

Pricing Strategies for Firms with market power

Fact: A firm will almost always increase its profit by charging different prices for the same product to different buyers and under different conditions (compared to the situation where the firm charges the same price for the product all the time).

1. 1st Degree Price Discrimination (aka Perfect Price Discrimination):

Charging each buyer the highest price that he/she is willing to pay (called the "reservation price").

Example: You run a bar and you're psychic so you know that Biff is willing to pay a maximum of \$20 for a glass of beer. You charge him \$20 for a glass of beer (not a penny less.

Problem: difficult or impossible for seller to determine each buyer's reservation price.

2. 2nd Degree Price Discrimination:

Charging a lower price per unit for extra units of a product a buyer purchases.

Example: Buy one, get next one 50% off

Concept: Make some extra money selling the extra items to the buyer; the buyer would not have bought the extra units without the discount.

3. 3rd Degree Price Discrimination

Separate buyers into groups; charge a different price to buyers depending on which group the buyer is in.

Example: Senior citizen discount

Example: Cheaper beer for women at the bar.

Example: Cheaper plane ticket for advanced purchasers.

Pitfalls of price discrimination:

1. Sometimes it's illegal

Example: In Massachusetts it's illegal to charge women less for a beer than men.

2. Don't tick off other customers.

3. Seller must avoid ARBITRAGE among buyers.

Arbitrage: Buying an item at a low price for the purpose of reselling at a higher price (locking in a profit).

Example: Students buy computers at a reduced "academic price", then resell it on Ebay for a profit.

(The computer maker loses a sale at a higher price to a non-academic buyer.)

Example: Ladies buy beer and give it to men during ladies' night at the bar

Other pricing strategies:

4. Peak Load pricing:

Pricing different prices for the same product at different times.

Example: Chinese buffet more expensive on weekends than weekdays.

Example: More expensive to buy air ticket for travel on December 24 than December 25.

5. Two-part tariff

Charge buyers a fee just to have the right to buy something, then charge them again when they buy it.

Example: COSTCO

Example: Initiation fee at country club

6. Bundling: Selling two or more products in a group for a lower price than if the buyer bought them separately.

7. Price Obfuscation: Breaking up the total price into small pieces to hide the true total price of the item.

Cell phone: Monthly fee + FCC fee + goofy fee

Airplane tickets: Ticket + bag fee + lunch + fuel surcharge

Checking accounts: Overlimit fee + printout fee + see a real teller fee.