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LEARNING OBJECTIVES (LOs)
By the end of this chapter, the reader should be able to:

LO1 Recognize that effective pricing is central to the financial success of service firms.

LO2 Outline the foundations of a pricing strategy as represented by the pricing tripod.

LO3 Define different types of financial costs and explain the limitations of cost-based pricing.

LO4 Understand the concept of net value and how gross value can be enhanced through value-based pricing and reduction of related monetary and nonmonetary costs.

LO5 Describe competition-based pricing and situations where service markets are less price-competitive.

LO6 Define revenue management and describe how it works.

LO7 Understand the role of rate fences in effective revenue management.

LO8 Be familiar with the issues of ethics and consumer concerns related to service pricing.

LO9 Understand how fairness can be designed into revenue management policies.

LO10 Know the seven questions marketers need to answer to design an effective pricing schedule.

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

OSCAR WILDE

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

RUSSIAN PROVERB
Dynamic Pricing at Easy Internet Café

easyInternetcafe is part of the easyGroup of companies headed by Stelios Haji-Ioannou, the Greek entrepreneur who received knighthood from Queen Elizabeth II for his contribution to entrepreneurship. This Internet café is entirely self-service and is unmanned. Vending machines dispense credit to customers. There are currently 25 easyInternetcafes in countries including the United Kingdom, the United States, Italy, Turkey, Greece, and France with a total of some 5,200 PCs.

easyInternetcafe has many features that allow revenue management to be used successfully. First, the capacity is perishable. Once no one uses the Internet access time, that hour is gone and cannot be resold. Second, there is relatively fixed capacity and high fixed costs. The equipment, software, bandwidth, and rental are fixed costs that are incurred whether or not a customer is in the café. Third, demand varies by time of the day, day of the week, months, and seasons. Finally, different customers are willing to pay different amounts for one hour of Internet access time.

To cater to the different price sensitivities of its customers, easyInternetcafe offers two different types of passes. Customers can either buy premium-priced passes that allow unlimited access during a set period of time or passes at the going rate. Passes sold at the going rate are priced using dynamic pricing. The variation in price does not come from the price of the pass (it is the same for both passes), but from the number of minutes on that pass. As the number of customers in the store increases, the number of minutes of individual surfing time decreases. The fewer customers in the store, the longer a pass will last. In this way, when it is very busy, the line will move faster as each user has a shorter time and when it is less busy, each user has a longer time and demand is allowed to build up. As a result, waiting time is also moderated. Price sensitive customers can use the café when they see that many terminals are available, and those customers willing to pay more know that even during busy periods, the wait is not that long. The concept has been very successful as a high percentage of customers feel that easyInternetcafe offers good value.

EFFECTIVE PRICING IS CENTRAL TO FINANCIAL SUCCESS

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

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

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

Pricing of services, however, is complicated. Consider the bewildering fee schedules of many consumer banks or cell phone service providers, or try to understand the fluctuating fare structure of a full-service airline. Service organizations even use different terms to describe the prices they set. Universities talk about tuition, professional firms collect fees, banks impose interest and service charges, brokers charge commissions, some expressways impose tolls, utilities set tariffs, and insurance companies determine premiums—the list goes on. Consumers often find service pricing difficult to understand (insurance products or hospital bills), risky (when you make a hotel reservation on three different days, you may be offered three different prices), and sometimes even unethical (many bank customers complain about an array of fees and charges they perceive as unfair). Examine your own purchasing behavior. How did you feel the last time you had...
to decide on booking a vacation, reserving a rental car, or opening a new bank account? In this chapter, you will learn how to set an effective pricing and revenue management strategy that fulfills the promise of the value proposition so that a value exchange takes place (i.e., the consumer decides to buy your service).

In many service industries of the past, pricing was traditionally driven by a financial and accounting perspective, which often used cost-plus pricing. Price schedules often were tightly constrained by government regulatory agencies—and some still are. Today, however, most service businesses enjoy significant freedom in setting prices and have a good understanding of value-based and competitive pricing. These developments have led to creative pricing schedules and sophisticated revenue management systems. In this chapter, we review the role of pricing in services marketing and provide guidelines on how to develop an effective pricing strategy.

Objectives for Establishing Prices

Any pricing strategy must be based on a clear understanding of a company’s pricing objectives. The most common pricing objectives are related to revenues and profits as well as building demand and developing a user base (Table 6.1).

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

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

**TABLE 6.1 Objectives for Pricing of Services**

<table>
<thead>
<tr>
<th>Revenue and Profit Objectives</th>
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</thead>
<tbody>
<tr>
<td><strong>Seek Profit</strong></td>
<td>• Make the largest possible contribution or profit.</td>
<td>• Achieve a specific target level, but do not seek to maximize profits.</td>
<td>• Maximize revenue from a fixed capacity by varying prices and target segments over time. This is done typically using revenue management systems.</td>
</tr>
<tr>
<td><strong>Cover costs</strong></td>
<td>• Cover fully allocated costs, including corporate overhead.</td>
<td>• Cover costs of providing one particular service, excluding overhead.</td>
<td>• Cover incremental costs of selling one extra unit or to one extra customer.</td>
</tr>
</tbody>
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**Patronage and User Base-Related Objectives**

**Build Demand**
• Maximize demand (when capacity is not a restriction), provided a certain minimum level of revenue is achieved.
• Achieve full capacity utilization, especially when high capacity utilization adds to the value created for all customers (e.g., ‘full-house’ adds excitement to a theater play or basketball game).

**Build a user Base**
• Encourage trial and adoption of a service. This is especially important for new service with high infrastructure costs, and for membership-type services that provide a large amount of revenues from their continued usage after adoption (e.g., cell phone service subscriptions, or life insurance plans).
• Build market share and/or a large user base, especially if there are a lot of economies of scale that lead to a competitive cost advantage (e.g., if development or fixed costs are high).
Part II • Applying the 4 Ps of Marketing to Services

BUILDING DEMAND AND DEVELOPING A USER BASE. In some instances, maximizing patronage, subject to achieving a certain minimum level of profits, may be more important than profit maximization. Getting a full house in a theater, sports stadium, or race track usually creates excitement that enhances the customer’s experience. It also creates an image of success that attracts new patrons.

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

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

PRICING STRATEGY STANDS ON THREE FOUNDATIONS

Once the pricing objectives are understood, we can focus on the pricing strategy. The foundations underlying pricing strategy can be described as a tripod, with costs to the provider, competitors’ pricing, and value to the customer as the three legs (Figure 6.2). In many service industries, pricing used to be viewed from a financial and accounting standpoint; therefore, cost-plus pricing often was used. Today however, most services have a good understanding of value-based and competitive pricing. In the pricing tripod, the costs a firm needs to recover usually sets a minimum price, or floor, for a specific service offering, and the customer’s perceived value of the offering sets a maximum, or ceiling.

The price charged by competing services typically determines where, within the floor-to-ceiling range, the price can be set. The pricing objectives of the organization then determine where actual prices should be set given the feasible range provided by the pricing tripod analysis. Let’s look at each leg of the pricing tripod in more detail, starting with cost to the provider.

Cost-Based Pricing

Pricing typically is more complex in services than in manufacturing. Because there’s no ownership of services, it’s usually harder to determine the financial costs of creating a
process or intangible real-time performance for a customer than it is to identify the labor, materials, machine time, storage, and shipping costs associated with producing and distributing a physical good. In addition, because of the labor and infrastructure needed to create performances, many service organizations have a much higher ratio of fixed costs to variable costs than is typical in manufacturing firms (Figure 6.3). Service businesses with high fixed costs include those with expensive physical facilities (such as hospitals or colleges), or a fleet of vehicles (such as airlines or trucking companies), or a network (such as railroads or telecommunications and gas pipeline companies).

ESTABLISHING THE COSTS OF PROVIDING SERVICE. Even if you have already taken a marketing course, you may find it helpful to review how service costs can be estimated, using fixed, semi-variable, and variable costs, as well as how the notions of contribution and break-even analysis can help in pricing decisions (see Marketing Review box on p. 140). These traditional cost-accounting approaches work well for service firms with significant variable costs and/or semi-variable costs (e.g., many professional services). For complex product lines with shared infrastructure (e.g., retail banking products), it may be worthwhile to consider the more complex activity-based costing (ABC) approach.

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

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

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

PRICING IMPLICATIONS OF COST ANALYSIS. To make a profit, a firm must set its price high enough to recover the full costs of producing and marketing the service and add a sufficient margin to yield the desired profit at the predicted sales volume. Managers in businesses with high fixed and marginal variable costs may feel they have tremendous pricing flexibility and be tempted to set low prices to boost sales. Some firms promote loss leaders—services sold at less than full cost to attract customers—who (it is hoped) will then be tempted to buy profitable service offerings from the same organization.
Fixed costs are economic costs a supplier would continue to incur (at least in the short run) even if no services were sold. These costs are likely to 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 an additional bank transaction or selling an additional seat on a flight. In many services, such costs are very low. For instance, very little labor or fuel cost is involved in transporting an extra passenger on a flight. In a theater, the cost of seating an extra patron is close to zero. More significant variable costs are associated with such activities as serving food and beverages or installing new parts when undertaking repairs, because they often include providing costly physical products in addition to labor. Just because a firm has sold a service at a price that exceeds its variable cost doesn’t mean the firm is now profitable, for there are still fixed and semi-variable costs to be recouped.

Semi-variable costs fall in between fixed and variable costs. They represent expenses that rise or fall in a stepwise fashion as the volume of business increases or 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 from the buyer of that service. It goes to cover fixed and semi-variable costs before creating profits.

Determining and allocating economic costs can be a challenging task in some service operations because of the difficulty of deciding how to assign fixed costs in a multiservice facility, such as a hospital. For instance, certain fixed costs are associated with running the emergency department in a hospital. Beyond that, there are fixed costs of running the hospital. So, how much of the hospital’s fixed costs should be allocated to the emergency department? A hospital manager might use one of several approaches to calculate the emergency department’s share of overhead costs. These could include (1) the percentage of total floor space it occupies, (2) the percentage of employee hours or payroll 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 show the emergency department to be very profitable, while the other might make it seem like a big loss-producing operation.

Break-even analysis allows managers 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 example, 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. The required sales volume needs to be related to price sensitivity (Will customers be willing to pay this much?), market size (Is the market large enough to support this level of patronage after taking competition into account?), and maximum capacity (the hotel in our example has a capacity of 36,500 room-nights per year, assuming no rooms are taken out of service for maintenance or renovation).

in the future. However, there will be no profit at the end of the year unless all relevant costs have been recovered. Many service businesses have gone bankrupt because they ignored this fact. Hence, firms that compete on low prices need to have a very good understanding of their cost structure and of the sales volumes needed to break even.

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

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

Management control which limits itself to cost monitoring without interesting itself in value is completely one-sided. . . . The problem of businesses is not so much that of cost control as it is the separation of value activities from other activities. The market only pays for the former. Businesses which carry out unnecessary activities are destined to find themselves being overtaken by competitors which have already eliminated these.6

Value-Based Pricing

Another leg of the pricing tripod is value to the customer. No customer will pay more for a service than he or she thinks it is worth. So, marketers need to understand how customers perceive service value in order to set an appropriate price.7
UNDERSTANDING NET VALUE. When customers purchase a service, they are weighing the perceived benefits of the service against the perceived costs they will incur. As we saw in Chapter 4, companies sometimes create several tiers of service, recognizing the different tradeoffs that customers are willing to make between these various costs. Customer definitions of value may be highly personal and idiosyncratic. Valarie Zeithaml proposes four broad expressions of value:

- Value is low price.
- Value is whatever I want in a product.
- Value is the quality I get for the price I pay.
- Value is what I get for what I give.8

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

If the perceived costs of a service are greater than the perceived benefits, then the service in question will possess negative net value, and the consumer will not buy. You can think of calculations customers make in their minds as similar to weighing materials on a pair of old-fashioned scales, with product benefits in one tray and the costs associated with obtaining those benefits in the other tray (Figure 6.4). When customers evaluate competing services, they are basically comparing the relative net values. As we discussed in Chapter 4, a marketer can increase the value of a service by adding benefits to the core product and by improving supplementary services.

MANAGING THE PERCEPTION OF VALUE.9 Service pricing strategies often are unsuccessful because they lack a clear association between price and value.10 Value is subjective, and not all customers have the expertise to assess the quality and value they receive. This is true in particular for credence services (discussed in Chapter 2), for which customers cannot assess the quality of a service even after consumption.11 Marketers of services such as strategy consulting and specialized hospitals must find ways to communicate the time, research, professional expertise, and attention to detail that go into, for example, completing a best practice consulting project. Why? Because the invisibility of back-stage facilities and labor makes it hard for customers to see what they’re getting for their money.

Consider a homeowner who calls an electrician to repair a defective circuit. The electrician arrives, carrying a small bag of tools. He disappears into the closet where the circuit board is located, locates the problem, replaces a defective circuit breaker, and presto! Everything works. A mere 20 minutes have elapsed. A few days later, the homeowner is horrified to receive a bill for $90, most of it for labor charges. Just think what the couple could have bought for that amount of money—new clothes, several DVDs, a nice dinner. Not surprisingly, customers are often left feeling exploited—take a look at Blondie’s reaction to the plumber in Figure 6.5.

To manage the perception of value, effective communications and even personal explanations are needed to help customers understand the value they receive. What they often fail to recognize are the fixed costs that business owners need to recoup: the office, telephone, insurance, vehicles, tools, fuel, and office support staff. The variable costs of a home visit are also higher than they appear. To the 20 minutes spent at the house, 15 minutes of driving each way might be added, plus 5 minutes each to unload and reload needed tools and supplies from the van, thus effectively tripling the labor time to a total of 60 minutes devoted to this call. And the firm still has to add a margin in order to make a profit.

More recently, auctions and dynamic pricing have become increasingly popular as a way to price according to value perceptions of customers. Our story on easyInternetcafe in the opening vignette is one such example of dynamic pricing. See Service Perspective 6.1 for other examples of dynamic pricing in the Internet environment.
REDUCING RELATED MONETARY AND NONMONETARY COSTS. When we consider customer net value, we need to understand the customers’ perceived costs. From a customer’s point of view, the price charged by a supplier is only part of the costs involved in buying and using a service. There are other costs of service, which are made up of the related monetary and nonmonetary costs.

Related Monetary Costs. Customers often incur significant financial costs in searching for, purchasing, and using the service, above and beyond the purchase price paid to the supplier. For instance, the cost of an evening at the theater for a couple with young children usually far exceeds the price of the two tickets, because it can include such expenses as hiring a babysitter, travel, parking, food, and beverages.

Nonmonetary Costs. Nonmonetary costs reflect the time, effort, and discomfort associated with search, purchase, and use of a service. Like many customers, you may refer to them collectively as “effort” or “hassle.” Nonmonetary costs tend to be higher when customers are involved in production (which is particularly important in people-processing services and in self-service) and must travel to the service site. Services high on experience and credence attributes may also create psychological costs, such as anxiety. There are four distinct categories of nonmonetary costs: time, physical, psychological, and sensory costs.

- **Time costs** are inherent in service delivery. Today’s customers often are time-constrained and may use similar terms to define time usage as they do for money; for instance, consumers talk about budgeting, spending, investing, wasting, losing, and saving time. Time spent on one activity represents an opportunity cost because it could be spent more profitably in other ways. Internet users often are frustrated by the amount of time they spend looking for information on a website. Many people loathe visiting government offices to obtain passports, driving licenses, or permits, not because of the fees involved, but because of the time “wasted.”
- **Physical costs** (like fatigue, discomfort) may be incurred in obtaining services, especially if customers must go to the service factory, if waiting is involved, and if delivery entails self-service.
- **Psychological costs** such as mental effort, perceived risk, cognitive dissonance, feelings of inadequacy, or fear sometimes are attached to buying and using a particular service.
- **Sensory costs** relate to unpleasant sensations affecting any of the five senses. In a service environment, these costs may include putting up with crowding, noise, unpleasant smells, drafts, excessive heat or cold, uncomfortable seating, and visually unappealing environments.

As shown in Figure 6.6, service users can incur costs during any of the three stages of the service consumption model as introduced in Chapter 2. Consequently, firms have to consider (1) search costs, (2) purchase and service encounter costs, and (3) postconsumption or after costs. When you were looking at colleges and universities, how much money, time, and effort did you spend before deciding where to apply? How much time and effort would you put into selecting a new cell phone service provider or a bank, or planning a vacation? A strategy of minimizing those nonmonetary and related monetary costs to increase consumer value can create competitive advantage for a firm. Possible approaches include:

- Working with operations experts to reduce the time required to complete service purchase, delivery and consumption; become “easy-to-do-business-with.”
SERVICE PERSPECTIVE 6.1

DYNAMIC PRICING ON THE INTERNET

Dynamic pricing—also known as customized or personalized pricing—is a new version of the age-old practice of price discrimination. It is popular with service suppliers because of its potential to increase profits and at the same time provide customers with what they value. E-tailing, or retailing over the Internet, lends itself well to this strategy because changing prices electronically is a simple procedure. Dynamic pricing enables e-tailers to charge different customers different prices for the same product based on information collected about their purchase history, preferences, price sensitivity, and so on. Tickets.com gained up to 45 percent more revenue per event when pricing of concerts and events was adjusted to meet demand and supply. However, customers may not be happy.

E-tailers often are uncomfortable about admitting to use of dynamic pricing because of the ethical and legal issues associated with price discrimination. Customers of Amazon.com were upset when they learned the online megastore was not charging everyone the same price for the same movie DVDs. A study of online consumers by the University of Pennsylvania’s Annenberg Public Policy Center found that 87 percent of respondents did not think dynamic pricing was acceptable.

Reverse Auctions

Travel e-tailers such as Priceline.com, Hotwire.com, and Lowestfare.com follow a customer-driven pricing strategy known as a reverse auction. Each firm acts as an intermediary between prospective buyers who request quotations for a product or service and multiple suppliers who quote the best price they’re willing to offer. Buyers can then review the offers and select the supplier that best meets their needs. Although the offer usually describes product attributes, it frequently doesn’t provide brand information. Priceline has moved to correct this deficiency. Says a spokesperson “Customers can now choose the exact brand name and product from a published list price, whereas before they could only use our name-your-own-price [service]. As a result, people were never sure what hotel they would get until they made their purchase. So, if you were traveling with friends, you wouldn’t know if you’d get the same hotel.”

Different business models underlie these services. Although some are provided free to end users, most e-tailers either receive a commission from the supplier or do not pass on the whole savings. Others charge customers either a fixed fee or one based on a percentage of the savings.

Traditional Auctions

Other e-tailers, such as eBay and Yahoo! Auctions, follow the traditional online auction model in which bidders place bids for an item and compete with each other to determine who buys it. Marketers of both consumer and industrial products use such auctions to sell obsolete or overstock items, collectibles, rare items, and second-hand merchandise. This form of retailing has become immensely successful since eBay launched it first in 1995.

Shopbots Help Consumers to Benefit from Dynamic Pricing

Consumers now have tools of their own to combat the potentially exploitive practices of dynamic pricing. One approach involves using shopbots to track competitive prices. Shopbots, or shopping robots, basically are intelligent agents that automatically collect price and product information from multiple online vendors. A customer has only to visit a shopbot site, such as Dealtime.com, and run a search for the desired item. The shopbot instantly queries all the associated retailers to check availability, features, and price, then presents the results in a comparison table.

There’s little doubt that dynamic pricing is here to stay. With further advances in technology and wider applications, its reach will extend to more and more service categories.

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- Minimizing unwanted psychological costs of service at each stage by eliminating or redesigning unpleasant or inconvenient procedures, educating customers on what to expect, and retraining staff to be friendlier and more helpful.
- Eliminating or minimizing unwanted physical effort, notably during search and delivery processes. Improve signage and "road mapping" in facilities and on webpages to improve way-finding and avoid customers getting lost and frustrated.
- Decreasing unpleasant sensory costs of service by creating more attractive visual environments, reducing noise, installing more comfortable furniture and equipment, curtailing offensive smells, and the like.
- Suggesting ways in which customers can reduce associated monetary costs, including discounts with partner suppliers (e.g., parking) or offering mail or online delivery of activities that previously required a personal visit.

Perceptions of net value may vary widely among customers and from one situation to another for the same customer. Most segments have at least two segments—one segment that spends time to save money, and another that spends money to save time. Therefore, many service markets can be segmented by sensitivity to time savings and convenience versus sensitivity to price savings. Consider Figure 6.7, which identifies a choice of three clinics available to an individual who needs to obtain a routine chest X-ray. In addition to varying dollar prices for the service, different time and effort costs are associated with using each service. Depending on the customer’s priorities, nonmonetary costs may be as important, or even more important, than the price charged by the service provider.

**Competition-based Pricing**

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

Price competition intensifies with (1) an increasing number of competitors, (2) an increasing number of substituting offers, (3) a wider distribution of competitor and/or substitution offers, and (4) an increasing surplus capacity in the industry. Although some service industries can be fiercely competitive (e.g., airlines or online banking), not all are, especially when one or more of the following circumstances reduce price competition:
Nonprice-related costs of using competing alternatives are high. When saving time and effort are of equal or greater importance to customers than price in selecting a supplier, the intensity of price competition is reduced.

Personal relationships matter. For services that are highly personalized and customized, such as hair styling or family medical care, relationships with individual providers often are very important to customers, thus discouraging them from responding to competitive offers.

Switching costs are high. When it takes time, money, and effort to switch providers, customers are less likely to take advantage of competing offers. Cell phone providers often require one- or two-year contracts from their subscribers and enforce significant financial penalties for early cancellation of service.

Time and location specificity reduce choice. When people want to use a service at a specific location or at a particular time (or perhaps both, simultaneously), they usually find they have fewer options. Firms that always react to competitors’ price changes run the risk of pricing lower than might really be necessary. Managers should be aware of falling into the trap of comparing competitors’ prices dollar for dollar and then seeking to match them. A better strategy is to take into account the entire cost to customers of each competitive offering, including all related financial and nonmonetary costs, plus potential switching costs, and then compare this total with that of the provider’s own service. Managers should also assess the impact of distribution, time and location factors, as well as estimating competitors’ available capacity before deciding what response is appropriate.

### REVENUE MANAGEMENT: WHAT IT IS AND HOW IT WORKS

Many service businesses now focus on strategies to maximize the revenue (or contribution) that can be derived from available capacity at any given point in time. Revenue management is important in value creation as it ensures better capacity utilization, and it reserves capacity for higher-paying segments. It’s a sophisticated approach to managing supply and demand under varying degrees of constraint. Airlines, hotels, and car rental firms, in particular, have become adept at varying their prices in response to the price sensitivity and needs of different market segments at different times of the day, week, or season. More recently hospitals, restaurants, golf courses, on-demand IT services, data processing centers, and even nonprofit organizations have increasingly used revenue management.
Revenue management is most effective when applied to service businesses characterized by:

- High fixed cost structure and relatively fixed capacity, which result in perishable inventory.
- Variable and uncertain demand.
- Varying customer price sensitivity.

**Reserving Capacity for High-yield Customers**

In practice, revenue management (also known as yield management) involves setting prices according to predicted demand levels among different market segments. The least price sensitive segment is the first to be allocated capacity, paying the highest price; other segments follow at progressively lower prices. Because higher-paying segments often book closer to the time of actual consumption, firms need a disciplined approach to save capacity for them instead of simply selling on a first-come, first-served basis. For example, business travelers often reserve airline seats, hotel rooms, and rental cars at short notice, but vacationers may book leisure travel months in advance, and convention organizers often block hotel space years in advance of a big event.

A well-designed revenue management system can predict with reasonable accuracy how many customers will use a given service at a specific time at each of several different price levels and then block the relevant amount of capacity at each level (known as a price bucket). Sophisticated firms use complex mathematical models for this purpose and employ revenue managers to make decisions about inventory allocation.

In the case of airlines, these models integrate massive historical databases on past passenger travel and can forecast demand of up to one year in advance for each individual departure. At fixed intervals, the revenue manager—who may be assigned specific routes at a large airline—checks the actual pace of bookings (i.e., sales at a given time before departure) and compares it with the forecasted pace. If significant deviations exist between actual and forecasted demand, the manager will adjust the size of the inventory buckets. For example, if the booking pace for a higher paying segment is stronger than expected, additional capacity is allocated to this segment and taken away from the lowest paying segment. The objective is to maximize the revenues from the flight. Best Practice in Action 6.1 shows how revenue management has been implemented at American Airlines, long an industry leader in its field.

**HOW DOES COMPETITORS’ PRICING AFFECT REVENUE MANAGEMENT?** Because revenue management systems monitor booking pace, they indirectly pick up the effect of competitors’ pricing. If a firm prices too low, it will experience a higher booking pace, and its cheaper seats fill up quickly. That generally is not good, as it means a higher share of late-booking but high fare-paying customers will not be able to get their seats confirmed and will therefore fly on competing airlines. If the initial pricing is too high, the firm will get too low a share of early booking segments (which still tend to offer a reasonable yield) and may later have to offer deeply discounted “last-minute” prices to sell excess capacity. Some of these sales may take place through reverse auctions, using intermediaries such as Priceline.com.

**Price Elasticity**

For revenue management to work effectively, there need to be two or more segments that attach different value to the service and have different price elasticities. To allocate and price capacity effectively, the revenue manager needs to determine how sensitive demand is to price and what net revenues will be generated at different prices for each target segment. The concept of elasticity describes how sensitive demand is to changes in price and is computed as follows:

\[
\text{Price elasticity} = \frac{\text{Percentage change in demand}}{\text{Percentage change in price}}
\]

When price elasticity is at “unity,” sales of a service rise (or fall) by the same percentage that price falls (or rises). If a small change in price has a big impact on sales,
BEST PRACTICE IN ACTION 6.1

Pricing Seats on AA Flight 2015

Revenue management departments use sophisticated yield management software and powerful computers to forecast, track, and manage each flight on a given date separately. Let’s look at American Airlines 2015, a popular flight from Chicago to Phoenix, which departs daily at 5:30 p.m. for the 1,370-mile (2,200 km) journey.

The 125 seats in coach (economy class) are divided into seven fare categories, called “buckets” by yield management specialists. There is an enormous variation in ticket prices among these seats: Round-trip fares range from $238 for a bargain excursion ticket (with various restrictions and a cancellation penalty), all the way up to $1,404 for an unrestricted fare. Seats are also available in the small first-class section. Scott McCartney tells how ongoing analysis by the computer program changes the allocation of seats among each the seven buckets in economy class:

In the weeks before each Chicago–Phoenix flight, American’s yield management computers constantly adjust the number of seats in each bucket, taking into account tickets sold, historical ridership patterns, and connecting passengers likely to use the route as one leg of a longer trip.

If advance bookings are slim, American adds seats to low-fare buckets. If business customers buy unrestricted fares earlier than expected, the yield management computer takes seats out of the discount buckets and reserves them for last-minute bookings that the database predicts will still show up.

With 69 of 125 coach seats already sold four weeks before one recent departure of Flight 2015, American’s computer began to limit the number of seats in lower-priced buckets. A week later, it totally shut off sales for the bottom three buckets, priced $300 or less. To a Chicago customer looking for a cheap seat, the flight was “sold out”....

One day before departure, with 130 passengers booked for the 125-seat flight, American still offered five seats at full fare because its computer database indicated 10 passengers were likely not to show up or take other flights. Flight 2015 departed full, and no one was bumped.

Although AA 2015 for that date is now history, it has not been forgotten. The booking experience for this flight was saved in the memory of the yield management program to help the airline do an even better job of forecasting in the future.


Demand for that product is said to be **price elastic**. If a change in price has little effect on sales, demand is described as **price inelastic**. The concept is illustrated in the simple chart presented in Figure 6.8, which shows the price elasticity for two segments, one with a highly elastic demand (a small change in price results in a big change in the amount demanded) and the other with a highly inelastic demand (even big changes in price have little impact on the amount demanded).

**Designing Rate Fences**

Inherent in revenue management is the concept of **price customization**—that is, charging different customers different prices for what is, in effect, the same product. As noted by Hermann Simon and Robert Dolan,

> The basic idea of price customization is simple: Have people pay prices based on the value they put on the product. 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

How can a firm ensure that customers for whom the service offers high value are unable to take advantage of lower price buckets? Properly designed rate fences allow customers to self-segment on the basis of service characteristics and willingness to pay and help companies to restrict lower prices to customers willing to accept certain restrictions on their purchase and consumption experiences.
**FIGURE 6.8** Illustrations of Price Elasticity

**TABLE 6.2** Key Categories of Rate Fences

<table>
<thead>
<tr>
<th>RATE FENCES</th>
<th>EXAMPLES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Physical (product-related) fences</td>
<td></td>
</tr>
<tr>
<td>• Basic product</td>
<td>• Class of travel (business/economy class)</td>
</tr>
<tr>
<td></td>
<td>• Size of rental car</td>
</tr>
<tr>
<td></td>
<td>• Size and furnishing of a hotel room</td>
</tr>
<tr>
<td></td>
<td>• Seat location in a theater or stadium</td>
</tr>
<tr>
<td>• Amenities</td>
<td>• Free breakfast at a hotel, airport pick up, etc.</td>
</tr>
<tr>
<td></td>
<td>• Free golf cart at a golf course</td>
</tr>
<tr>
<td></td>
<td>• Valet parking</td>
</tr>
<tr>
<td>• Service level</td>
<td>• Priority wait-listing, separate check-in counter with no or only short queues</td>
</tr>
<tr>
<td></td>
<td>• Improved food and beverage selection</td>
</tr>
<tr>
<td></td>
<td>• Dedicated service hotlines</td>
</tr>
<tr>
<td></td>
<td>• Personal butler</td>
</tr>
<tr>
<td></td>
<td>• Dedicated account management team</td>
</tr>
<tr>
<td>Non-Physical Fences</td>
<td></td>
</tr>
<tr>
<td>Transaction Characteristics</td>
<td></td>
</tr>
<tr>
<td>• Time of booking or reservation</td>
<td>• Discounts for advance purchase</td>
</tr>
<tr>
<td>• Location of booking or reservation</td>
<td>• Passengers booking air-tickets for an identical route in different countries are changed different prices.</td>
</tr>
<tr>
<td></td>
<td>• Customers making reservation online are changed a lower price than chose making reservation by phone</td>
</tr>
<tr>
<td>• Flexibility of ticket usage</td>
<td>• Fees/penalties for canceling or changing a reservation (up to loss of entire ticket price)</td>
</tr>
<tr>
<td></td>
<td>• Non-refundable reservation fees</td>
</tr>
<tr>
<td>Consumption Characteristics</td>
<td></td>
</tr>
<tr>
<td>• Time or duration of use</td>
<td>• Early bird special in a restaurant before 6:00pm</td>
</tr>
<tr>
<td>• Location of consumption</td>
<td>• Must stay over a Saturday night for an hotel booking.</td>
</tr>
<tr>
<td></td>
<td>• Must stay at least for five nights</td>
</tr>
<tr>
<td></td>
<td>• Price depends on departure location, especially in international travel.</td>
</tr>
<tr>
<td></td>
<td>• Prices vary by location (between cities, city center versus edges of the city)</td>
</tr>
<tr>
<td>Buyer Characteristics</td>
<td></td>
</tr>
<tr>
<td>• Frequency of volume of consumption</td>
<td>• Member of certain loyalty-tier with the firm (e.g. Platinum member) get priority pricing, discounts or loyalty benefits</td>
</tr>
<tr>
<td>• Group membership</td>
<td>• Child, student, senior citizen discounts</td>
</tr>
<tr>
<td></td>
<td>• Affiliation with certain groups (e.g. Alumni)</td>
</tr>
<tr>
<td></td>
<td>• Corporate rates</td>
</tr>
<tr>
<td>• Size of consumer group</td>
<td>• Group discounts based on size of group</td>
</tr>
<tr>
<td>• Geographic location</td>
<td>• Local customers are changed lower rates than tourists</td>
</tr>
<tr>
<td></td>
<td>• Customers from certain countries are changed higher prices</td>
</tr>
</tbody>
</table>
Fences can be either physical or nonphysical. Physical fences refer to tangible product differences related to the different prices, such as the seat location in a theatre, the size and furnishing of a hotel room, or the product bundle (e.g., first class is better than economy). In contrast, nonphysical fences refer to consumption, transaction or buyer characteristics, but otherwise they actually refer to the same basic service (e.g., there is no difference in economy class service whether a person bought a ticket really cheaply or paid full fare for it). Examples include having to book a certain length of time ahead, not being able to cancel or change a booking (or having to pay cancellation or change penalties), or having to stay over a weekend night. Examples of common rate fences are shown in Table 6.2.

In summary, using a detailed understanding of customer needs, preferences, and willingness to pay, product and revenue managers can jointly design effective products comprising the core service, physical product features (physical fences), and nonphysical product features (nonphysical fences). A good understanding of the demand curve is needed so that “buckets” of inventory can be assigned to the various products and price categories. An example from the airline industry is shown in Figure 6.9, and Service Perspective 6.2 provides insights to the thinking and work of a revenue manager. And lastly, the design of revenue management systems needs to incorporate safeguards for consumers as we will discuss in the next section on Ethical Concerns in Service Pricing.

**ETHICAL CONCERNS IN SERVICE PRICING**

Do you sometimes have difficulty understanding how much it’s going to cost you to use a service? Do you believe that many prices are unfair? If so, you’re not alone. The fact is, service users can’t always be sure in advance what they will receive in return for their money. There’s an implicit assumption among many customers that a higher priced service should offer more benefits and greater quality than a lower priced one. For example, a professional—say a lawyer—who charges very high fees is assumed more skilled than one who is relatively inexpensive. Although price can serve as a surrogate for quality, it is sometimes hard to be sure if the extra value is really there.
SERVICE PERSPECTIVE 6.2
INTERVIEW WITH A REVENUE MANAGER

What is your role as a revenue manager?
When I started in 1993, the primary focus was on forecasting, inventory control, pricing, market segment and geographic mix, and allotment control. The Internet changed the scene significantly and several global giants, like Expedia and Travelocity, emerged after 9/11 when travel bookings plummeted and the industry realized the power of the Internet to help them sell distressed inventory. But airlines and hotels want to control their own inventory and pricing to cut costs and reduce reliance on intermediaries, so there’s increasing focus on driving bookings via direct channels such as their own branded websites, building online brands, and implementing CRM programs. My role has also broadened to include revenue management of secondary income sources such as restaurants, golf courses and spa, as well as mainstream hotel rooms.

What differences do you see between revenue management for airlines and hotels?
Fundamentally, the techniques of forecasting and optimizing pricing and inventory controls are the same. However, some key differences exist. Airlines have a larger ability to use pricing to expand travel demand from the home market. By contrast, pricing practices in hotels can shift market share within a location but, as a rule, not overall market size. Although consumers see many pricing practices—such as advance purchase restrictions and discounts—as fair practice for the airline industry, they see them as less fair when applied by the hotel industry.

Organizational structure also tends to be different. The airlines adopt central revenue management control for all flights and revenue managers have little interaction with the reservations and sales teams in the field. A more precise and statistical application of pricing and inventory control is thus the focus. In the hotel industry, revenue management is decentralized to every hotel, requiring daily interaction with reservations and sales. The human element is key for successful implementation in hotels, requiring acceptance of pricing and inventory decisions not only by consumers but also by internal departments such as reservations, sales, and even front office.

What skills do you need to succeed as a revenue manager?
Strong statistical and analytical skills are essential, but to be really successful, revenue managers need to have equally strong interpersonal and influencing skills in order for their decisions to be accepted by other departments. Traditional ways of segmenting customers via their transactional characteristics such as booking lead time, channel of reservation, and type of promotion are insufficient. Both behavioral characteristics (such as motive for travel, products sought, spending pattern, and degree of autonomy) and emotional characteristics (such as self-image, conspicuous consumer or reluctant traveler, impulse or planned) need to be incorporated into revenue management considerations.

How are revenue management practices perceived by customers?
The art of implementation is not to let the customers feel that your pricing and inventory control practices are unfair and meant primarily to increase the top and bottom line of the company. Intelligent and meaningful rate fences have to be used to allow customers to self-segment so that they retain a feeling of choice.

Daily Nature of the Job
The market presents a lot of demand changes and you need to monitor your competitors’ price as it fluctuates daily across the various distribution channels. It’s definitely a prerequisite to be quick in analysis and decisive. One needs to feel comfortable taking calculated risks and choose from a plethora of revenue management and pricing tools to decide on the best fit for the situation.

Source: We thank Jeannette Ho, who was Vice President Distribution Marketing & Revenue Management at Raffles International Limited when this interview was conducted on January 6, 2006. Jeannette was responsible for spearheading and implementing the revenue management initiatives for the group. Her team drove the company’s global distribution strategy and oversaw its e-commerce channels and central reservations system. Jeannette is presently Vice President Marketing and Sales for Raffles Hotels & Resorts. Over the past 15 years, Jeannette has been working in revenue management with various international companies such as Singapore Airlines, Banyan Tree, and Westin Hotels & Resorts.
Service Pricing Is Complex

Pricing schedules for services tend to be complex and hard to understand. Comparison across providers may even require intricate spreadsheets or even mathematical formulas. Consumer advocates sometimes charge that this complexity represents a deliberate choice on the part of service suppliers who don’t want customers to determine who offers the best value for money and therefore reduce price competition. In fact, complexity makes it easy (and perhaps more tempting) for firms to engage in unethical behavior. The quoted prices typically used by consumers for price comparisons may be only the first of several charges they can be billed.

For example, cell phone companies have a confusing variety of plans to meet the distinct needs and calling patterns of different market segments. Plans can be national, regional, or purely local in scope. Monthly fees vary according to the number of minutes selected in advance, which typically include separate allowances for peak and off-peak minutes. Overtime minutes and “roaming minutes” on other carriers are charged at higher rates. Some plans allow unlimited off-peak calling, others allow free incoming calls. Some providers charge calls per second, per 6-second block, or even per-minute block, resulting in vastly different costs per call. Family plans let parents and children pool their monthly minutes for use on several phones as long as the total for everyone’s calling doesn’t exceed the monthly quota.

In addition, baffling new fees have started to appear on bills, ranging from “paper bill fee” to pay for the bill itself to obscure sounding fees such as “property tax allotment,” “single bill fee,” and “carrier cost recovery fee.” Bundled plans that include mobile, landline, and Internet services compound the confusion further, in that the various surcharges can increase the total bill by up to 25 percent. Phone bills include real taxes (e.g., sales tax), but on many bills the majority of surcharges, which users often misread as taxes, go directly to the phone company. For instance, the “property tax allotment” is nothing more than a factor for the property taxes the carrier pays, the “single bill fee” charges for consolidated billing of the mobile and land line service, and the “carrier cost recovery fee” is a catch-all for all sorts of operating expenses. In an editorial entitled “Cell Hell,” Jim Guest, Consumer Union’s president, observed:

In the 10 years since Consumer Reports started rating cell phones and calling plans, we’ve never found an easy way to compare actual costs. From what our readers tell us, they haven’t either. Each carrier presents its rates, extra charges, and calling areas differently. Deciphering one company’s plan is hard enough, but comparing plans from various carriers is nearly impossible.17

Many people find it difficult to forecast their own usage, which makes it hard to compute comparative prices when evaluating competing suppliers whose fees are based on a variety of usage-related factors. It’s no coincidence that the humorist Scott Adams (creator of Dilbert) used exclusively service examples when he “branded” the future of pricing as “confusiology.” Noting that firms—such as telecommunication companies, banks, insurance firms, and other financial service providers—offer nearly identical services, Adams remarks:

You would think this would create a price war and drive prices down to the cost of providing it (that’s what I learned between naps in my economic classes), but it isn’t happening. The companies are forming efficient confusopolies so customers can’t tell who has the lowest prices. Companies have learned to use the complexities of life as an economic tool.18

One of the roles of effective government regulation, says Adams, should be to discourage this tendency for certain service industries to evolve into “confusopolies.”
Piling on the Fees

Not all business models are based on generating income from sales. There is a growing trend today to impose fees that sometimes have little to do with usage. In the United States, the car rental industry has attracted some notoriety for advertising bargain rental prices and then telling customers on arrival that other fees like collision and personal insurance are compulsory. Also, staff sometimes fails to clarify certain “small print” contract terms such as (say) a high mileage 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.”¹⁹

There has also been a trend to adding (or increasing) fines and penalties. Banks have been heavily criticized for using penalties as an important revenue-generating tool as opposed to using them merely to educate customers and achieve compliance with payment deadlines. Chris Keeley, a New York University student, used his debit card to buy $230 worth of Christmas gifts. His holiday mood soured when he received a notice from his bank that he had overdrawn his checking account. Although his bank authorized each of his seven transactions, it charged him $31 per payment, totaling $217 for only $230 in purchases. Keeley maintained that he had never requested the so-called overdraft protection on his account and wished his bank had rejected the transactions, because he would then simply have paid by credit card. He fumed, “I can’t help but think they wanted me to keep spending money so that they could collect these fees.”²⁰

The importance of fees as a proportion of profits has increased dramatically—for some banks they now exceed earnings from mortgages, credit cards, and all other lending combined. None of the fees is more controversial than “bounce protection” (i.e., the practice of allowing you to overdraw your account beyond an agreed credit line), which generates some $8 billion in income for banks, and making up almost 30 percent of all their service fees. Critics feel that some banks market bounce protection too aggressively. Regulators are particularly worried about bounce protection offered via ATMs. For example, a customer with a balance of $300 in his account, but a $500 bounce protection could be told at the ATM that he has $800 available. If he withdrew $400, the ATM would still show available funds of $370 (after charging a fee of, for example, $30 for using the bounce protection balance).

Some banks don’t charge for overdraft protection. Said Dennis DiFlorio, president for retail banking at Commerce Bancorp Inc. in Cherry Hill, N.J.: “It’s outrageous. It’s not about customer convenience. It’s just a way for banks to make money off customers.” Some banks now offer services that cover overdrafts automatically from savings accounts, other accounts, or even the customer’s credit card, and don’t charge fees for doing so.²¹

It’s possible to design fees and even penalties that do not seem unfair to customers. Research Insights 6.1 describes what drives customers’ fairness perceptions with service fees and penalties.

Designing Fairness into Revenue Management

Like pricing plans and fees, revenue management practices can be perceived as highly unfair, and customer perceptions have to be carefully managed. Therefore, a well-implemented revenue management strategy cannot mean blind pursuit of short-term yield maximization. Rather, the following approaches can help to reconcile yield management practices with customers’ fairness perceptions and satisfaction, trust, and goodwill:²²

- **Design Price Schedules and Fences That Are Clear, Logical, and Fair.** Firms should proactively spell out all fees and expenses (e.g., no-show or cancellation charges) clearly in advance so there are no surprises. A related approach is to
RESEARCH INSIGHTS 6.1

CRIME AND PUNISHMENT: HOW CUSTOMERS RESPOND TO FINES AND PENALTIES

Various types of “penalties” are part and parcel of many pricing schedules, ranging from late fees for DVD rentals to cancellation charges for hotel bookings and charges for late credit card payments. Customer responses to penalties can be highly negative, and can lead to switching providers and poor word of mouth. Young Kim and Amy Smith conducted an online survey using the Critical Incident Technique (CIT) in which the 201 respondents were asked to recall a recent penalty incident, describe the situation, and then complete a set of structured questions based on how the respondents felt and how they responded to that incident. Their findings showed that negative consumer responses can be reduced significantly by following three guidelines:

1. **Make Penalties Relative to the Crime Committed.** The survey showed that customers’ negative reaction to a penalty increased drastically when they perceived that the penalty was out of proportion to the “crime” committed. Customers’ negative feelings were further aggravated if they were “surprised” by the penalty being suddenly charged to them and they had not been aware of the fee or the magnitude of the fee. These findings suggest that firms can reduce negative customer responses significantly by exploring which amounts are seen as reasonable or fair for a given “customer laps,” and the fines/fees are communicated effectively even before a chargeable incident happens that gets charged (e.g., in a banking context through a clearly explained fee schedule, and through front line staff that explains at the point of opening an account or selling additional services the potential fines or fees that are associated with various “violations,” such as overdrawning beyond the authorized limits, bounced checks, or late payments).

2. **Consider Causal Factors and Customize Penalties.** The study showed that customers’ perceptions of fairness were lower and negative responses were higher when they perceived the causes that led to the penalty to be out of their control (“I mailed the check on time—there must have been a delay in the postal system”), rather than when they felt it was within their control and really their fault (e.g., “I forgot to mail the check”). To increase the perception of fairness, firms may want to identify common penalty cases that typically are out of the control of the customer and allow the frontline to waive or reduce such fees.

   In addition, it was found that customers who generally observe all the rules, and therefore have not paid fines in the past, react particularly negatively if they are fined. One respondent said, “I have always made timely payments and have never been late with a payment—they should have considered this fact and waived the fee.” Service firms should take into account customers’ penalties history in dealing with penalties, and offer differential treatments based on past behavior—perhaps waiving the first fine for the first incident, while at the same time communicating that the fee will be charged for subsequent incidents, could improve fairness perceptions.

3. **Focus on Fairness and Manage Emotions during Penalty Situations.** Consumers’ responses are heavily driven by their perception of fairness perceptions. Customers are likely to perceive penalties as excessive and respond negatively if they find that a penalty is out of proportion compared to the damage or extra work caused by the penalized incident to the service firm. One consumer complained, “I thought this particular penalty [credit card late payment] was excessive. You are already paying high interest; the penalty should have been more in line with the payment. The penalty was more than the payment!” Considering customers’ perceptions of fairness might mean, for example, that the late fee for a keeping a DVD should not exceed the potentially lost rental fees during that period.

   Service companies can also make penalties seem fairer by providing adequate explanations and justifications for the penalty. Ideally, penalties should be imposed for the good of other customers (e.g., “We kept the room for you which we could have given to another guest on our wait list”) or community, but not as a means for generating significant profit. Finally, front-line employees should be trained in how to handle customers who have become angry or distressed and complain about penalties (see Chapter 13 for some recommendations on how to deal with such situations).

In sum, this study shows how firms can reduce customer unhappiness related to penalties.

develop a simple fee structure so customers can more easily understand the financial implications of a specific usage situation. For a rate fence to be perceived as fair, customers must understand them easily (i.e., fences have to be transparent and upfront), see the logic in them, and be convinced they are difficult to circumvent and therefore fair.

- **Use High Published Prices and Frame Fences as Discounts.** Rate fences framed as customer gains (i.e., discounts) generally are perceived as fairer than those framed as customer losses (i.e., surcharges) even if the situations are economically equivalent. For example, a customer who patronizes her hair salon on Saturdays may perceive the salon as profiteering if she finds herself facing a weekend surcharge. However, she is likely to find the higher weekend price more acceptable if the hair salon advertises its peak weekend price as the published price and offers a $5 discount for weekday haircuts. Furthermore, having a high published price also helps to increase the reference price and potentially quality perceptions in addition to the feeling of being rewarded for the weekday patronage.

- **Communicate Consumer Benefits of Revenue Management.** Marketing communications should position revenue management as a win–win practice. Providing different price and value balances allows a broader spectrum of customers to self-segment and enjoy the service. It allows each customer to find the price and benefits (value) balance that best satisfies his or her needs. For example, charging a higher price for the best seats in the theater recognizes that some people are willing and able to pay more for a better location and makes it possible to sell other seats at a lower price. Perceived fairness is affected by what customers perceive as normal. Hence, when customers become more familiar with particular revenue management practices, the unfairness perceptions are likely to decrease over time.²³

- **Use Bundling to “Hide” Discounts.** Bundling a service into a package effectively obscures the discounted price. When a cruise line includes the price of air travel or ground transportation in the cruise package, the customer knows only the total price, not the cost of the individual components. Bundling usually makes price comparisons between the bundles and its components impossible and thereby side-steps potential unfairness perceptions and reductions in reference prices.²⁴

- **Take Care of Loyal Customers.** Firms should build in strategies for retaining valued customers, even to the extent of not charging the maximum feasible amount on a given transaction. After all, customer perceptions of price gouging do not build trust. Yield management systems can be programmed to incorporate “loyalty multipliers” for regular customers, so that reservations systems can give them “special treatment” status at peak times, even when they are not paying premium rates.

- **Use Service Recovery to Compensate for Overbooking.** Many service firms overbook to compensate for anticipated cancellations and no-shows. Profits increase but so, too, does the incidence of being unable to honor reservations. Being “bumped” by an airline or “walked” by a hotel can lead to a loss of customer loyalty²⁵ and adversely affect a firm’s reputation. So it’s important to back up overbooking programs with well-designed service recovery procedures, such as:
  1. Give customers a choice between retaining their reservation and receiving compensation (e.g., many airlines practice voluntary offloading at check-in against cash compensation and a later flight).
  2. Provide sufficient advance notice that customers are able to make alternative arrangements (e.g., preemptive offloading and rescheduling to another flight on the day before departure, often in combination with cash compensation).
3. If possible, offer a substitute service that delights customers (e.g., upgrading a passenger to business or first class on the next available flight, often in combination with options 1 and 2 above).

A Westin beach resort found that it can free up capacity by offering guests who are departing the next day the option of spending their last night in a luxury hotel near the airport or in the city at no cost. Guest feedback on the free room, upgraded service, and a night in the city after a beach holiday has been very positive. From the hotel’s perspective, this practice trades the cost of securing a one-night stay in another hotel against that of turning away a multiple-night guest arriving that same day.

PUTTING SERVICE PRICING INTO PRACTICE

Although the main decision in pricing usually is seen as how much to charge, there are other decisions to be made. Table 6.3 summarizes the questions that service marketers need to ask themselves as they prepare to create and implement a well-thought-out pricing strategy. Let’s look at each in turn.

How Much to Charge?

Realistic decisions on pricing are critical for financial solvency. The pricing tripod model, discussed earlier (refer to Figure 6.2), provides a useful starting point. The three elements involve determining the relevant economic costs to be recovered at different sales volumes and setting the relevant floor price; assessing the elasticity of demand of the service from both the providers’ and customers’ perspectives, as it helps to set a “ceiling” price for any given market segment; and analyzing the intensity of price competition among the providers.

A specific figure must be set for the price itself. This task involves several considerations, including the need to consider the pros and cons of setting a rounded price and the ethical issues involved in setting a price exclusive of taxes, service charges, and other extras.

What Should Be the Specified Basis for Pricing?

It’s not always easy to define a unit of service as the specified basis for pricing. Many options may exist. For instance, should price be based on completing a promised service task—such as repairing a piece of equipment or cleaning a jacket? Should it be based on admission to a service performance—such as an educational program, a concert, or a sports event? Should it be time based—for instance, using an hour of a lawyer’s time or occupying a hotel room for a night? Alternatively, should it be related to a monetary value associated with service delivery, as when an insurance company scales its premiums to reflect the amount of coverage provided, or a realtor takes a commission that is a percentage of the selling price of a house?

Some service prices are tied to the consumption of physical resources such as food, drinks, water, or natural gas. In the hospitality industry, rather than charging customers an hourly rate for occupying a table and chairs, restaurants put a sizable markup on the food and drink items consumed. Recognizing the fixed cost of table service—such as a clean tablecloth for each party—restaurants in some countries impose a fixed cover charge that is added to the cost of the meal. Others may establish a minimum meal charge per person. Transport firms have traditionally charged by distance, with freight companies using a combination of weight or cubic volume and distance to set their rates. Such a policy has the virtue of consistency and reflects calculation of an average cost per mile (or kilometer). However, it ignores relative market strength on different routes, which should be included when a yield management system is used. Simplicity may suggest a flat rate, as with postal charges for...
For some services, prices may include separate charges for access and for usage. Recent research suggests that access or subscription fees are an important driver of adoption and customer retention, whereas usage fees are much more important drivers of actual usage.26

### TABLE 6.3 Some Pricing Issues

1. **How much should be charged for this service?**
   - What costs are the organization attempting to recover? Is the organization trying to achieve a specific profit margin or return on investment by selling this service?
   - How sensitive are customers to various prices?
   - What prices are charged by competitors?
   - What discount(s) should be offered from basic prices?
   - Are psychological pricing points (e.g., $4.95 versus $5.00) customarily used?

2. **What should be the basis of pricing?**
   - Execution of a specific task
   - Admission to a service facility
   - Units of time (hour, week, month, year)
   - Percentage commission on the value of the transaction
   - Physical resources consumed
   - Geographic distance covered
   - Weight or size of object serviced
   - Should each service element be billed independently?
   - Should a single price be charged for a bundled package?

3. **Who should collect payment?**
   - The organization that provides the service
   - A specialist intermediary (travel or ticket agent, bank, retailer, etc.)
   - How should the intermediary be compensated for this work—flat fee or percentage commission?

4. **Where should payment be made?**
   - The location at which the service is delivered
   - A convenient retail outlet or financial intermediary (e.g., bank)
   - The purchaser’s home (by mail or phone)

5. **When should payment be made?**
   - Before or after delivery of the service
   - At which times of day
   - On which days of the week

6. **How should payment be made?**
   - Cash (exact change or not?)
   - Token (where can these be purchased?)
   - Stored value card
   - Check (how to verify?)
   - Electronic funds transfer
   - Charge card (credit or debit)
   - Credit account with service provider
   - Vouchers
   - Third-party payment (e.g., insurance company or government agency)?

7. **How should prices be communicated to the target market?**
   - Through what communication medium? (advertising, signage, electronic display, salespeople, customer service personnel)
   - What message content (how much emphasis should be placed on price?)
**PRICE BUNDLING.** An important question for service marketers is whether to charge an inclusive price for all elements (referred to as a “bundle”) or to price component elements separately. If customers prefer to avoid making many small payments, then bundled pricing may be preferable. However, if they dislike being charged for product elements they do not use, itemized pricing may be preferable.

Bundled prices offer firms a certain level of guaranteed revenue from each customer, while providing customers a clear idea in advance of how much they can expect to pay. Unbundled pricing provides customers with the freedom to choose what to buy and pay for. For instance, many U.S. airlines now charge economy class passengers for meals, drinks, and check-in baggage on their domestic flights. However, customers may be angered if they discover the actual price of what they consume, inflated by all the “extras,” is substantially higher than the advertised base price that attracted them in the first place.

**DISCOUNTING.** Selective price discounting targeted at specific market segments can offer important opportunities to attract new customers and fill capacity that would otherwise go unused. However, unless it is used with effective rate fences that allow a clean targeting of specific segments, a strategy of discounting should be approached cautiously. It reduces the average price and contribution received and may attract customers whose only loyalty is to the firm that can offer the lowest price on the next transaction. Volume discounts are sometimes used to cement the loyalty of large corporate customers who might otherwise spread their purchases among several different suppliers.

**Who Should Collect Payment?**

As discussed in Chapter 4, supplementary services include information, order-taking, billing, and payment. Customers appreciate it when a firm makes it easy to obtain price information and make reservations. They also expect well-presented billing and convenient procedures for making payment. Sometimes, firms delegate these tasks to intermediaries such as travel agents who make hotel and transport bookings and collect payment from customers and ticket agents who sell seats for theaters, concert halls, and sports stadiums. Although the original supplier pays a commission, the intermediary usually is able to offer customers greater convenience in terms of where, when, and how payment can be paid. Using intermediaries may also result in a net savings in administrative costs. Nowadays, however, many service firms are promoting their websites with best rate or price guarantees as direct channels for customer self-service, thus bypassing traditional intermediaries and avoiding payment of commissions.

**Where Should Payment Be Made?**

Service delivery sites are not always conveniently located. Airports, theaters, and stadiums, for instance, often are situated some distance from where potential patrons live or work. When consumers have to purchase a service before using it, there are obvious benefits to using intermediaries that are more conveniently located, or allowing payment by mail or bank transfer. A growing number of organizations now accept Internet, telephone, and email bookings with payment by credit card.

**When Should Payment Be Made?**

Two basic options are to ask customers to pay in advance (as with an admission charge, airline ticket, or postage stamps) or to bill them once service delivery has been completed, as with restaurant bills and repair charges. Occasionally, a service provider may ask for an initial payment in advance of service delivery, with the balance due later (Figure 6.10). This approach is quite common for expensive repair and maintenance jobs, when the firm—often a small business with limited working capital—must buy materials upfront.

Asking customers to pay in advance means the buyer is paying before the benefits are received. However, prepayments may be advantageous to the customer as well as to the provider. Sometimes it is inconvenient to pay each time a regularly patronized service—such as the Postal Service or public transport—is used. To save time and effort, customers may prefer the convenience of buying a book of stamps or a monthly travel pass.
Performing arts organizations with heavy upfront financing requirements offer discounted subscription tickets in order to bring in money before the season begins.

Finally, the timing of payment can determine usage pattern. From an analysis of the payment and attendance records of a Colorado-based health club, John Gourville and Dilip Soman found that members’ usage patterns were closely related to their payment schedules. When members made payments, their use of the club was highest during the months immediately following payment and then declined steadily until the next payment; members with monthly payment plans used the health club much more consistently and were more likely to renew, perhaps because each month’s payment encouraged them to use what they were paying for.

Gourville and Soman conclude that the timing of payment can be used more strategically to manage capacity utilization. For instance, if a golf club wants to reduce the demand during its busiest time, it can bill its fees long before the season begins (e.g., in January rather than in May or June), as the member’s pain of payment will have faded by the time the peak summer months come, and thereby reduces the need to get his or her “money’s worth.” A reduction in demand during the peak period would then allow the club to increase its membership.28

**How Should Payment Be Made?**

As shown earlier in Table 6.3, there are many different forms of payment. Cash may appear to be the simplest method, but it raises security problems and is inconvenient when exact change is required to operate machines. Accepting payment by check for all but the smallest purchases is now fairly widespread and offers customer benefits, although it may require controls to discourage bad checks, such as a hefty charge for returned checks ($15–$20 on top of any bank charges is not uncommon at retail stores).

Credit and debit cards can be used around the world. As their acceptance has become almost universal, businesses that refuse to accept them increasingly find themselves at a competitive disadvantage. Many companies also offer customers the convenience of a credit account, which generates a membership relationship between the customer and the firm (see Chapter 12).

Other payment procedures include tokens or vouchers as supplements to (or instead of) cash. Vouchers are sometimes provided by social service agencies to elderly or low-income citizens. Such a policy achieves the same benefits as discounting, but avoids the need to publicize different prices and to require cashiers to check eligibility.

Now coming into broader usage are prepayment systems based on cards that store value on a magnetic strip or in a microchip embedded within the card. Service firms that want to accept payment in this form, however, must first install card readers. Service marketers should remember that the simplicity and speed with which payment is made may influence the customer’s perception of overall service quality. To save its customers time and effort, Chase bank has introduced credit cards with what it calls “blink,” an embedded technology that can be read by a point-of-sale terminal without physically touching it.

Interestingly, a recent study found that the payment mechanism has an effect on the total spending of customers, especially for discretionary consumption items such as spending in cafes.29 The less tangible or immediate the payment mechanism, the more consumers tend to spend. Cash is the most tangible (i.e., consumers will be more careful and spend less), followed by credit cards, prepayment cards, and finally more sophisticated and even less tangible and immediate mechanisms such as payment via one’s cell phone service bill.
How Should Prices Be Communicated to the Target Markets?

The final task, once each of the other issues has been addressed, is to decide how the organization’s pricing policies can best be communicated to its target market(s). 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 intelligible and unambiguous ways so that customers will not be misled and question the ethical standards of the firm. Dismayed by the complexity of cell phone calling plans in the United States, Consumers Union has called for a simple, standardized summary of the features of each calling plan that would simplify the process for consumers to compare competing offers. This would be similar in style to the government-mandated box printed on all credit card solicitations that lays out, in standard format and readable type, the offer’s essential rates and terms.30

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 or even hundreds of items, have been much criticized for inaccuracy. Hotel bills, despite containing fewer entries, are also notoriously inaccurate. One study estimated that business travelers in the United States may be overpaying for their hotel rooms by half-a-billion dollars a year, with 11.6 percent of all bills incorrect, resulting in an average overpayment of $11.36.31

CONCLUSION

To determine an effective pricing strategy, a firm has to have a good understanding of its costs, the value created for customers, and competitor pricing. In addition, revenue management is a powerful tool that helps to manage demand and to price different segments closer to their value perceptions. A pricing strategy must address the central issue of what price to charge for a given unit of service at a particular point in time (however that unit may be defined). Because services often combine multiple elements, pricing strategies can be highly creative.

Finally, firms need to be careful lest pricing schedules become so complex and hard to compare that they simply confuse customers and can lead to accusations of unethical behavior, loss of trust, and customer dissatisfaction. Therefore, great care has to be taken in the way service pricing and revenue management are implemented to ensure that customer satisfaction and perceived fairness are not compromised.

Chapter Summary

LO1 Effective pricing is central to the financial success of service firms. The objectives for establishing prices can be to generate profits, cover costs, build demand, and develop a user base. Once a firm sets its pricing objectives, it needs to decide on its pricing strategy.

LO2 The foundations of a pricing strategy are the three legs of the pricing tripod:
- The costs the firm needs to recover set the minimum or floor price.
- The customer’s perceived value of the offering sets a maximum or ceiling price.
- The price charged for competing services determines where, within the floor-to-ceiling range, the price can be set.

LO3 The first leg of the pricing tripod is the cost to the firm.
- Costing services often is complex. Services frequently have high fixed costs, varying capacity utilization, and large shared infrastructures that make it difficult to establish unit costs.
- If services have a large proportion of variable and/or semivariable costs, cost-accounting approaches work well (e.g., using contribution and break-even analysis).
- However, for complex services with shared infrastructure, activity-based costing (ABC) often is more appropriate.

LO4 The second leg of the pricing tripod is value to the customer.
- Net value is the sum of all perceived benefits (gross value) minus the sum of all the perceived costs of a service. Customers will only buy if the net value is positive. The net value can be enhanced by increasing value and reducing costs.
- Since value is perceived and subjective, it can be enhanced through communication and education
to help customers understand the value they receive.

• In addition to the price customers pay for the service, costs include related monetary costs (e.g., the taxi fare to the service location) and nonmonetary costs (e.g., time, physical, psychological, and sensory costs) during the search, purchase and service encounter, and postconsumption stages. Firms can enhance net value by reducing these related monetary and nonmonetary costs.

LO5 The third leg of the pricing tripod is competition.

• Price competition can be fierce in markets with relatively undifferentiated services. Here, firms need to closely observe what competitors are charging and price accordingly.

• However, services tend to be location- and time-specific, and competitor services have their own set of related monetary and nonmonetary costs, sometimes to the extent that the actual prices charged become secondary for competitive comparisons.

LO6 Revenue management (RM) increases revenue for the firm through better capacity utilization and reserving capacity for higher paying segments. Specifically, RM:

• Designs products using physical and nonphysical rate fences, and prices them for different segments according to their specific reservation prices.

• Sets prices according to predicted demand levels of different customer segments.

• Works best in service businesses characterized by (1) high fixed costs and perishable inventory, (2) several customer segments with different price elasticities, and (3) variable and uncertain demand.

LO7 Well-designed rate fences are needed to define “products” for each target segment so that customers with high value for a service offer are unable to take advantage of lower price buckets. Rate fences can be physical and nonphysical:

• Physical fences refer to tangible product differences related to different prices (e.g., seat location in a theatre, size of a hotel room, or service level).

• Nonphysical fences refer to consumption (e.g., stay must be over a weekend), transaction (e.g., two weeks advance booking with cancellation and change penalties), or buyer characteristics (e.g., student and group discounts). The service experience is identical across fence conditions although different prices are charged.

LO8 Customers often have difficulties understanding service pricing (e.g., RM practices and their many fences and fee schedules). Service firms need to be careful that their pricing does not become so complex and with hidden fees that customers perceive them as unethical and unfair.

LO9 The following ways help firms to improve customers’ fairness perceptions:

• Design price schedules and fences that are clear, logical, and fair.

• Use published prices and frame fences as discounts.

• Communicate consumer benefits of revenue management.

• Use bundling to “hide” discounts.

• Take care of loyal customers.

• Use service recovery to deal with overbooking.

LO10 To put service pricing into practice, service marketers need to consider seven questions to have a well-thought-out pricing strategy. The questions are:

1. How much to charge?
2. What should be the specified basis for pricing?
3. Who should collect payment?
4. Where should payment be made?
5. When should payment be made?
6. How should payment be made?
7. How should prices be communicated to the target markets?

Review Questions

1. What is the role of service pricing and revenue management in a business model?

2. Why is the pricing of services more difficult compared to the pricing of goods?

3. How can the pricing tripod approach to service pricing be useful to come to a good pricing point for a particular service?

4. How can a service firm compute its unit costs for pricing purposes? How does predicted and actual capacity utilization affect unit costs and profitability?

5. Why can’t we compare competitor prices dollar-for-dollar in a service context?

6. Why is the price charged by the firm only one, and often not the most important component of the total cost to the consumer? When should we cut non-price-related costs to the bone, even if that incurs higher costs and a higher price to be charged?

7. What is the role of nonmonetary costs in a business model, and how do they relate to the consumer’s value perceptions?
8. What is revenue management, how does it work, and what type of service operations benefit most from good revenue management systems and why?

9. Why are ethical concerns and fairness perception important issues when designing service pricing schedules and revenue management strategies? What are potential consumer responses to service pricing schedules or policies perceived as unfair?

10. How can we charge different prices to different segments without customers feeling cheated? How can we even charge the same customer different prices at different times, contexts, and/or occasions, and at the same time be seen as fair?

11. What are the seven key decisions managers need to make when designing an effective pricing schedule?

Application Exercises

1. Select a service organization of your choice, and find out what its pricing policies and methods are. In what respects are they similar to or different from what has been discussed in this chapter?

2. From the customer perspective, what serves to define value in the following services: (a) a hair salon, (b) a legal firm specializing in business and taxation law, and (c) a nightclub?

3. Explore two highly successful business models based on innovative service pricing and/or revenue management strategies, and identify two business models that failed because of major issues in their pricing strategy. What general lessons can you learn from your analysis?

4. Review recent bills you have received from service businesses, such as those for telephone, car repair, cable TV, and credit cards. 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, and (g) ease of access to customer service in case of problems or disputes.

5. How might revenue management be applied to (a) a professional service firm (e.g., consulting), (b) a restaurant, and (c) a golf course? What rate fences would you use and why?

6. Collect the pricing schedules of three leading cell phone service providers. Identify all the pricing dimensions (e.g., airtime, subscription fees, free minutes, per second/6 seconds per minute billing, air time roll-over, etc.) and pricing levels for each dimension (i.e., the range offered by the players in the market). Determine the usage profile for a particular target segment (e.g., a young executive who uses the phone mostly for personal calls or a full-time student). Based on the usage profile, determine the lowest-cost provider. Next, measure the pricing schedule preferences of your target segment (e.g., via conjoint analysis). Finally, advise the smallest of the three providers how to redesign its pricing schedule to make it more attractive to your target segment.

7. Consider a service of your choice, and develop a comprehensive pricing schedule. Apply the seven questions marketers need to answer for designing an effective pricing schedule.

Endnotes


21. The banking examples and data in this section were from Dean Foust, “Protection Racket? As Overdraft and Other Fees Become Huge Profit Sources for Banks, Critics See Abuses,” *Business Week*, 5, February 2005, 68–89.


