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## 25 Pricing in services

*Stowe Shoemaker and Anna S. Mattila*

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### **Abstract**

Most existing frameworks of pricing were developed in the context of consumer goods and, as such, they fail to explain how to price complex service offerings. In this chapter, the authors explain the characteristics of services that make services pricing different from goods. Relying on theory from both the general pricing literature and from services research, they develop a conceptual model of pricing of services. This framework incorporates critical pricing elements from both the consumer's and the service provider's perspective. The authors also explain how consumers form value perceptions in the context of service offerings and how such knowledge can be used for developing pricing strategies for various types of services. The chapter concludes with a discussion on measuring price sensitivity in service, competitive pricing and areas for future research.

### **Introduction**

Today, the service sector comprises 80 percent of US employment and 64 percent of US gross domestic product (WTO, 2007). It is well known that the professional disciplines required to manage the marketing function of service firms are different from those used in the marketing of goods. Consider for example an automobile manufacturing plant and the marketing of the cars produced by that plant. Now consider a law firm, the marketing of the services provided by the law firm and the individual lawyers in the firm. Finally consider both how the customer determines which car to buy and which lawyer to hire, and how this customer evaluates the purchase afterward. The many differences that exist between the marketing functions of these two types of industries, and the impact of these differences on pricing, are the subject of this chapter.

Customers will only give money for an item – whether it is a product or a service – if they believe that the value they are receiving is greater or equal to the price they pay for the desired product or service. This presents a challenge for those selling services (e.g. hospitality business, doctors, lawyers, consultants etc.) because the purchaser cannot evaluate services prior to purchasing them. Many services (e.g. vacations, hospital visits and restaurant meals) are high in experience qualities while other services (e.g. those high in credence qualities) are difficult to evaluate even after purchase and consumption (Darby and Karni, 1973; Nelson, 1970, 1974) and consumers often lack sufficient knowledge to assess the services received. This inability to evaluate services creates uncertainty about the utility of consumption, a factor that has direct bearing on the pricing of services. Intangibility (inability to touch and feel) is another characteristic of a service that makes pricing extremely difficult to determine if the item a customer is receiving is greater than or equal to what they are paying. These two characteristics of services, as well as other characteristics of services that will be discussed, introduce much risk into the purchase decision.

The main objective of this chapter is to show how firms both manage the heightened risk associated with service purchase and how they incorporate customers' beliefs (both

real and imagined) and knowledge into the pricing decision. The chapter is organized as follows: first, we discuss the many different types of pricing in services. We then discuss a framework for setting prices in services. Third, we review how services are different from goods. In this third section we also include a discussion of the implications of these differences between the perspectives of marketers and customers. We then explore different pricing strategies employed by service firms. This is followed by a discussion on how to assess customers' value perceptions. We end with a discussion on measuring price sensitivity in services, competitive pricing and areas for future research.

### **The many different types of service pricing**

#### *Definition of price and role of non-monetary costs*

From the customers' viewpoint, price can be defined as 'what he or she must give up to purchase the product or service'. The 'what' may include actual money, time (e.g. the time it takes to search for a doctor or lawyer), a product or service (e.g. an exchange of rooms for free advertising), mental or cognitive effort, and transaction cost (steps necessary to take actual possession of the product or service). Customers will often pay more for a reduction in both cognitive effort and search time by adopting such strategies as always buying the same brand (e.g. higher prices for in-room mini bars in hotels relative to a grocery store, and using an insurance agent that is around the corner rather than one further away).

#### *Pricing in services*

Pricing in services goes by many names (Ng, 2007). Table 25.1 provides examples of the terms used for the pricing of services. For instance, consumers pay 'entrance fees', 'cover charges' and 'green fees' when they purchase visits to museums, entrance to dance clubs and rounds of golf. To receive the knowledge of an attorney, one pays 'a retainer' and to attend college one pays 'tuition'. These activities are intangible and have experiential quality to them; therefore they require a different approach to pricing than is typically found with the pricing of goods.

### **Framework for setting prices for services**

Figure 25.1 provides a framework for price formation organized into two sections. The left section relates to the consumers' role in determining price, while the right section refers to the firms' role in price formation. The critical element in Figure 25.1 is the direct relationship between the 'reservation price' (the maximum price the customer will pay for a product) on the consumer side and the 'final price' on the service provider side. The difference between these two prices is the consumer surplus. Firms attempt to price exactly at the reservation price in order to extract the entire 'consumer surplus'. If they do not, they will be 'leaving money on the table'. The challenge for firms is to determine this reservation price and then get customers to happily pay this price. An additional challenge is to move this reservation price higher. While these challenges are also true for goods, the characteristics of services make it more complicated.

The model proposes that consumers' 'reservation price' is influenced by both the perceived fairness of the offer and the value consumers place on the offer. These features are influenced by the perceived risk of the purchase, which is a result of the consumers'

Table 25.1 The many different terms for price in services

Organization	What consumer is buying	Term used for price
Museum, theater, sports team, dance club, golf course	Performance, entertainment	Entrance fee, cover charge, green fee
Office buildings, apartments	Space	Rent
Hotel, resort	Comfortable place to sleep, entertainment, experience	Room rate
Bank	Access to capital	Interest rate
Telecommunications	Ability to communicate	Tariff
Consultant, doctor, educator	Advice, knowledge	Retainer, tuition

Source: Based on a table in Ng (2007).

characteristics, their reasons for purchase, the type of purchase, the non-monetary costs associated with the purchase, and finally the characteristics of the service. The 'final price' charged is influenced not only by consumers' reservation price, but also by how and if the product is bundled, the demand and supply characteristics, how the purchase is framed, competitors' prices, and costs to produce. We discuss each of these components next.

#### *Consumer side: characteristics of services*

The characteristics of services differ from the characteristics of manufactured goods in four important ways: intangibility, perishability, heterogeneity, and simultaneous production and consumption. In addition, unlike most consumer products, services provide only temporary possessions (Lovelock and Gummesson, 2004). These differences impact how service firms approach the pricing function, as shown in Table 25.2.

*Intangibility* Intangibility is believed to comprise three dimensions: physical intangibility, generality, and mental intangibility. The more intangible the service, the more risk there is for buyers. This makes pricing decisions difficult. The price has to be high enough to ensure confidence, but not too expensive that consumers will refuse to purchase (Zeithaml et al., 1996; Rust and Zahorik, 1993).

The inability to touch and feel the service before the purchase suggests that consumers make choice decisions based on their expectations of service delivery and by cues put forth by the seller. One cue is price. The higher the price, the higher the expectations that service quality will be delivered (Zeithaml et al., 1996). For instance, whom would you want to defend you against a crime you did not commit – a \$150 per hour lawyer or a \$1000 per hour lawyer? A second cue is the uniform worn by the service provider. Doctors wear white gowns not because they make them better doctors, but because of the impression the coats give to the patients; namely, authority, cleanliness and professionalism.

*Perishability* Services such as airline seats or hotel rooms, information sold by news services, and the time availability of a consultant are perishable. If the service is not sold, the revenue for that service is lost forever. Perishability is compounded by the fact that most services have fixed capacity and most are unable to increase their capacity in the short run. The challenge is to 'manage' both demand and capacity by getting customers

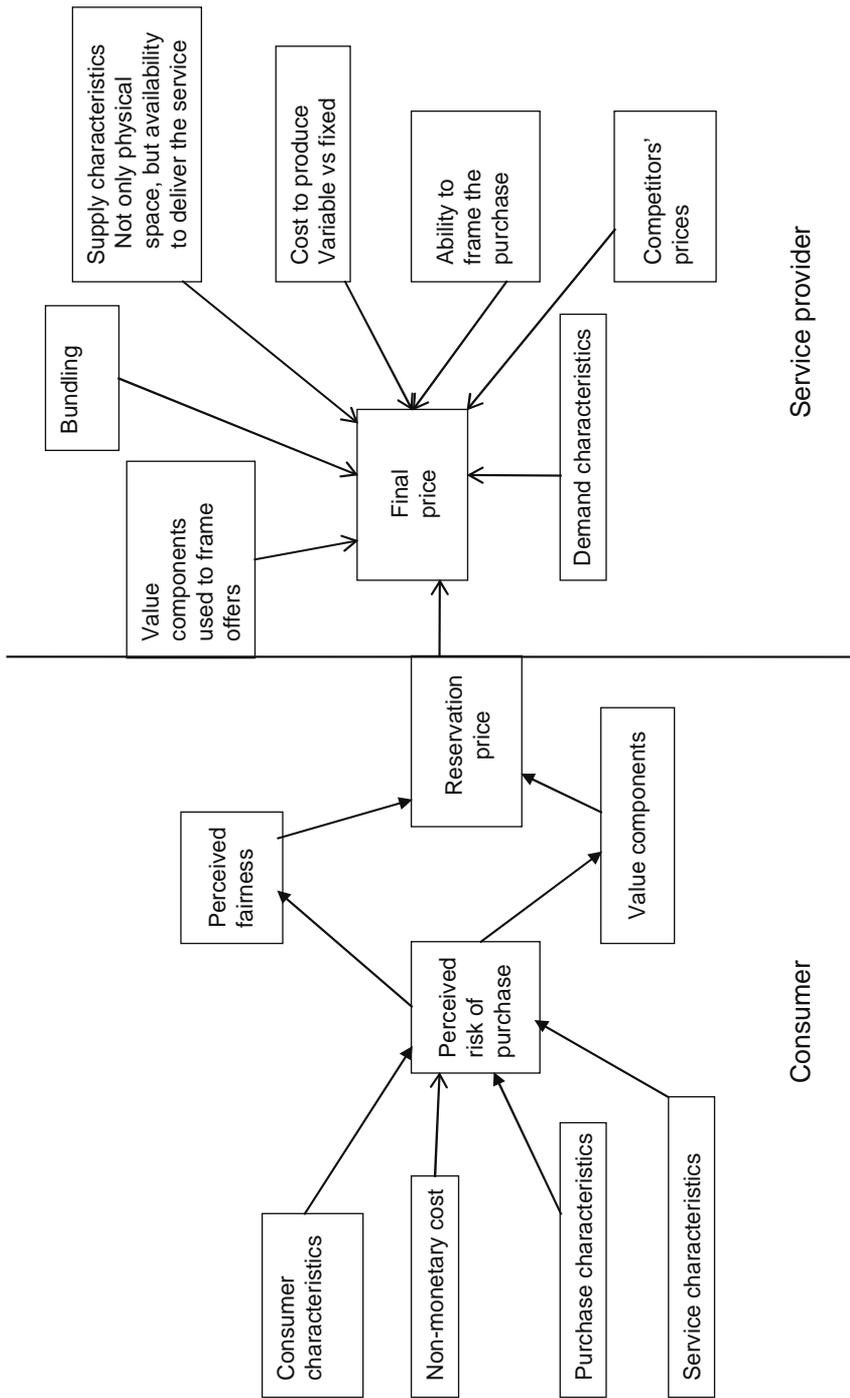


Figure 25.1 Model for pricing of services

Table 25.2 *Distinctive features of services and price challenges for firm and customer*

Distinctive features of services	Definition	Example	Resulting price challenges: firm
Intangibility	Incapable of being touched or perceived by touch. Also defined as being unable or difficult to be perceived by the five senses	Consulting services, teaching, law advice, medical diagnosis	Not easy to display and communicate intangible service offerings. Prices help set consumers' expectations.
Perishability	If service unit is not sold one day, the same service unit cannot be stored and sold next day	Hotel rooms, airline seats, personal athletic trainer, billing hour of an attorney	Firms needs to set price that guarantees sale but does not 'leave money on the table'; leads to revenue management.
Heterogeneity	The variation and lack of uniformity in the service being performed	Moments of truth in the service encounter. Person one day can give great service, but next day provide totally different service	Customers' heterogeneity impacts how they judge the quality of the purchase; employees' heterogeneity indicates there is an element of risk in the purchase.
Simultaneous production and consumption	The purchase and the delivery occur at the same time	Ordering dinner in a restaurant, hiring consulting service, visiting a lawyer or doctor	Customers may be less willing to pay higher prices unless they believe they will receive what they pay for.

to change their behavior so the firm can manage supply and demand. This is being accomplished more often by dynamic pricing, which is defined as setting prices based on the customer's willingness to pay and buying habits (Kannan and Kopalle, 2001; Huang et al., 2004). Dynamic pricing can be thought of as 'tell me what you want to pay, and I will tell you when you can use the service'. 'Tell me when you want to use the service, and I will tell you what you need to pay.'

*Heterogeneity* Heterogeneity of services refers to the variation in the service as a result of individual differences among employees of a service firm. Customers also contribute to heterogeneity as they often act as partial employees (Bateson, 1985; Bowen and Schneider, 1985). Although such co-production of services can greatly reduce employees' workload, it also creates another layer of uncertainty in service quality. The customer's knowledge, experience and proficiency or lack of it can affect how they judge the quality of the purchase. Uncertainty about performance quality tends to increase consumers' reliance on price as a cue for forming expectations (Dodds et al., 1991; Rao and Monroe, 1988). Since most services suffer from performance heterogeneity, service firms need to

truly understand price–performance inconsistencies from the consumer’s perspective (Voss et al., 1998). Moreover, the price–perceived quality literature suggests that consumers who have limited prior knowledge tend to use price to assess product quality more than consumers who have a moderate degree of prior knowledge (e.g. Zeithaml, 1981). Novice consumers easily interpret higher prices as indicators of higher value (Gerstner, 1985; Rao and Monroe, 1988).

Conversely, knowledgeable consumers tend to be less likely to use high prices as surrogate cues of high quality (Leavitt, 1954; McConnell, 1968). Due to their well-developed cognitive structures, experts are able to use intrinsic cues to evaluate quality (Marks and Olson, 1981). Consequently, for these consumers, there may be a decreased reliance on extrinsic information such as price in the evaluation of service quality.

For the service firm, the emphasis should be placed on understanding the customer, not the service. Many service firms offer their services in varying degrees of customization (e.g. consulting, software development) and consumers tend to be willing to pay a higher price for such customized services (Broekhuizen and Alsem, 2002; Jiang, 2002). Negotiating the price with the customer, as opposed to a fixed price scheme, is often used when the service involves a set of customized procedures (Roth et al., 2006).

*Simultaneity of production and consumption and purchase* The characteristic of simultaneous production and consumption is unique to services. As the attorney produces the information, the customer ‘consumes’ the information. Unlike goods, where the customer can examine the item she wants to purchase prior to purchase, in the services the purchase and the delivery occur at the same time. To ensure customer satisfaction, some organizations empower their employees to take appropriate action on the spot and advertise this, some offer service guarantees.

The purpose of the service guarantee is to remove pre-purchase risk and to convey a message that management takes complaints seriously and wants to fix the issues not just in the short term, but making sure the failure does not happen again. The service guarantee typically allows firms to charge more money, as the guarantee assures the consumer that quality will be delivered. One example of the service guarantee is the one offered by Starwood Hotels and Resorts, which promises to fix any defect on the spot, if possible, or offer a menu of ‘rewards’ (e.g. free lodging, airline miles etc.) to compensate for the troubles caused. Satisfaction guarantees are also offered by other service firms such as 1&1 ([www.1and1.com/web-hosting](http://www.1and1.com/web-hosting)), which bills itself as the world’s largest web hosting service, and offers a 90-day complete money-back guarantee, and buy-dissertations.net (<http://www.buy-dissertations.net/BuyDissertation/guarantee.asp>), which claims that not only will you get your masters, doctorate-level dissertation or research paper on time, but they will revise it if you are not happy with the content.

#### *Consumer influence: consumer characteristics*

*Lack of pricing knowledge* One consumer characteristic is the lack of pricing knowledge of a service that arises due to four reasons: (i) the firm offers multiple services at different levels (e.g. prices for an airline flight by class, time of day/week); (ii) difficulty for service providers to quote exact rates in advance until they begin to understand the customers’ exact needs (as in the case of attorney fees); (iii) availability of multiple options available to

fulfill a need (e.g. a multitude of doctors are available in a given area) (Miao and Mattila, 2007); and (iv) the fact that service prices are often not visible (Zeithaml et al., 2006). An example of this last point is American Express Financial Services, which found in a study of its customers that many did not know the prices of the services they were buying.

The lack of price knowledge suggests that consumers will use other cues besides price to determine the best option. Examples of such cues are lawyers locating their offices in expensive office buildings, real-estate agents driving expensive cars and doctors displaying their diplomas with the brand names of their medical schools. In all these examples, the firm attempts to make tangible that which is intangible; and at the same time, convey the belief that consumers should be willing to pay more for their services.

#### *Consumer influence: purchase characteristics*

The characteristics of the purchase situation also impact the perceived risk of purchase. For instance, the time of purchase influences the price. One way to think about revenue management is in terms of the following two statements: ‘Tell me when you want to use the service and I will tell you what you need to pay’; ‘Tell me what you want to pay and I will tell you when you can use the service.’ Consumers needing to be somewhere at a specific time are less price sensitive than those who have much flexibility. At the time of the use of the service, prices tend to rise, as supply usually decreases.

At times, it may be advantageous to separate the purchases from consumption (Shugan and Xie, 2000). One such way is to offer advance selling. When consumers feel uncertain about the future availability of the service, they might place higher value on it and thus be willing to pay a higher price at an earlier date. For instance, music fans might be willing to pay more for a concert ticket purchased two months in advance as the anticipation of the experience enhances its value. This often happens with vacation travel, especially cruises. With limited inventory, consumers are willing to pay in advance to guarantee that availability.

#### *Consumer influence: perceived fairness*

Charging different prices for essentially the same product or service raises concerns about fairness when dynamic pricing strategies are evaluated by consumers (Garbarion and Lee, 2003; Grewal et al., 2004). Unfair prices are a considerable cause for customer defections (Keaveney, 1995). Consumers evaluate price fairness based on three anchor points: past prices, competitors’ prices and production costs (Bolton and Myers, 2003). According to Xia et al.’s (2004) framework of fairness perceptions, transaction similarity is the key in prompting fairness judgments. When the degree of similarity between two transactions is high, consumers have little additional information to explain a price discrepancy. In such situations, they tend to believe that they are entitled to equal prices and hence consider price variations as unfair. Revenue management practices try to buffer the negative impact of differential pricing by using rate fences or framing to present price fluctuations in a more favorable light (Wirtz and Kimes, 2007). Wirtz and Kimes (2007) show that consumers’ familiarity with revenue management practices might moderate the effect of fencing and framing on consumers’ fairness perceptions.

To counter this issue of fairness, in the lodging sector major lodgings now offer ‘rate integrity’, which means that prices are the same regardless of the channel (Internet, central reservations etc.) through which the reservation came.

Table 25.3 *The components of value*

Value component	Definition	Implication
Financial	Actual currency (dollars, euros, etc.) exchanged for purchase of a service	Degree of service differentiation between competing firms, price relative to household income, and ease of switching all impact price sensitivity.
Temporal	Amount of time required to purchase and use a service	Adage 'time is money' is relevant here as customers continue to have less and less time. Consumers will pay more to save time.
Functional	Ability of the service to meet or exceed customers' expectations. Components are reliability, assurance, tangibility, empathy and responsiveness	Customers need to see or feel the components of functional value to know expectations are being met or exceeded. If they are, will both pay more and be more accepting of price paid.
Experiential	Also known as the hedonic aspects. Occurs when guests are active participants in the service experience	Need to create opportunities for guests to become active participants; for example, 'chef's table' in restaurant, ability to exchange frequency points for 'trophy' rewards.
Emotional	Ability of the service to make customers feel special or provide a certain level of comfort	Emotional bonding is a major driver of brand loyalty. Strong brands are less vulnerable to competitive attacks such as price discounts or other promotional tactics.
Social	Ability to enjoy the service with others – either your referent group or people you meet while consuming the service	Social interaction and the desire to please one's referent group helps create experiential and emotional value. The more perceived social value, the less price sensitive.
Trust	The belief that organization has customers' best interest in mind	The more the customers feel they can trust the organization, the less price sensitive they are.
Identification with the organization	Customers and organization share similar beliefs	The more the customers feel identification with the organization, the less price sensitive they are.

*Consumer influence: value components*

The final influence from the consumer side of the model is the components of value. There are eight components of value, presented in Table 25.3. Each of the value components listed has implications for pricing. For instance, consider 'temporal value'. This is based on the notion that 'time is money' and in order to save time, consumers will be willing to spend more money. The total price of a shopping basket at a traditional grocery (i.e. not a Wal-Mart Super Center) store is much higher than if the consumer shopped in multiple stores. Consumers typically shop in just one store because of its convenience. Firms can increase prices by understanding how much their customers' time is worth and then

determining how much of that figure customers would be willing to give back in order to save time.

Next, consider 'social value'. The theory of reasoned action (Ajzen and Fishbein, 1980) states that behavior is a function of two constructs: (1) the attitude towards performing the action and (2) the influence of the group norms. It is this second component that influences pricing. The desire to please one's referent group leads consumers to spend more money. Social value is also related to 'experiential' and 'emotional' value. D'Aveni (2007) revealed in research on restaurants the desire for customers to have a wonderful 'customer experience' and their willingness to pay additional funds for such experiences.

Functional value pertains to the belief that the service does what it is designed to do. A doctor who cures an illness is an example of functional value, as is the lawyer who keeps his client away from legal troubles. As discussed earlier, service guarantees play an important part in assuring the customer that the service will work as it was designed.

Other examples of pricing and consumer value can be seen in Table 25.3.

### **Service provider and setting prices**

Setting prices is a complex exercise, with any number of strategic and tactical implications. Service firms generally have fixed costs that need to be covered. Sometimes firms have to work with these costs and set prices accordingly. This is called product-driven pricing or cost-based pricing.<sup>1</sup> The problem with these methods of pricing is that the final price offered to the consumer may be less than the customer is willing to pay. The reason is that the only component of the price is from the firm's perspective and does not consider what the customer values. Firms need to consider what the customer values when setting pricing. It is for this reason that the value components 'box' is connected to both the consumer and the service provider.

Value-based pricing can be considered the antithesis of cost-based pricing. It involves choosing a price after developing estimates of how potential customers perceive the value of the product or service. It has nothing to do with the cost to produce the item. Value-based pricing has the advantage that it forces managers to keep in touch with the needs and preferences of customers.

#### *Service provider: value and framing*

Prospect theory (Kahneman and Tversky, 1979) argues that when people make decisions about buying products or services, they do so by examining the changes in their well-being that occur. This well-being is considered by examining changes from a neutral reference point. A positive change (or value) is considered a gain, while a negative change is considered a loss. Consumers are more likely to make decisions that avoid losses rather than make gains. How the consumer 'looks at the decision' – or the decision frame – can determine whether the outcome is in the domain of gain or loss. Decision frames are

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<sup>1</sup> Types of cost-based pricing: 'cost-plus pricing' involves establishing the total cost of a product, including a share of the overhead, plus a predetermined profit margin. 'Cost percentage or markup pricing' features either a dollar markup on the variable ingredient cost of the item, a percentage markup based on the desired ingredient cost percentage, or a combination of both. 'Contribution margin' pricing occurs when pricing is used to help cover costs.

controlled by the formulation of the problem and by the norms, habits and characteristics of the decision-maker. While the firm can do little to control the idiosyncrasies of the decision-maker, it can change how the consumer frames the decision problem so that the outcome becomes favorable to the firm.

Decision frames are currently being used in the airline industry as the legacy carriers battle the low-cost carriers (LCC). LCCs are believed to be cheaper (a gain), while the legacy carriers are thought to be more expensive (a loss). Yet the truth is more complex. On certain flights the legacy carriers may actually be cheaper. The challenge for the legacy carriers is to stay price competitive and at the same time move the frame of reference away from price to something on which they can compete; for example, pre-assigned seating, no luggage restrictions, landing at airports close to cities, etc. British Airways is currently running advertisements in Europe highlighting how they offer these options while the LCCs do not. These advertisements highlight the problems of flying with a low-cost carrier, not the benefits of flying BA (they are implied.).

As service firms move more of their information to the web, they need to consider how to use decision frames to gain customer compliance. Because consumers come to the website with different frames of reference, information needs to be presented in such a way ('framed') that price no longer becomes the dominant reference point. In the travel industry, firms are beginning to use reservation calendars that clearly show customers dates of availability and the corresponding lowest prices for those dates. Because price is clearly transparent, customers can consider other features, such as when they want to travel and what amenities they want included. As they 'click through' the calendar they are able to customize their purchase, which leads to higher prices.

Contextual pricing is another implication of prospect theory. Contextual pricing implies that the context in which the purchase is made will have an impact on the overall price paid. Essentially, the context changes the reference point. Consider going to dinner with a significant other for a special occasion versus going to dinner for a 'quick bite', or choosing an attorney for estate planning versus choosing an attorney to defend you in a civil suit. In both cases the reservation price will go up. Service firms should attempt to determine the context of the purchase prior to quoting a price.

#### *Service provider: price bundling*

Bundling or marketing two or more services in a single package for a special price is a common practice in many segments of the service industry (Guiltan, 1987; Johnson et al., 1999). Bundling can be a great way to maximize revenues (Dolan and Simon, 1996; Guiltan, 1987) and to increase customers' value perceptions (Yadav and Monroe, 1993; Soman and Gourville, 2001). From the consumer's perspective, bundling minimizes cognitive effort and also reduces the direct association between costs and benefits (Soman and Gourville, 2001).

Bundling works because consumers have different reservation prices for different components of a package. Bundling also works for the firm because it can protect its published prices; in many cases it is impossible for the consumer to tell what each part of the bundle costs.

Prospect theory suggests that losses should be bundled. The rationale is that once a consumer has agreed to spend \$159, getting them to spend an additional \$30 for another feature (e.g., free Internet access) is not difficult, as the psychological difference between

\$159 and \$189 is not that great. However, should the consumer wish to purchase the \$30 item at a later date, now the frame of reference is \$0 and the jump to \$30 (because the item is purchased at a later date) seems more expensive.

This idea of bundling, combined with how the issue is framed, has been profitable for firms. For example, in an unpublished study, a major hotel in Las Vegas bundled both the hotel room and a guaranteed Las Vegas Strip view for a total price of \$189. If the guest did not want a strip view, the rate was \$159. To test the impact of this bundling and the impact of the framing of the bundle, telephone reservation agents were divided into two groups. One group quote a rate of \$159 to stay anywhere in the hotel (view not bundled). If, however, the guest wanted a guaranteed Las Vegas Strip view, there would be a \$30 additional fee. This could be paid at time of booking (e.g. bundled) or purchased at time of check-in if available. A second group was quoted the \$189 with a guaranteed view (view bundled). If such a view was not included, the rate was \$159. Results revealed that when the \$159 unbundled rate was quoted, 13.6 percent elected to pay an additional \$30 at the time of booking. When the \$189 was quoted first, 20.1 percent elected to take the bundled option. By including the view as part of the bundle, revenues increased \$31 878 per month – revenue that went directly to the bottom line. While this may not seem like a big figure, on an annual basis it is \$382 536.

#### *Service provider: role of competition*

Although the notion of customer centricity is highly recognized in the service literature (e.g. Shah et al., 2006), most models focusing on value fail to incorporate competitive factors (Leone et al., 2006). Those that do incorporate competitive factors often use positioning maps to understand pricing from the customer's viewpoint. For instance, D'Aveni (2007) used positioning maps in part to understand that restaurants with dance floors charged \$4.50 – \$7.25 more for a meal than restaurants without. He also saw the pricing power of these restaurants rise over the three years, as they understood this price relationship.

Shoemaker (2007) shows how hospitality firms have used competitive positioning maps to determine their pricing strategies. This methodology is shown in Table 25.4 and data to illustrate the technique are shown in Table 25.5. The resulting positioning map is shown in Figure 25.2. Notice in Figure 25.2 that the prices charged are plotted on the vertical axis and the customer competitive index (CCI), which shows how the firm is perceived relative to the competition in terms of what features are important to the customer and how well the firm performs on those features, is plotted on the horizontal axis. The firm undertaking this analysis plots its price in the center of the *Y*-axis and its CCI score in the center of the *X*-axis. This makes it easy to tell which competitors are below or above the firm both in terms of CCI scores and price.

Figure 25.2 shows the Rio (the base hotel) positioned in the center with a rate of \$179 and a CCI of approximately 60.0. The positioning map reveals that Bally's and Caesars have higher rates than the Rio (\$185 and \$189, respectively). More important, both of these brands have a CCI lower than that of the Rio. This indicates that the Rio could probably raise its prices because its customers are generally more satisfied than are those of Bally's and Caesars, which are both earning a higher rate than the Rio. Boulder Station could also probably charge a higher rate because its CCI score is the highest. This analysis should be done for each market segment.

Table 25.4 *Developing competitive positioning maps for pricing hotel rooms (calculation of customer competitive index)*

Column feature	Importance	Brand A		Brand B	
		Performance rating	Score	Performance rating	Score
	A Scale: 1–10	B Scale: 1–10	C $A \times B$	D Scale: 1–10	E $A \times D$
It is a place friends like to go	7.30	7.60	55.48	6.40	46.72
Atmosphere is very pleasant	8.80	7.70	67.76	7.63	66.88
One place seems to have better odds	7.40	6.80	50.32	6.00	44.40
Slot machines filled in a timely manner	7.50	6.80	51.00	6.80	51.00
Types of promotions offered	7.40	7.70	56.98	6.80	50.32
<b>Total Index</b>	38.4		281.54 73.32*		259.32 67.53

Note: \* Sum all numbers in the column; divide sum by total in column A. Multiply by 10; index based on 100.

#### Questions used to determine importance and performance

##### *Importance question*

Next, please think for a moment about the reason for visiting a specific legalized gambling establishment in Las Vegas. Please tell me how important each reason is for you in your decision to choose one specific property over another. Please use a 1 to 10 scale where a 1 means the reason is not at all important and a 10 means the reason is very important. You may use any number on this 1 to 10 scale. Do you understand how this 1 to 10 scale works? How important is \_\_\_\_\_ in your decision to choose one place to visit over another?

##### *Performance question*

Now I am going to read you a list of features that may or may not describe some of the casinos in the Las Vegas area. We'll use a 1 to 10 scale where 1 means it 'does not describe the casino at all' and 10 means it 'describes the casino perfectly'. If you have not been to the casino personally, please base your answers on what you have heard or what you believe to be true. The first feature is \_\_\_\_\_. How well does this feature describe casino \_\_\_\_\_?

Although the method is simple, it has proven quite useful in the hotel industry and the airline industry to better understand competitors.

#### Selected current pricing examples

##### *Pay-for-performance pricing*

Pay-for-performance, or performance-based pricing, is 'an arrangement in which the seller is paid based on the actual performance of its product or service' (Shapiro, 1998, p. 2). This form of pricing is gaining popularity in particular in services based on agency–client

Table 25.5 Example of data collected on multiple firms in a market and average rate charged per room

	Feel safe there	Friendly employees	Place my friends like to go	Always have good entertainment	Drink orders taken in timely manner	Cashier lines are short	Restaurants offer great value	Can get change quickly	Slot machines filled in timely manner	Like the promotions offered	You can get compliments	Overall average
Importance	8.20	8.20	6.27	4.80	6.12	6.37	7.49	6.33	5.67	4.80	6.15	6.40
Rio	7.26	6.60	6.49	6.47	5.93	5.91	5.70	5.54	5.35	5.05	4.96	5.93
Bally	6.55	5.28	3.96	4.59	5.11	5.05	4.05	4.70	4.60	3.75	4.20	4.71
Boulder	7.40	6.88	6.40	5.74	6.50	5.90	6.54	6.11	5.89	6.16	6.05	6.32
Caesar	7.19	5.85	6.15	5.81	5.37	5.43	4.32	4.82	5.07	3.62	3.97	5.24
Circus	4.70	4.60	4.07	4.24	4.59	4.63	4.55	4.15	4.21	3.80	3.81	4.30
Excalibur	6.61	5.64	5.01	4.89	5.03	5.42	5.01	5.19	5.04	4.06	4.47	5.12
Fiesta	6.19	6.00	4.75	4.64	5.48	5.43	5.61	5.60	5.34	4.66	5.25	5.36
			Rate	CSI								
		Rio	\$179.00	59.97								
		Bally	\$185.00	47.91								
		Boulder	\$160.00	63.92								
		Caesar	\$189.00	53.16								
		Circus	\$159.00	43.41								
		Excalibur	\$140.00	52.07								
		Fiesta	\$155.00	54.3								

\$189				53.16 Caesar				
\$185			47.91 Bally					
\$180					59.97 Rio			
\$179						63.92 Boulder		
\$159		43.41 Circus						
\$155				54.3 Fiesta				
\$140				52.07 Excalibur				
	CSI	40	45	50	55	60	65	70

Figure 25.2 *Fictional data to illustrate competitive positioning*

relationships such as advertising, consulting and industrial services. Pay-for-performance pricing enables the goals of the buyer and the seller to be aligned through the negotiation process. Careful negotiations are in fact a prerequisite for a successful implementation of pay-for-performance-based pricing. In sum, pay-for-performance pricing maximizes value for both the customer and the service provider since customers pay only for what they value and suppliers can reduce costs by eliminating non-value-added components of their services.

Yet its applicability to a wide range of services is limited. There is also a great deal of uncertainty involved in this pricing method since the actual dollar amount cannot be determined in advance. Finally, pay-for-performance pricing is not appropriate in cases where short-term cash flows are an integral part of the company’s success (e.g. most startup companies).

*Modularity pricing*

To overcome the challenges caused by intangibility, many service firms have turned to modularity pricing (Docters et al., 2004). For this pricing strategy to work, it is crucial to determine the full range of services that the firm’s customers might want. Modular service bundles can then be developed to meet individual customer needs and wants. The mixing and matching allows the service firm to charge for components of its service delivery system that might otherwise be offered free of charge. Airlines, for example, have mastered modularity pricing – they not only charge for passengers, but also for excess baggage, pets, special ticketing, alcoholic beverages, and snacks, and even sometimes for pillows.

Modularity pricing enables companies to reflect both customer needs and their own cost structures, thus creating a potential win-win situation. A wide spectrum of prices for different components of the service also makes it harder for customers to compare prices

across competitors. However, for modular packages to succeed, it is important that there is minimal overlap among the service components – no customer is willing to pay twice for the same part of service!

### *Examples of complex service pricing*

We next provide three examples of complex service pricing. One example is from the business process outsourcing industry, the second is from the healthcare field and the third is from the legal profession.

In the business process outsourcing industry, prices are normally based on a fixed rate, where the rate is based upon an agreed metric (e.g. a ‘per-call basis’, a ‘per-minute basis’, or a ‘monthly per-head basis’ (Shoemaker, 2007). Price estimates are based upon client-supplied historical data of call volumes, arrival patterns and average handle time. Call centers also earn additional fees for meeting or exceeding specific service targets (e.g. 80 percent of calls answered within 120 seconds and exceeding customer satisfaction goals). Call centers are penalized (bonuses) up to 10 percent of the base contract price for not meeting (exceeding) the targets.

A leading computer manufacturer has recently taken a more radical approach and has asked that bids be based on a ‘per-resolution basis’, regardless of how long it takes to resolve the customer’s issue. To accurately create a bid price, call centers have a target of a certain number of minutes, on average, to resolve customer issues. This method of pricing not only limits the client’s cost, but also results in higher customer satisfaction, as there is an incentive to solve the problem as quickly as possible. This is an example of performance pricing at its best.

The second example comes from healthcare (Shoemaker, 2007). Since the 1980s the federal government has become the key player in determining healthcare pricing. Most pricing in today’s environment is driven by the Medicare diagnostic related groups (DRGs), which are set by Medicare, Medicaid and other government programs (e.g. Champus, Tricare). The healthcare provider and the insurance company use these prices to assign fee schedules for each procedure. Insurance premiums are set in part by the total number of units of service provided by each of the providers in that healthcare ‘experience’. Most insurance contracts have a ‘stop loss’ clause where after a threshold dollar amount is met, additional payments will be at a discounted charge.

Doctors’ offices have standardized billing codebooks for each type of service provided, such as a patient visit, a procedure etc., and the bill becomes a claim, or the ‘gross charge’. In the case of hospitals, the patient (patient co-pay plus company contribution) pays \$1 of premium to the insurance company and typically 15–18 percent of that premium goes to the hospital (acute care, sub-acute care, rehab etc.), 15–19 percent to the doctor, 10 percent to outpatient pharmacy and 15–20 percent to insurance administration and sales.

Differentiating services is the key to successful pricing. Typically, around 14 percent of healthcare services involve highly specialized services while the rest of the services reflect standard services that fall under ‘commodity’ pricing. The main challenge for healthcare organizations is to be able to increase prices in tandem for both the highly profitable commodity business and proprietary services. To that end, firms differentiate highly specialized services via special certification (i.e. stroke center, ‘center of excellence’), specific complex procedures, and state-of-the-art technology.

Law firms typically bill their clients by the hour, partly because that is how business has always been done. In addition to the professional code of ethics, competitive prices become a key consideration in determining the hourly rate. The billable hour method often causes dissatisfaction among clients as it doesn't tie costs to value and it fails to make lawyers accountable for the results. To address these concerns, some law firms are moving towards alternative fee arrangements including fixed fees, result-based fees, retainers, blended hourly rates and capped fees. Yet there is a great deal of resistance to change in the profession. One of the key issues to be addressed is risk and reward allocation. Who should bear the risk of a cost overrun, the risk of bad outcome or the risk of compromised quality due to alternative fee structures? Creating hybrid models with risk corridors might provide an alternative that satisfies both the law firm and the client. These more relationship type fee arrangements have started to gain popularity in recent years.

### **Ways to access consumers' reservation prices in services**

#### *Reference prices and reservation prices*

'Reference price' is the standard against which the price of a service is judged (Monroe, 1973) or the price at which consumers believe the product should sell. Consumers use both prior expectations and contextual information when forming reference prices (Mazumdar et al., 2005), resulting in multiple conceptualizations, including those based on predictive expectations (Kalyanaram and Weiner, 1995), normative expectations or fairness (Bolton and Lemon, 1999; Campbell, 1999; Xia et al., 2004). In other words, the reference price is formed when consumers consider such things as the following: price last paid, price of similar items, price considering the brand name, real or imagined cost to produce the item, and perceived cost of product failure. The last item is of considerable importance because it reflects consumers' imaginations of what could go wrong. For example, the reference price for a meal at which one is celebrating a special occasion is higher than the reference price for a meal with some old college friends, even though the restaurant may be the same. The risk of failure is critical in the first case and less critical in the second. Moreover, the internal reference price is crucial for continuously provided services such as healthcare, utilities, insurance and membership-based services (Mazumdar et al., 2005). For these types of services, consumers are likely to focus on payment equity (i.e. are they using the service enough, given the price charged; Bolton and Lemon, 1999). Hence, a high fixed fee might induce consumers to use the service more while a variable fee might have an opposite effect on service consumption (Mazumdar et al., 2005).

The second definition firms need to understand is 'reservation price', which was introduced at the beginning of this chapter. It is the maximum price the customer will pay for a product.

#### *Price sensitivity measurement*

One way to assess customers' willingness to pay is through price sensitivity measures (Gabor and Granger, 1966; Travers, 1983). This method is based on psychological and sociological principles, and aims to examine price perception by determining levels of customer resistance as they relate to quality perceptions and the market range of acceptable

prices for a specific product or service. For each specific product or service, four questions are asked:

1. At what price on the scale do you consider the product or service to be cheap?
2. At what price on the scale do you consider the product or service to be expensive?
3. At what price on the scale do you consider the product or service to be too expensive, so expensive that you would not consider buying it?
4. At what price on the scale do you consider the product or service too cheap, so cheap that you would question the quality?

A fifth question is sometimes asked: what price do you expect to pay?

Answers to the above questions are then plotted to reveal the information necessary to determine the appropriate price to charge. The responses to question 3, 'too cheap' and question 4, 'too expensive' are typically graphed with the reversed cumulative distributions of 'cheap' and 'expensive', which are then labeled 'not cheap' and 'not expensive'. The intersection of these two curves is the point of marginal cheapness (PMC). This is the point where the number of respondents who feel the service is too cheap is equal to the number of respondents who feel it is not cheap. The intersection of the 'not expensive' and 'too expensive' curves is the point of marginal expensiveness (PME). This is the point where the number of respondents who feel the product or service is too expensive is equal to the number of respondents who feel it is not expensive. The range of acceptable prices (RAP) has the PMC as its lower price limit and the PME as its upper price limit. It would be unwise to price outside this range unless there is real change in the perceived value or positioning of the product or service.

Lewis and Shoemaker (1997) show how hotel firms can use this technique to determine the range of acceptable prices for the association meeting market. This technique has been used quite successfully in proprietary studies conducted by the lead author of this chapter for a large international hotel company for hotel room pricing, a multi-unit restaurant and pie shop to determine the pricing of individual pies, an international restaurant chain to price its tacos, a major university for the pricing of its executive education programs, as well as other service firms.

Conjoint analysis is another common way to estimate consumers' willingness to pay. For example, Marriott Hotels used conjoint analysis to build and price its Courtyard brand (Goldberg et al., 1984). Conjoint analysis has also been used extensively in the cable and the travel industry to determine specific combinations of packages to offer and at what price.

### **Unresolved issues and future research directions**

We have identified several research topics that require conceptual and empirical attention to better understand pricing of services. First, our conceptual framework needs to be empirically tested. Should our model 'work' as we expect, it would provide practitioners with a clear set of tools that could be used to price more efficiently.

Second, what is the relationship between price-value and satisfaction in the context of services? Recent research suggests that satisfaction generates free word of mouth, thus greatly reducing the need for costly marketing campaigns (e.g. Luo and Homburg, 2007). Exploring some other key moderators such as emotional reactions to service offering

(Ladhari, 2007) or consumers' loyalty status would be highly beneficial for deepening our understanding of word of mouth in the context of intangible services. This knowledge will in turn help us understand how word of mouth influences consumers' willingness to pay. While formulas exist to calculate the value of word of mouth (Hallowell, 2001), these formulas are often based on the current price charged. The question of interest is: does word of mouth influence the price that can be charged, and if so, by what amount?

Third, the notion of fairness is an area that warrants future research. Although some attention has been paid to fair prices in the context of revenue management, the territory is largely uncovered (Wirtz and Kimes, 2007). For example, what is the role of the Internet (e.g. blogs and consumer review sites) in informing consumers of differential pricing policies? Do social comparisons made available via technology make fairness an even bigger issue for services? In a similar vein, how do self-service technologies (SSTs) (e.g. self-service kiosks) modify consumers' value perceptions of services? For example, do customer preferences for SSTs vary across market segments (Ding et al., 2007)? And if SSTs are used, does the consumer consider this to be a 'time saver' and hence is willing to pay more for the service, or does s/he feel that since the organization is providing less service, the customer should pay less? This is not a trivial question as more and more services are relying on self-service technologies.

Four, what is the role of framing in influencing customer perceptions of service offerings? Although discounts have been shown to have a positive impact on consumers' perceptions of deal value (e.g. Darke and Chung, 2005), service providers might need to be cautious about potential negative effects on quality inferences. Price bundling has been effectively used in many service settings (e.g. Soman and Gourville, 2001) to increase the perceptions of value, but separating the discounts in multiple savings might also be useful in enhancing customers' value perceptions (Ha, 2006; Johnson et al., 1999). Making sure that consumers use the regular price rather than discounted prices as price reference might be the key to boosting consumers' price perceptions (Krishna et al., 2002). For example, would reference prices change if on all invoices the following information were presented: normal price, discount, price you pay? Currently most invoices only present the price paid. Similarly, how does the rationale for the discount impact reference price and perceived fairness? This notion of reference price formation in the context of services warrants further research (Mazudmar et al., 2005).

Five, technology has made many service firms less labor intensive. Consider for instance how computer-aided design programs have automated many of the design functions of engineering firms. If such firms charge by the hour, the price charged should also go down, especially after all necessary computer software and equipment has been paid for. How should firms account for this decrease? How much reduction in price do consumers expect, if any?

Six, as more price information becomes more readily available, researchers need to understand what is the impact of this information on reference price and price acceptability. And, is this impact the same for all services or does it vary by type of service?

Seven, our model has proposed that the eight components of value detailed in Table 25.3 influence both the reservation price and the final price. Future research needs to investigate each of these components in more detail as well as the relative influence of each of the specific components on the reservation price and the final price for services. For instance, Mathwick et al. (2001) developed an experiential value scale that they used

to understand differences in perceived value for catalog versus Internet shopping. It would be useful to test this scale for the different services presented in Table 25.1. More important would be to test if a relationship existed between the scale score and the price paid; and, if such a relationship existed, how could the information be used in pricing?

Temporal value also needs to be investigated further. Leclerc et al. (1995) investigated the impact of time versus money and found in two studies that the value of time seemed to be highly context dependent. The two contexts investigated were (1) short wait time versus long wait time; and (2) a good or service with a high monetary value versus a good or service with a low value. The marginal value of time was higher in the short wait time context and the high monetary value context. They also found that time is nonfungible, which means that time savings and time losses cannot easily be transferred and exchanged. The natural question is: how do consumers trade off time for money and does this vary by service situation?

Much research has investigated what is known as the 'pennies-a-day' strategy (Gourville, 1998, 2003; Nagle and Holden, 2002). This strategy states that 'reframing a large aggregate expense as a small daily expense helps to reduce the perceived cost of a transaction' (Gourville, 2003, p. 125). This strategy has been found successful in terms of charitable notations, cellular telephone service, and health club memberships. A question that has not been investigated is how this strategy can be applied to the framing of one's time. For instance, a television commercial for a large tour operator in Europe shows a man lying on a chair that he moves to follow the sun. The voice-over talks about the number of hours this man had to work for each day in the sun. The implication is that it takes a lot of time to earn a vacation and therefore it is worth paying more to make sure the vacation is a good one. In this example the 'pennies-per-day' strategy is used not to minimize the cost, but to maximize it. This approach has yet to be investigated in the published literature and a natural question is: 'Does this approach get customers to pay more money than they normally would?'

Another value worth investigating is 'identification with the organization'. The question here is: will consumers pay more to purchase from a firm that has similar values? This is an important question given that many firms now promote that they are 'carbon neutral' and that their organization is 'green'. Ginsberg and Bloom (2004) state that consumers are willing to pay more for organic foods because they believe them to be safer and healthier. They also state that consumers have been willing to pay price premiums for energy-efficient appliances.

An eighth issue for future research is the presentation of the reservation calendar. Currently these calendars present exact prices, which imply that consumers must make the calculations necessary to examine the price differences between traveling one day versus another. No research has investigated the impact on pricing if a base price is presented and then each day shows the differential from this base. Research could investigate the use of a low base price and an increase for other days or the use of a high base price and a decrease for other days.

A final issue pertains to service guarantees. Service guarantees might influence consumers' value or price perceptions. Companies that consider fixing service failures as a serious business practice might induce higher satisfaction and repurchase intent levels than their counterparts that offer no risk buffers. The interesting question is: will this increase in satisfaction and repurchase intent lead to a willingness to pay higher prices?

Another question of interest pertains to the relationship between what the firm gives back to the customer in terms of a service failure and how much, if anything, the customer will be willing to pay extra for these guarantees. For instance, Starwood Hotels and Resorts provide a sliding scale depending upon what is wrong. For instance, inconveniences such as missing bath amenities or slow check-in are worth \$15, a large problem that can be fixed is worth anywhere from \$25 to \$75, and a large problem that cannot be fixed is worth a free night's stay. Essentially this is an insurance policy for the guest and, like all insurance policies, the amount of 'coverage' translates into higher premiums. Again, modeling the relationship between service guarantees (the coverage) and the price a firm can charge (the premium) is worth investigating.

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