The Agency Model and MFN Clauses

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The Agency Model and e-books

- An *agency model* combined with *most-favored-nation* clauses were implemented by Apple and Amazon for e-book sales
  - Similar models used in other markets
- The US sued, alleging collusion in the sale of books. Settlements have largely been reached
- How do agency models and MFNs work? Was the correct decision made?

Background facts—Economics

- Two distinct sales models:
  - Wholesale—very traditional
  - Agency—suppliers set final retail prices, and split profits
- Most-favored-nation (MFN) clauses—restrict suppliers to charge the same price to different retailers
  - Frequently considered anti-competitive

Background Facts—the e-book market

- Amazon—the larger player and first mover
- Apple—entered the market at the same time it released the iPad
- Apple and Amazon standards are incompatible
- Apple demanded publishers move to the agency model (with an MFN) as a condition of entry
- Book prices increased significantly

Key Questions

1. Is the agency model an anticompetitive tool?
2. Are MFNs anticompetitive tools?
3. Is the fact that prices went up in the e-book market substantial evidence that consumers were harmed?

Answers to Key Questions

1. Is the agency model an anticompetitive tool? **Possibly**
2. Are MFNs anticompetitive tools? **Maybe Not**
3. Does the fact that prices went up in the e-book market solid evidence that consumers were harmed? **Definitely Not**

Sketch of Model

- Imperfectly competitive upstream and downstream markets
- Each supplier sells to all retailers
- Under the agency model, suppliers set retail prices and receive share r of generated profit
- The wholesale model works in the typical fashion

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- Agency eliminates double markup and lowers retail prices
  - (Under certain complementarity assumptions on prices)
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- What happens if revenues rather than profits are shared? Each supplier i with marginal cost $c > 0$ maximizes

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- Because $r < 1$, $\frac{c}{r} > c \Rightarrow$ Agency can raise retail prices

MFNs and Entry in the Agency Model

- There is an incumbent (I) and a potential entrant (E)
- Suppose that life is very bad for suppliers if no entry occurs
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MFNs and Entry in the Agency Model

- There is an incumbent (I) and a potential entrant (E)
- Suppose that life is very bad for suppliers if no entry occurs
- Suppliers want entry but face a "problem" convincing E to enter
- MFNs provide a solution $\Rightarrow$ MFNs can be pro-competitive
- This may explain why Apple demanded the agency model, along with an MFN, prior to entering the e-book market

Dynamic Incentives in the Agency Model

- Goal: understand observed price increases in the e-book market
- Goal: understand welfare implications
- Remember: Apple and Amazon have incompatible e-book standards
- Model change: two periods with consumer lock-in, set marginal costs $c = 0$

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- The agency model raises first-period prices but lowers second-period prices
- Consumers prefer the agency model
- Hence, can not conclude consumers were harmed

Conclusion

- Agency eliminates the double markup and can (but need not) lower retail prices
- MFNs can encourage retail entry under the agency model
- In dynamic models, initial price increases are not solid evidence that consumers are harmed
- Final thoughts on the e-book case...

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