Netflix vs. Amazon Case Writeup

Introduction

On February 22, 2011, Amazon announced its entry into the digital video market. It would offer more than 5,000 movies and television shows for free to its Prime members, meaning they would be able to stream premium video content for free on PCs as well as almost two hundred connected TVs, Blu-ray players, and set-top boxes. Thus, for $6.58 per month, not only would Prime members receive free two-day shipping on products ordered on Amazon.com, but they would now also receive access to premium content.

Netflix, the major player in the premium digital video content market, with 61% market share, must now decide how to respond. With the digital video content market in its nascence and growing 135% in the next in the next five years, Netflix must decide how to counter, given its comparable offering, without free two-day Amazon.com shipping, is $7.99.

Industry Background

The premium digital video industry is one that has grown greatly with the rise of fast internet able to deliver high quality content. Thus, with the increasing costs of cable television as well as the proliferation of devices able to download and stream high quality video content, people have begun to get more of their video content online. The market is expected to grow 135% in the next five years, generating $78B in revenue[1].

[1] Insight Research Corp, 2010

As a result, a big industry has grown to try and capture this fast growing market. Apple, already selling download-to-own music online over iTunes, began to sell and rent video content through the store. Netflix, originally in the offline DVD subscription space, began to focus more and more of its efforts on an online video subscription service. Blockbuster also tried to copy its direct competitor with very little success. Amazon, primarily an offline product reseller, moved into this space with an online video on demand offering similar to that of Apple. The content owners also tried to capture some of this digital video market through the creation of Hulu, with both an ad-supported as well as a subscription-based offering. And finally, the content deliverers, the cable companies, moved into this space with both offline as well as online video on demand offerings.

By February 2010, all of the different players had different offerings in an effort to predict how consumers purchase their online video content. Netflix became the market's dominant player, with 61% market share, compared with 8% for Comcast and 4% each for DirecTV, Time Warner Cable, and Apple[2].

[2] NPD, 2011

Comparison of Online Premium Digital Video Content Offerings[3]

	Subscription Service			PPV		Free
	Amazon Prime Instant Video	Netflix	Hulu Plus	Amazon Instant Video	iTunes	Hulu Regular
Price per Month	Free/$6.58*	$7.99	$7.99	$ per purchase/rental	$ per purchase/rental	FREE
Price per Year	Free/$79*	$95.88	$95.88	$ per purchase/rental	$ per purchase/rental	FREE
# of TV Shows	500	750	450	2,300	2,500	1,250
# of TV Episodes	4,000	23,500	16,000**	62,000	69,000	29,700
# of Movies	1,700	8,250	775	32,000	12,000	1,350
Ads	No	No	Yes	No	No	Yes
Mobile	Plays on Android Browser	iPhone & iPad Apps	iPhone & iPad Apps	Plays on Android Browser	iPhone & iPad Apps	n/a
TV Content Window	Library Titles	Library Titles	Day After + Unlimited Viewing Window	Day After + Unlimited Viewing Window	Day After + Unlimited Viewing Window	Day After + Limited Viewing Windows
Movie Content Window	Library Titles	28 Days after DVD Release	28 Days after DVD Release	DVD Release	DVD Release + 28 Days After	Library Titles
HD Service	Yes (720p)	Yes (1080p)	Yes (720p)	Yes (720p)	Yes (720p)	No

*Free with $79 per year Amazon Prime membership (two-day shipping).
**4,600 episodes exclusive to Hulu Plus via PC, 16,000 across all other devices.

The Players

The Incumbent Dominant Market Leader - Netflix

Company Overview[4]

Now with more than 20M subscribers, Netflix launched as an offline DVD subscription service in 1999. At this time, a subscription movie and television service was a novel concept and Internet speeds were generally not fast enough to handle high quality video. However, Netflix was an innovative company and realized that, in the future, videos would be consumed

[3] Clicker, 2010
[4] All information from Netflix 10-K, 2010

digitally rather than on DVD. Thus, in 2007, Netflix launched a free unlimited streaming service for its subscribers, although initially with very limited content. Since then, online streaming has become a more prevalent part of Netflix's offering – over 60% of subscribers have streamed a show or movie, and more than one third of new subscribers are signing up for the pure streaming plan. And at peak times Netflix subscribers in the U.S. drives more than 20% of peak downstream Internet traffic[5].

The Offering

Although it had unlimited streaming since 2007, in November 2010, Netflix offered an unlimited streaming-only subscription for $7.99 a month, with the option to also get DVDs for $2 more and up; thus, all of Netflix's plans currently offer unlimited streaming. Netflix offers the largest, newest, and highest quality catalog of movies and television shows among the online subscription services and continues to grow this. Furthermore, hundreds of consumer electronics devices offer Netflix, meaning consumers can not only watch video on their PCs, but also on connected TVs, connected consoles, set-top boxes, Blu-ray players, and mobile devices. Netflix is in a unique position here compared to its competitors as it does not offer hardware, as do Apple, Sony, and Amazon, meaning it can be a neutral party on multiple types of devices.

The Incoming Rival - Amazon[6]

Company Overview

[5] Sandvine, 2010
[6] All information from Amazon 10-K, 2010

Amazon has become the market leader in online commerce since launching in 1995. Amazon started as an online bookstore, but soon diversified into numerous other areas. Amazon quickly expanded by making online retail inexpensive and easy, through price leadership as well as free shipping. Amazon had solely provided commerce for physical goods until launching Amazon Unbox (now Amazon Instant Video) in 2006. With this move, Amazon moved into the digital content commerce space with both music and video, and it further moved into selling content with the launch of the Kindle in 2007.

The Offering

Since 2006, Amazon has had an online video on demand service. However, on February 22, 2011, Amazon moved into the digital video subscription place, where Netflix is the dominant market player. While users are not paying directly for the video subscription service, unlimited Instant Videos are available for free for Amazon Prime customers. Amazon Prime is a service customers pay $79 a year for free two-day shipping; now, Prime customers will *also* receive free online videos, meaning it is cheaper at $6.58 per month than Netflix's comparable unlimited streaming option. At this point, much less content is available on Prime Instant Video than Netflix's comparable offering. However, as Amazon's video on demand service has a much larger library than even that of Netflix, it is likely that Amazon will be able to expand the content available for Prime Instant Video. Finally, as with Netflix, Instant Video is available on not only the PC, but also on hundreds of consumer electronics devices.

The Game

Assumptions

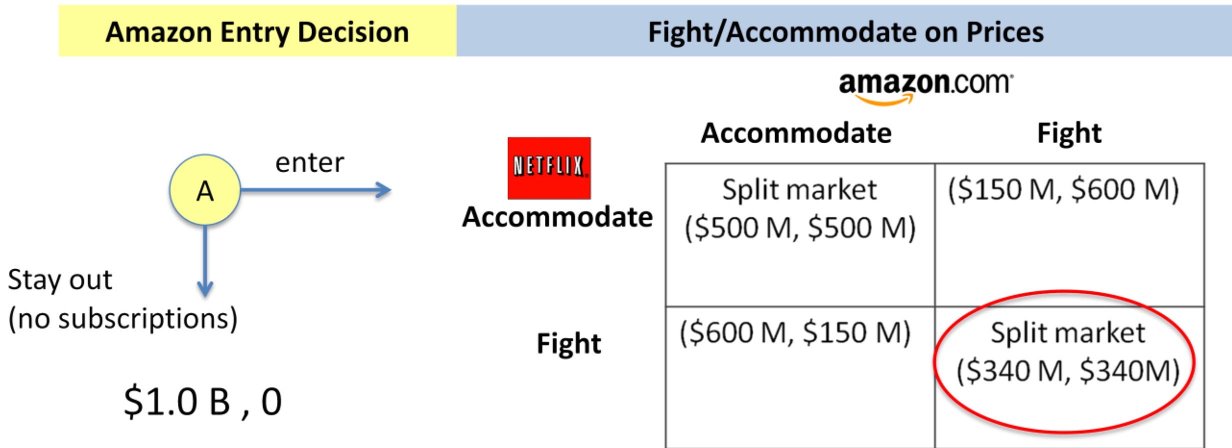
For the purposes of our analysis, we are making the following assumptions:

- The incumbent (Netflix) presently has all of the digital video subscription market. This is an exaggeration of reality since there are several other players, but Netflix is currently the clear-cut market leader.
- Amazon is seeking to be a player in the streaming video market and is not just using streaming video as an extra benefit for Amazon Prime customers.
    - For the calculations of our payouts, we are only including revenue from the Amazon Prime subscription fee (i.e., we are not including potential additional revenue if customers buy more due to free Amazon Prime shipping).
- The streaming video market will be $1B / year at the $7.99 price point. (This was calculated by assuming that 60% of Netflix subscribers stream video.)
- Customers are sensitive to price, and a $1 decrease in price will yield a 10% increase in demand.
- In our games, “accommodate” means to price at $7.99 / month, and “fight” means to price at $4.99 / month.

The Simultaneous Game

In this version of the game, now that Amazon has already decided to enter the market, both Amazon and Netflix will make their decisions about whether to accommodate or fight in unison. This situation could arise if both sides need to make preparations for marketing campaigns before knowing what the other will do. We assumed that 80% of customers will go to

the subscription service with the lowest price, and 20% would remain loyal due to switching costs or brand loyalty.

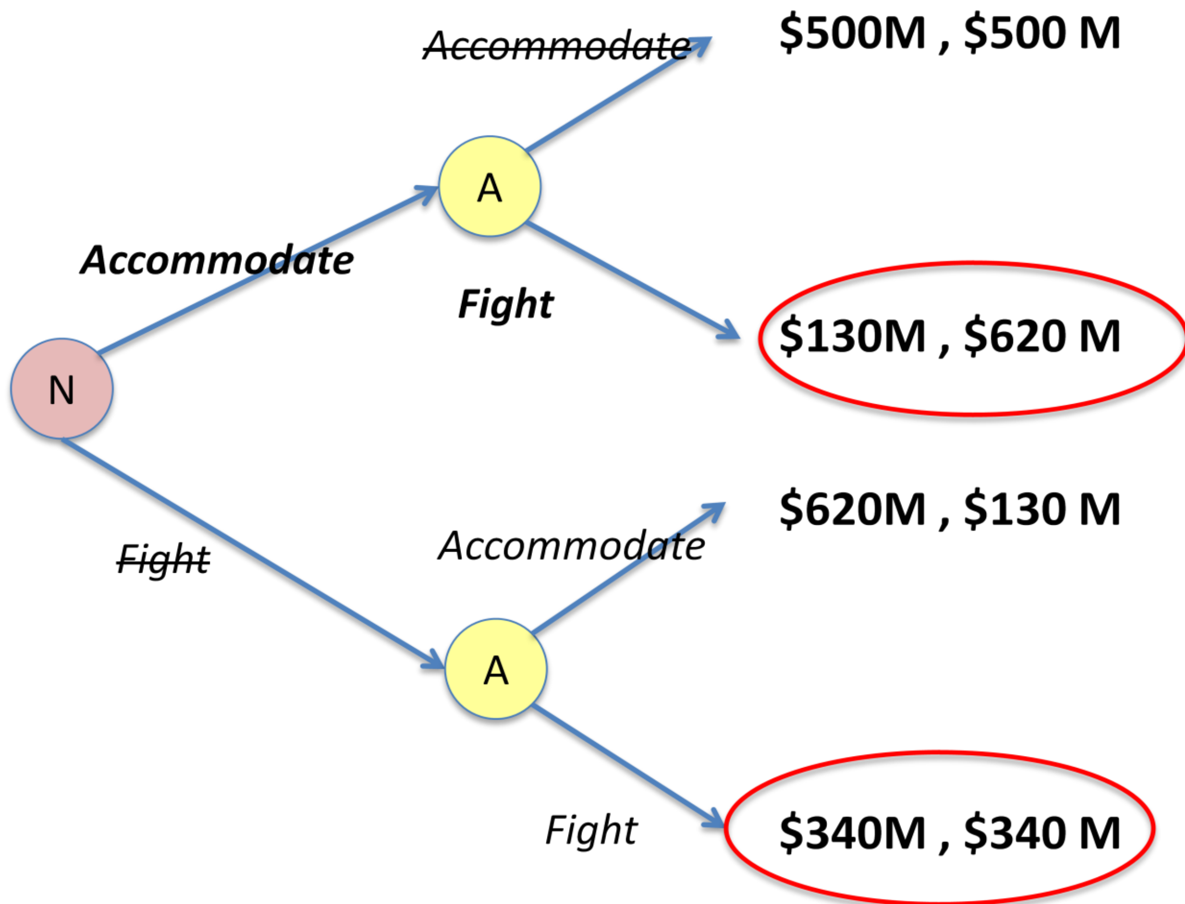


Amazon has already decided to enter because they realize that they will be profitable regardless of the outcome of the game. The simultaneous game model is a prisoner's dilemma, and the equilibrium will be reached with both Amazon and Netflix choosing to fight and splitting the market.

The Sequential Game

Instead of a simultaneous game, a sequential game might occur in the scenario in which customer switching costs are assumed to be extremely high. Amazon will want to aggressively pursue customers before they get locked into long-term contracts with Netflix, whereas Netflix will want the exact opposite scenario. Therefore, each company will seek first-mover advantage,

and the game will move towards a sequential game, with the company that moves first getting a small amount of additional revenue. The example below illustrates the outcome if Netflix moves first and is able to reach customers first, thus generating a slightly higher payout for Netflix.



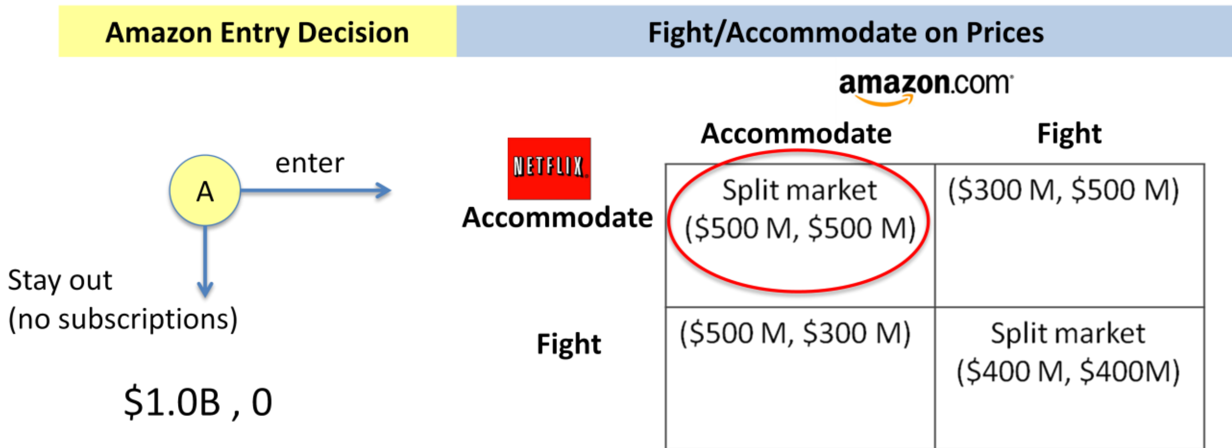
Alternatively, Amazon can change they game if it can successfully maintain a perception that it is only in the streaming video market as a way of providing an additional service to Amazon Prime customers. This is a "puppy dog" strategy where Amazon seeks to not make enough noise in the market to cause a reaction from the incumbent. However, making this perception credible will be a great challenge for Amazon, especially given the large projected growth and profit margins of the market.

How to Change the Game

Both companies have the opportunity to change the game and influence potential (and/or perceived) payouts.

Netflix has the opportunity to change the game and alter the potential payouts for Amazon by moving first and increasing customer loyalty. There are many ways in this can be accomplished, both through incentives and punishments. Netflix can have customers to commit to a long-term contract with a large fee for early termination. It can either require a contract for membership, or it can offer financial incentives to those who choose to enter into a contract. In addition, Netflix can seek to differentiate its service offering by providing unique programming, superb customer service, etc. For example, if Netflix is able to offer Disney movies through an exclusive contract, this might cause some customers to be more willing to stay with Netflix even if it costs more than Amazon. Netflix can also seek to differentiate based on devices. If it is able to offer its service on devices where Amazon is unable to offer service (e.g., the iPad), this can also serve as a means of increasing customer loyalty and decreasing incentives to defect.

Increasing customer loyalty would deter customers from switching to Amazon, and thus would limit Amazon's market penetration and profits. For these payoffs, we assumed that only 65% of customers will go to the lowest price and 35% will remain brand loyal. In this scenario, a new equilibrium is generated for the accommodate / accommodate strategy.



The increased loyalty effect would be strongest in the short-term, and customers would have more options over time as their contracts expire. Therefore, Netflix will need to provide long-term service differentiation as well if it hopes to not lose major market share to Amazon.

Conclusion

Both Amazon and Netflix have a lot to gain in the digital video subscription market. However, it is against the best interests of both sides to engage in a price war where consumers view the service as a commodity and simply go with the lowest price. If both sides seek to increase loyalty and/or differentiate their service, the industry can achieve cooperation and avoid a prisoner's dilemma situation. If successful, this will mean higher profits for both companies.