Monopoly Pricing
by
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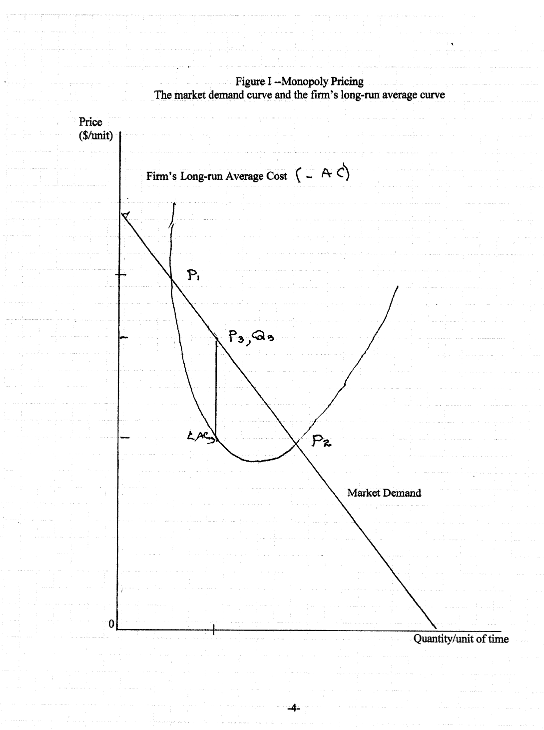
A novel product or process of production puts its producer in a monopoly position. That clarifies the company's pricing position and the new development's effect on society. There are two important considerations. The first is the cost of producing, marketing and distributing the new product. The second is the market demand for it. It is, once the buyers are made aware of it, the total amount of the product all of them are willing to purchase at each of the possible prices. The company must be able to:

- Produce -- a.k.a., manufacture -- the novel product;
- Market -- inform potential customers of its attributes and the price; and
- Distribute -- put it into the hands of customers.

In order for the venture to be worthwhile and viable in the long term, the price must cover the costs of all the parts of the procedure, including reimbursing the providers of the "capital" that made the venture possible. Any income that the firm receives over and above the long-term costs required to produce, market and distribute the new product or process of production are "excess profits". Some of the excess profits accrue when the company is a monopoly. That position allows the firm to charge a monopoly price and get monopoly profits.



Now let's look at the monopolist's pricing options and their effects. They depend upon the relationship between the market demand for the product and the long-run average costs of producing it. (See Figure I). The long-term average cost curve includes the cost of all the inputs required to produce the product including the cost of capital utilizing lean production techniques. The highest price monopolists can charge and still make any sales is where the demand curve intersects with the price axis. The largest amount that the buyers are willing to take off the market occurs when the price is zero. That amount is the maximum amount the monopolists can sell. The monopoly price can fall anywhere in between.

Two price levels, and the corresponding outputs, are significant. They are where the demand curve intersects the long-run average cost curve (LAC) at P1and P2. At those prices, the price just covers the long-run average cost of production, making the monopoly excess profits equal to zero. At any price in between the monopolist has an excess profit. If the monopolist sets a price equal to P3 it will sell

Q3 units, making a profit on each unit of P3 - LAC3. That would provide the monopolist with the maximum excess profit ((P3 - LAC3) x Q3).

There is no guarantee that the market demand will be large enough to cover the long-run average cost of production. When the demand curve falls below the long-run average cost curve at all levels of output, the product will simply not be made available. Only when demand exceeds long-run average cost over a range of outputs, can the supplier receive excess profits. The maximum profit is at the that level where the “marginal cost is equal to the marginal revenue”. That is economists’ way of saying that at that level, the additional money that the sale brings in just covers what it costs to produce the product.

The company can use those excess profits to help maintain and extend its control over the market. A classic example, one which you may already have heard about, is the EpiPen. It is a hand-held device to administer an emergency treatment of Epinephrine to those who are having a severe allergic reaction. The EpiPen, invented by Sheldon Kaplan at Survival Technology in Bethesda, MD, was approved for marketing by the FDA in 1987.

One of the oldest anti-competitive practices is price-fixing. It involves setting the ‘monopoly price’ well above the cost of production. Individual companies can do it when they have control over the market.

The recent EpiPen experience is a contemporary example of that old-fashioned way of doing business. Mylan, a pharmaceutical company, acquired the EpiPen in 2007. The Epinephrine auto-injector is sold in a two-pen set. At the time, pharmacies paid less than $100 for the set. Since the acquisition Mylan has steadily raised the wholesale price. In 2009 it was $103.50 for a set; in July 2013, $264.50; in May 2015, $461 and in May 2017 it was raised to $608.61. That led to a public outcry.

The EpiPen can deliver a life-saving dose for allergy sufferers. Mylan has a very substantial share of the market with no competitors in sight for now. The product and its delivery system have not changed significantly. The EpiPen patent expires in a year. Ideally, each packet should be replaced yearly. At current prices that provides Mylan with an additional $600 plus for each one it sells. In reaction to the public response Mylan recently came out with what they call the ‘generic version’ for $300. It is the same EpiPen with different packaging. It would be interesting to see EpiPen’s price history in other countries, like Canada. During the same period Mylan’s revenue, net income and executive’s salaries have gone up significantly. Furthermore, the company moved its headquarters overseas, apparently to save on its US taxes.

This is a clear example of a company using its monopoly position of power over the market to charge consumers a price well in excess of its cost of production, marketing and distribution.

See EpiPen Price Rise Sparks Concern for Allergy Sufferers. By Tara Parker-Pope and Rachel Rabkin Peachman.

The significantly higher prices:

- Make the EpiPen unavailable to potential customers,
- Puts them at risk, and
- Puts more money into Mylan's coffers.

EpiPen's high prices deprive Mylan's customers of a significant quantity of disposable income, income that they could use for other purposes.

The higher prices also increase the company's excess profits. That makes it possible for Mylan to use them to protect and enhance their monopoly position during the period of patent protection and beyond, even though Mylan was not involved in bringing the innovation to life. The excess profits also puts more money into the hands of the company's executives and owners. Those company and personal funds can also be used to influence the political process. The use of those funds to hire lobbyists is just one example. Those funds also make it possible for the firms and individuals to promote their private agenda.

Sometimes private equity firms, utilizing their expertise and money, are able to turn around firms that are in financial distress, in or near bankruptcy. Often they accomplish that by replacing the "old ways," reorganizing the operations and introducing recent advancements into the production and marketing process. The revival of Twinkies is an example. Two private equity firms, Apollo and Metropoulos, acquired some of the assets of the bankrupt company, turned it around and brought Twinkies back to life. They arranged to tap into future excess profits and put them into their own hands even before they were earned. Moreover, they did not compensate previous employees even though their hard work under difficult conditions kept Twinkies on the market during the transition. As a result the private equity firms, their managers and owners were pushed into the upper end of the income distribution.

For additional details about the EpiPen and Twinkies experiences and other examples of how companies have used their excess profits to extend their control over the market, influence political process and promote their private agenda see my book, <u>Making the Poor Richer: The Causes, Consequences and Potential Remedies for the Greater Inequality in the Income Distribution</u>. The EpiPen discussion is in Anti-competitive actions, pp. 14-15 and the Twinkies experience is in Chapter 7. Stage VI -- Bringing Twinkies Back and More.

<u>Summary</u>

For more about how innovations and monopoly prices affect the decision-making process and their effect on everyone's life, livelihood and lifestyle, see the accompanying essays entitled, <u>Some Fundamentals in Making Any Decision</u> and <u>Innovations: From the Creative Idea into Reality</u>. The higher monopoly prices take money out of the hands of its customers -- the individuals and the firms. When the monopoly position results from an innovation, the innovator deserves to be reimbursed for the expenses incurred to bring the innovation to life and to be rewarded for coming up with the novel idea. Any excess profits over and above that will lead to the greater inequality in the income distribution by those in control.