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E52-453 (x3-6641)

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15.013 — INDUSTRIAL ECONOMICS FOR STRATEGIC DECISIONS

FALL 2005

This subject is designed to provide a working knowledge of the analytical tools of industrial economics that bear most directly on the strategic decisions that firms must make. The kinds of decisions that will be of interest to us include: pricing and output; advertising; investment in new production capacity; the introduction of new products, brands, and quality variations; investments in R&D; and the use of patents. Throughout the course, our emphasis will be on industry structure, its relationship with the way firms interact strategically, and its implications for market power. The analysis of industry structure, strategic interactions among rival sellers, and strategies for entering an industry, or for deterring entry or controlling its impact, will be covered with a mix of theory and case material.

Students taking this course should have a good background in microeconomics — specifically, course 15.010 or its equivalent. In addition, some background in finance (course 15.401 or the equivalent) is strongly recommended.

No textbook will be assigned for this course. However, a set of readings and cases should be purchased from Copy Technology Center, which is in the basement of the Sloan Building.

Grading in the course will be based on four different aspects of your performance:

- *Classroom participation* (28% of grade) — All students are expected to read the assigned materials, to attend class, and to participate actively in class discussions.
- *Strategic oligopoly game* (15% of grade) — You and your teammate will be graded on your performance in this semester-long game. Your performance will be measured relative to the overall average performance of both sections of 15.013.
- *Exercises* (32% of grade) — We will assign 9 written “exercises” over the course of the semester. *You are only required to turn in 8 of these exercises.* (If you do all 9, we will drop the lowest grade.) You may do these exercises individually or in groups of up to three students.
- *Final exam* (25% of grade) — This will be an in-class exam.

Class Attendance: Students are expected to attend all classes, and to arrive in class promptly. Students are also expected to have done the required reading and be prepared to participate actively in class discussion. I will begin most classes by “cold calling” on two or three students.

Laptop Computers: Given the importance of classroom participation, we ask that you do *not* open your laptop computer during class. There are only two exceptions to this rule: (1) presentations and discussions of exercises, where spreadsheets or other results are on your computer; (2) students with special needs (e.g., handwriting difficulties), who get permission in advance to use their computers.

Group Work: *You are expected to participate fully in any exercise or other assignment that has your name on it.* It is absolutely unacceptable to “rotate” assignments among members of a group, or to take credit for an assignment in which you were not substantially involved. You may allocate the work needed to complete an assignment (e.g., one person does the internet research, another develops a spreadsheet model, etc.), but every member of the group must be substantially involved in the assignment.

DATES TO REMEMBER

<i>Monday, September 12</i>	Please turn in a short (1- or 2-paragraph) “biography” describing your background and interests. Include a photograph (your biocard photo is fine), the <i>phonetic spelling</i> of your name, and your e-mail address.
<i>Wednesday, September 14</i>	Exercise 1 is due. In addition, you should turn in a note on your choice of partner for the strategic oligopoly game.
<i>Monday, September 19</i>	Student Holiday. No Classes.
<i>Monday, September 26</i>	Trial play of strategic oligopoly game.
<i>Monday, October 3</i>	First real play of strategic oligopoly game. For the rest of the semester, game will be played every <i>Monday</i> .
<i>Monday, October 10</i>	NO CLASS (Columbus Day). Game play can be submitted to TAs via SloanSpace or by e-mail.
<i>Monday, October 24</i>	Exercise 5 and game play are both due by 9:00am.
<i>Monday, October 24, Wednesday, October 26</i>	No classes, SIP week.
<i>Monday, December 5</i>	Last play of strategic oligopoly game.
<i>Monday, December 12</i>	FINAL EXAM (90 minutes, in-class).
<i>Wednesday, December 14</i>	Debriefing, and results of strategy game. Discussion of additional topics as time permits.

TENTATIVE OUTLINE

- Sept 7** *Wed* Introduction: Sources and Uses of Market Power. Overview of the course. Market power and the value of the firm. Strategic decisions that affect market structure and market power.
- Sept 12** *Mon* Intertemporal Production Constraints and Market Power. How the dynamics of cost affects pricing and market power. The production and pricing of depletable resources. Production and pricing with a learning curve. Effects of uncertainty over future market conditions. Implications for market power. The learning curve in the strategic oligopoly game.
- Read: R. Pindyck & D. Rubinfeld, *Microeconomics*, Section 15.7 of 5th edition, Section 15.8 of 6th edition.
Lecture Notes on Intertemporal Production and Pricing, Sections 1 – 3.
- Turn in brief biography.*
Be prepared to answer questions on learning curve and oil well problem.
- Sept 14** *Wed* Market Structure and Evolution. The evolution of a mature industry: Market structure and firm behavior in the beer industry. Market definition: What is the “beer market”? The role of scale economies. Advertising and brand differentiation. How much to advertise? Competing through price versus advertising.
- Read: R. Pindyck & D. Rubinfeld, *Microeconomics*, Section 11.6
Readings on beer.
“Which Brew for You?” *Consumer Reports*, August 2001.
- Exercise 1 due.*
Hand in choice of game partner.
- Sept 19** *Mon* Student Holiday. No Classes.
- Sept 21** *Wed* Market Structure and Evolution (continued). The evolution of an emerging industry: The Internet and electronic commerce. Brief overview of Internet structure. Effects of network externalities. Connectivity (“peering”) in the Internet backbone. Internet auctions. The growth and future prospects of eBay, Inc.
- Read: “eBay, Inc.” (A) [HBS Case #9-700-007]
“eBay, Inc.” (B) [HBS Case #9-703-499]
Note on Internet economics and Market Structure.
Additional material on eBay (to be posted on SloanSpace).

- Sept 26** *Mon* Market Structure and Evolution (continued). Continued discussion of eBay, Inc. Risk and return in electronic commerce. Valuation models. Valuation of eBay, Inc.
- Read: Note on Discount Rate for Risky R&D
- Exercise 2 due.*
Trial play of Strategic Oligopoly Game.
- Sept 28** *Wed* Market Structure and Evolution: Information and Industry Transformation. What drives the transformation of entire industries? The role of the Internet. Will the Internet transform the medical industry? Asymmetric information in the medical industry. Analysis of WebMD.
- Read: “WebMD (A).” [HBS Case #N9-701-007]
 “WebMD (B).” [HBS Case #N9-701-133]
- Oct 3** *Mon* Vertical Structure. The implications of vertical structure for market power. Decisions involving buyers and suppliers. Monopsonistic price discrimination in theory and practice — the market for timber. “Build versus buy” decisions. The use of territorial exclusivity — the soft drink industry. Double marginalization in the market for college textbooks.
- Read: Lecture Notes on Vertical Structure, Sections 1 – 3.
 Pindyck & Rubinfeld, Section 10.5 & 10.6
- First real play of strategic oligopoly game.*
- Oct 5** *Wed* Part I. Vertical Structure (continued). The economics of franchising. Company-owned outlets versus franchised outlets. The free rider problem in franchising.
- Part II. Game Theory and Strategic Competition. Review of game-theoretic models of oligopolistic behavior, and development of tools and insights useful for strategic analysis. Rationalizable strategies. The war of attrition.
- Read: Lecture Notes on Vertical Structure, Section 4.
 Lecture Notes on Game Theory, Section 1.
- Exercise 3 due.*
- Oct 10** *Mon* Columbus Day. No Classes.
- Submit game play to TAs via SloanSpace or by email.*

- Oct 12** *Wed* Game Theory and Strategic Competition (continued). Continued discussion of game-theoretic models and their application. The use of promises, binding commitments, threats, and retaliations. Competing via price versus quantity. Decision making with asymmetric information, and the role of uncertainty. Does better information make a firm better off? Rational (and irrational) responses to entry: the Polaroid-Kodak experience.
- R. Gibbons, “An Introduction to Applicable Game Theory,” *Journal of Economic Perspectives*, Winter 1997.
Lecture Notes on Game Theory, Sections 2 – 3. (Section 4 is optional).
- Oct 17** *Mon* Entry, Market Uncertainty, and Investment. Analyzing and predicting the behavior of new entrants. Learning from an entrant. The option to invest and the value of waiting. The disposable diaper industry.
- Read: “The Disposable Diaper Industry in 2003” [HBS Case #9-703-491]
 “Kao Corporation.” [HBS Case #9-591-012]
- Exercise 4 due.*
- Oct 19** *Wed* Investments in Real Options. Introduction to real options. Investments that create options versus investments that exercise options. Option value and the Net Present Value rule. The value of flexibility. Analysis of scale versus flexibility in electric utility planning.
- Read: A. Dixit and R. Pindyck, “The Options Approach to Capital Investment,” *Harvard Business Review*, May/June 1995.
 A. Dixit and R. Pindyck, *Investment Under Uncertainty*, Chapter 2.
 Lecture Notes: Introduction to Real Options.
- Oct 24** *Mon* NO CLASS (SIP Week)
- However, Exercise 5 and strategic play of oligopoly game are both due by 9:00am.*
- Oct 26** *Wed* NO CLASS (SIP Week)

- Oct 31** *Mon* Part I: Information and the Strategic Timing of Investments. Completion of material on real options. Learning from nature and learning from others: oil, real estate, and R&D. Investment cascades and “wisdom after the fact.” Rational bubbles.
- Part II: Strategic Competition in the Airline Industry. Market definition in the airline industry. Competitive practices in the long run and the short run. Capacity decisions and route structure. Pricing behavior and profitability.
- Read: Lecture Notes on Information and Strategic Timing of Investments.
 Readings on Airlines.
- Nov 2** *Wed* Strategic Competition in the Airline Industry (continued). Continued discussion of short-run and long-run dynamics of the airline industry. Entry, predation, and price wars. Discussion of American Airlines Value Pricing.
Read: “American Airlines Value Pricing” (A) [HBS Case #9-594-001] and (B) [HBS Case #9-594-019].
- Exercise 6 due.*
- Nov 7** *Mon* Bargaining and Contracting: The Commercial Aircraft Industry. Game-theoretic models of bargaining. The durable goods monopolist problem. Introduction to the commercial aircraft industry. The cost structure of the Boeing 777.
- Read: Lecture Notes on Game Theory, Section 5.
 Readings on Commercial Aircraft Industry.
- Nov 9** *Wed* Bargaining and Contracting: The Commercial Aircraft Industry (continued). Competition between Boeing and Airbus in the sale of commercial aircraft. Bargaining between aircraft manufacturers and airlines. Boeing-Airbus-Delta Airlines bargaining exercise in class.
- Exercise 7 due.*
- Nov 14** *Mon* Deterrence via Bundling and Brand Proliferation. The use of bundling to deter entry and gain market power. Pricing and bundling complementary goods. Product line pricing. Bundling and monopoly leveraging. Bundling in the computer software industry: Microsoft in operating systems and office suites. Bundles competing against bundles.
- Read: Lecture Notes on Bundling and Brand Proliferation: Sections 1-2.

- Nov 16** *Wed* Deterrence via Bundling and Brand Proliferation (continued). Introduction to attribute space. Local competition among brands in attribute space. Choosing the attributes for new brands. Brand proliferation, entry deterrence, and market power. Analysis of the breakfast cereal industry.
- Read: Lecture Notes on Bundling and Brand Proliferation (complete).
 “The Ready-to-Eat Breakfast Cereal Industry in 1994 (A).” [HBS Case #9-795-191]
- Nov 21** *Mon* Network Externalities and Market Structure. How network externalities can affect market structure and market power, and implications for pricing, advertising, and investment. Market “tipping” and consumer holdout: compact disks, digital audio tape, and DVDs. Connectivity and compatibility. Compatibility in applications software. Strategic pricing decisions: the “DOS-MAC” market. Pharmaceutical markets: product-specific versus brand-specific externalities.
- Read: S. Besen and J. Farrell, “Choosing How to Compete: Strategies and Tactics in Standardization,” *Journal of Economic Perspectives*, Spring 1994.
 Lecture Notes on Network Externalities, Sections 1–3 (Section 4 is optional).
 “Philips’ Compact Disk Introduction (A).” [HBS Case #9-792-035]
- Exercise 8 due.*
- Nov 23** *Wed* Network Externalities and Market Structure (continued). Credit card networks. Economics of the credit and bank card industry. “Chicken and egg problems” in the evolution of card networks. Acquirers, issuers, and the interchange rate. The development of debit cards. Competition among card networks. “Duality” and competition in card issuance. Pricing and profitability. The impact of electronic money. Competition and market dynamics in card issuance. Discussion of Capital One Financial Corporation.
- Read: D. Evans and R. Schmalensee, *Paying with Plastic*, 2nd Edition, MIT Press, 2005, Chapters 3 and 9.
 “Capital One Financial Corporation.” [HBS Case #N9-700-124]
- Nov 28** *Mon* Strategic Entry Opportunities and Entry Deterrence. Opportunities for entry. Small entrants facing large incumbents: “judo economics.” Methods of discouraging potential entrants, or inducing existing competitors to exit. First-mover advantage with “experience goods.” Gillette’s introduction of the Sensor and the Mach 3 razors.
- Read: Lecture Notes on Entry and Reaction to Entry.

- Nov 30** *Wed* Pricing Strategies. Mark-up pricing in oligopolistic markets. Product line pricing revisited. Pricing with network externalities: static and dynamic. The DOS-MAC simulation. Strategic aspects of buying and selling on the spot market versus long-term contracting.
- Read: Lecture Notes on Pricing
- Dec 5** *Mon* R&D, Patenting, and Licensing. Implications of R&D and innovation for industry evolution and market structure. The race to innovate. Making the R&D investment decision: strategic and non-strategic aspects. Sleeping patents and the decision to adopt a new innovation. Licensing decisions.
- Read: Lecture Notes on R&D and Patent Licensing.
- Exercise 9 due.*
Last play of strategic oligopoly game.
- Dec 7** *Wed* R&D, Patenting, and Licensing (continued). Continued discussion of R&D and patent licensing decisions. Complementary patents: cross-licensing versus the formation of “patent pools.”
- Read: Lecture Notes on R&D and Patent Licensing.
- Dec 12** *Mon* **FINAL EXAM.**
- Dec 14** *Wed* Wrap-Up Class. Results of strategic oligopoly game. General discussion of topics related to course.