



# Contestable markets


EE 382

# Theory of contestable market

- Developed in the late 1970s and early 1980s by William Baumol
- What Baumol argued was that it was unnecessary for the market to be in perfect competition in order to produce economically efficient market behavior, **what really mattered was whether the market was contestable or not**
- Example
  - American domestic airlines
  - Low cost airlines

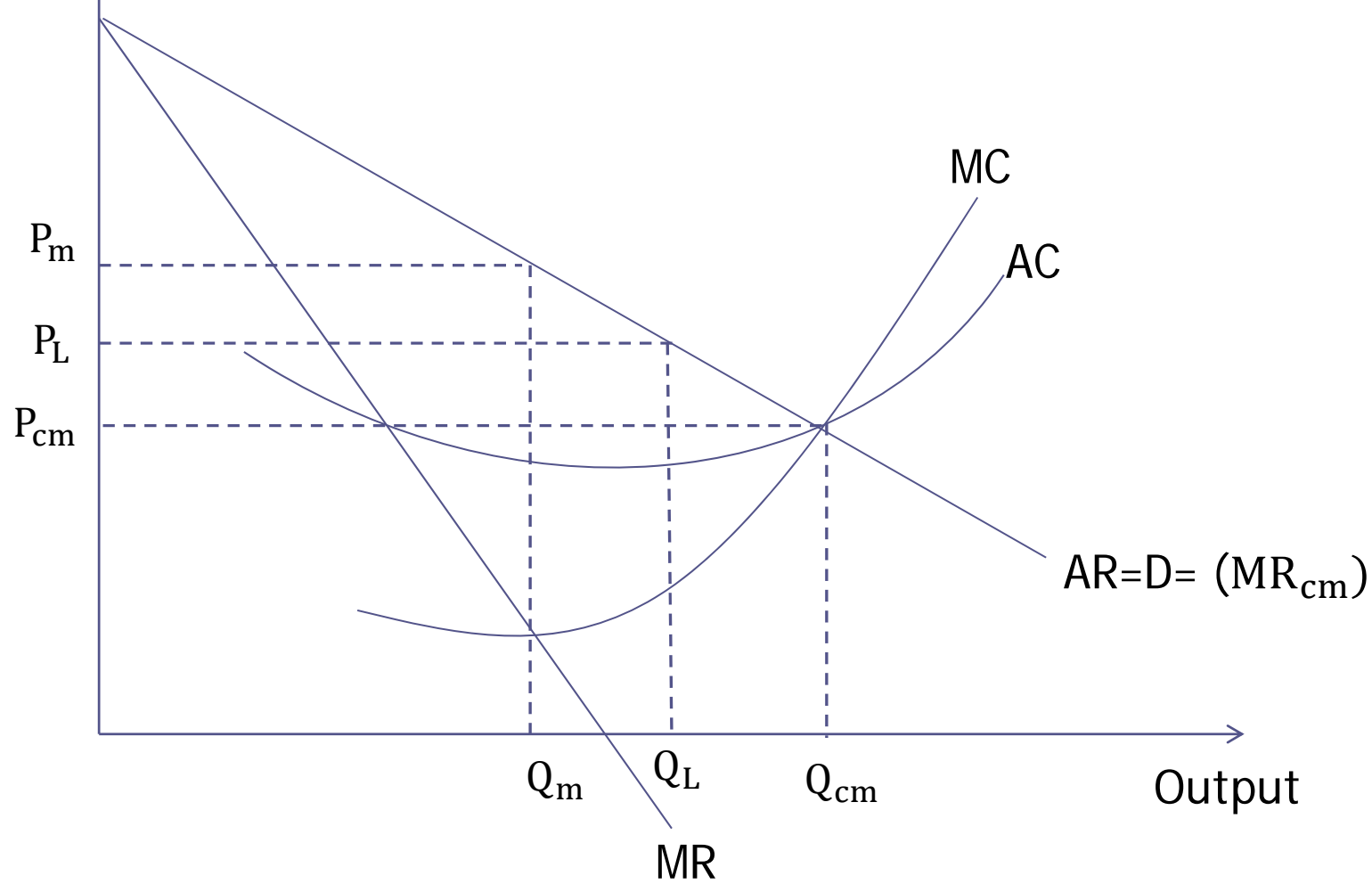
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- If a new entrant could enter the market and compete with the incumbent, then the threat of this potential competition would force the incumbent to act as if under a perfect (or near perfect) market competition
  - Rather than pursue super-normal profits therefore, the firm would only seek to achieve normal profits in order to deter market entry
  - Competitive pressures would thus be supplied by the constant threat of entry that force the firm to behave as if it was in a competitive market and hence at in an economically efficient manner


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- A perfect contestable market is said to exist where entry to the market is free and exit is costless, hence no financial barriers to entry exist
  - The basic premise is not that the monopolist would lose market share to a new entry but rather that the monopolist would lose the whole market to a new entrant - the market cannot support two firms; thus if truly contestable the threat is that a new entrant would take the whole market from the existing operator

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- Where strategic barriers exist, when this does not act as a clear barrier to the contestable market
    - The branding of airline services would make it far more difficult for a new entrant to gain customers from an established firm, and hence the incumbent's position would be far more secure and the contestability of the market significantly reduced

Costs and  
revenues

# Pricing and output levels in the contestable market






If all of the assumptions of the contestable market fully apply to the monopolist then the firm will not pursue a strategy that profit maximizes at output level  $Q_m$  with the associated market price of  $P_m$

Rather it will act like the perfectly competitive firm and set the output level at  $Q_{cm}$  with the associated price of  $P_{cm}$

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If entry and exit barriers are relatively high, then the contestability of the market is severely compromised and the firm's output level will tend towards the monopolist position of  $Q_M$


## The **most important feature** of a contestable market


- No barriers to entry and especially no sunk costs
  - Always a real threat that new producers will enter the industry to capture any abnormal profit that is being earned by charging lower price
  - **The threat of hit-and-run competition** - producers enter the market, set their price lower than the existing producers, capture the available abnormal profit, and then exit the industry



## The threat of hit-and-run competition

- If the full assumption of contestability are met, then with a zero entry and exit cost firms can enter the market and cream off abnormal profits while they are available and then exit the industry when market conditions tighten up and eradicate such profits

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- This is because if incumbent firms restrict market capacity in order to maintain prices at a level that produces abnormal profits, new firms can easily enter the industry in pursuit of the profits being made
  - Following entry, established firms will be forced to protect market positions by lowering prices and driving new firms out (at a zero exit cost to the existing firm) to re-establish their former market dominance
  - Related to hit and run entry, contestable markets are said to suffer from cherry-picking


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- They will have to be productively efficient so that they can compete with any potential entrants
  - They will **charge competitive prices** and **restrict earnings to normal profit** in order to avoid attracting hit-and-run competition
  - The **difference** between a contestable market and a perfectly competitive market is that it does not matter how many producers are actually there in a contestable market
    - The threat of entry by new producers that disciplines them all to behave in a competitive manner rather than the existence of actual competitors within the market

## Three other factors that are necessary for a market to be contestable

- Any entrants must have access to the **same technology** as existing producers
- Existing producers **do not have large reserves to finance** that they can use to reduce their prices instantly to a level below that charged by entrants in a price war
- There is **a low degree of brand loyalty** and so consumers respond instantly to any price difference by moving their purchases to the producer with the lowest price

# Contestability and the airline sector

- Control over landing slots is becoming less of an issue for a number of reasons
  - Landing slots have become available with the demise of certain airlines
  - A growth in the use of less congested regional airports which represents competition to the major hub airports such as Heathrow
- The internet has provided an important source of detail to potential passengers in terms of flights, prices, etc which was previously only in the domain of travel agents

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- The frequent flyer initiative, which was a mechanism used by airlines to tie passengers into using their services, is now less of a benefit to passengers than it has been in the past because the savings to be made on the low cost fares in many cases more than offsets the free air miles
  - The growth in low cost carriers



# Reference

- Mallard G., and Glaister S. (2008). Transport Economics: Theory, Application and Policy. Palgrave Macmillan.
- Cowie J. (2010). The Economics of Transport. Routledge.