Chapter 5: Exploring Business Models: Pricing and Revenue Management
Overview of Chapter 5

- 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 Is a Business Model?

- Use of effective pricing mechanism to:
  - Transform sales into revenues
  - Recover costs
  - Create value for owners of business

- Must clarify business logic that explains how firm can deliver value to customers at an appropriate cost

- Not all business models require end user of specific service to pay full cost—consider third-party payers:
  - Advertisers
  - Health insurers
  - Donors to nonprofit organizations
  - Tax subsidies for public services
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?
- Customers find many services hard to evaluate—what are they getting in return for their money?
- Importance of time factor—same service may have more value to customers when delivered faster
- Delivery through physical or electronic channels—may create differences in perceived value
Alternative Objectives for Pricing (Table 5.1)

- **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 5.1

Pricing strategy

Costs

Competition

Value to customer
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

- **Competition-based pricing**
  - Monitor competitors’ pricing strategy (especially if service lacks differentiation)
  - Who is the price leader? Does one firm set the pace?

- **Value-based pricing**
  - Relate price to value perceived by customer
Cost-based Pricing: Traditional vs. Activity-based Costing

- **Traditional costing approach**
  - Emphasizes expense categories (arbitrary overhead 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 5.2)

- Value exchange will not take place unless customer sees positive net value in transaction
- Net value = Perceived benefits to customer (gross value) minus all Perceived outlays (Money, Time, Mental/Physical effort)
- Monetary price is not only perceived outlay in purchasing, using a service
- Consumer surplus: difference between price paid and amount customer would have been willing to pay in absence of other options
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 outlays—costs incurred by customers**
  - Reduce price and/or other monetary costs of acquisition and usage
  - Cut amount of time required to evaluate, buy, use service
  - Lower physical and mental effort associated with purchase and use
  - Reduce perceptions of amount of cost, time, effort required
Value-based Pricing: Enhancing Perceptions of Gross Value

- **Reduce uncertainty**
  - Service guarantees
  - Benefit-driven—pricing aspect(s) of service that create value
  - Flat rate (quoting a fixed price in advance)

- **Relationship pricing**
  - Nonprice incentives
  - Discounts for volume purchases
  - Discounts for purchasing multiple services

- **Low-cost leadership**
  - Convince customers not to equate price with quality
  - Keep economic costs low to ensure profitability at low price
Paying for Service: The Customer’s Perspective

- Customer “expenditures” on service comprise both financial and nonfinancial outlays

- Incremental financial outlays
  - Price of purchasing service
  - Expenses associated with search, purchase activity, usage

- Nonmonetary costs
  - Time costs
  - Physical costs
  - Psychological (mental) costs
  - Sensory costs (unpleasant sights, sounds, feel, tastes, smells)
Determining Total Costs of a Service to Customer (Fig 5.4)

- **Search costs***
  - **Purchase and service encounter costs**
    - **After costs***
      - **Purchase**
      - **Operating costs**
        - **Incidental expenses**

- **Money**
- **Time**
- **Physical effort**
- **Psychological burdens**
- **Sensory burdens**
- **Necessary follow-up**
- **Problem solving**

* Includes all five cost categories
Trading Off Monetary and Nonmonetary Costs  (Fig 5.5)

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

<table>
<thead>
<tr>
<th>Clinic A</th>
<th>Clinic B</th>
<th>Clinic C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price $45</td>
<td>Price $85</td>
<td>Price $125</td>
</tr>
<tr>
<td>Located 1 hour away by car or transit</td>
<td>Located 15 mins away by car or transit</td>
<td>Located next to your office 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 appointment is in 1 day</td>
</tr>
<tr>
<td>Hours: Mon-Fri, 9AM-5PM</td>
<td>Hours: Mon-Fri, 8AM-10PM</td>
<td>Hours: Mon-Fri, 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 mins</td>
<td>By appointment—estimated wait at clinic is 0 to 15 mins</td>
</tr>
</tbody>
</table>
Increasing Net Value by Reducing Nonmonetary Costs of Service

- Reduce time costs of service at each stage
- Minimize unwanted psychological costs of service
  - Eliminate/redesign unpleasant/inconvenient procedures
- Eliminate unwanted physical costs of service
- Decrease unpleasant sensory costs of service
  - Unpleasant sights, sounds, smells, feel, tastes
Revenue Management:
What It Is and How It Works
Maximizing Revenue from Available Capacity at a Given Time

- **Price customization**
  - Charge different value segments different prices for same product

- **Useful in dynamic markets**
  - Different price buckets based on price sensitivity to different usage times, flexibility, other factors

- **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)**
The Strategic Levels of Revenue (Yield) Management

Quadrant 1
- Movies
- Stadiums/arenas
- Function space

Quadrant 2
- Hotel rooms
- Airline seats
- Rental cars
- Cruise lines

Quadrant 3
- Restaurants
- Golf courses

Quadrant 4
- Continuing care
- Hospitals

Source: Fig 1 from Kimes and Chase reading (p. 212)
Dealing with Customer Conflicts Arising from Revenue Management

<table>
<thead>
<tr>
<th>Customer conflict can arise from:</th>
<th>Marketing tools to reduce customer conflicts:</th>
</tr>
</thead>
</table>
| - Perceived unfairness and perceived financial risk associated with multitier pricing and selective inventory availability | - Fenced pricing  
- Bundling  
- Categorizing  
- High published price |
| - Unfulfilled inventory commitment                                                               | - Well-designed customer recovery program for overbooking                                                    |
| - Unfulfilled demand of regular customers                                                        | - Preferred availability policies                                                                                |
| - Unfulfilled price expectation of group customers                                                 | - Offer lower displacement cost alternatives                                                                     |
| - Change in nature of service                                                                     | - Physical segregation and perceptible extra service  
- Set optimal capacity utilization level                                                              |

Price Elasticity  (Fig 5.6)

Price per unit of service

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

Price elasticity =

\[
\frac{\text{Percentage change in demand}}{\text{Percentage change in price}}
\]
### Key Categories of Rate Fences (1)

Table 5.2

<table>
<thead>
<tr>
<th>Rate Fences</th>
<th>Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>Physical (product-related) Fences</td>
<td>▪ Class of travel (business/economy class)</td>
</tr>
<tr>
<td></td>
<td>▪ Size and furnishing of a hotel room</td>
</tr>
<tr>
<td></td>
<td>▪ Seat location in a theater</td>
</tr>
<tr>
<td>Basic product</td>
<td>▪ Free breakfast at a hotel, airport pickup, etc.</td>
</tr>
<tr>
<td></td>
<td>▪ Free golf cart at a golf course</td>
</tr>
<tr>
<td>Amenities</td>
<td>▪ Priority wait-listing</td>
</tr>
<tr>
<td></td>
<td>▪ Increase in baggage allowances</td>
</tr>
<tr>
<td>Service level</td>
<td>▪ Dedicated service hotlines</td>
</tr>
<tr>
<td></td>
<td>▪ Dedicated account management team</td>
</tr>
</tbody>
</table>
## Key Categories of Rate Fences (2)

### Table 5.2

<table>
<thead>
<tr>
<th>Nonphysical Fences</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Transaction Characteristics</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Time of booking or reservation</strong></td>
<td>Requirements for advance purchase</td>
</tr>
<tr>
<td></td>
<td>Must pay full fare two weeks before departure</td>
</tr>
<tr>
<td><strong>Location of booking or reservation</strong></td>
<td>Passengers booking air tickets for an identical route in different countries are charged different prices</td>
</tr>
<tr>
<td><strong>Flexibility of ticket usage</strong></td>
<td>Fees/penalties for canceling or changing a reservation (up to loss of entire ticket price)</td>
</tr>
<tr>
<td></td>
<td>Nonrefundable reservation fees</td>
</tr>
</tbody>
</table>
### Nonphysical Fences (cont’d)

#### Consumption Characteristics

<table>
<thead>
<tr>
<th>Time or duration of use</th>
<th>Early-bird special in restaurant before 6PM</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Must stay over on Saturday for airline, hotel</td>
</tr>
<tr>
<td></td>
<td>Must stay at least 5 days</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Location of consumption</th>
<th>Price depends on departure location, especially in international travel</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Prices vary by location (between cities, city center versus edges of city)</td>
</tr>
</tbody>
</table>
### Nonphysical Fences (cont’d)

<table>
<thead>
<tr>
<th>Buyer Characteristics</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Frequency or volume of consumption</strong></td>
<td>▪ Member of certain loyalty tier with the firm get priority pricing, discounts, or loyalty benefits</td>
</tr>
<tr>
<td><strong>Group membership</strong></td>
<td>▪ Child, student, senior citizen discounts</td>
</tr>
<tr>
<td></td>
<td>▪ Affiliation with certain groups (e.g., alumni)</td>
</tr>
<tr>
<td><strong>Size of customer group</strong></td>
<td>▪ Group discounts based on size of group</td>
</tr>
</tbody>
</table>
Relating Price Buckets and Fences to Demand Curve (Fig 5.7)

Price per seat

1st class

Full fare economy (no restrictions)

1 - week advance purchase

1 - week advance purchase, Saturday night stay

3 - week advance purchase, Saturday night stay

3-week advance purchase, Saturday night stay, $100 for changes

Specified flights, book on Internet, no changes/refunds

Late sales through consolidators/Internet, no refunds

Capacity of 1st class cabin

No. of seats demanded

Capacity of aircraft

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

- Customers are vulnerable when service is hard to evaluate or they don’t observe performance of work
- 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 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 (1)

- How much to charge?
  - The pricing tripod model provides a useful departure point
  - A specific figure must be set for the price
  - Need to consider the pros and cons, the ethical issues

- What basis for pricing? (How define unit of service?)
  - 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)
Putting Service Pricing into Practice (2)

- **Who should collect payment?**
  - Service provider or specialist intermediaries
  - Direct or nondirect channels

- **Where should payment be made?**
  - Conveniently located intermediaries
  - Mail/bank transfer

- **When should payment be made?**
  - In advance
  - Once service delivery has been completed
Putting Service Pricing into Practice (3)

- **How should payment be made?**
  - Cash
  - Token
  - Stored value card
  - Electronic fund transfer
  - Charge card (debit/credit)
  - Vouchers
  - Third-party payment

- **How to communicate prices?**
  - Relate the price to that of competing products
  - Ensure price is accurate and intelligible
Chase’s Blink Service  (Fig 5.10)

- Chase advertises its fast new credit card scanning service, “Blink”
- “Blink” can be read by a point-of-sale terminal without being physically touched
- Simplifies and speeds payment transaction, saves customer time and effort

Courtesy of JP Morgan Chase & Company
Frequency of Health Club Use Relates to Timing of Payments (RI 6.1)

Frequency of health club visits

Annual payment plan

Semiannual payment plan

Quarterly payment plan

Monthly payment plan

Pricing objectives can include
- Generating revenues and profit
- Building demand
- Developing user base

Three main foundations to pricing a service
- Cost-based pricing
- Competition-based pricing
- Value-based pricing

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

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

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