Insight

DOJ v. Apple: Monopolization of the Smartphone

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Executive Summary

- In March, the Department of Justice (DOJ) announced an antitrust lawsuit against Apple alleging the firm has illegally acquired and maintained a monopoly in smartphones.
- To succeed at trial, the DOJ will need to show that Apple has obtained monopoly power — the power to control prices or exclude competition — in the smartphone market using anticompetitive practices, rather than simply outcompeting rivals on the merits.
- To counter DOJ's claims, Apple will assert that competition in smartphone markets prevents it from controlling prices or excluding competition, and that there are procompetitive justifications for its conduct, such as improving the functionality of its devices and increasing privacy and security for its users.

Introduction

In March, the Department of Justice (DOJ) announced a major antitrust case against Apple, alleging the firm has illegally monopolized the smartphone market by limiting the cross-platform functionality of Apple devices to add high switching costs to Apple users. This case continues a trend in the Biden Administration of targeting large platforms out of a concern about concentration in technology markets, and could give insights into how likely courts are to embrace the "big is bad" approach to antitrust.

To succeed at trial, the DOJ must show that Apple has illegally acquired or will acquire monopoly power – the power to control prices or exclude competition – in the smartphone market through anticompetitive conduct, rather than by simply outcompeting rivals on the merits. The DOJ cites two high-level practices that it argues makes Apple's conduct anticompetitive: 1) enforcing unfair App Store rules designed to increase reliance on Apple's hardware, and 2) limiting cross-platform functionality of applications and devices to prevent current users from switching to Android or other alternative smartphones. In sum, the DOJ alleges that Apple is placing barriers to prevent users from switching to rival smartphones, harming both competition and the consumers who use Apple devices.

To counter the DOJ's claims, Apple will likely assert that it lacks monopoly power in any relevant smartphone market, and that it has a myriad procompetitive justifications for the conduct the DOJ alleges is anticompetitive. For example, creating a closed ecosystem allows Apple to improve the functionality of its services through the use of consumer data without adding security risks for users and protecting their privacy. This in turn gives Apple users more options and incentivizes rival smartphone manufacturers to continue to innovate to keep pace.

This primer breaks down the DOJ's case and how Apple will likely respond.

The DOJ's Claim: Illegal Monopoly Maintenance

The DOJ's case asserts a violation of Section 2 of the Sherman Antitrust Act (Sherman Act), which prohibits the monopolization of, or attempt to monopolize, "any part of the trade or commerce among the several States." Due to the broad language in the statute, the Supreme Court has defined two key elements for a Section 2 claim. First, the plaintiff must show that the firm in question has monopoly power, meaning it has the power to control prices or exclude competition. Second, if the plaintiff can show that the firm does in fact have monopoly power in a relevant market, the plaintiff must then show that the acquisition or maintenance of that monopoly power was achieved through anticompetitive means "as distinguished from growth or development as a consequence of a superior product, business acumen, or historic accident."

Element 1: Monopoly Power

To succeed at trial, the DOJ must show that Apple has monopoly power in a relevant market. A relevant market, for antitrust purposes, generally refers to the range of products that consumers view as substitutable, and thus could choose as an alternative to the defendant's products of the defendant. The relevant market also includes consideration of the relevant geographic area and timeframe, in addition to the focal product itself.

Relevant Market

In this case, the DOJ asserts two primary markets. First, it alleges that Apple occupies a narrower market, one of "performance" smartphones, in which Apple would be considered to have a larger share of the market, and thus more control over prices. As the DOJ defines it, the market of performance smartphones excludes entry-level smartphones, which generally are made with lower-quality materials, are less durable, and have slower processors and lower storage capacity. Second, the DOJ alleges that smartphones constitute a broader relevant product market, which excludes phones that lack the "breadth of access to the internet or third-party apps as smartphones."

For its part, Apple will argue that the relevant market is broader than the DOJ alleges, and will likely attempt to include all phones that consumers can choose as alternatives if Apple attempts to extract monopoly rents. For example, for consumers who simply need a phone, they can simply choose to buy an old flip phone if Apple's prices increase. At a minimum, Apple will likely attempt to broaden the market to smartphones generally, rather than performance smartphones. At trial, competition economics experts on both sides will present cases to demonstrate that rival products are, or are not, substitutable for consumers.

Power to Control Prices or Exclude Rivals

If the DOJ can establish that the relative market is relatively narrow, it will attempt to show that Apple can control costs and exclude rivals from that market, citing both market-share figures and anticompetitive conduct the agency alleges is designed to increase switching costs for Apple users.

Using the performance smartphone definition of the relevant market, the DOJ cites Apple's estimated market share of over 70 percent of U.S. sales. It also alleges that this figure understates Apple's true market share due to even higher shares among key demographics such as younger audiences and higher-income households. Apple's market share of the entire smartphone market is lower, but Apple still has a 65 percent share by revenue in that broader market.

Of note, the DOJ asserts that current market shares of smartphones are durable due to substantial barriers to entry and expansion, meaning that Apple can control prices without rival firms cutting into their market share. For example, the DOJ asserts fewer than 10 percent of smartphone purchasers are buying their first smartphone, meaning that for rivals to gain new customers, they must usually convince current iPhone users to switch. But, as detailed below, the DOJ alleges that Apple adds switching costs to entrench its position and benefits from network effects — the idea that the value of the smartphone increases the more users it has.

Despite these claims, the key challenge for the DOJ's argument is that many customers can and do switch to other devices. Android's smartphones currently have more than 41 percent of market share in the United States, and many customers value the open approach to the smartphone its platform offers. Android devices can also benefit from many of the same efficiencies that the DOJ cites, especially when considered it is developed by Google, a major competitor to Apple in a wide range of markets. Further, when looking globally, Apple smartphones only have 23 percent of market share, adding competitive constraints on the firm.

Element 2: Anticompetitive Conduct

To succeed on a Section 2 claim, the DOJ must also show that Apple willfully acquired or maintained its monopoly power not "as a consequence of a superior product, business acumen, or historic accident." In other words, the DOJ must establish that Apple engaged in anticompetitive conduct designed to exclude rivals, rather than simply outcompete on the merits.

The DOJ cites two high-level practices it argues are anticompetitive: 1) enforcing unfair App Store practices designed to increase reliance on Apple's hardware, and 2) limiting cross-platform functionality of applications and devices to prevent current users from switching to Android or other alternative smartphones.

According to the DOJ, Apple actively restricts competitors from accessing the iPhone platform not to provide benefits to iPhone users, but to increase the costs of switching from an iPhone to another smartphone. For example, Apple places restrictions in the App Store on what the DOJ describes as "super apps," which essentially act as a hub for a variety of mini apps. The DOJ alleges that super apps could undermine Apple's ecosystem by bundling a wide range of applications into a single interface and allowing users to access a consistent experience across devices, diminishing the iPhone's unique appeal and thus decreasing users' switching costs. This is likewise true of cloud gaming applications, which essentially allow users to run resource-intensive applications through the cloud, reducing the need for the high-capacity performance the iPhone provides. The DOJ alleges Apple restricts cloud gaming, therefore, to increase reliance on the iPhone's hardware and increase switching costs for users.

Similarly, the DOJ also alleges that restrictions on cross-platform functionality of text messaging services, watches, and wallets adds additional frictions to changing smartphones, locking these users into the iPhone. For example, the DOJ asserts that Apple creates a significantly degraded experience for iPhone users communicating with non-iOS devices through text messaging, reinforcing the iPhone's appeal among its user base through network effects and social pressures (i.e., the green bubbles). Likewise, Apple has designed its watch to only work with the iPhone, meaning those customers who switch to another device would need to buy a replacement watch. These limitations on cross-platform functionality make it more difficult for customers to switch and, as the DOJ alleges, harms competition to the detriment of the consumer.

Apple will undoubtedly argue that these practices do not stifle competition, but instead promotes it, leaving consumers with better products and more choice. For example, adding green bubbles to non-iPhone users' text

messages highlights that the added security incorporated into iMessage isn't available. Likewise, closing off the iPhone ecosystem allows Apple to maintain the safety and security of its users and their data while expanding the functionality of Apple products. By integrating Apple Watch into the iPhone, for example, Apple can allow the device increased access to the user's personal information, improving the functionality of the device. If Apple made the Watch available on Android, Apple Watch users could have valuable health data collected by the watch jeopardized if the Android device is breached, thus harming the Apple Watch reputation among smartwatches. By making its own ecosystem of products and services more efficient and secure when using an iPhone, other providers are then incentivized to enhance their own platforms to rival the user experience captured in Apple products. As a result, competition as a whole increases.

Further, many of the DOJ's arguments stem from a theory that Apple must help its rivals so that they can better compete, but under existing case law, Apple has no affirmative duty to deal with rivals. Only in extreme cases where no efficiency justifications support the practice has the Supreme Court found a refusal to deal anticompetitive, and subsequent decisions have drastically limited the applicability of this exception. While it may seem that adding interoperability requirements adds competition, offering a closed set of fully integrated devices and services gives consumers an option for additional security and privacy, one that would not be available otherwise. This increases the value of Apple products to those consumers, and rival firms must likewise continue to innovate and improve their own offerings if they want to compete, ultimately leaving consumers with more choices and better services.

Conclusion

Both consumers and businesses alike should carefully watch how this case unfolds. The legal theories here aren't novel, and many have been limited by courts over the last 50 years, but a push for broader applicability of antitrust law has gained traction in the Biden Administration. Because this case doesn't present novel theories of monopoly power or anticompetitive conduct, it could give insights into how likely courts are to embrace this new antitrust movement moving forward.