Business Data Management
Professor G. Venkatesh
Professor M Suresh Babu
Department of Humanities and Social Sciences
Indian Institute of Technology Madras
Types of Pricing Strategies

(Refer Slide Time: 0:15)

Professor M Suresh Babu: So, well, the broad pricing strategies are something we have listed out here, although it is a long list. But then, we will take up some of it because some of it is derived from the earlier discussions that we have and some of it is new. So, we will go through that quickly.

(Refer Slide Time: 0:33)

Professor M Suresh Babu: Now, a very interesting kind of pricing model is market skimming pricing. Basically, this is for high price and low volume. When is this important? This requires complete information of demand. That is to remember our definition of demand ability and willingness to pay. So, I should know the ability to pay, and when they realise that my customer has the ability to pay and will really pay because the customer thinks that there is a utility that is derived by paying an even higher price, I will skim the market.

Professor G Venkatesh: Skim? The word skim comes from milk, right?

Professor M Suresh Babu: You are taking out the cream. And better you be the cream.

Professor G Venkatesh: So presumably in the customer segment there is somebody who has got a lot of money. He is the cream. So, somehow you want to take the cream customer segment and charge them much higher.

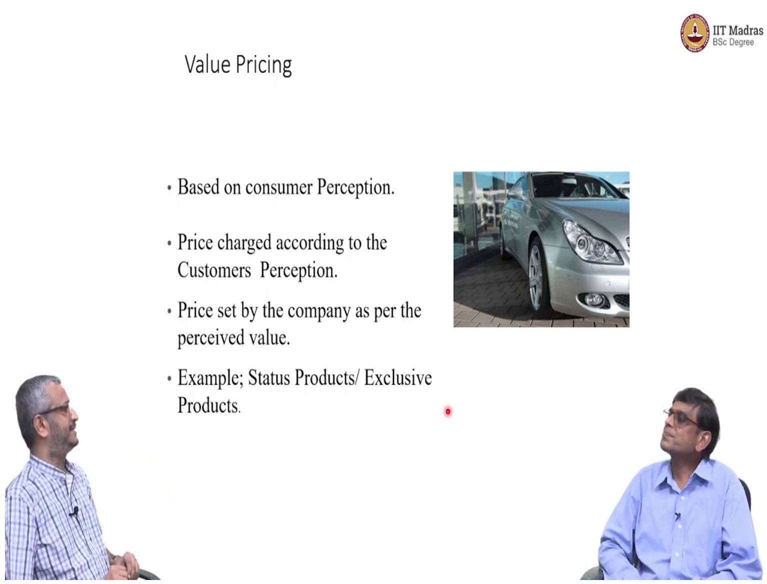
Professor M Suresh Babu: Much higher and then position in the market in such a way that well this product is a very premium product and there are people willing to pay for it. We also sometimes think of certain restaurants, for example, the same food we might have in some other restaurant which might be less in terms of the. But then that ambience, the kind of expectations of going to that place or it is not very crowded we can sit and chat for some time about all these things.

So, these kinds of restaurants are positioned in the market in such a way that they are going to skip these kinds of customers. So, that is a very interesting kind of model. Now, this is suitable for products that have a very short life cycle. You cannot keep skimming again and again because then the customer has no cream left. So, that is one. Second, there will also be competition. And when a potential entrant actually sees that there is this possibility of skimming, that potential entrant might also enter perhaps at a lower price undercutting your kind of sales volumes. So, you will be really in trouble in the long run.

Professor G Venkatesh: So, some of these fashion brands give limited editions and limit the number. So, that is clearly skimming. Then there may be 1000 of these high value cars or 1000 of these clothing or whatever it is branded clothing.

Professor M Suresh Babu: Boutique, clothing and things of that sort. I want a shirt which is unique and others should not have that when I go to the street. So, there will be a higher price of the same comfortable cotton. But then prices are very high for certain reasons. So that is one kind of strategy.

(Refer Slide Time: 3:26)



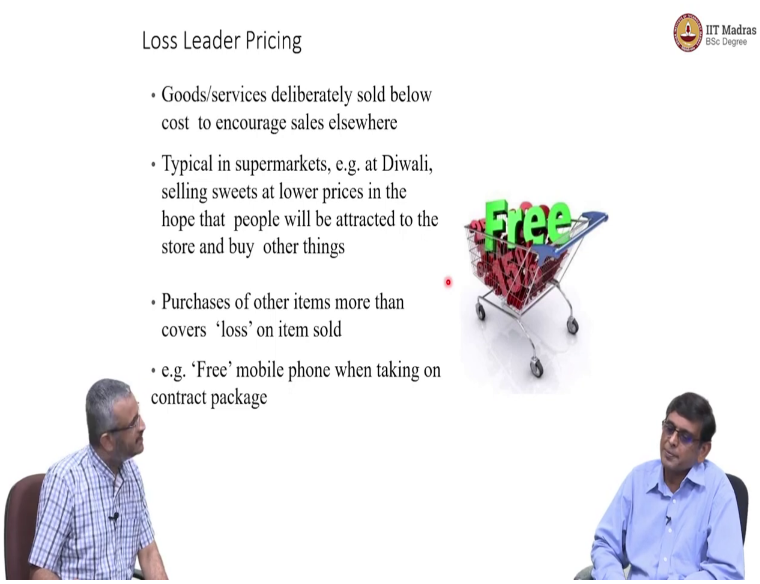
Professor M Suresh Babu: The second strategy is value pricing.

Professor G Venkatesh: These are the other types also.

Professor M Suresh Babu: Here, we also need customer perception data very well. And price is charged according to this customer's perception of the value for money of the product, we say when we buy certain things. So, perceived value has to be understood. So, why are we emphasising all these things? We are emphasizing all these because each one of these models requires intensive data work because you need to do surveys to find out what the customer is thinking about the product.

And then, you set the price according to this perceived value. Some are categorized as exclusive products. Some are categorized as low value. So, you charge according to that and get into that segment of the market position yourself in that category. So, that is another kind of model that firms use.

(Refer Slide Time: 4:26)



Professor M Suresh Babu: Third very interesting kind of model is what is known as loss leader pricing. That is below cost. And large volumes I want.

Professor G Venkatesh: But if it is below cost.

Professor M Suresh Babu: Dumping.

Professor G Venkatesh: More volume is more of a secondary.

Professor M Suresh Babu: No, but I will get a customer base, perhaps. So, I will do it.

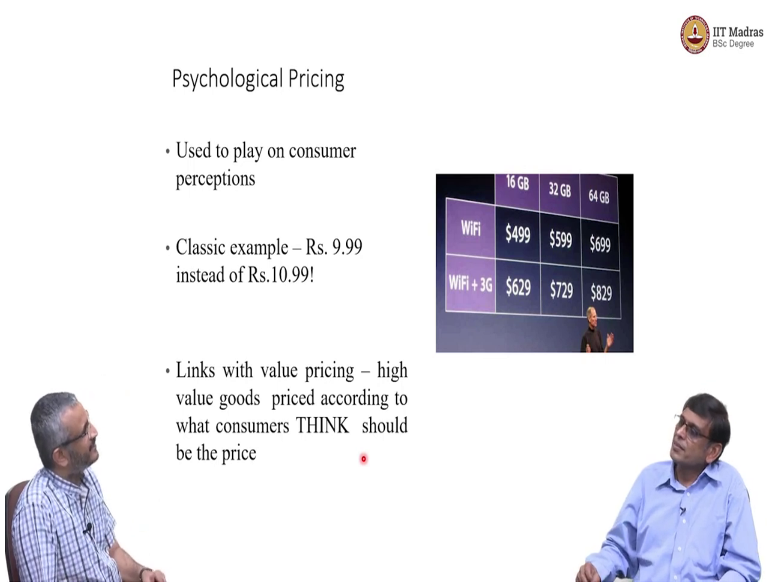
Professor G Venkatesh: I think I will repeat.

Professor M Suresh Babu: I will do it in period t and in period t1 if I make sure that the customer is coming back to me, perhaps I will now slowly start increasing this thing. So, it is a slightly long term strategy. So, this is typically in terms of supermarkets. In Diwali time, we see that selling sweets is a strategy in both ways. One just for the sheer volume of the sweets. Second, if you are a big supermarket and if you have a sweet counter outside you are actually attracting customers.

Professor G Venkatesh: They do it, in clothing they do that sale. There is a 50 % sale but there will be 4 items or Bata only 4 or 5 items which are actually on the 50 %. Once you go in you are going to buy something.

Professor M Suresh Babu: And then we find that new arrivals are there. New arrivals there are no discount. So, this is a very interesting kind of strategy. Because it is basically to attract people at your side. And then perhaps so it is a two-period kind of a strategy.

(Refer Slide Time: 5:51)



Professor M Suresh Babu: Then there is a psychological pricing that is another interesting kind of a thing again to play on consumers perception of value.

Professor G Venkatesh: On this perception when we kind of listen.

Professor M Suresh Babu: There is a threshold in terms of prices that the consumer sets in the mind.

Professor G Venkatesh: Commutatively you can understand.

Professor M Suresh Babu: They will arrive at that and keep that as a threshold. Oh, I do not want to pay more than 100 rupees for something. I decided like that. So, if there is something like a typical 9.99 price it is as good as 10 rupees. But the consumer in his or her mind has already fixed this threshold more than 10 rupees I do not want to really pay. So actually, the price could have been 10.99 instead of 11. But then I do not want to cross this 10.

So, only Bata's strategy 90.95 or 20.95 kind of thing was precisely to have this kind of psychology. So, basically this is charging according to what the consumers think should be the price. Because when I keep this threshold in my mind it is not worth paying for a coffee more than this much. So just below that. But again, the important thing is to understand the consumers' minds, which is very, very important. So, that is why at one level when we look at it, the interesting thing is that marketing and psychology are very much related.

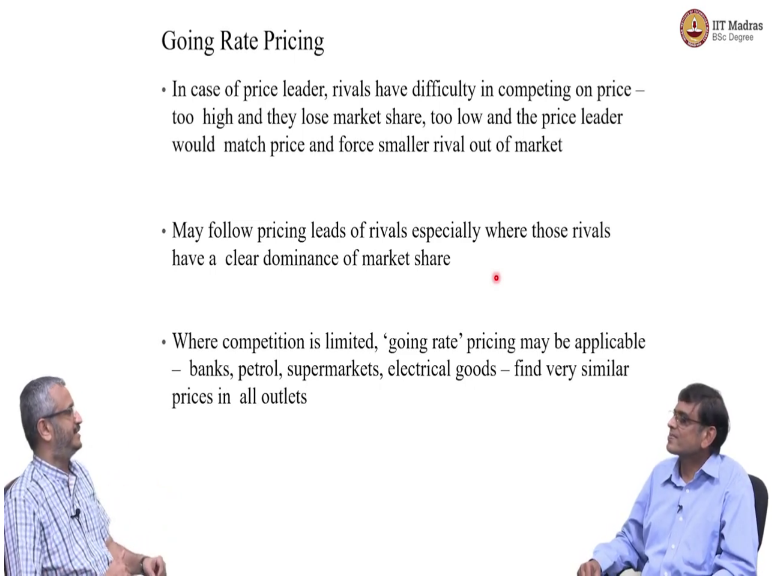
Professor G Venkatesh: Because people when it is very clear that people do not have the sense of numbers like we have in mathematics. For them 499. They might think of it like 400 or 300 just what is the difference between 350 and 499 they may not think it. But if it is a 500 they think it is a big number.

Professor M Suresh Babu: It is an upper threshold until you pay for it. That is too much.

Professor G Venkatesh: Number sense.

Professor M Suresh Babu: That is why this is called psychological price kind of a pricing.

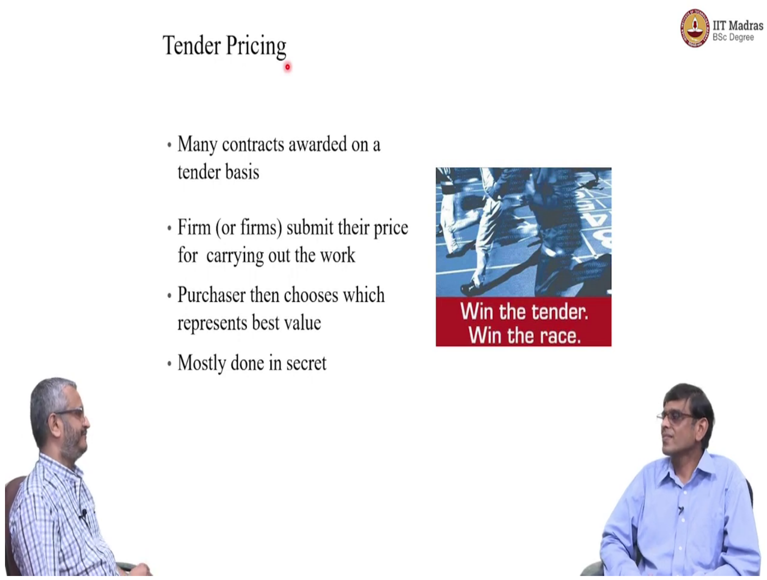
(Refer Slide Time: 7:50)



Professor M Suresh Babu: Now, then what is going rate pricing that is basically there is a market rate which is set by the players in the market. And I want to actually vary the price but I am not to vary the price because the rivals will immediately then dominate the market share. So, I am a price taker. I will just take what price is just there in the market. But in this kind of a pricing model, I need to constantly keep watch of what my rivals' prices are.

If the rival actually alters the price, perhaps it brings down the price. I should also immediately break down otherwise I may be pushed out. So, here not only the demand factor but also the rivals' pricing and rivals' kind of interactions with you in terms of possible price cutting or price increases also need to be understood in this kind of pricing strategy.

(Refer Slide Time: 8:48)



Professor M Suresh Babu: Then, tender pricing. This is common in certain kinds of work.

Professor G Venkatesh: Government Purchases.

Professor M Suresh Babu: yes Government purchases and some from corporates also. Because even though we call it a tenter pricing the idea here is to convey the perception that I might be low cost but I am really delivering value to you. So, in government we know that most of the tenders are for the lowest bidder. Now, even with such a low bid I will give you a quality. There is no doubt about it and I can deliver quality at that price. That is something which you have to convey. Now, here actually for tender pricing one important aspect is that in industrial organization what we call reputation is very important.

Professor G Venkatesh: Past progress.

Professor M Suresh Babu: For example, builders sometimes know we go by the reputation whether this builder will be able to deliver quality stuff within 12 months at this price or not. So, in tender pricing very important is reputation. And basically, in the market mechanism, reputation has an important role. But especially in this kind of situation, your ability to deliver is often gauged by the consumer in terms of your past track record.

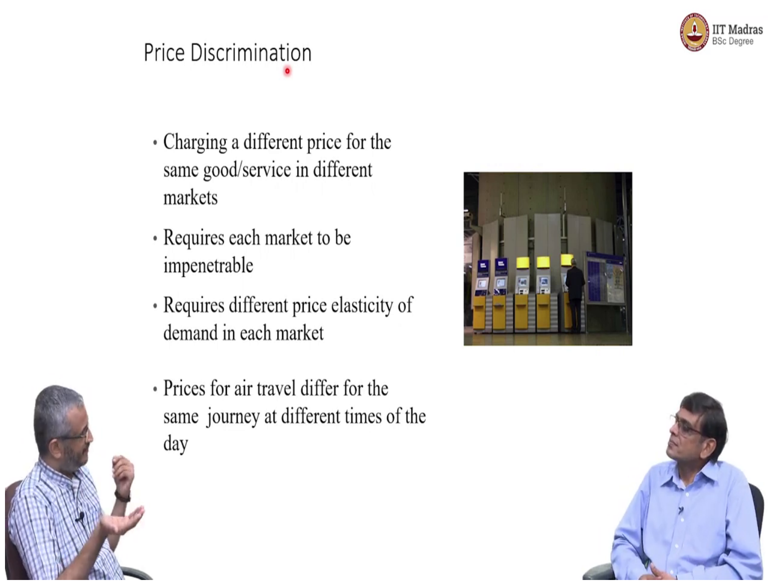
Professor G Venkatesh: If you do not have a past record they are not going to shortlist you here, then only it comes to bidding. You are first getting to the shortlist. Only you can get to the bidding stage.

Professor M Suresh Babu: So, here, the entry barriers are quite high. So, that is why the possibility of collusion is also high. Because that is only 4 or 5 and they will actually decide.

Professor G Venkatesh: If you know each other.

Professor M Suresh Babu: This time you go ahead I am not bidding. So, if there is a possibility of an information flow between these players then they will come to a collusive thing. So, one of the things that we always think about of auction markets is that it is quite efficient then it actually solves a lot of inefficiencies of the regular market mechanism. But if the possibility of collusion arises in such a situation then even this tender pricing will not be very effective.

(Refer Slide Time: 11:19)



Professor M Suresh Babu: Now, we have very interesting strategy that is price discrimination. That is, the same commodity is offered to different people at different prices. Classic case. Airline tickets. It is the same airline morning 9:30 flight.

Professor G Venkatesh: Even the same seat class where economy class sold at different prices

Professor M Suresh Babu: So, you would book?

Professor G Venkatesh: When are you booked?

Professor M Suresh Babu: You would have booked one week earlier, I booked at the last moment. But last moment booking can also be good as well as bad in the last moment. There could be discounts not in India but in other countries there are possibilities of discounts. But an early booking might also have an advantage.

Professor G Venkatesh: How you belong in a hotel and all that through travel agents.

Professor M Suresh Babu: So, the discrimination then is this kind of strategy where firms actually sell the same product at different customers at different prices. Now, these are very interesting kinds of strategies. Why? Because it depends on the customer, one, I should know the customer. Because it is based on an assumption that if a customer is coming in the next moment to book an airline ticket that travel is urgent. You can' postpone that is why this person is traveling. So, perhaps you will see that you are willing to pay a little more for that information.

Professor G Venkatesh: Or business class travelers may want to cancel a ticket or change the ticket. So, they read that feature. So, they are willing to pay.

Professor M Suresh Babu: They are willing to pay more. So, understanding the customer's value again is very important to offer discrimination. Second important condition for price discrimination to operate is that well there should not be any possibility of resale of the product. So, suppose I buy at a low price and then I sell it to you at a slightly higher price but lower than what the firm is actually charging. this price discrimination is not a successful thing.

So, in all these markets, when there is no possibility of resale only we can actually have price discrimination. The third important thing is that well it depends on the product to a great extent, in perishable commodities market, we find that price discrimination is often resorted because this is going to sell it off towards the end, because they know it is perishable. But the customer also might wait and watch up to a point.

And then after that, there is a turning point in terms of the perishability of the commodity. So, they will go just before that kind of thing. And buy it at a price which is lower than the warning price or whatever the sell of recoating. So, the price discrimination is a very, very important and very interesting kind of strategy. Now, this price discrimination allows us to have very different kinds of pricing models.

For example peak road pricing is actually a variant of price discrimination. Again, in terms of metro travel morning 8 to 10 if you are commuting if you do not have a season ticket or whatever it is then if you are buying tickets from the counter you need to pay more because 8 to 10 there is already large number of office goers who are going and so if you are also going at that particular point of time your travel is an urgent work that you have to do. You are willing to pay more for that.

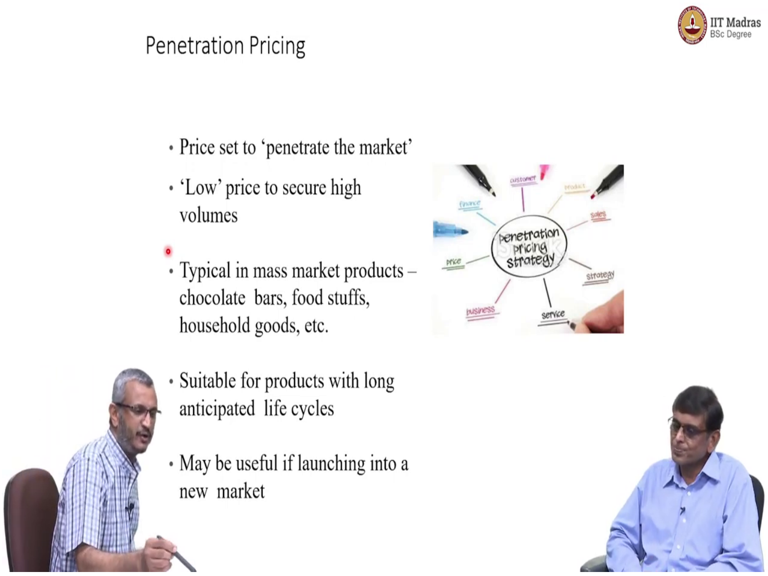
So, peak pricing off peak pricing is one kind of a very interesting kind of discrimination model. And especially the electricity pricing and peak pricing is usually, basically, second kind of a derivative of this price discrimination module is what we call as a kind of cross price subsidization. That is the same service I as a service provider has some information that this person is willing to pay more.

So, I will charge this person more but at the same time I get another customer who is not willing to, who does not have the ability to pay more. So, I might subsidize that customer so the subsidy that I'm giving to the customer is actually recovered from customer one. Electricity is like that. So, a number of service, it is all variant of this price discrimination model, it is the same service that people are getting.

Professor G Venkatesh: In trains also I think they subsidize the people who travel in general class.

Professor M Suresh Babu: The second AC third AC kind of a thing. So, price discrimination then it is a very interesting strategy. But the important thing is that we need complete information on the ability as well as a willingness of a consumer to pay and then arrive at a price. There should not be a resale of a product by the person who ever purchased it.

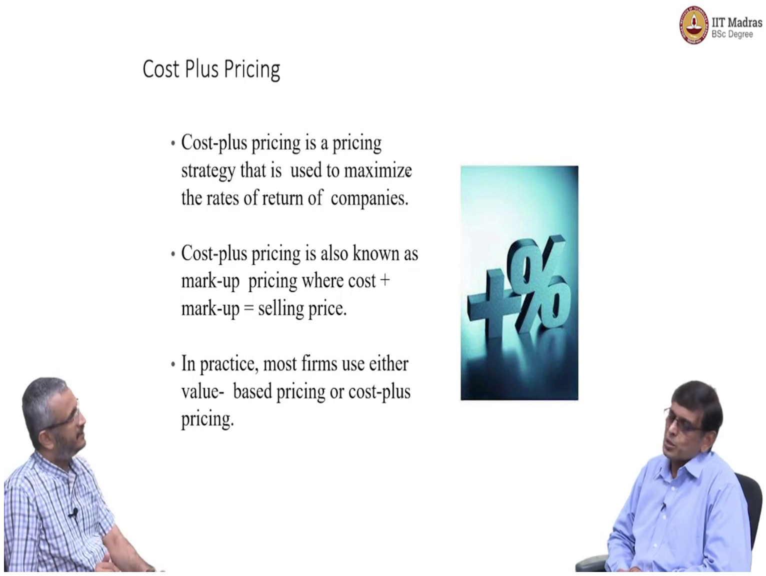
(Refer Slide Time: 16:37)



Professor M Suresh Babu: Now, that takes us to another interesting pricing model. That is penetration pricing. We talked about Jio's example. So, you initially keep the price at a very, very low level. And then you secure these high volumes. So typically, in mass markets, such products can be found. We keep it very, very low prices and then large volumes. Walmart kind of strategy all comes under this kind of penetration pricing. Now, here it is very useful when you launch a product.

Because immediately, the consumer will do many comparisons in mind like the existing product I am paying this much for. Here is this new one with all these kinds of features at a lower price. Why not let us try this? Kind of a thing. And you get a consumer to try it once at this low price perhaps you made a video with that kind of product. Now, firms use this to switch consumer loyalties. But we should also remember consumer loyalties are not only a function of price. Consumer loyalty is also a function of a lot of other features or features. And that is something which is getting exploited when they launch a new product through penetration pricing.

(Refer Slide Time: 18:07)



Professor M Suresh Babu: So, another perspective on pricing is to see pricing from a cost recovery angle. That is a firm would like to recover some costs fully. And some costs at least partially if not fully. And pricing then arrives in terms of how much you want to recover of what kind of cost. Now, in the long run, we know that if you cannot recover full cost then you really cannot survive for a long time. So, this cost-plus pricing is an important kind of a model that is used where there is a markup over costs. So, what is this markup? So, I know my cost then I also need certain profits. Because I am not in the market for those who have philanthropy. So, the costs post a factor.

Professor G Venkatesh: So, usually the customer knows your costs already. So, there is a transparency that the customer has because they know your costs, then they know what we have added on to it.

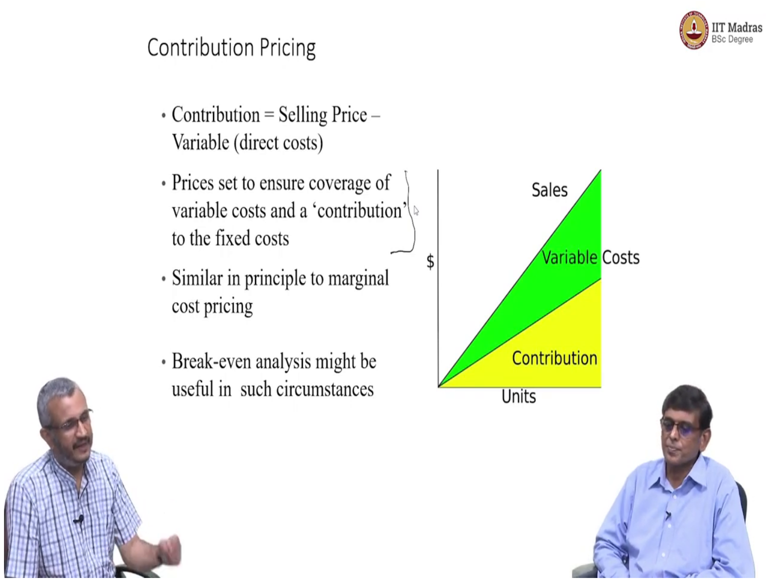
Professor M Suresh Babu: But the costs and approximately a customer will have because the firm might use different strategies to minimize the costs that might not be apparent to the customers. So, the customer has some idea in terms of the costs. And then you keep a markup over and above that cost. And then you arrive at a pricing formula that is called cost plus pricing.

Professor G Venkatesh: Now, manufacturing services are CMS since all huge costs plus. Mostly cost plus even automotive, I think the majority of the suppliers cost plus.

Professor M Suresh Babu: Bike manufacturing uses.

Professor G Venkatesh: Manufacturing uses cost plus.

(Refer Slide Time: 19:50)



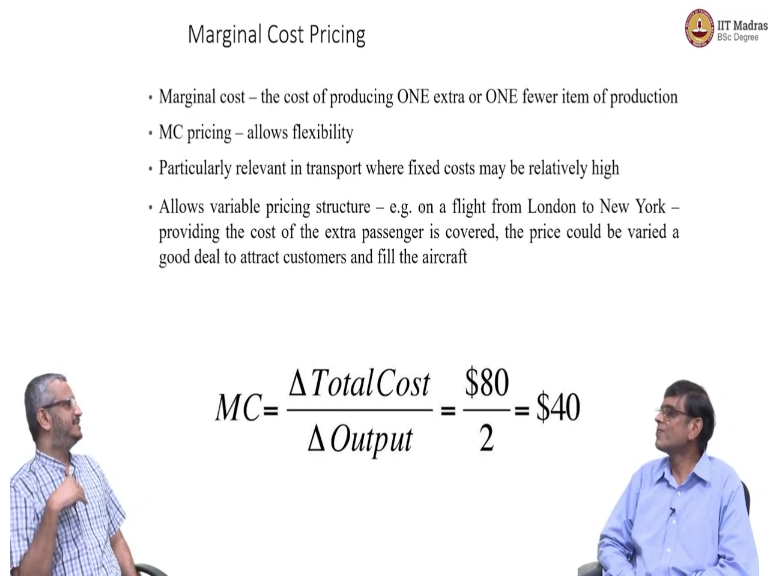
Professor M Suresh Babu: Now, when we look at this cost plus then there is a question as to what cost do you want to cover in the first instance? Generally, firms cover variable costs. That is prices are insured or are set to ensure a coverage of variable costs and a contribution to the fixed costs. At least a portion of the fixed costs if I can get all a longer period of time then I will recover my fixed costs. But variable costs I have to cover fully. So, that is one kind of a cost-plus pricing. So, there the cost is 100 % variable costs, a fraction of the fixed costs and then the markup that is a formula that firms use. And then that depending on the product and the market in which I operate I will arrive at a pricing strategy.

(Refer Slide Time: 20:48)

There is also something called target pricing. That is what I want, this much profit. I am already setting the objective of the firm as achieving this match of profits. There is a specific target in terms of profits. And to arrive at that I need to have a pricing formula. Where I might say cause variations might not be high first, second cost variance solutions sometimes are out of the control of the firm. For example, energy prices and things of that sort.

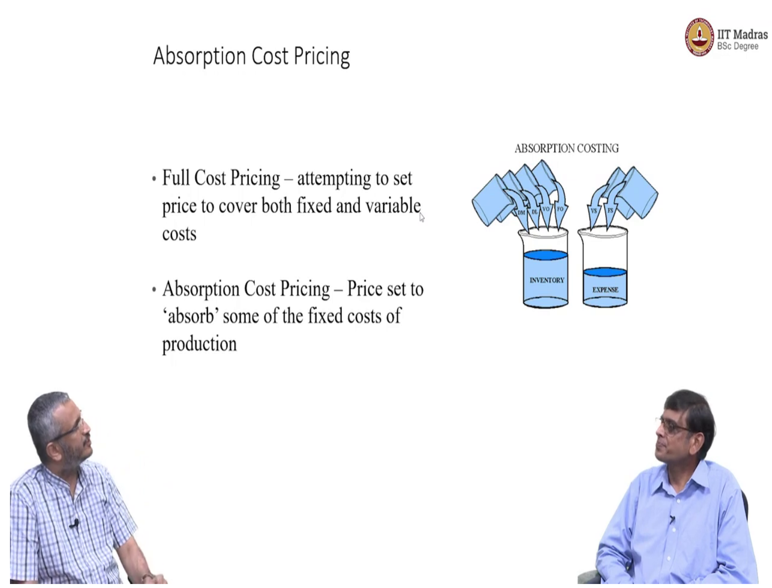
But markup is within the control of the firm. So, you vary your markup in such a way that you reach your target in terms of profits. For example, depending on the demand conditions, you actually might vary your markup. When the demand is very high in certain products markup will also be very high. Because they think that they can take maximum. But when the demand is skimming there. When the demand is actually low, then you are sometimes a little jittery. Because you are not sure what is going to happen in the next period. So, you might actually cut your mark up. So, depending on that you will actually achieve your targets using the target pricing model.

(Refer Slide Time: 22:07)



Professor M Suresh Babu: And most of these pricing models also use marginal cost pricing. That is we find that we know what marginal costs are. And marginal cost also allows us some flexibility because you can see variations in marginal cost. Because there is an incremental unit of output that is produced now. And what is the cost of that, you equate that to the price and perhaps add some markup to that depending on the market conditions in which you are operating. So, for the firm to arrive at marginal cost pricing is the most straightforward kind of a pricing formula.

(Refer Slide Time: 22:44)



Professor M Suresh Babu: But there is also the other thing that the firm wants to do that is full cost pricing. That is not only a marginal cost I want to cover the full cost that is incurred.

Professor G Venkatesh: Average total costs whatever.

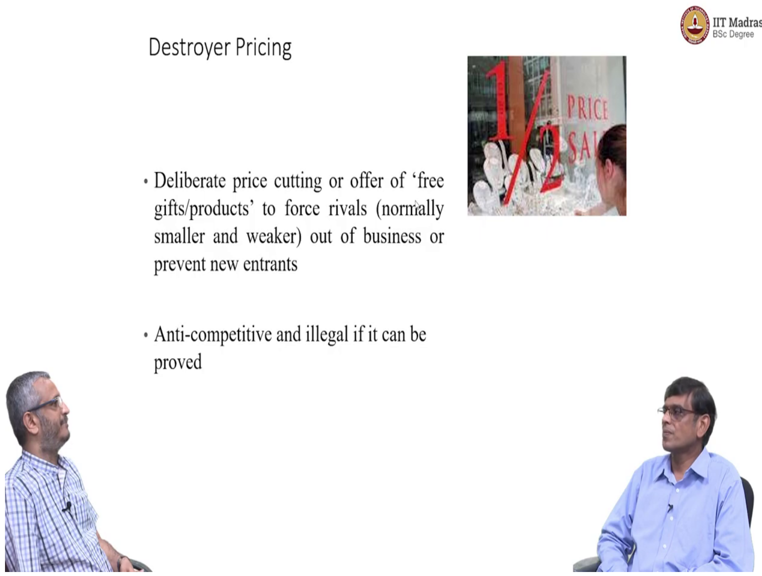
Professor M Suresh Babu: So, absorption cost pricing is called this kind of full cost pricing, that is some of the fixed costs are also covered. Then the variable costs are also covered. So, I am not looking at marginal cost which is mostly in the short running function of the variable costs but full cost is covered in this. Now, it also depends on the kind of a product that we are talking about. Then you have low sunk costs fit that is fixed costs is there

But a large portion of fixed costs is not sunk then perhaps you might go for absorption cost pricing. But when you have sunk costs that are very high then you might actually try to stagger it over a period of time. Then you need to be in the business for a long period of time. But the sunk cost is where you cannot exit very fast.

Professor G Venkatesh: Because there is no exit value for that.

Professor M Suresh Babu: So, in certain markets like what we call contestable markets where the demand is there at a particular point in time people might enter and then they might use this kind of absorption full cost pricing and keep the markup also higher than this cost and sometimes they might exit. So, each reach is some kind of thing, certain entries will come. We see that they come and make a lot of kind of an impact in the short run. But after some time, you can see that this vanishing because the sunk cost is very low for them. And they want to cover this full cost in their pricing strategy. So, absorption cost pricing is that other kind of thing.

(Refer Slide Time: 24:33)



Professor M Suresh Babu: Finally, related to this predatory pricing is what is known as destroyer pricing. That is I have a threat of an entry and I can smell it that there is somebody who is trying to enter into the market. Immediately I undercut my price, keep it at the lowest possible point. So, the new intern will find it very difficult to survive post entry. So, there are two decisions which an entrant would take, one, the decision to enter, two, the decision to survive or how long will it take for me to survive in this market post entry.

Now, more or less if we have made up the decision to enter you will enter as a new entrant. But with this destroyer pricing what you are doing is the time duration. Your survival factor is actually very difficult. So, they will try for some time and finally they are forced to exit. Now, this is a very interesting kind of strategy which has got implications in a lot of models of industrial organization.

For example, there is the prey-predator kind of pricing. So, I am a predator. I am just waiting for the new firm to come. As soon as I get a signal that the new firm is coming, I will just cut my price and keep it very low. Still, if this new firm is actually entering into the market, I will cut it again. I will make it very difficult. And at an appropriate point I will just point out to the new firm, I will acquire that through a merger or takeover.

And then I will increase our price, I am the monopolist, I will increase the prices. So, a lot of models of industrial organization use this kind of off pricing strategy. So, we have now seen a lot of models in terms of pricing but three things we need to keep in mind. One, we need to have an idea of demand, we need to have an idea of the perception of the product by the consumer to arrive at an appropriate pricing strategy. Two, we need to have full information about the costs because based on the cost you arrive at a pricing strategy. And three, we also need to have information about our rival strategy in terms of pricing. Depending on all this information, we will arrive at an appropriate pricing strategy.