

Cartel stability and price fixing in reality

Cartels self distrust

Eventually a cartel will self-distruct as cartel members try to do better than the cartel outcome..it may take a week or a year or more but eventually it will become unstable..a whistleblower could be incentivised to unscramble any cartel arrangement.

Indeed the EU Commission relies on whistle-blowers..check the recent fine on chemical companies and the role of a whistleblower. A key thing from non cooperative game theory is that eventually one player will deviate from a win:win outcome in the search for an elusive higher payoff. Once all players follow the win:win outcome becomes unstable and the cartel breaks up.

Is the real issue not that consumers are increasingly prepared to pay a price almost immune to how the price was arrived at but that once the price goes above a personal threshold the random consumer simply does not purchase the product.

do consumers worry more about 'fixed' prices or that prices are 'too high'..some consumers are not as price sensitive as others..would you agree??

This cartel self-destruction process brings a question to mind: To what extent should competition authorities spend resources investigating cartels if they will eventually self-destruct?

On another note, as Paddy suggests, whistleblowing could be incentivised using, for example, leniency schemes in order to shorten cartel life and to reduce the cost incurred by competition authorities.

Elasticity

Just ensuring I am on the right track.

A price is elastic when the elasticity is greater than 1 or it could be said that price is low and the demand is high and the reverse for an inelastic price/product.

Mike

Jamaica

Keep to Angela's interpretation...recall from Workshops that elasticity is all about the sensitivity of quantity [sales] to price. For example, discussions on web CT and forums is highly elastic to the timing of exams!
good luck guys ...you are on the right track
paddy

Thank you Angela

Hi Mike,

It is the "Demand for a good/service" that is said to be relatively elastic if the price elasticity of demand (PED) > 1 and it is relatively inelastic if PED < 1 .

For example if price decreases by 10% and this results in quantity demanded increasing by 20%, then PED = 2 (i.e. the demand is highly responsive to the change in price (relatively elastic)). Demand on the otherhand would be relatively inelastic (weakly responsive to changes in price) where a price decrease by 10% only results in quantity demand increasing by 5%.

The same applies for price increases - so if a 10% price increase does not result in anything greater than a corresponding 10% reduction of demand then this demand is relatively inelastic to the price increase. This scenario would apply for example to "necessity" goods and where no/few substitutes exist.

So, it's not really about low price/high demand and high price/ low demand relationships as you suggest, but more about the relative effect of % changes in price affecting % changes in demand...

Note also that a good/service can have relatively inelastic demand up to a certain price, above which demand may then become elastic.

Check out "Price elasticity of demand" in Wikipedia for a good intro to all this and for more detail/examples....

Cheers,
Angela

O. Williamson and Behavioral model cases

Dear Prof.

Low cost airlines are fine, but are they related to Williamson and behavioral models?

Thanks

In July 2007 semester you are being asked to consider the revenue maximising model in terms of retailing...everyday low prices..maybe generic [as opposed to branded] pharma drugs and maybe pre-paid mobile phone cards...think in general on how pricing is used to support revenue drivers.

Are petrol companies and mobile phone operators also adopting the revenue-maximising model with their price competitions?

Oh yes...look at Nokia pricing in emerging markets [high elasticities and low prices] and the N series smart phones in EU ...higher prices with low elasticities...and mobile tariffs pricing per second or per minute and the ARPU are all great examples of Baumol pricing...tell us more how you also think petrol companies price. Paddy

Low cost airlines [LCAs] use prices to max revenue or yields..this is classic Baumol model..and like a Baumol model they usually are exposed to high fixed costs..and management can minimise these costs...but max revenue per seat or per customer is the modus operandi of LCAs.

Petrol prices are mostly the same, so petrol companies offer discounts, speedpass payment system, loyalty card points, tie-ups with credit card companies, etc. to retain and attract more customers = trying to maximise revenue? So ultimately Baumol pricing is trying to grow market share?

The various theories and models are all concerned with profits, revenue, growth, etc., but none of them seems to consider cashflow. Liquidity is critical for a company's survival and a sale is not complete until the cash is collected...fast.

Remember that profits can be viewed as NPV inc cash-flow and also in theory economic profits include opportunity costs. A projected cash flow may be discounted in the overall costings anyway
patrick

Credit card companies have also been using pricing to maximise revenue/market share. E.g. waiving the annual fee if cardmembers accumulate a certain number of transactions on their cards during a period e.g. every three months. This attracts more people to apply for the cards and charge to their cards, thereby increasing market share and revenue for the credit card companies. Another way of pricing is the tiered interest rate i.e. lower interest rate on rollover credit for creditworthy cardmembers. This helps cardmembers save on interest charges and similarly attracts more people to apply for the cards and so on.

Principal Agent Problem

Professor:

The principal agent problem highlights the conflict between management and shareholders - that is that they each have conflicting interests. Can one assume that with the advent of profit sharing schemes and senior management being rewarded with shares that the separation of ownership and control is being reduced. Working with the Williamson model that the overriding goal for managers is to for optimum managerial welfare, could the rewards highlighted previously lead to a firm operating in a neo classical approach as it is in the interests of those running the organization?

Thanks,
Alex

Separation of ownership and control may still exist but with profit-sharing and incentives all employees have a greater sense of 'ownership' in the final product or service. And don't forget that many employees and customers are likely to be shareholders. The approach suggested can fit into the neo-classical model if we assume that consumers and investors and consumers and employees are not mutually exclusive.

Revenue maximiser (RM) vs Profit Maximiser (PM)

Hi All,
Belated happy new year and good luck in this term[:)]

The profit and revenue as a function of quantity have bell shape curves with $q(RM) > q(PM)$.

As decision makers for both firms are likely to be risk-averse, $q(RM)_{actual}$ would be less than $q(RM)$ leading to higher profit for the Revenue maximiser, and $q(PM)_{actual}$ would be less than $q(PM)$ leading to lower profit for the Profit maximiser.

Can we interpret anything here considering the bell shape of the profit curve? can we say that profit for both firms might coincide or come close?

Cheers

Samer

MBS - Jan 07 intake

Following Samer's point, consider that profit is maximised in economics at a point when a MC curve = a MR curve. check it out in the Unit. This happening in a real world scenario is unlikely as the management could over-shoot the point..so the link between the revenue and profit geometric shapes has scope for a real application...management should think of MC=MR [profit maximisation] as different from maximum profit [revenue exceeds costs]. Note that MC =MR [as slopes of lines, slope of TC and slope of TR] even with a loss..draw a diagram and convince yourself that this can happen!

There is a wide belief that firms try to maximise their profits, but with the associated uncertainties, they cannot locate the point where $MC=MR$, hence they try to maximise sales in anticipation for larger profits.

While the text assumes MR a straight horizontal line, it has a slope in actuality. Maximising revenues means trying to set $MR=0$, again with the uncertainties associated with the location of MC and demand curves, firms might end up setting the price lower than MC.

How do you think a firm would recognise that? and how would it react then?

Game theory for management

Game theory....PD

hi Paddy

we had an upset in our recent general election, the ruling coalition party failed to secure 2/3 majority. i have been thinking if what the politicians have done reflect PD in game theory.....

the politicians apparently have reclassified certain constituencies to manage opposition votes, banking on the majority ethnic group's votes to secure the 2/3. the results showed that the politicians' strategy failed.

does this reflect PD? the politicians in trying to do better i.e. reclassification of areas/constituencies to manage votes, they ended doing worse - they did not expect the majority group wld swing against them. Prisoners Dilemma?

It could be..I would need to know more about the time line of actions..but 'trying to do better' but actually ending up worse off is a key informant of PD.

let me know some signals.

paddy

In a game?

A company is a player in a game when it realises that there is interdependence between itself and other competitors in the market.

Whatever my price, it is relative to the price of a competitor. Consumers on average buy more when prices fall. If consumers look for a price difference, then they may buy my competitor's product because it is cheaper in relative terms to my own price. So my sales fall off due to the pricing of a competitor..we have interdependence. As the number of players decrease to 2 or 3 - for example, Intel v AMD; SAP v Oracle - each company as a player are acutely aware of the interdependence between them: a market share gain = market share loss.

If they switch to the higher priced good..still one company's gain is another loss in sales.

patrick

Consider the number of players in the game to be small, all players find ways to reduce their costs and hence thier price. If the products of one of the players is priced below the others and it is perceived as an inferior good, will not the consumers switch to the products with the relatively higher price? Would'nt this violate the zero sum assumption?

Power

Player v Signal

Hi

Richard Branson of Virgin announced a propose takeover of Northern Rock (a UK bank under financial stress due to subprime credit crunch). Is Virgin a de novo and is this a signal to the current incumbents?

AJ

excellent observation here although it may simply be a 'hit and run' entry plan..but has some characterisitcs of a de novo.

patrick

price as signals

One key point is the importance of price as a signal to other competitors particularly if they mis-read or mis-judge the signal as a threat to an existing price and thus precipitating a price war!

Incumbent may reduce price to dissuade a potential entrant but the entrant 'calls the bluff' of the incumbent, enters the market at a lower price and a price war begins.

Not only are prices signals but also capacity can be singalled to the market in terms of production delays or capacity constraints. The key is for one player to belief the other player so that no action is taken or action taken is conditional on information about the likely response from the competitor.

Could'nt price and capaity be used to send mix signals? Would this strickly be an "move" in the game or are there any ethical issues with this?

Dear Prof. Why do you think the reason behind an incumbent in a mature market (rather than a new entrant)starting a price war?

Sure we are talking about few number of firms in the market.

thanks, Mohamad

yes indeed both price and capacity are used as signals...aviation/airlines are a good rich source of observations

paddy

Prisoners Dilema

If in a market there are two firms say X and Y. The two firms decide or agree to maintain the immediate environment by maintaining sidewalks and all green areas. However, firm Y do not want to pay their part of the maintenance fee but they want to benefit from the fresh gardening and clean surroundings. Firm X is now frustrated and decides to also hold on their contribution to this corporate citizenship. X and Y is now in what is called a "Prisoners Dilema" because neither of them is willing to spend and the benefits is zero.

Mike

Hope exams were ok! Exams pass but game theory will always be here. Keep visiting the web page in 2008 for updates and briefing notes
patrick

Yes Mike and if both X and Y opt not to keep the 'green' area then weeds will grown etc and both are worse off. What you also describe for Y is a variant of the free rider or shirker which is unstable in a 2person situation as you describe it..
paddy

Thank you - I feel better for my exam tomorrow.

This was a very interesting course

Importance of dividends as signals to investors

Financial stocks are dividend play for 2008!

Look at the financials from RBS in UK to Bank of Ireland or BBVA...all good investments in current climate...a dividend play for your 2008 portfolio until risky debt is cleansed from the system.

patrick

Not all doom and gloom! Good p/e ratios amongst the EU stocks esp some of the banking stocks like Bank of Ireland or indeed RBS or BBVA. Not all US companies are bad investments..select those with overseas non-\$\$ earnings then check the dividend yields [average US yield about 2%) and call your broker...McDonalds, Pfizer, P&G are reasonably priced.

Pay dividends

Note that companies like Dell and Microsoft are paying dividends..is this to support the share price in a falling share price regime?

This topic on the role of dividends is being retained for the July 2007 semester and client participation...please look at old posts and today note the increasing number of dividends and returning cash to shareholders

more dividend play stocks in Vodafone, Diageo, Texas Instruments, McDonalds..keep watching and if your div yield exceeds the interest rate it is worth a punt investing in dividend play stocks at the moment. Good benchmark is a yield 5-7%. Follow the Fed and the UK MPC and EU as rates begin to move...watch this space ..but my advice is to invest in div play companies as long as the yield exceeds the interest rates, Some EU banks, Irish banks, have a div yield higher than the deposit rate!

patrick

Traditionally if an investor is guaranteed of appreciation of his stock holding, he would not be too bothered (be indifferent) if dividends are not declared.

However, if there is an expectation that the share price may not rise much further, or worse still, deteriorate, then giving the investor some dividend ensures his interest is maintained in the stock. Otherwise, he begins to seek for greener pastures, where his expectations could be met.

Microsoft and Dell may have sensed their investors are likely to get a bit disloyal and begin dumping their shares if there is no sweetener in sight.

Importance of Understanding Production Costs

Cost Structure: Short Run

Hi,

With reference to the SG2, Figure 1, it is observed that both MPL and APL increase and decrease in the same direction. I am not quite understand why the MPL decreases faster than APL. Both MPL and APL max is at different point. Could you pls explain with reference to some example?

Appreciate a lot. Thanks.

rgds,
CS

rgds,
CS

CS...are you an engineer? Or next time you enter an elevator look carefully at the safety notice on the number of passengers [every extra passenger is a marginal passenger] or the total weight the Total Product ..now ever been in an elevator when the safety noise sounds and somebody [the marginal person] has to get off until the average weight [AP] falls???.once AP =MP the elevator ascends safely! The geometry of the costs is an engineering necessity. Check it out..look at the notice on elevators..it is the law of productivity in action. patrick.

Hi Paddy,
Spot on. I am an engineer. [:)]
Thanks a lot for the pointer.

rgds,
CS

Ok..we are all mathematicians...see you at the Workshops..the unique minimum point that is MES cannot really be established empirically without limit theory..think of management as converging towards an ideal cost.
paddy

Costs, Demand and Prices

Hi all...the objective of Unit 2 is to understand Cost Leadership..check out the boxed paragraphs in Unit 2 Study Guide. However we need to also understand the link between demand and costs and prices.....Would it be fair for a store to increase its prices under various circumstances. So let's elicit your responses from an economics perspective. I am calling this the Umbrella Dilemma...we ignore where you are living and working but here in Ireland where I am the umbrella is essential!!

Dilemma: Scenario A: there is a heavy few days of rainfall and the local shops increase the price of umbrellas.

Scenario B: Alternatively, there is no rain and plenty of sunshine and umbrellas are on the shelves of the shops. However the cost of manufacturing umbrellas has increased and the shop-owners decide to increase the price of the umbrellas on their shelves.

I want you all to rank these two scenarios! Of the two scenarios A or B which is the more acceptable to you and why?

This is not a trick question but an attempt to understand the interplay between costs, prices and demand in explaining different scenarios. Paddy

Is Scenario A a case of expecting an increase in demand, hence the shops increase the price, which will bring the price and output back to equilibrium?

Scenario B is a case of excess supply. Won't increasing the price increase the surplus further?

The shop in Scenario B will appear to the consumer as having to clear stocks. The consumer will therefore expect it to reduce prices, not increase them. Covering the costs of manufacturing is not acceptable to the consumer as a reason to increase price in such a scenario.

I will opt for A.

Indeed Scenario B is a preferred option mainly due to your reasons preferred and the ethics of price gouging.
patrick

In my opinion, scenario B (sunny days, manufacturing costs increase and as a result shop owner increases prices) is preferable. I find it acceptable for a shop owner to want to make a fair profit, and as a shop owner (not manufacturer), I cannot assume the shop owner is being inefficient (actually, in this case, nor can I assume that the manufacturer is inefficiently producing umbrellas...eg., costs could be increasing b/c of wage rate increases in the developing country in which they are produced - not necessarily due to inefficiencies, but due to socio-economic development and improvements in standards of living).

Scenario A is price gauging. And re: "controlling supply," I don't see the relevance for the shop owner, as his/her objective is likely to maximize turnover, not maximize stock on shelves, and competitors have just as much to do with market supply, so one shop owner could never "control" supply for a common product like an umbrella.

interesting argument but in general most consumers do not like to be exploited on price increases simply because the firm can jsut do it.paddy

hi Paddy
let me try....

scenario A is driven by demand for umbrellas given the rainy weather. shops increase prices in an attempt to "control" supply.
scenario B is driven by internal costs, hence owners want to pass the increase costs to the consumers.

scenario A is more acceptable to me becous i refuse to pay for the owners' costs inefficiencies in scenario B. the owners could try cost management measures (JIT, kaizen etc). scenario A is (somewhat) acceptable given that there is a demand. lack of supply, prices go up. consumers expect that.

Hi Lesley...Scenario A is often called 'price gouging' and has negative connotations...ironically consumers in a recent survey voted for B...but ultimately it depends on your income and your demand for the product..and a you say..consumers expect A!
paddy

Importance of labour incentives and productivity

One way to reduce per unit costs is to increase labour productivity and one way to do that is to offer the employee an incentive..either a reward as payroll increase or a 'duvet day' off work as a reflection of a job well done.

What about investments in technology to improve productivity? Unless such expenditures are capitalised, won't they add to per unit costs?

The key to understanding per unit costs is to distinguish between the contribution of both AFC and AVC to average per unit costs and the extent to which investment costs are discounted or capitalised as you suggest..real world v textbook.

I agree..actually for engineers in a factory or plant a key economic issue is keeping plant at 95% capacity not 100% capacity so as to allow for an embodiment of slack or x-inefficiency, machine maintenance and seasonal demand..paddy

when looking for a company that can be used as a sales maximization model, would the general profile be one that is low-cost that focuses on standardization?

Increasing labour productivity can also be achieved by reducing labour inefficiency. E.g. minimising the over-lapping period between two production shifts. Where the over-lapping period is too long, the second shift has started but the workers wait around to use the machines that the first shift is still operating.

Susan..if you mean by standardisation as an a method to control costs in the vertical supply chain all the way to the point of sale..yes I would agree with you
paddy

Hi Paddy,
are you saying that by incentivised labour this will lead high performance hence increase productivity?

AJ

yes incentivised workers and management do perform better..more effort, less quality defects inter alia..all contributing to lower per unit costs.
patrick

X-inefficient , production costs

Hi Paddy

If a firm eradicate its x-inefficiencies and lower its LAC hence can afford to reduce price. If this price reduction threatening other rivals existence in the competition. Why is Anti-trust law against a firm that is efficiently run?

antitrust is not against a firm that is efficient..in fact there is now an efficiency defence available to firms in EU law..see my book on Law, Economics and Antitrust published in 2005/2006..info on my web page about the book,
patrick

Relevance of management models

About the Baumol Dynamic Model

Hi, Dear All, here I have some problems in understanding the meaning of the 3 curves demonstrated in the Figure 4.4 as Baumol's dynamic sales revenue-maximization model (Textbook Page 66)

Is there any body who can tell the exact meaning of these three curves regarding as Figure 4.4 (a), (b) & (c)? I know it is trying to illustrate us about the trade-offs between "Growth" and "Sales Revenue", only I just don't understand how come are the curves looking like these, especially the (b), why the curve are sloping down like this? and why the sloping down is in a "linear" way not some sort of "U" curve like others?

Unfortunately I can't find the exact answer in the textbook nor internet, so, here comes to you guys~~hope the question is not so Nuts since nobody are asking about it,haha~Or is it completely nothing to do with ME Assignment??

Please, somebody help to understand these 3 curves~~ Many Thanks!!

Waiting for kind responses!

Michael

Michael

The books iso-present line at page 66 is explained better by my iso-profit line as a NPV [net present value] and this is linear for a given discount rate,,the answer is found at the bottom of page 30 in the Workbook at the back on Unit 1..where 'i' is assumed fixed and the answer is the last lines on page 31.paddy

Dear Paddy, Thanks for your kindly reply~ but for the curve I mentioned previous, what I really mean is so called "iso-present value curve", which according to the textbook, was about the trade-off between growth and revenue~as it is an important part of Dynamic Model, so I think it might be important for me to really understand it and further understand dynamic model before I make the comparison with static model in assignment.

I searched in the textbook and internet, but I can not find an appropriate explanation of this iso-present value curve, so now what I can tell is only how the curve looks like according to the textbook, but I don't know why the curve is looking like this~(eg. why is the curve sloping down in such a linear way from left to right, while Y axis means "growth", X axis means "Revenue"?)

Michael...first do not focus on this in your assignment...the nuance will be explained in w/shops...simply a linear TR curve arises when prices are fixed...try it...with 2 columns, $q = 1, 2, 3, 4, 5$ and let $p = 2, 2, 2, 2, 2$ and $TR = 2, 4, 6, 8, 10$once you deviate from a fixed or constant price the TR becomes a curve as it is in the real world..! Adieu..patrick

Baumol and price elasticity

When Baumol firm faces an inelastic demand curve, will it continue to cut the price and increase the market share? It will result in a loss not only in SR but in LR as well. Am I on the right track?

Baumol pricing is guided by elastic price demand...because it is traditionally a monopoly type firm it is going to reduce price and always when demand is elastic
paddy

Baumol Model

Hi all

It is mentioned by Patrick that the low cost airlines is a typical Baumol model that tries to Max yields from customers using price. What does this mean and where can I read more on this?

Thanks
omoon

My understanding is that when the market is stable, both the profit maximising firm and the Baumol firm will report stable profits. The difference is actually seen when the market is either buoyant or depressed. Could someone help clarify this?

Hi Olajide,

The point $MR=MC$ relates to profit maximisation (See unit 1, pgs 14, 17) rather than the Baumol model. I find it simpler to relate the Baumol model firm to maximising TR (which translates to SRM).

Thus, $TR > TC$ is applicable to both models (Profit-maximising & Baumol) but the distinguishing factor would be the extent of profit i.e. diff between TR & TC. (Mark & Cook, pg 64, fig 4.2).

I believe Baumol firm aim is to achieve greater output with minimum profit. Therefore, they are still interested in $MR > MC$ but not so much to affect output level (quantity)

Hi all, are firms in the Baumol model actually interested in $MR > MC$ or they are happy to produce at $MR=MC$.

Traditional model i.e. profit max firm are concerned with $TR > TC$ but within the Baumol model are firms interested in $MR > MC$ or $MR=MC$?

In considering Baumol and how a firm reacts to higher costs on average watch the response from airlines as dollar fuel prices increase. Also check the relevance of elasticity [to be reviewed in Workshops later] for ASDA or M&S or US retailers as they try to regain revenues from bad holiday sales.

Originally posted by rdawrant

I think this is further complicated by the fact that the LCA's sell their cheap seats first, therefore once the plane starts to get full, the price goes up and the flight becomes profitable. Therefore the final seats sold add significantly to MR but not to MC, and so $MR > MC$. The MR and MC would have to be considered on an average level for the firm.

Does this mean that the TR curve is actually turning upwards rather than downwards as the quantity increases? If so, the actual graph will be quite different from the typical one we use now, won't it?

Strictly speaking zero price secures a 'normal economic profit' of zero where all opportunity costs are covered. In reality, if you board a low-cost airline at 0.01p for flight, and buy on board flight, revenue yield goes up. Alternatively, company X gives you a free coupon [zero price] to buy its razor blades..but you may opt to buy the razor! Ultimately there really is no such thing as a free lunch!/
/

"Baumol pricing simply recognises the price and TR link..even at zero price you can make a profit..get passenger on board at zero price and revenue yields from on-board sales provided per unit costs are reduced!!"

Does anyone know why even selling the ticket at zero price you can still make a profit in Baumol model?

quote:Originally posted by paddy
Omoon raises a good point...look at the pricing yield curves for LCAs like Easyjet or Ryanair by following the commentary on the financial press..Also look at their balance sheets...

What is the reason the Baumol firm responds to an increase in total fixed costs (TFC) by reducing its output level? If sales-revenue represent output, how can it be explained the reason for reducing its output level. Correctly quoted from the study guide of MBSW, it's also stated that Baumol firm reduces output by more than a profit maximising firm. Reason?

To add in on the above question, if the firm operates on a purely sales-maximisation approach, would the management reduce the sales output or owner reduce his min. profit constraint so that the management can still pursue a higher sales output?

quote:Originally posted by Xavier
Due to the principal agent problem that arises when the ownership and control of an organisation are separated, managers, who have more information than the shareholders, can pursue their own objectives. Baumol argues that the objective of the manager is to maximise sales revenue as growing sales usually improve the firm's position with respect to loans. Also, it is argued that there could be a positive correlation between sales growth and managerial salaries. Using a negatively sloped demand function, managers might reduce prices in order to increase sales. The essence of low cost airlines is to use prices as a competitive tool. You can find information on the Baumol model in the Study guide in Unit 1 and in most Managerial Economic textbooks.

Hi all,

Francis, I would have to assume that the business model for the LCA is to achieve 100% load factors, this model would be guided by Baumol's theory to maximise sales. The business reality is that 100% cannot be achieved as the theory is based on perfect competition and the rational consumer, for example the terrorist incident at the London Airports this summer would have impacted on the load factor statistics.

On another note there would be marginal revenue for every passenger, lets face it we all know about the free seats - free advertising, the revenue for each of the seats would be equivalent to the notional cost of the advertising. I wouldn't include taxes as marginal revenue, unless this revenue is booked by the airline.

I suspect that esco is right about LCAs being Baumol organisations, but even when LCAs give away tickets for 'free' they still charge the about £20 for taxes, fees and charges, (which may cover most of their marginal costs) plus any fees for luggage, duty free, snacks etc. so their marginal costs may be covered even in these circumstances.

Francis

My take on the LCC and airlines and the Baumol model is that you have to see the nature of the cost that Airlines have to incur. Most of the LCC cost is fixed, the planes, the pilot, the flight attendant. There is bit of variable cost in the fuel itself, but the flight will have to carry a minimum amount of fuel to get off the ground, and that passengers may add small percentage of the weight to total of flight itself. So it's in the Airlines best interest to get as many people on the flight as possible, as most of the cost is already incurred, even if the flight goes empty. That's my take, based on my limited understanding of the airline industry.

Cheers!
Amish in Toronto.

re. rdawrant's comment about LCAs potentially making bigger profits by charging a higher (average) price and only filling 75% of their planes.

Ryanair's average passenger loadings per annum is between 80% and 85%, with fluctuations between 70% and 95% depending on the season. (see ryanair's website). Although their load figures are better than other LCAs, surely if they wished to maximise their revenues they could price to fill much closer to 100% of the planes, or at least increase the loadings during the low seasons? Given that they seem to choose not to do this and to fly their planes partially full, can it be concluded that their yield management pricing is tuned to maximise profits after all?

Francis

I think the most important relevance of Baumol model to LCA is the that of Qsrm where the gap between TR and TC is narrower than on the Qpmm. Qsrm firm push for increase in output, thus LCA use advertising campaign and different fares (with conditions) as a mechanism to push up quantity level (seats). The aim is not to have $MR > MC$ which will lead to increase in profits but to gain large market share (ie. total output)

Economic theory, as I understand it, states that a profit maximising company will have more volatile stream of profits than a company which has a minimum profit constraint and other objectives to satisfy. This would suggest that the profits of LCAs such as Ryanair and easyJet are more stable than those of profit maximising companies - such as BA- who's stated number one key performance indicator is profitability/ operating margin (achieve 10%). In fact, although there is a big variation in the absolute value of BA's profits compared to those of the LCAs, a comparison of the % margins of these does not reveal a significant difference in variability. Neither have I found a significant difference in variability of other firms who should be affected by the same industry trends (Gate Gourmet and Thomas Cook).

The only explanation I have is that the profits are subject to so many other factors that the profit motivation is not a significant factor overall. Can anyone offer any helpful insights?

Francis

Following on the issues commented, note that the MC in LCAs is almost 0 because an extra passenger hardly increases the cost incurred by the airline as long as there are empty seats (the extra cost in terms of extra fuel are negligible). On the other hand, any passenger can contribute to MR even if the prize of the ticket is 0. Notice how LCAs tend to charge for any additional services from checking in luggage, to duty free shopping and on board bar service.

Well spotted by Omoon and Rdawrat...MC = MR is a unique profit maximising point..we argue in the Module that management never reach it..sometimes overshoot and sometimes undershoot...but maximum profit is a different issue to profit maximisation. Look at Ryanair recent profit and revenue forecasts..better than market predicted. Baumol pricing simply recognises the price and TR link..even at zero price you can make a profit..get passenger on board at zero price and revenue yields from on-board sales provided per unit costs are reduced!!.

I think this is further complicated by the fact that the LCA's sell their cheap seats first, therefore once the plane starts to get full, the price goes up and the flight becomes profitable. Therefore the final seats sold add significantly to MR but not to MC, and so MR>MC. The MR and MC would have to be considered on an average level for the firm.

Firm's also do not readily know their MR and MC. So the LCA's will not be knowingly moving to the right of Qprofitmax, it is merely that their goal is to get as many 'bums on seats' and this makes them more of a sales-maximiser. They will obviously still need to make a profit, but as long as they are doing so they will put the right pricing structure together to fill their planes.

They might make a bigger profit by charging a higher (average) price and only fill 75% of the plane, but this does not appear to be their goal.

Xavier, Paddy

Thank you for your replies.

However, I still have something that I have not quite figured out yet. In the Baumol model, it is assumed that firms wanting to maximise sales may operate at quantities to the right of Qprofitmax - the quantity in which profit is maximum - in their Total Revenue curve. However, by selling more than this quantity, the marginal revenue would be less than marginal cost - in other words the 'additional unit sale' would bring a loss.

From my limited knowledge of the LCAs, they have very low costs structure (at least relative to mainstream carriers), they are able to offer lower prices and they have very comprehensive yield management system that allows them excellent information to manage their pricing and passenger load. Having said that, they would only offer prices low enough to fill up the plane but not so low that the price would not cover its unit costs (at least marginal cost). Therefore, I would think that they still operate at quantities to the left of the Qprofitmax and not to the right side of it - in other words, a profit maximiser.

Would appreciate your comments.

Cheers

Omoon

Omoon raises a good point...look at the pricing yield curves for LCAs like Easyjet or Ryanair by following the commentary on the financial press..Also look at their balance sheets...

Due to the principal agent problem that arises when the ownership and control of an organisation are separated, managers, who have more information than the shareholders, can pursue their own objectives. Baumol argues that the objective of the manager is to maximise sales revenue as growing sales usually improve the firm's position with respect to loans. Also, it is argued that there could be a positive correlation between sales growth and managerial salaries.

Using a negatively sloped demand function, managers might reduce prices in order to increase sales. The essence of low cost airlines is to use prices as a competitive tool.

You can find information on the Baumol model in the Study guide in Unit 1 and in most Managerial Economic textbooks.

<blockquote id="quote">quote:<hr height="1" noshade id="quote"><i>Originally posted by Francis</i>
re. rdawrant's comment about LCAs potentially making bigger profits by charging a higher (average) price and only filling 75% of their planes.

Ryanair's average passenger loadings per annum is between 80% and 85%, with fluctuations between 70% and 95% depending on the season. (see ryanair's website). Although their load figures are better than other LCAs, surely if they wished to maximise their revenues they could price to fill much closer to 100% of the planes, or at least increase the loadings during the low seasons? Given that they seem to choose not to do this and to fly their planes partially full, can it be concluded that their yield management pricing is tuned to maximise profits after all?

Francis
<hr height="1" noshade id="quote"></blockquote id="quote">

I think the above comment actually fully establishes the Baumol model of revenue maximisation with a constraint. There is a minimum profit the airline must make to remain in business- and that leads to a pricing decision that makes it not to load up 100% of the seats, however, it still does a lot better in revenue terms than if it were to be charging full fares like the established airlines. Also, remember that the low cost airlines have a faster turnaround time. So overall output is greater.

Hi Adesai,

Your explanation of the LCA fixed costs demonstrates that they are likely to pursue sales revenue maximization. Since all airlines have similar cost structure, Total Cost (TC) is almost irrelevant in the strategy. Focus will be on price to drive output. That is to fill the aircraft with passengers. Therefore, price differential using yield management technique and strong advertising campaign will be key drivers in increasing output.

Aj Yusuf

<blockquote id="quote">quote:<hr height="1" noshade id="quote"><i>Originally posted by Paddy</i>
In considering Baumol and how a firm reacts to higher costs on average watch the response from airlines as dollar fuel prices increase. Also check the relevance of elasticity [to be reviewed in Workshops later] for ASDA or M&S or US retailers as they try to regain revenues from bad holiday sales.<hr height="1" noshade id="quote"></blockquote id="quote">

Hi Paddy,
in considering the Baumol model, we are looking always at price adjustments, but for LCA or even Airlines in general, what effect would have the overbooking policy?
Regards,
Nicolas

Nicolas

Pricing is complex...overbooking (was) very common amongst US airlines in 1980s, 1990s so much so that generous hotel offers and upgrades to business class were offered that customers with low opportunity costs [ie no connecting flight] to catch, no rush to get home today] began to avail intentionally of these offers. Today in 2008 over-booking is a guarantor for the airline that the flight will fly with full load..internet selling of tickets has you betting against yourself that fares will change..the search for the elusive cheap fare is a misnomer as the real cost of travelling has increased for you once you include all taxes and charges and the high opportunity cost of flying budget airlines..there are still Polish workers in Dublin who on travelling home for Christmas find that budget air fares have increased to such an extent that they consider a 2day bus and ferry journey! Ultimately it is all about 'bums on seats' or max TR!!

<blockquote id="quote">quote:<hr height="1" noshade id="quote"><i>Originally posted by YUSUF</i>
Hi Adesai,

Your explanation of the LCA fixed costs demonstrates that they are likely to pursue sales revenue maximization. Since all airlines have similar cost structure, Total Cost (TC) is almost irrelevant in the strategy. Focus will be on price to drive output. That is to fill the aircraft with passengers. Therefore, price differential using yield management technique and strong advertising campaign will be key drivers in increasing output.

Aj Yusuf
<hr height="1" noshade id="quote"></blockquote id="quote">

Hi Yusuf,
I would assume also that reducing the total costs of LCC plays a major role for these companies Vs mainstream carriers. Reducing the turnaround time in the aircrafts destination and picking secondary airports to operate within provide those LCCs a competitive edge Vs others main airlines, in terms of cost, and hence better pricing policy. I would diminish the role of advertising of LCCs since most of the business is executed on line.

Appreciate your response.

A. Shalash

Remember guys that in practice Baumol sales revenue maximising equates to 'more bums on seats' in the case of LCAs. In all cases if management are faced with increased demand [say due to low prices] one response may be to hire more workers...if so then this further indicates or signals low productivity with existing workers..hence more staff at the margin increases costs as revenues increase BUT profit warnings can be posted as well.

see you at the workshops
patrick

Baumol Model v Low Cost Airlines

In this model, emphasis is on maximising revenue. Revenue is a function of price and quantity ($p \times q = rev$). Hence, there is a minimum constraint on profit set by the owners of the business. Therefore, to achieve other objectives (eg growth/market share) management can influence either of the two variables (price or output). From low cost airlines strategy the variable would be price, but at what extent can price be manipulated in real world without triggering price war. Let us discuss

How about the behaviour of other firms in the market? Surely the other firms would follow suit and once that happens, the picture can get complicated.

Anyone can answer this?

Hi Aj,
One thing that needs to be taken on board particularly with airline fares is that price discrimination is key in this industry (that is no 2 seats on the same flight is sold for same price) so price is a major function at the disposal of management, as such once interests in the seats increase, the prices increase.

Another key is that the same seat can be sold in different markets, targeting different customers with totally different spending power as such charge different prices.

Baumol Static Model

One of the assumptions made in Baumol static model is a single time period. In a retail industry, can we consider seasonal toys or clothing, where the firm will try her very best to maximise the sales of the items within a particular season (i.e time)?

rgds,
CS

Indeed this would be OK..seasonal demand is defined for a given time period...the key distinction in theory is that static implies no profits reinvested in the company.
paddy

Thanks, Paddy.[:)]

rgds,
CS

Baumol Static model with advertising

Hi,

I think I'm missing a key point on this model. Due to advertising costs, TC is increased and therefore, profits will decrease. The model then states that that advertising spend will be at the level which satisfies the minimum profit constraint and at the same time allowing the the greatest level of sales to be made. This is where I get a bit lost.

Surely, the SRM is the point where the minimum profit constraint is met according to the level of advertising (or adv. cost per unit in this case)?

Or am I completely missing the point?

Many thanks

Amanda

You are not lost..on the right track ...think in terms of balancing a shareholder imposed profit constraint to allow management flexibility to increase sales but with advertising there is a cost..expend until the MR from advertising = MC of last pound spent on advertising..paddy

Hi Paddy,

Baumol's static sales revenue-maximisation model with advertising (Fig 4.3) has got straight line TC(Total cost).

I think it shouldn't be a straight line . It should be curve similar to Fig 4.2 and shift upwards due to advertisement cost.

Am I wrong ?

Sorry it is confusing but I am allowing for both possibilities, a linear and quadratic costs..you can allow for 4 representations but rememebr that when TR is linear or TC is linear you are assuning constant costs....work around the assumptions sicne each diagram in econ reflects an assumption. well spotted,
paddy
PS parallel shifts in linear forms in econ could be explained by an once-off lump sum increase in advertising cost/

Baumol/Neo-classical model

I have read that the Neo-classical model is unsatisfactory because it

"operates upon the outdated and inaccurate assumption that prices of the final product are determined by the costs of the factors of production"

which apparently goes against the insights provided by Menger (1871) and the Austrian Economics.

Can any one explain what is meant by the quote above in the " " ?

My interpretation is that it means the neo-classical economists assumed that price is a function of the cost inputs (i.e. that seller must have a price that more than covers the costs of production). Therefore as output increases so do costs and so does price, reaching a point where the price becomes too high and demand drops off, hence the concave TR function.

NB. TC is different to production costs as it also includes opportunity costs.

The assumption that price is cost plus a margin does not reflect reality. E.g. commodity prices set by market or complicated price structure of LCAs. I guess they are saying that the assumption was too simplistic.

Not sure though, struggle being an accountant in an economists world.

In the real world companies will attempt to control costs..take a hedged position on raw materials, hire and fire labour on fixed term contracts or indeed off-load supply chain costs to suppliers..it happens in retailing and in hedging in airlines with aviation fuel.

Difference Between Static and Dynamic Baumol Model

Hi Paddy,

I am nearly finished the first assignment but I was wondering if you could clear something up for me.

The assumptions for the Static model in the book (page 63, assumption 2) state that profits are exogenously determined by the shareholders. Assumption 2 of the dynamic model (page 65) states the **EXOGENOUSLY** determined profits are reinvested to fund growth.

However, in the notes (SG1, page 27) you have written "The dynamic version of the model has one important difference in the assumption regarding profit. In the dynamic model, profit is not a constraint as it is in the static one-period model. It is an instrumental variable determined **WITHIN** the firm."

Clearly the assumptions in the text book are different from what you have stated. In the assumptions of the dynamic model in the text, the reinvested profits are externally determined (presumably by the shareholders) while you state that the reinvested profits are internally determined (perhaps by management).

Could you clear up the apparent contradiction for me or am I reading it incorrectly.

Thanks for your help.

Have a great and glorious day

Paul in Taiwan but originally from sunny Durban....

Hi Paddy,

I understand that the profits in the dynamic model are reinvested in the firm, but the contradiction is WHO sets the profits: Are the profits set by the shareholders or internally by management?

From your reply above I assume it is set by the shareholders.

Also, as to your reply above, I would imagine that the reinvested profits would be set to increase the overall revenue in t+2 and not profits per se. Surely in a Baumol firm the revenue is the key and not the profit. I would therefore assume profits are reinvested to grow revenue and not profits. Could you please confirm that for me.

Thanks.

Paul, who is originally from Durban but now lives in Taipei.

Taipei..grt city....never got to Durban..Joburg was interesting.
First shareholders do drive the constraint.

There is a key point not to miss...profits per unit = TR less TC but in each of the TR and TC computations is volume and cost per unit. What I observe and indeed the young Baumol in 1960s is that in maximising profit too much focus was on TC when by increasing TR for a given TC profits can go up....the paradox [as I call it in my workshops] has contributed to low cost airlines being identified in terms of low price to users and now in EU one of the LCAs, faced with rising costs, has to increase prices. Management must never forget that in Baumol pricing, max profits follows max revenues for a given cost.so reinvested profits could be used to smooth impending higher costs as well. This is a paradox not unlike the proverbial chicken and egg..what comes first!paddy

Excellent point..there is no contradiction and here is why..in dynamic model, profits per se are reinvested, there is no specific amount of profit that has to be reached to satisfy shareholders if the profits are reinvested. Profit levels are a constraint, a binding constraint, when a level has to be reached as in the static model. The book uses the word 'exogenously' to define the point that in both models, static and dynamic, shareholders are binding on management behaviour. That I do not dispute, but my point is that under a dynamic model it is the reinvestment of the profits, no matter the level, that is key..but the invested profits will lead to higher profits in t+2..hence the reference to profits as an instrumental variable.

Everyday Low Prices

Hi everybody...go to the Discussion Forum in WebCT to review the issue here as to whether or not consumers are better off with everyday low pricing or coupons + frequent discounts. Indeed which option is preferred by the retailer? Max TR is a key to understand this issue..

paddy

Hi Paddy,

To me, your retailer's options sound as two forms of price discrimination. The revenue outcome depends on the current life cycle of the product (new product versus mature growth) and where we stand in the price/quantity equation: elasticity > 1 so a decrease in price is offset by the increase in quantity sold or elasticity < 1 wherein a decrease in price leads to lower revenues. In case of mature goods (forthcoming declining sales), I assume that the retailer will opt for the "everyday low pricing" bearing in mind that we shall start from a high price (elasticity > 1). The coupon option leverages the "bundle" approach, locking the client to different purchases so that the price of our good in question can be virtually maintained. This latter option is relevant if the price elasticity of the good is inferior to 1 bundled to other products that have other elasticities. The coupon for future discounts can be valuable for product that will bear soon lower production costs.

Ababacar

I agree with most of your points...but think again why retailers especial in the US suspended coupons after years of practice....shoppers who do have low opportunity costs can shop around but not all shoppers today!paddy

FORMULAE/GRAPHS IN ME

Dear Paddy/fellow colleagues

Just wondering, As we progress with the study material in ME, the graphs/formulae are increasing at a very fast rate. Some are logical and easy to remember, others are difficult/almost abstract to me.

To what extent are we expected to know/understand/remember these graphs/formula. Please advise.

Lucy

Lucy...Take your time with the diagrams..go onto my web page and under Study Centre find '12Apostles' p-point presentation..These 12 diagrams are the only 12 you need to understand as they have a direct application..hopefully at the workshops this will be clear.

best advice is to go to Kaelo software and also read the support notes available on WebCT support for ME.

Marris Firm

Hi there,

The Marris Firm states that the correlation between the Marris ratios and the parameter 'a' is rather complex.

However, what is this parameter 'a' which does not appear to be explained in the study guide.

Regards,

Recently I read that Oracle made a bid to take over BEA Systems, however, the article said "A bid without the BEA board's support wouldn't succeed because of takeover defenses including a so-called "poison pill,"". Can any one give me an example of a "poison pill" and can companies use this poison pill without the knowledge and consent of shareholders. What are some of the other defense mechanism used by compaies to avoid take overs.

Thanks

Clayton

This summer of 2007 more CEOs are announcing dividends,,latest is Texas Instruments...but Apple need not worry as shareholders are happy with \$140+ share price, up from \$5 less than 6 years ago! There is a trend, that more dividends do increase the share price..higher share price and the company is more expensive to acquire so CEOs are more 'secure' in averting a takeover threat..hence the Marris security parameter.

poison pill is a way to prevent a hostile takeover..for example issue preference shares which are then redeemed at a higher price post-merger...this makes the ex-ante takeover more expensive.

Marris is his 'a' parameter was trying to capture the security management get on preventing a takeover in terms of job security but also financial viability of the company.

patrick

Utility functions are concave but indifference curve are convex...simply keep to the indifference curves

paddy

Prof, I forgot to ask you this during the workshop - you shifted the BGP in Figure 9b of Workbook Unit 1 to meet the highest indifference curve, but maintained the point of origin at C on the vertical axis. What does C represent and why does the new BGP have to start at C? Thanks.

OK..The point refers to an intercept on the vertical axis..we keep it at same level so as to focus on the slope and position of BGP..it doesn't affect the economic intuition.paddy

its fine, read further on, "a" stands for financial security parameter. hopefully remembering all these symbols will get easier over time.

Regards,

Diva

In Kaelo & Management Models & Indifference Relationships & Applications, the last paragraph says: "...the more risk-averse management is, the more the shape of the proposed utility function is concave...". Is this utility function the same as the management indifference curve? But isn't the management indifference curve convex? If they are different, how is the concavity of the utility function explained?

Thanks.

What does the a-parameter refer to? Job security of management or financial security of the firm? Why does Study Guide 1 page 23 say "...job security would decrease [as 'a' increases]..."? Why does job security have a negative correlation with the a-parameter?

What exactly is the correlation between the a-parameter and the three ratios?

- Study Guide 1 page 23 says "...the leverage ratio and the retention ratio are positively correlated with the parameter 'a' and... the liquidity ratio is negatively correlated...".
- Then on page 24, it says "...job security...decrease as liquidity decreases and the retention and leverage ratios increase".
- The second paragraph on page 24 goes on to say "...increased indebtedness [leverage ratio increasing], increased profit margins and increased dividends [retention ratio decreases] contributing to loss in job security...".
- Study Guide 1 page 33 last paragraph implies if leverage ratio and retention ratio increase and liquidity ratio decreases, security decreases.
- Workbook 1 page 22 exercise 2 says the liquidity and retention ratios are positively correlated with a while the leverage ratio is negatively correlated with a .

I think security should be positively correlated with liquidity and retention but negatively correlated with leverage.

Is this a query from Singapore..we covered the security parameter 'a' in Singapore workshops and argued that a modern day interpretation of 'a' is a fear of takeover from the perspective of management and that one way to assuage that fear is to influence the Marris ratios....also look at the Diageo case in Kaelo v2.0

paddy

ME Assignment 1

Hi,

I've been struggling with the assignment for the last few days. My problem lies in the following:

- The assignment has no problem to solve. In this case, does the report format still apply?
- Part one sounds like it wants us to restate what we learned in our own words. Is this the case?
- For part two I have collected a lot of articles on LCA but I simply don't know how to go about writing the answer. Do we just outline how LCA fit the Baumol model, or is there more to it?

Truly confused,

AliM

Thank you dear oauwan,

This is my conclusion as well. However, if one is to write the reply to assignment in the form of a report, what would the title be?

Furthermore, how would you organise the report structure. My understanding is that all MBA assignments must be submitted in the form of a report.

AliM

You are both correct...prepare an Assignment as a report or exec memo but focus on the points addressed from the Baumol model using the economic arguments..patrick

My understanding is that part one of the assignment is meant to test our knowledge of the profit maximisation model, while part two is meant to test our understanding of the Baumol model and how it applies to the decisions of modern management (specifically on output and pricing).

Any article on LCA is suppose to provide an example of how (and maybe why) modern firms pursue sales maximisation.

I hope this helps.

Freedom is priceless!!

Profit maximisation

Dear All,
kindly I'd like to ask about the first point in thye assignment regarding the underpinning points for profit maximization as I noticed that all our readings always mentioning the criticism & drawbacks of this theory & till now i'm not able to pinpoint these points that could underpin the profit maximisation

Any help will be appreciated

Regards,
A.Helmy

Dear A.Helmy,
I think the "some" of the key points are listed on page 62 of Cook & Farquharson, under the subtitle 'Baumol's sales revenue-maximisation model.' It's a good start.
At least one criticism appears in the text about the 'static model with advertising', just before the exercise 4.1 box.
Try page 22 of the study guide for a couple more ideas, recognizing there is a static & dynamic model.

If I am talking out of my hat, please tell me. Otherwise, I hope this helps you.
Simon

How do we view companies that seemingly forego profit-maximisation for sales revenue-maximisation for the group? E.g. P and E are part of a group of companies; E provides services that P buys. E's competitors offer better prices and turnaround times, but P opts to go to E to help boost sales and market share of E. Hence P can't be maximising its profits. What type of model is P subscribing to?

Profit maximisation is a key cornerstone of the neo-classical theory under criticism from the managerial models of Baumol and Marris and Williamson. Practically, maximisation is obtained when $MC=MR$...but this can be an elusive point for management...but it does not deflect from achieving a maximum profit [at lower costs] or higher revenues.
The real criticism is that management do not spend time seaching for a unique point at which $MC=MR$.
patrick

The text book Cook & Farg. page 32-36 has some ideals on profit max. Pg 34 highlights some of the criticisms of profit max.

Thanks

Ken

The answer is actually in your question as both P and E are maximising mutual or group profits or revenues...the whole (P+E) is greater than the constituent parts....this is more likely an integrated or tying vertical agreement...check with the local antitrust or competition law where E's competitors may find the practice anti-competitive...paddy

Thanks, Prof.

Another question: when referring to profit maximisation, sometimes the TR minus TC equation is used and sometimes the $MC=MR$ equation is used. Are there specific situations when one reference is more relevant than the others?

You will not find many textbooks that support this model as it does not reflect reality. However, the neoclassical economist support it using price/output relationship.

The study guide also explain the economist and accountant theory. Then pre 1950 organisation when the idea of one owner/control with single objective..... is to maximise profits

I found wikipedia and google a good source for article on topics like this. Try both for articles written by other students and lecturer. Hopes this help

Hi,

An interesting point in relation to this model is the fact that even if this type of company existed, which is quite possible, lack of accurate cost and revenue data would still make it virtually impossible to find the point at which $MR=MC$. Looking at this from an MA perspective, one could suggest an ABC/ABM approach to resolve this issue, if the cost is not too prohibitive, although for a small self-owned company, this could be regarded as rather over the top.

Your thoughts?

Amanda

Exactly the $MR=MC$ is a point, its relevance is that if $MC > MR$ for a marginal unit, then there is a cost problem...ABC with its focus on activities is really an attempt to spread the fixed costs - and you will see this in Unit 2 when you come to understand the L-shaped LAC.

paddy

No. depends on data availability so easy to use TC and TR...the MC and MR are simply the first derivatives of the functions. once you have the totals. marginals follow.

Student Query on Baumol

Why is a defining characteristic of a Baumol firm its high cost base? Is this statement referring to a type of industry with a high level of fixed costs?

A. That is a Baumol firm..high fixed costs in a cost intensive industry, so the management attempt to control the costs..airlines are historically high cost but management can take a hedged position on costs eg on price of fuel in dollars!

- Low cost airlines and Baumol Model; is this link applicable to all those organizations where the products need to be sold by a certain date or with capacity constrain? One of the successful factors of low cost airlines is cutting costs policy; is this explained in the Baumol model?

B. Reaction to costs - yes look at the discussion on Baumol and reaction to costs in the Workbook Unit 1 pp4-5 and Exercise 5 pp13. For many products price positioning becomes important but 'at end of day' supermarkets can offer 2 for the price of 1 promotion.

Hi Paddy,

With regards to supermarkets and "everyday low prices" such as WalMart/Asda, would their strategy not be more reflective of a Marris firm focusing on Growth maximization and product diversification as they continue to expand their general merchandise range, rather than Baumol, despite their low price/high output volume marketing (and aggressive cost mngt)?

Thanks,
Angela

Angela.. you approach an interesting topic. From my experience in consulting it depends on the 'carry-trade' between Baumol and Marris model, in other words it depends on the equation: growth is a function of profits. and the type of industry from retailing

[Baumol] to banks [quasi-Marris] to big pharma [Marris/

regards

patrick

The Measurement of Opportunity Cost

A company makes super normal profit if Total Revenue is in excess of (Total direct cost + opportunity cost). In a company situation, how is opportunity cost measured. In other words what mechanism does company use to measure opportunity cost.

Regards

Clayton

Opportunity costs of not making a decision > Case A: if you had a \$10,000 either you could buy Apple stock or if not put it in a time deposit bank account and get 5-7% p.a = not an option...Case B Or instead of putting it into a European bank deposit account buy stock and get dividends > 7%: Yes.

good luck in exams

paddy

opportunity cost is measured as revenue foregone or sunk cost in a project that did not succeed. Think of the opportunity costs accrued to Dell [lost revenues] in not coming up with an iDell before the iPOD!

patrick

The redundancy of the traditional demand curve

Hello Prof McNutt

In page 3 of Critical essay 1 you mention that "demand has different connotations today with the almost redundancy of the traditional demand curve: a more realistic characterisation is with two demands, different elasticities and a LAC declining cost curve intersecting both demands."

Can you please elaborate on this?

Many thanks

Kaveenga

Kaveenga..you raise an interesting point..demand curve is really a discontinuous line in reality [we assume continuity in theory] .when you buy a soft drink the choice is 1 or 2 cans...not 1.5 cans!

For a company its cost structure is crucial to achieving profitability and especially when product demand is changing so quickly because of changing preferences and technology: this is the case with cars, iPods and mobile phones.

So the traditional demand is useful in textbooks but not so easily found in the real world..except that the average consumer buys more on average when the price falls!!

Transaction Costs Commentary

Transaction cost analysis and outsourcing

The diminished cost of carrying out market transactions has redefined the traditional boundaries of the firm and has resulted in the creation of complex networks of relationships between firms which rely on each other. Outsourcing can be seen as a process which results from these diminished transaction costs where firms create a network with other firms. An example of this is Nike who is not involved in the manufacturing of the products it sells. It is argued that developments in IT play an important role in reducing the cost of carrying out external transactions thus encouraging outsourcing. Can anyone provide examples of how the decreased cost of using the market mechanism results in outsourcing?

Think about the move to China and India, and also Eastern European countries of many back office functions - with SAP logistics, for example, a firm's plant could be located in any geographic location, provided labour costs are low. The problem with 'out-sourcing', is that the real costs will only prevail if productivity (and product quality) is maintained. Also in terms of a market dynamic..think of what will happen once outsourcers secure a competitive advantage (with knowledge transfer and labour adaptability) to re-export back to the home country! Watch this space for the emergence of Indian and Chinese global companies 're-sourcing' back to the home countries like EU and US. Consider Europeans working in EU for China Mobile or EU or US salesforce for Li-Ning or Bharti Airtel.
