Services Marketing: Integrating People, Technology, Strategy
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Lecture 14
Setting Prices and Implementing Revenue Management - Part 1

Welcome to this course on Services Marketing. Now, we will talk about module 14. We are talking about the second section of this course that is applying the 4 Ps of marketing to services. And we have talked about across various modules, we have talked about developing of service product and then we have also talked about distributing services through physical and electronic channels.

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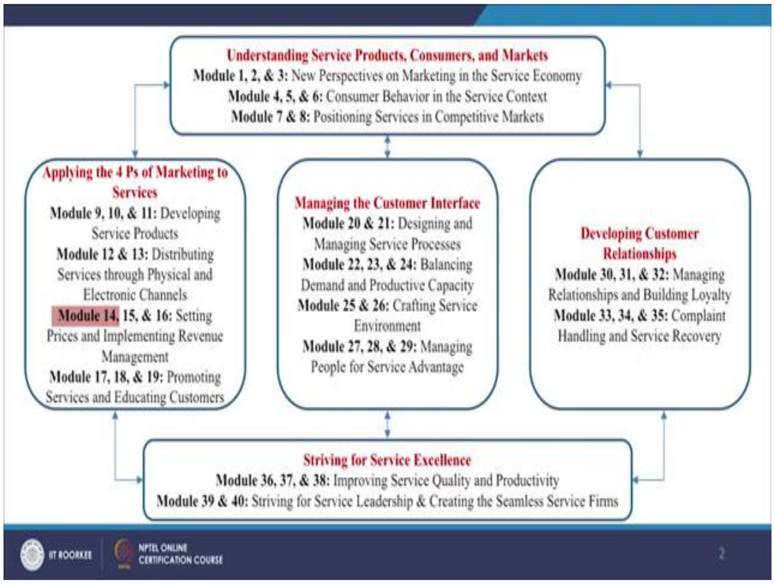

Now, in the next three modules, including the current one that is module 14, 15 and 16, we will talk about setting prices and implementing revenue management. So, let us start with this module 14, in which we will be talking about setting pricing, prices and implementing revenue management.

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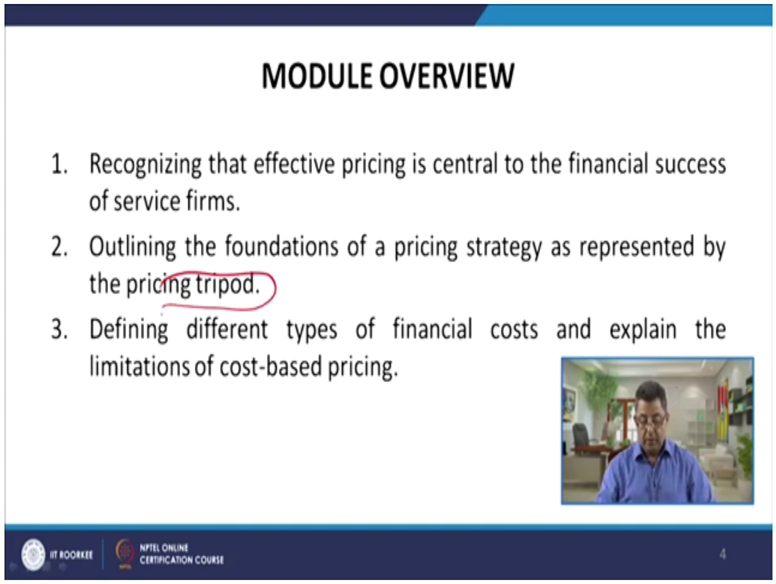

In this module, we will talk about the effective, how effective pricing is central to the financial success of a service firm. Then we will outline the foundations of a pricing strategy as represented by the pricing tripod. So, we will introduce a pricing tripod later on in this module. And defining different types of financial cost and explain limitations of the cost-based pricing. Now, this cost-based pricing is a normal pricing method in products, but in services, we will explain what are the limitations of this cost-based pricing.

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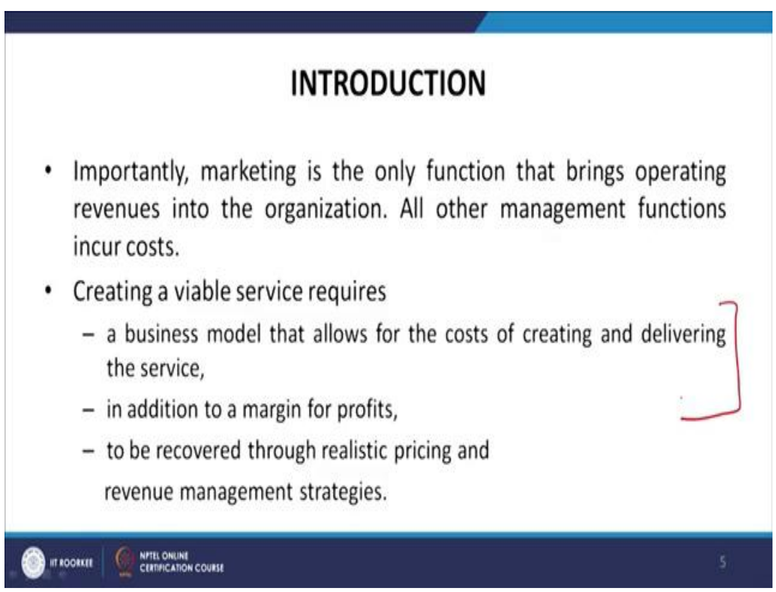

To start with, the important thing is that marketing is the only function that brings operating revenues into the organization. All other management functions, be it HR and finance and IT et cetera, they just incur cost. Now, creating a viable service requires first, a business model that allows for the cost of creating and delivering the service. So, one thing is that the cost for creating and delivering the service is covered.

The second is, we should add a margin of profits to this cost. So, to be recovered through realistic pricing and revenue management strategies. So, these are the two things that needs to be covered for any services, first is, the cost of the creating and delivering the service, one. Second is, certain amount of margins or profits. So, now these two objectives are to be achieved through realistic pricing and revenue management strategies.

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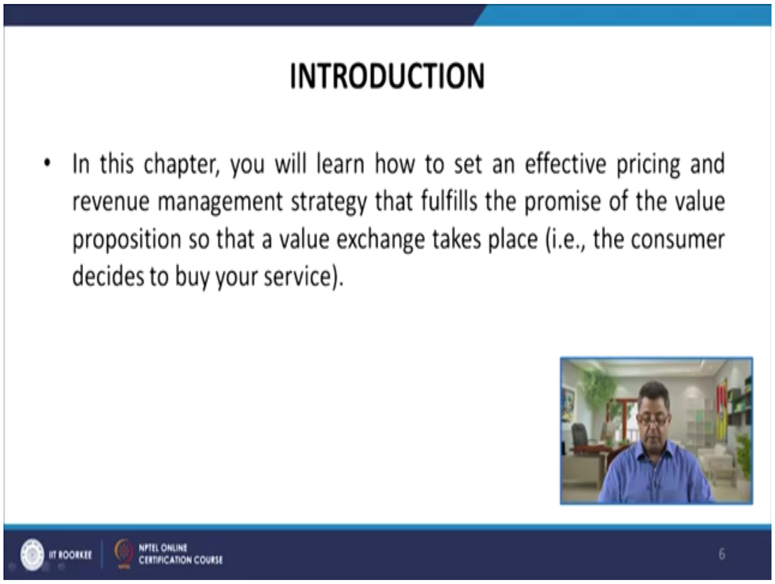

So, in this module, you will learn how to set an effective pricing and revenue management strategy that fulfils the promise of the value proposition so that the value exchange takes places, that is the consumer decides to buy your service. So, that maybe very important component of the, for the value proposition, because that gives the signal of the value to the customer.

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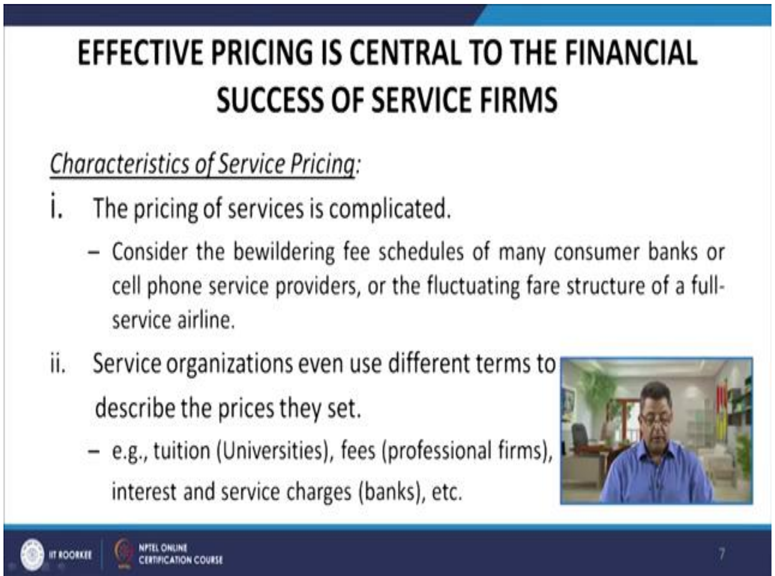

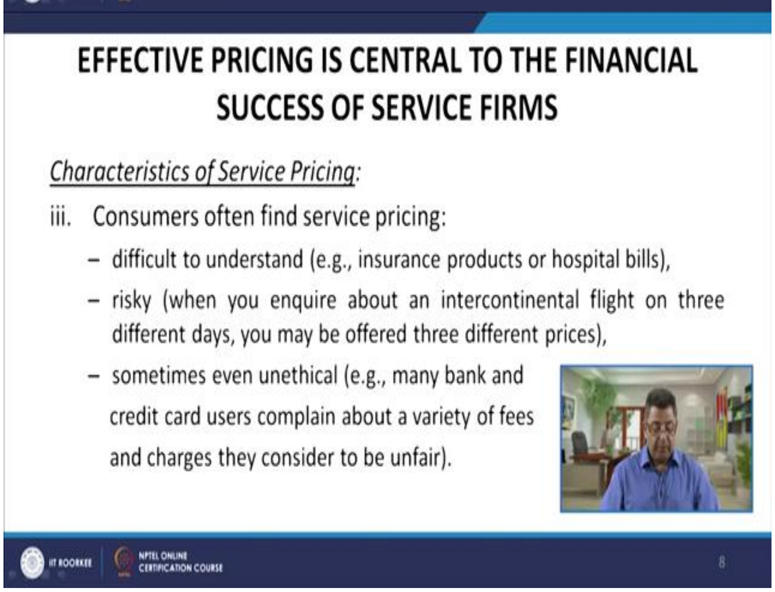

So, now effective pricing is central to the financial success of service firms, how? Let us look at the characteristics of service pricing. The first is the problem of service pricing is that pricing of services is complicated. For example, consider the bewildering fee schedule of many consumer banks or cell phone service providers or the fluctuating fare structure of a full service airlines. Also look at the packages of various DTH operators.

The second problem is service organization even use different terms to describe the prices they set. So, it is not always called as price. So, universities call it as tuition, professional firms call it as a fee and banks call it as interest and service charges.

The third problem is, consumers often find service pricing difficult to understand. For example, insurance product or hospital bills, they may also find it risky when you enquire about an intercontinental flight on three different days, you may be offered three different prices, and sometimes even unethical. For example, many banks and credit card users, they complain about a variety of fee and charges they consider to be unfair.

So, these are the three problems with pricing of services that is they are complicated. The name may be different for the prices and the consumer have certain kind of problems understanding this service pricing.

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Now, objectives for establishing pricing. Because effective pricing is central to the financial success of a firm, so, now let us look at the objectives for establishing pricing. The first is revenue and profit objectives that is to gain profits and to cover the cost of the delivering of the service. Patronage and user based-related objectives, build demand and develop a user base. And the third is strategy-related objectives, positioning and competitive strategy.

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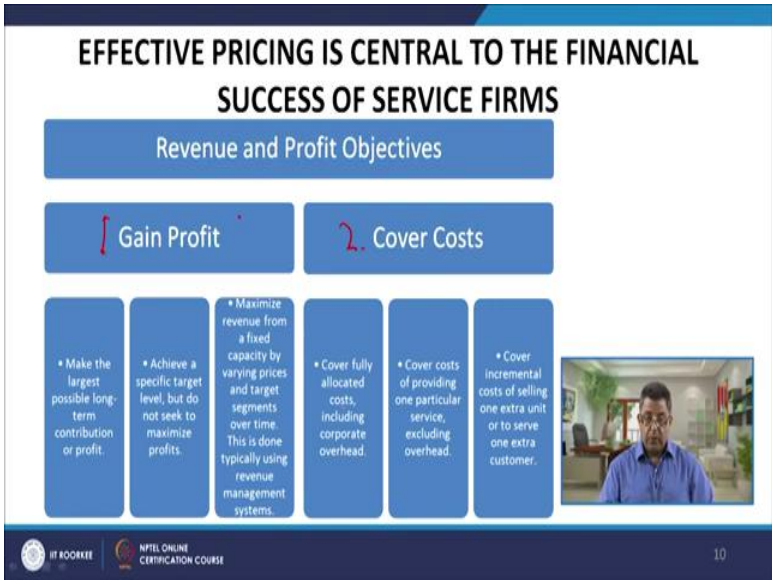

So, these look at this figure. So, we are talking of revenue and profit objectives. So, the first is to gain profits and the second is to cover cost. Now, what happens in gaining profits. Make the largest possible long-term contribution or profits. Achieve a specific target level but do not seek to maximize profits. And the third is to maximize revenues from a fixed capacity, by varying prices and target segment overtime. This is then typically using revenue management systems.

And when we are talking of covering cost, cover fully allocated costs, including corporate overheads. They should cover cost of providing one particular services, excluding the overhead or cover incremental cost of selling one extra unit or to serve one extra customer.

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The patronage and user based-related objectives. Again the first one is to build demand and the second is to develop a user base. So, when we are talking of building demand, these are the two things that may happen. So A1, is maximize demand when capacity is not a restriction provided a certain minimum level of revenue is achieved. For example, many non-profit organizations are focused on encouraging usage rather than revenue. But they still have to cover their cost.

In 1B what happens is that they want to achieve full capacity utilization, especially when high capacity utilization adds to the value created for all customers. For example, a full house adds excitement to a theatre play or a basketball game. So, in those kind of services where they are delivered in real-time, this can be an important criteria.

The second is to develop a user base. So, we are talking about the patronage and user based-related objectives. Here we have talked about how to go about building demand, now we will talk about developing how to go about developing a user base. So, you encourage trial and adoption of a service.

This is especially important for new services with high infrastructure cost and for membership type and for memberships type service that membership type service that generate a large amount of revenues from their continued usage after adoption. For example, cell phone service subscriptions or life insurance plans.

The next thing is, so this is 2A. Now, what happens in 2B, you build a market share and or a large user base especially if there are large economies of scales. That can lead to competitive cost advantage. For example, if development or fixed cost are high, or network effects where additional users enhance the value of the service to the existing user base. For example, the social networking sites like Facebook and LinkedIn.

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Then there are another set of objectives are strategy-related objectives. Again, we are talking of supporting positioning strategy or supporting competitive strategy. So, what happens when we are talking of supporting positioning strategy. Help and support the firms overall positioning and differentiation strategy for example as a price leader or portrait a premium image with premium pricing.

What happens in 1B, promote a we-will-not-be-undersold positioning, where by the firm promises the best possible service at the best possible price. That is the firm wants to communicate that the offered quality of service products cannot be brought at the lower cost elsewhere. When we are looking at strategy relative objectives that support competitive strategy, so we want to discourage existing competitors to expand the capacity, or we want to discourage a potential new competitor to enter the market.

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Now, this is the pricing tripod that is important to understand. So, pricing strategy that stands on three foundations of this pricing tripod. So, the foundation of pricing strategy can be described as a tripod, which cost to the providers, competitors' pricing and value and value to the customer at the three legs. So, we are talking about the pricing tripod and these are the three legs of this tripod. One is the cost to the provider, the competitors' pricing and the value to the customer. So, these are the three legs on which this pricing strategy stands.

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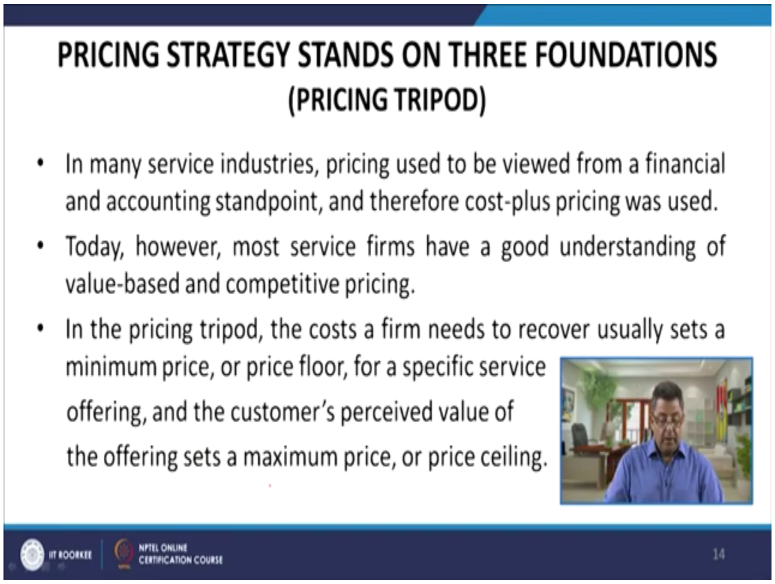

In many service industries, pricing used to be viewed from a financial and accounting standpoint, and therefore cost-plus pricing was used. So, these are the cost that we have incurred in delivering the service plus certain amount of profit, so that was a cost base pricing that was generally used earlier.

Today, however most service firms have a good understanding of value-based and competitive-based pricing. In the pricing tripod, the cost of firm needs to recover, usually sets the minimum price or the price floor for a specific service offering. So, the cost is the floor of this service offering. The cost is the floor of the price and the customer perceived value of the offering sets a maximum price or price ceiling. So, now in between you have an interval where to set your price. The floor is the cost and customer perceived value is the ceiling and in between these two, the price can be set.

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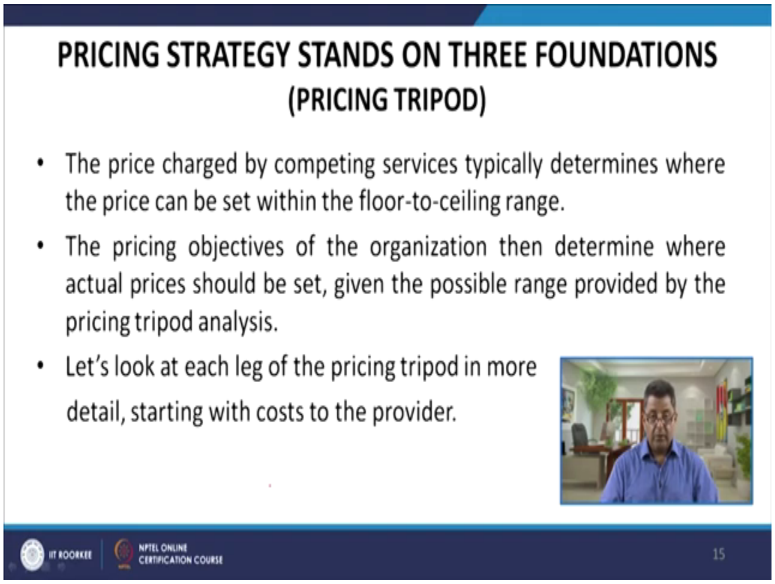

So, the pricing, the prices charged by competitive services typically determine where the price can be set within the floor to ceiling range. So, now another important thing we have talked about the floor and the ceiling, another important thing that comes in between is the prices that is, prices that are charged by the competitors. So, the pricing objective of the organization then determine where actual prices should be set, given the possible range provided by the pricing tripod analysis.

So at the bottom you have the cost, at the top you have the customer perceived value and then in between we are looking at the competitor prices and also the company's objectives. So, that in that range and looking at the competitors prices, and the company's objectives then we set the final price.

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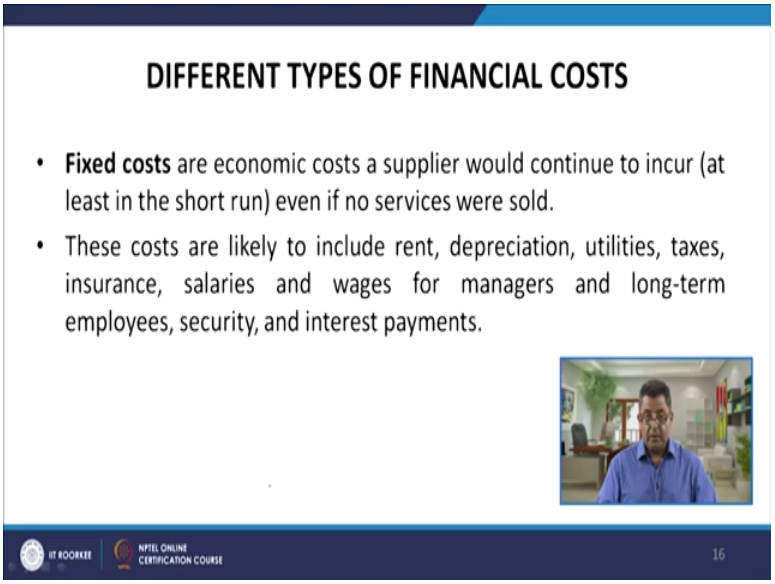

Now, let us look at the different types of financial cost that are incurred. The first is the fixed cost. So, fixed cost are economic cost a supplier would continue to incur at least in the short run, even if no service were sold. These cost are likely to include rent of the facility, depreciation, utilities, taxes, insurance, salaries and wages for managers and long-term employees, security and interest payments.

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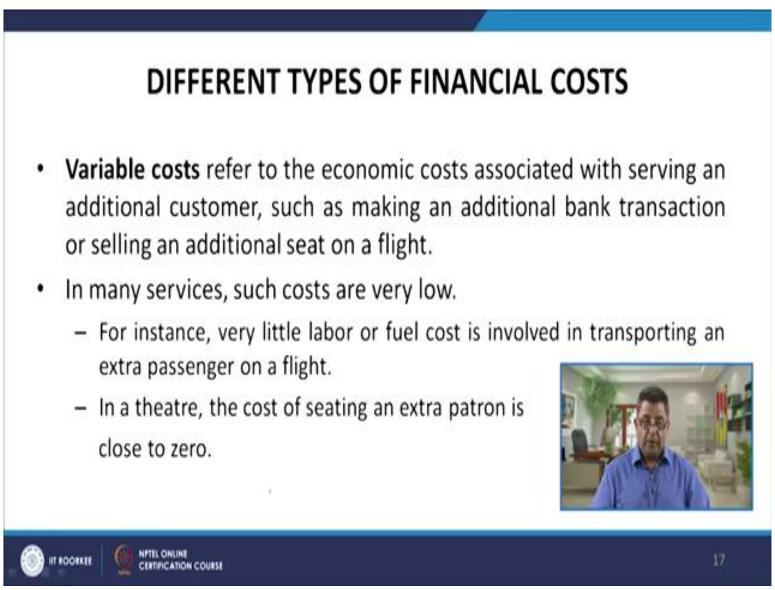

Then there are certain variable cost. So, these fixed cost will be incurred whether you are producing or selling anything or not. Now, let us move on to the next type of cost that is the variable cost. That refers to the economic cost associated with serving an additional customer, such as making an additional bank transaction or selling an additional seat on a flight. So, what additional cost will be incurred in that.

So, in many services such cost are very low. For instance, very little labour or fuel cost is involved in transporting an extra passenger on a flight and in a theatre, the cost of sitting an extra patron is closed to 0, because in any case, fixed cost is incurred and the service will be delivered. So, even if one person is there or he is not there, it will not, if one additional person is there, it will not add much to the variable cost.

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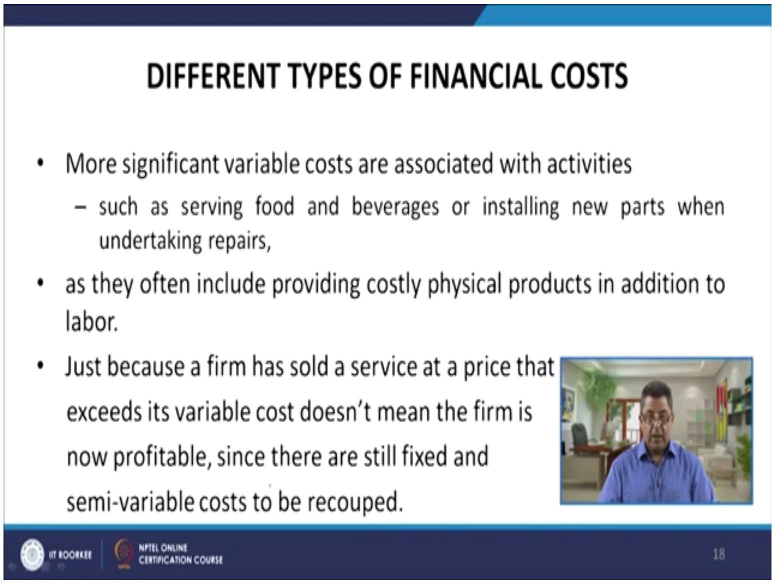

More significant variable cost are associated with activities such as, serving food and beverages or installing new parts when undertaking repairs. As they often include providing costly physical products in addition to labour. Just because a firm has sold a service at a price that exceeds its variable cost, does not mean the firm is now profitable.

Since there are still fixed and semi-variable cost to be recouped. So, just looking at the variable cost does not lead to the profitability, because there are the fixed cost that in any case the company has to incur, and then there are some semi-variable cost that has to be recouped.

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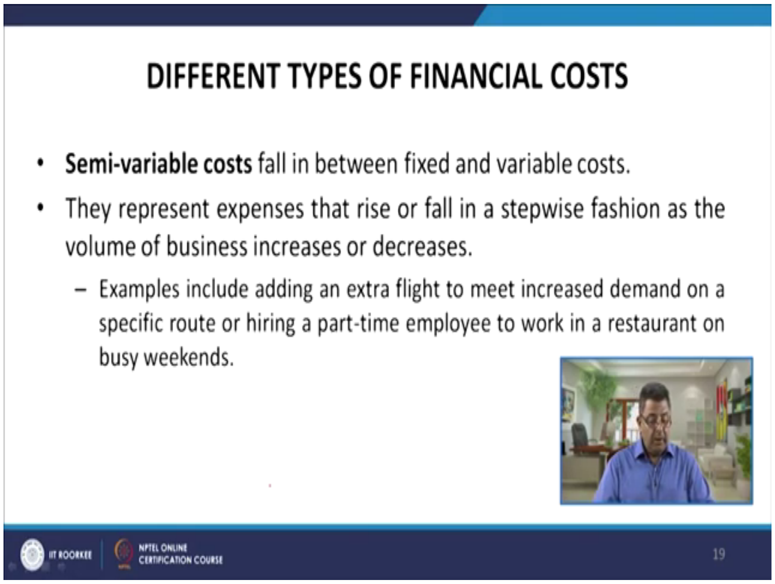

Now, what are these semi-variable cost. They fall between the fixed and the variable cost. So, they represent the expenses that rise or fall in a stepwise fashion as the volume of business increases or decreases. Example including adding an extra flight to meet increased demand on a specific route or hiring a part-time employee to work in a restaurant on busy weekends. So, these are some semi-variable cost.

So, when the demand goes up you need extra person or extra equipment. When the demand goes down, so these maybe not be required. So, because the demand is so variable the company does not want to acquire a new flight, new aircraft or have a full-time employee, because that will lead to increased fixed cost. Therefore, they are managing the demand with the extra flight or some extra employees and that leads to semi-variable cost.

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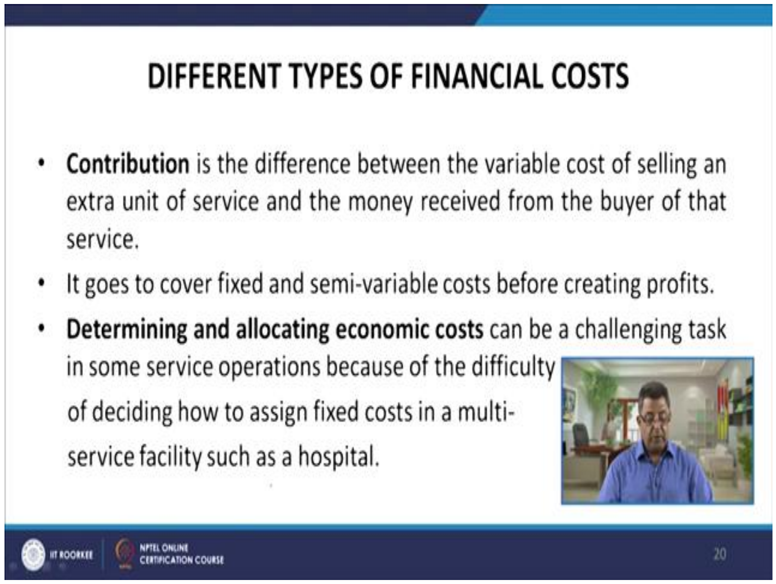

Contribution is the difference between variable cost of selling an extra unit of service and the money received from the buyer for that service. So, it goes to cover fixed and semi-variable cost before creating profits. Another is determining and allocating economic cost. It can be a challenging task in some service operations because of the difficulty of deciding, how to assign fixed cost in a multi-service facility such as a hospital. So, what is the fixed cost incurred in what kind, for what kind of patient, for what kind of activity.

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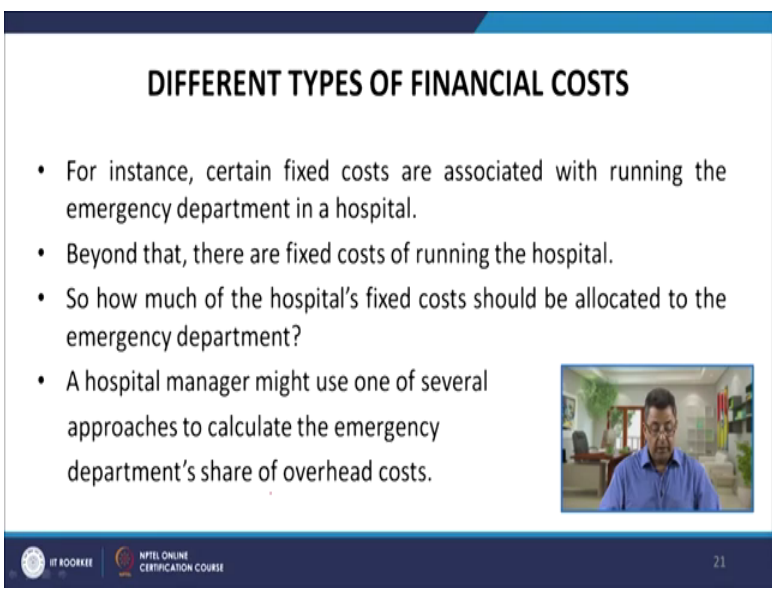

For instance, certain fixed cost are associated with running the emergency department in hospital. Beyond that, there are fixed cost of running the hospital. So, how much of the hospital fixed cost should be allocated to the emergency department. A hospital manger might use one of several approaches to calculate the emergency department share of the overhead cost.

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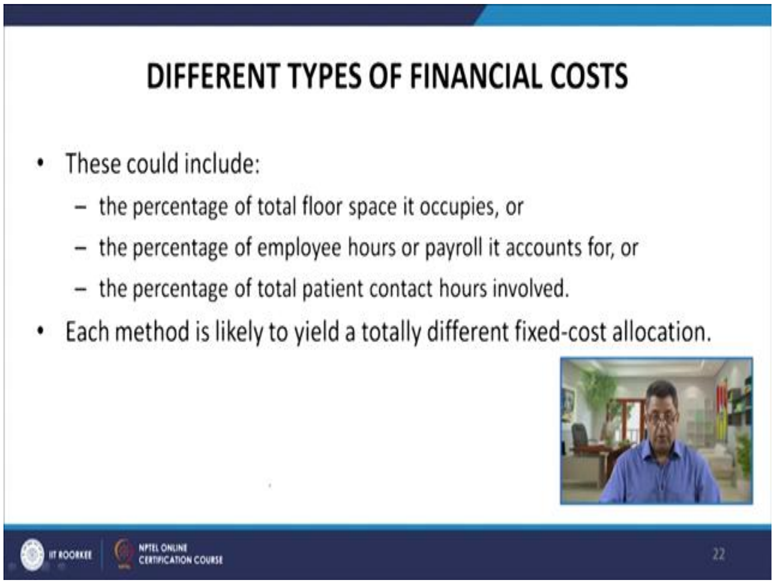

Now, this could include, one, the percentage of total floor space it occupies, which may not be a very good indicator. The next is, the percentage of employee hours or payroll it accounts for, or the percentage of total patient contact hours involved. So, there is no single variables, there is no single factor that can determine how this prices are to be distributed. Each method is likely to yield a totally different fixed cost allocation.

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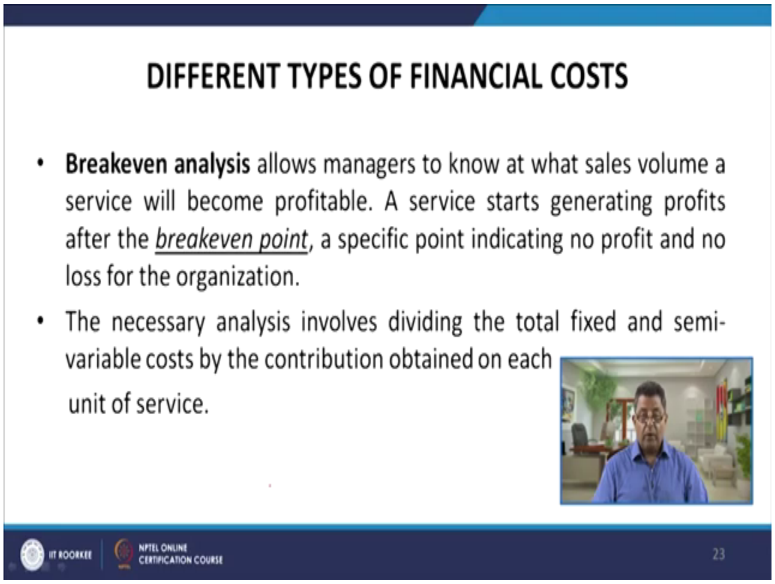

So, for that there is something called as breakeven analysis that allow managers to know at what sales volume a service will become profitable. A service start generating profits after the breakeven point, breakeven is a point where there is no loss and no profit. So, a specific point indicating no profit and no loss for the organization.

So, it is important for managers to identify what is that breakeven point. Beyond, after that the profits will start coming in. So, the necessary analysis involve dividing the total fixed cost and semi-variable cost by the contribution obtained on each unit of service.

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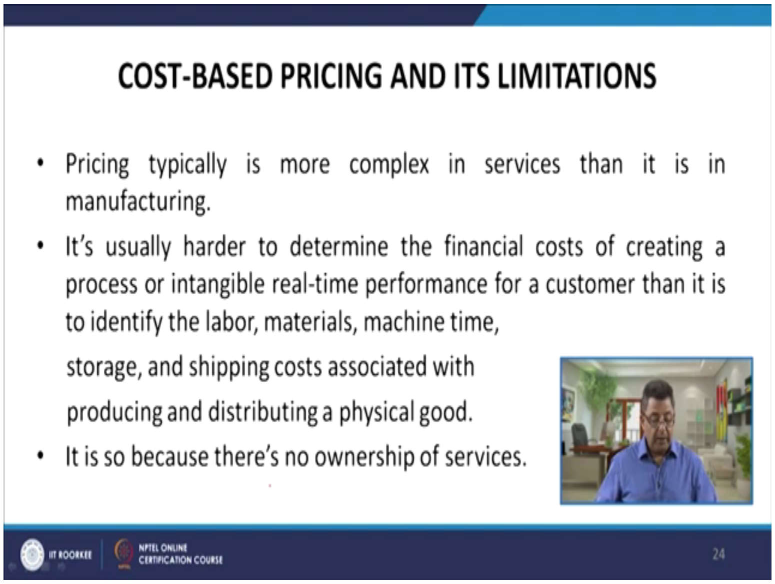

Let us look at the cost-based pricing and the limitations of that pricing strategy. So, pricing typically is more complex in services than it is in manufacturing, because of the several factors that we have seen earlier. So, it is usually harder to determine the financial cost of creating a process or intangible real-time performance for customer than it is to identify the labour, material and machine time.

So, now the problem here is in services is that generally it is harder to determine the financial cost of creating a process or intangible real-time performance for a customer. So, some customers may be placing more value on that intangible real-time performance, some maybe giving less value to that, so as compared to identify the labour, material and machine time.

Storage and the shipping cost associated with producing and distribution, distributing a physical good. So, as compared to a physical goods where the things are more tangible, so the determination of cost is much more easier as compared to services, where things are so intangible. It is so because there is no ownership of services.

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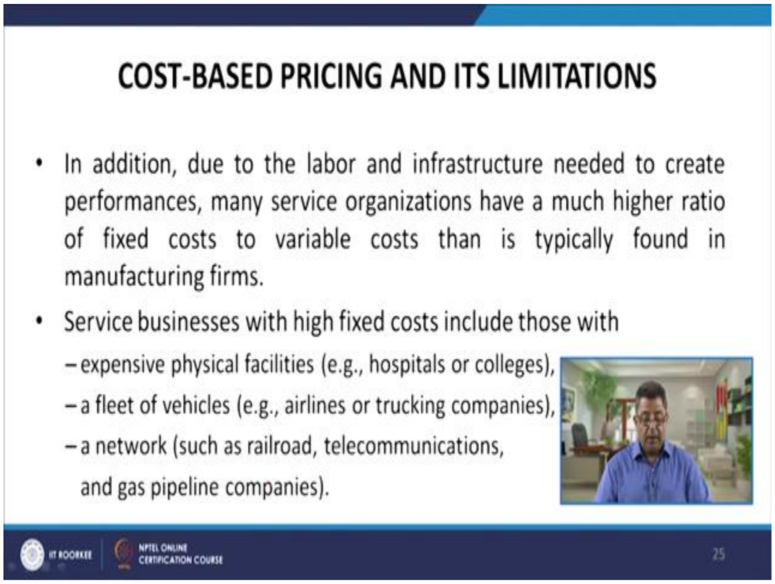

In addition, due to the labour and infrastructure needed to create performances, many service organization have a much higher ratio of fixed cost to variable cost that is typically found in manufacturing companies. Service businesses with high fixed cost include those with expensive physical facilities, so hospitals and colleges, so huge buildings are to be made and they have to be staffed appropriately.

Then another type of service businesses include a fleet of vehicles, airlines and trucking companies. So, there has to be a certain amount of aircraft or trucks et cetera available so that increases the fixed cost drastically. And a network such as a railroad, telecommunication and gas pipelines. So, lot of fixed cost is involved in these kind of businesses.

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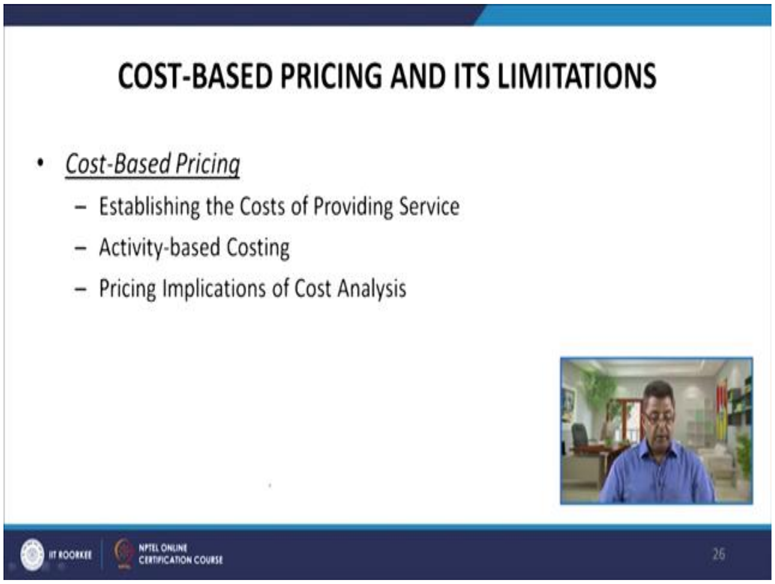

So, in cost-based pricing, establishing the cost of providing service is a problem, so how, what amount of cost has been incurred in delivering one type of service to one customer. For example, I go to a bank to just get my passbook updated, another person goes to a bank to get a loan, the third person goes to a bank to deposit certain amount of money, and then some person goes there to get a locker or open a locker or he was applying for a credit card or a debit card.

So, different people they have different amount of, different types of requirements, different demand. And the bank has a limited staff in that. So, now how do I or a bank manager or a banking company, they work out what is the cost involved in updating a passbook vis-à-vis applying for a credit card or a debit card or opening a locker. So, that becomes slightly ticklish issue. Another is the activity-based costing and pricing implications of cost analysis.

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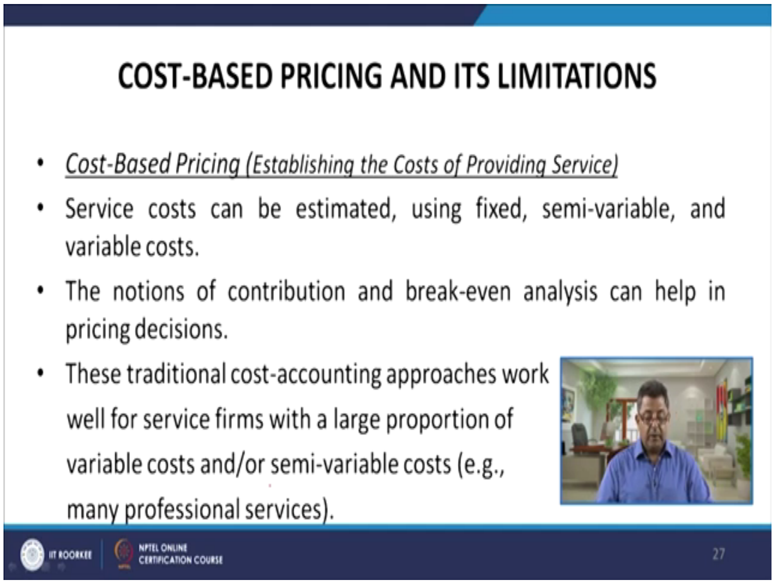

So, let us look at each of them. For cost-based pricing establishing the cost of providing services. So, service cost can be estimated, using fixed, semi-variable and variable cost. The notion of contribution and breakeven analysis can help in this pricing decision. So, the example I was giving about a bank, so what should be the, what is the cost incurred by bank in updating the passbook or when a customer walks in for opening the locker, or when he walks in for apply for a loan.

So, how to work out the cost of these three different services. So, the notion of contribution and breakeven analysis can help in this pricing decision. These traditional cost accounting approaches work well for service firms with large proportion of variable cost and or semi-variable cost, example many professional firms.

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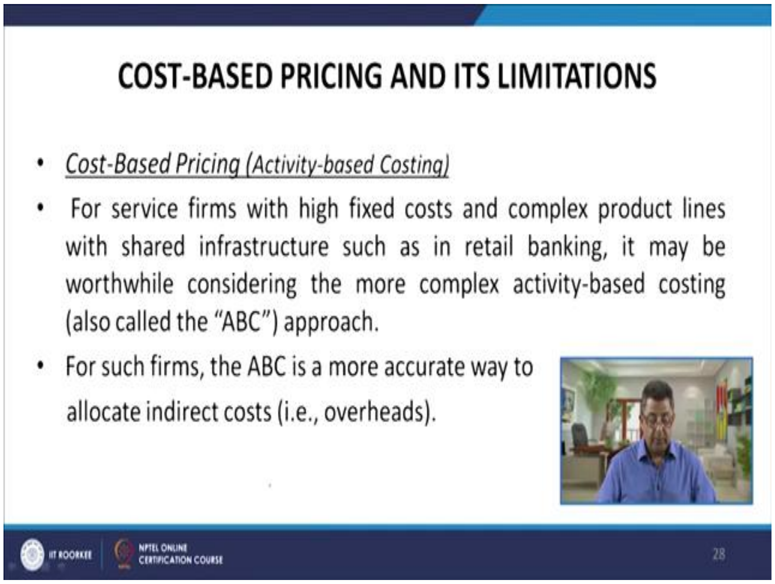

Now, let us look at the activity-based costing. For service firms with huge fixed cost and complex product lines with shared infrastructure such as in rental banking, such as in retail banking, it may be worthwhile considering the more complex activity-based costing, that is called as the ABC approach. For such firms, the ABC is more accurate way to allocate indirect cost, for example the overheads.

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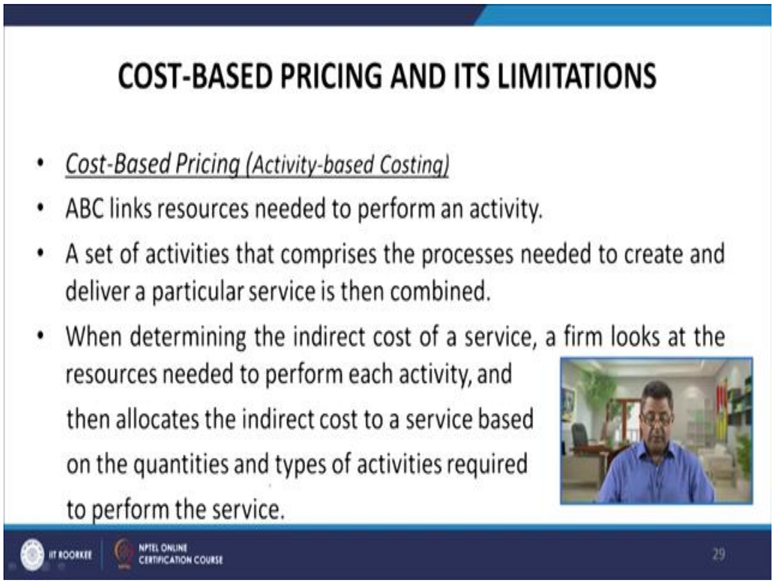

This activity-based costing of the ABC, it links resources needed to perform an activity. So, for each activity there is certain amount of resources that are needed so it links the resources with the activity. A set of activities that comprises the processes needed to create and deliver a particular service is then combined. When determining the indirect cost of a service, a firm looks at the resources needed to perform each activity and then allocate the indirect cost to a service based on the quantities and type of activities required to perform the service.

So, now this is important that when they are determining the indirect cost of the service, the firm has to look at resources needed to perform each activity. Now, again that is a difficult thing to understand how much resources will be needed to perform each activity. And then they allocate the indirect cost to a service based on the quantities and types of activity required to perform the service.

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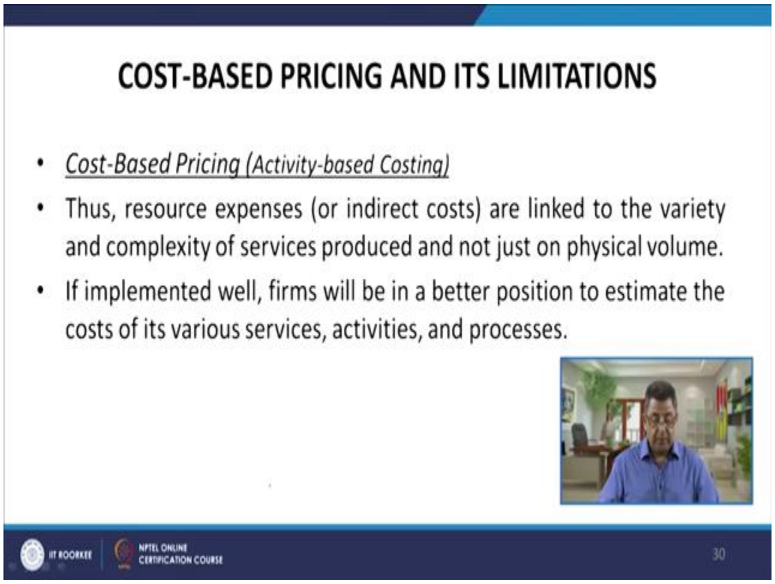

Thus resource expenses or indirect cost are linked to a variety and complexity of services provided and not just on physical volume. So, it is important that now we are not just looking at how many people, how many customers are served in a day. We, in a bank for example, so we are looking at resource expenses that are linked to this variety and complexity of service provided.

If implemented well, firms will be in a better position to estimate the cost of its various services, activities and processes. So, when this ABC is implemented well, then the companies they are in better position to estimate what is the cost that is incurred in various services or in performing various activity and in completing various processes.

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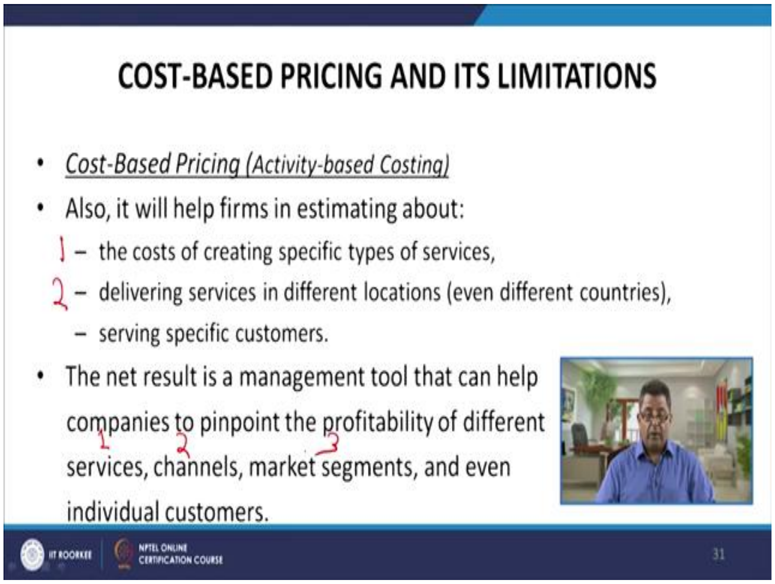

Also, it will help firms in estimating about the first is, the cost of creating specific type of services. So, some services will cost more and some services will cost less. So, for that there, a proper activity-based costing system has to be in place. The second is delivering services in different location even different countries. So, in one country delivering one kind of service maybe cheaper, in another country delivering the same service maybe expensive, so that has to be worked out. And then serving specific customers.

Now again, different customers or the cost in serving different types of customers is different, or the cost of servicing the same customer who comes in with different requirements at different point in time will be different. So, the net result is a management tool that can help companies to pinpoint the profitability of different services, one. So, we are looking at a management tool that can help companies to find out the profitability of different services. So, a company maybe offering many types of services, which service is more profitable which is not.

Second, channel which channel is more profitable which is not. So, we should, should we sell online, should we sell offline, should we have a franchise which is more cost effective. The third is market segment. Which market segments are more profitable. So, should we keep on selling just the credit cards and debit cards, should we also sell insurance or we are just there to take the cash, deposit the cash and to give back the cash.

So, the various services will have different kind of prices, the various channels will have different kind of prices, various market segments will have different type of prices, and even the individual customers coming in to a bank or buying a service at different points in time may have a different kind of cost.

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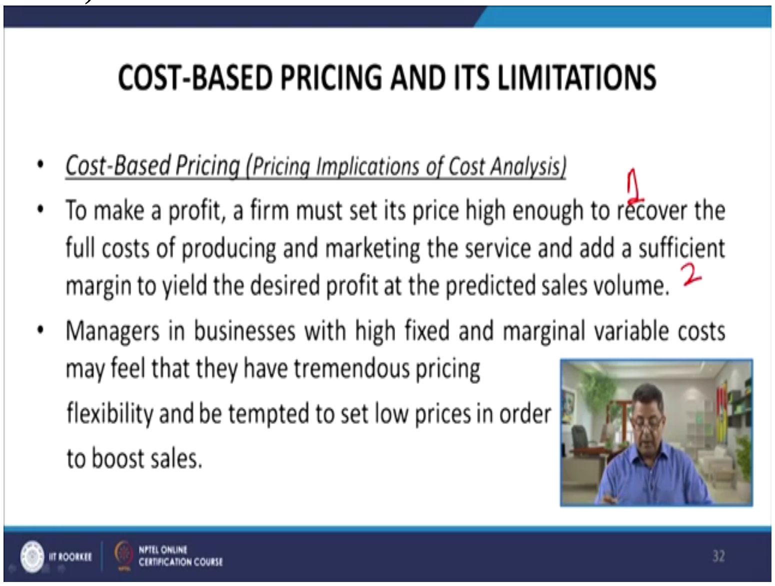

So, what are this pricing implications of this cost analysis. To make a profit, a firm must set its price high enough to recover the full cost of producing and marketing of a service, so that is the first thing. It should cover the cost that is the first thing. And a sufficient margin to yield the desired profit at the predicted sales volume. So, one is to cover the cost and the second is to add a margin to it, so that the predicted sales volume can be achieved.

So, managers in businesses with high fixed and marginal variable cost may feel that they have a tremendous pricing flexibility and be tempted to set low prices in order to boost sales. But then that will not lead to the sales volume or the profit and, profit subjective of this firm.

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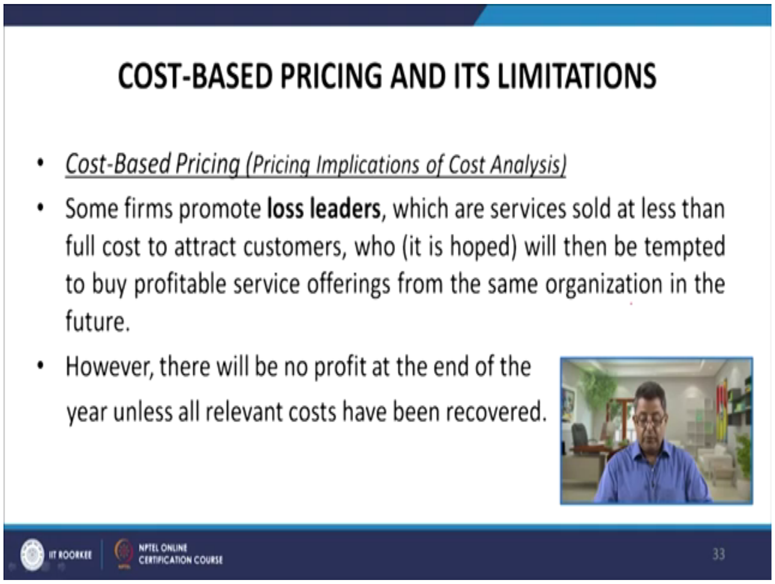

Some firm promote loss leader. A loss leader is a service sold at less than the full cost to attract customer. Because you see that some amount of fixed cost has already been incurred, so now they have a loss leader that are services, that are sold at a lesser cost so that the customers comes in. Who, it is hoped will then be tempted to buy profitable service offerings from the same organization in the future.

So, now we are selling one service at a lower cost and assuming that the customers who come in for the services they will buy other services. And therefore, the net profits for the firm will remain the same. So, however, there will be no profit at the end of the year unless all relevant cost have been recovered.

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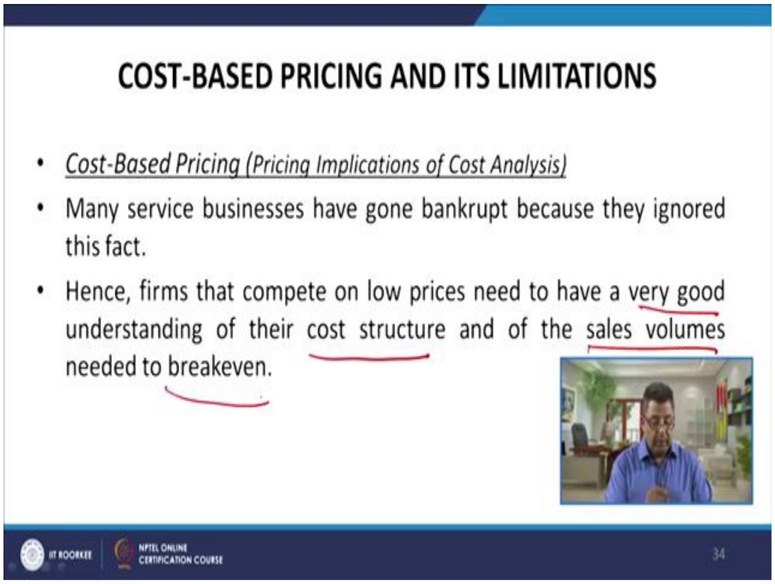

Many services businesses have gone bankrupt because they ignored this fact. The fact is that at the end of the year, all relevant cost have to be recovered. Hence the firm that competes on low price need to have very good understanding of their cost structure and of sales volume needed to breakeven. So this condition, this situation will be beneficial or it will work out only when the firms have a very good understanding of what is their cost structure and the sales volume, what cost and what sales is required for the breakeven. Because at the end of the day only then the company will be able to make profits.

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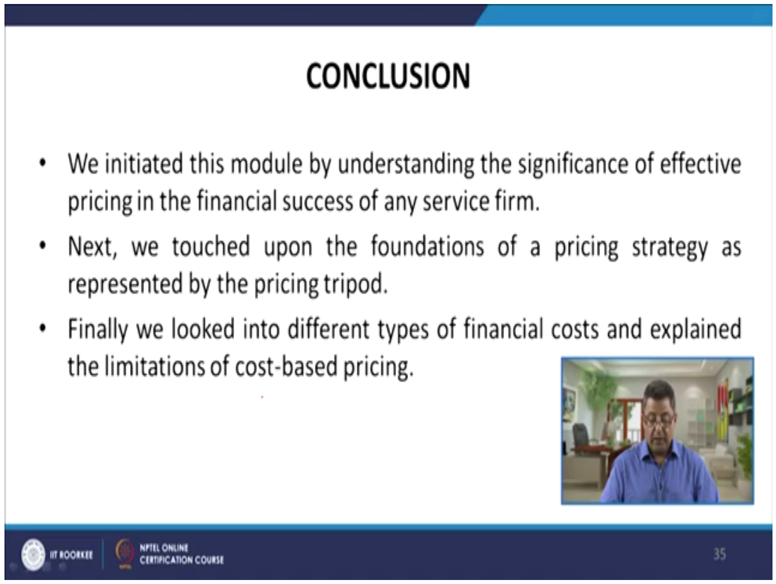

To conclude, we initiated in this module by understanding, we initiated this module by understanding the significance of effective pricing in the financial success of any service firms. So, we are, we talked about how important it is to have effective pricing and that is the only thing that will lead to financial success of any service firms.

Next, we touched upon the foundation of a pricing strategy as represented by the pricing tripod. Finally we looked into different types of financial costs, the fixed cost, the variable cost and the semi-variable cost, and explained the limitations of this cost-based pricing, which is more relevant in manufacturing rather in services.

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And these are the three books that were referred to while we were making this module. Thank you.