Chapter 14

Pricing Concepts For Establishing Value (Part II)

- Describe the difference between an everyday low price strategy (EDLP) and a high/low strategy

- Describe the pricing strategies used when introducing a new product

- Describe dynamic pricing

- Describe price discrimination

- **Everyday Low Pricing (EDLP)**
  - Promises to consumers a low price without the need to wait for sale price events or comparison shopping

- Consumers: reduces search costs → adds value
- Firms: saves effort and expense needed to mark down prices

- **High/low pricing**
  - Relies on promotion of **sales**
  - Attracts two different segments
    - Price insensitive customers (when price is high)
    - Price sensitive customers (when price is low)

    ## Amazon case

  - Big discounts can attract new users (whom would not have purchased the product otherwise!!)
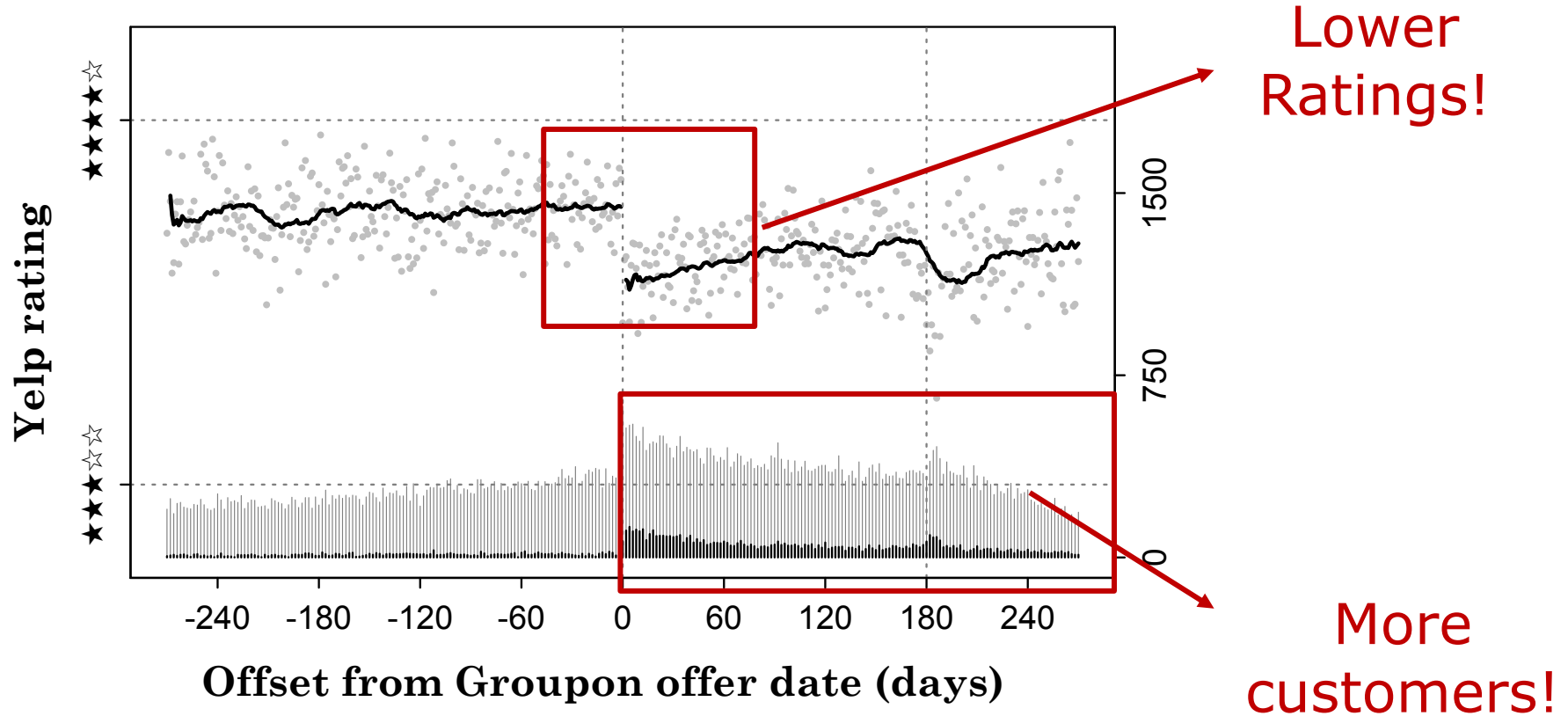   - E.g. Groupon case

(a) Rating vs. offset, centered on offer date
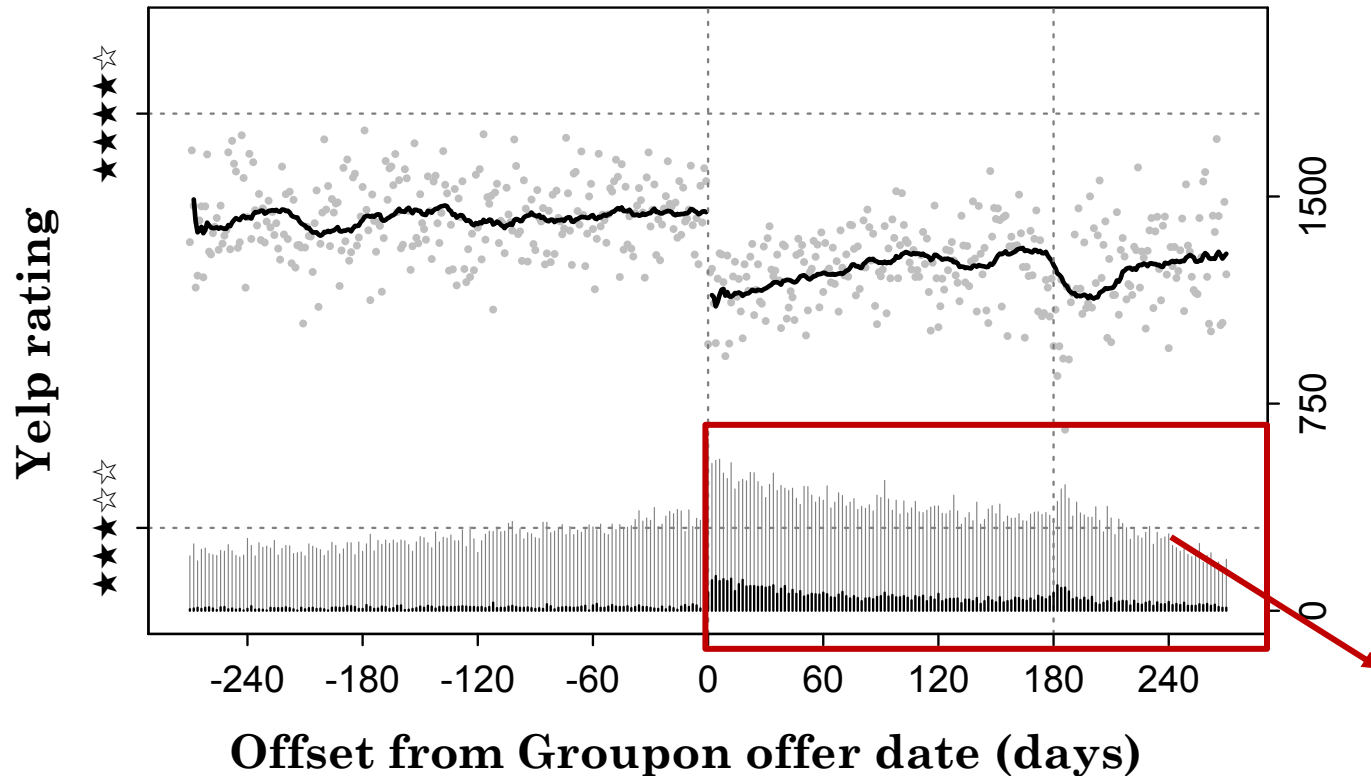
More customers!

(a) Rating vs. offset, centered on offer date

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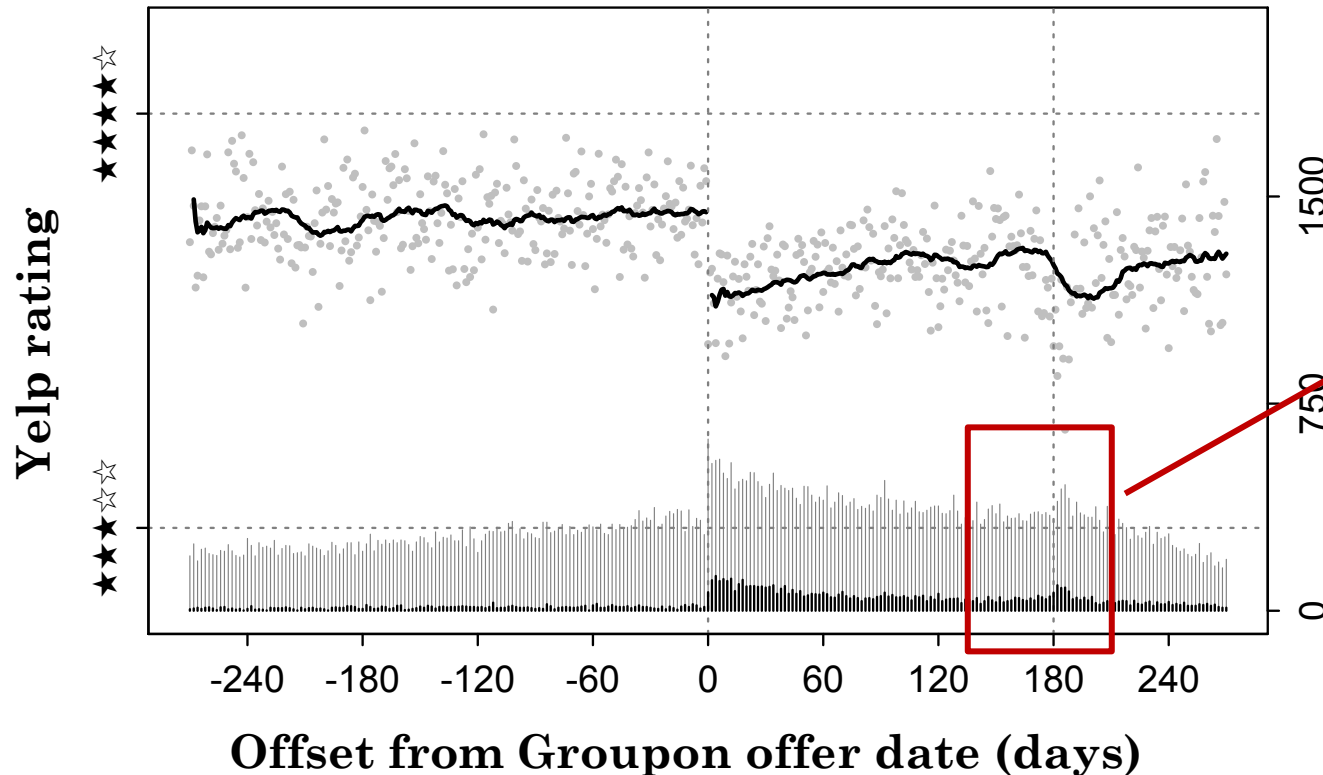
What do you think is going on here?

- Why do ratings decrease?

- Why do ratings decrease?
  - Groupon Businesses are More Likely to be "Bad" Businesses
    - Limited evidence

  - Groupon users are often engaging in experimentation

  - Groupon reviews are less likely to be artificially inflated (fake)

Two strategies:
1. Penetration pricing
2. Price skimming

- Set initial price low to build sales, market share, profits

- Good if cost of production decreases with quantity produced (economy of scale)

- Pros
  - Creates customer base quickly
  - Builds market share
  - Quick profits
  - Discourages competitors from entering the market
- Cons
  - Sacrifices higher profits (low margins)
  - Firm has to keep up with high demand
  - Signaling problem: Low price → low quality
  - May not create loyal customer base

- Cable, Internet companies, streaming services
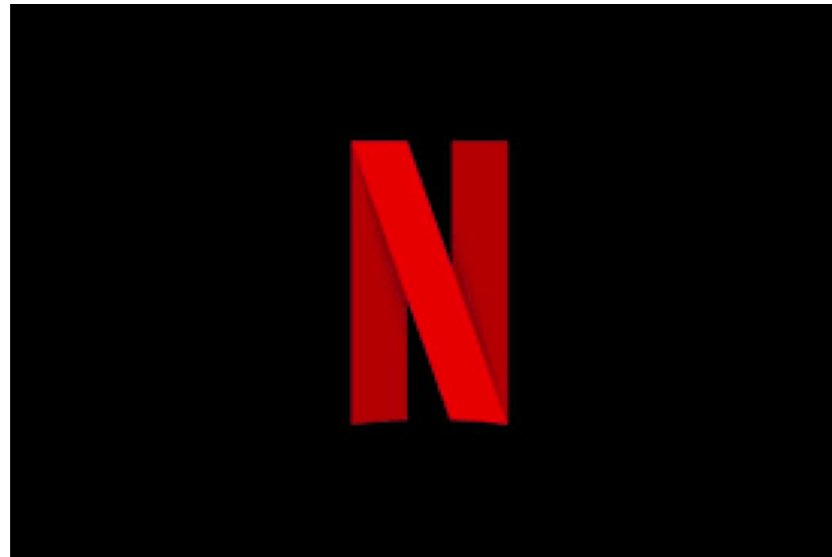
- At first high prices
  - Target consumers willing to pay premium to have innovation first
- When market saturates
  - Lower (skim) price
    - Target most price-sensitive segment
- Popular with technology products

- Pros
  - Increased Quality Perception
  - Benefits from Early Adopters
    - Brand ambassadors
  - Fast costs recovery
- Cons
  - Cannot last long
    - Competitors soon launch rival products
  - Consumer Dissatisfaction
    - Negative feedback from early adopters as the firm lowers its prices
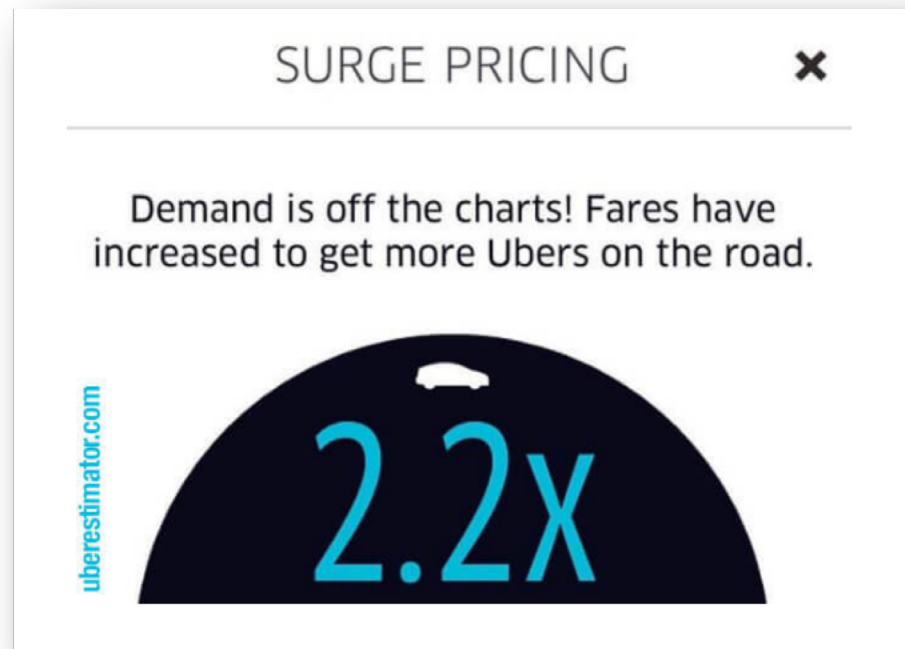
Apple

– New IPhone enters the market at a very high price

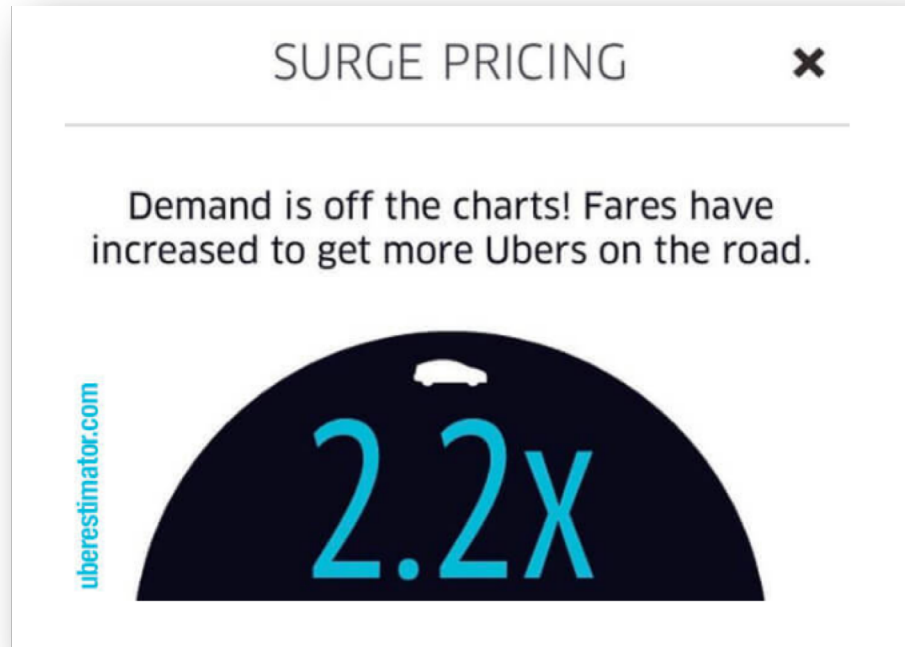• Reduced when or just before new version hit the markets

- How does Uber set prices?

- How does Uber set prices?

- How does Uber set prices?

SURGE PRICING

Demand is off the charts! Fares have increased to get more Ubers on the road.

2.2x

uberestimator.com

Rates automatically increase, when the taxi demand is higher than drivers around you.

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- ## Surge price in action [Nosko et al. 2015]

Figure 1: Demand for Uber Spikes Following Sold-Out Concert on March 21, 2015
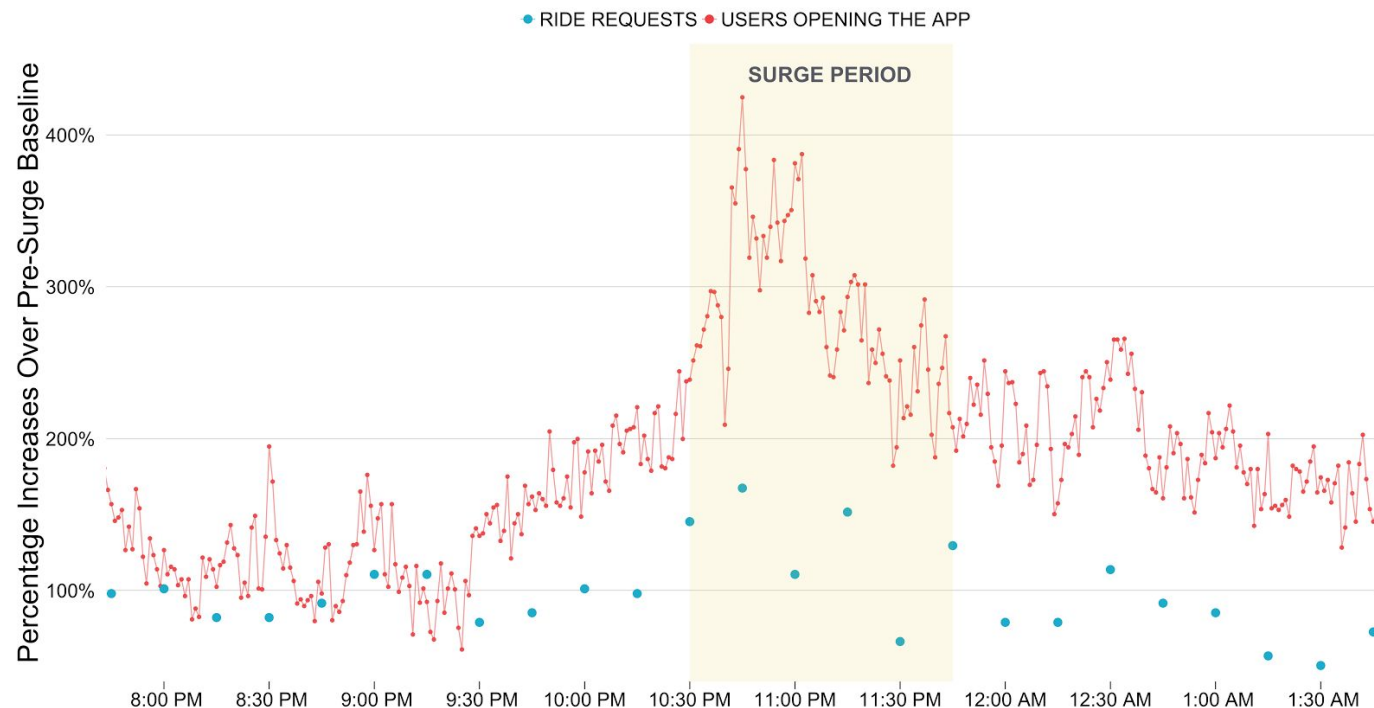
Note: Figure reports the number of users opening the Uber app each minute over the course of March 21, 2015 (in red), as well as the sum of total requests for Uber rides in 15-minute intervals over the same time period (blue circles). Data is for a restricted geospatial bounding box containing Madison Square Garden in New York City, roughly 5 avenues long and 15 streets wide, for uberX vehicles only. Pure volume counts have been normalized to a pre-surge baseline, defined as the average of values between 9:00 and 9:30 PM that evening, before surge turned on. "Surge period" (yellow box) is the time over which the surge multiplier increased beyond 1.0x.

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- ## Surge price in action [Nosko et al. 2015]

Figure 2: Uber Driver-Partner Supply Increases to Match Spike in Demand
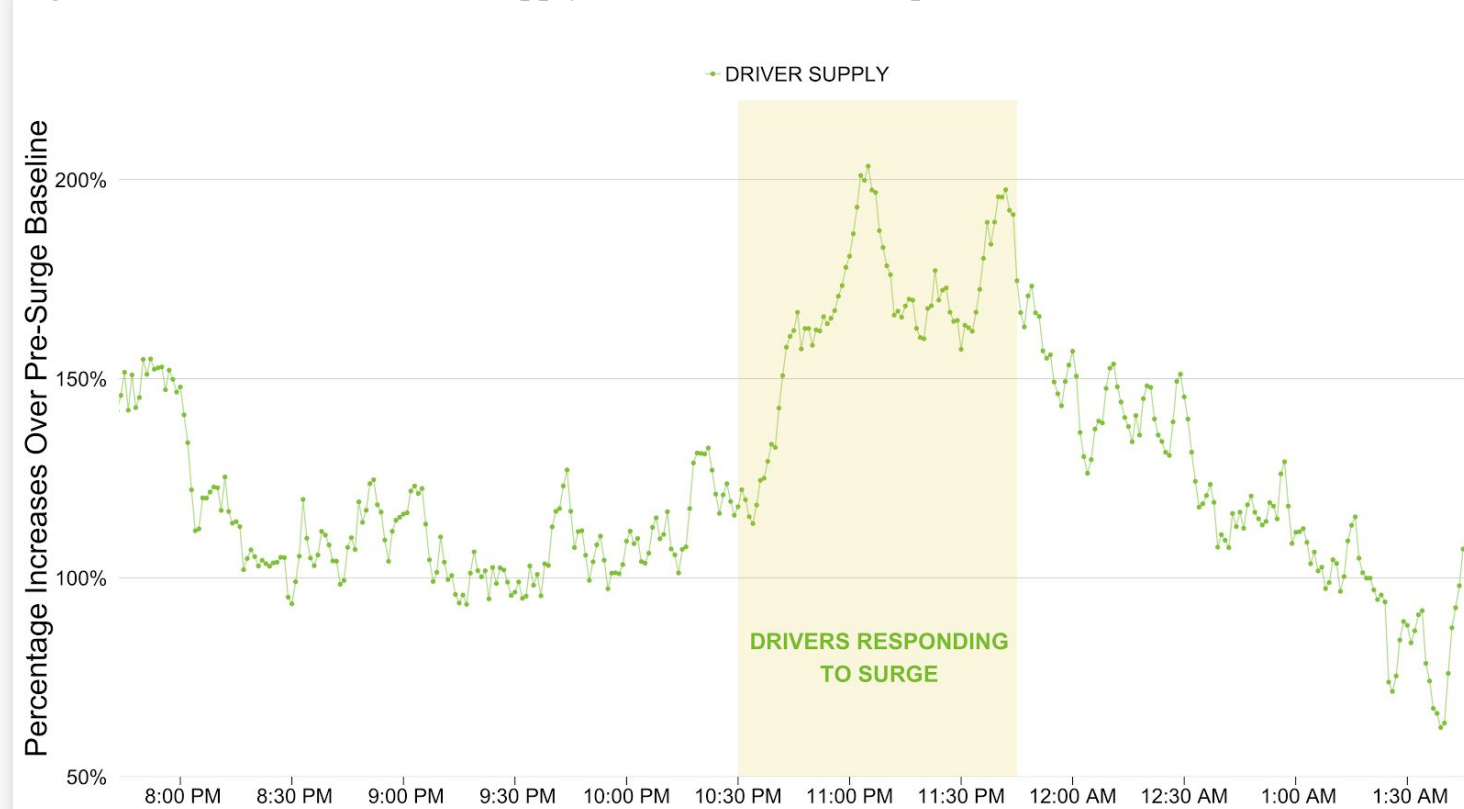
Note: Figure reports the number of "active" uberX driver-partners within the same geospatial box (noted above) each minute over the course of March 21, 2015 (in green). In this case, "active" means they were either open and ready to accept a trip, en route to pick up a passenger, or on trip with a passenger. Pure volume counts have been normalized to a pre-surge baseline, defined as the average of values between 9:00 and 9:30 PM that evening, before surge turned on. The "surge period" (yellow box) is the time over which the surge multiplier increased beyond 1.0x.

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• Surge price in action [Nosko et al. 2015]

Figure 4: Vital Signs of Surge Pricing in Action on March 21, 2015
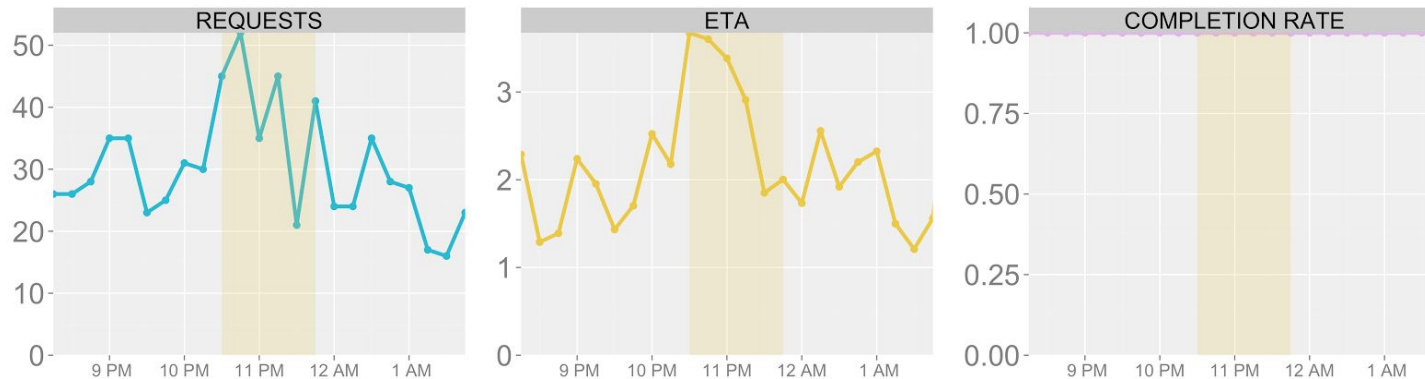
Note: All data above is for uberX vehicles from within the geospatial bounding box mentioned earlier, aggregated into 15 minute intervals over the course of the evening of March 21, 2015. "Requests" is the count of Uber trips requested during the 15 minute interval. "ETA" is the average wait time for a driver-partner to arrive, in minutes, over the 15 minute interval. "Completion rate" is the percentage of requests that are fulfilled (calculated as the number of completed trips within the 15 minute interval, divided by the sum of completed trips and unfulfilled trips). The yellow box indicates the same "surge period" highlighted in Figures 1-3.

- What is the goal (or goals) Uber is trying to achieve with the surge price algorithm?

  1. Match demand with supply

  2. Reducing waiting time

- We have seen:
  - Pricing strategies
    - EDLP
    - High/Low pricing

  - New products pricing strategies
    - Market penetration
    - Skimming

  - Dynamic pricing (Uber)

When a firm sets a very low price for one or more of its products with the intent to drive its competition out of business, it is using **predatory pricing**

- Illegal under both the Sherman Antitrust Act and the Federal Trade Commission Act

- Identical goods or services are sold at different prices by the same provider in different markets
- It requires
  - Market segmentation, e.g.,
    - Student vs non-students

  - No arbitrage
    - Lower-priced users cannot resell to high-priced users!

Example fro NYT

To discriminate you need to separate

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1. Personalized pricing (or first-degree price discrimination)

2. Product versioning (or second-degree price discrimination)

3. Group pricing (or third-degree price discrimination)

- Information: The firm is able to identify **each** consumer type

- Arbitrage: Not possible

- Prices: Will be different to each consumer and each unit

- Information: The firm cannot differentiate consumers ex-ante, but it must know the aggregate characteristics of the market
  - Can still segment!
- Arbitrage: Not possible
- Prices: Will change according to the quantity (or quality) the consumer buys
  - Electricity providers
  - Airlines (first class, economy, etc.)

Chart 3.4.1: Average UK non-domestic electricity prices Q3 2012
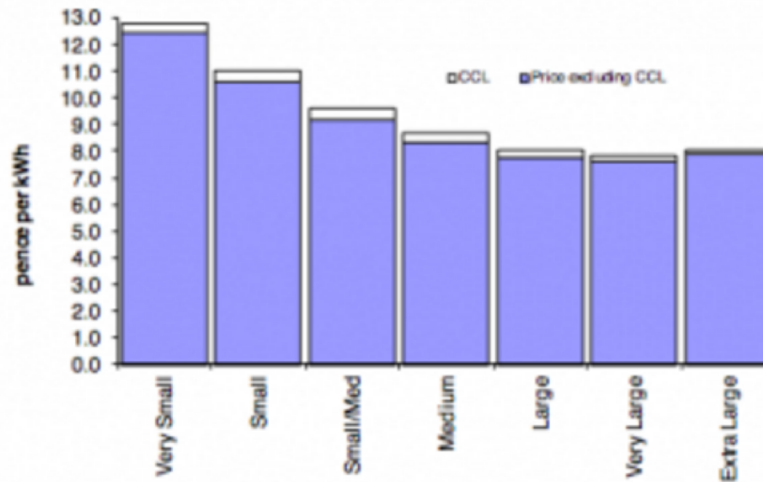
- Average electricity prices, excluding CCL, have risen in cash terms between Q3 2011 and Q3 2012 by an average of 9 per cent.

- Price changes have varied by sizeband, rising by between 5 and 9 per cent for smaller consumers, and by between 10 and 14 per cent for all other consumers.

- Average prices in Q3 2012 are 9 per cent lower than the high reached in Q1 2009.

- The inclusion of CCL increases the average price of electricity by between 2 and 4 per cent.

Source: energy prices

- Most common
- Information: can distinguish consumer groups through a signal (location, age, gender, etc.)
- Arbitrage: Not possible
- Prices: Will change according according to consumer groups (student, senior)

- Some internet retailers use personal information that users leave (involuntarily) online to price discriminate
  - Type of browser used
  - Location
  - Age, gender, etc.

- In the <u>news</u>

- Price discrimination
  - First-degree: "personalization"
  - Second-degree: quantity/version
  - Third-degree: groups

- Internet and big data are facilitating first degree price discrimination