Assessing the Potential of Differential Pricing Strategies
- Analysis of the Benefits and Pitfalls

Marketing Week Conference
28 May 2002
Good afternoon ladies and gentlemen. Over the course of the last two days you have heard about many different aspects of pricing. My brief is to analyse the issue of differential pricing and to develop some ideas of where it is heading. The principal focus of this talk is consumer marketing although some aspects of business to business will be relevant at some stages.

There are a number of areas that I will be covering. After a brief contextual analysis, I will define some of the areas where differential pricing is currently operating. The consumer perspective will view the subject from the other side to identify a number of issues that should be taken into account when developing a differential pricing strategy. Geographic pricing looks at how prices may vary across regions and countries. There are three future scenarios that show ways in which differential pricing is developing and the summary shows some of the issues that will be faced in the future.

The most important factor when analysing differential pricing is to recognise that it does not exist on its own. The pricing policy for a company or brand is part of the overall marketing mix.

Furthermore, there is nothing especially new about differential pricing. Haggling has been around for ages. Nevertheless, the marketing environment is changing so rapidly that the issue has come to the fore.

Marketers are rethinking their entire value change in order to focus more on the final consumer. Target market segmentation has been used as a way to develop tighter marketing strategies. The consumer has changed and is far more aware of prices that are being charged in different areas. Furthermore, marketing tools are evolving fast and are becoming more sophisticated to enable pricing to be undertaken in different ways.
The state of the economy also plays an important role and I will return to that subject.

As I said, differential pricing is nothing totally new. There are a number of ways in which it is being undertaken at present. I have identified four main areas although these are not necessarily exhaustive.

The key area is straightforward supply and demand where economic forces dictate the price. Promotional activity is the second area where prices are subject to change. Geographic pricing refers to where different prices may be charged in different areas at the same time and, finally, consumer-focused means the pricing is more dynamic and could even be varied by the consumer.

The first area is where the price is dictated by supply and demand. Under this mechanism a higher level of demand for the product or service raises the price although the product or service itself may not change in nature.

Examples of where this approach is used includes utilities such as telephones and electricity that have peak time and off-peak rates. Travel tickets are typically less expensive in off-peak periods for the same journey. In this case, the lower price for off-peak travel may be looking to encourage greater utilisation during these periods.

The use of price as a promotional instrument is more controversial. Price-led offers such as buy one-get one free or extra product are used commonly. A low price may also be used during an introductory period after product launch or to attract new consumers.

Good in theory maybe but the overuse of price as a promotional tool has had the effect of turning brands into commodities. A long-term low-price strategy changes the brand values. A brand can no longer be viewed as a premium product. Using low price as a key element of the brand is fine, EasyJet seems to be successful, but it cannot work if the
brand positioning is intended to focus more on premium aspects. This helps to explain the difficulties that Sainsbury's and British Airways have encountered when trying to compete in the price arena.

Geographic pricing is another area that is frequently controversial, receiving regular negative media coverage. A different price could be charged in different regions or in different countries. This is based on the assumption that different areas are able to afford different price levels or that the costs of marketing a product or service can vary by area.

Under customer-focused I am including prices that vary according to the actual customer. This is a common b2b scenario but is becoming more widespread in consumer marketing. A couple of examples here are rebates given to consumers who are important customers such as Tesco’s Clubcard vouchers or Sainsbury’s Reward points that effectively reduce the cost of the shopping basket. Cashback for existing customers, for example on a software purchase, may also fall within this category.

The price could also vary according to the “access method.” This could mean a lower price for somebody booking a ticket via a Web site as the marketer’s costs are lower. British Airways and EasyJet are examples of companies that adopt this approach.

These four elements take the marketer perspective on differential pricing. However, in order to be successful it is vital to consider the issue for the consumer. The consumer perspective is a crucial element, even more so with the increased transparency of pricing.
A differential pricing strategy will not work if it cannot work from the consumer side. This means that long-term considerations are equally important as short term. An uplift in sales or the number of new customers has little worth if the brand value is undermined or existing customers are disenfranchised.

Communications play an important role here. A differential pricing strategy can no longer be hidden. The media has seen to that. Therefore, the pricing options need to be communicated as something positive for the consumer. If lower prices are available then the consumer should be made aware of them prior to the purchase.

Consumers also know about stealth pricing, a recent example being the extensive media coverage about last minute holidays that seem to have so many necessary extras increasing the overall cost.

Consumers have become more price aware although this does not necessarily mean more price sensitive. An anticipated economic slowdown has made consumers, not just marketers, question price more. The media has played a crucial role in this with effective PR from price-led companies such as EasyJet and Ryanair but also media “exposés” of issues such as rip-off Britain.

Cross-border shopping has become more widespread. For example, the DVD of Harry Potter costs £16.99 at amazon.co.uk (a reduction of £6) but at amazon.com the price is just $19.95, equivalent to £13.73. Consumers now find it easier to shop where the price is lowest, even if means ordering overseas. This has implications for the government that is losing out on tax revenue and it has now investigated some product categories such as cars and forced the UK manufacturers to lower prices to nearer the European level.

The launch of the Euro is an area that is expected to lead to greater price harmonisation in Europe although there are doubts as to whether this is actually happening. I will return to this subject later.
In this case we are talking about the damage that could be caused to a brand by a misuse of promotional pricing. Brands normally command a price premium, indeed that is one of the key factors that differentiates a brand from merely a product. This price premium has to be continually reinforced and justified but overuse of promotional pricing is more likely to damage this premium so that consumers start the question the validity of the full priced product. The *brand* starts to lose its identity.

Furthermore, consumers may be conditioned to buying on price and will actively search out current offers. This may have the effect of promotional activity merely shifting sales rather than helping to increase them. Such a strategy may be useful, though, for shifting unsold inventory. It is interesting to note here that retailers take different approaches. Some do not like to discount ends-of line while others prefer to sell discounted merchandise through a controlled environment such as a factory outlet and maintain some control of brand values.

In addition, the use of promotional pricing has the ability to isolate existing customers where it is being used to attract new users. Why should long-term loyal consumers pay more than those whose patronage may be fleeting and are not loyal, even promiscuous? Those consumers who transfer their credit card balances every few months could pay nothing while the loyal consumers pay high rates of interest. This is what we are calling The Paradox of Loyalty.

Too frequently, there appears to be too much attention focused on gaining new customers while longer-term loyal customers are seemingly almost forgotten. This extends beyond pricing although the use of differential pricing or other incentives such as Air Miles is one of the elements that shows how new customers could be rewarded while existing customers are not. While loyal consumers may be prepared to pay a higher price premium, they should receive greater value. Maybe the service they receive can be better if they have a genuine engagement with the company or brand.

However, rather than operate a differential pricing policy there is clearly potential to encourage consumers to trade up or cross-purchase additional...
products and services. This is where added profitability should be generated, not by simply charging more.

By this stage it should have become clear that the operation of a differential pricing policy could be fraught with difficulties. Price is only one element of the marketing mix and should work in relation to the other variables. Furthermore, charging different prices to different consumers for what may be perceived as an identical product or service has the potential to generate unfavourable media coverage.

A few recent examples of where the press has reported in a negative way on this issue. Interestingly, a vending machine that raises prices in hot weather is presumably the same machine that lowers the price when it is cold.

The Halifax Bank received extensive negative coverage when the banking ombudsman ruled that it had two standard variable rates, one for new and one for existing customers. The bank received further bad publicity when it stated that it would compensate those existing customers who had complained about the dual rates prior to the ombudsman’s decision and would pay £100 goodwill only to other customers. The Nationwide, on the other hand, decided to compensate all customers but through reducing their mortgage commitments rather than by refunding payments already made.

I would like to return to the issue of geographic pricing for a while.
This is where the price differential depends on the region of the country or the country itself. This is an area that has been much in the news recently. There is the issue of the differential in car pricing between the UK and Europe. While the car manufacturers may argue that like-for-like is not being compared, the consumer perception, which may be media-driven, is that they are being ripped off. Difference or not, the consumer perception is that there is an issue.

Grey imports have also been receiving intense coverage with the most high profile example the case of Tesco and Levi’s where Tesco had been buying Levi jeans outside the UK and selling them lower than the Levi’s recommended price. Again it is the company looking to enforce differential pricing that has to deal with the problem. This is not a case of Levi’s against Tesco, this is Levi’s against consumer perception. Guess who is likely to lose here at the end of the day.

The recent launch of the Euro in many European currencies has been widely expected to lead to price harmonisation across the EuroZone as a common unit of currency will effectively hide and pricing differential. But what is happening so far?

The truth, albeit after five months only, is that differential pricing is being maintained. This recently published EU study shows that there are substantial differences in price for some well-known brands. However, even on the basis of the limited list of brands shown, we can conclude that it is the laws of supply and demand that are determining some of these prices.

Take a look at Barilla pasta which is substantially less expensive in Italy compared with Sweden. Could this be due to intense competition in the home of pasta? Equally Nescafé is priced relatively high in Italy, a roast and ground coffee market where, presumably, demand for instant coffee is fairly low. Similar reasoning can be applied to Evian mineral water in France and Kellogg’s Cornflakes in the UK. Conclusion: it is not as straightforward or linear as the press coverage would have you believe.
Differential pricing on a regional basis within one country is likely to be driven by different factors.

The retail chain Sainsbury’s was reported to be looking at adopting a regional pricing policy for its northern stores so that has more of a value offer than it may have in the south. However, there is the possibility that it would compromise its brand positioning by such a move. Sainsbury’s problems in the mid-1990s may have partly resulted from this type of approach nationally as the chain undermined its core value of quality by moving towards a lower price offer when discount chains were making gains.

The factors that impact on regional pricing may be different to those operating across countries. A marketer may choose to run differential pricing to reflect varying levels of disposable income or general regional price differences. They may reduce prices in areas of higher unemployment or where the type of employment varies. Equally the local household composition could affect the prices that consumers are willing or able to pay.

Pricing may also be established according to the level of local competition. In this case a retailer may reduce a price to match the competition. This may be more applicable to commodity products where the price cannot be higher than the competition. However, it cannot be classed as marketing initiative but more one of survival. Adopting a “follow the competition” policy will at best achieve parity rather than any significant competitive advantage.

This has been an overview of some of the important elements and issues in differential pricing currently.

The next stage is to consider where differential pricing is heading. We have analysed the different driving forces in the market together with indications of the pricing policies of some leading-edge companies to distil three possible scenarios for differential pricing.
Through the Loop

Assessing the Potential of Differential Pricing Strategies

These possible future scenarios are dynamic supply and demand, consumer aggregation and consumer value demand. These are not meant as an exhaustive list but an illustration of some potential ways forward.

Let us consider each in turn.

The dynamic supply and demand model moves forward from existing pricing based on supply and demand. This makes the assumption that consumer demand is not static and that the value of a product and brand can change according to different criteria. This could include factors such as the weather where a sunny day raises the value of an ice cream or a cold drink. Cooler weather has the opposite effect naturally. Road pricing could be used to charge a higher toll at peak periods thus discouraging driving at these times. Retail prices could vary according to the time of day, higher in peak periods but lower when the store is quieter. Finally should insurance risk be calculated according the driver's mileage or the time of travel rather than where he or she lives?

Progressive Insurance in the US has already developed a system where a car is tracked by satellite and the insurance charged according to mileage or time of journey. It is said to be possible at a later stage to adjust the premium according to the driver's behaviour behind the wheel. While this system would almost certainly face a number of implementation difficulties, it does illustrate that differential pricing could be used to define the premium for the individual user.

The second scenario is where consumer aggregation applies industrial bulk buying to the consumer sector. This enables groups of consumers to buy in bulk to force down prices. Such an approach is being used by so-called “reverse auctions” such as priceline.com or letsbuyit.com. Priceline.com allows consumers to state the price they are willing to pay and suppliers have the opportunity to bid for that consumer at that price. An answer is expected to be provided within fifteen minutes!

Letsbuyit.com enables consumers to sign up for a product with the price falling as the number of buyers increases. An example of this from the
letsbuyit.com Web site yesterday shows that you can purchase a Sony widescreen TV and Toshiba DVD for £1,055 compared with an average retail price of £1,499.

This really is a buyer’s market.

The third scenario is based on the value of individual customers and again brings b2b pricing into the consumer arena. It uses the assumption that different consumers have different buying behaviour and price points. Loyal customers can be treated accordingly. An example of where this could be used would be to reduce the price of a product where the consumer is clearly expressing an interest but not buying. Over time the marketer is able to build a complex picture of the individual’s purchasing behaviour and develop an appropriate pricing policy.

Such an approach may also be used to encourage consumers to trade up to higher value or higher profit items. As the consumer’s buying behaviour is known, perhaps through a reward scheme, he or she can be offered products and services appropriate to previous behaviour but in higher profit areas.

So what can be learned from this analysis? Firstly, the issue of differential pricing is, like the pricing, a dynamic area in itself.

With the move away from purely mass marketing to a model where the importance of individual consumers is being increasingly recognised, differential pricing takes on a whole new perspective.

Pricing is an essential element of the integrated marketing mix. Its role is different for different consumers and at different times. In addition, tools are now available that allow marketers to develop innovative pricing models that reflect the nature of consumers as individuals and the dynamic nature of
the price-value equation. Pricing elasticity should be measured on an individual customer basis not for the market as a whole.

However, the issue also brings a number of factors that should be taken into account when considering a differential pricing policy. Prices cannot be hidden or disguised so assume that prices are generally known.

There is a potential for massive PR both ways. The marketing communications need to emphasise genuine consumer benefits of the policy such as greater flexibility or ability to save money by shopping off-peak.

Further to this, differential pricing may be used to encourage a shift in the pattern of demand. Tesco.com is testing a new way of charging for its delivery fee based on the time of delivery with higher charges at peak times. This gives the customer the opportunity to save money and helps to make the Tesco system more efficient. The store claims that the system is already proving popular with pensioners.

Lower off peak transport fares are typically used to encourage greater utilisation of transport throughout the day. Would it make more sense to have lower fares for rush hour periods to firstly reward the “loyal” consumers who use public transport more often or to encourage use of public transport for travel to work? At present, higher peak time fares may act to encourage driving to work by car rather than taking a bus or train.

In conclusion, I have looked to outline some of the future directions in differential pricing that take advantage of a shift towards consumer power and control, new marketing tools and perceived failings of current models. While pricing is only one element of the overall marketing mix, it is an area where there are possibilities to achieve significant differentiation and consumer connection.

The operation of a differential pricing policy provides major potential for marketers to seize a very real consumer opportunity. In the age of the empowered consumer, those marketers that are best able to deliver genuine, relevant and more-highly tailored products and services are in the best position to
guarantee real consumer engagement and satisfaction.