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Competition Policy as a Means to Facilitate Development in Economically Depressed Regions: An Example of North Caucasus

Dynamic competition is playing the growing role in numerous modern markets characterized by high degree of innovation and product differentiation. Customers often agree to pay extra price for new and improved product features and characteristics that yields additional profits to suppliers, though over time the latter diminish due to competitive pressures. Seeking this temporary rent is one of the most essential motives for innovation. However, not all of the present day markets, especially in the developing part of the world and economically depressed regions are characterized by innovation and dynamic competition. In these markets rent seeking is rather based on exploitation of vertically integrated entities (customers, suppliers) by market dominant firms than socially desirable effects of innovation. It hinders the development of the entities and, thus, the overall economic recovery of these regions. Improving competitive situation in these regions is, therefore, a means to facilitate their overall economic development. Thus, in the context economic development and competition policy is likely to have a regional dimension. The North Caucasus region of Russia presents an interesting example of the relationship between competition and development in two of the region's major mutually related sectors – agribusiness and transportation (the latter looks equally important for a lot of developing and/or economically depressed regions all over the world and lessons learned in the North Caucasus may have a considerable practical applicability there).

The North Caucasus region is characterized by a high share of agricultural goods in gross regional product amounting to 50% and higher in some Subjects of the RF located there. In its nature the agricultural sector is competitive (it is comprised by hundreds of farms and thus approximates an ideal competitive market model) but it is jammed between highly concentrated markets integrated to it vertically. Its

direct customers (mainly intermediaries and traders) exercise buyer power over the agricultural producers. From the supply side (production factor markets) agricultural producers are subjected to exercising market power by natural monopolies furnishing electricity and natural gas as well as from highly concentrated oil sector. E.g. collective dominance of oil products suppliers was found in such subjects of the RF located in North Caucasus as Karachai-Cherkessia, Stavropol and Krasnodar regions. Apart from that agricultural producers also face limited or discriminatory access to essential facilities needed for agricultural production, primarily grain elevators where collective dominance and collusion look very likely.

Possibilities of direct competition authority interference in this situation and competition law enforcement are limited due to intransparent corporate control structure of agricultural traders and grain elevators companies (in their turn most of them are also vertically integrated and combine storing grain in elevators with trade in grain in the same firm), difficulties in finding direct evidence of collusion among them, lack of complaints and antitrust suits brought about by agricultural producers caused by their insufficient legal knowledge and support (that warrants competition advocacy and market monitoring primarily from the competition authority side).

While the direct evidence necessary for competition law enforcement is lacking the indirect evidence furnished by a simple economic analysis looks more than sufficient for assuming exercise of market power and abuse of dominance in the markets vertically integrated to that of agricultural products. E.g. in the cost of a loaf of bread produced in the South of Russia only 10% is comprised by grain and flour, 3% - by fertilizers, some very small fraction – by bakeries while about 80% is due to the inputs provided by highly concentrated sectors. 700% mark up on flour supplied to remote Northern territories of Russia was found among some traders.

The limited possibilities of direct interference of the antitrust authority due to the lack of legally valid evidence warrant competition policy intended to improve bargaining positions of agricultural producers and set up competitive constraints for market dominant companies in the vertically integrated markets.

To facilitate economic development in the North Caucasus FAS-Russia developed a policy intended to improve the competitive situation in the region and implemented jointly by the antitrust authority and Office of Plenipotentiary Representative of the President of the RF in Southern Federal District. Pursuant to this goal the policy included a set of specific objectives such as:

- Limiting buyer power and possibilities of monopsonic practices of intermediate buyers – agricultural goods traders
- Involving more actors from the buyer side

- Providing the producers with possibilities to avoid intermediaries and liaise directly with ultimate consumers of grain, flour, sunflower oil and other agricultural goods
- Extending geographic borders of the market for regional produce.

Change in institutional framework of trade in grain, sunflower oil and other homogeneous agricultural products seems to be a pivotal means to achieve these objectives. Therefore, the government is launching a project of establishing futures commodity exchange to service trade in agricultural products and to be accessed by farmers via Internet. The implementation of the project is followed by dissemination of the relevant information among farmers and their training in using Internet and skills in trading via futures commodity exchange. The degree if the project's success will be mainly measured by the number of the farmers' offers put at the exchange and finally – by the turnover of agricultural goods in it. From antitrust perspective the project can be recognized as a successful one if the turnover through the exchange amounts to 35% or more of its total value that will provide an evidence of substantial competitive constraints on the exercise of market power by the intermediaries. The range of products traded via this exchange is also supposed to expand over time, starting from homogeneous agricultural goods such as grain, flour, sunflower oil etc. and further include agricultural production factors (seeds, fertilizers and other inputs) and services to farmers.

Coupled with the government effort on improving the highway network in the South of Russia it would help the farmers to reach more direct customers (who would receive the farmers' products for less price than from the intermediaries), reallocate wealth from intermediaries (concentrated sector) to farmers (competitive sector) and put competitive constraints to intermediaries and make the overall agribusiness market function in a more balanced way. Presumably it will result into growing capitalization of farmers (at present their poor financial position and lack of working capital are the major motives for turning to the intermediaries who buy out the crop for low prices) and their possibilities to invest in expansion and/or vertical integration into more value added products, e.g. production of own bread, pasta or spaghetti from the home made flour. With this additional income the farmers individually or/and in cooperation with each other will be also able to invest in essential facilities (e.g., elevators) currently controlled by market dominant firms.

Apart from institutional infrastructure of trade in North Caucasus the transportation possibilities equally matter. The geographic location of the North Caucasus is a potential economic growth factor by itself due to importance of the region as both national and international transit area. It lays on the intersection of highways, railroads and sea ports linking South of Europe with Asia horizontally (historically it comprised a part of “The Great Silky Way”) and 9th European transportation corridor going vertically from Black to Baltic seas. The possibility of using transit as economic growth locomotive depends on a variety of factors, including, e.g.

efficiency of borderline control and customs service. However, most important is that the region's competitiveness as a transit area compared to alternative ways of transit, both Russian and foreign depends on efficiency (insured by competition) in rendering a variety of transit services that is characterized by such factors as:

- ***Fair access to essential facilities*** such as embankments, sea port installations, inter-modal junctions and cargo reloading points
- ***Elimination of unjustified rent seeking and customer exploitation at major transportation junctions*** by introducing competitive constraints on incumbent firms or tariff regulation in case competition is not possible for technical reasons. This policy can be exemplified by FAS recent interference in a situation with rendering ship steering services in one of the major Russian Black Sea ports that cost 2-4 times more compared to international benchmarks due to monopolization of this market. At the same time FAS legal initiatives are aimed at broadening the geographic and product market boundaries in sea port services. March 27 the Russian Government approved the FAS suggestions on amendments to the Law "On sea ports in the Russian Federation" aimed to remove legal division of ports into trade, fish and specialized (e.g. oil) and thus enable all the ports to provide a variety of services and increase the competition among them, therefore. According to the Head of FAS Mr. Artemjev "it would facilitate efficiency and competitiveness of the Russian seaports and the country compliance with its international obligations in maritime transportation."
- ***Facilitating inter-modal competition*** between alternative transportation markets (railway, highway, air), thus extending the product/service market and enhancing competition, therefore. E.g. rail road tariffs are more and more constrained by competitive air and highway transportation tariffs. For certain type of transportation services (e.g. passenger connection between Rostov-on-Don and Moscow) these three markets have actually merged into one with more effective competitive constraints than these that existed in these three types of transportation markets taken separately. These constraints originate from different types of regulation and/or market structure but work more effectively and provide synergetic impact on the transportation prices when combined: tariffs of railways (regulated natural monopoly) are constrained by Federal Tariff Commission (with FAS representative participating there) and in their turn constrain tariffs in highway and air transportation; highway transportation is actually a competitive market and costs of services there constrain the growth in railroad and air tariffs. Air transportation (originally highly concentrated and vertically integrated since the same companies operated airports and flights) is deconcentrating after FAS interference ended up with separation of airport services and flight operation and provision of different air carriers with equal access to essential airport facilities. Low cost carriers (e.g. Sky Express) appear in the air connection market and put competitive constraints not only at other air carriers but on highway and railroad service providers too. Remarkably about 2 months ago air tariffs got

lower than railroad tariffs for passenger connection from Rostov-on-Don to Moscow..

- ***Introducing legislative constraints on market concentration in transportation services*** by means of licensing and other policies. FAS suggested to amend the Law “On general principles of organization of transportation services to population on regular connection routes in the Russian Federation” by introducing 35% threshold for a lot of such services per route sold through a competitive bid. It would facilitate competition by attracting more private carriers to servicing each route.

The FAS attempts to pursue competition policy in North Caucasus helped to deduct some important lessons of applying competition analysis for the purposes of facilitation development by means of enhancing competition. Market definition issue and resulting dominance assessment are very important in the examples considered above and should be situation specific rather than industry specific. SSPI/hypothetic monopolist test is likely to have high practical applicability in analyzing transportation and agribusiness market in North Caucasus and other economically depressed or developing regions of the world confronting similar problems. Dominance – substantial market power analysis may have practical implications not only for proving abusive practices but for targeting the competition and development policy as well. Direct competition agency involvement (wherever possible, subject to possibility of obtaining legally valid evidence) should be targeted at market infrastructure elements and essential facilities crucial for employing economic growth factors of the region (e.g. ports, transportation junctions in North Caucasus case) and combined with more general government policy of developing regional market. Regional development policy should be combined with country-wide legal initiatives intended to facilitate competition and put competitive constraints on market dominant companies, including natural monopolies.