5.18: Putting It Together- Elasticity

Netflix Pricing Revisited

We began this module discussing a price change that Netflix imposed on its customers. Now that we understand price elasticity, we can better evaluate that case. How did the 60 percent price increase end up for Netflix? It was a very bumpy two-year ride. Before the price increase, there were about 24.6 million U.S. subscribers. After the price increase, 810,000 infuriated customers canceled their Netflix subscriptions, dropping the total number of subscribers to 23.79 million. Fast-forward to June 2013, when there were 36 million streaming Netflix subscribers in the United States. This was an increase of 11.4 million subscribers since the price increase—an average per-quarter growth of about 1.6 million. This growth is less than the 2 million-per-quarter increases Netflix experienced in the fourth quarter of 2010 and the first quarter of 2011.

During the first year after the price increase, the firm's stock price (a measure of future expectations for the firm) fell from about $300 per share to just under $54. By June 2013, the stock price had rebounded to about $200 per share—still off by more than one-third from its high, but definitely improving. What happened? Obviously, Netflix understood the law of demand. Company officials reported, when they announced the price increase, that this could result in the loss of about 600,000 existing subscribers. Using the elasticity of demand formula, it is easy to see that they expected an inelastic response:

$$\begin{array}{rcl}\text{Percent change in quantity}&=&\large{\frac{-600,000}{(24\text{ million}+24.6\text{ million})\div{2}}} \\ \text{Percent change in price}&=&\large{\frac{\$6}{(\$10+\$16)\div{2}}} \\ {\text{Price Elasticity of Demand}}&=&\large{\frac{-600,000/24.3\text{ million}}{\$6/\$13}}\\&=&\large{\frac{-0.025}{0.46}}\\&=&-0.05 \end{array}$$

In addition, Netflix officials had expected that the price increase would have little impact on attracting new customers. Netflix anticipated adding up to 1.29 million new subscribers in the third quarter of 2011. It is true that this was slower growth than the firm had experienced over the past year—about 2 million per quarter. Why was the estimate of customers leaving so far off? During the fourteen years after Netflix was founded, there was an increase in the number of close, but not perfect, substitutes. Consumers now had choices ranging from Vudu, Amazon Prime, Hulu, and Redbox to retail stores.

Jaime Weinman reported in *Maclean's* that Redbox kiosks are "a five-minute drive or less from 68 percent of Americans, and it seems that many people still find a five-minute drive more convenient than loading up a movie online." It seems that, in 2012, many consumers still preferred a physical DVD disk over streaming video. What missteps did the Netflix management make? In addition to misjudging the elasticity of demand, by failing to account for close substitutes, it seems they may have also misjudged customers' preferences and tastes (at the time being). Yet, we now see that as the population has increased, the preference for streaming video has overtaken the desire for physical DVD discs. Netflix, the target of numerous late-night talk-show jabs and laughs in 2011, may have had the last laugh in the end.

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