Pricing and the Psychology Of Consumption

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Do you know?

- The way you set prices does not just influence demand.
- It also guides the way buyers use your product or service (affect consumption) – and that can have a lasting impact on customer relationships.
Pricing: When and How

Influence Demand

- Increase demand
- Decrease demand

Guides the way buyers use the product or service (affect consumption)

A lasting impact on customer relationship

- Long-Term relationship
- Short-Term relationship
For Example

Mary and Bill join the local health club and both commit to one-year memberships.

Bill commits to -$600 one-year membership. He pays at the time he signs up.

Mary commits to -$600 one-year membership. She pays installment $50 a month.

$50 x 12 = $600
Questions

1. Who is more likely to work out on a regular basis?
2. And who is more likely to renew the membership the following year?
From the research, Mary is much more likely to exercise at the club than Bill.

And also Mary will be more likely to renew her membership the following year.

but Why ?????????
Even it seems to be the same paying amount, and Bill will feel the need to get his money’s worth early in his membership (sunk-cost effect), but that drive will lessen as the pain of his $600 payment fades into the past.
On the other hand, Mary will be steadily reminded of the cost of her membership because she makes payments every month. She will feel the need to get her money’s worth throughout the year (sunk-cost effect) and will work out more regularly.
Those regular workouts will lead to an extremely important result from the health club’s point of view and that’s why, Mary will be far more likely to renew her membership the following year.
What is the sunk-cost effect?

- People are more likely to consume a product when they are aware of its cost. This is known as the sunk-cost effect: Consumers feel compelled to use products they have paid for to avoid feeling that they have wasted their money.

- It is well documented that consumers routinely consider sunk costs when deciding future courses of action.

- For Example
In another example, a psychologist at Ohio University, asked 61 college students to assume that, by mistake, they had purchased tickets for a $50 and $100 ski trip for the same weekend. The students were informed they had have much more fun on the $50 trip. They were then told they had to choose between the two trips and let the other ticket go to waste. Amazingly, more than half the students reported that they would go on the less enjoyable $100 trip.

For those students, the larger sunk cost mattered more than the greater enjoyment they would get from $50 trip.
One of the first steps in building long-term relationships with customers, is to get them to consume products they've already purchased (consumption).

If they are satisfied the products or service, they will do repurchase. It will lead to long-term consumption.

For examples,
1. One field study found that health club members who worked out 4 times a week were much more likely to renew their memberships than those who worked out just once a week.

2. Another study reported that customers who regularly used an enhanced cable TV service in one year were more likely to renew their subscriptions in the next year than those who used their service only occasionally.
On the contrary, for many companies, pricing policies such as advance sales, season tickets, and price bundling which boosting sales in a short-term period and maybe trading off the long-term relationship.

Because those policies all serve to mask how much a buyer has spent on a given product, decreasing the likelihood that the buyer will actually use it.

If no actual consumption is unlikely to buy that product again.
Why is consumption important?

- Higher consumption means higher sales → the bottom line
- Consumption is important to any business that relies on satisfaction to generate repeat sales, and positive word-of-mouth.
  - In business that sell subscription or memberships such as magazines, health clubs, customer retention is vital. But keeping customers is tough. Most magazines experience renewal rates of 60% or less, health clubs retain just 50%.
  - In business that rely on a two-part revenue stream such as movie theaters, sports arenas and concert halls, ticket sales are just one source of revenue: parking, food and drink, and souvenir sales are a profitable second source. Clearly, if ticket holders don’t attend events, these high-margin secondary sales are lost.
- Consumption lead to long-term relationship
Pricing drives perceptions of cost?

- The consumption is driven so much by perceived cost as by its the actual cost of a paid–for product.
- The method of payment is a simple example, people will feel more pressure to consume products if they paid with cash than if they paid with a credit card.
- Another research, the no-show rate for credit card customers was 10 times higher than the no-show rate for cash customers.

$100 by cash

$100 by a credit card
The timing of payments influence consumption

- Some companies demand payment at or near the time the product is to be consumed.

- Some companies demand payment far in advance of consumption.

- Some businesses allow customers to pay long after a product is purchased.
In fact, payments that occur at or near the time of consumption increase attention to a product’s cost, boosting the likelihood of its consumption.

By contrast, payments made either long before or after the actual purchase reduce attention to a product’s cost and decrease the likelihood that it will be used.
For example, there are researchers conducting a survey at the Chicago Science Museum in 1997. They presented the following hypothetical scenario to two groups of 80 visitors:
A study of 200 members of prestigious health club, they were committed to one-year memberships that cost $600 each. The club’s pricing policies allowed members to choose from among 4 payment plans.

- Result:
  - Weather members made annual, semiannual, or quarterly payments, club use was the highest in the months immediately following payment and declined steadily until the next payment.
  - Members who paid on a monthly basis used the gym most consistently.

The usage pattern:
- Annual PP: Sunk-cost effect
- Semiannual PP: A sawtooth pattern
- Quarterly PP: Smooth
Price Unbundling VS Price Bundling

- **Price Unbundling**
  - an unbundled transaction makes the cost of that item obvious, creating a strong sunk-cost effect and high likelihood of consumption.

- **Price Bundling**
  - Price Bundling mask how much a buyer has spent on a given product, increase short-term demand, but it may also reduce consumption - the buyer will actually use it.
  
  - Nowhere is the impact of price bundling on consumption more obvious than in the case of season tickets. The purchaser pays one bundled sum for a collection costs to any one performance or game. This reduces the likelihood of its usage.
Example:

Researchers tested about Price bundling by analyzing ticket purchase and attendance data at a Shakespearean summer festival in 1997 and involved the production of 4 plays. Some ticket holders had purchased tickets to a single play, some to two or three of the plays, and others to all four plays.

- 1 play → No-show rate 0.6%
- 2 plays → No-show rate 3.5%
- 3 plays → No-show rate 13.1%
- 4 plays → No-show rate 21.5%

With a little sunk-cost pressure, many if these customers did not use tickets they had previous paid for, reducing their likelihood of repeating their ticket purchases for the following year.
Because pricing has such a powerful effect on consumption and a lasting relationship, managers must make careful decisions about when and how to charge for goods and services.

Some suggestions:
- Practice yield management.
- Stagger payments to smooth consumption.
- Time payments to maximize consumption.
- Psychologically link payments to benefits.
- Reduce consumption.
In order to running operations more efficiently, managers need to forecast actual demand given the naturally occurring mix of bundled versus unbundled purchases or the ration of advance to current purchases.

- For example, you are a theater manager. You might forecast a no-show rate of 20% if the proportion of season ticket holders is high but a no-show rate of 5% if the proportion of season ticket holders is low.
  - manage costs by staffing
  - increase revenues by overselling some events.
Stagger payments to smooth consumption.

- A second course of action would be to stagger billing cycles so that demand is smoothed over time.
- This is another yield management.
- Ex. If you are a manager of a health club, and you know that most of their new members sign up at specific times of the year, most commonly in January. Also many still offer discounts to members who pay in full at the start of the calendar year. The net effect is that peak usage occurs in Jan, Feb, March, which reduces customer satisfaction. What will you do?
- You should try to stagger billing cycles to offset that trend. For instance, a health club could offer 10 or 14 – month contracts to break the cycle of January renewals. Over time, this change would help smooth demand and increase customer satisfaction.
Managers can use their pricing policies to actively encourage consumption.

For example, Boston Red Sox season ticket holders were asked to pay for tickets five months before the season begins. To encourage consumption, the company could spread out that one large payment. They could bill patrons in 4 installment. Customers might prefer this approach because smaller installments are financially more manageable.

Another example, managers of health clubs can use the pricing policies to actively encourage consumption by promoting annual memberships with monthly, rather than annual payments.
Psychologically link payments to benefits.

- Some companies view price bundling as a necessary tool to promote initial sales.
- However, organizations could psychologically unbundled those offerings to promote consumption. One way of doing this would be to highlight the prices of individual items in the bundle after the payment has been made.
- For example, travel companies could itemize the approximate cost of offerings in vacation packages.
- Restaurants could offer the same dishes both à la carte and as part of a fixed-price dinner, so that item in the latter becomes clear.
Managers need to reduce consumption in some situations, for instance, a private golf course on a beautiful Sunday morning in June. Managing peak demand is the concern. By managing when and how payments are made, executives can maximize the total number of customers who pay for their services and limit peak demand. If the manager charges annual membership fees long before the golf season has begun, a member’s pain of payment will fade need to get his money’s worth.
Remember!!

- If you are the manager who make a decision about pricing,
- don’t forget to think about the psychology of Consumption,
- otherwise that can be a costly oversight!!
Thank you!