ICLE tl;dr

Apple v Epic: The Value of Closed Systems

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tl;dr

Background: Apple Inc. and Epic Games are currently locked in a high-stakes antitrust dispute. Epic is challenging Apple's rules that require apps to use Apple Pay for in-app purchases and that ban alternative app stores from iOS devices like iPhones and iPads.

The suit is part Epic's broader strategy, dubbed Project Liberty, to pay lower fees to online platforms. If it succeeds, Epic would be able to steer its users toward lower-priced payment processors. This would increase the competitive constraints that Apple faces when it sets platform fees.

But... Epic's proposals would allow large developers and rival payment processors to get the benefit of Apple's investments in iOS and the App Store without paying for them. It could also undermine other online platforms that rely on commissions to earn a positive return on their upfront investments. This could shrink investments in platform creation and upkeep, hurting users and leading to worse platforms overall.

KEY TAKEAWAYS

EPIC'S FREE-RIDING PROJECT 'LIBERTY'

"Free-riding" describes when someone uses a valuable resource without paying for it, undermining incentives to provide the resource in the first place. It can be a serious problem for goods where it is difficult to exclude those who haven't paid—for example, city parks. Everyone, even those who would be willing to pay, has an incentive to avoid fees. Thus, the good ends up being underprovided, or only provided with government subsidy. The most common solution to free-rider problems is to create ways to exclude those who are unwilling to pay.

In this case, Apple owns a valuable resource that it has created—the iPhone and iOS ecosystem, including the App Store. Apple currently charges commissions of between 15% and 30% for digital goods sold through the App Store, including for certain in-app purchases. Epic would like to access that ecosystem without paying. But while the company may benefit from its long-term strategy to reduce the fees it pays to Apple, consumers may not. If reductions in revenue from the iOS ecosystem mean that Apple has less incentive to invest in it, Epic's gain may come at consumers' expense.

PRICING BY DESIGN

Apple charges fees for app sales and in-game purchases, but "free" apps currently pay no fees. This approximates Ramsey pricing, where a company tries to cover the high upfront costs of certain products, like software or electricity, by charging lower prices to users with highly elastic demand. Such pricing tends to enhance overall consumer welfare.

By taking a share of sales, rather than charging a price to list an app on the App Store, Apple ensures that large developers contribute far more toward its fixed costs than small developers, whose apps generate fewer or no app sales. This likely increases the number of apps that are made available on the App Store, since the costs of entry are lower.

If Apple could not claim a piece of developer sales through the App Store, it might instead charge higher prices for access to its APIs and developer tools, likely leading to higher costs for small developers. Alternatively, it might offset reduced commission fees by increasing handset prices. That would impose higher costs on users who make fewer in-app purchases.

APPLE'S INCENTIVES

The App Store is only valuable because it is used by both consumers and developers. Apple has to balance both sides of that market, and will suffer if either leaves the market. The risk of developers leaving the iOS ecosystem creates a built-in ceiling on the prices Apple can charge; users will be less inclined to pay for Apple products if valuable developers are not there.

The commission fee business model gives Apple and other platforms significant incentives to develop new distribution mediums (like smart TVs, for example) and to improve existing ones. In turn, this expands the audience that software developers can reach. In short, developers may get a smaller share of revenues, but it is a smaller slice of a much larger pie. Before his death, Steve Jobs contended that giving consumers better access to media such as eBooks, video, and games was one of the driving forces behind the launch of the iPad. This model of innovation would be seriously undermined if developers and consumers could easily bypass platforms, as Epic seeks to do.

THE BENEFIT OF CLOSEDNESS

Apple's "closed" distribution model also allows the company to curate the App Store's apps and payment options. Apple's guidelines exclude apps that pose data security threats, threaten to impose physical harm on users, or undermine child-safety filters.

These rules increase trust between users and previously unknown developers, because users do not have to fear their apps contain malware. They also reduce user fears about payment fraud. Rivals could free-ride on Apple's curation by mimicking its decisions and undercutting it on price. Doing so would erode Apple's incentives to enforce such rules in the first place.

Apple's closed business model also enables it to maintain a high standard of performance on iOS devices by excluding apps that might slow devices or crash frequently. Indeed, users may struggle to attribute dips in performance to a given app, and may not be able to easily solve technical problems themselves. The closed model thus ensures that unscrupulous developers cannot impose negative externalities on the entire ecosystem.

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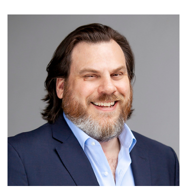

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