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Notes on Barriers to Entry

What is a barrier?

The economics literature provides a range of definitions of barriers to entry; but they have in common a rather simple idea. This is that businesses seek to make money and this causes them to copy the successful money-making formulae of others. So if one business is seen to be generating a high rate of return from its activities, others will try to undertake similar activities so as to share in this high rate of return. By duplicating the activity of the first firm, the second firm may cause an increase in the output of the market and a reduction in the price of the product(s).

A barrier to entry is the thing that may prevent this process from occurring. The barrier is the disadvantage that the potential entrants face in competing with the incumbent. This disadvantage enables the incumbent to earn a high rate of return without attracting entry into its market.

The link between the disadvantage and the barrier comes about through the process by which the potential entrant considers whether or not to enter. It will (either formally or informally) prepare a business plan that considers the likely profits it will be able to generate if it enters. These profits will be contingent upon the likely reaction of the incumbent to the new entrant.

Consider a barrier formed by a combination of: (i) economies of scale being large compared with the size of the market; and (ii) substantial sunk costs. If economies of scale are large compared with the size of the market any new entrant will need to gain a large share of the market in order to attain the level of unit costs needed to compete with incumbents. Unless the market is growing rapidly, gaining this large market share may require that an incumbent is eliminated. But this may not happen if the incumbent has incurred substantial sunk costs. The fact that the costs are sunk will mean that an incumbent may not exit the market – even if it is confronted by a more-efficient competitor. If these conditions hold, the efficient potential entrant is unlikely to enter because it will realise that entry will cause excess capacity in the market and a protracted price war; and it is the prospect of this protracted price war that could make entry unprofitable.

An example of a barrier of this kind was identified by the ACCC in its Public Competition Assessment of Woolworths proposed acquisition of hardware stores in Ballarat:

> The availability of sites for retail stores in Ballarat is unlikely to be a critical barrier to entry. However, while Ballarat is a growing regional area, the ACCC considered that the entry of another multi-category hardware, building supplies and home improvement product retailer, or expansion by a currently limited range incumbent (such as an existing small multi-category or specialist retailer), is unlikely in the foreseeable future, given that Bunnings (two stores), G Gay & Co (three stores), Masters (one store from August 2013) and Dahlsens (albeit one trade only store) are already present in the Ballarat area. (para 87)

This passage implicitly suggests that the market is already saturated with hardware stores. If a new one were to enter, none of the existing stores would exit (providing they were covering their avoidable costs). As a result, no new store is likely to find it profitable to enter.

Four points to remember concerning barriers

Although the idea of a barrier to entry is quite simple, identifying barriers to entry to a particular real-world market may require some subtle analysis. Here are four points that are worth remembering.

1. *A barrier to entry is a barrier to the market – not to a particular person*

A useful way to think of barriers to a particular market is to draw up a list of the most likely potential entrants to the market. These are likely to be businesses that are suppliers or purchasers of the goods in question – or businesses that are producing similar goods in different geographical locations.

Some things follow if one thinks of barriers this way. The most likely potential entrants are unlikely to have poorer access to funds than the incumbents. Because the most-likely potential entrants generally suffer no disadvantage in their cost of capital compared with incumbents, access to funds is rarely a barrier to entry.

2. *There is a time element to analysing a barrier that may require some subtlety*

Because the decision to enter must occur before entry, the gap in time sometimes plays an important part in analysing barriers to entry.

The *Stirling Harbour Services* case arose because the Port of Bunbury called to tenders to provide tugboat services at the Port. It proposed to give the firm that won the tender an exclusive right to provide the services. The issue in the case was whether this exclusivity would lessen competition. The incumbent (Stirling) argued that the market was contestable, so exclusivity lessened competition. However, the Court accepted the Port's argument that the exclusivity was needed in order to remove the incumbent from the Port and replace it with the firm that won the tender. Without the exclusivity, Stirling could keep its tugs in the Port

and continue to charge monopoly prices. No one else would find it profitable to enter, because potential entrants would know that, if they tried to enter, Stirling could lower its prices and make the entry of the second firm unprofitable. That is, the time delay between the decision to enter and entering into new contracts would give the incumbent time to reduce its prices and make unprofitable the decision to enter.

3. Licences that are tradable are not barriers

Many people think that all government restrictions on entry are barriers to entry. However, that is not the case. In particular, if licences are tradable (such as licences to provide taxis) they do not create a disadvantage for potential entrants compared with incumbents, so they do not qualify as barriers to entry.

If licences are tradable, the licence cost to an incumbent of staying in the market is exactly the same as the licence cost to a potential entrant of acquiring a licence. Both must forgo the going market price of the licence. Because there is no asymmetry, one would not expect taxi owners to earn a fancy rate of return on their investment. This is not to defend licences that are freely tradable. It is merely to acknowledge that they are not barriers to entry.

4. Is an efficiency element to barriers

One must always bear the definition of barriers to entry in mind. They are advantages attributable to incumbency. They are not advantages that derive merely from efficiency.

The ACCC seems not to have understood this point in its opposition to the acquisition of Macquarie Generation by AGL. In its Report to the Australian Competition Tribunal, the ACCC implicitly equated a reduction in the availability of hedge contracts with an increase in barriers to entry and expansion. After arguing that the proposed acquisition will lead to a reduction in the availability of hedge contracts, the ACCC stated:

> Given this likely increase in barriers to entry and expansion in NSW for retailers that are reliant on access to hedge contracts, in particular the non-vertically-integrated second tier retailers, the ACCC considers that the retail electricity market structure that would be likely to arise and be entrenched in NSW following the proposed acquisition is one that would be dominated by three large vertically integrated ‘gentailers’ – AGL, Origin and EnergyAustralia. The ACCC considers that competition between these three large vertically integrated ‘gentailers’ is likely to become muted over time without the existence or threat of competition from other strong and emerging retailers. The ACCC considers that independent and second tier retailers provide an important competitive constraint on the pricing behaviour of the larger firms and contribute to the development of innovative products and services for customers in the market. The ACCC considers that the threat of entry or expansion by such firms represents a dynamic source of competition and that the proposed acquisition would be likely to prevent or hinder this source of competition.

The problem with this reasoning is that small generators could acquire hedge contracts or merge with small retailers if they wished to secure access to the very efficiencies that AGL acquired through its merger. To the extent that an enterprise has a competitive advantage over another because of its efficiency (such as access to lower costs) that should not be classified as a barrier to entry or a barrier to expansion to the less-efficient rival. If an incumbent organises itself so that it has access to efficiencies that potential entrants could replicate, that advantage should not be classified as a barrier to entry. A barrier to entry only exists if an incumbent (**because of its incumbency**) has a competitive advantage over the most-likely potential entrant.

Frontier Economics Chairman Philip Williams gave this presentation to the Law Council of Australia 2014 Competition and Consumer Workshop, Brisbane, Australia, 13-14 September 2014.