UNIT 6

Market Strategies: Switching costs and Lock-in

Recognizing Lock-In

- When the costs of switching from one brand of technology to another are substantial, users face *lock-in.*
  - *Situation when user is compelled to stick to current brand or product*

- Switching costs and lock-in are ubiquitous in information systems, and managing these costs is very tricky for both buyers and sellers.

Lock in:Examples

1. Bell Atlantic
   - In the mid- to late-1980s, Bell Atlantic invested $3 billion in AT&T's
     5ESS digital switches to run its telephone network.
   - Bell Atlantic selected AT&T over Northern Telecom and Siemens to bring its telephone system into the digital age.
   - No doubt AT&T's switches were impressive at the time.

- Problem: <u>Lock-In</u>
  - Bell Atlantic didn’t look ahead to the mid-1990s and take steps to protect itself from the ensuing lock-in.
  - The 5ESS switches employ a proprietary operating system controlled by AT&T.

Examples

- So, every time Bell Atlantic wanted to add a new capability, or connect these switches to a new piece of peripheral hardware, Bell Atlantic found itself reliant on AT&T to provide the necessary upgrades for the operating system and to develop the required interfaces.
- Since it was extremely expensive for Bell Atlantic to replace the AT&T equipment, Bell Atlantic was locked into the AT&T switches.
- As a result, AT&T had monopoly over the price and conditions charging millions of dollars for upgrades which cost less in competitive market.
- Bell Atlantic was none too happy about AT&T's strong position in the aftermarket for upgrades and plug-ins to AT&T 5ESS switches.
- In 1995, Bell Atlantic sued AT&T for monopolization.

Examples

2. Apple

– When the iPod arrived in fall 2001, followed by the iTunes Music Store in spring 2003, few early adopters realized the commitment they were making by buying their media player and their media from the same source.

– Due to Apple's digital rights management setup, until April 2007 any music bought from iTunes could play in only three places: on an iPod, within registered iTunes software on a limited number of computers, or on certain Motorola phones.

Examples

- If consumers wanted to move the songs they bought to a cheaper player from a competing manufacturer, they had two options:
  - an onerous process in which they burned the songs to a CD and then re-ripped them as MP3s,
  - semi legal software that essentially did the same thing using your hard drive instead of a disc.
- Locking content to hardware cost consumers money--especially when first-, second-, and third-generation iPod batteries began failing.
  - Consumers could either shell out the cash for a new iPod or pay Apple as much as $100 (plus shipping) to put a new battery in their existing device.

Examples

- Even when switching costs appear low, they can be critical for strategy.
- A million customers, each of whom has switching costs of Rs. 100, are just as valuable, collectively, as a single customer whose switching costs are Rs. 10 million.

- Hence, companies should compare any switching costs to revenues on a *per-customer basis* and add up these costs across the entire installed base to value that base.

5.1a. Examples

- Changing mobile number each time customer changes his carrier may be inappropriate.
- The strategy based in this proposition is allowing customer to keep their number when they switch mobile carriers, there by reducing resistance in switching.

5.1a. Importance of Lock-In

- Switching costs are the norm, not the exception, in the information economy.

- People face lock-in and switching costs almost in regular basis.

- Ability to recognize lock-in protects individual from its adverse effects.

Valuing an installed base of customer

- To understand lock-in and deal with it effectively,
  - the first step is to recognize what constitutes true switching costs.

- Switching costs measure the extent of a customer's lock-in to a given supplier.

- **But the supplier also bears some costs when it acquires a new customer.**
  - such as creating a new entry in a database,
  - assembling a team of support personnel.

- Adding them up gives the Total switching cost

- Total cost of switching = **cost the customer bears + cost the new supplier bears**

5.1b. Valuing an Installed Base of Customers

- Example:
  - When consumer switch ISP from say ADSL to World-link:
  - Total switching costs = Consumer time and trouble in making the move + the marketing and setup costs incurred by World-link.
  - If World-link offers customer Rs. 1000 to change carrier, this tactic has no impact on total switching costs.
  - The switching costs borne by customer fall by Rs. 1000, and those borne by World-link rise by Rs. 1000.
  - What if World-link offers 1 GB free internet as a sweetener?

5.1b. Valuing an Installed Base of Customers

- Example:
  - What if World-link offers 1 GB free internet as a sweetener?
  - If customer value these free internet at Re. 1 per MB, or Rs. 1020 in total, the customer's switching costs reduce by Rs. 1020.
  - If the cost to World-link of offering these internet is Rs. 500 in total, the costs borne by World-link rise by only Rs. 500.
  - The free-internet offer has reduced total switching costs by (-1020+500) Rs. 520.

5.1b. Valuing an Installed Base of Customers

- It is essential for a sound analysis of whether it is <u>worthwhile</u> to acquire a new customer.

- This allows companies to answer a critical question:

How much should companies spend to attract a new customer?

- Depends on the costs that companies and new customer both bear.

5.1b. Valuing an Installed Base of Customers

- Example:
  - Imagine that switching ISP involves Rs. 500 worth of hassle for the customer, and it costs company Rs. 100 to set up a new account
  - Total switching costs = Rs. 600.
  - Encourage a customer to switch only if the expected flow of profit from this customer over time will be greater than Rs. 600.
  - If anticipated flow of profit is Rs. 1000, companies can afford to offer the consumer a couple of free months of service to overcome the Rs. 500 switching costs, pay the Rs. 100 account setup costs, and still be left with Rs. 400 of profit.

5.1b. Valuing an Installed Base of Customers

- Alternatively
  - Companies could invest Rs. 500 in advertising (rather than the free months) to convince the customer that switching to your service from his or her current ISP is worth the hassle.
  - But if anticipate profit is only Rs. 500 from the new customer, it just isn't worth trying to attract him/her, since the total switching costs of rs. 600 exceed the benefits of Rs 500.

5.1b. Valuing an Installed Base of Customers

Use of Valuation Principle:

1. By anticipating the value of tomorrows installed base of customers, companies can determine how much to invest today-in the form of price discounting, advertising or R&D, for example- to attract more customers and build that installed base.

5.1b. Valuing an Installed Base of Customers

Considerations

- Lock-in markets are characterized by sellers losing money up front and then making it back once the customers are locked-in.
- Accordingly, if a firm over-estimates the extent of lock-in, it's likely to lose quite a bit of money.
- Ideally, sellers should find ways to entrench lock-in once it occurs by developing complementary products and extensions.

Benefits

1. Create profits, assuming the margins on the complementary products and services are positive.
2. Increase and extend the lock-in.

Type of Lock-In	Switching Costs
A. Contractual Commitments	Compensatory or liquidated damages
B. Durable Purchases	Replacement of equipment; Tends to decline as the durable ages
C. Brand-Specific Training	Learning a new system, both direct costs and lost productivity; Tends to rise over time
D. Information and Databases	Converting data to new format; Tends to rise over time as collection grows
E. Specialized Suppliers	Funding of new supplier; Rise over time if capabilities are hard to find/maintain.
F. Search Costs	Combined buyer and seller search costs; Includes learning about quality of alternatives
G. Loyalty Programs	Any lost benefits from incumbent supplier, plus possible need to rebuild cumulative use

SUPPLIERS AND PARTNERS FACE LOCK-IN, TOO

- anyone who makes investments that are specific to a particular supplier, customer, or partner is subject to lock-in for the economic lifetime of those investments.

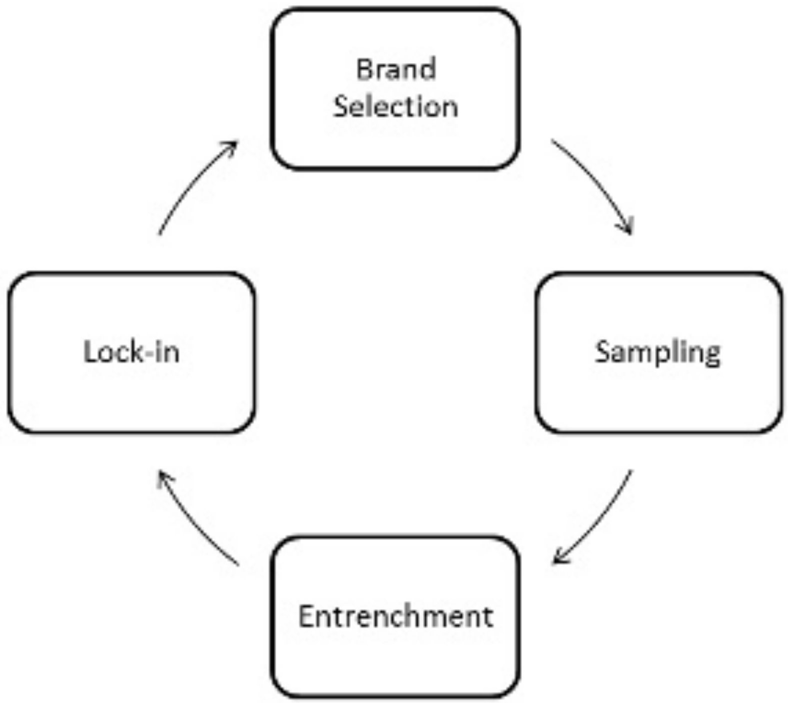
- Software houses that initially specialized in writing software for Apple computers needed to retool and thus bear very real switching costs: they had to become skillful at writing programs to run on DOS or Windows.

- Likewise for companies specializing in writing games for Sony's play station or the Nintendo 64 platform.

- Whether buyer, suppliers or partners; all should be <u>alert</u> when making investments that will leave them in weak bargaining position in future.

- There is <u>no point in locking-in</u> when there are <u>no additional benefit</u> from the deal.

Lock-in Cycle



THE LOCK-IN CYCLE

- Selection Phase
  - customer chooses a new brand. Brand choice could mean purchasing a new multimillion dollar switch, buying a videodisk player, purchasing a new software program
- Sampling phase
  - customer actively uses the new brand and takes advantage of whatever inducements were made to give it a try
  - Offering powerful sweeteners to attract new customers
  - Intention :
    - turn into revenue-paying customers

- *Entrenchment phase.*
  - consumer really gets used to the new brand, develops a preference for that brand over others, and perhaps becomes locked in to that brand

- *Lock In phase*
  - ***Switching costs increase significantly***

After this, we return to the brand selection point when the customer either switches brands or actively considers alternative brands without selecting them

MANAGING LOCK- IN

LOCK-IN STRATEGY FOR BUYERS

- **Bargain for discount or some long-term protection BEFORE becoming locked-in** :
  - convince your supplier that you are the type of customer most worthy of a very attractive initial package
  - Some incentives are immediate cash back e.g. initial discount on hardware, extended warranty or support switching from a previous information system. Seek free upgrades or customer service.
  - Emphasise switching costs you incur e.g. retraining costs
  - Establish you likeliness of substantial follow-on purchases i.e. future business for the supplier
  - Convince supplier of your capability of influencing purchase decisions of business associates, and ability for their lock-in e.g. offering a university free subscriptions as publisher recognises today's students are tomorrows readers

LOCK-IN STRATEGY FOR BUYERS

- ***Keeping Your Options Open***
  - Keep you own switching costs under control & convince supplier of ease of switching as a threat
  - Select an “open” system
    - partially switch to gain leverage in other business negotiations
  - Establish second source of supply
  - Beware of creeping lock-in, as it grows once more equipment is purchased and you become reliant

Do’s and Don’t for Buyers

- Don’t reveal too much about future vulnerabilities.
- Do insist suppliers to sign a contacts offering protection throughout the lock-in.
- Keep your option open.
- In entrenchment phase, devise strategy to partially switch to other supplier to gain leverage in negotiations about other parts.
- Extract favorable terms from your supplier each and every time you become more entrenched as the results of another round of hardware/software purchases, brand-specific training.
- Keep information on usage to yourself.

Buyer's Checklist

- Bargain for initial sweeteners, such as discounts or support for switching from your previous system.
- Don't be too anxious. Convey the impression that your benefits from switching are small and the costs large.
- Depict yourself as an attractive customer down the road, because of either your own future purchases or your ability to influence other purchasers.
- Seek protection from monopolistic exploitation down the road, but beware of vague promises offering such protection.
- Keep your options open via second sourcing. Partial switching is a way to gain leverage in negotiation.
- Watch out for creeping lock-in, and retain information about usage records.

LOCK-IN STRATEGY FOR SELLERS

- Investing in an installed base
  - build & retain a loyal base of customers.
- Encouraging Customer Entrenchment
  - Structure your relationship to induce buyer to become committed to your products, technology or services
- Leveraging the installed base
  - Selling complementary products to loyal customers

a. Investing in an installed base

- Evaluate profitability of each type of prospective customer and estimate profit margins on products you will sell to that customer over time
- form an accurate estimate of each customer's future switching costs to determine expected revenues
- Measure buyers' influence i.e. if this buyer stimulates other sales through word of mouth

b. Encouraging Customer Entrenchment

- Entrenchment by design
  - Incorporate new proprietary features into products & services to raise switching costs
- Offer favorable terms for incremental purchases where information required is readily available
- Special treatment of customers who have cumulated substantial usage in past

c. Leveraging the installed base

- Expanding the scope of complimentary products beyond that offered by rivals
- Selling vital customer demographics to marketing companies
- Give customers a good reason to upgrade & make transaction as easy & cheap as possible
- Make yourself easier to find & rivals kept hidden(SEO)
- Push customers to extend contracts before they expire or recommend premature upgrades

End of Unit 6