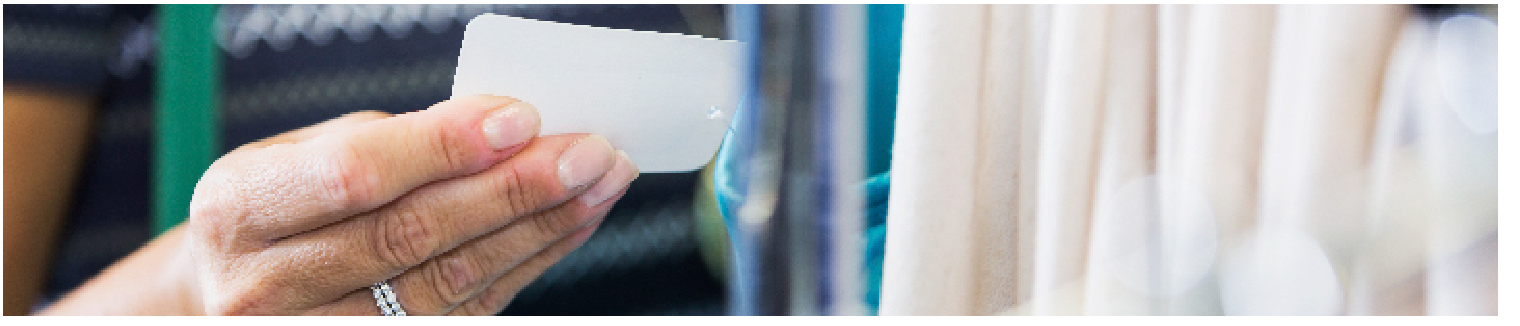
TOMORROW'S CHALLENGES



LET YOUR CUSTOMERS SEGMENT THEMSELVES BY WHAT THEY'RE WILLING TO PAY

CHARGING DIFFERENT CUSTOMERS DIFFERENT PRICES FOR THE SAME PRODUCT IS TRICKY. HERE'S HOW IT'S DONE.

By IMD Professor Stefan Michel – April 2015

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The late Sir Colin Marshall, when he was CEO and chairman at British Airways (BA), knew that success in his business came down to superior value capture. In a 1995 interview with *HBR*, he summed up the opportunity brilliantly: "You're always going to be faced with the fact that the great majority of people will buy on price. But even for a seeming commodity such as air travel, an element of the traveling public is willing to pay a slight premium for superior service …. In our case, we're talking about an average of 5%. On our revenues of £5 billion, however, that 5% translates into an extra £250 million, or $400 million, a year."

If you're out to capture more value, one surefire tactic is to figure out a way to charge different prices to customers with different willingness-to-pay (WTP). Economists sometimes call this "price discrimination," which sounds bad since discriminating against people is generally illegal, not to mention immoral. However, most of us encounter forms of price discrimination frequently that don't bother us. For example, who begrudges the discounts afforded to senior citizens and students? (Well, all right, I have occasionally felt a tinge as I see my retired neighbors driving much more expensive cars than mine.)

But charging different customers different prices for the same or a similar product or service is tricky for reasons having nothing to do with ethics. First: it is not easy to identify and group customers according to their willingness to pay. Second: if you have different prices in the market for a similar product, there is no preventing your well-heeled customers from taking advantage of the lower prices, too. Often, a marketer will try to scoop up sales from more price-sensitive shoppers (without cutting margins for its best customers) by launching a second, lower-end "fighter brand." But customers are smart, and this often invites another serious problem – indeed called by one of the scariest terms in the management vocabulary: cannibalization.

There is an elegant solution to this problem, which I call "self-segmented fencing." It consists of two parts: (1) Customers reveal their willingness-to-pay through self-segmenting, which is to say they themselves choose either the high- or low-price offer; and (2) Arbitrage is then prevented through effective fencing – that is, customers with high willingness-to-pay are fenced off from the low-price offer.

A fabulous example of this strategy is couponing. Grocers could simply offer the same attractive price to everyone, but instead they invite customers to present coupons to cashiers in order to get discounts on certain products during certain time periods. Why is this beautiful? Because many shoppers can't be bothered to search for, collect, and redeem coupons. Therefore, they effectively choose to pay full price. Frugal shoppers and families living on small budgets are more likely to make the opposite choice, self-selecting to participate in the lower-price offer by using coupons and even shopping specifically for products that are on sale. In this example, the coupon is the "fence" to identify the segments and discriminate the price.

Once you understand fencing, you see fences everywhere. Famous fashion and sporting goods brands, for example, fence premium buyers by putting 50 or 100 kilometers between their flagship stores in the city and the outlet strips where they sell previous and even current-season models for huge discounts. And, back to Sir Colin's business, fencing goes on left and right with airplane seats. It's hardly a random occurrence when a roundtrip price comes up much cheaper and there is a Sunday between the outgoing and incoming flight. That fences off the majority of business travelers, even (or especially) if they fly economy class. Another fencing mechanism is tickets with no flexibility for canceling and rescheduling flights. (If you are like some clever participants in seminars I've taught, the thought might be occurring to you that a fully refundable ticket is really a different offering than a nonrefundable ticket, and therefore, doesn't constitute fencing but simply selling different products at different prices. It's a valid point, but given that the price difference is sometimes over 400%, it is certainly not based on cost considerations. What the airlines want to do is fill underutilized planes with cheap tickets that are unattractive to high-paying customers.)

Once you begin to see the elegant workings of self-segmented fencing all around you, you might begin to see opportunities to use it in your business. If different customers are willing to pay different prices by choosing, for example, to pop into your flagship store or trek all the way out to the outlets, why not let them? However, because there is never a free lunch, this strategy requires a very good understanding of what customers really want and how segments differ from one another. The bigger picture here is, of course, that value-based pricing always requires a solid and sophisticated understanding of what customers value.

Finally, remember that fences are most powerful if they give even as they take away. Premium customers should enjoy at least one important attribute that the low-price-seekers don't get. The grass should never look much greener on the other side of the fence.

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