It is not what you do, it is whom you do it with

By Espen Andersen

Telecom strategy 101: In network markets, use network marketing

As anyone who has traveled by air knows, the main competitive differentiation in airlines is pricing. Travel is travel (almost) no matter what, and as long as an airline can get you there, you choose based on price -- at least if you pay for it yourself. The same goes for other undifferentiable products or services with huge fixed costs, such as electric power, railroad transportation and telecommunications.

Prices are tricky things -- especially in the telecommunications market, where the value of your service depends less on what you do than whom the customer wants to do it with. To explain it to my students, I tend to use the following example, shamelessly stolen from my bright colleague Øystein Fjeldstad: In a market of two mobile phone providers (let's call them Bigcom and Smallcom), one company (make that Bigcom) has 65 percent of the market and the other (that would be Smallcom) the remaining 35 percent. The services and the prices are the same, and there is no particular reason why a customer should choose one or the other. The market is growing at 20 percent per year.
Then, one fine morning in 1997, Smallcom's Executive Vice President of Marketing has a brainstorm and announces a new pricing scheme: Customers of Smallcom will get deep discounts if they call another Smallcom customer, but the same high price if they call someone who has a subscription with the competitor.

At first glance, this looks great -- after all, didn't MCI have a huge success with their Friends and Family program in the early nineties? The management board of Smallcom enthusiastically approves the press release.

Alas, this bright idea turns out to be a severe case of foot-in-mouth disease. As is all too common, Smallcom has forgotten that the world is not a microeconomic universe, with *ceteris paribus* and perfect information. Instead, it is more like game theory, with competitors that can mimic your every move and are more than willing to do so. Bigcom promptly changes to the same pricing scheme, and things ought to be the same again. However, they are not. Customers quickly discover that, since Bigcom's market share is larger than Smallcom's, most of their phone calls go to a Bigcom customer. Hence, customers being smart, quite a few of them start moving over to Bigcom. This is bad news for Smallcom, especially so since they started it -- and Bigcom could never have started this on their own, since that would have been using their larger market share to drive out the competition, subject to unwanted attention from regulatory bodies.

All this is Telecommunications Strategy 101. The interesting question, of course, is not how this came about, but what Smallcom should do once the horse has left the stable? Anything they can do Bigcom can do, too -- and often better. They can change their prices or increase their service, but so can Bigcom. They could get crazy and make it cheaper to call the competition than themselves (as sometimes happens in Europe, when it can be cheaper to call from abroad, so you get a foreign subscription). That would increase their market share with no profits. They could seek an alliance partner outside the market (say, in another country), but Bigcom can do that, too -- and everything else being the same, Bigcom has the larger market share and thus the more valuable service. This is what we academics call a *network externality*, and it is one of the reasons Bill Gates can buy any kind of hamburger he wants, as I once heard him say.

However, all is not lost for Smallcom: If you can't change what you sell, change whom you sell it to. What Smallcom can do (and, in fact, what the real Smallcom did) is to go out in the market and seek out *networks* or *clusters* of customers who talk a lot to each other, and then offer them incentives to sign up, as a group. One example here is taxi drivers: As known by anyone who has tried talking politics to a taxi driver, they mainly talk to each other. The same goes for consulting companies. Smallcom went to the taxi companies and the big consultancies, offering them good rates on intra-company calls.

Capturing this market secured a high market share in an insular market (thus getting the network externalities on your side). From this position, you can grow your market by facilitating connection to other groups of customers, starting with the families of the taxi drivers and consultants (the other constituency they talk to). And the marketing goes on -- when you face network externalities, use network marketing.

For those of you interested in strategic theory, we tend to call companies that facilitate the linking of people (or goods, or money) to each other *value networks*, a concept pioneered by Øystein Fjeldstad in 1998 [1]. Understanding strategy in value networks is increasingly important -- and frameworks have been hard to come by, since many value network companies (airlines, transportation, telecommunications and banking, for instance) have been regulated or at least only competing nationally. A managerially oriented explanation of the value network and another configuration, the value shop, can be found in Øystein's and my article [2] in the European Business Forum, at http://www.ebfonline.com/main_feat/in_depth/in_depth.asp?id=406.

For those of you who are technologists, the interesting message here is that if your marketing fails, there is often nothing wrong with your product or your services in themselves. When product designers, marketeers and techies get together to market something, they tend to focus on what the product does and what the price is or should be. What they should focus on is *who uses their products* -- *with whom*. Once you capture that relationship, your market position is entrenched. And if you can get your customers to be linked not just to you, but to each other *through* you, long-term business and, eventually, profits will follow.

As for Smallcom's Executive Vice President, I think he is no longer executing for a living.

References

[1]Stabell, C. B. and Ø. D. Fjeldstad (1998). "Configuring Value for Competitive Advantage: On Chains, Shops and Networks." *Strategic Management Journal* **19**: 413-437.

[2] Fjeldstad, Ø. and E. Andersen (2003). "Casting off the chains: Value shops and value networks." *European Business Forum* (14): 47-53.

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