panel tomorrow -- I'm sorry, on Thursday -- will
10 include, among others, a state legislator, a state
11 Attorney General and a former governor. We are
12 fortunate to have a terrific cooperative relationship
13 with the states, and we very much look forward to this
14 exchange of ideas and information with them.

15 I have long believed that federal agencies and
16 the states should cooperate to advance consumer welfare.
17 Indeed, the Commission recently has been working closely
18 with the states in promoting competition over the
19 Internet. For example, in March of this year, we filed
20 a staff comment before the Connecticut Board of
21 Examiners for Opticians, which is considering whether to
22 require stand-alone sellers of replacement contacts to
23 obtain Connecticut optician and optical establishment
24 licenses.

25 In preparing that comment, our staff worked hand

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1 in hand with the Connecticut Attorney General's Office
2 to analyze the possible effects of the proposed rule on
3 consumer health and welfare.

4 The third goal of this workshop is to help
5 educate private entities about the types of business
6 practices that may or may not be viewed as problematic.
7 My comments so far have focused on efforts to use
8 government to limit competition. We also have received
9 reports of private parties employing potentially
10 anticompetitive tactics. Some of the most obviously
11 troublesome conduct includes horizontal refusals to
12 deal.

13 For example, in the late 1990s, a group of 25
14 Chrysler dealers in the northwest threatened to refuse
15 to sell certain Chrysler models and to limit warranty
16 service, unless Chrysler limited its supply of cars to
17 an Internet seller. In 1998, the FTC filed an
18 administrative complaint against the dealers. The
19 matter was settled by a consent order that prohibited
20 the dealers' boycott.

21 We have also seen other reports, some published
22 and some anecdotal, suggesting that other distributors
23 may have applied pressure to discourage their suppliers
24 from selling online directly to consumers. We intend to
25 examine whether, and in what circumstances, this conduct

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1 may raise antitrust issues, or may instead address
2 legitimate concerns about free riding and channel
3 conflict. We hope to develop a better understanding of
4 the conduct and reasons for or against limiting retail
5 sales over the Internet.

6 The final goal of the workshop is to learn of
7 additional avenues to promote competition through
8 e-commerce. As I've mentioned, we have already
9 testified before Congress and filed staff comments in
10 Connecticut regarding these issues. We have also filed
11 three other comments involving Internet issues.

12 In North Carolina and Rhode Island, the
13 Commission filed joint comments with the Department of
14 Justice commenting on proposals to require the physical
15 presence of an attorney for all real estate closings and
16 refinancings.

17 More recently, in Federal District Court in
18 Oklahoma, we filed an Amicus brief explaining that the
19 FTC's Funeral Rule protects consumers by promoting
20 competition among providers of funeral goods, including
21 online casket sales. Through this workshop, we hope to
22 discover additional ways for the Commission and other
23 policy makers to promote competition over the Internet.

24 I look forward to a productive, informative
25 workshop.

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1 It's now my pleasure to introduce Congressman
2 Cliff Stearns, as I mentioned, the chairman of the
3 Consumer Protection Subcommittee of the House Energy and
4 Commerce Committee. The chairman is in his seventh
5 term, he is a Floridian and he is a good friend of the
6 Federal Trade Commission. I would like to thank him for
7 taking the time to be with us this morning.

8 As I mentioned, he recently held a hearing on
9 the barriers to e-commerce at which we were happy to
10 testify. Congressman Stearns has worked tirelessly to
11 address the issues confronting consumers in the evolving
12 electronic marketplace and his recent hearing and his
13 participation today are examples of his dedication.

14 Please welcome Congressman Stearns.

15 (Applause.)

16 MR. STEARNS: Good morning, and Chairman Muris,
17 thank you for inviting me for the kick-off of your
18 workshop exploring anticompetitive efforts restricting
19 competition on the Internet.

20 I commend the Commission for this timely
21 workshop, and I compliment Ted Cruz, who I am going to
22 now give the appellation of Czar Cruz of the Internet.
23 You know, across many countries they have identified one
24 person as the expert on the Internet, and I think Ted
25 probably qualifies. In fact, we could probably call him

1 Top Gun Czar Cruz, I don't know if he will like that
2 term, but I appreciate his help and also participating
3 in my hearing.

4 As the Chairman mentioned, I am from central
5 Florida, just above Orlando, all the way to
6 Jacksonville, and I have neither coast, the gulf or the
7 Atlantic, but I have some beautiful small towns with
8 beautiful Indian-sounding names like Ocala, which is my
9 home town, Ocklawaha, Micanopy, and Okahumpka. Recently
10 I had a town meeting in Okahumpka, and just to show you
11 how it is, particularly in an election year, here I
12 speak to the Federal Trade Commission and to a lot of
13 lobbyists, but obviously back home is where the politics
14 is, and this woman said to me, "Congressman, no one has
15 picked up my trash for two weeks and I want your help."
16 And I told her, I said, "Have you called the select men
17 here in Okahumpka?" And she said, "No, I have not."
18 And then I said to her, "What about the city council
19 person?" And she said, "No, I haven't." And I said out
20 of desperation, "Why don't you call the county
21 commission?" She said, "I just didn't do that either."
22 And I said to her, "Why didn't you call any one of those
23 people first?" And she said, "I didn't want to start
24 that high."

25 (Laughter.)

1 MR. STEARNS: So, whenever I come to meetings
2 like this and look at this very august body, I remember
3 that back in Okahumpka, there's a woman who wants to
4 make sure that I get rid of her trash.

5 As the chairman has mentioned, I chair the
6 Congress' Energy and Commerce Committee's Subcommittee
7 on Commerce, Trade and Consumer Protection. As
8 mentioned, last month we had a hearing on state legal
9 and regulatory impediments to e-commerce. That hearing
10 was one of a number of hearings that the subcommittee
11 has held on e-commerce in this Congress, including
12 hearings on cyber security, cyber fraud, and crime,
13 impediments to digital trade and supplier-owned online
14 travel sites.

15 I want to compliment the Chairman and Ted Cruz
16 for what they're doing. I think this is very important,
17 and is sort of a harbinger of things we should be doing
18 in this nation and you are taking the lead in a very
19 important area.

20 The subcommittee's hearing on state impediments
21 to e-commerce focused on three industries. We talked
22 about the contact lens industry, wine sales and of
23 course auctions. At the hearing, the witnesses
24 highlighted some of the anticompetitive effects of state
25 regulation on their online businesses. I'm pleased to

1 see Dr. Atkinson of the Progressive Policy Institute and
2 of course Mr. Cruz with the FTC who have both been
3 intimately involved with this issue and testified before
4 my committee.

5 I also understand and indeed I'm pleased that
6 you'll hear from other witnesses that we had at our
7 hearing at your workshop this morning. My friends,
8 there are many industries where state laws and
9 regulations either unintentionally or intentionally are
10 impeding the growth of e-commerce.

11 Many of those industries are a subject of this
12 workshop, and that's why it is important that you have
13 it this morning. They include: Retailing, automobile,
14 cyber-charter schools, real estate, mortgages, health
15 care, pharmaceuticals, tele-medicine, wine sales,
16 auctions, contact lenses and not the least is funerals,
17 caskets.

18 So, I think it is essential that the growth of
19 e-commerce not be stymied by state laws and regulations
20 that were enacted or promulgated at a time when, of
21 course, there was no e-commerce. As such, the impact of
22 those laws and regulations on e-commerce, of course, was
23 not anticipated.

24 Most of those state laws and regulations did and
25 still have important consumer protection objectives.

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1 Yet the fact is that many of those laws, and many of
2 those regulations, have a discriminatory impact when
3 applied today to e-commerce. Furthermore, a few state
4 laws and regulations seem to have no other reason for
5 their existence, but protection of local commercial
6 interests from online competitors. It is neither new
7 nor unusual for local commercial interests to appeal to
8 their local governments for protection against new
9 competitors employing new and innovative technologies or
10 business models.

11 The fact is that unintentional or intentional
12 anticompetitive effects on e-commerce of state laws and
13 regulations it is estimated costs the American consumer
14 anywhere from \$15 billion to \$32 billion per year, and
15 of course that number is growing.

16 So, I think it is imperative that every state
17 carefully examine its laws and regulations that were
18 intended to advance consumer protections, but now may
19 hinder e-commerce, although unintentionally.

20 I am confident that states would find
21 alternative legal and regulatory approaches that would
22 not impede e-commerce, and at the same time advance
23 state consumer protection interests. I think there's a
24 balance that can be had here.

25 At the hearing, eBay offered one such example in

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1 Illinois. Illinois examined and ultimately revised its
2 auction license rule so that the rule could be more
3 responsive to new online auction businesses, new auction
4 business models, such as eBay's. Now, if all the states
5 did what Illinois did in various industry sectors, it
6 would be very helpful towards making e-commerce
7 seamless.

8 In closing, I would reiterate my support for
9 this workshop, and the Commission's efforts under
10 Chairman Muris to better understand the particular state
11 laws and regulations that do, indeed, impede e-commerce
12 by having panels of expert discuss the presence of such
13 restraints within certain industries.

14 Now, upon completion of this workshop, and the
15 Commission's inquiry, including its review of all the
16 pertinent filings made pursuant to the Federal Register
17 notice of July 19th, 2002, I will invite the FTC to
18 testify as to its findings in a follow-up hearing at my
19 subcommittee in the 108th Congress.

20 So, I want to wish you God speed and tell you
21 how important it is that you accomplish your mission,
22 and I look forward to having the opportunity to hear the
23 results of this workshop in the 108th Congress, and so
24 may the good Lord take a liking to you, but not too
25 soon.

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1 (Applause.)

2 MR. CRUZ: Thank you, Congressman Stearns,
3 Chairman Muris, and we will now move directly to the
4 first panel, which will be legal and economic
5 perspectives, and that will be moderated by Dr. Jerry
6 Ellig, who is the Deputy Director of the Office of
7 Policy Planning.

8 MR. ELLIG: This panel will be one of two
9 overview panels that will look at the forest rather than
10 the trees and then of course we'll start getting into
11 some other panels later on in the afternoon in the next
12 few days that will look at specific industries, but this
13 morning, we've assembled a number of experts in law,
14 economics, and policy to talk about some of the broader
15 issues that are raised by e-commerce and possibly
16 anticompetitive private actions or anticompetitive
17 regulations that may get in the way of e-commerce.

18 Let me just explain the way we'll run all of
19 these panels. We'll ask each panelist to give some
20 overview remarks for about three to five minutes, and
21 then we will have some time for discussion in response
22 to discussions. I'll ask some questions. In addition,
23 members of the audience in this room are welcome to jot
24 down questions on index cards. We have some index cards
25 and pens out in the hallway, and hold them up, somebody

1 from the FTC staff will grab it and bring them on up to
2 me and we can ask some of those questions as well.

3 We'll have the panelists speak in alphabetical
4 order, so we actually start with A, B, C, Atkinson,
5 Bolick, Calkins and so on, and Senator Metzenbaum gets
6 to bat clean-up.

7 So, we'll have each person speak and then I'll
8 ask each one of the panelists as well. When I ask a
9 question, if you want to say something in response and
10 you need to get my attention, you can put your name card
11 up sort of sideways. If a lot of people want to speak
12 at the same time, that should work okay. Don't feel
13 obligated to say something in response to each question,
14 but all kinds of contributions would be welcome and
15 encouraged.

16 In any case, without further introduction, let's
17 go ahead and start with Rob Atkinson, and I'm not going
18 to give extensive introductions of each speaker,
19 anything you want to tell folks about your credentials
20 or background, go ahead and mention that in your opening
21 statement.

22 MR. ATKINSON: Thank you, Jerry.

23 I'm Rob Atkinson, Vice President and Director of
24 the Technology and New Economy Project at the
25 Progressive Policy Institute. When we started looking

1 at e-commerce in depth about five years ago, I was
2 pretty optimistic, I felt that it was the major
3 transformative force in our economy and was going to
4 lead towards all sorts of wonderful benefits,
5 particularly in terms of productivity. And then as I
6 got more into it, I started hearing little stories and
7 anecdotes that disturbed me, but I didn't really see
8 that there was a pattern. But eventually after three or
9 four of these cases, I suspected, ah-hah, I think
10 there's a pattern here.

11 So we wrote a report about a year and a half ago
12 called The Revenge of the Disintermediated: How the
13 Middle Man Is Fighting E-commerce and Hurting American
14 Consumers, where we documented a wide array of cases,
15 and you've heard all of the industries and others here,
16 so I won't go into that, but in our view, this notion
17 that middlemen and other incumbent industries or
18 professions are blocking e-commerce competition purely
19 for protectionist reasons is one of the major threats to
20 the future growth of e-commerce.

21 This isn't really the first time this has
22 happened, in fact, our history is really rife with these
23 sorts of stories. One of the first cases that Abraham
24 Lincoln tried was actually a case against -- he defended
25 the railroads when a boat hit a railroad bridge as it

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1 crossed the Mississippi River, and the boating industry,
2 the riverboat industry, as well as the city of St.
3 Louis, sued the railroads for having a railroad bridge,
4 and this was really a case about free interstate
5 commerce. And Lincoln, fortunately, won that case.

6 Well, the problem today, though, is that as a
7 new technology system arises, just like it did with the
8 railroad, rather than have competitors compete fairly or
9 in some cases just go out of business gracefully,
10 they're using government and the courts to block
11 competitors.

12 I think the key issue here is really is this
13 about consumer protection, or is it about producer
14 protection. At PPI, we're strong supporters of a strong
15 consumer protection regime. We're not libertarians. We
16 believe that the government has to play a strong role in
17 that. However, in many of these cases, I would argue
18 that consumer protection argument that the other side
19 invokes is really mostly a smoke screen.

20 In certain cases, like contact lenses, the
21 attorney generals have shown clearly that there's no
22 consumer harm. In other cases, like wine and
23 prescription drugs, to name two, it's easy to design
24 regulatory frameworks that protect consumers and address
25 taxation issues, but don't hinder e-commerce.

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1 As you focus over the next three days, I'm sure
2 you will hear some of the incumbent producers come up
3 with very creative defenses of why they need these laws.
4 The one I enjoy the most is from the National
5 Association of Auto Dealers, who claim that if car
6 manufacturers were actually allowed to sell directly to
7 a consumer, "they would still face a myriad of legal
8 challenges and would run a great risk of breaking the
9 law."

10 Well, the only reason they would run the risk of
11 breaking the law is because car dealers have succeeded
12 in passing laws in all 50 states to make it illegal.
13 So, that's a little bit of a dubious claim.

14 Well, what should the FTC do? What's the role
15 of the Federal Government here? I commend the FTC for
16 their efforts in the last six to nine months where they
17 are an aggressive advocate for competition, working with
18 the states and the courts, and I encourage them more to
19 do that. However, I am not sure that that will be
20 enough. I think at the end of the day we may need to
21 fundamentally rethink how we regulate commerce in this
22 country.

23 In the old economy, commerce was consigned
24 really to one state, a consumer and the producer were in
25 the same physical jurisdiction, nowadays increasingly

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1 it's going to be across borders. I think we have to
2 take seriously the notion of preemption, and as much as
3 I am all for states' rights, I used to work for a
4 governor, I think that ensuring that we have robust
5 cross-border commerce is a role for the Federal
6 Government to step into.

7 My final point is I think we need to rethink
8 antitrust doctrine. There's a sort of a reflective
9 notion or view among antitrust enforcers that any kind
10 of collaboration must be suspect. I think certain kinds
11 of collaboration are suspect, particularly when it comes
12 to middlemen collaborating over the distribution
13 channel, as was the case with the car dealer case in the
14 northwest that the FTC successfully intervened in. But
15 there are other types of collaboration where producers
16 need to collaborate, like in the case of Orbitz, where
17 they need to collaborate in order to create a robust
18 online channel, and I think those are a very different
19 type of collaboration, that in fact the FTC should be
20 encouraging.

21 So, thank you very much, and I am told that I
22 should stop there.

23 MR. ELLIG: Okay, thank you, Rob.

24 As you noticed, and I forgot to mention to the
25 panelists, we do have a time keeper sitting in the front

1 who will wave signs at you until you notice them.

2 Clint?

3 MR. BOLICK: Thanks, Jerry.

4 My name is Clint Bolick, I am Vice President at
5 the Institute for Justice, which is the nation's leading
6 pro-interface public interest law firm.

7 The Internet is the greatest catalyst for
8 consumer freedom in history. The potential for
9 personalizing commerce, matching producers of
10 distinctive goods with consumers wishing to purchase
11 them has expanded expeditiously with the advent of
12 e-commerce. But it seems that in modern America, no
13 good deed goes unregulated. Misguided regulation by
14 every level of government is hindering e-commerce. Not
15 always for the protection of consumers, but as Rob
16 mentioned, to preserve dominant economic interests, and
17 that threatens to strangle the potential of e-commerce
18 in its infancy.

19 We've talked about a number of areas where this
20 is happening, and such trade barriers are contrary to
21 the genius of our free enterprise system enshrined in
22 our constitution, particularly in the commerce clause.
23 Our nation is predicated upon a single national market,
24 unfettered by parochial trade barriers among the states.
25 The Internet, in particular, cannot easily abide

1 arbitrary political boundaries. The only way it can
2 adapt to parochial regulations is to adhere to the
3 lowest regulatory denominator, and if it does, it will
4 destroy the potential of e-commerce.

5 Allowing such barriers to persist would deprive
6 the Internet of its ability to bridge huge distances
7 between producers and consumers. The Institute for
8 Justice is presently challenging restrictions on direct
9 sale of wine to consumers in New York State, and on the
10 direct sale of caskets to consumers in Oklahoma, and we
11 are very grateful to the Federal Trade Commission for
12 its Amicus brief in the Oklahoma case.

13 The wine issue is a classic one, with direct
14 shipments prohibited in about half of the states,
15 allowed in the other half of the states, a felony in
16 some states. The type of economic balkanization that is
17 precisely what the e-commerce clause was designed to
18 prohibit. At the result of this patchwork of
19 regulations is that in many states wineries simply will
20 not ship at all, and that, therefore, vindicates the
21 protectionist aims of the liquor wholesalers and it
22 deprives consumers of important choices.

23 There are a number of constitutional tools that
24 are available to challenge these barriers to enterprise.
25 I have mentioned the commerce clause, the privileges and

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1 immunity clauses and others, but another is the First
2 Amendment. The Internet inherently involves speech, so
3 that all of these regulations implicate the First
4 Amendment. And the Institute for Justice intends to
5 vigorously use those constitutional tools to challenge
6 regulatory barriers, and we encourage others to use them
7 as well.

8 We applaud the Federal Trade Commission for
9 conducting hearings in this area. We believe regulatory
10 barriers to Internet commerce are the number one
11 consumer issue in America. Our hopes for these hearings
12 are three: First, to shed light on regulatory barriers
13 to Internet commerce, and the economic protectionism
14 that they promote; second, to bring the full authority
15 and power of the Federal Trade Commission to bear on
16 removing such barriers; and third, for the Institute for
17 Justice to identify more deserving bureaucrats to sue.

18 Excessive regulatory barriers to Internet
19 commerce are unwise, un-American, and unconstitutional.
20 Let's get rid of them, and unleash the full potential of
21 consumer freedom. Thank you.

22 MR. ELLIG: Okay, thank you, Clint. I hope that
23 comment about suing bureaucrats doesn't apply to us.

24 (Laughter.)

25 MR. ELLIG: Steve?

1 MR. CALKINS: Thank you.

2 I'm Steve Calkins, a professor at the Wayne
3 State Law School, and I was asked just briefly to
4 summarize the nonconstitutional legal issues raised by
5 the subject before us today. That, frankly, is almost a
6 hopeless assignment.

7 My conclusion is that one could teach a whole
8 course based solely on the Internet issues that we're
9 confronting. You could rattle through merger issues and
10 worry about market definition and whether or not mergers
11 are pro-competitive. You could go through
12 monopolization and try to separate out predatory
13 practices that should be prohibited from pro-competitive
14 efficiency enhancing practices. You could then throw in
15 some whole lot of Federal Trade Commission consumer
16 protection issues, which come up repeatedly on the
17 Internet.

18 You could then slide on, indeed, as Rob already
19 has, into horizontal agreements among producers, and you
20 could have a long series of classes trying to separate
21 out the pro-competitive horizontal agreements from those
22 that are anticompetitive, and you would observe that in
23 terms of the Internet, this makes observing of
24 competitor behavior particularly easy and quick, so does
25 that raise special issues.

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1 You could also talk about the way that the
2 Internet empowers consumers to search for the lowest
3 prices, and does that mean that it's especially
4 important to worry about things that may bias us or
5 interfere with that, and you could go and spend a great
6 deal of time on that. But I don't have time to go
7 through any of those issues.

8 I'm going to rattle off the three that seem to
9 me the ones that are most uniquely raised today. Or
10 that we've seen raised on the Internet.

11 The first being the Noerr Pennington Parker v.
12 Brown, which Chairman Muris referred to. You know, it
13 is absolutely clear, if you go through all the problems
14 that we've been talking about, that most of those are
15 the result of government behavior, but not government
16 behaviors that are motivated solely by political leaders
17 trying to respond to consumers, it's government behavior
18 responding to business interests. And that means you go
19 through the whole range of Noerr Pennington Parker
20 issues. You want to decide under Noerr whether or not
21 this is petitioning of a real governmental body, or is
22 it petitioning of something that doesn't qualify as a
23 governmental body.

24 Under Noerr, you need to separate out the
25 petitioning from the agreement to implement decision

1 that the petitioners may be trying to achieve, and it's
2 important to make that clear.

3 Going on to the Parker v. Brown, you've got --
4 well, in my view, you have a set of case law that allows
5 for Parker immunity to flow from some rather vague
6 levels of authorization, which prevents the political
7 process from holding elected officials accountable, and
8 it's important, it seems to me, for the Commission and
9 others to make sure that Parker is kept back where it
10 ought to be, so that we can have the political system
11 work, and to require that authorization for participants
12 in the market to lessen competition to be done clearly.

13 So, also in terms of supervision, you know, that
14 also is one wherein it's very easy for there to be
15 inadequate supervision. Indeed, in some of these
16 self-regulatory issues, you've got all of the problems
17 that flow from having a nice little mix of people who
18 are private actors, sort of putting on a public hat, and
19 were engaging in some self-regulation, and you end up
20 with confusion as to the roles. And for antitrust, it's
21 important to make clear that the antitrust immunity is
22 limited and is going to be cabined in where it ought to
23 be.

24 Next you could take a look at retail price
25 maintenance, which is something which was put forward in

1 this area rather specifically recently by the states
2 when they entered into a consent order in the George
3 Foreman Grill case, where the charge was that there --
4 and I refer to only what's alleged in the complaint, the
5 charge was that the Salton Company had decided to engage
6 in some classic resale price maintenance in order to
7 protect its Internet price. And it raises all the
8 wonderful questions about when and whether the
9 government should care about resale price maintenance
10 and what has to be done to prove a valid resale price
11 maintenance theory.

12 The classic problem, though, is the one where we
13 have manufacturers who are failing to use the Internet
14 as much as they might, or failing to discount on the
15 Internet, and the question is, are they responding to
16 their own self interest, are they responding to retailer
17 concerns that are expressed lawfully and unilaterally,
18 or are they responding to retailer concerns that mean
19 that there is an illegal agreement? And this goes
20 through the whole range of vertical issues, because
21 we're going to see retailers constantly expressing
22 concern.

23 Indeed, you look at the Wall Street Journal
24 issue recently talking about their Internet experience,
25 they say quite candidly that they were concerned about

1 retailers being upset and complaining about their role
2 on the Internet. And the case law, as you know, which
3 says I'm supposed to stop, makes it difficult to prove a
4 vertical agreement. Query: Should one come up with
5 times where a vertical agreement could be illegal, more
6 fundamentally, it's quite important for the horizontal
7 agreements to be searched out for the law to be clear
8 about what is illegal, is an attempt illegal, is an
9 agreement without market power illegal, what has to be
10 proven to prove an agreement because it's very important
11 that retailers be prevented by the antitrust laws from
12 going too far to pressure manufacturers.

13 In closing, I would say the Commission is
14 uniquely poised to make contributions here, because of
15 its role in doing hearings, and frankly because it is
16 both a consumer protection agency and an antitrust
17 agency. Thanks.

18 MR. ELLIG: Okay, thanks, Steve.

19 Now down to the other end of the table, Rob
20 Gertner.

21 MR. GERTNER: Good morning, I'm Rob Gertner, I'm
22 Professor of Economics and Strategy at the University of
23 Chicago.

24 As a University of Chicago economist, there's a
25 certain expectation that what I'm likely to say at an

1 event like this, and as a newer generation Chicago
2 economist, I often like to disappoint those
3 expectations, but I've tried hard and I think today I
4 will fail in my mission to do so.

5 The restrictions on e-commerce in the markets
6 that this workshop focuses on have limited the ability
7 of e-commerce companies to provide consumers with the
8 full potential of the Internet. The justification for
9 these restrictions are typically weak, and to the extent
10 that they respond to legitimate policy concerns, these
11 concerns can likely be addressed with less onerous
12 regulation and outright ban on transactions over the
13 Internet or other existing regulations.

14 The Internet has enhanced the efficiency of many
15 consumer markets, in its most obvious form, these
16 efficiencies arise from disintermediation of traditional
17 distribution channels. Airline ticketing has become
18 more efficient because consumers are able to make
19 reservations and access the information typically
20 provided by travel agents at lower costs. Consumers are
21 able to browse for, skim through and purchase books that
22 are not available at local bookstores. Restrictions on
23 e-commerce transactions limit the ability to reap these
24 benefits in many markets.

25 We will hear about two markets at this workshop

1 that are especially important: Housing and automobiles
2 represent the two largest expenditures for many
3 consumers. In 1999, sales of existing houses and condos
4 exceeded \$700 billion, and annual new and used car sales
5 are approximately \$200 billion.

6 If the Internet were to reduce standard real
7 estate agent commissions from around six percent by one
8 percentage point and reduce the cost of a new car by two
9 percent, annual consumer savings would exceed \$10
10 billion.

11 The most obvious cost of regulations in
12 e-commerce arise from the reduced competition from
13 intermediaries created by restrictions on Internet-based
14 sales. But these are not the only costs, and in many
15 markets, they may not be the most important ones. The
16 value of e-commerce extends well beyond enhanced
17 efficiency of transactions. Restrictions on e-commerce
18 may also result in lower levels of upstream competition.

19 For example, an automobile manufacturer without
20 a dealer in a particular local market may be a more
21 attractive choice if it could sell directly to consumers
22 in that market. This could result in greater
23 competition among manufacturers, and thereby lower
24 wholesale prices.

25 Americans who do not live in densely plated

1 markets have limited retail choices for many types of
2 products. Many travel large distances to meet anything
3 other than day-to-day needs.

4 Mail order is an important way that companies
5 compete for these consumers. The Internet reduces the
6 cost of competing for these consumers and extends the
7 benefits of mail order to many more products.

8 In many markets, the Internet is an attractive
9 distribution channel for new small-scale entrants,
10 because of its low fixed cost. Internet-based
11 distribution has been an essential part of the entry
12 strategy for many new musicians, software designers and
13 computer equipment makers. In markets in which this
14 distribution channel is blocked, there will be less
15 entry, less competition, and less innovation.

16 Recent economic research suggests that the
17 long-run cost to consumers for reductions in innovation
18 and resulting reductions and delays in new product
19 introductions can be very large. Therefore,
20 restrictions that limit the ability of entrants to use
21 the Internet for distribution may be very costly to
22 society.

23 Consumers also benefit directly from the
24 increased choice among differentiated products that are
25 available over the Internet. The Internet is an

1 incredible resource for consumers with uncommon
2 preferences to find products that satisfy those tastes.
3 eBay is a testament to this fact. Today consumers in
4 most states who visit a small winery in California while
5 on vacation and love its wine may simply have no
6 practical way to purchase that wine for consumption at
7 home.

8 In contrast, a consumer who hears a local band
9 on that same vacation has no trouble sampling the band's
10 music and purchasing its CD over the Internet.

11 On the other side of the equation, there are a
12 number of legitimate concerns about how consumers could
13 be harmed by e-commerce in particular markets. Probably
14 the strongest economic argument is that consumers will
15 free ride on the services of traditional distributors by
16 acquiring information and services from these
17 distributors and then purchasing from lower-priced and
18 lower-service Internet providers.

19 This is a legitimate concern in several of the
20 markets that are the focus of later sessions at this
21 conference. However, it is a very long way from this
22 concern to a conclusion that government restriction on
23 Internet sales is the appropriate remedy.

24 In fact, and I won't go through too many of the
25 details, in general, the natural response is going to be

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1 one private, and there are contractual restrictions that
2 companies could reach with their distributors that could
3 solve this problem. We're seeing very innovative ways
4 of doing it. We're seeing new pricing strategies and
5 new pricing models being involved in let's say
6 full-service brokerage firms that face competition from
7 Internet brokerage have changed their pricing models in
8 a way that they're actually starting to price directly
9 for those services, and therefore avoiding the free
10 rider problems. It's far from clear that regulations or
11 restrictions are necessary to solve this problem.

12 A second legitimate concern that motivates
13 restrictions in e-commerce and standards of commerce
14 protection against deceptive practices, fraud, and
15 dangerous consumer behavior. The policy goals should be
16 to come up with regulations that provide this consumer
17 protection with a minimal impact on competition.

18 It strikes me that many of the regulations we
19 see are simply too restrictive. There are and should be
20 less costly ways to provide consumers with protection
21 against fraud on the Internet. There may be an
22 important role for innovative licensing monitoring and
23 consumer complaint procedures to meet these consumer
24 protection goals. Perhaps the innovation of the
25 Internet can actually create new ways of doing this more

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1 effective and more efficiently.

2 In fact, the FTC, through procedures like
3 workshops like this, and from watching closely what's
4 going on in the states, may be able to play a valuable
5 role in identifying these best practices and
6 disseminating this information to policy makers.

7 Thank you.

8 MR. ELLIG: Okay, thanks.

9 Finally, Senator Metzenbaum.

10 MR. METZENBAUM: I want to commend the FTC.
11 I've been to a lot of meetings, I've made a lot of
12 speeches on the floor of the United States Senate and
13 committees, but I've never before had somebody in the
14 audience who had a sign saying "Stop." I think that's
15 great. I think that's great. I'm glad it wasn't --
16 that we didn't have that procedure when I was conducting
17 some filibusters.

18 (Laughter.)

19 MR. METZENBAUM: Today I appear here as chairman
20 of the Consumer Federation of America. CFA is a
21 nonprofit association of some 300 pro-consumer
22 organizations with a combined membership of over 50
23 million Americans.

24 I have to admit, that when I received an
25 invitation from the FTC to speak about the

1 anticompetitive practices in electronic commerce, my
2 first thought was that my grandkids are better prepared
3 than I to talk about the Internet, but the fact is, many
4 of the anticompetitive practices that I spent my career
5 in the Senate fighting against have migrated onto the
6 Internet.

7 We must not allow the anticompetitive practices
8 from the old economy to rob consumers of the benefit of
9 the Internet. The Internet is a revolutionary means of
10 communication and commerce that can dramatically enhance
11 consumers' sovereignty and empower citizens. It can
12 promote robust competition, it can also make it cheaper
13 and easier for businesses to collude illegally. The
14 benefits of the Internet are only available if access is
15 kept open, unfettered, and unbiased.

16 Public policy can hinder competitive
17 pro-consumer electronic consumers, or can be the crux of
18 its growth. We hope to see the Internet create an
19 environment that strengthens the market forces on both
20 the supply and demand side, reducing the middleman,
21 enhancing consumers' ability to search, shop, and find
22 information and reducing barriers to entry into
23 business.

24 It is our hope that the Internet creates an
25 environment that undermines companies' ability to

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1 exercise market power and to engage in anticompetitive
2 practices. However, generally, whenever entrenched
3 companies are confronted with significant economic or
4 technological change, they form cartels, employ
5 anticompetitive practices, or enlist the aid of the
6 government in their defense to impede change or a
7 different direct cost to the consumer.

8 It would be a critical mistake for policy makers
9 to believe that the power of technology alone will
10 ensure a consumer-friendly and pro-competitive
11 environment. For example, in the late 1980s and early
12 1990s, we resisted the efforts of the Baby Bells to
13 convince policy makers to allow them to impose their
14 centralized telecommunications model on the emerging
15 commercial Internet. Since the late 1990s, we have
16 opposed attempts by cable companies to exclude competing
17 Internet service providers from their high-speed
18 telecommunication networks.

19 Unfortunately, policy makers have not required
20 them to allow nondiscriminatory access. Throughout the
21 1990s, CFA opposed the effort of Microsoft to monopolize
22 the software that controls the PC and web browsers. We
23 are also deeply concerned about efforts by old economy
24 and industries to prevent the Internet from injecting
25 more competition and greater consumer sovereignty into

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1 their industries. We are concerned about joint ventures
2 between businesses that may control the availability of
3 products sold over the Internet, such as Orbitz, the
4 travel website. And we are concerned that automobile
5 dealers have been blocking the direct sale of cars over
6 the Internet.

7 In the late 19th Century, it became clear to
8 captains of industry, who later came to be known as
9 robber barons, that controlling the flow of primary
10 imports into the industrial process was the way to gain
11 control over the newly-emerging industrial economy. We
12 responded with a series of laws that rejected the
13 centralized controlled model in favor of an open,
14 competitive economy.

15 Today, a new industrial economy is being born
16 and we observe the captains of industry threatening to
17 become the robber barons once again, by foreclosing
18 entry and controlling the flow of the key imports in our
19 electronic economy data and information.

20 It is up to us here today to identify the past
21 and present anticompetitive efforts aimed to restrict
22 competition. It is up to the FTC to regulate
23 aggressively and enforce Internet public policy that
24 embraces unfettered access, robust competition, and most
25 importantly, policy that embraces the consumer, not big

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1 businesses.

2 In my written comments, I identify a number of
3 measures that are needed to prevent anticompetitive
4 business-to-business arrangements before they are
5 reached.

6 Thank you, Mr. Chairman.

7 MR. ELLIG: Okay, thank you.

8 I would like to focus in for a moment on what's
9 really going on here economically and hear your views on
10 this. Does the Internet and electronic commerce, are
11 they really cutting out the middleman or having the
12 potential to cut out the middleman and, you know, the
13 manufacturer or somebody else takes over some of those
14 functions? Or are they -- is the Internet a medium by
15 which other middlemen, whether it's new start-ups, or
16 maybe middlemen located in other geographical areas can
17 enter new markets and compete in new markets? Is it one
18 of those, is it both, or is it maybe different for
19 different industries?

20 MR. ATKINSON: Well, I'll comment on that.

21 I think it's clearly both of those. There are
22 certain industries where you have a direct relationship,
23 wine being one, where you can buy directly from a small
24 vineyard, although in wine you can also buy from
25 middlemen, like eVineyards, I think eVineyards. So, I

1 don't think there's any one particular model.

2 I guess I would be inclined to say that direct
3 is usually better in the sense that on balance I think
4 cutting out more of the middlemen is better just from an
5 efficiency perspective, but I think ultimately the
6 market and consumers need to decide what business model
7 makes the most sense. And so I don't think there's
8 any -- I don't think we should preclude and say one
9 is -- is going to be the one to make it happen, but I
10 think on balance, if there's a case where you can
11 encourage direct from producer all the way to consumer
12 without any middlemen, I think that is the ultimate, and
13 most beneficial, arrangement.

14 MR. GERTNER: I agree completely. I think you
15 can think about what role middlemen play, and they play
16 a role with respect to information, aggregation, and
17 certainly in the physical world, geographical proximity,
18 and I think that a lot of the information role can be
19 played to a large extent by the direct producer. It
20 doesn't matter whose page on whose website you're really
21 looking at to gather that information, but there is
22 still a real role for aggregation, for middlemen as
23 aggregators on the Internet.

24 I mean, it's much easier to browse for books on
25 a particular subject by using Amazon's very creative,

1 very easy-to-use website as a way to search across a
2 variety of books on a particular topic. Eliminating
3 that middleman service by having to go directly to the
4 publisher -- to a variety of different publishers,
5 although you could search for them, you could find them,
6 would, in fact, be quite inefficient.

7 So, there still remains, I think, a very
8 important role in many markets for the aggregation and
9 combine the aggregation information of middlemen.

10 MR. BOLICK: I would agree. In the two areas
11 where we're litigating it, it has different dimensions.
12 As Rob mentioned in the wine area, there's a tremendous
13 potential market for direct sales from producers to
14 consumers, but liquor stores and wine stores cannot
15 advertise on the Internet in states that forbid direct
16 sales either.

17 So, a store like Saki's in New York can't sell
18 to consumers around the country over the Internet in
19 states where direct sales are prohibited. And in that
20 kind of situation, let's say you wanted to order a wine
21 from Italy or something like that, and they're not on
22 the Internet, those stores are going to continue to not
23 only have a huge variety of wines, but also information
24 about wines and reduce prices on wines because of large
25 volume purchases as well.

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1 In the casket area, it is a substitution of
2 middlemen. Right now, in several states, only funeral
3 homes can sell caskets. And as a result, direct sellers
4 of caskets are forbidden from doing that, and there's a
5 huge mark-up. So, I would say the bottom line is that
6 what these barriers are doing is not necessarily
7 preserving middlemen versus direct sales, but preserving
8 an inefficient way of selling.

9 MR. ELLIG: Let's talk a little bit about the
10 private anticompetitive actions in antitrust. Do you
11 think we need new forms of antitrust analysis or new
12 antitrust doctrine to try to understand private
13 anticompetitive actions that affect electronic commerce,
14 or are the principal dangers the same types of business
15 practices that come up as problems whenever you have a
16 new type of sales channel? Are there new antitrust
17 issues here or is it the same old thing, just showing up
18 in a new place?

19 MR. METZENBAUM: I'm frank to say that this
20 administration, I would be concerned about new antitrust
21 approaches. I think the antitrust laws that we have and
22 the interpretations that we've had in the past have been
23 good, and haven't been in the public's interest. But I
24 would be concerned that if there were some new
25 approaches to antitrust at this point, I'm afraid we

1 would turn the clock backwards rather than turning it
2 forwards.

3 MR. CALKINS: I mean, the answer to your
4 question is always that existing antitrust doctrine is
5 sufficiently flexible that it could cover anything that
6 comes along, because all of antitrust is about
7 reasonableness and about applying it to the particular
8 facts, and so there's no need, in my view, to change
9 fundamental doctrine.

10 On the other hand, there is need to think
11 through how it works in particular fact patterns. I
12 mean, the fundamental problem in distribution is if a
13 manufacturer is not using the Internet, is that good
14 because it means that free riding is not being allowed,
15 and it means that when consumers go to the store and try
16 on the outfit, that, in fact, they're going to patronize
17 the store and the store is going to be able to stay in
18 business, or is it bad?

19 The basic problem in antitrust is it's very hard
20 for antitrust to draw that distinction, because there
21 are always just the classic sort of distribution problem
22 in a good case where free riding is a problem, you're
23 going to have complaints going from the dealers to the
24 manufacturers saying, golly, don't sell direct, because
25 then we'll go out of business, and antitrust has

1 resolved that by basically saying when that's the fact
2 pattern, we really cannot do anything about it.

3 On the other hand, when you can add a horizontal
4 element that antitrust can do something about it. Well,
5 the only thing interesting here is can you think of any
6 fact pattern where there should be a vertical challenge,
7 and then conversely, in the horizontal world, is
8 antitrust sufficiently clear about how quickly retailers
9 are going to get into trouble if they engage in
10 horizontal kind of discussions, agreements, negotiations
11 and things to pressure manufacturers.

12 It's not a matter of doctrine, it's a matter of
13 both applying it, thinking it through, and then giving
14 very clear guidance and having swift intervention.

15 MR. ATKINSON: I just want to build on a point
16 that Robert made about that. I think the thing to think
17 about, especially when we're thinking about this
18 question of what's the role of the producer is that
19 aggregation is important for particular industries.
20 It's not all that important for cars, let's say. You
21 don't go out and say well, I'm looking to buy a car, I
22 want to get all the car websites. It's pretty easy to
23 figure out and whether you like a Ford or a Chevy.

24 But, on the other hand, there's lots of
25 industries where you don't know the producer. I might

1 like Bob Dylan, but I have no idea who sells Bob Dylan.
2 I might want to go from here to Chicago on an airline,
3 and I know the airlines, but I don't know who and which
4 time the airlines are flying. And I need something to
5 aggregate those.

6 So, the key question is what is the role of
7 antitrust with regards to two possible forms of
8 aggregation. One is aggregation by the middleman, and
9 there we would probably argue that there's no big deal.
10 You have -- on Travelocity, let's say, for example, or
11 Amazon in books, I think the more critical question is
12 what's the role of antitrust when producers try to be
13 aggregators.

14 In our view, there really shouldn't be very many
15 antitrust issues. I think this is a much more
16 controversial issue than a lot of the agreement that we
17 have on other issues. But I think cases like Orbitz or
18 in the case of music, MusicMatch, and PressPlay, I think
19 those present essentially opportunities where producers
20 can say, we're going to aggregate, we're going to put it
21 all together, and make it easy for consumers.

22 I think that that's one area where we really do
23 need to rethink antitrust doctrine, because antitrust
24 tends to reflectively look at anything like that and
25 saying that's inherently bad. And I think we need to

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1 distinguish producer collaboration on the distribution
2 channel, which I think is good, or can be good, and
3 producer collaboration on the production of the good,
4 which I think is bad.

5 MR. GERTNER: I just want to say, I basically
6 agree with everything that's been said about the
7 antitrust issues. I want to present one slight caveat.
8 I think one area where antitrust doctrine has been
9 evolving in good directions, but rather slowly, is with
10 respect to vertical restrictions generally. Some policy
11 towards retail price maintenance and other types of
12 vertical restrictions that firms engage in, and I think
13 to some extent the Internet gives that grade of
14 prominence that, in fact, allowing manufacturers and
15 producers to have greater contractual control,
16 contractual freedom over the way in which their products
17 are going to be distributed with obviously keeping in
18 mind potential anticompetitive effects, the ones that
19 are sort of more aware of some of the values that
20 producers do have in having some contractual control
21 over that could play a bigger role, I think, with the
22 greater complexity added to distribution channels, and
23 the variety of distribution channels that are available
24 to firms within the Internet.

25 MR. CALKINS: You need some disagreement, so let

1 me just throw in a quick note. In one of his marvelous
2 papers, the Revenge paper, Rob makes the suggestion that
3 we do have a problem whereby manufacturers may fear to
4 use the Internet to sell directly, because they fear
5 retailer retaliation. And so the suggestion is that
6 it's important for the agencies to think about that and
7 whether or not one should be permissive of retailer
8 agreements collectively, if you will, to sell directly,
9 and thereby --

10 MR. ATKINSON: Producer agreements.

11 MR. CALKINS: Producer, I'm sorry, producer
12 agreements to sell collectively and thereby we'll all do
13 it so we won't fear retaliation. I guess it seems to me
14 that's an example where existing antitrust doctrine
15 works pretty well, because as I think it through, if you
16 simply had an agreement among producers saying that
17 we're going to go and start doing some selling, my guess
18 in the end of the day is that that would be lawful under
19 existing antitrust doctrine, and it may be that it's
20 important for the agencies to be able to have a quick
21 business review letter or a staff letter of advice, but
22 it's not a matter of changing doctrine.

23 And on the flip side of that, if, for instance,
24 you were to go and talk about we will discount and
25 thereby undercut retail stores, well my own instinct is

1 that that is getting into a sufficiently problematic
2 area whereby the agencies should not be allowing it.

3 To continue disagreeing slightly, with respect
4 to not Orbitz, because that's under investigation and I
5 don't really know the facts very well, but your
6 hypothetical situation where the producers have set up
7 their own online middlemen operation, I view that as
8 actually a very interesting and difficult question
9 because in a way it's a good thing if it gets
10 information out to consumers costly and efficiently.

11 If, on the other hand, it results in the
12 producers controlling that channel in a way that
13 prevents consumers from being able quickly to search for
14 the best product and the best fares, then there's
15 certainly potential for harm, and it seems to me that it
16 does require some careful analysis each time that comes
17 along to figure out whether this is producers improving
18 efficiency and helping consumers or producers looking
19 out for their shareholders, and attempting to prevent
20 consumers from finding the best product at the lowest
21 possible price.

22 MR. ELLIG: Okay, let me ask a question. Do we
23 have some audience questions written down? If you want
24 to bring those up.

25 Let me switch gears for a minute, though, and

1 talk a little about the legal and regulatory type
2 barriers. Do you all see many new legal and regulatory
3 barriers that seem to have emerged in response to the
4 rise of electronic commerce, or are we largely talking
5 about laws and regulations that were written a long time
6 ago, maybe before anybody even imagined the Internet,
7 and there may not be a good fit with the Internet, but
8 that's partly because they were written before the
9 Internet was invented?

10 MR. ATKINSON: Well, I guess I don't know that
11 anybody has ever analyzed that question.

12 MR. CALKINS: But you're the expert.

13 MR. ATKINSON: I'm the expert, so I think it's
14 18 percent on the first one, 72 percent -- who knows,
15 but I would guess it's 65/35, how's that? The 35 are
16 new. I think that may be a little bit too high.
17 Certainly in the case of auctions, that's new. There
18 are certainly cases in mortgage laws, Alabama recently
19 passed a mortgage law, South Carolina recently passed a
20 mortgage law. I guess some of the cases you're
21 intervening in are new. But I think at least half are
22 legacy laws, and certainly some are these new laws where
23 incumbents are -- I think there was an Illinois liquor
24 law that was tried to be passed and overturned, that was
25 a protectionist law. So, I think we're seeing a bit of

1 both.

2 MR. ELLIG: Okay, anybody else have a take on
3 that?

4 MR. METZENBAUM: I'm curious about the mortgage
5 law. What does that do?

6 MR. ATKINSON: There's a law in several states,
7 and this was -- we documented this in a report that's
8 out on the table, The Best States For E-commerce, where
9 mortgage brokers in states have gone to the legislature
10 and passed laws that say that if you want to broker a
11 mortgage for a citizen in our state, you must have a
12 physical office in the state, and essentially what it
13 has done is precluded out-of-state companies, unless
14 they're big national banking chains, from being able to
15 provide mortgages. So, it's precluded pure-play
16 Internet companies from brokering a mortgage for
17 someone.

18 MR. METZENBAUM: Have those laws been
19 challenged on a question of interstate commerce?

20 MR. ATKINSON: I am not aware of any challenge
21 to those laws, no. For example, there's one state,
22 South Carolina, that says you must have a physical
23 office of a certain 850 square footage, or bigger, and
24 it has to be open Monday through Friday, 9:00 to 5:00.
25 And obviously it's clearly protectionist in its intent.

1 I know that the industry association is pushing
2 for some sort of federal -- the ability of companies who
3 do that, mortgage companies, to get a federal charter so
4 that they could be chartered at the federal level as
5 opposed to the state level and then bypass these state
6 laws.

7 MR. CALKINS: The example that you mentioned
8 just points out what I think is marvelous about this
9 whole area, which is that it is a wonderful marriage of
10 Chicago school interest and economic efficiency with a
11 populist interest in helping the little wine merchant,
12 the little wine grower, the little mortgage offeror, and
13 it's one of those great cases where you can be a
14 populist and economically efficient at the same time.

15 (Laughter.)

16 MR. ELLIG: But --

17 MR. GERTNER: I think the question points out
18 there's this big, I think, middle ground category, which
19 are yes, the regulations and laws were written before
20 the Internet was discovered, or invented, and what that
21 does is it often leads a great deal of ability for the
22 regulators to actually interpret as they wish how it
23 applies to Internet sales.

24 So, it's something like a physical office
25 requirement when there's just a broad licensing

1 requirement in the law, it gives the ability of the
2 state regulator to effectively decide whether or not
3 that includes necessary physical office, which, of
4 course, prior to the Internet, no one would ever have
5 thought of the possibility of being able to offer the
6 service without a physical office.

7 So, I think there's this range where it's not
8 just applying the old laws in the new environment, but
9 there's a lot of flexibility in how those laws are
10 applied that could allow a great deal of restriction on
11 Internet commerce.

12 MR. ELLIG: Some of this discussion actually
13 plays into one of the questions from the audience, so
14 let me go ahead and ask that now. I'll paraphrase it a
15 little bit, but the basic gist is that to the extent
16 that some folks may want to talk about federal
17 preemption, the question is, because the benefits of
18 e-commerce are so obvious, why must the federal
19 government force it upon the states, and if it needs to
20 be forced, why, since the benefits may be pretty darn
21 obvious?

22 UNIDENTIFIED SPEAKER: Can I just qualify that,
23 too, just in the sense that our country has
24 protectionist policies, for instance, with the
25 intersection of foreign policy, sanctions on other

1 countries that don't really apply to the principles, yet
2 we don't want the states to have any of these types of
3 protectionist policies. So --

4 MR. ATKINSON: I think the answer is twofold.
5 One is that's why we have the WTO, because if trade were
6 in the interest of every country, we wouldn't have the
7 WTO. I think there are clearly cases where it is in the
8 clear -- might even be in the economic interest of a
9 state to preclude competition, because all the producers
10 are domestic, and domestic in the sense of being in the
11 state, and that the competitor is outside of the state.

12 But even if that's the not the case, even if
13 states are acting irrationally, which they do on a
14 fairly frequent basis, the reason that they would act
15 irrationally is a simple case of a colleague of mine who
16 used to cover the State House down in North Carolina
17 would tell me, the car dealers would go down and play
18 golf with the state legislators and donate heavily to
19 their campaigns and know their children. And then you
20 get these Yankees from Detroit coming down and trying to
21 tell them, yeah, let's open it up and get rid of these
22 car dealers. Let's have direct sales of cars.

23 You know, it's clear who was going to win that
24 argument. And I think states are certainly willing to
25 bend to political pressure to do things that are

1 protectionist and have a protectionist result, and I
2 think one of the things the Federal Government can do
3 best is to prohibit that. Or limit it.

4 MR. BOLICK: I would say that this is an issue
5 that was probably the primary cause for the creation of
6 the United States in the first place. There were
7 parochial trade barriers among the states that were very
8 injurious to the overall effort of forming a union. And
9 that was one of the reasons why we adopted the
10 Constitution and adopted the commerce laws. The notion
11 that we are one unified national market and we can't
12 have parochial trade barriers. It's an experiment
13 that's been so successful that two centuries later,
14 Europe is actually finally copying that example.

15 But to pick up on a point that Professor Gertner
16 was making a few moments ago, the Internet, it's very,
17 very difficult for the Internet to abide 50 different
18 rules within the United States. One specific example in
19 the New York wine case, there is a law in New York that
20 was obviously -- it was passed like in the 1930s saying
21 that you can't mail any advertisements for liquor into
22 the state of New York. In fact, you can't even post
23 prices in the state of New York.

24 Well, on the Internet, if a winery was to abide
25 by the laws of New York, it would mean that it could not

1 post prices of its products anywhere, because they are
2 inevitably by the nature of the Internet going to go
3 into the state of New York. And that's what I meant
4 before by talking about the lowest regulatory
5 denominator. If we allow parochial trade barriers in
6 various states, then the only way that a producer can
7 possibly respect the law of all states, if they are a
8 patchwork quilt, is to adopt the lowest or the most
9 harsh of the regulatory barriers. There would be very
10 little sense of e-commerce if we had that kind of rule.

11 MR. CALKINS: Well, finally, this is the classic
12 situation where the benefits from putting in some narrow
13 kind of regulation, you have to have an office in the
14 state if you're going to have a mortgage, is
15 concentrated on a few firms who can work hard to achieve
16 it, and the cost from that kind of thing are shared by
17 all of us, and it's the classic political problem
18 wherein that kind of situation, the political process
19 sometimes doesn't work so well and the narrowed favored
20 interests are sufficiently strong that they can overcome
21 the more diffuse cost to the general world.

22 And then the other part of that is that you have
23 ignorance. You could easily have a state put in a
24 you-must-have-an-office position. You would get very
25 little publicity and people wouldn't understand the

1 political ramifications to this and there's no cost for
2 the people who did it and you would get consequences
3 from the people who are favored.

4 One of the things that the Commission started
5 doing that really does make a contribution is to point
6 out the harm that is caused by some of these kind of
7 provisions, and the other thing the commission has
8 started doing is that when somebody pretends to be doing
9 consumer protection, and starts waving that flag, the
10 Commission has started saying, wait a minute, we're in
11 the consumer protection business, and this is not
12 protecting consumers. And so that's not a full
13 solution, but it's certainly an important contribution
14 that the Commission has started to make.

15 MR. ELLIG: Well, consumer protection may be a
16 cloak for producer protection sometimes, but not always,
17 and that gets into another issue of the benefits that
18 may flow to consumers from some of these types of
19 restrictions, particularly on the regulatory and the
20 legal side. We're covering a lot of industries in this
21 workshop, you've all seen the list of various things
22 that we're talking about, just --

23 MR. METZENBAUM: I thought we were talking
24 about wine.

25 MR. ELLIG: You'd think that if you looked at

1 the number of comments we got from the public. But
2 given all of the different industries we're talking
3 about, and on this list, in what areas do you think we
4 are likely to find that there are some significant
5 consumer protection or health and safety benefits
6 associated with some of these laws and regulations that
7 we need to consider pretty carefully, and in what cases
8 do you think it's really more a case of naked consumer
9 protection? You don't have to commit yourself for sure,
10 but just your general impression in a few areas.

11 MR. CALKINS: You don't really mean naked
12 consumer protection?

13 MR. ELLIG: Oh, excuse me, naked producer
14 protection, I'm sorry, thank you for the clarification.

15 MR. ATKINSON: I'll jump in again. I guess
16 overall, I'll go out on a limb and I'll say none.
17 That's not to say that in any of these cases there isn't
18 a legitimate role for protection. There are certain
19 industries to me like cars where there's none. I think
20 there are other cases like contact lenses, prescription
21 drugs overall that you certainly don't want an
22 unregulated regime where somebody could go and get a
23 contact lens from a non-regulated company without a
24 prescription, that's why we have prescription laws in
25 this country.

1 MR. METZENBAUM: What about cars? Why not
2 cars? You said cars.

3 MR. ATKINSON: I guess I would say that I think
4 most of the consumer protection laws in cars would apply
5 automatically to the producer.

6 MR. METZENBAUM: You know, what difference does
7 it make if somebody in Washington, D.C. buys a car from
8 somebody or a dealer in Missouri or Arizona or whatever
9 the case may be if he or she is willing to sell it for a
10 lesser amount of money? I assume that they could get
11 the same kind of dealer protection and maintenance, but
12 actually new cars don't require that much maintenance
13 and you could take that kind of gamble and save yourself
14 a thousand dollars?

15 MR. ATKINSON: I was actually saying cars was
16 one that I don't think there is much rationale.

17 MR. METZENBAUM: Thank you for clarifying that.

18 MR. ATKINSON: Yeah, cars is one, and when I
19 hear car dealers say that they're out to protect the
20 consumer, I wonder, and I laugh frankly. But certainly
21 there are industries where there needs to be some sort
22 of regulatory oversight, or review. Or regime in place.
23 But again, I haven't seen a single case where you
24 couldn't design one of those that let's e-commerce go
25 forward.

1 If somebody can present me with one, I would
2 love to hear the argument, but I haven't seen one yet.
3 I think the issues really divide into where there's no
4 issue at all and you could just go forward and then
5 there are issues like wine where we would argue that you
6 shouldn't be able to buy wine over the Internet unless
7 you pay tax, in our view. You should have to pay tax,
8 and you should have to prove that you're over 18 or 21
9 years of age.

10 So, we wouldn't say just no regulation there,
11 but again, you could easily design those regimes, and
12 certain states have done that, Clint knows which ones,
13 in a way that let's e-commerce go forward.

14 MR. BOLICK: Yes, the point that was raised
15 before by Rob and others about the mortgage companies
16 that have to have an office in the state, I mean, this
17 is pure protectionism.

18 This came up in the wine case in New York, and
19 the New York wholesalers said, all Mrs. Swedenburg has
20 to do is to open an office in New York and then she can
21 sell her wine. Well, if you call Mrs. Swedenburg's
22 winery in Virginia, the person who answers the phone is
23 Mrs. Swedenburg, the person who pours the wine is Mrs.
24 Swedenburg, the person who packs the crates is Mrs.
25 Swedenburg, and she can't also be in New York operating

1 an office there.

2 And to erect that kind of requirement is
3 basically to exclude her from being there. And the
4 state's legitimate interest in that context is
5 jurisdiction. It has to have jurisdiction over Mrs.
6 Swedenburg or other wine producers or mortgage producers
7 in order to protect consumer interest, but that doesn't
8 require an office.

9 Congress passed the 21st Amendment Enforcement
10 Act in the context of alcohol sales that gives states
11 jurisdiction over out-of-state wineries, and likewise
12 that exact same model could be followed elsewhere, but
13 Rob is exactly right, we have yet to see a situation
14 where a less burdensome regulatory alternative could not
15 be developed, and that is the test under the commerce
16 clause.

17 So, I think that as these regulations are
18 challenged, they are going to fall.

19 MR. ELLIG: Okay, well I have to admit, when we
20 were putting this workshop together, we were thinking
21 largely of the domestic U.S. market, but we have an
22 interesting question from the audience about the
23 international implications of the logic of what we're
24 talking about here.

25 The question is, "There's been discussion of

1 'arbitrary political boundaries' referring to state
2 borders being inappropriate for separating different
3 enforcement regulatory regimes. How does this logic
4 apply to federal laws in an international marketplace?"

5 So, I read that to mean, how does the logic of
6 what we're talking about here apply in an international
7 context?

8 MR. ATKINSON: I've got to jump into that one
9 because we just wrote a report last year called The
10 Third Way Framework for International E-commerce where
11 we thought, it was one of the hardest reports we've ever
12 done, because it was really I think incredibly difficult
13 intellectual issue to think through what's the right
14 framework.

15 I think in some ways the frameworks are
16 different. They're different for the simple reason that
17 you might want a national standard, an international
18 standard for let's say being able to sell a particular
19 item online, but who is going to enforce that? Whereas
20 at the United States, we can just say through the
21 courts, for example, that you have to be able to sell
22 wine on the Internet.

23 So, I think the issue in that sense is
24 different. I think the other issue, though, goes to
25 this point of country of origin or country of

1 destination, same with state of origin, state of
2 destination. Clint made the point about New York wine.
3 If you go with a country of destination framework, and
4 to say that Internet sellers have to comply with every
5 single law, that essentially they're going into the
6 State, or they're going into the country, in other words
7 they're targeting it, then you subject e-commerce to
8 basically every single law in the world, or every single
9 law in the states. And I don't think that framework is
10 really viable.

11 So, we came down on the side of unless there's
12 explicit targeting, you have to go with the country of
13 origin where the producer is. If the producer obeys the
14 laws that they are in, they don't have to obey the laws
15 of another state or another country unless they go out
16 and explicitly target there.

17 MR. ELLIG: Anybody else want to deal with the
18 international concept?

19 MR. CALKINS: I do just to follow-up. I assume
20 that the U.S. could have various requirements on
21 products, which would apply even if somebody is shipping
22 it in. You can't have an Internet site from Mexico and
23 sell cars that come in and don't comply with U.S. safety
24 rules. Just because you've got an Internet doesn't mean
25 that a country can't have a variety of regulations,

1 which applies.

2 MR. ATKINSON: Absolutely. And just to make it
3 clear, we weren't arguing that product laws would
4 change, that countries certainly would have the right
5 now and would continue to have the right to regulate
6 products that enter the country, but for example, take
7 the case of consumer protection on the Internet, and
8 let's say there's a country in Europe that says, when
9 you sell on the Internet, you have one year in which to
10 return the product if you don't like it.

11 Well, does that mean that if a website happens
12 to sell a product, let's say the product is a digitally
13 delivered product, do they have to obey that law? We
14 would argue no, that they shouldn't have to obey that
15 law.

16 MR. CALKINS: All right.

17 MR. ELLIG: Okay. Our next question is more of
18 a political economy question, and I'm curious to see if
19 anybody has any ideas on this one. It's pretty long, so
20 I'm going to cut to the chase. This is in the context
21 of state laws and regulations. "What can an innovative
22 entrepreneur installer company with limited resources do
23 when the government from the Governor to the Department
24 of State to the Division of Licensing collaborates with
25 established companies to the detriment of consumer

1 welfare?" So, what can a small guy do when they're
2 faced with some of these barriers?

3 MR. BOLICK: Call the Institute for Justice.

4 MR. CALKINS: I would think call you. I would
5 think call Jerry would be the right answer it seems to
6 me, that's what you're here for, in part.

7 MR. ELLIG: Well, there are certainly limits to
8 the FTC's jurisdiction, one of the reasons for jobs like
9 this is to simply shine some light and get people
10 thinking a little bit.

11 MR. GERTNER: This is a very old political
12 economy issue and question, that certainly is not very
13 different, because it shows up with the Internet, right?
14 It's the concentrated special interest against the broad
15 consumer interests, and as you know, lots of
16 institutions exist. We see them represented here, that
17 are designed as best we can to deal with that particular
18 conflict, and that seems to be the appropriate
19 institutions.

20 MR. BOLICK: Yeah, I would say the courts are
21 very favorable forums to the kinds of arguments that
22 we're making here today, and obviously litigation can be
23 very, very expensive, but we see situations where
24 plaintiffs like Juanita Swedenburg can bring down very,
25 very powerful interests, because the tools are so

1 powerful. All of the rules of the game are in favor of
2 innovation and competition at the constitutional level,
3 and that doesn't mean that you won't be forced to give
4 up your pound of flesh so to speak, but at the end of
5 the day, freedom of commerce, I am confident, will
6 prevail.

7 UNIDENTIFIED SPEAKER: Excuse me, I will take
8 ownership for that question that was just answered, and
9 I actually have contacted the Institute for Justice, and
10 have gotten some good feedback, but I think that I would
11 like to go on record here, that here this is a
12 government-sponsored meeting, and we're all familiar now
13 with the corruption of corporate fraud and audit fraud
14 by Arthur Andersen, and above that sits the government,
15 and what do you do when the government improperly
16 licenses dozens of companies for a certain license,
17 refuses to enforce compliance for that license, and then
18 on the other hand, and tries to selectively enforce that
19 same law which it has now improperly licensed companies
20 and doesn't enforce license companies, it then
21 selectively enforces it against an innovative company
22 because of political pressure due to special interest
23 groups. The government needs to do something, and
24 there's a lot of talk here, but I wonder, when is the
25 government going to take action?

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1 MR. ELLIG: Anybody have any further thoughts?

2 MR. METZENBAUM: Yes. I think the answer is
3 pretty simple, and that is the government isn't just
4 something ephemeral out there, the government is people.
5 And when the people who are running that government
6 don't do those things you're talking about, there's only
7 one alternative, and that is to throw them out.

8 Now some people in government do a good job.
9 Some people in government do a terrible job. And so I
10 don't think you can generalize as to what you do, what
11 government does or doesn't do, I think government does
12 or doesn't do what the people who are in the leadership
13 roles in those government positions decide that it shall
14 or shall not do. And I think that's the bottom line.
15 That is the kind of people that we the American people
16 send to run our government.

17 MR. CALKINS: Jerry?

18 MR. ELLIG: Yeah?

19 MR. CALKINS: The other answer, and I guess the
20 two answers are one, it's a genuinely hard problem,
21 because although there are times when litigation will
22 work, it won't always work. It's expensive and
23 difficult, and there are times when the Federal Trade
24 Commission doesn't have sufficient resources, when state
25 consumer protection or other things don't have

1 sufficient resources or won't be interested, at which
2 point you're reminded that one of the ways that the wine
3 issue has become such a cause is because the press has
4 taken interest in it. And so you might wander over here
5 to the reporters and see if you can find someone to make
6 you the next cause, because a free press is part of how
7 people resist against abusive government and industry.

8 MR. ELLIG: Okay, we have a question from the
9 audience, it's addressed to Senator Metzenbaum, but if
10 anybody else wants to take a cut at it, that's fine,
11 too. And the question is, "Does your call for open,
12 unbiased access mean that middlemen have a right to
13 distribute goods?"

14 MR. METZENBAUM: Well, I think they don't have
15 a right, I don't think it's a God-given right, I don't
16 think it's a government-given right. I think it's part
17 of any free economic system, and if they can justify
18 their existence, they justify their reason for being,
19 contributing something to the economic free flow between
20 the consumer and the manufacturer, or the producer,
21 whatever the case may be, then I think there's no
22 question about it, the middleman has a reason for his or
23 her existence. But if the middleman is just a factor
24 which causes the consumer some additional cost, then no,
25 I don't think the middleman does add anything to the

1 situation, and so I think it's the same way our economy
2 works generally. Either you have to justify your reason
3 for being, your business operations, or you go out of
4 business, and I think the same is true of the middlemen
5 generally.

6 MR. ELLIG: Okay, I want to ask a pair of
7 questions that are going to be kind of parallel. First
8 about private action, and then about laws and
9 regulations. First off, on the private action side, and
10 I would like to ask each panelist to respond to this
11 one. What do you think is the single most important
12 thing that the Federal Trade Commission could do to
13 ensure that electronic commerce is not unnecessarily
14 burdened by anticompetitive private actions? And I
15 guess to make it kind of fun and snappy, we could either
16 start down at this end of the panel with Steve or start
17 down at that end of the panel with Rob.

18 MR. CALKINS: Down there with Rob.

19 MR. GERTNER: Down with Steve.

20 MR. CALKINS: I thought you had two questions.

21 MR. ELLIG: That's the first one. I am going to
22 ask you the same question about the regulation side of
23 it, but first just anticompetitive private actions.

24 MR. CALKINS: All righty, I'll start just
25 because I'm a nice guy, Rob.

1 MR. GERTNER: Thank you.

2 MR. CALKINS: My kid is a freshman in Chicago,
3 will you be nice to him?

4 MR. GERTNER: I will.

5 MR. CALKINS: I think the number one thing that
6 the Federal Trade Commission could do would be to bring
7 a lawsuit. I am struck by how many times people have
8 referred to that consent order against Chrysler dealers,
9 and although I am supportive of comments and I am
10 supportive of Amicus briefs, I'm especially supportive
11 of Amicus briefs, and I am supportive of guidelines and
12 clear rules and all that's important, there is nothing
13 like a lawsuit, even if it ends in a consent order, to
14 let people know that the Federal Government is serious
15 and that there can be consequences, and that it by
16 itself, it can generate so much publicity and attention
17 and analysis that it can just make a massive difference.

18 And so my recommendation would be bring a
19 lawsuit.

20 MR. ELLIG: Clint?

21 MR. BOLICK: I am so litigious, I would have to
22 agree with that. The FTC, obviously, has limited
23 jurisdictional power. For example, the constitutional
24 provisions that I have talked about and that we litigate
25 very vigorously are not jurisdictional bases of

1 authority for the FTC, but antitrust obviously is, and
2 the issues that Chairman Muris was talking about before,
3 I think, are absolutely right. And the automobile
4 issue, I think, is one where the industry's efforts to
5 embrace government power to support its own efforts to
6 force compliance with their rules would be a good place
7 to look.

8 MR. ATKINSON: I agree with both comments. I
9 think it's going to be hard to find a sacrificial lamb
10 to go first from the industry side, because I think it's
11 sort of like trying to prosecute the mob. Nobody wants
12 to be the industry that threatens their dealers, and
13 takes them to court, or asks you to take them to court.

14 I just think there's so much fear and inertia in
15 the system, that you just can't -- I mean, I won't name
16 names, but there are certain industries that aren't here
17 today, or the next few days, and the reason they're not
18 here is simply because they don't want to alienate their
19 dealerships. They're not doing it for any sort of
20 economic rationality, they're doing it purely out of
21 retaliation, fears of retaliation.

22 So, I would maybe look -- hopefully maybe
23 someone will come forward who isn't as entrenched in
24 that and is trying to move into that area, but I just
25 think it's going to be hard. I wish you all the best in

1 trying to do it, because I agree that a case would be
2 very good.

3 MR. METZENBAUM: And I wouldn't take issue with
4 anything that either of the three previous speakers had
5 said, but when push comes to shove, the effective
6 enforcement of our laws has to do with whether or not
7 they're actually enforced, and that they're not just
8 talk-talk, but that the agency in charge with the
9 responsibility of enforcing those laws is willing to
10 belly-up to the bar and take action if action is
11 warranted, and you don't have to take many actions
12 before the message is out there that the governmental
13 agency means business and we better shape up or ship
14 out.

15 MR. GERTNER: I certainly don't have the
16 expertise to disagree with what my colleagues on the
17 panel have said. I think that at some level, as part of
18 Steve's answer he talked about the notion of the
19 publicity associated with a lawsuit and I think at some
20 level that the goal in a lot of these things where the
21 costs are borne broadly by consumers is to make
22 consumers broadly aware of it, and make it an issue in
23 their minds. And I think lawsuits are possibilities. I
24 think there are perhaps other ways that government
25 agencies can highlight the costs associated with these

1 restrictions in a way that it becomes a broader issue
2 and one that consumers at some level demand that things
3 change.

4 MR. ELLIG: Okay, well Rob, I'll warn you since
5 you got Steve to go first on the last question, you get
6 to go first on the next question. What's the single
7 most important thing that you think the Federal Trade
8 Commission could do to ensure that electronic commerce
9 is not unnecessarily burdened by laws or regulations
10 that may inhibit competition?

11 MR. GERTNER: Well, I guess I think even here
12 the jurisdictional issues probably become even more
13 severe, and I don't know that it's as clear that, again,
14 I don't know that the answer really is particularly
15 different. That it's the role doesn't seem to be much
16 stronger than really trying to highlight, point out the
17 cost and try to make it an issue that has wide resonance
18 with relevant constituencies.

19 MR. METZENBAUM: I think where there's a
20 situation that electronic commerce, and I can't pick one
21 up, because I am not that expert in it, but I'm sure you
22 can pick out one instance and for the FTC to take action
23 in that particular instance would send a loud and clear
24 message out to the entire industry of e-commerce that
25 the FTC means business, that they want competition to

1 exist, and they insist that it exist, and where it
2 doesn't exist, they're going to follow through in a
3 legal proceeding.

4 MR. ATKINSON: I think it would be very helpful
5 to pick one issue or one industry and think through what
6 are the issues and write a staff report on why these are
7 protectionist and if there is a need for some consumer
8 protection, what would that framework look like that's
9 nondiscriminatory, and then use that to go around to the
10 states where there are those restrictive laws and use
11 that as a way to leverage change.

12 MR. BOLICK: Well, first, I want to commend the
13 FTC for what it already is doing, this hearing is
14 fantastic. It also demonstrates the ideological breadth
15 of agreement on the need to unshackle Internet commerce.
16 I've had about a year to get used to the idea of
17 agreeing with the Progressive Policy Institute, and just
18 a few minutes to get to the idea of agreeing with
19 Senator Metzenbaum, but it's a habit that I would like
20 to get used to.

21 But the FTC also is supporting litigation in the
22 Amicus context, but one other thing, and I think that I
23 heard Chairman Muris say this before, the idea of
24 applying antitrust to state and local governmental
25 entities, I think, is absolutely vital. The marketplace

1 can often overcome private efforts at blocking
2 competition, but when they're backed by government, it
3 is almost impossible. And the notion that antitrust
4 laws should be suspended when the context is
5 governmental action, to me, really nullifies the idea of
6 the antitrust laws.

7 So, please, revisit that issue, and that would
8 be an enormous contribution.

9 MR. CALKINS: And my answer is simply, bring a
10 lawsuit. Although I suppose the variation here would be
11 to bring a Parker v. Brown Noerr Pennington lawsuit.
12 Bring a lawsuit that would go and challenge some kind of
13 regulation that should not be protected from the
14 antitrust laws because it's not legitimate proper
15 government regulation, but rather is a special interest
16 that is operating through the government in a way that
17 exceeds the bounds, and that would have all sorts of
18 beneficial effects.

19 MR. ELLIG: Okay. Well, thanks, in closing, I
20 would like to thank our panelists. We have folks here
21 from a wide variety of perspectives, ideologically, some
22 academic, some policy, various things, and a number of
23 areas where there's a great deal of agreement. I should
24 probably emphasize that that agreement was not exactly
25 by design. We did try very hard to find someone who

1 thought electronic commerce is not a good idea, and it's
2 an interesting comment on the debate that there don't
3 seem to be too many people against electronic commerce
4 generally, and most of the disagreement comes up in the
5 context of specific industries. So, if you're looking
6 for some very significant disagreements, wait, we're
7 going to have plenty on the specific industry angles.

8 We now have time for a break scheduled and we'll
9 reconvene at about 11:00 and hear from Dr. Randy
10 Kroszner from the President's Council of Economic
11 Advisers.

12 (A brief recess was taken.)

13 MR. ELLIG: Okay, I'm delighted to introduce Dr.
14 Randall Kroszner, who is a member of the President's
15 Council of Economic Advisers. For those of you who
16 don't follow the terminology, being a member of the
17 President's Council of Economic Advisers means he's one
18 of the top three guys over there. And in that capacity,
19 he deals a great deal with competition and regulatory
20 issues.

21 So, he's a good person to talk about this issue
22 for that reason, but there's another reason I want to
23 mention, and that is that I first think I met Randy, I
24 don't know, 12 years ago or so, and if you look at his
25 vitae, he's done a lot of research on monetary economics

1 and the evolution of money, including speculation about
2 what we might be using for money somewhere down the road
3 when maybe we're not using paper greenbacks. And at the
4 time when I saw this research, I thought, gee, that's
5 maybe of interesting historical value and I'm glad he
6 got some good publications out of it.

7 Now, however, I find myself walking around
8 carrying one of these things, it's a Metro Smart Trip
9 Card, if I want to get on the Metro or pay for my
10 parking at a Metro station, this thing is money. We're
11 talking about electronic commerce where there are
12 various alternatives to traditional credit cards and
13 checks, various kinds of electronic payments.

14 So, I think it's very appropriate that we have
15 somebody speaking who has had the foresight to look at
16 some of those kind of issues that are now quite topical
17 years ago at a time when they weren't the big thing in
18 the news, but yet now they're pretty significant and
19 important issues to e-commerce.

20 Randy?

21 MR. KROSZNER: Thanks. Well, the time when I
22 was doing that work, people just thought I was
23 completely crazy, now maybe they'll still think that I'm
24 completely crazy, but at least there's someone who
25 thinks that I was forward-looking rather than just

1 talking about things that could never actually occur.

2 And actually, to some extent, the Internet is
3 like that, if we think back 20 years, the idea that we
4 would be potentially sending movies over the telephone
5 lines, communicating through email, buying things
6 through and auctioning things through this electronic
7 means was really just something that hadn't been thought
8 of a long time ago. I think it's just part of the great
9 evolution of the U.S. and it's entrepreneurial and
10 innovative economy that we have been able to move
11 forward.

12 And so what I want to do just in my very, very
13 brief remarks, is talk a little bit about how the
14 Internet has broad impact on productivity growth, and
15 why focusing on impediments to the use of the Internet,
16 and to the use of e-commerce in general have bigger
17 effects than just the specific industry effects, but
18 also try to set up a framework for thinking about those
19 individual industry effects. And then I don't know if
20 there will be time for questions or not, I guess it
21 depends on how we're moving along.

22 So, when we think about productivity growth, we
23 think about a lot of different types of technological
24 innovations that can help to promote innovation, promote
25 growth, and obviously things related to high-tech and

1 e-commerce and Internet are part of that. We had a long
2 period of relatively low productivity growth, about 1.4
3 percent from the mid-1970s until 1995. In '95 we
4 supposedly had the advent of the new economy, and
5 productivity growth in the U.S. started to take off.
6 And it was about two and a half percent from '95 through
7 2000.

8 But what's been amazing in the last six
9 quarters, three of which have been recession and three
10 of which have been growth, we've actually had 2.9
11 percent productivity growth, and usually productivity
12 growth is a bit lower during recessionary periods. It's
13 really been quite strange to have such high productivity
14 growth.

15 In order to continue to move forward and for the
16 economy to grow, we have to maintain productivity
17 growth. Our long-term estimates are that we will have
18 3.1 percent economic growth. Part of that is just
19 driven by changes in the labor force, about one percent,
20 but 2.1 percent of that coming from productivity growth.
21 We have a fairly conservative view of how productivity
22 growth is going to affect the economy. I think many
23 economists think it will be much higher than 2.1,
24 especially over the last five years or seven years at
25 2.5 and then we've had 2.9 more recently.

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1 But part of the ability to continue to grow
2 really has to do with things like e-commerce, and
3 introducing new ideas and new technologies and new means
4 of undertaking transactions. Because on both the supply
5 and demand side, e-commerce has helped to lower overhead
6 costs and operating costs, and lower research costs.
7 Some of my colleagues at Chicago and one of my former
8 colleagues from the Council of Economic Advisers, Jeff
9 Brown and Goolsby from Chicago have looked into the
10 insurance markets and have found that by being able to
11 do price comparisons on the Internet, that term life
12 prices are down in the order of 10 percent or so,
13 increasing consumer surplus by more than \$100 million a
14 year.

15 So, there are real benefits in each of these
16 individual areas. And they accrue to consumers, and
17 they also manifest themselves in increased productivity
18 growth.

19 But part of the concerns that we have today are,
20 well, how do we make sure that we can unleash this
21 potential and take advantage of it and make sure there
22 aren't impediments to that. Because there certainly can
23 be through either existing regulations being extended in
24 a way that was never really conceived of before, much
25 like Jerry was talking about, thinking about money in a

1 completely different way, that you would just be using
2 little magnetic strips to make payments rather than
3 actual greenbacks. And that's something that's
4 important to think about.

5 So, we have this basic shock that's occurring in
6 these industries. We're having a new channel opening
7 up. And so whenever you have sort of a major
8 technological innovation, you're going to have sort of a
9 change in the balance of powers. And so there's usually
10 some sort of regulatory equilibrium that comes about
11 through a balancing of the different public and private
12 interests that come together, but when you have a major
13 change like that this usually leads to some sort of
14 regulatory change.

15 In work that I had done in the old days more
16 than a year ago when I was still at the University of
17 Chicago as an academic, I looked into the financial
18 services area in sort of a parallel to a much earlier,
19 but sort of a parallel of breaking down geographic
20 barriers, looking at why do we suddenly get this move
21 towards deregulation of interstate and intrastate
22 banking.

23 Well, there were shocks that came along. And
24 actually one of the major shocks that came along was
25 sort of the early version of the Internet. It was the

1 advent of the 800 number. Now of course we take that
2 completely for granted, but that was something that was
3 really quite innovative and dramatically decreased the
4 cost of search because now you could call a variety of
5 different providers, get information at very low cost.

6 Obviously the Internet was cheaper, but this was
7 sort of a major innovation that the consumer could now
8 find these things, make these calls, and basically
9 reduce the geographic connections between you and your
10 bank, because you could now easily correspond or talk to
11 your bank at very low cost.

12 Automatic teller machines were another example
13 of breaking down the geographic barriers, because now
14 your bank could be separated from where you were, but
15 you could still get access to your cash in a very easy
16 and simple way.

17 And so those technological innovations led to
18 changes in the strengths and also the interests of the
19 various groups, and led to a building up of a move
20 towards a greater and greater breakdown of these
21 barriers to geographic restrictions on financial
22 services.

23 We have some parallels in e-commerce: We have
24 some occupational licensing issues, whether they be in
25 caskets or contact lenses, but we have similar kinds of

1 things. Should the existing regulations that are kind
2 of bound, focused geographic entities be appropriate for
3 and be applied to something like the Internet, which
4 kind of cuts across those entities.

5 That's exactly the kind of policy challenges and
6 opportunities that we've had. But I think the key thing
7 is that now that there are these technological changes
8 that make it more likely that we'll have some sort of
9 regulatory change. The challenge for the regulators is
10 to make sure to try to guide that change in a
11 welfare-enhancing direction.

12 And thinking about the structure of some of the
13 changes and challenges, I want to think about just very
14 briefly two various types of scenarios, one of extending
15 existing rules to various e-commerce suppliers, and so
16 let me go through that with some examples from the wine
17 industry.

18 So, first, what you want to do is think about
19 what is the benefit of the rule? And obviously there
20 are a lot of local laws that are restricting wine sales
21 to different individuals, setting minimum age
22 requirements, et cetera. And so you want to think about
23 what are the benefits of those, and then if you extend
24 this rule to e-commerce suppliers, how do you maintain
25 the benefit?

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1 Think about the benefit, because the rule itself
2 is not the important thing, it's what is the economic or
3 social benefit that's coming from that. And so if we
4 think in wine sales, one of the issues is, well, if
5 we're very concerned about minors getting access to
6 alcohol, then you can require IDs at the time of
7 delivery. Is that a sufficient substitute for having
8 the ID when you actually go to the store? That's open
9 to debate, but that's something that you can do to try
10 to maintain the importance or the effect of the rule,
11 which is to try and prevent a sale of alcohol to minors,
12 but still allow for this new distribution channel to
13 occur.

14 And so more broadly we have to think about the
15 opportunity costs of extending this rule in e-commerce.
16 And obviously we know, and again, in wine and liquor
17 distribution, there are a lot of structures that are set
18 up, going through wholesalers, going through different
19 entities and institutions, in order to move the alcohol
20 towards the consumer.

21 And so we want to think about, well, do we
22 really need these institutions in order to provide
23 potential benefits, which obviously have to do with
24 state tax revenue, some argue that it supports
25 temperance by having these institutions there, and

1 obviously by preventing sales to minors.

2 But the trade-off that we have is how much will
3 extending these regulations deter entry and deter our
4 ability to get the benefits from this new distribution
5 channel, and get also access to greater variety, versus
6 preserving the bases for the rules and regulations in
7 the first place?

8 So, we have to sort of weigh the benefits
9 against the costs, but I think the key thing is to not
10 focus just on the legal rules themselves, but think
11 about the economic and social impact of them, and is
12 there a way to preserve them while also allowing for
13 increased competition through e-commerce?

14 And the second scenario is concerns that there
15 will be some sort of attempt to prevent trading partners
16 from doing business through the Internet. And obviously
17 a number of the issues that are going to be discussed in
18 the particular industry panels will be touching on these
19 kinds of issues.

20 This has come up a lot in auto sales; the FTC
21 has been active in this area. But I think we can think
22 about it very much in a traditional way in standard
23 vertical restraints types of issues. So, the tools for
24 dealing with something like this are relatively well
25 known, that in principle vertical restraints can

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1 facilitate foreclosure, but also, we know that their
2 standard use is something that helps to overcome
3 incentives for a free riding problem.

4 So, again, we have our standard trade-offs that
5 we have to think about. And so, what we have to do is
6 apply our ideas, our good economic ideas to the economic
7 impacts here. It is a new channel, but we can see that
8 the new channel does not necessarily mean that we need
9 new types of regulation, because we can use traditional
10 concepts to address some of those issues.

11 And so, as I said, the real challenge is to try
12 to put the pieces together in such a way that we can
13 continue to get the benefits of the productivity growth
14 that we've been seeing from the Internet revolution from
15 e-commerce revolution. We see benefits in terms of
16 higher productivity growth: It's now easier for people
17 to make purchases, to use a new distribution channel if
18 they so find it convenient. Obviously people can still
19 go to brick and mortar outlets and people still do that,
20 as people know who go to shopping malls, but now there's
21 an alternative for people to use.

22 And this is very important for broader economic
23 growth in the economy. The real challenge, though, as I
24 said, is now that we've got this technological
25 innovation, you're going to get a changing of the

1 balance of interest as to what different groups want,
2 also what the benefits to consumers are of different
3 types of regulations, and so that's the real challenge
4 that policy makers have to face now, is thinking about
5 precisely this.

6 Now that we're likely to get regulatory change
7 or regulatory innovation, because we have this
8 technological innovation that's changing the old
9 regulatory equilibrium, how can we make sure we're
10 guiding this in the direction that's welfare enhancing
11 rather than harming the consumer interest, because
12 ultimately that's what we're more interested in.

13 Just an aside on that, a lot of people had
14 thought that the great Internet revolution was going to
15 lead to extremely high profits and so we had a very high
16 valuation for a lot of Internet firms, but something
17 people seemed to forget is the role of competition,
18 which is exactly what we're about here today. If you
19 have a very competitive market, it's not at all clear
20 that the benefits of the innovation are going to accrue
21 to capital, that is to the investors in the Internet
22 firms.

23 Now, if there's potential, because of so much
24 innovation, that there could be higher returns, but as
25 we've seen, over the last decade, there's been an

1 enormous amount of investment inflow into the U.S. So,
2 this fairly elastic supply, that is a very competitive
3 supply of capital into these markets, suggests that a
4 lot of these benefits are not going to be accruing to
5 capital. There may be some there, but they are more
6 going to be accruing to the scarce factor of labor, if
7 there are special factors that aren't easily
8 reproducible and so people can't enter on a completely
9 free basis into the labor market, although I think
10 largely we do have that. But the consumer is going to
11 be the major beneficiary, because the competition is
12 going to lead to more innovation, new products, more
13 convenience. And I think that's largely what we've been
14 seeing.

15 And so, and that's sort of where the
16 productivity has been going, not for the higher profit
17 to Internet firms. A little bit in increase in wage
18 growth, but primarily we've been seeing it to innovative
19 products to consumer surplus. And that's why it's so
20 important not only for broader economic growth, but in
21 particular for consumer -- for the consumer to get these
22 policies right.

23 Thank you very much.

24 (Applause.)

25 MR. ELLIG: Okay, how are we doing on time? I

1 think we need to keep moving along. So, you get spared
2 the ordeal of questions and I'll turn things back to Ted
3 Cruz to moderate the next panel.

4 MR. CRUZ: Thank you, Randy, I appreciate you
5 coming and addressing the workshop.

6 MR. KROSZNER: Thank you.

7 MR. CRUZ: Now I would like to introduce our
8 next speaker, who is going to be Jeff Jordan. Jeff
9 Jordan is Senior Vice President and General Manager of
10 eBay U.S. In that capacity, he reports to the CEO, Meg
11 Whitman, and he oversees all U.S. operations in
12 marketing at eBay. eBay in particular has been a
13 company in the technology community that has been
14 particularly outspoken on these various sorts of
15 possible restraints that we are examining here today in
16 this workshop, and has been a leader in seeking to
17 address the impact of these restraints upon consumers.

18 Prior to joining eBay, Jeff was President of
19 reel.com, an online video and DVD retailer, and before
20 that he was Chief Financial Officer of Hollywood
21 Entertainment and also Disney Store Worldwide. He has
22 an MBA from Stanford and a BA in political science and
23 psychology from Amherst.

24 In addition, I will note that eBay's corporate
25 website lists Jeff's most treasured collection as an

1 autographed Michael Jordan game jersey, and given that
2 His Airness has graced the city of Washington with his
3 presence, it's particularly appropriate that Jeff is
4 with us, and also, I will say from a personal point of
5 view, as a basketball fan since I could walk, that no
6 one in the history of this sport has had such an ability
7 to face any defense and overcome any barrier, and so
8 it's particularly appropriate that Jeff would be here
9 today addressing possible barriers in an altogether
10 different context.

11 Thank you, Jeff Jordan.

12 (Applause.)

13 MR. JORDAN: That's tall billing living up to
14 Michael, I will undoubtedly not follow through.

15 I am Jeff Jordan, I'm Senior Vice President and
16 General Manager of eBay's U.S. operations. Thank you
17 for inviting eBay to participate in this workshop on the
18 potential negative effects state regulation can have on
19 Internet and e-commerce.

20 We are concerned that states are adopting
21 regulations that benefit local merchants and
22 discriminate against e-commerce companies. Such
23 regulations do not protect consumers, but penalize them.
24 They hobble electronic commerce instead of unleashing
25 its potential to deliver speed and efficiency and

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1 convenience to buyers and sellers in the 21st Century.

2 Accordingly, we applaud the Federal Trade
3 Commission that they are holding this workshop to shine
4 a spotlight on this serious problem. This is a very
5 positive step toward eventually ending unfair and
6 discriminatory state laws and regulations that deny
7 consumers the full benefit of e-commerce.

8 eBay is the world's first and largest online
9 trading community. Founded in September 1995 by Pierre
10 Omidyar, eBay brings together people and companies from
11 around the world in an online venue where they can buy
12 and sell just about anything. Pure vision in creating
13 eBay was to define the ultimate efficient marketplace.
14 Today with over 50 million registered users worldwide,
15 and over ten million items for sale daily, the eBay
16 community is filling that vision. Whether selling
17 through a bidding process, or fixed price format,
18 sellers on eBay must charge prices that are competitive,
19 not just with other eBay sellers, but also with those of
20 other offline retailers.

21 Similarly, retailers in the traditional brick
22 and mortar world can no longer base their prices merely
23 on local market conditions. They must now consider the
24 price consumers will pay on eBay and other e-commerce
25 sites. Such price competition is great for consumers

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1 but trouble for entrenched offline merchants who have
2 been able to set prices for years without repercussion.
3 E-commerce forces them to face an unpleasant prospect,
4 competition.

5 In order to manage this competition, these
6 retailers have successfully encouraged their allies in
7 local government to erect two serious obstacles to
8 e-commerce. The first is applying laws crafted for
9 brick and mortar companies before the rise of the
10 Internet in an inappropriate and detrimental way to
11 Internet businesses, and the second, drafting laws and
12 regulations that benefit home state brick and mortar
13 merchants from discriminating against Internet
14 companies.

15 Proponents justify these new, inappropriate and
16 often discriminatory barriers with spurious claims that
17 e-commerce may harm consumers. Far too often, though,
18 these obstacles to e-commerce penalize those they claim
19 to protect and instead help home state merchants to
20 protect their turf. These merchants fear that the
21 Internet will place them at a disadvantage so they seek
22 to tilt the playing field in their favor.

23 One major obstacle to e-commerce laws that is
24 crafted before the Internet for brick and mortar
25 businesses are being applied to the Internet businesses

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1 in an inappropriate way that makes no sense. A clear
2 example of this is state attempts to regulate eBay as an
3 auctioneer or auction house. While eBay itself is
4 neither, some of the listings on our site are referred
5 to as auctions because we provide an online venue for
6 consumers to bid on products and services.

7 As a result, some state regulators want to
8 interpret state auction laws as including eBay and other
9 online marketplaces that include bidding. Their efforts
10 are completely misguided. Our business has little in
11 common with offline auctioneer or auction houses. eBay
12 doesn't take possession of any listed item, provide
13 appraisals of the merchandise, collection commissions
14 from buyers or do many of the other things that are
15 common practice in traditional auctions.

16 Regulating eBay under traditional state auction
17 laws is like trying to put a dog collar on a fish. It
18 does not fit and is not going to work.

19 We are also very concerned about the potential
20 negative impact of this trend on the millions of eBay
21 sellers. Some of our sellers are casual participants in
22 e-commerce who use eBay to sell the treasures of their
23 garage or attic, but a growing number are smaller, hard
24 working entrepreneurs for whom the most efficient and
25 cost effective way to sell products or services is

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1 through an online market like eBay. Forcing these
2 millions of sellers to be licensed as auctioneers or
3 auction houses perhaps in a number of different states
4 would accomplish nothing than to exclude them totally
5 from this dynamic electronic marketplace.

6 While putting eBay sellers out of business by
7 treating them as auctioneers might benefit entrenched
8 offline competitors, it would hurt consumers, e-commerce
9 and indeed the economy overall.

10 In addition, to try to make eBay and its
11 participants fit inappropriately into traditional
12 auction laws, brick and mortar merchants continue to
13 push for new laws and regulations at the state and local
14 level to hobble their new Internet competition and
15 protect their position as the sole distributor of a
16 product or service. This kind of owner's discrimination
17 is prevalent in any number of markets in which the
18 Internet offers a new and less costly alternative to
19 traditional distribution.

20 Last year, for example, some state legislators
21 in Minnesota promoted a bill that would have stopped
22 everyone but state licensed auto dealers from selling
23 automobiles on the Internet. In Oklahoma, the state has
24 limited caskets online unless you happen to be a
25 licensed funeral home.

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1 Today, inconsistent and ambiguous state
2 regulations make it very difficult or totally impossible
3 to sell many categories of goods and services on eBay,
4 or on the Internet generally. Event tickets, travel
5 packages, packaged seeds and antique slot machines are
6 just a few examples.

7 In each case, proliferating state regulations
8 demand time-consuming and cumbersome efforts by eBay and
9 other e-commerce businesses to achieve compliance, none
10 of which benefits consumers. In fact, these state laws
11 and regulations have the effect of penalizing consumers
12 by limiting their access to goods and services and
13 thereby increasing the prices they must pay. All for
14 the sake of protecting less efficient business models.

15 The scope of goods and services on eBay for sale
16 alone is almost limitless. Sellers from around the
17 world currently offer almost ten million items for sale
18 on the site in over 18,000 different categories. The
19 range is staggering, from BMWs to bulldozers, from
20 antique furniture to high-tech computers, from the
21 oldest 78s to the most recent DVDs.

22 Every single one of these sales could
23 potentially be subject to regulation by one or more of
24 the 50 states or even by a county or municipality. If
25 left unchecked, this growing thicket of state and local

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1 regulation could strangle the efficient online
2 marketplace that eBay's community has created. We at
3 eBay are still committed to doing our best to determine
4 which state laws apply to listings on our site because
5 we know that it is critical to create a safe and legal
6 marketplace for our users.

7 While this is a constant struggle for eBay, it
8 is completely beyond the resources of small e-commerce
9 businesses like eBay's merchants and casual sellers.
10 They cannot possibly analyze and develop compliance
11 strategies for laws in the hundreds of jurisdictions
12 where the potential customers reside. Compliance with a
13 myriad of often inconsistent state and local laws become
14 an insurmountable barrier for entry for would-be
15 participants in the electronic marketplace of the new
16 millennium.

17 For these reasons, you can see why eBay is
18 concerned about the prospect of states treating Internet
19 companies different than offline competitors or
20 regulating them inappropriately. The fact is, unfair
21 and often discriminatory laws and regulations will only
22 end up negating the benefits of e-commerce and forcing
23 consumers to bear the brunt of higher prices and slower
24 services in the offline world. This must not be allowed
25 to happen.

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1 Working with the Federal Trade Commission, the
2 states and the federal government, we can reach a
3 solution and achieve our founder's vision, a competitive
4 nation-wide marketplace that puts the well-being of
5 consumers first. We applaud the Commission's decision
6 to hold this workshop and look forward to working with
7 you in the future on this very important issue.

8 Thank you.

9 (Applause.)

10 MR. CRUZ: All right, we will now move directly
11 into our next panel, which is the Industry Overview
12 Panel that hopefully will give some broad general
13 perspectives about how various players in the industry
14 and in the tech community are dealing with and facing
15 these various possible restrictions. And again we will
16 go in alphabetical order, starting with Tod on my right,
17 and I would ask each panelist to begin their statement
18 with a brief introduction of who they are and what their
19 affiliation is.

20 Again, as with the previous panel, if members of
21 the audience have particular questions, simply raise
22 your hand and an FTC staff member will pass you a note
23 card on which you can write a question and we will be
24 happy to ask the questions from up here.

25 Tod?

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1 MR. COHEN: Great. My name is Tod Cohen and I
2 am the Associate General Counsel for Global Policy for
3 eBay. Thank you, again, to the Federal Trade Commission
4 for inviting us to participate.

5 And I wanted to talk just a little bit more from
6 what Jeff talked about, about some specific examples
7 that we have been encountering where we think that the
8 state regulation is a real barrier to e-commerce.

9 First, while eBay does not permit the sale of
10 illegal goods on our site, bright lines between lawful
11 and unlawful items are often absent. And in many
12 instances, different jurisdictions may regulate the
13 same items differently. eBay still does allow the sale
14 of regulated items, as long as these sales comply with
15 applicable state regulations. In order to assist our
16 sellers, we have created a user-friendly list of
17 prohibited, questionable, and infringing items. It
18 includes 69 categories of goods and services that either
19 one, may not be listed at all, the prohibited items
20 category, including things like new credit cards,
21 prescription drugs, tobacco and postage meters. Two,
22 questionable items, those are items that may be listed
23 under certain conditions, such as event tickets, slot
24 machines and items bearing police insignia. Or three,
25 the infringing items, which may be listed unless they

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1 are in violation of certain intellectual property
2 rights, both copyrights, trademarks, database rights and
3 other rights.

4 Furthermore, our site provides hundreds and
5 hundreds of pages of explanations of why each category
6 is included, and under what circumstances, if any,
7 certain items can be sold.

8 One area where state and local laws are
9 extremely varied, confusing to consumers, almost
10 impossible to monitor, and in my estimation just plain
11 silly, are the resale of tickets to entertainment
12 events.

13 To assist users and promote lawful ticket sales,
14 eBay has attempted to identify just the states that
15 regulate the resale of event tickets and to provide its
16 users with that information. We have identified 17 such
17 states. State and local ticket regulations range from
18 prohibitions against the sale of tickets at any price
19 above face value, to prohibitions against the sales that
20 prices from \$1 to \$5 or 25 percent, whichever is
21 greater.

22 So, for example, the State of South Carolina
23 prohibits the resale of event tickets for \$1 over the
24 face value, as does Florida. Massachusetts, it's \$2;
25 Connecticut is \$3; Missouri, just for sporting events is

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1 \$3; New Jersey is \$3 or 20 percent above the face value,
2 whichever is higher; Rhode Island is \$3 or 10 percent
3 above the face value. We have not been able to identify
4 a state that has a \$4 limit, but New York has a \$5 limit
5 or 20 percent, and Pennsylvania has a \$5 limit or 25
6 percent.

7 As a further complication, some states apply
8 these restrictions to all event tickets, some only to a
9 subset of event, such as those taking place on state
10 property. Mississippi has prohibitions on the resale of
11 tickets for entertainment events on state-owned property
12 and college sports on state college campuses, whereas
13 New Mexico only has the restriction on college campuses,
14 not entertainment events.

15 When a seller in one of these regulated states
16 attempts to sell an event ticket, an automatic
17 disclaimer is added to that seller's listing explaining
18 the applicable state regulations to its providers. This
19 process is difficult, inefficient, and doesn't work for
20 both eBay and our users. We have to try to identify the
21 location of buyers and sellers, the location of the
22 state in which the event is occurring, and then you have
23 to go to a two-page chart, which is all mapped out
24 beautifully where you have to identify what the rule is
25 for the location of the seller, the location of the

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1 bidder, the eBay policy, and then each of the different
2 states that I've described below. And what makes this
3 most ridiculous and silliest of all is every sale on
4 eBay is transparent. You can see what the price was
5 that somebody purchased the event ticket for and
6 determine if that was a worthwhile price to pay for that
7 ticket or not.

8 Now I could also talk a lot about wine sales,
9 but there is an entire panel later today that's devoted
10 to wine sales, but I did want to just conclude in saying
11 that beyond just event tickets, and wine sales, and
12 travel packages, and package seeds, and antique slot
13 machines, and police insignia, there are, like I said,
14 69 different ones. All of these sectors have provided
15 an area in which the Internet has made the ability for
16 people to buy and sell everywhere much more efficient,
17 and especially in rural areas and in places where
18 there's not a large concentration of retail places to
19 find this.

20 We do look forward to continuing to work with
21 the FTC in the years ahead to ensure that consumers
22 continue to have access to less costly alternatives to
23 traditional offline commerce. Thank you.

24 MR. CRUZ: Thank you, Tod.

25 Declan?

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1 MR. McCULLAGH: Thanks. Good morning and thanks
2 for the opportunity to speak here today.

3 Let me preface my remarks by saying that I'm not
4 speaking on behalf of the CNET News.com, rather I'm
5 going to make some brief points based on my personal
6 experience as someone who writes about technology policy
7 and the people in this industry.

8 Before starting at news.com in June I spent four
9 years at Wired News and worked as a reporter. Before
10 that at Time Inc. and Hot Wired.

11 I want to start by recognizing that in some
12 cases, state governments have legitimate authority to
13 regulate shipments of products into their states, as we
14 will no doubt hear very soon, the 21st Amendment
15 contains a rare specific grant of power under the
16 constitution of state governments to regulate specific
17 products. Representatives of other industries, such as
18 car dealers, claim to financially benefit, or I'm sorry,
19 financially benefit from existing regulatory structures,
20 and state that they offer valuable services to consumers
21 that Internet sales cannot replicate. Optometrists and
22 opticians raise safety concerns.

23 Now there may be some truth to these arguments,
24 but I would urge the Commission to weigh the costs that
25 state regulations impose on consumers against the

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1 benefits that would accrue if the regulations were to be
2 removed. I believe that the costs of the regulations
3 outweigh the benefits.

4 Now, this is not a new debate. Advances in
5 technology often disrupt existing methods of doing
6 business. Until the mid-15th century, at first scribal
7 monks sanctioned by the church, and then their secular
8 counterparts at scriptoria or writing shops, that was
9 the mechanism Europe used to mass produce documents.
10 Then a goldsmith named Gutenberg, as we know, created a
11 printing press, he changed the way bulk documents were
12 printed and provided a better, cheaper alternative to
13 scriptoria.

14 A few centuries later, around the mid-19th
15 Century, a French economist, Frederic Bastiat, wrote a
16 satiric essay called The Petition that's worth
17 remembering today. It came from the French Association
18 of Candle Makers and Lighting Manufacturers and it
19 complains about unfair competition from the sun, saying
20 we ask you to be so good as to pass a law requiring the
21 closing of all windows, dormers, skylights, outside
22 shutters, et cetera, in short all openings, holes chinks
23 and fissures through which the light of the sun may
24 enter houses to the detriment of the fair industries
25 with which we are proud to say have endowed the country,

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1 a country that cannot without the trained ingratitude
2 abandon us today to so unequal a combat with the sun.

3 About 100 years later, another economist, Joseph
4 Schumpeter, helped popularize the term "creative
5 destruction," borrowing a term from biology, he also
6 called it "industrial mutation." He said that the
7 opening of new markets incessantly revolutionizes the
8 economic structure from within, incessantly destroying
9 the old one and incessantly creating a new one.

10 Now, this is even more true today. The policy
11 arguments that we're here to talk about are not new,
12 mail order businesses created some of the same concerns,
13 but the ability of the Internet to link buyers and
14 sellers with scant regard for political boundaries makes
15 the resolution of these topics more pressing and far
16 more is at stake.

17 The opening of new markets is creating a new
18 economic structure offering consumers lower prices and
19 more choices, or at least would if state regulations did
20 not stand in the way.

21 Off-shore businesses are another potential
22 market destructor and creator. In the long run, they
23 may render state regulations far less desirable.
24 Perhaps items that are heavy and bulky, like funeral
25 caskets, aren't going to be ordered in a hurry from

1 websites that are without the reach of U.S. law, but
2 other products like contact lenses are more likely
3 candidates.

4 If legitimate U.S. companies can't sell their
5 products nationally because of state barriers to
6 e-commerce, the resulting higher prices means that an
7 overseas market that is unregulated and not taxed by any
8 U.S. jurisdiction may become more attractive to
9 consumers.

10 Everyone likes competition, I'll wager in the
11 abstract, but nobody likes competitors. Today's
12 middlemen who argue that the scale of the cost benefit
13 analysis must be weighted differently are no exception.
14 Perhaps Internet firms also will echo those French
15 candle makers eventually and we will be back here in 20
16 or 30 years arguing that the big entrenched Internet
17 companies of tomorrow are trying to stifle competition
18 provided by the next upstart of disruptive technology,
19 but today, of course, that's not the case.

20 The costs of maintaining these existing state
21 regulatory structures outweighs the benefits and hinders
22 the process of creative destruction.

23 Thank you.

24 MR. CRUZ: Thank you, Declan, and I appreciate
25 you illustrating the breadth of industries we're

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1 addressing, all the way from the ones on the agendas all
2 the way to scribal monks and 19th Century French candle
3 makers.

4 Now I would like to turn to Paul Misener.

5 MR. MISENER: Thanks, Ted, I'm probably the
6 only one on the panel old enough to remember those
7 monks.

8 In my view, the state of competition on the
9 Internet is best evaluated by separately considering on
10 one hand the online activities that are substitutes for
11 and nationally competitive with offline activities, and
12 on the other hand, online activities that are truly
13 unique to the Internet. The former category includes
14 the sale of physical goods, for example, caskets and
15 wine, while the latter includes the provision of
16 consumer Internet access service.

17 In my estimation, the principal threats to
18 competition in these two categories are respectively
19 from government and industry. Government policy,
20 particularly that adopted at state and local government
21 levels, can restrict competition among online activities
22 that are substitutes for offline activities.

23 Competition between Internet businesses and
24 companies using other modes of commerce already is or at
25 least could be vibrant, and of course overall

1 competition is greater than what preexisted the
2 Internet. Yet some policy makers support "online only
3 laws" and regulations that could intentionally or
4 inadvertently restrict this competition by unfairly
5 regulating online activities that, for all practical
6 purposes, are identical to less regulated or unregulated
7 offline activities.

8 Why would policy makers restrict competition
9 this way? Well, this workshop undoubtedly will reveal
10 several specific efforts to intentionally and unfairly
11 protect offline businesses from competition. But there
12 may be a more benign and generally applicable
13 explanation: Unfamiliarity with the Internet.

14 Indeed, even though the web and email have
15 become essential tools of commerce, information
16 gathering and communication for most persons, the
17 Internet in its applications remain for many people,
18 including policy makers, mysterious at best and
19 downright scary at worst. Among federal policy makers,
20 the gap between perception and reality has narrowed
21 dramatically over the past few years, but many state and
22 local government officials continue to misapprehend the
23 technology and through ill-conceived legislative
24 proposals, threaten its character and usefulness for all
25 Americans, not just those in the smaller jurisdictions.

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1 The implications of these continuing
2 misapprehensions are vitally important for consumers,
3 industry, academia and policy makers to recognize and
4 address. For example, it is no longer sufficient for
5 federal policy makers to merely do no harm, they must
6 also be vigilant against the potential anticompetitive
7 harms caused by non-Federal Government officials.

8 To give a concrete example, many state
9 legislatures have considered well-meaning but
10 ill-conceived laws addressing consumer information
11 privacy that despite the pervasive nature of the issue
12 address only "online activities." To date there have
13 been dozens of online privacy bills introduced in spite
14 of the fact that consumer information is at least as
15 much at risk offline, only a small percentage of
16 consumer transactions are conducted online, and imposing
17 restrictions only on Internet-based commerce would have
18 the effect of aiding existing brick and mortar
19 businesses at the expense of online competition.

20 Moreover, taken together, such privacy laws
21 could easily create a crazy quilt of rules with which it
22 would be difficult, if not impossible, for web-based
23 enterprises to comply. It would impose regulatory
24 requirements outside the borders of the acting state.
25 Although it is likely that many of these rules would

1 fail a legal challenge based on former commerce laws of
2 jurisprudence, such constitutional fights can take years
3 to resolve, by which time irreparable damage could be
4 done to Internet commerce and information gathering and
5 communication.

6 The only sure-fire resolution, it appears, is
7 for the Federal Government to preempt state action,
8 either as a matter of education or policy or as a last
9 resort, as a matter of law. Fortunately, the FTC
10 already has begun to preempt the states through
11 education of policy. With its consumer education
12 campaigns and its policy of renewed focus on the
13 enforcement of existing consumer protection law, the
14 Commission has given non-federal governments less reason
15 to be considered inactive.

16 It may come to a point, however, where education
17 and policy preemption are not sufficient and Congress
18 may need to legislate to preempt state actions to
19 restrict competition among online activities that are
20 substitutes for offline activities.

21 As for the activities that are truly unique to
22 the Internet, however, commercial interests present more
23 significant anticompetitive threats than governments.
24 Thus federal officials also must be vigilant against
25 anticompetitive industry activities that, in the worst

1 case, could altar the character and usefulness of the
2 Internet as American consumers and citizens have come to
3 know it.

4 For example, although competition is fairly
5 robust and the current Internet access environment
6 whereby individuals link up through broadband corporate
7 or scholastic or from narrow band phone connections from
8 their homes, the broadband consumer home Internet access
9 environment may not be nearly so competitive.
10 Inter-modal residential broadband competition, that is
11 competition among platform service providers using, for
12 example, cable, DSL, satellite and wireless technologies
13 has not materialized and may not be technically feasible
14 in many parts of the country, and intra-modal
15 competition will obtain only if multiple ISPs are
16 available within each technical platform.

17 It seems to me that federal regulators must
18 primarily be concerned with the ultimate consumer and
19 citizen objective in connecting with the Internet, that
20 is unfettered access to the information services and
21 products offered by websites. If bottleneck broadband
22 Internet platform or service providers in any way
23 degrade or interfere with access to websites, the
24 character and usefulness of the web will be seriously
25 damaged.

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1 An appropriate approach here is federal
2 regulation, which would prevent the rapid
3 disenfranchisement of consumers and provide uncertainty
4 to this very young business sector. The Federal
5 Communications Commission could adopt rules to prescribe
6 this type of anticompetitive behavior or ensure
7 competition among broadband Internet service providers,
8 and the FTC could formally indicate that such behavior
9 would be considered anticompetitive.

10 Either way, competition authorities should
11 remain vigilant to ensure the continued competitiveness
12 of consumer Internet access and, indeed, of all online
13 activities that are truly unique to the Internet and
14 where inadequate competition, because there is no
15 offline substitute, could harm consumers and citizens.

16 In sum, consumers, industry, academia and policy
17 makers should monitor and address threats to competition
18 on the Internet in two principal areas, the online
19 activities that are substitutes for offline activities
20 and the online activities that are truly unique to the
21 Internet. Because the principal threats in each area
22 come from very different sources, government and
23 industry, respectively, different approaches are needed
24 for each. For the former, some form of federal
25 preemption of non-federal actions, either through

1 education, policy or laws are necessary, and through the
2 latter some form of federal regulation and competition
3 enforcement is appropriate.

4 Thank you.

5 MR. CRUZ: Thank you, Paul.

6 And now let's turn to Jonathan Zuck.

7 MR. ZUCK: Good morning. My name is Jonathan
8 Zuck and I'm the President of the Association for
9 Competitive Technology. We are a high-tech trade
10 association, and represent companies throughout the
11 high-tech sector, which includes software, hardware,
12 consulting and e-commerce companies, in total represent
13 about 3,000 companies in the high-tech sector.

14 You know, I give my little introduction with
15 head held high, because last night I was at an ANC
16 meeting, a local neighborhood commission meeting, and in
17 which they were debating about tree overlays, and well
18 this is really about the trees, but the underlying
19 current is we really don't want people building houses
20 because now that we've built our own house in the
21 neighborhood, we want the forest next door to remain
22 intact, and so we want this tree overlay thing. Oh, but
23 wait, I still need to put in a pool, but then I'll need
24 to take out a tree in order to do that.

25 So, I sat there thinking to myself, wow, thank

1 God, I get to deal with loftier issues than this. You
2 know, these guys, their heads must explode dealing with
3 this kind of pettiness, and then the more I think about
4 this issue, this issue can be summed up in four words.
5 Not in my backyard, right? It's the exact same issue
6 that we deal with at a neighborhood level, when we talk
7 about politics being local, that's exactly what
8 transpires in this particular issue.

9 These same guys that don't want automobile
10 manufacturers to be able to sell cars direct certainly
11 would like to be able to buy their contact lenses online
12 if they could, and so you have this level of
13 inconsistency in this issue in which it becomes this
14 very parcelled issue, and so, well, e-commerce is great,
15 I'm really a big fan of e-commerce, except when it comes
16 to automobiles, or I'm really a big fan of e-commerce,
17 because I just got a mortgage online, but I certainly
18 don't want any of my patients to get their contacts
19 online, because that would affect my bottom line.

20 So it's really a not-my-backyard problem which
21 we see over and over again. Which is why, you know, it
22 is worth noting that there wasn't anybody up here on
23 this original panel that said I oppose e-commerce, but
24 instead you just have everyone individually opposing it
25 in individual markets.

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1 And I think that's why this workshop is so
2 important, because it shines this kleg light on the
3 issue as a whole, so that when people see lobbyists, and
4 I guess we can all be thankful that the monks didn't
5 have lobbyists at the time, but when they see the
6 lobbyist come to their office, they say, hey, I know
7 what you're up to. Instead of it being like, oh, yeah,
8 I hate the airlines, so therefore I hate Orbitz, and I
9 hate these guys, and I hate Detroit, so I'll side with
10 you on this. They start to see this as part of a bigger
11 problem.

12 That if, in fact, we do block e-commerce in
13 every single market, we will have in turn blocked
14 e-commerce. And this thing that we all purport to
15 support. And e-commerce continues to play a significant
16 role in the economy, despite the .com bomb that we were
17 all kind of looking forward to. Those of us in the
18 high-tech industry knew that the new economy didn't have
19 anything to do with delivering fantasia and chocolate
20 chip cookies to you at 2:00 in the morning, in fact in
21 many respects that seems very old economy, and that
22 company was not destined to survive in any economy, but
23 instead you still see e-commerce growing ten times as
24 fast as the economy generally, and the real strong
25 players that are adding real service in the marketplace,

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1 companies like eBay and Amazon are, in fact, even
2 profitable, something that didn't even seem tenable in
3 the context of the new economy.

4 So, the e-commerce continues to play an
5 important role in helping to make more efficient
6 consumers' access to goods and services. So, there's a
7 lot of barriers to the growth and fatality of e-commerce
8 now more than ever, because, in fact, in the slowing
9 economy, the desire to protect what you've got, the
10 desire to make sure that nobody is able to come into my
11 marketplace, even goes up. So, I mean, a lot of these
12 issues again were sort of hidden when everybody was
13 doing well, but now when there's this slow down and the
14 consumers need lower prices and more efficient services,
15 more time, better convenience, these challenges are even
16 greater than they would be otherwise.

17 There's a patchwork of state laws and licensing
18 regulations and we've talked a little bit about that.
19 Traditional industry associations are trying to set up
20 rules and apply kind of monopoly tactics to prevent
21 e-commerce. And that's why we were part and supportive
22 of forming a coalition called Net Choice, that has a lot
23 of the major high-tech trade associations, as well as
24 trade associations like the Electronic Commerce
25 Association, the Electronic Retailers Association, and

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1 many companies like eBay and Orbitz and others that have
2 been victims of this kind of e-commerce-based targeting.
3 And Net Choice yesterday released a report that looked
4 at only four sectors of the economy, air travel,
5 automotive, residential real estate and contact lenses,
6 that's just four sectors, to see what the potential cost
7 to consumers would be of the kind of barriers that are
8 in place today.

9 Not even dealing with potential barriers that
10 eBay sellers, for example, are facing or that Amazon
11 buyers are facing, et cetera. And those numbers are
12 staggering. \$32 billion last year with as much as \$200
13 billion in costs to consumers over the last five years.
14 These are really big numbers because of the efficiencies
15 that e-commerce brings into place and that, of course,
16 traditional retailers and localities are looking to
17 block.

18 So, as far as calls to action, again, I think if
19 workshops like this are very important to shine a kind
20 of kleg light or realism on the issue as a whole so that
21 people are suspicious when the car dealers come and
22 start talking about consumer interests, right, that's
23 when we know the apocalypse is near.

24 Congress should really look seriously at the
25 constitutional implications of this and look at this as

1 potentially an opportunity to preempt state laws that
2 would affect interstate commerce. And then finally, I
3 think it's up to us and people like us, and we heard
4 this question before, to make sure that we let law
5 makers know that e-commerce generally is more important
6 than some specific special interest in our state, and
7 that we have to take that responsibility and make sure
8 that through organizations like Net Choice and other
9 trade associations that were vocal, and helped to tear
10 down these barriers and prevent new ones from being
11 thrown up.

12 MR. CRUZ: Okay. Thank you, Jonathan, thank you
13 to everyone on the panel. Again, if there are questions
14 in the audience, feel free to indicate and you can write
15 them on a note card.

16 I would like to begin with a few individual
17 questions to individual panelists, and then we'll move
18 to some general topics that hopefully everyone can jump
19 in on, but I would like to follow up on a couple of the
20 issues that were brought up and start, Tod, with what
21 you discussed, and in particular, what I'm interested in
22 is in what states is eBay facing the most significant
23 possibilities of being regulated as an auctioneer, and
24 what would be the consequences of that regulation if it
25 were imposed? And if you could include within that

1 response both direct regulation of eBay as an
2 auctioneer, and also the threat of regulation of
3 individual sellers of goods over eBay as auctioneers,
4 and your best estimate of what the costs and/or benefits
5 that would entail.

6 MR. COHEN: Well, the most significant risk that
7 we have experienced and we were able to come to what we
8 think is a good conclusion, it was the state of Illinois
9 this year. In 1999, in September '99, the state of
10 Illinois passed an amendment to their Auction Licensing
11 Act where they added the words of the scope of the act,
12 they added three words, "and the Internet," to determine
13 who would be subject to the act.

14 They went through a regulatory process that had
15 pretty much concluded in January of 2002 in which they
16 were going to issue notices to every online "auction
17 company" to obtain licenses in the state of Illinois or
18 not be allowed to do business in the state of Illinois.

19 We contacted them, we had been talking to them
20 for a couple of years, and then we were confronted with
21 the simple question, do you sue them under the Dormant
22 Commerce Clause, and impinging upon our rights, and the
23 rights of users everywhere. Or do you try to resolve
24 that through potentially a legislative vehicle?

25 And it was our determination that the better

1 solution was a legislative vehicle, but had we gone down
2 the court fight, we were very concerned that we would
3 have lost for three simple reasons. One, their
4 regulation would have imposed the regulation upon every
5 eBay seller based in Illinois, every piece of real
6 property or personal property sold from the state of
7 Illinois, or every potential bidder who was located in
8 the state of Illinois. We thought that we could win the
9 third one, that that would have been clearly an
10 infringement on the dormant commerce clause, because of
11 the outside interference, but the first two, sellers in
12 Illinois and property located in Illinois, we would have
13 had a very difficult claim that that impinged upon the
14 Dormant Commerce Clause.

15 Our estimates were that if it had gone through,
16 we would have confronted two situations, the direct eBay
17 situation was that the auction law in Illinois
18 required -- it wasn't obtaining the license that was the
19 problem, we could get a license, even one of our
20 subsidiaries, two of our subsidiaries had licenses in
21 the state of Illinois. It wouldn't apply that to all of
22 our businesses, but then it would have required every
23 item that was sold on eBay to be guaranteed by eBay.
24 And if you look at how our business works, the sellers
25 list the items, and eBay does not guarantee the items.

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1 In a traditional auction house that occurs, and the
2 price for the buyer is about 10 percent of the final
3 value, and the price for the seller is about 10 percent,
4 and within that 25 percent, the auction house takes a
5 cut, because they stand behind that item.

6 Well, the average eBay sale, we take less than
7 four percent. So, we would have had to have increased
8 the costs of all of our users by approximately, what is
9 that, four times the price, and we didn't necessarily
10 believe that would have added any additional benefit
11 from that.

12 So, then we were confronted with the real
13 possibility of just shutting down Illinois, or imposing
14 a restriction just on Illinois buyers and sellers of
15 increasing the cost just for them.

16 The other thing that we had found, so that would
17 have been a direct cost to eBay if we had closed
18 Illinois of approximately \$650 million in sales last
19 year through the state of Illinois. If we did \$10
20 billion worldwide, and our estimates were around \$650
21 million in sales were done in Illinois. Then if we had
22 required all of our sellers to obtain licenses, there
23 are a million five registered users in Illinois, there
24 are probably 150,000 of them that are sellers. So, then
25 they would have been imposed a cost to get licensed in

1 Illinois, it's about \$1,000, plus there was a
2 requirement that they do six months of training before
3 they could become a licensed auctioneer, and we have no
4 doubt that of the 150,000 sellers in Illinois, probably
5 less than 500 would have gone through the process of
6 doing that.

7 And all from what we could tell, simply because
8 they added the three words. Now that's about the best
9 we could figure it out, and I'll talk a lot more about
10 it on Thursday.

11 MR. CRUZ: Okay. Jonathan, I would be very
12 interested in hearing more about the study you
13 mentioned, and in particular the methodology whereby you
14 arrived upon the \$32 billion figure, what that
15 encompasses, and if there was any effort to measure any
16 benefits flowing from these restrictions.

17 MR. ZUCK: That's a good question. That came up
18 in the previous panel, this notion of benefits flowing
19 from restrictions, and I think that is what makes it
20 easy to convolute this debate. Right now there's a lot
21 of legislation being discussed about email, spam
22 prevention legislation and things like that. How many
23 people in this room don't use email?

24 Okay, well what if the answer to the problems
25 that we had with email were to simply ban it and say

1 that you could only use physical mail. Because that's
2 the equivalent, right, that the online version of mail
3 is email, but we've decided that the solution is simply
4 to eliminate email, and of course you use the post
5 office, because then you won't get viruses. Well,
6 except for anthrax, but other than that, you wouldn't
7 get any viruses if you just used physical mail.

8 So, again, looking towards the benefits, I
9 think, again, is a red herring. That's a context in
10 which you're able to define the context in which the
11 rules that need to be applied and how they should be
12 applied, but the point is not to apply them
13 discriminantly, and I think that's what it boils down
14 to.

15 We need to protect consumers' interest in all
16 kinds of commerce, and the laws that are in place
17 generally apply to the online world as well as the
18 offline.

19 As far as the study that Net Choice put out,
20 I'll talk about it briefly without getting too mired in
21 the details, because I'm happy to follow up with anybody
22 and our study is available, et cetera, but basically
23 we're looking at three sectors in which barriers
24 currently exist. I mean, we kind of divided the
25 e-commerce world into two different halves, if you will,

1 of those that are pretty open -- open and available
2 right now, which is sort of the environment that a
3 company like Amazon or eBay gets to play in today, but
4 they face challenges down the road, and then those
5 markets in which there are actually barriers that exist
6 today.

7 So there's sort of the threatened barriers, and
8 then these markets in which there's already some
9 barriers, which included air travel, automotive, real
10 estate, and contact lenses. And so generally speaking,
11 what we were doing was looking at a volume of retailing,
12 the e-commerce sort of uptake, in other words, how
13 people were going into e-commerce and being able to use
14 the web.

15 So, in the cases of automobiles, if you look at
16 all the people that are going on the web to find out
17 about what car to buy, but yet aren't able to buy it,
18 you get an idea of the kind of situations you're facing,
19 that there is, in fact, this impetus to make use of the
20 Internet, that's ultimately blocked in the end by the
21 inability to close that transaction.

22 So, we look at that Internet uptake in the
23 context of retail generally, and then in each case
24 there's different models for where those cost savings
25 come from, the average price difference in books that

1 are sold on eBay versus from a brick and mortar store.
2 The difference potentially in car prices in the places
3 where you are able to sell cars directly, and then it
4 becomes a multiplication issue.

5 After that, to look at those savings, to look at
6 the uptake issues in the context of retail generally,
7 and the growth of e-commerce, and again looking
8 anecdotally about the fact that people are attempting to
9 use the Internet to do all but make those purchases,
10 provides an indication that there are real savings to be
11 had, and they're not detracted from by the fact that not
12 everyone is on the Internet.

13 So, that was sort of the basic methodology to
14 come at those figures, and so the \$32 billion number,
15 again from those four sectors from this past year, and
16 then the five-year number, was just looking at the
17 growth and e-commerce uptake, and again doing the
18 multiplication, just to demonstrate the magnitude of the
19 issue, given the slowness with which reform often takes
20 place.

21 MR. CRUZ: Thank you, Jonathan.

22 Paul, I wanted to follow up on a bit of Amazon's
23 experience, and in particular, your judgment on what
24 some of the more significant barriers Amazon has faced
25 to growth, and barriers either from the government

1 restriction side, or from the conduct of private
2 individuals, such as private parties engaged in
3 horizontal boycotts and the like.

4 MR. MISENER: Sure. Thanks, Ted.

5 We frankly haven't seen or felt anywhere the
6 degree of barriers that my friends at eBay have felt.
7 There are a couple of reasons for that, simply put,
8 Amazon's biggest portion of Amazon's business is
9 conducted in areas that aren't affected by the same
10 sorts of laws and regulations both existing and
11 prospective that have come to haunt eBay. That's not to
12 say that things couldn't happen.

13 In fact, I think our bigger concerns right now,
14 both in the area of where there are online substitutes
15 and the issues that are government involvement, and then
16 in the areas where there's sort of the truly unique
17 Internet-based activities where the concern is mostly
18 having to do with private parties. Our concerns are
19 mostly prospective, and we're starting to see things
20 appear on the horizon, both in terms of legislative
21 proposals and in some industry activities. I mentioned
22 two examples, sort of the online privacy laws being
23 considered in states, as well as the -- sort of the
24 bottleneck service providers sort of platform and a true
25 service perspective for broadband Internet access.

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1 So, again, Ted, I appreciate the question, but
2 we're not in the casket business, nor in the contact
3 lens business. Those sorts of extant barriers certainly
4 do impose economics cost on us simply as a matter of
5 reducing the number of choices that we would have. All
6 things considered, it's more expensive for us to get the
7 casket retailing business than it otherwise would be.
8 Is that determinative of our decision whether or not to
9 engage in that business? Probably not. But still, the
10 extant costs are a concern, but most of the concerns are
11 prospective.

12 MR. CRUZ: Thank you.

13 Declan, I wanted to get your perspective on
14 really the views within the tech community, and really
15 two things. One, how significant of an issue are these
16 sets of issues we're discussing here today, within the
17 tech community, and how widespread of an awareness is
18 there in the tech community about these sorts of
19 restrictions and in particular an awareness that extends
20 beyond industry by industry, but a more global or
21 connected awareness of the potential impact of these
22 restrictions.

23 MR. McCULLAGH: Okay. Let me try to answer it
24 this way: Based on the interviews that I have done and
25 the writing that I have done over the last few years,

1 I've written about the Institute for Justice's wine
2 lawsuit against New York, for instance. I think that
3 awareness in the tech community overall is actually
4 pretty limited. I think that, however, once people
5 inside the tech community, maybe by reading my articles
6 or other articles become aware of a court case, look
7 into this, they're actually shocked by the depth and
8 breadth of some of the restrictions.

9 I think awareness is also growing. I think this
10 event and the recent hearing in the House are going to
11 do a lot. I think that if I had to predict, this is one
12 of the emerging issues for the tech community, and over
13 the next year or so we'll see radically changed
14 awareness, but right now it's still pretty limited.

15 MR. ZUCK: Ted, I would like to address that
16 actually.

17 MR. CRUZ: Sure.

18 MR. ZUCK: Coming from the tech industry, I know
19 that most of the people in the tech industry still view
20 Washington as part of the Smithsonian. I mean it's day
21 four of the tour to go see and get a pass to see the
22 debate of the great issues of our times. And so part of
23 it is that there's still a disconnect I think between
24 the tech industry and the policy makers and they don't
25 realize.

1 But also some of it is two things: One is that
2 the pure technology industry is a facilitating force in
3 this as opposed to being in an area that feels directly
4 blocked. So, our industry are the ones that are putting
5 these e-commerce systems in place, is developing the
6 technology to facilitate electronic commerce, et cetera.
7 So it's only indirectly that we see some of these
8 regulatory barriers.

9 And I think the other part of this is
10 definitional. What is the high-tech industry? I mean,
11 we deal with this right now, is Barnes & Noble a
12 high-tech company now that they have Barnes&Noble.com or
13 something, and like everything else there's a kind of
14 convergence where our industry is having to wake up to
15 these regulatory barriers because they understand that
16 they affect the business that they're able to do,
17 whether it's directly or indirectly, and I think that
18 Net Choice is a good example of a kind of awakening or
19 something like that associated with this.

20 Another part of this issue has to do with money,
21 too. During the .com craze there was all this venture
22 capital money that was going into all these start-ups
23 and things and since we thought of these as high-tech
24 companies, et cetera. And now where the money is coming
25 from really moved the ball in electronic commerce is

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1 actually going to be suppliers. The only people that
2 are really in a position to compete effectively against
3 existing entrenched distribution channels are going to
4 be the suppliers themselves.

5 So, I think we're going to see more and more
6 supplier-led e-commerce. Things like Orbitz that are,
7 again, going to put people's hackles up because it's the
8 airlines and we need to set that aside and remember that
9 consumers are getting better prices and better products
10 as a result, and keep our eye on the ball, even though
11 it's going to be suppliers, and not just wild and crazy
12 entrepreneurs with a business plan on a napkin that are
13 helping to drive the model forward.

14 MR. CRUZ: Okay, well let's use that, actually,
15 as a jumping off point to raise some discussion issues
16 for the panel, and I think what may make sense to begin
17 with is, from an industry perspective, how significant
18 are these sorts of possible restrictions to day-to-day
19 business decisions, be they on the front end, on the VC
20 side, looking at which projects to fund, which business
21 models are viable, or be it on the middle and back end
22 in terms of the day-to-day operation of a business in
23 the industry. How significant are these restrictions
24 and how much do they influence decisions in the
25 industry?

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1 MR. COHEN: From the day to day, I can tell you
2 that if you've ever tried to sell wine on eBay, it is
3 exceedingly, exceedingly difficult. And it is one in
4 which you have to become a licensed wine seller, and
5 there's a huge number of steps to even get into the
6 position to sell into those states that allow direct
7 sales. So, there is a day-to-day cost, and one which
8 makes it very unappealing for us to continue to even do
9 that business.

10 The other -- even though it would appear to be
11 like the perfect e-commerce business, and you'll hear
12 that today, but it's also one in which there's enormous
13 economies of scale, if you could do it.

14 On the venture capital side, we see it, a lot of
15 it is silent regulation. A lot of it is people say, I
16 don't want to confront that issue. And it's part of the
17 problem that we know that the FTC confronts in which
18 people did not want to come and talk about it, because
19 existing distributors and existing models put such a
20 heavy price on even trying to challenge them. We saw
21 this with the auto dealers and their success in 49
22 states. Remember, a lot of those autos are still sold
23 over the Internet, it's just that the benefit goes to a
24 dealer.

25 So, for example, for eBay, we see this, if you

1 want to get a new Mini, the dealer sells the new Mini,
2 rather than it being BMW that sells the Mini to you.
3 So, there's somebody getting the benefit from it, it's
4 just that there is an extra added cost to you as a
5 buyer.

6 And then on the larger huge barriers, I can give
7 you a perfect international example that is existing
8 that we're dealing with every day, which is that the
9 French auction laws, which are just amazing, because in
10 the 17th century, the King gave the concessions, and to
11 this day, those concessions are still enforced, and now
12 we're fighting their definition of cultural goods,
13 because of the fear that they will leave the country,
14 and the item is of national patrimony. Well, their
15 definition of cultural goods that they have come out
16 with is everything older than 50 years, which would mean
17 that every book that's older than 50 years could not
18 leave the country, or every piece of furniture that's
19 older than 50 years, that have nothing whatsoever to do
20 with protecting the national patrimony of France, but
21 have everything to do with protecting the existing
22 market players.

23 So, it impacts us day to day out there, and also
24 limits an enormous number of people from entering
25 markets.

1 MR. McCULLAGH: Let me add something to what
2 Jonathan said just a moment ago, that in terms of
3 differentiating between different types of tech
4 companies, let's look back at 100 members. There's a
5 difference between telecommunications providers, the
6 equipment vendors, who are building the hardware for the
7 800 numbers, versus the people actually running the 800
8 numbers and having direct contact with consumers. Both
9 would respond differently to regulations, and in this
10 case, tech firms who are the IT suppliers, the Intels,
11 the Syscos, are going to have a different response to
12 regulation and is going to impact them differently than
13 would state laws that generally would affect people who
14 have more day-to-day contact with customers.

15 MR. ZUCK: One answer to your question about
16 affecting day-to-day, I think, is partly an issue that
17 these are unrealized savings, too. Again, going back to
18 the email example, if we hadn't started using email yet
19 but were prevented from using it, we wouldn't feel the
20 effects, because it wouldn't change our day-to-day
21 business. We would keep putting a stamp on an envelope
22 and put it in the mail.

23 It's only now that we've realized those
24 advantages that having them taken away would seem like
25 such a bad alternative. It's the same thing. You're

1 used to going down to the car dealership every eight
2 years and reintroducing yourself to that marketplace and
3 relearning about lemon law taxes and things like that.
4 And so you consider it a part of doing business. And
5 so, I think in many respects, it's an unrealized
6 advantage, and that's what helps the entrenched
7 interests keep it from being a very visible issue
8 because it's a question of maintaining the status quo.

9 MR. CRUZ: And that actually raises a related
10 issue, which is if it is having these significant
11 day-to-day impacts, how would one go about measuring the
12 magnitude of that impact? And in particular, the costs
13 that are being imposed both on industry and the economy,
14 but also on consumers, and from your perspectives, what
15 are the best ways to actually measure and understand and
16 put in concrete, quantifiable terms the impact of these
17 possible restrictions?

18 MR. ZUCK: Well, certainly we made an attempt to
19 do that by participating in this coalition and in this
20 study that attempted to quantify it. And in some sense,
21 it's in a rhetorical sense, it only identifies four
22 sectors. I mean, we could spend an entire year trying
23 to quantify it across the entire economy, but with
24 numbers that big, they should definitely resonate.

25 I think that the other parts of this that are

1 unfortunately difficult to measure are convenience and
2 time and things like that that it's tough to put a
3 monetary value on, but your ability to buy online
4 instead of having to go and haggle with a car dealer,
5 your ability to buy airline tickets on Orbitz instead of
6 having to figure out that well, Travelocity is having a
7 special deal with American right now so they are showing
8 American Airlines tickets at the top of the list, even
9 they're more expensive than United Airline's tickets who
10 has really cut a deal with Expedia and things like that.
11 Having access to everybody's fares is a convenience that
12 does lead to a kind of cost savings over time, but one
13 that's probably ultimately impossible to measure.

14 And that's why it's so important to frame this
15 debate in these global terms, because, you know, one by
16 one, I think that it's very easy. As we saw in the case
17 of the ludicrous example of the car dealers, that
18 everyone mentions as the whackiest one, it's easy to
19 lose this, even despite its absurdity, unless, again, we
20 continue to realize that it's them against e-commerce,
21 them against consumers.

22 MR. McCULLAGH: Let me just throw one idea out,
23 keeping in mind that I don't have the industry
24 experience that my colleagues do. There are both the
25 additional costs imposed by regulation such as the eBay

1 licensing process or the would-be licensing process if
2 Illinois had its way, which raises costs to consumers,
3 and there's also the costs of not having a transaction
4 completed in the first place, because maybe these costs
5 are too high.

6 I would give an example, two days ago, on
7 Sunday, I was visiting wineries in Sonoma Valley,
8 California, which is one valley over to the west of
9 Napa, and I went to sign up for a wine club, which keeps
10 your credit card number on file and they send you three
11 or four bottles of wine every few months, but because I
12 live in Washington, D.C., they said I couldn't join
13 because the state is actually West Virginia, so I would
14 have to find someone in West Virginia to receive this.
15 The guy helpfully suggested that I could drive 70 miles
16 west.

17 In the end, not liking to drive 70 miles to West
18 Virginia in one direction only, I chose not to do that.
19 So, this is one cost or one transaction that did not
20 take place because of these regulations.

21 MR. MISENER: Well, see me, Declan, I have a
22 farm in West Virginia, I'll take a cut. I think one
23 thing that you want to keep in mind here, I think as my
24 colleagues have pointed out already, it is difficult to
25 do, it's not to say that it's impossible to undertake or

1 that it's not worth trying to quantify, even given the
2 uncertainties. But it seems to me that there's a
3 special burden, I would think, on new rules, and new
4 laws being developed.

5 Tod mentioned one in particular in Illinois.
6 There's one where it would be very difficult for the
7 proponents of the bill to argue that the benefits
8 clearly exceed the costs. It's going to be tougher to
9 go through in sort of a review process, state by state,
10 and knock out extant law, than it is to put legal and
11 regulatory proposals through this kind of sieve which is
12 there to determine whether or not the benefits exceed
13 the costs.

14 So, I would think an area where industry and
15 concerned government and academia can all come together
16 is to say that, look, every time a new legislative or
17 regulatory proposal is put forward and it has these kind
18 of squishy characteristics, could we actually try to
19 quantify and make the proponents of the bill, of the
20 measure, of the regulation, show us that the benefits
21 exceed the costs.

22 MR. ZUCK: Well, if we required that, there
23 would be hardly any bills, Paul, and it doesn't seem
24 fair at all.

25 MR. CRUZ: Well, let's actually talk for a

1 moment about the benefits side of the equation. From
2 your perspectives, what are the most significant
3 consumer protection issues that are raised by
4 e-commerce, and where is there the greatest need for
5 regulations either at the state and local level or at
6 the federal level?

7 MR. COHEN: Well, for us, at least, the hardest
8 one has been prescription drugs. I mean, that is a very
9 difficult issue for us to confront, and one in which the
10 ability to purchase it on eBay has been very difficult
11 to deal with. And so that's why we just have banned the
12 category all together. So, there are a series of our
13 prohibited list, where it becomes somewhat -- for
14 example we prohibited the sale of fireworks. Lots of
15 states allow the sale of fireworks. It's just that our
16 opinion has been based upon some of the consumer
17 protection laws and also just pure liability questions
18 that that's a difficult area in which to allow.

19 And guns, even though they're perfectly legal to
20 sell, another area where it has been very difficult to
21 determine where the right line is drawn, and one more
22 would be tobacco. But let me make sure what I mean by
23 this. I mean smokeable tobacco or chewable tobacco
24 today. There is a very large market on eBay for what
25 they call tobacciana, which is the sale of goods that

1 are tobacco related, so cigar bands and also old
2 cigarettes that are no longer smokeable, like hundred
3 year old cigars, and also there's a market for that.
4 That is a collectible. But there are certain state laws
5 that say, no tobacco at all, so then you're confronted
6 with what do you do in the tobacciana category.

7 MR. CRUZ: Let me actually jump in on that and
8 follow up with a question that was submitted from the
9 audience that's on exactly that topic and we'll get back
10 to the responses of the panel to this, which is directed
11 to you, Tod, and it said exactly what you were just
12 talking about, which is if eBay is allowed to auction
13 wine online, why not beer and liquor, tobacco products,
14 firearms. Is there a social benefit that outweighs the
15 economic benefit to regulate the sales of the above
16 items?

17 MR. COHEN: Well, on guns at least, the great
18 concern was the headline. Our greatest concern was it
19 was allowed until I believe it was February '98 or
20 February '99, guns were allowed to be sold on the site.
21 And there was a huge uproar in the community that how
22 dare eBay impose a restriction on the sale of guns, but
23 it was about social good. It was about not making the
24 determination, but the enormous fear of the headline
25 which is kid purchases gun on eBay, shoots neighbor.

1 That's what our greatest concern was.

2 Unfortunately there is no real easy standard to
3 apply in these. It's a matter of taste, and one of the
4 harder examples that we dealt with is that there's a
5 category of goods called murderabilia, where people buy
6 and sell serial killer items, and the way we determine
7 to regulate that was based upon time. The older the
8 item was, the less offensive it was to any victims and
9 victims' families, and that it is probably fine today to
10 buy John Wilkes Booth memorabilia, but it is not fine
11 today to buy Charles Manson or John Wayne Gacy, and it's
12 just a matter of time. And then of course in France it
13 would be illegal, because then it would be too old.

14 MR. CRUZ: Okay, and returning then to the panel
15 and the most important consumer protection issues in
16 e-commerce generally.

17 MR. McCULLAGH: As a general question and I'll
18 answer in general terms. Guns seem to be an interesting
19 issue, because last I checked, they only can be shipped
20 interstate if the recipient is a federal firearms
21 license holder or an FFL holder, which is you have to go
22 through a federal credentialing and licensing process.

23 But in terms of general recommendations, what
24 policy makers are trying to do is regulate the seller or
25 the intermediary, even though there's a strong demand

1 from buyers, and so, policy makers are finding
2 themselves, and this is going to be more and more the
3 case as more transactions happen online, they're trying
4 to interject themselves between the buyer and seller,
5 which becomes increasingly difficult.

6 So, my advice would be to focus your resources
7 on the most egregious cases.

8 MR. MISENER: It seems to me the consumer
9 protection is ultimately about giving consumers the
10 ability to make the choices for themselves. If they're
11 not allowed to make the choices or if the actual choices
12 are hidden from them, then no one benefits, the market
13 doesn't work freely, it doesn't operate well, and so it
14 seems to me that the sort of global consideration here
15 is ensuring that consumers have adequate access to not
16 only the information but the actual choices that they
17 can make as to whether they do business with a certain
18 entity or buy certain things or conduct other activities
19 online or off.

20 MR. ZUCK: I think there's always legitimate
21 consumer protection concerns, and the FTC's been
22 aggressive in protecting them. Chairman Muris has
23 entered into an educational campaign and others that I
24 think could be very valuable and help address the
25 consumer interests. I think where there's a lot of

1 misdirection is that somehow a specific business model
2 is in the consumer interest.

3 You see very often the argument of the car
4 dealers, well, we provide service, and the manufacturers
5 don't, so therefore you should preserve our business.
6 In other words, they don't make the argument that
7 consumers are willing to buy there instead because of
8 that service, because something innately pro-consumer
9 about their business that requires its preservation.

10 You have travel agents saying, well, we provide
11 better service because we'll walk the tickets up to your
12 office and talk you through your vacation plans,
13 therefore you should preserve our business. And I think
14 that that is where there's a huge fallacy that somehow
15 there's something innately consumer protective about a
16 particular business model, and that's where we need to
17 be really vigilant.

18 But when there are legitimate consumer
19 interests, they probably don't have anything to do with
20 the Internet specifically, but simply have to do with
21 the trade of goods and services, and nondiscriminatory
22 enforcement of the laws and regulations that are in
23 place is really the answer, together with consumer
24 education.

25 MR. CRUZ: Let me actually follow up, Tod, with

1 your answer a moment ago. With some of the goods that
2 you said that eBay does not allow the sale of online, to
3 what extent are those driven by legal prohibitions that
4 make it simply too expensive or even impossible to sell,
5 and to what extent are those decisions driven by
6 business judgments that you don't want to risk the
7 liability or risk the publicity or other judgments that
8 you would make irrespective of what regulations may
9 exist for those goods?

10 MR. COHEN: I wish I could give a principled
11 answer to it, because it tends to be an amalgamation of
12 them. So, if wine sales were much less restrictive,
13 there were many more direct sale states, it would
14 clearly be in our business interest to allow far more
15 wine sales. I will tell you that in most instances, the
16 prohibition is based upon something that is being sold
17 on the site, and then somebody brings it to our
18 attention that it is prohibited.

19 For example, in the United Kingdom, it is
20 illegal to sell soccer tickets, football tickets online.
21 It's not about scalping there, it's simply about
22 hooligans, and the restriction on resale is to prevent
23 hooligans from buying that. But that's not something
24 that is necessarily when our guys came into the UK, that
25 they would have had any idea about.

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1 Another example, and it's on the federal law, is
2 tortoise shell. Authentic real tortoise shell is
3 illegal to sell in the United States if it was harvested
4 pre-1964. Well, it's very difficult for us to look at
5 the tortoise shell in the listing and determine if it
6 was pre-1964. Tortoise shell glasses versus post-1964.

7 So, it's much more of a reaction in which the
8 Fish and Game Service comes to us and says, you can't
9 sell that. And then we set up another page, provide
10 information about it, deal with the sellers in the area,
11 and go forward.

12 One last example of that is Cuban goods.
13 Pre-1959 Cuban goods are legal. Now, there have been
14 people that have tried to put out pre-1959 cigars on the
15 site, which are prohibited anyway, but pre-1959 cigars,
16 you better have a hell of a good humidor that has been
17 protecting those, but it's another example of where if
18 you're selling a book from Cuba in 1950, that's legal to
19 sell. If you're selling a book from Cuba today that's
20 legal, because that's one of the exceptions, but if
21 you're selling a guitar, it's illegal.

22 MR. CRUZ: Well, from a personal perspective,
23 since my dad came from Cuba in 1957, I'm glad to see
24 that at least pre-1959 goods are available.

25 A couple of questions from the audience. Both

1 focused principally on Paul Misener and related to
2 something, Paul, you said concerning broadband, and let
3 me read them both to you and let you address them. The
4 first one, regarding your call for forced access to
5 broadband cable, wouldn't that reduce incentives to
6 build out broadband to rural Americans? And the second
7 question, the present power of the local cable companies
8 and to a lesser extent DSC providers have over the last
9 mile broadband is tremendous. Could you be more
10 specific on how this stranglehold could be lessened,
11 e.g., will it naturally occur, or is intervention
12 needed?

13 MR. MISENER: Okay, thanks, Ted, I will try to
14 answer both questions.

15 The first question, actually, misperceives what
16 I believe is the ultimate issue here for consumers. To
17 date, frankly, most of the discussion, if not all of it,
18 has been on forced access, meaning access of ISPs to
19 broadband facilities networks. As if that were a noble
20 goal in itself, I suppose to a certain extent it is, you
21 would like to think in some senses that if there were
22 multiple ISPs on a providing service, among which
23 consumers could choose, then the prices would be lower
24 and the quality of service for broadband ISP service
25 would be higher.

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1 That to me, though, is but a minor goal compared
2 to the ultimate goal of ensuring that consumers maintain
3 the unfettered access to the information, services and
4 goods available on the Internet. If there's anyone in
5 between the consumer and the ultimate websites, which
6 now number in the billions, then you would have serious
7 consumer protection problems. Having the choice of one
8 or two ISPs a decision most people make once a year,
9 maybe once every three years, is less important by
10 several orders of magnitude, it seems to us, than it is
11 to ensure the consumers have unfettered access.

12 Now, what do I mean by that? It's not only
13 consumers, by the way, it's also citizens in the sense
14 that there's a lot of information out there that you
15 could see where intermediaries might just want to cut
16 out for whatever perhaps noble reason, for example, a
17 Nazi website. What happens if the ISP or the service
18 provider says, hey, that kind of stuff is nasty, we're
19 not going to let consumers have access to it, we're not
20 going to let you perpetrate or send out their hate,
21 we're just going to cut them off, we're going to block
22 access to those sites.

23 Well, in today's narrow band world, that won't
24 happen because consumers will simply go to another
25 narrow band ISP. Because there are hundreds if not

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1 thousands to choose from. In tomorrow's broadband,
2 there may only be one ISP or maybe two or three. At
3 that kind of a level, you could see how you could run up
4 against, as I think the other question talked about, the
5 power that they have over this ultimate connection
6 between consumers and the information products and
7 services.

8 In my world, the consumer retail world, it's
9 perhaps less astonishing, but also as damaging to
10 consumers that the intermediaries could interfere with
11 that connection. Imagine a world which would allow an
12 intermediary to put a pop-up box for Amazon auctions
13 every time you typed in www.ebay.com. Come to Amazon
14 auctions, it's cheaper there, better service, don't go
15 to eBay. Well, we could today pay an --

16 MR. CRUZ: Tod wouldn't like that.

17 MR. MISENER: He wouldn't like it and he
18 shouldn't like it, because it relies on the information
19 about what the consumer wanted to see. If we paid an
20 ISP to put that pop-up box on every single site someone
21 visited, that's one thing. It's completely random, it's
22 an annoyance and it certainly would drive away
23 consumers. However, if we did it in such a way that the
24 ISP only put that Amazon auctions pop-up box when
25 someone typed in ebay.com, that becomes a real problem.

1 And that is a serious issue, one that I think
2 regulators have not yet addressed, and hopefully, this
3 Commission could say that that was -- they could
4 informally say that this is deemed anticompetitive and
5 certainly the other Commission, the Federal
6 Communications Commission could take one of two actions
7 it seems to me, to prescribe the behavior or to require
8 multiple ISPs, which would ensure competition.

9 MR. COHEN: Ted, can I go forward with that,
10 because I have some questions about this. Because, one,
11 there's a case out there, which is the Gator case,
12 that's gator.com, I believe, is engaged in exactly that,
13 which is when you type in a website, it pops up with its
14 own ads, and there's been an injunction imposed against
15 them, and I think I saw somewhere somebody else filed a
16 new lawsuit against them yesterday.

17 But our question, and it's to Paul, which is if
18 you envision that model then you're creating a
19 must-carry system, a cable must-carry system, which is
20 that the ISP has to carry everybody's items, and there's
21 lots of websites that we block right now and we want our
22 ISPs to block, copyright infringing websites, child
23 pornography websites, there's lots of websites that we
24 already have our ISPs blocking and it's considered
25 acceptable. And then you have to then write a whole

1 list of which ones are okay for them to block and which
2 ones are not okay for them to block.

3 But there's also the other side of that, which
4 is that if you create a must-carry world, I believe the
5 necessary compliment is a compulsory license model,
6 also. And so our concern has been, and we're not
7 necessarily thinking that the broadband open access is
8 not necessarily in the content side potentially good,
9 but there is also the question of ESPN charges right now
10 for everybody on the cable system to get it, and they
11 have market power to say to the cable companies, go
12 ahead, take us off. And instead, they have the market
13 power to say, no, no, no, no, no, we're going to carry
14 ESPN, because that's what you would expect. And I would
15 believe that most ISPs would probably run into an
16 enormous problem with their user base if they said
17 tomorrow we're blocking Amazon, because there's an
18 enormous number of consumers that have broadband or
19 narrow band specifically to get to Amazon.

20 And so our question is, is this really a
21 theoretical problem or is it a real problem in which
22 you've had people come and say, you're not going to be
23 allowed to go to Amazon anymore, we're going to do that.
24 I think the trademark law and the dilution law protects
25 somewhat in the Gator instance, but the must-carry

1 rules, I mean we're just not necessarily there yet.

2 MR. CRUZ: And let's Paul go ahead and respond
3 to that real quick and then we'll move on to another
4 question.

5 MR. MISENER: Ted, Tod and I can take a little
6 bit of this offline, but it does create a lot of
7 lingering questions about this issue. This is not
8 must-carry in the sense of cabling companies having to
9 carry certainly programming, it's a traditional FCC
10 regulation requiring the cable companies to carry local
11 broadcast signals. This is a fundamental difference
12 between the Internet and the cable casting world. Cable
13 casting is essentially push. You're pushing out 120
14 channels worth of information.

15 Broadband Internet access, on the other hand, is
16 pull. The consumer is deciding what he or she will pull
17 from the Internet, not from a choice of 120 channels,
18 but from the choice of two, three billion websites.
19 Now, you say, okay, well that's still potentially a
20 burden on cable companies. Well, in a minor way, yes.
21 Okay, we're talking about six megahertz, one channel out
22 of 120. So, do the math, it's less than a percent of
23 their bandwidth, I think they can handle this. This is
24 not a huge burden on cable companies to simply allow
25 their consumers the same broadband access that they

1 would have to some sites, get it to other websites as
2 well.

3 So, is it a real problem? Not yet. But we're
4 in the business of perceiving things before they
5 actually occur. We have seen instances where cable
6 companies have indicated to broadband websites that they
7 may be interested in some form of payment. It's not
8 actually come to the point where they have blocked them
9 or turned them off, but it's the cable companies, the
10 facilities providers, the bottleneck holders, that have
11 already indicated an interest in applying a must-carry
12 kind of regime, but in fact, this is not at all about
13 push, it's all about consumer pull.

14 MR. CRUZ: Okay, let me move on now to a couple
15 of related questions, and let me read them both, and
16 then ask the entire panel to address them. The first
17 one is, removing protectionist state barriers to
18 e-commerce is a laudable goal; however, pure-play
19 e-commerce companies, such as Amazon, have benefited
20 from such patchwork quilts and the lack of a physical
21 nexus to avoid the collection of local sales taxes.
22 Shouldn't this barrier that affects local bricks and
23 mortar merchants also be neutralized to provide a level
24 playing field? This can also apply to eBay. That's
25 question one.

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1 The second and related one, the 21st Amendment
2 Enforcement Act is a rare exception for alcohol sales.
3 In regard to products or services regulated by state
4 laws, how do states exercise jurisdiction for consumer
5 protection over out-of-state sellers who did not
6 specifically target the destination forum?

7 MR. MISENER: Well, I think the first question
8 was addressed to me, and maybe Tod as well. On sales
9 tax, we don't take the position that we should never,
10 ever be forced to collect it. That's not at all our
11 position. In fact, we are working and we have people
12 dedicated to the task of actually ensuring that state
13 sales tax regimes are simplified to the point where the
14 commerce clause no longer precludes states from doing
15 it.

16 This happens to be a constitutional protection.
17 It's one that's designed to protect out-of-state
18 entities. It's been there since the -- well, for 200
19 years. So, we have a circumstance where we're actually
20 trying to work with the states to simplify their tax
21 codes. Right now it just simply isn't possible. There
22 are some 7,500, 7,600 jurisdictions in this country that
23 collect tax, and it's all the way from the state of
24 Texas to some mosquito abatement district in Florida.

25 This is some difficult stuff to deal with. We

1 want to see it simplified. Once it's simplified, we're
2 happy to have that restriction removed such that states
3 could force us to collect the sales tax. Our business
4 model is not at all predicated on the noncollection of
5 sales tax.

6 MR. COHEN: Well, let me agree with that, with
7 Paul on that. Also, a significant issue for us has been
8 that there's a couple of things. One, as an
9 intermediary, and Amazon's used book market and others,
10 also, as intermediaries, we're very concerned about any
11 of the state sales tax models and simplifications that
12 shift the burden to the intermediary rather than the
13 ultimate buyer or seller.

14 And remember, all this is really about states
15 don't want to impose and collect their user taxes. They
16 don't want to -- the use tax is the hard part of this.
17 What we really believe is that if you want to go down
18 the intermediary route, there are lots of other
19 intermediaries that will make this technology neutral,
20 which is the most efficient to collect from a shopping
21 mall would be from the shopping mall owner, since the
22 shopping mall probably bases its rents upon the amount
23 of sales they do each month in the spaces they lease.

24 So, if what we are concerned about is burdens
25 that get placed on the Internet that don't get placed in

1 offline businesses, intermediaries direct sales, also.
2 Remember, also, we have an enormous number of sellers
3 that currently collect state sales taxes, in our entire
4 automobile marketplace, I can assure you that nobody
5 drives that car in the United States until they go and
6 register that car and pay the registration taxes.

7 So, there are a lot of taxes that are already
8 collected. There's also a lot of business on eBay which
9 is offline that is not collected. I don't know how many
10 of you have been to a garage sale and been to Virginia
11 and live in the District, but you are not paying any
12 state sales tax in Virginia for buying that. So, there
13 is also an equity issue across the border.

14 MR. ZUCK: I think that's a significant issue,
15 is that everyone, again, once again, can agree to the
16 search for equality, but at the same time, the online
17 retailer isn't benefitting from the street cleaners and
18 the police protection of their store front windows and
19 things like that that the brick and mortar retailer is.
20 So just exact replication of sales tax to the online
21 world might actually create a different kind of
22 inequality, and so it is a kind of complicated issue, in
23 addition to the complications of having 7,500 different
24 tax jurisdictions that are even different within them.

25 In many states Milky Ways charge differently

1 than a Snickers bar because the peanut content means
2 that it's called food instead of candy and things like
3 that. So, there is a complexity issue, but I think that
4 the equity issue is more complicated than sometimes is
5 presented that a true across-the-board sales tax could
6 invert the inequality that's currently perceived.

7 MR. McCULLAGH: And I think we should be clear
8 that the Internet does have a competitive advantage
9 where online retailers do have this advantage because
10 they don't have to generally collect sales taxes, but
11 there's a reason that this advantage exists. If
12 everything about sales taxes were simple, then the
13 answer would be simple. If every state had a five
14 percent or six percent sales tax, then sure, let's do
15 it, but the tens of thousands of taxing jurisdictions on
16 which tens of thousands regulations make it a lot more
17 difficult an answer to give.

18 MR. CRUZ: Let's shift gears for a moment to the
19 private conduct that we've been discussing, and in
20 particular an example that came up in the prior panel
21 was the FTC's case that was brought a couple of years
22 ago concerning Fair Allocation System which was
23 ultimately settled with a consent decree, where the
24 complaint alleged that a group of Chrysler dealers in
25 the northwest had engaged in a collective boycott

1 against Chrysler or had threatened to engage in a
2 collective boycott in order to dissuade Chrysler from
3 selling cars to another dealer who was selling them at a
4 lower cost over the Internet.

5 And the question I would ask the panel today is,
6 from your experience in the industry, how widespread are
7 private barriers to selling online? And those private
8 barriers could be coming from any of a number of
9 directions. They could be coming from as in the Fair
10 Allocation System case, horizontal efforts by dealers to
11 pressure manufacturers to stay offline.

12 They could be coming from uncoordinated
13 unilateral complaints to manufacturers, but nonetheless
14 pressure that manufacturers are feeling to stay offline,
15 or they could be coming from unilateral decisions by
16 manufacturers that the most efficient way to support
17 their dealers is not to compete by going online. And so
18 what I wanted to get was the perspectives of the panel
19 in terms of how widespread these issues are, and what
20 conduct is and isn't occurring.

21 MR. COHEN: I can give you two examples that I
22 know of that we deal with. Some of our golf club
23 sellers have started to receive letters from golf club
24 manufacturers through pro shops saying that they
25 violated their distribution agreements to resell the

1 items on eBay because it competes with the golf shop
2 pros extra added service in the area. And because I
3 can't quite determine what the consumer protection issue
4 is about a different golf ball, because the golf ball
5 manufacturers have complained, also. That we've
6 determined more and more suddenly a letter will go out
7 to a group of our sellers from a manufacturer, and it
8 will, in many instances, be generated by an article in a
9 trade publication complaining about sales on eBay. So,
10 that's one example we've seen it.

11 There's also a case right now in Massachusetts
12 where a person had his season tickets to the Patriots
13 stripped from him because he chose to sell two games of
14 the season on eBay, and so that's another restriction in
15 which the Patriots do not want anybody to sell the
16 tickets on eBay, even though they sell out every game.
17 That's the type of restriction that we are starting to
18 see more and more of.

19 MR. McCULLAGH: The question, in the case of the
20 golf clubs, were they private individuals selling or
21 businesses selling?

22 MR. COHEN: They're golf pros that we know have
23 been receiving the letters, so the country club golf
24 pro, and in some instances, the golf pro may own the
25 golf shop at the country club, or it may be the country

1 club itself, but in either case, they are in a position
2 where if they lose their supply, they're not able to
3 continue their business. And if you can't sell -- and I
4 don't want to use any names, because I don't have right
5 off the top of my head which manufacturers did this, so
6 I don't want to disparage them on the public record,
7 since I want to continue to play golf, too.

8 MR. ZUCK: I think this came up on a previous
9 panel as well, I think to some extent in the recent
10 years we've had an overemphasis on antitrust enforcement
11 in the case of unilateral activity, but when there's
12 real collusion in a monopoly context, that probably is
13 an area in which there's an opportunity for some
14 oversight either from the FTC or from the Department of
15 Justice, because you do see groups that have a lot of
16 market power to use that market power to then try to
17 prevent new entrants from changing the rules on them.

18 We saw some of that happen in the real estate
19 market, for example, where what happened wasn't an
20 attempt to block online sales of homes, but instead,
21 realizing the efficiency of the online sale, if that
22 makes sense. So, the online retailer decided, well,
23 because we're realizing these efficiencies, we're going
24 to kick back a percentage of the commission. We're
25 going to charge a lower commission, because our cost

1 structure is different.

2 And there was an attempt to prevent that
3 discount by the groups of realtors that were in a
4 position to withhold, for example, the multiple listing
5 service, the MLS, because they were the ones producing
6 it. So, you do have a situation in which you can have
7 private action, which happens in collusion, to prevent a
8 new entrant from even charging a lower price, which
9 again takes the notion of competition and turns it on
10 its head, pretty squarely on its head.

11 MR. MISENER: Ted, we haven't experienced as
12 many, or at least recently, companies or suppliers being
13 reluctant to deal with us. Frankly they see us as a
14 fairly strong and viable channel for them to do
15 business, and we no longer are running up against the
16 we're afraid of the Internet kind of thing. Where we've
17 seen the actions or the concern about the actions of
18 private entities has been the access to our site, which
19 I've discussed in some detail today already, and then
20 also in distribution of the physical goods.

21 After all, most of our business, 99 and several
22 nines worth of our business is in the sale of physical
23 goods, not electronically delivered ones, and therefore
24 our distribution channels are very important to us, and
25 to our customers, and we want to keep those costs as low

1 as possible. We've been concerned about the health of
2 the Postal Service, for example, as a way of actually
3 getting these items out to our customers, and to the
4 extent that the Postal Service suffers, it offers less
5 and less competition to other distributors who are out
6 there, and they number very few.

7 MR. CRUZ: Okay. And let me move on to the
8 final question, which is there's been widespread
9 agreement that the set of issues we are looking at here
10 in this workshop, both the sets of state and local
11 regulations, and the private conduct, there's been
12 widespread agreement that this set of issues is an
13 important issue.

14 So I guess my question is, what can or should be
15 done about it? And let me suggest a number of possible
16 actors to which I would encourage members of the panel
17 to address any or all of them. What can or should be
18 done about them by industry, by consumers, by states and
19 local governments, by Congress, by the FTC, or by anyone
20 else?

21 Let me start with Tod.

22 MR. COHEN: Well, we think that an enormous step
23 was taken by holding the workshop, and we're very
24 pleased with the workshop, because for the first time,
25 sunshine really is a disinfectant and you start to see

1 some of the public comments that have already been
2 received by the FTC, it's much easier to argue these
3 issues if you force the proponents of the oligopolies
4 already in play to make their issues in public and make
5 their claims in public. Either by not attending, or by
6 attending and making pretty ridiculous claims about
7 consumer protection, ones that were given about auto
8 dealers and others. That educational function. That
9 also allows us then to go to state legislators, who it's
10 much easier to say to a state legislator, here's what
11 this is about, it's not really about your fabulous
12 neighbor who puts up the yard sign for you, it's about
13 them trying to make sure that consumers don't get it.

14 We've been working with Net Choice in trying to
15 build the grass roots component. I mean, consumers do
16 care about this. There's no question, North Carolina,
17 for example, did not go ahead and try to regulate all of
18 our sellers in North Carolina, because sellers in North
19 Carolina said, "You're nuts, we're not going to go take
20 a hog calling class before we can sell on eBay." And I
21 wish that was an exaggeration, but it's not.

22 So, and you mentioned Congress, there's a bill
23 in front of Congress, 2421, Chairman Stearns' bill,
24 that's another step in that. More than anything else,
25 publicity is what the opponents don't want to have.

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1 MR. McCULLAGH: Well, too often around here,
2 folks will probably recognize the Federal Government
3 stretches the commerce clause almost beyond recognition
4 or at least takes a creative interpretation of what's in
5 this area improper under it, but this seems to be one of
6 the few really, really obvious times when Congress could
7 step in, and also, this workshop will educate my
8 colleagues in the technology media and let them be able
9 to refer back to the record, look at all the testimony
10 or documents that were posted online, and so I think
11 this is going to serve a very useful purpose in terms of
12 educating the media.

13 MR. MISENER: Well, Ted, thank you.

14 I've suggested two different categories of
15 activities that the policy makers need to be aware of,
16 especially at the federal level. One is those which are
17 substitutes online for offline activities, and it seems
18 to me that the principal area of concerns in there is
19 government regulation, particularly on the state and
20 local level. It seems to me that also federal policy
21 makers at the Commission or working in conjunction with
22 Congress can do a lot to solve those problems through
23 preemption, either by education, or policy, the
24 heightened enforcement policies, or as a last resort,
25 actual legal preemption by Congress.

1 On the other hand, the truly unique kinds of
2 Internet-based activity, such as connectivity, such as
3 the software used to get there, such as the hardware
4 that is the backbone of the Internet, it seems to me is
5 just traditional antitrust competition oversights, and
6 vigilance, if necessary, and that can be accomplished
7 either through oligopoly regulation or ex post
8 enforcement.

9 MR. CRUZ: Jonathan?

10 MR. ZUCK: It seems like a good opportunity,
11 again, to commend the FTC for holding these workshops.
12 I can point to a particular example. Congress was
13 holding a series of hearings on supplier-led e-commerce
14 initiatives that began with a hearing on Orbitz that I
15 testified at, and at that I mentioned that you were
16 planning to hold these workshops, and strangely enough,
17 hearing on the dangers of e-commerce to the middleman
18 cropped up in that very same committee.

19 So, just the notion that the FTC is looking at
20 this I think helps to raise the attentions of it and
21 hopefully helps to head off at the pass these sort of
22 industry bashing specific hearings that might have
23 happened on the other side of things.

24 Again, in addition, the Internet Task Force has
25 been active in doing amicus briefs and articles, et

1 cetera, kind of interventions, if you will, into some of
2 these disputes, and I think it's had some effectiveness
3 there and can continue to have some effectiveness.

4 Obviously, state legislatures need to hear more
5 from their consumers, so we at Net Choice are going to
6 be trying to work hard to make sure that that happens,
7 if they dismantled these vertical restrictions and
8 re-examine the laws that affect the direct sale of
9 goods. Congress should look hard potentially at some
10 preemptive legislation, such as Congressman Stearns has
11 suggested. And then the industry continues to be more
12 awakened and more vocal about this issue, because it
13 will ultimately affect all of us. And consumers need to
14 blow out their candles and let the sun shine in.

15 MR. CRUZ: Okay, terrific, I want to thank all
16 of our panelists for what I think was an excellent and
17 productive discussion, and remark that e-commerce may
18 really produce some efficiencies, since this is actually
19 a government proceeding that's ending on time.

20 We are going to adjourn for lunch and reconvene
21 at 2:00 to begin the first of the industry panels
22 looking at wine sales. I would encourage everyone for
23 lunch, there are restaurants up and down Pennsylvania
24 Avenue, and we also have a cafeteria on the seventh
25 floor, where you're certainly welcome, and I look

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1 forward to seeing everyone at 2:00. Thank you.

2 (Whereupon, at 1:03 p.m., a lunch recess was
3 taken.)

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1 AFTERNOON SESSION

2 (2:00 p.m.)

3 COMMISSIONER SWINDLE: Since we're talking about
4 wine, I guess it's an appropriate story to tell. I'm
5 Orson Swindle, a Commissioner on the Federal Trade
6 Commission. I was giving a lecture series over in Great
7 Britain many years ago, and I was speaking to military
8 units, and I was at the Irish Guard, the people that
9 guard Buckingham Palace, they wear the tall tunics and
10 have the tall bearskin hats.

11 We were having a dining in, and I had been the
12 speaker, but after the dining in -- a formal dinner,
13 with all the funny uniforms and everything, we had a
14 British brigadier who had been with Monty, and he was to
15 be the after-dinner speaker, and as a custom, I learned,
16 they have a series of bottles of port that they pass
17 around, and you stay there until all the port has been
18 consumed. Given this is a wine discussion here and it's
19 in the afternoon when everybody might be a bit sleepy, I
20 ought to be passing port around to keep everybody awake,
21 but we could not find enough free booze nor glasses, but
22 we do welcome you to this session.

23 I'd first like to think Asheesh Agarwal. He put
24 this panel together, and we've got a very distinguished
25 group of people here that are going to participate with

1 us, and I would like to very briefly mention them. I'm
2 sorry we don't have biographies for everyone, but just
3 some procedural things. Each panelist is going to be
4 given three to five minutes to make a short presentation
5 on their points of view. With one minute remaining
6 someone is going to raise a flag, and then when you're
7 one minute over, someone else comes up and grabs you by
8 the throat and drags you off the panel.

9 We'll have a discussion portion, and during that
10 period of time, people here in the audience will be
11 allowed to write questions for the panelists on
12 three-by-five cards, and they will be passed up here to
13 us. For the panelists, if once we get through the
14 presentations and you want to interject a thought, just
15 do like they do over in Europe, raise your little
16 placard. It's good to have you all here with us today,
17 and I think we will have a lively discussion.

18 Very quickly, I am going to run down by the list
19 that I have here and just mention who's here.
20 Unfortunately, we didn't have biographies, but I think
21 on one of the websites there's a link to some of the
22 biographies.

23 Tracy Genesen, Legal Director for the Coalition
24 for Free Trade. Boyden Gray, outside counsel for Wine &
25 Spirits Wholesalers of America. Steven Gross, the

1 Director of State Relations for the Wine Institute.
2 William Hurd, State Solicitor of the Office of Attorney
3 General of Virginia. Dan McFadden, Professor of
4 Economics, Nobel laureate in economics from the
5 University of California at Berkeley, and it's really an
6 honor to have you here with us.

7 Irene Mead, Assistant Attorney General, head of
8 Michigan's Liquor Control Division. Murphy Painter,
9 President of the National Conference of State Liquor
10 Administrators. And David Sloane, President of the
11 American Vintners Association. I'm really interested in
12 watching David work, because he's been on both sides of
13 this argument, and he's been vociferous on both sides.
14 I don't know how you reconcile that, David, in the
15 process of this discussion. I think I got everyone on
16 the list.

17 As I said, I hope this will be a lively
18 discussion. It's certainly an issue that is accompanied
19 by much controversy and contentiousness. We are going
20 to try to focus today, at least I would like to
21 encourage the panelists to focus today, more on a
22 perspective from enhancing consumer welfare rather than
23 the constitutional perspective, which may be difficult
24 for some in the room and the panel to avoid. But, let's
25 try to stick to the enhancing consumer welfare aspects

1 of the issue, more on how restrictions on internet
2 direct sales of wine favorably or unfavorably affect
3 consumers, including the public health issues, and as
4 some would speak of it, temperance.

5 In reading over statements and observing the
6 issue and reading various articles that appear, those
7 who would favor internet sales of wine certainly cite
8 convenience, price, choice, and I guess freedom would be
9 a major part of that. Those against it would cite tax
10 and license revenues, underage drinking, temperance and
11 control. I would expect we would have a few questions
12 on these issues from the audience, and I will throw out
13 a few questions here to get started. We have an hour
14 and 45 minutes. Is that right?

15 MR. AGARWAL: Right.

16 COMMISSIONER SWINDLE: If everyone speaks three
17 to five minutes, there are eight speakers, plus mine,
18 that's nine, that's 45 minutes, we should have an hour
19 of discussion, and the ability of us to do that is going
20 to depend on you staying awake, and if you start to
21 waiver a little bit, we will go get the port and start
22 working that around the room.

23 Why should we treat wine sales differently from
24 other products, such as airline tickets, car rentals,
25 cars, guns or swords? Does a claimed deficiency of the

1 three-tier system really exist? If so, does it outweigh
2 the efficiencies and conveniences for the consumer?
3 What's the impact of that system on price and choice?
4 Do bans on direct sales to consumers really have an
5 impact on prices that consumers pay? Why and why not?
6 Do bans on direct sales to consumers have an impact on
7 consumer choice?

8 Few retailers carry a wide variety of wines.
9 Does banning internet sales diminish consumer choice?
10 Is that diminished consumer choice, if we can assume
11 that's the case, offset by the greater good created by
12 the ban? Why, as some states do, is it possible to
13 protect tax revenues and license revenues and deter
14 underage drinking and promote temperance by allowing
15 internet sales within a state, but prohibit those sales
16 from out-of-state sources?

17 Cannot the same monitoring provisions be
18 applied? What do empirical studies tell us on this
19 debate about price, choice, drinking habits and underage
20 drinking?

21 I'm just curious, I would like for somebody
22 who's really an expert to tell us how many kids opt for
23 wine rather than beer. I know there's been a
24 generational change since I was that age, but I would
25 really be interested in how much consumption is

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1 attributed to underage drinkers. And promoting
2 temperance is often cited as one justification for the
3 ban on internet sales. I was at the Naval Academy's
4 football game with Georgia Tech a year ago, and Georgia
5 Tech is where I went to school, we beat them 77 to 7 if
6 I remember correctly. I was with the Class of '58 as a
7 guest. We went back over, the whole tailgating thing,
8 and they have Naval Academy flags flying that say,
9 "Remember, it's not about football," which I thought was
10 a rather feeble excuse, because I know it is about
11 football, and they just know they're going to lose, so
12 they opted to go with "it's leadership is what it's all
13 about." How much of it is really about temperance?
14 Maybe someone could address that. It's an important
15 issue.

16 With that, Tracy, you're on.

17 MS. GENESEN: It's up to me. Thank you very
18 much. I thank the Commission for this opportunity to
19 speak to you here today. It's a pleasure to be here,
20 and unfortunately I am going to speak about
21 constitutional law here today --

22 COMMISSIONER SWINDLE: I knew we would have one
23 of these. Kick her out. (Laughter).

24 MS. GENESEN: However, I hope to demonstrate how
25 the emerging constitutional law in this area is really

1 intended to benefit consumer choice.

2 I am the Legal Director for the Coalition for
3 Free Trade, a non-profit foundation composed of wine
4 industry representatives and legal experts who are
5 dedicated to using litigation as a means to eliminate
6 state statutory barriers to the free trade of wine.

7 I am speaking here today not just as a lawyer,
8 but also as a small vineyard owner in the Fiddletown
9 Appalachian of Amador County, California.

10 The direct shipping debate, including the
11 internet sale of wine, focuses on the balancing of
12 federal interests in free trade and a competitive
13 economy with state interests. First, I will address the
14 current and emerging status of the law applicable to
15 state bans on direct shipping. Second, I will examine
16 the legitimacy of the states' arguments that their core
17 concerns can only be achieved through the use of
18 discriminatory statutes. Finally, I'll provide a brief
19 update on the progress of the six active lawsuits filed
20 in the federal courts.

21 The question of the constitutionality of state
22 bans on the interstate direct shipment of wine has
23 become increasingly controversial. The Supreme Court
24 has not specifically spoken on direct importation of
25 wine, and the only federal appellate court to do so was

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1 the Seventh Circuit in the Bridenbaugh decision. Court
2 opinions in recent years have varied widely.

3 The Court in Bridenbaugh adopted the view that
4 Section 2 of the 21st Amendment provides nearly plenary
5 power to the states to establish draconian regulatory
6 systems as long as they claim they're doing so to
7 promote temperance, raise revenue and ensure orderly
8 market conditions. These opinions, like Bridenbaugh,
9 view any inequitable results to small wineries or
10 consumers as incidental and inconsequential.

11 However, the second group of opinions
12 illustrated by the most recent district court decisions
13 in Virginia, Texas and North Carolina apply more recent
14 Supreme Court developments in dormant commerce clause
15 analysis. In these opinions, the courts give
16 preeminence to economic discrimination resulting from
17 the state's disparate application of its regulatory
18 scheme to protect local producers from out-of-state
19 competition.

20 This latter interpretation recognizes the modern
21 day distribution impediments facing small wineries and
22 the resulting constriction of consumer choice. These
23 decisions seek to harmonize the relationship between
24 Section 2 of the 21st Amendment and the commerce clause
25 to serve the federal interests and free competition as

1 well as the states' interests to protect the health and
2 welfare of its citizens, raise revenue and maintain
3 orderly market conditions.

4 This more comprehensive recent interpretation
5 highlights the limitations on states' powers under the
6 21st Amendment imposed by the dormant commerce clause.
7 The analysis briefly goes like this:

8 If the Court finds that the effect of this state
9 law facially discriminates against out-of-state
10 producers, then the state examines whether the state's
11 purpose, either explicitly or often implicitly, falls
12 within legitimate nonprotectionist powers of Section 2
13 of the 21st Amendment. If the state can demonstrate
14 that there is no less restrictive means to achieve these
15 core interests, then the statute is saved from being
16 invalidated by the dormant commerce clause.

17 Now, let's examine these core interests that
18 always come up when you talk about states' arguments
19 regarding preventing direct shipping. The position
20 advanced by the State of Florida provides a
21 representative example of the type of argument asserting
22 that a state must discriminate against out-of-state
23 sellers in order to achieve their core interests. The
24 State of Florida has generally defended its
25 discriminatory law as serving those three interests;

1 raising revenue, protecting minors and maintaining an
2 orderly market.

3 Florida does not have to ban direct shipments in
4 order to raise revenue. Like many other states, it can
5 permit direct shipments and require out-of-state
6 wineries to obtain a license or permit to directly ship
7 wine to adult consumers. The license or permit could
8 cover the cost of regulation and could be subject to
9 revocation if appropriate taxes were not paid.

10 Florida then makes the specious argument that
11 direct shipment of wine into the state will lead to a
12 substantial rise in underage drinking. First, juveniles
13 who want to purchase alcoholic beverages do not
14 generally order premium wines over the internet. They
15 find somebody who looks older to go into a retail store
16 and purchase the liquor for them.

17 Second, Florida could require that out-of-state
18 wineries appropriately label their products so that
19 common carriers can require proof of age before
20 delivering wine to a consumer. And finally, some
21 interesting statistics out of the 2002 Pacific Research
22 study, which states, "Where states that allow internet
23 sales of wine, such as New Hampshire and Nebraska, do
24 not show an increase in underage drinking." The study
25 goes on to say that, "New York State, which banned

1 internet sales in 1997, attempted a sting operation in
2 which minors would make illegal transactions over the
3 internet, but before the operation could even get off
4 the ground, the State Attorney General reported that he
5 could not cite a single instance of minors acting on
6 their own --"

7 COMMISSIONER SWINDLE: Tracy, we are going to
8 have to wrap it up.

9 MS. GENESEN: Okay, using the internet. States
10 with permanent reciprocity laws report no significant
11 incidents of illegal internet sales to minors. Lastly,
12 the State of Florida could adopt an efficient
13 administrative system to govern out-of-state direct
14 shipment of wine. Those states that have reciprocity in
15 permit laws have devised such a system.

16 Now, I'll get quickly to the update on the
17 litigation, then I'm done.

18 COMMISSIONER SWINDLE: Excuse me, I think we're
19 well over the five minutes, so we will have to stop, so
20 maybe we can come back to your point later.

21 MS. GENESEN: Okay.

22 COMMISSIONER SWINDLE: Tracy reminds me, I grew
23 up as a Methodist in South Georgia. When you're sitting
24 in front of a Baptist preacher and he gets about 30
25 minutes into his sermon, and he says, "and finally,"

1 don't believe it. She said finally and lastly -- no,
2 thank you very much. We will come back and you can get
3 it in later.

4 MS. GENESEN: Okay.

5 COMMISSIONER SWINDLE: Boyden?

6 MR. GRAY: Commissioner Swindle, thank you very
7 much for the opportunity to participate in this
8 workshop. I don't want to get into the Constitution
9 arguments any more than I think you want me to except to
10 read the 21st Amendment just to remind everybody here
11 about how strongly written and how broadly written it
12 is.

13 It says, "The transportation or importation into
14 any state, territory or possession of the United States
15 for delivery or use therein of intoxicating liquors in
16 violation of the laws thereof is hereby prohibited."
17 This Amendment reflects a long history of difficulty
18 with alcohol in this country, a history that I think is
19 probably well known to everybody.

20 At the bottom, what people are worried about
21 with the three-tier system and this Amendment is direct
22 shipment to minors in ways that can't be monitored, and
23 of course, this doesn't have anything to do with the
24 internet. It long predates the internet. These laws
25 and systems weren't developed to defeat the internet.

1 They were there to defeat unaccountable direct sales and
2 shipments to minors, and they affect all forms of
3 commerce, whether triggered by catalog, direct mail,
4 advertising, subscription or anything else.

5 At the core of this, as you recognized in your
6 opening statement, is temperance and, of course, tax
7 collection to help enforce temperance. Teen-aged
8 drinking is a serious problem in every state, in every
9 high school, in every college. I have a 17-year-old
10 daughter, so I'm perhaps more acutely aware than I might
11 have been a few years ago or perhaps maybe a few years
12 from now. Testimony here that there's no evidence,
13 well, there have been many stings that have been
14 conducted where direct shipments from minors have been
15 implicated.

16 Michigan, recently there were 70 different
17 companies found to be shipping -- over 1000 bottles of
18 wine, 318 bottles of beer and 20 bottles of spirits,
19 many are going to underage buyers. There are other
20 examples like this which I think we will have or will
21 provide to this workshop.

22 I think that, again, to repeat, there's nothing
23 peculiar to the internet about teen-age drinking. Now,
24 I would concede for the purposes of this argument that
25 these teenagers or anybody who is seeking to abuse

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1 alcohol in ways that a state has a legitimate interest
2 in stopping probably aren't going after the \$50 boutique
3 bottle of chardonnay or merlot from a very fine vineyard
4 in California or some other state that might feel
5 slighted by my not mentioning them.

6 There's a feeling in this workshop or at least
7 in the -- not so much in this workshop but in the fight
8 against the 21st Amendment or the laws that are
9 permitted thereunder that wines, fine wine, somehow is
10 not alcohol, it's almost like a work of art, and I will
11 frankly concede that I have had bottles of wine that I
12 would characterize as works of art, but the trouble is
13 there's no way to distinguish between those works of art
14 and ordinary jug wine, which a teenager would, I'm
15 afraid, be happy to get over the internet if it made it
16 easier and bypassing the local retailer who knows who
17 you are and how old you are.

18 Now, does this mean at the end of the day that
19 consumers are really hurt? I don't think so. We have
20 recently conducted a poll which showed quite clearly
21 consumers were happy, 86 percent of those who consume
22 alcohol are satisfied with the selection they have
23 available locally; 85 of those who consume alcohol are
24 satisfied with the convenience of local purchase. That
25 doesn't mean that everybody's happy, but that's a very,

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1 very high approval rating. There is no showing that I
2 know of that the current system is inefficient and that
3 if you have a really good product with demand that it
4 won't be stocked in a local store.

5 Again, I believe that this is in a sense off
6 limits because of the 21st Amendment, but we think that
7 there are very, very compelling arguments which support
8 the laws that exist quite apart from the 21st Amendment.
9 Thank you very much.

10 COMMISSIONER SWINDLE: Thank you very much,
11 Boyden. I was recollecting my time at Georgia Tech, and
12 we thought Falstaff was a work of art. Anybody in here
13 old enough to remember Falstaff? Steven Gross does.

14 Steven?

15 MR. GROSS: Yes, I do.

16 My name's Steve Gross. I'm the state relations
17 manager at the Wine Institute. We represent over 600
18 California wineries and affiliated businesses that
19 produce 80 percent of the wines made in America and 93
20 percent of our exports, and on behalf of all our
21 members, I'm very pleased to be here today.

22 Today's issue is one with which I'm very
23 familiar. Concerns about the laws and regulations that
24 thwart competition in internet wine sales have been a
25 fundamental concern of our membership for decades.

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1 These restrictions impact consumer choice and hurt small
2 family-owned wineries.

3 As early as 1985, the Wine Institute created a
4 subcommittee to look into the issue of
5 direct-to-consumer sales, and I was designated the staff
6 contact on that committee in 1986. That's the cross
7 I've borne ever since.

8 The ability of consumers to have reasonable
9 access to the wines of their choosing has been and will
10 continue to be the foundation of our public policy
11 efforts in this area. We believe that positive changes
12 can be achieved within a regulated marketplace. Rather
13 than simply calling for the elimination of laws, we've
14 worked with state and federal governments to change bad
15 laws and to enhance good laws, both while accommodating
16 the requirements of state regulators and legislators.

17 Perhaps some background here would be helpful.
18 Most wineries begin their business life primarily
19 through the operation of a tasting room. This direct
20 interaction with consumers is key to them beginning to
21 build their brands. A unique aspect of the wine
22 industry is that our tasting rooms have also become
23 tourist destinations, and entire industries have
24 developed around visits to the wine country.
25 Inevitably, this means that consumers from out of state

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1 will begin to seek out ways to purchase more of the
2 wines they've tasted when visiting at the winery.

3 The role of the wine media is also important.
4 An entire niche industry of wine writers exists,
5 publishing in magazines, newspapers, on radio and
6 television, as well as in newsletters, catalogs and now
7 on the internet. These individuals review thousands of
8 wines every year, leading consumers to seek out the
9 wines about which they're reading and hearing. All too
10 often, they find that the wines they wish to sample are
11 not readily available to them where they live.

12 In a 1998 survey of our membership, we found
13 that only 17 percent of our winery members had
14 distribution in all 50 states. That makes for lots of
15 frustrated consumers.

16 It's important to understand what I mean by
17 "readily available." Others argue that the three-tier
18 system will allow for sufficient consumer choice. Our
19 members, however, are regularly contacted by consumers
20 seeking to buy products they can't find locally. Just
21 because a wine is listed by a wholesaler in a particular
22 state doesn't mean the wine is available statewide. For
23 example, a Florida wholesaler may have purchased three
24 cases of a particular wine and sold one case each to
25 restaurants in the Miami area. That doesn't mean that

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1 that wine's available for a consumer seeking it in
2 Tallahassee.

3 Consumers, when they contact the wineries to try
4 and find those wines, get very frustrated when they are
5 told that, yes, we have the wine, it's available for
6 shipping, but we can't ship it to you, because you live
7 in Florida. If you lived in one of 24 other states, it
8 would be legal, but Florida is one of the states where
9 it's not.

10 We feel that a number of state laws and
11 regulations that have developed since the repeal of
12 prohibition are, in fact, protectionist, discriminatory
13 and anti-competitive. The Wine Institute, though, has
14 worked carefully with our membership to craft solutions
15 to some of the more onerous laws without undermining the
16 role of state legislators, regulators, local wholesalers
17 and retailers. It's been our position that we need to
18 augment the three-tier system, not replace it.

19 Examples of some of the provisions that we have
20 found problematic would include the fact that 22 states
21 have passed some form of monopoly protection law that
22 further regulates the contractual relationship between a
23 wine supplier and a wholesaler in a manner more
24 restrictive than other general business contracts.
25 These laws consistently are designed to protect the

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1 interests of the in-state wholesalers.

2 Just this year, the courts and legislature, in
3 turn, struck down the new Illinois Wine and Spirits Fair
4 Dealing Law. These laws limit the number of competitive
5 wholesalers in the marketplace, and in turn, hamper the
6 ability for a winery to find and maintain satisfactory
7 wholesaler representation.

8 Some states, Washington and Missouri, for
9 example, have imposed taxes on all wines, including
10 out-of-state wines that are sold in the state, and these
11 funds are then used exclusively for the preferential
12 marketing and promotion of in-state wineries. Other
13 states have created preferential distribution channels
14 for in-state wines only. Arkansas allows only native
15 wines to be sold in grocery stores, while Virginia
16 allows only Virginia wines to be sold in state liquor
17 stores. All of these elements affect a consumer's
18 choice.

19 We do feel that solutions exist. Twenty-four
20 states have passed legislation that allow for limited
21 direct shipping. We're not here as proponents for an
22 unregulated, unlicensed marketplace; rather, I'm here to
23 say that reasonable accommodations have been made in
24 those states where laws have already been changed. They
25 have been carefully crafted to satisfy local concerns,

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1 some have been more successful than others, however.

2 Wine Institute certainly does not condone the
3 illegal shipping under any circumstances. I feel it's
4 important to point out the difference between illegal
5 and legal shipping actions. Boyden referred to the
6 Michigan stings. These were companies who were already
7 breaking the law by simply shipping into the State of
8 Michigan. To draw a conclusion from their behavior that
9 it's impossible to have a regulated winery cooperation,
10 payment of taxes and orderly licensing and registration
11 in a legal shipping state is unreasonable.

12 Further, Michigan's not an approved direct
13 shipping state for any of the common carriers;
14 therefore, no effort has been made to train drivers on
15 the special handling and proof-of-age requirements used
16 in the legal shipping states. Each major shipping
17 company, UPS, FedEx and DHL, maintains a distinct
18 contract in a set of approved states for those wineries
19 who participate in their legal shipping programs.

20 It's hard in our discussion today to single out
21 a specific separate role for e-commerce, although a few
22 states have already done so. In Minnesota, they
23 specifically excluded internet orders from their
24 reciprocal shipping law. While in contrast,
25 Pennsylvania just this year passed a law that allows for

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1 limited special order direct shipments only when placed
2 over the internet. In most cases, e-commerce simply is
3 grouped in with the other sales mechanisms, such as
4 catalog and phone orders that we've been dealing with
5 over the years.

6 In conclusion, I believe Wine Institute will
7 continue to work with the states and the Federal
8 Government to craft legislation that balances consumer
9 demand for choices and the regulatory requirements that
10 create a safe and orderly marketplace. We believe this
11 is the right path for the future. Seventeen years ago,
12 no state had passed direct shipping legislation. We now
13 have almost half the states on record with some type of
14 curative legislation on the books. Some of the existing
15 laws can be improved, bad laws should be repealed, and
16 ultimately the consumer's the winner. We appreciate any
17 role the FTC might play in helping us to achieve this
18 goal of providing customers with the choices that they
19 desire.

20 COMMISSIONER SWINDLE: Thank you, Steve, and
21 from the Commonwealth of Virginia, Bill Hurd.

22 MR. HURD: Thank you, Commissioner.

23 Tracy indicated that she was here not just as a
24 lawyer but also as the owner of a small vineyard. I am
25 here not just as a lawyer but as a -- I won't say

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1 connoisseur but at least a drinker of wine. Some of
2 it's fine, some of it not so fine.

3 More importantly, though, I'm also here as a
4 father of children who are entering their teenage years
5 and who, as time goes on, will be subjected to the
6 temptation to engage in underage drinking. I'm not
7 going to attempt to steal Irene Mead's thunder, but I
8 will point out that in her prepared remarks, she has
9 presented a persuasive case as to why underage drinking
10 would be exacerbated were direct shipment to be
11 legalized.

12 My friend here to my right, who should have
13 brought some samples with him, fine or not so fine,
14 mentioned that in Virginia, we do have a limitation that
15 our state ABC stores only sell Virginia wine. I'm not
16 sure why he thinks that's a problem. Every retailer has
17 to engage in choices about what niche in the marketplace
18 you will try to make for yourself and what products you
19 will stock. We have 256 ABC stores in Virginia. There
20 are several thousand stores that sell other sorts of
21 wine. If we don't try to compete with them and their
22 sale of California wine, I would think they would be
23 happy about that.

24 The Commissioner has said that one question here
25 is, why should we treat wine differently? The

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1 Commissioner has also asked us not to talk about the
2 Constitution very much. Those are really contradictory
3 requests.

4 COMMISSIONER SWINDLE: Makes it challenging,
5 though, doesn't it?

6 MR. HURD: It's a challenge to which I am not
7 up, and therefore, I will talk about the Constitution
8 just a bit, because since the end of prohibition,
9 Virginia, like almost all states, has placed special
10 controls on the importation, transportation and
11 distribution of alcohol, and we have done so pursuant to
12 the powers given to all the states by the 21st
13 Amendment, an Amendment which created an exception to
14 the normal operation of the commerce clause. Therefore,
15 any discussion about the interstate shipment of wine or
16 any hopes that Steve or others may have for action by
17 the FTC must begin by recognizing that the Federal
18 Government does not have the same jurisdiction with
19 respect to wine that it has with respect to other
20 products.

21 As the Supreme Court noted in a very different
22 case but one that nevertheless is significant here, dual
23 sovereignty is a defining feature of our nation's
24 Constitutional blueprint. They went on to say in
25 another case that the Constitution protects us from our

1 own best intentions. It divides power among sovereigns
2 precisely to we may resist the temptation to concentrate
3 power in one location as an expedient solution to the
4 crisis of the day.

5 Well, the crisis of today appears to be the
6 difficulty in ordering a bottle of wine over the
7 internet, and while some might be at the same time to
8 solve that problem by use of federal power, that
9 solution is permissible only if the Constitution places
10 the power in federal hands, and it does not.

11 Sovereignty has been divided between the Federal
12 Government and the state governments. An allocation of
13 that sovereignty has not always remained the same. For
14 example, with the 14th Amendment, sovereignty was
15 transferred from the states to the Federal Government,
16 and conversely, with the 21st Amendment, the people
17 returned to the states a portion of the power originally
18 surrendered to the Federal Government so that the states
19 could regulate the importation, transportation and
20 distribution of alcoholic beverages within their borders
21 even when those regulations would impose burdens on
22 commerce unacceptable -- otherwise unacceptable, I
23 should say, under the commerce clause.

24 In short, Judge Easterbrook said in a very
25 incisive remark, that the 21st Amendment "empowers

1 states to control alcohol in ways it cannot control
2 cheese." Thus, the FTC, the Federal Government at
3 large, may exercise power on the interstate shipment of
4 cheese or automobiles or contact lenses in ways it
5 simply may not exercise over wine.

6 The bottom line is this, that we have a lot of
7 vineyards out there that produce good wine. Consumer
8 choice is a good thing, and under our present system in
9 Virginia, as in most states, consumers have a wide array
10 of choices, and our door is open for other wines to come
11 in. All they ask is two things -- we ask two things:
12 One, that they comply with our laws, just as other
13 competitors have to comply with our laws, and two, that
14 if those laws are to be changed, that the changes be
15 left to the people of Virginia as the Constitution
16 allows.

17 Thank you.

18 COMMISSIONER SWINDLE: Thank you very much,
19 Bill. Professor McFadden?

20 MR. MCFADDEN: I am an economist appearing on
21 the panel as an individual. I own a small vineyard in
22 the Napa Valley. I sell grapes to large and small
23 wineries, and I'm familiar with the positions taken by
24 many people in the industry; however, my intention here
25 is to speak for consumers, not for the wine business.

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1 My work as a professional economist concentrates
2 primarily on consumer behavior with applications in
3 marketing, health and the environment. I'm not a
4 specialist in the economics of the wine industry.

5 In common with most economists, I believe that
6 consumers benefit from free markets operated with
7 minimum government regulation, the minimum government
8 regulation required for consumers' protection. The
9 history of government regulation to markets is littered
10 with examples of restrictions ostensibly adopted on
11 behalf of consumers that instead protect concentrated
12 economic interests in the end at the consumer's expense.
13 The restrictions on direct purchases of wines I believe
14 are an example of this abuse of the regulatory process.
15 They protect concentrated economic interests. They go
16 far beyond the minimum regulation needed to maintain the
17 integrity of state taxation and the protection of
18 minors.

19 For example, consider a Florida consumer who
20 visits one of the hundreds of small wineries in
21 California and finds in a tasting room a wine he would
22 like to purchase for his own consumption, but that wine
23 is not sold to retailers in Florida. Florida is one of
24 the more extreme of the states that prohibit interstate
25 wine shipments. As a consequence, this buyer cannot

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1 purchase this wine and have it shipped to himself, even
2 though if it were sold inside Florida, it would be legal
3 for him to conduct this transaction, and he would, in
4 any case, be willing to pay the Florida taxes.

5 The winery that he's visiting not only loses the
6 immediate sales to this prospective customer but also
7 loses the opportunity to develop a continuing
8 relationship with the customer through its wine club and
9 other devices.

10 For wineries that produce a few thousand of
11 cases per wine per year with varietals produced in two
12 small lots for national distribution, direct sales to
13 individuals are critical to their operations. The
14 shipping restrictions of states like Florida make a
15 felony of a market transaction that would be completely
16 legal if it were carried out within the Florida state
17 boundaries, and Florida provides no reasonable mechanism
18 for the buyer or the seller to meet the control and tax
19 requirements that Florida imposes on intrastate
20 transactions. Thus, the Florida legislation is a direct
21 attack on interstate commerce.

22 As a general matter, the development of
23 e-commerce has benefitted both producers and consumers,
24 opening markets that were previously not well served by
25 traditional distribution and retail networks. The

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1 experience of the last decade has been that in some
2 areas, this has substantially changed industrial
3 structure. That's true for business-to-business
4 transactions, for parts and things like that.

5 However, the worst fears of traditional
6 distributors and retailers about internet competition
7 have not been realized. In most cases, these
8 traditional market participants provide value added that
9 both producers and consumers value and are willing to
10 pay for, and they remain robust players in the
11 distribution system.

12 My understanding of the wine industry is that
13 where internet or winery purchases and shipments of
14 premium wines have been permitted, this has primarily
15 benefitted consumers by expanding choices and has
16 supplemented rather than replaced traditional
17 distribution channels. For example, in California,
18 which does permit intrastate wine shipments and internet
19 purchases, retailers and distributors seem to be very
20 healthy. That's also the case in Illinois.

21 My guess is that in many cases, the ability of
22 consumers to visit wineries, sample products and arrange
23 one-timer periodic shipments sharpens consumer interest
24 in premium wines. In the end, this increased interest
25 benefits rather than hurts traditional distributors and

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1 retailers.

2 Of course, there's the opposing view, which is
3 that distributors and retailers of alcoholic beverages
4 have, since the passage of the 21st Amendment, acquired
5 a great deal of market power through their influence on
6 the state legislatures. In this view, internet sales
7 and shipments are a serious threat to this market power.
8 If this is true, then clearly the interests of consumers
9 are not being served.

10 However, my suspicion, based on my experience as
11 an economist over many years, is that there's
12 considerably less money at stake than either the
13 distributors and retailers or their critics think.
14 Rents accrued from market power have a tendency to
15 dissipate through entry pressure and through the cost of
16 maintaining the market position. I believe the evidence
17 from states that allow direct sales indicates that
18 distributors and retailers would not be substantially
19 impacted.

20 As one winery owner I interviewed said to me,
21 "My distributor makes me feel powerless, but he does a
22 lot for me, and I value that. I would not do anything
23 to jeopardize the relationship." Similarly, I see the
24 value to consumers of direct wine shipments coming
25 primarily from access to wines that are not available in

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1 their communities. When consumers have retail outlets
2 with the same products, they will usually seek the
3 convenience and value added provided by their local
4 merchant.

5 Premium wine is a product which is clearly not
6 promising for the entry of generic or low price brands
7 distributed by direct shipment. If direct interstate
8 wine shipments were more widely available, I would
9 foresee some competitive pressure on distributors and
10 retailers. I think that would come primarily from
11 direct sales to large retailers, but I see no
12 substantial restructuring of the industry.

13 I find it particularly sad that the
14 anti-interstate shipping legislation that has been
15 passed is so disproportionate in its negative impact on
16 consumers relative to what I believe is a very modest
17 degree of protection that it provides to traditional
18 distributors and retailers.

19 COMMISSIONER SWINDLE: Dr. McFadden, can you
20 summarize here?

21 MR. MCFADDEN: Okay, let me just say one last
22 thing.

23 If the only issues were that of controlling
24 access of alcoholic beverages to minors and handling
25 taxation, there are direct ways to handle that which are

1 reasonable and proportionate. One way is through sales
2 arrangements that states make with wineries. Within a
3 reasonably regulated market, an alternative might emerge
4 that would be even more attractive for wine producers
5 and consumers.

6 Specialized shippers might take on the
7 responsibility of licensing shipment to the various
8 states and meeting state control and tax requirements.
9 States that authorize such shippers might find them
10 useful, in fact, for collecting taxes for other products
11 as well. Because alcoholic beverage distributors are
12 already experienced with interstate wine shipments, they
13 are well positioned to take the lead in providing such
14 shipping services. I believe that the shipping to wine
15 distributors instead of opposing free trade should get
16 with the program and do well by doing good.

17 I urge the FTC to look closely at the state
18 legislation that goes beyond the minimum regulation
19 needed to meet legitimate state concerns on control and
20 taxation of alcoholic beverages. I urge them to combat
21 the use of the 21st Amendment as a cover for a tax on
22 interstate commerce.

23 COMMISSIONER SWINDLE: Thank you, Dr. McFadden.
24 Irene?

25 MS. MEAD: Good afternoon. I have remarks that

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1 are on the website, and I am not going to read them all,
2 because it would take me way too much time, but I do
3 want to talk about Michigan's actual enforcement
4 experience and to touch on some things, because I think
5 I want to dispel a few myths about direct shipping.

6 The first thing is that this is a new problem.
7 It's not. Michigan's laws that prohibit direct shipping
8 have been on the books since prohibition was revealed.
9 In most states, that's the case as well.

10 Secondly, there is not a single state right now
11 that has unlimited shipping into their state. Even the
12 reciprocal states at best permit two cases per month, so
13 that there are limits placed there. It's not free
14 trade, as such.

15 The third thing is, it's not really an
16 e-commerce issue. What we're really talking about is a
17 form of smuggling. Prior to e-commerce, it was small --
18 I call it like I see them. You talk catalog sales, you
19 talk phone things. What got Michigan really going was a
20 few years back, there was a 17-year-old at an alcohol
21 rehab center, and he wrote a letter to a distillery and
22 wanted a case of their whiskeys, and they sent it to
23 him, and he got it at the distillery. So, he thought
24 this was great, so he wrote another letter to the
25 distillery saying, oh, the bottles were cracked, and he

1 got a replacement case. And at that point, it was
2 intercepted by an adult.

3 The problem with the numbers that people or the
4 issue about minors and counting minors and finding
5 minors is the same issue that's come up with bricks and
6 mortar. Minors do not report themselves so that they
7 can get a misdemeanor conviction. People who sell
8 illegally to minors do not report themselves. When
9 you're talking bricks and mortar sales, you find out
10 about these kinds of things because you find a kid in a
11 ditch. They're dead, they've hit somebody, this kind of
12 thing. Or maybe you're lucky enough to catch them
13 leaving a bar.

14 The same thing is true with the internet.
15 You're not going to find them reporting themselves. You
16 don't find that. The only way you'll really get a
17 handle on whether or not there are sales to minors going
18 on is through the controlled buy purchases. You use an
19 underage person. They may go in, they attempt to make a
20 buy. If they're successful, then you go forward against
21 the licensed establishment if you're within the state.

22 The same kind of thing was what Michigan decided
23 to do with respect to internet sellers, and what we did
24 was we set up a minor with a credit card, and about
25 one-third of the sites visited would sell. The other

1 two-thirds, some didn't ship to Michigan because they
2 knew Michigan did not permit that, and some didn't
3 because once they got the age in, and the minor put the
4 actual age in, they didn't complete the sale.

5 However, on the other sites, at best, you had to
6 click a button. "Click here if you're 21." Well, any
7 of you who have had any experience with underage people
8 trying to make a purchase know that a "click if you're
9 21" isn't going to get anywhere. Then we had UPS
10 deliver all of the purchases, and at best, when there
11 was a sticker saying, "adult signature required," they
12 would make sure that the person was 18. They did not
13 make sure that the person was 21, even where it was
14 identified as an alcohol product.

15 One of the sites was internetwines.com out of
16 Illinois. This is a person, when we went and charged
17 them with a misdemeanor sale to a minor, got very angry,
18 said he only dealt with upscale wines and this kind of
19 thing and they would never ever do business in Michigan
20 again, which was really what we were looking for.

21 However, while we were still proceeding with
22 this misdemeanor, they sent our minor a follow-up
23 saying, were you satisfied with your purchase? Would
24 you like to purchase again? So, he said sure. So, he
25 again purchased from them. So, we had two sales to

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1 them.

2 On this website, which -- oh, by the way, the
3 bottles of fine wine that were purchased were blackberry
4 wine. The first one was \$6.85, and the second one was I
5 think \$6.66. I don't really probably classify that as a
6 fine wine in my perspective, but maybe for the minor it
7 was.

8 However, they also have other things that
9 they're selling at the same website. I would invite you
10 to go there. At the time that we made the purchases,
11 there was an entire webpage that was devoted to grain
12 alcohol, ranging from 192 proof to 194, and if you
13 bought enough, they would suspend all their shipping
14 charges. So you get the frat -- first, go and check out
15 where you can buy the grain alcohol. Then you go and
16 you do the general internet search under grain alcohol,
17 and you come up with all of these wonderful recipes for
18 frat parties. They all begin, "you get a clean garbage
19 pail," and you put in your grain alcohol, about three or
20 four bottles, and then you cut it with cough medicine,
21 and then you add cottage cheese. These things are
22 really, really disgusting. The comments about them is,
23 yeah you drink one drink and you're out until Tuesday.

24 That appeals to minors. They think this is
25 really cool. So, there is this deal with minors, and

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1 you will not find the sales to minors without doing
2 stings, and stings on internet sites are very expensive
3 to do. We did about 3500 complaints on in-state
4 retailers in Michigan, about half of which were based on
5 underage sales. We have got a rate of underage sales
6 right now that's down to 20 percent. The 33 and a third
7 percent is what we have got on the internet sellers.
8 They don't have the same incentives. We can't take
9 their license. They don't have the same incentives not
10 to sell.

11 COMMISSIONER SWINDLE: Irene, we are going to
12 have to stop and come back.

13 MS. MEAD: Okay. Murphy Painter.

14 MR. PAINTER: My name is Murphy Painter, and I'm
15 the Commissioner of Alcohol and Tobacco Control in the
16 Louisiana Department of Revenue. I come here today
17 representing the Joint Committee of the States, which is
18 composed of two organizations and make up the two
19 different ways alcohol is presently regulated in the
20 United States.

21 The 18 control states that both sell and
22 regulate alcoholic beverages are represented by the
23 National Alcohol Beverage Control Association and the
24 National Conference of State Liquor Administrators
25 represents the 32 licensed or open states.

1 To start this dialogue, I want to call attention
2 to the one fact about wine that makes it different from
3 all other commodities that will be discussed in the next
4 three days, that difference being it is an alcoholic
5 beverage. In addition, none of the other commodities
6 and services being discussed here have been the subject
7 of a constitutional amendment that acts to restrict the
8 free flow of interstate commerce into the commodity or
9 service.

10 The 21st Amendment is explicit as to the
11 individual state's right to regulate alcohol. Section 1
12 of the Amendment repeals the 18th Amendment, which
13 establishes prohibition. Section 2 reads, "The
14 transportation or importation into any state, territory
15 or possession of the United States for delivery or use
16 therein of intoxicating liquor is in violation of the
17 laws thereof and is hereby prohibited."

18 Section 3, which gave the Federal Government
19 concurrent power to regulate, was deleted.
20 Accessibility to markets and consumers, the very thing
21 that out-of-state wineries, wholesalers and retailers
22 are fighting over on this issue is at the heart of the
23 21st Amendment and all of the acts and regulations that
24 exist today. Temperance, a word not often heard since
25 the death of Carry Nation, means moderation or

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1 abstinence. Where alcohol is permitted, the law demands
2 moderation. Where the people have voted to exclude
3 alcohol, they want total abstinence.

4 We regulators, as enforcers of the second tier
5 of a three-tiered federalist governmental system must
6 maintain that taxes are being paid, that access, both
7 temperances access and underage access, is enforced, and
8 that the duly needed fair trade laws of each state be
9 enforced to maintain a level playing field, but also to
10 maintain temperance.

11 We also argue that this is being done not only
12 through the authority of the 21st Amendment, but also
13 through the core police powers that are given to the
14 states by the Constitution to maintain the health,
15 safety and welfare of our citizens.

16 The ones here today to argue for e-commerce of
17 wine and direct shipping of such, because you can't have
18 one without the other, would want the FTC to look at
19 wine in a different light than beer and spirits. Even
20 though it may be arguable that wine's value is different
21 than beer and spirits, it is still an alcoholic
22 beverage, and unfortunately, when abused, an
23 intoxicating liquor, and as such, each state has the
24 right under the authority of the 21st Amendment to
25 regulate this product. This means to its exclusion if

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1 voted by local option.

2 I'm not a lawyer and will not try to cite cases
3 that make this stance stronger, nor am I an economist
4 and attempt to explain all the fundamentals about supply
5 and demand. Sources reflect that the number of wineries
6 in the United States has grown from approximately 900 in
7 the 1980s to over 2500 today; however, Wine Institute
8 data shows consumption in the United States being less
9 in 2000 than in peak years in the 1980s.

10 As a regulator representing every state
11 regulator of alcohol in the United States today that has
12 to take a stance on what others, that being state courts
13 and legislatures, have deemed to be worthwhile and
14 correct for the state that each of us represent. We are
15 charged with holding the line until the dynamic forces
16 of economics and politics create organized and lawful
17 change by legislative process.

18 Does the three-tier system limit online sales?
19 That answer is absolutely. Is this justified? That
20 answer is absolutely, also. As long as wine is
21 classified as an intoxicating commodity, it will have to
22 stand along with beer and spirits. If wine is exempt
23 from individual state regulation, then so is beer and
24 spirits.

25 Are there less restrictive means for achieving

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1 the same goals? The political and economic forces have
2 combined in some states to allow some sort of limited
3 access to wines. Louisiana is one state that passed a
4 direct shipping legislation in 1998. Fiscal year
5 2001-2002, ending June, last June, showed only \$1,700 of
6 taxes paid by this process versus approximately \$130
7 million paid through the tiered system. Only 20
8 out-of-state wineries out of the 2500-plus in the United
9 States and only four out-of-state retailers out of
10 hundreds of thousands chose to utilize this process.
11 This should be a good indicator of the demand.

12 Statistically, the present system is one of the
13 most efficient tax collection systems, if not the most
14 efficient, in existence today. It certainly is the most
15 efficient system as far as temperance. One only has to
16 look at the 15-year grand experience from 1919 to 1933
17 to prove that. We regulators, as duly appointed
18 gatekeepers of our individual state statutes, pledge to
19 continue to effect the police power granted to the
20 states to protect the public health, safety and morals
21 of our individual citizens that has been the norm since
22 1933.

23 I thank you for the opportunity to speak today.

24 COMMISSIONER SWINDLE: Thank you very much,
25 Murphy. David Sloane.

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1 MR. SLOANE: I also very much appreciate the
2 opportunity to be here today and thank you for holding
3 this hearing. I think it's a very important opportunity
4 for people to get some issues out on the table.

5 I am David Sloane, president of the American
6 Vintners Association, a national trade association of
7 650 mostly small wineries in 48 states. 2600 of the
8 more than 2700 wineries in the U.S. today face a market
9 access crisis. This is the result of a requirement in
10 most states that out-of-state wineries sell only through
11 licensed in-state wholesalers.

12 However, wholesalers generally do not wish to
13 enter into relationships with small wineries because
14 they lack the production capacity and the demand of
15 larger national wine brands. It's the ultimate catch-22
16 for small wineries.

17 As a consequence of this policy disconnect, the
18 vast majority of America's wineries are effectively shut
19 out of the commercial mainstream unless they have some
20 alternative means for getting their products into the
21 stream of commerce. That alternative market mechanism
22 is for states to allow wineries to ship limited
23 quantities of wine directly to consumers either in
24 intrastate or interstate commerce. A majority of
25 states, including Michigan, allow intrastate shipping,

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1 and 24 permit out-of-state wineries to sell directly to
2 consumers within their borders. This is a rational
3 solution to the market access conundrum facing small
4 wineries. Taxes are paid, where required, and to the
5 best of our knowledge, there have been no prosecutions
6 involving the internet sale of wine to minors.

7 However, wholesalers are strongly opposed to
8 direct shipment and have used their considerable
9 political influence in many state legislatures to
10 prevent the establishment of this critical alternative
11 market mechanism. Thanks to their lobbying efforts,
12 interstate shipment is a felony in seven states and a
13 misdemeanor in another 18.

14 Another factor which contributes to the market
15 access crisis for small wineries has to do with the
16 three-tier system itself. Wholesalers have not limited
17 their lobbying efforts to preventing direct shipment.
18 They have also waged highly successful campaigns in many
19 states to raise the bar on wholesaler entry, secure
20 franchise protection and to obtain exclusive
21 territories, all of which make the three-tier system an
22 increasingly monopolistic, inefficient and risky place
23 for small wineries to do business, to say nothing of
24 what the implications for consumers may be.

25 If you then factor in the implications of

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1 wholesaler consolidation, many markets are now down to
2 only two wholesalers, and the lack of alternative market
3 mechanisms, you begin to see how small wineries face a
4 genuine restraint of trade in certain markets.

5 As the federal agency tasked with safeguarding
6 competition and preventing unfair marketing practices,
7 we urge the Commission to commence a market-by-market
8 investigation of the liquor wholesale industry. This
9 situation deserves and demands your urgent and prompt
10 scrutiny.

11 We can all agree that alcohol is responsible for
12 many social ills and that its control is a necessary
13 function of government; however, there is no evidence to
14 suggest that the direct shipment of wine has contributed
15 to any of these ills. If underage access and tax
16 evasion were such serious concerns, why do a majority of
17 states permit the intrastate shipment of wine? Why do
18 24 states permit the interstate shipment of wine? It's
19 because underage access and tax evasion are largely red
20 herrings manufactured by wholesalers to discourage
21 direct shipment. Make no mistake about it, this fight
22 is about economics and economic protectionism primarily,
23 not about whether citizens can adequately -- whether
24 states can adequately protect their citizens against the
25 evils of alcohol.

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1 The threshold for state regulation, especially
2 when it involves shutting down commerce with other
3 states, needs to be higher than a simple showing that it
4 is possible for kids to obtain alcohol via the internet.
5 Knowing that such sales are possible is not the same as
6 having proof that they are actually occurring. In
7 reading Attorney General Mead's statement, I found it
8 interesting that no attempt was made to determine if any
9 of the 174 out-of-state alcohol shipments recently
10 seized by Michigan authorities were ordered by minors.
11 That I don't think would have been so difficult to
12 determine. General Mead's staff meticulously identified
13 what was in each of these statements, where they came
14 from and who sent them but apparently stopped short of
15 examining the most relevant question of the day, were
16 any of these products ordered by minors? Perhaps the
17 state did go that extra step, but the results were
18 omitted because they don't support what the General's
19 position is.

20 If Michigan has reservations about allowing
21 interstate shipping, it already permits intrastate
22 shipments. The state should take comfort in knowing
23 that a federal law was added to the books two years ago
24 that will help ensure that unlicensed, out-of-state
25 suppliers comply with their alcohol control laws. The

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1 21st Amendment Enforcement Act, which the Michigan
2 Attorney General supported, I believe, gives states
3 access to federal injunctive relief to hold remote
4 sellers accountable for their indiscretions.

5 Michigan should -- in closing, I should say --
6 should also take comfort in knowing that the Federal
7 Government has very recently endorsed the concept of
8 direct shipment in a law that's bound for the
9 President's desk to essentially reduce the burdens based
10 on the airline travel business of all of those carry-on
11 packages that people bring back with them from trips to
12 wine country. They will now be able to ship those back
13 to their homes, and the Federal Government seemed to
14 think that there were enough safeguards in place for
15 that to happen.

16 So, thank you.

17 COMMISSIONER SWINDLE: Thank you very much,
18 David. Excellent points of combat I think everybody has
19 pretty well staked out. Can any of you be listed as
20 uncommitted at this point in time, or undecided I guess?

21 David Sloane threw out several provocative
22 statements, and I think I'd like to start with those in
23 the interest of continuing the dialogue, and I would
24 like to ask anyone to weigh in. I would like to spend a
25 minimum time talking, but three points that I picked up,

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1 he certainly questioned the Michigan capture of large
2 amounts of product and questioned whether any of that
3 was from minors. I would like for Irene perhaps to have
4 a chance immediately here to respond to the particular
5 question, but David suggested that it's all about
6 economics and market power and very little to do with --
7 and I shouldn't put words in your mouth -- but it's not
8 really about temperance. The 21st Amendment, I think it
9 has pretty well been established here in the opinions of
10 some, that it is there, I think -- I forget who said it,
11 but it was suggested that it had to do with helping to
12 manage the morals of our people and avoid underage
13 drinking.

14 MR. AGARWAL: That was Murphy.

15 COMMISSIONER SWINDLE: Was that Murphy? Is the
16 21st Amendment really about that and is it really
17 relevant? There are some here who would say it's
18 extraordinarily relevant and some say it's not so
19 relevant. Another point that David brought up, if
20 intrastate commerce via the internet is permissible and
21 it's managed and it supports the temperance movement,
22 it's controllable, it's taxable, why couldn't the same
23 rules that apply to that be applied to interstate?

24 But first, on the Michigan question, any minors
25 in that group of people?

1 MS. MEAD: We aren't sure. What we would do is
2 when we got a shipment in, we sent a letter out to the
3 shipper and also to the minor -- well, to the intended
4 recipient. Sometimes it was a gift going, and what we
5 asked -- in both cases, we advised that it was illegal
6 to ship into Michigan interstate, and we asked them to
7 fill out a survey and respond.

8 When people filled out a survey, they generally
9 responded that they were of age. We had about half the
10 people that did that respond and -- would not respond.
11 In the cases of those that did respond, about half of
12 them indicated that their age was never checked, either
13 as a recipient of a gift or if they were ordering for
14 themselves.

15 We also ended up having about 65 percent of the
16 commercial shipments, which is not like, you know, a
17 cousin shipping to sister or to another cousin, that
18 kind of thing, 65 percent of the commercial shipments
19 were actually from alcohol retailers. They weren't from
20 wineries. The biggest problem is really from people who
21 are out there, the Sam's Wines & Liquors out of Chicago,
22 that kind of group who want to ship everything in, and
23 we did have tequilas and we had whiskeys and we had gins
24 and we had beers. We had some home brew beer that had
25 the caps from a major beer manufacturer put on their

1 beers. We had wines that -- I talked about the
2 blackberry. We had elderberry, we had choke cherry. We
3 had some very fine wines but some that I'm not sure
4 you'd want to touch. We have eye of newt wine, that was
5 my favorite, but it came from everywhere, and it didn't
6 include just wines. As I say, we had a lot of wine, but
7 we had a lot of other stuff as well, and 65 percent are
8 retailers. They're not wineries. So, it's not limited
9 to that.

10 COMMISSIONER SWINDLE: Well, we haven't solved
11 the problem with underage drinking customers. I may
12 have missed the point initially, but did you have many
13 underage drinking customers in that cache of
14 illegally --

15 MS. MEAD: We couldn't tell, because about 50
16 percent refused to respond to us. We took on the
17 intercept of these shipments as an additional level of
18 work for our office, and we have eight attorneys, which
19 is now going down to four after some budget cuts, that
20 do everything in state -- I mean, every kind of
21 complaint and charge and that sort of thing. So, we did
22 what we could with what we got.

23 COMMISSIONER SWINDLE: Well, you mentioned some
24 retailers were ordering and a number of other products
25 showed up in the orders. For those who are supportive

1 of wine being sold over the internet, I would pose a
2 question, and again I encourage you to challenge each
3 other, should wine be treated differently from spirits
4 or beer?

5 MR. GROSS: If I could maybe dive in on that
6 one, in the 24 states where we've passed legislation to
7 allow for direct shipping, each state legislature has
8 chosen what products they were going to include in
9 the -- what they legally allowed. There's two states,
10 New Hampshire and North Dakota have chosen to expand
11 more broadly than just wine. The other 22 states that
12 have passed legislation are wine only states, but that's
13 a decision that's up to the state legislatures when they
14 deal with this issue to make the choice of what products
15 they're going to include.

16 In Murphy's state, in Louisiana, they chose to
17 deal only with wines, but one of the unique things they
18 chose to do was to allow only wines from wineries that
19 aren't doing business in the State of Louisiana. So, in
20 that case, they've chosen to make an additional
21 distinction that you can apply for and receive a permit,
22 but you have to choose whether or not you want to be a
23 winery who's in the three-tier system or a winery that
24 is totally a direct shipping winery into the state.
25 They didn't allow for both.

1 I think those kinds of distinctions make for
2 differences in the number of wineries that would be
3 participating in the state or not, but the legislature
4 in each state ultimately has the decision-making power
5 to decide which products are going to be included when
6 they do pass direct shipping legislation.

7 MR. HURD: I would add one --

8 COMMISSIONER SWINDLE: Go ahead.

9 MR. HURD: -- just one brief point, that the
10 21st Amendment does not contain any wine codicil to it.

11 MR. GRAY: I said it earlier, but I think that
12 you can't assume that minors aren't interested in wine,
13 especially the sort of wine cooler type drink that's
14 very, very popular today, the sherry wines, the
15 raspberry wines or whatever. I am perfectly willing to
16 admit that a Petrus from France is not likely to get
17 ordered, it's too expensive, but I don't know how you
18 limit these kinds of sales to the wines that they're not
19 likely to order.

20 On the other question, I think there are other
21 stings other states have engaged in which show quite
22 clearly sales to minors, and I'm told -- I don't know
23 this firsthand -- that Governor Janklow of South Dakota
24 vetoed a direct shipping bill after learning that a
25 minor in his own office had ordered wine online using a

1 credit card. I know it's anecdotal, but we don't have
2 statistics on people reporting that they're violating
3 the law, self-reporting.

4 COMMISSIONER SWINDLE: From those who advocate
5 the sale of wine on the internet, some have suggested
6 that there are suitable systems -- I heard it repeated
7 just a minute ago -- they do it in state and they manage
8 to hold onto the age criteria and restrictions. Do you
9 have any information as to how successful that is? Is
10 it working? Are they finding a lot of minors?

11 MR. SLOANE: You mean in terms of the intrastate
12 shipment of wine? Certainly --

13 COMMISSIONER SWINDLE: Right. Are they managing
14 to circumvent the restrictions and checks?

15 MR. SLOANE: That I wouldn't be able to answer,
16 but I can certainly suggest to you that it's an ongoing
17 business in 20-some states, including Michigan and
18 including Virginia -- I think in Virginia as well.

19 COMMISSIONER SWINDLE: How is it --

20 MR. SLOANE: So --

21 MR. HURD: Sure, I can address that. We in
22 Virginia allow our farm wineries to have manufacturer's
23 licenses, also wholesale and retail licenses, so that
24 they are able to engage in direct shipment to customers
25 within the state, but there's an important difference

1 between in-state licensed farm wineries engaging in that
2 kind of activity and out-of-state wineries engaging in
3 that kind of activity.

4 To understand that, you've got to step back and
5 look at the basic structure of the three-tiered system.
6 It is a closed loop. Part of the whole purpose of the
7 ABC law is to make sure that alcohol is not diverted
8 outside of the closed loop. The Virginia wineries are
9 part of that loop. Direct shipment by out-of-state
10 wineries to Virginia consumers would be outside of that
11 loop.

12 Now, when a Virginia farm winery ships in state,
13 it darn well better make sure that it's not shipping to
14 someone who is underage, and it darn well better make
15 sure that the taxes are paid, because the ABC agents in
16 Virginia can walk into that winery and see its records,
17 and if there is some violation of the law, they stand to
18 be put out of business, and that creates a powerful
19 incentive for compliance that simply does not exist and
20 cannot be made to exist for out-of-state wineries.

21 There are thousands of them, all over the
22 country. They are far away from us. We can't go check
23 on their records. Our laws don't reach them nearly as
24 easily as they do for in-state wineries. And so, if
25 they were permitted to ship directly into the state, it

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1 would be very, very difficult to ensure compliance.

2 And I would ask this question in terms of our
3 economist here, if you could figure out what it would
4 take to make out-of-state enforcement as rigorous as
5 in-state enforcement is, and if you charged the
6 out-of-state wineries with the cost of that out-of-state
7 enforcement, what would be the effect, and wouldn't it
8 really price these out-of-state shipments out of the
9 market?

10 MR. SLOANE: Could I respond? I know you asked
11 for the economist, but I'd just like to make one or two
12 points there.

13 First of all, by allowing a remote sale at all,
14 you are not actually, in fact, keeping your little
15 closed loop scenario that you talk about with the
16 three-tier system. It's no longer a face-to-face
17 transaction. You are placing some significant faith in
18 that supplier, that they will, in fact, abide by the
19 laws, and the presence of a license can change -- you
20 can change that dynamic very easily.

21 Let me just read you something. Here is a --
22 what the Florida District -- Federal District Court
23 judge had to say about the law down there, and he ruled
24 against us in the decision on the 21st Amendment and the
25 direct shipping statute there. He says, "Although the

1 proffered justifications for the statutory scheme are
2 clearly legitimate, these purposes can adequately be
3 served by reasonably nondiscriminatory alternatives.
4 For instance, Florida could license and regulate
5 out-of-state wineries that wish to ship wine directly to
6 Florida consumers through a licensing process similar to
7 that employed with in-state wineries." What a novel
8 concept.

9 MR. HURD: Well, the judge, with all due
10 respect, is simply incorrect. If you are in Virginia,
11 you cannot regulate California the way you regulate
12 Culpeper County. It's impossible.

13 COMMISSIONER SWINDLE: Dr. McFadden?

14 MR. MCFADDEN: Yes, well, I'll respond to the
15 request for an economist's opinion. What about the
16 impact of allowing direct shipping with full control,
17 that is, so that every state regulation intrastate would
18 also be applied interstate? What would be the
19 consequences?

20 First of all, I think that could be done. It
21 was mentioned that it's hard to control thousands of
22 out-of-state wineries. It would be relatively easy to
23 control a relatively small market of a few dozen
24 interstate shippers that are authorized by the states to
25 ship into their states and instructed to meet all

1 regulations.

2 Would this completely kill the market? Would it
3 drive this business away? I believe that it is not a
4 huge market. What you have is a small number of
5 consumers who feel considerably disadvantaged and
6 exercised by these unreasonable restrictions. I do not
7 believe that overall it would have any great impact on
8 the broad market.

9 COMMISSIONER SWINDLE: A question from the
10 audience here, and I'll ask that --

11 MS. MEAD: Can I comment still on that one?

12 COMMISSIONER SWINDLE: Oh, I'm sorry, go ahead.

13 MS. MEAD: I have two points to make, and one
14 was going back to the underage drinking, there are some
15 statistics that I provide from the National Council on
16 Alcohol and Drug Abuse. Alcohol abuse is the leading
17 cause of death for 15 to 20-year-olds, and 11 percent of
18 all alcohol is consumed by underage drink customers.
19 Thirty-five percent of all wine coolers are purchased
20 and consumed by middle schoolers, junior high and high
21 schoolers, that this is accessible.

22 I also point out in there the websites that
23 people, winebrats, some of these. The wine industry,
24 there was a discussion here about the wine industry
25 being somewhat static in terms of sales, but there is an

1 overabundance right now of some types of grapes and
2 things, such as chardonnay. We found that whenever
3 there's that kind of pressure on a market, people try
4 and expand the market, and the place to go is to get new
5 drink customers, and so there are a lot of efforts, and
6 they are in the remarks, about getting underage people
7 interested in wine.

8 Secondly, with respect, again, to being able to
9 go out and enforce, right now there are estimates
10 between 2500 and 2800 wineries in the United States. I
11 read a statistic in USA Today that every 20 days there's
12 a new winery in Washington State. You add to that the
13 many, many retailers out there, which are thousands and
14 thousands and thousands more, which you would also have
15 to regulate in the same way, and then you go outside of
16 the United States, because we've had shipments in from
17 Australia and South Africa, too. It's simply -- you
18 simply can't do it within any state's budget.

19 Thank you.

20 COMMISSIONER SWINDLE: Just a comment on this,
21 and I do want to shift to another one, but you're
22 talking about the high percentage of underage drinkers
23 and the problems that alcohol has created. We have lots
24 of laws that say you can't do that, and yet it continues
25 to go on. I'm not sure that a law prohibiting the sale

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1 of this wine on the internet does not somewhat fall in
2 that category, that even though we have laws, it still
3 goes on, but let me pose a question to Tracy and Dr.
4 McFadden.

5 Since you're in the business of wine making, and
6 I think this may be not appropriate here, but -- because
7 Dr. McFadden said you grow grapes which you sell to
8 wineries as opposed to making wine yourself, is that
9 correct --

10 MS. GENESEN: And the same with me.

11 COMMISSIONER SWINDLE: So the question was, how
12 many wholesalers have you approached to market your
13 wines? How many have refused? I don't think that
14 question is appropriate, but I did want to raise it --
15 unless you choose to answer that question just as a
16 hypothetical.

17 MS. GENESEN: Not applicable right now.

18 MR. MCFADDEN: Let me try to answer, because I
19 interviewed a number of winery owners, small winery
20 owners, in preparation for this, and the pattern, what
21 they described, was that they typically can get a
22 distributor for their main wines, but they also produce
23 little specialized wines that they sell at the winery.
24 The biggest problem that the small wineries have is the
25 30 percent of their production that's in small lots,

1 that is not picked up by their regular distributor.

2 COMMISSIONER SWINDLE: This sort of leads into
3 the next question, it's for David Sloane and Steve
4 Gross.

5 If market access is really the issue, why have
6 wineries not utilized the offers by wholesalers and
7 retailers to get their products to consumers via special
8 order procedures? Did I make that question clear?

9 MR. GROSS: Well, I think what that's referring
10 to is there were companies and are companies that have
11 put together a program whereby they sell products via
12 internet sales or catalogs, whatever, that in states
13 that don't allow for direct shipping but that allow for
14 intrastate shipping. The requirement there is that the
15 products have to be available through the three-tier
16 system in that state.

17 In order for most of those systems to work, you
18 have to have a wholesaler in the state into which the
19 product is being shipped before the product can be
20 listed as one of the products available, and the same
21 issues we outlined before about the difficulties for
22 some of the smaller producers finding wholesale
23 representation would apply there.

24 There are companies that are now starting to
25 come up with new regulations or new procedures that

1 allow for you to apply for a special label that you
2 would then go to ATF, get a special label approval for
3 a -- kind of like a duplicate label, but it would just
4 say this is an offering of Steve's Wine Club in addition
5 to your normal label language that would then be offered
6 for sale in that state through a special handling
7 provision, but those are cumbersome. They haven't yet
8 proven to be effective.

9 There was a lot of focus on some of these
10 three-tier-compliant e-commerce models. The companies
11 that started them started, failed, were purchased,
12 started, failed, some of them haven't come to fruition
13 yet. So while there is perhaps potential there, they
14 certainly haven't proven themselves to be an answer to
15 all segments of the industry. They serve a small
16 percentage of it, but it doesn't handle everything.

17 COMMISSIONER SWINDLE: David, and then I want to
18 come back to Tracy, because I think I forgot to let you
19 make your comment.

20 MR. SLOANE: The only thing I would say is I
21 would be less than candid if I said that wineries would
22 not like to capture the retailer and the wholesaler
23 margin, where possible, which is one of the reasons why
24 they don't like to go through their systems, they
25 actually want to try to make a little bit of money on it

1 while they can. It's very expensive to work through the
2 three-tier system, adds about 33 percent to the cost of
3 doing business, if not more.

4 COMMISSIONER SWINDLE: Tracy?

5 MS. GENESEN: I just wanted to address the
6 feasibility of one state enforcing regulations on an
7 out-of-state producer selling wine into that original
8 state, and I think the most instructive thing is to look
9 at the reciprocity states, and have they had a lot of
10 problems in collecting taxes and underage sales to
11 minors? And if you take California as an example, the
12 ABC commissioner there has been on record in front of
13 the state legislature as saying that there have been no
14 significant problems with the reciprocity statute in
15 that state. So, you look at the experience of those who
16 are trying to regulate out of their territory and see
17 how it's working, and none of those reciprocity statutes
18 have been repealed.

19 You can imagine if there was a huge surge in
20 underage drinking, the groups that would be storming the
21 state legislature to get these statutes repealed, and
22 that has not happened.

23 COMMISSIONER SWINDLE: Related to that, and I
24 will address this to Bill Hurd for a comment, you
25 contend that it would be virtually impossible to control

1 the interstate commerce and the things that you would
2 need to do in terms of temperance, public health, taxes
3 and so forth.

4 How do you feel -- and this is an argument
5 that's somewhat related but yet apart from this -- there
6 has been a huge debate over the last several years about
7 taxing electronic commerce. There has been a great hue
8 and cry from Main Street, USA saying we're being
9 disadvantaged because people on the internet do not have
10 to pay sales tax. How would you comment regarding the
11 Commonwealth's ability to tax T-shirts from LL Bean?
12 And I'm really pleased to know that LL Bean is one of
13 the smugglers. I always did suspect them, but anyway,
14 there's a lot of e-commerce going on. Do we object to
15 e-commerce because we can't tax it? Should we tax it?

16 MR. HURD: Well, that's the -- I'm sure
17 arguments for and against taxing e-commerce, I know
18 there was a moratorium on that kind of taxation that may
19 or may not have expired or I'm not sure.

20 COMMISSIONER SWINDLE: I think it's been renewed
21 if I remember correctly.

22 MR. HURD: In any event, the motivation behind
23 that moratorium was to increase the free flow of
24 commerce among the states by making it easier to engage
25 in e-commerce. Whatever arguments may be marshalled in

1 favor of that kind of position is really trumped by the
2 concerns that underlie the 21st Amendment and by the
3 power that the states have under the 21st Amendment that
4 make alcohol very different than everything else and
5 certainly very different than T-shirts from LL Bean.

6 MR. SLOANE: Can I make a comment?

7 MR. GRAY: Just a quick comment, that question,
8 the assumption that this is a homogenous United States
9 in terms of cultural reaction and history about the role
10 that alcohol plays or has played. It just differs from
11 state to state and region to region. I grew up in the
12 south when if you gave a cocktail party, as my parents
13 would occasionally do, so you had to have two sittings,
14 there would be the Baptist sitting and then there would
15 be everybody else, and that's changed now somewhat, but
16 there's a long history here which you just can't ignore,
17 and it's different. This is not a national rule.

18 MR. SLOANE: Can I just mention one thing? We
19 actually have an extraordinary opportunity here that may
20 be somewhat out of the normal play book. You do have
21 the Commissioner of New Hampshire here today, who may or
22 may not care to talk about it, who has created a system
23 in their state for allowing direct shipment and for
24 trying to license out-of-state enterprises. I don't
25 know whether he would care to edify us on whether or not

1 that seems possible.

2 COMMISSIONER SWINDLE: Sure, I have no objection
3 to anyone having an opinion. Please stand up.

4 MR. BYRNE: For the record, my name is John
5 Byrne. I'm chairman of New Hampshire's Liquor
6 Commission, and thanks to Steve Gross. We did pass a
7 law four or five years ago allowing direct shipping of
8 alcoholic products into the State of New Hampshire, and
9 I think what I would say is that it was important that
10 we pass the law. It was important that New Hampshire's
11 Legislature decided how we were going to handle
12 alcoholic beverages, and that's why we support Murphy
13 Painter and why we support the 21st Amendment.

14 If Virginia wishes not to do it, then that's
15 Virginia's decision. Now, our experience in New
16 Hampshire has been that it is not a lot of commerce --

17 COMMISSIONER SWINDLE: It is not what? I'm
18 sorry.

19 MR. BYRNE: It is not a lot of commerce. Last
20 year, we did about \$350 million in sales of alcoholic
21 beverages, \$155 million of that was in wine. In our
22 direct shipping, we did about \$2 million in wine direct
23 shipped into the state.

24 When I look at the product that's shipped into
25 the state, it is not hard-to-get wine. It is generic

1 wine. It is wine that is table wine that you could go
2 down to the local grocery store and buy. What we have
3 are consumers who just like to buy over the internet.
4 They pay a huge increase in the cost for the product for
5 the convenience to be able to buy, but we as the State
6 of New Hampshire has allowed that for our consumers. If
7 other states wish to do that, they should. If other
8 states wish not to do that by the 21st Amendment, then
9 they should have the right not to do that.

10 COMMISSIONER SWINDLE: All right, just
11 mentioning the price, if I may. Out of curiosity, I
12 went on a couple of internet sites, and I found the
13 wines that I saw on those particular sites to be wines,
14 most of which I'd never heard of, but they were not
15 inexpensive, I might add. It seemed like a different
16 quality wine, at least by price, a different quality,
17 but have others experienced the same thing, that the
18 wines are generally speaking more expensive?

19 MR. BYRNE: Not in New Hampshire. One of the
20 biggest wines we had direct shipped in was Mondavi
21 Coastal.

22 COMMISSIONER SWINDLE: And that cost the
23 purchaser more?

24 MR. BYRNE: That goes for about \$9.

25 COMMISSIONER SWINDLE: What did it cost on the

1 internet?

2 MR. BYRNE: They paid \$9 plus 8 percent tax to
3 the State of New Hampshire plus federal shipping
4 charges, which was \$46 a case.

5 COMMISSIONER SWINDLE: Okay, thank you very
6 much.

7 MR. MCFADDEN: I just wanted to make one comment
8 relative to New Hampshire. One of the vineyard owners
9 that I talked to said -- I asked him what he did. He
10 said, well, I spent the \$200 and got a license to ship
11 to New Hampshire. I sold two cases of wine in a year.
12 So, I'm no longer shipping to New Hampshire. I think
13 that it illustrates one point, and that is that even
14 though I don't think \$200 is an unreasonable amount of
15 money, it is certainly cutting out probably hundreds of
16 small wineries who would not be able to ship --

17 COMMISSIONER SWINDLE: This could be reinforcing
18 Orson Wells saying, "No wine before its time," quickly.

19 MR. BYRNE: Unfortunately, Professor McFadden,
20 that is old law. We've changed that law about a year
21 and a half ago. There is no longer a fee.

22 MR. MCFADDEN: Okay, thank you.

23 MR. BYRNE: The process is very expedited, and
24 we have sent out over a thousand applications to
25 wineries, and only 142 wineries have permits to direct

1 ship, but there is no longer a \$200 fee.

2 MR. MCFADDEN: I'll pass that information along
3 to this winery.

4 COMMISSIONER SWINDLE: Steve Gross and then
5 Irene.

6 MR. GROSS: You asked another part of the
7 question, and David picked on John Byrne before I was
8 going to, so you are going to get double-dipped, but I
9 did want to touch on the point of the taxation, because
10 you had asked about that and about whether you could tax
11 these transactions.

12 The wine industry, unlike most of the other
13 retailers that have been arguing against the taxation,
14 has, in fact, said we will embrace any kind of scheme
15 that would require the payment of taxation if we can
16 simply get access to the markets. Our model legislation
17 that we've introduced in multiple states has included a
18 collection of tax.

19 COMMISSIONER SWINDLE: So, if they're willing to
20 be taxed --

21 MR. GROSS: They are willing.

22 COMMISSIONER SWINDLE: -- then they should also
23 be willing to have age verified by the same system that
24 seems to work intrastate that is not seemingly
25 applicable to interstate. Is that correct?

1 MR. GROSS: Well, we think that the system is
2 there. If you have a state with legal and above-board
3 direct shipping in the state, what you are going to have
4 is it's going to be recognized by the common carriers as
5 one of their legal interstate shipping states. When
6 that is the case, they require at the time of pickup
7 that the packages coming out of the winery has to
8 contain a sticker that says, "Contains alcohol, adult
9 signature over 21 required," and there's another step
10 which is in those legal states, the drivers are trained
11 on the special handling that's required for those
12 packages. You can't leave the package without a
13 signature. You can't do certain procedures, and that's
14 the reason that some shipping companies have chosen not
15 to do business in certain states but that, at Wine
16 Institute, we have an ongoing contract with Federal
17 Express for our members, and they're required to sign a
18 contract saying I will only do business in these
19 approved states, and if they were to ship a shipment to
20 an illegal state and are caught by FedEx doing that,
21 they're removed from the shipping program, and the cost
22 to them for doing that is they lose the discount that
23 they get, which is over 40 percent.

24 COMMISSIONER SWINDLE: Well, what I'm hearing, I
25 think, is that there's a possibility of setting up a

1 scheme in which -- probably not a good word to use --
2 but a scheme in which we can assure taxation.

3 MR. GROSS: We'll accept a scheme.

4 COMMISSIONER SWINDLE: -- we can assure delivery
5 and we can assure age verification.

6 Yes, Irene.

7 MS. MEAD: I was going to comment, first off,
8 Michigan is rated as one of the top ten for doing
9 business in e-commerce, and we do have a lot of people
10 that do business. Most of Michigan, the wine sold in
11 Michigan, is from other states.

12 Also, there have been several real successful
13 ones. Wine.com actually was taking orders, and then
14 they would work through a retailer, so they could work
15 within the three-tiered system. E-vineyards brought
16 them out. They had a different kind of a plan. What
17 they do is they actually set up and comply with each
18 state's laws and then make things available.

19 Michigan has no charge for registration. The
20 cost of tax on a bottle of wine, the excise tax is 10
21 cents for a 750 milliliter bottle. It's not that it's
22 prohibitive. Michigan has very liberal out-of-state
23 seller of wine licenses that can hold a bunch of
24 boutique wineries, but we have had a lot of experience
25 or a lot of wholesalers that come to us and tell us that

1 even though we have a product locator, even though there
2 are efforts made to obtain wines, bring them in, that a
3 lot of the small wineries, for business reasons and for
4 marketing, will not agree to work with a wholesaler
5 because they want their wine to have a certain cache,
6 that it's only available from the winery. So, I see
7 that as a marketing decision and not a prohibition
8 against wine coming into the state.

9 We also have had, in terms of identifying,
10 though, and getting the shipments checked, we have had a
11 winery out of California that we have had real problems
12 with. They package their bottles up in -- go to a
13 freight forwarder and tell them they're shipping
14 computer parts, and we have had a number of real
15 deceptive kinds of things like that. Whenever we've had
16 somebody who just really didn't know, we cooperate with
17 them and we have had a number of people who then joined
18 the system. So, it's not prohibited. Out-of-state
19 wines can come in. We just want them to do it within
20 the system Michigan set up.

21 COMMISSIONER SWINDLE: This question is to --
22 oh, I'm sorry, go ahead, David. The question is going
23 to be to you anyway, but go ahead.

24 MR. SLOANE: Oh, good. I just wanted to mention
25 one thing that I didn't mention here today but that's

1 included in our written statement. I do think the
2 Federal Trade Commission has an opportunity to work with
3 Congress and develop a statute that will help to provide
4 guidance to the courts and to the states for determining
5 the acceptability of opportunities when states choose to
6 interfere with interstate commerce, and I threw out the
7 Central Hudson Gas & Electric v. Public Service
8 Commission case, a Supreme Court case, it was actually a
9 First Amendment case action but offered three tests that
10 I thought would be very, very suitable to trying to
11 judge and to get to this whole question of when
12 something is really an acceptable barrier or not, and if
13 I could just take two seconds.

14 The test basically requires, one, the
15 demonstration of a substantial state interest; two, a
16 showing that the regulation or law in question directly
17 advances that governmental interest; and three, that
18 such measure is not more extensive than necessary to
19 serve the state interest. I think that kind of
20 legislation -- it's generic, it doesn't use the heavy
21 hand of preemption, it would provide a lot of important
22 guidance, particularly now that the internet has taken
23 off. I think it would be a useful thing, and I think it
24 would be a service that you folks could perform in
25 helping the Congress pass something like that.

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1 COMMISSIONER SWINDLE: It would be -- in keeping
2 with the nature of the question -- I'll get to you,
3 Boyden.

4 The question is, how does a bill introduced
5 without debate into a conference report become a
6 decision by the Federal Government that direct shipping
7 is appropriate?

8 MR. SLOANE: It happens. This is Congress.

9 COMMISSIONER SWINDLE: Like pork barrel
10 spending.

11 Boyden?

12 MR. GRAY: I just wanted to get back to a couple
13 points that have been made, when wineshopper.com was
14 operating, the vast majority of orders -- this is for
15 sales through a legitimate chain -- were for low to
16 medium-priced wines that were brand name, that were
17 available retail everywhere anyway. What I don't know
18 and what I'd like to know is why -- is the sense that
19 for the really special kind of wine, and I've heard
20 about them, you can only get them when you're in
21 California, they don't make them available, many of them
22 don't want to make them available retail. They could.
23 There are some wines that are so good you would snap
24 them up immediately if you get your hands on them, so
25 they are rationed, but for something really -- by the

1 producers in California or in some of the other states,
2 Washington State. Where there's a will, there's a way.
3 There's something I know, that friends of mine, that
4 say, oh, I really want to get this wine, they go to one
5 of their -- McArthur Liquor or whatever in the city, and
6 they can get the wine for you. Is it going to be more
7 expensive? Well, probably not any more expensive than
8 it would be if everything were totally changed, because
9 the commerce that would be represented from everything
10 that I'm hearing and from what I know about
11 wineshopper.com is that the amount involved is going to
12 be very, very, very small, and why can't that be
13 accommodated in the current system? I just don't
14 understand it. It is now.

15 COMMISSIONER SWINDLE: Boyden, you mentioned in
16 your comments earlier, I believe, that surveys or some
17 type of analysis indicated that people, by a very large
18 percentage, were quite satisfied with the way things are
19 today. I love books, and I'm sure most in here love
20 books, and I like to buy books, and I love book stores,
21 but I'm finding a delight in being able to order those
22 books over the internet. Why should the fact that
23 people are satisfied with the way things are in any way
24 deter them from being more satisfied by a change? I
25 look at the internet as being a tool for doing things

1 easier and better and more convenient. Is that
2 sufficient reason not to advocate the sale of wine over
3 the internet?

4 MR. GRAY: Well, I certainly want to encourage
5 my daughter to read as much as she can possibly read,
6 but I certainly don't want to encourage her to drink as
7 much as she can drink.

8 COMMISSIONER SWINDLE: Okay. For Dr.
9 McFadden --

10 MS. MEAD: I like that.

11 COMMISSIONER SWINDLE: Don't send her down to
12 Georgia Tech.

13 Dr. McFadden, are you aware of any studies that
14 examine the impact, if any, that direct sale bans on the
15 internet have on the price consumers pay for wine?

16 MR. MCFADDEN: No, I don't know of any specific
17 studies. One can look at the retail prices in states
18 that have direct shipments versus the ones that don't.
19 As far as I'm aware, but this is casual, there is no
20 discernible difference.

21 And as far as I know, most wineries that ship
22 direct ship at the retail price. They have
23 distributors. They don't want to cross their
24 distributors by undercutting the prices through the
25 traditional network.

1 COMMISSIONER SWINDLE: That's market power,
2 right?

3 Yes, Murphy.

4 MR. PAINTER: I'm hesitant to mention this new
5 area, but I think something that needs to be said, that
6 all of us states, most of us, have a minimum markup on
7 product to start with, and that's part of temperance.
8 The price is supposed to be for taxation reasons and to
9 keep consumer's choice, because if you don't limit the
10 price some kind of way, and this is from a historical
11 perspective, then you leave those people out completely,
12 and you are going to limit the choices that you are
13 going to have if some minimum price is not maintained.

14 COMMISSIONER SWINDLE: The minimum or -- some
15 minimum/maximum price. In other words, you're trying to
16 use price as a deterrence to drinking?

17 MR. PAINTER: That's the theory.

18 COMMISSIONER SWINDLE: I think we tried that in
19 cigarettes and it didn't work very well.

20 MR. PAINTER: Well, it's -- I mean --

21 COMMISSIONER SWINDLE: Anything that's
22 addictive, you know, I think I'm correct in this --

23 MR. PAINTER: The temperance of the three-tier
24 system is the control of the manufacture of the retail
25 and the wholesale tier for basically the same reason. I

1 would think probably it would take an hour or two to
2 talk about that, and that's why I was hesitant to bring
3 it up, but it is part of the temperance of the fair
4 trade laws that exist in each state and a reason for the
5 three-tiered system.

6 COMMISSIONER SWINDLE: From an economist's
7 standpoint, does cost deter use of a substance such as
8 wine, and I guess we could go over and say gasoline when
9 people feel they have to drive to go to work, et cetera?

10 MR. MCFADDEN: Well, it does, yes, and I don't
11 think there's any question that consumption is reduced
12 if it's taxed and the prices are higher.

13 Unfortunately -- well, fortunately or unfortunately,
14 premium wines are probably the least sensitive to that,
15 because they are being paid for by high income people
16 who are looking for the particular quality of the
17 product.

18 COMMISSIONER SWINDLE: Here's a question.
19 States routinely regulate out-of-state companies in all
20 industries, that is, licenses, registered agents, et
21 cetera. I do not see why state regulation of
22 out-of-state wine companies is impossible in this
23 context. The states still could require licenses and
24 the production records in state.

25 From the state standpoint, how difficult is

1 that?

2 MR. HURD: Well, I think we're talking about two
3 different things. It's one thing to say that if Ford
4 Motor Company is going to do business in Virginia, that
5 they have to have a registered agent and that sort of
6 thing, but we don't send our inspectors to Ford Motor
7 Company plants in Detroit to see what they're doing up
8 there, and yet what we would be forced to do here, if
9 we're to impose upon out-of-state wineries the same kind
10 of oversight we have for in-state wineries is to send
11 inspectors out to California to go through their records
12 and see what exactly they did sell to Virginia and
13 whether or not they have truly paid the tax on
14 everything and see what precautions they took about not
15 selling to underage people.

16 That really is terribly, terribly burdensome,
17 and if you were to think about what it would cost the
18 state to do that and you were to distribute that cost
19 over what our economist has said is really a very small
20 demand pool, the price would go through the roof. So,
21 the real solution here seems to me to lie in taking
22 advantage of the internet and trying to integrate it
23 with the three-tiered system. Wineshopper.com may be
24 not the only way to go, but rather than trying to beat
25 down the door of the 21st Amendment, perhaps more

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1 conversations between the wholesalers and the winery
2 associations ought to be held.

3 COMMISSIONER SWINDLE: The wine and liquor
4 distributorships in Virginia are highly regulated. The
5 distributors, retailers, wholesalers and I guess
6 producers all have to report to the state of Virginia, I
7 would presume, about their activities. Why not
8 reciprocity? Because I would assume they do the same
9 thing in every other state. Why can't regulations send
10 an inspector to Gallo Wines? Why not reciprocity with
11 the State of California to exchange information?

12 MR. HURD: Well, reciprocity is an idea that
13 some have suggested would be a solution to some of these
14 problems and is one that the General Assembly of
15 Virginia may well look at in the coming year. The
16 fundamental point that I want to make today is that that
17 is a decision that Virginia must make, and one of the
18 great things about our country and our federal system is
19 that we are a laboratory of states, and it may well be
20 that something out there tried somewhere in some other
21 state has worked well enough to persuade Virginia that
22 we ought to adopt it, but that's not to say that we must
23 and not to say that there aren't certain important
24 trade-offs that Virginia might have to make in adopting
25 that kind of system.

1 COMMISSIONER SWINDLE: When we say a decision,
2 we just shifted away from the solution, which could be
3 reciprocity, and if we're arguing about how do we do
4 this, that's one thing, and then the other thing is
5 decision, and that gets back to the culture and the
6 difference in different states. I certainly respect
7 that point of view, as I think the gentleman from New
8 Hampshire was speaking of, that it's Virginia's choice
9 not to do this. But then, we come back to the consumers
10 and whether or not these rules, regulations, laws,
11 prohibitions are a positive impact on consumers or a
12 negative impact on consumers.

13 MR. HURD: Well, I think that no one is simply a
14 wine drinker. We are all also taxpayers. We're all
15 members of a democracy that believes in self-government.
16 We all have people, members of our family or others in
17 our community that we're concerned about, the effect of
18 underage drinking. So, I think it's impossible to
19 segregate it out, people, and say, well, how does it
20 affect you as a drinker of wine?

21 The more important question, the larger question
22 is, how does it affect all of the interests that each of
23 us have and that are reflected through the laws that our
24 general assemblies and state legislatures pass?

25 COMMISSIONER SWINDLE: Steve?

1 MR. GROSS: I just want to add one thing. You
2 were talking at the outset where Mr. Hurd was saying
3 that the ability to track the industry is impossible and
4 would be entirely too expensive. I would disagree with
5 that, and the fact that all states right now, within
6 their three-tier system, require that every supplier
7 shipping into the state provide some form of accounting
8 of everything that you've shipped into the wholesaler
9 that you use in that state. Some states require copies
10 of the invoices. Some states simply require a report.
11 In theory, they have a three-point check that most
12 states coordinate. They look at the report filed by the
13 wholesaler, the report filed by the manufacturer, and
14 also the report filed by the transporting company, the
15 bill of lading or whatever that moved it into the state.

16 Similar structures to that are what are being
17 used in states like New Hampshire or others that are
18 requiring the people that are doing direct shipments,
19 that have applied for and received permits, to file a
20 monthly report or an annual report, it varies by state,
21 that lists these are the people to whom I sold, these
22 are the quantities which I shipped, and this is the
23 amount of tax which I owe you.

24 In most states, they've also got the double
25 check of being able to check the report that's filed

1 with them by the common carrier, such as FedEx, that
2 says, these are the shipments that came from the winery
3 into the state. Not every state has chosen to do that,
4 but a number of states require that as part of their
5 statute. The common carriers file a report with the
6 state saying these are the wine shipments that were
7 shipped into private individuals. If a state looks down
8 and says, gee, there's 50 things coming in from this
9 winery but they're not registered and I don't see them,
10 there's the ability there for people to go after them.

11 So there are means that are available to
12 regulators in order to track this which are not that
13 different than what they're already requiring for the
14 traditional three-tier system sales that are going
15 through.

16 COMMISSIONER SWINDLE: Here's a double question
17 from the same person, because I recognize the
18 handwriting, but it's for Dr. McFadden.

19 You concede the market is small. Therefore, if
20 the FTC is concerned with the average consumer, who is
21 satisfied with the selection, as was mentioned by
22 Boyden, why should the FTC get involved?

23 MR. MCFADDEN: Well, it's a small cut, perhaps,
24 to the consumer to have these wine shipments banned.
25 It's, after all, an elite that drink premium wines, but

1 it's one of a thousand cuts, and I think there's a
2 simple general economic principle that should be applied
3 here, which is that if there's not a good reason to
4 restrict a consumer's choice, why should government do
5 it? If there is a way to provide the control the
6 government needs to place on a market without
7 restricting consumer choice, why not do it?

8 COMMISSIONER SWINDLE: We've got about five
9 minutes left on this panel, and who -- somebody --

10 MR. AGARWAL: Tracy.

11 COMMISSIONER SWINDLE: Tracy? Okay, you're the
12 first one to go. You've got 40 seconds.

13 MS. GENESEN: Oh, my gosh.

14 I just wanted to make one brief point, though,
15 on consumer choice. I think it's important to note that
16 the primary impetus for these lawsuits being filed in
17 federal court were disgruntled consumers in those states
18 where there were complete restrictions on the
19 out-of-state importation of wine, and it was those
20 consumers who pushed into federal court because they
21 were not able to move through the massive wholesaler
22 lobbying efforts in those states. So --

23 COMMISSIONER SWINDLE: So, you're in effect
24 saying the masses may be satisfied, but some consumers,
25 and we are a country of individuals, are not happy, and

1 they would like to see it change, and therefore, they
2 consider this restriction a slap in their face?

3 MS. GENESEN: Exactly.

4 COMMISSIONER SWINDLE: Boyden?

5 MR. GRAY: I think consumers are by and large
6 very pleased. There may be a handful of people who are
7 frustrated in trying to get the really, really good
8 wines. I think if they work hard enough, they can get
9 them. To make it easier by throwing over everything I
10 think would just open up too much abuse, too much
11 opportunity for abuse by underage drinkers, and states
12 have a legitimate right, especially under the 21st
13 Amendment, to take steps to protect against that. The
14 risks aren't so high.

15 COMMISSIONER SWINDLE: Steve?

16 MR. GROSS: Well, I think our position is that
17 there are means available to us to come up with creative
18 solutions that allow for consumers to the choice that
19 they want to have that allow for an orderly and
20 regulated marketplace to exist. And that by making
21 these changes, we don't have to undermine the existing
22 three-tier system. We can simply augment it, and in
23 that way, I think everyone is better served, including
24 those consumers who choose to seek out product that's
25 currently not available to them.

1 COMMISSIONER SWINDLE: Bill?

2 MR. HURD: One of the ideas put forth today was
3 that Congress pass a law that would impose upon wine
4 sales, a rule much like Central Hudson has in free
5 speech cases, was imposed by the Supreme Court. Well,
6 the U.S. Constitution draws a distinction between the
7 freedom to speak and the freedom to drink, and I don't
8 think that Congress has the power to say otherwise.

9 COMMISSIONER SWINDLE: Dr. McFadden?

10 MR. MCFADDEN: Within the legitimate interests
11 of states regulating a flow of commodities, there is a
12 broad interest of consumers in the use of e-commerce and
13 internet and interstate shipment of goods as a way of
14 making the economic distribution system more efficient,
15 providing consumers with more choices. I do not think
16 that wine should be an exception to the target of making
17 the whole system work better.

18 MS. MEAD: I think that in most states that have
19 restrictions on direct shipping, it still is possible
20 for a responsible producer of wine to be able to sell in
21 that state within the system.

22 However, if you permit unfettered direct
23 shipping, you have no control, because you have no point
24 where the alcohol is coming to rest where the state can
25 exercise that. So, all the irresponsible people, all

1 the people who are making the various bizarre things,
2 will ship anyway, and you will have all of that coming
3 in, and you are also going to have the spirits and
4 everything else, because once you open it and alcohol is
5 permitted to be shipped interstate, you can't
6 distinguish it for practical purposes. Thanks.

7 MR. PAINTER: I want to echo my colleague from
8 New Hampshire and say that our position as state
9 regulators is that each state has its own choice of
10 choosing, and it's a legislative and political process
11 that we go through on the state level to make that
12 happen. What Mr. Gross is alleging, too, has happened
13 in our state, and I explained what the demand was there
14 and that it is pretty inconsequential at this particular
15 point, but it's still there and available.

16 The only other remark I'd like to make is that
17 it's not fair, also, to our state retailers or
18 wholesalers to pay fees and licenses for the
19 infrastructure, the Government of Louisiana and for some
20 out-of-state person not to come under some form of that
21 same regulation.

22 MR. SLOANE: I appreciate the opportunity to
23 have been here. The Central Hudson legislation I was
24 talking about would not be unique to wine, it would be
25 for everything. I think the generic nature of it is

1 what makes it a useful thing. I understand your point.

2 The one thought I'd like to leave you with is
3 that in a survey of Chicago, a very robust market
4 recently, today, there are some 25,000 wine labels in
5 domestic commerce, domestic wine labels. 500 were
6 available in Chicago during a recent survey, which
7 basically says about 2 percent of what's actually being
8 produced was available to consumers there.

9 Consumers need options and choices. Wineries
10 need ways to make that kind of commerce work. If the
11 three-tier system is not going to do it, it just seems
12 like a reasonable thing, lots of states have done it
13 successfully, so...

14 COMMISSIONER SWINDLE: Well, I thank you all for
15 a very interesting discussion. Obviously, the 21st
16 Amendment did not leave the table. I am always
17 concerned with our tendency sometimes to have laws that
18 affect the outliers when the bulk of us are getting
19 along just fine, but we come up with laws that affect us
20 all while trying to get to the outliers. I've learned
21 something here at the Federal Trade Commission in
22 antitrust. Never are the benefits proclaimed or the
23 harms bemoaned equal to the volume of what those who
24 would cry in either direction would say. So, I'm not
25 sure that all the bad things are as bad as they are or

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1 all the good things are as good as promised. Obviously,
2 the debate will continue. Back to the question to
3 David, how does legislation get passed? Obviously, the
4 lobbying will continue, the debate will go on, and
5 probably the least heard group of people in the whole
6 debate is probably the consumers.

7 Thank you very much for being with us.

8 (A brief recess was taken.)

9 MR. ELLIG: Okay, we'll go ahead and get
10 started. We'll go ahead and get started.

11 One of the reasons we hold these kind of
12 workshops is to educate ourselves about some issues and
13 find out what's going on out there, and I think it's
14 particularly appropriate to say that on a panel like
15 this, not just because the subject is education, and so
16 we educate ourselves, but also because this is a topic
17 where the FTC traditionally has not been as involved as
18 some of the other topics that we're dealing with in this
19 workshop, and yet, as we were putting the workshop
20 together, we realized that we were hitting a lot of the
21 major areas that are either important to the household
22 budget or important to the future economic success of a
23 household, automobiles, health care, mortgages, housing,
24 and it just seemed appropriate to deal with education as
25 well, because it's just so darn important to most

1 families and most consumers. So, that was kind of our
2 rationale for trying to take a look at some of the
3 e-commerce issues related to education.

4 As with the other panels, we'll start -- we have
5 everybody seated alphabetically again?

6 MR. AGARWAL: Yes.

7 MR. ELLIG: I see the backs of everybody's name
8 cards but not the front. We'll start and run through
9 alphabetically, give everybody a chance for about three
10 to five minutes to make some opening statements, and
11 then actually Asheesh and I will both be asking some
12 questions, and as previously, folks in the audience are
13 welcome to write questions on cards and send them on up,
14 and I'd ask each panelist to introduce yourself as we
15 start.

16 MR. BAILEY: Thank you. My name is John Bailey.
17 I'm the director of educational technology for the U.S.
18 Department of Education, and it's my pleasure to be with
19 you today to share a little bit about what the
20 Secretary, Secretary Paige, and the administration
21 believe in terms of cyber charter schools and virtual
22 schooling.

23 I applaud the FTC for making the effort to
24 explore the issues involving possible anti-competitive
25 efforts to restrict competition on the internet, in this

1 case cyber charter schools. This is also a topic of
2 great interest and concern for Secretary Paige, who
3 believes that e-learning is just one of many educational
4 options that should be available for students. This
5 belief was born out of his ten years as Superintendent
6 of the Houston Independent School District, where he
7 created the nation's first virtual middle school but has
8 hauled him here to Washington, D.C., where he has
9 committed to providing more alternatives and options for
10 students.

11 The President's "No Child Left Behind"
12 legislation comes at a time when the American education
13 system is undergoing a fundamental transformation.
14 Traditionally, educational resources, expertise and
15 courses have been limited to the geographic area in
16 which a student resides. Today, modern technologies are
17 expanding those opportunities to provide, as the motto
18 of the Florida Virtual School describes, "an education
19 that is anytime, anyplace, any path, any pace."

20 These new e-learning technologies expand the
21 options available to students by allowing the best
22 instruction to be brought to them regardless of their
23 location or economic status. In order for our nation to
24 accomplish the ambitious goals set forth by No Child
25 Left Behind, we must embrace a strong e-learning agenda,

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1 which should include cyber charter schools.

2 Much of the recent national discourse has
3 focused only on cyber charter schools and online
4 instruction over the internet; however, it is important
5 to realize that this is only part of the e-learning
6 landscape. Many traditional public, private and virtual
7 schools are supplementing instruction utilizing
8 e-learning courses. In fact, the Florida Virtual School
9 serves public, private and home school students all at
10 the same time.

11 The technologies enabling this form of
12 instruction can range from the internet to
13 computer-based instruction to video conferencing.
14 Regardless of the institutional structure or
15 instructional delivery system, the common benefits
16 offered by this approach include expanded access of
17 courses for students in rural and urban areas who might
18 not otherwise have access to teachers in a given
19 subject; expanded course offerings, including advanced
20 placement and advanced math and science classes;
21 flexibility for students to access course materials when
22 it is most convenient for them and not the provider;
23 individualized instruction that is tailored to a
24 student's unique strengths and weaknesses; and
25 effectiveness with diverse personalities, such as

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1 students who are shy, students who are disruptive in the
2 regular classroom, high achievers and also slow
3 learners.

4 This growing movement is experiencing obstacles
5 as it encounters laws, regulations and policies that
6 assume an education would only be provided in a
7 geographic area in a dedicated building. Policies that
8 may have served well for managing traditional schools
9 are now becoming obstacles and barriers for e-learning
10 programs. One of the reasons why e-learning is merging
11 within the charter school community can be attributed to
12 the flexibility charter schools have with designing
13 their instructional models, free from many of the
14 regulations that plague traditional schools.

15 As the Bipartisan Web-Based Education Commission
16 noted, the regulations that govern much of education
17 today, from pre-kindergarten to higher education, are
18 focused on supporting the welfare of the educational
19 institution, not the individual learner. They were
20 written for an earlier model, the factory model of
21 education in which the teacher is the center of all
22 instruction, and all learners must advance at the same
23 rate, despite their varying needs or abilities.

24 Many state policymakers are reacting to the
25 immediate issues raised by cyber charter schools without

1 considering how some of these same issues are found
2 within virtual public schools and other e-learning
3 programs. Policies are being constructed such as
4 limiting enrollment or the area in which a virtual
5 school can serve that restricts options that are
6 available to students. Rather than developing policies
7 that impose 19th Century regulations on 21st Century
8 innovation, states should consider policies that embrace
9 the new found flexibility e-learning offers. States
10 should hold e-learning courses to the highest standards,
11 but once those standards have been met, there should be
12 few restrictions for students who wish to benefit from
13 those courses. The guiding principle must always be
14 what is best for the student, not the institution.

15 E-learning is not an incremental form of change
16 for education as much as it is a fundamental catalyst
17 for systemic reform. Most interesting, the National
18 Association of State Boards of Education encouraged
19 policy makers to, and I quote, "consider the extent to
20 which the public education system should offer and
21 provide choices to families among different ways of
22 organizing and delivering learning services. Modern
23 technologies make it possible to empower families to
24 choose among numerous learning options. Some envision a
25 future system in which families would be provided with a

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1 range of educational choices within traditional schools
2 and without. Custom-tailored instruction would be
3 delivered by a number of providers who guarantee
4 results. Parents would direct with whom and how
5 education dollars are spent. Governments would fund
6 learners, not schools.

7 This is the hope of cyber charter schools and
8 the virtual school community, and I look forward to
9 working with the Commission and the rest of the members
10 on this panel as we move forward in tackling this
11 subject.

12 Thank you.

13 MR. ELLIG: Thank you, John. Sue?

14 MS. COLLINS: Good afternoon, everybody. My
15 name is Sue Collins. I am the chief education officer
16 at Apex Learning. I very much appreciate the
17 opportunity to be here today. Thank you.

18 For the past five years, Apex Learning has
19 provided online courses and other resources to high
20 schools across the country. Based on my Apex experience
21 and my experience as a teacher, district administrator
22 and state technology director, and as a member of the
23 Congressional Commission on Web-based Education, I
24 understand both sides of this issue.

25 For just a moment, imagine a student sitting

1 down in front of a computer in the school library. Now,
2 imagine him stepping through the computer to join
3 classmates and teachers from around the country. The
4 class is AP calculus B, a subject that isn't offered at
5 his high school. His online instructor has 13 years of
6 classroom experience, and she teaches the same number of
7 students that she would at school. Her students spend a
8 similar amount of time on their course. They learn from
9 standards-based content, and their high school will give
10 them credit for their online work.

11 By the year 2006, the majority of American high
12 school students will have participated in such an online
13 course before graduating. Most will take online courses
14 through their school, where teacher shortage and
15 scheduling conflicts prevent them from taking regular
16 classes. Other students will step away from the brick
17 and mortar schooling entirely and take all of their
18 courses from one of 30 or so cyber charter schools
19 nationwide.

20 Both the high school and the cyber school
21 students will face significant state and local barriers
22 to their online educational goals. Local policies once
23 designed to ensure the best possible education now often
24 prevent students from taking the courses they want.
25 Historically, education has been provided and regulated

1 at the local level. Fifty states, 15,000 school
2 districts have enacted as many different policies for
3 teacher certification, curriculum standards, textbook
4 adoption and funding, to ensure that their students
5 receive consistently high quality instruction.

6 I happen to believe very strongly that the best
7 educational decisions are normally made by those closest
8 to the child. At the same time, local policies should
9 not interfere with educational benefits provided by
10 technology innovations.

11 Some states don't allow students to use
12 accredited online courses to meet graduation
13 requirements, because they don't map to specific state
14 curriculum guidelines or adopted textbooks, or because
15 the online instructor isn't certified to teach in that
16 state. Such requirements disregard alternative
17 high-quality national standards for both curriculum and
18 teacher certification.

19 I believe that these barriers to e-learning were
20 enacted to guard per pupil funding and protect local
21 teaching jobs. Just when technology allows us to think
22 about anytime, anywhere education, individual states are
23 creating artificial barriers.

24 The most current example of legislation that
25 limits the growth of e-learning is in California. On

1 September 22nd, Governor Gray Davis signed Assembly Bill
2 885 limiting the number of school sites that may offer
3 online courses and mandating that those courses be
4 developed by local school districts and be taught by
5 local teachers in order to be ADA-compliant.

6 Online courses taken through post-secondary
7 institutions are allowed but do not qualify for ADA
8 credit. All other online courses must be granted
9 waivers from the State Board of Education, hardly a
10 conducive environment for online education.

11 Public schools who utilize online learning face
12 many of the same funding and accountability conflicts
13 that cyber charter schools do. Cyber charters are
14 typically hosted by a district, yet they accept students
15 from across the state and the nation, as well as home
16 schoolers who may be unaccounted for within the regular
17 public school system.

18 By enrolling students across district lines,
19 these schools compete for per pupil funding -- I'm
20 taking those words out of this. In June 2002,
21 Pennsylvania became the first state to define, fund and
22 regulate cyber charter education programs. I'm looking
23 forward to comments from the two gentlemen down the
24 table.

25 Again, just last week in California, not to pick

1 on California, Governor Davis signed Assembly Bill 1994
2 requiring charter schools and their students to stay
3 inside the boundaries and the oversight of their host
4 county or school district. In an online environment,
5 why confine enrollment to a small geographic area?

6 There are other examples in Ohio, and finally in
7 Minnesota, the state requires online students, home
8 schoolers who are attending a virtual academy, to work
9 inside a public school building at least five hours a
10 week in order to get credit.

11 In conclusion, Federal Government leaders need
12 to establish a national perspective, evaluating the ways
13 that technology improves teaching and learning and
14 creating a policy and funding environment that
15 facilitates the use of educational technology. State
16 government leaders and departments of public instruction
17 must evaluate their regulations and change those that
18 impede student access to virtual education. Compromises
19 that support quality and provide flexibility are
20 possible in curriculum standards, state teacher
21 certification and more.

22 While it may be important for students to know
23 where state lines are when they take geography classes,
24 when it comes to educational opportunities, those lines
25 must be transparent. Together, we need to work to

1 update regulations, to ensure that all U.S. students
2 have access to a first class education without barriers.

3 Thank you very much for the opportunity to be
4 here.

5 MR. ELLIG: Okay, thank you, Sue. Checker?

6 MR. FINN: Yeah, I submitted a statement, so I
7 think I'm just going to talk for a few minutes, inspired
8 by my colleagues here more than by my own word
9 processor.

10 I'm Chester Finn, I'm president of the Thomas B.
11 Fordham Foundation. I'm on the board of K12, which Ron
12 Packard is the CEO of, former Assistant Secretary of
13 Education and co-author of a book on charter schools, et
14 cetera. The "et cetera" is a long list you don't want
15 to hear. I'm sorry I wasn't here for wine, but I'm
16 thinking of coming back for caskets. This is a really
17 interesting program that you all are putting on.

18 I think there are three revolutions taking place
19 in American education right now that are germane, and
20 then there is one somewhat narrower issue that I think
21 is especially relevant to the FTC, as I understand your
22 brief, your bailiwick.

23 The first revolution, of course, is the school
24 choice revolution, the notion that there can be multiple
25 schools that you get to pick among and that you are not

1 the creature of a single government bureaucracy that
2 tells you what school to attend. In connection with the
3 school choice revolution, we have, for example, about
4 2700 charter schools operating in America today,
5 enrolling 600 or 700,000 kids, and we have about 40
6 states that have enacted charter school laws. This is
7 without even getting into the other flavors of school
8 choice, public school choice, magnet schools, home
9 schooling, vouchers, et cetera.

10 The second revolution is the technology
11 revolution that others have been talking about, the
12 notion that you don't actually have to be sitting
13 physically in a building called a school in order to be
14 educated, that technology is making it possible to be
15 educated anytime, anyplace, and this will in time, I
16 have absolutely no doubt, completely transform our
17 notion of what we mean by education and what we mean by
18 school. A school will no longer be a place; it will be
19 a process. It may be an outcome, but it's not going to
20 be a brick and mortar place, not forever, certainly not
21 for everybody.

22 And the third revolution is the outsourcing idea
23 being applied to public education, the notion that you
24 don't have to be run by a government agency directly in
25 order to be a public school. You can be run by a

1 non-profit or, and here's where we come to your
2 jurisdiction, a for-profit entity and still meet the
3 essential tests of public education, which I believe are
4 three in number.

5 First, that the school be open to all comers
6 without admissions prerequisites. Secondly, that it be
7 paid for by tax dollars, and you don't charge tuition.
8 And thirdly, that it be accountable to public
9 authorities for its performance, its success and its
10 continuation. If you meet those three tests, I believe
11 you're a public school, but you don't have to be run by
12 a government agency and staffed with government
13 employees in order to meet those tests. You can be
14 out-sourced to private operators, and many schools now
15 are being in the United States, hundreds actually, most
16 of them brick and mortar schools, but where these things
17 come together is in the idea of cyber charter schools, a
18 number of which, though not all of which, are being
19 out-sourced to private operators, including for-profit
20 operators.

21 This is a very positive development for
22 education because of the speed, the entrepreneurship,
23 the resources that these private organizations can bring
24 to the development of this educational breakthrough, and
25 I'm convinced that that's absolutely what it is going to

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1 turn out to be, but because of the controversial nature
2 of the profit motive in public education, this has been
3 an area fraught with push-back and political and
4 regulatory stress coming from a monopoly that doesn't
5 wish to be competed with and certainly doesn't wish to
6 be competed with by for-profit private operators of
7 virtual charter schools.

8 Almost everything the monopoly hates is summed
9 up in the phrase, "For-profit private operators of
10 virtual charter schools." That contains at least five
11 scary thoughts from the standpoint of what has long been
12 a public sector near monopoly, and that's why it's
13 controversial, and that's why the states are enacting
14 these restrictive laws, saying in some cases that if
15 you're for-profit you can't operate any kind of charter
16 school; in other cases, that if you're a virtual charter
17 school, you can't operate beyond 50 feet from somebody's
18 front door; in other cases, that if you're a
19 profit-seeking firm, you can't operate a virtual charter
20 school, et cetera, et cetera, et cetera.

21 Where legislative and regulatory restrictions
22 aren't able to be leveraged by this unhappy monopoly
23 through working mostly through states, sometimes through
24 local districts and local communities, then the
25 judiciary is invoked with lawsuits in several states

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1 attempting to prove that this form of public education
2 is unconstitutional under state constitutions. One of
3 those lawsuits is hot and heavy in Ohio right now, for
4 example.

5 But the resistance is spreading. The last two
6 states to enact charter legislation, Indiana and
7 Tennessee, both forbid the outsourcing of charter
8 schools to private operators, and this is not a good
9 sign if you believe in encouraging the development of
10 the three revolutions that I've been describing in
11 primary and secondary education. These kinds of
12 restrictions and constraints can only serve to constrain
13 that development, to constrain its evolution, to retard
14 the education sector behind every other sector in the
15 American economy that is allowing entrepreneurship and
16 innovation to flourish.

17 Thank you.

18 MR. ELLIG: Tom?

19 MR. GENTZEL: Good afternoon, I'm Tom Gentzel,
20 the Executive Director of the Pennsylvania School Boards
21 Association, I suppose the happy defender of the
22 monopoly that Checker was just talking about, but let me
23 try to debunk a few myths, if I can.

24 John actually said something that touches on a
25 key point I wanted to make, which talks about the

1 policies that are in place currently often get in the
2 way of online instruction, and I would agree with that.
3 Let me just talk a little bit about the Pennsylvania
4 experience. I understand that you don't want to be
5 bored with the details, and I won't do that, but I think
6 it's instructive, because what we've gone through in
7 Pennsylvania I think is pretty typical of the debate
8 around the country, and until a few months ago, we
9 really did not have a state law in effect which defined
10 what a cyber school is, established any minimum
11 requirements for those programs, provided any effective
12 means of oversight or monitoring of their performance,
13 or provided any kind of reliable and fair system of
14 funding for those schools.

15 Now, I said until recently. We did get a law
16 passed a few months ago which now finally provides 30
17 percent reimbursement to school districts for the costs
18 of cyber and charter schools, which is something we had
19 been asking for for a long time, but do the math.
20 There's still 70 percent that school districts are
21 paying. Now, the next issue becomes money. It's about
22 school districts trying to hold onto their dollars.
23 Well, it's an interesting debate, because as students
24 transfer to these other programs, our costs don't go
25 down.

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1 In fact, \$6,000 leaves the school district or
2 whatever the dollar amount is. Our costs don't go down.
3 We still have to educate the remaining students. So,
4 money is a problem, and it goes to the heart of the
5 matter, which is that if any level of government
6 believes these programs are important, and we think they
7 are, we think they're an important aspect of the
8 educational landscape in the future, we need to have
9 laws and policies in place which define and regulate and
10 provide a basis for measuring performance of these
11 programs.

12 In our state and, again, in other places, we've
13 seen cyber schools organized as charter schools, which
14 creates a very interesting process where one school
15 district in the state, again until recently, was able to
16 issue a charter and, in effect, establish a program that
17 enrolls students from across the states. Those other
18 districts have to provide funding. If they didn't,
19 Secretary Zogby's department was very efficient in
20 taking their subsidy money from them and sending it onto
21 the cyber school. No opportunity to ask questions, no
22 advanced notice, no access to records of those schools
23 to ensure, as we would with any other program that's
24 being publicly funded, that students, in fact, were
25 being served.

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1 So, these were real problems. They were
2 practical issues that nobody really wanted to address.
3 We can talk all we want about innovation and creativity
4 and free market forces, but the fact of the matter is if
5 we think that's important -- and I think Checker Finn
6 just said it -- we're trying to establish these things
7 using the current framework of public policy in this
8 country.

9 Now, I think what we need to talk about is
10 establishing laws that provide the answers to the
11 questions that I've just raised, and who is going to
12 establish the definitions? What are the enforcement
13 mechanisms? Ultimately, somebody has to be held
14 accountable.

15 Now, if the argument is, well, parents have the
16 choice, and if these programs fail, that's the
17 accountability mechanism, then I suppose we're just
18 going to have to agree to disagree, because I don't
19 think that's adequate accountability. These programs
20 are not funded by the parents who send their kids to
21 those schools alone, and in fact, most of the money is
22 coming from people who don't have kids in schools, who
23 are expecting somebody to be paying attention to how
24 these programs are operated and how the funds are spent.

25 Finally, let me just say, this is not a black or

1 white issue. This is not either you're for or you're
2 against cyber schools. We're going through an
3 interesting process with our membership right now where
4 we're asking them to define and describe the school
5 system of the future, the ideal system they'd like to
6 see, and I'm not surprised by the response that we're
7 getting from hundreds and hundreds of school board
8 members and superintendents around the state who are
9 saying cyber education is exactly one of the things they
10 think that is most important in public schools in the
11 future.

12 What we don't have is a policy framework, and it
13 makes no sense to me to say we're going to try to force
14 and encourage these things to happen without adequate
15 policies and oversight in place. So, that's our
16 position, and I'll be happy to participate in the
17 discussion.

18 MR. ELLIG: Thank you. Ron?

19 MR. PACKARD: Yes, I'm Ron Packard, a CEO and
20 founder of K12, which is I think one of the larger
21 virtual school operator companies around the country.
22 We currently operate in six states: Pennsylvania,
23 Colorado, California, Idaho, Ohio and Minnesota. Our
24 first schools opened last year. We're in our second
25 year now, and we're serving grades K through 5.

1 I think we've learned a lot about cyber
2 education and some of the barriers. Just to be clear,
3 K12 set up its curriculum designed to exceed the state
4 standards of all 50 states in the United States, and it
5 built a curriculum that was designed to be equivalent to
6 what the best private schools and public schools, not
7 just in the United States but in the world, do. In this
8 way, whenever we go into any state for a cyber charter,
9 we map out our curriculum against the standards in that
10 state and satisfy all bodies that we meet those
11 standards, and in most cases, we're significantly
12 exceeding those standards.

13 Cyber charters have a lot of advantages in the
14 sense that we can offer individualized education. It's
15 quite common that we may have children in the third
16 grade doing fifth grade math or fifth grade reading.
17 With the same curriculum, we're serving simultaneously
18 children who are highly gifted and children who have
19 learning disabilities as severe as autism. We have
20 cases of students, parents who were told by school
21 districts that their child would never be able to read,
22 they would only teach that child life skills. Several
23 of those children are now reading. So, it's a wonderful
24 thing for a lot of families. It's not right for
25 everybody, but we think it's very powerful for those

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1 that it serves.

2 Also, as was pointed out, these are schools of
3 choice. Every one of our schools are open to anybody,
4 and parents who enroll their children there choose to,
5 and if they don't, they can leave. It turns out these
6 have enormous demand for these schools, and we are now
7 well over 5000 children, almost 10,000 students enrolled
8 in these schools in the various states.

9 We've been now active all over the country. In
10 certain states like Pennsylvania, I think it's a
11 fantastic thing, that Pennsylvania has been out in
12 front, and they actually passed the cyber law and are
13 starting to define what a quality cyber school is, what
14 these schools need to do, because I believe the biggest
15 enemy to cyber education is cyber schools that are not
16 of high quality, that do not meet state standards, that
17 do not deliver what they say they're going to deliver.
18 They're not giving an education that the taxpayers in
19 that state would like to pay for. We view that as one
20 of the greatest obstacles.

21 What are the obstacles? We've seen a whole host
22 of them. One of the biggest obstacles is you'll see
23 things where there's open enrollment laws in states that
24 do not allow a child from a school district to enroll in
25 a school in another district. Those rules vary. Some

1 states have open enrollment, but often the sending
2 district can say, no, we won't let that child go to that
3 other school, and that's not only pertaining to cyber
4 education. A lot of these restrictions are not only
5 true for charter schools but also for other public
6 schools.

7 Checker mentioned regulations against for-profit
8 companies. It is extremely expensive and
9 capital-intensive to do cyber education right. It's in
10 the cost of well over \$100 million to build a full cyber
11 education school for grades K through 12. It's very
12 hard not to have some entity that can deliver that
13 amount of capital to deliver quality education. So, I
14 think a lot of these laws were developed knowing that
15 and as a specific way of preventing cyber education or
16 charter schools from ever happening in a large,
17 meaningful way.

18 Often local funding does not follow the child.
19 In Pennsylvania, it did. In other states, it does not.
20 So, even if you open a school, you will only get a small
21 part of the funding, which makes it very hard to
22 actually open a cyber school in those states. And also,
23 even when states pass laws in Pennsylvania, you see it
24 in Ohio, you're still subject to lawsuits. So, you have
25 to literally be ready to spend hundreds of thousands of

1 dollars on defending litigation even after a law is
2 passed. It's amazing what actually goes on in that
3 case.

4 But at the end of the day, we believe these
5 schools have a tremendous potential for families that
6 want to access a world class education, want to do it in
7 an environment, children that are world class athletes,
8 and it's interesting some of the type of kids we're
9 getting. In Pennsylvania, for example, 40 percent of
10 our students are free and reduced lunch eligible.
11 Thirty-five percent of our families had never used a
12 computer before. So, this is a choice -- a lot of the
13 things that really surprised us, but this is a
14 curriculum that serves those who live in areas, for
15 whatever reason, the public school isn't delivering
16 either the academic quality or the social environment
17 that they're looking for.

18 But in cases like Pennsylvania where we usually
19 end up getting 70 to 80 percent of the total funding
20 that goes into a public school, and what about results?
21 We believe in results. I think Bill Bennett, who is my
22 chairman and partner in this venture, has spoken about
23 results for the last 20 years. Our first year test
24 scores in Colorado indicate that that school would place
25 in the top 10 percent of all schools in the United

1 States in terms of scores, first year out of the box.
2 We hope they do better. So, basically it's an
3 incredibly efficient and effective model if you can
4 produce test scores that are in the top 5-10 percent of
5 the country while consuming 70 percent of the dollars
6 per child.

7 So, I'll end on that. Thank you.

8 MR. ELLIG: Secretary Zogby?

9 SECRETARY ZOGBY: Thank you. I'm Charles Zogby,
10 Secretary of Education for the Commonwealth of
11 Pennsylvania, and I appreciate the opportunity to be
12 here today to discuss one of Pennsylvania's most dynamic
13 and innovative education reforms, cyber charter schools.

14 Pennsylvania prides itself on being a national
15 leader in cyber education, and over the past five years,
16 we've made extensive progress in harnessing the power of
17 the internet to deliver a quality education to children
18 across our state. Cybers have shown a power to combine
19 customized curriculum of charter schools that we've seen
20 in our charter schools with the easy access and
21 flexibility of the internet, making these schools
22 uniquely adaptable to students' individual learning
23 needs.

24 Pennsylvania's cyber movement began in the fall
25 of 1998 when the Susq-Cyber School, located in

1 northeastern Pennsylvania, opened its virtual doors to
2 47 students. The school became the Commonwealth's first
3 online public school, and now, just a few short years
4 later, enrollment in the school has nearly doubled, with
5 a hundred students in grades 9 through 12 now receiving
6 their education via the internet.

7 Today, Susq-Cyber School has seven cyber
8 counterparts across the Commonwealth, all recognized as
9 public schools under our state's charter school law.
10 Together, these schools now deliver education to over
11 5000 students across the state.

12 The Ridge-Schweiker Administration believes
13 strongly in competition and the free market. We've
14 prided ourselves in giving parents a choice when it
15 comes to choosing the education that best suits the
16 needs of their children, because we believe choice is
17 not only a parent's right but improves education and the
18 quality of our schools.

19 The choice options we've created in Pennsylvania
20 are not limited to cyber charter schools. Through our
21 charter school law, more than 90 schools now deliver
22 education to more than 32,000 students. Others are
23 choosing to create what's known as independent schools,
24 which are quasi-charters within the context of a
25 collective bargaining agreement. We've also been

1 champions for school choice, both within the public
2 education system and through vouchers to allow children
3 to attend nonpublic schools.

4 Cyber education then is one more way of offering
5 choice to parents. We support competition, but we also
6 realize that cyber charter schools are still young, and
7 as with any new initiative, there are always ways to
8 make them better, and that is our goal as we continue to
9 enhance this dynamic new option for our children.

10 This past year, Governor Schweiker signed what
11 we believe is the nation's first comprehensive law to
12 strengthen and oversee and improve and provide academic
13 accountability for cyber charters. The law creates a
14 framework for the Department of Education to ensure the
15 parents and children are protected as consumers while at
16 the same time ensuring that cyber schools are delivering
17 high quality standards-based instruction and education.

18 We recognize that cyber schools, by their very
19 nature, pose new and unique challenges. The internet
20 and available technologies enable cyber charters to draw
21 students from across Pennsylvania, and enrollments are
22 not bound by the traditional physical or geographic
23 boundaries. A key component of the legislation that was
24 just passed included the centralized evaluation and
25 approval of oversight of charter schools, which in

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1 Pennsylvania will now rest with the Department.

2 And just to clarify some of the earlier remarks
3 by my colleague, Mr. Gentzel, a charter school law did
4 allow an avenue obviously for these charter schools to
5 come into being. What we found over the years were that
6 school districts, a single chartering district who's
7 ultimately responsible for the accountability of these
8 schools, because of the state-wide nature and reach of
9 the cybers, were not really in a very good position to
10 become overseers to assure that cyber charters were
11 meeting the requirements of the law.

12 So, what we did was to centralize, again,
13 oversight, approval and regulation of the charters at
14 the state level. The new law we think helps enhance
15 educational accountability. Cyber charter school
16 applications must now include an array of new
17 information and material and really trying to get at, is
18 this operator positioned with the infrastructure to
19 provide high quality educational experiences to
20 Pennsylvania young people?

21 We've encouraged and supported the cyber school
22 movement. We believe in empowering parents to make
23 decisions that are best for their children and providing
24 alternative education options. I believe that with our
25 new law, we have reached a balance that encourages cyber

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1 school growth and provides them with flexibility, while
2 making sure that they are accountable for the education
3 that they promise to deliver our young people.

4 Thousands of Pennsylvania parents already have
5 embraced cyber charter schools as an exciting and viable
6 education alternative for their children, yet as with
7 any new initiative, the department has the
8 responsibility to assess their success and strengthen
9 cyber schools to make them better. We believe that with
10 this new law and the steps that we've taken in
11 Pennsylvania, cyber charter schools will be an exciting
12 and viable education option on Pennsylvania's landscape
13 for years to come.

14 Thank you, and I would be pleased to answer any
15 questions.

16 MR. ELLIG: Thanks. I'd like to start off with
17 one really kind of broad, general question. When we
18 look at education and different options for education,
19 two of the really big questions that a lot of people
20 have are, well, how does this affect the quality of
21 education? How does it affect student academic
22 achievement? And then also, how does it affect the
23 cost? And I'm curious to know what kind of evidence
24 currently exists about how cyber charter schools affect
25 student academic achievement and how do they affect

1 costs, and since I'm an economist, I have to add, I'm
2 particularly interested in knowing if there's any
3 evidence about the way cyber schools affect student
4 achievement that can actually be attributed to the
5 performance of that school rather than being attributed
6 to the fact that maybe they attract better students, and
7 so, they would have higher test scores just because they
8 happen to get better students.

9 Anybody want to take a shot at it?

10 MR. PACKARD: Yeah, to be clear, there's not any
11 evidence that I'm aware of that would take out any
12 self-selection bias, yet it normalizes for the students
13 that go in there. I think there's strong evidence, if
14 you look at the students that go in there, relative to
15 poverty levels and everything, that the results are
16 extraordinary, but you can't -- it's hard to say that --
17 there's no normalized study versus a control group that
18 you're asking for that I'm aware of, but I think we're
19 trying to do that now.

20 MS. COLLINS: I actually can provide some data.
21 We happen to have started in advanced placement, which
22 is actually a very perfect laboratory for seeing how
23 effective online courses might be vis-a-vis classroom,
24 because in the end, they all take the same test. So, it
25 doesn't matter where the kids get their instruction, if

1 they do it online or whether they do it in the
2 classroom, and just to give you a sense of the kinds of
3 kids we have, about 65 percent of our kids come from
4 rural schools, and in almost 50 percent of our schools,
5 we are the only AP that they can offer. So, there's
6 sort of a nice conjunct of people who want to be able to
7 take these kinds of courses and are not able to as we
8 sell these courses.

9 So, let me tell you the results, and these are
10 not this year's, because we just got the data from ETS,
11 and we haven't finished it all, but last year, if a
12 student took an online course from us and passed the
13 course and took the test, and our kids take more tests
14 than the normal classroom kids do -- I'm not saying this
15 very well, I didn't have this very well organized in my
16 head -- but we have deeper penetration of test-takers in
17 our online classes. They do just as well as a classroom
18 student does. So, the national average is about 61
19 percent passage. That's just about what our kids do.
20 In certain subjects, they do extraordinarily better. I
21 think it's in chemistry that we have a 92 percent
22 passage rate, and the passage rate across the country is
23 like 68 percent.

24 So, there's some interesting data, and we'd be
25 happy to provide that to the Commission at any time.

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1 MR. FINN: This is a little bit like trying to
2 evaluate somebody's lifetime earning potential when
3 they're eight months old. This is a real infant of an
4 educational program, and it needs more time, more
5 research, some truer experiments if we can figure out
6 how to do that in order to get the achievement data
7 squared away.

8 Many of these schools have only been operating
9 for one year, two years, maximum really three years, and
10 I don't think anybody thinks that that's a fair test for
11 a school, and it is hard, as Ron said, to rule out the
12 selection effects. There haven't been any, to my
13 knowledge, true randomized type experiments with
14 full-fledged control groups. You can do demographic
15 matching and things like that. You still can't
16 eliminate all possible selection effects.

17 The expense data is clearer. It's pretty
18 universal across the country as an average that charter
19 schools, in general, get about 80 percent of the
20 operating budgets of regular public schools. They
21 usually don't get any capital funding, so they actually
22 get less than 80 percent of the funding of regular
23 public schools, which also get capital funding, and
24 sometimes the local dollars do or don't accompany kids
25 into the charter schools.

1 Cyber charter schools at the moment are getting
2 funded pretty much the same as brick and mortar charter
3 schools. Whether it stays that way indefinitely, I
4 don't know, and Charles could speak to the formula they
5 ended up with in Pennsylvania, because I can't begin to
6 explain it.

7 SECRETARY ZOGBY: I don't know that I can
8 explain the formula, per se, but in Pennsylvania, it's
9 roughly the same, about 80 cents on the dollar that
10 moves with a charter or cyber charter student. Funding
11 for students enrolled in cyber charters mirrors that of
12 children in charter schools. The 30 percent
13 reimbursement that Mr. Gentzel referenced was actually a
14 separate appropriations act by the General Assembly
15 where at least in our state we have begun to, again,
16 reimburse school districts for up to 30 percent of the
17 cost associated with students attending charter schools
18 or cyber charters.

19 MR. GENTZEL: If I may, another country heard
20 from. Let me just offer a couple of thoughts about
21 this. One is I find it intriguing that we're saying
22 that this whole movement is too new for us to evaluate,
23 and a couple years is not an adequate period of time to
24 be fair to the school, and yet we've just passed federal
25 legislation that has the hammer coming down on some

1 school districts immediately if they fail to meet
2 certain performance levels. So, I think maybe we ought
3 to revisit that whole question.

4 But let me get back to this funding issue.
5 We're going to separate and I'd like us to separate
6 charters and cybers, because although they may be called
7 cyber charter schools, these are not bricks and mortar
8 facilities. So, I think the apples-to-apples comparison
9 is to look at the instructional cost of school
10 districts, the classroom operating costs of school
11 districts versus the cyber schools, and in Pennsylvania
12 in some cases, they're charging more because of the
13 formula, which we want to explain, but the fixed
14 formula, they're actually getting more per pupil than
15 some school districts are paying for the instruction of
16 their own students.

17 The reality is that we don't know whether this
18 experiment works. We think it's certainly well worth
19 trying, but the flip side of the coin is, what happens
20 where it clearly fails? And we have had that example in
21 Pennsylvania. It's not a K12 program, and this is
22 certainly no criticism of K12. What I've seen, I've
23 been impressed with, but there have been other cyber
24 schools that have been -- particularly one that I think
25 the department itself, I think, came down on it and told

1 the school district to shut it down. What do you do
2 when you have, in that case, 3000 students enrolled
3 across the state in a program that's basically
4 fraudulent and taking advantage and bilking the
5 taxpayers of this state? Well, the answer was finally,
6 well, tell them to close, after millions of dollars
7 literally had been spent.

8 Again, we can wish for good things to happen.
9 We can hope that the right people step up to the plate
10 and do the right thing to serve kids, and clearly these
11 programs can serve some kids very, very well, but if we
12 don't have adequate safeguards, I think we are
13 essentially insulting the taxpayers of this country to
14 suggest that we ought to just let dollars follow kids to
15 wherever they want to go and hope the right things
16 happen. I don't think that's adequate accountability.

17 MR. BAILEY: On the question of the research, I
18 agree with Checker, there's been very little randomized
19 assignments in terms of measuring online instruction or
20 the impact that's had on education. We've seen a lot of
21 distance learning courses as supplemental courses.
22 That's not new. That's not new to the cyber charter
23 school movement. That has actually been around for
24 years, using everything from satellite technologies to
25 video conferencing to more recently the internet.

1 We've seen some real positive trends in that,
2 including a school district in Alaska that's larger than
3 the entire State of West Virginia, that when they
4 started enacting e-learning and using e-learning as
5 their school district's primary instructional delivery
6 system, student test scores rose, students going on to
7 college increased, and the quality thresholds were so
8 high they received the President's Baldrige Award this
9 year. So, I think that's a real clear example of how,
10 again, one successful e-learning implementation has had
11 some pretty dramatic student achievement.

12 In terms of measuring the quality of this, I
13 think what you start finding is once you strip away the
14 technology aspects of cyber charter schools or cyber
15 schools in general, the same things you look for in a
16 quality instructional program in a traditional school
17 are the same things you look for in a cyber charter
18 school. It's qualified teachers, it's quality
19 curriculum, and it's also rigorous, high academic
20 standards. You don't want the technology to sort of
21 gloss over these other more fundamental, important
22 issues that you start looking at, and if those things
23 are there, there will be good instruction taking place,
24 and students will be learning.

25 MR. PACKARD: Yeah, I would like to just add to

1 that. We view exactly that, a great virtual school is
2 no different than a great physical school. It has a
3 great curriculum, great teachers, innovative and high
4 accountability. So, in reality, they function almost
5 the same way, and I think the value that we look for is
6 that we can deliver it basically 80 percent or less of
7 the cost of what a normal state is paying, a school
8 that's going to deliver for them test scores in the top
9 10 percent and serve a higher percentage of poor
10 children than the average school in that state has. So,
11 I think that's an attractive value to most states, and
12 hopefully we'll be able to demonstrate that even with
13 the selection, that we still out-perform what a normal
14 school might do or an average school might do. There
15 are always fantastic schools.

16 MR. FINN: The Alaska comment underscores
17 something that I'm not sure anybody's said that's worth
18 emphasizing. There are some situations where distance
19 learning is particularly wonderful for kids and
20 families, and this includes deeply rural situations,
21 people who live on sort of mountain tops and deep
22 valleys and across snow fields. It also includes kids
23 who for various reasons are not very portable, kids who
24 are ill or disabled or fragile or have emotional or
25 social problems, and a variety of other circumstances

1 that you can begin to imagine in which bringing the
2 school to the kid essentially makes a whole lot more
3 sense than any other form of educational delivery.

4 MR. AGARWAL: I'd like to touch on the
5 accountability issue again. To whom do cyber charter
6 schools need to be accountable? Is it enough that
7 they're accountable to the parents and the parent can
8 take the child out of the cyber charter school, or do
9 they also need to be accountable to the school district
10 or the State Board of Education?

11 MR. FINN: Well, they are accountable to some
12 public body by virtue of being a charter school. Every
13 single charter state in the country has set up an
14 arrangement -- it doesn't always work very well -- but
15 in the law and in principle, the charter is issued by a
16 public body. It's often a State Board of Education,
17 it's sometimes a Local Board of Education. In a few
18 states, it's a university, which is then responsible for
19 checking to see whether that charter school is
20 delivering the results that it said it was going to
21 deliver within the period of time that it said it was
22 going to deliver them, typically on average a five-year
23 charter, and reviewing the performance of the school
24 against its stated goals and state standards and usually
25 state tests, and then determining at the end of that

1 period of time whether the school should be continued or
2 not.

3 There is a formal arrangement of that sort
4 underway every place that there is a charter school.
5 There is a sense here worth underscoring I think, also,
6 in which charter schools are more accountable than
7 regular schools, because they're accountable in two
8 directions at once. They are accountable to the
9 marketplace, because they are schools of choice, and
10 they are also accountable to a public body that issued
11 their charter and is judging their performance.

12 MR. GENTZEL: I'd like to agree with that. I
13 think in theory that's the way it should work. Charles
14 and I, as you might have guessed, have not agreed on a
15 lot of things around this subject, but I think we did
16 finally reach some common ground. We might have backed
17 into the same spot, I'm not sure, but the reality is
18 that this did not work, when we're talking about a cyber
19 school being chartered by an individual school district.
20 That was the problem of shoehorning cyber schools into a
21 charter school law that was never intended to support
22 that kind of a program.

23 It was clearly intended to support a bricks and
24 mortar facility. That's what our charter school law
25 was. It made no sense to tell a small district of a

1 thousand students in the suburbs of Philadelphia that
2 had granted a charter to a cyber school that they now
3 had to monitor the performance of a school that was two
4 or three times its own size with students spread all
5 across the state.

6 Now, unfortunately, we had two years of hell
7 before we got legislation passed that finally addressed
8 that subject and tried to bring some closure to it, and
9 my caution is that we should not be doing that. If
10 there's a lesson to be learned from the Pennsylvania
11 experience, it is that if cyber schools want to be
12 promoted as a matter of public policy, then there ought
13 to be a public policy. It ought to be clearly
14 articulated. There ought to be a funding mechanism in
15 place, and there ought to be an accountability measure
16 in place.

17 Let me just raise one other quick question
18 that's related to this. One of the things that was
19 never answered, for example, was are cyber schools
20 appropriate for all students? I talked to a cyber
21 school operator who told me that he had in his program
22 kids as young as kindergarten-aged students enrolled in
23 his cyber school, and I was intrigued by that. I was
24 trying to remember my kids when they were in
25 kindergarten, and I thought, is it really appropriate

1 for kindergartners to be in front of a computer all day?
2 And the answer was, well, they're not in front of the
3 computer all day, but where are they the rest of the
4 time? Well, they're with their parents. What are the
5 parents doing? The parents are teaching them. Well,
6 that's home schooling, and one of the reasons we filed
7 our lawsuit and that a lot of school districts were
8 involved in this was we have a law that provides a
9 policy. A parent wants to teach a child at home, we
10 have a state law that regulates how that happens, who's
11 qualified, the nature of the program. What we had here
12 was home schooling taking place under a cyber school law
13 without the protections of home schooling.

14 Now, again, my point is very simple. If we want
15 to do it, and I think we should, then there ought to be
16 a public policy that answers those questions.

17 SECRETARY ZOGBY: I'd just like to make another
18 point on the accountability. I think one of the things
19 that we have found with charter schools, with both our
20 charter schools as well as our cyber charters when they
21 were approved at a local level, is that our public
22 school districts are not very good at holding their own
23 schools accountable. We are not used to in public
24 education, for instance, setting academic goals of where
25 children should be in reading and math and other core

1 subject areas, and then if you're a school that fails to
2 deliver, that there are actually consequences that
3 occur. You know, my friend Tom referenced a problem
4 cyber charter that we had in Pennsylvania, and indeed,
5 we went through some legal gymnastics to be able to get
6 this school to fulfill its obligations, but I think the
7 key point to be made there is that with these and other
8 charter type schools, we were able to move against those
9 that were failing to deliver, were failing to live up to
10 their obligations. We have, unfortunately, too many
11 public schools that fail our children year after year,
12 where we know a number of schools that opened this past
13 September that will close next June with children not
14 really making that much progress, and yet,
15 unfortunately, in years past, we've not had
16 accountability for those schools. There have not been
17 consequences for their failure.

18 I think the other key point to be made is now
19 with the new No Child Left Behind law, every public
20 school, whether you're cyber, charter, or traditional,
21 you are going to be under some form of accountability to
22 moving children to a proficient level of learning and
23 reading and math and soon to be science, and so we're
24 going to have, if you will, a level playing field across
25 all public schools, both in the Commonwealth and the

1 nation.

2 MR. AGARWAL: What is the effect -- and it might
3 be too early to know this -- but what is the effect of
4 cyber charter schools on traditional schools?

5 SECRETARY ZOGBY: I think that's a very -- I'll
6 maybe give a Pennsylvania view here -- very difficult to
7 measure. We have some who have sort of like the old
8 definition of conservative, standing astride the world
9 shouting no. There are some districts that have just
10 reflexively seen this as a problem that they wish would
11 go away. Others are taking it as a challenge, and
12 they're using their own technology programs to offer new
13 and better offerings to their young people, to the
14 parents, as a way to draw students back into their
15 public education systems, and I really applaud some of
16 our superintendents across the Commonwealth who have
17 been leaders in this effort. They know that they're
18 offering quality education in their local districts. Up
19 until now, they have had no way to export that
20 education, and the technology is now giving them, again,
21 in the districts, the ability to draw students in from
22 other areas of the state, and they're seeing this as a
23 market niche in the future where they're going to go
24 after customers, because these children can bring money
25 with them, and they can offer high quality education.

1 MR. PACKARD: And we've been approached by
2 multiple school districts now, consortiums of school
3 districts, who want to do virtual education in their
4 districts and want our help in delivering the curriculum
5 and also whatever technology and systems we've built,
6 and our attitude is we're happy to help them, and we
7 believe that parents that want this type of education
8 should have it, whether it's provided through a charter
9 school associated with K12 or whether it's provided by a
10 district itself. So, we're seeing districts from all
11 over the country, particularly in Pennsylvania, calling
12 us and saying, can we do this? So, some of them are
13 starting to embrace this.

14 MR. BAILEY: I think we're also seeing a lot of
15 schools starting not make it an either/or debate, but
16 creating blended experiences where students will have
17 received the majority of their instruction in a
18 traditional setting, but for some courses of which it's
19 just beyond the reach of that school to offer advanced
20 courses, they're turning to distance learning providers,
21 whether it's Apex Learning or other for-profits, where
22 they're turning to other schools and they're sharing
23 their teachers and expertise across school district
24 boundaries, across state lines, to help bring those type
25 of courses and expertise to our students. So, it

1 doesn't have to be an either/or. It could be very, very
2 much of a blended approach in some cases for students
3 with very unique needs.

4 Migrant education workers, it's a way that as
5 those families travel from state to state, from town to
6 town each year, that student can maintain a relationship
7 with their teacher throughout the whole year and not
8 have the disruption that typically has occurred, where
9 they're introduced to two different teachers throughout
10 the year and given two different types of instructional
11 methods. This keeps their education somewhat consistent
12 over time. So, students with high mobility, students
13 with other unique needs, students with families that
14 travel in the military, all of these offer rich
15 opportunities for online learning in a traditional type
16 of setting, through a traditional type of school.

17 MR. ELLIG: Actually, that -- oh, did you have a
18 comment?

19 MR. GENTZEL: I did very quickly. I would add
20 that it's superintendents and school boards. I think a
21 lot of our folks are looking at this as an opportunity
22 to change the landscape of public education. I want to
23 just build on what John was just saying, though, because
24 one of the reasons why I think we need a
25 well-articulated public policy on cyber schools is that,

1 for instance -- again, not to get lost in the
2 Pennsylvania law -- but our charter school law requires
3 it to be a full-day program. If you go to a charter
4 program, it's a full-time enrollment. That's limiting
5 to a cyber program, and I agree completely, we need to
6 think more creatively about ways we can bring distance
7 learning into Pennsylvania and other schools around the
8 country, but again, one of the comments I heard from our
9 members across the state was they like cyber schools.
10 They think there's a lot of value in it. They wish they
11 had had the resources to be able to provide that kind of
12 funding and a computer for every child to have in their
13 home. That's one of the disadvantages to this. We need
14 to sit down and say, if these things are important,
15 we're going to provide the resources to help all
16 students have access to it, not just those who happen to
17 get through the charter school law.

18 MR. ELLIG: Actually, John's comment about folks
19 traveling around piques an interesting question, which
20 is to what extent are any cyber charter schools
21 interstate operations rather than just serving students
22 in one state? I understand there are some companies and
23 other organizations that maybe operate multiple schools
24 in multiple states, but to what extent do you have maybe
25 a single school or program where you have people in

1 multiple states?

2 MR. PACKARD: They can't do that by law, because
3 the students in each of the states have to be residents
4 of that state, and one of the big processes in the
5 enrollment thing is verifying that they actually live in
6 that state. So, that's impossible -- it's hard to do
7 with the current funding mechanisms and state laws.
8 Now, a family could travel over Christmas to Florida
9 from Pennsylvania, and they can do the education there.
10 It's available anytime, anywhere, as long as you have a
11 dial-up connection, you can do it anywhere, but you
12 can't serve a resident of different state and get
13 funding for that.

14 MR. FINN: It could be done through some kind of
15 a reciprocity or compact arrangement, if states agreed
16 to share, for example, across state boundaries, but as
17 long as the fundamental education law and funding in the
18 country is state-based, I think that public education is
19 going to continue to be bounded by state boundaries.

20 MR. BAILEY: The schools that I've seen that
21 have done either multiple states or even multiple
22 countries, the Concord Consortium does a virtual high
23 school program, serves students in a variety of
24 different countries, but they have to develop agreements
25 with those countries and with the states that they're

1 working with. The Florida Virtual School I think is
2 actually serving students from 13 different states now,
3 but they have to go in and negotiate agreements with
4 those states and then also with the school districts.
5 So, those are definitely barriers. They are not able to
6 serve as many students because of the barriers of
7 traditional regulations as it relates to education.

8 MR. AGARWAL: There have been some reports that
9 there may be a teacher shortage coming up in the next
10 few years. Are cyber charter schools one way of dealing
11 with that?

12 MR. FINN: You could have an entire hearing on
13 the teacher shortage issue itself and ways of dealing
14 with it. It's extremely variable depending on which
15 part of the country you're in, what subjects you're
16 talking about the shortage being in. There are some
17 states that over-produce teachers; there are other
18 states that are importing them. There are subjects like
19 high school science that have a shortage. There are
20 subjects like elementary social studies that don't have
21 a shortage. And furthermore, a lot of the shortage is
22 self-induced by state requirements having to do with
23 training and certification.

24 There are lots of people out there that would
25 like to be teachers who aren't allowed to be. If you

1 want to get into a restraint of movement and opportunity
2 issue at the Federal Trade Commission, this would be a
3 real Jim Dandy of an issue to get into, but in any case,
4 the cyber charters, where they're not restricted by laws
5 like California's, to have 25 kids per teacher and it
6 has to be a certified teacher, which is to recreate the
7 same shortage issue within the cyber charter, where
8 they're not restricted in that way, sure, they can be a
9 fantastic partial solution to a teacher shortage.

10 Imagine a real school, a brick and mortar school
11 that's having trouble finding a suitable sixth grade
12 math teacher and says to the cyber charter provider, we
13 would like to bring in your sixth grade math program
14 into our school, because we don't have a good sixth
15 grade math teacher, but we can use your program with
16 another adult to deliver sixth grade math to our kids.
17 There's a huge potential here, both of kids in brick and
18 mortar schools and kids scattered in other locations.

19 MR. PACKARD: I think the other thing with a
20 teacher shortage is virtual teachers can attract people
21 that normally might leave the teaching profession. For
22 example, young teachers who have just had children and
23 who are going to take off to be home with those
24 children; retired teachers who don't want to stand in
25 front of a classroom all day; teachers with physical

1 disabilities that can't stand in a class -- they can now
2 teach, be part of their life-long chosen profession,
3 which they couldn't do under the current system in a
4 brick and mortar school. So, we're seeing those kind of
5 applicants.

6 MS. COLLINS: In absolute numbers of the
7 teacher-to-student ratio, what we've found is you really
8 aren't able to teach any more kids a day. When I was an
9 eighth grade teacher, I had 180 kids. Imagine 180
10 eighth-graders every day, if you can imagine that --

11 MR. FINN: Even virtual eighth-grader.

12 MS. COLLINS: Even virtual would be.

13 Anyway, there's only a few more kids probably
14 that a virtual teacher can have as opposed to a
15 classroom teacher. So, you cannot say we're going to
16 teach 300 kids per teacher in a virtual environment.
17 That just doesn't work. I do agree that you can attract
18 people back who would not teach. We have teachers who
19 are back from maternity leave and want to teach two
20 classes a day. Schools can't accommodate that very
21 well. We have a teacher who teaches half-time in a
22 regular school, because that's all that they have kids
23 for, teaches half-time for us.

24 I do think one of the real advantages, though,
25 gets back to this state line problem is it can solve

1 local and/or geographic shortages. So, I'll give you a
2 real example. Austin School District wanted to have an
3 AP physics class, I believe. They had an AP physics
4 teacher in one high school, did not have it in any other
5 school, and so they were either bussing the kids or the
6 teacher became an itinerant teacher who taught two and
7 three kids at each school. That absolutely can help
8 that situation.

9 It can also help other situations where you have
10 a partial class here and a partial class there, two kids
11 there, or you have a class here and a class there, so
12 that there's local disparity of coverage. All those
13 things can be helped by cyber schools or cyber charters
14 or virtual schools or whatever we want to call these
15 today.

16 MR. AGARWAL: What is the typical
17 teacher-student ratio at cyber charter school?

18 MS. COLLINS: Well, for us, we have a
19 requirement that they're about the normal load of a
20 public school teacher, which in general is somewhere
21 between 150 and 180 kids. We're in high school only, so
22 it's not the matter of what you have in a second grade
23 classroom or a third grade classroom, and that's sort of
24 the normal load a public school teacher has.

25 You do have to remember that there is a

1 different weighting of what they do. In a cyber
2 situation, what the technology conveys is the
3 curriculum, so that the teacher is relieved from much of
4 the curriculum actually, the content conveyance to kids,
5 and has a much bigger responsibility to provide feedback
6 and answer questions and do those things with students
7 as opposed to the teacher in the classroom who has both
8 content and feedback requirements.

9 MR. FINN: You have to change your paradigm a
10 little bit. In a virtual situation, there are arguably
11 three teachers interacting with the kid. There's the
12 teacher who created the lesson that's coming in with the
13 help of technology. Secondly, there is the sort of
14 official teacher who is at the other end often of an
15 e-mail or a telephone or an interactive video
16 conferencing. And then thirdly, there's the adult in
17 the room with the kid, which might be a parent and might
18 be an older sibling and might be a tutor or a day-care
19 worker or an after-school worker or a wide variety or a
20 regular teacher who's moonlighting in an after-school
21 program. There's three different adults in this sense
22 serving as teachers for the child in this situation.

23 MR. AGARWAL: That actually brings me back to an
24 earlier point that you made about what groups or
25 constituencies are principally opposed to cyber charter

1 schools, and in particular, you made the point, Checker,
2 that teachers in your view are opposed to cyber
3 charters. I'm wondering how the other sort of groups --

4 MR. FINN: Teachers unions.

5 MR. AGARWAL: Teachers unions.

6 MR. ELLIG: By the way, this wasn't our
7 question. This was from the audience.

8 MR. AGARWAL: Yes, this is from the audience.

9 MR. FINN: Teacher unions, the interest groups
10 that have a vested interest in the traditional delivery
11 are who's opposed. They're opposed in general to
12 competition. They're opposed in general to charter
13 schools. They're opposed in general to for-profit
14 entrants into public education, and they're certainly
15 opposed to this amalgam of those things.

16 It's a list as long as your arm. It operates at
17 both the national level and the state level, but if you
18 went to the Yellow Pages and looked up National
19 Association of and then plugged in everyone that had
20 education or some version of that in its name, first of
21 all, you'd have hundreds of groups, and secondly, you'd
22 have hundreds of opponents, and they all have state
23 affiliates. So, in Ohio, for example, the state-wide
24 lawsuit against the charter schools, including but not
25 limited to the cyber charter schools, was organized by

1 the two state teacher unions and then joined in by all
2 the other public school associations in the state, the
3 school boards association, the administrators
4 association, the PTA, the colleges of education, and on
5 and on and on down actually a very long list of
6 complainants here, who all believe that they, I think,
7 stand to lose if this movement spreads.

8 MR. GENTZEL: Well, let me just say, again, here
9 we go with you're either in this camp or you're in that
10 camp. I tried to lay out in our case, and I think the
11 same argument holds true in other states, at least for
12 our association, which supported the creation of charter
13 schools, believes cyber schools have a lot of merit and
14 should be developed in our state, and as we just
15 discussed, a number of districts are doing that right
16 now. We were very specific in complaining about how
17 they were developed in Pennsylvania, because they were
18 developing extra-legally, in our opinion, that the law
19 did not provide for their creation. We needed to have
20 the same sort of statutory authority for them as we have
21 had for home schooling and for charter schools and for
22 other changes in the educational landscape. We didn't
23 do that in this case.

24 So, I think it's a little bit disingenuous, with
25 all due respect, to suggest that when somebody raises an

1 objection, they're somehow just opposed to reform or to
2 change. That's literally not true. A lot of us have
3 been promoting changes in the public education system
4 for a long time, but there were legitimate complaints
5 about this issue and about some others, and I think we
6 did the right thing. I'm proud of what we did. I think
7 it helped force some discussion and some changes in the
8 legislature that might not have happened otherwise.

9 MR. BAILEY: I would just say from my
10 observation, I found very few people that oppose cyber
11 charter schools, but when you listen to the song behind
12 the music, if you will, the opposition is more of along
13 the lines of funding. They oppose the loss of funding
14 that their traditional school has traditionally
15 received, and now all of a sudden they have to send to a
16 cyber charter school. So, it has a whole lot less to do
17 about cyber schools than it does about the loss of
18 funding that the cyber schools have somewhat triggered,
19 and that's what is generating, I think, just from an
20 observation at the national level a lot of the lawsuits
21 you're seeing in some of the states.

22 The second issue is on the quality, asking about
23 the quality of education that is delivered online, and
24 what's interesting about that is often you see a lot of
25 questions being asked about cyber charter schools that

1 are often not asked about traditional schools and that I
2 think a lot of folks would encourage being asked about
3 traditional schools, and Secretary Zogby was addressing
4 that a little bit before, but again, I think it all
5 comes back down to funding as opposed to the online
6 delivery of instruction via the internet or other
7 technologies.

8 MR. GENTZEL: If I could have a qualified
9 agreement with that, there are, as I say, other policy
10 issues that I think are critical, but John's right. It
11 is about funding, too. So, now the question becomes,
12 well, there you go, the school boards are just trying to
13 hold onto their money.

14 The reality is that as students transfer -- and
15 again, I'm talking about our state, but a lot of other
16 state laws are very similar -- as they transfer, money
17 follows the student to the charter school or the cyber
18 school. Well, that seems to make sense. The problem
19 is, the money doesn't follow the child into the district
20 in the first place. In other words, in our case, we
21 don't get another \$5,000 or \$6,000 from the Commonwealth
22 of Pennsylvania for each new student who enrolled. If
23 that were true, then again, this might be possible.
24 Money follows the kid in; money follows the child out.
25 Well, that might work. In this case, we have to find

1 \$6,000 or \$8,000 or \$10,000 to support the education of
2 that student in the alternative setting, but our costs
3 have not dropped by that much money. As a matter of
4 fact, they continue to go up with the other students.
5 We still have all the overhead costs. All the other
6 mandates that people are so quick to relieve charter and
7 cyber schools from, we're still saddled with. So, yeah,
8 it is about the money.

9 MR. FINN: Well, Tom said one thing along the
10 way that I did agree with, but not his most recent
11 intervention.

12 The public school systems and indeed most public
13 everythings are completely inelastic with respect to
14 their budgets in a period of contraction. They don't
15 know how to shrink. They assume that all their fixed
16 costs remain fixed. They don't know how to lay off
17 people, close facilities, gain efficiencies, replace one
18 kind of cost with another kind of cost. They have
19 completely inelastic budgeting and finance systems, and
20 so they will always tell you, faced with any kind of
21 competition, be it cyber or real, that their costs don't
22 go down when the number of students enrolled in their
23 schools goes down.

24 Well, on its face, it's kind of hard to believe
25 until you get into the innards of all the assumptions

1 that are taken about a public school system's economics,
2 and if you agree with all the assumptions, that nothing
3 can change when 100 kids leave and nothing else must
4 change, then yeah, the costs don't go down, but why
5 don't things change when 100 students go somewhere else?

6 MR. GENTZEL: Checker, if I may, let me just
7 finish on this one. They don't leave in groups of 30 so
8 that we can lay off a teacher. At least in
9 Pennsylvania, we don't have the authority to lay off
10 teachers for economic reasons. We can for substantial
11 declines in enrollment. So, I knock the ball back over
12 the net to you and to Secretary Zogby and others who are
13 promoting the creation of these programs and say, then
14 you owe it to us to give us the tools to be able to make
15 those changes. You haven't done that, but we get
16 criticized when we don't cut back. We don't have the
17 authority to do it.

18 SECRETARY ZOGBY: I just wanted to make the
19 point that around the funding, there is this tension of
20 sort of the old way of doing business and the new way.
21 I happen to believe and our governors in Pennsylvania
22 have believed that money ought to begin to follow the
23 children throughout the education system, not just for
24 cyber charter school students or those in charter
25 schools, and the tension that we have is that we have

1 historically funded public education by, through
2 whatever means, sending money to district offices, and
3 then some bureaucrat in a district office decides how
4 much your child gets to back their particular education,
5 and I think we need to move towards a system where every
6 child, no matter where they come from, the color of
7 their skin, whatever, there is a certain amount of money
8 that is strapped to their back, and whether they move
9 from public school to a cyber charter or within the
10 public school system itself, that that money ought to
11 follow that child, and whether it's the district or the
12 school, that they have to make adjustments.

13 MS. COLLINS: Would you send the money home with
14 them if they go to home schooling?

15 SECRETARY ZOGBY: Well, in the Zogby world, I'd
16 probably send some portion of tax dollars. Those
17 parents are paying taxes as well, and I think they maybe
18 wouldn't have the same level of support. Voucher
19 programs, for instance, that we've proposed in
20 Pennsylvania have always had grant amounts of, say,
21 \$1,000 or \$3,000, depending on your level of income,
22 nowhere near the average that we spend in our state of
23 about \$6,500, and in some districts as much as
24 \$10,000-\$12,000 per child, but from a social justice
25 standpoint, I believe that some money ought to go to

1 every child, no matter where they get their education.

2 MR. AGARWAL: Setting aside some of the funding
3 issues, what are some of the other barriers to cyber
4 charter schools, and I'm thinking in particular of
5 accreditation problems that Sue Collins mentioned in her
6 written statement.

7 MS. COLLINS: Well, I can certainly talk about
8 some. We happen to run what's called the Apex Virtual
9 School, and it serves kids in 49 different states, and
10 so we have a situation where we actually try to deal
11 with the educational policy and regulations that exist
12 as not only around teacher certification and textbook
13 adoption, but curriculum standards around every single
14 subject area, the funding laws that exist in the state,
15 and some states are like Pennsylvania, some states are
16 not like Pennsylvania, and in a commercial world, I do
17 think you need to be able to adapt to the needs of your
18 customers.

19 At the same time, some of these barriers are so
20 great, it's almost impossible to provide this as an
21 opportunity for students in a state. So, we have
22 created different models. So, for example, in Iowa and
23 Texas they require that a virtual school that is or a
24 course that comes from a virtual school and serves a
25 Texas student or an Iowa student requires that they have

1 an Iowa certified or a Texas certified teacher, we
2 actually have gone through the effort of making sure
3 that our teachers were certified, even though many of
4 our teachers are nationally certified, and so there's
5 actually a national way that we could look at these
6 teachers and say, okay, these have been certified in a
7 national way, they don't actually have to meet Iowa's
8 requirements and Texas' requirements, but Texas and Iowa
9 both require that, for example.

10 So, it's many different iterations. You can go
11 down the list. Content standards, student-teacher class
12 size, the amount of money that follows every child, the
13 funding pattern, the curriculum standards, teacher
14 certification, how many hours you have to be in a
15 building, seat time versus what you might call e-time,
16 and that's part of the sort of accountability thing,
17 sort of the basis of part of the lawsuit in Ohio is how
18 do you account for offline time when a student actually
19 isn't in a building? How do you know they're actually
20 reading that novel you've assigned, where in a school
21 you can actually look and say, oh, look, he's reading,
22 whereas in a cyber school, you can't actually say, oh,
23 look, he's reading.

24 It may be that the proof of the fact that he's
25 actually read the novel is in the work he does at the

1 conclusion of the time period when he's supposed to read
2 the novel. So, there are many different iterations of
3 all of those things as you can count schools, and in
4 some places, there are actually district rules that
5 supersede state rules. So, it's a relatively complex
6 commercial environment to work in.

7 MR. ELLIG: Okay, let me ask a final question
8 and ask for a response from everybody, which is simply
9 this: Since this is the Federal Trade Commission,
10 education traditionally has been much more of a state
11 and local responsibility, but what do you believe should
12 be the role of the Federal Government in regard to cyber
13 charters, and I would ask John to start, also just to
14 clarify, what is the Federal Government's current role?

15 MR. BAILEY: Maybe we should start with
16 Secretary Zogby.

17 MS. COLLINS: I'm changing my name.

18 MR. BAILEY: Because this is such a new area,
19 particularly in the realm of cyber charter schools and
20 virtual schools, we are right now in the process of
21 trying to define and identify what that proper federal
22 role is. We are convening a group of cyber educators
23 and providers at the end of this month to help start
24 identifying what are the top policy issues and what are
25 some of the strategies that we should be pursuing as a

1 Federal Government.

2 We are in the process of constructing a charter
3 school guidance and regulations right now as part of the
4 No Child Left Behind Act, and virtual schools and cyber
5 charter schools are being considered as part of that.
6 So, we're still in the midst of trying to identify what
7 is that right and appropriate federal role, if there is
8 any, or if this is really something that should still be
9 left to the states, although the interesting thing is
10 that as education becomes something that can be imported
11 and exported between districts, between states and even
12 between countries, a lot of issues start coming up to
13 the level of the Federal Government in terms of deciding
14 what happens if we have a student in Pennsylvania or in
15 Florida or Nebraska that wants to start taking courses
16 from a school that's in France or a school that's in
17 England? How do we help regulate and manage the same
18 type of issues, with funding, with quality, with teacher
19 qualifications and quality assurance and so forth?

20 So, I don't know if we have real specific
21 answers at this moment. It's something that we're
22 looking at along with the FTC as to what should the
23 appropriate roles and responsibilities be.

24 MS. COLLINS: Well, I think it's a very
25 difficult problem, specifically because so little of the

1 funding that actually goes down to the individual school
2 level comes from the Federal Government. It's only
3 about 7 percent of the normal dollars, although it
4 varies a little bit based on the kinds of programs
5 you're in.

6 My personal feeling is that one of the ways that
7 the Department of Ed, the Federal Government, the
8 Congress can help is by establishing policies that
9 actually are national in scope as opposed to
10 state-specific. So, for example, if there's federal
11 dollars that flow down through a state to a district, if
12 the rules could be established in such a way that it
13 could be more like some charter legislation that says,
14 we're giving you these dollars. You don't actually have
15 to send them to provide a teacher in your district. You
16 could actually fund seats in a cyber charter, and that
17 cyber charter doesn't actually have to exist in your
18 state, for example, so that there was some ability to
19 cross lines with the spending.

20 Some of those models would be really wonderful
21 to have established, and hopefully to encourage states
22 to say maybe that's a better education for our kids, is
23 to allow less -- parochial not being a bad word -- a
24 less parochial view of education.

25 MR. FINN: Well, I think there's three broad

1 categories of the federal role here. The first is
2 financial support of various kinds. Some of it is
3 support for technology, innovation. Some of it is
4 startup support that is already flowing for charter
5 schools to get going in various states. The third are
6 the federal categorical programs such as Title I and
7 special ed where charter schools in general and cyber
8 charters in particular are not necessarily getting their
9 fair share of federal funding that is available for, in
10 these cases, disadvantaged kid and handicapped kids and
11 so forth. So, funding -- it is a pittance,
12 comparatively, it is 7 or 8 cents on the dollar, but it
13 should flow into these schools as well as into regular
14 schools.

15 Secondly, there are some quality control
16 opportunities for the Federal Government here. The No
17 Child Left Behind Act certainly carries with it some
18 academic quality control issues for anything that calls
19 itself a public school. There are civil rights issues
20 that I'd put into this heading, if a kid feels he's
21 discriminated against. There's disability issues.
22 There's kind of these enforcement issues to make sure
23 both that the school is delivering a quality product and
24 that individuals are not being sort of persecuted as
25 they try to attend the school.

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1 And then a third category, which I think might
2 be one the most relevant to the FTC is trying to do
3 something about inappropriate barriers that keep these
4 things from being tried in states and communities, and
5 the inappropriate barriers can range from, for example,
6 teacher certification rules that Secretary Paige has
7 recently raised questions about as a kind of unnecessary
8 constraint on the flow of capable people into teaching,
9 to the kind of interstate barriers on for-profit school
10 operators that we were talking about earlier in the
11 session.

12 Why should it be possible for a non-profit
13 operator of schools to operate in a state but for a
14 for-profit operator that is otherwise identical to not
15 be allowed to operate a school in that state? Or in
16 that particular community? What form of persecution of
17 interstate commerce and capitalism is this? And would
18 it not be an appropriate federal role to at least look
19 more closely into that matter?

20 MR. GENTZEL: Well, this seems kind of odd to
21 me, but I'll be the conservative on this one. I'm not
22 so sure there is a federal role in this, and I'm
23 troubled by the suggestion that the Federal Government
24 should become actively involved. I believe firmly that
25 education is primarily a function of the states. I

1 think the Federal Government can provide some leavening
2 and can try to support some efforts, and I certainly
3 would agree with that, but I think in terms of a
4 regulatory role, I think that would be very dangerous.

5 The reality of the matter is, I believe, for
6 most states, these schools, cyber schools, have a great
7 potential in the future. It is a matter of getting
8 state legislatures and state administrations, and I
9 would add interest groups who have I think concerns
10 about these things, to develop policies that promote the
11 formation of cyber schools, but I believe that has to be
12 done primarily on a state-by-state basis.

13 MR. PACKARD: I think for me the Federal
14 Government role, there's a lot of them, but one of them
15 I think is by allowing programs that use federal
16 dollars, after-school programs, summer school, failing
17 schools, to use cyber schools or education as an option,
18 I think that would be a valuable thing. I think it is
19 an option. I think you have children in failing schools
20 as part of No Child Left Behind that really have no
21 option. There's no capacity in the school systems in
22 several cities, where do they go? It takes a while for
23 a brick and mortar charter school to even pop up or
24 other options. So, to the extent that cyber schools are
25 clearly defined as a valid option for children in

1 failing schools and some of the other programs, I think
2 that would be a very valuable thing the Federal
3 Government could do. They could also put out quality
4 guidelines, like Pennsylvania did in their legislation.
5 I think that's a great role for the Federal Government.
6 And also, there are states that want to experiment with
7 this. Any way the Federal Government can help and fund
8 pilot programs and things like that to show how they can
9 work in that state, I think that's a valuable option.
10 So, that's my thoughts.

11 SECRETARY ZOGBY: I guess Checker started off
12 and talked about three revolutions. I would probably
13 add a fourth, and maybe it's not as broad as American
14 education as a whole, but certainly in Pennsylvania and
15 at the federal level, I think there's been a revolution
16 of sorts in how we look at education and the appropriate
17 role of all these bodies. Namely, five, seven years
18 ago, you would never have imagined something as
19 expansive and as far-reaching as No Child Left Behind
20 being passed and the federal role in public education.
21 So, I guess in crystal-balling, I'm probably I'd guess
22 double the oddity of Tom here in agreeing with him from
23 a regulatory perspective, as a state chief, I would not
24 want to see the Federal Government play a role, at least
25 at this point in time, in the regulation of cyber

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1 charter schools. I think some of the comments that have
2 been made in terms of allowing cybers or online vehicles
3 to be eligible for federal funding programs and the like
4 is good, but would tend to be more conservative on the
5 issue and say that for now, at least, I think the
6 Federal Government staying out of our business in terms
7 of the oversight and regulation of cyber charters or
8 cyber public schools is probably the best place to be.

9 MR. ELLIG: Okay, well, I'd like to thank all
10 the panelists for an interesting and informative
11 discussion and let you know you've changed my mind about
12 one thing. Going into this topic, I was kind of
13 thinking, well, gee, cyber charter school sounds a lot
14 like telecommuting, only it's a school and since we've
15 moved in this country toward telecommuting, maybe
16 eventually we'll move toward cyber charter schools.
17 This discussion has convinced me that the sort of
18 cultural objections to the technology and so forth may
19 very well be less for cyber charter schools than for
20 telecommuting. Thank you.

21 (Whereupon, at 5:30 p.m. the proceedings were
22 adjourned.)

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CERTIFICATE OF REPORTERS

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We, Sally Jo Bowling and Sonia Gonzalez, do hereby certify that the foregoing proceedings were taken by us in stenotype and/or audiotape and thereafter reduced to typewriting under our supervision; that we are neither counsel for, related to, nor employed by any of the parties to the action in which these proceedings were taken; and further, that we are not a relative or employee of any attorney or counsel employed by the parties hereto, nor financially or otherwise interested in the outcome of the action.

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