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Seeking Closure: Competition in Complementary Markets

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Consider Apple Computer's sales of iPod players and iTunes music. The iPod competes in the market for MP3 players, and iTunes competes in the complementary market for downloadable songs. The demand for the MP3 players (hardware) and for the music available for the players (software) each influence demand for the other. By adhering to a proprietary technological standard, Apple attempts to reinforce such cross-market externalities between its own product offerings – to the chagrin of its competitors.

A firm with a product that competes in a market that has a complementary product (in a different market) must consider the interdependence between the complementary products as well as the competition within markets. If a firm participates in both markets, the balancing act becomes even more challenging. This paper provides insights about strategies in this latter setting. When does a strategy based on preclusion make sense, and when would firms be better off by accepting a common standard? To address these questions, we employ standard game theoretic analysis to a simple spatial model that captures aspects of both inter-market externalities and intra-market competition. We find that if a firm participates in both markets and chooses a closed standard, it achieves lower short-run profits compared to an open standard, but greater market share. Surprisingly, we find that customers are better off when standards are kept proprietary.

Hans Sebastian (Seb) Heese is Assistant Professor of Operations & Decision Technologies at the Kelley School of Business at Indiana University. His research addresses supply chain management problems, with a focus on manufacturer-retailer interactions and retail operations. Prior to joining Indiana University, Seb earned his PhD in Operations, Technology and Innovation Management from the Kenan-Flagler Business School at the University of North Carolina at Chapel Hill.

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