

Business Data Management
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Production Cost

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The Costs of Production



Professor: G Venkatesh: So, Prof. Suresh, last week we saw, we discussed the role of a consumer.

Professor M Suresh Babu: Yeah.

Professor: G Venkatesh: In the economy.

Professor M Suresh Babu: Yeah.

Professor: G Venkatesh: And consumer, of course, that means consumption.

Professor M Suresh Babu: Yeah.

Professor: G Venkatesh: Consumer means consumption. We identified the consumption of different households. We looked at.

Professor M Suresh Babu: Yeah.

Professor: G Venkatesh: What the basket consumption basket looks for.

Professor M Suresh Babu: Yeah.

Professor: G Venkatesh: Different types of houses. How does it change?

Professor M Suresh Babu: Yeah.

Professor: G Venkatesh: With time and with income, and there is other things.

Professor M Suresh Babu: Right.

Professor: G Venkatesh: And theoretically, we tried to underpin it by two concepts. One is that of utility, which tells you how a consumer tries to gain satisfaction as for some.

Professor M Suresh Babu: Yeah.

Professor: G Venkatesh: By consuming.

Professor M Suresh Babu: Yeah.

Professor: G Venkatesh: And their objective, I guess, is to maximize utility consumption.

Professor M Suresh Babu: Utility. Yeah.

Professor: G Venkatesh: Then we said, how do we look at this aggregation of this consumption into a notion of a demand?

Professor M Suresh Babu: Yeah.

Professor: G Venkatesh: How does the demand link to other.

Professor M Suresh Babu: Other factors, which really affect this demand in the price of related goods? Yeah.

Professor: G Venkatesh: Or maybe some other kind of factors. Interesting factors, like for example, women making decisions we saw.

Professor M Suresh Babu: Yeah.

Professor: G Venkatesh: So maybe some trends or some other things like.

Professor M Suresh Babu: Taste and preferences over time.

Professor: G Venkatesh: So, that gives us a picture of the consumer side.

Professor M Suresh Babu: Yeah.

Professor: G Venkatesh: Now, this week, we want to talk about the other side.

Professor M Suresh Babu: Yeah.

Professor: G Venkatesh: The two, these are two-agent models.

Professor M Suresh Babu: Yeah.

Professor: G Venkatesh: The other side is the firm or producer.

Professor M Suresh Babu: Yeah.

Professor: G Venkatesh: So, is there a similar picture that one can draw? Just like this consumption pattern for the household?

Professor M Suresh Babu: Yes.

Professor: G Venkatesh: There are similar pictures we can draw for the firm.

Professor M Suresh Babu: Yeah.

Professor: G Venkatesh: On the producer side.

Professor M Suresh Babu: Yeah. So, there we saw the demand side of the market. In the market, there are two agents, the person who demands and the person who supplies. Now from the demand side, now we cross over to the supply side. So exactly, we find a lot of parallels here. For example, the objective of a consumer is to maximize utility, while the objective of a person who supplies or a firm in our model is to maximize profits.

We are not talking about philanthropic firms. We are talking about firms, which there is an objective of profit or profit maximization. So, when we cross over to this side of the market, we find many similarities, and exactly like a demand curve there is also a supply curve.

Professor: G Venkatesh: Right.

Professor M Suresh Babu: And there are factors that affect supply. And perhaps, the most important variable that affects supply is the cost of production.

Professor: G Venkatesh: Okay.

Professor M Suresh Babu: Depending on the cost of production, you actually decide in terms of how much to supply, what to supply, in what kind of a market you want to supply. If we

recollect our earlier discussions, certain segments in the market where you want to pitch your product, the bottom of the pyramid or all these kind of decisions in terms of supply or viewing from the supply side of the market then is intimately related to the concept of cost.

Professor: G Venkatesh: Okay.

Professor M Suresh Babu: So, understanding cost then is a prerequisite for understanding supplied decisions.

Professor: G Venkatesh: So, the consumption bars when we broke down the consumers' purchasing in terms of the different types of things that person consume.

Professor M Suresh Babu: Yeah.

Professor: G Venkatesh: Based on their income.

Professor M Suresh Babu: Yes.

Professor: G Venkatesh: Of course, they have a budget.

Professor M Suresh Babu: Yes.

Professor: G Venkatesh: Here, the equivalent is that we have to see based on their, the equivalent of budget, that is something.

Professor M Suresh Babu: Yeah. The firm has a total set of resources, what we broadly call as capital availability.

Professor: G Venkatesh: Okay.

Professor M Suresh Babu: And this capital availability will have to be distributed according to the price, as well as according to the requirement of the firm to various other components that are used in terms of production, and each one of that will have a cost. So, exactly like what we saw in a consumption basket, there is a bouquet of costs now.

Professor: G Venkatesh: That is a parallel.

Professor M Suresh Babu: So, yeah. So, understanding that then is very important in terms of understanding the supply side.

Professor: G Venkatesh: Okay.

Professor M Suresh Babu: So, here actually, GV, I want to ask you one thing. See, you have industry experience. On the other side, viewing this set of theories and all that may be discussed from an industry's perspective, what are the kinds of costs you actually encountered in the industry?

Professor: G Venkatesh: It changes, I think, from industry to industry.

Professor M Suresh Babu: Okay.

Professor: G Venkatesh: So, since I was part of IT industry, for us labor was obviously the most significant cost could be like 50 percent of revenue was labor cost, more also.

Professor M Suresh Babu: Okay.

Professor: G Venkatesh: But if I guess, if it is a manufacturing company there would be materials could also be a very significant cost, labor would also be a cost.

Professor M Suresh Babu: Okay.

Professor: G Venkatesh: Energy consumption would be a very significant cost.

Professor M Suresh Babu: Okay.

Professor: G Venkatesh: If it is an FMCG company, I mean, something which is like Hindustan Lever, Nestle, companies which are selling consumer products, their advertising, marketing, sales that will be very significant. It is not so much for an IT company the sales and marketing would not be very substantial.

Professor M Suresh Babu: Okay.

Professor: G Venkatesh: But for them, it might be very significant. If it is a pharmaceutical company, you would see a lot of money being spent on new molecule design, R&D.

Professor M Suresh Babu: R&D.

Professor: G Venkatesh: All that could be a very significant cost.

Professor M Suresh Babu: Okay.

Professor: G Venkatesh: So, it depends. I guess it depends on quite a lot on the company.

Professor M Suresh Babu: Okay.

Professor: G Venkatesh: What kind of company it is, the cost. But broadly, I think there would be these heads, materials, labor, transportation, logistics, and all that travel. In the case of IT, we have travel costs.

Professor M Suresh Babu: Okay.

Professor: G Venkatesh: For projects. And, of course, capital costs. Suppose you have, if it is a very, if the manufacturing, you need large machines and so on you have to buy those machines.

Professor M Suresh Babu: Okay.

Professor: G Venkatesh: So, if you are an airline company you have to buy aero planes, so these aero planes, it is a big cost. So, it depends on the industry.

Professor M Suresh Babu: Okay. So, I think that is the important point for us, when we see us, for economists to look at. Because the types of costs actually vary from industry to industry.

Professor: G Venkatesh: Just like in consumption, right.

Professor M Suresh Babu: Just like in consumption.

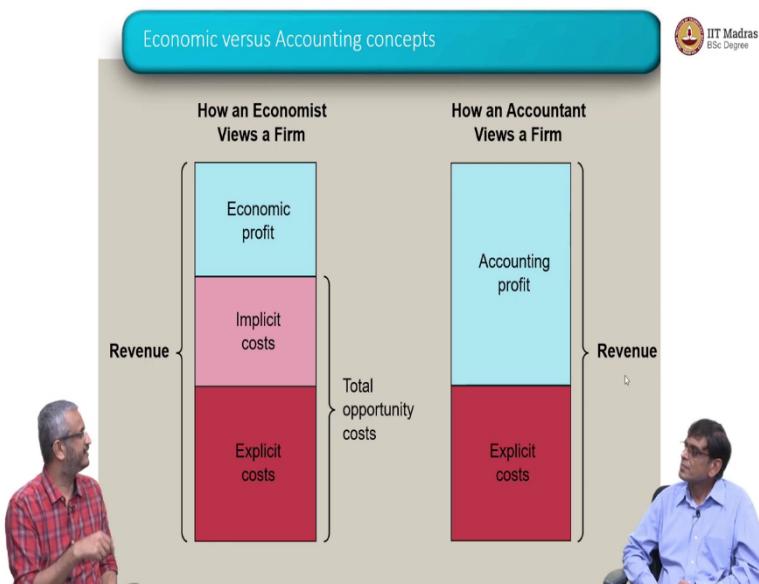
Professor: G Venkatesh: Consumption changes from person to person.

Professor M Suresh Babu: One, there is a variation in the types of costs that we see from industry to industry. Two, it also could vary according to the size of the firm, small firms, large firms.

Professor: G Venkatesh: Of course.

Professor M Suresh Babu: Three, it could also vary depending upon the technology that is available for production for each firm. Because ultimately, technology is a determinant of cost. So, let me try and draw some generalizations based on this point that you just raised, that is, there could be variations across industries, but then there are some common costs, or some generalizations can be drawn, looking at industries as well as firms. Now, I am going to draw some generalizations. Afterward, you come back and tell me in actual reality, is this the kind of thing you encounter in industry?

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Now, so let me start with some basic differences between an economist and an accountant. An economist sees this whole notion of cost from a very broader angle. That is, there is a concept of opportunity cost in economics.

Professor: G Venkatesh: Okay.

Professor M Suresh Babu: What do we mean by opportunity costs, we will just come to that in a moment, but resources have multiple uses. So, if you are using resources for one particular activity, then you are foregoing some other activity for which it could have been utilized. So, there is a cost of forgoing something that is an opportunity cost that we have to look. So, economists always view everything in terms of opportunity cost, and there is a trade-off. Whereas, for an accountant, the accountant says that it is not directly visible to us. Where is it getting reported? At the end of the day, we have to see it.

Professor: G Venkatesh: See the voucher.

Professor M Suresh Babu: Then only we can make, you see, the bill. So, there is a difference between accounting concepts and economists. Now, for an economist, there are three important aspects in the revenue of a firm. There is a set of explicit cost. There is a set of implicit cost.

And I will elaborate on what is explicit and implicit in a minute, and then there is economic profit. For an accountant, there is only explicit cost, implicit thing is it is not visible, so it is

just not. You have to, at the end of the day, you have to have it in numbers. So, they will look at explicit cost. And, of course, there is a concept of accounting profits. What they do in accounting profit is to include the implicit cost also into that.

Professor: G Venkatesh: Into the profit.

Professor M Suresh Babu: Into the profit. So, their accounting profit will always be high, whereas an economic profit concept will always be less. So that is a kind of tension between economists and accountants. And perhaps, if I say there is one place where economists and accountants converge in terms of this is the budget of a country because ultimately, budget is an accounting statement.

Economists might talk of big, big theories and things of that sort, but at the end of the day, an accountant might turn back and ask that, well, give it to me in numbers. An economist might say that, look, your numbers are approximations, conceptually it is like this and all, but in real life, we have to deal with numbers. So, we shall translate some of these concepts into numbers towards the end of our discussions today.

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Types of costs

- Opportunity cost and actual cost
- Direct and indirect cost
- Explicit and implicit cost
- Historical and replacement cost
- Fixed cost and variable cost
- Real and prime cost
- Total, average, and marginal cost

Professor M Suresh Babu: So, what are the broad type of costs that we can generalize? One, as we just talked about opportunity cost and then actual cost, then there is direct and indirect, which is in terms of in a variant of explicit and implicit. There is historical and replacement, and I will come to that later, then we draw some generalizations on the basis of fixed and

variable cost. We just talked about labor costs and the cost of capital plant and machinery, which is a fixed cost, whereas labor costs could be variable.

Professor: G Venkatesh: So, variable cost basically means that you can reduce the cost if the revenue comes down. But you cannot reduce the labor cost.

Professor M Suresh Babu: Yeah, the variability is related to the quantity of output produced. If you want to increase your output, you should have more labor and materials given the machine's capacity that has already been purchased. So, we need to complicate a little in terms of the time factor, which we talk about this fixity and variability. Perhaps, in the long run, everything is variable. So, we need to bring in the concept of a long run and the short run. And then there is the total average marginal cost.

Professor: G Venkatesh: Cost, typical variable cost. Materials and labor are considered variable.

Professor M Suresh Babu: Yes.

Professor: G Venkatesh: Travel and all would be variable.

Professor M Suresh Babu: Yes.

Professor: G Venkatesh: But capital equipment.

Professor M Suresh Babu: Machinery land for the factory.

Professor: G Venkatesh: Land purchasing land.

Professor M Suresh Babu: All that are consumption.

Professor: G Venkatesh: Taking long-term leases.

Professor M Suresh Babu: Yeah. All these are fixed costs.

Professor: G Venkatesh: All that could be fixed costs.

Professor M Suresh Babu: Yeah.

Professor: G Venkatesh: Now, something like rent and all would be.

Professor M Suresh Babu: Rent will be a variable cost.

Professor: G Venkatesh: Because you can always decide to give up the lease

Professor M Suresh Babu: Yeah. And then you can actually take when you expand production. You can take additional things like rent.

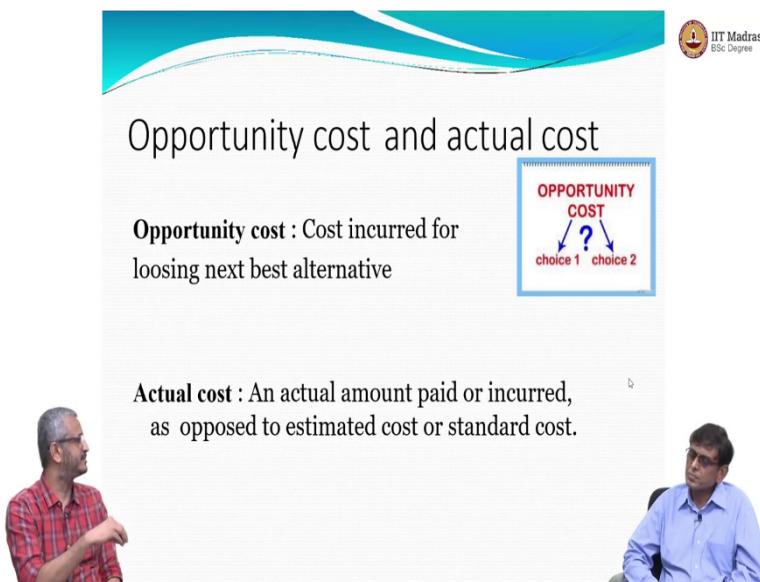
Professor: G Venkatesh: So, converting something, say instead of buying something, if you rent something, you are actually moving costs from the fixed head to be.

Professor M Suresh Babu: Variable.

Professor: G Venkatesh: Variable head.

Professor M Suresh Babu: Yeah. Which means that you have some control over controlling the costs. Why because controlling cost is very important for increasing your profits. So, firms are, and when we see some of the numbers on certain industries. We will see an industry with very high fixed costs, for example, cement; then we will see how they control costs. And because of controlling costs, we will see how their profits have increased.

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Professor M Suresh Babu: Now, so let me just run through this quickly. Just a one-line concept. Basically. So, opportunity cost is nothing but the cost incurred for losing the next best alternative, and that is a concept of trade-off that we talked about. And you are giving up something to get something else, so what you are giving up has a cost, that you are actually imputing. And you have multiple choices.

So, if you choose one over the other, the cost of other is imputed, that is the concept of opportunity cost. Actual cost is nothing, but actual amount paid, as opposed to the estimated of standard cost. So, you have estimated costs and then actually what you pay out might be slightly different from this cost. So, when an accountant looks at this whole costing, they look at actual cost, they do not look at estimated costs.

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The image shows a video call between two men. On the left, a man with glasses and a red plaid shirt is speaking. On the right, another man with dark hair and a light blue shirt is listening. The background is a white slide with a blue decorative bar at the top. The title of the slide is 'Explicit and implicit cost'. Below the title, there are two definitions:
Explicit cost refers to the money expended to buy or hire resources from outside the organization for the process of production
Implicit cost refers to the cost of use of the self owned resources of organization that are used in production

Professor M Suresh Babu: Then implicit and explicit cost, we had talked about this, but it refers to the money that is basically expended to buy or hire resources from an outside organization. So, resources can be from within the organization, and resources can be from outside the organization. So, anything that is from out.

Professor: G Venkatesh: By exact.

Professor M Suresh Babu: That is another production decision. Depending on these available resources, you have to decide whether you can buy or you can make.

Professor: G Venkatesh: But this is about whether this is a hidden cost because it is inside the regular. You may be using something because of.

Professor M Suresh Babu: Yes, a very simple kind of an example, GV, is well I have some capital with me, I can use that capital to buy machinery, but at the same time, I can actually be a slightly risk averse entrepreneur and say that look my money I do not need to take but I can borrow from the bank and start a business.

Professor: G Venkatesh: Okay.

Professor M Suresh Babu: Now, borrowing from the bank is a resource that is outside of my purview.

Professor: G Venkatesh: Okay.

Professor M Suresh Babu: So, there is an outflow. When I take my own money, there is no outflow of interest payments of any cash.

Professor: G Venkatesh: It is more about cash outflows.

Professor M Suresh Babu: It is cash outflows. And that is why it is called explicit. Whereas implicit cost is a cost of self-owned sources of organization that is used in production. And in the small firms.

Professor: G Venkatesh: Because you cannot see it from outside. From outside firm we cannot see this.

Professor M Suresh Babu: And in the context of small firms in developing economies, such an implicit cost is a family labor.

Professor: G Venkatesh: Right.

Professor M Suresh Babu: In a family-run enterprise, the entire family comes in.

Professor: G Venkatesh: Even in startups, the entrepreneur basically does a lot of work and does not. They will be paid for it.

Professor M Suresh Babu: All that will come as the implicit cost.

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Direct and Indirect cost

Direct cost is a cost.

Direct Cost: Direct costs are those cost that have directly accountable to specific cost object such as a process or product

Ex:wages paid ,salary paid labor, material...etc

Indirect cost:

Indirect cost are those costs which are not directly accountable to specific cost object or not directly related to production

Ex: insurance, maintenance ,telecom,etc



Professor M Suresh Babu: Now, direct costs are those costs that have accountable to a very specific cost object that is, wages, salaries, very specific head of accounting. Indirect could be in terms of not directly accountable, but it is related to production. For example, maintenance and insurance, certain insurance coverage all that is not going to the production process directly, but is a cost.

Professor: G Venkatesh: People say the cost of goods sold, cost of goods. So direct costs will be the cost of goods, and indirect costs will not be the cost of goods.

Professor M Suresh Babu: No. Indirect costs would be.

Professor: G Venkatesh: Is it a part of the cost?

Professor M Suresh Babu: Yeah, it is an outflow, but it does not directly contribute to the production process.

Professor: G Venkatesh: Directly, that it makes. Both are part of cost of goods.

Professor M Suresh Babu: Yeah, for example, I have produced something. When I am transporting goods in a truck to my market, I might have insurance for that product. But that is also a cost for the firm.

Professor: G Venkatesh: Correct. It is not fuel and travel cost anything.

Professor M Suresh Babu: It is not fuel or anything. It is also not the cost of transporting. There is insurance, which I am having for my product is over and about the production cost. But for a firm, it is an outflow.

Professor: G Venkatesh: Correct.

Professor M Suresh Babu: So, it is a cost from an enterprise or a firm's point of view. Now you can choose to avoid that and send the material without insurance, but that is a risk that one takes. So, all those kind of things come under these indirect costs.

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The slide has a blue decorative header with a wavy pattern. In the top right corner, there is a logo for 'IIT Madras BSc Degree'.

Historical and replacement cost

Historical cost refers to the original (actual) cost incurred at the time the asset was acquired

The **replacement cost** is the price that an entity would pay to replace an existing assets at current market price that may not be market value of that asset.

Below the text, there are two small photographs of men. On the left, Professor M Suresh Babu is shown from the side, wearing a red plaid shirt. On the right, Professor G Venkatesh is shown from the front, wearing a light blue shirt.

Then there are two important concepts, which we need to keep in mind when we talk about production. And that is historical costs and replacement costs. The historical cost actually refers to the actual cost when you are purchasing an asset. I am starting this firm in 2021, and I am purchasing land for this factory. What I am paying out in 2021 is the cost that is historical cost.

Why do we say historical? Because 5 years later, when I decide to expand my operations or move from one location to another location and all, in my balance sheet, this is what is accounted, in 2021 so and so purchased land for one crore or whatever it is. So, from that point of view, it is called historical, but replacement cost is the price that is required for replacing an asset at the current market price, that is, 5 years later.

Professor: G Venkatesh: Value maybe more or less.

Professor M Suresh Babu: Maybe more or less. So, that, why is this important? This is important because we always need to account for replacement costs if you are planning a little ahead in terms of your production process.

Professor: G Venkatesh: Right.

Professor M Suresh Babu: Because one simple aspect of production is that every machinery will have a wear and tear. And every machinery at the end of the day is a living kind of a creature, and it might die down. That is a machine might just fall sick and then it will stop producing, so you will have to replace that machine. When you go out to replace that machine, you have to pay the market price prevailing in that year to buy new machinery. So, that is the kind of a concept called replacement cost that we use.

Professor: G Venkatesh: So, if you use the historical cost to calculate your unit cost crossing the profitability, then suddenly, when you do the replaceable machine, you will no longer be profitable.

Professor M Suresh Babu: Yeah. So yes.

Professor: G Venkatesh: Because the price has gone up.

Professor M Suresh Babu: Yes. So, that is why firms bring in this whole notion.

Professor: G Venkatesh: Value of replacement cost.

Professor M Suresh Babu: Of replacement cost, and they will set aside an element of depreciation every year. So that at the end of the life of, if suppose the life of a machine is 15 years, at the end of the 15th year, there is enough resources available to buy a new machine.

Professor: G Venkatesh: There is a reserve depreciation reserve.

Professor M Suresh Babu: Reserve. So, you are putting into the kitty, right from.

Professor: G Venkatesh: Saving some money for a replacement.

Professor M Suresh Babu: Year one, for replacement. So, historical in historical values, I would have bought a machinery for 5 crores, but after 15 years, it would have been 20 crores or whatever it is. So, you calculate the inflation factor, and then you have a projected value. And then you set aside little money right from year 1, so that at the end of this 15th or 20th

year, you have enough resources to buy a new machine. So that is where this whole historical and replacement cost analysis becomes very important.

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Fixed and variable cost

Fixed cost is the cost that remains unchanged irrespective of the output level or sales revenue such as interest, rent, salaries etc

Variable cost are those costs that vary depending on a company's production volume; they raise as production increases and fall as production decreases

Professor M Suresh Babu (left) and Professor G Venkatesh (right) are seated at a table, engaged in a conversation.

Professor M Suresh Babu: Now, then we come to little theoretical concepts of fixed and variable costs, which is all discussed in earlier concepts as well, but we are trying to put it together into a big heading kind of thing.

Fixed cost remains unchanged irrespective of the output level. That is, when I am purchasing a machinery, there is a capacity for the machinery. My enterprise is for example, a coffee shop, so I bought this coffee vending machine. This coffee vending machine has a capacity in an hour it can produce so many coffees.

Now, then it is up to me, depending on the demand whether I should produce. So, for example, in an hour, let us assume that this machine can generate 100 cups of coffee. Depending on the demand, I can stop at 20 or I can go to 80, 90. But if the demand all of a sudden increases to 140 or 120 sorry, my machine cannot actually take that. So, I will have to.

Professor: G Venkatesh: Buy another machine.

Professor M Suresh Babu: Another machine or I will have to buy from somewhere else coffees and then distribute to my clients all these make or buy decisions then become very

important. So, fixed cost is the cost that is incurred irrespective of the output level or the sales revenue.

Now, an example of that is basically interest that we pay, you have borrowed capital to buy this coffee-making machine. Now you have to pay whether my sales is good or bad I have to do.

Professor: G Venkatesh: Pay an interest.

Professor M Suresh Babu: And that is a big kind of thing, especially in the context of the COVID crisis now. Because I would have taken this loan to buy, especially in the context of MSMEs to buy equipment. You have to.

Professor: G Venkatesh: Whether or not your business is running, you have to pay.

Professor M Suresh Babu: You have to pay the loan and keep servicing the loan. So fixed costs are those kinds of costs. Variable costs are those that vary depending on the company's production volume. For example, in my coffee making machines example, when I am making 20 coffees, then I need only one person to serve to that 20 people who are there, but if the demand increases to 45, then this one person cannot reach, so I will have to hire one more worker. So that is a variable cost.

So, today the demand is 40, I have hired one more worker. Tomorrow if the demand comes down to 25, I can ask this worker to leave depending on my contractual agreement with that worker. So, that is why it is variable. So, all such costs actually increase as a part of production and fall when the production also falls in variable costs. A classic example of that is energy and materials, input costs and energy the use of energy varies with your production.

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Real cost and Prime cost

Real cost of a production refers to the physical quantities of various factors used in producing commodity

Ex: Real cost of a table composes of a carpenter's labor to cubic feet of a wood ,a dozen of nails, half a bottle of varnish.....etc

"Real cost thus signifies the aggregate of real productive resources absorbed in the production"

So, then finally, we have a concept of no real cost and prime cost. Now the real cost is basically the physical quantities of various factors. For example, the carpenter's labor that is going to produce this table or the cubic feet of wood required to produce this. Yeah, all that in real terms, if we quantify. So, we are trying to account the material balances in this, not in terms of money terms. This is not a very commonly used concept, but in terms of earlier planned economic system, we wanted this because everything was planned in a planned economy. How much of cars should be produced is planned.

Professor: G Venkatesh: I think the price will be fixed by then.

Professor M Suresh Babu: Everything is.

Professor: G Venkatesh: Price also is determined.

Professor M Suresh Babu: By the planner. So, then you need to have an idea of each of these.

Professor: G Venkatesh: Items, how many nails.

Professor M Suresh Babu: How many nails do you need to produce in an economy, etc. So, that is why this is very, very useful at that point.

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Prime cost

The direct cost of commodity in terms of the materials and labor involved in its production excluding fixed cost

By calculating prime cost the firm can decide how much should be their selling price to earn profit

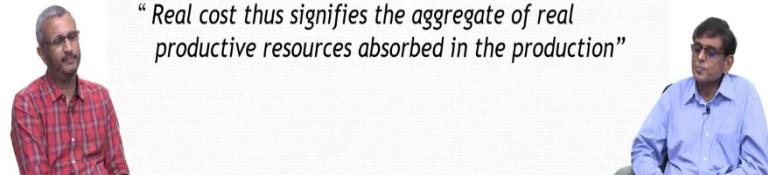


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“Real cost thus signifies the aggregate of real productive resources absorbed in the production”



Professor M Suresh Babu: And the prime cost is nothing, but the cost of a commodity in terms of materials and which includes the fix, which includes only the variable costs, but it excludes the fixed costs within this whole cost concept that we discussed that is in real cost. So, let me give an example of this.

You have produced something, and then over and above, you incur a selling cost that is there is a cost that is incurred to sell that product in the market to earn the profit. Now, that is to be added in your total cost. So, when we talk about prime costs, it involves production costs and these other costs associated with earning this revenue. And that is very important when we talk about different industries, FMCG, and other things. In certain industries, there is huge

advertisement costs, and in certain industries, there is a bundling of certain commodities, which also requires some kind of cost outlays.