

Barriers to entry

Matthew Bennett, Vice President, CRA
Oxford, May 2013



A whistle stop tour of barriers to entry

What are barriers to entry?

Strategic barriers to entry through firm agreements

Strategic barriers to entry through single firm behaviour

What are barriers to entry?

Stiglitz (1968)

- An entry barrier is a cost advantage that an incumbent enjoys compared to entrants.
- This implies that the incumbent can permanently raise its price above the its costs and therefore earn a supra-competitive return.

Key is that barrier only exists if entrant can't replicate it. Demsetz (1968)

- If incumbent invests £1m in brand, it is only a barrier to entry if entrant couldn't invest £1m in brand.
- If it could, would expect competitive price.
- Asymmetry is key for there to be a barrier to entry.

What are barriers to entry?

Carlton's (2005) implications for Stiglitz definition:

- Suppose Mexican government sells 100 licenses to 100 firms for Tequila brewing on the open market?
- Is this a barrier to entry?

According to Stiglitz no barrier to entry.

- Any firm can buy and sell the licenses on the open market, hence no firm disadvantaged.
- In such a case each firm makes normal profits, with any excess profits given to government.
- Restriction may be inefficient, but is it a barrier to entry in the strategic sense?

Why care about barriers to entry?

Barriers to entry may tell us something about the outcome of a market.

- But need to be careful of falling into trap of over generalising and assuming barriers to entry are exogenous.

Fundamental to economic efficiency:

- Competition is a dynamic process – efficient entry facilitates this process and increases productivity.
- Entry drives up efficiency within firms – compete or be killed.
- Entry drives up efficiency across firms (within industries) – survival of the fittest ensures average efficiency increases.

Why care about barriers to entry?

Fundamental to our views about policy:

- Will markets self correct?
- If not then intervention.
- If self correct why intervene?
- Fundamental to dynamic efficiency

Most extreme version of belief in markets is theory of contestability...

Why care about barriers to entry?

Intervention in competition law is increasingly predicated on barriers to entry:

- In EU the concept of dominance is key to intervention in abuse cases – used as a screen for Article 102.
- Dominance: “*a position of economic strength enjoyed by an undertaking, which enables it to prevent effective competition being maintained on a relevant market, by affording it the power to behave to an appreciable extent independently of its competitors, its customers and ultimately of consumers.*” Article 102 Prioritisation Guidelines.

Barriers key element in determining whether a firm can prevent effective competition being maintained.

Concerns regarding creation of strategic barriers to entry form basis of much of the intervention in competition policy.

Strategic barriers to entry (i): Agreements



Agreements to raise barriers to entry?

Vertical agreements to raise barriers

- RPM
- MFNs (Retail and Wholesale)
- Exclusive dealing, absolute territorial protection

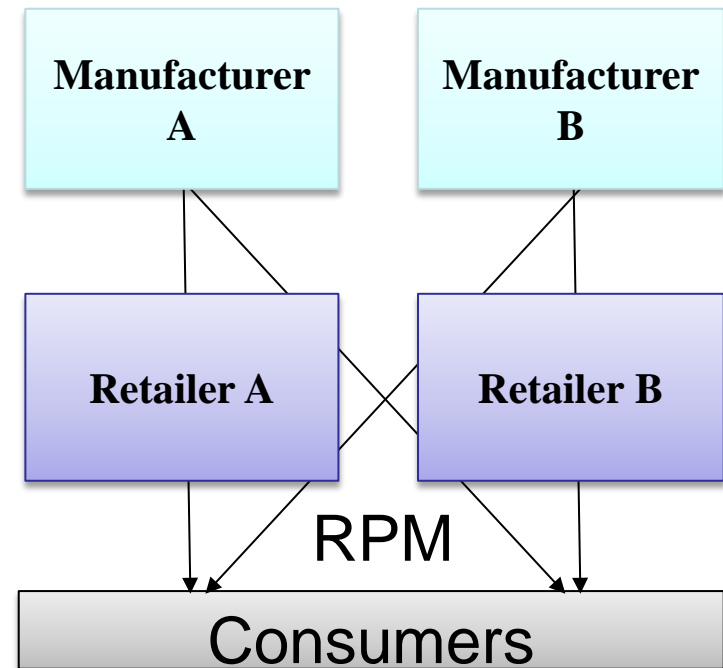
Horizontal agreements to raise barriers

- Information exchange (See EU Horizontal Guidelines)
- Standardisation (see EU Horizontal Guidelines)

RPM and Barriers to Entry

How may RPM change barriers to entry?

- Where competition is predominantly on retail price, instigation of RPM may make it harder for entering retailers.
- Entrant retailers cannot reduce price in order to encourage people to platform.
- Retailers may have an incentive to encourage RPM to the extent that it reduces competition on price and hence makes it more difficult for new retail entrants to grow their share of the retail market.



RPM and Barriers to Entry

Is entry always more difficult?

- Note that retailer competition may move from competition on retailer price to competition on commissions.
- Manufacturers may have a strong incentive to use new retailer if it charges a lower commission and is generally comparable to the other retailers.
- In such a case substitution will take place at the manufacturer level rather than the retailer level, but there will still be substitution.

Impact depends on the relative degree of competition upstream and downstream.

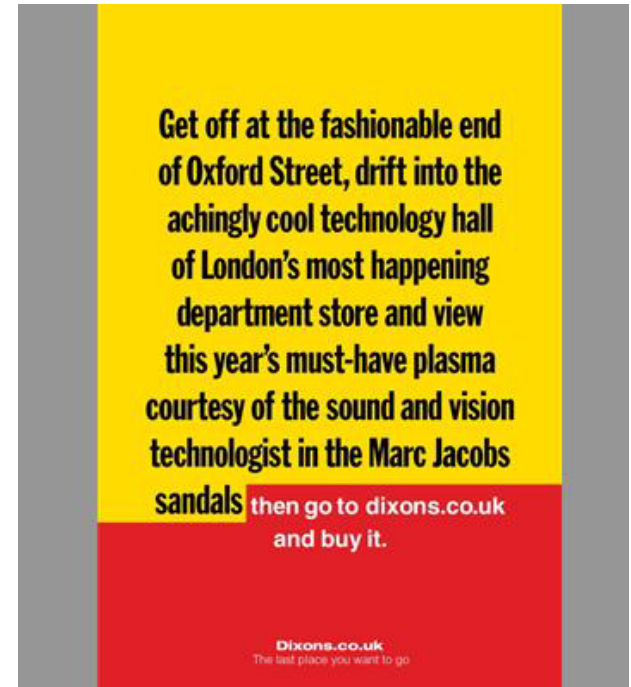
Remember RPM may be pro-competitive

Promoting inter-brand competition

- Let retailers compete through offering a great range of products or services, rather than discounting on price

Prevents free riding by discounters on services provided by other retailers

Facilitates new entry by encouraging retailers to invest in new products or brands (as alternative to exclusivity)



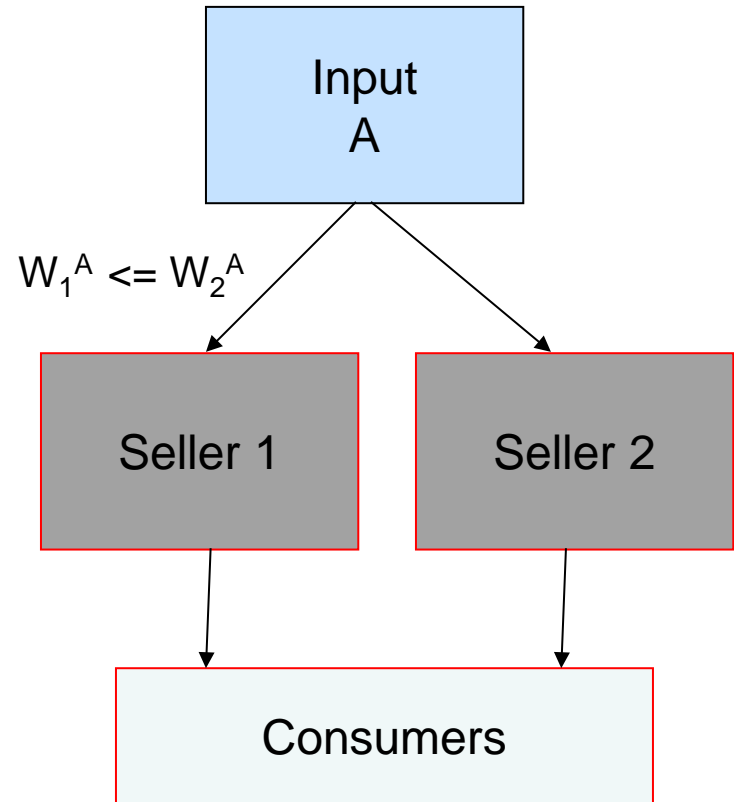
Wholesale Price MFNs?

Input A sells to two sellers (1 and 2) who then sell to consumers.

Seller 1 states to input A:

- *“you must give me sell me your input at a price which is at least as low as the price you are giving to Seller 2”*

Thus vertical restraint pertains to relative wholesale prices.

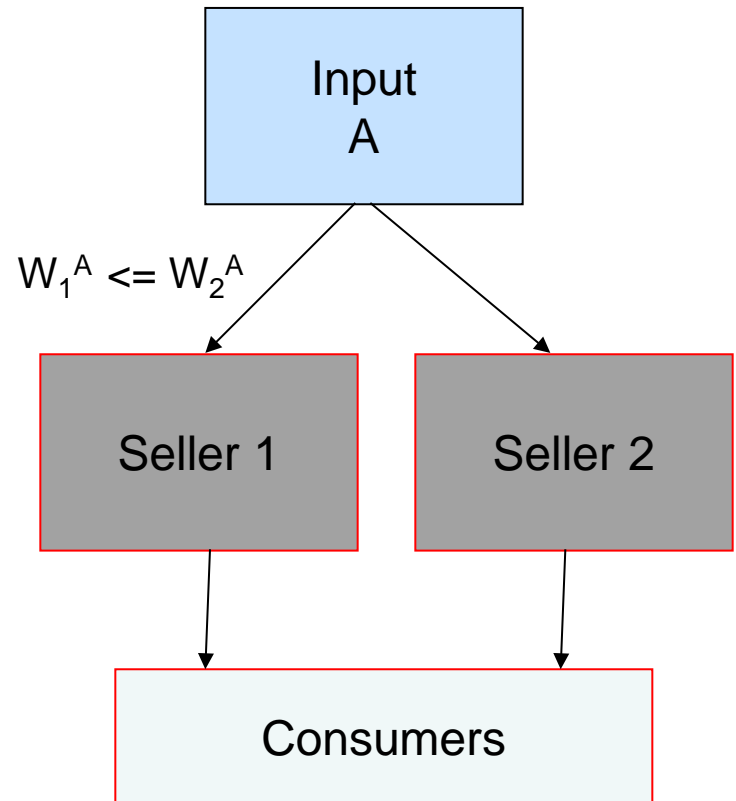


Where may there be a concern?

What happens if Seller 1 is dominant/must-have?

- Makes it much harder for Seller 2 to negotiate lower prices with input A?
- Cost of lower prices to Input A is double.
- Reduces Seller 2's ability to expand and increases barrier to entry

BlueCross/BlueShield – DOJ.



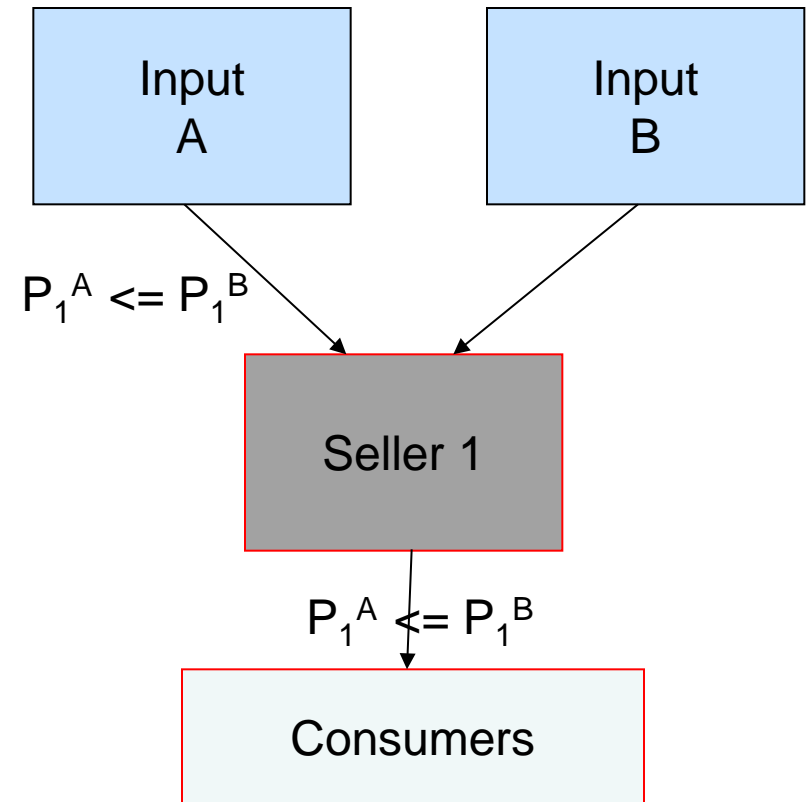
Retail Price MFNs?

Seller sells two products, one made with input A, one made with input B.

Input provider A says to seller:

- “you must ensure that the retail price of the product in which my input is sold, is no more expensive than the retail price of the product in which my rival’s input is sold”

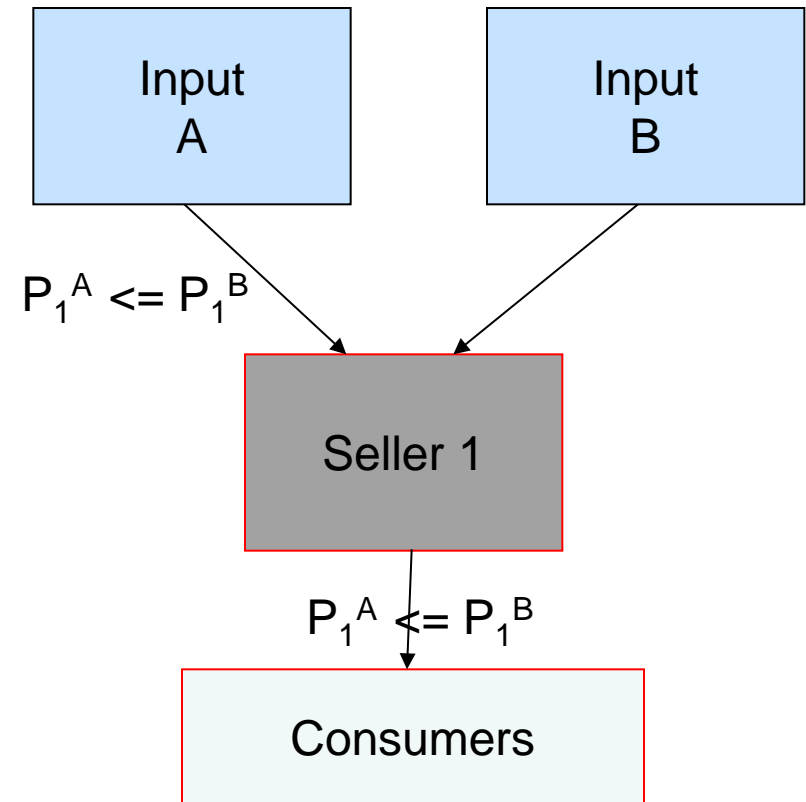
Thus a vertical constraint that pertains to relative retail prices within a single seller.



Barriers to entry and Retail Price MFNs?

Increasing barriers to entry/expansion?

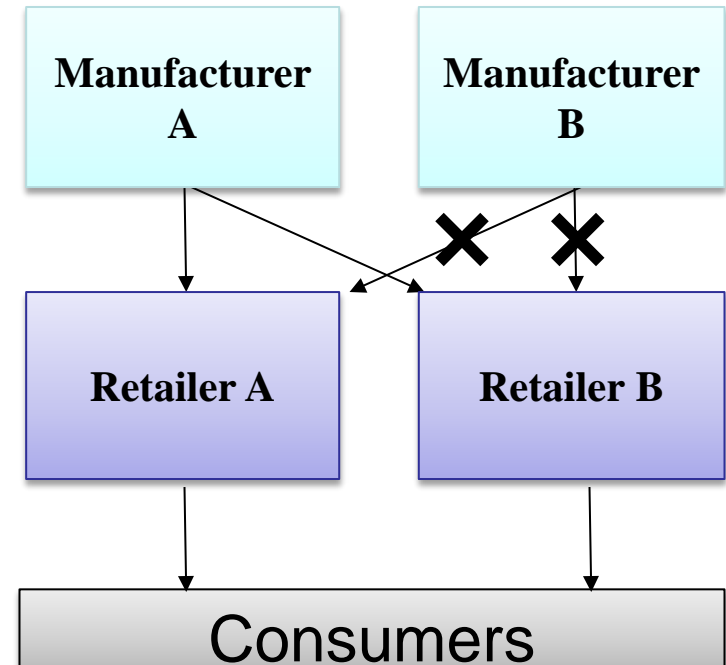
- Suppose input B is a new lower cost entrant for market in which key competitive variable is price.
- Retail MFN may make it harder for B to enter/expand.
- If B cuts price, then unless Seller 1 can pass reduction through to retail price, it won't sell any more of its product.
- Thus, assuming Retail MFN binds, less ability for B to win new business.



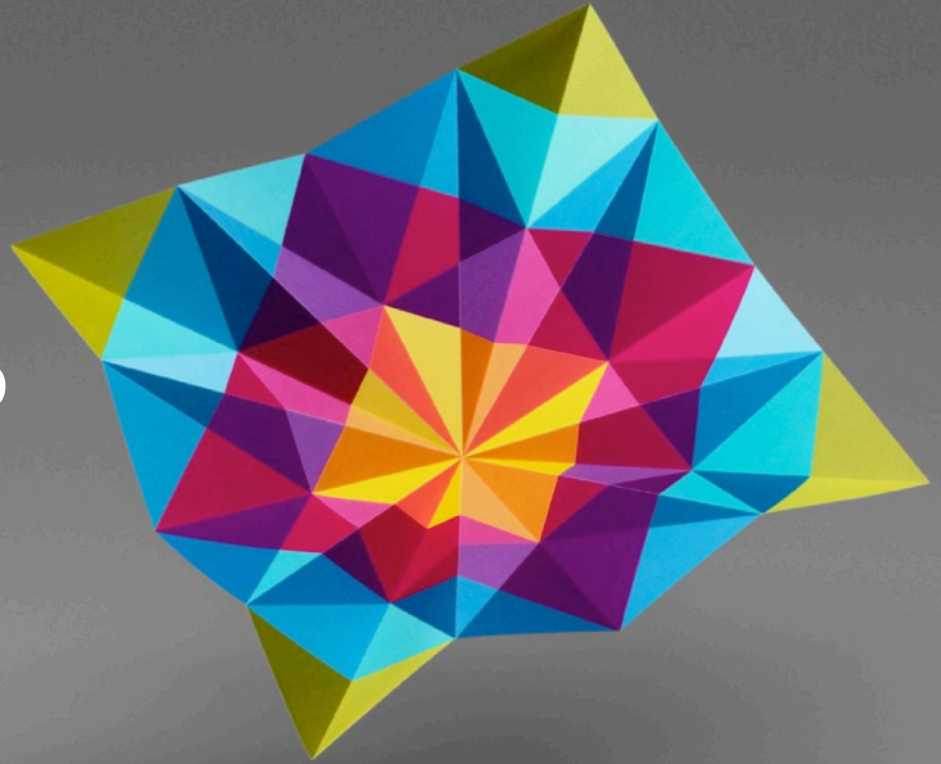
Exclusive Agreements

Foreclosure upstream

- Creates a defacto barrier to entry for Manufacturer B as it can't access the market.
- Foreclosure (e.g. if an incumbent manufacturer ties up all the retail outlets a new entrant will have difficulty reaching the customer)



Strategic barriers to entry (ii): Abuse of Dominance



Strategic Barriers to entry via abuses?

Predation

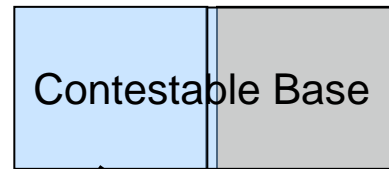
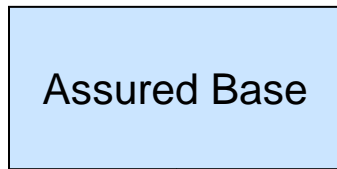
Bundling and Rebates

Refusals to supply

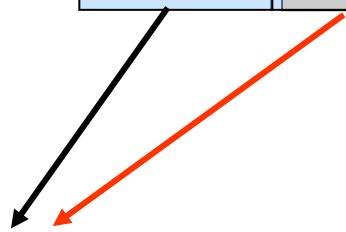
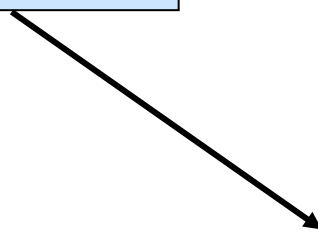
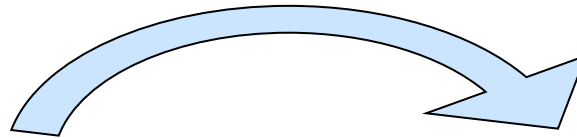
Leveraging theory of harm: Rebate Arrangements

Firm discounts the assured base conditional
on distributor buying in contestable base

Firm A has an
assured
base of sales
in Market X
(i.e. must have)



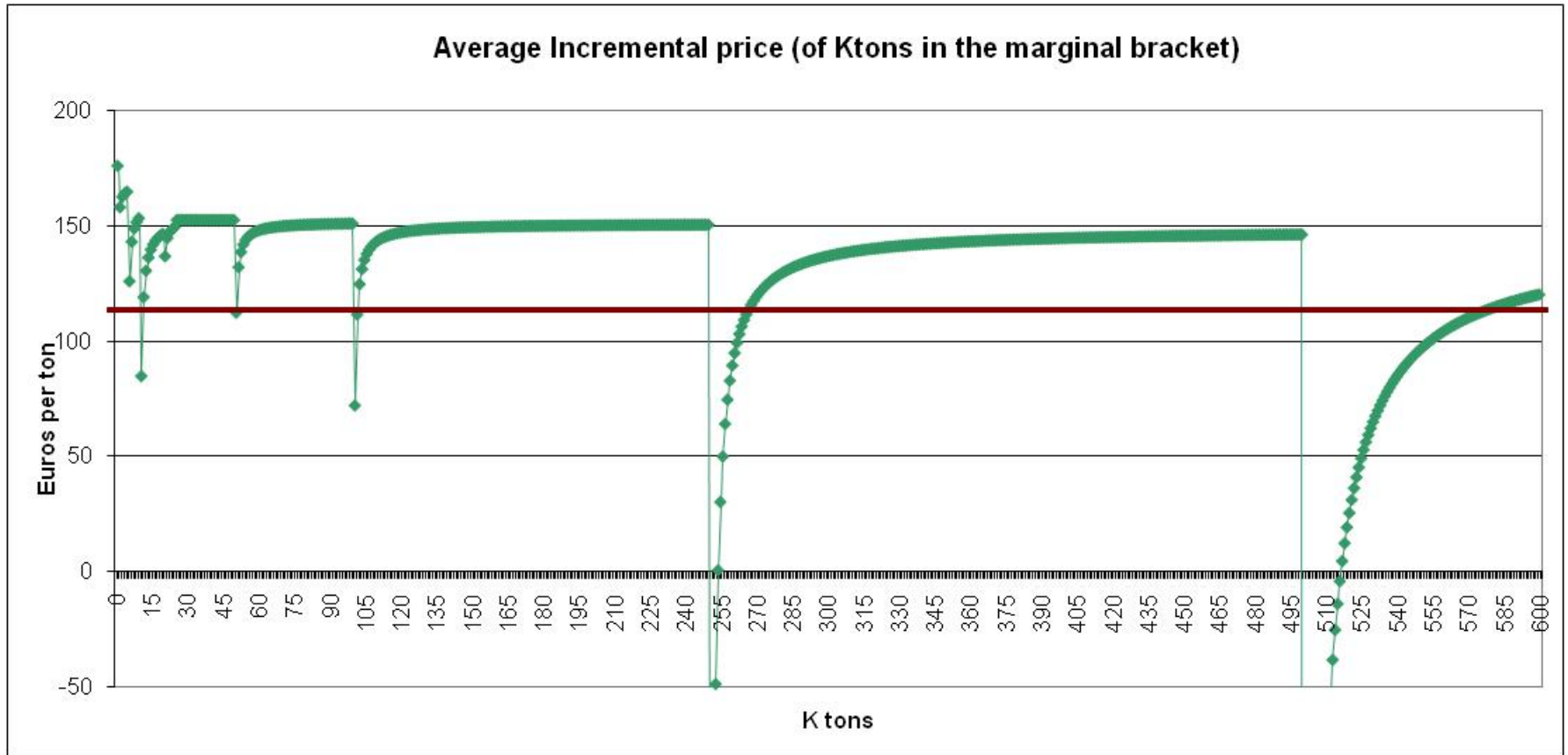
Also a contestable
base of sales in
Market X with which
Firm B competes



Actual example of a retrospective rebate

	European Discount (%)	0.0%	-2.0%	-3.0%	-3.5%	-4.0%	-4.5%	-6.0%	-9.0%
Local (%)	tonnage France\Europe		> 5	>10	> 20	> 50	> 100	>250	>500
-12.0%	>10	158	155	154	153	152	151	149	144.1
-9.0%	>5	164	A: 143,9	B 166,6	158	157	156	154	149
-7%	>1	C165	164	162	162	E: 159,6	160	157	152
-2%	>0,5	D 182,9	173	171	170	169	168	166	161
0%	> 0,2	180							
180									

Retrospective rebate in action



Key questions on a retrospective rebate?

Where is the assured base and the contestable base?

- What divides the contestable from the assured base?
- Why can't the entrant compete over the entire customer's requirement?

How big is the assured base relative to the contestable base?

- If assured base sales are small relative to contestable base then effect is likely to be small.

Intel/AMD Commission decision.

Rebates used by a dominant company may raise the barriers to entry and expansion.

- Provide a 'tax' on entrants that makes customers less willing to switch, and hence increases cost of entry.
- However rebates may also be beneficial, thus simple form based approach is unlikely to be suitable.

Conclusion



Presenter name here
00/00/2010

CRA Charles River
Associates

Conclusions

Barriers to entry:

- Barriers to entry only provide a strategic advantage to the extent that they are asymmetric between the incumbent and the entrant.
- These disadvantage the entrant vis-à-vis the incumbent.

Many of the main concerns in competition policy have the raising of barriers to entry as the core mechanism:

- Agreements formed between firms can act as strategic barriers to foreclose entrants.
- Unilateral behaviour can act as a strategic barrier to foreclose entrants

London

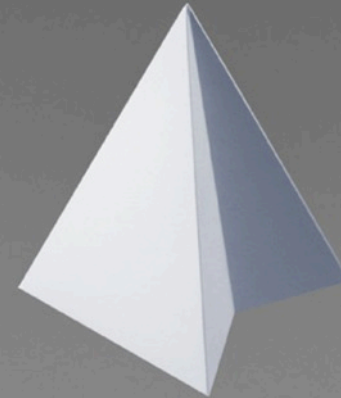
Tel +44 (0)20 7664 3700
Fax +44 (0)20 7664 3998
99 Bishopsgate
London EC2M 3XD
United Kingdom

Brussels

Tel +32 (0)2 627 1400
81 Avenue Louise
Brussels B-1050
Belgium

Paris

Tel +33 (0)1 70 38 52 78
27 Avenue de l'Opéra
75001 Paris
France



www.crai.com/ecp