



Chapter 6: Setting **Prices** and Implementing **Revenue Management**



Overview Of Chapter 6



- **Effective Pricing is Central to Financial Success**
- **Pricing Strategy as Represented by the Pricing Tripod**
- **Revenue Management: What it is and How it Works**
- **Ethical Concerns in Service Pricing**
- **Putting Service Pricing into Practice**



Effective Pricing is Central to Financial Success

What Makes Service Pricing Strategy Different and Difficult?



- **Harder to calculate financial costs of creating a service process or performance than a manufactured good**
- **Variability of inputs and outputs:**
 - ➔ **How can firms define a “unit of service” and establish basis for pricing?**
- **Importance of time factor – same service may have more value to customers when delivered faster**
- **Customers find service pricing difficult to understand, risky, and sometimes even unethical**

Objectives for Pricing of Services



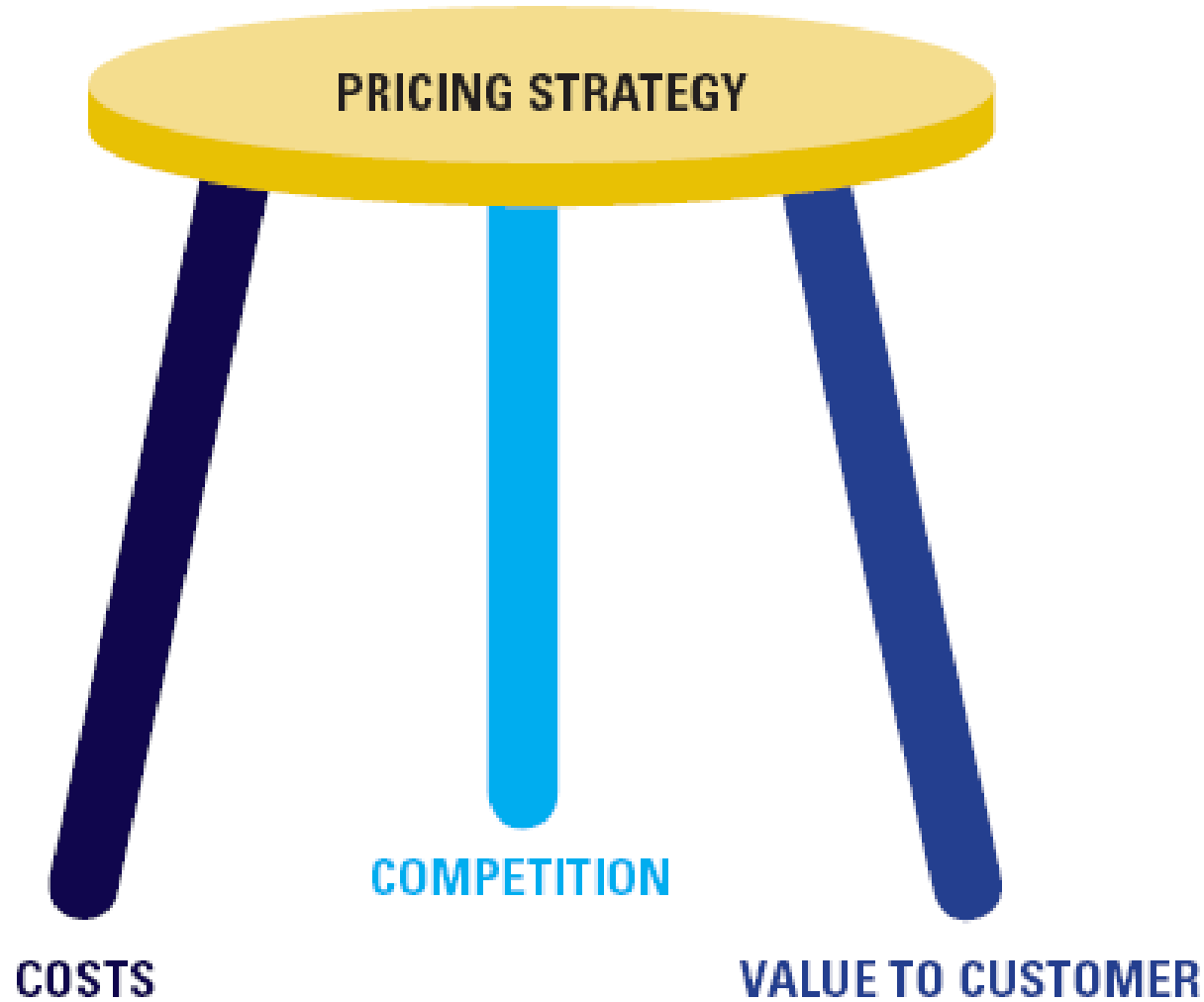
- **Revenue and Profit Objectives**
 - **Seek profit**
 - **Cover costs**

- **Patronage and User-Based Objectives**
 - **Build demand**
 - *Demand maximization*
 - *Full capacity utilization*
 - **Build a user base**
 - *Stimulate trial and adoption of new service*
 - *Build market share/large user base*

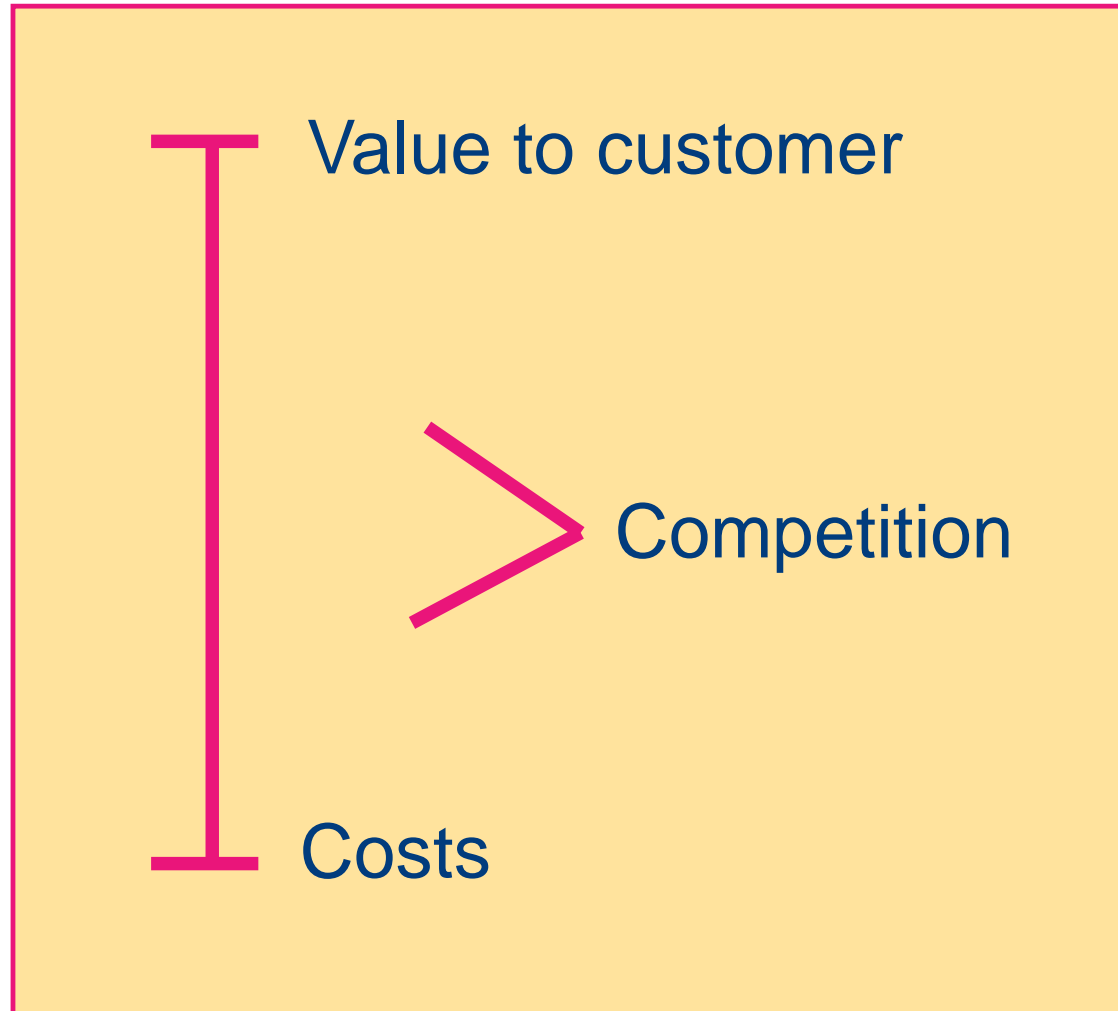


Pricing Strategy As Represented by the Pricing Tripod

The Pricing Tripod



Floor and Ceiling of Price



Three Main Approaches to Pricing



Cost-Based Pricing

- Set prices relative to financial costs
- Activity-Based Costing
- Pricing implications of cost analysis

Value-Based Pricing

- Relate price to value perceived by customer

Competition-Based Pricing

- Monitor competitors' pricing strategy
- Dependent on the price leader

Cost-Based Pricing: Traditional vs. Activity-Based Costing



- **Traditional costing approach**
 - Emphasizes expense categories (arbitrary overheads allocation)
 - May result in reducing value generated for customers
- **ABC management systems**
 - Link resource expenses to variety and complexity of goods/services produced
 - Yields accurate cost information

BUT, customers care about value to themselves, not what service production costs the firm

Value-Based Pricing: Understanding Net Value



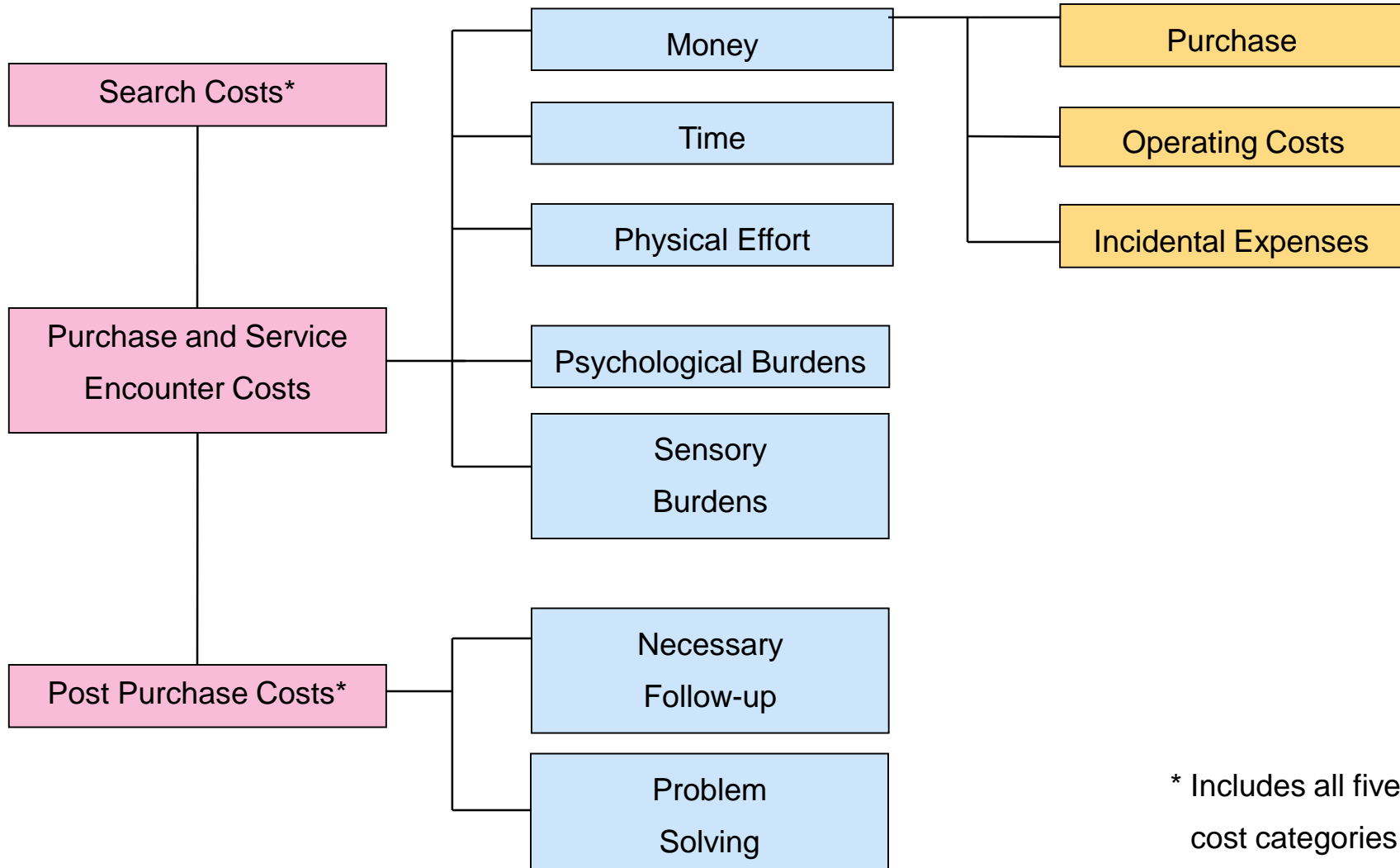
- **Net Value = Perceived Benefits to Customer (Gross Value) minus All Perceived Outlays (Money, Time, Mental/Physical Effort)**
- **Consumer surplus: difference between price paid and amount customer would have been willing to pay in absence of other options**
- **Competing services are then evaluated via comparison of net value**

Value-Based Pricing: Strategies for Enhancing Net Value



- **Enhance gross value – benefits delivered**
 - ➔ Add benefits to core product
 - ➔ Enhance supplementary service
 - ➔ Manage perceptions of benefits delivered
- **Reduce costs incurred by**
 - ➔ Reducing monetary costs of acquisition and usage
 - ➔ Cutting amount of time required to evaluate, buy, use service
 - ➔ Lowering effort associated with purchase and use

Defining Total User Cost



* Includes all five cost categories

Competition-Based Pricing



Price competition increases due to:

- Increasing competition
- Increase in substituting offers
- Wider distribution of competitor
- Increasing surplus capacity in the industry



However under these circumstances, price competition can decrease:

- High non-price-related costs of using alternatives
- Personal relationships matter
- Switching costs are high
- Time and location specificity reduces choice
- Managers should examine all related financial and non-monetary costs

Competitive-Based Pricing



Which clinic would you patronize if you needed a chest x-ray (assuming that all three clinics offer good technical quality)?

Clinic A

- Price \$65
- Located 1 hour away by car or transit
- Next available appointment is in 3 weeks
- Hours: Monday – Friday, 9am – 5pm
- Estimated wait at clinic is about 2 hours

Clinic B

- Price \$125
- Located 15 min away by car or transit
- Next available appointment is in 1 week
- Hours: Monday – Friday, 8am – 10pm
- Estimated wait at clinic is about 30 to 45 minutes

Clinic C

- Price \$185
- Located next to your office building (or college)
- Next available appointment is in 1 day
- Hours: Monday – Saturday, 8am – 10pm
- By appointment – estimated wait at clinic is about 0 to 15 minutes



Revenue Management: What it is and How it works

Maximizing Revenue from Available Capacity at a Given Time



- **Most effective in the following conditions:**
 - High fixed cost structure
 - Relatively fixed capacity
 - Perishable inventory
 - Variable and uncertain demand
 - Varying customer price sensitivity
- **Revenue management (RM) is price customization**
 - Charge different value segments different prices for same product based on price sensitivity

Maximizing Revenue from Available Capacity at a Given Time



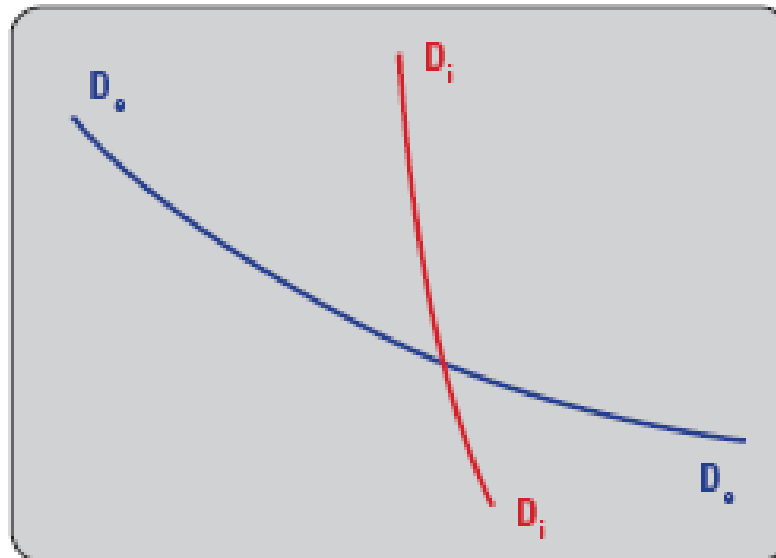
- **RM uses mathematical models to examine historical data and real time information to determine**
 - ➔ **What prices to charge within each price bucket**
 - ➔ **How many service units to allocate to each bucket**
- **Rate fences deter customers willing to pay more from trading down to lower prices (minimize consumer surplus)**

Price Elasticity



Services Marketing

PRICE PER UNIT
OF SERVICE



QUANTITY OF UNITS DEMANDED

$$\text{Price Elasticity} = \frac{\text{Percentage change in demand}}{\text{Percentage change in price}}$$

- D_e : Demand is *price elastic*. Small changes in price lead to big changes in demand
- D_i : Demand for service is *price inelastic*. Big changes have little impact on demand

Key Categories of Rate Fences: Physical (Product-Related) Fences



Product-Related Fences

| Rate Fences | Examples |
|---------------|---|
| Basic Product | <ul style="list-style-type: none">▪ Class of travel (Business/Economy class)▪ Size and furnishing of a hotel room▪ Seat location in a theater |
| Amenities | <ul style="list-style-type: none">▪ Free breakfast at a hotel, airport pick up, etc.▪ Free golf cart at a golf course |
| Service Level | <ul style="list-style-type: none">▪ Priority wait listing▪ Increase in baggage allowances▪ Dedicated service hotlines▪ Dedicated account management team |

Key Categories of Rate Fences: Non Physical Fences



Transaction Characteristics

| Rate Fences | Examples |
|------------------------------------|--|
| Time of booking or reservation | <ul style="list-style-type: none">▪ Requirements for advance purchase▪ Must pay full fare two weeks before departure |
| Location of booking or reservation | <ul style="list-style-type: none">▪ Passengers booking air tickets for an identical route in different countries are charged different prices |
| Flexibility of ticket usage | <ul style="list-style-type: none">▪ Fees/penalties for canceling or changing a reservation (up to loss of entire ticket price)▪ Non-refundable reservation fees |

Key Categories of Rate Fences: Non Physical Fences



Consumption Characteristics

| Rate Fences | Example |
|-------------------------|---|
| Time or duration of use | <ul style="list-style-type: none">▪ Early bird special in restaurant before 6pm▪ Must stay over on Sat for airline, hotel▪ Must stay at least five days |
| Location of consumption | <ul style="list-style-type: none">▪ Price depends on departure location, especially in international travel▪ Prices vary by location (between cities, city centre vs. edges of city) |

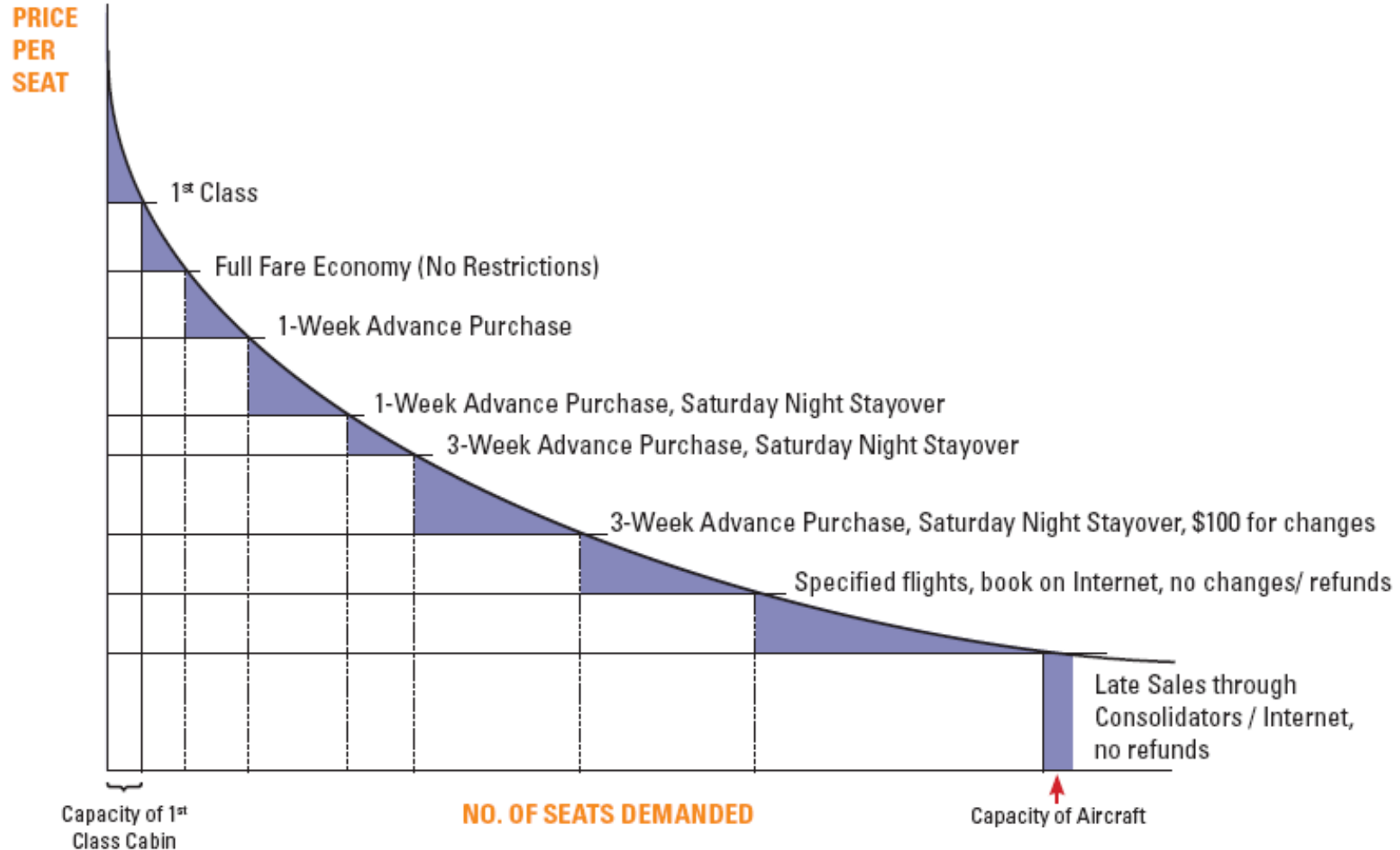
Key Categories of Rate Fences: Non Physical Fences



Buyer Characteristics

| Rate Fences | Examples |
|------------------------------------|--|
| Frequency or volume of consumption | <ul style="list-style-type: none">Member of certain loyalty tier with the firm get priority pricing, discounts or loyalty benefits |
| Group membership | <ul style="list-style-type: none">Child, student, senior citizen discountsAffiliation with certain groups (e.g., Alumni) |
| Size of customer group | <ul style="list-style-type: none">Group discounts based on size of group |

Relating Price Buckets and Fences to Demand Curve



* Dark areas denote amount of consumer surplus (goal of segmented pricing is to reduce this)



Ethical Concerns in Service Pricing

Ethical Concerns in Pricing



- **Many services have complex pricing schedules**
 - hard to understand
 - difficult to calculate full costs in advance of service
- **Unfairness and misrepresentation in price promotions**
 - misleading advertising
 - hidden charges
- **Too many rules and regulations**
 - customers feel constrained, exploited
 - customers unfairly penalized when plans change

Designing Fairness into Revenue Management



- **Design clear, logical, and fair price schedules and fences**
- **Use high published prices and present fences as opportunities for discounts**
- **Communicate consumer benefits of revenue management**
- **Use bundling to “hide” discounts**
- **Take care of loyal customers**
- **Use service recovery to compensate for overbooking**



Putting Service Pricing into Practice

Pricing Issues: Putting Strategy into Practice



1. How much to charge?

2. What basis for pricing?

3. Who should collect payment?

4. Where should payment be made?

5. When should payment be made?

6. How should payment be made?

7. How to communicate prices?

Putting Service Pricing into Practice



- **How much to charge?**

- Pricing tripod provides a useful starting point
- A specific figure must be set for the price
- Need to consider the pros and cons, and ethical issues

1. How much to charge?

- **What basis for pricing?**

- Completing a task
- Admission to a service performance
- Time based
- Monetary value of service delivered (e.g., commission)
- Consumption of physical resources (e.g., food and beverages)

2. What basis for pricing?

Putting Service Pricing into Practice



- **Who should collect payment?**

- **Service provider or specialist intermediaries**
- **Direct or non-direct channels**

3. Who should collect payment?

- **Where should payment be made?**

- **Conveniently located intermediaries**
- **Mail/bank transfer**

4. Where should payment be made?

- **When should payment be made?**

- **In advance**
- **Once service delivery has been completed**

5. When should payment be made?

Putting Service Pricing into Practice



● How should payment be made?

- Cash
- Token
- Stored value card
- Electronic fund transfer
- Charge Card (Debit/Credit)
- Vouchers

6. How should payment be made?

● How to communicate prices?

- Relate the price to that of competing products
- Ensure price is accurate and intelligible

7. How to communicate prices?

Summary



- **Pricing objectives can include**
 - ➔ **Generating revenues and profit, building demand, and developing user base**
- **Three main foundations to pricing a service**
 - ➔ **Cost-based pricing**
 - ➔ **Competition-based pricing**
 - ➔ **Value-based pricing**
- **Firm must be aware of competitive pricing but may be harder to compare for services than for goods**

Summary



- **Revenue management**

- Maximizes revenue from a given capacity at a point in time
- Manage demand and set prices for each segment closer to perceived value
- Use of rate fences

- **Ethical issues in pricing**

- Complex pricing schedules
- Unfairness and misrepresentation in advertising
- Hidden charges
- Too many rules and regulations