When Customers Help Set Prices

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BY MARCO BERTINI AND ODED KOENIGSBERG

FOR MOST COMPANIES, pricing has long been a sensitive, private affair. Management has a fundamental obligation to recoup costs and earn an adequate return. But it’s worth asking: Is your pricing model one of your core competencies? And does it provide you with a competitive advantage? If your answer to these questions is “no,” then it may be time to rethink the way you look at pricing.

This article is directed at managers who seek to profit from differentiation. If you sense that your company is leaving good money on the table and struggling to convert product differentiation into revenue and profits, then you should consider enlisting the help of unlikely partners: your customers. To be sure, the thought of working with customers on a critical business activity such as pricing can be unnerving for managers. However, in the same spirit that companies today are recruiting customers to improve product design and marketing communications, managers need to recognize that it’s those who purchase a company’s products or services who ultimately determine what they are worth. While customers need not have sole discretion over these activities, they can certainly

THE LEADING QUESTION
Under what circumstances should companies involve customers in pricing decisions?

FINDINGS
- Although company-imposed pricing is common, prices can also be set in collaboration with customers — or even by customers.
- Letting customers have input on prices provides opportunities for customization and can promote greater customer engagement.
- Decisions to move away from fixed prices have organizational impacts and entail costs.
provide important input. It’s critical to recognize that outsourcing pricing to customers isn’t an all-or-nothing proposition: Managers can select pricing models ranging from complete oversight to complete delegation. The trick is to choose an approach that is suited to the characteristics of the market you’re in and that limits the costs, real and potential, that may arise.

In this article, we integrate classic views on pricing with the latest research and practice to develop a simple framework to help managers decide how much pricing control they should retain and how much they should relinquish to customers. (See “About the Research.”) To be clear, we do not recommend that companies go out and fire their pricing teams and invite customers to pay whatever they wish. However, we do recommend that companies take a fresh look at their approach to pricing — a part of the business that may be ripe for revamping.

Clarifying the Choices in Pricing

Pricing models, especially those that have emerged thanks to advances in information technology, are often difficult to interpret and even harder to compare. As a result, many businesses have a hard time deciding which approach to pricing plays to their market strengths. Should they try to maintain control over pricing? Should they collaborate with their customers? Or should they let customers call the shots? To clarify the choices, we outline three general philosophies to pricing — company-imposed pricing, collaborative pricing and customer-imposed pricing — and then present specific models that exist within each. (See “The Customer Participation Continuum.”)

Company-imposed pricing For most businesses, the default approach is to have a single fixed price and sell to anyone willing to pay that amount. Although there may be different views within an organization about how to arrive at the “right” price, there is no question that the company has full control under this approach and that customers are bystanders. Fixed prices didn’t really become widespread until the early 1860s, when John Wanamaker opened his first retail store in Philadelphia. A devout Christian, Wanamaker believed that if everyone was equal before God, then everyone should pay the same price. In practice, however, using single fixed prices is economically inefficient. To the extent that there are variations in how different customers value products, selecting one number implies that those prepared to pay more in effect receive a discount; those willing to pay less (but who are still profitable) are turned away.

One way to address this inefficiency is to introduce variability into pricing. This is the domain of personalized prices, in which data analytics help companies identify characteristics of the purchase environment or the customer’s profile and behavior that impact willingness to pay. In the United States, for example, The Wall Street Journal found that office superstore Staples adjusted prices on its website, apparently based on, among other factors, the distance a customer was from Office Max or Office Depot brick-and-mortar stores. Similarly, Home Depot used a shopper’s geographical location and browsing history to fine-tune prices. A third example of personalized pricing is Orbitz, the popular online travel company. It was found to display different hotel options and rates depending on the computer platform that generated the query; Mac users spent up to 30% more per night on lodging than their demographic counterparts who used PCs.

But the success of personalized prices depends on at least three factors. First, companies need abundant, high-quality data. Second, they need to overcome the organizational challenges that are likely to surface — dedication to advanced analytics may require changing management styles and human resource policies. And third, companies

ABOUT THE RESEARCH
The literature on pricing models is extremely disjointed. For each model, one can readily find scores of academic articles that isolate and study the key ingredients in excruciating depth. Yet these articles are seldom written with a managerial audience in mind. Beyond this overall context, we were also guided by three experiences from working with companies. First, we noticed that companies spend a disproportionate amount of time determining “how much to charge” rather than “how to charge.” Second, companies that prided themselves on being innovative in terms of value creation rarely applied the same innovative spirit to value extraction. This is unfortunate, because there are significant opportunities for innovation on both sides of the equation. Third, pricing was one of the most heavily guarded activities of an organization.

We wanted to help managers improve their understanding of pricing. This article is the result of our synthesis and interpretation of the academic literature (mainly in the areas of price discrimination and participative pricing schemes), our ongoing research in pricing (which uses a variety of methodologies, including formal analytical modeling and laboratory and field experiments) and our interactions with business.
should be prepared for pushback from customers claiming that the approach isn’t fair.

Although personalization can lead to lower prices, just as it can lead to higher prices, setting prices based on contextual and customer information can be controversial. Coca-Cola, for example, encountered criticism for proposing to vary prices based on outdoor temperatures. Practically speaking, few businesses have thought through the downside of this approach to pricing.5

The second route to greater pricing efficiency is to create a price menu. This involves managing multiple price points and giving customers choices. Managers have two options: First, they can develop a portfolio of products that are different on one or more dimensions — a “good-better-best” assortment; second, they can offer one basic product but configure the price menu around a set of purchase requirements that benefit the company.

Volkswagen Group uses the product portfolio approach to market an array of autos under brands that include Volkswagen, Audi, Porsche and Lamborghini. Customers can select the combination of brand, price and features that yields the greatest amount of net satisfaction for them. From the company’s perspective, the trick is to put together an assortment that not only achieves the highest sales volume possible but also maximizes revenue by motivating customers to select the car that’s priced closest to their willingness to pay.

Companies pursuing the purchase-requirement approach give customers the opportunity to pay lower prices when they meet certain requirements such as buying sooner, in greater quantity or more frequently. Such behaviors are intended to add to the bottom line. The issue for customers, of course, is whether the potential savings justify the cost or inconvenience of doing what’s required. For companies, a big concern is cannibalization: giving discounts to customers who in fact would be willing to pay the full price.

The reality is that price menus can be frustrating for customers. If customers struggle to make sense of an assortment of choices and are unsure which product suits them best, they may think that the seller isn’t being forthright and is trying to manipulate them to buy more than they want or need. This reaction is fairly common with services such as mobile telecommunications, banking and energy. Similarly, if customers feel that meeting the purchase requirement is out of their control, then they may act out against the seller in an attempt to reassert their autonomy. For example, Uber, the San Francisco-based transportation network that connects passengers and drivers via a mobile phone application, has recently been criticized for its practice of charging customers inflated “surge” prices during periods of peak demand.

Collaborative pricing As companies become more interested in interactive approaches to pricing, there are three collaborative models worth noting: auctions, name-your-own-price auctions and negotiations. With auctions, companies encourage prospective buyers to bid against each other for the right to make a purchase. Auctions are commonly associated with the sale of antiques, collectibles, fine art and other unique items. However, this model has become increasingly popular in other familiar settings. For example, Ticketmaster, the ticket sales company based in West Hollywood, California, uses auctions to allocate tickets for in-demand concerts to people who value the events the most. Google uses auctions to encourage advertisers to bid for a higher rank in the sponsored links section of search results.
Procurement departments use business-market auctions to increase price competition among suppliers; governments use auctions to license scarce resources (such as mineral rights or frequencies of the electromagnetic spectrum for mobile telephony) to the private sector.

The rules for bidding in auctions and the processes that determine the final prices can vary widely. In some auctions, sellers retain the option to void a sale if the highest bid falls short of the reserve price; in others, there is no such right. Similarly, sellers can choose to make bids public or keep them private. Whatever the specifics, set prices don’t exist; arriving at the price is truly a collaborative process.

Name-your-own-price is a particular type of auction that warrants a separate mention. Here individuals suggest the purchase price and companies accept, reject or counter with a higher price. For instance, several airlines, including American Airlines and Virgin Atlantic, use software developed by Plusgrade, based in New York City, to offer passengers opportunities to request seating upgrades by naming their own price. There are two noteworthy aspects of the name-your-own-price model. First, buyers take the initiative: they approach the company, demonstrate interest and rule out all but a small range of agreeable prices. Second, transaction details can be opaque if the company relies on an intermediary to shield its or the product’s identity. Indeed, channeling sales through online retailers such as Priceline or Greentoe allows companies to trim inventory without cannibalizing their full-price sales through conventional channels.

Pricing through negotiation is the most interactive collaborative model. Negotiations are common in business markets, where face-to-face consultative selling makes sense, and also in some consumer markets. For example, in financial services, banks such as BBVA, headquartered in Bilbao, Spain, publish standard interest rates for their loan products, but they give branch managers latitude to adjust rates on an individual basis. In the hotel industry, the central office of Barceló Hotels & Resorts, located in Palma de Mallorca, Spain, is responsible for setting room rates at the company’s more than 140 hotels, but it authorizes individual hotel directors to negotiate with travel agents, tour operators and other important intermediaries. In some sectors, negotiation for services is not uncommon. According to two 2013 U.K. surveys, 86% of mobile phone customers and 85% of pay TV customers who asked for a better deal were successful in getting one; what’s more, 42% of the mobile phone discounts received and 26% of the pay-TV discounts the consumers were offered were ongoing rather than just for a limited time.

Generally speaking, negotiations are more private and less structured than auctions, and the tenor of the interpersonal relationships shapes the outcome. A negotiation, therefore, is more than a mechanism for setting prices; it is a process by which parties learn about each other and, potentially, about the product for sale. Of course, it is also an opportunity for the different parties to exert influence and gain the upper hand. In the end, customers with good negotiating skills can have a significant say in the final price.

Customer-imposed pricing Under pay-as-you-wish, the company delegates responsibility for pricing to the customer. Customers can pay any amount they desire (even zero), and sellers are committed to honoring their obligation. Wikipedia, the popular online encyclopedia, has used this model since founding in 2001. But pay-as-you-wish pricing gained visibility in October 2007 when Radiohead, an English rock band, released the digital download version of its In Rainbows album without a set price. Today there are pay-as-you-wish applications for even such mainstream services as banking.

The obvious limitation of pay-as-you-wish is that customers may be tempted to undermine sellers with unreasonably low prices. (See “Guarding Against Freeloaders.”) One way companies can mitigate this risk is to set a price floor. Generous, a new pay-as-you-wish social e-commerce platform, offers exactly this feature. Another option is to suggest a payment amount or to develop guidelines to nudge customers toward a higher figure. Bonvoy Adventure Travel, based in New York City, for example, lists the hard cost of its trips and clearly communicates the markup added to reach the retail price; under its “flex pricing” approach, customers can request trip discounts. San Francisco-based Humble Bundle, which sells collections of video games and other digital content, has taken the pay-as-you-wish model
GUARDING AGAINST FRELOADERS

If customers have a say in pricing, can we trust them not to exploit their power? The ideal safeguard against freeloaders is to ensure that the pricing model aligns self-interest and truth telling — that is, that customers reveal their personal valuations because it is in their best interests to do so. A price menu, for example, must be designed so that customers choose the option priced closest to their individual willingness to pay. Similarly, a successful auction is one that motivates people to bid what the item is worth to them.

However, this level of precision is not always possible. Here are three alternatives: 1. Companies can attempt to nudge customers by using benchmarks. The Metropolitan Museum of Art in New York offers an excellent example. Technically, admission to the museum is pay-as-you-wish, yet its website recommends a $25 donation for adults, with this explanation: “To help cover the costs of exhibitions, we ask that you please pay the full recommended amount.” In explaining its pay-as-you-wish model, Humble Bundle explicitly encourages buyers to pay a bit more to “beat the average price,” which entitles them to added benefits; the site publicizes a running tally of highest-paying customers and the prices they paid. 2. Companies can downplay market norms and instead emphasize social norms geared to fairness, altruism and reciprocity. Disney tested pay-as-you-wish service at a loss; if customers care, they won’t be able to offer the product or service at a loss; if customers care, they will agree to pay more.

Striking the Right Balance

How much pricing input from customers should a business seek? Selecting the right pricing model is conditioned by two important considerations. First, every situation is different: Each market has its unique challenges, and what’s suited for one environment may not work elsewhere. Therefore, it’s useful to have a sense for which models are best suited to a particular environment. Second, any decision to move away from a single fixed price is likely to entail several costs. In addition to expenses directly associated with implementing and managing a new pricing process, there are risks that a more complex process may trigger errors.

Understanding the market In order to figure out the best approach to pricing, managers need to ask themselves up to four questions:

1. The first question is designed to probe how customers value the product: Is there a significant disparity among customers in their valuations of your product? If the answer is no, then there is no reason to ask customers to take part in the pricing process, and managers are probably better off retaining control and continuing with a single fixed price.

2. However, if there are significant differences in the way different customer groups value a product, there are potential advantages to customer participation, which leads to the second question: Can my company document these differences in valuation with confidence? If the answer is yes and the key drivers of value are known and observable, managers hoping to squeeze more revenue out of the market can go ahead and personalize prices. However, if the value drivers are not known or are difficult to ascertain, managers may want to develop a price menu that encourages customers to reveal their valuations through their choices.

3. In practice, many companies lack the necessary know-how to implement personalized prices or design clever price menus. If that’s the case, managers should consider a third question: Do customers understand what our product is worth to them? If managers fear that the answer is no and that customers are not sufficiently educated about the product, then they need a pricing model such as negotiation that allows companies to interact with prospective customers.
4. On the other hand, if customers are already familiar with a company’s offerings yet have different valuations for them that are hard for the company to identify up front, managers need to advance to the final question: Is demand for my product likely to outstrip its supply? If the answer is “yes,” then it may make sense to run an auction, which is meant to identify the people who place the highest valuations on your offerings. If the answer is “perhaps,” however, managers need to be wary about entering into a situation in which demand uncertainty puts excessive downward pressure on prices. In other words, they need to get a sense of demand before settling on a price. In this context, a name-your-own-price auction model could be appropriate. If the answer is “no,” a company may want to explore a pay-as-you-wish model — particularly for products such as digital goods, where there are hardly any incremental costs associated with selling additional units. When there’s plenty of supply and varying customer valuations, companies want to motivate customers to reveal their true valuations — valuations that are otherwise hard to observe and measure. Pay-as-you-wish grants customers the autonomy to express their individual preferences.

Understanding the costs The second consideration in determining which pricing model to use is cost. Managers need to assess the incremental resources necessary (money, time, etc.) to set up and sustain a new system. They also need to assess the potential for errors resulting from the added complexity. Each approach to pricing presents its own set of issues. For example, in order to develop personalized prices, managers need to invest in advanced analytics and specialized personnel. Establishing price menus implies being able to calibrate and coordinate multiple price points, which increases the possibilities of cannibalization. Further, auctions are burdensome to set up and run.

In general, the problem of cost is greater for complex businesses that manage multiple product lines or, alternatively, that market few products purchased in high frequency. For example, it may be impractical for large grocery retailers to auction or negotiate the prices of thousands of stock-keeping units directly with patrons. However, new technology may make this easier. For example, Pricer, a company based in Stockholm, Sweden, has developed an electronic system for updating shelf prices within a matter of seconds and at a fraction of the cost of doing it manually. Pricer is installing more than 12 million digital price labels in Carrefour’s hypermarkets in France as well as in selected Carrefour stores elsewhere in Europe, Asia and South America.10

Two additional factors worth mentioning are the product’s variable cost — the expense of raw materials and supplies, labor and so forth — and the cognitive cost required from customers by the pricing model. The first, the expense of raw materials, is often viewed as a proxy for the financial risk of delegating pricing authority and is therefore likely to also influence a manager’s choice of pricing models. Consider pay-as-you-wish pricing. The mere thought of not covering costs tends to make managers uneasy — and rightly so. In fact, it’s no coincidence that name-your-own-price, pay-as-you-wish and other, similar models are often associated with digital products, because the incremental expense associated with selling additional units of a digital product is negligible. The second, the cognitive cost to customers, is important because participating in the pricing decision requires effort, and this can demotivate customers and cause them to defer or abandon purchases. Managers need to be aware of this possibility and understand how it can be mitigated.

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Beyond Efficiency Gains

The case for leveraging customer input to capture a bigger share of the value created in the market is intuitive and compelling. However, asking customers to weigh in on price can have benefits that go beyond promoting greater efficiency. First, it can promote engagement. Asking customers to participate in a pricing decision is empowering, and empowerment can be associated with greater satisfaction. When businesses set prices unilaterally, customers make a simple “buy-not buy” decision (Is the product worth the price?). If customers have a say about price, however, they have a greater incentive to determine what the product is actually worth to them, which is more demanding but also more engaging.

Second, giving customers input on pricing provides an opportunity for customization. When managers think of customization, they generally think of tailoring the product’s features to the buyers’ individual needs and wants. However, they forget that price is a product feature in its own right. Occasions where the amount paid can be used to signal social status (luxury goods, for example) are a case in point. In such contexts, the ability to customize price is attractive because it allows customers to say something specific and credible about their own abilities, resources and values.

Third, customer input can be used to signal information about the company or the product. Logos Bible Software, a software company and electronic book publisher based in Bellingham, Washington, uses “community pricing,” a variation on name-your-own-price, when considering some e-book projects. Rather than setting a price, Logos lets customers propose what they would pay for the e-book if it is produced; when a group of customers offering to pay a given price results in enough projected revenue to make the project viable, Logos produces the e-book and all customers who bid that price or higher will receive it at that “community price”; later customers, however, will be charged more.12

With respect to the product itself, it’s unlikely that a company would cede control over pricing if it didn’t have confidence in what it was selling. Outsourcing price therefore signals superior quality. Finally, giving customers a voice on price has the potential to reduce competition.13 Many companies use pricing to take market share away from their rivals. If a company gives customers greater control of pricing, it effectively shifts competition to other dimensions, such as product quality and relationship management.

Bringing Customers Into the Fold

Marketing departments pay a lot of attention to customer intimacy, and they rely heavily on research specialists to gather and analyze data on customer behavior and what competitors are doing. However, the idea of getting customers involved in pricing is not a topic that is widely discussed. In regulated environments or settings where intermediaries are able to dictate terms, the notion is irrelevant: Companies have no control to relinquish in the first place. In other settings, the idea of letting customers have sway over pricing seems irresponsible and dangerously counterproductive. First, pricing is rarely considered an area where innovation is possible or even desirable. In most cases it is heavily focused on cost recovery, as opposed to capturing value. Second, pricing conversations tend to be shrouded in secrecy, which makes reaching out to customers unlikely. Finally, few businesses conduct any type of regular analysis of pricing performance.

The right kind of customer participation in pricing offers companies important advantages — particularly the ability to capture value and achieve greater differentiation. In addition, it can increase customer engagement.
customer engagement, broaden the scope for customization, signal a company’s values or the quality of its product and relax competition. Nevertheless, customer participation is not a case where “more is better.” It requires managers to read their environment, carefully consider all the additional costs and then evaluate the options.

Many managers complain that once-healthy markets have grown stale, that too many products are being copied and that there are fewer opportunities for meaningful innovation than there used to be. Working with customers to develop new pricing strategies offers one way for companies to create a new sense of excitement.

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1. To be fair, the literature already contains several classifications of pricing models. Probably the most popular are those that describe different levels or types of price discrimination—for instance, the distinction between first-, second- and third-degree discrimination. However, in our mind these alternatives tend to have a strong academic slant and consequently are less useful from a practical standpoint. For an excellent early example that has inspired much research, including our own, see M. Harris and A. Raviv, “A Theory of Monopoly Pricing Schemes with Demand Uncertainty,” American Economic Review 71, no. 3 (June 1981): 347-365.

2. For a thoughtful discussion on the economic inefficiency of single fixed prices, see L. Philips, “The Economics of Price Discrimination” (Cambridge, United Kingdom: Cambridge University Press, 1983).


8. In the banking sector, GoBank lets its customers pay whatever they think is fair (between $0 and $9) for monthly membership. In legal services, both Summit Law Group, in Seattle, and Valorem Law Group, in Chicago and San Jose, California, feature “value adjustment lines” on their bills, allowing clients to make any type of adjustment on previously agreed-upon fees.


10. For details, see “Case Study: Food Retail — Carrefour,” www.pricer.com/en.


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