

## **Why Does the DOJ Sue Apple on e-Book?**

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On April 2011, the U.S. Department of Justice brought a lawsuit against Apple and several publishers over a scheme to fix e-book prices. The U.S. court ruled Apple guilty on July 9, 2013. Judge Denise Cote served injunction on September 15, 2013. Apple filed its notice of appeal on October 7, 2013.

The “price fixing” in this lawsuit was NOT related to the fixed prices for all e-books sold in Apple iBookstores, which was commonly thought to be the standardized price of \$12.99, as many people thought. All e-books in Bookstores sold as \$12.99 are a fixed price, which is a common practice in order to simplify the shopping experience for consumers and is practiced in many other businesses, such as Dollar Tree store, Dollar Menu in McDonald's. Fixed prices are legal and lawful. However, the reason for this lawsuit was because of “price fixing”, which Apple, with several publishers, worked to eliminate competition between e-book retailers.

In the traditional book market, book publishers print the suggested retail prices on the book back cover. Publishers then sell the books in bulk to book retailers with wholesale prices, which is usually half of the printed retail price. Retailers then sell books to consumers, sometimes with discounted retail prices, in order to compete with other retailers. This is called the “Wholesale Model”. In this model, publishers receive their revenue from the retailers, without the control of the retail price consumers need to

pay. Each retailer controls their own prices. Consumers pay for what the retailer decides to sell it for, not what the publisher decides to sell it for. The competition between retailers drives down the prices of these books and benefits the consumers. This model has been used by the traditional book market for over a century and is still the model employed today.

Before Apple announced the iBookstore with the launch of the iPad on January 27, 2010, the e-book markets also followed the same wholesale model. Amazon and other e-book retailers purchased the right to sell e-books from publishers under this model. To compete with traditional book purchases, and other e-books retailers, Amazon set all their e-book prices to \$9.99 or under. This low price dramatically increased the adoption of e-books. However, many publishers were not happy with such low e-books discounted prices on Amazon. They were afraid that \$9.99 would become a standard for all newly released e-books and would disrupt their traditional book markets. They would like to see e-book prices at a higher range, but they have no way to do so alone. With many private meetings and direct phone calls between executives of publishers, and with the help from Apple to facilitate a new Agency Model, several major publishers changed the whole e-book market to Agency Model in April of 2010. In the Agency Model, the publishers decide the retail prices, and the retailers get a percentage of the revenues as commission. In the case between Apple and publishers, Apple gets 30% of the revenue. Since the retail prices under this model are decided by the publishers, rather than the retailers, there are no price competitions between retailers. The only choice the retailer has for a particular book is either sell it for the

price the publisher set and get the commission, or not sell the book at all.

The complaint from DOJ in 12-CV-2826 United State of American v Apple Computer et al, outlines the following unlawful activities conducted by Apple and several publishers:

- Major e-book publishers recognize a common thread- the “\$9.99 problem”
- Major publishers conspire to raise retail e-book prices under the guise of joint venture discussions
- Major publishers and Apple agree to increase and stabilize retail e-book prices by collectively adopting an Agency Model.
- Major publishers and Apple further the conspiracy by pressuring another publisher to adopt the Agency Model
- Conspiracy Succeeds at raising and stabilizing consumer e-book prices

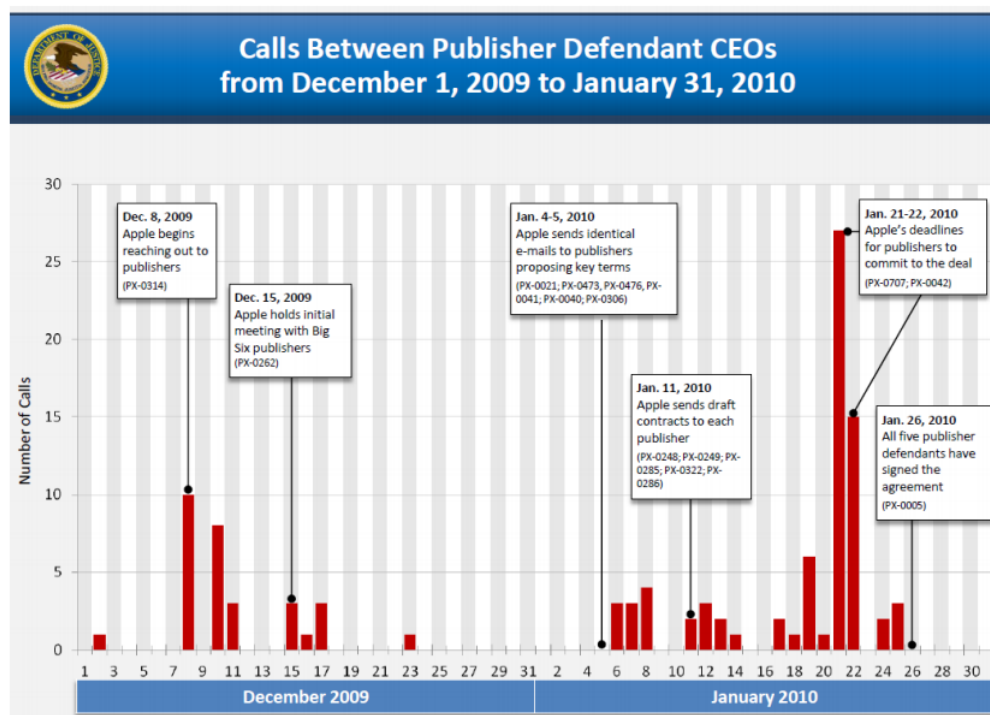
DOJ argues that the reason several publishers can change the business model for e-book quickly is not an accident. It is due to several factors:

1. Apple facilitated such a new model and ensured all these major publishers will all get the same Apple Agency Agreement with Apple and they won’t be singled out to change the model with other major publishers kept in the old model.

2. Apple mandated all the publishers with a special Most Favored Nation (“MFN”) provision. Notice this MFN is very different from other MFN. The standard MFN would favor Apple as a favored retailer, ensuring Apple would receive the best available wholesale prices and ensuring that publishers would not set a higher retail price on Apple than other retailers they had price control over. Instead, this special MFN required

publishers to lower prices on Apple to match the lowest price on any other retailers, regardless whether such publishers had price control on those retailers or not. In other words, this MFN protects Apple from having to compete on prices, while keeping a 30 percent margin. This MFN doesn't just protect Apple's ability to compete, as a standard MFN would do. Under such provision in the Apple Agency Agreement, the publishers would either revoke their wholesale agreement with other retailers and switch over completely to the Agency Model, or have to match the retail prices they set on iBookstore with the lowest retail price set by retailers still in the Wholesale Model. Therefore, such provision forces the publisher, in order to maintain profit from e-book, to revoke the previous Wholesale Model agreement with all the e-book retailers and mandate all of them to resign under the Agency Model.

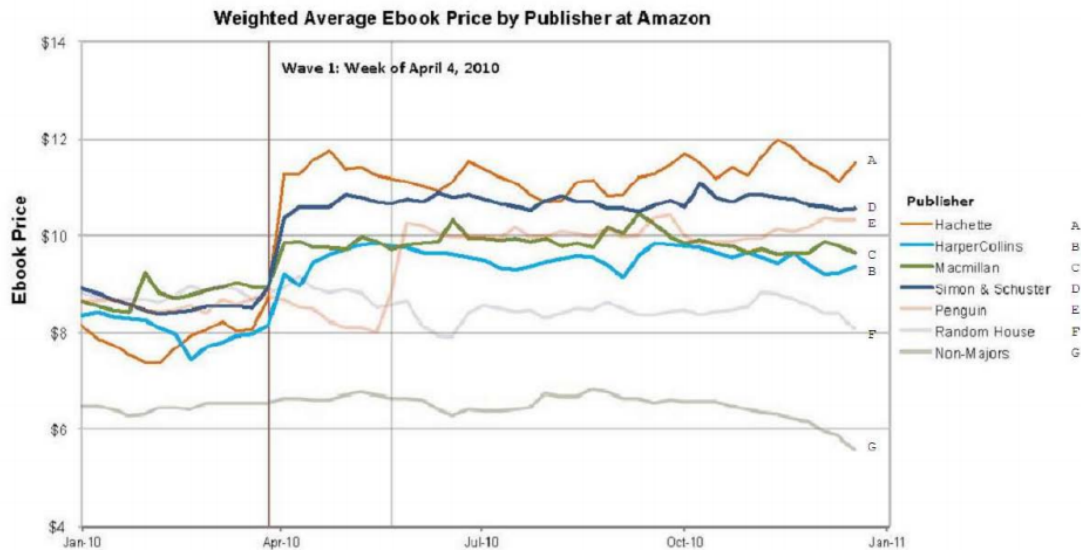
3. The major publishers got assurance from each other that they will all agree with Apple in the same Agency Model. This is shown by several pieces of evidence in the DOJ case, including the dramatic increase of private phone calls between CEOs of major publishers in the specific period of time prior to the iBookstore launch. "The timing, frequency, duration and content of the Publisher Defendant CEO's phone calls demonstrate that the Publisher Defendants used them to seek and exchange assurances of common strategies and business plans regarding the Apple Agency Agreements", stated in the clause 73 of 12-CV-2826 United State of America v Apple Inc. et al case page 24. The timeline graph below, from Appendix A of the verdict ("Opinion & Order") of the case written by United States District Judge Denise Cote, show the abnormal increase of phone calls between major publisher CEOs:



Therefore, the Agency Model and the special MFN provision in the Apple Agency Agreement, and the arrangement facilitated by Apple between several major publishers are the core of this Antitrust lawsuit. Such arrangements eliminate other e-book retailers to compete in price, because they simply can no longer set the price under the Agency Model agreement. And because these major publishers work together, with assurance from each other, they are able to press Amazon and other e-book retailers to adopt the new Agency Model from their previous Wholesale Model without too much resistance.

“Within the four months following the signing of the Apple Agency Agreements, and over Amazon’s objections, each Publisher Defendant had transformed its business relationship with all of the major e-book retailers from a Wholesale Model to an Agency Model and imposed flat prohibitions against e-book discounting or other price competition on all non-Apple e-book retailers.” stated in clause 79 of 12-CV-2826. DOJ

argues that the special MFN provision designed by Apple worked as their intend.



The results of these unlawful activities are clear: all e-book agreements in the US switch the business model from Wholesale Model to Agency Model and move the retail price decision from e-book retailers to e-book publishers and grant the publishers central control over price. The above timeline, found in page 95 of the verdict, shows the increase of weighted average e-book price by publishers at Amazon between Jan 2010 and Jan 2011. We can clearly see a significant increase in the week of April 4,

E-Book Average Price Increases at Amazon by Publisher  
Defendants Following the Move to Agency

Amazon Weighted Average Price Increases				
Publisher	All eBooks	New Releases	NYT Bestsellers	Backlist
Hachette	33.0%	14.1%	37.9%	37.5%
HarperCollins	13.6%	12.5%	44.0%	15.2%
Macmillan	11.6%	14.0%	-	11.2%
Penguin	18.3%	19.5%	43.6%	17.6%
Simon & Schuster	18.0%	15.1%	28.7%	19.8%
Defendant Publishers	18.6%	14.2%	42.7%	19.6%
Random House	0.01%	1.9%	0.2%	0.3%
Non-Majors	-0.2%	-0.9%	1.1%	0.1%

2010.

The table above, found in page 96 of the verdict, shows the Weighted Average Price Increase at Amazon e-book before and after the publishers adopt the Apple Agency Model. Notice the retail price before is decided by Amazon, but the retail price after is determined by the publishers. The table below shows the conspiracy to increase the e-book retail price not only on Amazon, but also Barnes & Noble and Sony.

Average E-book Prices of Backlist and New Release Titles  
in the Periods Before and After Agency

	Amazon	Barnes & Noble	Sony
<b>Backlist</b>			
Before Agency	\$7.16	\$6.84	\$8.07
After Agency	\$8.78	\$8.20	\$8.43
Percent Change	23%	20%	4%
<b>Hardcover New Release and NYT Bestsellers</b>			
Before Agency	\$10.37	\$9.99	\$11.31
After Agency	\$12.28	\$11.60	\$11.97
Percent Change	18%	16%	6%

The Apple e-book anti-trust case is an interesting example showing how conspiracy between competitors could hurt the consumers. The core of the case surrounding unusual communications between publishers CEOs in specific sensitive time, dramatic change of e-book business model from Wholesale Model to Agency Model, the unusual MFN provision in the Apple Agency Agreement that protect Apple not only have ability to compete, but eliminate Apple's need to price compete with other e-book retailers. And finally, the alliance formed by major publishers to pressure Amazon and other e-book retailers to quickly adopt the Agency Model in order to stay in business. The case is currently appealed by Apple, and may eventually be ruled by the US Supreme Court.

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