Price Skimming Paradoxes

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Managers in new and growing markets often use price skimming to maximize firm profits. Relying on conceptions of distributive and procedural justice, I suggest price skimming can create consumer perceptions of unfairness, negatively affecting satisfaction and behavioral intentions. Existing customer pricing policies may moderate these effects, depending on whether policies are distributively and/or procedurally just. Four experimental studies support these assertions. This research reveals a managerial paradox: price skimming, thought to maximize firm profits, may be a suboptimal strategy in some markets. Instead, most-favored customer pricing policies are jointly optimal for consumers and firms, revealing a consumer welfare paradox.

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EXTENDED ABSTRACT

A common pricing strategy employed by managers in new and growing markets is price skimming—setting prices high at introduction and dropping them over time. As product life cycles become shorter and the number of new products and services increase every year, managerial use of price skimming appears to be increasing. Likewise, as prices drop at ever increasing rates for a range of products and services, consumer awareness of price skimming also appears to be increasing.

The managerial attractiveness of price skimming is straightforward: by sequentially lowering price over time, capturing incremental customers with every price drop, price skimming allows a firm to charge each customer their reservation price (e.g., Besanko and Winston 1990). A central assumption of price skimming is because each consumer pays a price at or below his or her reservation price, each consumer is satisfied with his or her purchase.

However, beyond the purchase decision, there is scant research on consumers’ responses to price skimming. Instead, investigations concern firm profit maximization and variables impacting profit maximization, such as diffusion rates, competition and production learning curves (e.g., Robinson and Lakhani 1975; Irwin and Klenow 1994). Thus, although price skimming is widely used by managers and investigated in the economics and strategy literatures, it has received little attention in consumer research.

This research investigates the relationship between price skimming and post-purchase consumer attitudes and behavioral intentions. Prior research has found pricing information, even when revealed after purchase and consumption, affects customer satisfaction levels (Voss, Parasuraman, and Grewal 1998; Varki and Colgate 2001; Fornell et al. 1996). Additionally, empirical studies suggest customers’ perceptions of pricing fairness are a significant predictor of customer satisfaction levels (Xia, Monroe, and Cox 2004), which are positively related to positive word-of-mouth, repurchase intent and customer life-time-value (Szymanski and Henard 2001; Anderson, Fornell, and Mazvancheryl 2004). In this research I explore whether and under what conditions consumers perceive price skimming as fair and how those perceptions affect post-purchase attitudes, behavioral intentions and customer life-time-value.

Consumer behavior research relies primarily on equity theory to explain differences in fairness perceptions (e.g., Xia, Monroe, and Cox 2004). According to equity theory, people compare their inputs and outputs to referent others in similar exchange situations to determine whether an exchange is fair (e.g., Huppertz, Arenson, and Evans 1978). In contrast to the consumer behavior literature, organizational behavior conceptualizations of social justice delineate between distributive and procedural justice (Tyler 1997). Distributive justice ascertains fairness based on inputs and outputs of comparative others, consistent with equity theory. Procedural justice focuses on the process mediating inputs and outputs to ascertain fairness. Although related, empirical studies support distributive and procedural justice as distinct constructs (Cohen-Charash and Spector 2001). These distinctions suggest consumers ascertain fairness based on whether prices and pricing policies differ among customers for the same product or service.

I conduct four experimental studies investigating under what conditions consumers perceive price skimming as fair or unfair and how pricing policies for existing customers may moderate or reverse fairness perceptions. The first study investigates the relationship between price-skimming strategies and consumer attitudes, given new customers are paying lower prices than existing customers. I find price skimming for relational services is associated with significantly lower perceptions of fairness, satisfaction and behavioral intentions, than products and discrete services with similar price points and changes over identical time periods. Analysis of free form responses suggests price skimming for relational services is perceived as distributively unfair.

Study two investigates the moderating effect of four existing customer pricing policies for relational services: (1) no adjustment (same as study one); (2) lower price if the customer extends agreement; (3) lower price at customer’s request; and (4) most-favored customer pricing, where all existing customers automatically receive the same lower price offered new customers (e.g., Besanko and Lyon 1993). I find policies with identical inputs and outputs are associated with similar satisfaction levels, but significantly different perceptions of fairness, likelihood to repurchase and positive word-of-mouth intentions. These results support the notion that consumers react differently to distributively and procedurally just pricing policies.

Study three compares price skimming by a service provider versus the provider’s competitor. Significant differences in participants suggest social justice concerns differ between intrafirm and interfirm price skimming.

Although social justice concerns explain the moderating effects of existing customer policies, moderating effects can also be explained by simple mental accounting: consumers receiving a lower price realize a gain, leading to more positive attitudes and behavioral intentions (e.g., Thaler 1985). Study four explores these competing explanations by investigating the moderating impact of most-favored customer policies on price skimming for products, discrete services and relational services. If perceptions of social justice are responsible for differences, most-favored customer policies should only affect consumer attitudes when price skimming is perceived as socially unjust. The results of study four show a significant reversal for relational services, but not for products or discrete services, supporting a social justice explanation.

Finally, using wireless telephony industry metrics, I illustrate how some firms may be realizing suboptimal revenues and profits by employing price-skimming strategies, paradoxically, thought to maximize revenues and profits. This managerial paradox of price skimming is only apparent when considering consumer perceptions of fairness, satisfaction, likelihood to repurchase and positive word-of-mouth intent. Furthermore, I suggest a consumer welfare paradox of price skimming: most-favored customer pricing policies may be jointly optimal for consumers and firms in markets where consumers perceive price skimming as distributively or procedurally unfair.

REFERENCES


