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Economic Impacts of the Canadian Educational Sector's Fair Dealing Guidelines

Executive Summary

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PwC has assessed the actual and expected market impacts of the implementation of the Fair Dealing Guidelines (also referred to as "Guidelines") adopted in 2012 by the Council of Ministers of Education, Canada (CMEC), Association of Universities and Colleges Canada (AUCC), and Colleges and Institutes Canada (CICan).[1] These Guidelines apply to K-12 schools and post-secondary institutions in Canada, excluding the province of Quebec.[2]

Our Assessment finds that, since implementation of the Fair Dealing Guidelines, the educational publishing industry in Canada has been subject to a significant negative impact. Licensing income is substantially reduced. Revenues from sales are experiencing an accelerated decline. These declines, we believe, will accelerate further, causing adverse structural change in an industry already weakened by numerous other negative developments in the educational content market.

Application of the Guidelines significantly compromises the ability of educational publishers to publish original materials and meet varied academic needs. Indeed, we expect that over time, the publishing of new content for K-12 schools in Canada will for the most part disappear, and the quality of the content used by school students will thereby decline. As for post-secondary institutions, we expect that the publishing of materials will be rationalized and consolidated to focus only on certain segments of the market. Specialty subjects will be underserved in favour of high-enrolment subjects, with a corresponding decline in the availability of Canadian content. Many small- and medium-size publishers that currently serve this market will be forced out of it in search of more profitable publishing areas. This development will lead to lower competition, less content diversity, and higher prices for what is produced. In short, fewer works will be developed by Canadian content producers, both creators and publishers.

The economic footprint of the educational publishing industry is shrinking. If present patterns persist, many relatively high-paying jobs are expected to disappear. Foreign publisher subsidiaries may be forced to transition from producing Canadian content in Canada to distributing U.S. content in Canada. The incomes of Canadian writers, authors, and illustrators from Canadian sources will decline, and as no immediate or eventual replacement is apparent, this income decline will drive many from the sector.

The Guidelines, and the resulting market impacts, impede the ability of content producers to seize digital opportunities and discourage innovation in the Canadian digital knowledge-based economy.

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[1] Formerly, the Association of Canadian Community Colleges.

[2] Access Copyright's sister collective, Société québécoise de gestion collective des droits de reproduction (Copibec), licenses the copying of portions of copyright-protected works in the province of Quebec. As of the date of writing, Quebec elementary and secondary schools and the vast majority of colleges and universities remain licensed by Copibec and are thus excluded from this Assessment. For the purpose of this Assessment, "Canada" refers to Canada excluding the province of Quebec, unless otherwise noted.

A. The Context—The Canadian Educational Publishing Industry

There are many varied stakeholders in the industry that produces educational content for K-12 schools and post-secondary students in Canada (the Canadian "Educational Publishing Industry"): large, multinational organizations that offer a diverse portfolio of educational materials; authors and visual artists (together, "creators") who write and create for publication in textbooks, trade books, and journals; and small- to medium-size enterprises, or "SME publishers," that often focus on niche subject areas, such as Canadian history, language learning, arts, and culture. All of these stakeholders produce unique content that is read, used, and copied by students, teachers, and professors in Canada and around the world.

In the Midst of Transition toward a Digital Marketplace

Major changes have buffeted the Canadian educational publishing industry in recent years. In particular, the industry is in the midst of a transition from traditional business models, focused on print textbook publishing, to the development of innovative digital products, solutions, and services for the Canadian market. Many industry players are actively engaged in creating digital tools and content to maintain and expand their businesses, however, the transition to a digital marketplace requires significant investment.

The ability of large publishers and SME publishers to make the necessary investments is quite uneven. Large publishers are making major investments in transforming their products into more comprehensive offerings, including interactive materials, assessment tools, and practice questions. They are aiming to ensure that their customers have easy online access to their content. In general, SME publishers, too, are striving to transition to a digital based business. They have, however, been facing a shrinking market and significantly lower profitability that has made such a transformation challenging when compared to the more heavily capitalized large publishers.

Effects of a Government Spending Focus on Technology Hardware

At the same time that publishers are moving to develop digital content, provincial governments have limited spending on educational content in favour of technology hardware. The K-12 publishing sector has felt a substantial negative impact because of this decision.[3] While several provincial governments have expressed interest in the development of digital content for K-12 classes, the increased spending on digital hardware for schools has not been matched by a corresponding investment in digital content. Neither has provincial government spending on digital content come close to offsetting the significant decline in spending on print materials. With less content purchased for the classroom, teachers are increasingly required to fill the void by copying and repurposing published content.

As the market shifts away from the purchase of traditional paper-bound textbooks to the adoption of digital technology, the revenues of K-12 publishers and related creators have fallen

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[3] See, for instance, *Consultation on K to 12 Educational Publishing in Canada,* by Glenn Rollans and Simon de Jocas (prepared under the direction of the Association of Canadian Publishers Education Committee), 2012, pp. 19-20.

dramatically. Total revenues generated in the K-12 Educational Publishing Market[4] have declined by 40% since 2008. Any revenue gains from digital content to date have consisted primarily of an increase in *blended content*, which combines print and digital components for generally the same price as print alone. In response to a continuing demand for print and in an effort to protect their market share, publishers have borne the costs of investing in digital solutions on top of having to maintain the material they offer in print. This reality has a significant negative impact on even the large industry participants in this market.

Effects of a Move Away from Traditional Post-Secondary Textbooks

The post-secondary Educational Publishing Market is also experiencing declining sales. Sales revenue declined in the post-secondary market by approximately 12% between 2010 and 2014. The post-secondary sector has been moving away from traditional textbooks towards the offering of coursepacks (containing excerpts from multiple works) and course management systems, which enable instructors to make disaggregated content available to students electronically. This model, like the one developing for K-12 classes, depends on the copying of published content.

Many publishers have sought to offset declines in revenues from print materials with new revenue models, innovative services, and digital content that offer new learning experiences to students. These models include customized publishing, disaggregated content (such as offering e-chapters for sale through their websites), and value-added digital components, which supplement traditional materials.

Large post-secondary publishers are also intensively investing in the development of interactive digital platforms for students to supplement their print or digital textbooks.

As with the K-12 publishing sector, however, the transition costs of adopting digital content and delivery are high. Canadian-owned and small publishers have reported an inability to maintain competitiveness in the face of rising levels of technology investment.

The Education Sector's New Position on the Payment of Licensing Royalties

Over the past decade, the above negative trends have significantly weakened the publishing industry in Canada; then, at the end of 2012, a new issue arose: one relating to the interpretation of copyright legislation by educational institutions.[5]

For more than 20 years, Canadian provincial ministries of education and school boards, universities, and colleges paid royalties to creators and publishers for the copying of this content. These royalties[6] were paid either directly to creators and publishers or through Access Copyright, a non-profit copyright collective acting on behalf of authors, visual artists, and

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[4]For the purpose of our Assessment, the Educational Publishing Market is defined as the supply and demand for copyright-protected published works used by K-12 schools and post-secondary institutions—together, "educational institutions"—in Canada, excluding the province of Quebec.

[5] See Section 4 of the Assessment for a discussion of the purpose of copyright legislation and its economic implications.

[6] Throughout this report, revenues for the copying of portions of published works will be referred to as licensing income, revenues or royalties.

publishers of published literary works (together, “content producers”) to administer the reproduction of their works in Canada, outside Quebec.[7]

That practice began shifting in January 2013. All of the provincial governments and several universities and colleges stopped paying those royalties. The education sector now takes the position that its members are effectively not required to pay for the copying of this content by virtue of the “fair dealing” exception in the *Copyright Act*[8]. Associations representing most K-12, college, and university users in Canada developed guidelines that purport to authorize teacher, student, and professor copying of copyright-protected works for free under the “fair dealing” provision. For the balance of this report, we will refer to these documents as “the Guidelines.”

This issue introduces a new challenge to an industry striving to innovate and seize opportunities in response to demands from Canadian consumers in the digital, knowledge-based economy.

B. The Lens Through Which This Assessment Is Made

Given the implementation of the Guidelines across the country by K-12 schools, colleges, and universities, PwC was engaged to assess the economic impacts on the Canadian market for educational content and, more generally, on the Canadian economy.

In so doing, PwC has considered the issue in light of the economic theory behind copyright protection and its counterbalance, the fair dealing exception in the *Copyright Act*. The theory is that, without the proper regulation, prospective users could consume certain goods without paying for them (in other words, they could “free ride”), resulting in a “market failure.” This failure is signified by a reduction in the economic incentives to develop new creative content. A socially optimal level of copyright protection is thus essential to ensure that Canada is favourably positioned to transition to, compete in, and innovate in a digital, knowledge-based economy.

At issue is the balance between encouraging the creation of works of the arts and intellect, encouraging the dissemination of those works and obtaining just rewards for their creators: in other words, how well the purposes of copyright are being achieved. Copyright protection of original content creates a market that gives owners the ability to sell and license that content. The sales income and copyright licensing fees that are paid to creators and publishers for the reproduction of that content are designed to encourage innovation by maintaining the financial incentive to create new works. By permitting some free uses of copyright-protected content, the concept of “fair dealing” is intended to help maintain a balance between the public’s interest in giving copyright owners control over certain uses of their content while encouraging the dissemination of that content by users and owners.

Determining whether a socially optimal level of protection is being met involves assessing the impact of copying claimed to be “fair dealing” on the market for the content. This Assessment

[7] Access Copyright’s sister collective, Société québécoise de gestion collective des droits de reproduction (Copibec), licenses the copying of portions of copyright-protected works in the province of Quebec.
[8] The Guidelines allow royalty-free copying up to a certain threshold; however, this threshold is high enough such that it effectively eliminates all payments for materials copied by these institutions.

examines the impacts of the Guidelines on the Canadian Educational Publishing Market, both content producers and users.

C. The Impacts of the Guidelines

There are indications that the adoption of the Guidelines has already brought harm to the educational publishing industry in Canada. We expect further significant negative economic impacts, and these encompass content users, too. The following nine points set out those impacts and, where applicable, data we have observed in relation to those impacts.

1. **Without licensing income—a significant source of income for content producers, especially SME publishers and creators—many Canadian publishers will not only reduce their content output, but may be forced to exit the Educational Publishing Market.**

   As a result of the Guidelines, licensing income from the K-12 sector has been all but eliminated. Provincial governments stopped paying licensing fees to Access Copyright for the copying of content in K-12 schools in January 2013. A similar outcome is expected in the post-secondary market once current licensing agreements expire at the end of 2015.

   - The expected cessation of licensing payments for the use of parts of works would represent a loss of approximately $30 million per year in payments to content producers.
   - Licensing revenue historically received by content producers through Access Copyright has not been replaced or offset by an increase in licensing revenue from direct permissions—that is, direct payments by users to content producers for the copying of their works—from the education sector. In fact, for both large and SME publishers, licensing revenue from direct permissions has decreased significantly since 2009.
   - Licensing income has a direct impact on each publisher's bottom line. It is estimated that large K-12 educational publishers alone would need to achieve an additional $24 million worth of sales revenue each year (or an additional 18%) to make up this lost revenue. That scenario is highly unlikely given that the K-12 market has declined by 40% since 2008.
   - For many SME publishers, licensing revenues represent the difference between profit and loss. The profits of SME educational publishers have declined sharply since 2008; for these publishers, EBITDA (Earnings Before Interest, Tax, Depreciation, and Amortization) declined by 81% between 2008 and 2012. In 2013, licensing revenues represented 16% of EBITDA for SME publishers, so the loss of this revenue source would have a substantial negative impact on profitability. The loss of licensing revenues is expected to cause some SME publishers to exit the Educational Publishing Market.
   - Over half of SME publishers indicated that the decrease in licensing income from Access Copyright will hamper them from investing in the production of digital products and content; it will also limit the variety and number of works they publish, particularly for the education sector.

2. The Guidelines are expected to cause a further decline in sales in the Educational Publishing Market.

Copying portions of works can substitute for the purchase of the original work. The Guidelines encourage instructors to adopt coursepacks composed of copied excerpts or use course management systems instead of purchasing textbooks. By reducing the cost of copying, the Guidelines are expected to cause a further decline in sales for educational publishers, as they are replaced by "free" copies of identical or equivalent content that would otherwise be sold by those publishers. Certain content producers, such as those that specialize in anthologies, will be particularly harmed. Because the Guidelines permit royalty-free copying of excerpts, they enable and accelerate a reliance on teacher-compiled resources composed of copied works.

- K-12 teachers copy 350 million pages of published content annually - the equivalent of 1.3 million books every year. This copying competes with and substitutes for the purchase of tens of millions of books in the same time frame.
- Since the introduction of the Guidelines, the rate of annual decline in K-12 sales has accelerated, on average, by about 0.7 percentage points per annum.[9] Outside Ontario (which recently released a new social studies curriculum), the acceleration of the decline in sales revenue is about 7.0%.
- In the post-secondary market, the rate of annual decline in overall unit sales has accelerated, on average, by about 3.2 percentage points per annum in 2012 to 2014 relative to the 2010 to 2012 period—this acceleration is more pronounced for Canadian titles compared to imported titles. The rate of annual decline in post-secondary sales revenue has accelerated, on average, by about 0.7 percentage points per annum.[10]
- The Guidelines authorize free copying that competes directly with innovative publisher business models designed to offer customers greater customization and choice, such as the sale of individual chapters and custom compilation services. The Guidelines thus undermine the development of monetization models based on disaggregated content and further diminish the value and likelihood that both the disaggregated content <u>and</u> the original, aggregated work would be purchased.

[9] Based on a comparison of the compound annual growth rate in primary revenues from 2012 to 2014 relative to 2010 to 2012.
[10] Based on a comparison of the compound annual growth rate in primary revenues from 2012 to 2014 relative to 2010 to 2012.

3. **The Guidelines were introduced following a period of substantial loss of sales in the K-12 sector, resulting mainly from limited public funding of educational resources. Thus, the introduction of the Guidelines is expected, over time, to result in the elimination of much of the Canadian K-12 publishing industry.**

   As a result of reduced funding for educational resources and other measures instituted by K-12 schools, companies operating in this sector have experienced substantially reduced revenues and profits prior to the introduction of the Guidelines. This has weakened their ability to withstand the negative impacts of the Guidelines and some of them have already exited the market. We expect more publishers to exit the K-12 educational content market, further reducing competition in the market with potential negative impacts to innovation, quality and prices.

4. **Canadian SME publishers are especially hard hit by the reduction in sales and licensing revenues precipitated by the Guidelines.**

   Due to their relatively small size and their limited access to external financing, the loss of sales and licensing income has a significantly larger financial impact on SMEs. As a result, we expect that many SMEs will be unable to continue their investments in digital solutions and content for the Canadian educational sector. Many SMEs will be forced to exit the Educational Publishing Market. Some are expected to direct their resources towards areas of publishing with more favourable and sustainable market conditions.

   - Due to a decline in sales, SME educational publishers' EBITDA declined substantially between 2008 and 2012 (by approximately 80%). As a result, licensing income has become an increasingly important source of income for SMEs. In 2013, approximately 16% of EBITDA produced by SMEs came from licensing income (up from 5% in 2009; despite the fact that many educational institutions have already started to eliminate their payments in 2013).
   - The loss of licensing, income following the introduction of the Guidelines by educational institutions further impedes the ability of SME publishers to invest in the production of digital content and services and limits the variety and number of works published for the educational market.

5. **Under the Guidelines, creators have significantly lower incentives to create content for the Educational Publishing Market, or, indeed, to remain in the education sector. As a result, we expect a reduction in the number of works and amount of Canadian content.**

   As a result of the Guidelines, Canadian writers, authors, and illustrators will earn less income from Canadian sources—sources for which there appears to be no immediate or eventual replacement. This income decline will reduce the incentive for creators to remain in the educational sector. We expect that as a result of the Guidelines, and based on our survey of creators, approximately one in three creators will produce fewer works and will reduce focus and time spent on creating content for the education sector.

- Licensing income is an important source of income for creators. The median income for creators affiliated with Access Copyright from their written or visual works is $15,000 per year. Licensing income represents approximately 20% of this income.
- Between 34% and 37% of Access Copyright's affiliate creators indicated that if the Guidelines were to reduce their licensing income, they would reduce the number of works created, the time they spend creating written and visual works, and their focus on creating content for the Educational Publishing Market.

6. **The Guidelines and weak market are expected to cause educational publishers to reduce their investments in Canada; in turn, there will be fewer titles, including fewer titles tailored for the Canadian market, and less variety in titles produced. The pace and move towards innovative digital publishing will slow**.

   - Large educational publishers are expected to increase their reliance on the import and distribution of U.S. materials.
   - Large educational publishers have reduced their headcount by over 10% since implementation of the Guidelines.
   - Oxford University Press (one of the largest educational publishers in Canada) exited the Canadian K-12 market, citing the Guidelines and related loss of licensing revenues as a major reason.
   - Nelson Education, one of the top two educational publishers in Canada, has filed for bankruptcy protection in Canada and is being restructured. The decline in the market for educational resources was identified as a key contributor to the filing.

7. **The Guidelines are expected to lead to a reduction in the diversity and quality of content produced for the Educational Publishing Market, with certain courses or subject-areas becoming underserved.**

   Given the negative impact on profitability created by the Guidelines, we expect publishers to reduce their product offering for subject areas lacking sufficient scale or demand to justify investment in new content and capital-intensive digital solutions. Alternatives to publisher-developed resources will ultimately lower the quality of learning resources available to students.

   - Fewer publishers are responding to requests for proposals to produce textbooks for new K-12 curriculum.
   - Title and product rationalization are expected to occur due to reductions in investment, leading to fewer Canadian titles produced in Canada, fewer titles per course subjects, and fewer course subjects served.
   - In response to declining sales, publishers have already begun to reduce the number and variety of titles produced. The impact is felt most in disciplines with high distribution costs (e.g., low enrolment and more advanced courses), where publishers are producing fewer titles and showing reluctance to develop digital solutions due to insufficient return on investment.

- In the post-secondary market, large publishers indicated that the Guidelines will further cause them to focus on courses with high income potential, where information must be timely and relevant, particularly the scientific, technical, and medical areas. Less attention will go to creating content for such subject areas as history, arts, language, and culture.

8. **The implementation of the Guidelines contributed to a significant decline in the economic footprint of the educational publishing industry between 2011 and 2013. Jobs in the publishing industry, particularly in the K-12 sector, and the overall future of the industry are at risk of further decline.**

- Jobs in publishing are particularly high value jobs, which is indicative of high labour productivity. They are critical to a thriving knowledge-based economy.
- The total economic footprint of the Canadian educational publishing industry[11] in 2013 was significant, estimated at about $620 million in GDP (gross domestic product) and 6,400 jobs. This figure, however, represents a significant 16% reduction from the 2011 estimated footprint of $740 million in GDP and 7,650 jobs.
- Given the particular challenges faced by K-12 content producers, it is apparent that the economic footprint of that sector of the market[12] (estimated at approximately $150 million in GDP and 1,600 jobs) is particularly at risk of further significant decline.

9. **The apparent short-term gains that Ministries of Education, universities and colleges receive through the Guidelines mean higher prices, more work for teachers and professors and compromised content of variable quality for their students.**

- The students who continue to use updated quality materials will pay higher text prices, as a result of reductions both in economies of scale available to publishers and in competition among publishers.
- K-12 teachers will have heavier workloads due to the responsibility for developing class materials.
- If individual teachers are obliged to create their own resources, there will be greater disparity in the quality of learning resources provided to students across localities.
- K-12 schools will have to rely increasingly on repurposed copied materials that are outdated or that do not meet the high education standards that Canadians have come to expect.
- Fewer works and less digital content will be developed by Canadian creators and publishers, and specialty subjects will be underserved in favour of high-enrolment subjects, leading to a decline in the availability of Canadian content for Canadians.

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[11] Excluding the Quebec K-12 publishing industry but including the Quebec post-secondary publishing industry.
[12] Excluding the Quebec K-12 publishing industry.

In the longer term, Canadian K-12 and post-secondary students, teachers, and professors—namely, the users of educational content—will also be subject to negative impacts from the limited availability of digital and Canadian content, a deterioration in the diversity and quality of content used in the classroom, and a market framework that eliminates incentives and discourages innovation in the Canadian digital, knowledge-based economy.