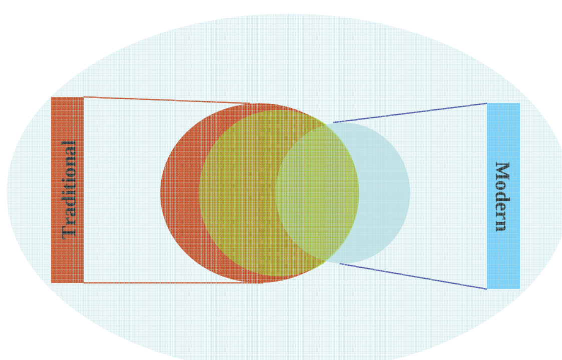
Concentration of Primer C/C market

Executive Summary

Articles 2 and 21 of the Competition Law



Belgrade, 24 January 2008

Introduction

The Commission for the Protection of Competition again prohibited the merger of C market and Primer C, which is a part of Delta Group. The rationale for the new Ruling includes more details than the previous one; however, it is based on the same arguments which were already the subject of disagreements and denials among lawyers and economists. The basic motive of the authors of this study is not to pass judgment on the case in question, but to offer an analysis, as objectively as possible, of all the economic factors which could contribute to reaching the correct solution. Our interest is solely in the application of Articles 2 and 21 of the Law on the Protection of Competition, and no other. At the end of the text is a table with comparative assessments of the Competition Commission and our findings, on the basis of which one can clearly decide what view we hold on the subject. Prior to that, all conclusions in this study are of analytical nature and it would be erroneous for them to be read out of context.

The method of the analysis is systematic, and the presentation unfolds step by step according to the blueprint set by the European Commission when making decisions on horizontal concentration. It corresponds to Phase I of the research conducted by the Directorate for Competition in the European Commission, but also, in part, relates to Phase II. It is noteworthy that this division does not exist in Serbian law. Also in question is the concentration of two legal entities in the field of retail trade in daily consumer goods, with definition of relevant market being decisive for a final decision. Although we have devoted much attention to the European practice, it would be a great mistake simply to copy it. The European retail market is a modern market, whereas Serbia's retail market is still a traditional market, despite the fact that the last two years have witnessed its extraordinary development.

Our analysis has a typical ex-post character because of the lapse of exactly two years since the takeover of C market, and is dynamic in its nature. In our view, the dynamic aspect of the analysis is crucial here. It was necessary to take into account the changes that have occurred in terms of quality of services in trade and of retail trade efficiency in the absence of which it would not be possible to decide whether consumers are today more or less satisfied after the effectiveness of the concentration. That is why we have gathered new relevant statistical data, conducted a market research and applied econometric models to the extent possible in the circumstances of relatively scarce data. Based on the lessons that might be drawn from this case, we finally suggested possible adjustments of rules and practices in the competition policy in Serbia.

Relevant Market

Answer to the question whether a concentration substantially prevents, limits or disrupts competition depends on the definition of a relevant market, as it is the market where dominant position of market operators is created or strengthens. It is possible to view the relevant retail market from two different aspects – the aspect of sales chains and that of types of shopping missions. Our conclusion is that our retail market is in the process of transition from traditional to modern trade and that it is impossible at the moment to separate these two aspects.

If the relevant market is assessed from the aspect of sales chains, it is necessary to separate modern self-service retail formats of all size (hypermarkets, supermarkets and smaller self-service stores)[1] from all other sales formats (groceries, small shops, bakeries, butcher's shops, drug stores and other specialized stores, kiosks, tobacconist's shops and unincorporated retailers in green markets).

Belgrade retail market, 2007				
Sales formats	Shopping missions			Market type
	Convenience shopping	One-stop	Total	
Self-service stores	27%	22%	49%	Modern
Grocery stores	21%	3%	24%	Traditio-nal
Others	17%	10%	27%	
Total	65%	35%	100%	
Source: Strategic Marketing Research				

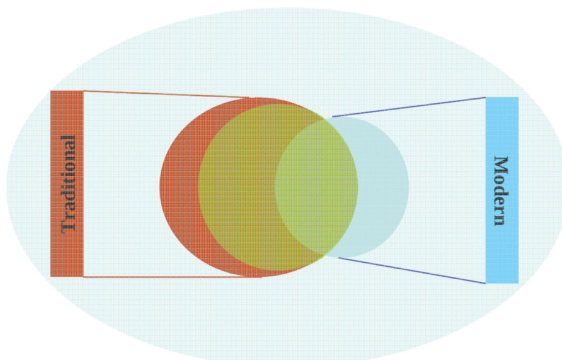
The first market segment is a modern retail market in European sense, while the second segment has been inherited from the past and represents our traditional retail trade. According to the research done by *Strategic Marketing Research*, in 1,000 interviewed households in Belgrade in a period of 7 days, with the keeping of daily consumption diaries, modern retail trade accounts for 49% of the volume of total purchases of food, drink (alcoholic and nonalcoholic), tobacco and other everyday consumption in the households in Belgrade, while traditional retail trade shares 51% of the same market (as of these percentage, 24% refer to grocery stores and 27% to other mostly specialized stores).

If the relevant market definition cares for the type of shopping missions only – small everyday convenience shopping or weekly one-stop purchases with a range of different products or consumer goods baskets – small purchases

[1] Serbian modern retail market is underdeveloped and any further deliniation of it along the lines of the size of sales area is not appropriate.

account for 65% of the market, and large weekly shopping accounts for 35% of the market. Ratio is almost 2:1 in favor of everyday small shopping missions.

The relevant data are shown in the table above and visualized in the figure bellow. Modern retail is represented by the blue circle in the figure, while the red circle stands for traditional retail. Both circles correspond to appropriate sets of retail formats. Their intersection (marked in two green colors) dominates in both sets and denotes convenience shopping missions. One-stop shopping area is beyond the green circle space.



The section of two sets divides modern retail trade area into two parts, the larger of them represents small convenience shopping missions and accounts for 27% of all purchases in the market, while one-stop shopping missions account for remaining 22% of all purchases. Such a big portion of small purchases in modern formats is explained by the fact that the vicinity of a sales outlet is the most important factor for buyers when choosing a shopping place. At that part of the product market, therefore, there is a strong competition between modern and traditional retail outlets. Somewhat smaller competition is present in the case of large weekly shopping mainly carried out in hypermarkets and large self-service stores (22%), but groceries stores, green markets and other retailers are keeping their ground well because they take up as much as 14% of the total market. When it comes to large weekly purchases of fresh fruits, vegetables and meat, direct competitors are the supermarkets (Tempo) and green markets.

Overlapping of Markets

As everyday convenience shopping missions – for which issues like wide product ranges, parking facilities, various food counters, sweepstakes and promotional sales, family shopping, cafés, galleries and other conveniences have no relevance – account for 65% of total retail, it follows that modern and traditional retail in Belgrade are overlapping to such an extent that it is all but impossible to separate them at present. Our research therefore suggests that both these segments should be treated as a single retail market.

However, if we take into account the range of products sold on such a market, it can be further refined in order to better approximate the prevailing European practices. Product range in hypermarkets and supermarkets is stretched to more than 5,000 product lines, while in grocery stores it accounts on average to 2,000 goods permanently on stock, and is much further reduced in specialized stores, kiosks and green market. Due to the narrow range of products offered by specialized stores and green market, *the Competition Commission* insists to exclude them from the relevant market, which we do not much complain. However, we strongly disagree to exclude grocery stores from the relevant market because of two reasons, one is formal the other is of essence: i) *The Competition Commission* has included grocery stores in the relevant market in the similar case *Merkator/M Rodić*[2], and there is no need to arbitrary change the established practice, and ii) There is a substantial overlapping between self-service outlets of all size and grocery stores regarding daily convenience shopping missions. Those missions prevail in larger supermarkets/hypermarkets contrary to a typical European practice. Shopping missions and retail formats are completely mismatched in Belgrade so far. Our research provides strong evidences that grocery stores compete to larger sales formats even if the number of stock-keeping units is smaller.

Relevant Geographic Market

The concentration level of the Serbian market is very low, so the market as a whole is not covered by this analysis. The only relevant geographic market of concern is deemed to be the Belgrade market.

European Practice

Our country is on the way to EU accession and it is therefore necessary to take into account the competition protection practice applicable in the EU. Regarding the definition of the relevant market, *the European Commission* defines it as: i) primarily the market of hypermarkets and large supermarkets (with total sales area of more than 400m2), but ii) it allows for modifications of the definition depending on local circumstances in Members State, in the sense that they may include smaller formats belonging to traditional retail. Our country is now at the point of the development of retail sale of food and other everyday groceries supply where the European Union was exactly twenty years ago, when the share of traditional retail accounted for a half of

[2] Ruling No. 104/06 as of 26.9.2006.

total sales. In this context, future definitions of the relevant market will certainly be in line with the developments in Europe and conform to typical European practice. Today, however, simply copying that practice and applying it to Serbia does not make sense, particularly because the European Commission grants certain departures depending on local circumstances.

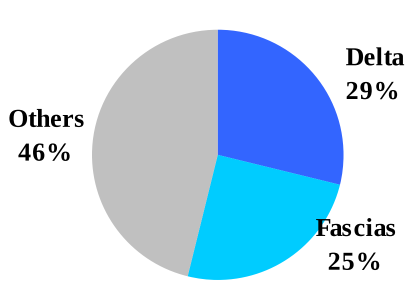
Dominant Position

Much of the argument in the subject case concerns the existence or non-existence of a dominant position of Delta Group – and we have been compelled to deal with this issue in some detail – although it is not the most important issue in this matter. The most important issue here is whether the actual position of Delta Group after horizontal merger "significantly hampers, restricts or distorts" competition in the retail market in Belgrade. The alleged 40% market share is nothing more than a challengeable legal assumption on the market power of Delta Group. *The Competition Commission* could argue that Delta Group significantly distorted competition even if it had a market share of less than 40%, just as Delta Group could argue it was not distorting competition even with a market share higher than 40%.

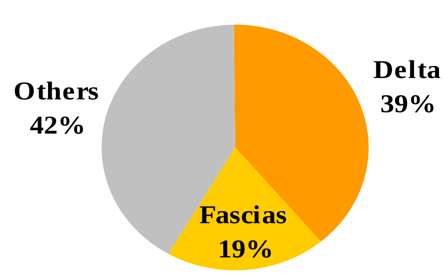
Market Share

The Competition Commission claims Delta Group has a share of more than 50% in the Belgrade market, possibly even as much as 70%. However, in the case *Mekator/M Rodić*, *the Commission* stated Delta Group had a market share of 35.4% in Belgrade. The latter percentage matches accurately the statistics provided by *the Republic Statistics Bureau* (35.8% in Q1 2006, immediately after the acquisition of C market).

Shares in the total retail market in Belgrade



Shares in Belgrade retail market as of self-service outlets and grocery stores



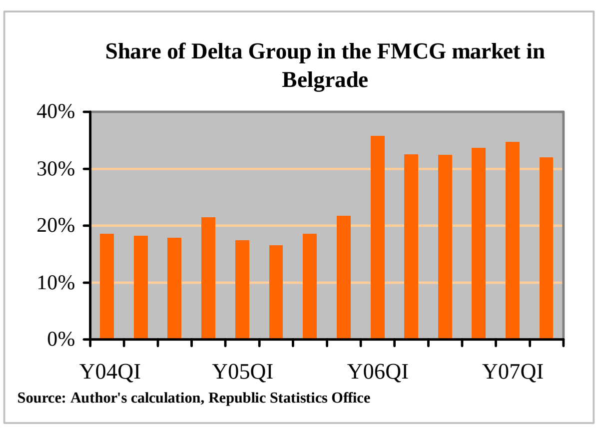
Source: Strategic Marketing Research

Statistical data were gathered by *the Republic Statistics Bureau* on the supply side by interviewing retailers with the status of legal entities. Data for the demand side were collected by *Strategic Marketing Research* on the basis of consumption surveys carried out in December 2007.

According to these data, the share of Delta Group in the Belgrade relevant market ranges between 29% (on the total retail market) and 39% (on the relevant market of self-service outlets of all size and grocery stores).[3]. If data on the supply side (indicating the corresponding share of 32%) are matched with relevant data on the demand side, we will see that Delta Group has not overstepped the line of 40% market share in the relevant market in Belgrade.

<u>Dynamism</u>

All the delays in the adoption of a legal solution for the merger of "Primer C/C market" have had analytical benefits. Under normal circumstances, it is necessary to estimate future market development after the merger of two economic entities. Such estimation always implies a high level of uncertainty, because it is always possible to estimate future developments wrongly. Indeed, this has happened in the subject case, because the increased concentration expected by *the Competition Commission* has not actually materialized in practice. Quarterly time series provided by *the Republic Statistics Bureau* for the period 2004-07 enable precise determination of the development of Delta Group's share in the relevant Belgrade market in the last four years.



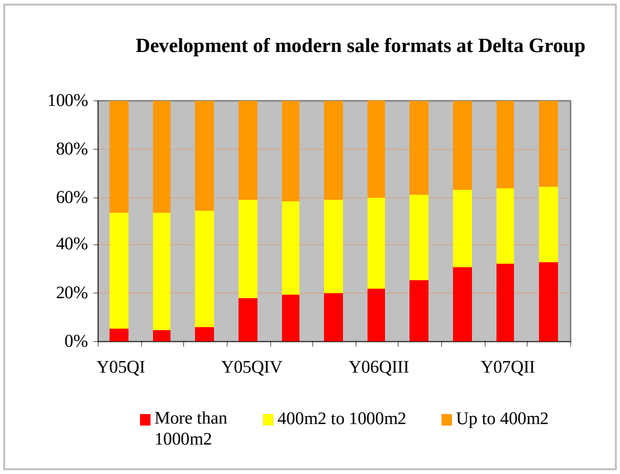
After the merger in Q1 2006, the share of Delta Group in the Belgrade market exceeded 35%, but later oscillated to a lower level. Delta Group underwent vigorous development throughout the period – despite its acquisition of C market – but did not increase its market share. The reason for this lies in the fact that the competition also experienced strong development at that time. Such parallel development of competitors contradicts the claim that Delta Group "significantly restricted" competition in the retail market in Belgrade. It is generally

[3] This definition of the relevant market is adopted in Croatia, Czech Republic and Bulgaria, countries that are closer to Serbian than to European level od retail development.

assumed that the development of Delta Group is a consequence of its merger with C market. Facts, however, indicate that the opposite is the case. Delta Group paid €44 million for C market, only to discover a hidden loss of €54 million. The paid value of C market – €300 per share – thus *de facto* doubled and reached a level high above its market value. C market needs to generate a profit growth rate of between 40% and 50% per annum in order to recover this capital loss over the following ten years, assuming the applicable interest rate is 5%.

Modernization of Retail

Modern retail is characterized by two inevitable trends – concentration and modernization. No country is capable of preventing further concentration of retail because it is a byproduct of world trade globalization. All a government can do is to keep such concentration under control – balancing between a small number of leading retailers – to make sure that these phenomena do not adversely affect the consumers. The same also applies to our country and *the Competition Commission*. While pursing this policy, *the Commission* needs to ensure it is not hampering further modernization of retail.

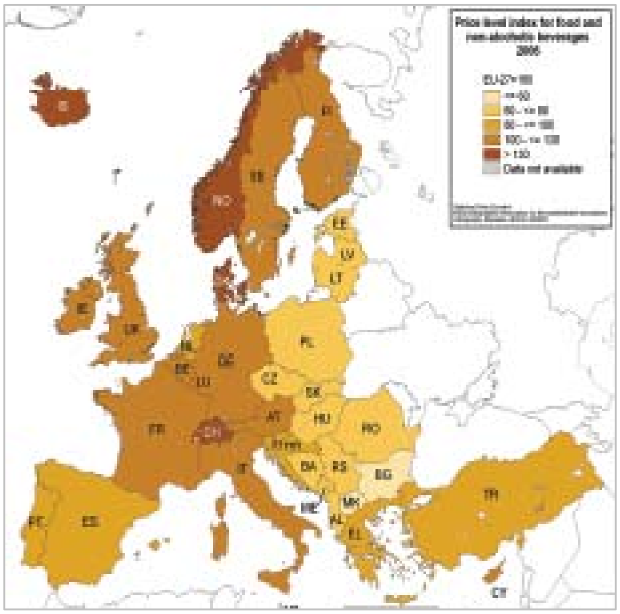


Source: Author’s calculation, Delta Group

Delta Group has given a substantial contribution to the modernization of retail in Belgrade over the recent years. The relation between modern and traditional retail formats at Delta Group accurately reflects the development of the European retail market, allowing for a delay of about 20 years in our case. Contrary to the commonly held view, C market was a traditional retailer. Its acquisition delayed the development of modern sales formats at Delta Group for three quarters, but it became visible again in 2007.

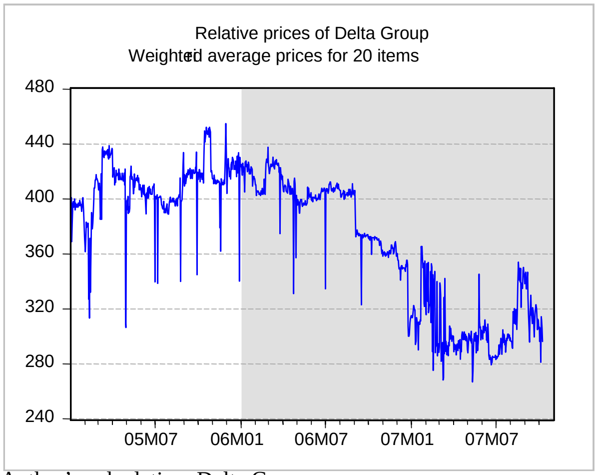
Prices and Consumer Position

Another important issue apart from efficiency of retail is consumers’ benefit; combined, these are the two leading criteria governing decisions on legality of mergers between trade chains. Everyone who has experienced the 1990s in Serbia will not find it hard to compare the quality of retail then and now. In the recent years it has been developing – both before and after the merger of Primer C/C market. All chains are opening new, modern outlets, food quality standards are being adopted, the supply is diversifying and becoming far more branded. Of course, all this only deepens the sharp contrast between the low standard of living and the increasing supply of fast-moving consumer goods. Underlying this discrepancy are the fundamental problems faced by our economy. Low real wages are increased by artificial means to a level which exceeds the rate of labor productivity growth, foreign debt and balance of payments deficit are looming ominously, country risk is deterring foreign direct investment; not even the unrealistically strong exchange rate can curb inflation. Under such circumstances it is easy to manipulate the public and accuse retailers of monopolies and high prices. According to a research by *Eurostat*, the official statistical service of the EU, which examined comparable prices of 500 food, liquor and tobacco items in 2006, adjusted by consumers' purchasing power, our country belongs to the group of cheaper European countries (index 67 against the average of 100), with lower comparable prices found only in Bulgaria and FYR Macedonia[4]. We had to point this out in order to dispense with one of the most widespread misconceptions, namely that Serbia is the most expensive country in Europe.



Another misconception concerns the role of retailers in the generation of inflation. In this specific case of concentration, the main issue is whether there is "significant restriction of competition" resulting from the merger of the two chains. This case has nothing to do with another possible case identified under the law as "abuse of dominant position", although these two cases are often mistaken by the public. To determine whether a dominant position is abused, it is important to establish if prices and margins are "too high or inadmissible" as a result of illegal monopoly actions, which have absolutely no relevance for this case of concentration.

[4] Eurostat, Economy and Finance, 90/2007



Author's calculation, Delta Group

Nevertheless, we have analyzed the prices of Delta Group over a three-year period for each outlet in order to determine the elasticity of substitution in consumption. It is an econometric test that has been in use for half a century in competition lawsuits all over the world. The demand elasticity ratios of most products were well above one, which indicates that the pricing policy of Delta Group was restricted by consumer behavior and their inclination to buy cheaper goods elsewhere. In effect, competition is existent. In aggregate amounts, the prices of the basket of twenty products had a period of relative growth a year before the concentration (measured against the overall consumer price index), followed by a period of decreasing for nearly two years after the merger. Such pricing policy could certainly not have been detrimental to the consumers.

<u>Other Competitiveness Factors</u>

Other competitiveness factors – supplier status, obstacles for entry into or exit from the industry, international competition, market development and innovation in retail – point to the conclusion that the merger between "Primer C and C market" has not significantly restricted competition in the retail market in Belgrade, which is the legal requirement for not allowing mergers.

On the average, Delta Group buys from its main suppliers 10 of their output and is thus not objectively capable of bringing them to a subordinated market position; the number of retail chains is far above three, which is taken to be the lower limit for viability of competition; Delta Group has competitive prices compared with the neighboring countries; the entire retail market is developing at a very fast pace, so that no one's position is guaranteed in the long term; Delta Group was the first Serbian retailer to be certified against the HACCP standard for food quality and the first to introduce mini-bakeries into grocery stores, expand the supply of fresh fruits and vegetables, promote the use of beverage refrigerators – all of which have by now become standard in our retail, following a brief period of sharp competition.

Many theories have been put forth in connection with the alleged obstacles for entry into the retail business, including the skepticism of *the Competition Commission*, but there has not been a single research or statistically relevant indicator. We have shown that trade, and retail in particular, has developed at a much faster pace than the rest of the economy and that obstacles for pursuing commercial operations in Serbia, according to *the World Bank* methodology, have been diminishing constantly, ultimately reaching the average level for the entire Southeast Europe region. If these two facts are taken in correlation with a third one – namely that the market share of Delta Group has been declining slightly after the merger – there is no basis for the conclusion that there are great practical obstacles for entering the retail market. Obviously, there will be obstacles, but there are certain differences between great and average obstacles. Large global chains are still absent from our market, but the reason for this is that, unfortunately, our market is still not attractive to them, just like our economy is still not attractive for large-scale foreign direct investment.

Conclusion

The decision of *the Competition Commission* in the subject case was rigid – and as such inappropriate both in substance and form. There were only two options that *the Commission* took into consideration – to allow or to ban the merger. Under the law, *the Commission* could have made a conditional positive decision, just like it had done in a similar merger between *Merkator and Rodić*, which had an evidently higher concentration in the local market in Novi Sad than is the case with this merger in Belgrade.

This subject case has prompted the Government to propose amendments to the Competition Law. While the proposed legislative amendments are certainly necessary, they are not in themselves sufficient, and the existing legislative provisions had not failed in preventing the passing of a proper resolution in the case under review. Apart from the law, it is also necessary to work on the development of a competition protection methodology and on capacity building at *the Competition Commission*. Both of these actions are not only in the best interest of the state and consumers, but also in the interest of the economy – because takeovers and mergers are inevitable in a market economy.