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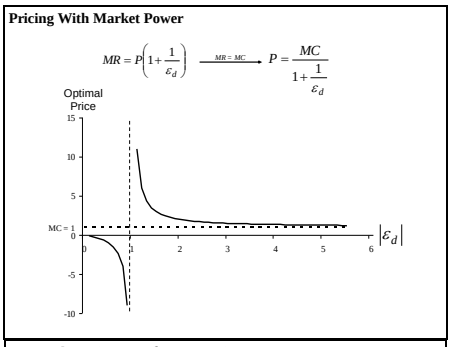
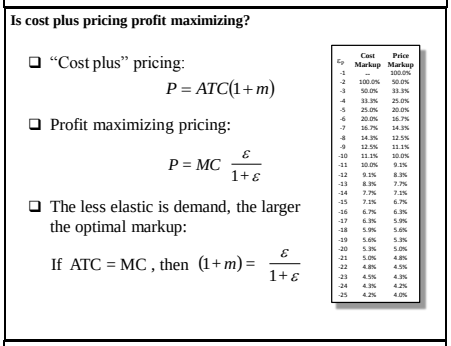
SV353, Industrial Organization

3-1: Pricing With Market Power

When a firm has market power (when price elasticity is less than infinite), and when marginal costs are constant (thus, equal to ATC), the optimal markup is a simple function of ε.

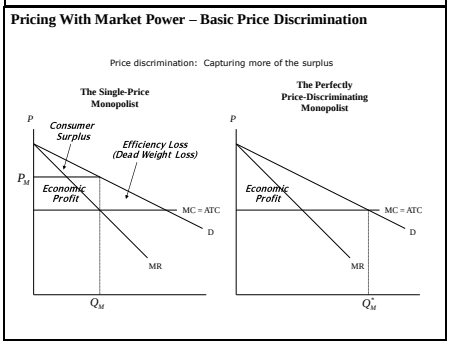
Firms often employ a "cost-plus" pricing strategy, but cost-plus is optimal only under a set of restrictive conditions.





Price discrimination: charging different prices to different customers based upon their elasticity of demand.

- Differential pricing based on cost differences does not constitute price discrimination.
- With price discrimination, the ratio of prices across markets will be different than the ratio of marginal costs



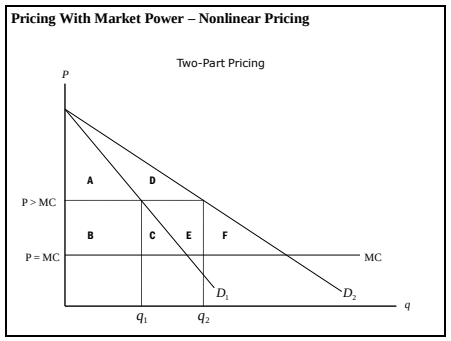
Requirements for price discrimination:

1. Market Power
2. Information (about ε)
3. Ability to prevent arbitrage

Types:

1. 1st degree (perfect)
2. 2nd degree (self-selection by customer)
3. 3rd degree (selection by indicators; market segmentation)

Non-linear pricing: the "two-part tariff"



Relevant exercises: Problem Set 3, exercises 1 through 3.