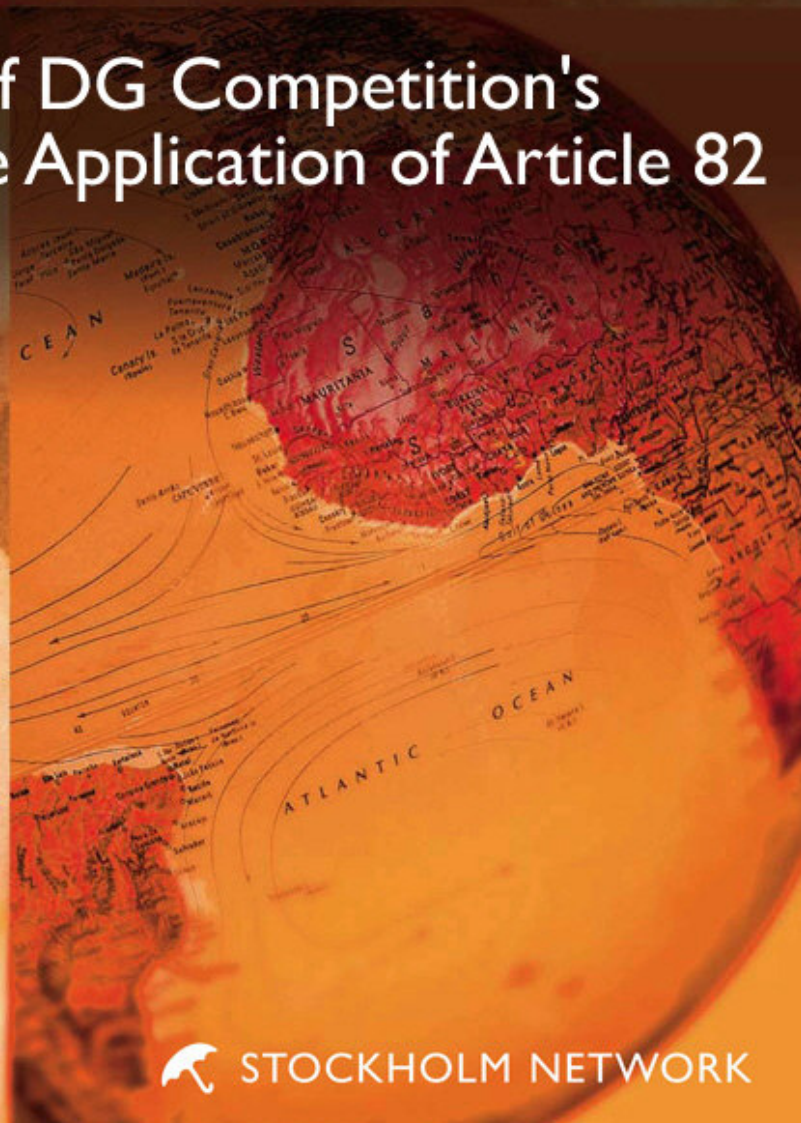




The Stockholm Network Experts' Series on Intellectual Property and Competition

An Economic Analysis of DG Competition's Discussion Paper on the Application of Article 82



By Dr Brian Hindley



STOCKHOLM NETWORK

Intellectual Property Rights and Competition Policy – An Economic Analysis of DG Competition’s Discussion Paper on the Application of Article 82

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Table of Contents

1) Introduction.....	page 4
2) Indeterminacy in the economic analysis of IPRs and CP.....	page 5
2.1) Intellectual Property Rights.....	page 6
2.2) Competition Policy.....	page 6
3) Alleged Abuses.....	page 6
3.1) Extension of the patent monopoly to other products.....	page 6
3.2) Refusal to license.....	page 8
4) Suppression of improvements.....	page 10
5) Conclusion	page 11

Introduction

Intellectual property rights (IPRs) achieve their effects by suspending for the item they protect the open competition and free entry that competition policy (CP) attempts to maintain or create. On this basis, IPRs and CP are often said to conflict.

This general conflict, however, yields little of interest. It is not uncommon, after all, to suspend the pursuit of one set of policy objectives in an effort to further the achievement of another set. Moreover, this general conflict could easily be resolved by declaring that in the case of a clash, one or the other side would always win. The law could be set up, for example, so that competition law did not apply to any case involving IPRs.

That position might be regarded as extreme – though it is in fact not too far distant from current EC legal reality. It is used as a starting point in this paper, though, not for its descriptive qualities, but because it is analytically useful. The postulation that IPRs always trump competition policy highlights specific conflicts between CP and IPRs that have economic and legal content. If CP were to be disabled in the face of IPRs, what economic losses might arise, and how?

The IPR literature yields several possibilities – describing what are sometimes referred to as “abuses” of IPRs – that will create social costs, which, it is said, could be avoided through CP.

They include assertions that IPR holders might:

- (a) attempt to extend their IPR monopoly to other products, not directly subject to IPRs;
- (b) impose burdensome conditions of licensing, including refusal to licence; and
- (c) suppress improvements to their IP when these are created by other persons.

Discussion of these propositions will make up the bulk of this paper. To focus the discussion, the analysis centres on a recent European Commission discussion paper¹ that deals with these issues.

Before turning to that, however, it is necessary to briefly address problematic features of both IPRs and CP. In a nutshell, the effects of both are indeterminate; and this indeterminacy affects the possibility of making propositions that are at once sharp, clear and truthful.

¹ *DG Competition discussion paper on the application of Article 82 of the Treaty to exclusionary abuses*, Brussels, December 2005. At <http://ec.europa.eu/comm/competition/antitrust/others/discpaper2005.pdf>, hereafter *Application*.

Indeterminacy in the economic analysis of IPRs and CP

Intellectual Property Rights

In trying to solve one problem, patents (and copyrights) create another. The problem that patents try to solve is that of ensuring that inventors are properly rewarded for their work. In the absence of patents, a new invention can legally be copied, and the copy sold, by anyone. Such activity will depress the price of the original, possibly severely. But the return on the investment that was required to create the original depends on the price at which the inventor can sell the invention; and the lower price brought about by copying will reduce that return, possibly to a level so low that she will fail to recover the amount invested in creating the original. A consequence is that investment in the creation of inventions and works of art will be deterred, to the general impoverishment of society. Patents (and copyrights) attempt to avoid this outcome by giving inventors a legal means of preventing sales of copies.

Nevertheless, the price that follows unrestricted copying is a more appropriate price, from a social point of view, than the price of the original when protected by an IPR. This is the problem that patents create or worsen. They protect the commercial exploitation of new knowledge, and allow a price to be placed upon it.

Knowledge, though, is a public good: one that can be consumed by one person without reducing the amount available for others. Since public goods are not scarce, there is no social reason to restrict use of them, and, were resources optimally allocated, the price of public goods would be zero. In an ideal economy, inventions will be sold at a price that reflects their use of scarce resources – the chemicals in a pill and the factors of production used to mix them – but *not* the knowledge embedded in the pill, which is not scarce. The problem created by patents is that they cause this rule for optimal pricing to be broken.

To say this is not to attack IPRs. They may be the best available solution to the incentive problem.² IPRs, however, balance a good against a bad, and almost all changes in IPRs increase or decrease both the good and the bad. That, and the practical impossibility of measurement, makes assessment of the outcome of alterations in the treatment of IPRs difficult. Clear statements about the patent system are hard to come by: it is usually impossible to show that the net effects of a change unambiguously improve welfare or decrease it.

Suppose, for example, that the general conflict between CP and IPRs were resolved by declaring CP to be the winner in any collision. That rule would tend to reduce or eliminate restrictive use of patents – and in the limit would eliminate them as effective means of increasing the returns to invention. In turn, that would almost certainly reduce the resources devoted to invention and would therefore reduce the flow of new inventions – a potential social loss. It also, however, gives rise to a

² Hindley (2006) offers a more complete discussion.

potential social gain in that those inventions that were made would be sold at a lower price. The net result might be a social gain (but might also be a loss).

Competition Policy

The indeterminacy in CP rarely arises from its declarations of intent, which are almost invariably full of virtue, but rather from its application. CP is a powerful weapon. It can be used to keep in business competitors who ought to go to the wall or to harry large firms for purposes and with motives that have little to do with efficient resource allocation.

Even when legitimate goals are pursued, problems may appear. Competition authorities sometimes seem to see themselves as a modern-day inquisition, sniffing out evil wherever it may be found. But such enthusiasm is neither efficient nor rational. An efficient competition policy will pursue abuses so long as the cost of correcting them is less than the expected gain from the correction. The more strained the arguments used by a competition authority become, and the more complicated the computations it must perform to further its pursuit of virtue, the stronger the ground for doubt that it is attempting to follow that rational rule.

Alleged abuses

Extension of the patent monopoly to other products

The notion that a right holder may be able to extend her legitimate IPR to a market in a related product, not protected by IPRs, is an old one. Very often, this is said to occur through 'tying': bundling two products together so that buyers cannot get only one, but must take both.

A series of cases in the U.S, for example, involve a patented machine that requires an unpatented input – computers and cards, for instance (an example suggesting the age of the argument) or machines for attaching heels to shoes and the heels themselves. The machines were typically leased, not sold outright, and a condition of the lease was that the lessee must purchase the necessary input from the lessor (the IPR holder) or from a supplier designated by him. U.S. courts ruled that the right holders were extending their IPR monopoly in machines to the market for the input, and it is easy to see why they found that conclusion attractive.³

But while tying may indicate a monopolist playing games, it is very far from being an infallible indicator. Tying is ubiquitous – and ubiquitous in situations in which monopoly is not an issue. Walking boots, for example, typically come with laces. In principle, the two products could be sold separately, but

³ Though economic analysis suggests that the situation is in fact is less straightforward. The cost of using a machine is its rent plus the cost of the input. So the seller of a machine has no apparent interest in the price of the input being high: her interests are surely best served by a price for the input that is as low as possible, since the lower the price of the input, the more a user will be prepared to pay for the machine. Stated alternatively, forcing users of the patented machine to buy the input at a higher price than they could obtain elsewhere simply raise the effective price of the machine. Why not raise the price of the machine directly?

A clue to a possible answer lies in the fact that selling the input at a higher price will not raise the price of machine plus input equally for all buyers. Those who use the input especially intensively will pay more. Such intensive users might also be expected to be willing to pay more – and if a monopolist can find a way of charging them more, she will find it profitable to do so. The tying of the machine and the input, on this reading, is not to extend the IPR monopoly to the market for the input: it is a scheme to allow the patent monopolist in machines to become a discriminating monopolist in machines – and to obtain more revenue from the IPR than otherwise would be possible.

most boot-buyers probably do not want to spend time selecting boots, and then more time choosing laces. Moreover, boot manufacturers are probably able to obtain well-matching laces more cheaply than retail boot buyers. On either ground, selling boots and laces as a bundle is efficient.

DG Competition recognises this obvious point (*Application* para 178). It also acknowledges that the objective of competition policy is to make consumers better off. Whether it succeeds in putting these principles into effect, however, is less clear.

One reason for doubt is that although DG Competition correctly says that competition policy is about maintaining competition, not competitors (*Application* para 54) it also says that it will deviate from that rule in particular circumstances. It says (*Application* para 67) that "...it may sometimes be necessary in the consumers' interest to protect competitors that are not (yet) as efficient as the dominant company."

This nod in the direction of industrial policy is dangerous. A company that is not yet as efficient as the dominant company may never be: and DG Competition has no obvious competence to assess this risk. Getting it wrong, however, is likely to be expensive for Europeans.

DG Competition, moreover, goes on to say that in considering the costs of competitors, it will take into account "...economies of scale and scope, learning curve effects or first mover disadvantages that later entrants could not be expected to match even if they were able to achieve the same production volumes as the dominant company." These factors – even if DG Competition could accurately assess them, which is very much in doubt – provide a fertile ground for asserting that companies that are not efficient will be, with appropriate official action.

Furthermore, it is open to doubt whether protecting competitors who are not (yet) as efficient as the dominant company will have very much effect on the behaviour of the dominant company. If the dominant company raises its prices, for example, will the officially sponsored competitor hold its prices constant, in order to acquire market share (which might provide a basis for a policy to hold it in the market despite its lack of efficiency), or will it raise its own prices?

A second reason for doubt about the actions implied by *Applications* is the level of concern DG Competition displays at the possibility of extension of IPR monopolies. DG Competition sometimes seems to suggest that such extension is a *per se* motivation of an IPR holder – that she will attempt to achieve an extension of her IPR monopoly to other markets even if it is not profitable for her to do so. That is dangerous. Giving actors in economic models motives other than profit maximisation certainly produces models that arrive at the conclusion that their actions will lead to inefficient outcomes. Policy based on behavioural premises that lack empirical justification, however, is also likely to lead to inefficient outcomes.

Refusal to license

Licensing agreements often limit the way in which the licensee may sell the licensed output – specifying, for example, a minimum price or maximum quantity. This is sometimes cited as an ‘abuse’ of the patent, which is a silly use of the word. Restriction of output is an integral part of the patent system. Holders of patents have an incentive to serve their markets at the lowest possible cost; and will licence or not, and place such conditions on licensees, as seems to them likely to achieve that objective. To successfully argue that anything is to be gained by second guessing the decisions of right holders is not easy.

Until quite recently, this appeared to be the position that informed European law.⁴ That changed, however, with the European Courts of Justice’s (ECJ) decision in *Magill*.⁵

Magill, a publisher, wished to produce a comprehensive guide to television programmes broadcast in Ireland, but was prevented from doing so by the refusal of the broadcasting channels RTE and ITP to provide or allow the use of information on their future programming. They asserted copyright in their programme schedules and refused to licence *Magill* to use this information.

The ECJ held that the exercise of IPRs could in exceptional circumstances be abusive conduct under Article 82 (the treaty article that prohibits undertakings with a dominant position from abusing that position). It held that the refusal by RTE and ITP to licence their copyrighted schedules constituted such an exceptional circumstance, in that they prevented the appearance of a brand new product for which there was proven consumer demand.

Building on *Magill* – and a further case (*IMS Health v. NDC Health*⁶) - *Application* maintains that five general conditions must be met for a refusal to supply to be abusive. It then adds two more for refusal to license an IPR. The first five are that:

- (1) the behaviour can properly be characterised as a refusal to supply;
- (2) the refusing undertaking is dominant;
- (3) the input is indispensable;
- (4) the refusal is likely to have a negative effect on competition;
- (5) the refusal is not objectively justified.

The first condition specific to IPRs is that:

- (6) the undertaking refused a license intends to produce new goods and services not offered by the owner of the right and for which there is potential consumer demand.

⁴ *Volvo v. Veng* (1989) 4CMLR 122.

⁵ *RTE and ITP v. Commission* (1995) ECR I-743.

⁶ Case C-481/01

If the analysis had stopped there, the effect of DG Competition's activity on IPRs probably would not be serious. It might be thought objectionable that DG Competition should assume the right to determine whether a right holder is "objectively justified" in his licensing policies; and one might wonder if aspiring licensees will go out of their way to invent new uses for IPR-protected knowledge in order to obtain a license for its use when their primary concern is to compete with the right-holder. But these issues quite possibly lack practical weight.

DG Competition then adds, however, its second IPR condition. This is, in its entirety:

"A special case arises when an undertaking refuses to supply information in a way that allows it to extend its dominance from one market to another. Although there is no general obligation even for dominant companies to ensure interoperability, leveraging market power from one market to another by refusing interoperability may be an abuse of a dominant position.

"Even if such information may be considered a trade secret it may not be appropriate to apply to such refusals to supply information the same high standards for intervention as those described in the previous subsection."

This condition has the feel of having been added as an afterthought, and no argument for its inclusion is provided. It is very probable that it refers to one aspect of DG Competition's extended joust with Microsoft. Microsoft refuses to license the source code for Windows to competitors, and DG Competition contends that this refusal allows Microsoft to create a dominant position in the market for servers. Most servers must co-operate with the ubiquitous Windows, and potential competitors are so disadvantaged by their lack of the source code, the Commission says, that Microsoft is able to dominate the market for servers even though it has no IPR for servers.

One issue raised by the wording of this condition relates to the ranking of trade secrets and patents or copyrights. Microsoft argued that the source codes were protected by copyright, DG Competition that they were merely trade secrets. In the wording of the final condition, DG Competition says "...considered as a trade secret", which may be DG Competition's view of the outcome of its argument with Microsoft, but still leaves open the question of whether DG Competition would feel free to set aside a patent or copyright on these grounds.

Leave that question aside, however, to focus on another one. Should a company that is dominant in a market be forced to license its IPRs because they give it an advantage in another market?

The word market seems an artificial construct from this point of view. Patents and copyrights measure the importance of the covered work by the scope of its use. If no one uses a patented invention, the inventor gets nothing for it. If many people do, the inventor is likely to earn a great deal. If an IPR is important in two markets, it is likely to be more socially valuable than if it is important in only one.

DG Competition is essentially using the argument, noted in the introduction to this paper, that it is better for society to have an invention without IPR protection than with it. That is correct. But, without some other solution to the incentive problem, it is a poor ground on which to remove IPR protection.

Suppression of improvements

DG Competition says (*Application* para 240) that:

“A refusal to license an IPR protected technology which is indispensable as a basis for follow-on innovation by competitors may be abusive even if the license is not sought to directly incorporate the technology in clearly identifiable new goods and services. The refusal of licensing an IPR protected technology should not impair consumers’ ability to benefit from innovation brought about by the dominant undertaking’s competitors”.

What circumstances, though, is DG Competition visualising here? The importance of the issue it raises might be doubted, since, very often, the most likely source of improvements is the holder of the original IPR.

Still, suppose an innovation does come from another source. If the innovation holds a potential benefit for consumers, it holds a potential profit for the IPR holder. If consumers will pay for it, that is to say, then it is valuable to the IPR holder.

It is true that bargaining in these circumstances has a wide variety of possible outcomes. Without intervention by the Commission, the creator of an improvement has only one buyer – the owner of the original IPR. That being the case, she may be willing to accept a low price for her improvement. On the other hand, the owner of the original IPR should be prepared to pay up to the amount that would be added to her own income by adoption of the improvement. These two prices are likely to be widely separated.

Yet neither party can gain by refusing to do business with the other, so a deal is likely. Moreover, there is no reason to suppose that it will be a poor deal from the standpoint of the follow-on innovator – where valuable improvements may come from outside parties, the holder of the original IPR has an incentive to establish a reputation for generosity.

Why, then, does DG Competition seek to involve itself in this bargaining process? The effect of its statement that it may intervene is to shift bargaining power to the follow-on innovator: if DG Competition will force the issue of a license if no deal is struck, the follow-on innovator always has an incentive to hold out for more. There is, however, no obvious public-interest rationale for the Commission to force such a shift in bargaining weight.⁷

⁷ *Magill* may have unduly influenced DG Competition. An obvious question about *Magill*, for an economist, is why the parties asserting copyright did not co-operate with one another (or with *Magill*) to produce a comprehensive TV guide. Some glitch in personal relationships is a possible answer, but it would be foolish to take this to be a normal state of affairs. One can, of course, philosophise about the appropriate use of law when bad relationships or eccentricity prevent a development that would be in the public interest *and* in the interests of the parties themselves.

Conclusion

The central thrust of *Applications* is sound. There is, however, ground to fear that DG Competition is being over-diligent in its pursuit of ‘abuses’ where IPRs are involved. That IPRs should win when they clash with CP is a sound dictum. DG Competition’s efforts to escape from it are unconvincing.

A defensible view is that such occurrences are likely to be rare, and that the social benefit of having laws to correct them is likely to be outweighed by the cost of misapplications and false trails that such a law opens.