Recent Developments in Standard Essential Patent (SEP) Pricing Mechanisms in China and the UK

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At the China Competition Policy Forum in Shanghai on August 31, 2017, a high standing official of the Price Supervision and Antimonopoly Bureau (PSAB) gave comment on the potential enactment of regulations on Standard Essential Patent (SEP) licensing practice by China's National Development and Reform Commission (NDRC). This proposal follows in the wake of forthcoming draft Intellectual Property Rights (IPR) related antitrust guidelines that are expected to provide an analytical framework and recommended approaches to SEP related issues in China. The new proposed SEP guidelines will advise on a more fixed approach to the pricing mechanism for SEP licenses, as they apply to products used or sold in China[1], since these would not be covered under the forthcoming IPR guidelines.

To this end, the NDRC's proposal is aimed, not at interfering with the rights of SEP holders to price and negotiate appropriate licenses, but rather, to provide further practical guidance to ensure greater consistency with the Anti-monopoly Law of China (AML) and further refine a consistent approach to enforcement on IPR-related anticompetitive conduct as it relates to SEP holders' pricing practices[2].

In studying the relevant SEP licencing cost formation factors that will inform such guidelines, the trial judgment passed down in the recent UK High Court case of *Unwired Planet v Huawei*[3] could provide a useful roadmap for determining and negotiating licenses. This case is notable not only for being the first UK court decision to determine a FRAND royalty rate, but for the wide-ranging transparency with which it discusses issues relevant to the assessment of royalties on SEP's subject to FRAND licensing commitments, amongst other issues relating to the parties contractual and competition law obligations in the face of these commitments. While some of its conclusions remain somewhat contentious, it may yet prove a useful point of reference for negotiating parties, courts and rule-makers alike in other jurisdictions, including China.

By way of background, these developments are based on the cellular telecommunication standards that have largely been developed in tandem with Standard Setting Organisations (SSO's). SSO participants come from all quarters of the telecommunications industry, from manufacturers and sellers of cellular and wireless equipment, to network service providers, and researchers and developers of applications and solutions. According to the European Telecommunications Standards Institute (ETSI) (one of the primary members of the 3rd Generation Partnership Project (3GPP) responsible for promulgating cellular standards), it is incumbent upon ETSI members with potential SEP's (those being patents that cover aspects of

[1] https://app.parr-global.com/intelligence/view/prime-2494454?src_alert_id=132338

[2] https://app.parr-global.com/intelligence/view/prime-2494454?src_alert_id=132338

[3] [2017] EWHC 711 (Pat)

a technical standard related to mobile phone communication), to be prepared to grant irrevocable licenses to those SEP's on fair, reasonable, and non-discriminatory ('FRAND') terms and conditions. This allows for a unified and collaborative approach to proliferating technical standards, while also recognising and appropriately rewarding those licensors for developing methods and processes for incorporation into those standards.

In concluding such a license, the two negotiating parties generally enjoy the freedom to conduct negotiations according to their own specific circumstances, albeit that the negotiation should be conducted in good faith, and in pursuit of a license whose terms and conditions are FRAND. Given the complexity of the licensing issues typically at stake, and a mutual desire to avoid costly and protracted litigation, it is understood that in most instances the parties themselves are best positioned to reach the most appropriate commercial arrangement. While stalled negotiations may result in injunction claims to restrain patent infringement, citing the implementer's failure to accept terms the litigating party regards as FRAND (an "unwilling licensee"), and corresponding counterclaims, this can be viewed more often as a strategic manoeuvre, rather than a serious call for court judgment. And if a neutral third party is called upon to settle an issue (including by arbitration), it is usually with regards to specific issues rather than key terms related to scope, duration and the technology for licensing.

The NDRC's recent proposals implicitly recognise a developing need for greater guidance for parties when pricing SEP's in China. Greater clarity on the price formation factors that should inform the course of negotiating SEP licenses, and whether or not their related terms are formulated on a FRAND basis, could help towards avoiding needlessly protracted negotiations and costly injunction claims. Such would be in keeping with a beneficial focus on "freedom of operation"; or in other words, the ability, as a practical matter, to focus on designing, manufacturing and selling products, unencumbered by potential patent infringement suits and other uncertainties. This is especially important for large manufacturers, such as Huawei and ZTE, and other major wireless telecommunications companies, who operate in a fiercely contested global environment with short product cycles, and cannot afford too many unnecessary interruptions and impediments.

According to the slides presented at the aforementioned China Competition Policy Forum held in Shanghai, factors to be considered by patent holders when deciding concrete licensing fees include (but are not limited to): the number of patents and the proportion of the patents in a specific standard, the geographic scope covered by the patents, value to a product contributed by a patent portfolio, patent expiry dates and expired patents, the proportion of the patents in China, average selling prices of the relevant product in the Chinese market, and average margins of the manufacturers of the end products[4]. In addition, there is a recognised concern over "royalty stacking", which occurs where a single product may infringe upon a multitude of patents, thereby bearing multiple royalty burdens that eat into profits. While not revelatory, this does indicate the focus of the NDRC in its consideration of further guidelines.

[4] https://app.parr-global.com/intelligence/view/prime-2494454?src_alert_id=132338

In the interim, for those negotiating SEP licences in China and elsewhere, some value may be drawn from the case of *Unwired Planet v Huawei*[5]. One of the most significant aspects of the case is the diligent calculation set out by the judge in determining the applicable FRAND royalty rates to apply between the parties, and their methodologies. While the case is still undergoing a fairly wide-ranging appeal, the appeal issues are mainly concerned with the importance of competition law on FRAND issues[6]. While common methodologies for valuing SEP's in terms of their relevance and quality are inevitably drawn from the various technical factors as mentioned in conjunction with the NDRC's proposals, in this case the judge offers two methods for calculating the relevant royalties; by analysis of comparable licenses elsewhere, and by top-down analysis based on the total aggregate royalty applicable to the relevant standards and SEP's.[7]

The comparative methodology relies upon identifying comparable licensing agreements to the FRAND licence agreement under contention. In this case reference was made to the prior licensing agreement by which Unwired Planet acquired a portion of SEP's from Ericsson. Since these included some of the SEP's in question with Huawei, a relatively simple apportionment calculation was possible. While this method may not be so easily applied by parties in cases where there is no directly comparable license, the case does lend support for the comparative methodology as being one of the most appropriate means for valuing SEP licenses. The top-down methodology, a standalone means for evaluating royalty rates in its own right, is used in this case to corroborate the results of the comparative methodology above. This method involves aggregating the total royalty payable for use of all the SEP's required to incorporate a particular standard (e.g. 4G), as a percentage of a product's price (e.g. smart phones). This value can then be filtered by various means, including the counting of patents and establishing their relevance to the standard, to determine what proportion of that royalty rate should apply to the portfolio of SEP's in question.

Hence the values derived from such pricing mechanisms provide a necessary basis for establishing the (relative) strength of an SEP portfolio. They are however a prelude to what is in essence a commercial arrangement since they do not accurately reflect the market dynamics between the parties, and cannot be considered in isolation as such. The true FRAND royalty rate and its associated terms in any negotiation will also incorporate commercial considerations relating not only to the parties' relative positions, but their positions in relation to other third parties and the market at large. These may involve terms that relate to scope, forms of payment, sales exposure and expected sales, amongst other factors that may be unique to those parties. Consideration of these issues and the compromises they involve are reflective of a unique set of circumstances specific to the negotiating parties, and are not necessarily open for comparison. This emphasizes the applicable limits of the SEP pricing mechanisms under

[5] [2017] EWHC 711 (Pat)

[6] https://www.lexology.com/library/detail.aspx?g=dff5d4f3-b6e8-4edd-8cd1-f2af2e81f240

[7] https://patentlyo.com/patent/2017/04/unwired-perspective-royalties.html

contemplation by the NRDC. It also underpins one of the key findings in *Unwired Planet v Huawei;* that there is only one set of license terms that are FRAND in a given set of circumstances.

This serves to highlight that in postulating guidelines for valuing SEP's, the NDRC is not intending to impinge upon commercial negotiations themselves, but rather lay down a more certain footing for them. This shall be valuable to the industry in providing a fixed and more consistent approach to complying with the AML, and to enforcement on anticompetitive conduct relating to SEP pricing. The *Unwired Planet v Huawei* case goes further. It not only applies FRAND royalty calculation methodologies towards determining an appropriate rate, but also lays down some further FRAND commitments that may have a legal bearing on negotiating stances. In particular that there is only one set of FRAND license terms in any SEP negotiation. While in the prior case of *Vringo v. ZTE*[8]the same judge considered a set of competing FRAND licensing offers, or a range thereof, to both be FRAND, in *Unwired Planet v Huawei* that interpretation was narrowed, thereby solving the problem of which set of competing claims to accept for the purposes of an injunction. It may also further compel licensing parties to work towards a negotiated outcome, rather than sitting on a position they presume to be within an acceptable FRAND range. This would then free them up to get on with their core businesses without further distraction.

[8][2013] EWHC 1591 (Pat) and [2015] EWHC 214 (Pat))