Amazon Prime Video: War with Netflix or Mainly a Decoy?

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Introduction

Recently, there have been headlines about an Amazon-Netflix war, like "*Amazon plans to 'significantly' increase investment in video as it goes to war with Netflix.*"
http://www.businessinsider.com/amazon-plans-to-significantly-increase-investment-in-video-2016-4
Such headlines were triggered by Amazon introducing an option to subscribe to its video content as a standalone service without a full-blown Prime membership that also includes free shipping when ordering products from Amazon. Amazon also introduced an option to subscribe to full Prime membership on a monthly basis instead of annually. Here are the pricing options that were announced:
Prime Video: $8.99/month
Prime (monthly): $10.99/month
Prime (annually): $99/year

By giving customers the option of just subscribing to video content on a monthly basis, it would seem like Amazon would be offering the same kind of service as Netflix and undercutting it on price by about a dollar or so. Not surprisingly, there were headlines about how Amazon is now trying to compete with Netflix in the streaming video market. A lot of commentators argued that it would be tough for Amazon to take on such an entrenched player even if charging a dollar less. There were suggestions that Netflix's service is superior and that Amazon's original content is no match for that of Netflix. Someone speculated that Prime Video was meant to steer customers to rent or buy movies on Amazon Instant Video.
http://www.businessinsider.com/amazon-never-has-to-make-money-off-prime-video-2016-4

But is this all that is going on here? Is Amazon just trying to steal Netflix's market or could there be more to it than that? Arguably, adding the new pricing options for monthly subscriptions to either Prime Video or the full Prime didn't cost Amazon a lot of money. They are just new buying options for Prime services that already exist and that, from a pricing standpoint, would seem more lucrative for Amazon and less attractive to customers, and maybe that's part of the point of offering them.

Price decoys

In his book "Predictably Irrational," Behavioral Economist Dan Ariely describes an online ad he saw for subscriptions to the Economist magazine. The ad had three options for subscriptions:

1. Web subscription only: $59.
2. Print subscription only: $125.
3. Both web and print subscription: $125.

Ariely was puzzled by the second alternative. Why would anyone in his right mind pick it over the third alternative? Why would the Economist even bother offering it? It turned out that there was a good reason. A survey among his students at MIT's Sloan showed, unsurprisingly, that no one would pick alternative 2, but that there was a clear majority who would pick number 3. He then created an alternative version of the ad where alternative 2 had been removed and the choice was simply between 1 and 3. Now alternative 1 became the clear winner. So the mere presence of alternative 2 – an alternative that no one would pick – tilted the choice to the most expensive subscription option. While it would be hard to judge the relative value of 1 and 3 in isolation, the presence of 2 made 3 stand out as good value at least relative to 2, and that made 3 the preferred option when all three alternatives were in place. Hence, the presence of alternative 2 was merely as a *decoy* meant to make something else look like a good deal. The decoy effect, while violating the independence axiom of decision theory, is a well-known phenomenon in marketing. Could something like that be the reason behind Amazon's Prime Video service?

Understanding Amazon Prime

Prime is one of Amazon's three major pillars of success along with AWS and third-party sellers. Before adding music and video perks, Prime was all about free shipping and one could argue that free shipping is still its essence and that the free video and music are mainly there to entice people to sign up. The beauty of Prime, from Amazon's perspective, is that once customers become members, they will typically buy more from Amazon. Having paid a membership fee, it's natural to try to get your money's worth in the form of free shipping. So why not use Amazon as much as possible for your shopping needs? After all, Amazon usually has competitive prices, a huge selection, valuable customer reviews, the shipping is free, and the merchandise conveniently gets delivered to your door. Prime is like a drug that gets people addicted to Amazon and once hooked, members spend much more money than non-members.

But doesn't the free shipping cost Amazon a lot of money? Yes, but even with free shipping, Amazon still makes money on almost all the things it sells. Amazon is going for revenue growth and increasing economies of scales, which is a key factor in logistics – Amazon is rumored to be getting volume discounts of 70 percent or more from its shipping partners. With huge investments in logistics infrastructure and increasing economies of scale, one would think that Amazon's shipping expenses would be going down, but they are not. Instead, Amazon is using its improving logistics system to improve its service. Same-day, free shipping for Prime members is now available on many items in many metropolitan areas on orders over $35. Order before noon and you get the items the same day. That's convenience. Imagine the following scenario: It's a winter weekend and you need to buy some things at the mall. But you're not eager to brave inclement weather, bad traffic, and the crowds at the mall. Solution: Order the items from Amazon. You can spend the day watching football on TV and still get the goods the same day with free shipping and without the trip to the mall.

It's pretty obvious whom Amazon is targeting with its logistics buildup: The retail industry, which is predominantly brick-and-mortar companies that may or may not do ecommerce as well. In the U.S. alone, that's about 4-5 trillion dollars in sales. Compare that to the annual revenue of Netflix, which is a little under $7 billion. Amazon is currently growing its revenue on the order of $20 billion a year and obviously, Netflix's market is a very limited opportunity compared to going after brick-and-mortar stores. But going after the retail industry requires increasing economies of scale in logistics, something that Amazon gets when more people sign up for Prime and buy more goods, but not when they sign up for Prime Video.

Price decoys revisited

Let's look at how Amazon presents your options if you want to sign up for Prime Video.

Choose a membership for your 30-day FREE trial

amazon Prime	Prime Video $8.99/month	Prime (monthly) $10.99/month	BEST VALUE Prime (annual) $99/year Equivalent to $8.25/month
Free Two-Day shipping		✓	✓
Unlimited movies and TV shows Including HD, Ultra HD & HDR (when available)	✓	✓	✓
Unlimited music streaming		✓	✓
Over a million ebooks		✓	✓
Early access to Lightning Deals		✓	✓
Free Same-Day Delivery in eligible areas		✓	✓
Save 25% with prepayment discount			✓

As presented, the two full Prime options look like much better deals than the video-only option. At $8.99, it's only two dollars less per month than a full membership, so if you are going to order anything from Amazon that month, you would likely save money by getting the full membership and free shipping. And the annual full membership option is equivalent to only $8.25/month. However, even if very few people choose the video-only option, it doesn't cost Amazon very much to offer it and it gave rise to a lot of free publicity when it was rolled out. So it may well be that Prime Video is less of an attempt to take on Netflix and more of a price decoy with the purpose of making a full Prime membership look like a great deal.

Conclusion

Amazon's major war is not with Netflix; it's with the brick-and-mortar retailers. In this war, Prime is an important weapon that may or may not subject Netflix to some collateral damage. However, the headlines that Amazon is trying to take out Netflix may not tell the whole story.