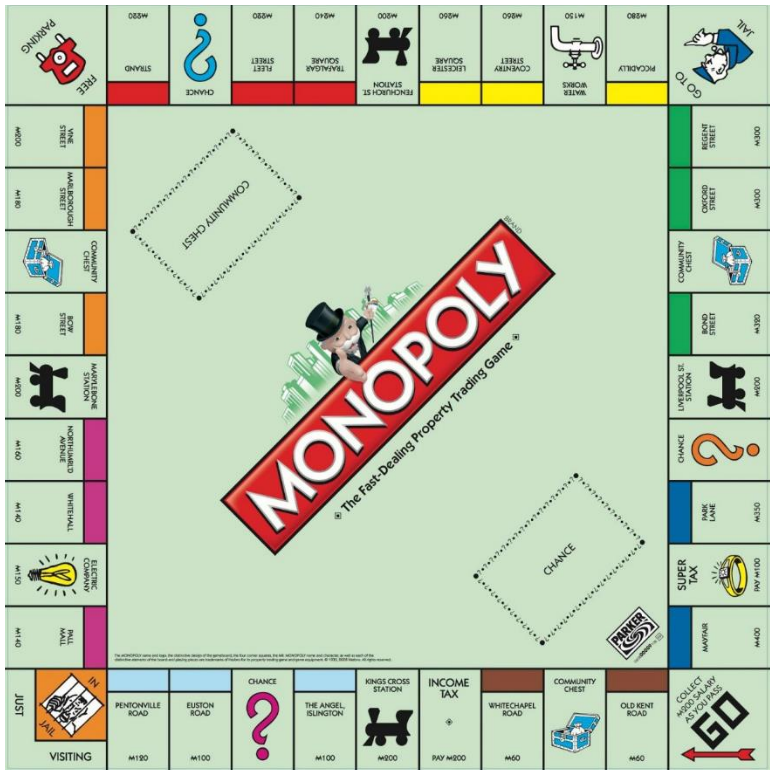
Are Monopolies Good or Bad?

An exclusive report from CompStrat Consulting Team



Team 3:
Rohit Kumar Gupta
Cynthia Mayer
Nebo Iwenofu

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Executive Summary

In this report, we have done research on how being a monopoly can be bad or good for a company. Based on this research, we have done analysis to answer the question: "Are monopolies good or bad?". We started our report by defining a monopoly as a situation where a company controls the market, and then went on to explain the different types of monopolies. We described the main characteristics of a monopoly and then expanded the characteristic of being able to maximize profits. The monopoly maximizes its profit by selecting a price at which its marginal revenue equals marginal cost.

Further, in this report, we performed SWOT analysis to identify the cases for and against monopoly. We identified strengths of monopolies as the power to maximize profits, economies of scale and easiness of fending off the new entrants or competition. The weakness of the monopoly are that they get blinded by the profit maximization which stagnates the innovation. External factors such as opportunities for the monopolies are cheaper to sell complementary products to the customer and leveraging their position to introduce new products whereas the threats are government scrutiny, bad reputation, and loss of freedom.

We then perform a Porter's/Hopper's forces analysis to prove that being a monopoly is associated with few risks. Based on the SWOT analysis and the porter's framework, we explained our position why a profit-oriented company should strive to become a monopoly.

In the past, we have seen that monopolies blinded by the profit maximization can often misuse their position which can have a negative impact on customers, market, and suppliers. To address this problem, we suggested when governments should intervene to stop the abuse of power.

Finally, we suggested how a monopoly should behave to avoid attacks by government and fend off competition. The proper behavior of a monopoly should be ethical and transparent which includes not misusing your position to stifle competition, suppliers and to exploit your customers.

A. What is a Monopoly?

A.1 Definition

A monopoly is a situation whereby a company controls the market. This market control can be conferred by regulatory bodies or by the virtue of the quality of a company's product or service offering.

In this report, we may refer to 3 different kinds of monopolies:

- **Conferred Monopoly**: This kind of monopoly is granted to a company by a regulatory body to protect the company's profits. For example, Patents granted to Pharmaceutical companies by the US government.
- **Natural monopoly**: This kind of monopoly occurs when a company is the only or clear dominant provider of a product or service in a market. This happens because a company is the only provider of a good or service in a geography, or because a company's products or services are significantly preferred and consumed by customers. For example, Google is considered to have a monopoly in the search market because their search service is superior to its competitors. **NOTE:** this definition is different from the economic definition of a monopoly.

- **Government-owned monopoly:** This kind of monopoly occurs when a product or service is publicly owned and operated by a government entity. This situation occurs when the governing body in a geography wants to ensure some basic access to a product or service at a reasonable price. For example, the National Health Service (NHS) in the UK is their government-run health care.

A.2 Main Characteristics:

A monopoly has two important characteristics:

- It has goods or services that cannot be easily provided by another company. This can be either by a superior product or by government regulation.
- A company or small set of companies can set prices and quantity supplied in such a way as to optimize profits.

To further illustrate the characteristics of a monopoly, we will contrast a monopoly against a perfect competition. Monopoly and perfect competition are two extremes of the competition spectrum. Perfect competition is when all the companies are selling identical (or undifferentiated) products or services with no power over price of the product or service, and the price is determined by the market forces of demand and supply. While in monopoly as mentioned above, the product is highly differentiated, and the company has power to set the price of their product or services. In other words, we can say that in perfect competition, market is controlling the company whereas, in monopoly, the company controls the market.

A.3 How do monopolies maximize their profits?

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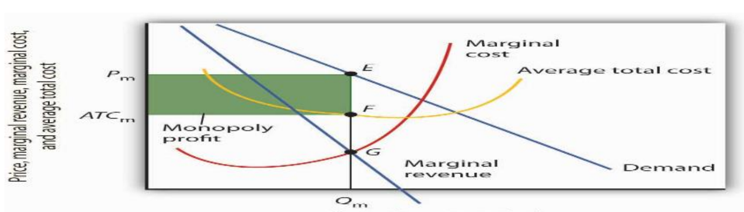

Figure 1: Price Determination in a Monoplistic Environment

[1] https://open.lib.umn.edu/principleseconomics/chapter/10-2-the-monopoly-model/

B. Case for and against being a monopoly:

To understand the cases for and against being a monopoly, we will do a SWOT analysis to understand the strengths, weaknesses, opportunities and threats monopolies typically face.

B.1 Strengths:

- Monopolies typically have the power to maximize their revenues by optimizing price and controlling supply and production. The monopolist has the power to set prices[2] at levels that maximize its profits because of a lack of customer substitutes. Customers have no choice but to purchase from the monopoly. This lack of competition also allows a monopoly to set its production and supply levels to optimize its profits. Unlike a competitive market, in a monopoly, there is no relationship between price and quantity supplied so companies can usually set quantity supplied to maximize their marginal revenue.
- Monopolies can gain from economies of scale and be run very efficiently relative to companies in a competitive market. Production at this large scale means that the percentage of marginal revenue attributed to fixed costs is lower than it would be at a smaller scale. As a monopolist grows, the percentage of fixed cost relative to revenue drops. This economies of scale is more difficult for companies in a competitive market to achieve because it is more difficult for them to grow.
- Companies in a monopoly position can easily fend off competition from new market entrants and smaller niche companies because of their first mover advantage and their familiarity with the market dynamics. Some monopolies that have a first mover advantage in an industry become synonymous with the industry, making it difficult for other players to enter the industry. Also, having significant market knowledge, insights and customer relationships, can prevent competitors from entering a market where customer needs are being met, and customers are unwilling to switch customers easily. Monopolists usually have significantly more resources than smaller competitors and have significant fixed costs that protects them from competition by scaring interested entrants away. This also gives monopolies an advantage because they can afford to drive prices down to very levels that are unsustainable for new entrants or companies without deep enough pockets.

B.2 Weaknesses:

- Monopolists usually shift focus to maximizing profits after attaining monopoly status. This focus shift usually means the monopolists aren't as interested in investing in innovating to improve their current product offering or looking past their current horizon one business. This is a weak position to be in because when there's a paradigm shift (which could be brought about by technology change or changes in regulatory climate), the monopolist will not be in a good position to innovate and will be overtaken by new entrants.
- For companies focused on social entrepreneurship or trying to introduce a new technology to market, having a monopoly could stifle widespread access to your good or service. This would be anathema to your company's vision. For example, Tesla released a lot of their patents to the public to help development of electric engines. Holding these patents private could have slowed growth of the industry.

[2] http://www.sparknotes.com/economics/micro/monopolies/section1/page/3/

B.3 Opportunities:

- Relative to companies in competitive markets, monopolists can grow their business faster because they can easily switch management focus and resources to enter new markets. A monopoly is usually stable, so, monopolists can switch their focus from their current market to grow their business in other markets. This is an opportunity companies in competitive markets do not have.
- Since monopolists can manipulate price to maximize their profits, they have a reliable cash cow business that could provide funds to invest in other innovations or improving the company's current offering. A monopolist can switch its focus to other industries and try to fund research and development of new products and services in those industries. This makes it easier for a monopoly to grow relative to companies that are in only competitive markets.
- A monopoly position can make it cheaper to sell complementary products to customers. Monopolists can build out complementary products and sell to their existing customer base at significantly lower prices than competitors for those complementary products. Monopolists can do this because it costs them less to acquire an existing customer and customers are usually willing to fulfill a need by signing up with one vendor. For example, it costs Microsoft less to sell additional products like one drive to business customers that have Office365 and business customers will always consider Microsoft solutions for an issue because they already subscribe to products like Windows and Office365.
- Monopolists that have built their business by providing a superior product can leverage their reputation to introduce new products successfully. These monopolists have built trust and familiarity with customers, so it's easier for them to leverage their brand reputation and awareness to create new products and enter new industries. For example, Google's monopoly position in search gave it a good reputation and made it easy to win customers over in the mail provider and phone OS industries.

B.4 Threats.

- In a monopoly, the monopolist is usually the face of the industry and is usually subject to government scrutiny should something go wrong in the industry. For example, Facebook's dominance in the social media space has made it a punching bag on Capitol Hill in the investigation on Russia's attempt to influence the American public through social media. Monopolists need to be prepared to speak on behalf of the industry when things go wrong - even if they haven't done anything wrong themselves.
- Monopolists can be subject to a bad reputation in the public when they try to maximize profits instead of focusing on their customer's experience. For example, Pharmaceutical companies have a bad reputation in the U.S. because they steadily increased prices of potentially life-saving medication to maximize their profits while their customers have to go in debt to be able to afford these prices. While these price increases are legal, they've led to a bad perception of these companies in the US.

C. Should a company strive to be a monopoly?

C.1 Being a Monopoly Presents Low Risks

Although we said being a monopoly is the best sustainable way to secure profits, a company should not lose sight of the external threats surrounding its status, which it could loose if it loses attention to them. We use Porter's and Hopper's forces to describe those threats, sorted by level of risk:

Low risks

Industry Rivalry: Industry rivalry for companies operating as monopolies is a low threat. Monopolies typically own huge market shares, and have superior product by differentiation, so competitors, if there are any, cannot pose a real threat.

Threat of New Entrant: Threat of new entrants to monopolies is very low. This is because of the huge barriers of entry (market shares or huge start up costs) that the monopoly creates in its market. Furthermore, in cases of conferred monopolies or government owned monopolies, entry is not possible because of protection from the government.

Globalization: This force has low impact on monopolies as a threat. Globalization in fact, is an opportunity for the monopoly to extend its power and position on the international market. Companies which have domestic monopoly find it easier to enter international markets.

Supplier Power: Because a monopoly company is an important client for its supplier, and can often be the only buyer because of its monopoly, it is rather the monopoly which is a threat to its supplier, it holds the buyer power and can easier negotiate prices. This force poses a low threat.

Social and Cultural Shifts: This force as low impact as a threat. Monopolies can drive social and culture shifts with their power. Because of their ability to invest in R&D, they can come up with innovative products, be the front runners and shape trends. For example, Google, which held monopoly in search markets, used innovation to come up with Gmail, Cloud and other software and helped in shaping the trend of using online means to communicate and store data.

Threat of complements: Complements in the industry where a monopoly operates doesn't have high impact on limiting profits if the monopoly established its with a single product already. It's often the monopolies who tie complementary products with their core product to push it to the customers.

Moderate risks

Threat of Substitutes: This force as a threat is moderate. Even though being a monopoly means no competitor can offer a close substitute to a company's offerings, other solutions can be appealing to customers and make the monopoly lose market share - and thus its status. For example, the train company in France (SNCF) is a government-owned monopoly and began to be threaten a couple of years ago by the bus and car-sharing markets offering lower prices to customers, even though bus and cars could not compete with the speed of the trains. So SNCF entered the low-cost bus market in order to compete with the bus companies that were offering better prices to low-income customers (such as students) than a regular train ticket does.

Buyer power: This force as a threat is moderate. A monopoly can set its own prices and not worry about reaction from competitors or market. But if an established monopoly has set its prices too high, customers might ask for more government regulations like farmers did during the Granger Revolution, and this will impact the monopoly's profit and reputation in a negative way.

High risks

AT&T was restricted by government regulations on innovation and failed to follow the trend of microwaves for communication, which transformed the industry and later made it lose its status. This illustrates two high risks for monopolies:

Technology & Pace of Change: This force as a threat is high. As mentioned several times before, a monopoly that tends to forget the importance of innovation within its own company, might not see other companies innovating on new products delivering a superior quality and answering better the job to be done for the customers.

Government: This force as a threat is high. Governments can impose market restrictions on monopolies that decrease their profit and make them lose their freedom over customers.

For the few high risks that threaten monopolies (Substitutes, Buyer power, Technology & Government), some actions can be taken to address them and reduce their impact. They will be addressed in section E. So, overall, the risks posed by being a monopoly are low compared to when it has competition and is subject to High Industry Rivalry, Threat of new entrants, etc. and it is an argument in favor of becoming a monopoly.

C.2 Our Response

We believe companies **should strive** to become monopolists. Given the reasons we discussed above, we believe the benefits outweigh the risks. Also, not striving to be a monopoly means not trying to maximize profits - which is against most companies goals. To make profits, the company needs to escape competition by differentiating itself from the competitors. This is dovetails nicely with striving to be a monopoly.

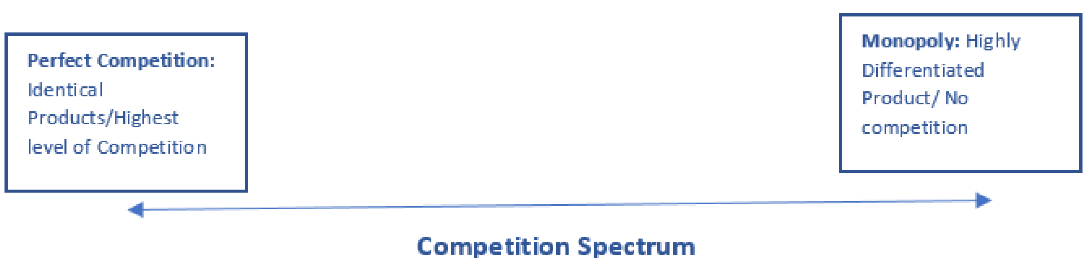

Figure 2: Competitive spectrum

In other words, the goal of a company is to move towards the monopoly extreme of the competition spectrum.
This will allow the company to access the exclusive, proven economic benefits described in the previous section that come only when being a monopoly. Concerning the drawbacks, we believe actions can be taken to prevent or limit their impact, as it will be described in the next section E.

Note: In the cases when a company's primary goal is to maximize its social impact (as for social businesses) or accelerate innovation, then the company should avoid becoming a monopoly. Competition, in social businesses cases or innovation-driven companies, means collaboration and faster widespread of impact.

Achieving wide-scale social impact has been recognized to happen effectively mainly through collective impact. This is somewhat anathema to the traditional operations of a monopoly.

D. When should government regulate monopolies?

Company executives may never admit to chasing a monopoly status, but all indications point to the fact that most companies chase this status. Monopolies have frequently abused their power and position to maximize their profits, not caring about the economy or customers and have created bad reputation for other monopolists. For example:

- Monopolies also abused their power as sole supplier as a product to demand customers pay unreasonable prices. Drug company Concordia has monopoly in the supply of liothyronine tablets, which is an essential drug in treating hypothyroidism. Leveraging their position as the only supplier of the drug, Concordia was able to increase the price per pack of the drug from 4.46 pounds to 258.19 pounds, an increase of 6000% just over a period of ten years to drive up their profit[3].
- Not just price, monopolies have also abused their position to offer products with lesser quality simply because there is no one else offering a close substitute. They have also tied their other products with the products in which they have monopoly and forced them upon customers. An example of such a company is Microsoft. The first several versions of Word for Macintosh and Windows were great products, won many awards, and so Word became the leading word processor. Now that it controls over 60% of the market share, Microsoft comes out with new versions of Word that lacks the grace of previous versions. But people upgrade anyway because there is not a viable alternative[4]. Microsoft in the past has also tied internet explorer, the web browser, to their operating system and crushed other browsers.

These examples show how monopolists have used their position to wildly increase prices and prevent the growth of other quality offerings. The actions by the monopolists in the above examples have hurt customers in the market by subjecting them from unreasonable price increases or by restricting their access to suitable alternative offerings.

Governments should step in to regulate monopolies when the monopolists are taking actions that affect customers access to choice or affect customers' ability to pay a reasonable price for an essential offering. The examples above provide examples of these kind of actions and governments should step in to protect customers in these situations.

E. How a monopolist should behave

After achieving monopoly status, companies have often behaved badly and then eventually lost this status due to government intervention or overtaking by a new entrant. To prevent regulatory body intervention or loss of status to a new entrant monopolists should follow these guidelines:

- **Don't stifle competitors by defaulting to your offerings.** Stifling innovation by going after potential competitors is sure to attract scrutiny and eventual regulation from governments. For example, to combat the growth of Netscape, Microsoft released Internet Explorer and made it a default web browser program on all Windows machines. This move killed off Netscape but drew the ire of US regulators. This forced Microsoft to invest in Apple to grow its competition and led

[3]https://www.reuters.com/article/britain-medicine-concordia-hlthcr/britain-says-canadas-concordia-overcharging-health-service-for-thyroid-drug-idUSL8N1NR209

[4] https://cs.stanford.edu/people/eroberts/cs201/projects/corporate-monopolies/dangers.html

to Apple winning considerable market share in the personal computing space. Monopolies should find a way to encourage innovation by other companies on its platforms. A good reference would be Apple's decision to create the App Store and open it to developers. This increased the popularity of Apple's devices and allowed for innovation on the company's platform, benefitting Apple tremendously.

- **Don't lose customer focus.** Monopolists have tended to reduce investments in R&D once monopoly status is achieved. They have focused on minimizing costs by not improving on their product offering. Customers notice this, and after a while, they're satisfaction starts to fall, and they start looking for substitutes to improve their experience. For example, AT&T focused on maximizing profits during its monopoly years and failed to invest in improving the customer's experience. Once customers had substitutes, they left AT&T because their satisfaction was so low that they were willing to try offerings by other companies. To combat this tendency, Monopolists should follow Google's example in the search industry. Google achieved monopoly status early on in the search industry but didn't stop innovating there. They've made incremental improvements over time to personalize search results based on noted customer preferences. This way customers receive relevant searches any time they go to Google. This high customer satisfaction has helped Google maintain its monopoly in the search industry.

- **Don't price-gouge your customers.** Some monopolists have taken full advantage of their ability to maximize profits and irresponsibly increased prices in a way that causes pain to their customers. Doing this irritates customers and makes the monopolist a target for government regulation. For example, pharmaceutical companies in the US, like Valeant, raised their drug prices by almost 800% on life-saving drugs. This made the industry a political talking point during the 2016 presidential election and a target for price ceiling regulations. To avoid this tendency, monopolies should be transparent with their customers and explain price increases. This promotes trust in the market. An example of this can be found in the ride-sharing industry. Uber and Lyft lead the industry, and they determine prices on a dynamic basis based on customer demand, supply, and distance. Customers know that when there is a high or outsized demand for rides, prices will surge. Even when trips get expensive, customers are willing to accept these costs because they understand the mechanics that went in to determine the price. Monopolists can adopt such behaviors to improve trust among its customers.

- **Don't prevent the development of other technologies by buying patents or other legal maneuverings.** Monopolists that prevent the growth of other industries by lobbying for regulations on them or by buying up patents create bad reputations that could harm customer sentiment. For example, the oil companies like Chevron controlled the energy industry and bought patents around electric vehicles and stifled research that showed fossil fuels are bad for the environment to prevent the growth and development of the electric vehicle industry. Since this has come out, the reputation of these companies have dropped, and more customers are buying electric vehicles. Rather than try to stifle the growth of a competing industry, monopolists can invest in these industries and treat them like a horizon 2 or 3 business. An example of how to do this can be seen in how the automobile industry has responded to the rise of autonomous vehicles and ride sharing. Instead of trying to squash this new developments, companies like Ford, and General Motors are partnering with leaders in the autonomous vehicle and ride sharing industries to make sure they are well positioned when those industries are mature. Monopolists can adopt this mindset to better prepare for the future.