

# **Antitrust Vertical Control Policy in a World of Daughter Companies**

*Master thesis - EMLE program*

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## **Authorship Declaration**

*I hereby declare and confirm that this thesis is entirely the result of my own work except where otherwise indicated. I gratefully acknowledge supervision and guidance I have received from prof. Vincenzo Denicolo.*

*Date 12.8.05*

*signature -Eti-*

## **Abstract**

Vertical restraints and vertical mergers are supervised under antitrust policy. In case of inability of a company to choose vertical restraints or merger, it can enter the secondary market itself (through a daughter company). In light of this option, market equilibrium is changed. Moreover, in case of entry, it is likely that anticompetitive harm will occur. Therefore, antitrust policy has to anticipate the possibility of entry while making decisions regarding vertical mergers and vertical restraints. The possibility of substitution between vertical mergers, vertical restraints and daughter companies, and their anticompetitive and welfare effects, will be demonstrated by the Israeli case of the newspaper “Yedi’ot Aharonot”.

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## Abbreviations

**US** - upstream / upstream company (depends on the context).

**DS** - downstream / downstream company (depends on the context).

**M-D relationships** – manufacturer distributor relationships

**Antitrust policy** - antitrust legislation, directives and guidelines.

**Vertical control** - Antitrust control upon Vertical restraints and Vertical mergers.

**The RTP** - The Israeli Restrictive Trade Practices Law 5748 – 1988.

**The declaration**- Declaration according to sec. 43.a.1, About the Existence of Restrictive Arrangements in the (local) Newspaper Market in Haifa, 1999.

**The verdict** - The verdict in Antitrust Procedure 4179/00 Yedi'ot Aharonot LTD Vs. The General Director of the Israeli Antitrust Authority, 2003.

**The vertical guidelines**- EC Vertical Guidelines, Guidelines on Vertical Restraints (2000/C291/01).

**The horizontal guidelines** - The guidelines on the assessment of horizontal mergers (2004/C

## **Introduction**

At the present time, products are becoming more and more complicated and sophisticated. Most of the goods combine complementary components. The production process is composed of different stages, from primary idea until distributing the final product to the consumer. An efficient production process requires some degree of specialization in every stage, and frequently this specialization means that different firms are involved in the production process of one product: For example, one firm produces the body, a second produces the engine, a third produces the wheels and finally, a distributor sells the car to the final consumer.

This process raises a lot of problems regarding the relationship between the involved companies. Hold up problems between companies that became highly specialized in one stage of the production process can lead to abuse of their market power. Double marginalization problems increase both the price for the final consumer and the cost of renegotiating and contracting between the firms. These problems affect the ownership structure along the production process and give incentives to firms to vertically integrate or design restrictive contracts. There is more than one efficient ownership structure of firms along the production process. The efficient ownership structure depends on the magnitude of these problems, the level of specialization required for a specific product, the cost of specialization, and the level of competition in the involved markets.

Vertical relationships can be divided into two main typical types of relationships. The first type is outsourcing or semi-outsourcing relationships, in which a downstream<sup>1</sup> firm buys a component from an upstream firm. In this type of relationship, the downstream company has a greater share in producing the final product, while the upstream firm specializes in producing a specific component only. The second type is manufacturer–retailer/distributor (M-D) relationships. In this type of relationship, the manufacturer, which is the upstream company, traditionally has a greater share in producing the final product. Waterson (1996) argues that retailers and distributors can also have market power. Retailing is much more than simply a mechanism for distribution, since the ‘service’ provided by retailers contributes to the

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<sup>1</sup> The distinction between downstream and upstream firms is based on the question of who sells the final product to the final consumer. According to Rey and Tirole (2003) the downstream firm is the firm that sells the final product to the consumer. 1

value which consumers place on the product, so that demand is not exogenous to retailing. This paper is relevant to both types of vertical relationships, although I will focus on the first one.

Assuming, for example, there is car producer who buys specific wheels required for its cars from a firm that produces wheels. Between the parties there is contractual relationship. In case of hold up problems, the car producer can choose between three solutions in order to minimize the costs of these problems:

- 1) A contractual solution: Re-negotiating with the wheels producer and designing a new restrictive contract.
- 2) Merging with the wheels producer.
- 3) Entering into the wheels market and producing its own wheels.

While the first solution doesn't affect the ownership structure, the second and third solutions change the ownership structure along the production process. With respect to the efficient governance structure, each solution has its own welfare effects.

In cases that the car producer is not able to find a way to overcome hold up problems by choosing either the first or the second solution, due to limits of the antitrust policy, it will choose entry.

In addition, each solution has some anticompetitive effects which affect total welfare, but while the first and second solutions are supervised under antitrust policy, the third solution-entry-isn't. Entry may lead to higher anticompetitive effects than the first or the second solutions. In these cases, although there are anticompetitive effects of the first solution - vertical restraints, and the second solution - vertical merger, antitrust policy should refrain from interfering, allowing some degree of anticompetitive harm (that it wouldn't be able to prevent) in order to avoid higher negative welfare effects (or even higher anticompetitive effects). An antitrust policy which focuses mainly on preventing anticompetitive effects, and ignores wider welfare context (which is affected by choosing an ownership structure), or the limits of its capability prevent anticompetitive effects, won't lead to efficient results. Neither will an antitrust policy which doesn't anticipate the effects of its decision on the "default solution" for the company and on the incumbent companies in the market.

Moreover, entry needn't occur in practice in order to influence the market

equilibria. The parties anticipate the possibility of entry into their propositions while renegotiating a contractual solution. The possibility of entry changes the market equilibria and can lead to higher inefficient outcomes in cases of renegotiation constrained by linear prices than under merger or vertical restraints. Since the parties anticipate the option of entry, so should antitrust policy.

The complexity of the final product also raises questions of market definition. What is the real product? Is it the whole car? Or are the body, the engine and the wheels three different products that have been tied together?

Market definition is a basic question, which has determined the quality of antitrust decisions since the product was only a simple banana. Economic-based market definition is becoming more and more relevant today in light of hi-tech products that combine hardware, software and applications.

In this paper I will define the components that compose the final product as different components of a single product. Whenever I refer to the final product as several products that are tied or bundled together this will be done explicitly.

In section 1 I will present the facts of the Israeli Yedi'ot Aaharonot case law. In section 2 I will describe the Israeli antitrust policy regarding vertical control (mergers and restraints). In section 3 I will present a simple model. In section 4 I will discuss the assumptions of the model, its limitations and its expansions. In section 5 I will present law and economic analysis of the Yedi'ot Aharonot case in light of the simple model. In section 6 I will point out some lessons for antitrust policy, including presentation of the role of antitrust policy and the vertical control policy in the EU. In addition, in this section I will make some policy suggestions. In section 7 I will conclude this paper and suggest some ideas for further research.

## **1) The facts of the Yedi'ot Aharonot Case law**

In Israel there are three significant national daily newspapers: Yedi'ot Aharonot, Maarive, and Haaretz. Each one of them has two versions; the daily version (published Sunday through Thursday), and the weekend version (published on Fridays). Each of the newspapers, in both its versions, includes several different sections, such as the news section, the economic section and

the sports section, which together comprise the final product - the whole daily or weekend newspaper.

### 1.8 Yedi'ot Aharonot – a monopoly

Yedi'ot Aharonot is the biggest Israeli daily newspaper. Yedi'ot Aharonot was declared a “monopoly” in the Israeli daily newspaper market<sup>2</sup> according to section 26<sup>3</sup> of the Israeli RTP. The declaration took place on 12.4.1995 and was renewed on 13.4.1999.

### 1.9 Local newspapers

In Israel there is another type of newspapers - local newspapers. These newspapers are usually published on weekends. Every city or area in Israel has its own local newspaper. There are two types of local newspapers in Israel: Independently held local newspapers, which are held by an independent holder (these newspapers can be sold apart from any daily newspaper or sold together with a daily newspaper due to a selling agreement), and affiliated local newspapers, which are held by one of the three main daily newspapers.

Originally, local newspapers were sold apart from the daily newspapers, but in the last decade, every daily newspaper has included a local newspaper as a part of its weekend version.

The relationships between the local and daily newspaper markets and specific market definitions were discussed in several policy decisions:

In the 1995 IAA declaration of Yedi'ot Aharonot as a monopoly it was stated that today local newspapers are a complementary product to daily newspapers. In 1996 the practice of selling the weekend newspaper together with a local newspaper was brought before the Israeli antitrust tribunal as a question of prohibited tying practice. The tribunal, in its decision in the “Mon

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<sup>2</sup> The relevant market was defined as daily newspapers in the Hebrew language, excluding religious orientated daily newspapers, or local newspapers, but including economic orientated daily newspapers.

<sup>3</sup> 26(a): “For the purposes of this Law, concentration of more than half of the total supply or acquisition of an asset, or more than half of the total provision or acquisition of a service, in the hands of one person (hereinafter - 4 Monopolist) shall be deemed to be a Monopoly”. This is the equivalent of “dominant position” under the European antitrust policy (Art. 82 of EC Treaty).

2/96” case, determined that the practice was not prohibited tying, since it was a common trade practice to sell local newspapers and weekend newspapers together. This practice was natural efficient tying, since the local newspaper had become a part of the final product of the weekend newspaper<sup>4</sup>.

In the IAA declaration according to sec. 43.a.1 of RTP of 21.2.1999 (the declaration on the existence of vertical restraints) these markets were considered as separate markets, although there was some linkage between them.

### **1.10 The Haifa local newspaper market- the market and the players**

In Haifa (one of the three main cities in Israel), three local newspapers were published: **Kolbo** (which was the first and most significant local newspaper), **Yedi’ot Haifa** and **Bair Haifa**. The last one was affiliated with the daily newspaper Maarive (Yedi’ot Aharonot’s main competitor), and the other two were independently held (Kolbo was held by Shoken and Yedi’ot Haifa was held by Migdalar). In the Haifa area, Yedi’ot Aharonot didn’t have an affiliated local newspaper (this was the only area in Israel, out of 14 areas in total, in which Yedi’ot Aharonot didn’t have an affiliated local newspaper).

### **1.11 Operating through a daughter company**

In 1993 Yedi’ot Aharonot started publishing an affiliated local newspaper named “Koteret”, held by the Yedi’ot Aharonot daughter company “Yedi’ot Tikshoret”. Koteret was sold apart from the Yedi’ot Aharonot weekend newspaper (at that time local newspapers were sold separately from weekend newspapers). Since 1995 the local newspaper Koteret was a section of the Yedi’ot Aharonot weekend newspaper, but was also sold separately from it. Probably Koteret wasn’t economically profitable and it was shut down within a year.

### **1.12 Merger**

Since 1996 local newspapers in Israel have been sold together with weekend newspapers as a common trade practice. As part of this practice, Maarive started

<sup>4</sup> The general director appealed this verdict to the Supreme Court; the appeal hasn’t been decided yet (the appeal-SA 9240/99).

to publish an affiliated local newspaper in Haifa (Bair Haifa) and sold it as a part of the weekend newspaper. Because this became a common trade practice, Yedi'ot Aharonot needed a local newspaper for its weekend package, and in the beginning of 1996 it asked to merge with the independently held local newspaper Yedi'ot Haifa.

In his decision, dated 18.9.1996, the general director of the IAA approved the merger under the condition that the local newspaper had to be sold apart from the Yedi'ot Aharonot weekend newspaper. This condition made the merger deal unattractive for Yedi'ot Aharonot, since it didn't fulfill its need for a local newspaper that would be a part of its weekend newspaper. The merger deal didn't come through.

### **1.13 Vertical restraints**

After the abandonment of the merger deal, Yedi'ot Aharonot made restrictive agreements with the holders of the two independent local newspapers - Migdalor and Shoken. According to these agreements the local newspapers Yedi'ot Haifa and Kolbo would be sold as sections in the Yedi'ot Aharonot weekend newspaper, with an extra charge of 1 NIS to Yedi'ot Aharonot's customers<sup>5</sup>, and with no extra charge to Yedi'ot Aharonot's subscribers.

On 21.2.1999 the general director declared, according to sec. 43.a.1 of RTP, that these arrangements restricted competition in four ways<sup>6</sup>: Firstly, they restricted competition between the national newspapers. Secondly they harmed the competition between the local newspapers (between Kolbo and Yedi'ot Haifa, and between these two and Maariv's local newspaper). Thirdly, they harmed the competition since Yedi'ot Aharonot was a potential competitor in the local newspaper market (because it had operated in that market before with Koteret, it was considered as a potential competitor in the local newspapers market). Fourthly, there was a fear of seeping of the cooperation between Yedi'ot Aharonot and Shoken (Kolbo's holder) into other geographic markets<sup>7</sup>. For the above reasons these agreements were deemed illegal.

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<sup>5</sup> Separately the price of Yedi'ot Haifa was 3.3 NIS and the price of Kolbo was 4.4 NIS.

<sup>6</sup> See Declaration dated 21.12.99, appendix 2

<sup>7</sup> I found the fear of seeping of the cooperation between Yedi'ot Aharonot and Shoken irrelevant to this paper, and therefore didn't discuss it.

Due to this declaration, Yedi'ot Aharonot, Shoken and Migdalor reached new agreements. According to the new agreements, the local newspapers were printed in Yedi'ot Aharonot facilities, using Yedi'ot Aharonot capital. In exchange, Yedi'ot Aharonot got copies of the local newspapers to sell as sections of its weekend newspaper. Yedi'ot Aharonot didn't charge them for using its capital but didn't have to pay for the copies of the independent local newspapers. Under these new agreements, Kolbo and Yedi'ot Haifa could be sold separately from Yedi'ot Aharonot but not as a section of Maarive or Haaretz. In addition, another restraint in the agreements was with respect to advertising areas in the local newspaper. Yedi'ot Aharonot had priority and could determine that certain advertisements would be published in the local newspapers. Under the new agreement these local newspapers were published as part of Yedi'ot Aharonot's weekend newspaper with no additional charge for the consumers.

The parties to these agreements turned to the antitrust authority and applied for individual exemption from approval of restrictive agreements according to sec. 14 of the RTP. In his decision, dated 21.8.2000, the general director rejected the request and declared that these agreements were not compatible with the requirements of the RTP. According to the Israeli RTP the parties could appeal against that decision before the antitrust tribunal, and so they did on 21.11.03<sup>8</sup>.

#### **1.14 The tribunal's verdict as to the reason why Yedi'ot Aharonot shouldn't enter into the local newspaper market again**

In its verdict<sup>9</sup>, the tribunal confirmed the new agreements between Yedi'ot Aharonot and Yedi'ot Haifa and exempted the restraints that were included in them. Yedi'ot Aharonot withdrew its request for the tribunal's approval of the agreement with Kolbo, and therefore the arrangement was abandoned.

There were several arguments that the tribunal made in its verdict: First, since at that time local newspapers were a part of the weekend newspapers, Yedi'ot

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<sup>8</sup> See verdict in case TR 4179/00, appendix 3.

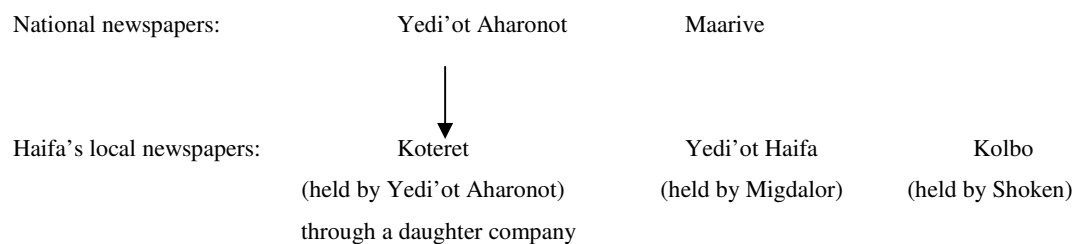
<sup>9</sup> The parties to the appeal were Yedi'ot Aharonot Ltd Vs. the General Director. Originally, Maarive was a party to the appeal procedure, since it objected to the agreements, but later it withdrew its objection. Although Maarive withdrew its objection, the appeal was heard and not automatically approved, since the tribunal defends the competition and not the competitors. In this case the tribunal still had to decide whether these agreements were beneficial to the public interest.

Aharonot had to have one in order to compete efficiently in the daily newspaper market; therefore, if the agreements hadn't been approved Yedi'ot Aharonot would have entered the market itself. Second, Yedi'ot Aharonot had already competed in the local newspaper market with Koteret in the past and wasn't an efficient competitor; therefore there was no point forcing it to compete again in this market. According to the tribunal, preserving an inefficient competitor which would have to bear losses only because it had to compete, wouldn't advantage the competition in the local newspaper market.

Third, the tribunal took into account the possibility of entry or exit of competitors from the market on the "day after"; Assuming Yedi'ot Aharonot produced its local newspaper on its own, what would happen to the competitors in Haifa's local newspaper market active at that time? According to the verdict, since Maarive had its own affiliated local newspaper, and Yedi'ot Aharonot would have its own affiliated local newspaper as well, there was no place for four competitors in this market. Therefore, there was a probability that both independently held newspapers, would be disadvantaged, and most probably Yedi'ot Haifa would be pushed out of the market (because Kolbo was the stronger of the two). Another reason why Yedi'ot Haifa would probably be pushed out of the market was that since Yedi'ot Haifa printed its copies using Yedi'ot Aharonot's capital, there was an expectation that it wouldn't be able to keep competing at the same level, due to lack of capital.

### 1.15 Road map

1993: There was no practice of selling local newspaper together with the weekend national newspaper:





Vertical restraints

Haifa's local newspapers:	Yedi'ot Haifa (held by Migdalor)	<b>Kolbo</b> (held by Shoken)	Bair Haifa (held by Maarive) through a daughter company
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**2) The Israeli antitrust policy regarding vertical restraints and vertical mergers**

In the following section there is a brief presentation of the principles of Israeli antitrust policy regarding vertical mergers and vertical restraints. The decisions in the Yedi'ot Aharonot case were based on these principles.

**2.4 Vertical restraints**

In section 4 of the Israeli RTP there is a prohibition of being a party to a restrictive arrangement, in whole or in part, unless an exemption according to law is obtained. The definition of "Restrictive Arrangement" is found in sec. 2 of the RTP and refers to vertical as well as horizontal restraints.

Sec 2 (a) gives a wide and general definition of a restrictive arrangement:

*"A restrictive arrangement is an arrangement entered into by persons conducting business, according to which at least one of the parties restricts itself in a manner liable to eliminate or reduce the business competition between it and the other parties to the arrangement, or any of them, or between it and a person not party to the arrangement".*

Sec. 2 (b) gives an explicit list of issues that are deemed to be restrictive:

- "(1) The price to be demanded, offered or paid;*
- (2) The profit to be obtained;*

*(3) Division of all or part of the market, in accordance with the location of the business or in accordance with the persons or type of persons with whom business is to be conducted;*  
*(4) The quantity, quality or type of assets or services in the business.”*

Sec. 3 excludes arrangements that aren't deemed to be restrictive<sup>10</sup>.

In order to include the restrictive arrangements under the scope of section 2 of the RTP, there is no explicit demand for any economic standards or tests in the sections themselves. On the face of it, it is sufficient that one of the parties “restricts itself in a manner liable to eliminate or reduce the business competition”, for the arrangement not to be compatible with the RTP.

The wide definition of a restrictive arrangement in the RTP led to non-coherent verdicts of the Israeli Supreme Court about the nature of restraints that should be prohibited by the RTP<sup>11</sup>. Unlike the Israeli Supreme Court, the Israeli antitrust authority and the Israeli antitrust tribunal adopted an economic approach for evaluating anticompetitive effects of restrictive arrangements. The arrangements mentioned in Sec. 2 (b) are considered as illegal per-se, while the arrangements that fall within the scope of Sec. 2 (a) are dealt with under ROR. In evaluating anticompetitive affects under Sec. 2(a) the authority takes into account considerations such as the market power of the parties and entry and exit barriers, as can be seen from the decisions in the Yedi'ot Ahaonot case.

While considering approval or objection of vertical restraints, according to its power from the RTP, the IAA must consider only the anticompetitive effects. The tribunal, on the other hand, has the power to take into account a wider scope of considerations for “the benefit of the public interest”, including welfare considerations. Yagur (2002) claims that according to the RTP the IAA isn't authorized to consider general efficiency considerations; it is authorized to take into account only considerations regarding harm to competition.

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<sup>10</sup> Including mutual exclusivity arrangements, see the Israeli RTP, appendix 1.

<sup>11</sup> For example, there was a discussion of clauses that restrict a seller that sells his share in a company from opening a competing firm for a certain period - ASP 4465/98 Tivo'ol (1993) Ltd v. Shef Hayam (1994) Ltd.

Since 2001 block exemptions for different kinds of restraints have been enforced. There are two relevant groups of block exemptions: General block exemptions, such as de-minimis, and vertical block exemptions, which include exemptions for franchise agreements, exclusive distribution agreements and exclusive purchasing agreements. These block exemptions can be applied in very specific cases<sup>12</sup> in which the market share of the parties is limited. Some of the block exemptions are limited to parties with no more than 10%, 20% and 30% market share. None of the block exemptions can be applied when one of the parties is a monopolist. Applying the block exemptions also depends on the type of restraint (don't apply in cases of an RPM or naked restraint).

## **2.5 The IAA General Directors' powers regarding vertical restraints (that are relevant to the Yedi'ot Aharonot case)**

The Israeli RTP gives the general director different powers with respect to prevention and elimination of harm to competition. Regarding vertical restraints, the general director can give (or not) an individual exemption which exempts the parties to the restrictive arrangement from the requirement of obtaining the approval of the tribunal according the conditions in Sec. 14. The General Director's decision can be subjected to appeal before the antitrust tribunal.

When the IAA notices that a restrictive arrangement exists in practice, it has the authority, given in Sec. 43(1), to determine and declare on the existence of a restrictive arrangement which is not compatible with the RTP.

## **2.6 Vertical mergers**

Supervision of mergers is legislated under Chapter 3 of the RTP.

Mergers that can be subjected to the authority's examination and objection,

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<sup>12</sup> The vertical block exemptions don't apply in cases where at least one of the parties is a monopolist, or the parties are competitors or potential competitors, or the agreement is for a period longer than 10 years. In addition, the franchise agreements block exemption doesn't apply in cases where the restraint is an RPM. The exclusive distribution and exclusive purchasing block exemptions don't apply in cases in which there are no substitutive goods in the territorial market, or the restraints are naked, or when there is more than 30% market share in the product market. The de-minimis block exemption doesn't apply if the restraint is a per-se restraint or if the market share of one of the parties is above 20% of the product market. 12

according to sec 17, are mergers in which at least one of the merged parties has some level of market power (that is indicated by a minimum market share or turnover). If a merger (vertical, horizontal or conglomerate) falls in this scope, the general director is authorized to object to the merger if (according to sec. 21):

*“He believes that there is a reasonable risk that, as a result of the merger as proposed, the competition in the relevant sector would be significantly damaged or that the public would be injured in one of the following regards: (1) The price level of an Asset or a Service; (2) Low quality of an Asset or of a Service; (3) The quantity of the Asset or the scope of the Service supplied, or the constancy and conditions of such supply”.*

As in restrictive arrangements, in merger policy the RTP also doesn't demand explicit economic standards for objecting to a merger request. In practice, the authority, while evaluating a merger's anticompetitive effects, takes into account economic considerations and evaluates coordinated effects as well as non coordinated effects of the merger with respect to the parties market power, barriers for entry or exit, horizontal overlaps and foreseen foreclosure<sup>13</sup>.

### **3) A simple model**

In this simple model I will show that a strict antitrust policy that forbids vertical restraints and/or vertical mergers, without anticipating the firm's option to enter into the secondary market (through a daughter company) can lead to inefficient results, since due to of the possibility for entry, the market equilibrium changes.

#### **3.6 Assumptions**

A downstream firm is a monopoly in its market (like Yedi'ot Aharonot in its

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<sup>13</sup> Ytzhak yagur antitrust law, 3ed Ed, 2002.

market), while an upstream firm is in perfect competition (the local newspapers market in Haifa had some degree of competition, although it wasn't "perfect competition"). The US produces input for the DS, which sells the output to the market (like in the Yedi'ot Aharonot case – Yedio't Aharonot had to have a local newspaper as a section in its final output-the weekend newspaper). There is a fixed proportion technology between US input and DS output (one local newspaper as a section in one weekend newspaper). The US input that is required for this specific DS has some level of differentiation from the whole upstream market general input (the wheels must fit the DS specific brand, or, with respect to the Yedi'ot Aharonot case, the colors of the local newspaper, the format and the design have to fit to Yedi'ot Aharonot requirements). In order to produce the input required for this specific DS, the US has to take specialization-sunk costs<sup>14</sup>  $=F < 1/4$ . Excluding these sunk costs, there are no transaction costs or fixed costs.

The DS faces demand curve  $D=q=1-p$ ,  $DS(mc) < 1$ . There are constant MCs for both DS and US:  $US(mc)=c=US(p)=0$  while  $DS(mc) = W$ .

Hold up problems are eliminated completely in any solution that DS chooses in order to eliminate these problems (e.g vertical restraints, vertical integration or entry). Market solution (e.g renegotiation under linear prices constraint), on the other hand, doesn't completely eliminate hold up problems and can lead to uncertainty. The probability of reaching "stable equilibrium" under "market solution" is  $= \alpha$  ( $\alpha < 1$ ).

When DS chooses a solution such as merger or entry, this solution has its costs. If DS wishes to merge with US, it will carry merger costs  $= M$ . If DS wishes to enter the US market, it will carry entering costs  $= E$ . In this model, in case of entry, DS would be able to produce the upstream product at  $c=W$ , exactly like the most efficient US ( $c=0$ ).

In a solution of renegotiation on a two tariff agreement (vertical restraint) the US is able to make a "take it or leave it" offer (if there is Nash bargaining, the solution is probably similar). Bargaining between the parties would lead to an efficient solution in all cases.

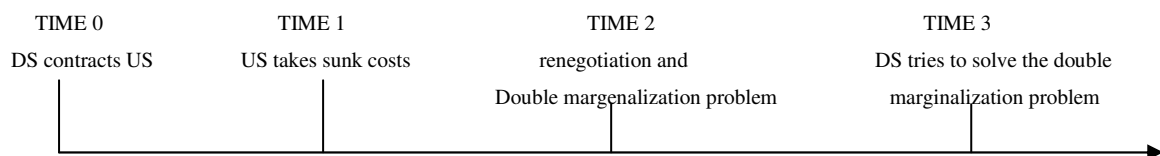
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<sup>14</sup> Such as in GM- Fisher Body case

Both merger and vertical restraint hold anticompetitive effects and therefore are prohibited by antitrust policy as possible solutions for the parties (as happened in the Yedi'ot Aharonot case).

### 3.7 Time line

The game proceeds in four successive stages. **At time 0**, DS chooses to contract with one US firm to purchase the input for its final product. At this time, the US market is in perfect competition. **At time 1**, the chosen US sinks its specialization costs. After the US sinks the specialization costs, a sub-market is created between DS and US. US becomes the only firm that can supply the demand for the differentiated DS input; therefore it has market power toward DS (like in GM- Fisher Body case). **At time 2** there is contractual renegotiation between US and DS which contains hold up problems (similar to a bi-lateral monopoly situation). At this time, US tries to maximize its profits as if DS had no options but to accept its offer. The parties reach a double marginalization situation. **At time 3** DS tries to solve the double marginalization problem. In this stage DS faces 4 options: Firstly, it can renegotiate with US, and the parties can agree on a two part tariff agreement, which is a vertical restraint. Secondly, the parties can negotiate under constraint of linear prices (not a vertical agreement). Thirdly, the parties can vertically integrate. Fourthly, DS can enter the upstream market.



#### 3.7.1 Time 0

Since at time 0, the upstream market is in perfect competition, DS would choose the most efficient US competitor that produces at minimum cost -  $W=c=0$ .

### **Downstream monopoly maximizes its profits**

Since the DS is a monopoly, it will set the Q in  $MC=MR$ , and set the P according to its demand curve.

$$DS(mc)=DS(mr)$$

$$Q=1-p \rightarrow p=1-q \rightarrow DS(mr) \rightarrow p=1-2q \rightarrow W=1-2q \rightarrow Q=1/2-W/2$$

$$P=1-q \rightarrow 1-(1/2-W/2) = 1/2+W/2 = \text{retail price}$$

$$DS \text{ Max Profit: } \Pi = (p-c)q =$$

$$\underline{(1/2-w/2)^2} = \underline{(1/2-c/2)^2} \quad (1)$$

Under  $US(mc)=W=c=0$ , the price =  $1/2$ , the quantity =  $1/2$ , and the aggregate industry profit is  $1/4$

### **3.7.2 Time 1**

At time one, US sinks specialization costs = F.

### **3.7.3 Time 2**

At time two, renegotiation takes place. After sinking specialization costs, the US becomes a monopoly itself towards the downstream monopoly and will try to maximize its own profits. Since specific investments were sunk, there is a hold up problem between US and DS which leads to a double marginalization solution.

### **Upstream profit maximization:**

Since US is supplying output to DS, and DS is a monopoly in its market, US demand is  $DS(mr)=US(q)=1-2q$ . At this stage, the US would maximize its profits as a monopolist itself; therefore it would set its Q at  $MC=MR$  and set its P according to its demand curve.

$$US(mr)=p=1-4q = c \rightarrow \underline{q=1/4-c/4}$$

$$US(p)=W=1-2(1/4-c/4) = \underline{1/2+c/2}$$

$$US(\Pi)=(W-c)q=\frac{1-c}{2} \cdot \frac{1-c}{4} = \frac{(1-c)^2}{8} - F = 1/8-F \quad (2)$$

### **DS monopoly new profits**

Since the US changed the input price, the DS costs now equal the new US price.

$$DS(p)=1/2+W/2=3/4+c/4$$

$$DS(q)=1-(3/4+c/4)=1/4-c/4$$

$$DS(\Pi)=(p-W)q = \left(\frac{3+c}{4} - \frac{1+c}{2}\right) \frac{1-c}{4} =$$

$$\frac{(1-c)^2}{16} = 1/16 \quad (3)$$

## **3.8 The optional equilibria**

In order to solve the double marginalization problem, DS faces four possible options:

- b) It can renegotiate with US and the parties can agree on a two part tariff agreement, which is a vertical restraint.
- c) The parties can negotiate under constraint of linear prices (market solution-not a vertical agreement).
- d) The parties can vertically integrate.
- e) DS can enter the upstream market.

Under each option the market will reach a different equilibrium, which will anticipate different factors, such as the bargaining power of the parties, the option of DS to switch to another US competitor, and the option of DS to enter the US market itself.

### **3.8.1 Possible equilibrium with no interference of antitrust law - vertical restraints**

With no limit on vertical restraints, US and DS will negotiate on the

surplus of the whole aggregate industry profit =1/4.

Since US is able to make a “take it or leave it offer”, it will capture the maximum surplus until it is constrained by DS switching options (or until it breaks even). A possible agreement between the parties will be a two tariff agreement with  $w=0$  and  $\text{commission}=F$  (fixed payout covers sunk costs).

$$\Pi(\text{us}) = F - F(\text{sunk})$$

$$\Pi(\text{ds}) = 1/4 - F$$

$$W = 0$$

$$Q = 1/2$$

$$P(\text{ds}) = 1/2$$

The whole aggregate industry profit in this case is  $1/4 - F$  (4)

### 3.8.2 **Vertical restraints are prohibited under antitrust policy**

If vertical restraints are prohibited under antitrust policy, the parties will renegotiate, constrained by linear prices. At this renegotiation, the parties know that DS has two options, either to switch to one of US’s competitors or to enter into the US market itself, and they will anticipate these options in their renegotiation proposals.

### 3.8.3 **Equilibrium under option of switching to another US competitor, with no option for DS to enter the US market**

The DS will accept an offer on the exact amount that leaves it indifferent between switching to a new competitor and

staying with the incumbent US competitor. Since the renegotiation isn't able to completely eliminate hold up problems caused by switching to another competitor, and the outside option for DS contains an element of uncertainty =  $\alpha$ , the US will make an offer which will be equal to  $\alpha(1/4-F)$ .

In this case  $W > 0$ , and the DS monopoly would maximize its profits:

$$\begin{aligned} \Pi(ds) &= (1/2 - W/2)^2 = \alpha(1/4 - F) \rightarrow W = 1 - \sqrt{\alpha(1 - 4F)} & (5) \\ Q(ds) &= 1/2 - W/2 = \frac{-\sqrt{\alpha(1 - 4F)}}{2} \\ P(ds) &= 1/2 + W/2 = 1 + \frac{\sqrt{\alpha(1 - 4F)}}{2} \end{aligned}$$

### **3.8.4 Equilibrium under the DS options either to switch to another US competitor or to enter into the US market**

Under the option of switching or entering into the US market, the offer that the DS will accept, anticipates the possibility of entry, in addition to the possibility of switching to another competitor. The offer in this case is constrained by the size of the surplus  $1/4 - F - E$  = the aggregate industry profit. Since bargaining will lead to an efficient outcome, the DS will accept this offer and entry won't occur. In this case market equilibrium will be as follows:

$$w > 0.$$

$$\begin{aligned} \Pi(ds) &= (1/2 - w/2)^2 = 1/4 - F - E \rightarrow W = \sqrt{1 - 4F - 4E} & (6) \\ Q(ds) &= 1/2 - w/2 = \frac{-\sqrt{1 - 4F - 4E}}{2} \\ P(ds) &= 1/2 + w/2 = 1 + \frac{\sqrt{1 - 4F - 4E}}{2} \end{aligned}$$

### 3.8.5 Possible equilibrium with no interference of antitrust law - merger

Merger will reduce the distortion in the wholesale price, but will raise merger costs. The merged firm will maximize its profits and the equilibrium in this case will be as follows:

$$\underline{\Pi(u)=\frac{1}{4}F-M} = (1/2-w/2)^2 \rightarrow W = \sqrt{1-4F-4M} \quad (7)$$

$$Q(ds) = 1/2 - w/2 = \frac{-\sqrt{1-4F-4M}}{2}$$

$$P(ds) = 1/2 + w/2 = \frac{1 + \sqrt{1-4F-4M}}{2}$$

### 3.8.6 In case the merger is prohibited under antitrust policy or merger costs are high

In such a case the parties will negotiate under linear prices and reach the same results described in sec 3.3.3.

### 3.9 Discussion of possible equilibria

Under vertical restraint, the price of the final product to the consumer is  $1/2$  while the quantity offered is  $1/2$ . If there is no option of entry, under renegotiation constrained by linear prices the price for the consumer is

$$\frac{1 + \sqrt{\alpha(1-4F)}}{2} > 1/2$$

and the quantity is  $\frac{-\sqrt{\alpha(1-4F)}}{2} < 1/2$

Since the vertical restraint is a two part tariff, wholesale price under the restraint is  $W=0$  and the vertical restraint benefits the final consumer. The aggregate industry profit under renegotiation constrained by linear prices is an  $\alpha$

portion of the aggregate industry profit under vertical restraints, and lower than it, since  $\alpha < 1$ .

Entry and merger eliminate  $\alpha$  but on the other hand shrink the size of the surplus.

In light of the option of entry, the aggregate industrial profit shrinks by the size of E to  $\frac{1}{4}F-E$ . In this case the price to the final consumer is

$$1 + \frac{\sqrt{1-4F-4E}}{2} > 1/2$$

and the quantity is 
$$\frac{-\sqrt{1-4F-4E}}{2} < 1/2$$

In case of merger, the aggregate industrial profit shrinks by the size of M to  $\frac{1}{4}F-M$ . In this case the price to the final consumer is

$$1 + \frac{\sqrt{1-4F-4M}}{2} > 1/2$$

and the quantity is 
$$\frac{-\sqrt{1-4F-4M}}{2} < 1/2$$

Under merger equilibrium the price to the final consumer is also lower than the price under the renegotiation constrained by linear price equilibrium.

### 3.10 Conclusions

- Vertical mergers, vertical restraints, and entry are options which are considered when wishing to minimize the distortion in the wholesale price. Besides vertical restraints that eliminate the distortion in W (Since the

restraint is a two part tariff restraint), each of the other solution holds some degree of distortion in  $W$  that affects prices and quantity as well as social welfare.

- Prohibiting vertical restraints is always bad because the equilibrium with vertical restraints creates lower prices and greater quantity or at worst, the same prices and quantities as any other equilibrium.
- Merger and entry would take place when renegotiation under linear prices isn't efficient due to high hold up problems. Merger and entry aim is to eliminate  $\alpha$ . The higher the  $\alpha$  the closer we get to a double marginalisation solution.
- If  $M > E$  permitting or prohibiting the merger is irrelevant because entry is always better than merger.
- If  $M < E$  there are two possible options:
  - a) If vertical restraints are allowed, permitting the merger in addition to the vertical restraints shapes the proposals in the renegotiation, because the DS can capture a greater share of industry profit in the bargaining with the US. Nevertheless, that doesn't affect social welfare (only a distributive effect).
  - b) If vertical restraints are not allowed, prohibiting the merger (extreme antitrust policy) facilitates an inefficient solution and leads to higher prices and lower output as well as reduction of social welfare. Since the outside option of DS is now weaker (entry), it allows the US to raise the wholesale price, which leads both to greater distribution effect and greater dead weight loss (welfare effect).**

#### **4) Discussion on the assumptions of the model, its limitations and its expansions**

In this section I will clarify the limitations of the simple model and discuss its assumptions. In the first part of this section I will generally refer to the role of ownership structure; in the second part I will refer to specific assumptions and outcomes of the simple model, and in the third part I will discuss the antitrust policy in a wider context.

##### **4.1 The role of ownership structure**

The suggested model is an “industrial organization” type of model. In this model the decisions of the involved firms are taken from strategic reasons and the main factor that is considered when the company has to decide upon its ownership structure (choosing between renegotiation, merger or entering into the secondary market), is profit maximization. The industrial organization approach has its own boundaries and according to later approaches, firms have other roles in addition to the strategic profit maximization role. According to property right approaches, the role of a firm is efficient property right location, and efficient control over the firm’s assets (capital and human capital). Therefore, the efficient ownership structure can be affected by several factors and not only by decisions on profit maximization. Since there are several reasons for a company to choose ownership structure, merger and entry are in reality more common, while in the model, entry, most likely, will never occur (since bargaining will lead to an efficient solution).

The G-H-M model predicts under which conditions integration or separated ownership will be the efficient structure that will lead to the optimal level of specific investments (Hart 1995).

Following its assumptions, the G-H-M model proposes that under any of the suggested ownership structures there is underinvestment in specific investments. Besides, while the model proposes allocation of assets, which maximizes the ex-post surplus for the parties, according to the G-H-M model:

If assets a1 and a2 are independent,<sup>15</sup> non-integration is optimal, if assets a1 and a2 are strictly complementary,<sup>16</sup> some form of integration is optimal, and if m1's (m2) human capital is essential, type 1 (type2) integration is optimal. If both m1's human capital and m2's human capital are essential<sup>17</sup>, all ownership structures are equally optimal.

In other words, according to the G-H-M model there are two main elements that should affect a firm's control allocation decision (even if it does not maximize the ex-post surplus of a party): First, the nature of the involved assets: in case of highly complementary assets, they should be under common ownership, while independent assets should be separately owned, and a contractual relationship is preferred. Second, a party is more likely to control an asset if it has to make a relatively important investment decision regarding the asset. Therefore if the downstream company has to make an investment decision regarding the upstream asset, it should control it. In this case, merger or operating through a daughter company is more efficient.

#### **4.1.1 Vertical restraints, vertical mergers and daughter companies - possible reasons for choosing the ownership structures**

In addition to the reasons that were discussed in the G-H-M model, and in addition to the role of the company in profit maximization that was presented in the simple model, "in the real world" companies choose allocation of residual control rights in order to overcome different problems that stem from the nature of vertical relationships between firms. Each one of the ownership structures presents some problems and solves others; the choice between the structures requires some level of trade off. Therefore, "in the real world", unlike in the simple model, entry is more likely to occur, since it holds the advantages of common ownership.

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<sup>15</sup> Assets are independent when access to a2 will not increase m1's marginal return from investment when it has access to a1 and vice versa.

<sup>16</sup> Assets are strictly complementary when either access to a1 alone does not affect m1's marginal return from investment and vice versa (m1 needs a2 as well).

<sup>17</sup> M1's human capital is essential if m2's marginal return from investment is not enhanced by the presence of assets a1 and a2 in the absence of m1's human capital and vice versa.

#### **4.2.2 Location of residual control rights: separate ownership - contractual restraints as a solution to contractual problems**

Vertical long-term contracts can raise free riding problems, agency problems, as well as transaction costs and opportunistic behavior between the parties. A possible solution for the above problems doesn't necessarily presume relocation of residual control rights. Such a solution can be achieved by restrictive clauses in the contract itself, while keeping ownership separation (Butler and Baysinger 1986), and enjoying the advantages of separate ownership, such as specialization and saving in governance costs.

In a contractual solution different problems can be solved by different types of clauses. Some examples are: Double marginalization can be dealt with by means of a two-part tariffs clause, quantity requirements, or retail price ceilings. Harming competition between retailers can be solved by RPM or exclusive distribution. The contractual solution for free riding by retail price discounters on the pre-sales services can be service requirements, RPM, or exclusive distribution (Waterson 1996).

The main disadvantage of a contractual solution is that it is a temporary solution. Contractual renegotiation between the parties is a repetitive game. Therefore a contractual solution may not be able to solve hold up problems.

#### **4.2.3 Location of residual control rights - costs and benefits of outsourcing**

Since the model involves vertical relationships of the "outsourcing" type, it might be relevant to have a brief discussion of the costs and benefits that result from choosing this kind of separate ownership structure.

Specialist firms are able to produce at lower costs, but on the other hand, suffer from two potential disadvantages: Firstly, the need to find a suitable buyer for their product and the costs involved in finding such a buyer. Secondly, problems in proving their product's quality. In addition,

there is a trade off in different kinds of costs. The outsourcing firm saves fixed costs, wages, and governance and control costs, but incurs search, bargaining and contract costs. The specialist firm can produce a lower MC but incurs entry and fixed costs, search costs, and bargaining and contractual costs. There is a trade off between diseconomies of scope and transaction costs.

Grossman and Helpman (2001) maintain in their model that when the manufacturing cost advantage of specialized components isn't great and the bargaining power of these producers is slight, intense competition between final producers favors vertically-integrated firms.

De Groot (1998) maintains that outsourcing also has macroeconomic consequences for economic growth, R&D efficiency level, product diversity, firm size and total welfare (although private profitability doesn't coincide with social desirability, since firms do not take these considerations into account).

#### **4.2.4 Location of residual control rights: Merger and operating through a daughter company as a solution for contractual hold up problems**

A long term contractual relationship requires a well designed long term contract that covers as many possible business events between the parties as can be foreseen at the contracting time. Besides contracting and transaction costs, long-term contracts usually raise problems such as asymmetric information, and need for specific investments. All these raise hold up problems in renegotiation. In complicated products that require some level of specialization and specific investments (given that specific investments are sunk at the time of renegotiation), the party which sunk such investments may be the exploited or exploiter, since it has some market power after making the investment<sup>18</sup>. Grossman and Helpman (2001) maintain that in specialized input products, suppliers maximize the profits but compromise their bargaining power.

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<sup>18</sup> The GM – Fisher Body case is an example of a long-term contract that was designed to protect Fisher Body from being exploited by GM, but eventually, Fisher Body became an exploiter itself. Due to the hold up problems, the share of the surplus did not reflect the parties' actual investment effort.

Merger is a possible solution for these problems. By locating the residual control rights in one firm's hands, merger minimizes transaction costs. Unlike a long-term contract, when renegotiation is a repetitive situation, merger is a single negotiation situation<sup>19</sup>. On the other hand, merger has its own merger costs that affect total welfare. Sometimes these costs can be higher than the benefits; in these cases, merger probably won't occur<sup>20</sup>.

Operating through a daughter company has the same effects as merger with respect to location of residual rights of control. The difference between merger and operating through daughter companies is that instead of bilateral merger negotiation there is a unilateral governance decision to operate in the "secondary market". Merger, as well as operating through a daughter company, involves entry costs, which are sunk costs, and can be inefficient, since the entry duplicates sunk and fixed costs.

Moreover, ownership of capital involves costs. For example, the firm has to repair its machines when they break down, renew them, replace them with more highly developed technologies, and provide further training of its operators<sup>21</sup>.

Besides, common ownership of assets involves an increase in the scope of a firm and it can lead to changes in the nature of remuneration and incentives, which can cause loss in efficiency, since there is a limit to the efficiency gains from size (Church 2004). A limited scope of production provides benefits of specialization. A specialized firm can produce the product at a lower cost and more efficiently.

When there is separate ownership, the firm is able to keep contracting the most efficient producer and switch to a different producer when the incumbent becomes inefficient. When control is unified, the firm has to make an effort to remain the most efficient producer on both producing

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<sup>19</sup> Merger was the solution in the GM – Fisher Body case. GM merged with Fisher Body because it wanted to be sure that the next time around it would be in a stronger bargaining position.

<sup>20</sup> . For example, the GM- A. O. Smith case (Hart 1995).

<sup>21</sup> On the other hand, the firm which has control rights on the capital has an incentive to make sure that it will be repaired or modify quickly (hart 1995).

levels, in the long run. Failing in doing so can create inefficiencies that affect both production levels.

#### **4.3 A discussion of specific assumptions and outcomes of the model, its limitations and its expansions**

The assumptions that underlie the model, as well as the model itself, raise some questions. In the following paragraph I will discuss and relax some of the model's assumptions and set its limits.

##### **4.3.4 Vertical restraints, merger and entry “in the real world”**

Since bargaining leads to an efficient solution in the model, merger and entry will most likely not occur. However the possibility of entry and merger will be anticipated in the parties' proposals in the renegotiation. In “the real world”, bargaining can fail due to several problems. In such a case entry and merger will occur, and there will be a substitution between  $\alpha$ , (which represents in the model the uncertainty factor in separated ownership) and M or E costs. In addition, although under vertical restraints the distortion in W is eliminated, vertical restraint can have its own inefficiencies such as inefficiencies resulting from separate ownership as well as those resulting from anticompetitive effects. Therefore, in “the real world” vertical restraints don't always have absolute priority. In considering different solutions, in “the real world”, other factors, such as the magnitude of the hold up problem and the TC that is associated with each of the solutions, will have to be taken into account.

##### **4.3.5 The MC costs of the downstream company in producing the upstream product**

In the model it was assumed that when the DS enters the upstream market, after it sinks costs, it is capable of producing the upstream product at least as efficiently as the most efficient US competitor, which in the

model is  $mc=0$ . In reality, since producing the US product requires some degree of specialization, and DS is a generalized firm; there may be disadvantages of size and scope. It is likely that the DS firm will produce the US product in  $mc>0$ .

In this case the inefficiency of entry and the distortion to  $W$  are even greater.

#### **4.3.6 Bilateral and multilateral supply agreements**

The structure that was suggested in the model is of an upstream firm which sells its products to one downstream monopolist, in a bilateral relationship. In this case, the downstream monopolist sets the demand for the upstream input. Relaxing the downstream monopolist assumption to two downstream firms with some degree of market power, and assuming that the upstream firm supplies input to both of them, Motta (2004) maintains in a simple model that in this case vertical integration will foreclose the rival downstream firm by not providing it any input.

It can be argued that the suggested model holds only in case of a bilateral supply structure, when the upstream company supplies only to one downstream company (which sets the demand). It can also be argued that in multilateral supply structures, daughter companies should be preferred to vertical integration, since the latter causes greater foreclose. I will answer this argument with three points:

- a) The possibility of foreclose doesn't necessarily presume that vertical integration isn't efficient. As Motta (2004) shows in a simple model, in case of two downstream firms that have market power, vertical integration can be efficient, since it removes double marginalization, and customers benefit from it. The inefficiency of the foreclosure should be offset against the efficiency gains of the vertical merger and total welfare should be evaluated with respect to welfare outcomes of the daughter company.

- b) The foreclosure outcome of the vertical merger doesn't exclude the daughter company's anticompetitive effects. In cases where the main concern is leveraging market power, input (market) foreclosure or size as an entry barrier, this anticompetitive outcome will occur in the daughter company solution as well. Again, anticompetitive harms must be weighed against welfare effects.
  
- c) In addition to the assumption that the DS is a monopoly; there is also an assumption that the market of the US is in perfect competition. In the latter case, (unlike in Motta's model) the danger of foreclosure is minimized since the rivals of the DS can switch to another upstream competitor. In this case, it is less likely that vertical integration will lead to greater foreclosure than an entry.

#### **4.3.7 Monopoly power in the downstream market and distributional agreements**

The assumption of the existence of market power in the downstream market is a somewhat exceptional assumption. Ray and Tirole (2003) argue that monopoly power will lead to anticompetitive effects only if the monopolist is located in the upstream market, since there is no commitment problem if the monopolist is in the downstream market (as was suggested in the model). In contrast, Waterson (1996) suggests that retailing is much more than simply being a mechanism for distribution, since the 'service' provided by retailers contributes to the value which consumers place on the product (so that demand is not exogenous to retailing). Church (2004) suggests that input foreclosure can cause concerns about extending upstream market power downstream, while customer foreclosure can cause concerns about market power downstream being extended upstream.

In M-D vertical relationships, the upstream company determines the main value of the product, while the downstream company adds some additional value to it. M-D contractual relationships lead to the same problems and

costs as other types of vertical relationships, such as hold up problems and transaction costs. Motta (2004) maintains that when a downstream company doesn't have any market power, vertical integration won't take place, since it doesn't increase the profits of the upstream firm. Vertical integration in M-D relationships will take place when there are contractual problems that cannot be solved with vertical contractual restraints, when the distributor has some degree of market power towards the manufacturer.

To illustrate the substitution between vertical restraints and vertical integration in M-D relationships, Van den Bergh & Camessasca (2001) give an example of the Grundig-Consten case as a case in which contractual problems between the German manufacturer and its French distributor couldn't be solved with contractual clauses. The contractual vertical restraints in this case, which were aimed at solving free rider problem, were rejected by the commission. This rejection was in practice a conferring of an absolute territorial protection upon the French distributor. Due to this decision, the German manufacturer and the French distributor vertically integrated.

Since vertical restraints and vertical integration are also substitutes for each other in M-D relationships, the option of entry and operating through a daughter company is also a substitute for either one of them. In case that the contractual problems cannot be solved, due to strict antitrust policy, either through vertical restraints or vertical merger, it is most likely that the manufacturer will choose entering the market itself (as it can be supposed that Grundig would have done if its merger request had been rejected).

#### **4.4 The model rationales, with respect to a wider antitrust policy**

Efficient antitrust policy requires a correct market definition. It should also take into account several factors which affect the anticompetitive outcome of the merger or restraint. The suggested model can be limited in light of some of these factors, but can hold even in a wider antitrust context, in light of different ones.

#### 4.4.1 **Anticompetitive effects and the increasing competition myth**

The main argument of antitrust policy against the rationale of this model would focus on the “potential competitor” role. The “potential competitor” argument suggests that entry to the secondary market through a daughter company would be pro-competitive and efficient since a new competitor in the market increases the competition (which vertical restraint or vertical merger would eliminate).

This argument may hold in cases that both downstream and upstream markets are in perfect competition, or when there is a low concentration in the involved markets. But in these cases, there is no reason to object to vertical merger or vertical restraint in the first place.

Objecting to vertical merger or restraints occurs mainly in cases where one of the parties holds some kind of a dominant position in its market. In these cases, the party that has market power, sets the demand or supply constraint in the second market as well. In cases when the DS has a dominant position in its market, and the US product is an input for the DS output (which means that the DS sets the demand for the upstream product), when DS enters into the secondary market, it will fulfill its own demand, which will shrink the total demand for the upstream product in the same proportion.

There is no real potential competition between the daughter company and the other US competitors for the DS demand. That is why market foreclosure is unavoidable. Since DS has a great portion in the DS market, and since there is a fixed proportion relationship with the US product, it is more than likely that after DS enters the secondary market it will foreclose it and there will be no place in the market for all of the competitors, so that some of them will be pushed out of the market. It is particularly likely that the former US producer, which sunk costs, will have some problem coping and competing in the market, since it adjusted itself to the specific DS sub-market, and probably will have to take some switching costs to adjust itself back to the general market, in addition to its losses from the costs it sunk.

Moreover, before the entry of the DS to the US market, the US market was in perfect competition. There was no need for antitrust intervention in order to increase competition in the US market; the intervention occurred because of anticompetitive concerns, such as leveraging monopoly power. Nevertheless, such intervention would not prevent these concerns since the same anticompetitive effects would occur in case of entry.

#### 4.4.2 **Market definition, tying and daughter companies**

Economically well-based market definition is a primary and most crucial condition for efficient antitrust decisions. In case of vertical relations between firms along the production process, there is a very thin line between defining the product as one product which contains several different components, and defining each component as a different product (a generalist and specialist product) tied in one final package. Moreover, as it emerges from the Yedi'ot Aharonot case, market definition regarding complex products is dynamic and can be changed over time. In the Yedi'ot Aharonot case, products that were defined as separate tied products in practice became naturally tied together as components in one final product.

Whether the market-product definition is “one product that contains several components”, as was suggested in the model, or whether it is “one specialized product that is tied together with another general product in one package”, the same questions regarding ownership structure and anticompetitive effects apply.

Tying can be a tool for abuse of dominant position, as well as a tool for vertical supervision. Often, antitrust policies lack the distinction between these two<sup>22</sup>. Where vertical supervision is concerned, tying may be used by an upstream manufacturer to protect a product's reputation by preventing free-riding by distributors, and consumers are likely to benefit from the prevention. On the other hand, in this case tying can also be used to enhance

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<sup>22</sup> While under the European antitrust policy tying is prohibited both as a unilateral action of abusing of dominant position (under Article 82(d) of the EC-Treaty), and as a bilateral vertical restraint (under sec. 221-224 to the vertical guidelines), under the Israeli RTP, tying is an explicitly prohibited practice only under Sec 29(a)(4), which deals with abuse of dominant position. In practice, tying is also examined with respect to vertical control, as in the case in the Yedi'ot Aharonot case.

monopoly power. When tying is a mechanism of vertical supervision, society loses to the extent that tying increases the monopoly power of the input monopolist. However, these losses are offset by the fact that social welfare is improved, since the allocation of productive inputs remains closer to the cost-minimizing combination (Andy C. Chen & K. N. Hylton 1999).

Tying and bundling can be used to enhance market power and also can be an effective tool for a firm with market power to implement price discrimination in order to leverage its power. Tying and bundling have anticompetitive effects on the secondary as well as on the primary market.

On the other hand, tying and bundling can be justified on the basis of efficiency arguments. The benefit of tying of complementary products stems from the Cournot effect and the application of the single profit theory to complements (Church 2004). It allows profitable price discrimination and it saves customers' search costs as well as marginal costs (distributing and packing costs), shelf space and the administrative and transaction costs associated with multiple product lines.

Matutes and Regibeau (1988) as well as Denicolo (2000) maintain that in cases where there are more than one specialist firm which provide components to a generalist firm, the more differentiated specialized company will have an incentive to integrate. The type of integration is either vertical integration with the generalist firm or horizontal integration with the other specialist firm, since the second specialist firm can free ride the customers who are attracted by the more differentiated component. On the other hand, the less differentiated specialist firm and the generalist firm will prefer incompatibility and ownership separation at low degrees of differentiation, since industry profits are higher under incompatibility.

It is efficient to tie products that are naturally tied together or when their tying becomes commercial usage, and the consumer expects to buy the tied products as one package<sup>23</sup>. In cases when components have a high degree of compatibility, and are naturally tied together, the downstream company has to provide the whole package in order to compete in the final market. In such

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<sup>23</sup> Both under the European and the Israeli antitrust policies, the scope of prohibited tying explicitly excludes cases of tying of products that are naturally tied together or when tying becomes commercial usage. 34

a case there is almost no difference between defining the product either as two naturally tied products or as one product that combines several components. Since the DS has to provide the whole package, prohibiting it from tying will lead to vertical integration. Rejecting its merger request can lead to entry. Antitrust policy should anticipate the option of entry into the secondary/tied market (in case that it defines the product's components as tied products) in its decisions, as it should do in cases of vertical control.

Referring to the relevant literature, with respect to the option of entry into the tied market, Matutes and Regibeau (1988) maintain that in a case where a specialist firm supplies all the components, a fully integrated firm (compatibility) is preferred in order to save network externalities. In such a case, a fully integrated firm is in the interest of the generalist firm. If its merger request is rejected, entry is relevant. In case that the integration is in the interest of the more differentiated specialist company (a defensive merger) (Denicolo 2000), even if the merger request is rejected, it is unlikely that either the specialist company will enter the general market, or the generalist company will enter the specialized market. In case of defensive mergers the contractual problems don't harm the relatively powerful party; therefore its incentives to change the ownership structure are limited.

#### **4.4.3 Horizontal overlap**

Vertical restraints, especially RPMs, facilitate collusions on both levels of the product process. In general, horizontal anticompetitive effects are considered to have more significant welfare effects than vertical anticompetitive effects, since they don't have any efficiency gains to offset the welfare reduction. Operating through a daughter company is a unilateral step. It can cause concentration in the involved markets but its horizontal overlap is minor.

Horizontal overlaps in case of vertical restraint or merger, can be a reason for antitrust policy to block vertical restraints or vertical integration and lead to a solution of entry. In any case, welfare comparison still has to be made.

## 5) **Law and economic analysis of the Yedi'ot Aharonot case in light of the simple model**

In the following section, I will present some legal and economic insights into the Yedi'ot Aharonot case.

### 5.1 **A dynamic market-product definition**

It is well known that in the Israeli antitrust policy any decision about market definition is never a final judgment and it can be changed due to any change in circumstances. In the Yedi'ot Aharonot case the antitrust authority failed to observe the changes that had occurred in the market. Originally, the local newspaper market was a different market than the daily newspaper market, and the products were sold independently. During the mid 90's the market changed and the local newspaper became a part of the final product-the weekend newspaper. It is questionable whether there was only one final product or two tied products that became naturally tied. In both cases, Yedi'ot Aharonot had to have a local newspaper as a part of its weekend newspaper. In his declaration, the general director defined the local newspaper market as a different market than the daily newspaper market (but with some common links). This definition didn't fit the practice in the market at that time, especially in light of the tribunal's decision in MON 2/96 that determined that these two were naturally sold together as a common market practice.

### 5.2 **Daughter companies and potential competitors**

As was mentioned in the tribunal's verdict, since it has become a common practice to add a local newspaper to the weekend national newspaper, Yedi'ot Aharonot couldn't afford not to add one. According to the tribunal's verdict that since there was no other option for Yedi'ot Aharonot (in case of objecting both the mergers and the individual exemption requests), it could be foreseen that it would enter the Haifa local newspaper market itself. The general director, in his declaration, was aware of the entry possibility but interpreted it

differently. According to the declaration, Yedi'ot Aharonot was a potential competitor in the Haifa local newspaper market (since it had operated in the local newspaper market with Koteret), and therefore its entry into the local market would facilitate potential competition in this market.

In the declaration the general director referred to literature on the importance of a potential competitor in facilitating competition<sup>24</sup>. It must be noted that the most of the literature referred to the potential competitor role in horizontal relationships and joint ventures. There is a crucial difference between the application of the potential competitor's doctrine in horizontal control and in vertical control. In horizontal or conglomerate joint ventures, when the competitor's decision to enter the market is based upon business considerations (and if it isn't an efficient competitor, it will be pushed out of the market), the "potential competitor" doctrine may hold. On the other hand, in vertical relationships the doctrine may not hold. In vertical relationships the potential competitor has to stay in the market even if it isn't efficient, since it has to operate in this market too, as a default, in order to be able to produce its finale product (in its original market). Therefore, this doctrine doesn't assure that the efficient potential competitor would enter independently into the market, but can preserve inefficient competitors in the market. Moreover, in cases where the potential competitor has market power in the final product market, it would probably cross subsidize its inefficiency in the secondary market with the final product price (and not necessarily be forced to be efficient in order to compete in the secondary market).

When considering vertical relationships, previous unsuccessful attempts to enter the market, like in the Yedi'ot Aharonot case with Koteret, can indicate that the potential competitor was not an efficient actual competitor. While in horizontal relationships, denying any other options (such as joint ventures) assures that the potential competitor will enter and survive in the market only if it is efficient, in vertical relationships this is not so.

As the tribunal mentioned in its verdict, since Yedi'ot Aharonot closed Koteret, it more than likely hadn't been profitable. Therefore, there was an

<sup>24</sup> For example, the verdict regarding "Yamaha Motors Co", which prevented the potential competitor from entering into a joint venture after failing to enter this market, twice, itself.

indication that Yedi'ot Aharonot wouldn't be an efficient competitor in this market and there was no use in forcing it to compete in this market.

Another aspect that is unique to the potential competitor approach where vertical relationships are concerned is the possibility of market foreclosure. The potential competitor doesn't compete under equal conditions like the rest of the incumbent competitors, since it operates in two sequel stages of the production process. The entry of the potential competitor to the secondary market affects the demand, and reduces it for the incumbent competitors, and therefore can hurt them.

### 5.3 **The economic significance of the approved vertical restraints**

The approved vertical restraints gave the right to Yedi'ot Haifa to use Yedi'ot Aharonot's capital. In exchange, Yedi'ot Aharonot got the copies for its weekend newspapers (and of course, Yedi'ot Haifa didn't sell its copies to Maarive). This kind of agreement was designed to make sure that there would be no hold up problems and Yedi'ot Aharonot would get the local newspaper at the real MC of using the capital. There was no money involved. The agreement was services for copies. In this perspective the approved vertical restraints could be compared to a merger de-facto. It is questionable whether Yedi'ot Haifa had an independent existence without Yedi'ot Aharonot's capital. Regarding this question, the tribunal had its doubts.

### 5.4 **Transaction costs**

Finally, in the Yedi'ot Aharonot case the tribunal made a decision that saved Yedi'ot Aharonot from the necessity to enter the local newspapers market. Until that point Yedi'ot Aharonot spent 7.5 years in litigating before the authorities (from the merger request until the tribunal's verdict). The IAA had made three decisions regarding this case and two procedures were brought before the tribunal. It is possible that the most efficient decision under economic based antitrust policy would have been permitting the merger, which was Yedi'ot Aharonot's first request in 1996. In addition to being the

efficient solution, it could have saved 7.5 years of litigation, and minimized transaction costs and litigation costs.

### 5.5 The incumbent local newspapers

In its verdict the tribunal maintained that if Yedi'ot Aharonot did enter the local newspaper market, it would harm the incumbent local newspaper producers, and probably Yedi'ot Haifa would be pushed out of the market. The tribunal maintained that when Yedi'ot Aharonot fulfilled its own demand for a local newspaper, it would actually foreclose the market, at least for those marginal consumers who preferred to have the local newspaper as a part of the weekend newspaper package. Yedi'ot Haifa, and Kolbo were left to compete for a much smaller portion of the demand (the infra marginal consumers). Of these two, Kolbo was the first and most widely read local newspaper, and in 1997 Kolbo's market share was above 50%; therefore it was assumed that it would be the one that would survive. Moreover, without Yedi'ot Aharonot capital, Yedi'ot Haifa had to take sunk and fixed costs in order to compete. Entry of Yedi'ot Aharonot couldn't increase competition, but could harm Yedi'ot Haifa, due to unavoidable foreclosure.

Since the tribunal had estimated that at least Yedi'ot Haifa would be pushed out of the market, it pointed out that approving the vertical restraints in this case, despite some possible anticompetitive effects, would have similar characteristics to a decision according to a "failing company doctrine"<sup>25</sup>. Although the failing company doctrine is much stricter in its requirements<sup>26</sup> and applicable to mergers and not to vertical restraints, it is an example of cases in which the antitrust policy takes into account further considerations than anticompetitive effects, and examines the defaults in the market if it rejects the merger request.

### 5.6 Advertisers- the hidden bias of the Yedi'ot Aharonot case

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<sup>25</sup> The failing company doctrine is a doctrine that facilitates merger, despite its clear anticompetitive effects, in case one of the merging parties is about to leave the market due to its failure to compete, e.g. - goes bankrupt. This doctrine is applied under the Israeli merger control as well as under EU merger control of horizontal mergers (2004/c 31/03) in guidelines 89-91.

<sup>26</sup> Generally, the failing company has to be under clear and immediate risk of going out of the market.

In the verdict, the tribunal approved another restraint between Yedi'ot Aharonot and Yedi'ot Haifa, regarding advertisements. Advertisement sections are the primary market for newspapers. The local newspaper has advertisement sections, which are a market for local advertisers (some of the local newspapers in Israel are distributed to the consumer free of charge, and the newspaper revenues are from selling advertising space). The general director, as well as the tribunal, focused on the benefit to the final consumer, who got a cheaper package (the local newspaper were given without extra charge) and on the anticompetitive effects in reducing the competition between local and daily the newspapers, but the restraint regarding advertisements and the issue of advertisers as consumers of advertising space didn't get full attention and appropriate economic analysis.

Under the approved restraints the market for advertising space has become concentrated. The approved restraints might have made the final package cheaper to the final consumer, but foreclosed the primary market for advertising space in the local newspapers. Well based economic evaluation of the harm to the advertising space market, wasn't carried out at any stage of the Yediont Aharonot case.

## **5.7 Restricting the competition between the national newspapers and subsidizing the local newspapers**

One of the arguments of the general director in the declaration was that the arrangement improved the status of the daily newspaper Yedi'ot Aharonot, and therefore, there was harm to competition between the national newspapers (especially between Yedi'ot Aharonot and Maarive). In its verdict the tribunal referred to this statement and maintained that the fact that distinction had to be made between protecting the competition and protecting the competitor-Maarive. The opinion of the tribunal was that the improvement in the status of Yedi'ot Aharonot didn't necessarily mean that the arrangement harmed the

competition, since the improvement in the status could have been the outcome of efficient arrangements.

Another argument in the declaration was that in selling Yedi'ot Haifa together with Yedi'ot Aharonot with no charge, Yedi'ot Aharonot subsidized the price of the local newspaper. In light of the nature of the agreements, it is difficult to presume subsidy only due to a reduction in the local newspaper's price. The reduction could have been attributed to the fact that it was cheaper to print the local newspaper using Yedi'ot Aharonot's capital.

## **6) Lessons for antitrust policy**

In this section I will make some suggestions for antitrust vertical control policy in light of the possibility of entry and operating through daughter companies. In the first part of this section I will briefly present the anticompetitive effects of vertical restraints and vertical mergers that antitrust policy aims to eliminate, and the anticompetitive effects of operating through daughter companies. In the second part of this section I will briefly present the EU vertical control policy. In the third part of this section I will make some policy suggestions.

### **6.1 The role of antitrust policy**

Vertical restraints vertical mergers (and operating through daughter companies) have negative welfare effects on society, since they harm competition (or at least have distributive effects). The role of antitrust policy regarding vertical relationships is to examine these effects and to prevent disutilities for society caused by the anticompetitive effects.

Each of the vertical relationships has its own anticompetitive effects and therefore, antitrust policy has a different attitude towards each of them.

#### **6.1.6 General approaches to normative antitrust vertical control policy**

Restraints (and mergers) in vertical relationships have several efficiency justifications. Therefore, most of the antitrust policies don't

prohibit vertical restraints (and mergers) per se<sup>27</sup>. Usually they are treated under ROR, which takes into account efficiency gains, as well as several other factors, such as specific information about the relevant business, its conditions before and after the restraint was imposed and the nature of the restraint (Van Den Berg & Camesasca 2001).

The Chicago school approach holds that there is no place for legal intervention in vertical restraints<sup>28</sup>. The Chicago school approach isn't common among antitrust policy makers and most of the antitrust policies include some level of prohibition on vertical restraints. However, antitrust policy makers today are aware of the trade off between the efficiency gains (efficiency defense) and anticompetitive effects (Van Den Berg & Camesasca 2001).

#### **6.1.7 Anticompetitive effects of vertical restraints and efficiency defenses**

Vertical restraints can be divided into two main groups: price and non-price restraints.

Vertical price restraints include: price fixing between US and DS firms (which can be max RPM, min RPM or two part tariffs). Min RPM has more significant anticompetitive effects since it has horizontal overlaps. RPM can also facilitate collusion between DS firms or distributors since it causes disciplining price cuts among retailers and prevents development of more efficient forms of distribution.

Vertical non-price restraints include: exclusive dealing or purchasing, selective distribution and franchise. Exclusive dealing or purchasing can limit inter-brand competition. They can also facilitate market foreclosure by raising the rivals' costs. Exclusive distribution can lead to a reduction of inter-brand competition as well as of intra-brand competition. Rasmusen, Ramseyer and Wiley (1991) maintain that a monopolist could raise entry barriers and exclude potential rivals from entering into the market cheaply, by exploiting its customer's inability to coordinate their actions. Selective distribution can reduce intra-brand

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<sup>27</sup> Despite that there are some restraints that are traditionally prohibited per se, such as RPM.

<sup>28</sup> According to the Chicago approach, vertical restraints serve to remove any downstream pricing distortions, optimize investment levels and eliminate avoidable transaction costs, adverse selection and moral hazard.

competition. Franchise can reduce inter-brand competition (in the short run) by facilitating horizontal collusion, and (in the long run) by entry deterrence.

Pro-competitive effects and efficiency gains of RPM: Max RPM prevents double marginalization and helps to overcome agency problems and lack of co-ordination between manufacturer and distributor<sup>29</sup>. Min RPM gives incentives to provide additional value to the product, it prevents free-riding on the manufacturer advertising efforts and pre-sales services. RPM is also a mechanism for assuring quality if after-sales services are important, and has a risk-sharing function when demand is risky or uncertain.

Non-price restraints may increase inter-brand competition in case of entering new markets. Some non-price restraints eliminate double monopoly mark-up. Output expansion reduces prices at retail level, eliminates free riding when incorporating vertical restraints in distribution contracts is possible, and eliminates transaction costs by reducing opportunistic behaviour.

#### **6.1.8 Anticompetitive effects of vertical mergers and efficiency defenses**

One anticompetitive effect of vertical mergers is the potential for a monopolist leveraging its market power either downstream or upstream by vertically integrating, and by that facilitating market foreclosure<sup>30</sup> (input and/or consumer foreclosure). Leveraging market power depends on either raising the costs of rivals through input foreclosure or reducing the revenue of rivals through customer foreclosure. Market foreclosure as well as the size of the merged firm, can deter a rival from entering or exiting a market, and raise barriers, especially in cases of technological advantages of the merged firms.

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<sup>29</sup> High retail price is not in the manufacturer's interest since it reduces the demand for the product. 43

<sup>30</sup> Heavner (1999) suggests that since a vertically integrated firm cannot commit to refrain from influencing downstream competition, downstream firms avoid purchasing from their vertically integrated competitors (voluntary foreclosure).

There are several efficiency advantages in vertical integration. Vertical integration enhances coordination and monitoring between different stages of the production process and facilitates information exchange, lower production costs, higher quality, and shorter lead times. It also mitigates opportunistic behavior, improves quality control, reduces costs of inventory, optimizes production runs and facilitates internalization of vertical externalities and alignment of incentives within the vertical structure. In addition, vertical integration prevents free-riding by rivals on product innovation and design.

Other types of efficiency gains from vertical integration are more controversial. Vertical integration can eliminate double marginalization and facilitate the Cournot effect. On the other hand, neither of these efficiency gains should automatically be presumed. Contractual solutions might eliminate double marginalization more efficiently than vertical integration, and the importance of the Cournot effect is reduced if there is price discrimination in pre-merger stage (Church 2004).

#### **6.1.9 Anticompetitive effects of operating through a daughter company and efficiency defenses**

Since operating through a daughter company leads to the same market structure as vertical integration (common ownership), the most significant anticompetitive effects of entry to the secondary market are similar to the anticompetitive effects of vertical mergers (the anticompetitive effects are: leveraging market power to the secondary market, facilitating market foreclosure, entry or exit deterrence of a rival, and raising barriers).

Efficiency gains from operating through a daughter company are also similar to efficiency gains from vertical integration. It enhances coordination and monitoring between different stages of the production process and facilitates information exchange. It also facilitates internalization of vertical externalities and alignment of incentives along

the vertical structure. Moreover, it prevents the rival's free-riding, facilitates transaction cost savings, mitigates opportunistic behavior and minimizes double marginalization.

**6.1.10 The possibility for substitution between vertical restraints, vertical mergers and daughter companies - differences in the antitrust policy**

Since each of the vertical relationship structures has some degree of anticompetitive effect, a non-coherent antitrust policy would lead the firm to choose one structure or another but would not necessarily prevent harm to competition, and could lead to inefficient outcome.

**6.1.10.1 Vertical restraints Vs. vertical mergers**

Full vertical integration is an alternative to vertical restraints. From the economic point of view, vertical integration in hierarchical structure is set up to minimize exactly the same costs that vertical restraints aim to reduce and to enhance coordination between vertical producers. Therefore, an economic based antitrust policy should treat vertical restraints and vertical mergers in exactly the same way, and facilitate vertical restraints only in cases where the costs of vertical integration are higher than the costs of imposing vertical restraints (Van den Bergh & Camesasca 2001). It should do so also in cases where the anticompetitive effects of vertical integration reduce welfare more than the anticompetitive effects of vertical restraints, without compensating for this welfare loss by welfare benefits from the common ownership.

**6.1.10.2 Antitrust policy and daughter companies**

While vertical restraints are a well known substitute for vertical mergers, operating through a daughter company is not considered a substitute, although in practice it is. Operating through a daughter company is also aimed at minimizing exactly the same costs that

vertical restraints and vertical mergers aim to reduce. In addition, it is aimed at mitigating hold up problems and enhancing coordination and monitoring along the vertical structure, such as vertical mergers and restraints.

In general, operating through a daughter company is hardly supervised by the antitrust policy. By means of the definition of merger, antitrust policy can intervene in an entry in cases where the daughter company tries to buy its competitor's assets. The assets that the daughter company can purchase, can be divided into three categories:

**The competitor's securities and the competitor's real assets:** purchasing these assets up to a certain level can be supervised as a part of merger control policy<sup>31</sup>.

**The competitor's human capital:** According to the G-H-M model, the importance of human capital is increasing. While physical assets are less unique and more accessible to firms, human capital such as highly skilled innovative workers, is the most important type of capital (Hart 1995). There is no antitrust limitation on "purchasing" the competitor's human capital, since, the competitor is not a direct party to the "purchasing" deal<sup>32</sup>.

When a daughter company doesn't aim at purchasing any of its competitor's assets, there is no antitrust constraint on entry to the secondary market.

Since operating in the secondary market is a substitute for vertical mergers and vertical restraints, and it holds anticompetitive effects as well as other inefficiencies, and since there is almost no antitrust constraint on operating through a daughter company, the foreseen effects of operating through a daughter company must be anticipated through antitrust policy regarding vertical mergers and vertical restraints.

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<sup>31</sup>E.g - merger definition in the Israeli RTP in sec. 1 - see appendix 1.

<sup>32</sup> Another reason might be the "freedom of occupation" that is considered to be a fundamental/constitutional right of the "human capital" in many countries. In Israel this fundamental right is legislated under the "freedom of occupation" basic law.

An antitrust vertical control policy that anticipates the option of entry should facilitate vertical merger and vertical restraints as a second best solution, although they clearly have anticompetitive effects. Vertical restraints or mergers should be considered a second best solution, among others, when costs of entry are higher than the costs of imposing vertical restraints or mergers, and when the anticompetitive effects of entry reduce welfare more than the anticompetitive effects of vertical integration or vertical restraint.

Welfare should be examined in a broader sense, taking into account other inefficiencies that arise from entry of a new player to the secondary market, such as duplication of sunk and fixed costs.

Moreover, since the possibility for entry is anticipated in the proposals of the parties during renegotiation, and has an influence even in cases when entry doesn't occur in practice, antitrust policy should anticipate the possibility of entry into the welfare comparison while considering possible merger or vertical restraint.

## **6.2 EU antitrust vertical control policy**

EU antitrust vertical control policy is not coherent in its attitude towards vertical mergers and vertical restraints. Although there has been a changed and economic evaluation of vertical relationships has become more common, the option of operating through a daughter company still doesn't seem to be taken into account when it comes to vertical control.

### **6.2.1 Vertical restraints**

Vertical (as well as horizontal) restrictive agreements are prohibited in Article 81(1) of the EC-Treaty. The restraints are prohibited when they cause

*“prevention, restriction or distortion of competition within the common market”.*

Restrictive agreement can be exempted either individually under Article 81(3) or under the vertical Block exemption (139/2004) (which covers different restraints between two or more producers or distributors operating in different stages of the production chain), or under general de-minimis Block exemption. Under the EC vertical restraints policy, there is strict prohibition of RPM (which is inconsistent with economic insights). The safe harbor of the block exemptions is limited to companies with 30% market share or less for the vertical block exemption, and 10% or less for the de minimis block exemption. Moreover, the block exemption does not cover agency agreements.

The EC vertical guidelines (2000/c 291/01) provide standards for evaluating vertical restraints. Sec. 119 provides general standards for evaluation, such as assessment of the concentration in the relevant market and assessment of inter and intra brand competition. Sec. 121-133 provides the relevant criteria for assessment under Article 81(1), such as market positions of the supplier, the competitor and the buyer, entry barriers, level of trade, etc. Comparison evaluation of the restraints and other default solutions doesn't exist explicitly, but is briefly implied in Sec. 133, which is a basket section.

### **6.2.2 Vertical mergers**

EC Merger Regulation (139/2004) regulates the supervision on vertical mergers in the EU. Under the merger regulation, a merger falls within the scope of the authority review, if at least one of the parties has a minimum turnover (Article 1)<sup>33</sup>. Article 2(3) determines that a merger that causes:

*“Concentration which would significantly impede effective competition...in particular as a result of the creation or strengthening of a dominant position shall be declared incompatible with the common market”.*

There are no specific guidelines to measure effects of a vertical merger on competition. Traditionally, the main focus was on coordinated effects of the

<sup>33</sup> The horizontal guidelines (2004/c 31/03), guidelines 14-18 also refer to assessment of market share in addition to the turnover that was mentioned under the merger regulation (139/2004).

merger and the possibility that the merger will bring the merged firm to a dominant position. The traditional tool for measuring the merger's foreseen effects was the HHI indication, which measured concentration in the market pre and post merger (which indicated possibility for creation of a dominant position).

In recent years there has been a change in the EU antitrust policy towards mergers. The guidelines on the assessment of horizontal mergers (2004/C 31/03) can demonstrate the change of attitude towards the assessment of horizontal mergers. The horizontal guidelines require wider economic evaluation of the merger deal in order to assess its effects. Non-coordinated effects of the mergers are also taken into account, as well as countervailing factors. An economic test of the "hypothetical merger" is used for a comparison evaluation of the merger's effects and other defaults in case the merger doesn't take place. Par 9 of the general part of the guidelines proposes the "hypothetical merger" test:

***"In assessing the competitive effects of a merger, the Commission compares the competitive conditions that would result from the notified merger with the conditions that would have prevailed without the merger. In most cases the competitive conditions existing at the time of the merger constitute the relevant comparison for evaluating the effects of a merger. However, in some circumstances, the Commission may take into account future changes to the market that can reasonably be predicted. It may, in particular, take account of the likely entry or exit of firms if the merger did not take place when considering what constitutes the relevant comparison"*** (highlights not in the original text).

Under this "hypothetical merger" test, there is a place for broader considerations such as the effects of entering the market through daughter companies. This approach is relevant for assessment of horizontal mergers but

may infiltrate the assessment of vertical mergers as well.

### **6.2.3 Substitutive relationships between vertical restraints, mergers under the EU policy**

According to Van den Bergh and Camesasca (2001) under the old EU merger policy, companies had incentives to merge and not to choose vertical restraints. It must be noticed that the book by Van den Bergh & Camesasca preceded the new merger regulation; therefore their conclusion may not hold after the change in merger policy. Although the main changes under the new merger policy can be applied to antitrust policy in cases of horizontal mergers, there can be effects on antitrust policy in vertical mergers as well.

### **6.4 Policy suggestions**

Efficient antitrust policy should facilitate the most efficient outcome or the second best outcome. Since vertical restraints, vertical mergers and entry can replace one another, the evaluation of vertical mergers and restraints should be carried out while anticipating entry and the possibility of entry. I wish to make four policy suggestions:

- a) Regarding the application of the “potential competitor” doctrine in cases of vertical relationships, when antitrust policy aims at encouraging entry of competitors into the secondary market, it should make a hypothetical “**What if not?**” test.

The antitrust policy should examine the question what would happen in the market if it does not approve the suggested restraints or merger. It should compare the foreseen effects of the entry to those of mergers and/or vertical restraints. The comparison of anticompetitive effects should include examination of the effects on the primary market and/or the after-market, and should take into account the foreseen effects on the incumbent competitors and their likelihood of exit from the market. In addition, the policy should examine the general welfare

effects (such as elimination of hold up problems due to the change in the ownership structure or due to the restrictions in the contractual relationship) of the default solution that would be reached in the market.

- b) Antitrust policy should anticipate the welfare outcomes of the possibility of entry in the total welfare estimation while evaluating the possible effects of vertical merger or restraint.
- c) In industries where the sunk costs are relatively high or in industries that require a high level of specialization, the foreseen equilibrium of entry should be evaluated against possible merger or restraints outcomes, since in these industries entry is more likely to cause greater inefficiencies.
- d) With respect to the Israeli RTP, the general director should have the power to consider the effects of restraints on the total welfare and not be limited to competitive considerations.

These suggestions should be applied in addition to the accurate vertical control policy. Naturally, there will be some differences between the application of these suggestions in Israel and in the EU, due to policy and legislation differences. Moreover, contrary to Israeli<sup>34</sup> antitrust policy, EU antitrust policy should take into account cross border effects, market integration and harmonization<sup>35</sup>.

Regarding EU policy, the economic based approach in the new horizontal mergers guidelines should be expanded and applied to vertical control as well.

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<sup>34</sup> The Israeli market is small and very concentrated. The Israeli economy can be described as an island economy since Israel has almost no trade relationships with any of its neighbors.

<sup>35</sup> The last two considerations are not pure efficiency considerations, but can be considered a goal in itself (with respect to vertical mergers, this is explicit in the regulation; with respect to vertical restraints-see Van den Berg and Camasasca 2001).

## **7) Conclusions and further research.**

In this paper I have shown that entry into the secondary market through a daughter company is a substitute for vertical integration and vertical restraints as a way for companies to mitigate hold up problems, TC and problems stemming from ownership structure. Therefore entry (and the possibility of entry) is anticipated in the company's strategic decisions. The possibility of entry affects market equilibrium, as well as entry itself, and has welfare effects.

Since entry, mergers, and vertical restraints have anticompetitive and welfare effects, but the antitrust policy only supervises vertical mergers and restraints, efficient antitrust policy should anticipate the possibility of entry, and the outcomes of foreseen entry in its vertical control policy (including the application of the potential competitor doctrine in vertical cases). In light of the mistakes that have been made in the Yedi'ot Aharonot case, efficient vertical control antitrust policy that anticipates the possibility for entry, should approve vertical restraints or mergers as a second best solution when anticompetitive outcomes are undeniable and blocking both mergers and restraints will lead to inefficient outcomes.

Further research should focus on the role of hold up costs, transaction costs and the benefits from specialization in the company's choice of ownership structure, in light of the possibility of entry. Further research may examine the possibility for unstable equilibria and repetitive games in cases of separated ownership structure, taking into account the possibility of entry. More precise evaluation of anticompetitive effects of entry and comparison with the evaluated anticompetitive effects of mergers and restraints also has a place in further research.

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### 3) **Laws and directives**

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- 3.2 EC Vertical Regulation, No 2790/1999 (1999/L223/21).
- 3.3 EC Vertical Guidelines, Guidelines on Vertical Restraints (2000/C 291/01).
- 3.4 EC Merger Regulation (139/2004) (block exemption).
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- 3.7 Israeli block exemption-de minimis - 2001.
- 3.8 Israeli block exemption – exclusive purchase - 2001.
- 3.9 Israeli block exemption – exclusive distribution - 2001.
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### 4) **Law cases**

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- 4.2 Declaration About an existence of a Monopolist, Yedi’ot Aharonot, 1995, 1999.
- 4.3 Declaration according to sec. 43.a.1, of the Existence of Restrictive Arrangements in the (local) Newspaper Market in Haifa, 1999.
- 4.4 Monopoly procedure 2/96 Antitrust authority general director Vs. Yedi’ot Aharonot and others, final verdict-2000. (tribunal’s verdict).
- 4.5 Decision according to sec. 14 on the Objection to Giving an Individual Exemption to Restrictive Arrangements, 2000.
- 4.6 Antitrust Procedure 4179/00 Yedi’ot Aharonot LTD Vs. The General Director of the Israeli Antitrust Authority, 2003 (tribunal’s verdict).
- 4.7 ASP 4465/98 Tivo’ol (1993) Ltd v. Shef Hayam (1994) Ltd, V-56 V(1) 56 (Supreme court’s verdict).

5) **Internet websites**

5.1 The Israeli Antitrust Authority website – [www.antitrust.gov.il](http://www.antitrust.gov.il)

5.2 The EU commission (DG competition) website –  
[http://europa.eu.int/comm/competition/index\\_en.html](http://europa.eu.int/comm/competition/index_en.html)