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SEP REGULATION: PROPOSED MECHANISMS IN DETERMINING A REASONABLE AGGREGATE ROYALTY

Speaker: Dr. Justus Baron
Host: Axel Ferrazzini



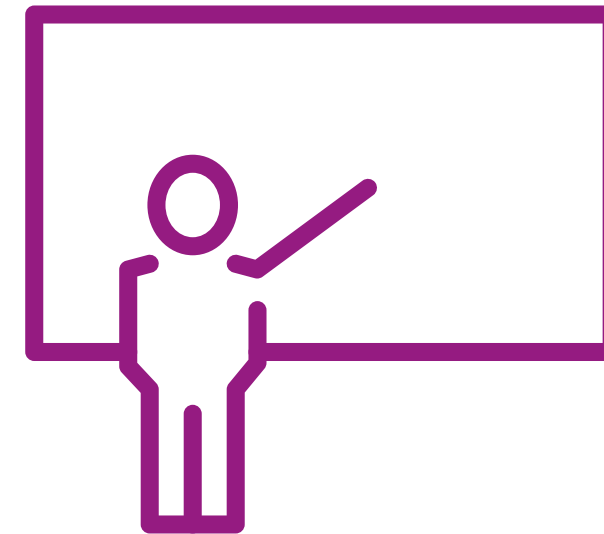
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1 Summaries of papers, studies, guides and case law

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The collage features several key materials from the 4iP Council:

- Webinar: How Weak Are Strong Patents: Patent Holdout and Small(er) Technology Firms**
 - Host: Dr. Claudia Tapia, President of 4iP Council
 - Presenters: Bowman Heiden, UC-Berkeley; Matthew Rappaport, UC-Berkeley
 - Date: 17/02/2019
- Report: Essentiality Checks and Standards Essential Patents**
 - Why automated patent analysis can be wrong, even when it's right by Axel Contreras-Alvarez
 - Patent Landscaping Studies And Essentiality Checks: Rigorous (And U Rigorous) Approaches by Haris Tsilikas
 - Estimating 5G Patent Leadership: The Importance of Credible Reports by Ig Nikolic
- Report: The Viability of FRAND: How the Seminal Microsoft Ruling Could Impact the Value of Standard Essential Patents and the Future of Telecom Standards**
 - Presented by Bowman Heiden, Center for Intellectual Property (CIP), Department of Technology Management and Economics, Chalmers University of Technology, Gothenburg, Sweden
- Report: EC new framework for Standard-Essential Patents**
 - Host: Axel Ferrazzini, Managing Director, 4iP Council
 - Presenters: Dr Bowman Heiden, Dr Justus Baron
 - Date: 02/10/2019
- Report: Patent Trespass and the Royalty Gap: Exploring the Nature and Impact of "Patent Holdout"**
 - by Bowman Heiden, Center for Intellectual Property (CIP), and Nicolas Petit, Professor of Law, University of Liege
- Infographic: ESSENTIALITY CHECKS**
 - Key Takeaways:
 - Essentiality checks are costly and time-consuming.
 - An essentiality check system needs to balance accuracy, transparency and costs.
 - Essentiality checks are only effective if legally binding.
 - The patent-by-patent assessment: potentially effective for small but unfeasible for large portfolios.
 - High risk of inaccuracy for essentiality checks of a subset of patents.

Case Law post CJEU ruling *Huawei v ZTE*

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SEP REGULATION: PROPOSED MECHANISMS IN DETERMINING A REASONABLE AGGREGATE ROYALTY



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Introduction

- Discussion prior to proposed SEP regulation had largely focused on SEP transparency
- Articles 15 to 18 of proposed Regulation: Mechanisms for pronouncements on *Reasonable Aggregate Royalties* (RAR)
 - Definitions make it clear that the stated RAR would define *maximum* rates
- Apparently based on Expert Group Report proposals 42-44
 - albeit with significant differences
- In this paper, I assess the necessity, potential economic impacts, and overall policy relevance of the proposed mechanism

Problem Assessment

There are different potential problems that RAR may solve:

- Royalty stacking – aggregate cost of royalty payments may be excessive
- Pricing uncertainty – impossibility to predict future royalty costs may chill investment
- Excessive pricing – royalty rates charged by individual SEP licensors may be incompatible with a reasonable aggregate royalty

Problem Assessment - Royalty Stacking

- Commission's Impact Assessment Report describes the evidence on royalty stacking as mixed
- Alleged empirical support for royalty stacking problem relies on individual licensors' stated rates
- Effective rates tend to be lower, and not all implementers are licensed to all licensors
- Empirical research documents found that effective aggregate royalty rates in mobile telecommunication are low (3-5%)

Problem Assessment - Pricing Uncertainty

- It is clear that effective royalty costs become more predictable over time
- To discourage investment, royalty costs would need to plausibly exceed the value of using the technology
- Licensors have incentives to offer earlier information when it is critical for adoption decisions
- Overall, lack of evidence that SEP licensing uncertainty discourages standard implementation

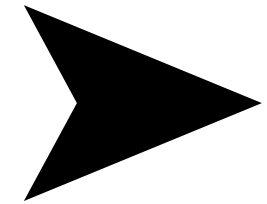
Problem Assessment - Excessive Pricing

Commission redefines royalty stacking as a situation in which individual licensors' requests are incompatible with RAR

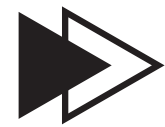
- Purely redistributive, no clear social welfare implications
- Effective aggregate royalty would be much lower than announced RAR
- No assessment whether the proposed outcome is viable

Impact Assessment - What statements will be made?

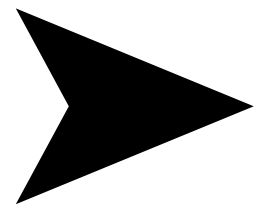
Experience from past statements - Precedent from 2002-2007:



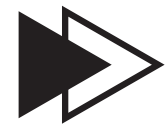
Statements from major licensors; worded as descriptive or predictive; but useful only as performative statements



In line with economic theory – licensors provide (costly) reinsurance to implementers in order to boost demand



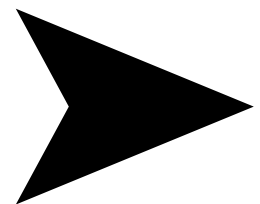
Only potentially useful



“Self-serving statements about other people’s money”



Stated limits to companies’ own future royalty requests tend to be high ceilings



No significant recent statements on aggregate royalty rates



To be distinguished from a pool’s licensing offer; e.g. Avanci

Impact Assessment - What statements will be made?

Specific mechanism contemplated by the Commission:

- Up to three different processes:
 - Submissions by SEP holders
 - Agreement between different SEP holders, facilitated by a conciliator
 - Appointed panel of experts
- Different quantitative thresholds and deadlines
 - (Self-assessed?) share of SEPs
 - (Self-assessed / Predicted?) market share
 - Within a specified number of months "after release of a new standard" or "introduction of new use case"
- Clearly open to net licensees
 - No effort to discourage statements from groups consisting of only net licensors or only net licensees

Impact Assessment - What statements will be made?

Commission's proposed mechanism raises many questions

- Statements from net licensees about maximum RAR serve no clear purpose:
 - Not an objective source of information
 - But also not a meaningful performative reassurance
- No clear scope for negotiations between net licensors and net licensees over a maximum aggregate royalty
- Expert panel as “stick” to elicit participation and willingness to negotiate?
- Competition between multiple statements to sway expert panel and/or public opinion
 - 'Baseball style' or 'skew the royalty horizon'

Impact Assessment - Types of Effects

Three different impacts contemplated by the Commission

- Increase predictability of prices
- Reduce the cost of SEP licensing negotiations
- Thwart excessive pricing

Related to (but distinct from) three different functions of the RAR:

- Forecast of future price levels
- Objective indication of FRAND royalty level
- Binding obligation on parties to offer consistent licensing terms

Impact Assessment - Effects on Licensing Costs

- Impact Assessment Report predicts significant (20%) licensing transaction cost savings
 - Availability of objective indicator of aggregate royalty may replace parties' own efforts
 - Or obviate need for other (more costly) types of assessments
- Such significant cost savings are not plausible
 - Assessments of aggregate royalty are not currently a significant cost factor
 - Comparable licenses would still be necessary, and top down still costly
- Pronouncements with binding effects could obviously reduce transaction costs
 - But at what (social) cost?

Impact Assessment - Effects on Royalty Rates

- Fundamental importance of "getting the rates right"
 - Not in the sense of optimality, but sufficiency
- No welfare analysis has been done to assess whether rates should be higher or lower
 - But the policy mechanisms only have the potential to lower rates
- Top-down from a single aggregate royalty may not be capable of producing efficient FRAND rates
 - Efficient aggregate rates need to be allowed to vary
 - Top-down should not be imposed in the absence of an appropriate apportionment method

Policy Assessment – Global Context

EU Regulation foresees pronouncements on global RAR

- Impact of EU pronouncements on global licensing negotiations
 - EU sets the rates for the World?
 - SEP licenses carve out EU-specific rates?
 - Licensors seek alternative venues to resolve their global disputes?
- Response from foreign regulators to EU Regulation
 - "Brussels effect" - other regions follow the European lead?
 - Trade wars - governments in other regions oppose EU efforts to set global rates
 - Regulatory race - other government actors also intervene in the determination of FRAND rates

Policy Assessment – Dynamic Implications

- Short term pain for uncertain long term gains
 - Chilling effect on ongoing licensing negotiations
 - Significant learning period - case law and practice needed
 - Probative value of existing comparable licenses in doubt
- Traveling back to a past fork in the road
 - RAR pronouncements were made in a different context
 - Proposal not aligned with significant progress achieved: FRAND determinations by courts, Huawei/ZTE framework
 - Incidence and scope of SEP licensing disputes has decreased

Policy Assessment – Role for Overall SEP Regulation

- Policy complementarity with SEP transparency
 - RAR and counts of (assessed) SEPs can be complements in a top down approach
 - Essentiality checks do little to improve the relevance of patent counting
 - Incentivizing companies to inflate counts imperils goal of creating a leaner and cleaner register
- Policy complementarity with FRAND conciliation
 - Conciliator *may* rely on RAR for a proposed FRAND determination
 - Existing arbitration processes do not rely on RAR
 - Existence of an institutional process for bilateral conciliation reduces the need for central rate fixing

Conclusion

- Proposed mechanisms for determination of RAR should not be adopted
- The empirical evidence and the geopolitical context favor an incremental approach
- Other, more carefully considered parts of the SEP regulation do not require RAR determination
- Potential bright future for top-down approaches
 - Based on price and demand data not available before market formation
 - Conditional on making progress on apportionment methods

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