The Economics of E-commerce and Technology

Industry Analysis
Industry Profits

- In Econ 11, Economic Profits = 0
- In reality, many industries have much higher profits:

![Average Industry ROIC (1992 – 2006)](chart.png)
Industry Analysis

- Identify factors determining industry profitability.
  - Provides context for strategic analysis.
  - Analysis depends on market definition.

- Porter’s “five” forces
  - Substitutes
  - Competitor Rivalry
  - New entrants
  - Buyer bargaining power
  - Supplier bargaining power
  - Complements

The Five Forces That Shape Industry Competition

Force 1: Substitutes

- A firm’s markup is determined by its demand elasticity
  \[
  \frac{p - c}{p} = \frac{1}{e} \quad \text{where} \quad e = -\frac{p}{q} \frac{dq}{dp}
  \]

- Which elasticity?
  - Demand for smart phones is inelastic
  - Demand for Samsung’s Galaxy G3 is elastic

- What about strategic interaction?
  - If I change my price, this may affect behavior of others

- Substitutes outside the market
  - Ignore strategic interactions

- Substitutes inside the market
  - Pay attention to strategic interaction
Force 1: Substitutes

- Consider two products: What is a substitute?
  1. Price of $x$ goes up, then demand for $y$ goes up.
  2. If $x$ and $y$ indivisible goods, $V_{xy} < V_x + V_y$

- Degree of substitutability matters
  - Affects how our firm interacts with competitors.
  - Depends on type of product differentiation.
Force 2: Competitor Rivalry

- Bertrand benchmark
- Assumptions
  - Two firms simultaneously set prices
  - Constant marginal cost, c
  - Firm with lowest price serves whole market
- Example: gas stations next to each other.
- What is elasticity of demand?
- What is equilibrium price?
Force 2: Rivalry

- Dominant firm (e.g. eBay)
  - Biggest danger comes from new entrants.
- Oligopoly (e.g. Dating sites – match, eharmony, jdate)
  - Competition and cooperation issues become interesting!
- Fragmented (e.g. blogs)
  - Little strategy for fragmented industry.
Force 2: Competitor Rivalry

- What determines how intense competition is?
  - Product differentiation
    - Real differences in products
    - Switching costs
    - Search costs
  - Cost structure
    - Supply side returns to scale
    - Capacity constraints
  - Network effects (demand side returns to scale)
  - Collusion
    - Explicit or tacit
Force 3: New Entrants

- Incumbents often blind-sided by new products.
  - IBM and Microsoft/Intel
  - Microsoft and the internet.
- Are fixed costs an entry barrier?
  - Intuition: High fixed costs reduce entry, lower elasticity of demand and increase profits.
- Flaw in argument?
  - Profits are positive after paid fixed cost.
  - But what about ex-ante?
  - There needs to be incumbency advantage.
Force 3: Entry Barriers

- **Demand side**
  - Switching costs (e.g. TurboTax)
  - Demand-side returns to scale (network effects, e.g. MS Word)
  - Reputation (e.g. Apple)

- **Supply side**
  - Proprietary technology (e.g. patents)
  - Access to raw materials (e.g. Apple and flash memory)
  - Learning curve (e.g. NY Times)

- **Equilibrium**
  - The threat of post-entry price war. (e.g. CD Phone Books)

- **Strategy**
  - Should you preemptively block or fight entry?
First Mover Advantage via Competition

- Suppose firm A is in industry.
  - Has marginal cost 5.
  - 100 customers with value 10.
  - A is currently charging $p=10$ and making $\pi=100(10-5)=500$.

- Firm B is considering entering
  - Has marginal cost 4 and fixed cost 150.
  - Good is homogenous.

- Should firm B enter?
  - If it enters, Bertrand competition implies price falls to $p=5$.
  - B’s profits are $\pi=100(5-4)-150 = -50$.
  - B should not enter, anticipating the cut-throat competition.
How big is the pie?
- Potential pie = value of relationship.
- Ex-post costs of negotiation: market power (e.g. double marginalization), delay (e.g. strikes), bargaining costs (e.g. lawyers)
- Ex-ante costs of negotiation: underinvestment in relationship, cultivation of outside options. Called “holdup problem”.

How is the pie split?
- Long side vs. short side of market
- Concentration on each side of the market
- Power to commit to one stance
- Information
Example: Double Marginalisation

- Example (the cable business)
  - HBO sells input to TW; TW sells output to customers.
  - Market demand is $q=100-p$. Both firms have zero costs.

- Maximal Industry Profits
  - Charge $p=50$, sell quantity $q=50$. Profits = $50\times50 = 2500$.

- What if HBO charges transfer price $t$?
  - Then TW maximizes $\pi_{TW}=(p-t)(100-p)$
  - Chooses $p=50+t/2$ and sells $q=50-t/2$, treating ‘$t$’ as input cost.

- What input price does HBO choose?
  - HBO maximizes $\pi_{HBO}=t(50-t/2)$, implying $t=50$, $q=25$ and $p=75$.

- Firms charge more than monopoly price!
  - Intuitively, each firm exert negative externality on the other.
  - Can raise profits by merging or using two-part-tariff
Case Study: Nintendo

- Nintendo invented NES in 1983
  - Cheap hardware: 8-bit processor dated to 1970s.
- Limited power of software firm
  - Limited to 5 titles a year.
  - Exclusivity condition: games only for Nintendo.
- Limited power of retailers (e.g. Walmart, ToysRUS)
  - In 1988 retailers requested 110m units.
  - Supplied 33m units.
  - Threaten to cut off, if carry competitors products?
- Nintendo gets large slice of pie
- Danger: strategies reduce pie and invite entry
Force 6: Complementors

- What is a complement?
  1. Price of x goes up, then demand for y goes down.
  2. If x and y indivisible goods, $V_{xy} > V_x + V_y$

- Complementors make the pie bigger.

- Xbox and games
  - When launched in 2001, not many games for Xbox
  - It bought Bunjie and used “Halo” as launch title.
  - Provide tools to encourage third party developers.

- Relation to platform market
  - Xbox is platform where users interact with software.
  - Not all platforms are for complementors: Google searchers may dislike ads.
Market Definition

- How define the market for Dell Desktop?
  - Other desktops? Laptops? Netbooks? iPads?
  - It depends what question you are asking!

- You should think about
  - Demand interactions: elasticity of substitution
  - Strategic interactions: whether firm A reacts to firm B’s decisions.

- Case Study: Epson
  - Epson dominated low-end dot-matrix printers.
  - HP dominated the Inkjet and high-end laser printer market.
  - Epson in “wrong market”, so launched cheap laser printer in 1989.
  - Price war: Laser prices fell, Inkjet prices fell, and dot-matrix market..?
  - Lesson: There’s always a bigger market.
There’s always a bigger market…

"Hal! We got him now!"
Example: Amazon’s Book Business

- **Substitutes:**
  - Inside market: other booksellers (online, offline), eBooks
  - Outside market: libraries, magazines, TV etc.

- **Buyers:**
  - Individuals. Buyer bargaining power: Little.

- **Suppliers:**
  - Publishers, USPS. Supplier bargaining power: Varying.

- **Rivals:**
  - Online/offline sellers. Small sellers, bookstores, superstores.
  - Industry structure: Oligopoly with fragmented fringe.

- **Entrants:**
  - Specialty sellers, other offline stores, Yahoo.

- **Compliments:**
  - Broadband, reviews, credit cards.