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The Good, the Bad, and the Ugly: Comments to the Commission's Horizontal Guidelines—Standardization

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I. INTRODUCTION

This note sets out my comments to Section 7 of the *Guidelines on the applicability of Article 101 of the TFEU to horizontal co-operation agreements* ("Guidelines")[2] and, in particular, to the criteria for assessment of standardization agreements which (a) involve intellectual property rights ("IPR"), (b) establish technical interoperability and compatibility between products and systems, and (c) give rise to a *de facto* industry standard.

There are many statements in these Guidelines that I find helpful and support. (See Section A below.) However, I disagree with other statements. I am concerned that the policy principles contained in those statements may chill innovation and undermine the process of standardization. (See Section B.) Finally, there are many statements that I find confusing and where I would appreciate some further clarification. (See Section C.)

II. POSITIVE STATEMENTS—THE GOOD

The Guidelines contain many helpful statements. Most importantly:

- *The Guidelines presume that standardization agreements facilitating technical interoperability and compatibility give rise to efficiencies that are passed on to consumers*.
  - The Guidelines acknowledge that, "[s]tandardisation agreements frequently give rise to significant efficiency gains." In particular, standards which establish technical interoperability and compatibility between products and systems "often encourage competition on the merits between technologies from different companies and help prevent lock-in to one particular supplier."[3]
  - The Guidelines state, "[w]here standards facilitate technical and interoperability and compatibility or competition between new and already existing products, services and processes, it can be presumed that the standard will benefit consumers."[4]

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[2] *Guidelines on the applicability of Article 101 of the Treaty on the Functioning of the European Union to horizontal co-operation agreements* C(2010) 9274/2, Section 7, hereafter "Guidelines."

[3] *Id.* ¶308.

[4] *Id.* ¶321.

- *The Guidelines make it clear that while standardization agreements may create or increase the market power of holders of essential IPR, they do not necessarily give rise to dominance or can be considered anticompetitive* per se.
  - The Guidelines state, "even if the establishment of a standard can create or increase the market power of IPR holders possessing IPR essential to the standard, there is no presumption that holding or exercising IPR essential to a standard equates to the possession or exercise of market power."[5]
- *The Guidelines also clarify that high royalty rates need not be regarded as excessive unless they are unrelated to the economic value of the IPR.*
  - The Guidelines state, "[h]igh royalty rates can only be qualified as excessive if the conditions for an abuse of dominant position as set out in Article 102 of the Treaty and the case law of the Court of Justice of the European Union are fulfilled."[6]
  - They go on to say "the assessment of whether fees charged for IPR in the standard setting context are unfair or unreasonable should be based on whether the fees bear a reasonable relationship to the economic value of the IPR."[7]
- *The Guidelines recognize that there are firms with different business models and thus different interests in standard-setting organizations and that no standardization agreement should favor one business model over another. In particular, the exclusion of pure innovators could lead to the selection of inferior technologies.*
  - The Guidelines state, "[i]n the context of standards involving intellectual property rights ("IPR"), three main groups of companies with different interests in standard-setting can be distinguished in the abstract. First, there are upstream-only companies that solely develop and market technologies. ... Secondly, there are downstream-only companies that solely manufacture products or offer services based on technologies developed by others and do not hold relevant IPR. ... Finally, there are vertically integrated companies that both develop technology and sell products ..." [8]
  - The Guidelines also say, "if a standard-setting organisation explicitly excludes upstream only companies (that is to say, companies not active on the downstream production market), this could lead to an exclusion of potentially better technologies."[9]
- *Furthermore, the Guidelines acknowledge that the business model of pure innovators requires them to charge royalties and, therefore, the imposition of royalty caps questions their business model.*
  - The Guidelines state that in the context of standards involving IPR "there are upstream-only companies that solely develop and market technologies. Their only source of income is licensing revenue and their incentive is to maximise their royalties." [10]

[5] *Id.* ¶269.
[6] *Id.* footnote 106.
[7] *Id.* ¶289.
[8] *Id.* ¶267.
[9] *Id.* ¶297
[10] *Id.* ¶267.

- *Finally, the Guidelines also acknowledge that forcing companies participating in a standard-setting process to disclose their IPR* ex ante *may be disproportionate and inefficient in situations where it can be presumed that there is IPR reading on the standard.*
  - The Guidelines say, "[t]herefore, any IPR disclosure would not have the positive effect of enabling the members to factor in the amount of IPR when choosing technology since regardless of what technology is chosen, it can be presumed that there is IPR reading on that technology. IPR disclosure would be unlikely to contribute to guaranteeing effective access to the standard that in this scenario is sufficiently guaranteed by the blanket commitment to license any IPR that might read on the future standard on FRAND terms. On the contrary, an IPR disclosure obligation might in this context lead to additional costs for the participants. The absence of IPR disclosure might also, in those circumstances, lead to a quicker adoption of the standard which might be important if there are several competing standard-setting organisations."[11]

III. PROBLEMATIC STATEMENTS—THE BAD

The Guidelines contain some statements that I find problematic. My concern is that the rules set out in the Guidelines risk chilling innovation and may also undermine the process of standardization. I expressed the same concern when commenting on the Draft Guidelines in a brief paper, joint with Anne Layne-Farrar, published in 2010.[12] While the Guidelines have effectively dealt with some of the doubts Anne and I had about the Draft Guidelines, I am afraid they have not addressed this concern satisfactorily.

This is for two reasons. First, I believe the Guidelines may be interpreted as imposing a limit to the compensation received by IPR owners of essential technologies, irrespective of whether or not they enjoy a dominant position. Second, I believe the Guidelines may make it impossible to apply Article 101(3) unless IPR holders, wishing to include their IPR in the standard, commit to license their essential IPR on fair, reasonable, and non-discriminatory ("FRAND") terms, irrespective of their social benefits.

The Guidelines set out four conditions under which standardization agreements would fall outside the scope of Article 101(1).[13] One of those conditions, as applied to standards involving IPR, demands that all participants wishing to have their IPR included in the standard are required to offer to license their essential IPR on FRAND terms.[14]

According to the Guidelines, however, these conditions are *sufficient but not necessary*. So, in principle, a standardization agreement involving IPR that does not include FRAND commitments may not infringe Article 101(1) and, even if it does, it may still be exempted if the conditions of Article 101(3) are fulfilled.[15]

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[11] *Id.* Example 3.

[12] Anne Layne-Farrar and Jorge Padilla, *Comments to the Commission's Draft Horizontal Guidelines – Standardisation,* (9)1CPI ANTITRUST CHRON., (Sep. 2010), *available at* https://www.competitionpolicyinternational.com/sep-10/.

[13] Guidelines, *supra* note 2, ¶278.

[14] *Id.* ¶285.

[15] *Id.* ¶279.

A. The Impossibility of an Article 101(1) Defense in the Absence of FRAND Commitments

Whether an agreement that does not require IPR holders to offer FRAND commitments infringes Article 101(1) or not will depend on the Commission's assessment of its likely effects on the markets concerned.[16] The Guidelines are not very clear about how that assessment will be conducted. However, my interpretation of the principles laid out in the Guidelines is that they can be used to conclude that such an agreement is likely to restrict competition unless there are several competing standards or there is effective competition between the standardized and non-standardized solutions.

Indeed, I read paragraph 294 as saying that if the standardization agreement gives rise to a *de facto* industry standard,[17] limiting access to the standard and, in particular, to the essential IPR for implementing the standard is likely to restrict competition and therefore infringe Article 101(1). In particular, since offering discriminatory terms to members or non-members of the standard-setting organization will limit access to the standard, it is therefore likely to restrict competition. So, the standardization agreement will infringe Article 101(1) unless IPR holders apply ND terms.

Moreover, paragraphs 286 and 299, read in conjunction, may be interpreted as implying that effective access to the standard is likely to require the industry to be fully informed not only as to the available technical options and the associated IPR, but also as to the likely cost of that IPR. The Guidelines consider that the industry will be fully informed of the cost of the IPR, and hence effective access will be granted, when IPR holders commit to apply licensing terms *ex post* (once the industry is locked into the standard) that are equal to the terms applied *ex ante* (before the industry was locked in).[18] Alternatively, effective access will not be an issue when (a) IPR holders announce their licensing terms (or their most restrictive terms) *ex ante* and commit to apply those terms (or more favorable ones) *ex post*;[19] or (b) with a royalty-free standards.[20] So, access to the standard appears to be regarded as "effective" only when IPR holders license their IPR for free or, alternatively, commit *ex ante* to certain terms or, what is the same according to the Guidelines, make a FR commitment.

B. The Impossibility of an Article 101(3) Exemption in the Absence of FRAND Commitments

I have just explained why I believe that any standardization agreement involving IPR that does not include FRAND commitments and gives rise to a *de facto* industry standard may be taken to infringe Article 101(1) under the Guidelines. I also believe that such an agreement may not be exempted under Article 101(3) even when it gives rise to substantial efficiencies. Basically, my reading of the Guidelines is that agreements involving IPR but no FRAND commitments are likely to fail to satisfy the *no elimination of competition* condition of Article 101(3).

This is based on the following observation. The Guidelines state that where a standard becomes a *de facto* industry standard, "competition may be eliminated if third parties are

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[16] *See Id.* ¶292.

[17] That is, when there are no competing standards and there is no competition between the standardized solution and the non-standardized solution.

[18] *Id.* ¶289.

[19] *Id.* ¶¶290 and 299.

[20] *Id.* ¶286.

foreclosed from effective access to the standard."[21] As explained above, I believe the Guidelines imply that "effective" access to the standard can only be achieved if the members of the standard-setting organization commit to apply *ex ante* licensing terms (or alternatively offer royalty-free licenses).

C. The Meaning of FRAND

The welfare implications of requiring IPR holder to make FRAND commitments to avoid infringing Article 101 depend on how FRAND is defined. The Guidelines list four different approaches to assess whether the terms offered by holders of essential IPR reading on the standard are FRAND; two of them lack support in economics and are bound to produce erroneous valuations, and the other two, while in principle conceptually sound, are bound to cause underinvestment and discourage participation in standard-setting efforts.

Two of the approaches to define FRAND terms in the Guidelines make no economic sense.[22] The first is to rely on an independent expert assessment of the relevant IPR portfolio's objective quality and centrality to the standard at issue. This approach is open to potential manipulation and, due to its subjectivity, likely to yield biased estimates of the value of the IPR. The second alternative is to use the rates charged for the same IPR in other comparable standards as a benchmark. However, in my experience, there are no comparable standards, because each standard has unique features and addresses specific needs. As a result, the same IPR is bound to have very different economic values across seemingly comparable standards.

The other two approaches involve *ex ante licensing*. The first is to compare the terms and conditions applied *ex post* with the terms and conditions applied *ex ante*.[23] This is known as the "incremental value rule."[24] As explained by Layne-Farrar et al.,[25] this rule risks reducing R&D investment and innovation and would limit the incentives of IPR holders to participate in the standard-setting process under fairly general conditions. The Guidelines also consider it possible to assess the fairness of the terms offered *ex post* by reference to *ex ante* disclosures of licensing terms.[26] This method has the same problems than the incremental value rule: it may lead to underinvestment and discourage standardization.

IV. CONFUSING STATEMENTS—THE UGLY

I have drawn three clear lessons from the Guidelines in connection with the competitive assessment of standardization agreements involving IPR. I have no major queries with any of them.

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[21] *Id.* ¶324.

[22] *Id.* ¶290.

[23] *Id.* ¶289.

[24] *See* D. G. Swanson & W. J. Baumol, *Reasonable and Nondiscriminatory (RAND) Royalties, Standards Selection, and Control of Market Power*, ANTITRUST L.J., (2005), and A. Layne-Farrar, J. Padilla, & R. Schmalensee, *Pricing Patents for Licensing in Standard Setting Organisations: Making Sense of FRAND Commitments*, ANTITRUST L.J., (2007)

[25] *See* A. Layne-Farrar, G. Llobet, & J. Padilla, Increments and Incentives: The Dynamic Innovation Implications of Licensing Patents under an Incremental Value Rule, REGULATING INNOVATION, COMPETITION POLICY AND PATENT LAW UNDER UNCERTAINTY, (G.A. Manne & J.D. Wright, eds.) (2010). *See also* A. Layne-Farrar, G. Llobet, & J. Padilla, *Payments and Participation: The Incentives to Join Cooperative Standard Setting Efforts,* Working Paper, February 2010, *available at* http://www.cemfi.es/~llobet/joinSSO.pdf.

[26] Guidelines, *supra* note 2, ¶290.

- Agreements that form part of a broader exclusionary agreement and agreements that use the disclosure of licensing terms to collude constitute infringements by object.[27]
- Agreements where participation in standard-setting is unrestricted and the procedure for adopting the standard in question is transparent, standardization agreements which contain no obligation to comply with the standard and provide access to the standard on fair, reasonable, and non-discriminatory terms will normally not restrict competition.[28]
- Standards where IPR is licensed royalty free,[29] or which face several competing standards or effective competition from the non-standardized solution,[30] are unlikely to produce restrictive effects on competition.

As I have argued in Section B above, I believe that the Guidelines also imply that any standardization agreement involving IPR that does not include FRAND commitments and gives rise to a *de facto* industry standard is (a) likely to restrict competition and thus infringes Article 101(1) and (b) is unlikely to be exempted under Article 101(3). I disagree with this implication. It will hurt innovation incentives and will reduce long-term welfare. Innovators will be harmed and consumers will be harmed, too. Only downstream manufacturers and vertically integrated companies may be better off.

I am prepared to contemplate the possibility that my interpretation is erroneous. But if that is the case, I promise the reason does not lie in any aprioristic bias against the Guidelines. The paragraphs dealing with the effects-based assessment of standardization agreements under Article 101(1),[31] as well as the paragraphs referring to the assessment of those agreements under Article 101(3),[32] are extremely confusing. And no example is included to clarify these paragraphs. The Guidelines fail to provide clear guidance on the standards the Commission intends to use to assess standardization agreements outside the safe harbor defined by the sufficient conditions laid out in paragraph 280.

Unless the meanings of those paragraphs are clarified and those standards of analysis meaningfully explained, standard-setting organizations as well as the companies involved in standard-setting processes may interpret them as I do or, alternatively, may ignore them and treat the *sufficient* conditions for non-infringement, including the need to commit to licensing on FRAND terms under the *ex ante* interpretation of FRAND defended in the Guidelines, as *necessary*. Both alternatives are, I respectfully submit, undesirable, because in both cases the return to investment and innovation may be capped at an inefficiently low level.

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[27] *Id.* ¶¶273, 274.
[28] *Id.* ¶280.
[29] *Id.* ¶286.
[30] *Id.* ¶294.
[31] *Id.* ¶¶292 – 299.
[32] *Id.* ¶¶308 – 311, 315 – 319, 321, 324.