

Pricing Strategies for Services

"Name Your Own Price" with Priceline.com

Priceline.com was launched in 1998 to give customers some leverage in purchasing a variety of services.¹ Using the slogan, "Name Your Own Price," the Internet-based company invited price-conscious consumers to make offers for services such as airline tickets, hotel rooms, rental cars, long-distance phone service, and mortgages. In addition to helping customers save money, Priceline offered sellers an opportunity to generate incremental revenue without disrupting their existing distribution channels or retail pricing structures.

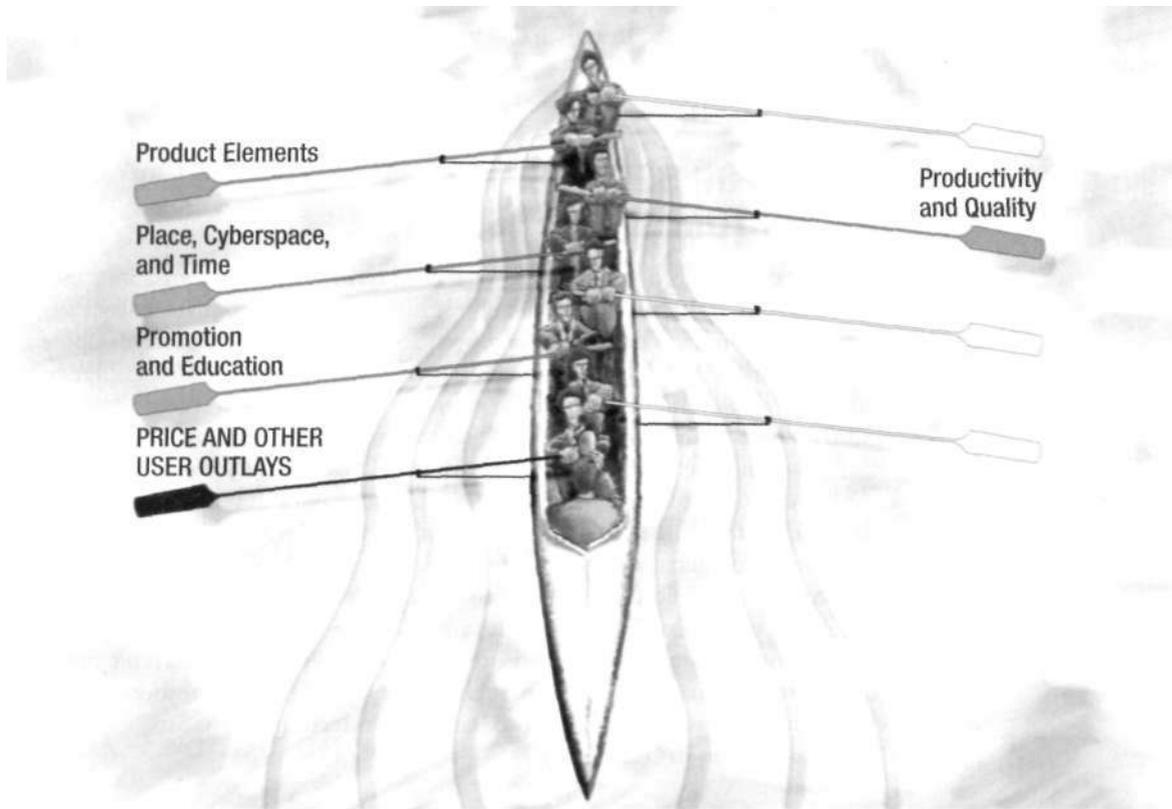
Priceline termed its approach a demand collection system. Through its Web site, the firm collected consumer demand (in the form of individual bids guaranteed by a credit card) for a particular service at prices set by those customers. It then communicated that demand directly to participating sellers or to their private databases. Customers agreed to hold their offers open for a specified period of time, during which Priceline sought to fulfill their offers from inventory provided by participating sellers. Users of the service had to be flexible with regard to brands, sellers, and/or product features. Once fulfilled, purchases normally couldn't be canceled.

The concept of giving customers the freedom to set their own prices initially attracted a lot of attention and enthusiasm. The firm's market value rose to \$20 billion within a month after it went public in 1999. Founder (and then-CEO) Jay Walker expanded Priceline's offerings to include hotel rooms, rental cars, home mortgages, long-distance telephone services, and cars. He also added services like WebHouse Club that allowed customers to bid on groceries and gasoline. Promoted heavily through television advertising featuring actor

William Shatner (best known for his role of Captain Kirk in *Star Trek*), Priceline soon became one of the most widely recognized brand names in e-commerce.

But in spite of Priceline's promising start, things began to go wrong in 2000. Instead of taking a markup on the inventory that it held and resold, Priceline sometimes found itself selling rooms, tickets, and even gasoline at prices below its own cost. There was a growing number of complaints, ranging from hidden airline charges to shabby hotel facilities; consumer dissatisfaction was compounded by poor customer service, eventually leading to an investigation by the attorney general in the company's home state of Connecticut and expulsion from the local Better Business Bureau. The company's business model had worked best in the air travel market, where Priceline accounted for about 4 percent of all ticket sales in the United States. However, new competition emerged in October 2000 when a number of airlines got together to create their own Internet service to dispose of unsold tickets at discounts of up to 40 percent. Named Hotwire, this service differed from Priceline in that users specified their travel needs (but no price) and received an almost immediate fare offer; however, as with Priceline, customers didn't learn the carrier name or precise schedule until after they had purchased the ticket.

WebHouse Club service had to be discontinued in late 2000 when it became clear that suppliers weren't eager to provide groceries or gasoline at cut-rate prices in response to consumer bids. And consumers themselves got frustrated at the conditions that sellers often



attached to sales, such as a requirement to sign up for trial magazine subscriptions.

In response to investigations into consumer complaints, the firm added more customer service reps, improved its training procedures, and instituted more consistent guidelines on problem resolution. Misleading procedures on the Web site were corrected. In particular, the full amount that customers would have to pay for an airline ticket, including all taxes and fuel charges, was disclosed on a single page; previously, the extras were noted on separate screens. Finally, an important phrasing change, from "Submitting my offer now" to "Buy my ticket now" clarified that customers were committing themselves to a purchase if their offer was accepted.

Seeking to sharpen its focus, Priceline announced that it was restructuring its operations, cutting staff, and canceling plans to add cell phone services and insurance. But Hotwire disclosed that it was expanding service to include hotel rooms and international air travel. Further bad news for Priceline came from the departure of key executives and a plummeting stock price.

All in all, the future looked very uncertain for Priceline as it entered 2001, with promises of profits still unfulfilled and news that the company's market valuation on Wall Street had sunk to an all-time low of only \$200 million—down more than 99 percent from its peak.

© Learning Objectives

After reading this chapter, you should be able to

- £> explain how the differences between goods and services affect pricing strategy
- £> appreciate ethical concerns in pricing policy
- £> identify the different outlays customers incur in purchasing and using a service
- £> discuss the relationship between pricing and demand
- ^> understand yield management and how it relates to price elasticity
- ^ describe the key issues in designing and implementing pricing strategies

PAYING FOR SERVICE: THE CUSTOMER'S PERSPECTIVE

Have you ever noticed what a wide variety of terms service organizations use to describe the prices they set? Universities talk about *tuition*, professional firms collect *fees*, and banks charge *interest* on loans or add *service charges*. Some bridges and highways impose *tolls*, transport operators collect *fares*, clubs charge *subscriptions*, utilities set *tariffs*, insurance companies establish *premiums*, and hotels establish *room rates*. These diverse terms are a signal that service industries have historically taken a different approach to pricing than manufacturers.

Answering the question, *What price should we charge for our service?* is a task that can't be left solely to financial managers. The challenges of service pricing require active participation from marketers who understand customer needs and behavior and from operations managers who recognize the importance of matching demand to available capacity. The discussion that follows in this chapter assumes a basic understanding of the economic costs—fixed, semivariable, and variable—incurred by companies, as well as the concepts of contribution and break-even analysis. If you haven't previously been exposed to this material or feel you could benefit from a refresher, you may want to review the information in the box titled "Understanding Costs, Contribution, and Break-Even Analysis" on page 169.

What Makes Service Pricing Different?

Let's consider how some of the differences between goods and services marketing that we discussed in Chapter 1 may affect pricing strategy.

No Ownership of Services It's usually harder for managers to calculate the financial costs involved in creating an intangible performance for a customer 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 hope to price at levels sufficient to achieve a desired profit margin?

Higher Ratio of Fixed Costs to Variable Costs 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 found in manufacturing firms.² Service businesses with high fixed costs include those with an expensive physical facility (e.g., a hotel, a hospital, a university, or a theater), or a fleet of vehicles (e.g., an airline, a bus company, or a trucking company), or a network dependent on company-owned infrastructure (e.g., a telecommunications company, an Internet provider, a railroad, or a gas pipeline). While the fixed costs may be high for such businesses, the variable costs for serving one extra customer may be minimal.

Variability of Both Inputs and Outputs. It's not always easy to define a unit of service, raising questions as to what should be the basis for service pricing. And seemingly similar units of service may not cost the same to produce, nor may they be of equal value to all customers. The potential for variability in service performances (especially those that involve interactions with employees and other customers) means that customers may pay the same price for a service but receive different levels of quality and value. Alternatively, they may be charged radically different prices for the same service offering, as often happens in the hotel industry. Advertising byTravelscape.com, the do-it-yourself travel site, emphasizes its ability to help customers quickly find the cheapest price for a hotel room (see Figure 8.1).

Many Services Are Hard to Evaluate The intangibility of service performances and the invisibility of the backstage facilities and labor make it harder for customers to know what they are getting for their money than when they purchase a physical good.

Consider the homeowners who call an electrical firm, seeking repairs to a defective circuit. A few days later (if they are lucky) an electrician arrives with a small bag of tools. Within 20 minutes, the problem is located and a new circuit breaker installed. Presto, everything works! Subsequently, the owners are horrified to receive a bill for \$65, most of it for labor charges. But they're overlooking all the fixed costs that the firm needs to recover, such as the office, telephone, vehicles, tools, fuel, and support staff. The variable costs of the visit are also higher than they appear. Fifteen minutes of driving back and forth plus 5 minutes to unload (and later reload) needed tools and supplies from the van on arrival at the house must be added to the 20 minutes spent at the customers' house. These activities effectively double the labor time devoted to this call. Finally, the firm

Understanding Costs, Contribution, and Break-Even Analysis

Fixed costs—sometimes referred to as overheads—are those economic costs that a supplier would continue to incur (at least in the short run) even if no services were sold. These costs may include rent, depreciation, utilities, taxes, insurance, salaries and wages for managers and long-term employees, security, and interest payments.

Variable costs refer to the economic costs associated with serving an additional customer, such as making another bank transaction, selling an additional seat in a train or theater, serving an extra hotel guest for the night in a hotel, or completing one more repair job. For many services, such costs are very low. There is, for instance, very little labor or fuel cost involved in transporting an extra bus passenger. Selling a hotel room for the night has slightly higher variable costs, since the room will need to be cleaned and the linens sent to the laundry after a guest leaves. More significant variable costs are associated with activities like serving food and beverages or installing a new part when making repairs, since they include the provision of costly physical products in addition to labor. Just because a firm has sold a service at a price that exceeds its variable costs does not mean that the firm is now profitable. There are still fixed and semivariable costs to be covered.

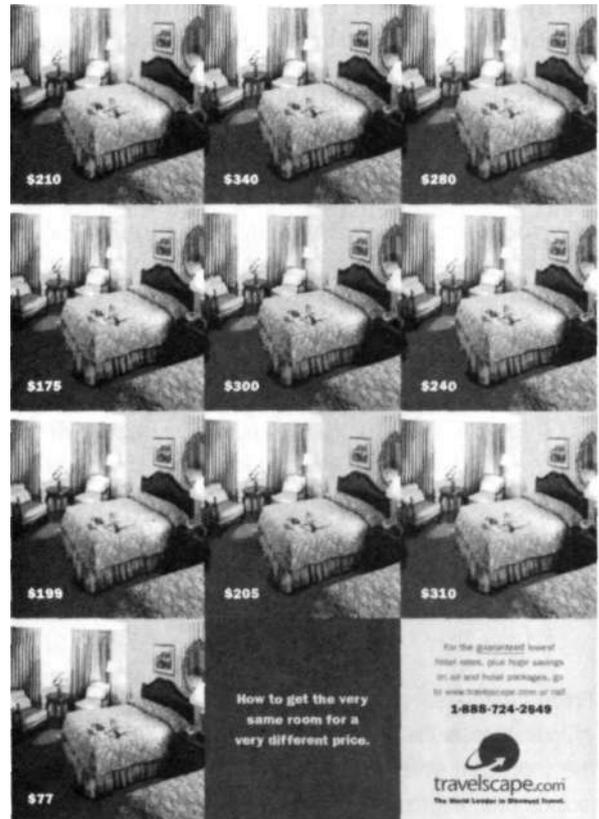
Semivariable costs fall in between fixed and variable costs. They represent expenses that rise or fall in stepwise fashion as the volume of business increases/decreases. Examples include adding an extra flight to meet increased demand on a specific air route, or hiring a part-time employee to work in a restaurant on busy weekends.

Contribution is the difference between the variable cost of selling an extra unit of service and the money received for that service. It goes to cover fixed and semivariable costs before creating profits.

Determining and allocating economic costs can be a challenging task in some service operations. For example, it's difficult to decide how to assign fixed costs in a multi-service facility like a hospital. There are certain fixed costs associated with running the emergency unit. Beyond that there are fixed costs for running the entire hospital. How much of the hospital's fixed costs should be allocated to the emergency unit? A hospital manager might use one of several approaches to calculate the unit's share of overheads. These could include (1) the percentage of total floor space that it occupies, (2) the percentage of employee hours or payroll that it accounts for, or (3) the percentage of total patient contact hours involved. Each method is likely to yield a totally different fixed-cost allocation. One method might indicate that the emergency unit is very profitable, another might make it seem like a break-even operation, and a third might suggest that the unit is losing money.

Break-even analysis. Managers need to know at what sales volume a service will become profitable. This is called the break-even point. The necessary analysis involves dividing the total fixed and semivariable costs by the contribution obtained on each unit of service. For instance, if a 100-room hotel needs to cover fixed and semivariable costs of \$2 million a year and the average contribution per room-night is \$100, then the hotel will need to sell 20,000 room-nights per year out of a total annual capacity of 36,500. If prices are cut by an average of \$20 per room night (or variable costs rise by \$20), then the contribution will drop to \$80 and the hotel's break-even volume will rise to 25,000 room nights.

FIGURE 8.1
Travelscape.com Helps Customers
 Find the Cheapest Price for a
 Hotel Room



has to add a margin to the bill in order to make a profit for the owner. However, these intrinsic costs are not readily visible to the customers, who are making their comparisons of price versus value based solely on visible service attributes.

Importance of the Time Factor Time often drives value. In many instances, customers are willing to pay more for a service delivered at a preferred time than for a service offered at a less convenient time. They may also choose to pay more for faster delivery of some services—compare the cost of express mail against that of regular mail. Sometimes greater speed increases operating costs for the service provider, reflecting the need to pay overtime wages or use more expensive equipment. In other instances, achieving faster turnaround is simply a matter of giving priority to one customer over another. For instance, clothes requiring express dry-cleaning take the same amount of time to clean. The firm saves time for these customers by moving their jobs to the head of the line.

Availability of Both Electronic and Physical Distribution Channels The use of different channels to deliver the same service can affect costs and perceived value. Electronic banking transactions are much cheaper for a bank than face-to-face contact in a branch. While some people like the convenience of impersonal but efficient electronic transactions, others prefer to deal with a real bank teller. Thus, a service delivered through a particular channel may have value for one person but not for another. Companies must balance customer needs and preferences against the desire to reduce production costs, because in some cases customers may be willing to accept a price increase in order to have access to a physical distribution channel.

Ethical Concerns

Services often invite performance and pricing abuses. The problem is especially acute for services that are high in credence attributes, whose quality and benefits are hard to evaluate even after delivery.³

Exploiting Customer Ignorance When customers don't know what they are getting from a service supplier, are not present when the work is being performed, and lack the technical skills to know if a good job has been done, they are vulnerable to paying for work that wasn't done, wasn't necessary, or was poorly executed. Although price can serve as a surrogate for quality, it's sometimes hard to be sure if the extra value is really there. This is an important issue, since customers may rely more heavily on price cues as an indication of service value when perceived risks (e.g., functional, financial, psychological, or social) are high.

Web sites sometimes take advantage of customer ignorance, particularly where airline tickets are concerned. Although there are many Internet travel sites, finding the cheapest fare isn't easy. Priceline initially confused customers by not clarifying that airport taxes and fuel surcharges had to be added to ticket prices.

Complexity and Unfairness Pricing schedules for services are often quite complex. Changing circumstances sometimes result in complicated pricing schedules that are difficult for consumers to interpret. Consider the credit card industry. Traditionally, the banks that issue these cards received revenues from two sources: a small percentage of the value of each transaction (paid by the merchant), and high interest charges on credit balances. As credit cards became more popular, costs started to rise for the banks on two fronts. First, more customers defaulted on their balances, leading to a big increase in bad debts. Second, as competition increased between banks, marketing expenses rose and gold and platinum cards started offering more affluent customers features like free travel insurance, emergency card replacement, and points redeemable for air miles. But as marketing expenses were rising, more customers started to pay off their monthly balances in full and competition led to lower interest rates, resulting in lower revenues. So the banks increased other charges and imposed new fees that were often confusing to customers. Details of charges by one major bank for its platinum card are shown in the box entitled "Charges, Fees, and Terms for a Platinum Visa Card."

Another industry that has gained notoriety for its complex and sometimes misleading pricing schedules is cellular telephone service. *Consumer Reports* has warned its readers about such practices as rounding up calling time to the nearest minute, misrepresentation of "free" service elements that turn out not to be so, and huge cancellation fees (\$150 to \$200) for terminating a one-year contract before it expires.⁵

Complexity makes it easier—and perhaps more tempting—for firms to engage in unethical behavior. The car rental industry has attracted some notoriety for advertising bargain rental prices and then telling customers on arrival that other fees like collision insurance and personal insurance are compulsory. And employees sometimes fail to clarify certain "small print" contract terms such as a high per mile charge that is added once the car exceeds a very low threshold of free miles. The "hidden extras" phenomenon for car rentals in some Florida resort towns got so bad at one point that people were joking: "the car is free, the keys are extra!" A not uncommon practice is to charge fees for refueling a partially empty tank that far exceed what the driver would pay at the pump.

When customers know that they are vulnerable to potential abuse, they become suspicious of both the firm and its employees. Assuming that a firm has honest manage-

ment, the best approach is a proactive one, spelling out all fees and expenses clearly in advance so that there are no surprises. A related approach is to develop a simple fee structure so that customers can easily understand the financial implications of a specific usage situation.

Identifying User Outlays

From a customer's standpoint, the monetary price charged by a supplier is not the only cost or outlay associated with purchase and delivery of a service. Let's take a look at what's involved (see Figure 8.2). As we do so, please consider your own experiences in different service contexts.

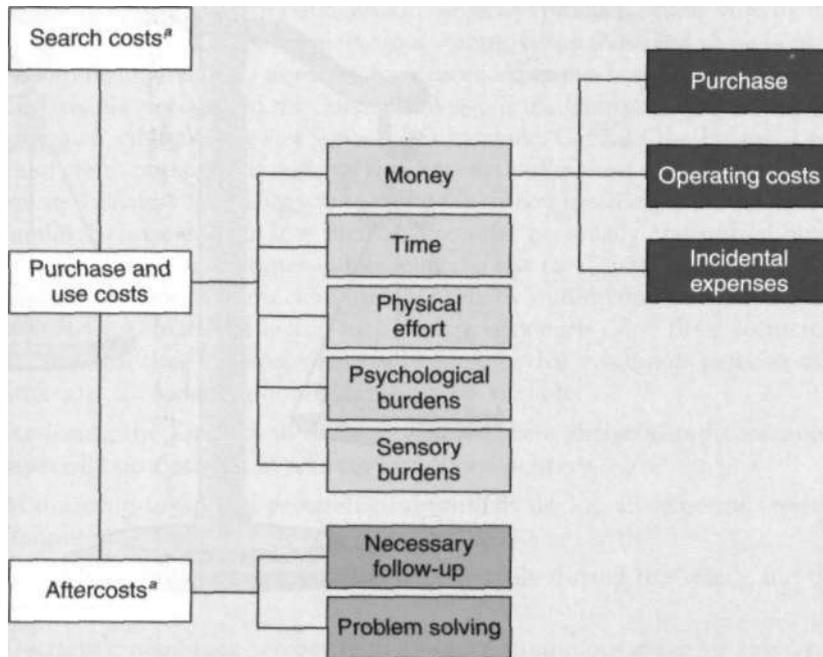
financial outlays: all monetary expenditures incurred by customers in purchasing and consuming a service.

Price and Other Financial Expenses Customers often spend additional amounts over and above the purchase price. Necessary incidental expenses may include travel to the service site, parking, and purchase of other facilitating goods or services ranging from meals to babysitting. We call the total of all these expenses (including the price of the service itself) the **financial outlays** associated with purchasing and consuming a service.

Charges, Fees, and Terms for a Platinum Visa Card

Annual fee	First year free; thereafter \$65
Finance charges on unpaid balances	
Purchases	9.99% (min. charge \$0.50)*
Cash advances	19.99% (min. charge \$0.50)
After failure to make two monthly payments within 6 months (applies to all balances)	22.99%
Transaction charges for purchase of money order, wire transfer, or use of "convenience checks"	3% of transaction value (min. \$5)
Cash advance (use card to obtain money from an ATM or bank)	2% of cash advance value (min. \$10)
Other charges	
Late fee	\$29
Returned check fee (payment)	\$29
Overlimit fee	\$29
Payment terms	Due by 10 A.M. on payment due date specified on monthly statement. Failure to enclose coupon, pay by check or money order, or use envelope provided may result in up to a 5-day delay in posting.

*Minimum annual percentage rates (or prime rate + 0.99%, whichever is higher)
Source: First USA Bank (data taken from card member agreement, amended May 2000).



"Includes all five cost categories

FIGURE 8.2

Determining the Total Costs of a Service: More Than Meets the Eye?

Nonfinancial Outlays Customers may incur a variety of **nonfinancial outlays**, representing the time, effort, and discomfort associated with searching for, purchasing, and using a service. We can group nonfinancial outlays into four distinct categories.

- >• **Time expenditures** are inherent in the service delivery process. Time may also be wasted simply waiting for service. There's an opportunity cost involved because customers could spend that time in other ways.
- >• **Physical effort** (including fatigue, discomfort, and occasionally even injury) may be incurred during visits to the service factory or while using a company's self-service equipment.
- >- **Psychological burdens** like mental effort, feelings of inadequacy, or fear may accompany the tasks of evaluating service alternatives, making a selection, and then using the chosen service. Services that are high in experience and credence attributes may create psychological burdens like anxiety since service outcomes are more difficult to evaluate.
- >- **Sensory burdens** relate to unpleasant sensations affecting any of the five senses. They may include putting up with noise, unpleasant smells, drafts, excessive heat or cold, uncomfortable seating or lighting, visually unappealing environments, and even unpleasant tastes.

The total costs of purchasing and using a service also include those associated with search activities. When you were looking at colleges, how much money, time, and effort did you spend before deciding where to apply? And how much effort would you put into comparing alternative haircutters if your existing one was no longer available? There may even be further outlays after service delivery is completed. A doctor may

nonfinancial outlays: the time expenditures, physical and mental effort, and unwanted sensory experiences associated with searching for, buying, and using a service.

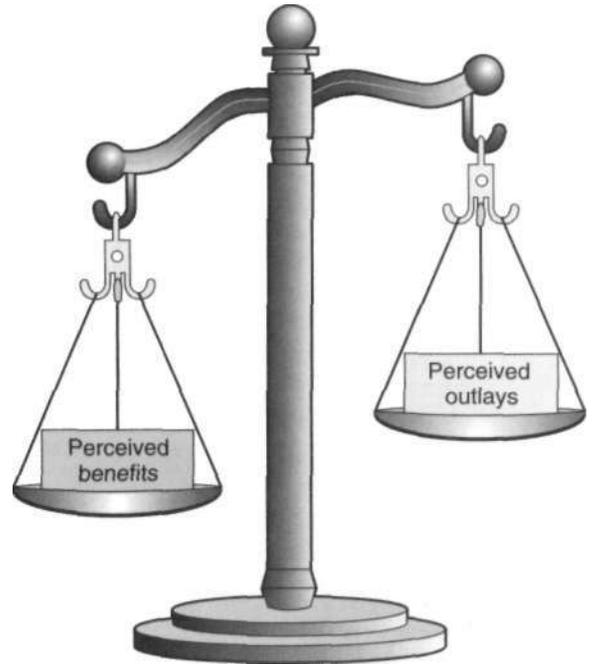
time expenditures: time spent by customers during all aspects of the service delivery process.

physical effort: undesired consequences to a customer's body that occur during the service delivery process.

psychological burdens: undesired mental or emotional states experienced by customers as a result of the service delivery process.

sensory burdens: negative sensations experienced through a customer's five senses during the service delivery process.

FIGURE 8.3
 Net Value = Benefits — Outlays



diagnose a medical problem for a patient and then prescribe a course of physical therapy and drugs to be continued over several months. Obtaining refunds after service failures may force customers to waste time, money, and effort in trying to resolve the problem.

Understanding Net Value

When customers evaluate a service, they consider the benefits it offers relative to the financial and nonfinancial outlays they will incur in purchasing and using it. Although there are several ways to describe value, we have chosen to define value as "what I get for what I give."⁶ **Net value** is defined as the sum of all the perceived benefits (gross value) minus the sum of all the perceived outlays for the customer. The greater the positive difference between the two, the greater the net value. If the perceived costs and other outlays are greater than the perceived benefits, then the service in question will possess negative net value.

Perceptions of net value may vary widely between customers, and even for the same customer depending on the situation. How customers feel about the net value of a service may be sharply different post-use and pre-use, reflecting the experiential qualities of many services. When customers use a service and find that it has cost more and delivered fewer benefits than expected, they are unlikely to repurchase it and may complain about "poor value."

You can think of the value calculations that customers make in their minds as being similar to weighing materials on an old-fashioned pair of scales, with product benefits in one tray and the outlays associated with obtaining those benefits in the other (see Figure 8.3). When customers evaluate competing services, they are basically comparing the relative net values.

Increasing Net Value by Reducing Nonfinancial Outlays

Although our focus in this chapter is mainly on the monetary aspects of pricing, you've probably noticed that people often pay a premium to save time, minimize unwanted effort, and obtain greater comfort. In other words, they are willing to pay higher prices to reduce

net value: the sum of all perceived benefits (gross value) minus the sum of all perceived outlays.

their nonfinancial outlays. Marketers can increase the net value of a service by adding benefits to the core product, enhancing supplementary services, or reducing the financial costs and other outlays associated with purchase and use of the product. People who fly first class versus coach class are paying for more spacious seating, better food, and more personalized attention from flight attendants in return for a more expensive fare. Other types of service companies have also recognized the different trade-offs that customers are willing to make and have created multiple levels of service. For example, Capital One Financial provides thousands of credit card options with varying benefits and interest rates. The company uses its sophisticated database technology to segment the market based on spending patterns and other consumer characteristics. It is then able to offer personally customized bundles of benefits that add value for customers while reducing risk for Capital One.⁷

In many cases, service firms can improve value by minimizing unwanted nonfinancial outlays for customers. Reducing such outlays may even cause firms to increase the monetary price for their services while still offering what customers perceive as "good value." Strategies for reducing nonfinancial outlays include:

- >• Reducing the time involved in service purchase, delivery, and consumption—especially time wasted in waiting for service delivery
- >- Minimizing unwanted psychological burdens during all stages of service consumption
- >• Eliminating unwanted physical effort, especially during the search and delivery processes
- >- Decreasing unpleasant sensory burdens by creating more attractive visual environments, reducing noise, installing more comfortable furniture and equipment, curtailing offensive smells, and ensuring that foods, drinks, or medicines taste appealing

FOUNDATIONS OF PRICING STRATEGY

The foundations underlying pricing strategy can be described as a tripod, with costs to the provider, competition, and value to the customer as the three legs (see Figure 8.4). The costs that a firm needs to recover usually impose a minimum or floor price for a specific service offering. The perceived value of the offering to customers sets a maximum, or ceiling. The price charged by competitors for similar services typically deter-

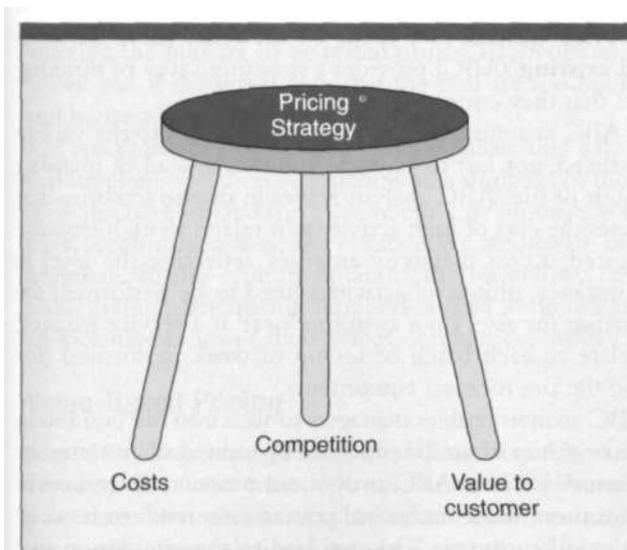


FIGURE 8.4
The Pricing Tripod

mines where, within the floor-to-ceiling range, the price should actually be set. Let's look at each leg of the pricing tripod in more detail.

Cost-Based Pricing

cost-based pricing: the practice of relating the price to be charged to the costs associated with producing, delivering, and marketing a product.

Cost-based pricing involves setting prices relative to financial costs. Companies seeking to make a profit must set a price sufficient to recover the full costs—variable, semi-variable, and fixed—of producing and marketing a service. A sufficient margin must also be added to provide the desired level of profit at the predicted sales volume. When fixed costs are high and the variable costs of serving an additional customer are very low, managers may feel that they have tremendous pricing flexibility and be tempted to price low in order to make an extra sale. However, there can be no profit at the end of the year unless all relevant costs have been recovered. Firms that compete on the basis of low prices need to analyze their cost structure and identify the sales volume needed to break even at particular prices.

Regulatory Pressures Not all service firms are free to charge whatever price they choose. Most local utilities—like telephone, water, cable TV, electricity, and gas—have been regulated historically by government agencies that control all changes in prices and terms of service. Industry regulators or politicians, responding to complaints about excessively high prices, sometimes put pressure on these types of businesses to clarify and account for service costs.

Sometimes companies lack the necessary information to calculate the costs associated with serving different types of users. In this case, managers may simply determine the total costs incurred during a certain period, divide them by actual unit sales, calculate an average cost per unit of service (e.g., kilowatt-hours or monthly phone line rental fees), and add a certain percentage for profit. However, more sophisticated costing analysis in the telecommunications industry has shown that this is not always the most effective pricing strategy. The results of this analysis indicated that business users had been subsidizing household subscribers who were, in fact, much more expensive to serve. The net result was a shift in regulatory policy to allow relatively larger price increases for households than for business users.

Activity-Based Costing It's a mistake to look at costs from just an accounting perspective. Progressive managers view them as an integral part of their company's efforts to create value for customers.⁸ Unfortunately for the accountants, costs have nothing to do with value, which is market driven. Customers aren't interested in what it costs the firm to produce a service; instead, they focus on the relationship between price and value. **Activity-based costing** (ABC) provides a structured way of thinking about activities and the resources that they consume.

activity-based costing: an approach to costing based on identifying the activities being performed and then determining the resources that each consumes.

Many firms have developed ABC systems that link resource expenses to the variety and complexity of products produced, not just to physical volume. Instead of focusing on expense categories, such as labor or fuel, ABC analysis zeroes in on the activities that are performed and then determines the cost of each activity as it relates to each expense category. As activities are segregated, a cost hierarchy emerges, reflecting the level at which the cost is incurred. For instance, unit-level activities need to be performed for each unit of service (such as rotating the tires on a customer's car at a service garage), whereas batch-level activities relate to each batch or set-up of work performed (for instance, periodically maintaining the tire rotation equipment).

Cooper and Kaplan note "ABC analysis enables managers to slice into the business in many different ways—by product or group of similar products, by individual customer or client group, or by distribution channel."¹⁰ Thus ABC analysis can pinpoint differences in the costs of serving individual customers, while traditional cost analysis tends to result in loading the same overhead costs on all customers. This can lead to the assumption that

large customers are more profitable. But a large customer who makes extensive demands on a supplier may, in fact, be less profitable than a small and undemanding customer.

Controlling costs by cutting back certain activities often leads to reduced value for customers because a curtailed activity may be crucial to providing a certain level and quality of service. Many telecommunications firms created marketing problems for themselves when they dismissed customer service staff to save money. This strategy resulted in a sharp decline in service responsiveness that led discontented customers to take their business elsewhere.

Competition-Based Pricing

If customers see little or no difference between the services offered in the marketplace, they may just choose the cheapest alternative. Under conditions of **competition-based pricing**, the firm with the lowest cost per unit of service enjoys an enviable marketing advantage. It has the option of either competing on price at levels that higher-cost competitors cannot afford to match, or charging the going market rate and earning larger profits than competing firms.

Price Leadership In some industries, one firm may act as the **price leader**, with others taking their cue from this company. You can see this phenomenon at the local level when several gas stations compete within a short distance of one another, or on opposite corners of a crossroads. As soon as one station raises or lowers its prices, each of the others will follow promptly. During boom times in competitive industries such as airlines, hotels, and rental cars, firms are often willing to go along with the leader since prices tend to be set at a level that allows good profits. However, during an economic downturn, these industries quickly find themselves with surplus productive capacity. To attract more customers, one firm (often not the original leader) may cut prices. Since pricing is the easiest and fastest marketing variable to change, a price war may result overnight as competitors rush to match the competition's bargain prices.

Price Bids and Negotiations Industrial buyers sometimes request bids from competing service suppliers. Companies who outsource contracts to provide food service or facilities maintenance often use this approach to pricing. Under these conditions, each bidder needs to review costs and think about what the buyer might be willing to pay in addition to estimating the level of bid that competitors are likely to submit. The more tightly specified the buyer's requirements, the less opportunity there is to differentiate one bidder's offer from another. The terms of the bid will specify whether the bids are to be sealed or not, and whether the buyer is obligated to take the lowest bid. If the buyer feels that the bids are too high, it may change the specifications and invite a new round of bidding.

An alternative to bidding is negotiation. The firm may request proposals from several suppliers and then negotiate with a short list of those firms that seem the most qualified and have offered the most relevant or innovative approaches. Large consulting projects, accounting audits, and engineering studies are often initiated through requests for proposals. In this type of situation, the buyer may conduct several rounds of negotiations, giving participating suppliers at least some information about competing offers as an incentive to lower their prices, conduct the work faster, or offer more features.

Value-Based Pricing

Service pricing strategies are often unsuccessful because they lack any clear association between price and value.¹¹ In discussing **value-based pricing**, Berry and Yadav propose three strategies for capturing and communicating the value of a service: uncertainty reduction, relationship enhancement, and cost leadership.

competition-based pricing: the practice of setting prices relative to those charged by competitors.

price leader: a firm that takes the initiative on price changes in its market area and is copied by others.

value-based pricing: the practice of setting prices with reference to what customers are willing to pay for the value they believe they will receive.

benefit-driven pricing: the strategy of relating the price to that aspect of the service that directly creates benefits for customers.

flat-rate pricing: the strategy of quoting a fixed price for a service in advance of delivery.

Pricing Strategies to Reduce Uncertainty If customers are unsure about how much value they will receive from a particular service, they may remain with a known supplier or not purchase at all. **Benefit-driven pricing** helps reduce uncertainty by focusing on that aspect of the service that directly benefits customers (requiring marketers to research what aspects of the service the customers do and do not value). This strategy requires firms to communicate service benefits clearly so that customers can see the relationship between value and costs. **Flat-rate pricing** involves quoting a fixed price in advance of service delivery so that there are no surprises. This approach transfers the risk from the customer to the supplier in the event that service production costs more than anticipated. Flat-rate pricing can be an effective differentiation tool in industries where service prices are unpredictable and suppliers are poor at controlling their costs.

Relationship Enhancement In general, discounting to win new business is not the best way to attract customers who will remain loyal over time, since those who are attracted by cut-rate pricing are easily enticed away by competing offers. However, offering discounts when customers purchase two or more services together may be a viable relationship-building strategy. The greater the number of different services a customer purchases from a single supplier, the closer the relationship is likely to be. Both parties get to know each other better, and it's more inconvenient for such customers to take their business elsewhere.

Cost Leadership This strategy is based on achieving the lowest costs in an industry. Low-priced services have particular appeal to customers who are on a tight financial budget. They may also lead purchasers to buy in larger volumes. One challenge when pricing low is to convince customers that they shouldn't equate price with quality—they

Southwest Airlines: Low-Price Leader with a Low-Cost Culture

The most consistently profitable airline in North America is Southwest Airlines, which emphasizes relatively short-haul, point-to-point routes within the United States and has no international service.¹³ Southwest's strategy is to price low enough to compete with surface travel by car, bus, or train, rather than pricing to compete against other airlines. Whenever it enters a new market, demand increases substantially as people shift from other modes of transportation, start to travel more frequently, or make trips they would not previously have made before.

Supporting Southwest's low-price marketing efforts is a low-cost operational strategy and a culture among the airline's dedicated employees of doing everything possible to keep costs low, including working very productively. "Thanks to the Culture at Southwest Airlines," observed a recent annual report, "we do not have to motivate our Employees with programs to reduce costs; rather it is their goal each and every day."

By minimizing the amount of time aircraft spend at the gate, Southwest keeps them in the air more hours per day. Using only one aircraft type, the Boeing 737, in its fleet of some 350 aircraft simplifies the airline's operation and saves further costs. Southwest offers a very basic core service (transportation), with few of the supplementary elements found in full-service carriers. But it manages customer expectations so that travelers are not surprised to find no reserved seats, no meals, and no baggage transfer to other airlines. The absence of these supplementary services contributes to Southwest's record as having the lowest costs per seat-mile of any major American carrier. Southwest creates value by saving its customers time and money and by doing a superb job of delivering basic air transportation safely, reliably, and consistently, with friendly employees providing a human touch.

must feel they are also getting good value. A second challenge is to ensure that economic costs are kept low enough to enable the firm to make a profit. Some service businesses have built their entire strategy around being the **cost leader**, which enables them to remain profitable despite rock bottom prices. Southwest Airlines provides a classic case of a focused low-cost pricing strategy that continues to be highly successful. The airline's approach is based on a low-cost culture that competitors find difficult to imitate (see the boxed story "Southwest Airlines: Low-Price Leader with a Low-Cost Culture").

cost leader; a firm that bases its pricing strategy on achieving the lowest costs in its industry.

PRICING AND DEMAND

In most services, there's an inverse relationship between price levels and demand levels. Demand tends to fall as price rises. This phenomenon has implications for revenue planning and also for filling capacity in businesses that experience wide swings in demand over time.

Price Elasticity

The concept of elasticity describes how sensitive demand is to changes in price. When **price elasticity** is at "unity," sales of a service rise (or fall) by the same percentage that prices fall (or rise). When a small price change has a big impact on sales, demand for that product is said to be *price elastic*. But when a change in price has little effect, demand is described as *price inelastic*. One advantage of Internet-based marketing is that it gives firms the opportunity to test prices continuously to determine customers' responses to price variations.¹⁴

price elasticity: the extent to which a change in price leads to a corresponding change in demand in the opposite direction. (Demand is described as "price inelastic" when changes in price have little or no impact on demand.)

Demand can often be segmented according to customers' sensitivity to price or service features. For example, few theaters, concert halls, and stadiums have a single, fixed admission price for performances. Instead, prices vary according to (1) seat locations, (2) performance times, (3) projected staging costs, and (4) the anticipated appeal of the performance. In establishing prices for different blocks of seats and deciding how many seats to offer within each price block (known as scaling the house), theater managers need to estimate the demand within each price category. A poor pricing decision may result in many empty seats in some price categories and immediate sell-outs (and disappointed customers) in other categories.

Management also needs to know theatergoers' preferences for scheduling of performances, such as matinees versus evenings, weekends versus weekdays, and even seasonal variations. In each instance, the goal is to manage demand over time to maximize attendance, revenues, or a combination of the two (e.g., maximizing revenues, subject to a minimum attendance goal of 70 percent of all seats sold at each performance). A good reason for seeking to achieve sell-outs is that they encourage people to book and pay in advance (thus committing themselves) instead of waiting until the last minute when they might change their minds.

What if the mission statement includes the goal of attracting less-affluent segments, such as students and senior citizens? In such cases, management may wish to set aside some seats at a discount for people in those target segments. In a theater context, this social goal is sometimes addressed by offering unsold tickets at deeply discounted prices on the day of the performance.

Yield Management

Service organizations often use the percentage of capacity sold as a measure of operational efficiency. By themselves, however, these percentage figures tell us little about the relative profitability of the customer base. High utilization rates may be obtained at the expense of heavy discounting, or even outright give-aways.

yield managements a pricing strategy based on charging different prices to different users in order to maximize the revenue yield that can be derived from a firm's available capacity at any specific point in time.

price bucket: an allocation of service capacity (for instance, seats) for sale at a particular price.

rate fences: techniques for separating customers so that segments for whom the service offers high value are unable to take advantage of lower-priced offers.

auction: a selling procedure managed by a specialist intermediary in which the price is set by allowing prospective purchasers to bid against each other for a product offered by a seller.

Yield management pricing strategies are based on maximizing the revenue yield that can be derived from available capacity at any given time. Effective yield management models can significantly improve a company's profitability. Airlines, hotels, and car rental firms, in particular, have become adept at varying their prices in response to the price sensitivity of different market segments at different times of the day, week, or season. The challenge is to capture sufficient customers to fill the organization's perishable capacity without selling at lower prices to those customers who would have been willing to pay more.

How does a firm know what level of demand to expect at different prices in a market environment where the factors influencing demand are constantly changing? Many markets are very dynamic. For instance, the demand for both business and pleasure travel changes in response to competition and economic conditions. Although business travelers may be less sensitive to price changes, tourists and other pleasure travelers may be so price sensitive that special promotions involving discounted airfares and hotel room rates can encourage them to undertake trips that they wouldn't otherwise have made.

Advances in software and computing power have made it possible for managers to use sophisticated mathematical models to address complicated yield management issues. In the case of an airline, for example, these models integrate massive historical databases on past passenger travel with real-time information on current bookings. The output helps analysts predict how many passengers would want to travel between two cities at a particular fare on a flight leaving at a specified time and date. Airlines use yield management analysis to allocate seats at different fares (known as **price buckets**) for a specific flight with the objective of improving its yield.

The use of price buckets illustrates the concept of price customization—that is, charging different customers different prices for what is, in effect, the same product. The basic idea is simple: have people pay prices based on the value they put on the product. As Simon and Dolan point out, "Obviously you can't just hang out a sign saying 'Pay me what it's worth to you' or 'It's \$80 if you value it that much but only \$40 if you don't.' You have to find a way to segment customers by their valuations. In a sense, you have to 'build a fence' between high-value customers and low-value customers so the 'high' buyers can't take advantage of the low price."¹⁵ Successful yield management strategies require an understanding of the shape of the demand curve and an ability to relate the size and price levels of the different "buckets" to different value segments (see Figure 8.5).

Fencing Mechanisms Firms need to be able to separate or "fence off" different value segments so that customers for whom the service offers high value are unable to purchase it cheaply. **Rate fences** can be either physical or nonphysical and involve setting qualifications that must be met in order to receive a certain level of discount from the full price.¹⁶ Physical fences include observable characteristics of the customer (like child versus adult) and service characteristics such as class of travel, type of hotel room, or inclusion of certain amenities with a higher price (free breakfast at a hotel, free golf cart at a golf course). Nonphysical fences include penalties for canceling or changing an inexpensive reservation, requirements for advance purchase, group membership or affiliation, and time of use (e.g., happy hours in bars before 8:00 P.M., travelers must stay over a Saturday night to obtain a cheap airline booking).

Customer-Led Pricing: Auctions and Bids

One method of pricing that has attracted a lot of attention with the advent of the Internet is inviting customers to bid the price that they are prepared to pay. The Internet provides a good medium for **auctions** because of its ability to aggregate buyers from all around the world. DoveBid, a long-established auctioneer of capital assets, now

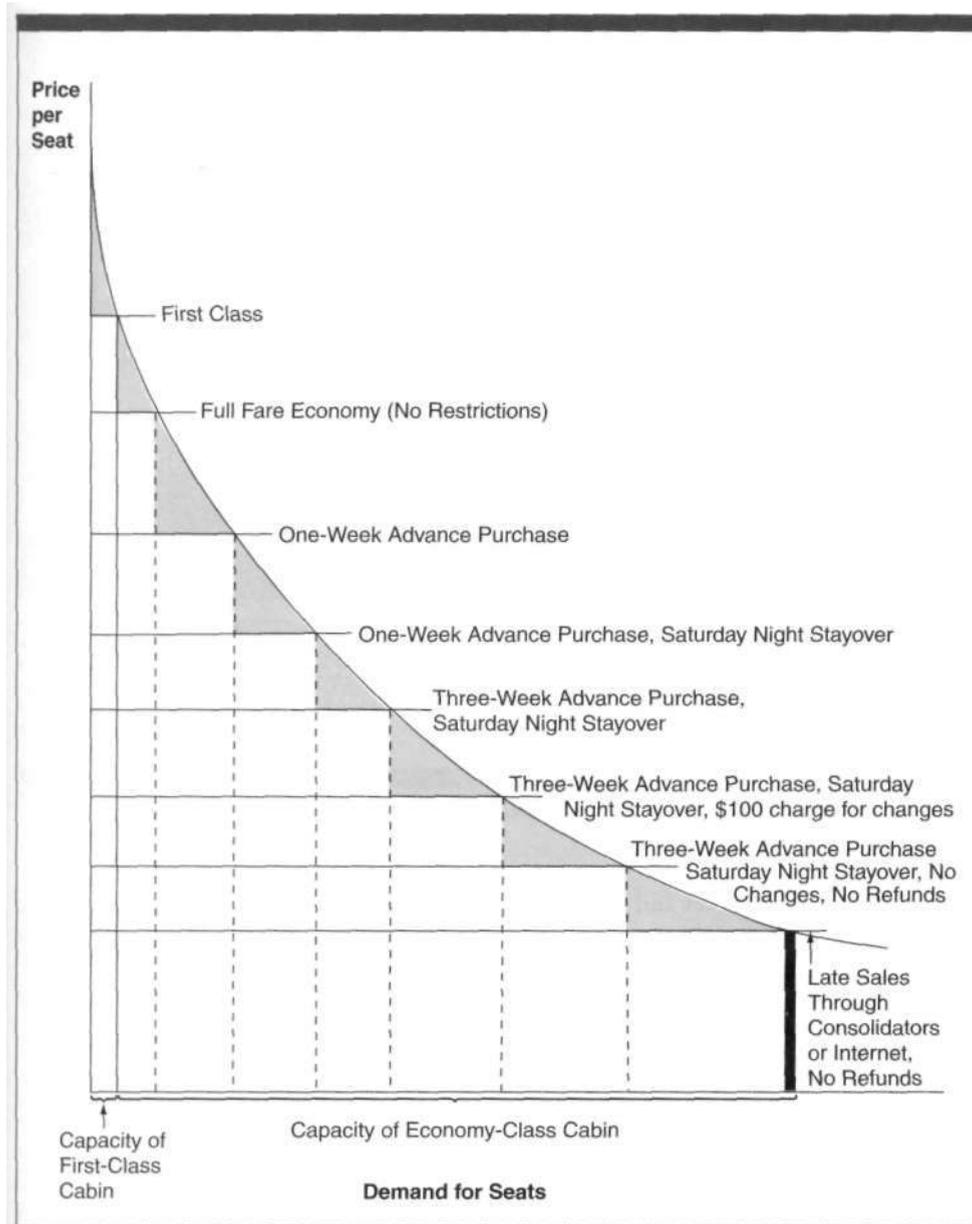


FIGURE 8.5

Relating Price Buckets and Fences to the Shape of the Demand Curve for a Specific Flight

Note: Shaded areas denote amount of consumer surplus (goal of segmented pricing is to minimize this).

conducts Webcast business auctions worldwide (Figure 8.6). DoveBid's Webcast auctions are open-outcry auctions broadcast live via the Internet, allowing remote buyers around the globe to bid real-time against bidders who are on-location at plant auctions. This type of auction increases the number of auction bidders as well as creating price premiums. Auctions employing the speed and reach of the Internet are particularly useful for corporate purchasers seeking to identify sellers of such time-sensitive service products as energy, telecommunications capacity, and advertising space, and then bid competitively for the amount and type that they need.¹⁷

The Web also offers many opportunities for consumers to bid on prices for goods and services. eBay.com (which describes itself as "the world's online marketplace")

FIGURE 8.6
In Auctions, the Highest Bidder
Usually Sets the Selling Price



**IN THE WORLD OF
B2B AUCTIONS,
ALL PEOPLE WANT
ARE RESULTS.**

**(HOW DOES SELLING OVER \$3 BILLION
IN CAPITAL ASSETS SOUND?)**

These days the only thing anyone wants to hear about are results. Well, that's perfectly fine with us, because we've got plenty of them. DoveBid has sold well over \$3 billion worth of capital assets for hundreds of the world's leading companies including Packard Bell, Harris, Fujitsu, Boeing, Lockheed-Martin and DaimlerChrysler.

DoveBid has 63 years of auction experience, and has successfully conducted over 5,000 auctions worldwide. Plus, with our live webcasts, we can now reach more buyers than ever before. So whatever capital assets you want to buy or sell, come to www.dovebid.com. Because if it's results you want, it's results you'll get.

Check website for upcoming webcast auctions.
www.dovebid.com

DOVEBID
Business Auctions Worldwide

dominates the U.S. market and has plans to expand worldwide. Its unique approach to helping individual customers sell to each other is reflected in the following statement from its home page:

*Welcome! eBay is the world's first, biggest and best person-to-person online trading community. It's your place to find the stuff you want, to sell the stuff you have and to make a few friends while you're at it.*¹⁸

Some financial services are sold through auctions. Rather than approaching individual financial institutions for a mortgage or other loan, borrowers can enter their requirements and personal situations at a Web site that solicits bids for the required loans. And online market makers let buyers decide how much they are willing to offer for many other types of services. uBid.com recently held an auction for an eight-day Hawaiian vacation on its site. The highest accepted bid was \$519, but most successful bidders ended up paying only \$99!¹⁹

PUTTING PRICING STRATEGIES INTO PRACTICE

Although the main decision in pricing is usually seen as how much to charge, there are other important decisions to be made. Table 8.1 summarizes the questions that service marketers need to ask themselves as they design and implement a pricing strategy.

How Much to Charge?

Realistic decisions on pricing are critical for financial solvency. The pricing tripod model (Figure 8.4) provides a useful departure point. The task begins with determining the relevant financial costs, which set the relevant "floor" price. The second step is to

establish a "ceiling" price for specific market segments. This involves assessing market sensitivity to different prices, which reflects both the overall value of the service to prospective customers and their ability to pay. Competitive prices provide a third input. The greater the number of similar alternatives, the greater the pressure to keep prices at or below those of the competition. The situation is particularly challenging when some competitors choose to compete on the basis of low price and couple this with an operating strategy designed to achieve low costs, as does Southwest Airlines.

The wider the gap between the floor and ceiling prices, the more room there is for maneuvering. If a ceiling price is below the floor price, the manager has several choices. One alternative is to recognize that the service is noncompetitive, in which case it should be discontinued. The other is to modify it in ways that differentiate it from the competition and add value for prospective customers. This makes it competitive at a higher price.²⁰

Finally, a specific figure must be set for the price that customers will be asked to pay. Should the firm price in round numbers or try to create the impression that prices are

TABLE 8.1
Some Pricing Issues

1. How much should be charged for this service?
 - a. What costs is the organization attempting to recover? Is the organization trying to achieve a specific profit margin or return on investment by selling this service?
 - b. How sensitive are customers to different prices?
 - c. What prices are charged by competitors?
 - d. What discount(s) should be offered from basic prices?
 - e. Are psychological pricing points (e.g., \$4.95 versus \$5.00) customarily used?
2. What should be the basis of pricing?
 - a. Execution of a specific task
 - b. Admission to a service facility
 - c. Units of time (hour, week, month, year)
 - d. Percentage commission on the value of the transaction
 - e. Physical resources consumed
 - f. Geographic distance covered
 - g. Weight or size of object serviced
 - h. Should each service element be billed independently?
 - i. Should a single price be charged for a bundled package?
3. Who should collect payment?
 - a. The organization that provides the service
 - b. A specialist intermediary (travel or ticket agent, bank, retailer, etc.)
 - c. How should the intermediary be compensated for this work—flat fee or percentage commission?
4. Where should payment be made?
 - a. The location at which the service is delivered
 - b. A convenient retail outlet or financial intermediary (e.g., bank)
 - c. The purchaser's home (by mail or phone)
5. When should payment be made?
 - a. Before or after delivery of the service
 - b. At which times of day
 - c. On which days of the week
6. How should payment be made?
 - a. Cash (exact change or not?)
 - b. Token (where can these be purchased?)
 - c. Stored value card
 - d. Check (how to verify?)
 - e. Electronic funds transfer
 - f. Charge card (credit or debit)
 - g. Credit account with service provider
 - h. Vouchers
 - i. Third-party payment (e.g., insurance company or government agency)?
7. How should prices be communicated to the target market?
 - a. Through what communication medium? (advertising, signage, electronic display, sales people, customer service personnel)
 - b. What message content (how much emphasis should be placed on price?)

slightly lower than they really are? If competitors set prices like \$4.95 or \$19.95, then charging \$5.00 or \$20.00 may make the firm appear uncompetitive. However, most services (aside from car rental firms and hotels) tend to avoid odd pricing—perhaps because this pricing strategy is often associated with a discount or low-quality image.²¹

An ethical issue concerns the practice of promoting a price that excludes tax, service charges, and other extras. This approach is misleading if customers expect the quoted price to be inclusive. Managers also need to recognize that changes in pricing policy sometimes result in consumer opposition. For instance, new ATM surcharges have generated numerous complaints about "price gouging" (see box titled "Consumers Protest ATM Surcharges").

What Should Be the Basis for Pricing?

To set a price, managers must define the unit of service consumption. Should it be based on completing a specific service task, such as repairing a piece of equipment, cleaning a jacket, or cutting a customer's hair? Should it be based on admission to a service performance, such as an educational program, film, concert, or sports event? Should it be time based, as in using an hour of a lawyer's time, occupying a hotel room for a night, or renting a car for a week? Should it be tied to value, as when an insurance company scales its premiums to reflect the amount of coverage provided or a realtor takes a percentage commission on the selling price of a house?

Some service prices are tied to consumption of physical resources like food, water, or natural gas. Rather than charging customers an hourly rate for occupying a table and

Consumers Protest ATM Surcharges

Most banks charge their customers an extra fee when they use a "foreign" ATM (that is, one belonging to another bank). This surcharge is on top of any service charges for account activity, which might be as much as \$1.25 per transaction if the balance falls below a certain level. The surcharge, initially \$1.00, was first implemented in 1996 after heavy lobbying by banks to convince the two largest ATM networks—Visa's "Plus" and MasterCard's "Cirrus"—to withdraw their ban on additional surcharges. The banks argued successfully that permitting surcharges would encourage placement of ATMs in useful, but out-of-the-way places where volume would be lower. By 1999, 90 percent of all banks were surcharging at an average rate of \$1.35; in addition, all independently owned ATMs imposed charges, averaging \$1.59 per transaction. The result was accusations by consumer groups of price gouging, leading to growing political pressure in the United States to limit or even ban surcharges. Banks responded with claims that making ATMs available to noncustomers was a service that offered value and that people were clearly prepared to pay for this convenience. However, data showed ATM usage peaking in late 1999 as more people used their

debit cards to obtain cash when making purchases at grocery stores, which don't typically charge fees.

The big winners from surcharges appear to be several dozen small companies that install inexpensive ATMs and connect them to a national network. These nonbank ATMs impose a double surcharge: first the \$1 + fee for use of a "foreign" ATM *plus* an additional charge that may be as high as \$3 for a simple cash withdrawal. To make matters worse, nonbank ATMs often fail to disclose the extra surcharge. The first that users know about it is when they find it billed to their bank accounts.

Despite these drawbacks, many small business owners approve of the nonbanks' approach to doing business. When the owner of a minimart was unable to persuade a bank to put an ATM in his store, he leased a machine from a company for about \$300 a month. Users pay an extra \$1.50 surcharge for each transaction, of which \$0.80 goes to the minimart owner. He claims that, thanks to the machine, his store attracts more customers and sells more merchandise, netting him a profit of up to \$50 a month after paying the leasing fee.

chairs, restaurants put a sizeable mark-up on the food and drink items consumed. Long-distance phone call pricing reflects a combination of distance and time rates. Transportation firms have traditionally charged by distance, with freight companies using a combination of weight or cubic volume and distance to set their rates. Another straightforward pricing strategy involves charging a flat rate, like postal charges for domestic letters below a certain weight or a zone rate for packages that groups geographic distances into broad clusters. These policies have the virtue of consistency, but they ignore relative market strength on different routes.

Price Bundling Many services unite a core product with various supplementary services, such as a cruise ship where the tariff includes meals and bar service. Should such service packages be priced as a whole (referred to as a "bundle"), or should each element be priced separately? If people prefer to avoid making many small payments, **price bundling** may be preferable—and it's certainly simpler to administer. However, if customers dislike being charged for product elements they don't use, itemized pricing may be better. Bundled prices offer a guaranteed revenue from each customer, while giving users a clear idea in advance of how much the bill will be. By contrast, unbundled pricing provides customers with flexibility. Some firms offer an array of choices. Mobile phone subscribers, for instance, can select from among several service options. One choice involves paying a small monthly fee for a basic service and then extra for each call. Another alternative is to pay a higher flat rate in return for several hundred minutes of calling time. At the top of the pricing scale is the option that provides business users with unlimited access to long-distance calls over a prescribed area.

price bundling: the practice of charging a base price for a core service plus additional fees for optional supplementary elements.

Discounting To attract the attention of prospective buyers or to boost sales during a period of low demand, firms may discount their prices, often publicizing this price cut with coupons or an advertising campaign. Marketers of subscription services, such as cable television, Internet service, cellular telephone service, or credit cards, often employ a strategy of offering the service at a discount—or even free of charge—for an introductory period. There are risks to a **discounting** strategy. It dilutes the contribution from each sale, may attract customers whose only loyalty is to the firm that can offer the lowest price on the next transaction, and may give a bargain to customers who would have been willing to pay more. Nevertheless, selective price discounting targeted at specific market segments can help to fill capacity that would otherwise go unused. Volume discounts are sometimes used to cement the loyalty of large corporate customers, who might be inclined to spread their purchases among several different suppliers. Rewarding smaller customers by occasionally offering them a discount off their next purchase may also build loyalty.

discounting! a strategy of reducing the price of an item below the normal level.

Who Should Collect Payment?

Sometimes firms choose to delegate provision of supplementary services like billing to an intermediary. Although the original supplier pays a commission, using a third party may still be cheaper and more efficient than performing those tasks itself. Commonly used intermediaries include travel agents who make hotel and transportation bookings; ticket agents who sell seats for theaters, concert halls, and sports stadiums; and retailers who sell services ranging from prepaid phone cards to home and equipment repair.

Where Should Payment Be Made?

Payment for many services is collected at the service facility just before or immediately following service delivery. When consumers purchase a service well in advance of using it, there are obvious benefits to using intermediaries that are more conveniently located, or allowing payment by mail. (Airports, theaters, and stadiums, for instance, are often situated

some distance from where potential customers live or work.) A growing number of service providers now accept credit cards for telephone bookings and sales over the Internet.

The simplicity and speed with which payment is made may influence the customer's perceptions of overall service quality. Thus service firms should pay special attention to providing payment collection procedures that are both efficient and effective from both the customers' and the companies' perspectives. Poorly designed payment methods may encourage "jaycustomer" behaviors like delayed payments—or worse yet—no payment at all. For example, one driver told a journalist that he refuses to pay tolls at New Jersey's automated tollbooths "on principle, because the toll plazas are badly designed and irritating—the state set up a system so bad, you have to abuse it.

When Should Payment Be Made?

Two basic options are to ask customers to pay in advance (e.g., an admission charge, airline ticket, or postage stamps), or to bill them on completion of service delivery (e.g., restaurant bills and repair charges). Occasionally a service provider may ask for an initial payment in advance of service delivery, with the balance being due later (e.g., management consulting). This approach is also quite common with expensive repair and maintenance jobs, especially when the firm—often a small business with limited working capital—must buy materials up front. Asking customers to pay in advance means that the buyer is paying before the benefits are received. But prepayments may be advantageous to the customer as well as to the provider. Advance payment saves time and effort, especially with frequently purchased services.

How Should Payment Be Made?

Service businesses must decide on the types of payments they will accept. Although cash is a simple payment method, it raises security problems and is not always convenient for customers (especially for large purchases). Checks are convenient for customers, but sellers need to develop controls to discourage invalid payment. A \$15 to \$20 charge for returned checks is not uncommon at retail stores.

Credit cards are convenient and have the advantage of being accepted worldwide, regardless of currency. Businesses that refuse to accept such cards increasingly find themselves at a competitive disadvantage. Prepayment cards simplify the process of paying for services like road and bridge tolls or telephone calls. Internet service provider World Online has introduced a new type of prepayment card in the United Kingdom that operates on the prepaid model popular in the mobile phone industry. British consumers buy the cards from local retailers and then use a PIN number located on a scratch-off panel on the back of the card to open an account with World Online. These cards are mainly aimed at teenagers, but they are also marketed to the 50 percent of British adults who don't have credit cards. World Online plans to roll out the service across the rest of Europe.²³

Smart cards store value in a microchip embedded within the card. To accept payment in this form, however, service firms must first install card readers. This sophisticated payment option requires partnerships between banks, retailers, and telephone companies. Working together, these partners can provide a smart card that serves as an "electronic wallet," enabling customers to download digital money to their cards from their bank accounts from an ATM or by telephone, using a special card reader. The latest innovation is card readers that can be attached to an account holder's computer. As a student, you may have personal experience with this form of payment, since many universities provide students with personalized smart cards that can be used to buy drinks from vending machines, make photocopies, pay fines for late return of library books, and many other purposes.

Other payment procedures include directing the bill to a third party for payment and using vouchers as supplements to (or instead of) cash. Insurance companies often designate approved garages to inspect and repair customers' vehicles when they are

involved in accidents. To make life easier for the customer, the garage bills the insurance company directly for the work performed. This saves the customer the effort of paying personally, filing a claim, and waiting for reimbursement. Vouchers are sometimes provided by social service agencies to elderly or low-income people. Such a policy achieves the same benefits as discounting but avoids the need to publicize different prices or require cashiers to check eligibility.

In the business-to-business environment, most suppliers offer credit accounts, payable monthly, which generate membership relationships with customers. Online payments are often made through third-party firms like Clareon that specialize in managing electronic transactions between customers and vendors (Figure 8.7).

Communicating Prices to the Target Markets

The final task is to decide how the organization's pricing policies can best be communicated to its target markets. People need to know the price for some product offerings well in advance of purchase. They may also need to know how, where, and when that price is payable. This information must be presented in ways that are intelligible and unambiguous, so that customers will not feel misled. Managers must decide whether or not to include information on pricing in advertisements for the service or on the company's Web site. Advertising sometimes relates the price to those of competing products or to alternative ways of spending one's money. Customers expect salespeople and service representatives to be able to give prompt, accurate responses to queries about pricing, payment, and credit. Good signage at retail points of sale saves staff members from having to answer basic questions on prices.

Finally, when the price is presented in the form of an itemized bill, marketers should ensure that it is both accurate and intelligible. Hospital bills, which may run to several pages and contain dozens of items, have been much criticized for inaccuracy.²⁴ Telephone bills, too, used to be confusing. They were often printed on small sheets of



*"Saveny, if I'm going to take irvdifitir fins fxyrment jsiivwtigm shif,
int had dii'rtti well better teff me what it all means!"*

The check's not in the mail.

There's tic faking it in the new economy. Real success requires something more. Something better. Welcome to Clareon, the B2B payment solution that makes paper checks virtually obsolete. Clareon tmabfea internet commerce with cross platform ease. Global access. State-of-the-art security Breakthrough efficiency. In other words, everyirwno, electronic payment needs to be.

www.clareon.net

clareon
the business payment network

FIGURE 8.7
Clareon Offers Internet-Based
B2B Payment Services

paper, crammed with technical jargon and it was hard to determine how the total charge due was computed. But many firms have worked to develop new and clearer formats that are easier for consumers to interpret.

Conclusion

Customers pay more to use a service than just the purchase price specified by the supplier. Additional outlays may include related financial costs (such as travel to the service site), time expenditures, psychological and sensory burdens, and physical effort. Customers are often willing to pay a higher price when the nonfinancial outlays are minimized, since the value of a service reflects the benefits that it delivers to the customer minus all the associated costs.

Pricing strategy must address the central issue of what price to charge for a given unit of service at a particular point in time, no matter how that unit may be defined. It's essential that the monetary price charged should reflect knowledge of the service provider's fixed and variable costs, competitor's pricing policies, and the value of the service to the customer.

Study Questions and Exercises

1. Is pricing strategy more difficult to implement in some service industries than in others? If so, why? Be specific and give examples.
2. Of the various nonfinancial outlays incurred by customers, which are likely to be the most significant in situations involving: (a) traditional retail banking; (b) home banking; (c) going to the movies; (d) taking a taxi in an unfamiliar city; (e) surgery?
3. Why is cost-based pricing (as it relates to financial costs) particularly problematic in service industries?
4. In what ways does competition-based pricing work in favor of many service providers? In what circumstances does it not?
5. Explain the concept of yield management in a service setting. How might it be applied to (a) a professional firm (e.g., consulting); (b) a restaurant; (c) a golf course?
6. Identify three aspects of pricing strategy that might raise ethical considerations. In each instance, how should such abuses be prevented?
7. From a customer perspective, what defines value in the following services: (a) a nightclub; (b) a hairdressing salon; (c) a legal firm specializing in business and tax law?
8. Choose a service organization and investigate its pricing policies and methods. In what respects are they similar to, or different from, what has been discussed in this chapter?
9. Review recent bills that you have received from service businesses. Evaluate each one against the following criteria: (a) general appearance and clarity of presentation; (b) easily understood terms of payment; (c) avoidance of confusing terms and definitions; (d) appropriate level of detail; (e) unanticipated ("hidden") charges; (f) accuracy; (g) ease of access to customer service in case of problems or disputes.

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