

# Entry Barriers

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\*The views expressed are those of the author and do not necessarily reflect those of DG COMP or the European Commission

# Introduction

- n Entry analysis plays an important role in assessing the competitive effects of mergers
- n Where entry conditions are easy, incumbent firms may be unable to exercise market power without attracting new entry.
- n Conversely, where a potential entrant imposes an actual or future competitive threat on an incumbent, cooperation or integration between them can harm consumer welfare.

# The checklist approach

- n Objective: to determine whether "entry barriers" are high or low according to some definition
- n Steps:
  - n Draw up a list of entry barriers
  - n Check how many elements of that list are present in a given case (e.g. by asking competitors)
  - n Measure entry barriers (?)
  - n If not possible to measure the more entry barriers are present the more difficult is entry
- n All aspects of entry are conflated into one: height

# Bain

- n conditions of entry should be:  
“evaluated roughly by the advantages of established sellers in an industry over potential entrants, these advantages being reflected in the extent to which established sellers can persistently raise their prices above a competitive level without attracting new firms to enter the industry”

# Bain stressed three factors that could prevent entry

- n Economies of scale: as an entrant must either enter at a suboptimal scale with a cost disadvantage, or at an efficient scale with a depressing effect on prices.
- n Product differentiation: by allowing incumbents to charge higher prices than entrants and thus to sell profitably when potential entrants could not.
- n Absolute cost advantages: by allowing incumbents to sell profitably at prices below the costs of potential entrants.

# Stigler

n Entry barriers are:

“... a cost of producing (at some or every rate of output). . . which must be borne by a firm which seeks to enter an industry but is not borne by firms already in the industry”

# Stigler's list is much shorter

- n Economies of scale are not barriers to entry. If an entrant incurs a higher cost because it must produce at a lower level of output, the cost disadvantage is a consequence of overall demand being small relative to minimum efficiency scale.
- n Product differentiation is normally not a barrier to entry. Only if the costs of differentiation (design, advertising, etc.) are higher for a new firm than an existing firm.
- n Cost advantages arising from scarce factors of production, such as patents and natural resources are not entry barriers.
  - n Scarce factors generate "economic rents," i.e., returns in excess of those necessary to attract them away from other uses. These rents should be properly understood as opportunity costs.

# In fact...

Entry Barriers?	Bain	Stigler
Economies of scale	P	0
Product Differentiation	P	0
Advertising	P	0
Capital requirements	P	0
Patents	P	0
Absolute cost advantages	P	0
Regulation	P	P



n Consider this example:

an established firm commits itself to producing the monopoly output, and this being the case, no other firm can enter at a profit.

n Do entrants face a barrier?

- n Consider the system of taxi medallions in New York City: 10000 licenses have been given that can then be resold.
- n Are there barriers to entry in this market?

# Entry analysis: A positive approach

- n competition authorities should explain how the industry will behave over the next several years and how rapidly and to what extent entry could enhance competition.
- n Entry barriers: asymmetries that might favour an incumbent firm over a potential entrant
- n Focus on:
  - n Identify and describe potential entrants
  - n Assess likelihood of entry of one or more potential entrants not whether entry barriers are high or low in any given case
  - n Take into account impediments which delay the process of entry. Such delays offer temporary advantages to incumbents over entrants
- n Entry likelihood = entry profitability

# Post-entry profitability is critically affected by two factors

- n Intensity of competition post-entry: a tough competitive regime post-entry leads entrants to anticipate lower prices, reducing the profitability of entry thus making it less attractive.
- n Extent to which entry costs are sunk (investments that cannot be recovered upon exit):
  - n Allow the incumbent to commit to compete vigorously
  - n Raise the risks of entry
  - n Sunk costs can be endogenous (an increase in demand does not lead to new entry rather a competitive escalation in investments raises the equilibrium level of sunk costs)

# EU Commission evolving to the positive approach

- n Vertical Restraints Guidelines (2000)

“Entry barriers are measured by the extent to which incumbent companies can increase their price above the competitive level and make supra-normal profits without attracting entry” (§126).
- n Horizontal Merger Guidelines (2004):

“Potential entrants may encounter barriers to entry which determine entry risks and costs and thus have an impact on the profitability of entry. Barriers to entry are specific features of the market, which give incumbent firms advantages over potential competitors”. (§70)
- n In the HMG entry barriers are relevant not because they allow an incumbent to enjoy excess profits but because they reduce the profitability of entry.

# Role of entry considerations

- n When delineating the relevant market
- n When assessing the relevant comparison to determine the effects of the merger
- n When assessing the competitive effects of the merger
- n When assessing remedies

# Delineating the relevant market

- n EU Notice on Market Definition: supply-side substitution may be taken into account if suppliers are able “to switch production to the relevant products and market them in the short term.”
- n SSS different to Potential competition along two dimensions:
  - n SSS responds promptly to price increases
  - n SSS does not require (additional) irreversible investment
- n In the EU, SSS leads to market aggregation, but only if it is nearly universal (this implies hit-and-run entry may not be taken into account)

- n US approach treats uncommitted entrants as market participants and assigns them market shares.
  - n Advantage: market shares are not overestimated. This improves screening function of safe harbours.
  - n Disadvantages: time consuming to perform calculations called for by "uncommitted entry" analysis such as
    - (i) extent of an uncommitted entrant's sunk costs,
    - (ii) the likelihood that consumers will purchase the uncommitted entrant's product, and
    - (iii) the profitability of alternative uses of the uncommitted entrant's assets in different markets.
- n Hit-and-run entry appears rare in practice



# Contestability Theory

- n Some scholars believe that the mere anticipation of entry will induce incumbents to lower their prices toward more competitive levels, and thus that entry need not necessarily occur to have an effect on market performance.
- n “perfectly contestable” markets: incumbent firms and potential entrants (i) share the same technology and potential competitors can (ii) enter and exit without capital loss (iii) before incumbent firms can adjust prices.
- n But the theory is famously non-robust to even small deviations from the three extreme assumption

# Identifying the Counterfactual

- n Principle explicit in the HMG.
  - n The conditions of competition are likely to evolve over time irrespective of the merger.
  - n In general, it is necessary to identify the most likely competitive environment that would prevail in the absence of the merger and compare it with the scenario that results if the merger is authorized.
- n But applies more generally to agreements and abuses
- n Rarely acknowledged (even in mergers) and not applied consistently

# Assessing competitive effects and identifying adequate remedies (+)

- n Even if limited entry is expected in the absence of the merger
- n Mergers may induce entry (reducing competition concerns)
  - n By reducing competition, a merger may increase the expected profitability of entry to overcome existing entry costs.
  - n Such merger-induced entry would tend mitigate the anti-competitive effects of the merger, in part or in full
  - n Allowing the merger to be authorized without or with lesser remedies, respectively.
- n It is not enough that the merger creates an incentive for entry. Merger-induced entry must be “likely, timely, and sufficient to deter or defeat any potential anti-competitive effects of the merger

- n Likelihood analysis asks whether an entry plan would be profitable to carry out in the post-merger environment.
  - n Entry can be profitable at the pre-merger price in the post-entry economic environment even if it was not profitable at the same price in the pre-entry merger environment; this change in incentives is the focus of likelihood analysis
- n Sufficiency: even rapid and profitable entry might not be sufficient “to deter or defeat any potential anti-competitive effects of the merger”.(
  - n But may do so in part and this may affect the remedies
- n Timeliness: what matters is how fast entry erodes any price increase caused by a merger, and not whether it eventually does so. Impediments to entry are most relevant in this respect

# Assessing competitive effects and identifying adequate remedies (-)

- n If entry can be reasonably predicted in the absence of the merger
- n Mergers may limit entry (increasing competition concerns)
  - n (i) by eliminating a potential entrant or
  - n (ii) by increasing the ability and incentive of the merged entity (or third parties) of strategically deterring entry.
- n Remedies geared to restore competition (e.g. divestiture) reduce entry barriers (e.g. license) commit not to engage in strategic entry deterrence (e.g. promise not to bundle)