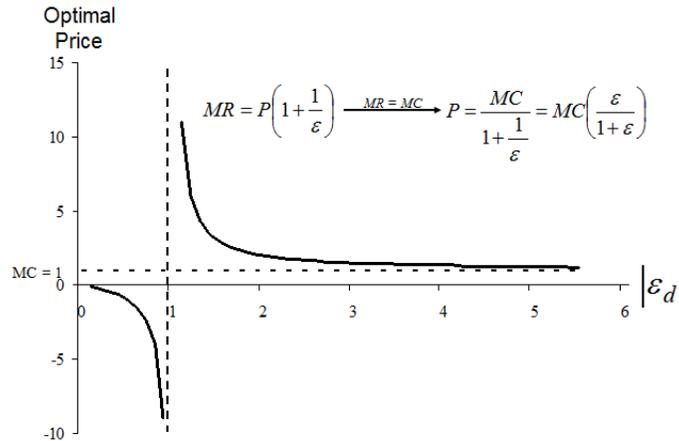


3.6: Pricing With Market Power

To prepare for this lecture, read Hirschey, chapter 15.

Economic theory defines optimal pricing in terms of marginal cost and elasticity of demand:



In practice, the most common pricing policy is some form of **mark-up pricing**, which sets price in terms of average total cost (or **unit costs**) and a **markup on cost**, m :

$$P = ATC(1 + m)$$

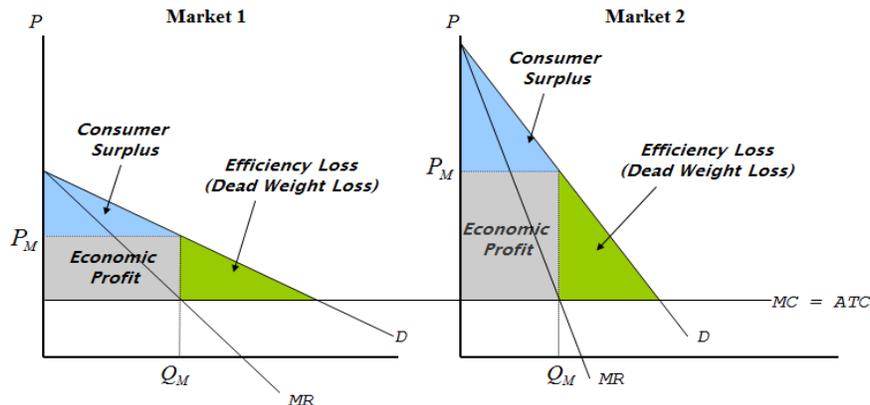
Thus, if $ATC = MC$, the optimal markup on cost, m , will be some function of price elasticity of demand:

$$m = \left(\frac{\epsilon}{\epsilon + 1} \right) - 1 = \frac{-1}{\epsilon + 1}$$

Aside from highlighting the value of accurate estimate of price elasticity of demand (or at least a reasonable understanding of it!), these observations also raise an important question: under what conditions would average total cost (or unit cost) be a reasonable proxy for marginal cost?

Price Discrimination

This is any pricing practice that sets different prices for different markets for reasons that are unrelated to differences in cost of production and delivery. Building on the notion that different **market segments** may exhibit different price elasticities of demand, it is easy to see that, given consistent marginal costs across segments, optimal prices are higher for market segments with more inelastic demand:

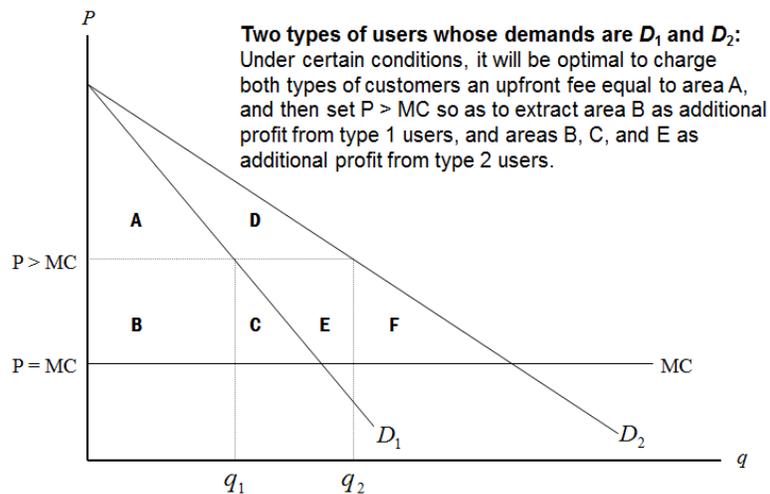


Economists distinguish among three types of price discrimination:

1. **First-degree** (also known as perfect price discrimination), which involves charging a different price to each customer.
2. **Second-degree**, which involves charging different prices based upon usage or purchase patterns. **Two-part pricing** is a very common form of second-degree price discrimination.
3. **Third-degree**, which involves charging different prices to different user groups (market segments) based upon implied price elasticities of demand.

Notice that in order for any form of price discrimination to succeed, firms first must acquire information about the elasticity of demand for individuals or groups, and then must be able to prevent resale among the individuals or groups.

We can use the following diagram to understand the concept of two-part pricing:



Bundling

This is a pricing strategy in which several products are offered for sale as one combined product. Its success depends upon at least two conditions:

1. There are contrasting demand characteristics for the two goods: distinct market segments will exhibit contrasting willingness to pay for two different products. Ideally, their willingness to pay will be negatively correlated.
2. There are economies of scope in distribution; thus, the marginal costs of bundling are low.

Note that bundling is not the same as using market dominance to force acceptance of related products. Such practices are known as tying, and are often considered anticompetitive by antitrust officials.

Other Relevant Pricing Practices

Dynamic Pricing: Real-time pricing structures that can be updated according to customer type or current market conditions.

Limit Pricing: A pricing strategy by an incumbent firm in which price is set at a level (usually below the monopoly profit-maximizing level) in order to discourage entry into a market by new competitors.

Transfer Pricing: See Hirschey, Appendix 15A.

Relevant Textbook Problems: 15.4, 15.7, 15.8