Getting a sharper edge

A framework for pricing decisions

STRATEGY BULLETIN

July 2001

Every manager knows that pricing is critical. Any percentage increase in revenues will normally have a much bigger impact on the bottom line than the same percentage reduction in costs. Yet even in the best-run businesses, it is surprising how often prices turn out to have been set by habit, instinct, or back-of-the-envelope estimates of competitive pressure rather than on the basis of rigorous analysis. Frontier has been engaged by several clients to set frameworks for pricing decisions, work that crucially begins with empirical analysis of the customer base.

Pricing helps define a company's competitive position, sending signals to competitors and customers. For most companies, however, within any given competitive position there are opportunities to improve performance through better price-setting. This is known as "price sharpening". Success depends on understanding customers and how they value products.

Simple pricing is blunt

Plainly, the simplest approach is to set prices in the same way for all products and all customers. A retailer, for example, might decide to spread fixed costs equally across all product lines, and then add the marginal cost of each product. But it is almost always more profitable to vary pricing across the range of transactions. The figure shows why. It illustrates the demand for a particular product. The demand line is built up from the different prices that potential customers are prepared to pay, known as their "WTP" (willingness to pay).

If (as in the first of the three charts), the supplier sets a single price, it will obviously succeed in selling to all customers with WTPs above that figure, but not to any with lower WTPs. If the supplier could differentiate between all customers, and set a price to all of them that exactly matched their WTPs, it would both sell to more people and bring in more revenue. Provided even the lowest price covered the cost of supplying that customer, this would clearly be a more profitable approach. The third chart illustrates a half-way house: a supplier that manages to distinguish between two groups according to their WTPs, and charge two different prices.

There are a number of ways in which firms can sharpen their prices, including:

- setting different prices on different products to the same customer;
- setting prices on bundles of products that differ from the prices on these products when sold separately;
- setting different prices on products according to the time of the day, week or month at which they are sold; and
- setting different prices on the same product to different customers.

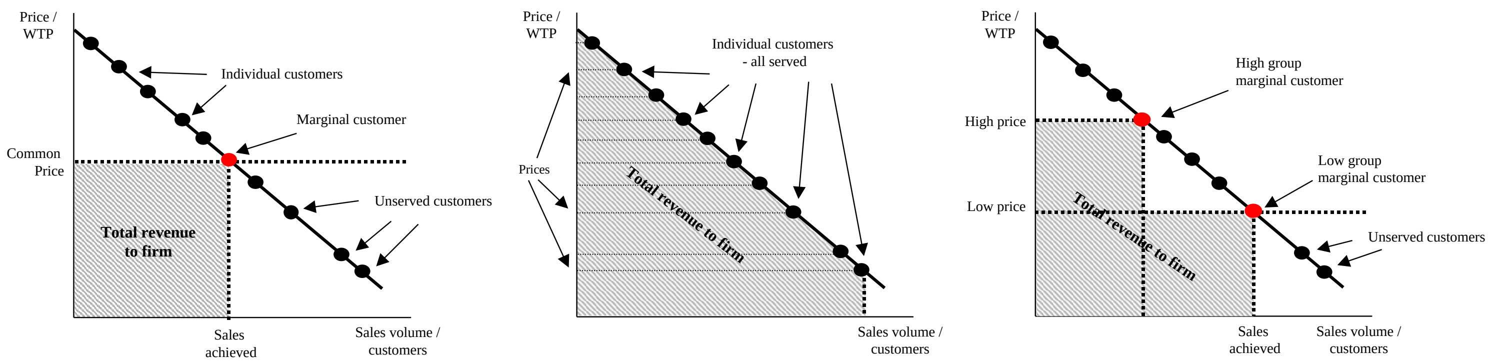
Companies' ability to engage in the more sophisticated business of price sharpening depends on the ability to analyse different customers' WTPs, and charge them accordingly.

Finding the razor's edge

Perfect price sharpening – where each transaction is priced on the basis of the customer's WTP – is rarely possible. Even firms that know a lot about their customers do not know the WTP of each of them. Moreover, even if the WTPs of all customers are known, it can be difficult to prevent "demand leakage" as customers pick off better prices or even arbitrage across groups (e.g. getting their grandma to buy items on a senior citizen discount).

However, perfect price sharpening does represent a good benchmark against which to measure other strategies. And there are two types of pricing strategy which can come close to the razor's edge: "group pricing" and "menu pricing".

Sharp or blunt?



With group pricing, firms identify particular groups of transactions that have different WTPs (and thus elasticities of demand) attached. The firms then charge higher gross margins for the groups of transactions with lower price elasticity. For example, they may charge:

- by location – many companies price regionally, within countries or across countries (petrol tends to cost more on the motorway than on the high street, and soft drinks cost more at the beach);
- by identifiable customer group – museums, cinemas and rail companies often charge lower prices to students and OAPs, utilities charge different prices to residential and business customers and hairdressers often charge more to women than to men;
- by time - airline and rail companies charge different amounts for travel at different times of the day, telephony suppliers have peak and off-peak tariffs and package holiday companies vary their prices by season and within season.

Many of these strategies have been in place for years. However, the combination of e-commerce, database management and new analytical techniques have made it possible for more businesses to vary their prices effectively by undertaking good customer segmentation.

Menu pricing, on the other hand, relies less on information about customer groups. Firms simply offer a menu of tariffs, so that customers can choose their preferred option. The idea is that a well-designed tariff structure will encourage customers with high WTPs to take high-price packages and those with low WTPs to take low-price packages.

For example, mobile phone companies offer a large number of different tariffs with combinations of fixed line rentals and variable call charges (including free minutes). Customers with high usage choose packages with high fixed, low variable charges; customers with low usage choose "Pay as you Go" packages. By exercising this choice, customers segment themselves into groups, which will have different elasticities. By careful choice of tariffs, therefore, it is possible to attract more customers and more revenue.

Another form of menu pricing is "versioning", whereby firms change the product slightly in order to segment the customer base. For example:

- publishers put out hardback and softback versions of books;
- film companies put out films on cinema release, then video, pay-TV, and free-to-air TV; and
- software companies often release different versions of programs for different types of users (e.g. a "home" version and a "professional" version).

In each case, customers are encouraged to choose their preferred option and the firm aims to achieve segmentation that will maximise sales revenues with minimum cost implications.

Choose your weapon

The choice of pricing policy depends on a number of different factors.

- **Customer differences**. If the customer base is relatively homogeneous, it is likely that WTPs do not vary greatly, making price sharpening harder work and less profitable. If WTPs do vary, these need to be clearly related to identifiable factors, such as the type or location of the household to which the customer belongs.
- **Time-critical products.** Congestion charging is one way of differentiating between customers according to their willingness to pay. Delivery charges may be another. It may prove harder to sharpen prices for products that are neither perishable nor time-sensitive.
- **Information flow**. Try to sharpen prices without knowing much about your customers, and you may end up waving your knife in the air. Building up an information base is obviously easier when products are frequently purchased and/or when customers have an incentive to inform supplier about their characteristics (starting with their addresses).
- **Leakage.** If competition is intense across all transactions, it is clearly more difficult to sharpen prices – the opportunity for high WTP customers to switch to more appealing suppliers is too great. However, the degree of competition may well vary across product lines. One way of monitoring this is to watch out for patterns of switching behaviour.
- **Visibility.** In markets where prices are highly visible, customers may simply refuse to accept such strategies, turning against suppliers who try to apply them. Tolerances are not always easy to predict: holiday travellers, for example, accept the fact that their neighbours may have paid only half the price, provided their noses are not rubbed in the difference.
- **Technology.** Sharp pricing depends on information and management systems that are capable of implementing these strategies. It is obviously easier where transactions are recorded electronically.
- **Cost structure.** Firms with high fixed costs are likely to benefit most from price sharpening, since they will gain from policies that allow them to price both above and below average cost. Where input costs are joint across a range of products, price sharpening is also likely to be attractive, particularly in the design of "bundles" of products to be sold together.

Now sharpen your pencils

Whether the objective is group pricing or menu pricing, some preliminary work is required. Try answering the following questions:

- Do WTPs for your product vary amongst your customers?
- How big are the differences, and are they correlated with anything about your customers that you can observe?
- Can different prices be charged, and would your customers accept the differences (and would the competition authorities object)?
- Do you have enough information on customers and transactions to test your answers empirically, or to engage in experimentation?

If the answer to two or more of these questions is "yes", then it is worth investigating a new pricing policy. To do this, estimates of demand elasticities are required, along with detailed thinking about likely competitor and customer responses. This investment is usually worthwhile.

Please contact Simon Gaysford for more information about Frontier's Strategy Practice (on 020 7611 9438 or simon.gaysford@frontier-economics.com).