Economies of Scale

- Economies of scale are cost advantages companies experience when production becomes efficient, as costs can be spread over a larger amount of goods.

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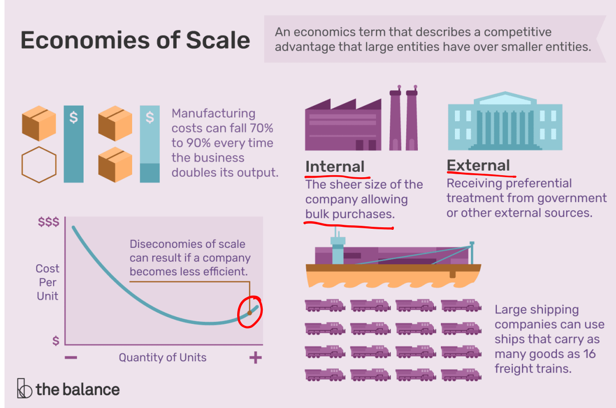

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Economies of Scale

- Internal economies of scale happen when a company cuts costs internally, so they're unique to that particular firm
  - **Technical**: large-scale machines or production processes that increase productivity
  - **Purchasing**: discounts on cost due to purchasing in bulk
  - **Managerial**: employing specialists to oversee and improve different parts of the production process

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Economies of Scale

- Internal economies of scale happen when a company cuts costs internally, so they're unique to that particular firm
  - **Risk-Bearing**: spreading risks out across multiple investors
  - **Financial**: higher creditworthiness, which increases access to capital and more favorable interest rates
  - **Marketing**: more advertising power spread out across a larger market, as well as a position in the market to negotiate

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Economies of Scale

- External economies of scale are achieved because of external factors, or factors that affect an entire industry.
  - These occur when there is a highly-skilled labor pool, subsidies and/or tax reductions, and partnerships and joint ventures—anything that can cut down on costs to many companies in a specific industry.

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Economies of Scope

- Economies of scope describe situations where producing two or more goods together results in a lower marginal cost than producing them separately.
  - Economies of scope can result from goods that are co-products or complements in production, goods that have complementary production processes, or goods that share inputs to production.

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Economies of Scope

Four Types

Operational Financial	Economies of scale relate to cost economies from increasing output of a ***single product***.
Anticompetitive Managerialism	Economies of scope relate to cost economies from increasing the output of ***multiple products***.

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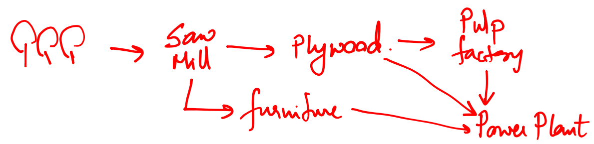
Economies of Sequence

- The "economies of sequence" is defined as building segments in an efficient sequence. Prerequisite conditions on segments comprise those segments that contribute to a reduction in transport costs.

Crude ↓



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Economies of Sequence

- Cost of the Value Chain in one firm is lower than that it multiple firms.
  - Lower transportation cost
  - Lower energy cost
  - Better labor utilization
  - Lower inventory

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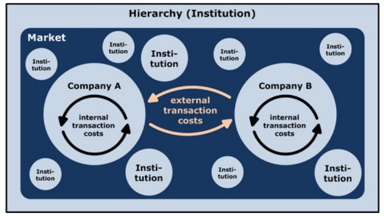
Why do firms exist?

Ronald Coase.
↳ David Williamson

TCE
Transaction Cost Economies

Boundary of the firm.

- According to Ronald Coase's essay "The Nature of the Firm", people begin to organise their production in firms when the transaction cost of coordinating production through the market exchange, given imperfect information, is greater than within the firm.



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Transaction Costs

- Williamson defines transaction costs as the costs of running an economic system of companies, and unlike production costs, decision-makers determine strategies of companies by measuring transaction costs and production costs. Transaction costs are the total costs of making a transaction, including the cost of planning, deciding, changing plans, resolving disputes, and after-sales.

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Transaction Costs

Transaction costs are directly linked to:

- Search & Information Cost (find supplier)
- Bargaining Cost (Purchase).
- Enforcement (monitoring)

Internalise (Employment cost)

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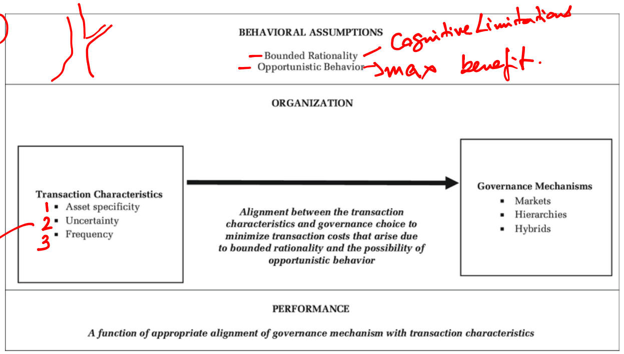
Transaction Costs

Amoco.



fire disease.

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What Is Vertical Integration?

- Vertical integration is a special exponent of unrelated diversification
  - A firm is engaged in several stages of a given industry's value chain

- Existence – why do firms emerge?
- Boundaries – why is the boundary between firms and the market located exactly there as to size and output variety?

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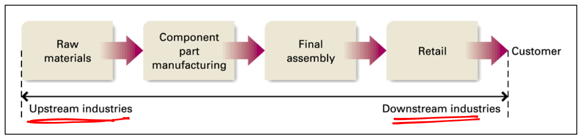
What Is Vertical Integration?



Oil wells. → Refining → Polyester. → Vimal.

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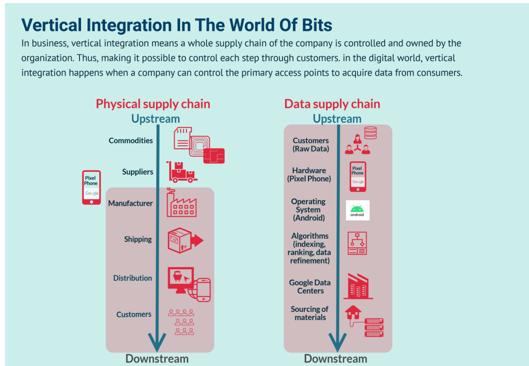
What Is Vertical Integration?



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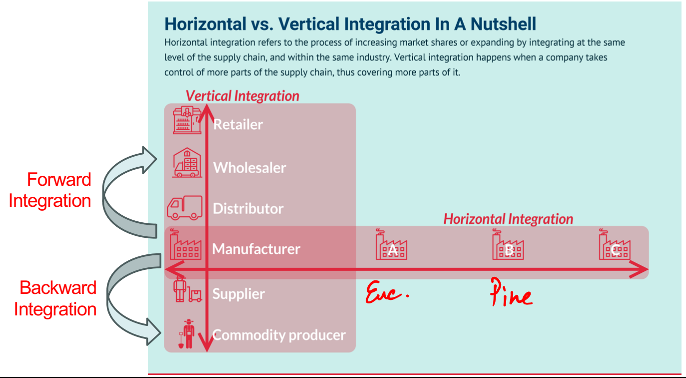
What Is Vertical Integration?



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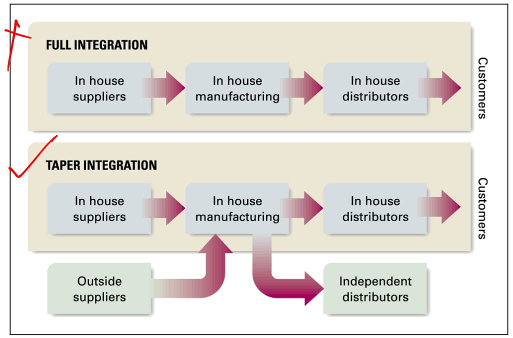
What Is Vertical Integration?



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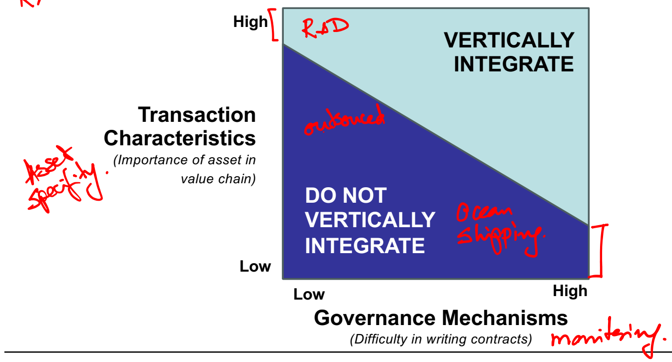
R&D. labs.

When to Vertically Integrate?



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Value Chain Economies

The Logic of Value Chain Economies

- **Strategic**
  - **Power** — Building barriers to entry
  - **Positioning** — Protecting product quality
- **Efficiency**
  - **Governance** — Facilitating investments in specialized assets
  - **Transaction Cost** — Improved scheduling

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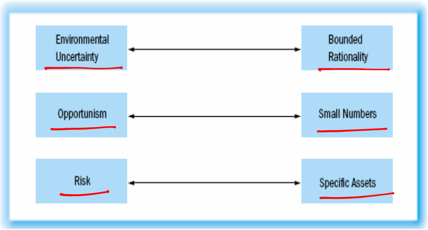
Vertical Integration

Value Chain Economies

The Logic of Value Chain Economies



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Vertical Integration

Value Chain Economies

The Logic of Value Chain Economies

- Value migration
- Differentiation
- Customers demand integrated solutions
- Synergies
- Emerging industries
  - Credibility
  - Compatibility/standards

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Vertical Integration

Arguments Against Vertical Integration

- Cost disadvantages
  - Company-owned suppliers that have higher costs than external suppliers
- Rapid technological change
  - Tying a company to an obsolescent technology
- Demand unpredictability
  - Difficulty of achieving close coordination among vertically integrated activities
- Bureaucratic costs

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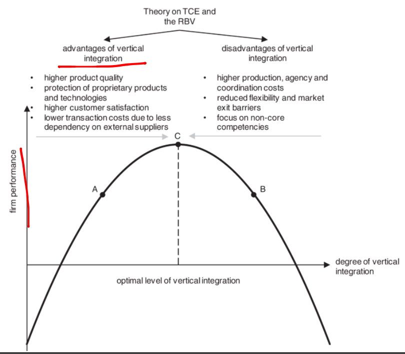
Vertical Integration

Link to Firm Performance



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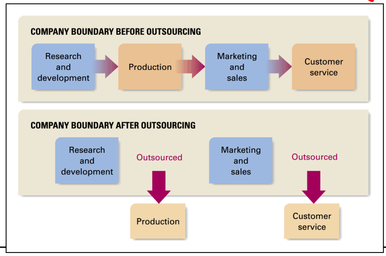
Alternatives to Vertical Integration

- Short-term contracts and competitive bidding bargaining ↓
- Strategic alliances and long-term contracting search cost ↓
- Building long-term cooperative relationships monitoring ↓



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When is Vertical Integration More Attractive than Outsourcing?

How many firms are available to undertake the activities? →	The fewer the companies the more attractive is VI
Is transaction-specific investment needed? asset specifity	→ If yes, VI more attractive
Does limited information permit cheating? monitoring.	→ VI can limit opportunism
Are taxes or regulation imposed on transactions?	→ VI can avoid them

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When is Vertical Integration More Attractive than Outsourcing?

Do the different stages have similar optimal scales of operation? output$_1$ → input$_2$ → output$_2$ → input$_3$	→ Greater the similarity, the more attractive is VI
Are the two stages strategically similar? Related.	→ Greater the strategic similarity ---the more attractive is VI
How great the need for entrepreneurship & continual upgrading of capabilities Capex ↑	→ Greater the need, the greater the disadvantages of VI
How uncertain is market demand? cyclicity.	→ Greater the unpredictability ----the more costly is VI
Are risks compounded by linkages between vertical stages uncertainty.	→ VI increases risk.

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Summary

Vertical Integration…

- makes sense when value chain economies can be created and captured
- may allow a firm to leverage capabilities
- may be a response to the threat of opportunism and uncertainty
- as a form of exchange *per se*, is not rare nor costly to imitate

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