Competitive Strategy: Week 12

Organisational Scope

Simon Board

Make or Buy?

- Should you make a product in-house, or buy from outside?
- Example: Lockheed Martin is merchant buyer
  - A division buys cheapest parts, from inside or outside.
- Benefits of using market
  - Comparative advantage
  - Why make product if you take a loss?

Reasons to Make

- Holdup (week 6)
- Double marginalisation (week 9)
- Leakage of proprietary information
  - Example: Defence firms or Coke.
- Foreclosure
  - Two upstream firms U_1 and U_2, and one downstream D_1.
  - If U_1 merges with D_1 they can kill competitor, U_2.
  - Example: Sabre gave advantages to AA flights.
  - But is this good idea? There is only one monopoly profit.
- Tapered Integration: Both make and buy
  - Pro: Disciplines insiders and outsiders.
  - Con: Loss of scale and efficiency.

Definitions

- What is an Organisation?
  - Alchian and Demsetz: A nexus of contracts.
  - Have contract between firm and workers, suppliers, buyers.
  - Easier than complex multilateral contracts.
- What is Ownership?
  - Residual rights of control
  - Contracts are incomplete. Owner control what's not in contract.

Transactions Cost Analysis

"It is surely important to inquire why coordination is the work of the price mechanism in one case and of the entrepreneur in another." Ronald Coase (1937)

- Why not let market do everything?
  - Markets are efficient and provide incentives (see FWT).
  - Markets coordinate economic activity.
- What are the limits to organisation?
  - Suppose two firms, A and B, operate separately.
  - Why not merge them? One can always keep everything the same, and replicate the unintegrated outcome.
- Unit of analysis: Transaction
- Design organisations to minimise costs of production and trade.
  - Would like to hold production costs constant.

Dimensions of Transactions

- Specificity of investments
  - Potential for hold-up.
- Frequency transactions occur and duration they last for
  - Cooperation requires repeated contact.
  - Frequent contact means contract can be more specific.
- Complexity of transaction.
  - Is item standard or one-of-a-kind?
  - How much uncertainty is there?
- Difficulty in measuring performance.
  - How measure performance of your doctor?
- Connectedness to other transactions
  - To sell a computer one needs many other transactions.

Transactions Costs: List 1

- Holdup and asset specificity
  - Renegotiate prices after specific investment.
  - Undermines incentives to invest.
  - Problem: lack of commitment.
  - Note: This can be one– or two–sided.
- Coordination costs
  - Different divisions need to coordinate activities.
  - Need to agree of common parts.
  - Need to share information.
- Motivation and incentive costs (week 13)
  - Tradeoff: incentives vs. risk
  - Need to measure performance.
  - Monitoring costs.

Transactions Costs: List 2

- Information acquisition costs
  - "Free" information is costly to collect.
  - Information costly to extract from employees who have individual interests.
- Information processing costs
  - Large data systems costly.
  - Example: When Exxon and Mobil merged, they delivered 100 million pages of information to FTC.
  - If processing is easy, why go to school?
- Contracting costs
  - Cost of writing contracts.

Transactions Costs: List 3

- Search costs
  - Cost of finding employees, suppliers and customers.
- Enforcement costs
  - If contract is breached, enforcement is costly.
- Bargaining costs (week 2)
  - Negotiation is costly and takes time.
- Measurement costs
  - Outputs and inputs need to be measured.

Influence Costs

- Why not have one giant firm?
  - Why is selective intervention not possible?
- After merger a decision maker has the *power* to intervene
  - But doesn't know exactly how to intervene.
- Agents try to influence the principal's decision.
  - Direct cost of influence activities (time, ingenuity).
  - Cost of wrong decisions.
  - Cost of reorganising firm to minimise influence costs.

Tennaco and Houston Oil

- In 1980, Tennaco acquired Houston Oil and Minerals.
- Houston
  - Discovered oil and minerals.
  - Aggressive, risk–taking, entrepreneurial.
- Tennaco planned to run Houston as separate firm.
  - Keep high–powered incentives.
- Problem
  - Tennaco's 100,000 employees were jealous.
  - Pressure to increase equity.
  - 1/3 of Houston's managers left firm.

General Motors vs. Ford

- In 1921, Alfred Sloan was appointed to head GM.
- General Motors. 11% of U.S. market.
  - Collection of car companies (Cadillac, Buick, Olds etc.).
  - No central direction.
  - No coordination on parts: high costs.
  - Firms competed heavily with each other.
  - Inventory costs not assigned to division, so huge inventories during 1920 recession.
- Ford. 45% of U.S. market.
  - Single product: Model T. Very low costs.
  - "People can have the Model T in any colour - so long as it's black".
  - Hierarchical Unitary structure (U–form).

General Motors vs. Ford cont.

- Sloan's Plan
  - Design different cars for different segments.
  - Cadillac at the top, Chevrolet at the bottom.
- Problems
  - Variety: new designs, new delearships, new factories.
  - Coordination: reduce competition between divisions, share ideas, coordinate R&D, agree on common parts.
- The Multidivisional firm
  - Central office: plan overall strategy, audit divisions. Also responsible for research, legal and financial roles.
  - Divisions: autonomy on day–to–day activities. Make and sell car targeted at allotted segment.
- In 1940, Ford had 16% market share. GM had 45%.

The Multidivisional Firm

- Based on divisions
  - Product divisions. e.g. Dupont has explosives, chemicals etc.
  - Customer divisions. e.g. GM.
  - Geographical divisions.
- How set transfer prices?
- Marginal cost
  - Buying firm makes right purchase decision.
  - But fixed costs mean supplier makes loss.
  - Selling firm makes suboptimal investment choice.
- Average cost pricing

The Multidivisional Firm cont.

- Each firm profit maximises
  - Double marginalisation
- Price equal to outside market price
  - Need outside market to exist.
  - Incentives OK, if can buy from outsiders.
  - If forced to buy inside firm, seller's quality declines.
- Investment and the partnership problem
  - Both divisions can't have right incentives.
- Why did divisions integrate in first place?
  - Often because market didn't work!

Toyota

- In 1950s, Toyota was small Japanese car firm.
  - Little capital, no scale economies.
  - Couldn't mimic American mass production.
- Just-in-time manufacturing
  - Inventories act as buffer, but subject to large economies of scale.
  - Toyota reduced inventories via close coordination.
- Reliability of process
  - Without buffer of inventories, engineers worked on reliability of every step of production line.
- Fewer flaws in product
  - Problems noticed immediately, rather than sitting in inventories.

Toyota cont.

- Suppliers
  - Little scale, so can't produce in–house.
  - Communicate on day–to day basis.
  - Long term relationships.
- Skilled workers trained to fix own machines.
  - In US, this was specialised job.
- Flexible machines, due to lack of scale.
  - Leader in use of robots.
- Frequent redesigns possible
  - Because of flexibility of production line.
- Strategies are complements.

Modern Manufacturing

	Mass Production	Modern Manufacturing
Varieties	Small	Large
Machines	Specialised	Flexible
Workers	Specialised	Multiple tasks
Inventories	Large	Just-in-time
Authority	Centralised	Decentralised
Communications	Infrequent, top-down	Fast, bidirectional

Hudson's Bay Company

- HBC formed in 1670.
  - Trading monopoly in Quebec, Ontario and Manitoba.
  - Centralised decision making, based in London.
  - Paid employees flat salary.
  - Relied on intermediaries for furs: Double markup.
- North West Company
  - Independent traders based in Montreal, far from furs.
  - Traders moved and travelled back to Montreal once a year.
  - NWC close to customers.
  - NWC had decentralised decision making.
- By 1809, NWC had 80% of fur trade. HBC then copied NWC.
  - By 1921, HBC had beaten NWC and they merged.

Salomon Brothers

- During 1980s, Salomon most profitable investment bank.
  - Very good at bond trading.
- Pay Structure: small salary plus bonus.
  - Every transaction prices: just like piece–rate.
  - Bonuses very big. Incentives very large.
  - Aggressive, risk–taking culture.
  - But lack of cooperation between departments.
- Stock scheme
  - Define bonus as before.
  - Then invest fixed proportion in Salomon shares.
  - Can't withdraw for five years.