

LECTURE 1.0

INTRODUCTION

ABOUT ME

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Communications

- For questions concerning course content, please post them on the Discussion board of Canvas. There is a discussion for each week. I will respond there or in class.
- For administrative or personal matters, please email. We can set up an appointment if required.
- At the end of each week's live lecture I will hold an office hour where you can drop in.

LECTURE STRUCTURE

Lectures for this unit are scheduled from 6pm to 9pm each Wednesday. Lectures and tutorials will take the following format:

- From 6pm I will hold a live session on Zoom for approximately an hour. This week's session is an introduction to the course. For subsequent weeks, this hour will be used to work through tutorial questions and any other questions raised by students. These sessions will be recorded and made available on Canvas.
- Other lecture materials will be pre-recorded. These will be available on Canvas for viewing during the remainder of the scheduled lecture time between 7pm and 9pm. However, you are free to watch these recordings at another time as is convenient for you.
- I will hold an office hour immediately following the live session from approximately 7pm.
- In Week 8, there will be a mid-semester test. There will be no live session that week.

CANVAS

Canvas is one of our primary means of communication:

- Tutorials for each week will be posted immediately after the Wednesday night session of the week before.
- Lectures will be available each week before the Wednesday night session. As we progress through semester, some of these may be posted in advance to give you some flexibility as to when you watch them. When they are posted early, I will make an announcement on Canvas.
- As already noted, please use the Discussion board to ask questions about the course content. There are discussion areas for each week. Also feel free to start your own discussion. On weekdays, I will respond within a day. I will respond to questions on weekends by the end of Monday.

READING

- There is no required textbook for this unit. Readings are drawn from a variety of sources. All will be available for download or accessible via link from Canvas.
- Readings for the full course are already available on Canvas.
- Most of the readings are the source from which the lecture material was drawn. Reading them will give a more in depth analysis, and sometimes a different lens. If you are struggling with a concept in the lectures, the readings will be helpful.
- I will suggest some optional reading along the way. These will not be assessable, but will provide guidance for those interested in taking their understanding to the next level.

ASSESSMENT

Mid-semester test

Weight: 25%

Coverage: Weeks 1 to 6

Date: 6pm Wednesday
21 October (Week 8)

How: Online quiz in Canvas

Term paper

Weight: 25%

Coverage: Weeks 7 to 11

Due: 23:59 Wednesday
18 November (Week 12)

How: Submit in Canvas

Final exam

Weight: 50%

Coverage: All course content

Date: During final exam period

How: Attend final exam

COURSE STRUCTURE

Week	Date	Theme	Lecture
1	26 August	Economic concepts	The Economic approach
2	2 September		Game Theory
3	9 September	External relationships	Market Structure
4	16 September		Pricing
5	23 September		Product differentiation
6	30 September	Internal relationships	What is a firm
	7 October		No lecture - Session break
7	14 October		Organisational structure
8	21 October		Mid-term test
9	28 October		Hiring and retention
10	4 November		Incentive compensation
11	11 November		Evaluating performance
12	18 November		Vertical integration and the boundaries of the firm

ECONOMICS AND THE ECONOMIC APPROACH

READING

Chapter 1, “Introduction” in Brickley, Smith and Zimmerman (2016) *Managerial Economics and Organizational Architecture* (6th ed)

Chapter 2 , “Economists' View of Behavior” in Brickley, Smith and Zimmerman (2016) *Managerial Economics and Organizational Architecture* (6th ed)

“Introduction” in McAfee (2002) *Competitive Solutions*

Links to readings or downloads are available in Canvas.

WHY ARE WE INTERESTED IN THE ECONOMICS OF BUSINESS STRATEGY?

Let's illustrate with the story of Enron.

Enron Corporation formed in 1985 through the merger of two gas pipeline companies.

With deregulation creating new opportunities, Enron built an innovative business model. It was a pioneer in trading derivative securities tied to assets like natural gas, electricity, and coal. It transformed from a capital-intensive gas pipeline company, shrinking reliance on hard assets and developing creative and unconventional products and practices.

Enron was named “Most Innovative” of Fortune’s Most Admired Companies list six years in a row.

WHY ARE WE INTERESTED IN THE ECONOMICS OF BUSINESS STRATEGY?

By 2000, Enron operated in:

- transportation and distribution, supplying gas and electric transmission services
- wholesale services, providing energy services and other products to energy suppliers and other firms
- retail services, offering business customers energy products and services
- broadband services, providing service providers with access to a fiber-optic cable network
- other businesses including water resources and wind energy.

WHY ARE WE INTERESTED IN THE ECONOMICS OF BUSINESS STRATEGY?

In 1990, 80 percent of Enron's revenues came from its regulated gas pipeline business. By 2000, over 90 percent of revenues came from its wholesale energy operations and services segment.

Enron used sophisticated partnerships whose financing details were kept off Enron's balance sheet.

For example, Enron formed a partnership called the Atlantic Water Trust in which it held a 50 percent stake. When Enron's partner, Marlin Water Trust, was marketed to institutional investors, Enron guaranteed the debt with its own stock. If Enron's credit rating fell below investment grade and the stock fell below a stipulated price, Enron would be responsible for the partnership's \$915 million debt.

WHY ARE WE INTERESTED IN THE ECONOMICS OF BUSINESS STRATEGY?

When Enron prospered, these guarantees appeared to cost the company little. But Enron began to experience significant problems.

- In 2000, following a power shortage in California that resulted in blackouts, California launched an investigation into price gouging by Enron and other power marketers.
- Enron's investment in water concessions in Brazil and England ran into political obstacles. For instance, British regulators cut the rates that it was allowed to charge its customers.
- Enron had a 65 percent stake in a \$3 billion power project in India, which was embroiled in a dispute with its largest customer, who refused to pay for electricity.
- The fall in oil prices following the 11 September 2001 attacks generated losses for Enron's trading operations. Technology changes produced a glut of broadband services.

WHY ARE WE INTERESTED IN THE ECONOMICS OF BUSINESS STRATEGY?

After reaching a peak of nearly \$70 billion in August 2000, Enron collapsed, filing for bankruptcy in December 2001.

Why did this occur?

Business Week wrote:

Enron didn't fail just because of improper accounting or alleged corruption at the top. . . . The unrelenting emphasis on earnings growth and individual initiative, coupled with a shocking absence of the usual corporate checks and balances, tipped the culture from one that rewarded aggressive strategy to one that increasingly relied on unethical corner cutting. In the end, too much leeway was given to young, inexperienced managers without the necessary controls to minimize failures. This was a company that simply placed a lot of bad bets on businesses that weren't so promising to begin with.

WHY ARE WE INTERESTED IN THE ECONOMICS OF BUSINESS STRATEGY?

The failure of Enron rested on three core strategic failures:

- **Organisational architecture:** The assignment of decision rights in the firm. What was the management and decision-making structure? Who was making decisions? Was there any oversight or checks and balances?
- **Incentive compensation:** The methods of rewarding individuals. Did performance measures encouraged excessive risk taking?
- **Performance evaluation:** The structure of the of the systems to evaluate performance of individuals and business units. Did the accounting measures provide an accurate view of performance?

These three areas will all be covered this semester.

INTRODUCTION TO THE ECONOMICS OF STRATEGY

In this unit, we are going to use an economic lens to understand firm success. We will examine both inside and outside the firm, as economics can offer insight across all these issues.

We will examine interactions with external agents, such as:

- Which markets to enter
- How to enter markets and deter rival entry
- Product differentiation
- How to price products

We will also examine the internal organisation of firms (as per the issues we have just identified with Enron):

- Hiring and retaining the right employees
- Designing incentives and decision rights
- Evaluating and rewarding performance

INTRODUCTION TO THE ECONOMICS OF STRATEGY

Economics studies how individuals make choices under constraints.

- What do consumers buy with limited income?
- How do managers and employees make production and pricing decisions with limited resources?

Economics emphasises the role of incentives.

- What are the incentives of firms to compete?
- What are the incentives of employees to work hard and make good decisions?

In this course we try to understand how economics can provide insight into value creation

INTRODUCTION TO THE ECONOMICS OF STRATEGY

In this unit we will examine how economics can provide insight into business strategy.
We want to go beyond the black box



INTRODUCTION TO THE ECONOMICS OF STRATEGY

We will use economics to discuss issues such as the following:

- Centralisation versus decentralisation within the firm.
- Bundling tasks: which tasks to bundle and how
- Bundling jobs into business decision units
- Objective versus subjective performance measures.
- Incentive compensation schemes
- The make versus buy decision
- How to interact with customers (pricing) and competitors.

We will analyse these questions with some bread and butter economic concepts. The challenge will be construct simple models that shed light on each, and use our models to help explain what works, what doesn't, and why.

THE PRE-RECORDED LECTURES

This week's pre-recorded lectures cover the following areas:

- 1.1 The economic approach
- 1.2 Decision making under risk
- 1.3 Multi-period models
- 1.4 Concepts: cost and profit
- 1.5 Concepts: demand and elasticity

SUMMARY

We will be using economics to explain:

- external relationships of the firm: with rivals, potential entrants, suppliers, regulators, customers
- internal relationships of the firm: with employees, managers, divisions.

The economic approach helps us understand what strategies and tactics do (or do not) work.

Economics can present a stylised description of the world. We use models that are simplifications of reality. Be critical and open-minded!

CLOSING QUESTIONS

Read the “Introduction” to McAfee, *Competitive Solutions* (article on Canvas). McAfee discusses the dominance of AOL in the early days of ISPs and the world wide web

What explained its dominance?

Why did it decline as an internet powerhouse?