CHAPTER 6

Setting Prices and Implementing Revenue MANAGEMENT
Overview Of Chapter 6

- Effective Pricing is Central to Financial Success
- Pricing Strategy Stands on Three Legs
- 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 (Table 6.1)

- **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 Stands on Three Legs
The Pricing Tripod (Fig. 6.3)
The Pricing Tripod - Basis for Any Pricing Strategy

- Costs
- Value to customer
- Competition
Three Main Approaches to Pricing

- **Cost-Based Pricing**
  - Set prices relative to financial costs (problem: defining 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 (especially if service lacks differentiation)
  - Who is the price leader - does one firm set the pace?
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

- When looking at prices, customers care about value to themselves, not what service production costs the firm
Value-Based Pricing
Understanding Net Value (Fig. 6.7)

- Value exchange will not take place unless the customer sees positive net value in the transaction.
- Net Value = Perceived Benefits to Customer (Gross Value) minus All Perceived Outlays (Money, Time, Mental/Physical Effort).
- Monetary price is not only the perceived outlay in purchasing, using a service.
- When looking at competing services, customers are mainly comparing relative net values.
Value-Based Pricing: Managing Perception of Value

- Need effective communication and personal explanations to explain value

- Reduce related-monetary costs
  - Cut time spent searching for, purchasing and using service

- Reduce non-monetary costs
  - Time Costs
  - Physical Costs
  - Psychological (Mental) Costs
  - Sensory Costs (unpleasant sights, sounds, feel, tastes, smells)
Defining Total User Costs (Fig. 6.11)

- Search Costs
  - Money
  - Time
  - Physical Effort
  - Psychological Burdens
  - Sensory Burden
- Purchase and Service Encounter Costs
  - Necessary Follow-up
- Post Purchase Costs
  - Problem Solving
- Purchase
  - Operating Costs
  - Incidental Expenses

* Includes all five cost categories
Value-Based Pricing: Approaches to Reducing Non-monetary and Related-monetary Costs

- Reduce time costs of service at each stage
- Minimize unwanted psychological costs of service
  - e.g. eliminate/redesign unpleasant/inconvenient procedures
- Eliminate unwanted physical costs of service
- Decrease unpleasant sensory costs of service
  - Unpleasant sights, sounds, smells, feel, tastes
- Suggest ways for customers to reduce other monetary costs
Trading Off Monetary and Non-Monetary Costs (Fig. 6.12)

<table>
<thead>
<tr>
<th>Clinic A</th>
<th>Clinic B</th>
<th>Clinic C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price $65</td>
<td>Price $125</td>
<td>Price $185</td>
</tr>
<tr>
<td>Located 1 hour away by car</td>
<td>Located 15 min away by car</td>
<td>Located next to your office</td>
</tr>
<tr>
<td>or transit</td>
<td>or transit</td>
<td>building (or college)</td>
</tr>
<tr>
<td>Next available appointment is in 3 weeks</td>
<td>Next available appointment is in 1 week</td>
<td>Next available appointment is in 1 day</td>
</tr>
<tr>
<td>Hours: Monday – Friday, 9am – 5pm</td>
<td>Hours: Monday – Friday, 8am – 10pm</td>
<td>Hours: Monday – Saturday, 8am – 10pm</td>
</tr>
<tr>
<td>Estimated wait at clinic is about 2 hours</td>
<td>Estimated wait at clinic is about 30 to 45 minutes</td>
<td>By appointment – estimated wait at clinic is about 0 to 15 minutes</td>
</tr>
</tbody>
</table>

Which clinic would you patronize if you needed a chest x-ray (assuming that all three clinics offer good technical quality)?
Competition-Based Pricing: When Price Competition is Reduced

- Non-price-related costs of using competing alternatives are high
- Personal relationships matter
- Switching costs are high
- Time and location specificity reduces choice
- Managers should not only look at competitor’s prices dollar for dollar, but should examine all related financial and non-monetary costs
Revenue Management: What It Is and How It Works
Maximizing Revenue from Available Capacity at a Given Time (1)

- **Most effective when:**
  - Relatively high fixed capacity
  - High fixed cost structure
  - Perishable inventory
  - Variable and uncertain demand
  - Varying customer price sensitivity

- **Revenue management is price customization**
  - Charge different value segments different prices for same product based on price sensitivity
Revenue management 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 (Fig. 6.16)

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

**PRICE PER UNIT OF SERVICE**

**QUANTITY OF UNITS DEMANDED**

\(D_o\) : 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 (1)

(Table 6.2)

<table>
<thead>
<tr>
<th>RATE FENCES</th>
<th>EXAMPLES</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Physical (product-related) Fences</strong></td>
<td>• Class of travel (business/economy class)</td>
</tr>
<tr>
<td></td>
<td>• Size of rental car</td>
</tr>
<tr>
<td></td>
<td>• Size and furnishing of a hotel room</td>
</tr>
<tr>
<td></td>
<td>• Seat location in a theater or stadium</td>
</tr>
<tr>
<td>• Amenities</td>
<td>• Free breakfast at a hotel, airport pick up, etc.</td>
</tr>
<tr>
<td></td>
<td>• Free golf cart at a golf course</td>
</tr>
<tr>
<td></td>
<td>• Valet parking</td>
</tr>
<tr>
<td>• Service level</td>
<td>• Priority wait-listing, separate check-in counters with no or only short queues</td>
</tr>
<tr>
<td></td>
<td>• Improved food and beverage selection</td>
</tr>
<tr>
<td></td>
<td>• Dedicated service hotlines</td>
</tr>
<tr>
<td></td>
<td>• Personal butler</td>
</tr>
</tbody>
</table>
### Key Categories of Rate Fences: Non-physical (1)
(Table 6.2)

<table>
<thead>
<tr>
<th>RATE FENCES</th>
<th>EXAMPLES</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Non-Physical Fences</strong></td>
<td></td>
</tr>
<tr>
<td><em>Transaction Characteristics</em></td>
<td></td>
</tr>
<tr>
<td>• Time of booking or reservation</td>
<td><em>Discounts for advance purchase</em></td>
</tr>
</tbody>
</table>
|  • Location of booking or reservation    | *Passengers booking air-tickets for an identical route in different countries are charged different prices.*  
  *Customers making reservations online are charged a lower price than those making reservations by phone* |
|  • Flexibility of ticket usage           | *Fees/penalties for cancelling or changing a reservation (up to loss of entire ticket price)*  
  *Non-refundable reservations fees*      |
# Key Categories of Rate Fences: Non-physical (2) (Table 6.2)

<table>
<thead>
<tr>
<th>RATE FENCES</th>
<th>EXAMPLES</th>
</tr>
</thead>
<tbody>
<tr>
<td><em>Consumption Characteristics</em></td>
<td></td>
</tr>
<tr>
<td>• Time or duration of use</td>
<td>• Early bird special in a restaurant before 6:00pm</td>
</tr>
<tr>
<td></td>
<td>• Must stay over a Saturday night for an hotel booking.</td>
</tr>
<tr>
<td></td>
<td>• Must stay at least for five nights</td>
</tr>
<tr>
<td>• Location of consumption</td>
<td>• Price depends on departure location, especially in international travel.</td>
</tr>
<tr>
<td></td>
<td>• Prices vary by location (between cities, city center versus edges of the city)</td>
</tr>
</tbody>
</table>
### Key Categories of Rate Fences: Non-physical (3)

(Table 6.2)

<table>
<thead>
<tr>
<th>RATE FENCES</th>
<th>EXAMPLES</th>
</tr>
</thead>
<tbody>
<tr>
<td><em>Buyer Characteristics</em></td>
<td></td>
</tr>
<tr>
<td>• Frequency or volume of consumption</td>
<td>• Member of certain loyalty-tier with the firm (e.g. Platinum member) get priority pricing, discounts or loyalty benefits</td>
</tr>
<tr>
<td>• Group membership</td>
<td>• Child, student, senior citizen discounts</td>
</tr>
<tr>
<td></td>
<td>• Affiliation with certain groups (e.g. Alumni)</td>
</tr>
<tr>
<td></td>
<td>• Corporate rates</td>
</tr>
<tr>
<td>• Size of customer group</td>
<td>• Group discounts based on size of group</td>
</tr>
<tr>
<td>• Geographic location</td>
<td>• Local customers are charged lower rates than tourists</td>
</tr>
<tr>
<td></td>
<td>• Customers from certain countries are charged higher prices</td>
</tr>
</tbody>
</table>
Relating Price Buckets and Fences to Demand Curve (Fig. 6.18)

* Dark areas denote amount of consumer surplus (goal of segmented pricing is to reduce this)
Ethical Concerns in Service Pricing
Ethical Concerns in Pricing

- Customers are vulnerable when service is hard to evaluate as they assume that higher price indicates better quality

- Many services have complex pricing schedules
  - Hard to understand
  - Difficult to calculate full costs in advance of service

- Quoted prices not the only prices
  - Hidden charges
  - Many kinds of fees

- Too many rules and regulations
  - Customers feel constrained, exploited
  - Customers face unfair fines and penalties
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 (rather than quoting lower prices and using fence as basis to impose surcharges)
- 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 (Table 5.3)

- How much to charge?
- What basis for pricing?
- Who should collect payment?
- Where should payment be made?
- When should payment be made?
- How should payment be made?
- How to communicate prices?
How much to charge?

- Pricing tripod model is a useful to use for costs, price sensitivity of customers and competitors
- Depends on whether discounts are offered
- Any psychological pricing points used?
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)
- Distance-based (e.g., transportation)
Who should collect payment?
- Service provider or specialist intermediaries
- Direct or non-direct channels

Where should payment be made?
- Conveniently-located intermediaries
- Mail/bank transfer
- Credit card payment through internet, phone, fax
When should payment be made?

- In advance
- Once service delivery has been completed

How should payment be made?

- Cash
- Check
- Charge Card (Debit / Credit)
- Tokens or vouchers
- Stored value card
How to communicate prices?

- Relate the price to that of competing products
- Use salespeople and customer service representatives
- Good signage at retail points
- Ensure price is accurate and intelligible
Pricing objectives can include

- Generating revenues and profit
- Building demand
- Developing user base

Three main foundations to pricing a service

- Cost-based pricing
- Value-based pricing
- Competition-based pricing

Cost-based pricing seeks to recover costs plus a margin for profit; includes both traditional and activity-based costing

Value-based pricing should reflect net benefits to customer after deducting all costs

Firm must be aware of competitive pricing but may be harder to compare for services than for goods
Revenue management

- Maximizes revenue from a given capacity at a point in time
- Helps manage demand and set prices for each segment closer to perceived value
- Involves use of rate fences to deter segments willing to pay more from trading down to lower prices

Ethical issues in pricing

- Customers are vulnerable when service is hard to evaluate
- Many services have deliberately complex pricing schedules
- Fees and hidden charges catch customers by surprise
- Too many rules and regulations
Questions to ask when putting service pricing into practice

- How much to charge?
- What should the specified basis for pricing be?
- Who should collect payment?
- Where should payment be made?
- When should payment be made?
- How should payment be made?
- How should prices be communicated to the right target market?