Viable Business Strategies for Declining Cost Industries in the Global Information Age

CEI is hosting a workshop/seminar dealing with *Declining Marginal Cost Industries in the Global Information Age*. The goal is an insightful roundtable discussion dealing with the common problems (and solutions) of a range of industrial sectors all of which face the same basic difficulty. We plan to commission (or reprint with permission) a few survey papers to structure the discussion and then transcribe, edit and publish the proceedings to influence the policy debate. The event will be held in Washington, DC, on the evening of May 6 and during the day on May 7.

I believe that all declining cost firms face continued threats unless we find some way of legitimizing the multi-part pricing policies (or other financial arrangements such as pre-purchase or long-term purchase agreements) necessary for financial viability.

Background

As Professor Ronald Coase, Nobel Prize winner and Chicago school economist, long ago noted in his article, "The Marginal Cost Controversy," a declining cost industry must find some way to finance itself: either via creative multipart pricing (facilitated by bundling or contracts) or via some form of government subsidy. The markets solution has traditionally relied on distinct marketing strategies in different geographic regions and to different segments of the markets, with market segmentation facilitated by the high costs to consumers of transport and/or the difficulty of acquiring information about the prices paid by others. The government subsidy approach inevitably entails government regulatory and /or price controls (there are no "free" subsidies). Clearly, we prefer the market solution. But how?

This declining cost problem remains the key challenge to a range of industries: the entertainment industry (music and movies), the airlines and other high-fixed cost sectors, the various network industries (railroad, electricity, telephone), the software and the pharmaceutical industry. In all these industries, the challenge faced is similar: the amount one must charge to ensure a positive contribution to overhead (the charge required to cover variable or avoidable costs) is small compared to the amount one must charge to remain economically viable. In a non-cooperative competitive environment, therefore, prices may be driven below those needed to ensure dynamic, creative change. We get one generation of "cheap" services and then nothing.

But, of course, this problem is certainly not novel. How have declining marginal cost businesses survived to date? There are a number of methods – the dominant approach has been to rely on some form of multi-part pricing. Variants include some fixed fee to allow any purchase and then differential pricing varied by region, timing, quantity, value of services and so forth. In a global economy (one in which geographic price differentials soon disappear) where information costs are low (and thus purchasers can soon realize the prices paid by others), multi-part pricing is increasingly difficult.

A range of policies reinforce this multi-part pricing concept: intellectual property (which by granting the individual the sole right to sell certain products makes it easier to price differentially – although prices remain constrained by ability to pay and thus in many nations one must sell at low prices (and find some way of preventing resale) or forgo sales totally (and thus appear inhumane). Note, however, that antitrust regulations make it difficult for competitors to coordinate selling policies and, thus, prevent a rush toward marginal and non-sustainable prices. Indeed, the strict application of some laws, such as Robinson-Patman (non-discriminatory rules), would make selective pricing impossible.

The declining marginal cost question arises in part because the "pricing/financing" task may be optimized at a scale larger than the production/distribution tasks. (That is, some degree of price coordination may be needed to ensure reasonable pricing.) This was the criticism levied by Bittlingmeyer, after all, of Addyston Pipe. A firm (according to Coase) is best viewed as an organization to perform efficiently a set of tasks which can be done reasonable at the same scale. Smaller tasks (janitorial services, for example) might better be contracted out; larger tasks (R&D, for example) might be performed best by joint ventures (partial mergers); and complete mergers may be an optimal form of leveraging pricing efficiencies within an industry. It is possible that DMC industries are those where pricing is best performed at a supra-firm level. If so, there may be an efficiency case for price coordination that is blocked by current policies (at least, as I've understood that case).

Other options include Ramsey pricing; delayed sales (for example, hard bound books sold some months in advance of paperbound books); differentiated products (lower quality goods sold at lower prices in selected markets); retail price maintenance; after-sales rebates (such as coupons); selective bundling to capture selected values from selected customers; controlled distribution and sales channels (including exclusive market arrangements); selective refusals to deal; penalty fees and penalty fee accounts for leakage from dedicated sales channels (transfers); selective purchasing arrangements (pill splitting strategies); frequent shopping; document prices varying by payment methods; selling cartels (if antitrust exemptions available); sales limitations; packaging (perfumes, for example); and prizes. There are probably others, which this seminar will hopefully explore.

Our goal is threefold: to explore the array of business strategies that exist to ensure financial viability, to examine how these arrangements might be legitimized, and to review whether other policies (anti-trust rules, trade policies) may hinder differential pricing. The problem is important: the use of the term "discriminatory pricing" which suggests this practice is "wrong or even illegal." We need to explore ways to legitimize such strategies.

Participants

Exploring what might be done is the purpose of the seminar. The seminar/roundtable workshop would attract individuals in five categories: academics, policy analysts, government analysts, practitioners and to a limited extent, the media.

Structure

There will be separate panels for each industry. All panels would address the same basic issues: the nature of the cost structure of that industry, the ways in which this leads to DMC problems, the difficulties faced in differential pricing, the public policies that exacerbate this problem, and practical approaches adopted to overcome these problems. The ways in which globalization and reduced information costs (harder to "hide" prices charged others) has made the industry problem more complex. The seminar will begin with a dinner and a kickoff speech by Vernon Smith on Thursday, May 6. There will likely be three panels, each moderated by a rapporteur that would summarize and keep each panel on track. In addition, we will have a luncheon speaker.

Outcome:

The goal of this seminar/workshop is to summarize how financial viability for declining cost industries can be devised, perpetuated and legitimized in various settings. The discussion will be transcribed, edited, published and presented to various policy groups, academics and those in industry.

More details will follow as they become finalized. I look forward to assimilating a great group of people that will get the debate moving forward on an issue that will continue to grow in importance as marginal costs decline.

Fred Smith