

## 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

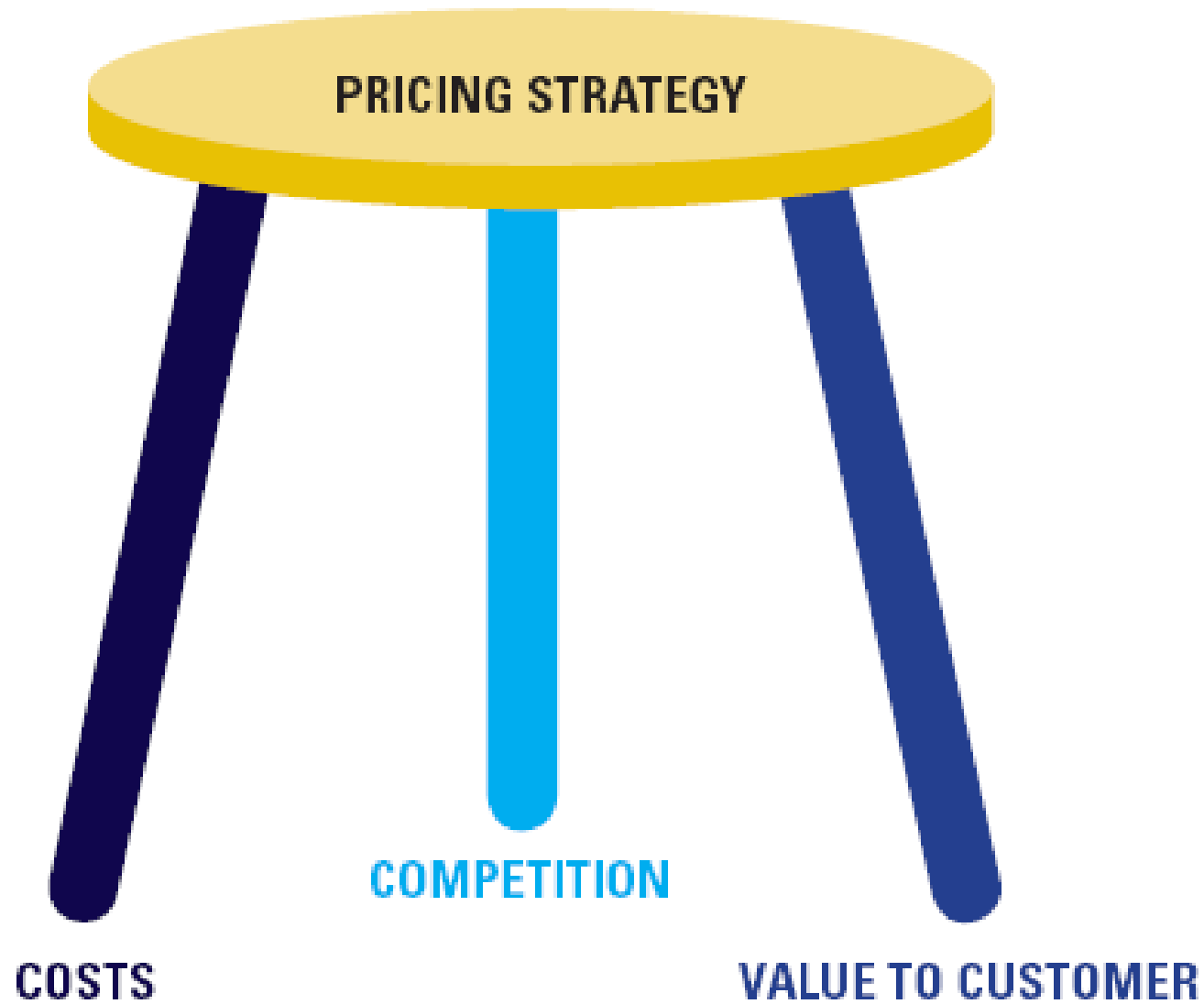
- Stimulate trial and adoption of new service
- Build market share/large user base



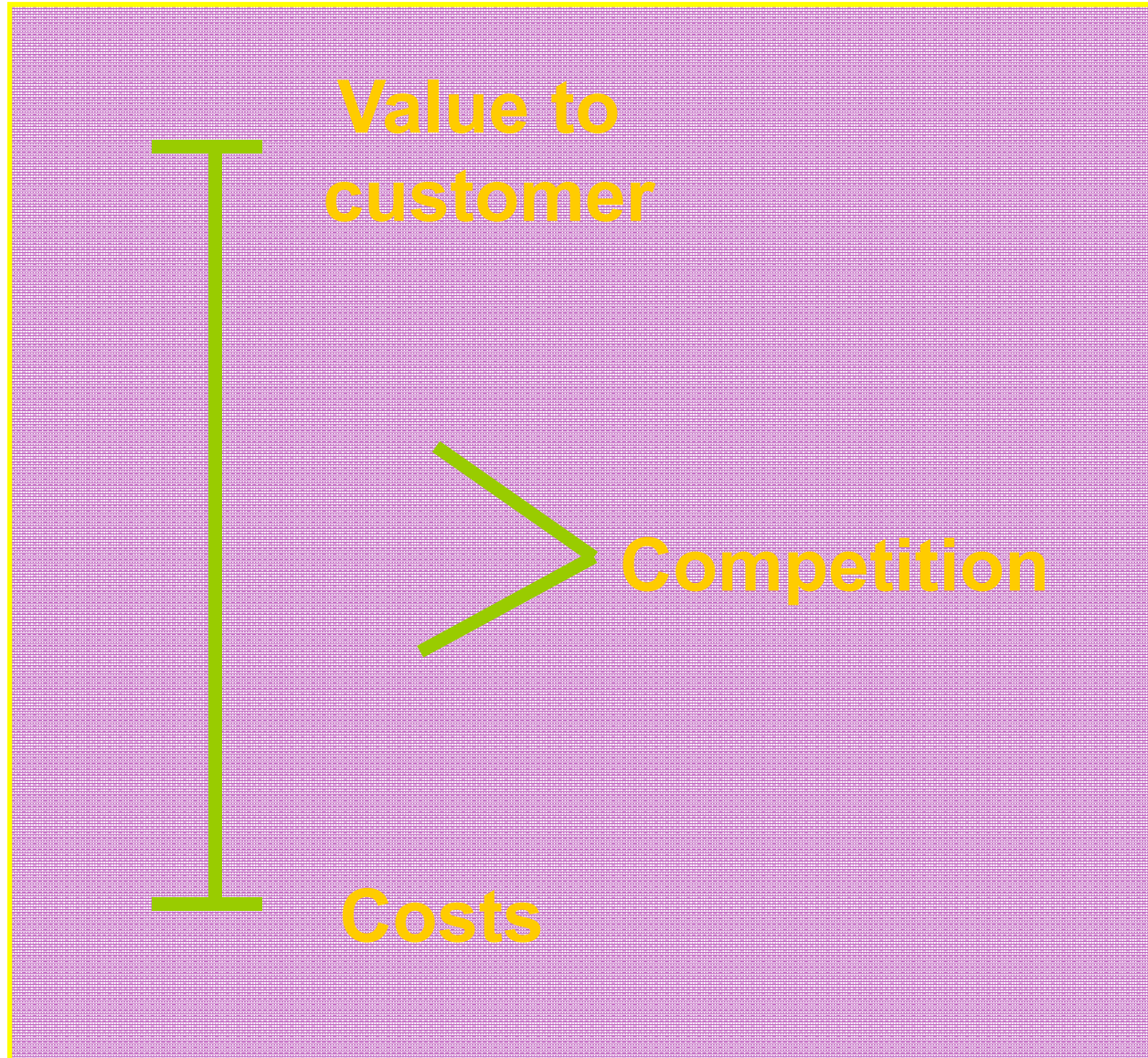


# ***Pricing Strategy Stands on Three Legs***

# The Pricing Tripod (Fig. 6.3)



# The Pricing Tripod - Basis for Any Pricing Strategy





# 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



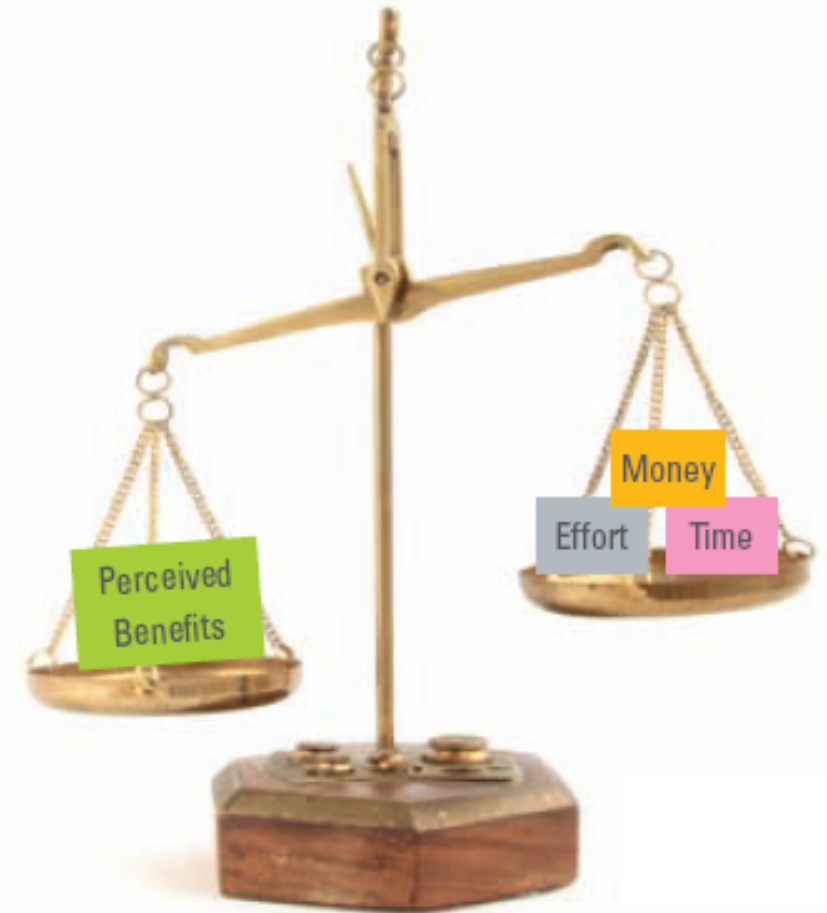
- **Traditional costing approach**
  - Emphasizes expense categories (arbitrary overheads allocation)
  - May result in reducing value generated for customers
- **ABC management systems**
  - Link resource expenses to variety and complexity of goods/services produced
  - Yields accurate cost information
- **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 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
- When looking at competing services, customers are mainly comparing relative net values

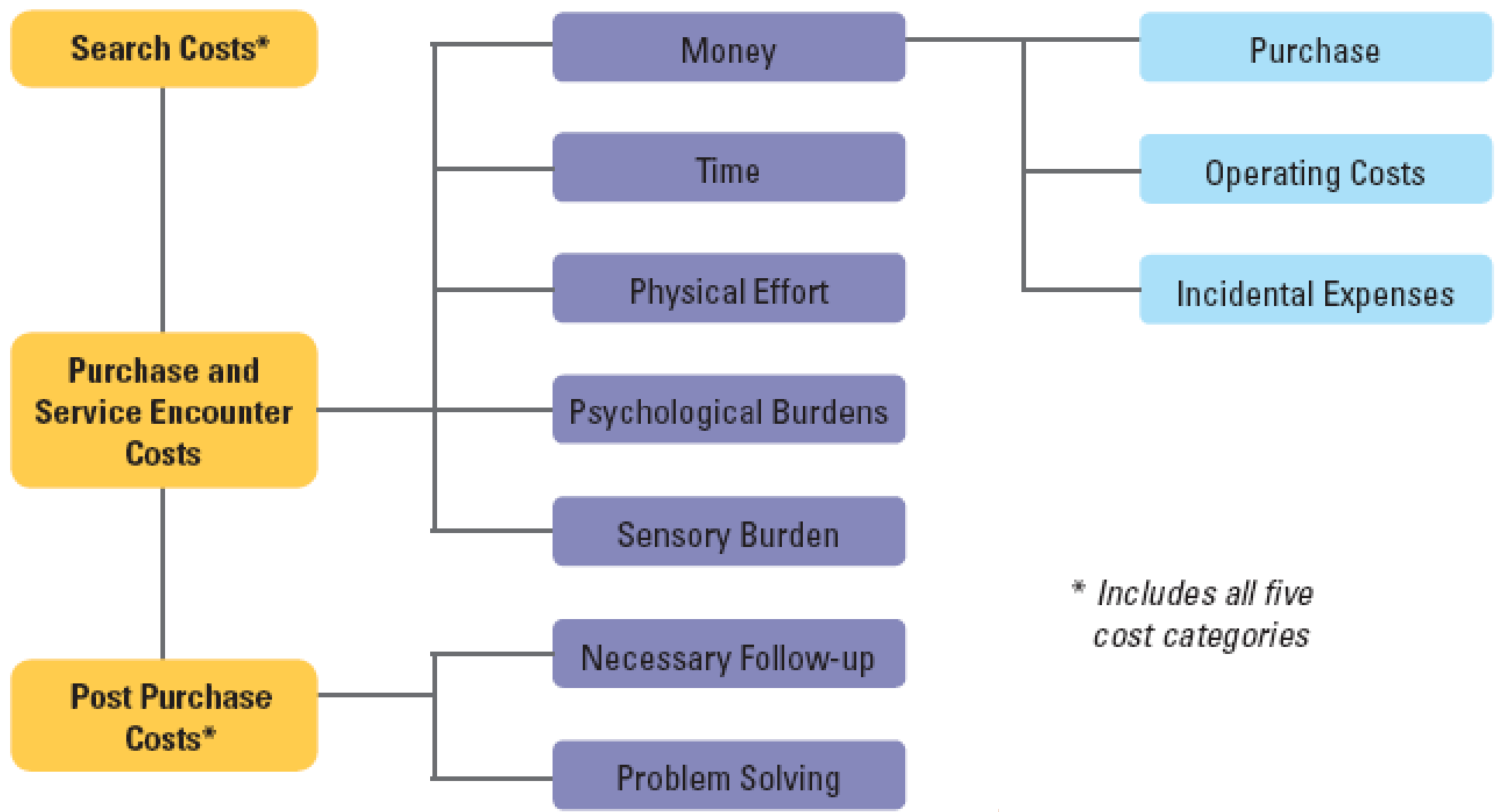


# Value-Based Pricing: Managing Perception of Value



- **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)



# 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)



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

# 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

# Maximizing Revenue from Available Capacity at a Given Time (2)

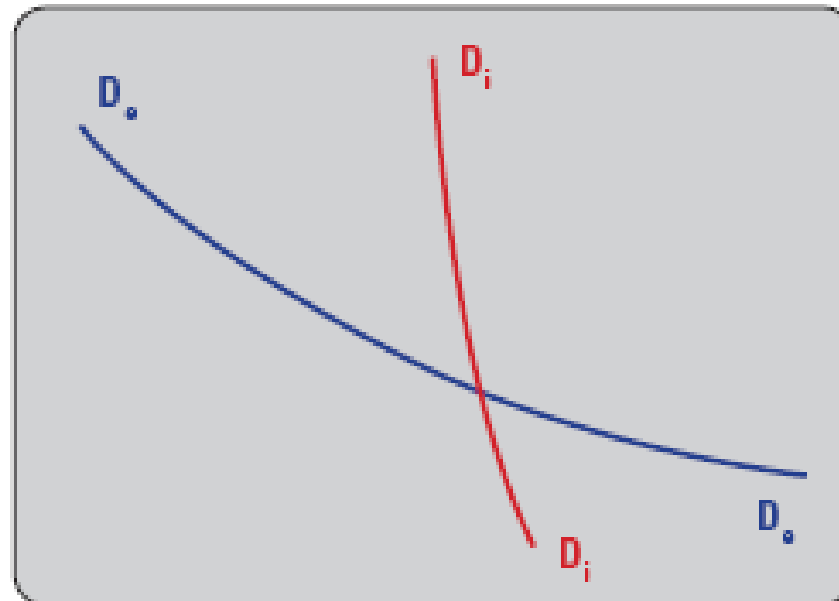


- Revenue management uses mathematical models to examine historical data and real time information to determine
  - What prices to charge within each price bucket
  - How many service units to allocate to each bucket
- Rate fences deter customers willing to pay more from trading down to lower prices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



# Price Elasticity (Fig. 6.16)

PRICE 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 (1)

(Table 6.2)



RATE FENCES	EXAMPLES
<b>Physical (product-related) Fences</b> <ul style="list-style-type: none"><li>• Basic product</li></ul>	<ul style="list-style-type: none"><li>• Class of travel (business/economy class)</li><li>• Size of rental car</li><li>• Size and furnishing of a hotel room</li><li>• Seat location in a theater or stadium</li></ul>
<ul style="list-style-type: none"><li>• Amenities</li></ul>	<ul style="list-style-type: none"><li>• Free breakfast at a hotel, airport pick up, etc.</li><li>• Free golf cart at a golf course</li><li>• Valet parking</li></ul>
<ul style="list-style-type: none"><li>• Service level</li></ul>	<ul style="list-style-type: none"><li>• Priority wait-listing, separate check-in counters with no or only short queues</li><li>• Improved food and beverage selection</li><li>• Dedicated service hotlines</li><li>• Personal butler</li></ul>

# Key Categories of Rate Fences: Non-physical (1)

(Table 6.2)



RATE FENCES	EXAMPLES
<b>Non-Physical Fences</b> <i>Transaction Characteristics</i>	
<ul style="list-style-type: none"><li>• Time of booking or reservation</li></ul>	<ul style="list-style-type: none"><li>• Discounts for advance purchase</li></ul>
<ul style="list-style-type: none"><li>• Location of booking or reservation</li></ul>	<ul style="list-style-type: none"><li>• Passengers booking air-tickets for an identical route in different countries are charged different prices.</li><li>• Customers making reservations online are charged a lower price than those making reservations by phone</li></ul>
<ul style="list-style-type: none"><li>• Flexibility of ticket usage</li></ul>	<ul style="list-style-type: none"><li>• Fees/penalties for cancelling or changing a reservation (up to loss of entire ticket price)</li><li>• Non-refundable reservations fees</li></ul>

# Key Categories of Rate Fences: Non-physical (2)

(Table 6.2)



RATE FENCES	EXAMPLES
<i>Consumption Characteristics</i>	
<ul style="list-style-type: none"><li>• Time or duration of use</li></ul>	<ul style="list-style-type: none"><li>• Early bird special in a restaurant before 6:00pm</li><li>• Must stay over a Saturday night for an hotel booking.</li><li>• Must stay at least for five nights</li></ul>
<ul style="list-style-type: none"><li>• Location of consumption</li></ul>	<ul style="list-style-type: none"><li>• Price depends on departure location, especially in international travel.</li><li>• Prices vary by location (between cities, city center versus edges of the city)</li></ul>

# Key Categories of Rate Fences: Non-physical (3)

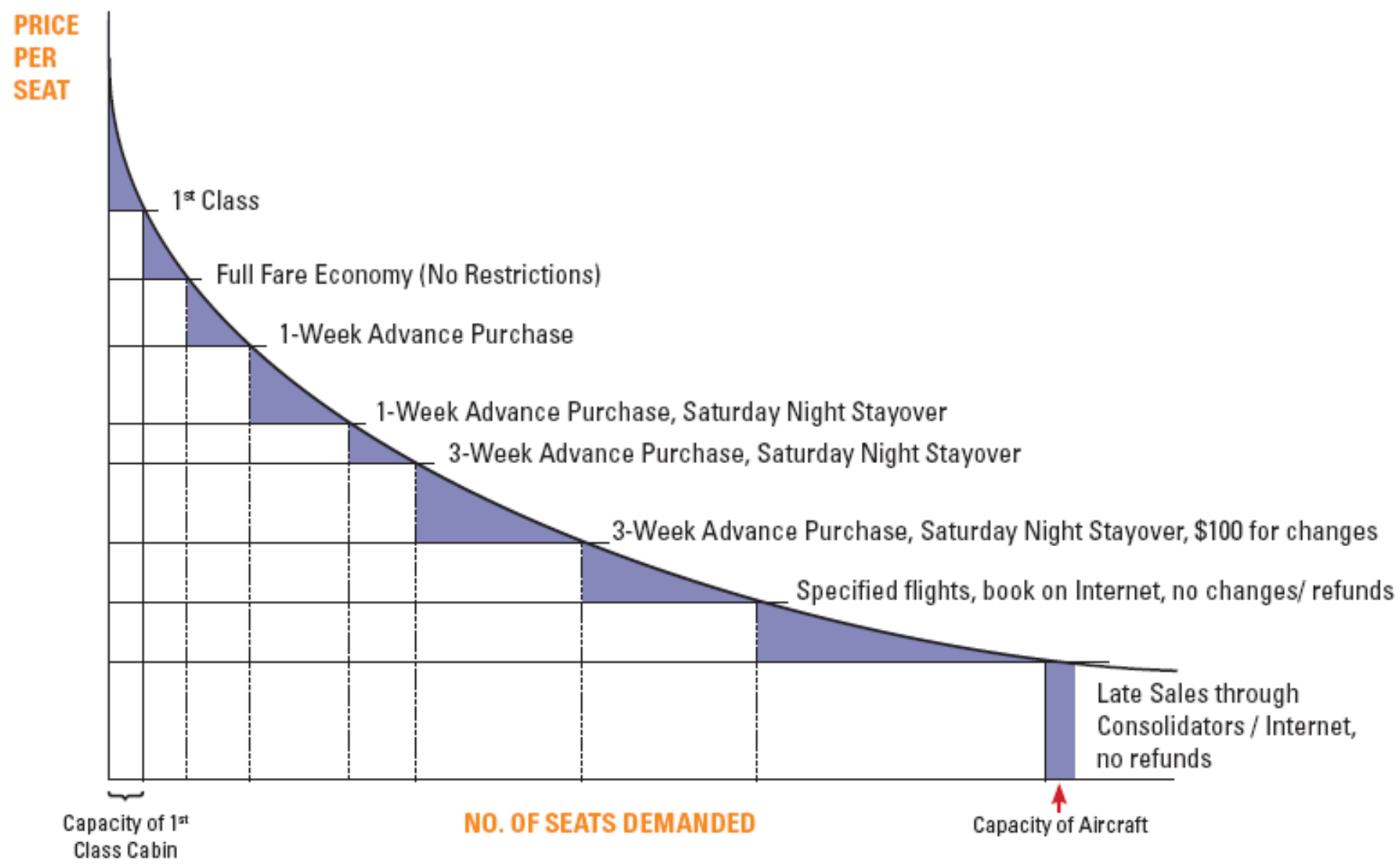
(Table 6.2)



RATE FENCES	EXAMPLES
<i>Buyer Characteristics</i>	
<ul style="list-style-type: none"><li>• Frequency or volume of consumption</li></ul>	<ul style="list-style-type: none"><li>• Member of certain loyalty-tier with the firm (e.g. Platinum member) get priority pricing, discounts or loyalty benefits</li></ul>
<ul style="list-style-type: none"><li>• Group membership</li></ul>	<ul style="list-style-type: none"><li>• Child, student, senior citizen discounts</li><li>• Affiliation with certain groups (e.g. Alumni)</li><li>• Corporate rates</li></ul>
<ul style="list-style-type: none"><li>• Size of customer group</li></ul>	<ul style="list-style-type: none"><li>• Group discounts based on size of group</li></ul>
<ul style="list-style-type: none"><li>• Geographic location</li></ul>	<ul style="list-style-type: none"><li>• Local customers are charged lower rates than tourists</li><li>• Customers from certain countries are charged higher prices</li></ul>



# 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

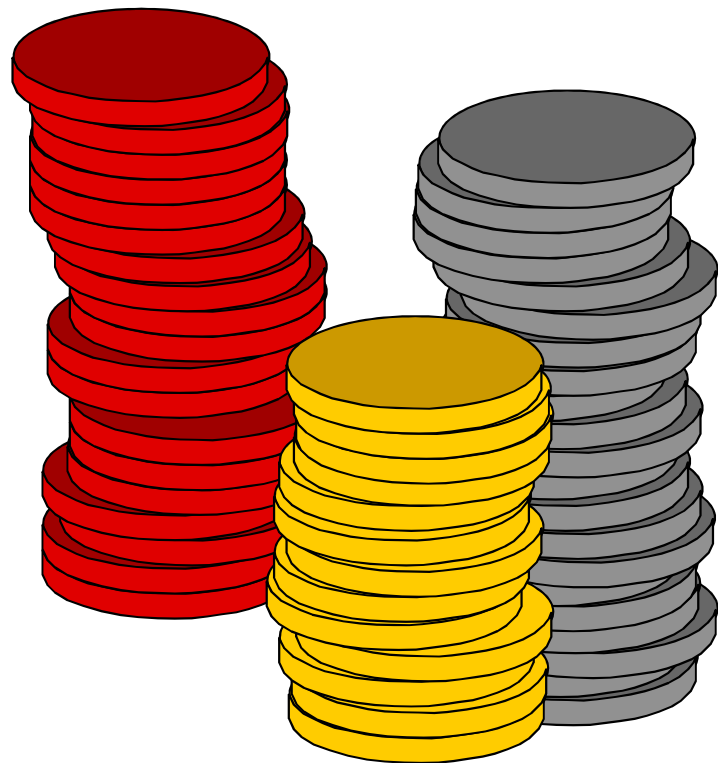


- **Design clear, logical and fair price schedules and fences**
- **Use high published prices and present fences as opportunities for discounts (rather than quoting lower prices and using fence as basis to impose surcharges)**
- **Communicate consumer benefits of revenue management**
- **Use bundling 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?

# Putting Service Pricing into Practice (1)



## ● 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?



# Putting Service Pricing into Practice (2)



## ● 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)





# Putting Service Pricing into Practice (3)



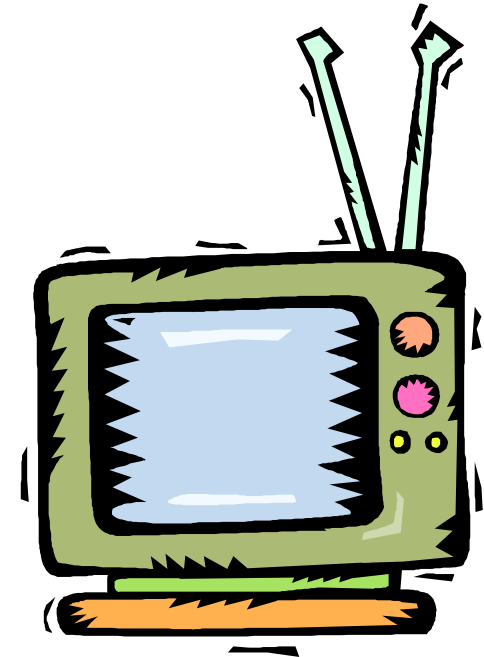
- **Who should collect payment?**
  - Service provider or specialist intermediaries
  - Direct or non-direct channels
- **Where should payment be made?**
  - Conveniently-located intermediaries
  - Mail/bank transfer
  - Credit card payment through internet, phone, fax



# Putting Service Pricing into Practice (4)



- **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



# Putting Service Pricing into Practice (5)



## ● 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



# Summary of Chapter 6: Pricing and Revenue Management (1)



- **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**

# Summary of Chapter 6: Pricing and Revenue Management (2)



- **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

# Summary of Chapter 6: Pricing and Revenue Management (3)



- **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?