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The Effect of Pricing and Advertising on Customer Retention in a Liberalizing Market ☆

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Abstract

This study investigates the drivers of customer retention in a liberalizing market. The authors address key retention issues that allow them to contribute to existing retention research in several critical ways. They (1) examine the effects of pricing and mass advertising, (2) account for (new entrants) competitors' actions, (3) investigate the dynamic impact of marketing tactics, and (4) study the proposed relationships in a market recently opened to competition. Using longitudinal data for a sample of 650 mobile phone consumers and a split-population hazard model that accounts for the notion that some customers are never at risk of defection, the authors show that both the focal firm's (incumbent) and the competitors' price and mass advertising exert a significant influence on the probability of terminating an existing incumbent relationship. They find that the relationships between marketing variables and retention are not static but vary over time. Price is generally less effective in the early stages of market liberalization, which suggests that customers become more price sensitive in later stages. Finally, the study findings can have important strategic implications on designing customer management and marketing resource allocation strategies, as well as on providing a competitive regulatory framework in liberalizing markets.

Keywords: Customer retention; Pricing; Mass advertising; Liberalizing market; Split-population hazard model

Introduction

Customer retention and the building of long-standing relationships with customers are central elements in the creation of value (Berger and Nasr 1998; Gupta, Lehmann, and Stuart 2004). For this reason, both marketing research and practice show great interest in understanding the driving forces behind "establishing, developing, and maintaining successful relational exchanges" (Morgan and Hunt 1994, p. 22). Various studies have investigated the antecedents of customer retention or customer relationship duration (Bolton 1998; Drèze and Bonfrer 2008; Pfeifer and Farris 2004; Reinartz and Kumar 2003; Verhoef 2003). However, such studies often neglect the effect of mass marketing instruments (Verhoef, van Doorn, and Dorotic 2007), the influence of pricing (Blattberg, Malthouse, and Neslin 2009), and/or the impact of competitors' pricing and advertising strategies on a focal firm's relationships (Gupta and Zeithaml 2006).

Recently, some studies have started to consider these influences. Prins and Verhoef (2007) note the impact of advertising expenditures by the firm and its competitors on customer adoption of a new e-service. Venkatesan, Reinartz, and Ravishanker (2009) investigate the impact of customer attitudes toward the focal firm and the competitors on customer behavior in the presence of CRM activities. Rust, Lemon, and Zeithaml (2004) examine the effect of brand advertising on

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retention and explicitly incorporate competition to project financial returns from marketing investments. Dawes (2009) investigates the impact of price levels and increases on customer retention and finds that a price increase leads to greater churn, though the effect differs across customer groups.

Notably, studies in this research stream have only investigated liberalized markets (Wieringa and Verhoef 2007). The deregulation of strategic, utility goods markets (e.g., power, transport and telecommunications) is occurring in many countries (Roberts, Nelson, and Morrison 2005) and forces state-owned monopolists (i.e., incumbents) to compete with new entrants. Existing customer retention knowledge might, therefore, improve significantly with further empirical applications in liberalizing markets,[1] and this knowledge may be of significant value to incumbents, who must understand the determinants of relational continuity and develop defensive strategies (Hauser and Shugan 1983), as well as to new entrants, who require an understanding of the factors that motivate existing customers to switch (Green, Barclay, and Ryans 1995). Research that examines defensive and offensive marketing strategies in these newly competitive markets remains limited. We respond to this gap by investigating the extent to which the incumbent's and competitors' price and advertising affect customer retention in a liberalizing market.

We have the following research objectives and areas of contribution to the literature. First, we assess the impact of the incumbent's price and mass (or above-the-line) advertising efforts on customer retention and, thereby, identify specific actions that incumbents can develop to increase relationship duration and profitability (Bolton 1998). Second, we provide insights into the effects of pricing and mass advertising by competitors to help them identify the issues that must be addressed in order to attract customers from the incumbent firm. Third, we investigate whether these effects change over time in a liberalizing market and, thus, help clarify its changing dynamics. Fourth, we offer a methodological novelty and apply a split-population hazard model that takes a segment of customers who never leave the incumbent company into account and, thereby, offer insights into how incumbent firms and new entrants should formulate their strategies to allocate marketing resources optimally. This knowledge is relevant for public policy officials too because they have to design a fully-competitive regulatory framework.

We rely particularly on Bolton's (1998) research which examines the impact of price on customer retention. She finds that an increase in price decreases retention. In the context of the recently liberalized Spanish mobile phone market, we extend Bolton's research in several critical ways. We study the effect of advertising on the timing to customer defection, explicitly account for competitors' prices and advertising, and examine these dynamic relationships in a liberalizing market. Using a sample of 650 mobile phone customers and a split-population hazard model, our results reveal that the length of an incumbent relationship depends mainly on the incumbent's price and advertising, as well as the competitors' price, that the effects of pricing on retention strengthen over time, which implies that customers become more price sensitive, and that a segment of incumbent customers has a zero probability of terminating the relationship (and switching to a new provider).

The remainder of this manuscript proceeds as follows: In the next section, we review previous research about the role of price and above-the-line advertising in customer retention and discuss their expected effects in the context of liberalizing markets. We then describe the study context and data set that we use to examine the drivers of retention and discuss the research methodology. Subsequently, we present the estimation results and conclude with a discussion of the main findings and contributions of our study.

Theory and Hypotheses

We consider two types of firm in a liberalizing market: the incumbent firm and competitors that enter the market. In our study, we are interested not only in the direct impact of price and mass advertising of both the incumbent firm and its competitors on the probability that incumbent firm's customers terminate their relationships and switch to the new entrants, but also their potential dynamic effects. To outline the role of pricing, we begin by hypothesizing about the effects of the incumbent firm's price before continuing with the effects of competitive pricing and, finally, discussing the potential dynamic effects of both incumbent and competitive pricing. We follow a similar pattern in our discussion of the role of advertising in retention.

Price

Incumbent Price and Customer Retention

Price consistently appears as an important conceptual determinant of customer behavior (Bolton, Lemon, and Verhoef 2004). Pricing research in various disciplines, including microeconomics, psychology and marketing, concludes that price explains more variance in customer purchase decisions than other marketing mix variables do (Keaveney 1995; Winer 1986). Customer relationship management (CRM) studies have mainly focused on the role of price for acquiring new customers (e.g., Lewis 2006). However, researchers have also acknowledged that pricing strategies to acquire customers might also impact customer retention and customer lifetime value (e.g., Lewis 2006; Verhoef and Donkers 2005).

Marketing modeling studies often consider the impact of price and price promotions on market performance metrics such as sales and market share (e.g., Bijmolt, van Heerde, and Pieters 2005; Nijs et al. 2001). Meta-analytical evidence suggests high price elasticities and, at the consumer level, microeconomic theory suggests that utility-maximizing consumers respond to changes in price by changing their product or service demand (Guadagni and Little 1983; Winer 1986). The consideration of price remains rather limited for CRM research. Some studies note the impact of price perceptions or payment equity, which

[1] We use the term "liberalizing market" to refer to a market previously dominated by a state-owned monopoly that has been opened to allow other firms to compete (Roberts, Nelson, and Morrison 2005; Wieringa and Verhoef 2007).