



SEGMENTED PRICING: USING PRICE FENCES TO SEGMENT MARKETS AND CAPTURE VALUE

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Price Fences to Operationally Segment Markets

The use of segmented pricing—the practice of charging different customers different prices—is a critical element in every marketer’s toolkit. Yet if charging different customers different prices were easy, everyone would do it. So how can it be done? The answer is by creating a profit-driven price structure that varies not just the price, but also the offer or the criteria to qualify for it. This can be achieved through price fences.

Price fences are criteria that customers must meet to qualify for a lower price. At movie theaters, price fences are usually based on age (with discounts for children and seniors) but are sometimes also based on educational status (full-time students get discounts), or possession of a coupon from a local paper (which benefit “locals”). All three types of customers have the same need and cost to serve them, but perceive a different value from the purchase.

Price fences are one of the most effective tools a marketer has, but care must be taken to prevent customers from somehow bypassing the fence. For example, Americans looking for discounts on pharmaceuticals travel to Canada to buy the same brands at lower prices, thwarting the geographic fence. The art of price fencing involves not only finding a natural separation of buyers by price sensitivity, but also a means to enforce the separation.

Below are seven generic approaches to segment using price fences and examples of how they are used successfully.

1. Segmenting by Buyer Identification

Occasionally, pricing differently among segments is easy because buyers in the different segments have obvious characteristics that distinguish them. For instance, barbers charge different prices to cut short and long hair because long hair is usually more difficult to cut. But identification of customers in different segments is rarely so straightforward.

Often a buyer’s relative price sensitivity does not depend on anything immediately observable or on factors a customer freely reveals, but rather on how well-informed about alternatives a customer is. In such cases, the classification of buyers by segment usually requires an expert salesperson trained in soliciting and evaluating the information necessary for segmented pricing. The retail price of an automobile is typically set by the salesperson, who evaluates the buyer’s willingness to pay by taking a personal interest in the customer, asking what the customer does for a living (ability to pay), what kinds of cars she has bought before (loyalty to a particular brand), and where she lives (value placed on the dealer’s location). By the time a deal has been put together, the salesperson has a fairly good idea of how

sensitive the buyer's purchase decision will be to the product's price.

2. Segmenting by Purchase Location

Customers who perceive different values, and who buy at different locations, can be segmented by purchase location. For example, dentists, opticians, and other professionals sometimes have multiple offices in different parts of a city, each with a different price schedule reflecting differences in their clients' price sensitivity.

A segmented pricing tactic common for pricing bulky industrial products, such as steel and coal, is freight absorption. Freight absorption is the agreement by the seller to bear part of the shipping costs of the product, the amount depending upon the buyer's location. The purpose is to segment buyers according to the attractiveness of their alternatives. A steel mill in Pittsburgh, for example, might agree to charge buyers the cost of shipping from either Pittsburgh or from Chicago, where his major competitor is located. The seller in Pittsburgh receives only the price the buyer pays, less the absorbed portion of any excess cost to ship from Pittsburgh. This enables the Pittsburgh supplier to cut price to customers nearer the competitor without having to cut price to customers for whom his Chicago competitors have no location advantage.

3. Segmenting by Time of Purchase

When customers in different market segments purchase at different times, they can be segmented for pricing by time of purchase. Theaters segment their markets by offering midday matinees at substantially reduced prices, attracting the price-sensitive retirees, students, and unemployed workers who can most easily attend at such times. Less price-sensitive evening patrons cannot so easily arrange dates or work schedules to take advantage of the cheaper midday ticket prices.

Segmenting by time is also useful when demand varies significantly with the time of purchase but the product or service is not storable. Airlines, for example, face greater demand for seats on Mondays, Thursdays, and Fridays than on other days. However, they cannot store the excess seats they have

on Tuesdays in order to meet exceptional demand on Fridays. Seats left unused on Tuesday flights are lost, whereas the ability to serve customers on Friday afternoon is limited by capacity at that time. Therefore, airlines charge more on the days that seats are in demand, and less on days when they have excess capacity.

4. Segmenting by Purchase Quantity

When customers in different segments buy different quantities, one can sometimes segment them for pricing with quantity discounts. There are four types of quantity discount tactics—*volume discounts*, *order discounts*, *step discounts*, and *two-part prices*—examples of which follow.

Volume discounts are based on the customer's total purchases rather than on the amount purchased at any one time. For example, steel manufacturers grant auto companies substantially lower prices than they offer other industrial buyers because auto manufacturers use such large volumes that they could easily operate their own mills.

Order discounts are used when sellers vary prices by the size of an order rather than by the size of a customer's total purchase. This is because many of the costs of processing an order are unrelated to the size of it; consequently, the per-unit cost of processing and shipping declines with the quantity ordered. For this reason, sellers generally prefer that buyers place large, infrequent orders rather than small, frequent ones.

Step discounts apply only to a purchase beyond a specified amount. This is to encourage individual buyers to purchase more of a product without having to cut the price on smaller quantities for which they would pay a higher price. Step discounting may segment not only different customers, but also different purchases by the same customers. Such pricing is common for public utilities from which customers buy water and electricity for multiple uses and place a different value on for each use.

Two-part pricing involves two separate charges to consume a single product. For example, car rental companies have a daily rate plus a mileage charge, and health clubs

charge an annual membership fee plus additional fees for tennis court time. In these cases, heavy users pay less than do light users for the same product, since the fixed fee is spread over more units.

5. Segmenting by Product Bundling

Product bundling is a widely used tactic for segmented pricing. Restaurants bundle foods into fixed-price dinners, generally a cheaper alternative to the same items served à la carte. Bundling is a successful tactic because the products bundled together have a particular relationship to one another in their value to different buyer segments.

Most firms use optional bundling where products can be bought separately, but the option is available to buy them in a bundle at prices below their cost if bought separately. Optional bundling is more profitable than indivisible bundling whenever some buyers value one of the items in the bundle very highly but value the other less than it costs to offer it. For example, residential cable companies offer bundles of cable internet, cable-based telephone, and cable television services for reduced prices off their à la carte price.

6. Segmenting by Tie-Ins and Metering

Segmentation by tie-ins or metering is often important for pricing tangible and intangible assets, because buyers generally place greater value on an asset the more intensely they use it. Food processors canning fruit year-round in California value canning machines more than fish packers do in Alaska, who can salmon-fish only a few months each year. In such cases, tactics that segment buyers by use intensity can substantially improve both sales volume and profitability.

In service-based companies, tie-in contracts are frequently used to reduce the cost for new buyers to try their services. Wireless phone providers offer a digital telephone for a nominal fee, and sometimes for free, if the buyer agrees to purchase a long-term service contract to use the company's wireless network.

7. Segmenting by Product Design

The important factor in segmenting by product design is differences in value driven
Spring 2006

by differences in alternatives, uses, or income. To make this tactic work, one must offer a lower-priced version that is in some way inadequate to meet the needs of price-insensitive buyers but still acceptable to price-sensitive buyers. Microsoft has a lower-priced version of its dominant Windows operating software, targeted at first-time computer users in developing countries. This Windows Starter Edition allows users to open only three applications at a time and restricts instant messaging. It also offers limited word processing, no out-of-the-box Internet access, and a screen resolution that won't support the newest computer games. The cost to limit the capabilities of this new product is minimal, consisting mostly of "turning off" different elements of the software's code.

In Summary – The Importance of Segmented Pricing

Designing an optimal price structure that effectively segments your market and maximizes your profitable sales opportunities is clearly among the most difficult aspects of pricing strategy. While the types of segmentation tactics discussed can serve as a guide to separating markets, finding a basis for segmentation (i.e., a particular buyer characteristic or a particular bundling combination) ultimately requires creative insight. Since each example of segmented pricing is unique in its method of implementation, there can be no simple formula. Finding a basis for segmentation is the key to maintaining a strong competitive position; in some cases, it is essential to remaining viable.



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