Lecture Text

Professor Frances X. Frei

Capitalizing on the Power of the Customer

(*edited for clarity*)

Introduction

So, we'll get started. What I want to do is just share with you some of the highlights from the research that I've been doing over the last seven years here at Harvard. I'm in the Technology and Operations Management unit, but I teach a course called *Managing Service Operations*, and my love is the interaction between the firm and the customer. So I put together a few slides. It's just basically going to take us through two parts of the highlights of the work that I've done. The first one is, how do you differentiate on service? And how do you do it in a sustainable matter? So, how do you differentiate on service so that customers are better off and you make disproportionately large profits?

We all know how to deliver great service and lose money, and we know how to deliver lousy service. That actually seems to be known even more than the delivering great service. I want to talk about firms that have successfully disproportionately delivered better service and disproportionately made more money. And there are three successful strategies, so we'll go over that. And then the second part of it is, how do you get customers to act in the best interest of the firm? And I'll seed this along the way with all of my pet mantras. But that the customers are probably your most powerful asset is mantra number one. And we'll talk about how you can influence customers to act in the best interest of the firm.

Differentiation on Service

So, I'm going to start with a story of—three stories, three very different ways of how firms have differentiated on service.

Commerce Bank

The first one is Commerce Bank, which is an East Coast bank. Is anyone a Commerce Bank customer? Rodney, you're a Commerce Bank customer. What adjectives come to mind when you think of Commerce?

__: Always open.

PROFESSOR FREI: Always open. Commerce is a company. On a scale of one to ten, how happy are you with the company?

__: Probably an eight or a nine.

PROFESSOR FREI: The average customer is going to be at an eight or a nine on the scale. The average customer at another bank is closer to the three and four range. So here's what Commerce has done. They entered a mature industry where the overall level of customer satisfaction was pretty low. They entered a mature industry, and conventional wisdom in that industry was, if you want to grow, you have to offer the best rates in deposits or you have to buy another company. It’s a mature industry. We're not generating new deposits. Everybody's just shuffling deposits around. Commerce came in. They offered the worst deposit rate in every single local market they're in. So they offered not the best, the worst. They have never made an acquisition. They're the fastest-growing bank in the country. So

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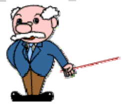

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they've completely defied conventional wisdom and they are performing better than everyone else. And the way they've done it is they've differentiated on service.

So I'll give you a few of the ways that they've gone after that. The first thing is, they're always open. They're open seven days a week. They're open late at night. It's very, very expensive to do that. I only want you to differentiate on service if you can make a disproportionate amount of the profits. So we're going to have to figure out how to pay for that. So they're open much longer hours. In each of their branches they have penny arcades, coin machines. So you can go to a supermarket with all of your coins and put them in there, and the supermarket will keep—I don't know—twelve cents or ten cents out of every dollar. Commerce has those for free for customers and for noncustomers. Their employees genuinely are friendlier, and they set up their organization such that the employees are set up for success. They're set up to be friendlier.

So I'll give you a few of the things that they do. They only have four checking accounts when their competition has forty checking accounts. The implication of that is that I can train employees now on service, not on compliance, not on product specification. The first day of training at Commerce, you're handed a stack of little laminated cards—the first day of orientation, when you have never interacted with this bank before. You're an employee. You get there. They give you these cards and they say, “Any time you ever experience an exceptional service encounter, hand somebody one of these cards. Hand the person who delivered that service this card. Invite them to come work at Commerce.” Ten minutes into the first day of orientation, the culture of customer service is cemented in every employee's mind.

Now, many companies talk the talk, but then they'll go and violate that in different ways. So for example, most companies say to their frontline employees, especially a call center employee, “We really care about the customers. We want you to get really good customer service, and by the way, we're timing how long you're on the phone with the customer.” So they give these mixed messages that they ask the frontline employees to go ahead and manage. And if I ask a thousand frontline employees to manage that, chances are they're not going to manage it in the same way. Commerce says, “We're not going to measure you on how long you stay on the phone. We're measuring you on the service you deliver to the customers. How happy are the customers?”

Again you think, well, that's going to be costly. So they're open longer. They put in these penny arcades and that technology is expensive. They have newspapers and coffee, and the staff is really friendly. All of this costs money. But they're growing faster than anyone else and they're making better profits than everyone else. How do they do it? They pay the lowest rates in every market. They pay the worst rates on deposits. They advertise that they will pay you—they guarantee to pay you—the worst rates. They're the fastest-growing bank into the country. And the reason is—think about it. The money that you're willing to put in a checking account, would you trade half a percentage point less in interest to have what truly is exceptional service? It turns out that there are enough people that they're growing faster than everyone else.

When they went into New York, into Manhattan, two years ago, they grew faster in Manhattan than they had grown anywhere else. I was talking to people from Citibank last week, and after the end of a call I said, “You know, I just want to just play a little word association game: Commerce Bank.” And they just gave a big sigh. And it makes them crazy because they can't respond. What is Citi going to do—stay open until 11:00 at night, open on weekends in their branch network? It would be too costly. Tell their employees to emphasize service? They have forty checking accounts. They have forty loan accounts. They have other compliance things they have to do. They're not set up to differentiate on service.

So these are the first examples of how you differentiate on service, and we'll cycle back to these. And ask questions at any point. But the first example is, they basically figured out how to get customers to pay for the service in a rather clever way. It turns out that a lot of us don't care if we get a half a point less in interest. So every day that we have money deposited at Commerce, Commerce makes money. If they charged us every time we came in, chances are we would feel differently about it. So they found a palatable way to have customers pay for service. So that's the first way to differentiate on service. But not every industry is set up so that you can actually get the customers to pay more.

Progressive
The next example is an auto insurance company, which I'm sure most of you are familiar with. Auto insurance is an industry where customers will not pay for service. This is a price-sensitive industry, and people are going with the best price, full stop. Full stop, we want the best price. Now, another thing about the auto insurance industry is that companies lose money on auto insurance, and what they're in business for is to provide auto insurance. Every company in the auto insurance business, with the exception of maybe five, loses money on auto insurance. They make up for that loss and get a little bit of profit by investing the prepaid premiums. So you lose money on insurance but you make up for it by investing the premiums.

Progressive makes money on insurance and spends more on service in the provision of insurance than any other company. So everyone else loses money on insurance. Progressive makes money on insurance and has more costly service features than everyone else. And people will not pay them for those costly service features. People will only go to the one with the best price. So now you're like, OK, how do they do it? And I'll give you two service features, examples of how they, in a very clever way, manage to make this work.

The first one is the vans that I'm showing here, the immediate response vans. If you get into an accident and you're a Progressive customer and you call up Progressive, it’s not unusual for Progressive to show up at the scene of an accident before the police do. Now, it's really expensive, right? Fleet management, wireless technology. And again, everyone else loses money on insurance. Progressive makes money on insurance. They don't get paid any more. And they have to add this cost into it. So how does that work? How does that end up being a cost savings to them? What do you think is going on?

__: I’m going to venture a guess here. Is it because if you settle with them before you have an opportunity to talk to anybody else about how much it’s really going to cost to fix your car, they’ll be able to settle with you at a lower settling cost than after you talk to your lawyer and say, “Hey, did they pay you for lost wages” and all the other stuff?

PROFESSOR FREI: That's exactly right. In fact, they will say, “We will write you a check on the spot.” What a very benevolent company. We care about you. Well, it turns out that it substantially reduces the probability that you'll use a lawyer. And it reduces fraud substantially. The money that they save on fraud and lawyers, which is about fifteen cents out of every dollar in the industry, the money they save on that way more than pays for the cost of this. So they're delivering more service. They call this immediate response. They could have called it fraud busters. They're better at marketing than I would be, but that's what it is to them. This is their fraud reduction, their reduction of legal fees.

So that's the first service feature. And they have many service features. I'll just highlight two of them for you. The second one is comparison quote. At Progressive, what they'll do is, say you call up Progressive or you log onto their Web site. You want to get a quote for auto insurance. They will happily give you a quote from them and from all of their nearest competitors. So you call up for a quote and they'll give you everyone else's. And the quotes are accurate. And they are lowest less than half the time. And if they're not lowest, the customer goes elsewhere. So you're like, OK, how does that make sense? They're not going to be the lowest more than half the time. Customers leave. Yet this turns out to be an incredibly beneficial thing for them.

What they're capitalizing on is that Progressive is better at data analysis than all of their competition. So they have an operational expertise, which is data analysis, segmenting of customers. But if you have that expertise, it's only valuable if you can actually come up with a clever service design to take advantage of it. Comparison quote is their clever service design that takes advantage of their data analysis superiority. What happens is, they can get at the true riskiness of a customer in a more refined way than anyone else can. So you can think about it that they're closer to the market—they know the true risk better than the competition.

So if two customers call Progressive, for one customer the competition is higher. Progressive is the lower price. In that case, the competition was higher. Progressive says, “You're overpricing the competition. We have a better sense of how risky you are.” Progressive is going to get that customer. In the other situation, if Progressive is not the lowest price, they say, “We actually understand how risky you are. The competition is underpricing you. We are delighted for you to go to State Farm. We'll give you their number. We'll connect you.” They win in both cases. Remember, most companies lose money on insurance. Progressive is helping their competition lose money on insurance. They are happy to have the competition get those customers. They would love for State Farm to offer comparison quote. It's only going to play into their hand. If State Farm starts doing immediate response, they too can save money on fraud and on the participation of lawyers.

__: What do you think has kept the other insurers from being able to develop that database and understanding of—I mean, it's been seven or eight years now that Progressive has been doing this.

PROFESSOR FREI: Yeah. And in fact, since their inception they've been better at data analysis. I mean, part of it I think is legacy. So a hobby of mine is data analysis. It's not that hard. I know that. So why have smart people in the industry not been able to do it? It's never been clear to me, except that they stay one step ahead. I'll give you an example of how it plays out. So, if two elderly drivers have a traffic infraction—one had a speeding ticket, the other had a failure to yield—the competition treats these customers exactly the same. They give them a surcharge on their insurance exactly the same for elderly people. As distinct from teenagers, elderly people had one of these two traffic infractions. Same thing happens.

Progressive, on average, treats these two the same way the competition does. But the surcharge is much higher for one of these infractions than the other. So the competition doesn't distinguish between then and Progressive does. And then as soon as the competition could distinguish them, Progressive is going to use more and more features. They've been able to stay out in front. Except for the fact that it's their cultural legacy, it's not clear to me how the competition hasn't done it.

Which one of these, by the way, does Progressive end up charging more? So the competition: speeding, failure to yield the same way?

__: Failure to yield.

PROFESSOR FREI: Failure to yield gets charged more or less? Charged more? Why?

__: Not paying attention. More likely to be an accident, as opposed to speeding, which is more of, usually, an intended action.

PROFESSOR FREI: And then if you layer that onto the elderly population, what they found is that speeding—that actually shows you're kind of still with it. Failure to yield was actually—we're very afraid. We're going to put a big surcharge there because that could mean that you're starting to go. These are things that Progressive just goes to a finer granularity with than the competition.

Intuit

OK, one more company in terms of the differentiating of service, and then we're going to talk about how to influence customer behaviors. So, Scott Cook, who is the CEO at Intuit, here is his famous quote. They offer free cradle-to-grave customer service on a product that costs thirty dollars or forty dollars or maybe fifty dollars. Now, a phone call on customer service, you can ask how much it costs, but people will quote somewhere—I don't know—ten, twelve, fifteen dollars. They offer free cradle-to-grade customer service on a product that costs thirty dollars. Not surprisingly, their competition—and this was especially true when they came out—thought they were crazy. And they made a lot of money. If they got the same call volume as their competition, they would have been out of business.

So Intuit's entire organization is geared towards minimizing the need for customer service. So their strategy is to minimize demand. Now, this is not the very popular strategy of, “Let me hide the phone number very deep in the Web site so that you can’t find it so you don't call me,” minimizing demand. This is genuinely minimizing demand. Customer service is excellent and the need for it is rare. That's what their guiding principle is. So the deliberate choice they make is that, first of all, everything is geared towards doing it right the second time. It's OK that there's a mistake the first time but everything is geared towards, if we hear about a mistake today, we will not hear about that mistake next month. We will not hear about that mistake next year. That's not true in many of the competitors.

So doing it right the second time means that the people who are answering the phone are part of the product development team. They have feedback into it, and the customers feel like they're part of the product development team. The employees are paid more because their job is not just to satisfy you but it's how do we then go back and talk with the engineers. Status among engineers is earned in interesting ways. It's usually the person who can be the most sophisticated, the most clever. Intuit wants straightforward engineering, wants people who will design products for their mother and have a good time doing it. Will your mother be able to use the software you've created? The vast majority of engineers, that's not their goal. They want these whiz-bang things. Those engineers are not welcome at Intuit.

Summary: Differentiation on service

So Intuit's philosophy is in this third camp. One is, increase the customer willingness to pay: Commerce. The other is, take operational savings and wrap it up in a stealth kind of way in service features. And that's what happens in a price-sensitive industry where you can't get customers to pay. That's Progressive. And then Intuit is, make customer service excellent, but remove the need for it. Make the need for it rare.

So those are three camps along a continuum of how to differentiate on service. Now, these are not the norm. I mean, these are very celebrated companies. I'm sure you've all heard about all of these companies before.

Customer as advocate or adversary

A great example of all of these things not working in a spectacular way is the cell phone industry. When I think about the cell phone industry, a continuum comes to mind. Customer as advocate is the companies we just looked at. Customer as adversary is the cell phone industry. And the cell phone industry, I mean, you get the sense they just don't trust themselves to deliver good service.

So I got a call from one of these cell phone companies recently, and they said that they wanted to become customer focused. So I went and did a little research on them, looked at it, and then called them back and said, “I don't believe you.” Because if you look at all of their long-term contracts, customers have to guess their usage. And the company is really there banking on that. They make money when you guess wrong. Think about your cell phone plan. How many minutes do you want a month? You want 800 minutes a month? OK. The company makes more money when you pay for capacity you don't use, or if you go to 900 minutes that month, those last 100 minutes are four or five times the charge per minute as the first 800. The company has set up the customer in an adversarial role. They benefit when the customer does not benefit.

That's not the case with Progressive and their customer service—I got to reduce fraud; you got better customer service. So having the customer as adversary is a big problem. So now these guys say, “No, no, no, we're serious. We really want to become customer-focused. How can we influence customers to behave in our best interest?” So I'm going to take you through a few examples of lessons we've learned on how to successfully influence customer behavior.

But what I said to these guys was, “Let's just do a small experiment. Imagine for a moment that you were given seed money to start a new cell phone company, whatever amount of money that would cost. We're going to give it to you. You start the company and your only mandate is: build a customer-focused company.” So we built it and that was, frankly, the cheeriest part of the conversation. That was fun and uplifting. The guy was very happy on the phone. It was a team of people. They all had great ideas for what to do.

Then we stopped and stepped back and said, “Now, how scared are you at your current company?” And they didn't see a way to get from here to there. And how likely do you think that company is going to exist in the cell phone industry in five years? They all think that company is going to exist in five years. And the race is can they get there or is it going to be a new entrant coming in?

And the new entrant that’s going to champion the customer—because this industry is like the banking industry—they’re waiting. They say, “Our customers are price-sensitive. We can't get them to pay for service.” I explained that perhaps they hadn't tested that yet. If you give lousy service for a lot of money, and lousy service for a little money, it turns out that customers choose lousy service for a little money. Have you proven that they're price-sensitive? I don't know. Will customers pay for service? It's an open question in the cell phone industry. Is it going to be like Commerce or is it going to be like Progressive?

If you think about firms and populate them on the customer as advocate/customer as adversary, there's more on the customer as adversary side than the customer as advocate side. It's just an interesting way to think about firms you're associated with: What's the contract you have with the customer? If you win when they lose, you're leaving the door open for someone else to come in and champion the customer.

Influencing Customer Behavior

Influencing customer behavior. So, I believe that customers are desperate to be helpful to companies and that customers are very smart. I believe both of these things to be true. Now I'm going to tell you a story about Zipcar and I'm going to give you a little test. I'm going to help you solve one of their problems.

Zipcar

Zipcar is a car-sharing service. It started in Boston. It's a service that really thrives in areas where the cost of car ownership is high. In places where parking is expensive, insurance is expensive, they come in and they say, "You don't have to have insurance. You don't have to pay for gas. You don't have to pay for maintenance. We're going to park cars throughout the city and you can reserve one of those cars. You go and use it for, like, eight dollars an hour and return it to its spot. There's no Zipcar employee there to monitor it, so you have to bring the car back. We ask you to keep it clean. If it goes below a quarter tank in gas, there's a Zipcar credit card, and we ask you to fill the tank up." So it's based on this nice community feeling. And you don't have to have any insurance, any personal car insurance. For some people, this works perfectly. It really does. It's a great replacement of car ownership. When you've reserved the car, only your key works to open the car. So it's not that you can go to a Zipcar and open it at any time. They'll activate it through radio technology.

So now, here's a situation. Victoria has the car reserved from 4:00 to 6:00, and Dan has it reserved from 6:00 to 8:00. What can go wrong?

__: She can be late.

PROFESSOR FREI: Right. You're late. Dan shows up at the parking spot and the car is not there. Let's help Zipcar. What should we do? Because that's no good. Because then Dan's not going to stay there very long. Nobody wins in that case, from the firm. So let's help Zipcar solve this lateness problem. What do you suggest?

__: A stock of cars that are free-flowing. Cars they can drop off within five minutes if someone turns up late. A stock of cars they can drop off.

PROFESSOR FREI: OK. So, Zipcar could hold slack inventory and disperse them. The cars would be expensive and the people to deliver them would be expensive. So that's a good solution. Let's see if we can come up with a solution that's less expensive. One way is to build slack into the system, and responsive slack, so that we don't upset Dan. David?

__: Since we're already meeting, how about we just get in touch with each other? Kind of how we'd solve it in real life. Give me the cell phone number or the e-mail or whatever to get in touch with you, and I'll have you pick me up wherever I am.

PROFESSOR FREI: Let's check.

__: No. I don't want to call Dan and say, “I'm going to be late, Dan. Sorry.”

__: No, I'm going to call you and say . . .

__: And say, “Where's the car?” I don't want that either.

PROFESSOR FREI: Dan, what are we going to do?

__: Play intermediary. Take the people out of the equation. If you said you can already remotely activate your car, apply technology, and just say, “OK, we're going to track where the car is, and if it looks like it's going to be late we're going to tell you that along the way.”

PROFESSOR FREI: Rodney?

__: A future discount for Victoria if she returns our car early or on time.

PROFESSOR FREI: So we're going to pay her to behave well.

__: And a surcharge if it’s late.

PROFESSOR FREI: And so we can pay her to behave well. We can charge her. Either way it turns out it might not be quite as expensive as holding slack in the system. If we pay her to behave well, we have to charge a little bit more. And how much should we charge her? Mike, how much should we charge Victoria if she's late?

__: Long-term cost of recruiting a new customer.

PROFESSOR FREI: So if it's eight dollars an hour. I could give you that. But what's your sense of how much should it be for the . . .

__: Very expensive. Five times.

PROFESSOR FREI: So, forty dollars.

__: Fifty bucks.

PROFESSOR FREI: Fifty dollars. Let's just check in. I charge Victoria fifty dollars. Dan, how are you feeling?

__: It doesn't solve my problem, because my problem is I needed the car at the time.

PROFESSOR FREI: It's an extreme problem, where one customer's behavior can affect the quality of service of another customer. So that's not typical.

__: Can you tie these two together, so if somebody is late, and somebody is early, then you trade off whatever you get on a penalty and give it to the other?

PROFESSOR FREI: So if you're late, Victoria, and Dan got the forty dollars, that might be sort of a transfer thing. Here's an experiment they ran. They had the late fee and, when I talk about this with people, it's almost everybody's first instinct, because we're used to using carrots and sticks. I mean, that's just instinctually how we influence behavior. We do it for employees. We do it for customers. Experiment was, we're going to remove the late fee. The late fee was giving Victoria economic license to be late. It's forty dollars. Is this meeting important enough that it's worth forty dollars to me? That's not the calculus the company wanted her to run. If I'm late, I'm going to be disappointing another customer who lives or works near me, and will be wanting to use the car when I'm going to be using it, setting up a normative environment instead of the carrot-and-stick or instrumental environment.

Our instincts are always instrumental: carrots and sticks. For employees, we know very well that norms are more effective than instrumental. Zipcar thought, well, let's apply norms to customers. If you want to unlock the power of customers, let's not stop at instrumental. And sometimes instrumental is better, but can we create an environment such that normative is better than instrumental? When they removed the late fees, lateness all but stopped.

Normative environments
Another example of using a normative environment—there's a Scandinavian bank that was a low-cost provider of financial services. They try to keep costs down, and they refund fees—any fee you get from another bank for using their ATM machine, anything like that, they refund you. It was getting expensive for them to do that. So they had a problem of, OK, I don't want to charge you, because our contract is that we're the place that we really want you to go, and we want you to feel good about us. But fees are going through the roof.

They posted on their Web site a sign that said, "To the extent possible, please refrain from doing out-of-network ATM transactions to help us keep our costs down." They just went away. People stopped doing them. Now, customer as adversary, customer as advocate. When I asked Fleet customers, "If Fleet told you an activity you could do to save them money, what would your response be?" Often the response is, "I would repeatedly do the opposite." So you want to think, how do I create an environment, and then if I can get the customers to act in my best interests, what are the normative behaviors that I can go after?

So one way is norms, which is counterintuitive, because we usually think in instrumentals. So thinking of norms is one way to influence customer behavior.

Fail-safes
Sometimes there are customer behaviors where I don't want to go through the effort of creating a norm. Customers leave ATM cards in machines. I could create a normative environment, but really I just want you to stop leaving your ATM card in the machine, because everybody loses. So what they did in this case is they made a fail-safe. They fail-safed the process, blocking the error from happening to the extent possible. What was the fail-safe that they created?

__: You have to take your card before they give you the money.

PROFESSOR FREI: Turns out that people stick around for the money. They don't always stick around for the card, but they do stick around for the money. So they just reversed the order of it. They used to have it beep first. But at busy intersections people weren't hearing the beeping, so they fail-safed the process to really reduce the likelihood of it happening.

Here's another one. I want you to come up with a fail-safe. And to come up with a fail-safe, we first have to figure out, well, what's the root cause? So there was a situation where startled shouts, not overwhelming, but startled shouts were occurring at the back of an airplane. This was happening regularly, and when you're at 30,000 feet, and I'm not talking about big shrieks, but at 30,000 feet you're a little more nervous. You're in a confined space. So they do root cause analysis and they find out, what was the cause of this? It turned out that people were walking in on people as they were going to the bathroom. Nobody had bad intentions. And if someone walks in on you going to the bathroom when you're up in the air, it startles you more than if it happens here. So they thought, we don't want this to occur anymore. How do we block this from occurring? How do we fail-safe this process?

__: The light.

PROFESSOR FREI: The light is attached to the lock. You can't be in the bathroom with the light on unless the door is locked. They fail-safed it from occurring. So we can influence customers to behave differently, or we can just block them from doing the activity we don't want them to do. Different ones are true for different areas.

I'll give you one more of these. And by the way, fail-safes for employees are just as powerful as fail-safes for customers. OK, in New York, this problem was becoming very, very expensive. Customers were calling up the cable company in large numbers and saying, “Our cable is out.” Now, the cable was not out, but the customers mistakenly thought the cable was out. We're in New York, so we go back. We do the root cause analysis, and the source was that the people had the TV turned to the wrong channel. So they did some investigation. They found out that people had turned the TV to the wrong channel. It made it feel like the cable was out. So the customer calls and says, “My cable is out. When is the service going to be up?” The service person says, “The cable's not out. Your TV is on the wrong channel. Just go ahead and make sure it's on channel four.”

“My TV is not on the wrong channel.” And remember, it's New York. “My TV is not on the wrong channel. I haven't touched that TV for weeks.” “You're the thirtieth person to call today. Your TV is on the wrong channel.” It just goes back and forth. Now it's a stalemate and it's an expensive stalemate. Their average speed of answer—all of these things are being affected. What words can the customer service person say to get around this stalemate? You can't block it from occurring. But we need some fail-safe-y thing. And asking them, telling them they're wrong, that didn't work. So what they did is they said, “You know, it's the craziest thing. We don't know why it works, but if you switch the TV to channel twelve and back to channel four, it fixes the problem.” So influencing customer behavior, you want to take deliberate action. Normative, fail-safe, or as close to fail-safe as we can get.

Starbucks
OK. There are just two more companies for influencing customer behavior. Starbucks. How many of you are regular Starbucks drinkers? Giselle, what's your drink?

__: It's like a coconut milk drink.

PROFESSOR FREI: When you ask a roomful of people what their Starbucks drinks are, you'll hear a lot of adjective-laden phrases. And when you ask, “What are you getting for that $3.50, one is you're getting a great drink. But the other that you're getting is this ability to express yourself. I mean, some people go in and they'll have five, six, seven adjectives, in the order of some coffee, and “dry” is one of the adjectives, for coffee. You're like, what the heck is going on? And Starbucks actually publishes books on its Web site for how to order more effectively and what all these adjectives mean. So for $3.50 you get a great cup of coffee and you get the ability to express yourself.

But from Starbucks' perspective, they want you to be able to order. They don't want Giselle to order, “Can I have that coconut thing?” If she does that, the person will coach her through the first time, and tell her exact phrasing to use next time. And Giselle will come in the next time, and she'll be OK with the phrasing. And they'll correct it again. She'll come in the next time until you're going to actually be really good at it.

__**:** Can you just explain a little bit how this sort of customization that is well articulated to employees plays against the earlier point you were making of Commerce Bank having four bank accounts to choose from.

PROFESSOR FREI: So, here's what Starbucks did. They used to give their employees a manual with a thousand drinks. Maybe not a thousand, but close to a thousand drinks. And the employees were spending their time on these thousand drinks, remembering what all the drinks were. And then they realized, let's offload the customization to the customer. They have this whole “customize your cup” campaign. The customer basically tells you the components you want. They advertise that they have 16,000 drinks. That's how many combinations there are. So it's simple from the employees' side. They don't have to remember all of these things. The customers do the customizing. It falls down if Giselle is not precise in her ordering. So instead of training the employees to remember the thousand drinks, they train the customer to order efficiently.

The overlooked genius of Starbucks is that they made standardization aspirational. If you have a complicated coffee and you order it well, and you order it to the Starbucks person, the Starbucks person calls it out to someone else. That person calls it back, so that everybody there understands. They're going to make all kinds of opinions about who Giselle is, based on what this drink is that she's ordered. So they offloaded the training. They trained the customer. And it is aspirational. You feel good. If you don't get it right, they very kindly correct you. You think, I'm going to get it right next time. They made training aspirational.

So they didn't train the employees so that the employees could concentrate on service. They tried and it wasn't working. They were overloading them. Instead their campaign is customize your cup. Let's offload training to the customer. But if we don't help the customer, it's going to be a disaster for us. The lines are going to go out the door. So they train the customers. And the way they do that is they make it cool for you to get it right. And they figured out how to do that.

Southwest Airlines
OK, one last one for the influencing customer behavior. In order for me to explain this—and Southwest Airlines is very well understood and celebrated for all of the right reasons—I'm going to show you one perhaps overlooked part of Southwest Airlines. And in order to show you that, I just have to very quickly show you the back-of-the-envelope economics of the airline industry. So, if there's a plane with 100 seats, the revenue from the first sixty-three passengers covers the entire cost of the flight. If sixty-four passengers are on that flight, it doesn't add anything to the cost. So this is a high fixed cost. We can call it zero marginal cost industry. So the revenue from the first sixty-three passengers covers the costs. And the revenue from the sixty-fourth and above, all of their revenue is profit. So the revenue from the last few people on the plane represents all of the profit.

At Southwest, the average customer, the average load is 70 percent. So on a 100-seat plane, seventy customers are showing up on average. On average, there are thirty empty seats. On average, the profit comes from the last seven people on the plane. On other airlines—United, Delta—in the years where they make money, their profit comes from the last one-and-a-quarter people on the plane. So the last person, not even the last two people, the last one point something people, for most airlines, represents all of the profit for that flight. This helps explain why these airlines are just crazy for frequent fliers. If one frequent flier stops flying United, if they flew 100 flights a year, 100 flights go from being profitable to unprofitable. So in this industry, the economics are very tenuous. Southwest has a much bigger cushion than others, but even still, the last seven people on the plane.

Here's a customer service problem that Southwest is having, and I just want you to solve it for them. Their problem is that their most frequent fliers, here is what their life is. And the thing about the Southwest boarding process is, it's first-come, first-served. You get there. You get your low number boarding card. If you get there thirty minutes before the flight, you're guaranteed to be the last one on the plane. No seat assignments.

To get the lowest number boarding card, how early do you have to be at a Southwest flight? Three, four days in advance, right? I mean, the culture is that people get there early for these. Frequent fliers disproportionately get the high number boarding cards because they're busy. They don't have picnic baskets that they bring with them. This is the typical view of Southwest's best customer. You get the high number boarding card. Well, the people before you took first all of the aisle seats and then all of the window seats.

Their best customer says to Southwest, “Look, we love the airline. We want just a chance, a prayer of seeing a view other than this. Will you save just one per flight? Will you save a low number boarding card for the most frequent fliers—200 flights a year, whatever number, whatever threshold you want?” And it would be costless for the airline to do this. They already know who the frequent fliers are. It's saving a plastic boarding card. So they're saying, “We're your best customers. We understand the economics of the industry. Will you give us this little teeny perk? And it won't cost anything.”

You're Southwest. How do you respond? Free service to your best customer in an economically tenuous industry. You feel like you're being set up, don't you? You have that look about you. It sounds like a no-brainer. If it really is free—and it is free—it will not add to the cost. Give it to them.

If Terry comes in thirty minutes before the flight and gets it, will the rest of the Southwest customers notice? Think about the community of people. It will be a very visible service. Southwest says no to this policy, and every year it's the single biggest complaint that their most frequent fliers have. Every year, some of Southwest's best customers leave the airline because of this. And Southwest lets them go. And they let them go because if they visibly treat Terry better, the service that we got yesterday, that we were delighted with, we're going to get exactly the same service today. We'll get to sit in the same seat. I mean, Terry, he's one person. He's not going to affect our early-bird lives. But he got there after us and got on before us? All of a sudden, we're going to start looking around and realize we're getting pretty crappy service.

Everybody was delighted with their no-frills service yesterday because everyone was getting no-frills service. If we give in to Terry, it changes our perception of our service. So, with Zipcar, Victoria's behavior could genuinely affect the quality of Dan's service. Southwest—how I treat Terry will affect Giselle's perception of her own service, even if it didn't affect her own service. So customers can influence the quality of other customers. Customers can influence the perceptions of quality of other customers. Southwest doesn't give in to this request because of the perception game. So when you're managing customers and you're trying to influence customer behavior, especially in services, it's not just the actual service, it’s the perceptions of the service.

Listening to customers
OK. The last part I want to talk to you about in terms of influencing customers and using customers as a benefit. I teach a second-year elective called *Managing Service Operations*, and we had 300 students take the class this fall. So we gave them all projects and we said, “You can write any letter. Write a letter to a company. Praise or complain.” So they would write the letter. They sent it out to the company. And then we had them code their letter. What's the tone of the outgoing letter? What industry was it to? Did you name people by name? Did you just do the company? We code them, and I don't expect you to be able to read this, but we ask them all kinds of questions about it.

They send the letter out. They get a response. About 70 percent of companies respond. And then we have them code the response. And we did the analysis of this, because, you know, customers are very valuable. Capitalize on the power of the customer means that you should really . . . So, let me just show you one excerpt from here that shows perhaps one way that you might not want to go after this: “The purpose of this e-mail is to congratulate you on your recent decision to place an ATM machine in Spangler. I was delighted to realize that I would once again be able to conduct my banking transactions at a location close to school.” Really just, like, they're delighted with the company. There's joy there. You code that on joy. It's not overflowing but they're delighted. That's a good word.

“We appreciate your taking the time to e-mail us your satisfaction as we continually strive to enhance your banking experience. We have forwarded your comments to the appropriate department for review. Customer comments and suggestions are reviewed on an ongoing basis. If you have any further questions . . .” Close to delighted, on the high end of the joy scale. They got this response? They think they're morons. They would have been better off not responding. So, capitalize on the power of the customer. Actually, just be neutral until you can figure out how to capitalize on the power of the customer. Don't do anything because you can do things badly.

Let me give you a different response. There was the same sort of outgoing letter. “Thank you for contacting J. Crew. We appreciate your complimentary remarks about our merchandise and service. It brightens our day when a customer notices our efforts, and we truly appreciate your taking the time to write us. We will forward your compliment on to the store manager.” For this person, it elevated their opinion of J. Crew. Each one sent out a letter of praise, and then we asked at the end what your overall satisfaction was. For some people who sent praise, satisfaction plummeted. So when you want to capitalize on the power of the customer, knowing how to talk to customers plays a big role.

Rocks in the Pond
OK. I'm going to end this and then we'll just open it up to a discussion. I want to tell you a little story. Do you know the story of the rocks in the pond? You don't know the story of the rocks in the pond. That's a pond and those are rocks, which could have been keeping you from doing it. And you're the skipper of this boat. And you want to get from point *A* to point *B*. What do you do? What's preventing you from crossing? There's no water. So let's add water. We add water. And they say I don't know technology. Look at that animation. So you add water, go across from point *A* to *B*. Works great. It turns out, however, that these are a pesky kind of rock. They grow in water. You want to get back from point *B* to point *A*. What do you do?

__: Add more water.

PROFESSOR FREI: Add more water, right? We know how to solve this. If we taught you one thing, it's how to solve repeated tasks well. Pattern managing. We call it learning by analogy. So we can keep adding water, but we just have a lurking feeling that there's something wrong with this strategy. So let's go ahead and see. We could continue to add water and crossings would be possible. Let's look at what some of the more advanced companies would do.

Skipper of a boat: You get here and you don't see any rocks. You want to go from point *A* to point *B*. Steven, what are you going to do?

__: I'm going to drain the pond and walk.

PROFESSOR FREI: Drain the pond. See, it does help. Just throwing something out there can sometimes help. Don't you remember that from class? Take some water out, expose the rocks, work on the rocks, drain more water out, expose more of the rocks until you have as little water as possible needed to cross. Remove as much water as possible and then cross. What do the water and rocks symbolize? Think about it from a manufacturing context.
By working on the rocks—rocks are problems. The water you can think of as inventory from a manufacturing setting. Problems grow when you buffer them with inventory. If you think what makes Toyota great, it's constantly trying to expose problems. Toyota is constantly lowering the water. When they can't see problems they're not happy. When Intuit doesn't see problems they're not happy. They want to constantly get better. That means that calm seas are not the goal. Constantly work to expose problems and then to work on the problems.

Now, the question is, how do you work on the problems? What Toyota will say that they do is they ask the five whys. Let me just give you the standard five whys or root cause analysis. We're having quality problems—asking, "Well, why are we having quality problems?" as opposed to, "Let me just go act on the quality problems." And if you're going to act on the quality problems, you can check the materials, put in quality checkers. You could spend all kinds of resources on the quality problems. Or you could ask, why are you having the quality problems? Because people aren't performing well. Why aren't they performing well? They're not being trained. Why aren't they being trained? We're hiring them too fast to keep up with the training. Why are we hiring them too fast? Because we didn't forecast demand well.

What looked like a quality problem was actually a forecasting problem. Venture to say that all of the resources you were going to spend on that quality problem probably weren't going to get near the forecasting function. What Toyota does, what Intuit does, what companies that are trying to improve do, is that they're lowering the water, exposing problems. They're doing that with their employees, and often they're doing that with the customer to try to bring them in.

So, I want to end there, and we can hang out and talk about anything you want, or you can go off to lunch early. But this is just an opportunity for me to share some research findings with you, and to give you guys a chance to talk with each other.

So, this is just the beginning of a conversation. I'm delighted that you took some time to come here. And if I can ever be helpful to you, don't hesitate to contact me.