

**DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS  
COMPETITION COMMITTEE**

**Competition Issues in Aftermarkets - Note from Israel**

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*This document reproduces a written contribution from Israel submitted for Item 4 of the 127th OECD Competition committee on 21-23 June 2017.*

*More documents related to this discussion can be found at*

*[www.oecd.org/daf/competition/aftermarkets-competition-issues.htm](http://www.oecd.org/daf/competition/aftermarkets-competition-issues.htm)*

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### 1. Background

1. The IAA's primary experience with enforcement and policy in aftermarkets in recent times has been in the course of its investigation of the elevator service sector, which has been conducted for the past few years and is still ongoing. Therefore, this contribution will focus on the IAA's experiences and perspective primarily through the lens of this investigation. In general, Israeli law and policy has no unique framework for examining aftermarkets; instead, aftermarkets are examined using the traditional antitrust tools, adjusted to take into account the link with the primary market.

2. The IAA's investigation into the elevator service sector was sparked by numerous complaints received from residents looking to purchase repair and maintenance services for elevators installed in their buildings, who claimed that they were unable to receive offers from any companies other than the elevator's installer. The investigation originally focused on the possibility of exercising the Director General's powers to issue instructions to monopolists under the monopoly chapter of the Restrictive Trade Practices Act 1988 ("the Law"), as will be further discussed.

3. The IAA's preliminary findings indicate that over the recent years, there has been a shift in Israel from relatively technologically simple elevators, assembled by local companies with parts purchased from a variety of local and international companies, to more technologically advanced elevators, manufactured as a kit by a foreign company and then imported to Israel (hereinafter: "**kit elevators**"). It seems that these modern kit elevators generally incorporate components that are unique to that manufacturer and are characterized by a high level of interconnectivity between the different parts of the elevator. All the parts are typically controlled by a unique control panel which comes as part of the kit. There are a number of Israeli companies that install kit elevators; it seems that each installs the elevators manufactured by a specific international company affiliated in some way with the installer (parent company, exclusive distributorship agreement, etc.).

4. Since an elevator is a durable good (with a lifespan of up to 25 years or more), it requires regular maintenance and repairs. Service for the elevator is thus a secondary service, purchased subsequent to and as a result of the purchase of the elevator in the primary market. The IAA's preliminary investigations seem to indicate that in the vast majority of cases, service for a kit elevator in a residential building is provided by the company that installed it; thus, it seems that the market characteristics may grant each installation company significant market power in providing service to their elevators, as we will elaborate below.

### 2. Market definition in aftermarkets – general

5. This case required the IAA to consider the questions raised by market definition in aftermarkets. In this context, it is important to note that under current Israeli law, a monopoly is defined as a concentration of more than 50% of market share in the hands of a single party; precise market definition and calculation of market share is thus uniquely important to monopoly investigations.

6. In general, the IAA defines markets using the traditional hypothetical monopolist test, examining the substitutability of products and services. However, because of the link between the elevator service aftermarket and the elevator installation primary market, it seemed that market definition and analysis of market power required the additional step of examining the degree to which competition in the primary market can serve as an effective restraint on the monopoly power of a hypothetical monopolist in the aftermarket. In a sense, this examination can be regarded as another aspect of the hypothetical monopolist test: it still asks whether exercise of market power would be worthwhile for a hypothetical monopolist, but expands the considerations that such a hypothetical monopolist would weigh, by asking how the exercise of monopoly power by a hypothetical monopolist in the aftermarket would affect its sales and incentives in the primary market and subsequent sales in the secondary market. The level of restraint exercised by the primary market would seem to determine whether it is appropriate to define a systems market, while the degree of substitutability between various secondary products would seemingly differentiate between dual markets and multiple markets.

7. Just as the hypothetical monopolist test is generally based on the various indirect indications relating to product characteristics and consumer preferences, examining the level of restraint exercised by the primary market would also rely on indirect indications intended to track the level of competition in the primary market, the ability of consumers to weigh the costs of the secondary product when purchasing the primary product ('whole life costing') and the costs and barriers entailed in switching to another primary product.

8. In the following section, we will show how these two complementary tests can be examined in the elevator service sector.

### 3. Market definition in the elevator service sector

#### 3.1. Restraint by the primary market

9. In the case of elevators, the IAA's preliminary findings raise questions about the ability of competition in the primary market to effectively restrain market power in the aftermarket, due to the following market characteristics:

- **The identity of the consumers:** In residential buildings, the elevator is generally installed during construction and chosen and funded by the contractor or the construction company. The service costs, on the other hand, are borne by the residents who purchase apartments in the building. This would seem liable to create an agency problem, by which the contractor will have limited incentive to weigh future costs borne by other parties and will thus tend to choose the company that offers the lowest installation price regardless of future service costs.
- **Limited reputational effects:** For most consumers, buying an apartment is a rare event. Furthermore, the cost of elevator maintenance is negligible compared to the cost of a new apartment and the myriad considerations that go into choosing one, so that its effect on the choice of apartment would seem to be negligible. This may mean that exercise of market power with regard to service is unlikely to harm future sales in the installation market directly or even indirectly harm the reputation of the contractor who chose that elevator.
- **Incomplete information:** In addition to the above, a private consumer may have difficulties in correctly assessing the cost of service and repairs that will be needed in the future, since this requires estimating the chance of malfunctions and

the cost of service through the elevator's lifespan (25 years or more). That is to say – even if the consumer were involved in choosing the elevator to install, it is not clear the degree to which he would be able to reach an informed decision weighting the cost of the elevator and the future costs of service.

- **Cost of replacement:** Even if exercise of market power is not anticipated to harm future sales of the primary product, the ability to exercise such market power depends on the costs and barriers to replacing the primary product; if these costs and barriers are not significant, any attempt to exercise market power will simply lead the consumer to buy a new primary product, which will allow him to choose a new secondary product (e.g., buying a new handle for a razor if one type of blades becomes too expensive). However, the IAA's preliminary findings seem to indicate that it costs hundreds of thousands of shekels to replace an elevator and tens of thousands of shekels to replace key parts with generic components so as to make the elevator "universal".<sup>1</sup> Service costs amount to thousands of shekels a year, so that it is not clear how often it would be worthwhile to replace the elevator or make it universal in response to exercise of market power. In addition, the preliminary findings indicate that there is no market for second-hand elevators, so a consumer replacing his elevator cannot recoup any of the costs. For an apartment building, it seems that switching also requires overcoming the challenge of reaching an agreement with a quorum of residents to bear the necessary costs.

10. Based on the above factors, the preliminary findings raise serious questions about whether the installation sector can serve as an effective restraint on exercise of monopoly power in the secondary market; in the event that it does not serve as such a restraint, a systems market would not be an appropriate market definition.

### 3.2. Substitutability from the perspective of a consumer who has already purchased an elevator

11. In this case, there was an additional complication in terms of defining the relevant product market, which was particularly relevant to the IAA's investigation in light of Section 26's emphasis on market share: in the strictest theoretical sense, one might argue that one can define each elevator as a separate relevant market, since the demand for service for each elevator is not interchangeable, discrimination is possible and arbitrage is impossible. (This is similar to the hypothetical discussed in the academic literature where "size 38 shoes" and "size 40 shoes" could theoretically be defined as separate relevant markets).<sup>2</sup> However, this literalistic approach to market definition would seem to lead to an absurd result, in which each company that provides service to any elevator automatically has a 100% monopoly in that "market". This would not advance the understanding of the competitive situation in any meaningful way, and so in cases similar to this one accepted solution is to combine "markets" in which identical competitive

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<sup>1</sup> Some service companies indicated that they have the capacity to remove the proprietary control panel and certain key parts connected to it and replace them with generic parts, thus making the elevator "universal" and allowing service to be provided without access to unique parts and knowledge.

<sup>2</sup> See, for example, James Kavanagh, Helen Jenkins, Gunnar Niels, *ECONOMICS FOR COMPETITION LAWYERS*, section 2.7.5 (2011); Alison Jones and Brenda Sufrin, *EU COMPETITION LAW: Text, Cases and Materials*, p. 72 and citations there (2016, 3<sup>rd</sup> ed.)

conditions exist, including in terms of inputs, and to treat them as a single relevant market.

12. Another way to look at the question of relevant market definition is to see each elevator as a separate bidding market, so that suppliers compete *for* the market, rather than *in* it. In such cases, one accepted practice is to attribute market shares based on each supplier's *ex ante* chance of winning the bidding to supply services in that market. In the elevator service sector, we would seemingly be able to base this attribution on hundreds of similar independent observations (all other similar elevators). Thus we would be able to attribute to each supplier an *ex ante* probability of providing service to a given elevator of a certain type based on its share of other similar elevators. The final result would, in effect, be identical to attributing market share based on share in the combined market as described above.

13. The IAA's preliminary findings seem to indicate that kit elevators, because of the high level of interconnectivity between parts that characterizes them, have unique control panels and require spare parts specially designed for that elevator. In other words, it seems that there are a large number of components that it is very difficult to service without original parts. The IAA's findings also seem, on their face, to indicate that providing service to kit elevators requires access to specialized knowledge, particularly with regards to programming the control panel. It seems that the knowledge needed to provide service to a kit elevator made by one manufacturer does not necessarily allow providing service to a kit elevator of another manufacturer.

14. In summation, the IAA's preliminary findings seem to indicate that the inputs needed to provide service for a given kit elevator –and, accordingly, the service providers relevant for a given consumer– are determined by the identity of the manufacturer. Insofar as this is the case, it would be appropriate to define a separate relevant market consisting of consumers who have purchased kit elevators manufactured by a given manufacturer – *i.e.* multiple markets based on the identity of the elevator manufacturer.

#### 4. Market power

15. Under the assumption that the primary market does not effectively restrain exercise of market power in the secondary market, as discussed above, the IAA's examination of market power would seemingly focus on barriers to entry and transfer within the secondary market alone –*i.e.* similar to a traditional examination of market power.

16. According to the IAA's preliminary findings, the installation company may enjoy a significant advantage in terms of access to the unique spare parts and specialized technical information required to provide service to that specific type of kit elevator, thanks to its affiliation with the international manufacturer. This would mean that although there are dozens of licensed service companies that provide service to older elevators, consumers with kit elevators would be left with limited ability to switch from the company that installed the elevator to another service provider. This preliminary finding would seem consistent with the very low rate of transfers away from the installation company that seems to arise from the data collected by the IAA, and the numerous complaints received from residents of being unable to receive offers from service companies other than the company that installed the elevator.

17. In this context, one argument that could be raised is that even if the installation company enjoys and exercises market power in the secondary market, the detrimental

effects on consumers are off-set by the "waterbed effect" on the installation prices. According to this argument, when the companies compete for the installation contract, they do so with the knowledge that winning the contract means earning supra-competitive prices in the aftermarket. They will thus be willing to install the elevator at a cheaper price or even at a loss, so that the competition between them for installation will lead to them selling the elevator at a savings equal to their future monopoly profits. Since this saving will be rolled-over to the consumer, in the form of a lower price for the apartment, there should be no concern of harm to consumers as a result of exercise of market power in the secondary market.

18. However, it seems that the argument that consumers are not harmed can only stand if certain conditions are met: there must be perfect competition in the installation market, as well as perfect competition in the apartment sales market, so that the contractors' profits are entirely rolled over the consumers. It seems highly unlikely these conditions are in fact met.

## 5. Enforcement experience and remedies

19. The Law grants the Director General the power to issue instructions to a monopolist as to steps it must take to prevent harm to competition caused by its existence or actions.

20. At the beginning of its investigation, the enforcement direction that the IAA considered was to declare each of the largest installation companies as a monopoly (in the market for the provision of service to the kit elevators manufactured by the foreign manufacturer with whom it was affiliated), and to issue instructions regarding the steps they must take to prevent the competitive harms.

21. In August 2014, the IAA informed six major installation companies of the Director General's intention to declare them monopolies and issue them the following instructions, subject to hearing:

- Prior to installation, the installation company must commit to maximum service prices for a period of ten years;
- The installation company must publish a price list for all spare parts (including software and hardware required to access the control panel), stating maximum price and supply time;
- In supplying spare parts, the installation company is prohibited from discriminating based on the identity of the party purchasing the part and the identity of the party providing service to the elevator for which it is intended;
- The installation company must provide all technical information needed to access the control panel and control the elevator (including any codes, passwords or explanations) by another service provider;
- The installation companies are limited in their ability to sign no-compete agreements with employees.

22. However, in the course of the hearings in this case and after additional investigation, the IAA began to also weigh the possibility that the competitive issues are sectoral in nature, rather than relating to one particular manufacturer or installation company. The Director General's instructions, in contrast, could only be issued to specific companies with regard to specific elevators; this would mean that they would require constant updating and expansion to match changes in the identity of players in the

installation sector, and would have difficulty covering all the relevant players and elevators, in the event that the problem is found to be sectoral in nature. In addition, the IAA is weighing the level of oversight and expertise in the technical aspects of elevator service that would be required to enforce the instructions – for example, overseeing how the parts were provided, when and subject to what conditions; overseeing which technical information was provided, how fully it was explained, how accurate it was, etc.

23. For these reasons, the IAA is considering the possibility of publishing a report concerning the elevator services sector, outlining the competitive issues and recommending regulatory steps by the government ministries responsible for overseeing contractors and elevator service companies, as well as by the Consumer Protection Authority. The primary steps which the IAA is currently considering recommending are: regulation to obligate any company that installs an elevator to supply all spare parts needed for that elevator, so long as it continues to provide service for the elevator itself and regulation to obligate installation companies to provide service manuals together with the elevators they install, with detailed instructions as to how to provide service to the elevator, including any information needed to access the control panel. The IAA is also considering recommending regulation to increase the link between the primary and secondary markets.

24. In terms of the duty to provide information, the IAA recognizes the importance of formulating regulation carefully, so as to require only provision of information necessary to service an elevator, but not necessarily information that would allow a competitor to manufacture or copy the IP-protected components of the elevator.

25. In addition to the regulatory steps mentioned above, the IAA believes that refusal to supply the spare parts needed to provide service to an elevator may constitute abuse of dominant position or refusal to supply, which can be handled with the traditional tools granted the Director General under the Restrictive Trade Practices Law. Therefore, the IAA continues to monitor any claims of refusal to supply, including looking into several complaints by independent service companies. Obviously, these investigations may be complex when the installation company merely delays supply or charges higher prices, but these difficulties do not seem to be inherently different from those faced in any refusal to deal case.

26. In terms of enforcement against exploitative conduct, the IAA recently (28.2.2017) published revised guidelines regarding enforcement against abuse of monopoly position through excessive pricing. According to the guidelines, the IAA will generally tend to enforce excessive pricing primarily when it is convinced that there are no possible remedies that will open the market to competition. Since this does not seem to be the case in the elevator service sector, it does not seem to be an appropriate market for excessive pricing enforcement at this point.