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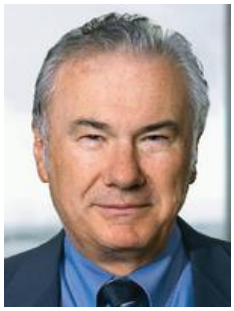
The 'Naked Tax' In FTC V. Qualcomm Is Patently Absurd

By **David Teece** (February 1, 2019, 2:29 PM EST)



David Teece

In a San Jose courtroom, during the government shutdown, those that care can be witness to a controversial antitrust case literally brought days before the change in administration that, far from improving competition, threatens to harm American industry and American consumers by crippling the leading innovator in mobile technology, Qualcomm, all in the name of shaving a few dollars off the price of Apple's and other implementers' technology licensing cost. The new incoming acting Federal Trade Commission commissioner at the time wrote a rare and biting dissent arguing that the case has no economic basis; but in the deadlock of 1-1 commissioner vote at the time, the case went forward while the FTC waited to be reconstituted.

The case is an ill-conceived one and reflects, at best, an incomplete understanding of yesterday's market conditions. Its existence also reflects the inability of our regulatory and legal system to come to grips with broader issues which threaten our economy and even the "big tech" (e.g. Apple, Intel) companies that goaded the FTC to bring a case against (comparatively) "little tech" (Qualcomm) way back in early 2017. If the FTC prevails, it will be a short-term regulatory victory for the FTC's staff litigators, over the long-term interests of the American consumer, the American economy and even the big tech companies agitating for the suit.

The true ultimate winner is likely to be China's Huawei Technologies Co. Ltd. — the only company other than Qualcomm in the running for 5G technology leadership. That possibility ought to set off alarm bells in policy circles, executive suites, Congress and in the FTC itself, whose star witnesses have included Huawei.

Qualcomm is one of our most innovative companies. Its inventions have revolutionized mobile telecommunications. Consumers wouldn't be too eager to buy new smartphones without faster upload and download speeds and new apps enabled by better and faster connectivity. Qualcomm invented the CDMA technologies underpinning the 3G revolution. Qualcomm is a major contributor to the technology underlying the foundation of 4G and 5G systems. It has invested billions in R&D to support the tens of thousands of engineers who drive advanced technologies that allow wireless telecommunications technology networks to function. Qualcomm also develops and supplies sophisticated chips which incorporate some, but not all of those wireless technologies needed to make mobile phones work. Many of the features consumers value and appreciate rely on Qualcomm technologies, such as fewer dropped calls, faster downloads, streaming video, real-time location tracking, etc.

Qualcomm has a very large patent portfolio to undergird and protect its technologies. From its early days as a technology developer, Qualcomm has always followed the established practice of licensing this portfolio related to the functioning of the whole wireless network to device makers, or original equipment manufacturers . No other licensor in the space follows any other practice. Subsequently, Qualcomm started designing and supplying chips and adopted a policy that an infringing user of its intellectual property, such as an OEM, must have a license. Qualcomm will not sell its chips to an infringer of its IP. It seems legitimate for IP owners to not be forced to sell their products to those who break the law and infringe on their IP. Note that at no point in time did Qualcomm ever practice a "no chips no license" policy.

The FTC claims that Qualcomm's business model is anti-competitive. Its claim is directed at a gerrymandered chip market where asserts that Qualcomm was a monopolist in certain products — CDMA and "premium LTE" modem chips only — in certain limited periods — when Qualcomm's offerings were better than other chips for certain specific products. As the FTC puts it, "by bringing leverage from Qualcomm's modem chip monopoly to bear on license negotiations, Qualcomm has been able to negotiate royalties that exceed the reasonable royalties that Qualcomm would have otherwise negotiated."

Note that the FTC is, in essence, saying that the price Qualcomm is charging for access to its technology is just too high. It has no reasonable benchmark for saying this. The FTC's economic expert, my colleague, University of California, Berkeley, economics professor Carl Shapiro, was the only expert the FTC put forward in its case at trial who was capable of calculating a monopoly overcharge. Surprisingly, the FTC instead relied upon a licensing consultant, Michael Lasinski, with strong ties to Huawei, whose unscientific methodology somehow concluded the price was too high.

When what's been valued is thousands of patents, all very different, there is no single method available that can lead to a confident comparison, least of all Lasinski's so-called patent counting methodology. Lasinski disclaimed expertise to evaluate both the technical importance of Qualcomm's patents and the legal compliance of Qualcomm's licensing under the FRAND commitment, particularly for ETSI, a key standards development organization for 3G, 4G and 5G wireless telecommunications. Shapiro didn't attempt the valuation exercise, leaving the FTC lawyers to advance Lasinski's deeply flawed methodology. Shapiro's testimony nevertheless led to news headlines that Qualcomm's royalties were a "naked tax." On careful inspection it turns out that, as Shapiro admitted in his cross-examination, this tax was assumed, not observed, to exist. This completely circular reasoning — of assuming one's conclusion — should not escape anyone's attention.

Besides its expert economist's assumption of a royalty surcharge ("I believe it's substantial," he testified), the FTC has resorted to another sleight-of-hand: to label Qualcomm rather than Apple as the perpetrator of a pricing surcharge. Since by law the FTC regulates competitive conditions, not prices, the commission argues that the wireless communications technologist (David) has too much bargaining leverage against the iPhone-iPad producer (Goliath). To reach this odd conclusion, David must be a monopolist. Only by adopting very narrow markets can the FTC can get there. It does so as noted earlier by narrowly segmenting the market for LTE chips into premium and nonpremium (high, medium and low-end LTE chips), and ignoring the competitive forces at work in the premium space, where Qualcomm faces competition from MediaTek, Huawei, Samsung and Intel. High or low, Qualcomm's market shares in chips did not impact its licensing policy.

When one realizes that Qualcomm royalties have stayed about the same, no matter its market share, in

so-called “premium” chips, or in the WCDMA chips for which the FTC does not claim any market power ever, then one is forgiven for asking where is the evidence of a chip monopoly driven surcharge?

Silicon Valley should shudder because, with the FTC’s approach to market definition, almost all innovative firms can be accused of monopoly power, and have their business models overturned by the government. Best not to be too innovative? Ironically, Apple dialed down the performance of the Qualcomm chips it put into iPhones so that unlucky consumers who got an iPhone with an Intel chip inside wouldn’t notice the slower speed relative to the equivalent Qualcomm-inside iPhones. This suggests that if there is market power lurking in this neighborhood, it’s not with Qualcomm but with Apple … with whom the FTC has a common interest agreement in this case.

In any case, the antitrust laws require that the FTC must prove a negative “competitive effect” from improper conduct. Harm to competitors is not enough; in fact, our antitrust laws invite and encourage harming competitors by beating their prices and bettering their products. There is no way the FTC can show or did show actual harm. All Qualcomm is trying to do is get Apple and all other users of its technology… whether in America, Europe or in China … to pay for its technology. Patents are not self-enforcing, and the FTC should recognize that Qualcomm’s business model is simply trying to get reluctant and recalcitrant infringers to pay a price sufficient to support the R&D investments needed to propel the industry forward. What is wrong with refusing to sell chips to someone infringing your patents? A homeowner who refuses to rent a bed to a trespasser is typically excused.

Qualcomm’s licensing policy is sometimes compared, by the FTC and Shapiro, to Microsoft’s “per-processor licensing,” the subject of a 1994 U.S. Department of Justice consent decree. The comparison rests on the simplistic plank that just as Microsoft required its OEM-licensees to pay for Windows licenses even if a non-Windows operating system were shipped, Qualcomm’s licensees are paying Qualcomm royalties even when using a non-Qualcomm chip.

That latter statement is facially true, but the pertinent truth, making the comparison to Microsoft inapposite, is that Qualcomm’s licensees are using Qualcomm’s technology for which a royalty is due. Qualcomm is recouping its technology investment embodied in its own patents, not simply charging for products delivered by rivals. Hence, calling this royalty a “naked tax” is patently absurd. The royalties received are the compensation necessary to maintain Qualcomm’s contributions to technological progress. Thomas Edison said that “profits are the return needed to keep on inventing.” This is Qualcomm’s practice.

The proper royalty level is at its core an industrial policy/technology policy issue that heretofore the competitive marketplace had solved quite well by arm’s length negotiated transactions. Apple and possibly Intel may eventually be bitten by their current regulation-for-thee-but-not-for-me attitude. Heavy-handed de facto price regulation is now being spirited into an important technology market by the FTC without evidence, sound principle or a whit of concern for economic and national security and longer term consumer consequences.

Qualcomm competes in chips not just from Intel, but from Huawei, Samsung, MediaTek and Spreadtrum. Demonstrably adequate competition and rapid innovation usually stifle antitrust concerns. It is only the hubris and myopia of the FTC staff running the case (given front-office recusals) that is giving life to this ill-conceived case.

The FTC risks existential harm to an important American technology developer. It will also damage the global technology market by replacing negotiation with court determined price regulation not guided in

any way by consideration of the business model and financial returns needed to draw forth the investment needed to keep this industry competitive. The American people have already signaled that they are getting sick of such elitist, arrogant and damaging government interventions.

The regulatory excess on display in FTC v. Qualcomm would be less troubling if the future of the mobile ecosystem, and American's leading role in shaping and benefiting from it, weren't at stake. 2G, 3G and 4G were mainly about connecting people; 5G is also about connecting everything. Healthcare, autonomous vehicles, smart homes and practically all other industries who need to communicate are the visible frontier. U.S. leadership here is critical. Indeed, in March 2018 the U.S. Department of Treasury and the Committee on Foreign Investment in the United States recognized that "a reduction in Qualcomm's long term competitiveness … would significantly impact US national security."

What Broadcom couldn't do by acquisition, our own FTC is hell-bent on doing by injunction. There is no doubt that if Judge Lucy Koh enters an injunction dissolving Qualcomm's business model, which is what the FTC has requested, Qualcomm will be destroyed as nearly all licensees cease paying their agreed-upon royalties, and leadership in 5G R&D will be ceded to Huawei.

The FTC and CFIUS are at war with each other, but the U.S. government has no institutional mechanism to bring these antagonists to terms. The FTC's case should fail for lack of merit. The sheer complexity of patent and antitrust issues and the possibility of judicial error could coalesce into monumental pitfalls for the U.S. economy (consumers and businesses) and national security. In my view, even Apple, which needs rapid innovation in mobile communications technologies to make its new product releases truly meaningful, is at risk. The judge, FTC commissioners and members of Congress should pay very close attention.

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