

Contestability

Baumol defined **contestable markets**{xe "Contestable Markets"} as existing where “an entrant has access to all production techniques available to the incumbents, is not prohibited from wooing the incumbent’s customers, and entry decisions can be reversed without cost.”

The key idea is that even a monopoly may be forced to be efficient by **potential new entrants**{xe "new entrants"}. Such monopolies would give less cause for government intervention than those in less contestable markets. From a theoretical point of view it would then be wrong to base competition on market *structure* e.g. by having a policy that sought to undo all monopolies and return their industries to a state as close as possible to perfect competition. Even a single-firm industry *might*, to all intents and purposes, behave as if competitive, disciplined by the threat of **hit-and-run tactics** by potential new entrants.

In Baumol’s definition above, the **incumbent firm**{xe "Incumbent Firm"} is the one already in the market. The definition offers three conditions for contestability.

- Perfect information and the right to use the best available technology.
- Freedom to advertise and being legally free to enter the market.
- The absence of sunk costs.

Sunk Costs{xe "Sunk Costs"} are those which a firm incurs or would incur in setting up and running a business which are irrecoverable to the owners of the firm should it decide to leave that particular industry or go bankrupt.

If an industry is contestable then incumbent firms may be forced to act as if they are in competition and be satisfied with making only **normal profits** because of the threat of hit and run tactics. Any firm making supernormal profits would be opening up opportunities for new entrants to come into the market, undercut existing prices and take the profit for themselves. They could then leave the industry by recouping their original expenditures on the assumption of no sunk costs.

The suggestion is then that even if an incumbent firm has **market power** it may not exercise it if the market is contestable. There would then be no need for government regulation of the industry. Any competition policy based on, say, the **degree of concentration** in an industry would be misplaced. Thus, for example, in the UK the Office of Fair Trading considers the contestability of the market before deciding whether a firm is likely to be in a position to dominate. Further, if a market is not contestable then the optimal policy may be to remove those aspects creating exit costs rather than interfere in the incumbent’s activities more directly. Thus the splitting up of privatised utility companies into distribution (a regulated natural monopoly e.g.

Railtrack, BT, Transco) and sales (where a number of companies compete for customers by sharing the infrastructure.)

There may also be markets where there are a number of firms that find **cartel like behaviour** possible because of the absence of contestability. Relatively low concentration ratios may still be associated with uncompetitive practices and require regulation.

One way of thinking of the various regulatory bodies set up by the government after the privatisation of the utility companies is that they act as a **surrogate for competition**, i.e. their rationale is to make up for missing contestability. Thus any utility company making supernormal profits is likely to have its prices capped by the regulator – as if new firms had been attracted into the market.

Evaluating the Theory of Contestable Markets

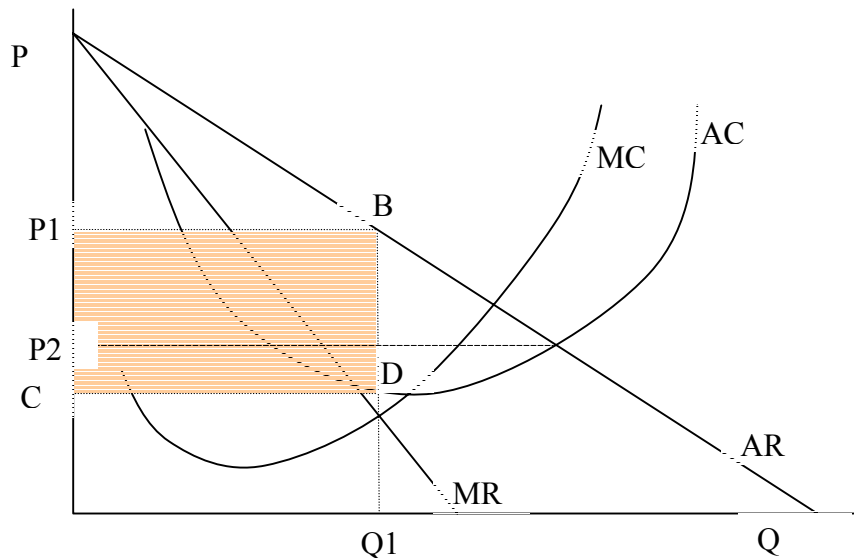
The theory of contestable markets can be criticised along a number of lines:

- Clearly, no market is **perfectly contestable**, i.e. has *zero* sunk costs. The theory acts as a reference point, the relevant question is the *degree* of contestability.
- To test the theory (i.e. that the absence of sunk costs restrains the activities of incumbent monopolists) would require a great deal of information about the cost structure of the incumbent. This is not usually available. The trouble is that the idea centres around the *threat* of new entry, not necessarily new entry itself. The absence of new competition in an industry over a period of time does not contribute evidence of lack of contestability.
- There is some controversy about whether the threat of hit and run competition is sufficient to make incumbent firms go weak at the knees. Why not carry on making supernormal profits anyway until the hit and run occurs, and then, if necessary, use these as reserves with which to teach the impertinent new entrant a lesson – e.g. by reducing prices below costs for a while.

Sometimes structural changes in an industry occur that point towards the importance of sunk costs in determining conduct and performance. A classic example is retail banking where the internet has sharply reduced (though by no means eliminated) barriers to entry. It is possible to see the appearance (and disappearance!) of a number of internet banks as a sign of increased contestability in banking. Surviving online banks such as Egg – profitable for the first time in 2001 having been set up by the Prudential in 1998 – offer much higher interest rates to customers than the previous incumbents. However, Egg's survival is also down to a considerable branding exercise, the marketing of which certainly constitutes a sunk cost. The suspicion might be that Egg's success is not so much due to contestability as the changing nature of business in the networked world.

Diagram for a discussion of Contestable Markets

Suppose that a firm enjoys a monopoly position in a perfectly contestable market. If the firm produces at output Q_1 and price P_1 in order to make supernormal profits of P_1BCD in the diagram below then new entrants will be attracted in.



Because of costless entry and exit new firms will arrive and take away the incumbent firm's market share unless price is reduced to where the firm is making only normal profit, i.e. at price P_2 . In terms of the objectives of firms, contestability may force the incumbent away from profit maximising to a sales maximising strategy more in line with the interests of consumers.

This is the ideal case. More generally, the degree of contestability should determine the extent of the price reduction.

Checklist for Dealing with Examples in Data Response Questions

If you are asked to assess the level of contestability in a particular market it may be useful to have a checklist to hand. The following list is by no means comprehensive, but it is a good starting point for analysis:

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| Technological change | A new entrant may find they have committed themselves to capital expenditure based on obsolete technology. This is particularly acute in highly capital intensive industries (e.g. electricity generation) or where technology changes very fast (e.g. internet based businesses) |
| Natural monopoly aspects | Some industries have very high levels of non- |

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| | <p>recoupable and non-relocatable infrastructure expenditure (e.g. the sunk costs of gas pipelines.) Notice that high levels of capital expenditure are not in themselves proof of low contestability: for example airplanes can be flown to their next owner.</p> |
| High levels of advertising expenditure and branding | <p>If the market is characterised by very strong brands (e.g. soap powders) then any new entrant would have to spend heavily on marketing their new product. If the product fails such expenditure cannot be clawed back. This would include advertising and the design of packaging.</p> |
| Limit pricing | <p>If incumbent firms establish a reputation for limit pricing then potential new entrants may feel that they are guaranteed losses should they risk entering the industry.</p> |
| Information asymmetry | <p>The traditional theory of the firm tends to assume that there is symmetrical information available to both potential new entrants and to incumbents. However there may in reality be an imbalance or ‘asymmetry’ here. This is an “invisible” barrier to entry: if the incumbent has better information about the way the industry works than the potential new entrant it will take expensive time for new entrants to acquire this ‘know-how’.</p> |
| Possession of exclusive rights to raw materials or distribution facilities. | <p>The potential new entrant will find it difficult to acquire the raw materials necessary to begin producing (backward vertical constraints). An ice-cream maker may be unable to get going if the incumbents have successfully tied newsagents fridges or ice cream vans (forward vertical constraints).</p> |

Questions To Consider

Is the theory of contestability a better reference point than the theory of perfect competition in discussions of competition policy?

Does the theory of contestability justify the deregulation of the bus industry in the UK?