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BARRIERS TO ENTRY

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Introduction

Generally speaking, barriers to market entry create conditions which make it difficult for new competitors to enter the market. They are therefore a significant indicator for the extent to which potential competition exists. Where a market is characterised by high barriers to entry, the incentive to enter the market is low and consequently potential competition is weak. Where a market is characterised by low barriers to entry, however, it is to be expected that further companies will enter the market. Consequently, barriers to market entry have an impact on the competitive behaviour of undertakings, both, those that are already active in the market and orientate their market strategy towards potential competitors, and those that are potential competitors and consider entering the market. There are three forms of market entry: (1) market extension, (2) product extension by established companies by external or internal diversification into a different market or (3) start-up of a company.

1. The definition of barriers to entry

International discussion of this issue in scientific literature is still largely dominated by the definitions of *George Stigler* and *Joe S. Bain*. *Stigler* defines barriers to entry as “...a cost of producing ... which must be borne by a firm which seeks to enter a industry but which is not to be borne by firms already in the industry.”¹ *Bain* sees barriers to entry as “the extent to which, in the long run, established firms can elevate their selling prices above the minimal average costs of production and distribution...without inducing potential entrants to enter the industry.”²

Barriers to entry play a significant role in German decision-making practice. They are one of the criteria which are taken into account as part of an overall appraisal of various market characteristics when establishing whether a dominant position can be affirmed. Just as market shares give an indication of the relationship between the current competitors, barriers to entry provide information on the significance of potential competitors for competition in the market concerned. However, the practice of German competition authorities and courts is not based on a general definition of barriers to entry. Rather, the focus is on the actual market situation which is established by means of market analysis. The structural characteristics of a market and the competitive behaviour of the market participants are examined with regard to their tangible effects on the market. Based on the results of these examinations it is established whether the market is characterised by high barriers to entry and to what extent potential competition really exists.

The decision-making practice of the Bundeskartellamt has shown, however, that both the possibilities of established companies to avoid competitive pressure (barriers to entry according to *Bain*'s definition) and the low profit expectations of potential competitors (barriers to entry according to *Stigler*'s definition) can constitute barriers to entry. This is based on the opinion that the differences between the definitions of *Bain* and *Stigler* are blurred and that they are often interdependent or overlap each other. This is

¹ Stigler, Barriers to Entry, Economies of Scale, and Firm Size in: Stigler, The Organization of Industry, p. 67.

² Bain, Barriers to New Competition, p. 3.

particularly the case because in practice often several factors have an accumulated effect on the competitive situation in a market.

For example, the Bundeskartellamt assumed market dominance in several merger cases concerning cable network operators in the telecommunications sector also because potential newcomers to this market were faced with high barriers to entry in the form of necessary investments in their own networks. On the one hand considerable investment costs are a factor potential competitors have to take into account because they reduce their profit expectations. On the other hand, they reduce competitive pressure for the established companies simply by constituting a barrier for newcomers. Where the established companies have further structural advantages, such as company size or product differentiation, competitive pressure decreases even further. At the same time investment risks for potential competitors rise and their profit expectations fall.

2. Different types of barriers to entry

According to the Bundeskartellamt's decision practice barriers to entry can be roughly divided into three categories:

- ☐ **statutory** barriers to entry
- ☐ **structural** barriers to entry
- ☐ **strategic** barriers to entry

2.1 *Statutory barriers to entry*

Statutory barriers to entry are those set up in the context of the state's monopoly on power in the form of laws, regulations and administrative practice. Legal provisions or administrative regulations may restrict entry or the use of certain parameters by companies, thereby decreasing potential competition in favour of established companies. Some examples of the decision practice in Germany are:

- restrictions on granting permission for operations that are damaging to the environment, or special waste disposal regulations³;
- nation-wide individual procedures for the clearance of pharmaceuticals⁴
- the protection of patents⁵ and
- restrictions on granting permission for transport companies in the local public transport sector⁶.

Statutory regulations may also be used by established suppliers in individual cases in order to consciously extend barriers to entry, thereby deterring potential suppliers from entering the market. This shows once more that no clear-cut distinctions can be made between the categories of barriers to entry. An example of this is the targeted and comprehensive use of commercial legal protection, particularly the

³ 112 WuW/E BKartA 2247, 2250 "Hüls/Condea" (1986), cf. also Commission, judgment of 20.09.1995 "Orkla/Volvo" OJ. EC 1996 L 66/17, para. 106.

⁴ WuW/E BKartA 2591, 2601 "Fresenius/Schiwa" (1993).

⁵ Bundeskartellamt "Degussa/Elephant Holding BV", 1993/94 Activity Report, p. 79; Bundeskartellamt case "BTR/MCC Holding" 1997/98 Activity Report, p. 128/9, Bundeskartellamt, decision of 20.09.1999 "Henkel/Luhns", p. 32.

⁶ WuW/E BKartA 937, 943 „ÖPNV Saarland“

method of protecting the whole environment around an innovation and possible technological alternatives by protective rights (so-called "ring fencing").⁷

2.2 *Structural barriers to entry*

Structural barriers to market entry usually arise from certain technological or demand-related industry characteristics, but may also lie in the resources that are required to be successful on the market. They are not generally created intentionally to prevent entry.

In most cases, structural barriers to entry involve one or more of the following factors:

Resources

A substantial deterrent potential exists, for example, if the market leader has considerable market-specific resources at its disposal.⁸ This is particularly true with regard to limited resources in the hands of established companies, for example raw material, waste storage sites or take-off and landing slots at airports.⁹

Market trends

Individual market phases can constitute structural barriers to market entry. For example, market capacity is higher in the experimental and expansion phase than in the mature market and stagnation phase.

Transport costs / proximity to customers

Transport cost disadvantages are a significant product-related barrier to entry unless they can be offset by other cost advantages, e.g. of production.¹⁰

Economies of scale

Size alone does not lead to competitive efficiency and a deterring potential. But a deterring potential exists, for example, if costs of R&D, production or sales decrease with growing company size, and entry necessitates a high output in order for the new entrant to make a profit. Especially when the sunk costs are high, it makes sense for established producers to maintain a high long-term output. The result may be that new entrants cannot assume that they will achieve an output allowing them to break even in the medium term, and therefore decide not to enter the market. The greater the market share that is required to achieve the same economies of scale as established competitors, the higher the barriers to market entry due to the necessary initial capital requirements and risks to be borne by new entrants.

Economies of scope

Diversified companies in particular often have advantages through economies of scope. These arise when a company is engaged in a number of commercial activities at lower costs than would be incurred if

⁷ Cf. Bundeskartellamt, decision of 20.09.1999 "Henkel/Luhns", p. 30 ff.

⁸ WuW/E BGH 2276, 2283 "SZ-Donau Kurier" (1986); "RAG/VEBA" 1995/96 Activity Report, p.152.

⁹ WuW/E BKartA 2391, 2394 "DLT/Südavia" (1989).

¹⁰ WuW/E BKartA 2865 "Kali+Salz/PCS" (1997), Bundeskartellamt case "Ruhrkohle/Veba", 95/96 Activity Report, p. 152.

different companies carried out each activity separately. Economies of scope are also involved when vertically-integrated companies have advantages that may require a new entrant to enter the market at more than one level at the same time.

Technical barriers to entry

High barriers to entry also exist when entry does not appear to be impossible in the long term, but, due to the need for technical development, is not likely in the short term.

2.3 Strategic barriers to entry

Strategic barriers to entry are intentionally set up by incumbents in a market in order to deter potential suppliers from entry. By their market conduct, established companies may erect de facto barriers for new entrants, thereby impeding their entry. The practice of all manufacturers in a particular industry to conclude long-term supply contracts¹¹ or exclusive contracts with their customers¹², is an example of strategic barriers to entry. Demarcation and concession agreements¹³, industry-wide or individual companies' standards for complementary goods¹⁴ or the development of propriety technical access systems¹⁵ have similar effects. If they have been created by advertising and inter-brand competition, buyer preferences may suggest that there are strategic barriers to entry. This may entail cost disadvantages for new entrants compared with established companies until the former have attracted attention and won a reputation of their own.¹⁶ Conversely, strategic market conduct by customers and the threat that they may switch to another supplier can lead to potential competitors effectively limiting the scope of powerful companies.¹⁷

2.4 Special case: Access to network based markets and essential infrastructure facilities

In decision practice the way in which a barrier to entry is determined does not differ according to whether a merger or abuse of power is under examination. However, there are a number of markets in which such activities are only possible through the establishment or co-utilisation of costly networks. Classical examples of these markets, previously often characterised as natural monopolies, are those for gas and electricity, telecommunications and rail services. In these markets newcomers intending to enter into competition with the network owner have to use the existing networks if they do not wish to go to the lengths of setting up their own networks (often impossible in practice). Very high barriers to entry are immanent in the structure of these markets. All these cases raise the difficult question of under which conditions competitors can claim a right to co-utilise existing networks. As a solution to this problem, often discussed under the key term "essential facilities doctrine", a provision was adopted in the 6th Amendment to the German Act against Restraints of Competition in 1999 stating explicitly that the denial of access by a dominant company to its networks or other infrastructure facilities without any objective

¹¹ VEBA/SW Bremen, 1995/96 Activity Report, p.121; BGH WuW/E DE - R 32 "Stadtwerke Garbsen"; BGH WuW/E DE - R 24 "Stromversorgung Aggertal"; Bundeskartellamt decision of 25.02.1999 "Lekkerland/Tobaccoland", p. 18.

¹² WuW/E BKartA 2215 f. "Linde-Agefko" (1985).

¹³ WuW/E BKartA 2157 f. "EVS-TWS" (1984).

¹⁴ 133 WuW/E BKartA 2894 "Herlitz/Landré" (1997).

¹⁵ Commission, judgment of 09.11.1994, "MSG Media Service", OJ EC 1995 No. L. 364/1.

¹⁶ WuW/E BKartA 2376 "Melitta/Kraft" (1989); WuW/E BKartA 2591 "Fresenius/Schiwa" (1993); WuW/E BKartA 2865 "Kali+Salz/PCS" (1997); WuW/E BKartA 2905 "Merck/KMF" (1997).

¹⁷ Bundeskartellamt decision of 03.03.2000 "Cisco/IBM", p. 20 f.

justification constitutes abusive conduct. On the basis of this provision the Bundeskartellamt has executed abuse proceedings in particular against gas and electricity providers.

3. Competition law enforcement: Long-term gas supply contracts as a barrier to entry

A current example of the Bundeskartellamt's decision-making practice regarding barriers to entry is the problem of long-term gas supply contracts between gas transmission companies and distributors. A survey has shown that almost three quarters of the contracts concerned cover 100 per cent of the gas distributor's requirement or at least quantities of between 80 per cent and 100 per cent of the distributor's requirement. Almost all of these contracts run for more than four years, in some cases up to twenty years. This combination of long contract periods on the one hand and a high degree of requirement satisfaction on the other leads to considerable foreclosure effects. The Bundeskartellamt considers these long-term gas supply contracts to be one of the major reasons for the unsatisfactory competitive situation in the gas sector.

The Bundeskartellamt initially tried to achieve a consensus-based solution in order to counteract this restraint of competition. It took up the problem of long-term gas supply contracts *ex officio* without immediately initiating prohibition proceedings against the companies. Instead the authority conducted numerous discussions with the gas transmission companies, trading companies and distributors. The purpose of these discussions was to find a solution which serves the interests of effective competition and provides both the established and new gas suppliers with a clear schedule for their planning processes.

A key elements paper in which the Bundeskartellamt explained its assessment criteria under competition law served as a basis for the discussions. This discussion paper was published and thus made available to the general public with the possibility to comment on it. The Bundeskartellamt then sent a letter to 15 gas transmission companies stating the obligations necessary for the companies to undertake to prevent the authority from initiating formal prohibition proceedings.

The most important element was a limitation of the contract periods. The gas transmission companies were asked to undertake the obligation not to exceed a term of 4 years for contracts covering more than 50 per cent and up to 80 per cent of the distributor's requirement, and not to exceed a term of 2 years for contracts covering more than 80 per cent of the requirement. These terms were set according to the percentage of the distributor's actual requirements. Contract-splitting in terms of quantities or periods of supply was thus inadmissible. Furthermore the terms represented upper limits which were not to be exceeded, not even on a short-term basis. After all, the contracts concluded by gas transmission companies were to be assessed as a whole and the supply shares of affiliated companies added up. Within the context of the formal obligation the Bundeskartellamt intended to accept certain levels of excepted quantities for long-term supply contracts to allow the gas transmission companies some scope in drawing up their contracts. This was also meant to create scope for the companies' individual needs. The contracts were to be adjusted to the Bundeskartellamt criteria mentioned above within one year. For the gas year 2006/2007 a higher excepted quantity was granted which was to be considerably reduced in the following year.

However, the attempt to open up long-term gas supply contracts by consensus has failed, in particular due to the fact that the market leader, E.ON/Ruhrigas, was not prepared to sign the formal obligation required. The Bundeskartellamt will now tackle long-term gas supply contracts in prohibition proceedings.

