Cheatography

Value-based Pricing & the Four Dimensions of Value Cheat Sheet

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Introduction

For many companies, the traditional way to set prices has been some form of cost-plus pricing. In other words, they calculate their costs, slap on a margin, and there they have a price. However, this pricing scheme has come under increasing pressure as of late, and exploration is underway into other pricing schemes.
The most prized goal at the moment is often value-based pricing: determining the value the customer is able to create with the service and adjusting the price accordingly.

http://www.kilkku.com/blog/2015/06/value-based-pricing-and-the-four-dimensions-of-value/#more-1027

Price discrimination

One of the key concepts in pricing is price discrimination. It means that identical or largely similar goods are priced differently by the same provider depending on the customers' willingness to pay (WTP). Providers typically love to be able to employ some form of price discrimination, because it enables them to improve their profits: if you can sell with high price to people who really want the product and at a lower price (still covering your costs) to people who do not want the product quite as much, you can maximize profits..

Three Types of Price Discrimination:

First-degree price discrimination (personalized pricing): The firm can price its products to perfectly match each customer's willingness to pay. Project business is the most classic example of where this is possible, although it is becoming increasingly common to do this on consumer markets over the internet as well – Amazon began experimenting with this in the early 2000s, showing different prices for different people for the same products, but the big consumer backlash forced it to stop that practice back then. However, the practice has gained more prevalence as of late.. **Second-degree price discrimination (menu pricing):** The firm offers different deals, e.g. combinations of price and quality/quantity, and the customers self-select the deal they want. Examples of this include non-linear pricing (volume discounts), versioning (economy/business class flights; student versions of software), and bundling (PS4 with The Last of Us; Word and Excel in MS Office bundle).
Third-degree price discrimination (group pricing): The firm is unable to determine individual willingness to pay, but it can determine rough estimates for different groups. The groups can be identifies, for example, based on work status (student discounts), location (soft drink at a supermarket or at an airport), region, country, or time (travel in peak season or off-peak season).

Value-based Pricing & Four Dimensions of Value

Using Value-Based Pricing Effectively

In order to use value-based pricing effectively, it is vital that the company is able to use some form of price discrimination, preferably the first-degree variant. However, it is important to note that just because a company uses some form of price discrimination, it does not necessarily do this on value basis.

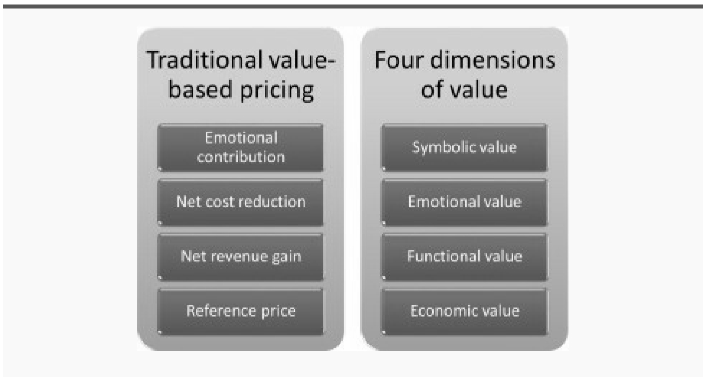
Value-based pricing

Value-based pricing is based on recognizing the value of the service, and sharing the gains created in its use by all involved parties.
Traditionally, a value-based price is formed from four building blocks:
- Reference price. The market price of the alternative service the customer could buy.
- Net revenue gain. The net revenue gain for the customer compared to the competing service. This has to be realistic and take into account possible revenue losses as well.
- Net cost reduction. The net cost reduction for the customer compared to the competing service. This has to be realistic and take into account possible cost increases as well.
- Emotional contribution. The most difficult piece to quantify, this refers to things such as reduced risk, better trust, and user preference.

Together, these form the maximum value-based price. Of course, if the price eats up all of the added value, then the customer does not have a particular interest in buying this service over any other. Therefore, there is a negotiation corridor with which the price is set somewhere between the reference price and the maximum value-based price.

Starting with Value-based Pricing

- Understand your customer: Without understanding the customer, you cannot differentiate.
- Know your differentiation: You also need to understand the competition, in order to know where you can differentiate.
- Quantify the differentiation: Without quantification, you cannot come up with a value-based price.
- Communicate your differentiated value: If you don't tell the customer how you are different, the customer will never know, and selling value becomes impossible.


Traditional value-based pricing
Emotional contribution
Net cost reduction
Net revenue gain
Reference price
Four dimensions of value
Symbolic value
Emotional value
Functional value
Economic value