UCLA Law First Annual Institute on

US and EU Antitrust Aspects of

Mergers and Acquisitions

Antitrust Aspects of Barriers to Entry

by

John D. Culbertson
Vice-President
Glassman-Oliver Economic Consultants
Washington, D.C.

and

Roy Weinstein
President
Micronomics, Inc.
Los Angeles, CA

February 27 & 28, 2004

Ritz-Carlton Hotel
Marina del Rey
Los Angeles, CA

U.S. Federal Courts and the U.S. Antitrust Agencies (FTC and DOJ) have recognized that conduct is unlikely to create any competitive problem, and hence harm consumers, in markets where there are no barriers to entry. For example, the *U.S. Horizontal Merger Guidelines* state that "[a] merger is not likely to create or enhance market power or to facilitate its exercise, if entry into the market is so easy that market participants, after the merger, either collectively or unilaterally could not profitably maintain a price increase above premerger levels."

Many Federal Courts have reached this same conclusion. For example, in *Rebel Oil v. Atlantic Richfield Company*,[1] the court stated that "[t]o justify a finding that a defendant has the power to control prices, entry barriers must be significant – they must be capable of constraining the normal operation of the market to the extent that the problem is unlikely to be self-correcting." Thus, a finding that entry barriers are not significant represents a "trump card" in the economic analysis of market power; regardless of the precise delineation of relevant product and geographic market and the nature of the defendant's conduct, there cannot be any adverse impact on competition and no antitrust injury unless entry barriers are significant.

Because there cannot be a significant adverse impact on competition if entry is easy, plaintiffs will almost always allege the existence of barriers to entry. If the courts hold plaintiffs' proof of barriers to entry to a high standard, and reject alleged barriers that are inconsistent with economics or the factual record, barriers to entry can serve as a useful screen for identifying antitrust cases that potentially involve harm to competition and consumers. In this paper, we first review briefly the economics of barriers to entry. This sets the stage for our discussion of barriers to entry under the *Merger Guidelines* and in Federal Court decisions. We follow this with some conclusions regarding the proof of barriers to entry.

I. Economics of Barriers to Entry

The economics of barriers to entry can provide a basis for three important issues in the analysis of barriers to entry in antitrust cases: (1) how is a barrier to entry defined, (2) what are the barriers to entry that are generally accepted in economic literature, and (3) what does economic theory teach regarding the entry that would be expected in industries with and without barriers to entry?

The definition of barriers to entry usefully starts with the economic model of profits in the long run, which is a period of time long enough so that firms can adjust all aspects of their business, including investments in plant and equipment. If new entrants can enter a market with the same cost curves and facing the same prices as incumbents, then incumbents cannot persistently earn monopoly profits in the long run. To earn monopoly profits, the incumbent would have to have some economic advantage over potential entrants, since otherwise these profits would provide an incentive for firms to enter, and this entry would continue until prices fell enough so that firms expected to earn only a normal profit. This economic model is the basis for the following widely-accepted definition of barriers to entry: a barrier to entry is a cost that must be incurred by new entrants that incumbents do not or have not had to bear.[2]

Government regulations are a classic example of barriers to entry. If a single firm or group of competitors can convince the government to pass a law that raises the cost of entry to new entrants, or altogether prevents their entry, then this government regulation

---

[1] *Rebel Oil v. Atlantic Richfield Company*, 51 F.3d 1421.

will be a barrier to entry. The practices of trade associations that set standards to be adopted by (typically) local governments generally are scrutinized closely because of the concern that these standards will be set not to protect consumers, but rather to protect the profits of incumbents by erecting a barrier to entry. In recent years, the FTC has been involved in a number of matters where it has intervened in an attempt to strike down governmental barriers to entry.

Patents are often identified as a barrier to entry. The U.S. patent system grants to the patent holder a monopoly on the use of the patented invention for a period of 17 years. If firms cannot compete in the market without infringing the patent, then the patent would be a barrier to entry that would allow the patent holder to enjoy a lawful monopoly for the life of the patent. Of course, patented products may compete in a market with non-infringing substitutes (and products made with patented production processes may compete with other products made with non-infringing production processes), so valid patents are not necessarily barriers to entry into relevant product markets.

Bain (1956) was one of the first economists to analyze barriers to entry. Bain identified three aspects of firms and markets as barriers to entry: absolute cost advantage, economies of scale that require large capital expenditures, and product differentiation. If incumbents have an absolute cost advantage, then their costs will be lower than entrants' costs, and they may be able to earn above-normal profits in the long run without inducing entry.[3] Thus, absolute cost advantage meets the definition of a

---

[2] Our discussion of the economics of barriers to entry follows Dennis W. Carleton and Jeffrey M. Perloff, *Modern Industrial Organization*, Third Edition, 1999, pp. 76-82.

[3] It is not easy to determine whether economic profits are being earned; economic profits are different from accounting profits. In industries where incumbents have absolute cost advantages, incumbents

barrier to entry. Since Bain, economists have come to realize that economies of scale and product differentiation generally are not barriers to entry because entrants, like incumbents, can invest in efficient-sized plants and advertising to differentiate their products. The cost to enter, by itself, is not a barrier to entry, since firms generally have the financial capacity to make the necessary investments to enter industries in which they expect to earn normal or above-normal profits. Of course, if entry requires large sunk-cost investments, firms will enter only if they expect post-entry prices will be high enough to allow them to earn a normal return on their investments to enter.

Bain-type barriers to entry from economies of scale and product differentiation have generally proven to be poor predictors of entry. While Bain identified product differentiation as a barrier to entry, entry often has occurred in markets with highly differentiated products. In fact, product differentiation can facilitate entry. Entrants may be able to identify areas in product space that are not well served by incumbents, and enter with differentiated products that meet the demands of those customers. In addition, by entering with products that are some distance in product space from incumbents' products, entrants may experience less intense competition from incumbents. When Phillip Morris acquired Miller Brewing, some economists argued that competition in the beer market would be reduced because Phillip Morris' financial strength and expertise in advertising would raise the allegedly high product differentiation barriers to entry into brewing beer. In fact, after this acquisition many firms have entered the beer market by, *inter alia*, selling distinctive microbrew and imported beers.

---

may be earning only a normal economic profit after adjusting for the economic rents attributable to certain factors of production (but not reflected in accounting profits).

Cigarettes may be another example illustrating the failure of Bain-type alleged entry barriers to predict actual entry when prices are raised. Using Bain-type barriers to entry, cigarettes would be considered to have very high barriers to entry, primarily because of product differentiation and capital requirements barriers to entry (but also from scale economy and absolute cost barriers).[4] After the 1998 Master Settlement Agreement, the big four cigarette manufacturers raised prices significantly to make payments to the states. In response to this price increase, entrants have flooded the cigarette market to the point where numerous states are now considering or have adopted legislation to create barriers to the entry and expansion of new cigarette manufacturers.[5] Bain-type barriers to entry did not accurately predict the entry of new cigarette sellers after prices were raised, since very high barriers to entry predict that price increases would not induce entry.

A common mistake in antitrust cases is for the plaintiffs to identify as barriers to entry costs that all firms have to pay, or delays that all firms have to endure, to enter the market. To enter almost any market takes time, requires investments in equipment and buildings, and involves costs and delays for hiring specialized employees. If these costs are a barrier to entry, then virtually every market has barriers to entry, and the concept of barriers to entry is useless for the purpose of identifying markets in which anticompetitive conduct could cause long-term harm to competition and consumers. In the economic model of competition, entry eliminates monopoly profits only in the long run, not instantaneously and at zero cost.

---

4 See, Carleton and Perloff, p. 81.

5 See, for example, Jo Becker, "Upstarts Upset the Tobacco Cart," Washington Post, January 13, 2004. www.washingtonpost.com/wp-dyn/articles/A11231-2004Jan12.html.

One would expect to observe entry into markets with no barriers to entry if incumbents' current and expected economic profits are significantly above normal. Certainly, evidence of entry into any market tends to establish that there are no barriers to entry into that market. Conversely, if significant economic profits have been persistently earned in a market over a significant period of time without any entry, this is circumstantial evidence of the existence of a barrier to entry.[6] Thus, in markets in which monopoly profits are being earned, actual entry disproves the existence of barriers to entry and would be expected to drive prices and profits to normal levels, while the absence of entry reveals the existence of barriers to entry.

On the other hand, markets that are competitive with no barriers to entry may or may not experience entry. In the model of long-run competition, entry occurs in response to profit opportunities, so normal economic profits earned in competitive markets do not provide any inducement to enter. Thus, in markets with normal profits, it would be a mistake to infer the existence of barriers to entry from the absence of entry. However, many competitive markets do experience significant entry (and exit), even at competitive prices, because entrants who think they have better products or production process can freely enter. Thus, while the absence of entry in competitive markets does not prove the existence of entry barriers, actual entry generally establishes that there are no barriers to entry.

II. Barriers to Entry Under the Merger Guidelines and in Federal Courts

As described above in the introduction, both the Merger Guidelines of the Federal Antitrust Agencies and Federal Courts have recognized that if entry is easy, mergers or

[6] Of course, it is difficult to establish that anticipated, economically-meaningful profits are being earned, so the absence of entry could just reflect that expected profits are normal.

other alleged anticompetitive conduct cannot have an adverse impact on competition and consumers. In this section, we describe how the Federal Antitrust Agencies and some courts have analyzed the existence of barriers to entry.

The Horizontal Merger Guidelines describe the analytical framework and specific standards used by the FTC and DOJ to analyze barriers to entry. Specifically, the Guidelines suggest that market entry is easy (and therefore will prevent firms from profitably maintaining a price increase over premerger levels) if the entry would be "timely, likely, and sufficient in its magnitude, character, and scope." The Guidelines also explain that making these determinations can be aided by examining recent examples of entry into the relevant market, if any exist.

If potential entry requires too long a period of time to develop, it cannot discourage or neutralize a merger's effect on competition. The FTC and DOJ ordinarily consider timely "only those committed entry alternatives that can be achieved within two years from initial planning to significant market impact."

The likelihood of entry is based on whether premerger prices are profitable, and whether entrants can secure such prices. In addition, the agencies analyze whether the entrant is likely to realize minimum viable scale, the volume of sales at premerger prices that must be consistently reached for profitability. In assessing whether minimum viable scale can be achieved, the agencies will perform detailed analyses of factors likely to increase or decrease sales opportunities of potential entrants.

If entry into the market is assessed as both timely and likely, the final area of inquiry is whether entry will be sufficient to deter or counteract the competitive effects of concern. The agencies will analyze whether the entrant or entrants possess adequate resources to fully exploit available sales opportunities. In the face of a significant post-merger price increase, entering firms must be able to capture enough sales from incumbents to return prices to premerger levels.

Numerous courts also have determined whether there are barriers to entry. We will not attempt to summarize here all of these decisions, which may adopt somewhat different approaches to analyzing barriers to entry. Courts typically have found that where there is evidence of entry, barriers do not exist.

The Court of Appeals for the Ninth Circuit in *United States v. Syufy Enterprises*[7] addressed the issue of barriers to entry at great length. The Court described the general nature of the problem in antitrust cases as follows:

> Is this the type of situation where market forces are likely to cure the perceived problem within a reasonable period of time? Or, have barriers been erected to constrain the normal operation of the market, so that the problem is not likely to be self-correcting? In the latter situation, it might well be necessary for a court to correct the market imbalance; in the former, a court ought to exercise extreme caution because judicial intervention in a competitive situation can itself upset the balance of market forces, bringing about the very ills the antitrust laws were meant to prevent.[8]

Thus, the Court here recognized that if there are no barriers to entry, any reduction in competition will be transitory and cured by the entry of new competitors into the market. According to the Court, the showing of first-run films in Las Vegas was characterized by "a rough-and-tumble industry, marked by easy market access, fluid relationships with distributors, an ample and continuous supply of product, and a healthy and growing

[7] *United States v Syufy Enterprises*, 903 F.2d 659.
[8] *Syufy* at 663.

demand. It would be difficult to design a market less susceptible to monopolization."[9] The Court rejected the Justice Department's apparent claims that the cost to build a multiplex, that Las Vegas was "overscreened," and aggressive competition from Syufy were barriers to entry. The Court rejected the first two of these alleged barriers to entry based on the factual record, including the opening of three multiplexes by a new entrant and the third based on the legal proposition, with which economists would agree, that aggressive competition on the merits is procompetitive, not anticompetitive.

Barriers to entry also were examined in *Los Angeles Land Co. v. Brunswick*.[10] Citing Areeda and Hovenkamp's *Antitrust Law*, the Court defined entry barriers as "additional long-run costs that were not incurred by incumbent firms but must be incurred by new entrants," or "factors in the market that deter entry while permitting incumbent firms to earn monopoly returns."[11] The ruling also listed main sources of barriers: "(1) legal license; (2) control over an essential or superior resource; (3) entrenched buyer preferences for established brands or company reputations; and (4) capital market evaluations imposing higher capital costs on new entrants."[12] Los Angeles Land Co. proposed high financing costs as a barrier to entry, but the Court ruled that these costs affected all market participants, not just new entrants. Therefore, although Brunswick was the owner of the only bowling center in the area and thus had 100% market share, the company did not possess market power.

United States v. Waste Management, Inc.[13] is an earlier case involving waste collection in Dallas, Texas. The Second Circuit reversed a lower court ruling and found

---

[9] *Syufy* at 667.
[10] *Los Angeles Land Co. v. Brunswick*, 6 F.3d 1422.
[11] *Los Angeles Land Co.* at 1427-1428.
[12] *Los Angeles Land Co.* at 1428.

that Waste Management's 48.8 percent market share did not accurately reflect future market power because entry into the market was so easy. The Court went so far as to say that “any anti-competitive impact of the merger before us would be eliminated more quickly by such competition than by litigation.”[14] The Court described how starting a waste collection operation would be a fairly simple task, and that companies from neighboring vicinities like Fort Worth could send trucks to the Dallas area if profit opportunities arose. This case provides an example of how a lack of actual entrants into a market does not prove that barriers to entry exist; the Court noted that while there had been no frequent entry into the market, this “reflects only the existence of competitive, entry-forestalling prices.”[15]

In *Independent Ink v. Trident*,[16] the US District Court for the Central District of California granted summary judgment against Independent Ink’s antitrust claims in part because it presented no evidence of entry barriers in the relevant market. Independent Ink alleged that defendant’s license agreements, requiring the purchase of Trident ink for use in its printers, were illegal tying agreements. The record showed two other competitors had entered the market, demonstrating that obstacles deterring market entry “such as R&D and manufacturing costs, are not so great as to prevent competitors from entering the market.”[17]

Similarly, in *R.J. Reynolds Tobacco v. Philip Morris*,[18] the Court found evidence of entry to disprove that market power was present in the cigarette industry. The market

---

13 *United States v. Waste Management, Inc.*, 743 F.2d 976.
14 *WMI* at 983.
15 *WMI* at 983.
16 *Independent Ink v. Trident*, 210 F. Supp 2d 1155.
17 *Independent Ink* at 1167.
18 *R.J. Reynolds Tobacco v. Philip Morris,* 199 F. Supp 2d 362.

share of entrants increased from 0.6% in 1996 to 4.1% in 2001,[19] which the Court characterized as significant. This suggests that entry of as little as four percent of the market can be found sufficient; even the plaintiffs in this case acknowledge that a one percent share was substantial.[20]

Evidence of entry also proved the nonexistence of barriers in *Fieldturf v. Southwest Recreational Industries*.[21] This decision detailed how the plaintiffs themselves identified eleven competitors entering the market for filled turf in a two year span. As such, even if one assumed that the defendant controlled 90 percent of the market, "[e]ntry of new competitors proves the existence of a competitive market and an absence of barriers to entry"[22] Further, the Court confirmed that to be a barrier to entry, a cost must impact entrants more than incumbents when it stated, "experience requirements are not substantial barriers to entry as they apply to everyone equally."[23]

A final example in which the presence of a viable entrant precluded the determination of market power is *Tops Markets v. Quality Markets*.[24] As in other cases cited above, the defendant enjoyed a high market share, in this instance over 70 percent. In spite of this, the record showed that a competitor was able to open a food store and increase its market share to a respectable level in a short period of time. This successful entry "refutes any inference of the existence of monopoly power that might be drawn from Quality's market share."[25]

---

19 *R.J. Reynolds Tobacco v. Philip Morris* at 384.
20 *R.J. Reynolds Tobacco v. Philip Morris* at 384.
21 *Fieldturf v. Southwest Recreational Industries*, 235 F. Supp 2d 708.
22 *Fieldturf* at 724.
23 *Fieldturf* at 724.
24 *Tops Markets v. Quality Markets*, 142 F.3d 90.
25 *Tops Markets* at 99.

The U.S. Antitrust Agencies and the Courts appear to have adopted a somewhat similar approach to barriers to entry by focusing on the record evidence to determine whether entry will restore the competition allegedly lost due to the defendant's actions. However, in some cases the Government and the Courts clearly have reached different conclusions on this issue from the record evidence because, for example, several of the cases discussed above involved instances where the Government claimed the existence of significant barriers to entry, while the Courts rejected the claim based on the absence of barriers to entry. In particular, a number of courts have rejected barriers to entry hypothesized by plaintiffs' experts or counsel for plaintiffs when the case record reveals that there has been significant entry.

III. Conclusion

Many antitrust cases involve markets in which there cannot be any barriers to entry based on the record in the case. For example, entry is easy into many distribution and retail markets, and the record in these cases generally will contain useful examples of firms entering and exiting the market. In addition, even a cursory examination of the economics of these businesses will reveal that there are no barriers to entry. It will typically be clear from the facts in these cases that there is no barrier to entry, and the best that the plaintiff will be able to offer will be speculation about some hypothetical entry barrier. In these situations, plaintiffs will not have a reasonable basis for a concluding that there are barriers to entry, and hence cannot show any impact on competition or consumers. As the Judge in *Syufy* found, this should be the end of the game since the conclusion that there is no impact on competition depends only on the absence of barriers to entry, and is not contingent on market definition nor on the defendants' conduct.

It is remarkable how many cases are brought in which it is difficult to imagine how the plaintiff could ever show any reasonable evidence of barriers to entry. For example, the Indiana Grocery antitrust case was brought by several smaller food retailers in Indianapolis after Cub Foods ("Cub") entered the Indianapolis market with four large stores, and the leading chain incumbent, Kroger, cut some of its prices to meet the lower prices offered by Cub.[26] Because the claims in the case arose from the large-scale entry of a new seller in the market, it is difficult to imagine how the plaintiffs could ever prove that there were barriers to entry into this market. The trial judge found for the defendants on the antitrust claims, and in the years since this ruling Wal-Mart Supercenters, Kmart Super Centers, Trader Joe's, and Wild Oats also have entered into the Indianapolis food retailing market.[27] Clearly there were no barriers to entry either before or after Cub's entry, so Cub's entry and Kroger's competitive response could not have any adverse impact on competition.

Of course, some industries may not have a history of entry from which the court can find that there are no barriers to entry. This absence of entry can occur because there are barriers to entry, or because there has not been a sufficient economic incentive to enter. Here the plaintiffs must show that even if prices were anticompetitively raised in the market (above competitive levels), firms would not enter and restore the status quo ante. To ensure that antitrust cases involve harm to consumers and competition, not just

---

[26] *Indiana Grocery v. Super Valu Stores*, 864 F.2d 1409.

[27] *Grocery Distribution Analysis and Guide*, Metro Market Studies, 29th (1989) and 42nd (2002) Annual Editions.

harm to a competitor, plaintiffs' proof of barriers to entry should be based on sound economic science supported by solid factual evidence from the record.