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CASE STUDIES

"Case Studies" presents a case pertinent to contemporary issues and events in investment management. Insightful and provocative questions are posed at the end of each case to challenge the reader. Each case is an invitation to the critical thinking and pragmatic problem solving that are so fundamental to the practice of investment management.

Jack L. Treynor, Senior Editor

GAS CAPS AND THE SHERMAN ACT

When gas stations switched to self-service, it was a bonanza for manufacturers of replacement gas caps. Employees of gas stations who forgot to replace the cap when they had finished pumping gas did not remain employees. But some customers never learned. Harried, hurried, distracted, they regularly drove off without their gas caps. And when it came to buying a replacement, they were in no position to bargain.

The bonanza was shared by the manufacturer of the molding machines that combined the essential metal parts with a sturdy plastic body. There were enough manufacturers of replacement caps that their industry was competitive. But there was only one manufacturer of the molding machines. He suspected that, because demand for replacement caps was not responsive to price, every new molding machine he manufactured displaced an old molding machine.

But then the economic life of his molding machine would go down, if his production rate went up. And the shorter its life, the smaller the difference in technology, between the new machines and the marginal machines-hence the smaller the scarcity rent on the new machines. But their value to his customers depended on the product of scarcity rent and economic life.

And the value of the old, but not yet marginal machines in the hands of his customers depended on a similar product: When they bought his new machines were they counting on him not to increase his production rate?

What had provoked those thoughts was a call from a Washington law firm. The law firm argued that he was an "imperfect competitor" whose output affected his price, and said it was incumbent on imperfect competitors to demonstrate that they were pushing their output levels to the point where marginal cost equaled price.

Not for Distribution

The law firm mentioned something about treble damages.

Many of his customers had borrowed to buy his machines. How many would be bankrupted if he increased his output rate? He was uncertain what to tell the lawyers.

Discussion

If the manufacturer of the molding machine doubles his output, what happens to his prices?

What happens to his revenue?

If the manufacturer of the molding machines is offered the chance to buy additional capacity at a bargain price, how should he respond?

If demand for gas caps were price elastic, how would your answers change?

What should he tell the lawyers?

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