

# Chapter

## Exploring Business Models: Pricing and Revenue Management

*What is a cynic? A man who knows the price of everything and the value of nothing.*

OSCAR WILDE

*There are two fools in any market: One does not charge enough. The other charges too much.*

RUSSIAN PROVERB

Creating a viable service requires a business model that allows the cost of creating and delivering the service, plus a margin for profits, to be recovered through realistic pricing and revenue management strategies.

Pricing of services, however, is complicated. Consider the bewildering fee schedules of many consumer banks or mobile phone service providers, or try to understand the fluctuating fare structure of a full-service airline. Service organizations even use different terms to describe the prices they set. Universities talk about tuition, professional firms collect fees, banks impose interest and service charges, brokers charge commissions, some expressways impose tolls, utilities set tariffs, and insurance companies determine premiums—and the list goes on.

A key goal of effective pricing strategy is to manage revenues in ways that support the firm's profitability objectives. Doing so requires a good understanding of costs, competitors' pricing, and the value created for customers. This sounds straightforward, but it is a real challenge for service firms, for whom unit costs may be difficult to determine and fixed costs difficult to allocate appropriately across multiple service offerings. Competitors' pricing cannot be compared dollar for dollar as services are often location- and time-specific, and customer's switching costs can

significant. Increasingly, customers complain of pricing schedules that they perceive as confusing and unfair. Finally, value to customers usually varies widely among segments and even within the same segment across time. And customers won't buy unless they perceive that the benefits they are obtaining in this value exchange exceed the financial and other costs—notably time and effort—that they incur. That's why we refer to this element of the 8 Ps as *Price and other user outlays*.

In this chapter, we review the role of pricing in services marketing and provide some guidelines on how to develop an effective pricing strategy. Specifically, we address the following questions:

1. What are the three main foundations to pricing a service?
2. Why is cost-based pricing so challenging for many service firms, and how can activity-based costing improve costing of services?
3. How do customers perceive the nonmonetary costs of obtaining service, and what might service providers do to reduce them?
4. How does revenue management improve profitability?
5. Why are some key ethical concerns today about service pricing strategies?
6. What are the seven questions marketers need to answer before designing an effective pricing schedule?

## EFFECTIVE PRICING IS CENTRAL TO FINANCIAL SUCCESS

Marketing is the only function that brings operating revenues into the organization. All other management functions incur costs. A *business model* is the mechanism whereby, through effective pricing, sales are transformed into revenues, costs are covered, and value is created for the owners of the business. As noted by Joan Magretta:

A good business model answers Peter Drucker's age-old questions: Who is the customer? And what does the customer value? It also answers the fundamental questions that every manager must ask: How do we make money in this business? What is the underlying economic logic that explains how we can deliver value to customers at an appropriate cost?<sup>1</sup>

In many service industries, pricing was traditionally driven by a financial and accounting perspective, which often used cost-plus pricing. Price schedules were often tightly constrained by government regulatory agencies—and some still are. Today, however, most service businesses enjoy significant freedom in setting prices, and have a good understanding of value-based and competitive pricing. These developments have led to creative pricing schedules and sophisticated revenue management systems.

In this chapter we focus on business models that require end users to pay a price that covers the financial costs of receiving service. However, there are many instances when all or part of the cost is covered by third parties. Thus, advertising revenues pay the cost of supplying most broadcast radio and TV services, health insurers pay much of the cost of medical care for patients who carry such insurance, donations enable museums to set admission prices lower than they would otherwise, and tax revenues allow public schools to offer free education.

Pricing is typically more complex in services than it is in manufacturing. Because there's no ownership of services, it's usually harder for managers to determine the financial costs of creating a process or performance for a customer, compared to identifying the costs associated with creating and distributing a physical good. The inability to inventory services places a premium on bringing demand and supply into balance, a task in which pricing plays a key role. The importance of the time factor in service delivery means that speed of delivery and avoidance of waiting time

often increase value. With the increase in value, customers may be prepared to pay a higher price for the service.

What does a marketing perspective bring to pricing? Effective pricing strategies seek to enhance (or even maximize) the level of revenues, often by discriminating among different market segments based on their value perceptions and ability to pay, and among different time periods based on variations in demand levels over time.

Consumers often find service pricing difficult to understand (e.g., insurance products or hospital bills), risky (when you make a hotel reservation on three different days, you may be offered three different prices), and sometimes even unethical (e.g., many bank customers complain about an array of fees and charges they perceive as unfair). Examine your own purchasing behavior: How did you feel the last time you had to decide on booking a vacation, reserving a rental car, or opening a new bank account? In this chapter, you will learn how to set an effective pricing and revenue management strategy that fulfills the promise of the value proposition so that a value exchange takes place (i.e., the consumer decides to buy your service).

## Objectives for Establishing Prices

Any pricing strategy must be based on a clear understanding of a company's pricing objectives. The most common pricing objectives are related to revenue and profits, building demand, and developing a user base (Table 5.1).

### Generating Revenues and Profits

Within certain limits, profit-seeking firms aim to maximize long-term revenue, contributions, and profits. Perhaps top management is eager to reach a particular financial target or seeks a specific percentage return on investment. Revenue targets may be broken down by division, geographic unit, type of service, and even by key customer segments. This practice requires prices to be set based on a good knowledge of costing, competition, and price elasticity of the market and value perceptions, all of which we will discuss later in this chapter.

**Table 5.1**  
Alternative Objectives  
for Pricing

Revenue and Profit Objectives
<i>Seek Profit</i>
<ul style="list-style-type: none"><li>• Make the largest possible contribution or profit.</li><li>• Achieve a specific target level, but do not seek to maximize profits.</li><li>• Maximize revenue from a fixed capacity by varying prices and target segments over time, typically using a yield or revenue management system.</li></ul>
<i>Cover Costs</i>
<ul style="list-style-type: none"><li>• Cover fully allocated costs, including institutional overhead.</li><li>• Cover costs of providing one particular service, excluding overhead.</li><li>• Cover incremental costs of selling one extra unit or to one extra customer.</li></ul>
Patronage and User Base-Related Objectives
<i>Build Demand</i>
<ul style="list-style-type: none"><li>• Maximize demand (when capacity is not a constraint), subject to achieving a certain minimum level of revenues.</li><li>• Achieve full capacity utilization, especially when high capacity utilization adds to the value created for all customers (e.g., a "full house" adds excitement to a play or a basketball game).</li></ul>
<i>Build a User Base</i>
<ul style="list-style-type: none"><li>• Stimulate trial and adoption of a service. This is especially important for new services with high infrastructure costs and for membership-type services that generate significant revenues from their continued use after adoption (e.g., mobile phone service subscriptions, or life insurance plans).</li><li>• Build market share and/or a large user base, especially if there are significant economies of scale that can lead to a competitive cost advantage (e.g., if development or fixed costs are high).</li></ul>

In capacity-constrained organizations, financial success is often a function of ensuring optimal use of productive capacity at any given time. Hotels, for instance, seek to fill their rooms, because an empty room is an unproductive asset. Similarly, professional firms want to keep their staff members occupied. Thus, when demand is low, such organizations may offer special discounts to attract additional business. Conversely, when demand exceeds capacity, these types of businesses may increase their prices, and focus on segments that are willing to pay higher amounts. We'll discuss these practices in detail in the section on revenue management.

*Building Demand*

In some instances, maximizing patronage, subject to achieving a certain minimum level of profits, may be more important than maximizing profit. Getting a full house in a theater, sports stadium, or race track usually creates excitement that enhances customers' experience. It also creates an image of success that attracts new patrons.

*Developing a User Base*

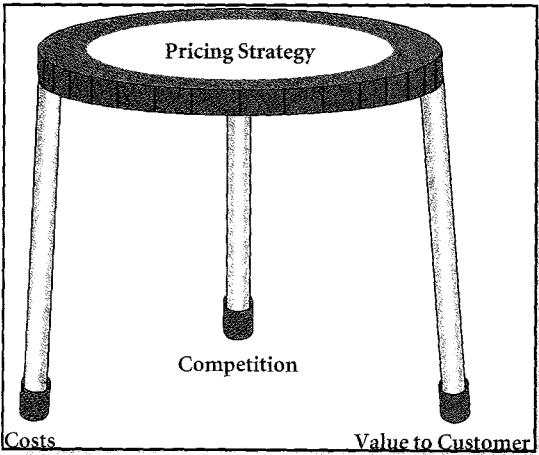
New services, in particular, often have trouble attracting customers. Yet, in order to create the impression of a successful launch, and to enhance the image of the firm, it's important that the firm is seen to be attracting a good volume of business from the right types of customers. Introductory price discounts are often used to stimulate trial and sign up customers, sometimes in combination with promotional activities such as contests and giveaways. For example, to compete with rival UPS and build sales for its network of more than 1,300 FedEx Kinko's Office and Print Center locations in the United States, FedEx promoted savings of up to 30 percent on express shipments from these stores.

In those industries that require large investments in infrastructure (e.g., mobile phone or broadband service), it's important to build a critical mass of users quickly. Market leadership often means low cost per user, so volume is necessary to generate sufficient revenue for future investments such as upgrading technology and infrastructure. As a result, penetration pricing is often used in such industries.

PRICING STRATEGY STANDS ON THREE LEGS

The foundation underlying pricing strategy can be described as a tripod, with costs to the provider, competition, and value to the customer as the three legs (Figure 5.1). The costs that a firm needs to recover usually impose a minimum price, or floor, for a specific service offering, and the customer's perceived value of the offering sets a maximum, or ceiling. The price charged by competitors for similar or substitute services typically determines where, within the floor-to-ceiling range, the price can be

Figure 5.1 The Pricing Tripod



set. The pricing objectives of the organization then determine where actual prices should be set given the feasible range provided by the pricing tripod analysis. Let's look at each leg of the pricing tripod in more detail.

### **Cost-Based Pricing**

It's usually harder to establish the costs involved in producing an intangible performance than it is to identify the labor, materials, machine time, storage, and shipping costs associated with producing a physical good. Yet without a good understanding of costs, how can managers price at levels sufficient to yield a desired profit margin? Because of the labor and infrastructure needed to create performances, many service organizations have a much higher ratio of fixed costs to variable costs than is typical in manufacturing firms.

#### ***Establishing the Costs of Providing Service***

Even if you have already taken a marketing course, you may find it helpful to review how service costs can be estimated, using fixed, semivariable, and variable costs, as well as how the notions of contribution and break-even analysis can help in pricing decisions (see Marketing Review box on page 129). These traditional cost accounting approaches work well for service firms with significant variable costs and/or semivariable costs (e.g., many professional services). For complex product lines with shared infrastructure (e.g., retail banking products), it may be worthwhile to consider the more complex activity-based costing (ABC) approach.

#### ***Activity-Based Costing***

A growing number of organizations have reduced their dependence on traditional cost accounting systems and developed activity-based cost management systems, which recognize that virtually all activities taking place within a firm directly or indirectly support the production, marketing, and delivery of goods and services. Moreover, ABC systems link resource expenses to the variety and complexity of goods and services produced—not just to the physical volume. A set of activities is combined that comprise the processes needed to create and deliver the service. Each step in a flowchart constitutes an activity with which costs can be associated. This approach makes ABC ideally suited for use in a service organization.

If it is implemented well, the ABC approach yields reasonably accurate cost information about service business activities and processes—and about the costs of creating specific types of services, performing activities in different locations (even different countries), or serving specific customers.<sup>2</sup> The net result is a management tool that can help companies pinpoint the profitability of different services, channels, market segments, and individual customers.<sup>3</sup>

It's essential to distinguish between those activities that are mandatory for operation of a particular service business and those that are discretionary. The traditional approach to cost control often results in reducing the value generated for customers, because the activity that is pruned is, in fact, mandatory to provide a certain level and quality of service. For instance, many firms have created marketing problems for themselves by firing large numbers of customer service employees, in an attempt to save money. However, this strategy often boomeranged, resulting in a rapid decline in service levels that spurred discontented customers to take their business elsewhere.

#### ***Pricing Implications of Cost Analysis***

To make a profit, a firm must set its price high enough to recover the full costs of producing and marketing the service, and add a sufficient margin to yield the desired profit margin at the predicted sales volume. Service businesses with high fixed costs include those with expensive physical facilities (such as hospitals or colleges), or a fleet of vehicles (such as airlines or trucking companies), or a network (such as telecommunications companies, railroads, or gas pipeline companies).

In some of these services, however, the variable costs of serving an extra customer may be minimal. Under such conditions, managers may feel that they have

As a service marketer, you will need to move beyond seeing costs just from an accounting perspective. Rather, you should view them as an integral part of the company's efforts to create value for its customers. Antonella Carù and Antonella Cugini clarify the limitations of traditional cost measurement systems, and recommend relating the costs of any given activity to the value generated:

Costs have nothing to do with value, which is established by the market and, in the final analysis, by the degree of customer acceptance. The customer is not interested a priori in the cost of a product . . . but in its value and price. . . .

Management control which limits itself to cost monitoring without interesting itself in value is completely one-sided. . . . The problem of businesses is not so much that of cost control as it is the separation of value activities from other activities. The market only pays for the former. Businesses which carry out unnecessary activities are destined to find themselves being overtaken by competitors which have already eliminated these.<sup>4</sup>

### Competition-Based Pricing

Firms with relatively undifferentiated services need to monitor what competitors are charging and should try to price accordingly. When customers see little or no difference between competing offerings, they may just choose what they perceive to be the cheapest. In such a situation, the firm with the lowest cost per unit of service enjoys an enviable market advantage, and often assumes *price leadership*. Here, one firm acts as the price leader, with others taking their cue from this company. You can sometimes see this phenomenon at the local level when several gas stations within a short distance of one another compete. As soon as one station raises or lowers its prices, the others follow suit.

Price competition intensifies with (1) increasing number of competitors, (2) increasing number of substituting offers, (3) wider distribution of competitor and/or substitution offers, and (4) increasing surplus capacity in the industry. Although some service industries can be fiercely competitive (e.g., the airline industry or online banking), not all are, especially when one or more of the following circumstances reduce price competition:

- *Non-price-related costs of using competing alternatives are high.* When saving time and effort are of equal or greater importance to customers than price in selecting a supplier, the intensity of price competition is reduced.
- *Personal relationships matter.* For services that are highly personalized and customized, such as hair styling or family medical care, relationships with individual providers are often very important to customers, thus discouraging them from responding to competitive offers.
- *Switching costs are high.* When it takes time, money, and effort to switch providers, customers are less likely to take advantage of competing offers. Cellular phone providers often require a one- or two-year contract from their subscribers, and specifying significant financial penalties for early cancellation of service.
- *Time and location specificity reduce choice.* When people want to use a service at a specific location or at a particular time (or perhaps both, simultaneously), they usually find they have fewer options.<sup>5</sup>

Firms that are always reacting to competitors' price changes run the risk of pricing *lower* than might really be necessary. Managers should beware of falling into the trap of comparing competitors' prices dollar for dollar, and then seeking to match them. A better strategy is to take into account the entire cost to customers of each competitive offering, including all related financial and nonmonetary costs, plus potential switching costs, and then compare this total with that of the provider's own service. Managers should also assess the effect of distribution, time, and location factors, as well as estimating competitors' available capacity, before deciding what response is appropriate.

## Value-Based Pricing

No customer will pay more for a service than he or she thinks it is worth (although people are often disappointed when they review the value of the service they actually received). So marketers need to understand how customers perceive service value in order to set an appropriate price. Gerald Smith and Thomas Nagle emphasize the importance of understanding the monetary worth of the incremental value created by a service, a task that often requires extensive marketing research, especially in business-to-business markets.<sup>6</sup>

### Understanding Net Value

When customers purchase a service, they are weighing the perceived benefits of the service against the perceived costs they will incur. As we saw in Chapter 3, companies sometimes create several tiers of service, recognizing the various trade-offs that customers are willing to make among these various costs. Customer definitions of value may be highly personal and idiosyncratic. Valarie Zeithaml proposes four broad expressions of value:

- Value is low price.
- Value is whatever I want in a product.
- Value is the quality I get for the price I pay.
- Value is what I get for what I give.<sup>7</sup>

In this book, we focus on the fourth category and use the term *net value*, which is the sum of all perceived benefits (*gross value*) minus the sum of all perceived costs of service. The greater the positive difference between the two, the greater is the net value. Economists use the term *consumer surplus* to define the difference between the price customers pay and the amount they would actually have been willing to pay to obtain the desired benefits (or “utility”) offered by a specific product.

If the perceived costs of a service are greater than the perceived benefits, then the service in question will possess negative net value, and the consumer will not buy. You can think of calculations that customers make in their minds as being similar to weighing materials on a pair of old-fashioned scales, with product benefits in one tray and the costs associated with obtaining those benefits in the other tray (Figure 5.2). When customers evaluate competing services, they are basically comparing the relative net values.

### Enhancing Gross Value

Hermann Simon, an international consultant, argues that service pricing strategies are often unsuccessful because they lack a clear association between price and value.<sup>8</sup> As we discussed in Chapter 3, a marketer can increase the gross value of a service by adding benefits to the core product and by enhancing supplementary services. There are four distinct but related strategies for capturing and communicating the value of a service: uncertainty reduction, relationship enhancement, low cost leadership, and value perception management.<sup>9</sup>

### Reducing Uncertainty

If customers are unsure about how much value they will receive from a particular service, they may remain with a supplier they already know or not purchase at all. Possible ways, individually or in combination, to reduce this uncertainty, include benefit-driven pricing, and flat-rate pricing.

- *Benefit-driven pricing* involves pricing that aspect of the service that benefits customers directly (requiring marketers to research what aspects of the service their customers value most and what aspects they value least.) For instance, prices for online information services are often based on log-on time, but what customers really value is the information that is browsed and retrieved. Poorly designed web sites often waste customers’ time because they are difficult to navigate and make it hard for users to find what they’re looking for. The result is that pricing and value creation are out of sync.