

Retail Pricing Strategies and Market Power

Gordon Mills

with a contribution by David Monk



MELBOURNE UNIVERSITY PRESS

MELBOURNE UNIVERSITY PRESS
PO Box 278, Carlton South, Victoria 3053, Australia
mup-info@unimelb.edu.au
www.mup.com.au

First published 2002
Text © Gordon Mills 2002
Design and typography © Melbourne University Press 2002

This book is copyright. Apart from any use permitted under the *Copyright Act* 1968 and subsequent amendments, no part may be reproduced, stored in a retrieval system or transmitted by any means or process whatsoever without the prior written permission of the publisher.

Typeset by Syarikat Seng Teik Sdn. Bhd., Malaysia
in 10 point Meridien
Printed in Australia by Ligare Pty Ltd

National Library of Australia Cataloguing-in-Publication entry
Mills, Gordon, 1934– .

Retail pricing strategies and market power.

Bibliography.

Includes index.

ISBN 0 522 85038 3.

1. Pricing—Australia. 2. Marketing—Australia. I. Title.

338.520994

Contents

Preface	ix
The Economic Framework	
1 First Ideas on Pricing Strategies	3
How consumers differ, and why sellers take note	
A brief history of price differentiation	
Some recent trends	
2 Price Dispersion and Consumer Knowledge	8
The characteristics of product quality	
The concept of a market	
Price dispersion	
The strategies of sellers	
Further consideration of consumer search	
Conclusions	
3 Price Discrimination	16
Price discrimination defined	
Cost structures and price discrimination	
When is price discrimination feasible?	
Types of price discrimination	
Third-degree discrimination	
Second-degree discrimination	
Second-degree discrimination for a <i>uniform</i> product	
Incomplete customer information, differing product qualities	
Price discrimination, profitability and competition	
Does price discrimination serve the public interest?	
Appendix 1: Compatible pricing for self-selection	
Appendix 2: Price discrimination and the public interest	
Markets for Branded Goods	
4 Branded Goods: Retailing and Shopping	47
Why <i>are</i> goods branded?	
An example of a branded market: instant coffee	

	The shopper's decisions	
	Distribution channels and the pricing of branded goods	
	Selling decisions and strategies	
	Product differentiation and market segmentation	
	Does a high price signify high quality?	
	Price and quality: the empirical evidence	
	Price-quality relationships: the case of instant coffee	
	Price 'dealing'	
	Public utilities: deregulation, branding and customer inertia	
5	Store Prices: Dispersion and Discrimination	79
	Pricing in stores that sell many goods	
	Dispersion in grocery prices: earlier empirical studies	
	Food prices in supermarkets in Sydney	
	Pricing of branded clothing in Sydney	
	Some conclusions on these Sydney prices	
	Spatial price discrimination between supermarkets	
	Empirical studies of markets where prices are not posted	
	Conclusions	
	Appendix: Details of the regression analyses	
6	Bundling: Hamburgers and More	100
	The just price for a hamburger?	
	Bundling: analysis of a numerical example	
	Now, back to McDonald's . . .	
	Further examples of bundling	
	Some conclusions	
	Appendix: A further example of discriminatory bundling	
7	Package Sizes and Unit Pricing	115
	Differences between customers	
	Producer and retailer strategies	
	Quantity surcharges in US supermarkets	
	Supermarket pricing in Sydney	
	Unit pricing	
	Appendix 1: Collecting prices in supermarkets in Sydney, January 1995	
	Appendix 2: Studies of unit pricing in US stores	
8	Pharmaceuticals	134
	Patient payments under the PBS scheme	
	Negotiation of wholesale prices for PBS pharmaceuticals	
	Determination of the price that pharmacists may charge	
	Further consideration of the pricing arrangements	
	Evidence on pharmacists' prices for PBS pharmaceuticals	
	Pricing practices for non-PBS pharmaceuticals	
	The retailing of 'over-the-counter' pharmaceuticals	
	Some analysis and conclusions	
Markets for Services		
9	Retail Foreign Exchange	155
	The retail foreign exchange market in Sydney	

	Market terms	
	The total cost to a customer who buys foreign notes	
	Costs incurred by dealers in selling bank notes	
	Charges and price discrimination: dealer <i>selling</i> of foreign notes	
	Dealer <i>buying</i> of foreign notes	
	The dealers' buying and selling margins	
	Information and customer search	
	Public policy considerations	
10	Personal Accounts at Banks	172
	The personal bank account defined	
	Personal accounts offered in New South Wales	
	Some account comparisons: trading between features	
	Coexistence of inferior and superior accounts	
	Pensioner 'deeming' accounts	
	The gross margins the banks receive from personal accounts	
	Analysis of the effective rate of interest paid on a personal account	
	Account charges and the potential for price discrimination	
	Summary and conclusions	
	Appendix 1: Informing the customer	
	Appendix 2: Demonstration description of a personal bank account	
11	Air Travel in Australia	195
	Structure of the industry	
	Airline commission arrangements for travel agents	
	Discounting practices in Australia	
	Discounting mechanisms and seat availability	
	The study of travel-agent performance	
	Conclusions on the performance of travel agents	
	Strategies for consumers	
	Discounting and airline costs	
	Airline strategies since deregulation	
	Appendix: The fieldwork and the travel agents' responses	
12	Conveyancing in Australia	216
	Authorisation of conveyancing practitioners, as at June 1991	
	The division of labour—and of remuneration	
	The fee schedules prevailing in 1991	
	Inter-state comparisons of <i>ad valorem</i> fees	
	Comparison of task-based fees	
	Advertising of solicitors' fees	
	The 1991 position of 'conveyancers' in New South Wales	
	Recent changes in New South Wales	
	Evidence of market power in the 1991 fee schedules	
	Limitations on market power	
	Some other dimensions of the consumer interest	
	Appendix: Further information about the fee schedules prevailing in June 1991	

13	General (and other) Medical Practice	241
	General practitioners and specialists	
	The Medicare rules for reimbursement	
	Evidence on the fees charged by general practitioners	
	Some comparisons with Hobart data	
	Display of billing and fee information	
	Doctor's discretion: charity <i>and</i> price discrimination?	
	Other aspects of the market for GP services	
	Fees for hospital and day surgery	
	Conclusions	
	Policy Conclusions	
14	Government Regulation of Price Discrimination	257
	Traditional and contemporary approaches to price regulation	
	Price discrimination and the public interest	
	The regulatory approach to price discrimination in the USA	
	The United Kingdom approach to price discrimination	
	The Australian approach to price discrimination	
	When and how to regulate	
	Government-initiated price discrimination	
	Price discrimination in telecommunication	
	Price discrimination in airline service	
	Price discrimination in retail banking	
	Quantity discounts	
	Conclusions	
15	Consumer Information	290
	Consumer search and evaluation: the basic framework	
	Information states and consumer learning	
	'Simple' goods and services	
	Markets with multiple price components	
	Markets with limited disclosure of prices and other information	
	The importance of switching costs	
	Should governments and other third parties intervene?	
	The benefits and costs of intervention in particular circumstances	
	Products having complex price and performance measures	
	Commercial provision of information	
	Information format	
	Consumer information mechanisms and programmes	
	Conclusions	
	References	326
	Index	337

Preface

FOR THE PRESENT-DAY RETAILER, pricing is a business strategy of great importance, especially when the seller has market power. The contemporary marketer is keen to set price at the value of the product in the hands of the customer—rather than merely by reference to cost. To this end, businesses have gone far beyond the traditional techniques of haggling. In particular, they have invented more ways of dividing customers into groups, in order to set differing, group-specific prices. To support this strategy, they sometimes target particular groups by devising tailored product varieties.

This approach applies not only in markets for new and second-hand goods, but also in markets for personal services—including services offered by members of the professions. In some sectors, businesses may use group-specific pricing as a weapon in dealing with current (or potential) competitors.

This book deals with all these matters. It looks at the pricing practices themselves, and does so especially by detailed study of several specific markets for goods and services. It analyses the consequences for the profits of the business, and the implications for the ‘public interest’—a concept that needs careful development.

To some extent, the pricing strategies depend on the shortcomings in the customer’s knowledge of product quality and of available price-offers. The book examines this, too, from both a business and a public-interest viewpoint. It also considers the potential for government to regulate pricing strategies and to influence the provision of information to consumers.

Although some of the discussion depends on basic ideas in economic analysis, the exposition does not suppose prior knowledge of those ideas. Further, the conceptual development is kept as simple as possible, to avoid inessential technicalities.

In this way, the book has as its audience those having a professional concern in developing business strategies or in fostering consumer interests. The level of the exposition makes the book appropriate also for undergraduate (and some graduate) students in business, marketing and economics.

Most of the studies of individual business sectors depend on detailed and laborious fieldwork, which I have undertaken over the last ten years or so. Much of that detail serves to illustrate general principles that are here to stay. Accordingly, there is no attempt to ensure that all the details are up-to-date. However, for some sectors where there has been significant change since the latest fieldwork, the text includes brief accounts of relevant developments.

A book that contains so much empirical material necessarily depends on the work of many participants. I mention particularly the role of David Monk. Besides helping with data collection in several of the other studies, he collected, analysed and reported the conveyancing fee-scales then prevailing in each of the Australian states. He went on to write the first draft of much of the chapter on conveyancing. In recognition, he is designated as co-author of that chapter.

Others who undertook fieldwork and helped to analyse the data are Mei Ying Lee, Milo Lucich, Nara Puthuchear, Sun Byn Shynn, Eric Swan and Sally Tansley. Much of the fieldwork was very demanding; I express my appreciation of their skill and commitment. (Of course, the present employers of those people are in no way committed by the contents of the book.)

Equally, I am very grateful for the work of (in chronological order) Muriel Trouvé (now Guillemot), Aristeia Paschalidis and Corinne McKenzie. Their duties in the office included data entry and analysis, as well as the keyboarding of text—and of the tables, which are so complex and which became (eventually!) so good-looking. Beyond the call of duty came the giving of good advice on expression and, sometimes, on content too.

Much of the early fieldwork was funded by an Australian Research Council award (Grant Number A79030046), for which I express my gratitude. Of course, the most expensive input was my own time—a major commitment over a decade—and for that, the University of Sydney gets the credit.

Gordon Mills
Sydney, December 2001

The Economic Framework

1

First Ideas on Pricing Strategies

WHEN A CONSUMER GOES SHOPPING, choosing what to buy may prove to be quite complicated. In the case of products with physical presence—such as bread, soft drinks, or socks—there may be a wide choice among varieties that differ in quality, and that sell at different prices. Are the socks with the up-market brand name worth the extra money? Is it better to buy the large bottle of soft drink at a low price per litre rather than some small cans (of the same brand) at a higher price per litre.

In the case of services, the story is similar, though the selling strategies may be a little different. Personal services (hair cutting, for example) cannot be transferred from one buyer to another; so it is easy for the provider to charge different prices to different customers. To see a movie, a child pays less than an adult; and the cinema offers reduced prices to pensioners on Tuesdays. Anyone who chooses an airline flight at least several days in advance may get a (non-transferable) ticket at a discounted price. In contrast, the customer who books the same flight only one day before travel pays the full price. For the monthly rental of a telephone line connecting shop, office or residence to the local exchange, the telephone company charges more to a business user than to a residential customer.

As the examples suggest, price differences *can* arise even when the product or service is of uniform quality. In other cases, there are differences in quality too. Although recognising that the manufacture of a high-quality product generally costs more, the customer may wonder whether the extra cost is as large as the difference in the prices. Often, it seems, retail pricing rests in part on opportunism, with higher profit margins sought when the seller believes the customer is an ‘easy touch’, whether by virtue of high income or for other reasons.

As a consumer, you may suspect the presence of such opportunism when you discover after buying that you did not know about all the seller’s

alternative deals. After taking a hotel room at the published rate, you may find that others are staying there on a discount deal. You would have been eligible for this. But the hotel directed its publicity for discount rates to selected consumer groups only, and you neglected to ask whether there was any special offer.

It is important to be well informed about the prices of rival sellers too. After buying a pair of socks, you may find the same article offered at a different price in another store. In consequence, you enjoy pleasure or rage depending on whether the price you paid is lower or higher.

In all these situations, the individual consumer's immediate interest is in learning how to organise buying to secure a good deal. For the student of retailing, there is the added interest of categorising the various practices, identifying the seller's aims, and reaching an understanding of when and how the practices work. Consumer organisations and others concerned with public policy also wonder whether the practices are in the public interest. If not, is government intervention justified, and if so, what form should it take? Also of concern is how to educate consumers so that they may look after their own interests as effectively as possible.

These are the major issues examined in this book. The remainder of this chapter presents further introductory ideas. The next two chapters establish some basic concepts needed for clear interpretation of the retail pricing practices.

Chapter 4 considers the 'branding' of goods (and services), and the associated pricing strategies. Chapters 5, 6 and 7 examines some specific marketing practices, looking in particular at the selling of clothing, and of foods and other supermarket lines. After that, Chapters 8 to 13 report on individual retailing sectors; in each case, the chapter presents detailed evidence, and analyses the practices. The last part of the book (Chapters 14 and 15) considers the scope for government intervention and consumer education.

How consumers differ, and why sellers take note

The standard economic analysis of retail pricing rests upon a common-sense observation that customers who buy a particular good can differ markedly in 'how badly they want the good'. The consumer's desire for the product usually depends on available income, and may depend on other factors such as household size and composition, and ethnic origin. Consequently, some consumers are willing to pay high prices, while others will buy only at lower prices. Equally, there can be differences in the quantities purchased by individual customers or households, even when all customers pay the same price.

In some cases, a consumer will buy at most one unit, per time-period. For a striking example, consider a household decision on whether to subscribe to a pay-TV service distributed by cable. If there is available only one such service, and if it offers a fixed number of channels, the consumer has to make an all-or-nothing decision. For the moment, suppose that the company charges the same price to all.

At that price, some households will decide not to subscribe. Households with very low incomes may consider that the service is too expensive. Among households with higher incomes, some have many other leisure pursuits and so may prefer to spend their money there. They do so because they think they would devote little time to watching TV, and would not derive sufficient benefit from subscription to justify the expenditure.

Nevertheless, the seller's standard price is likely to be low enough to encourage many households to subscribe. Among these, some will find the deal only just worth having, while others will see it as more attractive. Indeed, many of those who are addicted to television may find the deal very attractive indeed; they would be willing to pay a higher price if required to do so.

Instead of charging the same price to all, the supplier may now try to increase profit by charging a higher price to those who put a particularly high value on the service. To do this, however, the seller must be able to divide customers into separate categories. This *is* possible in some markets; the relevant techniques are discussed later. (On the other hand, government regulation may *require* the seller to charge the same price to all.)

As well as charging a high price to keen TV watchers, the seller may set a price *below* the (previous) standard price, for those who place little value on the service. By varying prices in these ways, the supplier may be able to increase the total number of subscribers. In that case, the pricing strategy *may* bring benefits to society as well as extra profits to the seller. (On that proposition, see Chapter 3.)

A brief history of price differentiation

The idea of charging different prices to different customers is *not* the invention of some latter-day marketing expert. Rather, the practice goes back to the earliest times: a seller would have a minimum acceptable price. In general, this would reflect the cost of supply—but in the case of a perishable good, it would depend also on the prospects of finding buyers before the stock became too old to sell. Subject to that minimum, the seller would seek to clinch a deal with each, and every, potential customer. In individual negotiations with each buyer, the seller would try to discover, and then receive, the highest price that the buyer was willing to pay.

In today's society, anyone who has bought a car from a used-car dealer will recognise the process. It requires a great deal of time and effort on the part of the seller as well as the buyer. It relies on the seller being financially motivated—often by being the owner of the good, and hence the recipient of all the profit realised in the individual sale. Such ownership also avoids any difficulties over accountability for sales revenue, when the amount varies from one sale to the next.

These features help to explain why the practice of individual haggling declined as economic development brought mass retailing. Large retail enterprises usually *employ* salespeople on hourly wage rates; and they find it convenient to sell a product on standard terms, at a price that is displayed (or *posted*, as the practice is called). All the customers learn of this standard price.

In commenting on this, economics textbooks sometimes draw a comparison between the uniform pricing that they see as predominating in developed economies, and the bargaining culture that is said to prevail in many other countries. '[To assume] that sellers quote a uniform price to all buyers during any short period of time . . . is a tolerable first approximation for retail product pricing in the United States and Europe (but not in the Middle East)' (Scherer and Ross, 1990, p. 489). With recent economic development leading to large-scale retailing, especially in many burgeoning Asian economies, the comparison has become less apposite. Also, as Scherer and Ross themselves note, even in developed economies there are many exceptions to uniform pricing.

One particular manifestation of the trend towards larger enterprises was the development of very large suppliers in rail and other transport modes, and in electricity, gas and telecommunications—the so-called 'public utilities'. Soon, the inherent market power of these large companies caught the attention of governments. In the USA, in the late nineteenth century, some state governments and then the Federal government established regulatory bodies with jurisdiction over the pricing decisions of some of these private companies. On the other hand, in Europe—and in Australia, too—the mechanism for government control was generally government ownership.

Whatever the approach, there was usually a presumption that public utilities should serve all members of society, and should do so equally and without favour for particular groups. The utilities made published price lists available to all customers; all of those who bought a particular service paid the same, standard price.

More generally, as companies grew larger, price differentiation did not disappear; but the earlier prevalence of *individual* bargaining greatly diminished. In most countries large companies sold at posted prices, known to all and offered to all.

Some recent trends

In recent years, there seems to have been renewed emphasis on price differentiation—though instead of bargaining at an individual level, the large enterprises of today focus on *customer-class pricing*. For a given product, all customers within a class or group (pensioners, for example) pay the same price; but there can be significant differences between the prices charged to different classes. Sellers have shown considerable ingenuity in devising customer categories. In some cases, the use of a computerised database facilitates the adoption of a complex pricing scheme.

This is part of what seems to be a growing awareness that such pricing can increase the seller's profits by tapping the variations in demand intensity that arise between consumer types. This thinking now extends even to public utilities. Some of those previously owned by government have been sold to private owners. Others have become government-owned business enterprises, with commercial objectives. In both circumstances, there is less emphasis on the public obligation to treat all customers equally, and some such utilities engage in customer-class pricing.