UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

UNITED STATES OF AMERICA, Plaintiff, v. APPLE, INC., et al., Defendants.	Civil Action No. 12-cv-2826 (DLC)
THE STATE OF TEXAS; THE STATE OF CONNECTICUT; et al., Plaintiffs, v. PENGUIN GROUP (USA) INC. et al., Defendants.	Civil Action No. 12-cv-03394 (DLC)

DIRECT TESTIMONY OF DAVID NAGGAR (AMAZON.COM)

1. My name is David Naggar. I am employed by Amazon.com ("Amazon") as Vice President of Kindle Content.

Background, Current Position

2. I have a Bachelor of Science degree from Cornell University, and an MBA from Stern NYU.

3. Immediately prior to joining Amazon at the end of April 2009, I ran a self-serve media platform called iAmplify. Before that I had spent 16 years with Bertelsmann, starting with positions in the CEO's office and finance at Bantam Doubleday Dell Publishing in New York from 1991 to 1994. I then worked for Bertelsmann's Book Club in France for three years, returning to the U.S. in 1998. This was just at the time when Bertelsmann acquired Random House and put it together with Bantam Doubleday Dell to create the Random House that exists today; I worked there in various roles until 2007, including running Random House's US sales force and, at the time I left, President of one of Random House's publishing divisions (a division that included audiobooks, Fodor's Travel, Princeton Review Publishing, and Random House Reference, among other groups).

4. My team at Amazon is responsible for relationships, both technical and business, with publishers around the world. We negotiate contracts with publishers who provide content for Kindle and manage the relationship post-contract signing. I currently report to Russ Grandinetti, VP Kindle.

Joining Amazon

5. When Amazon first started recruiting me late in 2008, there were no Kindle apps, it was just the device [redacted] But while I was

trying to decide about this offer, Amazon announced Kindle for iPhone. I called my contact at the company and asked if I could assume that this wasn't an isolated announcement. He couldn't give me details, but he assured me it was not, and that's when I accepted the job.

6. This commitment to apps meant customers would be able to read their Kindle books even if they chose not to buy a Kindle device, and that Amazon's focus was, and would continue to be, on selling content regardless of the customer's hardware choice. That has proven true over my four years at the company – we work hard to make a great device customers will love, but at the same time, we believe that when it comes to building an ebook library, the customer should never have to worry about their hardware choices – if they choose not to buy one of our devices, they should still have full access to their library and the Kindle ecosystem. No matter what device you're using on any given day, we want your Kindle library to follow you everywhere. Other Kindle apps followed that iPhone app very quickly, and in fact, on the day the iPad first went on sale, our Kindle app for iPad was in that app store and ready to roll.

Amazon's Ebook Pricing

7. I heard publishers and agents complain about our practice of pricing most *New York Times* bestsellers at $9.99 from the time I started working at Amazon. In an effort to understand why they were so upset, I tried to clarify the perceived problem. The issue was clearly not the amount we paid to the publishers, because the publishers and their authors were paid based on the publisher's list price, regardless of Amazon's consumer price. They all agreed that a $9.99 price on an ebook whose print equivalent was a $12.99 trade paperback wasn't an issue; it was the $9.99 price on ebooks where the print version was a hardcover that was creating the agitation.

8. So I dug into the facts and met and spoke with major publishers (including HarperCollins, Simon & Schuster, Hachette, Penguin and Random House) over the summer of 2009 to explain. (AMZN-MDL-0160989 – 991; AMZN-MDL-0160726 – 727; AMZN-MDL-0160728; AMZN-MDL-0160724 – 725) I reminded them that until late 2008 – early 2009, many $9.99 new release ebooks were essentially being sold at cost, not at a loss. Most

publishers' standard list price for digital was 20% less than the list price for print, which seems a rational position given the cost savings of digital versus print. This meant that for a $25 hardcover (a common price point for print hardcovers at that time), the digital list price would have been $20. With a 50% discount to the retailer (also common), we were paying the publishers $10 and selling to the consumer at $9.99.

9. Then, after all the biggest publishers raised their digital list prices to be the same as the print list prices (which makes no sense in any rational world given the savings on manufacturing, distribution, etc. of publishing digitally), the $9.99 consumer price did represent a discount of more than 50% off the digital list price for some titles. But what I found – and explained in detail to the publishers – was that the deep discounting they were so upset about was happening on a small percentage of titles. This is a classic loss-leading strategy, which is common in the books business. I explained that the deeply-discounted books accounted for around 3% of the titles in the catalogue and somewhere between 15 and 20% of ebook revenue, so the other 80-85% of ebook revenue was at positive margins. And though Amazon had grown its Kindle business quickly since 2007, ebooks were still a very, very small part – [redacted] – of the publishers' business. As I demonstrated to them, the $9.99 ebooks they were upset about were a small part of that segment.

10. I also pointed out that [redacted] almost no one actually buys that hardcover book for the $25 list price set by the publisher. I know, as the former head of sales at Random House, that on a big bestseller in print, over 50% of sales can come from the big price clubs, like Costco, Target, or Wal-Mart. They're selling that $25 list-price book for $13 or $14. The publishing industry had been doing that for decades, [redacted] The appropriate comparison is between a $9.99 ebook and a $13 hardcover, because Amazon was doing that deep ebook discounting only on the head of the list, and those hardcovers were also available at the deep discounted retailers for $13. When you

compare $13 for a print book to $10 for something that's not manufactured or shipped or handled or stored, it felt like very rational pricing.

11. I also explained to the publishers that Amazon's pricing strategy was highly sustainable and, quite frankly, no different than the Amazon print book pricing model publishers had been very happy with for 15 years; that model, which has always included some loss leaders, was and is sustainable [redacted]

12. Again, the ebook loss leaders represented a very small percentage of sales. And one of the great things about attractive pricing on front list titles is that it often prompts customers to make immediate purchases from the backlist. The practical reality is this: you're lying in bed and it's 11 o'clock and you've just finished a book that you loved and you're not ready to go to sleep, you want to read some more. Given that you're holding a bookstore in your hand with a Kindle, you're likely to buy another book by that author, which generally means a backlist title where the deep discounting was not in effect. Amazon's print business has always been more backlist-driven than other retailers just because it's all there, all the time – there are no shelf-space issues, and it's easy to find other books by an author you just read. The immediacy of availability with the Kindle makes digital even more backlist-driven than print. And the backlist, publishers have said from time immemorial, is the most profitable part of their business, as it is for us.

13. When I looked at this picture in 2009 after joining Amazon, I could not understand what was so bad about the way the business was going. I spent three months meeting with publishers and explaining it to them, but I pretty much ran into brick walls.

Publishers' Efforts to Force Amazon to Raise its Prices

14. Before I got to Amazon, most major publishers had raised their standard digital list price to equal the print list price. In some cases, the digital list price exceeded the print list price. [redacted]

[redacted]

15. During my visits with publishers at that time, several told me that they were surprised we had not moved off of our $9.99 price point after they had raised the list prices. There were two major reasons why we didn't change our pricing in response to the publishers' move. First, we'd made a customer promise that they were going to be able to buy most *New York Times* bestsellers and new releases at $9.99 and customer trust is something Amazon is deeply committed to. [redacted]

16. Not long after I arrived at Amazon, publishers began to float the idea of delaying the digital edition of certain titles, a practice known as "windowing." This was not a customer-friendly move, and I told the publishers that. Customers have an expectation that they should be able to read a book that's out in the market in either digital or print. One specific conversation I recall was with Carolyn Reidy, CEO of Simon & Schuster. She told me they were planning to delay the digital edition of Stephen King's upcoming book because they were going to be charging a lot for it in print and they did not want to see the Kindle version selling for $9.99. (AMZN-MDL-0160650 – 651) I pointed out to her that on a book like that, a significant portion of sales would be at warehouse clubs, who would be selling it at a deep discount. Other publishers also did selective windowing, including Hachette (Ted Kennedy's autobiography), and HarperCollins (Sarah Palin's memoir).

17. On several occasions, we showed the publishers statistics regarding their top authors and how sales of the print books hadn't changed at all since the introduction of digital and that they were just losing revenue by not making the books available digitally.

18. In December, the publishers got much more aggressive about windowing. On December 3, 2009, I met with Arnaud Nourry, Global CEO of Hachette Book Group, over breakfast in New York. During that meeting, he asked me if we were firm on pricing bestsellers at $9.99 and said that this was a big problem "for us." He went on to say that even an increase of a dollar or two in our pricing would solve the problem, and that if I was worried about my

competitors, I shouldn't be because he had spoken with other retailers who had said they would be "fine" at $11.99 or $12.99. I responded that I could not discuss details of customer pricing with him, but that I didn't see us changing our approach. At that point he said they were having a board meeting that afternoon, and that they would make a "decision." When I meet with publishers, I try to have a pen and a small notebook to take notes of the meeting. My notes from the breakfast meeting are attached. (AMZN-TXCID-0001136)

19. [redacted] The next day, Arnaud wrote to me and said that the Hachette board had made a decision regarding the ebook market, and that Maja would be in touch with my team regarding details. I responded that I was surprised that Arnaud had not told me the news himself during our meeting. He replied that it would have been unfair to his board to talk with me before the meeting, but that he had "made it clear" to me that "we have a problem." (AMZN-MDL-0076118 – 119)

20. [redacted]

21. The following week, Amazon learned that Simon & Schuster, like Hachette, would also be withholding digital editions of ebooks. HarperCollins and Macmillan soon joined Hachette and Simon & Schuster. Brian Murray of HarperCollins told the *Wall Street Journal* that it would be delaying digital release of five to ten new hardcover titles for up to six months.

Macmillan announced a similar policy, except where the ebook was enhanced and would, presumably, sell for more than $9.99.

22. We were very concerned about the apparent coordination among the publishers, and the fact that their actions seemed designed to force Amazon to raise its prices. [redacted] Delaying digital editions of books means lost sales during the period of time when customer interest in a book is most intense. One example of how senseless windowing was happened in early January 2010, with the book *Game Change*, by John Heilemann and Mark Halperin and published by HarperCollins. The book was a huge surprise hit and within days the physical edition was out of stock everywhere. But because HarperCollins was delaying the digital edition, customers who were hearing about the book couldn't buy it in any form. Like any media-driven business, you need to strike while the iron's hot and if you miss that white hot center of attention, you lose most of your sales potential. The digital file was ready to go; we could have had it available for sale within an hour. I talked to Brian Murray about all this and I even proposed the option of offering the ebook just until the print book was back in stock. HarperCollins refused to reconsider. (AMZN-MDL-0036668)

Five of the Largest Publishers Demand Agency

23. In mid-January 2010, we started hearing that these same publishers and others were negotiating with Apple to sell ebooks under a new model, rather than under the reseller approach that had always been used for books and ebooks.

24. On January 11, 2010 Madeline Macintosh called me and told me that Apple was talking to all the publishers in great detail about their plans and that any publisher that wanted to be part of the Apple bookstore had to be on the agency model. I recall that she said that Random had made a pretty straightforward decision that agency was not in their best interest and they were worried about being the only one who would not be in the Apple store.

25. On January 18, 2010, the *Wall Street Journal* reported that HarperCollins was negotiating with Apple. That same day, my colleague Laura Porco had dinner with Madeline Macintosh, who again expressed concern that HarperCollins, Simon & Schuster and Hachette

were going to enter into deals with Apple that would allow them to control price and that they would release new titles on Apple only, delaying digital titles to Amazon. (AMZN-MDL-0142874; AMZN-MDL-0160969 – 971)

26. I also received an email on the 18th from Michael Cader, of *Publishers Lunch*, asking if I'd heard about the new "Apple-and-beyond ebook selling model" and whether we had decided what to do about it. This message surprised me because while I know Cader, I don't recall any email communications with him prior to that one. (AMZN-MDL-0077424) [redacted]

27. Over the next few days, we heard from HarperCollins, Simon & Schuster, Hachette, and Macmillan that they were planning to move to an agency model. The following week, immediately after the iPad announcement, Penguin told us they were also moving to agency. The next day, January 28, John Sargent came to Amazon and told us we could either move to agency with Macmillan, or stay reseller but not be allowed to sell any of their new releases until the books were seven months old. (AMZN-MDL-0161084 – 087, AMZN-MDL-0161098 - 103).

28. As it turned out, this was not ultimately a choice he was able to offer. Macmillan basically made it clear that it was really either agency or no ebooks at all, and the other four publishers did, too. Having no ebooks from these five publishers in the Kindle store was simply not an option for us. We could not do without titles from five of the largest publishers because we are primarily a content business.

29. When we realized we had no choice but to move to agency with these five publishers, we wanted to be sure that we were not going to be disadvantaged vis-à-vis customers. We had enough evidence, including public statements from the publishers, that they were looking specifically to slow us down, so the notion that they might give other retailers more favorable pricing or withhold selection from us wasn't far-fetched. So we insisted on various

parity provisions regarding price and selection, which meant that publishers couldn't raise agency prices for Amazon's platform or deny content to Amazon that was available on another agent's platform.

30. Given Macmillan's ultimatum, they were the first publisher we negotiated with. But the only reason we negotiated with them at all was because it had become clear by then that all five of the publishers were making this move at the same time and there was no way we could fight them all together.

31. We understood the basic concept of agency, but the devil is in the details and there were a lot of details to work through, so we had to feel our way through the first negotiation, focusing on Macmillan. It was five straight days of nothing but the Macmillan negotiation, though as soon as the other publishers knew we were negotiating, they started calling to ask when we could start negotiating with them. We told them we couldn't discuss it yet and focused on the Macmillan deal.

32. Once we finalized the Macmillan agreement, we had to immediately start the process with the other four because they had set deadlines that were in the very near future. We spent the next few weeks doing nothing but negotiating these contracts with the publishers, often having multiple very long conversations a day, each with a different publisher. It went on like that until the Hachette, Simon & Schuster and HarperCollins contracts were signed.

33. Penguin's negotiation was put aside because there was a clause in their reseller contract that was still active that said that they needed to keep supplying us with ebooks. They agreed that they couldn't pull anything they had already given us, but they refused to give us anything new. So once we finished with the others, we had to turn to Penguin. (AMZN-MDL-0160900 – 901)

34. It was clear throughout the negotiation process that the publishers were talking to each other about their discussions with us. We would make a concession on an important deal point and have it come back to us from another publisher asking for the same thing or proposing similar language. In one instance in late March, Tim McCall, of Penguin, left me a voicemail

saying that they were "hearing through the grapevine that you guys are maybe coming to some agreements that are less than three years . . . maybe you're moving off of that." (AMZN-MDL-0034517) In addition to being improper, this was irritating and made negotiations from our standpoint much more complex, because we knew if we gave on one point with one publisher, the others would all know about it.

Pricing In the Agency World

35. We strongly resisted moving to agency and would not have done so but for these publishers insisting on it simultaneously. At Amazon, we're focused on the customer experience first and foremost – build a great customer experience, and customers will respond to it by engaging in your service. And our strong feeling was that customers would not be benefited by a move to an agency model. Not only would they pay higher prices, but the publishers simply weren't equipped to price efficiently. They had not hired any staff or done any other work to be prepared to handle consumer pricing for thousands of books in a digital environment, where pricing should be dynamic.

36. During the agency negotiations in 2010, I asked the publishers what they had done to prepare to take on responsibility for retail pricing. Next to acquiring the book, how you price and promote it is the most important thing in determining a book's success. Publishers were not prepared for this complexity. They were used to setting an initial list price, then weeks later deciding whether to change the list price on their next reprint, and then thinking about it again in two months' time when their inventory had run out. But online pricing to consumers is dynamic – particularly with ebooks. So I asked them who they had hired with expertise in developing digital pricing strategies, and what developers they had hired to write the algorithms to decide day to day where they should be pricing particular titles. The response I got was shocking: "We'll get to it." As it turned out, our fears were justified.

Efforts to Show the Negative Effects of Agency Pricing

37. As expected, after the agency agreements were in place, many agency ebook prices went up. We presented data to the agency publishers at every business review showing

them how their pricing benchmarked against reseller customer pricing. We showed them slides on their growth rates and how their pricing related to that. The data was very clear – the agency publishers' growth rate was significantly diminished versus reseller publishers. Penguin, whose pricing was far above everybody else, showed growth that was slow even compared to their agency compatriots. (AMZN-DOJ-000466 – 483; AMZN-DOJ-000417 – 420)

38. By these presentations, we were trying to convince the publishers that their approach to agency pricing wasn't in their own best interest, much less in the best interest of consumers. With a print book, you've got to manufacture and ship physical books, so there is a real marginal cost to distributing another unit – you're making pricing decisions based on print runs – how you can get your print cost down enough to justify the print run, how long you'll have to keep it in inventory, etc., etc. But with digital books, once you've done the editorial work and an ebook file exists and the cover's done, the marginal cost of manufacturing and distributing the next unit is zero. So it's clear to us that in a digital world you want to price to maximize overall revenue. Based on the growth numbers we were seeing, the agency publishers clearly weren't doing that, and we showed them the numbers.

39. Some of the publishers dismissed our data, arguing that the advantages enjoyed by the reseller publishers, especially Random House, could all be attributed to Amazon's focus post-agency on promoting reseller titles. But that wasn't accurate. We were promoting value to the customer, as we had done pre-agency. We didn't feel a $14.99 ebook was a good value to the customer so we weren't going to promote that book. Had any agency publisher dropped its $14.99 book to $9.99, we'd have been happy to promote it. That business decision was not based on the agency model, but on what value was presented to the customer. Second, and more importantly, the publishers' argument only holds on frontlist books. We promote the backlist by showing customers things they might be interested in based on the books and authors they've read. Our systems do that very well and none of that changed with agency, so on backlist books, which are the vast majority of ebook sales through Amazon, the argument is specious because the books showing up in those algorithms were showing up regardless of price or business

model. The impact of agency prices was felt across the publishers' sales, whether you looked at frontlist or backlist or both. We broke out the data we showed them into frontlist and backlist for that very reason.

I declare under penalty of perjury that the foregoing is true and correct.

EXECUTED on April 23, 2013.

David Naggar