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## CONCENTRATION - DETERMINATION OF THE RELEVANT MARKET - THEORY AND PRACTICE IN THE REPUBLIC OF SERBIA<sup>1</sup>

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### Summary

*Identifying of the concentration level on certain markets is a starting point in the analysis of market structures. This is also a prerequisite for subsequent decision making at the institutional level and estimating state policy effects on the market.*

*Concentration and its effects on competition are determined by taking into account the relevant products and relevant market. It is generally accepted that competition is desirable and that it has positive effects. Fair competition results in lower production costs and lower product prices, and stimulates innovation as well.*

*Analysis of concentration provides information about the intensity of competition. Despite the importance of concentration, in domestic literature these issues are not often found. One reason is the lack of complete institutional arrangements for this area.*

*This paper presents the theoretical principles of concentration determination and shows the practice in the Republic of Serbia.*

**Key words:** *concentration, the relevant market, the Republic of Serbia,*

### Introduction

Concentration to a certain extent it is economically desirable as it contributes to the welfare of consumers in both the short and in the long run. The purpose of the existence of state regulation in this area is to provide a level of concentration and

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competition that is most favourable to the consumer.

Trade of agricultural and food products in the Republic of Serbia have had a rapid growth after the changes in 2000. A change has occurred because of privatization, then the emergence of new local and foreign retail chains and the emergence of a large number of small retail stores.

Bearing in mind the importance of agri-food sector in the Republic of Serbia, analysis of concentration and its effects is of particular importance for the further development of competitiveness.

The paper analyzes the theoretical principles and definitions of the relevant product and relevant market, then the legislation in the Republic of Serbia in this area and its application in practice<sup>3</sup>.

### **Material and methods**

For the analysis presented in this paper, firstly the desk research was applied, then consultations with experts in various fields, and finally, it has been analyzed the practice of determining the concentration in the Republic of Serbia.

### **The importance of the relevant market determination for examination of concentration**

Defining of relevant markets is important for assessing the concentration in the economy, for the assessment of market structure, as well as the assessing market power of individual entrepreneurs acting in the relevant market (Koester / Zaric, 2009.1).

To research the concentration is necessary to define the essential concept of the relevant market. In order to determine the relevant market at the first place it is necessary to

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3 New phase in development of legislation and policies of protection of competition in Serbia started with adoption of the Law on Protection of Competition in September, 14, 2005 ("Official Gazette of RS", No. 79/2005), which is in force from September, 23, 2005. The Competition Commission has been established in April, 12, 2006 by election of the President and Vice President of The Commission Council. The latest Law on Protection of Competition ("Official Gazette of RS", No. 51/2009) is being in use since November, 01, 2009, and by this law jurisdiction and practical actions of The Commission are extended. The Commission is an independent body which has property of legal entity and works as a public authority in accordance with the law. The Commission reports to the Serbian Parliament about its work. The Commission is consisted of The Commission Council and Expert service Commission (Source: <http://www.kzk.org.rs>). At the end of 2010 a total of 30 persons were employed in the Commission, and by the judgement of the Commission President, for full use of institutional capacity 70 persons minimum is necessary ("Danas", September, 21, 2010).

define the product and its substitutes<sup>4</sup>. There are basically two approaches to determining the relevant market, namely from the standpoint of supply and from the demand side.

From the standpoint of supply of products and services possibilities of providing products substitutes are examined. In a certain area, the products are considered interchangeable if they have identical or very similar characteristics

However, from the production aspect, exchangeability of the product depends not only on the similarity of their features but also on the fact whether customers will recognize the products as substitutes.

From the standpoint of demand, namely customers who decide to purchase, the existence of mutually interchangeable products are studied. In the fact buyers determine the similarities and differences between products based on product characteristics, which can be observed from the purchasing decision.

Indicator of the intensity of substitution is the elasticity of supply and elasticity of demand. The elasticity could be measured in several ways, but in the EU the common practice is to use The Small but Significant Non-transitory Increase in Prices (SSNIP) test. This test measures the ability of changes in demand and it is also known as the hypothetical monopolist test<sup>5</sup>.

In the case that changes the price of one product affect demand for other products, these products are substitutes. In this way the limits of the relevant markets are a certain area in which customers respond. Thus defined, the market supply and market demand is a key element in determining the concentration of individual markets and in describing the intensity of competition.

The concentration can be considered as desirable as long as it has positive effects on competition. Indicators of market concentration are often used to describe the intensity of competition, which shows that there are close links between these two indicators. However, some research shows that it is not always possible indicators of the concentration used as a valid means to explain the competition.

A commonly accepted measure of market concentration is the Herfindahl-Hirschman Index (HHI)<sup>6</sup> and by using this indicator in some countries there is a high

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4 This area was treated by the consumer's behaviour theory. More specific, see Kotler, P. (1999): Marketing management – Analysis, Planning, Implementation & Control, 9th Edition. Informator. Zagreb.

5 The Small but Significant Non-transitory Increase in Prices (SSNIP) test was introduced with the 1982 U. S. Merger Guidelines and is widely used by competition authors to define the relevant market (Doljord, Ø. / Sørsgad, L. / Thomassen, Ø. (2007). The SSNIP-test in EU was used for the first time in 1992 in topic M.190 Nestlé/Perrier OJ 1992 L356/1. Starting with 1997 this became an official method of measuring impact on prices in EU, because the Commission used the stated definition in its notification about identification of the relevant market (Commission Notice on the definition of the relevant market for the purposes of Community competition law, (1997), OJ C372/5). According to the SSNIP-test "Hypothetically small (from 5% to 10%) but permanent increase of prices criteria is in use.

6 Bikker, J. A. (2004): Competition and efficiency in the Unified European Banking Market. Edward Elgar, USA.

concentration. However, if in the same situation different methodological approaches were applied, such as model "Panzar & Ross"<sup>7</sup>, it comes to the conclusion that a low level of concentration and intensive competition is in place. In addition, neither of these two methodological approaches can provide an answer on the strength of individual market participants.

According to the "structure-conduct-performance"<sup>8</sup> model higher concentration means as a rule the greater market power that leads to distortion of competition. However, in cases where there are low barriers to entering the industry, a large proportion of an enterprise is not a great market power. For the intensity of competition there are important barriers in entering and exiting, and the amount of profits and risks related to a particular activity<sup>9</sup>.

In contrast to the structure-conduct-performance model, the theory of efficient structures contains the main hypothesis that market concentration does not lead to the distortion of competition. According to this theory an efficient entrepreneurs can choose between two strategies. The first strategy would mean maintaining price and market share at the same level. More efficient production would increase value for shareholders. Another strategy would mean a reduction in prices, increase market share and therefore increase profits. Apart from increasing efficiency, high concentration may prevent the bankruptcy of the entrepreneur, although it has adverse effect on competition.

## Determination of the relevant market in the Republic of Serbia

Rules for defining the relevant market in the laws of the Republic of Serbia are mostly aligned with the EU<sup>10</sup> *acquis communautaire*. Relevant market is considered the

7 Panzar, J. I. & Rosse, J. N. (1987): Testing for Monopoly Equilibrium. The Journal of Industrial Economics. Vol. 35. No. 4. str. 443-456

8 Bain, J. S. (1956): Barriers to New Competition. Harvard University Press.

9 Porter, M. E. (1993): Wettbewerbsstrategie (Competitive Strategy). 7. Auflage. Campus. Frankfurt.

10 Agreement on Stabilization and Association (ASA) is an international agreement, which has been signed in April, 29, 2008 between Republic of Serbia and European Union. According to this Agreement the Republic of Serbia committed to establish the free trade zone and harmonize the legislation with Acquis Communautaire. Considering the large number of EU regulations, priority areas which have direct impact on creation of the free trade zone between EU and Serbia have been selected: protection of competitiveness and control of allocation of state aid, intellectual property legislation, procurement, standardization and consumers protection (see: EU Integration Office of The Republic of Serbia). Competition Protection Law complies with primary and secondary EU legislation in competition protection area. "Applying the Law and regulations adopted, and those waiting for adoption, provisions specified in articles 81 and 82 of Treaty of establishing the European Community and provisions of article code 73 of Agreement on Stabilization an Association" (Annual report of The EU Integration Office for 2009).

market of goods and/or services in specific geographical areas<sup>11</sup>.

The relevant market includes the supply of goods and/or services which consumers and other users consider as substitute<sup>12</sup>. The geographic market is defined as market on which the firms produce or sell. This market has the same or similar conditions of competition, which is essentially different from the conditions of competition in neighbouring geographic markets. A single firm may operate in a number of different geographic markets.

Criteria for determining the relevant market are explained in the Regulation ("Official Gazette of RS", No. 89/2009)<sup>13</sup>. The relevant product market and relevant geographic market should be defined for each specific case. It is important to point out that institutions dealing with the protection of competition tend to define the relevant market on a more narrow way, whereas market participants tend to use a broader definition. It is clear that the concentration level depends on of the relevant market definition (Zaric, 2008.2)<sup>14</sup>.

In the case that the representative market is assumed as a small geographical area, for example Sumadija in Serbia, it will be easier to prove the existence of negative effects of competition, than in the case when the representative market is seen the market of the Republic of Serbia or the CEFTA market.

According to the law, if there is a merger of market player, they are obliged to report in the case that they together exceeds the minimum amount of total income that has been made in the preceding year. There is a distinction in turnover on the world market, at least 100 million €, and in the Republic of Serbia at least € 10 million if there is one participant, or € 20 million if there are two of them. In this way the Commission can devote more attention to assess the concentration of the major effects

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11 The article code 6. (The Law on Protection of Competition, "Official Gazette of RS" No. 51/2009).

12 Substitutions of products and/or services are related to properties, common purpose, and prices.

13 See, articles 3, 4 and 5 of the Regulation on Criteria for Determination of Relevant Market ("Official Gazette of RS", No.89/2009).

14 In the opinion of the Competition Commission on the Belgrade market there is a dominant position of one company "Delta" by 63% share of retail market. Hence the Belgrade market is the most dynamic in Serbia, dominant position offers significant benefits (Ekonomski Magazin, No 399, January 14th 2008, p. 20). However, Statistical Office of The Republic of Serbia found that market share of "Delta Maksi" during the first half of 2007 on the Serbian market was 6.4% and on the Belgrade market was 11.6%. This result was found on the basis of the regular quarterly survey on retail trade. If we ignore other possible reasons for different results, here is obviously a different definition of relevant market. Suppose that Statistical Office is not an interested party, hence it is a state institution which has its own methodological approaches. In later discussions on this matter it has been shown that the "Delta" officials, as interested parties, want to impose the wider definition of relevant market (Zarić, V. (2008): Analysis of competitiveness of agricultural and food products in Serbia. Publisher: Faculty of Agriculture, University of Belgrade).

on competition as well as processes and procedures that lead to serious violations of competition. Increasing the quality of analysis will contribute to the sector analysis that the Commission may obtain.

In the event that the relevant market is narrowly defined and do not take into account all the substitutes, or if the geographical area defined narrowly, it would be that market participants have unrealistically high shares. This will lead to a restrictive attitude and policy towards concentration and at the same time weak competitive capacity with respect to suppliers from other areas.

The practice of the Competition Commission shows quite a cautious approach and a narrow interpretation of the relevant market. This attitude can be interpreted as the need for the Commission to explain all aspects of the negative effects of concentration on competition as precisely as possible.

In order to assess the relevant market and the concentration of entrepreneurs Commission for Protection of Competition have to collect data, before starting the analysis. According to the law, parties involved in the concentration are required to submit data to the Commission. In addition, under Regulation Commission makes estimates based on "all available data". The Regulation sets out what types of data on which estimates are made, but does not specify the data sources<sup>15</sup>.

According to the Law, in order to obtain information, Commission has the ability to down raid market participants and to look at the material that it deems relevant to the study of concentration and decision making.

In addition, state authorities are obliged after Commission request, to provide information, documents or other material. Despite this broadly defined notion of sources in practice it happens that the Commission does not have comprehensive information for analysis.

The legislator was mindful of difficulty of finding valid data. In the process of initiation of ex officio predicted that conclusion by the Commission should contain statement "... and an invitation to all persons who have information, documents or other relevant information, to submit them to the Commission." This confirms the difficulty in obtaining valid information<sup>16</sup>. Getting information on time is one of the important conditions for the Commission work, because Commission is obliged to make decisions within limited period.

According to the law, a violation of competition is considered when there is a significant restriction, prevention or distortion of competition<sup>17</sup>, through restrictive agreements<sup>18</sup> and abuse of dominant position<sup>19</sup>. Dominant position is defined by market

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15 In the article 3 and 4 of Regulation stand's "all available", but in the article 5 data coverage extends to states "... and other available data, ..."

16 See for example the cases of Frikom s.c.; Idea ltd and Grand prom s.c.; Idea s.c. and Swisslion group ltd.

17 Article code 9 "Law on Protection of Competition"

18 Article code 10 "Law on Protection of Competition"

19 Article code 16. "Law on Protection of Competition"

share at least 40% by one competitor, or 50% and more if there are two or more competitors<sup>20</sup>.

In the opinion of the President of the Commission the food sector in the Republic Serbia has the characteristic of a cartel that dictates the price to wholesale and retail. Due to the fact of market power of existing companies in the whole sale and retail marketing chains, they are able to keep high margins. This is because of existing barriers to entry into Serbian wholesale and retail market. The main problem for the new competitor in Serbian trade market is to find an appropriate location (Danas, 21st September 2010)<sup>21</sup>.

The Commission noted the abuse of dominant position in the case of Frikom. In this case the relevant market was defined as following: "market production and sale of ice cream and market production and sale of frozen food." Misuse of market power is defined in relation to the manner of granting discount to customers. Namely, in relation to the types of discount, the procedure and method of calculation as well as conditions of payment for using discount (Frikom Case).

In the case of trade with agricultural and food products Commission concluded that there are restrictive agreements in the vertical chain. There are agreements to determine the lowest retail price as fixed or minimum price in further trade with commodities.

In one case discount per invoice was promised if recommended commodity price were applied (the case of Idea/Grand Prom) and in the second contract discount was connected with a specific formula for calculating the retail price for different formats of customers (the case of Idea/Swisslion).

The Commission concluded that there is a restrictive agreement as the parties foresee the exchange of confidential business data with an allowance equivalent to 1% of the value of invoice. The payment would be done on the monthly level (the case of Metro/Delta).

In these cases where there are restrictive agreements Commission did not specified the relevant market but one can assume that this could be a production and marketing program listed companies.

## Conclusion

The basis for the concentration analysis is to define the relevant market in terms

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20 Article code 15. "Law on Protection of Competition"

21 Daily newspaper "Danas" of September, 21, 2010 published "The most violations of competitiveness rules are in food industry and retail chains" ([www.danas.rs](http://www.danas.rs)). In Commission President's opinion, in the Republic of Serbia the state contributed the most to creation of conditions for violations of competitiveness and existence of cartels and monopolies. Structures mentioned above have been established through the privatisation process, when there was the planned economy that provided positions. Today's cartels and monopolies in Republic of Serbia are not made on the basis of competition, application of innovation and high efficiency.

of defining the product and its substitutes and in terms of geographical coverage. The relevant market can be determined from the demand and supply points. It is essentially important to determine the intensity of substitution and elasticity. There are several models used to determine the exchangeability of products. In practice, the EU is mostly used SSNIP test. In addition to knowing the structure it is important to know the power of the individual competitor as well as barriers to entry and barriers to exit from certain sectors.

Determination of the relevant market in the Republic of Serbia is in line with the rules and procedures applied in the EU. Tendency of the Commission is to define narrower markets does not lead inevitably to the conclusions which could be unfavourable for competition development.

The Commission has rather careful methods of work and this should be interpreted as a need to avoid adverse effects.

Although the Commission has broad authority for obtaining information, the current situation in Serbia may make it considerable difficult. For further development of competition it is necessary to strengthen Commission capacity and to increase cooperation with institutions dealing with issues of competition.

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