Session 10: Pricing

- review of differentiation

- strategic decisions
  - low-price or premium
  - mass market or niche
  - impact on channel partners

- market tools can set the right price
  - expected value in use (EVIU)
  - value to the channel (EVC)
  - breakeven analysis
  - conjoint analysis
If competition is imperfect, raising perceived value can have high leverage

- Annual demand = 100M units
- Variable costs = $196
- Current price = $200
- Current profit = $400M

- What if we could raise perceived value (and price accordingly) by 1%? 10%?

- Profit increases by ________%?

value = benefits vs. price
Making competition imperfect

- Tylenol (vs. aspirin)
- Snapple (quirky indulgence)
- Brita (vs. P&G)

<table>
<thead>
<tr>
<th></th>
<th>Taste</th>
<th>Impurities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pitcher</td>
<td>Brita Dominates</td>
<td>PUR best on impurities</td>
</tr>
<tr>
<td>Faucet</td>
<td>Brita best tasting</td>
<td>PUR Dominates</td>
</tr>
</tbody>
</table>
Differentiation makes for “local monopolies”

- Imperfect competition (“local monopolies”)
  - Perdue chickens
Local monopolies are better than commodity markets

- Branding?
  - lobsters are caught by small boats (2.8M traps)
  - sold at market price by boats
  - key item in restaurants
  - why not “Prelude” lobsters?

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Expected value in use (EVIU)

- Unique benefits increases perceive value (hence price)

- In many markets, the unique benefits can be cost savings
  - Expected value in use (EVIU)
  - EVIU =
    • Cost to customer without product
    • minus cost to customer with product
EVIU in pile-driving pads

Image is in the public domain.
The pile-driving market

- **Pile Driving Pads**
  - driving piles generates heat, need pads
  - current solution is asbestos pads (toxic, change often, hot and dangerous)
  - proposal: curled metal pads (not toxic, lasts whole job, not as hot)

- **Players in the market (analogies to Aqualisa)**
  - pile-driving contractors: 75% own machines, 25% rent them
  - buy supplies from supply houses (if own machines) or rental companies
  - influenced by
    - architectural and consulting engineers
    - general contractors (who often have machine shops)
## Expect value in use (EVIU)
### Illustrative calculations

<table>
<thead>
<tr>
<th></th>
<th>Current Solution</th>
<th>CMI Pile-driving Pads</th>
<th>Savings to customer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hours to drive 300 piles</td>
<td>100 hours</td>
<td>75 hours</td>
<td>25 hours</td>
</tr>
<tr>
<td>Set-up time</td>
<td>6 2/3 hours</td>
<td>4 minutes</td>
<td>6 2/3 hours</td>
</tr>
<tr>
<td>Net @ $200/hour</td>
<td>$21,334 = 106 2/3 hr x $200/hr</td>
<td>$15,000 = 75 hr x $200/hr</td>
<td>$6,334</td>
</tr>
<tr>
<td>Weight/handing temp</td>
<td>40 pounds/700°</td>
<td>15 pounds/250°</td>
<td></td>
</tr>
<tr>
<td>Recycling costs</td>
<td>Asbestos</td>
<td>Curled metal</td>
<td>$1,000</td>
</tr>
<tr>
<td>Price</td>
<td>$1,000 = 20 sets x $50/set</td>
<td>1 set x CMI price/set</td>
<td>$1,000 – CMI price</td>
</tr>
<tr>
<td>Net EVIU</td>
<td></td>
<td></td>
<td>$8,334 – CMI price</td>
</tr>
<tr>
<td>Product cost</td>
<td></td>
<td></td>
<td>$150/set</td>
</tr>
<tr>
<td>Minimum margin</td>
<td></td>
<td></td>
<td>50%</td>
</tr>
</tbody>
</table>
Key ideas so far

- **Differentiate (vs. competition)**
  - perceived value
  - reduce price competition

- **EVIU (to end customer)**
  - gives maximum price
  - achievable if patent, production, or image protection

- **Value to Channel (EVC)**
  - Sonance speakers
Expected value to the channel: Market for built-in speakers

Sonance speakers
Slightly better for customer.

Typical dealer installs about 450 units per year.

Speakercraft speakers
Much easier to install.

End customers often defer to dealer who is a systems integrator.

Images © Sonance; Speakercraft. All rights reserved. This content is excluded from our Creative Commons license. For more information, see http://ocw.mit.edu/help/faq-fair-use/.
Channel is important to pricing

- **Sonance speakers (custom installed)**
  - Speakercraft streamlined installation, reduced cost
  - savings to installers
    - reduced time to install
    - higher dealer margin per hour of labor

<table>
<thead>
<tr>
<th>Dealer Economics</th>
<th>Speaker craft</th>
<th>Sonance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail price</td>
<td>$365</td>
<td>$400</td>
</tr>
<tr>
<td>Dealer margin</td>
<td>75%</td>
<td>65%</td>
</tr>
<tr>
<td>Return to dealer</td>
<td>$275</td>
<td>75% of $365</td>
</tr>
<tr>
<td>Time to install</td>
<td>½ hour</td>
<td>1 hour</td>
</tr>
<tr>
<td>Dealer cost/hour</td>
<td>$60</td>
<td>$60</td>
</tr>
<tr>
<td>Dealer cost installed</td>
<td>$30</td>
<td>½ hr x $60/hr</td>
</tr>
<tr>
<td>Net profit dealer</td>
<td>$245</td>
<td>$275 – $30</td>
</tr>
</tbody>
</table>
Sonance Architectural Series

• Must do something to respond to Speakercraft

• Developed a new series of flush-mounted speakers.
  – Technology innovation that helps the channel (now ½ hour)
  – Also substantially better for end customers

• Pricing decision
  – high-end niche
  – or, mass market
B/E analysis to evaluate a niche

- **Niche**: smaller, but higher price
- **Mass market**: larger, but competitive price
- **Breakeven (B/E)**
  - number of units that must be sold to cover fixed costs
  - compare to needed market share
  - useful in Aqualisa

  - conjoint analysis (next) determines if there is demand at that price
Sonance Architectural Series

- Compare mass and niche markets.
- For given prices, what share is needed.
- Strategic considerations
  - Speakercraft is a threat in mass market (EVC).
  - exclusive partners in niche

<table>
<thead>
<tr>
<th></th>
<th>Mass Market</th>
<th>Niche market</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail price</td>
<td>$750</td>
<td>$2,500</td>
</tr>
<tr>
<td>Dealer price</td>
<td>$305</td>
<td>$875</td>
</tr>
<tr>
<td>Sonance cost</td>
<td>$200</td>
<td>$200</td>
</tr>
<tr>
<td>Dealer margin</td>
<td>$415</td>
<td>$750 – $305 – $30</td>
</tr>
<tr>
<td>Sonance margin</td>
<td>$105</td>
<td>$305 – $200</td>
</tr>
<tr>
<td>Units per dealer</td>
<td>450</td>
<td>450</td>
</tr>
</tbody>
</table>

Profit per dealer = 450d x $105/d = $47,250

Dealers to B/E = $2M / $47,250 = 42.3

Min market share = 10% = 42.3 drs / 425 drs = 9.5%

15.810 Marketing Management
B/E and price-evaluations need conditional demand estimates

• We’ve seen intention scaling (as in XM Digital Satellite Radio).

• Conjoint analysis

Conjoint analysis is the most commonly applied marketing science method!

<table>
<thead>
<tr>
<th>Taking everything into account, how likely are you to subscribe to XM radio at $8 per month.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Certain, practically certain (99 in 100)</td>
</tr>
<tr>
<td>Almost sure (9 in 10)</td>
</tr>
<tr>
<td>Very probable (8 in 10)</td>
</tr>
<tr>
<td>Probable (7 in 10)</td>
</tr>
<tr>
<td>Good possibility (6 in 10)</td>
</tr>
<tr>
<td>Fairly good possibility (5 in 10)</td>
</tr>
<tr>
<td>Fair possibility (4 in 10)</td>
</tr>
<tr>
<td>Some possibility (3 in 10)</td>
</tr>
<tr>
<td>Slight possibility (2 in 10)</td>
</tr>
<tr>
<td>Very slight possibility (1 in 10)</td>
</tr>
<tr>
<td>No chance, almost no chance (1 in 100)</td>
</tr>
</tbody>
</table>
Basic idea of conjoint analysis
Willingness-to-pay for features

- Timbuk2 bags

- Consumers asked to choose among various bags with different features and prices.

- Obtain a willingness to pay for each feature, e.g., $8 for the mesh pocket.
Ideas are classic (but methods are modern)

- Ford and the River Rouge Plant
  - 2,000 acres, 120,000 employees, 53,000 machine tools, 90 miles of track, 27 miles of conveyors
  - power plant, glass plant, cement plant, paint, rubber, etc.
  - Model A

Image is in the public domain.
From the GM archives.
Consumers chose among rear contours
Consumers chose among grills and starterator

The Proving Ground of Public Opinion
Self-stated scales for many features

Check Your Appraisal

VERY LITTLE → A WHOLE LOT

<table>
<thead>
<tr>
<th>Feature</th>
<th>0</th>
<th>$1</th>
<th>$5</th>
<th>$10</th>
<th>$15</th>
<th>$20</th>
<th>$25</th>
<th>$30</th>
<th>$40</th>
<th>$50</th>
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<tbody>
<tr>
<td>Dash Compartment</td>
<td></td>
<td></td>
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<tr>
<td>Adjustable Seats</td>
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<tr>
<td>Independent Suspension</td>
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<tr>
<td>Starterator</td>
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<td></td>
<td></td>
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<tr>
<td>Safety Glass</td>
<td></td>
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<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
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<tr>
<td>Automatic Choke</td>
<td></td>
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<tr>
<td>Syncro-Mesh</td>
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<td></td>
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<tr>
<td>Stabilized Front End</td>
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<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Hydraulic Brakes</td>
<td></td>
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<td></td>
<td></td>
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<tr>
<td>No-Draft Ventilation</td>
<td></td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>All Steel Top</td>
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<td></td>
<td></td>
<td></td>
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<td></td>
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</tr>
</tbody>
</table>

What are they worth to You?

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But for some products market experiments are not feasible.

• Suppose you are designing a Maserati SUV
  – automatic parking
  – auto-adjust acceleration – fuel saver, normal, sport, OMG
  – Bose active suspension
  – fire suppression
  – four vs. five seats
  – true off-road capability
  – Jeep vs. Ferrari engine
  – towing capability
  – active cruise control
  – standard transmission
  – Etc.

Courtesy of Automobile Italia on Flickr. License: BY.
How would you advise the CEO?

- Which features would you add to the Maserati SUV?

- How would you price those features?

- How much should you pay to license a patented technology on automatic parking?
Conjoint analysis determines consumers’ willingness to pay

Maserati SUV
- Auto-adjust acceleration = $1250
- Off-road capability = – $500
- Auto parking = $2,000
- Etc.
- Of course, we need to worry about segments, combinations of features, competition, and core strengths.

10,000+ applications yearly
- EZPass system
- Courtyard by Marriott
- RIM’s Blackberry smartphones
- XM-Sirius service
- AMEX card service
- Intel chips
- Hallmark Cards
- GM cars
- Audi cars
- …
I-Zone camera illustration (classic CA)

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Familiarize consumers (kids) with features and category

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Feature tradeoffs

8 Questions

Ready for something a little different? Here’s what to do:

1. We are going to show you 8 different pairs of cameras with some of the features and options we just showed you.
2. For each of the 8 pairs, compare the 2 different cameras.
3. Click on the white circle below to tell us how much you like one camera compared to the other.
4. Touch the yellow dots to see what each white circle means.
5. Try the example question below...

<table>
<thead>
<tr>
<th>Features</th>
<th>Camera A</th>
<th>Camera B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price</td>
<td>$34.99</td>
<td>$24.99</td>
</tr>
<tr>
<td>Picture Removal</td>
<td>Manual</td>
<td>Automatic</td>
</tr>
<tr>
<td>Picture Taking</td>
<td>2 Step</td>
<td>1 Step</td>
</tr>
<tr>
<td>Styling Covers</td>
<td>Changeable</td>
<td>Permanent</td>
</tr>
</tbody>
</table>

Need the scale? Touch the yellow dot

I like A completely more than B

I like B completely more than A
Conjoint data analysis output: Calculate willingness to pay

**REGRESSION**

<table>
<thead>
<tr>
<th>Variables</th>
<th>B</th>
<th>Std. Error</th>
<th>t</th>
<th>Significance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>15.5</td>
<td>5.6</td>
<td>2.7</td>
<td>.006</td>
</tr>
<tr>
<td>Price ($34.99 vs. 24.99)</td>
<td>22.6</td>
<td>3.0</td>
<td>7.4</td>
<td>.000</td>
</tr>
<tr>
<td>Removable Covers</td>
<td>21.2</td>
<td>3.2</td>
<td>6.7</td>
<td>.000</td>
</tr>
<tr>
<td>Picture Quality</td>
<td>30.5</td>
<td>6.3</td>
<td>4.8</td>
<td>.000</td>
</tr>
<tr>
<td>Auto vs. 2-step</td>
<td>-0.8</td>
<td>2.8</td>
<td>-0.3</td>
<td>.763</td>
</tr>
</tbody>
</table>

Dependent Variable = Relative Preference Between Pairs of Profiles
### Satellite Television Service

<table>
<thead>
<tr>
<th></th>
<th>Profile 1</th>
<th>Profile 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Network</td>
<td>Dish</td>
<td>Dish</td>
</tr>
<tr>
<td>Number of Channels</td>
<td>120</td>
<td>120</td>
</tr>
<tr>
<td>Premium Channels</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Includes DVR</td>
<td>NO</td>
<td>YES</td>
</tr>
<tr>
<td>Price</td>
<td>$35</td>
<td>$40</td>
</tr>
</tbody>
</table>

**Which product do you choose between the two?**

- Profile 1
- Profile 2

Choice-based Conjoint analysis intuition
### Satellite Television Service

<table>
<thead>
<tr>
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<th>Profile 2</th>
</tr>
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</tr>
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<td>3</td>
<td>3</td>
</tr>
<tr>
<td><strong>Includes DVR</strong></td>
<td>NO</td>
<td>YES</td>
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Which product do you choose between the two?
### Satellite Television Service

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<tr>
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<td>120</td>
<td>120</td>
</tr>
<tr>
<td>Premium Channels</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Includes DVR</td>
<td><strong>NO</strong></td>
<td><strong>YES</strong></td>
</tr>
<tr>
<td>Price</td>
<td>$35</td>
<td>$40</td>
</tr>
</tbody>
</table>

Which product do you choose between the two? [ ]

Would you buy the product you chose above at the indicated price? [ ] Yes [ ] No
Choice-based conjoint analysis – basic concept

By analyzing choices among products, we identify the value of all features.

16 choices x 3 inequalities per choice x 450 consumers = 21,600 “constraints”

economic theory tells us low price preferred to high price, etc. → many more “constraints”

By analyzing choices among products, we identify the value of all features.
There was careful “craft”

• Selection of panel

• Quality control
  – pretests
  – CAPCHAs, ID verification, security controls
  – fast, slow, etc.
  – sensitivity analyses

• State-of-art estimation (Hierarchical Bayes)
Sawtooth Discover
Create your own conjoint study
Caveat: “Craft” matters!

If these were your only options, which would you choose?

<table>
<thead>
<tr>
<th>Case Color</th>
<th>Watch Face</th>
<th>Band</th>
<th>Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Silver</td>
<td>Round</td>
<td>Matching Metal</td>
<td>$249</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gold</td>
<td>Rectangular</td>
<td>Black Leather</td>
<td>$299</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gold</td>
<td>Rectangular</td>
<td>Brown Leather</td>
<td>$349</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>NONE: I wouldn't choose any of these.</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

If these are the available smartwatches which one do you like best?

<table>
<thead>
<tr>
<th></th>
<th>Watch 1</th>
<th>Watch 2</th>
<th>Watch 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Case color:</td>
<td>Rectangular</td>
<td>Gold-colored</td>
<td>Silver-colored</td>
</tr>
<tr>
<td>Band:</td>
<td>Brown leather band</td>
<td>Matching metal band</td>
<td>Black leather band</td>
</tr>
<tr>
<td>Price:</td>
<td>$349.-</td>
<td>$399.-</td>
<td>$299.-</td>
</tr>
</tbody>
</table>

Best option:  

Would you consider buying your preferred option if it was available?

- Yes
- No
State of the art “craft”

If these are the available smartwatches which one do you like best?

Please assume that all watches are from your preferred brand Apple and are compatible with your smartphone so that they can show incoming messages or calls. Assume that all of these watches have a battery that lasts a day or more, a heart rate monitor, Bluetooth, high definition color LED touchscreen, 1.2 GHz processor, 4 GB storage, and 512 MB RAM.

To change the perspective view, click detail, top, or app:

Watch 1
- Rectangular
- Gold-colored
- Brown leather band
- Price: $340.00

Watch 2
- Round
- Gold-colored
- Matching metal band
- Price: $390.00

Watch 3
- Rectangular
- Silver-colored
- Black leather band
- Price: $200.00

Would you consider buying your preferred option if it was available?

- Yes
- No

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Simplified example

• metric rather than choice-based
• no animations, rely on your imagination
• simple regression rather than HB logit
• only two prices

• but captures the basic intuition
In-class example of conjoint analysis

- **Location**
  - Beacon Hill vs. Somerville

- **Size**
  - small (400 sq. ft. efficiency) vs. large (800 sq. ft. one-bedroom)

- **Finish**
  - tired vs. luxury

- **Rent**
  - $800 vs. $1,600
Rate your preferences

- Option Juliet
  - Beacon Hill
  - One bedroom
  - Luxury
  - $800 per month

- Option Mike
  - Somerville
  - Efficiency
  - Tired
  - $1,600 per month

100 0
Rate your preferences

• Option Alfa
• Beacon Hill
• One bedroom
• Tired
• $1,600 per month

• Option Bravo
• Somerville
• Efficiency
• Luxury
• $1,600 per month
### Express your preference

<table>
<thead>
<tr>
<th>Your preference</th>
<th>Apartment</th>
<th>Location</th>
<th>Size</th>
<th>Rent</th>
<th>Finish</th>
</tr>
</thead>
<tbody>
<tr>
<td>100</td>
<td>Alfa</td>
<td>Beacon Hill</td>
<td>One bedroom</td>
<td>$1600 per month</td>
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“This CD player costs less than players selling for twice as much”
It’s not often you get good news instead of a bill, but we’ve got some for you. If you’ve heard all those rumors about your basic cable rate going up $10 or more a month, you can relax: *it’s not going to happen!* The great news is the rate for basic cable in increasing only $2 a month.

– Russo and Shoemaker – Framing Example
Summary

• differentiation leads to imperfect competition

• strategic decisions
  – low-price or premium
  – mass market or niche
  – impact on channel partners

• market tools can set the right price
  – expected value in use (EVIU)
  – value to the channel (EVC)
  – breakeven analysis (B/E)
  – conjoint analysis
  – framing and schema effects