Chapter 4. Pricing with Market Power

4.1 Introduction to Pricing with Market Power

In economics, the firm’s objective is assumed to be to maximize profits. Firms with market power do this by capturing consumer surplus, and converting it to producer surplus. In Figure 4.1, a monopoly finds the profit-maximizing price and quantity by setting MR equal to MC. This strategy maximizes profits for a firm setting a single price and charging all customers the same price. In some situations, it is possible for a monopolist to increase profits beyond the monopoly solution. Figure 4.1 shows that there are two sources of consumer willingness to pay that the monopoly has not taken advantage of by producing a quantity of $Q_M$ and selling it at price $P_M$.

![Figure 4.1 Pricing Strategy for Firms with Market Power](image)

Area A along the demand curve represents consumers with a higher willingness to pay than the monopoly price $P_M$. Area B represents consumers who have been priced out of the market, since the monopoly price is higher than their willingness to pay. These two
groups of consumers represent two areas of untapped consumer surplus for a monopoly.

The monopoly price $P_M$ represents the profit-maximizing price if the monopolist is constrained to set only a single price, and charge all customers the same single price. However, if the monopolist could charge more than one price, it may be able to capture more consumer surplus (willingness to pay) and convert it into producer surplus (profits). This Chapter describes and explains several pricing strategies for firms with market power. These strategies enhance profits over and above the single price profit level shown in Figure 4.1. The strategies include price discrimination, peak-load pricing, and two-part pricing.