Pricing Strategy

Expand Your Pricing Paradigm

Look to other industries for inspiration. by Rafi Mohammed

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Summary. With inflation high, a global recession possible, and consumers spending carefully, many companies are concerned about preserving profit margins. In this article, pricing consultant Rafi Mohammed argues that instead of simply adjusting prices, firms should...

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For nearly a century, most auto insurance companies have priced their services in the same way, charging customers an annual

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premium for unlimited driving. The premium varies depending on a driver's age, vehicle, driving history, estimated annual mileage, coverage levels, and other factors, but the basic pricing scheme—an annual premium—has been an industry standard.

A little more than a decade ago, executives at Allstate began debating a question: If we could better assess who's driving safely and how much someone is behind the wheel, could we improve the way we set prices—and attract new customers in the process? After careful study, Allstate decided the answer was yes.

In 2010 the company introduced Drivewise, a program that uses telemetric technology (a plug-in device or a smartphone app) to monitor enrolled customers' real-time driving habits, such as sudden braking and excessive speed. Allstate could now rely on more-accurate data and adjust premiums accordingly. People who consider themselves safer drivers flocked to Drivewise, which also offers them personalized feedback about behaviors they can change to lower their bill. "Customers get excited over the savings and the gamification," says David MacInnis, who led the telematics program until recently.

In 2016 Allstate introduced another innovation, Milewise, aimed at customers who don't drive frequently. Instead of fixed annual premiums, Milewise customers pay a low daily rate for insurance coverage, plus a per-mile fee based on actual driving (also determined by telemetric data). Drivers who sign up for Milewise see premiums drop by 50%, on average.

In states that allow telematics-based insurance pricing, 36% of new Allstate auto insurance customers now choose the Drivewise or Milewise pricing options. During 2020 and 2021, when Covid-19 restrictions reduced commuting, the number of vehicles covered by Allstate’s Milewise program increased by 725%. “Customer satisfaction with these products shows that this is the future of auto insurance,” says MacInnis. Indeed, Allstate has plenty of company in offering telematics-based policies: Progressive, Liberty Mutual, State Farm, and Nationwide, for instance, all do the same.

Most industries have traditional ways of pricing goods and services. Firewood is priced by the cord, and deli meats are priced by the pound—that’s just the way things are done. But some companies have begun to rethink these paradigms in ways that can benefit existing customers while simultaneously attracting new ones, thus boosting revenue and profit margins. Software firms once practiced per-seat licensing, charging corporate clients a fee for each employee with access to the programs; today many have shifted to a software-as-a-service model that relies on metered usage, the way utility companies charge for water or energy consumption. Shipping and mailing fees have traditionally been based on weight and travel distance, but now the U.S. Postal Service allows customers to cram as much as they can into flat-rate boxes and envelopes, paying the same price regardless of how heavy the package is or how far it’s going. Magazine publishers once offered annual subscriptions for printed issues, but as publishing has moved online, some media companies (including HBR, for which I’ve worked as a consultant) now offer monthly subscription options too.

Technologies that are now commonplace—such as GPS, smartphone apps, predictive analytics, and AI—make it easier than ever to design and use new pricing models.

Rethinking a pricing paradigm requires creative thinking. At most organizations, discussions around pricing focus on simple price-setting: whether to charge $27.99 or $29.99 for a restaurant entrée, for example. Those decisions depend largely on costs, customer demand, and value relative to other options. Some companies do adopt a more sophisticated approach, such as good-better-best (G-B-B) pricing. That involves bundling product elements or services into distinct pricing tiers (typically three) and encouraging customers to decide which set of offerings makes sense for them. (See my article, "The Good-Better-Best Approach to Pricing," HBR, September–October 2018.) When fancy restaurants offer early bird, regular, and chef's table options, that's an example of G-B-B pricing.

This is the right moment, however, for companies to investigate other, more inventive pricing strategies. A key reason is that recent economic changes (including record inflation and fear of a recession) have forced businesses to scrutinize their pricing in order to preserve margins. Meanwhile, many consumers are examining their household budgets and spending more cautiously. In this economic environment, offering a new pricing structure can be an attractive alternative to simply adjusting prices. Furthermore, technologies that are now commonplace —such as GPS, smartphone apps, predictive analytics, and artificial intelligence—make it easier than ever to design and use new pricing models.

Changing your pricing strategy can also help you target different demographic groups. For instance, research shows that Millennials and Gen Zers are especially open to no-haggle pricing and to renting or leasing as an alternative to owning. Additionally, announcing a pricing change can generate excitement: When Subway introduced $5 footlong sandwiches in response to the Great Recession, same-store revenues jumped an average of 25% in two weeks.

In this article I describe various pricing models that companies might consider, and I offer guidance on identifying and implementing the right ones. By adding one or more of these as an option alongside existing price plans, firms can better serve their current customers and win over new ones.

Many of the pricing moves that I see companies trying are not particularly novel; instead, what's innovative is that they're being imported to an unexpected sector or product category. Men have rented tuxedos since the middle of the 20th century, but the rental model had rarely been applied to women's clothing until Rent the Runway launched in 2009. Vacation timeshares have existed since the 1960s; more recently, entrepreneurs have appropriated this split-ownership model for private jets and yachts. There's nothing new about all-you-can-eat restaurant buffets, but because they are still unusual in the fast-food industry, customers flock to the only KFC in Canada that offers a deal on unlimited fried chicken and sides; some people drive three or four hours to dine at that location.

For products or services subject to price swings, offering customers a way to guarantee a future price could prove attractive.

In short, when it comes to pricing, innovation often consists of borrowing ideas that are already proven to work in other industries.

The pricing tactics that follow are grouped into five categories based on the objectives they help companies accomplish. Those objectives are not mutually exclusive; many of the tactics deliver multiple benefits and could be listed in more than one category.

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Accommodate Different Usage Levels and Preferences

Customers have unique needs in terms of how much they use a product. At the simplest level, this is why coffee chains offer small, medium, and large sizes. Consider these other approaches that marketers can use to price goods and services to please people who want a high or low quantity and certainty over what they'll be charged:

Unlimited or all-inclusive plans. These deals appeal to people who seek to avoid extra charges or enjoy consuming heavily for a fixed price. All-inclusive vacations are an example: Travelers know they can partake of all the food, beverage, and activity options available, and they won't receive a surprise bill at the end of the trip. In the ski and theme park industries, season passes are another example. Kings Island amusement park, in Ohio, not only offers passes for unlimited admission, it also sells a $105 pass entitling customers to two meals in the park every day. And in 2022 the concert promoter LiveNation offered a $199 pass that provided entry into the lawn section for all regular concerts at a selected venue.

À la carte or unbundled pricing. This is the opposite of unlimited, and it appeals to consumers who prefer to pick and choose to avoid paying for things they don't want. Over the past decade, much of the airline industry has shifted to an à la carte pricing model, charging travelers lower base fares and then add-on fees for checked baggage, early boarding, in-flight meals, and so forth. Those extra charges can add up: In 2021 Spirit Airlines passengers spent, on average, $46.16 in airfare and an additional $58.64 in nonticket revenue. Some consumer advocates are pushing for à la carte cable television so that viewers with no interest in, say, sports needn't buy a cable bundle that includes ESPN. Some resorts sell daytime access to pools and fitness facilities to people who aren't staying the night. If high inflation and a weak economy cause consumers to be especially price conscious, companies that launch à la carte pricing may find additional customers.

Metering. Allstate's decision to offer car insurance for a per-mile charge is an example of metering, as is the software-as-a-service model. Metering has similarities to unbundling, but it typically involves transparently tying charges to small incremental increases in usage, the way the meter in a taxi charges users for every eighth of a mile driven.

Pricing by unconventional time increments. Zipcar, which rents cars by the hour, upended the customary practice of renting by the day or the week. Changing the traditional time increment of pricing can be a powerful tool to activate customers for whom a higher price is prohibitive. When Amazon introduced its Prime membership service, in

2005, it charged an annual fee of $79. (The cost is now $139.) When it began offering Prime as a pay-by-the-month option, currently at $14.99, membership surged.

Split usage, leasing, and rentals. These pricing models appeal to customers who cannot afford or don't want to own a product. Split usage works well for high-priced assets that the typical owner doesn't use often —second homes, private planes, and the like—and usually involves selling fractional ownership interest in the asset. (Vacation timeshares are the classic example of split usage.) Leases and rentals are well-understood pricing models for houses and cars, but they can be applied to other types of products. For instance, many cities now offer bike rentals by the hour—an innovation that combines renting, altering the standard time increment (from by the day to by the hour), and using technology that allows bikes to be unlocked from unstaffed kiosks (requiring no employees) located all around a city.

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Appeal to Customers on a Tight Budget

Even before inflation escalated, many consumers struggled to afford purchases. Companies that offer financing alternatives—which are a form of pricing— can help people afford goods and services within their cash-flow constraints. Here are some ways companies make pricing more attractive via financing:

Payment over time. Both brick-and-mortar and online retailers have expanded the options for paying over time—which include buy now, pay later (BNPL) programs, layaway plans, and installment loans—partly because of the growth of third-party financial companies such as Affirm.

Payment plans appeal to consumers who don't trust (or can't get approved by) credit card companies. They also tout transparency, offer fixed interest rates, and generally avoid late-payment charges—advantages over traditional credit cards. An October 2022 survey by LendingTree found that more than a third of Americans (36%) expected to apply for a BNPL loan in the next six months. Even industries that have always offered financing are finding ways to innovate. When General Motors introduced car loans in 1919, it required a 35% down payment and full repayment within one year. Over the past century, auto-loan repayment terms stretched out longer as vehicle prices rose. By the first quarter of 2022, the most popular length of a new car loan in the United States was six years, and 73% of loans were for more than five years, up from 40% in 2010.

Prepayment. Cellular companies pioneered the use of prepaid plans to serve people who wouldn't pass a credit check. That's a significant market: More than one-third of Americans have credit scores that place them in the category of subprime. For companies, prepaid plans reduce the costs of delinquencies, bad debt, and billing. Car rental agencies and hotels are other businesses that use prepayment as a common pricing tactic, offering nonrefundable, prepaid reservations. If a recession further reduces consumers' creditworthiness, look for prepaid options to proliferate.

Capped or flat rates. These pricing plans appeal to customers who prefer certainty to surprises. Home heating companies frequently offer season contracts guaranteeing a fixed rate on oil prices for the entire winter. Part of the appeal of the ride-sharing services Uber and Lyft is that they quote a flat rate for a trip at the time of booking, avoiding the uncertainty created by metered taxi service. Flat-rate shipping boxes provide not only price certainty but convenience, by eliminating the need to weigh packages.

Future options. Investors have long had the ability to buy an option, which gives them the right to buy or sell a security at a fixed price sometime in the future. Options are also common in commodity markets; for instance, airlines typically use options to reduce their exposure to fuel price fluctuations. Now predictive analytics can allow some companies to offer consumers pricing models that function like options. Hopper, the fintech travel company, has a Price Freeze product that guarantees the price of an airline fare, a car rental, or a hotel room for a fixed time. Nearly 20% of hotel bookings on Hopper are frozen before being purchased. For products or services subject to price swings, offering customers a way to guarantee a future price could prove attractive.

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Provide Price Break Opportunities

Some consumers take particular pleasure in snagging bargains and getting discounts. The following three models appeal to those customers, often by showing them exactly how much they're saving off the regular price.

Mixed bundling. This strategy combines different products into a package at a single price. Examples include fast-food meal deals; symphony, ballet, and theater packages that include tickets to multiple productions; and bundled plans for homeowner's, auto, and life insurance policies. Mixed bundles work best when many customers are likely to be interested in all the included components. Trying to combine services that appeal to different kinds of people can prove less effective. In 2020 Apple launched its Apple One bundles, which combine TV streaming, music, video games, and iCloud storage in a single subscription (with news and fitness services as optional additions). But for me, including Apple Arcade in all the packages renders them unattractive since I do not play video games.

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Volume discounts. This strategy encourages customers to purchase more than they otherwise might. Volume discounts can be especially compelling to businesses when the marginal cost of a product is negligible. Big Gulp soft drinks at 7-Eleven are one example: When the convenience store chain began offering them, profits from soft drinks nearly doubled; today they can account for up to 10% of sales at stores. Warehouse clubs such as Costco have built entire businesses catering to consumers who enjoy the discounts that come from buying in large quantities.

Progressive pricing. Events and conferences often use this model, in which prices start out at one rate and increase at set intervals prior to the event day. “The three reasons for employing progressive prices are to reward loyal customers who purchase early, create a sense of urgency, and incentivize commitment,” says Bill Donabedian, an events producer and promoter in Cincinnati. This strategy also provides an excuse to reach out to customers repeatedly (often by email or social media) under the guise of saving them money before the price increases. At the same time, event organizers gain insight from the pace of sales: If many customers buy early, demand may be stronger than the business expected.

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Establish Prices When Value Is Uncertain

Businesses face an unusual challenge when deciding what to charge for a new offering or an experience that's happening just once, because they have little historical data to guide them. Companies can use the following techniques to let customer demand influence pricing:

Auctions. Competing in "bidding wars" for purchases makes some consumers anxious. Others love the thrill. Auctions appeal to people who hope for a bargain if the bidding proves weak. This model can be especially useful for sellers who are uncertain what to charge. For years Warren Buffett auctioned off (for charity) the opportunity to have lunch with him. Before 2022, the most a bidder had paid for the experience was $4.57 million, but when Buffett announced that 2022 would be the last lunch he'd offer, the auction garnered $19 million. If Buffett had set the price himself, he probably would not have chosen such a high figure, so an auction made sense and proved advantageous. Priceline and eBay are two companies that grew by allowing customers to make bids for purchases that aren't typically sold by auction. Other industries are trying the technique too. For instance, cruise ships and airlines have begun using auctions that allow customers to bid on cabin upgrades. Technology is one factor driving experimentation with auction pricing. Live, in-person auctions are cumbersome, but computers can make auctions a seamless experience. This pricing model also lets companies optimize revenue by allowing consumers to tell them exactly what they're willing to spend.

> **The most-promising pricing plans can be pilot tested to gauge consumer interest in real time and then quickly modified to adapt to market response.**

Royalties and sales commissions. Because publishers don't know how many copies of a book will sell, they traditionally deal with that uncertainty by offering authors a royalty—a payment based on overall sales. Fast-food franchising uses the model, too, because sales can vary dramatically by location. Business Insider reported in 2020 that Chick-fil-A charges franchisees just $10,000 to open a new store but then collects a 15% royalty on sales and 50% of the remaining pretax profits. Similarly, real estate agents work on commission, charging their clients a percentage of the selling price of a property rather than setting a fixed price for their services.

Dynamic pricing. Since computerization became common in the 1980s, airlines and hotels have adjusted prices minute by minute according to supply and demand. In the past decade, sports teams and musicians have used dynamic pricing for tickets too. (Bruce Springsteen recently drew ire when tickets for his 2023 concerts reached $5,000 as a result of high demand.) Dynamic pricing can be off-putting to consumers (see "The Pitfalls of Pricing Algorithms," HBR, September–October 2021), but more consumers are becoming used to the model, especially since Uber introduced surge pricing.

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Use Pricing to Enhance Business Efficiency

Most shifts in pricing models are aimed at attracting or retaining customers and boosting revenue. But introducing a different pricing paradigm can also serve to change customer behavior in advantageous ways. For instance, some industries offer terms such as 2/10 net 30, meaning that customers owe the full amount within 30 days but get a 2% discount for payment within 10 days—a tactic that encourages early payment and helps reduce a firm's accounts receivable. Here are three more pricing models that can help companies operate more efficiently:

Off-peak pricing. Certain types of businesses—especially those in the service sector—have capacity constraints. They may benefit by setting different prices for peak and off-peak hours. Some restaurants do this with midweek "kids eat free" promotions. Hairstylists, who are especially busy on Saturdays, can even out their schedules by offering lower prices on weekdays. Some movie theaters discount their matinee shows; some gyms offer specially priced plans that limit access during the busiest hours. For businesses that face predictable fluctuations in demand, it's worth asking: What pricing model might help smooth that pattern?

Subscriptions. Although subscriptions were traditionally associated with certain kinds of businesses, such as newspapers, the model has spread over the past decade. Music from services like Spotify has largely displaced 99-cent songs from Apple's iTunes, while upscale consumers often subscribe to services like Blue Apron's meal-kit delivery and Peloton's online fitness classes. Buyers tend to like subscriptions because they mean low up-front costs and manageable regular payments. Sellers love the fact that most subscriptions work on autorenewal (no need to "close" a subsequent sale) and lead to more-predictable revenue and higher numbers for customer lifetime value. The model is now finding success in other unexpected sectors. For instance, Mammoth Holdings, which owns multiple car-washing businesses, reports that more than 60% of its revenue comes from customers who pay a monthly fee for unlimited washes. Porsche offers a $3,600 monthly subscription that lets subscribers drive any of the vehicles available in its leasing fleet, switching from one car to another at will. Some plumbing companies charge $19.99 a month to maintain home water heaters; this subscription (which is really a warranty paid by the month) covers parts and labor for repairs, or full replacement if the unit fails.

Initiation fees. One problem with the subscription model, particularly when it involves digital content, is that some customers may join for a short time, binge on consumption, and then quickly cancel. I call these people "darters," and I am one: I typically subscribe to HBO just a couple of times a year, watch entire seasons of my favorite shows in a month or two, and then cancel. Since their inception, country clubs have used up-front initiation fees to prevent people from jumping on and off membership rolls. (Some people call this type of pricing "the country club model.") Gyms often use this technique too. Any company utilizing a subscription model might also consider initiation fees. Although they do provide revenue, businesses typically implement them to defray up-front costs or to create disincentives for people to cancel. The obvious downside of initiation fees is that they may deter initial purchase—but for companies seeing high turnover among subscribers, it's a model worth considering.

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Identifying and Implementing a New Pricing Strategy

To zero in on pricing models that might work for your business, start with a group brainstorming session. Go through the list of options in the exhibit "A Menu of Pricing Plans" to try to identify ones that might activate new or dormant customers. Ask yourself: Do customers differ in their usage needs? What would help people on tight budgets? Will a discount plan lead to additional purchases? Are customers best positioned to determine the value of an offering? Then consider which of the tactics on the list might be effective.

A Menu of Pricing Plans

The art of designing an effective pricing strategy involves creatively mixing various tactics to serve the ...

Even if you're selling a product or service that does not rely on a traditional sales force, it can be useful to focus on the customer objections an imaginary salesperson might encounter—and then build a pricing strategy that would overcome them. Also look at how various pricing options might help the business in ways other than generating more sales—say, by smoothing demand or shifting some purchases away from your busiest time.

Once you've identified the tactics with the highest potential, do a cost-benefit analysis. For costs, consider the complexity, time, and investment that would be required to implement the new pricing strategy. When thinking about complexity, don't underestimate the challenge of communicating a complicated pricing change to consumers. In 2011, when Netflix was still renting DVDs by mail while also moving aggressively into digital streaming, the company publicly announced a plan to reprice the service as two separate offerings, with the DVD-by-mail operation renamed Qwikster. The plan might have made strategic sense for Netflix and benefited customers who wanted only DVDs or only streaming, but the complexity—with some subscribers suddenly being asked to create two accounts and pay two fees—sparked a backlash that caused the company's stock to plummet. Netflix quickly abandoned the plan.

After you've done a thorough assessment of costs, assign each pricing tactic a grade from A to F.

Next look at the potential benefits. Start by making a ballpark estimate of the boost in annual revenue, profit, and number of customers that might result from each new tactic. Making these estimates may feel like guesswork, so I advise relying on four methods to forecast the financial upside:

Expert judgment. The people inside your organization have significant experience working with, thinking about, and interacting with your customers about products. Managers with P&L responsibility have a sense of how small pricing tweaks can affect revenue. Salespeople and other employees in customer-facing roles have a deep understanding of your customers' needs and objections. C-level executives may have a vision of particular pricing plans the company should offer. Be sure to tap into the expertise of people at every level.

General market research. Quantitative and qualitative surveys focusing on value and customer satisfaction can yield insights on pricing-related roadblocks to purchase. Are customers nervous about not knowing the final price? Are they interested in making relatively small purchasing commitments? General market research can efficiently provide directional guidance about pricing.

Discrete-choice surveying. This type of in-depth market research involves presenting survey respondents with a slate of pricing options and seeing which they prefer. For example, you might ask participants if they'd rather purchase a product outright or make a partial up-front payment and subsequent installment payments. Discrete-choice analysis can provide insight into the percentage of customers who favor each tactic, and it can be helpful in pinpointing optimal prices. But it's usually more time-consuming and expensive than other types of market research.

Piloting. The most-promising pricing plans can be pilot tested to gauge consumer interest in real time and then quickly modified to adapt to market response. When tried out on a small scale, many of the tactics outlined in this article are low-cost and straightforward to implement. Giant companies like Walmart, for instance, conduct pilots by offering experimental pricing plans in a single store or two. The advantage of such testing over the other three methods is that it captures consumers' actual purchasing behavior—not just predictions about it.

Once you've determined the financial upside of the pricing options you're considering, give each a letter grade from A to F. Then focus on the one or two tactics with the highest grades for both costs and potential benefits.

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When a company thinks creatively and offers customers a new pricing paradigm, the result is an expanded set of customer choices. I refer to this outcome as "Pick-a-Plan." In an ideal world, every person who walks through the door will find a menu of pricing options—including one that feels tailored to his or her needs.

If your company does not have a mix of pricing plans, it has untapped growth potential. There are probably customers out there who would love your product, but they don't like the current options for buying or renting it. Finding a new way to charge them requires imagination and flexibility, but it's an exercise that can pay off handsomely.

Read more on **Pricing strategy** or related topics **Customer strategy**, **Consumer behavior**, **Customer experience** and **Behavioral science**

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Rafi Mohammed is the founder of Culture of Profit, a consultancy that helps companies develop and improve their pricing strategies. He's also the author of *The Art of Pricing: How to Find the Hidden Profits to Grow Your Business* (Crown Business, 2005) and *The 1% Windfall: How Successful Companies Use Price to Profit and Grow* (HarperCollins, 2010).

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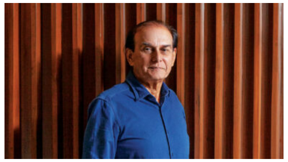
The Good-Better-Best Approach to Pricing

Managing in the Age of Outrage



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