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Technology transfer: The draft block exemption – the role of market definition

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Technology transfer

The draft block exemption – the role of market definition

By *Dermot Glynn and Geoffrey Randall, Europe Economics**

The European Commission has proposed important changes to the technology transfer rules in the 1996 block exemption, Regulation 240/96. The draft was published on 1 October 2003 (*OJ 2003 C235/10*; see also *CLI November 2003, p.8*).

The Commission has published its first response to the consultation in a speech by Commissioner Mario Monti, given in Paris on 16 January 2004. Monti noted that the submissions received in the public consultation process were generally supportive. However, a number of the comments received were critical on a number of important aspects of the proposals, including the use of market share thresholds.

To address many of the concerns the Commission has revised the draft text of the draft regulation and guidelines. These revised proposals will be sent to member states in advance of the next discussion on 18 February 2004.

The Commission still intends that the new regulation should come into force on 1 May 2004 at the same time as the modernised competition law regime. The changes continue the transformation of the Commission's thinking on block exemptions.

The draft regulation represents a shift from a legalistic to a more economic approach, in line with the new rules on vertical and horizontal agreements. Parties wishing to enter into agreements will be able to decide for themselves whether or not they are entitled to access to the "safe harbour" of the new block exemption – indeed, they will generally be obliged to do so. This self-assessment will depend on the issue of market definition and the calculation of market shares. It is this aspect of the block exemption that forms the subject-matter of this note.

Aims of the block exemption

The objective of the regulation is to allow agreements concerned with the transfer of technology (e.g. patents or know-how) between two parties, where the technical and other economic benefits outweigh any possible anticompetitive effects. Likely benefits include technology diffusion, reduced research and development duplication, greater incentives for the initial research and development, spurring of incremental innovation and increased product market competition.

On the other side of the scales, the seriousness of any possible anticompetitive effects (perhaps on prices, output, innovation or the variety and quality of goods) due to restrictions, such as territorial or field of use restrictions, implicit in technology transfer agreements will depend on the market power of the undertakings. Usually the larger the market share, the greater the likely market power. This basic economic reasoning explains why the Commission now proposes the use of market share tests for the granting of a block exemption. The draft regulation rests on a number of economic concepts.

The proposals treat agreements between competitors differently from those between non-competitors, and exempt all agreements between parties under certain market share thresholds – subject to them not including a list of hard-core restrictions, such as price fixing, which are set out in article 4 of the draft regulation.

Competitors and non-competitors are treated differently on the basis that agreements between competitors are potentially more damaging to competition. The draft regulation defines competitors as undertakings that compete on the "relevant technology market" and/or the "relevant product market."

Companies compete on the relevant technology market if they license competing technologies (actual competitors). They compete on the relevant product market if they are both active on the "relevant product and geographic market(s)" where the products are sold (actual competitors), or if they would realistically enter those markets in response to a small and permanent increase in relative prices (potential competitors).

Monti's recent speech went on to say that, for parties to be considered potential competitors, such entry should take place within one or two years, and this change will be reflected in the next set of guidelines.

A product market is a market for the sale and purchase of products or services to consumers or to other producers. A technology market is a market for the licensing of a technology. This may come in the form of a set of techniques, perhaps protected by intellectual property rights or by industrial know-how. The natural way to measure the size of a technology market would be the revenues received – say in licence fees – for the use of the technology.

In order to decide whether parties are competitors or non-competitors and then to measure their market shares, a definition of the relevant market is required. Market definition is frequently used in competition policy to define relevant product or service markets. The novelty here is the inclusion of the technology market.

Market definition and the hypothetical monopolist test (HMT) – the concepts

Market definition is a tool to identify and define the boundaries of competition between firms. The theoretical approach for defining markets put forward by the European Commission's notice on the definition of the relevant market for the purpose of EC competition law (*OJ 1997 C372/1*) is based on the HMT or SSNIP (small but significant and non-transitory increase in price) test, which was first introduced by the US Department of Justice in its 1982 Horizontal Merger Guidelines.

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Market definition in technology transfer

The hypothetical monopolist test is a thought experiment that can be used as a framework for defining relevant markets. The proposition behind it is that, for antitrust purposes, a relevant market is defined when a hypothetical monopolist (or hypothetical cartel) containing all the firms in the market could increase profit by imposing a small but significant and non-transitory increase in price. This has sometimes been specified as a 5–10% increase for at least one year, although the 1984 revision of the US Merger Guidelines abandoned the “5% rule” in favour of the “small but significant standard,” and the European Commission’s notice on market definition specifies a permanent change.

To apply this test, the situation of a hypothetical monopolist in a candidate market is considered. If the hypothetical monopolist were considered able to raise its prices profitably, then the candidate market is accepted as a relevant market, since competition from outside it is not a sufficiently effective constraint on behaviour within it. By contrast, if the prices of other products effectively constrain the terms offered by the hypothetical monopolist, then the relevant market must be defined more broadly.

At the heart of the assessment of whether it can be profitable for the hypothetical monopolist to raise prices is an estimate of the constraints exerted by demand- and supply-side substitutability. The price of a product is constrained on the demand side if the supplier does not find it profitable to increase price because of the threat of customers switching their consumption away from the product. The price of a product is constrained on the supply side if the supplier does not find it profitable to increase price because of the threat of other producers switching their supply to products that would themselves act as demand-side substitutes.

Thus the hypothetical monopolist test seeks to bring together evidence on demand- and supply-side substitutability into a single framework for defining the relevant market. Where sufficient data are available, statistical and econometric techniques can be used to determine appropriate demand- and supply-side substitutability. Where such data are not available or are inconclusive, alternative approaches such as the use of surveys or expert technical opinion may be required to help determine the appropriate market definition. Even with non-statistical approaches it is important that the HMT is used as it provides the appropriate framework for analysis.

The methodology for defining technology markets follows the same principles as the definition of product markets. The essence is substitutability. For any technology, the analysis would focus on identifying other technologies to which producers could switch in response to a small but permanent increase in royalties.

The draft regulation – safe harbours

This section provides an overview of the criteria by reference to which the safe harbours provided by the draft regulation are defined. The many other elements of the draft regulation and guidelines are not discussed here.

Technology transfer agreements between competitors will benefit from the block exemption if the parties have a combined market share not exceeding 20% of either the relevant product or the relevant technology market. For agreements

between non-competitors, the block exemption will apply if none of the parties’ market shares exceeds 30%.

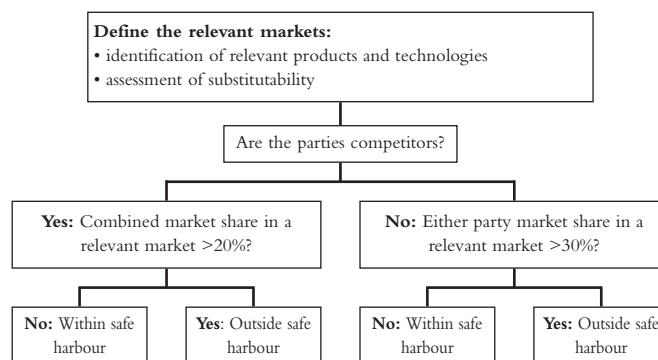
Agreements falling outside the safe harbour because the parties’ market shares exceed the defined limits are to be subject to individual assessment under article 81.

The way of measuring the market share of a relevant technology market for the purposes of the proposed block exemption is in terms of the presence of the technology on the market(s) for products using the technology, either from the party owning the technology or from suppliers to which it has been licensed or would be licensed under a technology transfer agreement.

Thus a licensor’s market share on the relevant technology market(s) is the combined share on the relevant product market(s) of the products incorporating the licensed technology manufactured or provided by the licensor and its licensees. This definition means that the relevant technology market is defined only to determine whether the parties are competitors on this market. The technology market shares are then measured in terms of shares of the relevant product markets.

For the purpose of the block exemption, market shares for the relevant markets are to be calculated on the basis of market sales value data for the preceding calendar year. If these are not available, other reliable market information such as market sales volumes may be substituted.

This diagram provides a summary of the decisions that need to be made for determining access to the safe harbour.



When discussing the inappropriateness of market shares for highly dynamic sectors, Monti gave an indication of what can be expected in the next set of guidelines. He said:

In addition, the guidelines will contain a second safe harbour based on the number of competing technologies that are available to potential licensees at a comparable cost. This will provide extra guidance especially for dynamic sectors.

It appears that the competing technologies will be those found in the relevant technology market, providing an additional use for this market definition.

Some implications

Market definition is complex at the best of times and there are frequently disputed market definitions. The block exemption adds further complexity with the distinction between the technology and product markets. Both markets need to be looked at to determine whether the block exemption applies.

However, if under every plausible market definition the conditions for exemption are met, then an in-depth market definition study is clearly not required and the parties can be reasonably certain of entitlement to the benefit of the block exemption.

For example, suppose that a company has developed a new technology for use in devices used in inhaling medicines, and was making inhalers itself, rather than licensing the technology to others, and currently selling them only to the public health service and only for use with one particular anti-asthma drug. Suppose also that the inhalers have no particular addictive quality, so that a patient using them could switch to another type without jeopardising his or her wellbeing.

Candidate relevant product markets might be “devices for inhaling medicines,” “devices for inhaling anti-asthma drugs,” “devices for inhaling drug X” or “devices for inhaling drug X by public health service patients.” To settle which of these was correct might require an economic study but, if the sales of the company’s products amounted to, say, only 5% of the smallest possible market (the market for inhalers of drug X in the public health service with no regional variations in concentration), then there would be no need, as long as the other party were in a similar position.

A problem can be that under one market definition access would be granted to the safe harbour, but under another the block exemption will not apply.

Consider the example of a company that develops technologies for making small motors, such as those used in portable computers and music systems which use them in the drive systems for playing or recording hard disks. Suppose that this company develops a new technology for a motor that is only suitable for use in mobile phones, in which it would activate the noiseless buzzers. We will assume that this is the first technology developed by the company for such a purpose (i.e. it possesses no other competing technologies) and that it is not active in the mobile phone handset market.

We will now assume that it wishes to license this technology to a mobile phone manufacturer who would then be able to cut costs and offer increased battery life by using the new technology in all its phones, replacing the freely available non-proprietary technology it currently uses for noiseless buzzers. It will be assumed that the mobile phone manufacturer does not possess its own licensed motor technology for this purpose and the new technology, if licensed, will be introduced into all handsets produced by the manufacturer.

To decide whether the parties would be able to use the block exemption, the first step would be to look at the relevant technology and product market definitions. Looking first at the relevant technology market, it would need to be decided which other technologies represent appropriate substitutes for the small motor technology in question. This would be determined by identifying other technologies to which customers could switch in response to a small but permanent increase in royalty payments.

Then the relevant product markets would need to be identified. It would need to be decided whether, for example, mobile phones were just one relevant market (definition A) or if there were in fact two relevant markets to be considered – one for camera phones and another for phones without built-in cameras (definition B).

Since one party is only active in the relevant technology market and the other in the relevant product market(s) then they can clearly be identified as non-competitors and the 30% market threshold applies. The small motor company’s share of the technology market will therefore be calculated on the basis of the share of sales of phones incorporating the licensed technology in the relevant product markets in the previous year (which would be zero for the first year of the agreement).

The mobile phones manufacturer active in the relevant product markets might have a low market share under the first market definition A, but be particularly strong in the camera phones segment and thus, under market definition B, be over the 30% market share threshold. Under the two possible market definitions discussed here the first would enable access to the safe harbour whereas the second clearly would not.

In order to determine the appropriate market definition, an HMT study would need to be carried out to determine eligibility for the block exemption. The HMT test would look at whether the different characteristics, possible intended uses and the prices of camera phones warrant them being in a separate relevant market.

Another obvious problem is that technology markets are prone to rapidly changing circumstances due to the very nature of innovation. This creates problems for market definition.

There are several possible implications. For instance, two parties at the start of an agreement might find themselves categorised as competitors, but if the licensor’s technology turns out to be such a dramatic advance that it renders the licensee’s technology obsolete, the companies might be re-categorised as non-competitors.

Another example would be that of a new technology that at its outset would have a zero market share and potentially allow a technology transfer under the block exemption. If the technology quickly rose to prominence, the company in question could quickly exceed the market share threshold.

In both these examples it would be important for parties to keep their positions under review. There is also the problem that, where a new technology creates its own market, the licensor will have a 100% market share, removing the availability of the safe harbour.

In the case where parties initially fall under the market share thresholds but later exceed them, they retain the benefit of the block exemption for two consecutive calendar years, provided that the relevant market share does not exceed 25% (competitors) or 35% (non-competitors). If these higher thresholds are exceeded, the exemption continues to apply for only one calendar year.

It is necessary to repeat that agreements that fall outside the block exemption, for example because the market share thresholds are exceeded, are subject to individual assessment. There is no presumption of illegality of agreements falling outside the scope of the block exemption, provided that they do not contain hard-core restrictions of competition, but each case has to be assessed individually with respect to article 81. Market definition will continue to be an important element of the assessment.

Material that appears in *Competition Law Insight* without an author’s byline is written by the Editor, Celia Hampton

Conclusion

The draft TTBE regulation sets out a new, more economic approach to the application of article 81 to agreements on the transfer of technology, and a new set of rules to determine whether the block exemption applies to such potentially anti-competitive agreements. At the heart of the approach, as with other block exemptions, is the concept of safe harbours, defined in terms of market shares.

The new approach is in general to be welcomed. Clearly, however, the usefulness of the safe harbour concept to business requires that firms and their advisers are able to identify the markets relevant to their particular situation and to measure their shares of those markets.

Yet the definition of the markets relevant to the assessment of the effects of an agreement to transfer technology can be a particularly difficult exercise, not least because of the distinction between technology and product markets and the dynamic nature of (most) such markets.

TTBE responses, and Commissioner's response

Responses from industry, lawyers and others to the Commission's proposal for a new block exemption for technology transfer agreements have been published on DG Competition's website (europa.eu.int/comm/competition/antitrust/technology_transfer_2/).

Taking the contributions from organisations starting with the initial A or B as a sample (a fifth of the whole), the average length of each paper was slightly less than 5,000 words. This made a numbing total of nearly four million words for the Commission to read.

It seems that they have all been read and noted, but there must be something to be said for pithy comments when it comes to catching the official eye.

Commissioner Monti's 16 January speech mentioned some changes beyond those discussed in the article above (p.13).

Agreements between competitors/non-competitors: An agreement between non-competitors will be treated as such throughout the life of the agreement, even if the parties later become competitors. This is designed to give greater legal security, and bases legality on an *ex ante* assessment. Two other changes will be made in this context:

- when assessing potential competition, likely entry into the market will be limited to entry in the next two years
- the burden of proving that patents are blocking will be eased to admit expert opinion as well as court decisions

Hard-core list: These provisions have been adjusted to forbid only those practices that are likely to have a collusive outcome. Reciprocal "running" royalties will only be treated as hard-core in licence agreements that are cartels in disguise.

Non-reciprocal output restrictions will be removed from the hard-core list, as will cross-licensing between competitors that contains field of use restrictions.

Territorial and customer restrictions in a non-reciprocal agreement between a licensor and a licensee who are competitors will be block-exempted. A licensing agreement, whether between competitors or non-competitors, will be able to

Industry participants will eagerly await the details of the revised regulation and guidelines. Commissioner Monti has made it clear that the market share tests are to remain, while the introduction of a second safe harbour will reinforce the importance of market definition in applying the regulation.

This note has illustrated some of the difficulties. Nevertheless, markets have to be defined. In focusing on the degree of substitutability between both alternative technologies and alternative products, the HMT provides the framework for arriving at the correct market definition. This is so even if the data with which to provide a statistical basis for the definition are not available. Without a rigorous approach to market definition, the logic of the safe harbours in the TTBE will be undermined.

Reference

Competition rules relating to technology transfer agreements – communication (OJ 2003 C235/10)

confine a supplier to one customer where the purpose of the agreement is to give that customer a second source of supply.

In agreements between non-competitors, the licensor's active and passive sales and the licensee's active sales into the other's exclusive territory or customer group may be limited. A licensee's passive sales into another licensee's exclusive domain will be exempt for the first two years of that other licensee's operations.

EU blocks US anti-dumping statute

For the first time in many years, the EU has enacted legislation blocking enforcement of a foreign law. Its target is the US Anti-Dumping Act of 1916. Regulation 2238/2203 (OJ 2003 L333/1) came into force on 9 January.

The WTO ruled that the US Act was in breach of the US's trade law duties on 26 September 2000. The US Administration has not yet persuaded Congress to repeal it, although the House Judiciary Committee voted for repeal on 28 January.

The regulation blocks the recognition and enforcement of any action taken under the 1916 Act, which created a private right of action against dumping that was intended to harm US industry or competition on the US market.

Some lawsuits that affect EU companies are pending. WTO remedies are inter-governmental and would not help those affected. Accordingly, an individual who is resident, or a company that is incorporated, in the EU may now bring an action in any EU jurisdiction to recover costs or liabilities incurred as a result of the 1916 Act or an action based on it. The right to recovery arises as soon as the US suit is filed.

To sue a US party, who would normally be the US plaintiff, the EU litigant will be considerably helped by a broad concept of those "related to" the US party – officers and directors, business partners, or a company that controls or is controlled by the US plaintiff, or is a sister subsidiary. This presumably overrides the limits placed on "lifting the veil" that make it hard to sue EU-based corporate relatives of a US wrongdoer.