ECON8854 - Industrial Organization II

Lecture Notes from Charlie Murry and Michael Grubb's lectures

Paul Anthony Sarkis
Boston College

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Chapter 1

Nonlinear Pricing

1.1 Two types

This section covers the model of nonlinear pricing where a monopolist offers a menu of two quantity/quality-price pairs to consumers of two types (H, with high value for the good and L with low value).

Without loss of generality, we consider contracts such that each type chooses a contract and has no incentives to deviate. The monopolist chooses a quantity/quality and a price for each contracts, such that its profits are maximized. We get a problem with three elements: (1) an optimization problem, (2) a set of participation constraint (making sure each type buys the contract) and (3) an incentive constraint (making sure no type deviates).

The results of this model tells us that the optimal contracts are designed in such a way that the quantity/quality of the highest type is not distorted, while for the lowest type, they will receive a lower quantity/quality than their first best!

1.2 Continuous types

The continuous types model has the same structure as the one presented in the previous section, however, now types lie on a continuum from lowest to highest. As before, the model is separated in the three same parts and display a similar distrortion where consumers of the highest types get their first best contract, while the lowest types get lower quantity/quality.

1.3 Crawford and Shum (2007)

1.3.1 Summary

The research question of this paper is: "To what extent is quality degradation prevalent in cable TV markets? And what are the effects of regulation on this issue?"

They add quality to the decision of the monopolist (add a dimension). Because of imperfect competition, we might think that quality will also be distorted (as prices are), which would create welfare losses. This is the framework of Mussa-Rosen, which is applied to the setting of cable TV.

Mussa-Rosen

There are three types of consumers (one to allow some consumers to not care about cable TV), and two contracts. The model displays distortion for the lowest types and no distortion at the top. They further go to show that this result holds even if consumer types are continuous if qualities are discrete.

Regulation is set up as a constraint on the optimization problem such that quality cannot go lower than a certain point. This turns out to only restrict the lowest quantity, while the top quantity stays undistorted.

Cable TV industry

Contracts are based on bundles of networks. Basic service is the one that everyone has, then you can buy extended service or premium (maps well to theory presented before, but premium is ignored because horizontal differentiation).

Bundle quality is measured in two ways: number of networks in said bundle (assuming same underlying quality) or through the implied values from consumer distribution (a first-stage problem from Mussa-Rosen).

Empirical model

Results

Quality distortion is present. Regulation mitigates the problem.

1.3.2 Discussion

The theory clearly lacks horizontal differentiation between contracts! Because of this, they ignore some data.

Functional form dictates a lot of the results!

Chapter 2

Price Discrimination

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Search

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Switching Costs

Chapter 5

Learning

5.1 Literature Review

5.2 Covert (2015)

5.2.1 Summary

The research question in this paper is: "Do firms learn (in production)?"

Using data on hydraulic fracturing in the Bakken Shale and a model of input choice under technology uncertainty, Covert shows that firms only learned partially, leaving out 40% of profits in the process.

Background

New industry after advances on how to extract shale gas. Almost 1000% growth in 8 years.

Fracking is pumping a mix of sand, water and chemicals in the ground = choice to make on the "recipe" that affects production and costs! But no one knew at the

time how to do it = opportunities for learning.

Firms have their own data (private for 6 months) and then get access to other data (after six months).

Evidence for learning

Covert looks for three types of learning: (1) is experience (age of firms) correlated with productivity (oil per well drilled)? Which is estimated using a Benkard type of model. (2) is the choice of inputs more profitable over time? which is estimated using ex ante and ex post profits comparison.

Results

One of the first empirical analyses of learning behavior in production. Find that firms increased the profit capturing rate from 20% to 60%. No experimenting to learn as firms go to more certain input choices. Firms overweight their data compared to other firms' data.

5.2.2 Model

Production function

The output is log-log specified as a function of:

- t: the number of days of operation of the well.
- D: the number of days of production.
- H: length of the well.
- Z: other topologic controls
- ϵ: well-specific shock
- ν: idiosyncratic shock

Profits

Firm's profits depend on the usual stuff: share, market size, price, and cost of inputs.

Preferences

Firms get utility from the mean profit and standard deviation of profits given an input.

Gaussian Process Regressions

5.2.3 Comments

Results

Firms underutilize sand and water but: are costs measured correctly? If costs are convex, then findings corroborate optimal choice? Overestimate return to production?

Public policy

Delayed disclosure of information lowers barriers to entry while leaving rents on the table.

Experimenting

Nice framework but conclusion too hasty? Experimenting is too linked with risk, what if even when experimenting firms would choose safe levels of inputs? Or sub-optimal experimenting?

Other questions

Risk aversion or myopia?

Prior beliefs are correctly specified?