

ON REFUSALS TO DEAL IN THE EUROPEAN COMPETITION REGIME

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ABSTRACT

A central discussion in antitrust economics is the determination of the circumstances under which a monopolist has a duty to deal with competitors and to assist them by providing access to key facilities. As in most areas of economics, the debate regarding the implementation of duty to deal provisions is centred on the final balance between costs and benefits. On the one hand, the implementation of compulsory sharing is argued to increase the level of competition and innovation in downstream markets. On the other hand, compulsory sharing is also presumed to have a dynamic (and long term) negative effect on investment incentives because sharing adversely affects the initial expected returns on

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the facility. This document reviews the way the European Commission has dealt with refusals to deal cases in tangible and intangible assets. It is concluded that physical and non-physical assets should not be treated differently since what matters is how compulsory access on a particular facility affects owner's incentives for investment. It also argued that the US jurisdiction seems to give special deference to intellectual property holders that refuse to license their rights to third parties. The European Commission's case against Microsoft seems to indicate that such deference for the owners of these rights does not exist in Europe.

Key words: refusals to deal, essential facilities, european competition, intellectual property.

OBLIGACIONES DE ACCESO EN EL RÉGIMEN DE COMPETENCIA EUROPEO

RESUMEN

Uno de los principales temas de discusión en el área de la competencia económica se refiere a la identificación de las circunstancias bajo las cuales un monopolio tiene la obligación de negociar comercialmente con empresas rivales y darles acceso a su "infraestructura esencial". Naturalmente, el debate sobre la pertinencia de establecer obligaciones de acceso a una infraestructura esencial depende en última instancia de la evaluación relativa de sus costos y beneficios. Si bien es cierto que la instrumentación de obligaciones de acceso posee el potencial de incrementar el nivel de competencia e innovación en algunos segmentos del mercado, también es cierto que estas obligaciones pueden generar un efecto adverso de largo plazo sobre los incentivos a la inversión, ya que disminuye los retornos esperados de la explotación de la infraestructura. Este trabajo discute la

manera en que la Comisión Europea ha venido analizando este tema tanto para activos tangibles como intangibles. Concluimos que no existen elementos para justificar un tratamiento diferenciado entre estos dos tipos de activos ya que, en cada uno de estos casos, el punto relevante es el impacto que las obligaciones de acceso generan sobre los incentivos a la inversión. Se argumenta finalmente que el régimen de competencia estadounidense toma especial cuidado en no imponer obligaciones de acceso en casos que implican propiedad intelectual, en tanto que el régimen de competencia europeo es mucho más laxo en esta materia, como el reciente caso de Microsoft pone en evidencia.

Palabras clave: *obligaciones de acceso, infraestructura esencial, régimen de competencia europeo, propiedad intelectual.*

1. INTRODUCTION

A central discussion in antitrust economics is the determination of the circumstances under which a monopolist has a duty to deal with competitors and to assist them by providing access to key facilities. An alternative way of analysing the same problem would be to ask to what extent a refusal to deal with competitors by a firm with significant market power should be permitted by antitrust authorities. From a general point of view, a refusal to deal can be either explicit (e.g., naked exclusion) or implicit. Explicit exclusion includes practices like the termination of an existing commercial relationship, the refusal to supply products, information or intellectual property rights or the refusal to grant access to an “essential facility”. Implicit refusals to deal involves practices such as delaying tactics in supplying, imposing unfair trading conditions, charging excessive prices for the input or margin/price squeezes.¹

1 These practices are also called “constructive” refusals.

As in most areas of economics, the debate regarding the implementation of duty to deal provisions is centred on the final balance between costs and benefits. On one hand, the implementation of compulsory sharing is argued to increase the level of competition in downstream markets and thus increasing short-term consumer welfare because of lower prices. A more controversial benefit of mandatory sharing is the effect that this policy has on the rate of innovation in downstream markets. As we will discuss further below, compulsory sharing may improve the innovation incentives of the competitors having access since the higher the downstream competition the higher the incentive for innovation as a means of market differentiation. On the other hand, compulsory sharing is also presumed to have a dynamic (and long term) negative effect on investment incentives because sharing adversely affects the initial expected returns on the facility. The extent investment incentives are affected by compulsory sharing, the argument goes, will depend on the final terms of access established between the parties. In addition to this negative effect on incentives, one also should add the *regulatory cost* of determining and monitoring access prices. Most of the debate regarding the rationality of implementing compulsory sharing inevitably ends up being a debate between relative weight that regulatory authorities should assign to each of these costs and benefits.

This document is organised as follows. Sections 2 and 3 review the way the European Commission has dealt with refusals to deal cases where mainly physical assets are involved. Section 4 provides a brief description of the two European leading cases concerning duty to deal in the presence of intellectual property rights while section 5 provide an economic analysis of the criteria used by the European Commission when analysing these cases. Section 6 provides a general discussion of the lessons to be learnt from our previous analysis and finally section 7 concludes.

2. THE “ESSENTIAL FACILITIES” DOCTRINE IN EUROPEAN CASE LAW

In Europe, the question of exclusionary refusals to deal by dominant firms was first discussed by the European Court of Justice (ECJ) in 1974 in *Commercial Solvents*. *Commercial Solvents* was a monopoly in the production and sale of raw materials used for the manufacture of ethambutol. Since 1966 this dominant firm supplied raw materials to Zoja, a manufacturer of ethambutol. However, in 1970, *Commercial Solvents* decided to cease supplying raw materials to Zoja in order to facilitate its own access to the ethambutol market. Zoja filed a lawsuit and the case ended up in courts. The ECJ declared that the refusal by a dominant firm to supply a competitor with an essential input might be considered as an abuse of a dominant position under article 82. In particular, the ECJ was of the opinion that:

“...an undertaking which has a dominant position in the market in raw materials and which, with the object of reserving such raw material for manufacturing its own derivatives, refuses to supply a customer, which is itself a manufacturer of these derivatives, and therefore risks eliminating all competition on the part of this customer, is abusing its dominant position within the meaning of Article [82]”.²

A central aspect of this decision was the view that it was not feasible to manufacture ethambutol, on an industrial scale, by using a different set of inputs so that access to the raw materials provided by *Commercial Solvents* was essential for Zonja’s production.³ Taking *Commercial Solvents* as reference, the European Commission initiated a number of Article 82 actions against refusals to deal in a broad variety of sectors. A first relevant case occurred in 1985 in *Telemarketing*, where the

2 *Commercial Solvents*, paragraph 25.

3 As pointed out by some authors, an interesting aspect of the *Commercial Solvents* decision is that there was no indication that this refusal to supply would have led to higher prices in the downstream market. This is important because the refusal to supply could have been justified by showing that *Commercial Solvents*’ decision to start manufacturing ethambutol itself might potentially lead to efficiencies and hence to lower prices in the downstream industry.

Court established that the reservation of an ancillary activity by an undertaking in a dominant position with the intention of eliminating all competition in the downstream market should be considered as an abuse of dominant position.⁴ In 1994, in *Port of Rodby*, the Commission argued that the refusal to grant access to a port was abusive, particularly in a context where the Danish government refused to authorize the construction of new port facilities.⁵ An important aspect of this decision is that, since the downstream entrant firm was in the possibility of duplicating the port facility then, the refusal to provide access could have been justified on the grounds that the port of Rodby was not an essential facility. However, the refusal of the Danish government to authorise the construction of an alternative port turned Rodby into an essential facility. In another decision made during 1994, *Sea Containers v Stena Link*, the Commission stated that a port is an essential facility whenever its duplication is not feasible.⁶

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- 4 In *Telemarketing*, the RTL television station had a legal monopoly on television advertising on the Belgian market. In 1983 IPB, RTL's subsidiary, granted Centre Belge, an undertaking specialised in telemarketing, the exclusive right to conduct telemarketing on RTL television. The station advertised Centre Belge's telephone number to viewers and Centre Belge made its telephone lines and operators available to advertisers and to the television station. When the agreement expired, IPB notified advertisers that RTL would no longer accept advertisements involving an invitation to make a telephone call to a number other than its own. The Belgian Court stayed the proceedings initiated by Centre Belge and referred preliminary questions to the Court of Justice. The Court held that to subject the sale of advertising time to the requirement that only its own phone number be used amounted to a refusal to deal.
 - 5 DSB was a Danish public company, which owned and operated the port of Rodby. DSB also operated the only ferry service between Rodby and the port of Puttgarden. Stena, another ferry company, intended to exploit the same sailing route as DSB. The Danish government refused Stena the right to use the port of Rodby on the grounds that doing otherwise would prevent companies already operating in the port from expanding their activities. It also refused Stena the right to build a new port in its vicinity, arguing that Stena had not demonstrated an unsatisfied demand for a ferry service and that it was unlikely that such demand would arise.
 - 6 *Stena Link* was the owner and operator of the port of Holyhead. One of its subsidiaries operated ferry services from the same port. *Sea Containers* intended to start ferry services on the same route as *Stena Link's* subsidiary but with a faster ship. *Stena Link* delayed negotiations but after a complaint was lodged with the Commission, it concluded an agreement with *Sea Containers*.

A breaking point in the evolution of the essential facilities doctrine in Europe occurred in 1998, when the ECJ described explicitly the set of circumstances under which a dominant firm will be obligated to grant access to their facilities to competitors. This occurred in *Bronner*, where the ECJ laid out a three part test for refusal to deal liability.⁷

In particular, the Court said that a refusal to deal could be an abuse if the following three conditions were met:

- the facility is truly indispensable in the sense that there is no substitute for it;
- the refusal to deal would prevent the affected party from competing in the market and,
- there is no objective justification for such refusal to deal.

When assessing the ability of competitors to develop their own facilities, the standard used by the Commission was not whether the requesting party was in the position to develop an alternative facility but whether a firm operating on the same scale than the incumbent could be able to do so. In the particular case of *Bronner*, the Court held that there was no abuse because the “facility” was not indispensable in the sense that there were other distribution methods and that no technical, legal or economic obstacles existed that would make difficult the duplication of the relevant facility.

The mandatory access question as discussed in the context of network industries is explored below.

⁷ *Mediaprint*, a publisher of two Austrian newspapers with a large market share, refused to grant to its competitor, *Oscar Bronner*, access to its nationwide early-morning newspaper home-delivery network. According to *Bronner*, *Mediaprint* bore a duty to grant access to its distribution network claiming that a dominant company is required to allow access to competitors in the downstream market unless refusal to supply can be objectively justified. *Bronner* contended that the access requested was essential for its business since it was not economically feasible, due to limited circulation of its newspaper, to establish its own distribution network.

3. ARE NETWORK INDUSTRIES DIFFERENT?

In its 1988 *London European/Sabena* decision, the Commission ordered the airline Sabena to provide access to its computer reservation system to London European, a new entrant. The refusal to deal was considered abusive since it would have prevented the entrant from effectively competing in the relevant market. The Commission made its decision observing that there was little competition on the downstream market and that the incumbent had sufficient capacity in its reservation system to satisfy the needs associated with both operators. On the other hand, in its 1991 *RTT* decision, the ECJ held that a firm holding a monopoly in the market for the establishment and operation of a network is liable of abuse of its dominant position whenever it:

*“...reserves to itself a neighboring but separate market, in this case, the market for the importation, marketing, connection, commissioning and maintenance of equipment for connection to the same network, thereby eliminating all competition from other undertakings...”*⁸

The Court then confirmed the view that a firm may not use its dominant position to eliminate competition in a downstream market.⁹ In its 1992 *British Midland/Aer Lingus* decision, the Commission found Aer Lingus' refusal to provide access to interlining facilities to competitors an abuse. In particular, the Commission stated that dominant firms should not withhold facilities (interlining services) that are important for the viable operation of competitors.

8 *RTT*, paragraph 19.

9 *RTT* held a monopoly under Belgian Law over the establishment and operation of public telegraph and telephone lines. *RTT* also had the power to grant or withhold authorizations to connect telephone equipment to networks, the power to set the technical standards for the equipment and the power to check whether the equipment produced by third parties conformed to the specifications it had laid out. *RTT* was also in the business of selling its own telephones for the network. The conflict in this case arose when *RTT* tried to prevent *GB-Inno-BM* from selling non-approved telephones.

In another important investigation that took place on March 1997, the European Commission initiated formal proceedings against *SWIFT*, a monopoly in the international network for the transference of payment messages between financial institutions worldwide.¹⁰ The investigation was based on the fact that, by refusing access to its network, the conduct represented a factual exclusion from the market of international transfers. An important element of this investigation was the perception that the SWIFT network represented an essential infrastructure in its own right, so that access to it was indispensable for effective competition. The Commission decided to suspend the corresponding proceedings associated with this case when *SWIFT* undertook the compromise of granting complete access to any entity which met the criteria laid down by the European Monetary Institute for admission to domestic payment systems (European Commission, 1998).

In *European Night Services*, 1998, the main railway companies of the United Kingdom, France, Germany and The Netherlands formed a joint venture, ENS, to operate overnight passenger rail services through the Channel Tunnel. The railway companies agreed to provide ENS with railway paths through the Channel Tunnel, crew and locomotives in a situation where the market share of ENS on the routes it served was between five and eight percent. The Commission found that the agreement violated Article 81 of the EC Treaty but it granted an exemption for eight years provided that the parties would make the same rail services, train paths, crews and locomotives available to competitors. The Court of First Instance annulled the Commission's decision on the grounds that:

"...neither the parent undertaking nor [ENS] may be regarded as being in possession of infrastructure, products or services which are necessary or

10 *SWIFT* is a cooperative owned by 2000 banks which manages an international telecommunications network specialising in the supply of data transmission and processing services to financial institutions around the world. Further to a complaint from *La Poste*, a French public firm which had been refused access to the network, the Commission considered that *SWIFT* had been infringed European antitrust laws. In particular, the Commission established that *SWIFT* had abused its dominant position by laying down unjustified admission criteria.

*essential for entry in the relevant market unless such infrastructure, products or services are not interchangeable and unless, by reason of their special characteristics –in particular, the prohibitive cost of and/or time reasonably required for reproducing them- there are no viable alternatives available to potential competitors of the joint venture, which are thereby excluded from the market”.*¹¹

Regarding train paths, the Court decided that there were no grounds for the conditions imposed by the Commission since Directive 91/440/EEC already guaranteed access to potential competitors of *ENS*. The Court also held that a refusal to provide locomotives to *ENS*' competitors would not have the effect of excluding them given *ENS*' small market share.

As the above cases show, the principles underlying the essential facilities doctrine have found a fertile field of application in network industries. One of the most relevant cases of refusals to deal in the context of network industries occurred in the US in *Trinko*. The forced question is obvious: would a case like *Trinko* be valid in Europe?

An important aspect of *Trinko* was the US Court view that a violation of the 1996 Telecommunications Act was not, *ipso facto*, a violation of the Sherman Act.¹² In particular, the Court emphasized that it was not unlawful for a firm to exploit its market power so that the monopolist has the right to refuse to deal with other firms if it considers convenient to do so.¹³ The most important implication of *Trinko* lies in the area of the limits of antitrust liability in regulated industries.

11 *European Night Services*, paragraph 209.

12 The 1996 Telecommunications Act required that Verizon lease part of its network to new competitors at cost, which Verizon had failed to do properly, hence violating the content of this Act. The plaintiff, *Trinko*, a telephone customer of one of the new competitors, claimed that Verizon's failure to share with the new competitor as the Telecommunications Act required was essentially an antitrust violation.

13 Taking into account the *Trinko* case as reference, the US antitrust agencies proposed a standard under which a monopolist would be liable for refusing to deal only where it was anticompetitive and otherwise costly for the monopolist. Specifically, the standard advocated was that “conduct is not exclusionary or predatory unless it would make no economic sense for the defendant but for its tendency to eliminate or lessen competition”.

In particular, the US Court argued that the extension of antitrust liability into regulated sectors was not appropriate since in that case antitrust enforcement would have the negative effect of undercutting the sector-specific regulatory scheme. In the particular case of *Trinko*, the Court justified this position by arguing that operators in the telecommunications sector are placed under the detailed scrutiny of the Federal Communications Commission, which enjoys significant powers to prevent the likelihood of competitive harm. Therefore, the presumption under this approach is that the existence of a detailed regulatory framework in a particular industry implies a certain degree of immunity with respect to liability derived from antitrust enforcement.

It is important to note that, in the European Community, sector-specific regulation in the telecommunications sector is, in general, not as intrusive as in the US, since it leaves important discretion on National Regulatory Authorities to decide whether to initiate a particular action. Hence, the fact that sector-specific regulation in European-wide telecommunications is less intrusive than in the US, opens the possibility that the enforcement of competition rules in this sector might be find useful implementations. A good point in case is the Commission's decision in *Deutsche Telekom*. This case concerned the prices charged by Deutsche Telekom to its competitors and consumers for access to the local loop between 1998 and 2002. In particular, several of *Deutsche Telekom's* competitors had lodged complains before the European Commission arguing that Deutsche Telekom's prices for access to the local loop represented a violation of Article 82. In particular, a comparison between wholesale and retail tariffs resulted in a negative margin for competitors, or a very small positive margin, thus leading to the allegation of margin squeeze. *Deutsche Telekom* argued that its conduct could not be seen as a violation of Article 82 since its tariffs had previously been approved by the German telecommunications regulator. This argument was refuted by the Commission which argued that:

“...the competition rules may apply where the sector specific legislation does not preclude the undertakings it governs from engaging in autonomous conduct that prevents, restricts or distort competition”.¹⁴

Hence, the *Deutsche Telekom* case provides an instance where competition rules are enforced against a firm which has some discretion on its conduct even in the context where specific-regulation (in this case at the national level) applies. There are, however, other instances where the European Commission has taken decisions that are closer to the American approach. For example, in the *O2/T-Mobile* decision, the Commission decided not to intervene because sector-specific remedies were provided by Article 12 of the Framework Directive on Electronic Communications and hence they could be used by National Regulatory Authorities in cases of anticompetitive conduct.¹⁵ In the area of energy, the Commission also decided in *HFC Bank/British Gas Trading* to refrain from action because the UK gas regulator concluded that the risk of anticompetitive effect was unlikely.

To sum up, in the US, the application of antitrust rules to regulated sectors is rejected through the adoption of the principle that the scope of antitrust rules should not be extended where an appropriate regulatory structure exists. In contrast, in Europe, the enforcement of competition rules in addition to sector specific regulation always remains a reserved possibility. Although the European approach gives some degree of flexibility in the space of antitrust enforcement, it would be useful to see the European Commission adopting “best practice” standards in this area and thus producing a document explaining when competition rules shall be enforced in regulated industries, as it has been done in the telecommunications sector with the 1998 “Notice on the Application of Competition Rules to Access Agreements in the Telecommunications Sector” (Petit, 2004).

14 *Deutsche Telekom*, paragraph 54.

15 The case involved a notified agreement on infrastructure sharing that entailed the risk of foreclosure on sites used for installing antennas, masts and other network elements.

Another important aspect pointed out by the US Supreme Court in *Trinko* was that, in general, courts are not well equipped to deal with the continuous enforcement and monitoring of the remedies they impose on the basis of antitrust rules. This represents a strong basis for refusing to expand antitrust enforcement in industries where some specific-regulation is already in place but it also leaves unanswered the question of how antitrust authorities should proceed in situations where antitrust enforcement and extensive monitoring are necessary since they apply to an unregulated sector. In other words, to what extent the possibility of facing a complex judicial oversight will affect the *nature* of the remedies imposed?

4. COMPULSORY ACCESS TO INTELLECTUAL PROPERTY

The European Commission (2005) has argued that intellectual properties rights might be considered as “indispensable input” in cases where it is not possible for competitors to turn to any workable alternative technology. This is particularly the case when a technology has become the standard or when interoperability with the right holder’s intellectual property right protected product is necessary for a company to enter or remain on the product market. Two seminal decisions supporting this Commission’s point of view are *Magill* and *IMS*. In *Magill*, the ECJ established that the exercise of an exclusive right is not, by itself, an abuse.¹⁶ Nevertheless, it also argued that, in “exceptional circumstances”, the right holder is obligated to grant third party access where three conditions are met:

- the refusal to deal prevents the emergence of a new product which would have competed with the products supplied by the licensor;

16 In *Magill*, three television stations (RTE, ITV and BBC) broadcasting in Ireland and Northern Ireland refused to license their copyright on the information contained in their respective program listings to the Irish publisher Magill TV Guide.

- the parties refusing to deal reserve for themselves a monopoly in the secondary market by excluding all competition and,
- there is no business justification for such refusal to deal.

It is worth noting that two of these three conditions are essentially identical to the ones described in *Bronner*. The third condition is identical while the second is just a tighter version of the second *Bronner* principle. The main difference between the conditions established in *Bronner* and *Magill* lies in the first condition, where a requirement that the exclusionary conduct impedes the provision of a new product or service in the marketplace is added to the initial *Bronner* conditions.

In *IMS*, the ECJ confirmed that only when the “exceptional circumstances” as stated in *Magill* are satisfied a compulsory license on property rights should be granted.¹⁷ An interesting feature of the *IMS* decision is the Court’s view that to show the existence of two markets would be enough to identify a “potential” or “hypothetical” upstream market. In particular, the ECJ argued that: “it is determinative that two different stages of production may be identified and that they are interconnected, the upstream product is indispensable in as much as for the supply of the downstream market”.¹⁸ The Court therefore suggested that it does not matter that the upstream input was never independently marketed before.

17 *IMS* provided pharmaceutical companies with data on wholesale sales to pharmacies in Germany. Over several years, and with input from the pharmaceutical industry, *IMS* developed a copyrighted “brick” structure, according to which German postal districts were broken into 1,860 areas or “bricks”. *IMS* refused to license the brick structure to competitors, who felt disadvantaged because customers had begun to rely on the *IMS* brick structure to evaluate such data.

18 *IMS* (2004), paragraph 45.

5. THE ECONOMIC ANALYSIS OF COMPULSORY IP LICENSING CRITERIA

This section provides a brief discussion of some of the criteria that are central in the debate of compulsory access to intellectual property rights.

Hypothetical Market. The European Commission (2005) has argued that:

“In some circumstances, there may not be an existing market for the input in question as it used only by the owner in a captive market. For example, an IPR may be nothing more than an input that is not marketed separately from the goods and services to which the IPR relates. However, it is sufficient that a captive market, that is, a potential market, or even a hypothetical market, can be identified. Such is the case where there is actual demand for the input on the part of undertakings seeking to carry out the activity for which the input is indispensable.”¹⁹

For example, in its *Bronner* decision, the Court identified as upstream market the market for home delivery of daily newspapers and as a downstream market the market for daily newspaper themselves. The fact that the home-delivery service was not marketed separately was not regarded as precluding the possibility of identifying a separate market. Hence, this approach relies in the identification of an upstream “hypothetical” market for which access is important in order to compete in a downstream market.

The definition of a hypothetical market is subject to some interpretative ambiguity though. Consider the situation where there is only one market. TEMPLE LANG (2002) has described that a one market situation arises when the “essential” element is not an input that could be bought since if it could then there would be two markets: the market for the input and the market for the goods or services for which this input is necessary. In the case where the essential input is not marketed it should be the case that the input has been developed by firms in order to obtain a competitive advantage. Thus, in a one market situation,

19 EUROPEAN COMMISSION (2005), paragraph 227.

it should be counterproductive to mandate access to this input since such action would destroy firm's incentives to create inputs that give firms a competitive edge. In other words, compulsory access in a one market situation would discourage firms to behave in a direction that effectively promotes competition. From this point of view, an input creating a competitive advantage in a single market context should never be subject to mandatory access. Therefore, compulsory access should be restricted to situations where a firm gains control of a necessary input with the purpose of leveraging its market power into a secondary market. Implicit in this argument is the logic that it would not be unlawful for a dominant firm to refuse to licence its intellectual property right in the market with which this property right is primarily concerned. Only when the refusal to deal is made with the purpose of leveraging dominant's firm market power into a secondary market or to protect it from competition in the related market such a refusal would indeed be unlawful.

This distinction between the one- and the two-market scenarios becomes blur under the European Commission "hypothetical" market definition contained in its 2005 Discussion Paper. This is because the Commission does not require the essential input being actually marketed but only that this input is indispensable for the activities of rival firms and therefore that there exists actual demand for it. This description of a hypothetical market is problematic because any intellectual property right could 'potentially' be marketed as a stand-alone item and hence it could be identified as a hypothetical market. The implication is that the holder of the right would then be forced to grant a licence to competitors as long as they prove that such licence is necessary to compete in the downstream market. In other words, under the hypothetical market approach followed by the Commission, compulsory access might be forced in cases where only one market exists.

As pointed out by O'DONOGHUE & PADILLA (2006), the Commission should recognise that the demand for an input does not represent a sufficient condition for the identification of a hypothetical market. When such identification is required, competition authorities should be looking for a 'potential market' (in the sense that it refers to something that is

inherently capable of being sold or licensed) that is not primarily concerned with the property right under analysis. In particular,

*“The ‘market to which the right primarily relates’ would include all the markets for which the intellectual property right was developed or in which it would directly apply. The distinction seems to be between an intellectual property right insofar as it applies to all or greater part of the markets to which it primarily relates, and a right insofar as it applies to one input in a market otherwise outside the scope of the IPR”.*²⁰

For example, a firm with a property right refusing to license this right for its exploitation in a market for which the property right was acquired in the first place should lead to the conclusion that a hypothetical market does not exist, so that compulsory licensing should not be enforced. In contrast, when such refusal is made with the purpose of foreclosing the exploitation of this property right in a market outside the original market scope associated with the right then a hypothetical market can be identified.

New Product. *Magill* has established the precedent that a compulsory license can be granted whenever it can be demonstrated that such licensing policy will facilitate the provision of “innovative” products in the market. Thus, it is considered that in order to qualify for the benefits of compulsory access, a third party must demonstrate that it has developed a distinct product from that of the right holder. As explained by some authors the rationale behind the “new product” provision is two-fold:

*“First, there is no general justification for ordering a licence that would allow the production of copies of the dominant firm’s products, since this would deprive the IP owner of the reward for his creative efforts. The second reason is that a duty to deal is only appropriate where there is a clear benefit to competition in ordering access, or put differently, “prejudice to consumers” under Article 82(b) if a licence is not granted.”*²¹

20 EUROPEAN COMMISSION (2005), paragraph 227.

21 TEMPLE LANG (2002), page 13.

The first rationale can be read as the condition that, when consumer's do not get any clear benefit from compulsory licensing (i.e., no new products are marketed) then it is socially optimal to preserve the rewards that intellectual property law gives to innovators already operating in the market. However, when compulsory licensing leads to a market expansion in the sense that the emergence of new products will cover current unsatisfied demands then the rewards associated with the preservation of property rights are assumed to have a much lower weight so that compulsory licensing might be optimal. The second rationale is more controversial since it seems to argue that compulsory licensing is only adequate when consumers are able to obtain clear benefits from the implementation of such policy. It is clear that as long as innovation represents the creation of successful new products consumers are better off. How about when the only 'innovation' generated by compulsory licensing is better quality and lower prices in otherwise similar products? In this case consumers are also better off so that it is not clear why this type of more 'restricted' innovation does not qualify as a valid one. It has been argued that this restricted innovation does not guarantee clear benefits to consumers since, once compulsory licensing has been implemented, the intensity of price competition will depend on the royalty charges that the licensee pays to the licensor. Since the benefits to consumers depend on the terms of the licence then, it is argued, they cannot qualify as a 'clear' consumer benefits. The drawback of this line of analysis is that, as a matter of fact, a significant number of cases involving compulsory licensing end up in a situation where the determination of the terms of the licence will also be *exogenously* determined (by competition authorities, courts or trustees) so that the degree of price competition will also be a result of the compulsory licensing mandate. The implication of this is simple: it is still no clear why this type of more 'restricted' innovation is excluded from the analysis of the Commission.

On the other hand, a first substantial problem with the 'new product' provision is precisely what should be understood by "new product". Does qualify as new product only a product that is entirely different from the product already offered by the copyright holder? Does qualify

as new product a product which reflects improvements of the product already sold in the market but that, from a general perspective, is essentially the same that the one promoted by the copyright holder? In other words, the first problem with the use of the new product definition is the lack of a proper characterization of what “new” should mean. As argued by GERADIN (2005), the ECJ has chosen to refer to the concept of “new” rather than to the better established concept of substitution. One of the clear advantages of using the concept of substitution instead of the idea of “new” is that in the first case it might be possible to give a quantitative dimension to its concept. In particular, the fact that the degree of substitution between two products can be quantified might help to determine some ranges of substitutability between products that might be instrumental in the analysis associated with the determination of how different a new product is from the ones prevailing in the market. The main drawback with this approach is that, in most of the cases, it would be extremely difficult to determine the potential demand associated with the new product so that the quantification of its degree of substitution or innovativeness, when possible, should rely on indirect empirical evidence.

On the other hand, RIDYARD (2004) has also criticised the economic foundations of this “new” product requirement. He argues that if the initial perception is that by foreclosing competition a monopolist has been able to sustain high prices, then there is a case for compulsory licensing that favours the establishment of prices closer to competitive levels. Since compulsory licensing would have an economic justification in cases where its only effect in the market is lower prices there should be no reason why the ‘innovation’ requirement should invalidate the benefits of such policy. On the other hand, RIDYARD (2004) argues that if the initial perception is that the monopolistic outcome is closer to a competitive outcome then, there is no role for forcing innovation through competitive licensing since in that case all firms will have natural incentives to improve their market performance through innovative activities.

Finally, it might be that the rationale behind this “new” product approach is the perception that compulsory licensing undermines innovation so that licensing should be compulsory only in cases where

some degree of innovation is guaranteed. However, the notion that compulsory licensing adversely affects innovation may be the result of having a too narrow point of view. For example, it is true that a compulsory license affect the incentives for innovation by the dominant firm but it is also true that this policy affects the innovation incentives associated with the licensees and potential entrants. By assuming that compulsory licensing has a neutral effect on potential entrants' incentives on innovation, it could be possible that the adverse effects on innovation associated with the dominant firms are outweighed by the positive effects that this policy has on the innovation incentives associated with competitors. This point of view has been supported by J. Baker, who has argued that compulsory licensing can make a significant difference to rivals while "it is unlikely that the dominant firm's innovation incentives would decline substantially as a consequence of antitrust enforcement in industries where innovation competition has strong winner-take-all properties".²² The central implication of the above argument is simple: innovation incentives should be assessed on an industry-wide basis so that compulsory licensing does not necessarily imply lower overall innovation incentives. Hence, it is a kind of paradox that this last line of reasoning has been supported by the European Commission's decision on *Microsoft* where it stated that:

"...on balance, the possible negative impact of an order to supply on Microsoft's incentives to innovate is outweighed by its positive impact on the level of innovation of the whole industry (including Microsoft)".²³

Intellectual Property Value. It has been argued that one of the reasons behind the ECJ's compulsory licensing mandate in *Magill* was the fact that the intellectual property rights involved were relatively

22 BAKER, J. (1999), "Promoting Innovation Competition through the *Aspen/Kodak* Rule", *George Mason Law Review*, 7, pp. 495-522.

23 *Microsoft*, paragraph 783.

“weak”. Although one is compelled to recognise that not all property rights are equally valuable is equally important to recognise that competition law has a very restrictive role to play in the evaluation of when a particular intellectual property right has been awarded on the basis of its appropriate value. In general, competition law cannot be used to “correct” situations where an operator has obtained copyright for a product or service that from the perspective of competition officials or judges did not deserve protection. Once a right over the exploitation of intellectual property has been assigned, antitrust enforcement should take its value as granted and should not put it under further scrutiny. As mentioned by some authors:

*“Finally, if certain property rights are aberrant, the correct remedy is to amend the legislation that creates such aberrant rights. This does not mean that competition law has no role to play, but it means that competition law should not, in the first instance, be a means of correcting defects in property laws”.*²⁴

In the following, we make a sharp distinction between the price and the value of intellectual property. We proceed to discuss the price dimension first. When compulsory licensing is implemented the most immediate difficulty to solve is the level of its pricing. On one hand, licensors will claim that licensing rates should be set such as to compensate them for the loss of profits they will suffer as a result of admitting the licensee as a competitor in downstream markets. One methodology used to calculate this dominant’s firm opportunity cost is the efficient component pricing rule (ECPR), a compensating mechanism that sends strong signals concerning the protection of intellectual property and that minimise the damage to dynamic economic incentives that compulsory dealing might create. On the other hand, licensees will seek a price that only reflects the “documentation costs” of providing such license. The rationale behind this position is that the prices proposed by the licensor reflect the market power that this firm enjoys in the

24 O’DONOGHUE & PADILLA (2006), page 462.

relevant market so that the fraction of the price deriving from the exercise of market power should not be included in the price charged to licensees. Cost-based rules are typically employed for the determination of the terms of access in cases where this is the prevailing view. This debate is clearly illustrated in the case of *Magill*, where the copyright owners (the broadcasters) looked for the establishment of licensing terms able to compensate them for the anticipated lost profits in their respective TV listing magazines. The licensee, in contrast, argued that such high compensation was only a result of the market power these firms were enjoying in the market. Finally, the Copyright Tribunal, the entity playing the role of price setter since the ECJ did not discuss pricing, resolved the dispute in terms that were more favourable to the licensees. Naturally, the “right” price associated with a compulsory license will always be an element of contention.

The aspect of the “right” price associated with a license has been one of the central points of debate in the implementation of the European Commission’s remedies in *Microsoft*. In particular, the Commission has established that *Microsoft* will be forbidden to include in its license pricing the margin associated with its exercise of market power: the so-called “strategic value”. The determination of the “strategic value” is not straightforward. This is because the relevant parties (Microsoft or the regulatory authorities) are obligated to “extract” from Microsoft’s prices the fraction of the nominal price that is just a reflection of its exercise of market power. In other words, it would be necessary to specify how far Microsoft’s proposed prices are above of the competitive level. This is a challenging task.

On the other hand, there is still the discussion of the extent the price associated with a compulsory license should reflect either its intrinsic or its market value (i.e., the discounted sum of future cash flows). Let’s take the example of the *Magill* case. This is a situation where the value of the innovation was not particularly significant however the financial value associated with the license was, presumably, not negligible. Hence, *Magill* is a case where the intrinsic value of the intellectual property right was low but its market value was high. It seems that *Microsoft* provides a similar case. The Commission has argued that the innovation

associated with the interoperability information provided by Microsoft is not particularly significant so that the price of the license should reflect this. In other words, in the opinion of the Commission, the price of the license should reflect only the intrinsic value associated with the interoperability information. In the opposite side of this point of view, is the position that the price of the license that Microsoft should be entitled to charge should reflect the market value of this information. The market value of the interoperability information is presumably high since it will allow competitors to improve the “quality perception” of their services and hence to improve their market performance.

Efficiencies. The European Commission (2005) has suggested the introduction of an “efficiency defence” in the analysis of article 82 cases. According to this proposal, exclusionary conduct in general could be justified by showing that that:

- it generates efficiencies (quality improvements, cost reductions)
- the exclusionary conduct is indispensable to realise these efficiencies;
- consumers will benefit from these efficiencies;
- competition in respect of a substantial part of the products concerned is not eliminated.

Regarding the benefits obtained by consumers, the Commission has expressed that, when evaluating the benefits that consumers would obtain from the implementation of exclusionary conduct, the value of consumers’ gains in the future will not be evaluated as equal to the gains that consumers get at present. In particular, the Commission is of the view that, the later the efficiencies are expected to materialise in the future, the lower the weight will be assign to them. Although this procedure of discounting benefits is pretty much standard nowadays, it might be subject to some degree of controversy during the years to come. The recent Stern Report on climate change, for example, has initiated a debate on the proper way of discounting inter-temporal benefits. In particular, the report shares the view that there is no reason why futures

generations should have less weight at the time of evaluating current and future policies.

Finally, in the particular context of the termination of an existing supply relationship, the Commission has suggested that the dominant company will be in the position to argue that it is terminating the supply relationship because it wants to integrate downstream and itself perform the downstream activities. In such a situation it falls on the dominant firm to show that consumers are better off with the supply relationship terminated. As explicitly described by the Commission, this situation should be compared with both the existing situation continuing and with the situation where the vertically integrated dominant company competes downstream with its input customers.

6. REMEDIES ON IP REFUSALS TO DEAL

Microsoft Remedies: Interoperability. In March 2004 the European Commission found Microsoft to have infringed the EC Treaty rules on abuse of a dominant position (Article 82) by leveraging its near monopoly in the market for PC operating systems onto the market for work group server operating systems. Thus, Microsoft was mandated to disclose complete and accurate interface documentation on reasonable and non-discriminatory terms allowing non-Microsoft work group servers to interoperate with Windows PCs and servers. Microsoft provided two separate licensing agreements. The first was a ‘No Patent Agreement’, allowing licensees to use the protocols which together comprise the interoperability information but without taking a license for some key patents. The second, the ‘All IP Agreement’, combines this first licence with a licence for these patents. Companies therefore were offered a choice of agreement, depending on whether they would consider necessary a patent licence or not. An assessment of the reasonableness of Microsoft’s prices depended, on Commission’s view, on whether there is innovation in the protocols and, if there is, what is charged for comparable technologies in the market. As of 1st March

2007, the European Commission preliminary view was that the interoperability information lacked of significant innovation so that the prices proposed by Microsoft were unreasonable.

Lessons from Microsoft & Trinko. If the ECJ supports the Commission's analysis, Microsoft will be the origin of a debate regarding the extent compulsory licensing should be used in cases where the "innovative" dimension of the license is much more significant (at least in comparison to cases as Magill or IMS). This would be just the first part of the debate. The second and maybe most important part of the discussion will be faced in the area of the terms of access. A requirement to grant access without specifying precisely its terms will leave the problem only part-solved. As discussed before, any debate that pretends to discuss the terms of access in the context of intellectual property rights would be forced to debate the extent license pricing should stem from its intrinsic or its market value. This also leads us to a second point that was also discussed in the case of Trinko: the implementation of compulsory sharing forces antitrust courts to act as "central planners" since they need to be engaged in pricing discussions for which they are ill-suited. As stated by LIPSKY and SIDAK (1999):

*"In sum, endorsement of the essential facilities doctrine must be based on acceptance of the concept of full judicial regulation of natural monopolies if it is to be capable of improving consumer welfare even in theory. Courts must be prepared (1) to command that access be provided by others, (2) to regulate the prices, terms, and conditions for the provision of such access, (3) to command the capacity expansion required to make such access feasible, and (4) to command that the service of the facility –as expanded to make access feasible- actually be provided to those who demand it. There is no "free lunch" in natural monopoly regulation."*²⁵

It seems that, where compulsory licensing is implemented, certain degree of judicial oversight will always be required since, even in cases where trustees and experts are nominated to be in charge for deciding

25 Pages 1222-1223.

on technical decisions as pricing, it will always be necessary to monitor the degree of compliance.

7. FINAL COMMENTS

A central point on the duty to deal debate concerns the effects that compulsory sharing has on the profits of the firm owning the essential facility. The standard argument is that compulsory sharing represents a ‘property confiscation’ since by reducing the returns associated with the facility this policy makes impossible to recover the value of the initial investments. This argument, however, might be no relevant in cases where compulsory sharing is implemented long time after the facility owner has been exercising its market power and hence enjoying its supernormal rents. In other words, the implementation of compulsory sharing in circumstances where the facility owner has been enjoying monopolistic rents for a significant period of time invalidates the argument that this policy does not allow for the recovery of the initial investments made. This is particularly true in industries with strong network effects where “winner-takes-all” outcomes are more likely. The important point is that in these cases, the implementation of compulsory sharing would have no negative effects on innovation incentives since expected returns had been recovered from the previous use of the facility.

A second aspect worth mentioning is the link between compulsory sharing and the *type* of innovation. In general, there are two types of innovations: incremental and drastic. Incremental innovations would be described by changes that represent no radical improvements in the features of previous generations of products. In contrast, drastic innovations are those that radically change the features of the products and thus where the substitution between new- and old-generation products is particularly low or literally impossible. The effect of implementing compulsory sharing on these two types of innovation might be distinct depending on the type of firm involved. One could argue that when compulsory sharing is exploited mainly by firms already competing in the market innovation will be strongly biased towards

innovative processes of the incremental type. This is because the nature of the innovation would be somehow “locked-in” by a technology that is already in place. In contrast, when access is mainly exploited by new entrants the probability of deploying drastic innovations would be higher since, in principle, the technology to be deployed has higher degrees of freedom.

It seems then that economic analysis does not support the idea that physical and intellectual property rights should be treated differently. What matters is how compulsory access on a particular facility affects owner’s incentives for investment and this does not depend on the nature of the property right involved. Therefore, a first recommendation is that, when analysing refusals to deal, the European Commission should eliminate the asymmetry in treatment between physical and intellectual property rights.

It also important to observe that that the US jurisdiction seems to give special deference to intellectual property holders that refuse to license their rights to third parties. The European Commission’s case against *Microsoft* seems to indicate that such deference for the owners of these rights does not exist in Europe. It is not difficult to guess that the main difference between these two approaches lays in the assumed impact that compulsory licensing have on the innovation incentives associated with the owner of those property rights. The presumption in the US is that the costs of compulsory licensing outweigh its total benefits so that compulsory access should be enforced only in special cases. In Europe, the view seems to be that the negative impact of compulsory licensing on innovation incentives is much weaker so that the benefits of implementing this policy can be obtained without affecting the process of innovation significantly. It is difficult to tell which of these two approaches is the most appropriate. As a matter of fact, this is an empirical question. Nevertheless and to the extent that the link between innovation and licensing enforcement tends to be empirically clarified there will always be room for policy convergence across jurisdictions that will remain differentiated otherwise.

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