



Incentives to innovate – another look at Microsoft's defence in the work group server case

In a landmark decision in March 2004, the European Commission found that Microsoft's conduct in the markets for work group server operating systems and streaming media players constituted an abuse of Microsoft's dominance in the market for PC operating systems, thereby infringing Article 82 EC. In September 2007, the Court of First Instance (CFI) upheld the Commission's Decision and Microsoft subsequently announced that it would not appeal. These events brought to an end a battle that began nine years ago following a complaint in December 1998 by Sun Microsystems.¹

The work group server part of the case concerned interfaces and protocols used by Microsoft's work group server products to communicate and interoperate with Microsoft's PC operating system.² Microsoft's work group server products made use of these interfaces and protocols, but Microsoft refused to enter into licences with rival suppliers of work group server operating systems that would allow these rivals to build support for these interfaces and protocols into their own work group server products.

The CFI Decision

The Commission concluded, and the CFI agreed, that Microsoft's refusal to license infringed Article 82. The Commission and the CFI concluded that the information sought by Microsoft's rivals was essential for effective competition in the market for work group server operating systems because of the need for any work group server operating system to interoperate effectively with Microsoft's PC operating systems – products which continue to have a market share in excess of 90%.

The Commission's remedy, which the CFI upheld, was compulsory licensing. Microsoft vigorously

objected to this remedy, advancing reasons related primarily to innovation incentives. Microsoft argued that it had invested substantial sums in developing the interfaces and protocols at issue – interfaces and protocols which it regarded as its intellectual property (IP).³ Microsoft further argued that its return on this R&D investment would be significantly reduced if it were now forced to license information on interfaces and protocols that would allow its rivals to compete more effectively in the market for work group server operating systems. Microsoft warned the Commission and the CFI that compulsory licensing of the interfaces and protocols at issue in this case would set a precedent that would have significant negative effects on future incentives to invest in the development of IP.

The CFI rejected Microsoft's innovation arguments on the grounds that, in considering effects on innovation, the relevant question should be the effects on industry-wide incentives to innovate, and not simply the effects on the innovation incentives of any one firm. The CFI rejected Microsoft's claim that licensing of the requested interfaces and protocols would reduce rivals' incentives to invest; it observed that, to the contrary, licensing of the requested interfaces and protocols could be expected to increase rivals' incentives to innovate in work group server products that could interoperate effectively with Microsoft's PC operating systems.

The CFI's focus on industry-wide incentives to innovate was clearly correct. However, there was another problem with Microsoft's innovation argument that the CFI did not address, but which is equally, if not more, important.

Microsoft's failure to explain *why* licensing would have significantly reduced its profits

As noted above, Microsoft consistently argued that its profits would be significantly reduced if it licensed information on interfaces and protocols that would allow its rivals to compete more effectively in the

¹ The authors of this note, Robert Stillman and Hristina Dantcheva, advised Sun and later the European Committee for Interoperable Systems (ECIS), an industry group comprised of software firms opposed to Microsoft on interoperability issues. The views expressed in this memo are those of the authors alone.

² Work group servers handle functions such as log-on, authorisation, storing files centrally so that multiple users can have access, and controlling the use of network devices such as printers. As such, interoperability with PC operating systems is a "must have" for any work group server operating system.

³ Other firms in the software industry have disputed whether the interfaces and communication protocols should be regarded as intellectual property. For the purposes of this note, we accept Microsoft's position that the interfaces and protocols at issue do include Microsoft intellectual property.

market for work group server operating systems. However, to our knowledge, Microsoft never explained *why* licensing of this information would have significantly reduced its profits. This failure to provide a coherent, efficiency-based explanation of its refusal to license in our view reinforces the conclusion that Microsoft's refusal to license was fundamentally about maintaining and enhancing market power rather than innovation incentives.

Licensing the requested interfaces and protocols would not have allowed Microsoft's competitors in the market for work group server operating systems to free ride on Microsoft's innovative efforts. If Microsoft had licensed information on the requested interfaces and protocols, it would have earned licensing revenues – in the same way that firms routinely earn revenues when they license IP to competitors. These licensing revenues would have helped Microsoft make a return on investment in R&D.

It has been suggested that perhaps the reason Microsoft did not pursue a licensing strategy was a concern that, if it tried to capture value from its interfaces and protocols through royalty rates, it might have found itself facing charges of excessive pricing. This argument is highly dubious. Even if Microsoft were constrained for some reason in the royalty rates it could charge, Microsoft could capture value from its interfaces and protocols through the prices of its PC operating systems designed for network use (as well as through royalty rates). The price of PC operating systems designed for network use provided (and still provides) Microsoft with another instrument (in addition to licence royalties) of realising returns on the investment in developing the IP embedded in the interfaces and protocols at issue.

Another of Microsoft's defences for its refusal to license the requested information related to the risk of cloning. Microsoft argued that if the requested information on interfaces and protocols were provided to rival suppliers of work group server operating systems, it might enable its competitors to learn the inner workings of the Microsoft work group server operating system and enable its rivals to develop clones of Microsoft's product offerings. The Commission rejected this cloning argument on factual grounds and the CFI agreed. Each pointed to the recognised distinction in the software industry between the *specification* of an interface or protocol (the rules for interoperability) and the *implementation* (the source code that makes use of the interfaces and protocols). The Commission and the CFI found that disclosure of the specification of interfaces and protocols does not imply the disclosure of implementation details. The fact that it is common practice in the software industry to disclose the specification of interfaces and protocols clearly supports this point.

Issue is not *whether* licensing would have reduced Microsoft's profits – but *why*

We are not suggesting that a strategy of licensing – and/or earning a return through the price of the PC operating systems designed for network use – would have been equally as profitable to Microsoft as its strategy of withholding interoperability information from competitors. The fact that Microsoft's preferred strategy was a refusal to license reveals that Microsoft believed that this was a more profitable strategy. The question however remains: *why* was refusing to license a more profitable strategy?

To our knowledge, Microsoft never answered this question. It never presented a coherent efficiency-based explanation of *why* it regarded licensing (at non-prohibitive royalty rates) as an unacceptable option. For the reasons just explained, the argument that a refusal to supply was necessary in order to prevent rivals from free riding on its innovative efforts is inadequate, and cannot constitute an "objective justification" for Microsoft's conduct.

Conclusions

We are not suggesting that every dominant firm should have an obligation to license IP or supply other essential inputs to rivals in adjacent markets. This is a larger topic – beyond the scope of this note.

We are also not suggesting that vertically integrated firms which decide not to supply essential inputs to non-integrated rivals necessarily should have an obligation to justify their decision – though a dominant firm considering such a strategy would do well to have such an explanation. Having an efficiency justification is especially important when there is a plausible alternative theory to explain why the dominant firm might have an anti-competitive incentive to refuse to supply.

Our main points relate to the specifics of the Microsoft case – one of the most important Article 82 cases yet decided by the Commission and the CFI. The Commission's Decision clearly articulated how refusing to license the requested interfaces and protocols could help Microsoft maintain over time the market power it currently derives from its effective monopoly in PC operating systems.⁴ Against this background, Microsoft's failure to provide a coherent, efficiency-based explanation for its refusal to license should be regarded as further evidence that the refusal to license was part of a strategy to maintain and enhance market power and that the concerns about the anti-competitive effects of Microsoft's conduct were well founded.

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4 EC Decision, paragraphs 764-778.