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DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
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ROUNDTABLE ON BARRIERS TO ENTRY

-- Note by Lithuania --

This note is submitted by the Lithuanian Delegation to the Competition Committee FOR DISCUSSION at its forthcoming meeting to be held on 19 and 20 October 2005.

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1. The Definition and Assessment of Entry Barriers

1. The Competition Council assigns to the term of barriers to entry a crucial role mostly in cases involving abuse of dominance and analysing the likely competitive effects of mergers. The concept of barriers to entry received the most thorough and explicit treatment in "Explanations of the Competition Council concerning definition of the dominant position"[1]. According to the Law on Competition of the Republic of Lithuania[2] a dominant position

> means the position of one or more undertakings in the relevant market directly facing no competition or enabling it to make unilateral decisive influence in such relevant market by effectively restricting competition. Unless proved otherwise, the undertaking with the market share of not less than 40% shall be considered to have a dominant position in the relevant market. Unless proved otherwise, each of a group of three or a smaller number of undertakings with the largest shares of the relevant market, jointly holding 70% or more of the relevant market shall be considered to enjoy a dominant position.

2. Although the law establishes that a firm having at least 40% market share will be presumed to hold a dominant position, however, the aforementioned Explanations explicitly state that presumption can be refuted by considering other relevant aspects. The most important among them is the distribution and stability of market shares and the likely changes in the market structure. The latter are determined mostly by the entry possibilities that depend on the barriers to entry. Therefore according to the Explanations

> when there is evidence that barriers to entry are low, then raised prices will encourage the entry of new market participants, and that means that potential competition will not allow exercising unilateral decisive influence on the relevant market.

3. The Competition Council views the barriers to entry as belonging to the three broad categories: absolute advantages, strategic advantages, and exclusionary behaviour. The first category encompasses factors that allow incumbents to enjoy privileged position created by the regulation limiting access to the market, e.g. licensing rules. On the other hand, an incumbent might derive an absolute cost advantage from owning an essential facility or important patents that allow an exclusive use of crucial technology. The second category includes factors that make entry strategy riskier. In this case sunk costs play a prominent role. The presence of substantial sunk costs makes the Competition Council think that the potential entrant will face a significant risk when deciding whether to enter and therefore the entry might be unlikely. The asymmetry of information concerning production costs might play a similar role. The first two categories consist of factors that might be taken as given by an incumbent, however the last category relates to incumbent's behaviour. One of the ways by to exclude other competitors is by using vertical restrains. An incumbent might be able to prevent the entry by foreclosing access to related markets. This could take a form of vertical restraints on distribution channels or vertical integration upstream.

4. From what has been said before, the conclusion can be made that the Competition Council thinks that any impediment that has the effect of reducing competition (preventing entry) constitutes an entry barrier. Therefore the Competition Council implicitly prefers the definition closer to the reasoning of Joe S. Bain[3] rather than George J. Stigler[4].

5. In our view for the purposes of enforcing competition law we should focus on the most important question of whether entry is likely in a case under investigation. Although it might be desirable to avoid all conceptual arguments about what constitutes the correct definition of entry barriers but it is hardly possible. As long as free entry is defined by the absence of barriers we will need to define an entry barrier.

6. So far the Competition Council has made only the qualitative assessment of the presence of entry barriers. Such an assessment used to be quite sufficient in cases when the most important barriers to entry were government regulation, e.g. licensing or import restrictions.

1.1 Duration and Nature of Entry Barriers

7. According to the mainstream economic theory excessive profits are eliminated in the long run in the absence of significant barriers to entry. Textbook distinction between the short run and the long run is typically based on the very possibility of entry and does not involve time dimension. Nevertheless, when trying to focus on the most important factors that could impede entry it is meaningful to assign a minimum amount of time that an impediment must persist before it should be recognised as an entry barrier. Such an assignment will be always arbitrary to some extent; however, a period of at least two years seems to be reasonable.

8. In our view the only difference the nature of entry barrier makes to the competition policy purposes is because of the need to choose the right policy instruments. When a barrier to entry is related to the deliberate behaviour of the incumbents then the preference should be given to antitrust law. On the other hand, when a barrier to entry is purely structural (*i.e.* related to the characteristics of the industry itself), then preference might be given to a sectoral regulation instead of antitrust law. A natural monopoly could be a good example of such a case.

1.2 Experience with Entry Barriers

9. The legacy of a recent transition period from the centrally planned to a market economy has influenced the experience of the Competition Council dealing with the types of market features that were considered to be entry barriers. Quite often we have to take into account such government regulation as licensing rules for certain economic activities and/or import restrictions. The following several cases serve as characteristic examples.

10. For example, on 17 December 1999, the Competition Council started investigation concerning actions of the local oil refinery *AB Mazeikiu nafta*. The product markets consisted of petrol and diesel fuels. The geographic market covered the entire territory of Lithuania and was defined as a national market. The two major factors that determined the geographical market definition were large costs that a firm had to pay for a license allowing to import oil products and 15% tariff imposed by the national government on imported oil products.

11. In the beginning of 1999 *AB Mazeikių nafta* concluded a petrol and diesel fuel sale-purchase agreements with the companies that were able to import oil products into Lithuania. The agreements contained a *no compete* clause, since the buyer explicitly agreed neither to import nor purchase imported oil products except in cases where *AB Mazeikių nafta* had no possibility to supply such products. In return the buyer was rewarded with the 6% quantity discount (rebate). *AB Mazeikiu nafta* had a goal to neutralize or at least to mitigate a threat that the other parties to the aforementioned agreements were able to pose. The Competition Council found this to be an attempt to create additional barriers to entry by the means of exclusionary behaviour.

12. The next case relates to what was earlier referred to as an entry barrier created by the ownership of essential facility. In 2000, the Competition Council received complaints from several Internet service providers (ISPs) that *AB Lietuvos telekomas* started to install filters that restricted available frequency of leased analogue lines. At that time *AB Lietuvos telekomas* had numerous lease agreements of analogue lines with independent operators that were using the leased lines mostly for data transmission services including the Internet access services. The filters substantially reduced available bandwidth and made the

lines unsuitable for high-speed data transmission. A local analogue line is easily converted into digital subscriber line by connecting DSL modems to its ends. Complaining ISPs used to upgrade leased analogue lines with the help of such technology. On the other hand, *AB Lietuvos telekomas* began to offer DSL lines by itself and had to compete with existing independent ISPs. The incumbent telecom operator being the owner of analogue lines enjoyed an absolute advantage and decided to avoid competition by degrading quality of a leased product. The Competition Council found this to be an attempt to abuse a dominant position.

13. The last example describes a merger case when the Competition Council had to assess the relative importance of different barriers to entry. In 2004 one of the largest local producers of strong alcoholic beverages and wines *AB Alita* applied for permission to acquire a local competitor *AB Anyksciu vynas*. At that time the industry of alcoholic beverages was shaped by the legacy of recently abolished state monopoly on production of strong alcoholic beverages. There were only four local producers in the market. The intended merger provoked hostile reaction from competitors and the Competition Council received complaints that the merged company will be able to bundle a large range of products and thereby will be able to create barriers to entry and/or expansion for other competitors. After the extensive consideration the Competition Council decided that the most important factors that were going to change the structure of the industry were the abolishment of state monopoly on production and the imminent liberalisation of trade after the EU enlargement on 1 May 2004. In other words, the incumbents were expected to lose an absolute advantage they used to enjoy. The events that followed confirmed the judgement of the Competition Council. In a year the general level of prices of strong alcoholic beverages significantly decreased (especially in the premium quality segment), the market share of the merged company also decreased, however, the total production of strong alcoholic beverages in Lithuania increased by 15%.

NOTES

1. Resolution No.52 of the Competition Council, 17 May 2000. (Official Gazette, 2000, No. 24-363.)

2. Article 3.11, Law on Competition, 23 March 1999, No VIII-1099, Vilnius. (As amended by 15 April 2004 No. IX-2126.)

3. Bain , Joe S. *Barriers to new competition*, Harvard University Press, 1956.

4. Stigler, George, J. *The organization of industry*, University of Chicago Press, 1968.