





Power Pricing


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Revolutionizing Global Leadership




Haas School of Business
UC Berkeley
Center for Executive Development




Session Objectives

- Learn how to price new products
- Master the most important power pricing concepts

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Class Outline

- Flawed pricing practices
- The economic value to the customer (*EVC*)
- Factors affecting price sensitivity
- Price customization strategies

Flawed Pricing Practices (1)

Cost-plus pricing

- Adding a standard markup to the cost of the product
 - Average cost → price
 - Purpose is to “guarantee” a margin
 - Internal focus

Flawed Pricing Practices (2)

Market share based pricing

- Setting price based on market share targets and goals
 - Future market share goal → Price
 - Assumption: High market share → High profit

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MacBook Air

<http://www.apple.com/macbookair/design.html>



Amazingly thin. Amazingly full-size.

The thinness of MacBook Air is stirring. But perhaps more impressive, there's a full-size notebook encased in the 0.16 to 0.76 inch of sleek, sturdy anodized aluminum. And at just 3.0 pounds, MacBook Air is more than portable — it's with you everywhere you go.

How much is your willingness to pay?

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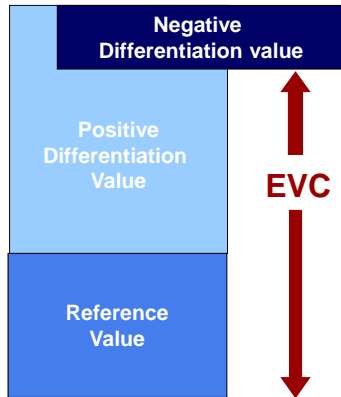
Motivation Questions

- As a buyer, what information do you use to determine how much you are willing to pay for a MacBook Air Laptop?
- What can a company do to influence consumer's willingness to pay?

EVC Analysis

- **Economic value to the customer (EVC):** the maximum amount a customer should be willing to pay, assuming that s/he is fully informed about the benefits of the product and the offerings of competitors
 $EVC = \text{Reference Value} + \text{Differentiation Value}$
- **Reference value:** the price of perceived closest substitute adjusted by difference in quantity used
- **Differentiation value:** value of a product's attribute difference between your offering and the closest substitute (+ or -)

EVC Analysis



- Differentiation Value
 - Superior performance
 - Better reliability
 - Additional features
 - Lower maintenance cost
 - Faster service
- Reference Value

Differentiation Value: An In-Class Example

- A magazine publisher consistently encountered price resistance from media buyers.
- Despite the fact that the magazine had better writers, more interesting articles, nicer photography, and a more loyal and wealthier readership, advertisers still resisted its pricing.
- They argued that the value of the magazine's quality was reflected in the number of subscribers drawn to it.
- Since the magazine generated 11% more circulation than its nearest competitor, media buyers would pay no more than an 11% premium to run an ad.
- The nearest competitor charges \$25,000 for a full-page ad.

Differentiation Value: An In-Class Example

	Competing Magazine	Our Magazine	Advantage
Circulation	1,400,000	1,550,000	11%
Readers Per Copy	1.8	2.1	
Readership	2,520,000	3,255,000	
% See Ad	9.20%	14.5%	
% Motivated / Ad Seen	1.60%	2.20%	
% Sold / Motivated	20%	20%	
# Readers Sold	742	2,077	
Sales Per Customer	\$180	\$200	
Gross Margin	30%	30%	
Value of Ad	\$40,062	\$124,601	\$84,539
Cost of Ad	\$25,000	?	
Media Buyers' WTP		\$27,750	
EVC		\$109,539	

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Dryel (released in June 1999)

Dry Clean Only
Fabric Care in Your Dryer

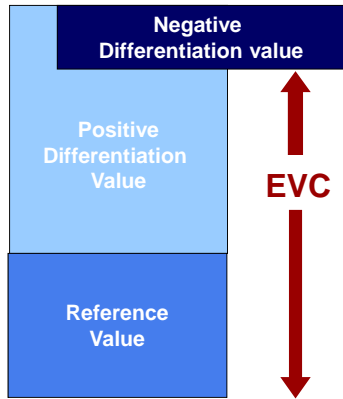


Welcome to Dryel® — the safe, easy way to care for dry clean only and special care clothes in your home in about 30 minutes. At about \$0.60 per garment (*based on average national retail price*), Dryel is the affordable alternative to dry cleaning your clothes. Discover how Dryel can give you the freedom to purchase and wear the kind of clothes you want, whenever you want.

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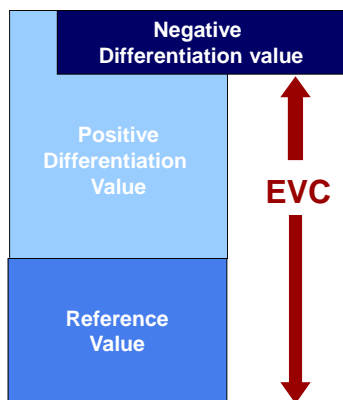
EVC in 1999



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EVC in 2003



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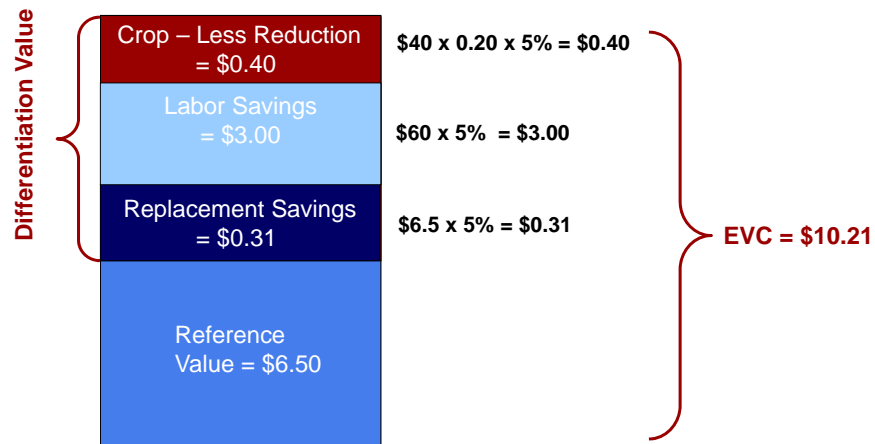
An Example: Alathon 25

- In 1995, Du Pont introduced *Alathon 25*, a polyethylene resin designed to compete with other resins in the manufacture of flexible pipe. Tests indicated that *Alathon 25* pipe had failure rates of **3%** compared with **8%** for the competition. Farmers purchased *Alathon* pipe as part of below-ground irrigation system. The common substitute for *Alathon* pipe was a pipe made of an off-grade resin selling for \$6.5 per hundred feet. Labor cost of replacing a failed pipe is about \$60. Pipe failures, if not detected quickly, can also damage crops. The damage could range from 0 (if the plants were mature) to \$40 when vulnerable seedlings were washed out. Young, poorly rooted crops are in place approximately 20% of the time that the irrigation system is in use.
 - What was the product's economic value for the farmers?
 - What if the failure rate is reduced from 7% to 1% (*instead of 8% to 3%*)?

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An Example: Alathon 25

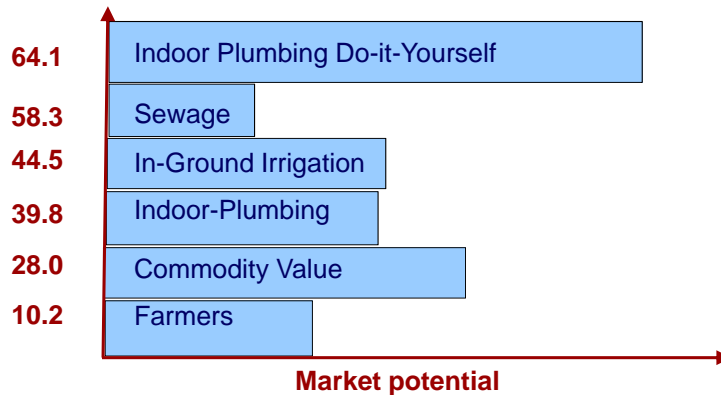


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Using EVC to Segment Market

- **EVC Profile:** Different segments have different EVCs. You need to determine the EVC of each segment and its size for formulating an effective pricing strategy.



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Communicating EVC to Your Customers

- Do not assume customers know EVC
- Educate customers is important when
 - The product delivers a stream of benefits over time
 - The product is highly innovative
- The fact that consumers are not buying your product is not by itself a reason to cut price. It may be a reason to change your marketing program to justify the price

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Steps in EVC Analysis

1. Identify the price of the closest competitive product to determine reference value
2. Identify all factors that differentiate your product from the competitive product
3. Determine the differentiation value
4. Sum up the reference value and differentiation value to determine EVC
5. Develop EVC profile for each segment
6. Develop marketing programs to educate consumers about EVC

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Use of EVC

- **Advantages**
 - Describe decision process of sophisticated purchasers
 - Enables firm to distinguish between under-promoted vs. overpriced product
 - Can indicate attribute improvements which give largest gain in EVC (i.e., channel your improvement effort)
 - Can be a great aid to sales force
- **Limitations**
 - Actual willingness to pay depends *perceived* differentiation value and *perceived* value of the competitive product

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Class Outline

- Flawed pricing practices
- The economic value to the customer (EVC)
- **Factors affecting price sensitivity**
- Price customization strategies

Factors Affecting Actual Willingness to Pay (1)

- **Substitutes awareness effect**
 - Buyers are more price sensitive the higher the price difference between this product and the perceived substitute
- **Difficult comparison effect**
 - buyers are less price sensitive the more difficult to evaluate competing offers
- **Switching cost effect**
 - Buyers are less price sensitive the greater the sunk investment they have made in anticipation of its continued use

Baby Oil (Rite Aid versus Johnson & Johnson)



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UC Medical Plans

	HMO	POS	PPO	Indemnity Plan
Definition	Health Maintenance Organization (Health Net, Kaiser, PacifiCare, WHA).	Point-of-Service Plan (Blue Cross Plus).	Preferred Provider Organization (Blue Cross PPO).	Traditional Fee-for-Service Plan (Core).
Reasons People Choose This Type of Plan	Least Costly Overall.	Greater Choice of Medical Providers than an HMO; ability to go outside the network for care (at a higher cost).	Broader network of providers than HMO or POS; preferred doctor only participates in this kind of plan.	No limits on access to providers; desire to self-insure a larger part of front-end costs (high deductible).
Choice of Providers	You choose a PCP or a primary care group from the network. Both your primary and speciality care is through your chosen PCP/medical group.	Tier 1 works like an HMO. Tier 2—you may choose any provider, but you pay more of the costs (see "Cost Sharing for Services" below).	You do not choose a PCP; you pay less if you use a network provider. If you use a non-network provider, your costs will be higher (see "Cost Sharing for Services" below).	Unrestricted access to any provider (see "Cost Sharing for Services" below).
Provider Relationships	Providers and medical groups contracted through the HMO network.	Providers and medical groups contracted through the HMO network for Tier 1; no network for Tier 2.	Providers and medical groups contracted through the PPO network.	No network.
Primary Care	Care is coordinated by a PCP.	In Tier 1, care is coordinated by a PCP; Tier 2 does not require a PCP.	No PCP required.	No PCP required.
Speciality Care	Your PCP authorizes referrals to specialists.	Your PCP authorizes referrals in Tier 1. You may self-refer in Tier 2.	You may self-refer in or out of network.	You may self-refer.
Networks	Plan networks are limited. Fewer HMO networks are available outside urban areas and providers are becoming less willing to contract with HMOs.	Tier 1 is similar to an HMO network. Tier 2 has no network.	Networks tend to be wider than HMO networks. Plans often have nationwide networks.	No network.

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UC Medical Plans

In-Area Coverage	You must receive services from a network provider.	You must receive services from a network provider to have coverage at the Tier 1 benefit level; Tier 2 has no requirement.	You must receive services from a network provider to have coverage at the highest level in the plan.	No restriction.
Out-of-Network Coverage	You are only covered for emergency services.	For services outside the network, you pay a deductible and share more of the costs.	For services outside the network, you pay a deductible and share more of the costs.	No restriction.
US Premiums	Lowest premiums (except for Core).	More expensive than an HMO; less expensive than PPO.	Most expensive.	Lowest premium due to plan design (high deductible, catastrophic coverage).
Cost Sharing for Services (copayment = flat dollar cost; coinsurance = % of total cost)	Copayments for services; no deductibles or co-insurance.	Tier 1--Higher copayments for services than HMO; Tier 2--deductibles & coinsurance.	Annual deductibles; coinsurance payments lower for network providers; higher for non-network providers.	Coinsurance coverage lower than most PPOs after high annual deductible is satisfied.
Out-of-Pocket Maximum Claims	Yes. No Claims, but preauthorization required for some services (see plan details).	Yes Tier 1--like an HMO. Tier 2--members file claims for partial payment of costs after deductible is satisfied.	Yes Members file claims for partial payment of costs after deductible is satisfied.	Yes Members file claims for partial payment of costs after deductible is satisfied.
Prescriptions	Typically, a card program with a formulary and different copayments for generic, brand name, and non-formulary drugs. Usually has a mail-order program for maintenance drugs.	Typically, a card program with a formulary and different copayments for generic, brand name, and non-formulary drugs. Usually has a mail-order program for maintenance drugs.	Coinsurance design--with a retail network and a mail order program.	No formulary; prescriptions covered on straight percentage reimbursement with no discounts.
How It Works with a FSA (flexible spending account)	May be used to cover copayments, expense not covered by plan or with limited coverage (e.g. laser eye surgery).	May be used to cover copayments in Tier 1, deductibles and coinsurance in Tier 2, expenses not covered by plan or with limited coverage (e.g. laser eye surgery).	May be used to cover deductibles and coinsurance, expenses not covered by plan or with limited coverage (e.g. laser eye surgery).	May be used to cover deductibles and coinsurance, expenses not covered by plan or with limited coverage (e.g. laser eye surgery).

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UC Medical Plan

Plan	Type	Self	Self & Family
Blue Cross Plus	POS	\$64.23	\$186.26
Blue Cross PPO	PPO	\$86.78	\$251.66
BluePremier HMO NM	HMO	\$75.51	\$218.18
Core	Idemnity	\$-	\$-
Health Net	HMO	\$17.64	\$51.15
Kaiser Permanente-CA	HMO	\$10.00	\$29.00
PacificCare of CA	HMO	\$16.12	\$48.55
Western Health Advantage	HMO	\$10.50	\$30.45

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Factors Affecting Actual Willingness to Pay (2)

- **Price-quality effect**

- Buyers are less price sensitive to the extent that higher price signals higher quality. (Image and exclusive products or products without quality cues)

- **Fairness effect**

- Buyers are more price sensitive when it is outside the range that they perceive as “fair”

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Price-Quality Effect: <http://www.sephora.com>



Flower by Kenzo

Kenzo's soft floral with hints of violet, vanilla, and rose, uniquely packaged in poppy-embossed bottles is a contemporary fragrance for the modern, city woman who looks to nature for inspiration and renewal.



VERA WANG

Created for a man of taste and refinement, Vera Wang For Men is a masculine, seductive, aromatic oriental, designed to elicit desire, emotion and passion.

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Two Problems with Single Price Strategy

- Leave money on the table (**margin opportunities**)
 - Some customers are willing to pay more
- Pass-up Profit (**volume opportunities**)
 - Some potential customers were not served even though the firm could have served them at prices above the variable cost

Customize by Customers (WHO)

- Based on observable characteristics that signal buyers' price sensitivity
 - <http://www.chessclub.com/>: Students: \$29.95/year; Adults: \$59.95
 - Harvard Publishing: Academic Institutes: \$28.00; Corporate Customers: \$50.00
 - Jewelry shopping in Hong Kong
- Select the segmentation variables that
 - Separate consumers into groups with different sensitivities (*e.g., ability to pay (tuition), age (movie)*)
 - Induce customers to reveal information (*e.g., rebates and coupons*)

Customize by Purchase Location (WHERE)

- Consumers at different purchase locations have different price sensitivity

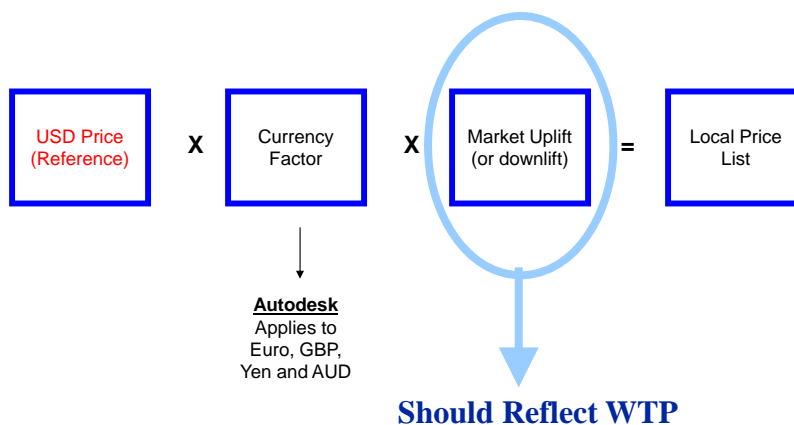
- J. Crew

	U.S.	Japan
Rollneck sweater	\$48.00	\$130
Polartec cap	\$14.00	\$39

- Cure for anthrax: \$450 in the U.S. \$190 in Canada
<http://www.canadadrugs.com>
- Staples website asks for zip code <http://www.staples.com/>

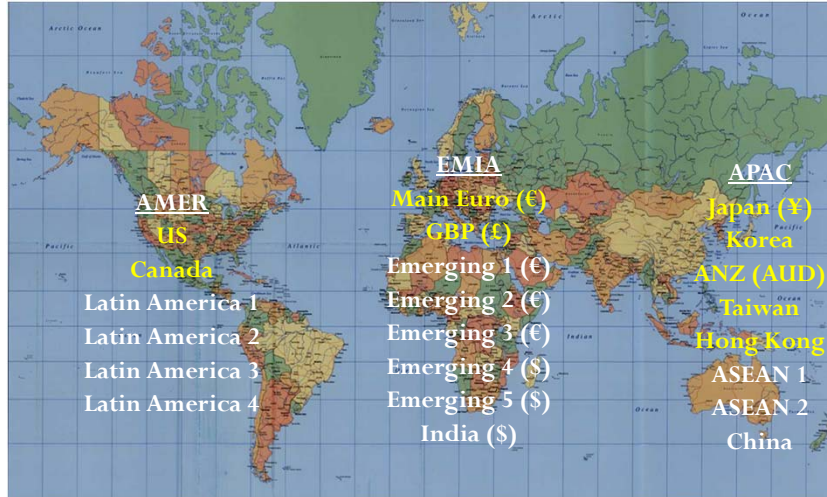
- Select segmentation variables that ensure
 - different segments purchase at different locations
 - high shipping cost to prevent arbitrage

Price Customization by Location: Global Pricing Model



Price Lists

- Twenty two price list areas with different local market factor & SRPs



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Customize By Time of Purchase (WHEN)

- Charge different prices because cost and price sensitivity are different at different time
 - Peak-load pricing**: designed to re-distribute usage from peak time to off-peak time
 - redeye flight, hotels (e.g., <http://www.mgmmirage.com/>)
 - Yield management**: pricing discount seats weeks before a flight and still have enough seats left to serve its best customers at full fare
 - Airlines, hotels
 - Catalogues: 7 versions with increasingly lower prices
 - Marked down by retailers (e.g., Gap, Inc.)
- Key:**
 - Avoid resale (e.g., non-transferable airline tickets)
 - Avoid training customers to wait

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Customize by Product Design (WHAT)

- Some consumers want unique features and are less price sensitive
 - Product line differentiation
 - <http://www.lexar.com/jumpdrive/>
 - Software versioning
 - <http://turbotax.intuit.com/>
 - Lead time differentiation
 - <http://www.psprint.com/>
- Key
 - Understand consumer needs to sort consumers
 - Price difference can be much higher than cost difference

Customize by Quantity (HOW MANY)

- Bigger quantity buyers are usually more price sensitive
 - volume discount
 - 1995, Club Med for ski vacation, “11th person in a group is free”
 - HP, AT&T
 - A fixed fee plus a variable charge (*heavy users have a lower average cost because the fixed fee is spread over more units*)
 - <http://onlinestorez.cingular.com/cell-phone-service/>
- Key
 - Do not hinder competition (*in B2B Markets*)
 - The product cannot be easily resold or stored for later use
 - It is possible to segment buyers for pricing into groups with similar demand elasticity



Price Customization Strategies

PRICE MENU

FRONT OF LINE PASS <small>PLUS: FREE VISITS FOR ALL OF 2005!</small>	89
VIP EXPERIENCE <small>FULL DAY VIP GUIDED TOUR WITH STUDIO ACCESS</small>	135
ANNUAL PASS <small>12 MONTH PASS, BLACK-OUT DATES APPLY</small>	79 59.75
DELUXE ANNUAL PASS <small>12 MONTH PASS, NO BLACK-OUT DATES</small>	99
PREMIUM ANNUAL PASS <small>12 MONTH PASS, NO BLACK-OUT DATES, FREE PARKING DURING BOX OFFICE HOURS</small>	129
GENERAL ADMISSION	52
UNDER 48" TALL	42

DISCOUNTS APPLY ONLY TO GENERAL ADMISSION TICKETS, UNLESS OTHERWISE SPECIFIED

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Front of Line Pass



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Punch-Line

- Avoid cost-plus and market share based pricing strategies
- $EVC = \text{Reference value} + \text{Differentiation value}$
- Pay attention to factors that influence actual price sensitivity
- Price customization strategies (*customer, location, time of purchase, quantity, and product design*)

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