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# Customer-centric pricing: The surprising secret for profitability

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**Abstract** Companies spend enormous amounts of energy and capital in creating value for customers, but less regard is given to actually capturing the value they have created. Segmentation based on buying behavior uncovers a tremendous differential in willingness to pay for subjective product attributes such as convenience, status, and quality. Purchase decisions are made through an assessment of a myriad of factors balancing perceptions of value components against price in a subtle, complex, and often sub-conscious decision matrix. Customer-centric pricing requires the simultaneous and continuous assessment of product attributes, customer perceptions, and the circumstances of time and place by listening to customers' actions. It is a means of assuring that companies assess the value they create for customers and extract that value from the marketplace.
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## 1. In search of opportunity

Despite recent productivity gains, pressures on profitability persist. Due to an uncertain economy and fierce global competition, profits will continue to be inconsistent. Many companies have already cut costs and squeezed productivity to the extent that they are now cutting flesh, not fat. They need to find new ways to consistently grow the bottom line.

Companies spend billions on enhancing brand preference and product differentiation. However, when faced with the prospect of extracting the benefits of these efforts through price differentials, they often fail. Firms tend to respond to lower-priced competition in one of two ways: either by capitulation (cutting prices to meet competition), or by inaction (not responding and ultimately surrendering market share to competitors) (Porter, 1979). They do not often expend the effort to determine the appropriate price differential for their products in the marketplace, an oversight that results in billions of dollars of lost opportunity.

## 2. Back to the future

Prior to the industrial revolution, all sales transactions were customer-centric, as each trans-

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action was subject to individual bargaining and negotiation. After the industrial revolution tapped mass markets, however, face-to-face negotiations became impractical. Mass-market expansion led to standardized means of production and standardized sales terms. Accordingly, companies became more product-centric. This product centricity encompassed all aspect of the product, including product features, distribution, service, and price.

Currently, most pricing is still product-centric. Product managers focus on the cost of the product, its physical attributes (size, features, and functions), and the margins they seek from the product. Product positioning vis-à-vis the company's other offerings and competitive offerings may also play a role. This mostly internal focus often creates a disparity between what product managers and customers perceive a product's value to be. This disparity in value perception leads to lost profit opportunities from under-pricing (creating consumer surplus) or over-pricing (lost sales).

However, many businesses are becoming more conscious of the need to look externally, with greater frequency, at the customer perception of value when setting and revising prices. This phenomenon is a function of increased product differentiation and customer segmentation (Porter, 1979), as well as an increase in the knowledge and technology associated with predicting customer response (Cross, 1997).

## 3. The customer-centric pricing process

Successful companies go beyond the concept of value creation to the reality of value extraction. While value creation is about getting into the heads of the consumer, value extraction is about getting into their wallets. It is only when the customer agrees with the value proposition and pays for the goods or services that the efforts in value creation pay off. Key to this process is setting customer-centric prices that accurately reflect the perceived value of their products to each customer segment (Anderson & Narus, 2003; Cross, 1997; Dolan, 1995).

Price should be seen as a communicative device between buyer and seller which continually reflects constantly changing market variables such as brand preference, the availability of supply, substitutable alternatives, and a host of other factors (Hayek, 1945). Companies which understand this function and use a customer-centric approach to pricing will be able to extract more from their value-creation strategies.

The customer-centric pricing process is described in Fig. 1. Companies can take advantage of customer heterogeneity by careful attention to:

(1) customer segmentation;
(2) measuring customer value;
(3) capturing the value created by pricing;
(4) continual reassessment of the product's perceived value in the relevant market. (Fleischmann, Hall, & Pyke, 2004).

## 4. Segmentation based on value perceptions and buyer behavior

Significant profit potential comes from understanding the value each customer segment places on individual products, then charging prices that accurately reflect that perceived value (Anderson & Narus, 2003, 2004; Nagle & Holden, 2002). Assessing and capturing the value that a firm creates for a specific market segment requires segmenting the customers into groups with similar perceptions of value and willingness to pay. Since customers define value by a wide variety of metrics, this is not an easy task. Conventional market segmentation techniques include demographic variables such as age, sex, race, income, marital status, education level, and geographical location, as well as psychographic variables such as activities, interests, opinions, and life-style (Assael & Roscoe, 1976; Wells, 1975).

These traditional methodologies have been able to effectively classify relatively homogeneous groups for purposes of product development, promotions, communications, advertising, and other marketing mix variables. (Smith, 1956; Haley, 1968; Frank, Massy, & Wind, 1972; Wansink & Park, 2000). They are not, however, necessarily effective in segmenting customers by willingness to pay, which varies based upon the customer's specific circumstances of time and place (Belk, 1975; Smith & Nagle, 2002). For example, demographic and psychographic segmentations do not adequately account for who will pay for the convenience of an ATM and when and where they will accept an additional fee.

To extract value from the marketplace through customer-centric pricing, we must answer the question: "What is this customer willing to pay at this point in time?" Segmentation by buying behavior is required to determine the answer. Unlike demographics and psychographics that attempt to

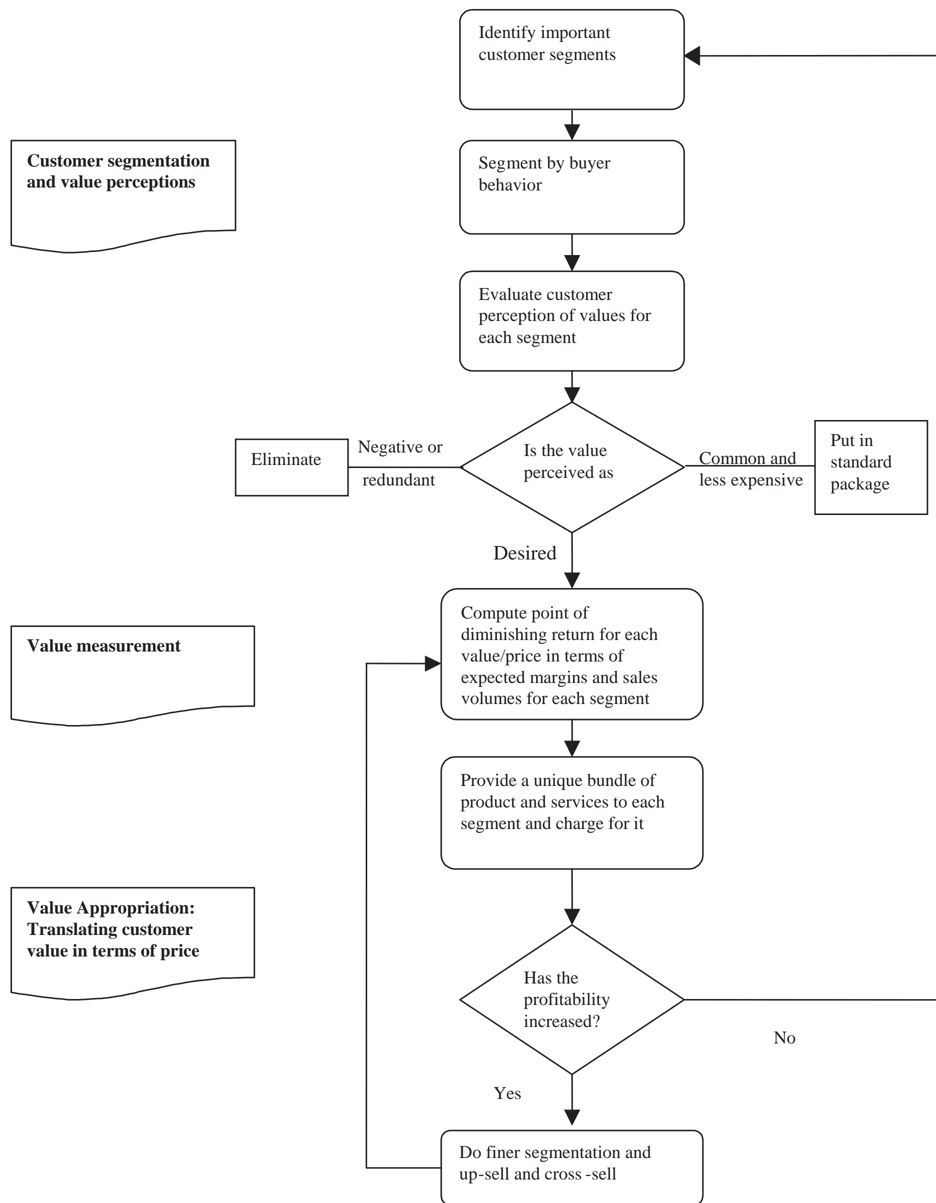


**Figure 1** The customer-centric pricing process.

define who the customers are, segmentation by buying behavior focuses on predicting how they will respond at the time of purchase. The hospitality industry has discovered that such customer-centric segmentation is a much better indicator of price sensitivity than either demographics or psychographics.

Take a sales executive for a pharmaceutical company, for example. She may be very specific about hotel location (proximate to the hospital she is calling on), but relatively indifferent to price if she is on an expense account. However, the same individual, whose demographics and psychographics remain the same, is likely to be more flexible about hotel location and significantly more price conscious if she is traveling with her family on a personal budget.

A customer's perception of the value of any product may change based on subjective factors, some related to the product itself, and others related to the individual's particular circumstances vis-à-vis the product. Factors that may tremendously influence the price a customer is willing to pay for a product include such seemingly difficult to isolate and quantify concepts as status, loyalty, convenience, urgency, and quality. In fact, these subjective, intangible factors may be more meaningful and valuable to the consumer than the product's tangible attributes.

### 4.1. The surprising secret to profitability

Segmentation based on buying behavior uncovers a tremendous differential in willingness to pay for subjective product attributes such as convenience, status, quality, and need. These price differentials are far greater than most businesses assume, and they can be the basis for substantial profits. It is this price differential that companies could have or should have which is essential to incremental profit. For example, price increases which recognize value creation based on brand preference can reduce consumer surplus. If they do not reduce sales, the additional revenue drops directly to the bottom line. Similarly, discounts offered to micro-market segments of customers which have only a casual need for the product or who are brand indifferent might spark incremental sales. Both present profit-generating opportunities. Unfortunately, these opportunities are sometimes missed.

The desire for an edgy prestige among professionals has helped Harley Davidson leverage a relatively low-tech motorcycle into a premium-priced American icon. Accordingly, the value created by the brand image was captured. Comparable cravings were created when BMW launched its exotic Z8 sports car. However, many of the first buyers sold their cars for more than twice the sticker price to other eager customers who could not get on BMW's waiting list; thus, BMW did not extract all the value it had created. Similarly, extraordinary demand for Microsoft's Xbox game console (launched just prior to Christmas, 2001) caused many of the first units, bought at retail for $199, to be sold for over $1000 on auction sites. In each of these cases, the subjective value in status overwhelms the objective value of the item itself. Moreover, the consumer surplus sometimes shows up as profit to arbitrageurs, not as incremental profit to the entity that created the value in the first place.

Sporting events, concerts, and theaters often do not appreciate the vast differentials in perceived customer value they create. Super Bowl seats are often resold by "brokers" at prices that are generally five times what the NFL charges. When Mel Brooks' musical, "The Producers" first came out, the $35 Balcony seats were sold out for the next five months, and the $99 Orchestra seats were not available for another year, except from "brokers" who charged up to ten times the original price.

Customer-centric pricing aligns the price charged with the value created for the specific customer segment at the relevant time and place. This alignment reduces consumer surplus and significantly enhances profits as the incremental revenue from pricing precision becomes incremental profit. Accordingly, with customer-centric pricing, the company that creates the value captures the benefit of that value, not brokers or other resellers.

Not long ago, the Washington Opera was faced with a revenue shortfall. Rather than attempting to raise across-the-board ticket prices by 5% as they had always done in the past, they evaluated each seat based upon "customer experience" criteria. They found significant differences in the quality of the experience, even within the Orchestra section. The back row at the side of the Orchestra section was extremely different from the tenth row center, yet the price was the same. They also recognized that weekend performances were always sold out, but weekday performances invariably had empty seats. Previously, all seats were sold at one of three price levels: $47, $63, and $85. After customer-centric segmentation, they applied customer-centric prices that were aligned with the perception of value for each seat, for each day of the week. Nine different price levels were installed with a broader dispersion of prices. Ticket prices were spread between $29 and $150, with midweek and weekend differentials. Seats in the balcony that would otherwise go unsold on weekdays were filled with people who could now afford the opera. Raising the price of the prime Orchestra seats closer to market value reduced the consumer surplus. As a result, the Washington Opera increased its revenues the next year by 9%, almost double what it could have only hoped for under a 5% across-the-board increase (Cross, 1997). These customer-centric pricing techniques are available to any business, irrespective of the level of sophistication, as illustrated by Miss Margaritte's Salon.

Box 1
Application of principles

Miss Margaritte's Salon

Margaritte Jackson owns a hair styling salon in a suburban office building. Her clients range from professional women working in the building to retirees living in the neighborhood. She has two stylists dedicated to "cut and style." She currently charges $50 for that service (which takes about one hour), and the two stylists perform, on average, 50 of these services per week, generating $2500 in revenue. This weekly revenue barely covers her costs. Her shop is extremely busy on Fridays

and Saturdays, but virtually empty on Tuesdays and Wednesdays. To reduce her costs, she has considered asking each of her stylists to take one of those midweek days off with no pay.

Margaritte was reluctant to ask her employees to take a cut in pay. Fortunately, she understood the concept of value creation. She renovated her shop and switched to an exclusive line of hair care products. She expected these actions to increase the perceived value of her services by 20 percent. Accordingly, she raised her price by 20 percent to $60 and maintained the same number of customers, generating a 20 percent increase in revenue to $3000.

Despite this increase in revenue, she was still not netting much more income because of paying for the renovations and the increased cost of her supplies. Tuesdays and Wednesdays were still slow, and Fridays and Saturdays were still completely booked. She wished that she could spread the customers more evenly throughout the week, but she knew that most of them wanted their hair freshly done for the weekend. She decided to segment her customers by the perceived value they put on different days of the week. For Friday and Saturday cuts, she raised her price to $65. She gave a price incentive to customers who were willing to move to Tuesday and Wednesday, lowering the cost to $45. As it turns out, many of her retired customers were time-flexible and were glad to move to weekdays for a discount. Margaritte was still able to fill her Friday and Saturday schedules with those women who were less price conscious and more style conscious.

To Margaritte's surprise and delight, by increasing her sales midweek and charging more on weekends, she increased her revenue another 20 percent. Only this time, it cost her nothing. The additional $600 per week was pure profit. It came from understanding that customers valued her services differently on different days of the week. This is customer-centric pricing.

## 5. Customer perceptions of value components

Customer-centric pricing requires the simultaneous and continuous assessment of product attributes, customer perceptions, and the circumstances of time and place. Customers' purchase decisions are made through an assessment of a myriad of factors balancing perceptions of value components against price using subtle, complex, and often sub-conscious decision variables.

Customer-centric pricing requires understanding and utilizing these decision variables, in order to optimize revenue opportunities. For example, airlines have been adept at exploiting an urgency factor through revenue management to price-ration seats for last-minute, high-fare travelers while offering deeply discounted seats to advance-purchase customers who have time to shop for the lowest fare (Cross, 1997).

Brand loyalty is prized for fostering customer retention and raising competitive barriers. However, it also creates a significant opportunity for price premiums. Gillette has continued to invest in product improvement and promotion, and has created and leveraged brand loyalty successfully to raise razor prices, extracting very healthy margins from relatively ordinary shaving items. These profits enable Gillette to invest in R and D for new products, thus assuring market leadership.

Customer-centric segmentation by buying behavior helps distinguish customers' decision patterns that are price-insensitive. Price-insensitive attributes identify where customer value is high and price premiums can be charged. Business managers frequently miss capturing the value they create. The Ritz Carlton hotel chain established an extraordinary reputation for luxury, quality, and customer service; however, it did not fully extract the value it created in the market, and was only marginally profitable for years. When Marriott International acquired the Ritz Carlton chain, it used sophisticated revenue optimization technology to understand when and where it could increase price. In its first five years of ownership of Ritz Carlton, Marriott was able to extract the value Ritz Carlton had created through its reputation for quality, consistency, and customer service. Marriott increased the average daily rate of the Ritz Carlton properties by 26%, compared to only a 6% increase in its other full service hotels.

On the other hand, Marriott stays attuned to the desires of price-sensitive customer segments, as well. They introduced capacity-controlled discount rates with advance purchase restrictions. During the first summer these rates were offered, almost a quarter of a million room-nights were sold at this rate. Two-thirds of these room-nights represented incremental business (Hanks, Cross, & Noland, 1992).

## 6. Value measurement: Listening to customer actions

Most firms that attempt to align product prices with customer value perceptions do so by gathering information through customer focus groups, surveys, or similar methods. Unfortunately, customers often say one thing, but do another. For example, Philips conducted a focus group of teenagers to assess their color preferences for boom boxes, and a majority of the participants listed "yellow" as their preferred color. However, at the end of the session, when participants were given their choice of picking a yellow or black boom box as they left the room, most took black boom boxes, even though they had marked "yellow" as their preferred color.

That actions speak louder than words should not come as a surprise. How many people would tell Coca-Cola, through a survey or traditional focus group, that they are willing to pay $4 for a 12 oz. can of Coke? Yet millions of $4 cans have been sold through hotel mini-bars. It is not that consumers would necessarily try to bias the results of the market research efforts; it is just that the consumers, themselves, may not be able to predict exactly what they would do, until faced with the decision. At that time, their decision will be influenced by the particulars of time and place. In this example, they may not be able to predict how thirsty they will be and whether there will be suitable alternatives.

At the critical point in the purchase decision, customers scan the immediate offerings in the marketplace and develop a consideration set based upon factors particular to their individual preferences. Within these factors, they develop a hierarchy based on their perceived values for different offerings (Zeithaml, 1988), and their purchase behavior is correlated to these perceptions of value at the instant of the decision.

The difficulties presented for customer-centric pricing are twofold. A consumer considering an automobile purchase will assign a wide range of values to each product attribute. Some will be relatively objective economic values such as fuel efficiency, maintenance, warranty, and resale value. Others will be subjective hedonic values such as design, safety, comfort, and status. Moreover, the consumer may not know in advance of making the purchase decision exactly how much weight he or she may give to each component in the value equation. Accordingly, adept companies must capture and analyze detailed customer transaction data to determine how typical members of the relevant micro-market respond to the offerings in similar circumstances. From this, they can model and predict future customer behavior.

Ford Motor Company has pioneered the application of these techniques in the automobile industry to determine what features the customers in each micro-market segment most desire and what they are willing to pay for them. Understanding the wide range of customer preferences across a broad product line and expansive geographical market requires significant experimentation, data gathering, and analysis. Customers' perception of value will vary based on geography (trucks are more highly valued in the Southwest than the Northeast), vehicle type (truck buyers are more sensitive to cash rebates than car buyers), and product configuration (certain add-ons are much more valuable than their incremental cost).

How much rebates will affect market volume and profitability must be continually tested and analyzed. Through such market testing and analysis, Ford found that a $700 rebate for its Ranger Super Cab could encourage almost half of the customers considering the base model Ranger to upgrade to the more accommodating Super Cab. Despite the cash rebate, Ford still made thousands of dollars more profit on a Super Cab than a base model, since the customers' perception of incremental value is significantly more than the incremental cost to Ford in making the upgraded model. The automaker applied such "smarter pricing" techniques across its product lines, and Lloyd Hansen, Ford's Controller for Marketing and Sales, estimates that about $3 billion in pre-tax profits came from a series of such revenue management initiatives (Leibs, 2000).

## 7. From value creation to value appropriation

Customer-centric pricing involves identifying key customer segments, understanding what these customers value, creating customer value by offering unique bundles of products or services, and charging for it appropriately. Value creation is the basis for growth. The better a product is aligned with specific customers' preferences, the more it is valued. The more it is valued, the higher the probability that it will have competitive success. That is the premise behind customer focused value-creation strategies such as One-to-One Marketing and Mass Customization (Peppers & Rogers, 1993; Siminson, 2005; Zipkin, 2001).

These strategies understand the demise of the mass market and the rise of individualistic micro-market segments that demand products that address

their specific needs, requirements, and desires. One-to-One Marketing and Mass Customization are successful to the extent they can differentiate both customers and products by recognizing enormous diversity in the global marketplace.

Most of these efforts at value creation focus on gaining market share or customer share in order to increase revenue and profitability. What they miss is the understanding that not only do customers want individualized products, they are often willing to pay a significant premium for them. The more differentiated a product, the less price-sensitive it will be.

Price should be a function of perceived value (Zeithaml, 1988). As companies engage in value-creation strategies and the perceived value increases to the specific customer set, the price should escalate. Often it does not. The result is what economists term a "consumer surplus," that is, a gap between what a customer is willing to pay, and what he or she actually pays.

There have been numerous predictions that the Internet would lower consumer search costs and enable software agents and shop-bots to drive costs down to the lowest common denominator. This phenomenon, however, has not occurred (Baker, Marn, & Zawada, 2001). Purchase decisions are still subjective. For the most part, they are not objectively driven by economically defined measures that can be incorporated into shop-bots. Consumers still place extraordinary value on their individual, subjective perceptions of the supplier related to factors such as reliability, convenience, and trust. These values are typically not predefined, and they vary based on circumstances of time and place. Accordingly, prices in the virtual world of commerce have exhibited the same degree of price dispersion as in the physical world.

One of the keys to customer-centric pricing is having a wide range of prices that address the relative values customers actually place on the products. As firms continue to attempt to differentiate themselves through customer value-add and more fully understand capturing the value they create through customer-centric pricing, the potential for even greater price differentiation exists.

Getting the optimal price has a salubrious effect on the bottom line. For companies with 8% profit margins, a 1% differential in price results in a 12.5% margin difference (Dolan, 1995). Through customer-centric pricing, firms set prices based on the perceived value of a product or service to specific customers or segments of customers. This strategy minimizes consumer surplus and maximizes profitability. Resourceful firms can use customer-centric pricing to leverage the value they have built in the marketplace and appreciably increase profits.

## 8. Sustaining value

Building and sustaining customer value that generates a source of continual revenue requires long-term customer relations. Customer relationship management (CRM) processes and techniques have evolved to manage the effective interaction with customers over time (Lemon, White, & Winer, 2002; Sheth & Parvatiyaar, 1995). However, customer-centric prices are essential to complete the customer retention cycle.

Invariably, if the price is not right, the customer relationship is endangered. This is obvious if the price is too high, but it can also be true if the price is too low. Sports fans have always understood the tremendous difference in experience from one event to another. Unfortunately, during the highest demand times such as play-off games, often a majority of fans seeking to attend the games must resort to ticket brokers, thus bypassing the customer relationship process with the team altogether. The inability of the team to accurately assess the true value of the game and to price it accordingly causes awkwardness for the fan, who must seek out third party intermediaries. Not only does this error in pricing disrupt the customer relationship, it allows a third party arbitrageur to steal the financial premium that customers put on the event.

Major league baseball teams are just now discovering that fans are willing to pay significantly more for unique experiences such as big rivalries, or for big names such as Barry Bonds. On the other hand, these teams are also recognizing that ordinary games on weekdays against weak teams require significant discounts to fill the stands. The New York Yankees, despite setting a franchise attendance record in 2002, offered cheap $5 upper deck seats for weekday games in 2003 that would have otherwise gone unsold. A wide dispersion of prices can work to give different segments of fans the seats they desire, at the games they want, at prices they are willing to pay.

Let us revisit how Microsoft could have taken advantage of customer-centric pricing to create greater value for its customers and itself when it launched the Xbox in 2001. Microsoft knew the demand for the game console would far outstrip its ability to produce enough units to satisfy the pre-Christmas demand. Many of the most valuable gaming customers (the ones who wanted the latest product and were willing to pay a premium for it) were required to go to EBay and other auction sites

and pay prices that were often five times the retail price. Microsoft could have simply raised the price to ration the early demand. That would have reduced the consumer surplus and kept the customers from going through third parties, but it would also have created the perception that the early purchasers were "ripped off" once productive capacity was brought in line with demand and prices dropped.

Following a customer-centric approach as outlined in Fig. 1, Microsoft could have created a "Collector's Edition" for the first few million units it was able to produce prior to the 2001 Christmas season. It could have included some free games, gold-tipped cables, a Collector's Edition box, and other features that were low in cost, but high in perceived value to the enthusiastic customer segment. Microsoft could have charged $499 (instead of $199) for the first few million units, kept its relationship with the most passionate gamers, and generated far greater profits. In addition to enhancing customer satisfaction for this group, Microsoft could have then created the perception of a bargain for the ordinary game console at a price of $199.

The innovative bundling of various product components with pricing aligned to the price sensitivities of each micro-market segment is the way to create sustainable value in the marketplace. A firm that optimizes revenue through customer-centric pricing not only increases profit, but is in a better position to offer price-sensitive customers lower-priced products with only attributes they value.

## 9. Economic benefits

Understanding customer value creation and capturing that value through customer-centric pricing is a step toward a pareto optimal in the economy. A pareto optimal is a relationship in which all parties are better off, and no one is worse off (Pareto, 1906). Accordingly, both producers and consumers benefit.

Producers benefit from understanding customer willingness to pay for tangible product attributes such as product features, functions, warranties, and customer service. More importantly, using the feedback from customer-centric pricing, producers can assess the market value that various customer segments place on more subjective attributes such as brand preference, status, quality, and reliability.

Customer-centric pricing is more than just establishing price; it is a means of constantly communicating with consumers through the price mechanism and using that communication as a means to balance what the firm offers in terms of product attributes. For price-insensitive customers, that might mean a higher degree of reliability, or access to a product at the last minute. On the other hand, price-sensitive customers communicate their willingness to forgo certain product features or attributes for a lower price. Southwest Airlines, for example, has demonstrated that airline passengers don not want to pay a premium for a meal or assigned seating, but they will pay up to three times as much for a last-minute seat on certain flights at certain times. Accordingly, Southwest gives its customers what they want when they want, but not more, thereby increasing Southwest's profitability.

Finding these incremental revenue opportunities requires an accurate assessment of who will pay what amount at what time. These opportunities cannot be accurately predicted by surveys or focus groups. They require monitoring the real-time decision-making of millions of consumers in a dynamic marketplace and responding appropriately with a customer-centric focus. Missing these opportunities could result in missing a chance to extract a brand premium in certain market segments or undermine a competitor's advantage in others with precision discounting. These missed opportunities are a stealthy thief of profits. Money a firm could have had or should have had is hard to find, but extremely profitable if captured, as these revenues from existing assets fall right to the bottom line.

Profit-seeking companies must seize these opportunities. Once missed, they are gone forever. Customer-centric pricing is a means to assure that the value a firm creates is accurately assessed and captured through the price mechanism. This is the secret to profitability.

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