

# Lecture 12: Pricing Strategies

November 14, 2023

# Course Administration

1. Use Numbers 3 graded next week
2. Two more lectures: Externalities and public goods
3. Final – Dec. 13 and 14
4. Any questions?

## Ripped from the Headlines

Next week – article due by Wednesday midnight

Finder	Presenter
Tara	Jared

# Ripped from the Headlines

Finder	Presenter
<hr/>	
Jared	Trenton

## Where We Are Going

- Pricing strategy basics
- Perfect price discrimination
- Segmenting
- Indirect price discrimination
- Bundling
- Ex. 1: Taylor Swift and Ticketmaster debacle
- Ex. 2: Gas stations in Los Angeles

# Pricing Strategy Basics

# Pricing Strategies

So far, we have studied

- perfectly competitive firms
  - set  $P = MC$
- firms with market power that charge the same price for all consumers
  - set  $MR = MC$ , and  $MR \neq P$

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- why?



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Today, we let firms charge different prices to different consumers

- why? to make more money!
- price discrimination  $\equiv$  “the practice of charging different prices to different consumers of the same product”

## Why Do We Care About These Strategies?

- Helps us understand firm behavior
- Which illuminates scope for policy

## Why Do We Care About These Strategies?

- Helps us understand firm behavior
- Which illuminates scope for policy
- Prices can differ because of
  - cost differences → “price differences”
  - offering different products can also → “price differences”
  - market power and pricing strategies → “price discrimination”
  - there is legal and illegal price discrimination
- Allows us to differentiate between legal and illegal differences in price

# Two Requirements for a Firm to Have Any Pricing Strategy

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## 1. Market power

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- ≡ when a firm has the ability to influence the market price

## Two Requirements for a Firm to Have Any Pricing Strategy

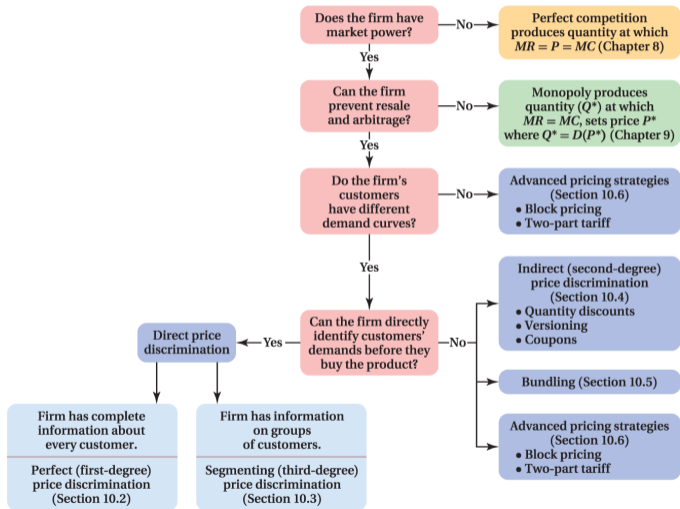
1. Market power
  - $\equiv$  when a firm has the ability to influence the market price
2. Firm must be able to prevent resale



## Two Requirements for a Firm to Have Any Pricing Strategy

1. Market power
  - $\equiv$  when a firm has the ability to influence the market price
2. Firm must be able to prevent resale
  - because resale allows the pricing strategy to break down

# Pricing Strategy Overview



# Logical Organization of Discussion

For each pricing strategy

1. Strategy requirements
2. Strategy definition
3. Examples
4. Consumer and producer surplus implications

# Perfect Price Discrimination Or, First Degree Price Discrimination

## Requirements for Perfect Price Discrimination

1. Firm has market power and can prevent resale
2. Firm's customers have different demand curves
3. Firm knows each customer's demand and can identify customers

## Perfect Price Discrimination

- Charge each customer their willingness to pay for each unit
- If your demand curve slopes downward, what does this mean?
  - High price for first units
  - Lower prices for later units

## Examples of Perfect Price Discrimination

Actually pretty hard in real life

- College tuition

## Examples of Perfect Price Discrimination

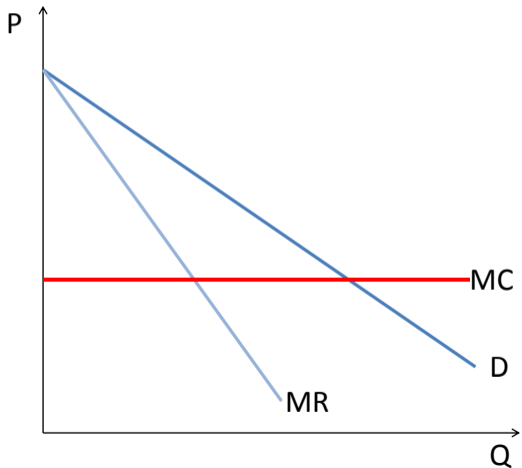
Actually pretty hard in real life

- College tuition
- Things you buy on ebay
- Fine art auctions



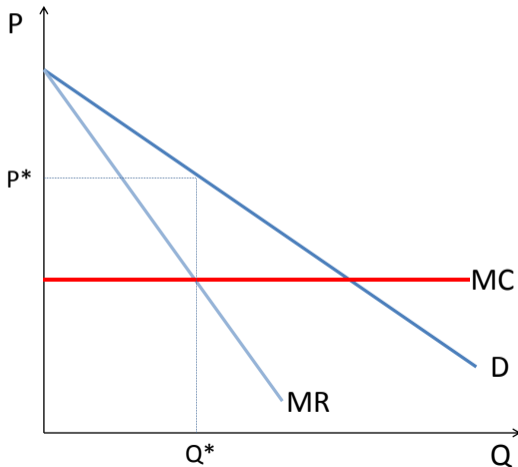
# Recall Producer and Consumer Surplus with Market Power

Where is the Profit Maximizing  $P$  and  $Q$ ?



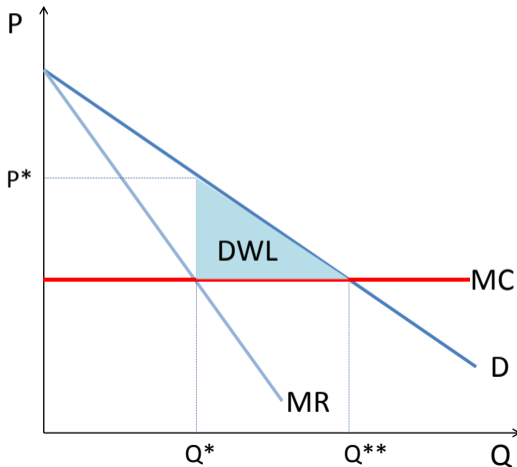
# Recall Producer and Consumer Surplus with Market Power

Where are the Trades that Don't Take Place?



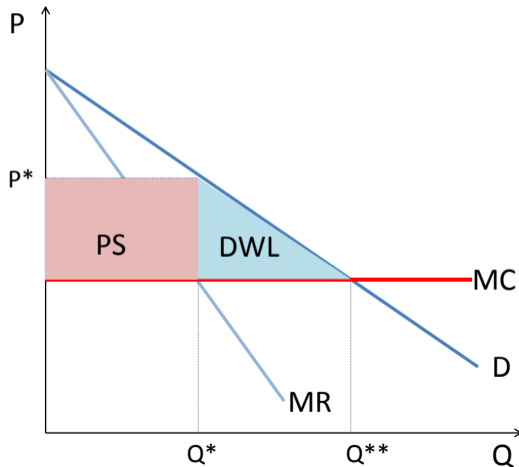
# Recall Producer and Consumer Surplus with Market Power

Where is *PS*?



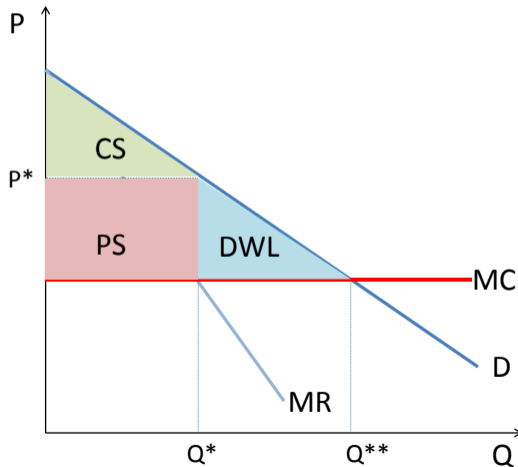
# Recall Producer and Consumer Surplus with Market Power

Where is CS?



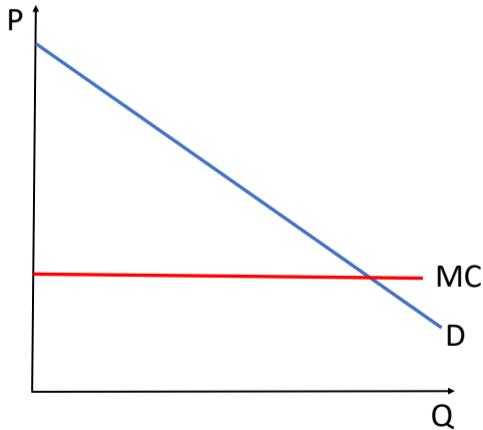
# Recall Producer and Consumer Surplus with Market Power

Consumers Worse Off, Producers Better Off



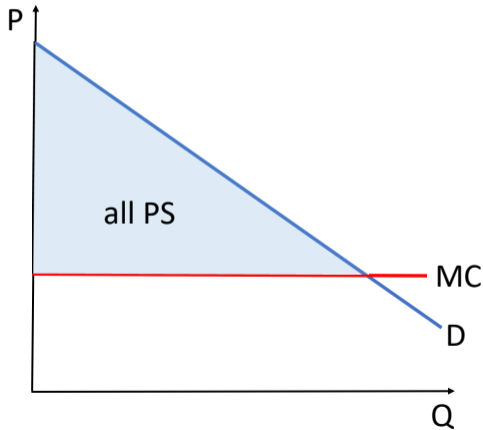
# What is Producer Surplus With Perfect Price Discrimination?

Here is a firm with market power, facing downward sloping demand



# What is Producer Surplus With Perfect Price Discrimination?

Firm scoops up every last bit of surplus



## The Extent of Deadweight Loss

Regime	DWL?	CS	PS
Perfect competition			



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Regime	DWL?	CS	PS
Perfect competition	none	entirely	none

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Regime	DWL?	CS	PS
Perfect competition	none	entirely	none
Market power, no price discrimination	yes	some	some
Market power, perfect price discrimination	none	none	entirely

# Segmenting Or, Third Degree Price Discrimination

## Requirements for Price Discrimination via Segmenting

1. Firm has market power and can prevent resale
2. Firm's customers have different demand curves
3. Firm can identify group demand for the product and can identify group members before purchase; it cannot identify individual demand

## Price Discrimination via Segmenting

- Charge a different price to different segments of the market
- Firm identifies segments via observable attributes



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Why does the firm need to prevent resale?

# How to Segment Consumers?

- By customer characteristics

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  - student discount
  - business travelers vs leisure travelers

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  - if price sensitivity differs
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  - new consumer discount for high switching cost industries
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- By location
  - if price sensitivity differs
  - see gas stations
- Over time
  - are you the first to buy a new iphone?

# Why Segment?

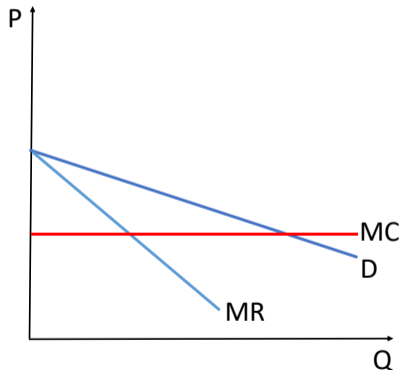
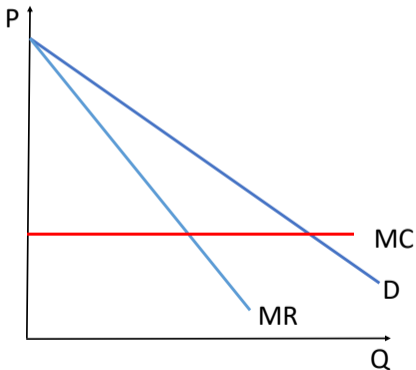
# Why Segment? To Make More Money!

## Basic strategy

- identify groups
- find marginal revenue of groups
- set marginal revenue = marginal cost to get  $\pi$  maximizing quantity
- charge price from demand curve at this quantity

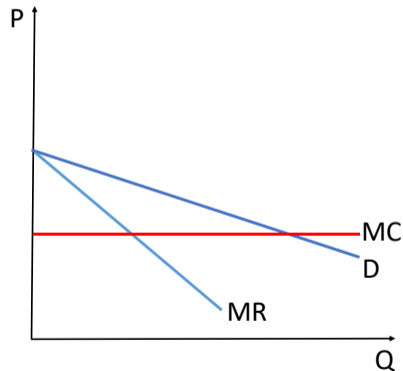
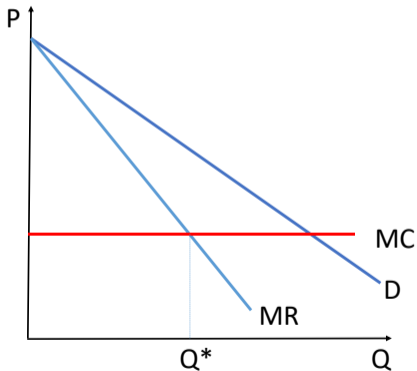
# Why Firms with Market Power Want to Segment the Market

What is profit maximizing  $Q$  for higher valuation, less elastic consumers?



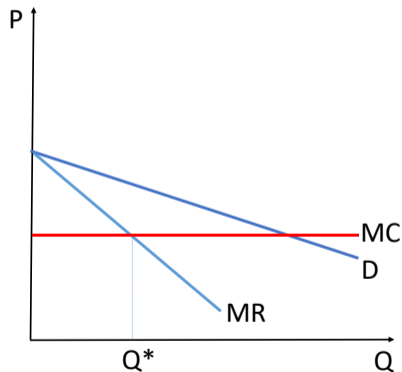
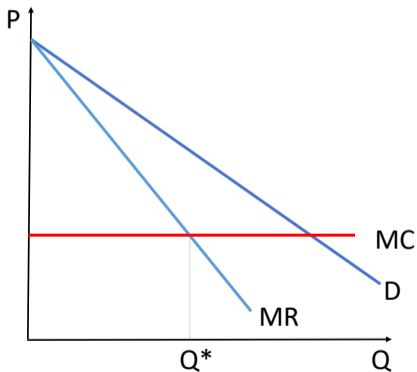
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What is profit maximizing  $Q$  for lower valuation, more elastic consumers?



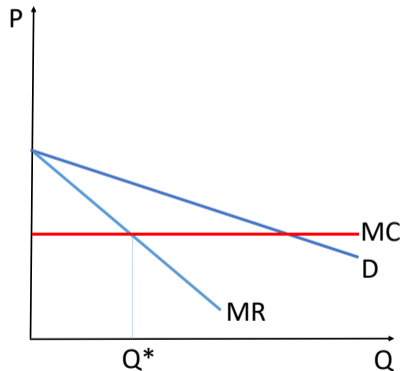
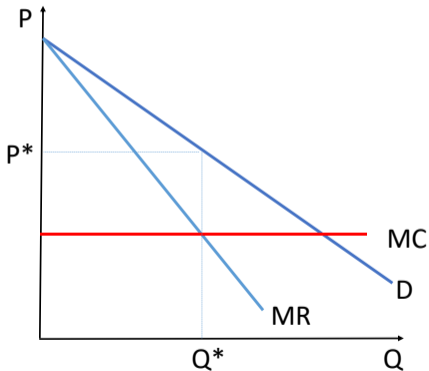
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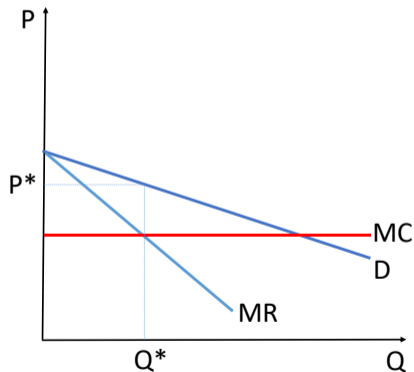
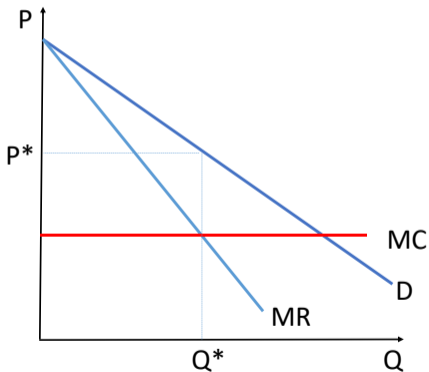
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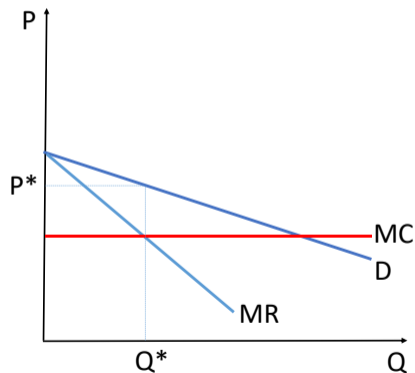
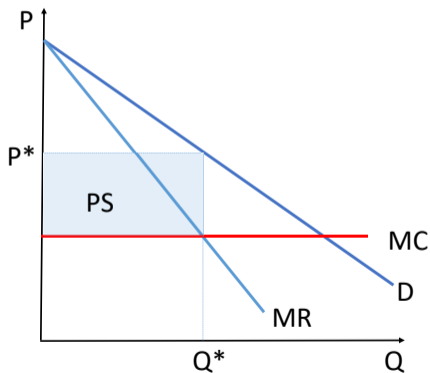
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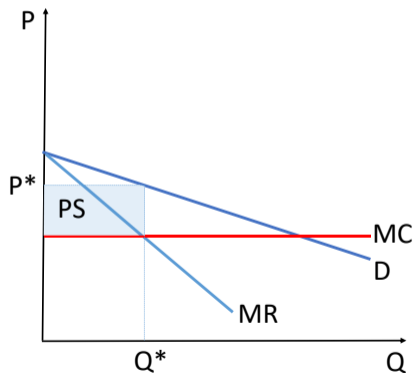
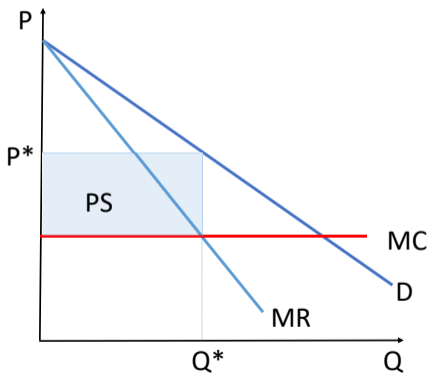
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What is *PS* for lower valuation, more elastic consumers?



# Why Firms with Market Power Want to Segment the Market

Firm gains surplus from segmenting market



## What Does this Mean for Producer Surplus?

- By focusing on each group separately, the firm makes more profits
- Otherwise it would have to charge some intermediate price

Note that we omit discussion of pricing with Lerner index.

# Indirect Price Discrimination Or, Second Degree Price Discrimination

## Requirements for Price Discrimination via Segmenting

1. Firm has market power and can prevent resale
2. Firm's customers have different demand curves
3. Firm **cannot** identify customers' demand before purchase

## Two Types of Indirect Price Discrimination

1. Quantity discounts
2. Versioning

## What is a Quantity Discount?

- Pay less if you buy more
- Works **only** if
  - “customers who purchase larger quantities of a product have relatively more elastic demands than consumers who buy smaller quantities” and
  - the plan is incentive compatible
- Can you think of such an example?

## When a Plan is Incentive Compatible

incentive compatibility  $\equiv$   
a plan such that the price offered to each group is chosen by that group



## When a Plan is Incentive Compatible

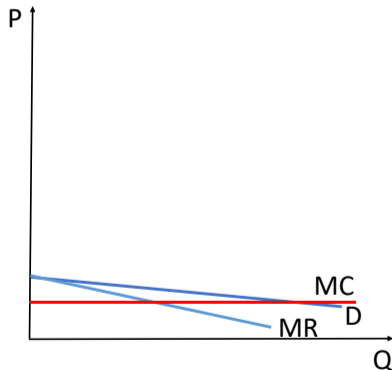
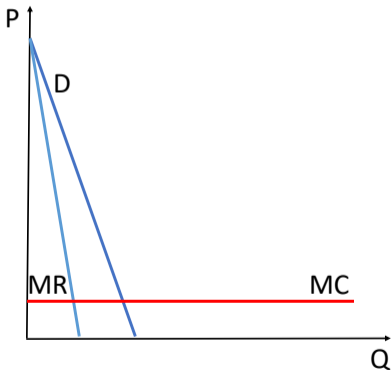
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Example?

- bread at the bakery in the morning
- same bread at closing, heavily discounted

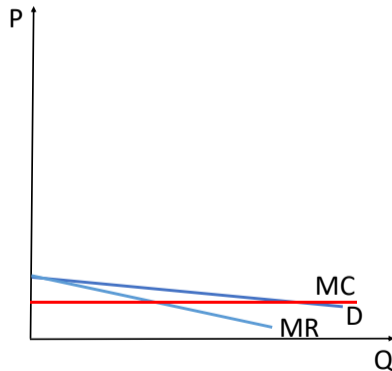
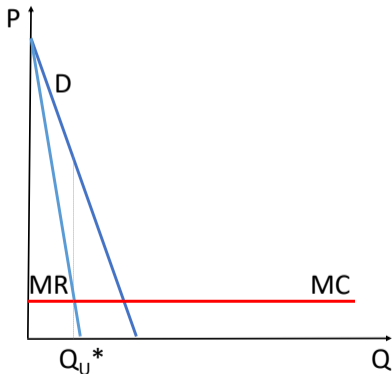
# What is profit maximizing $Q$ for less elastic consumers?

Less elastic demand vs more elastic demand



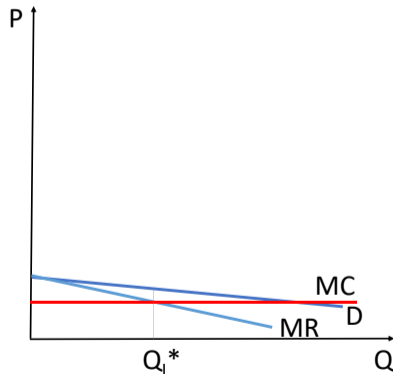
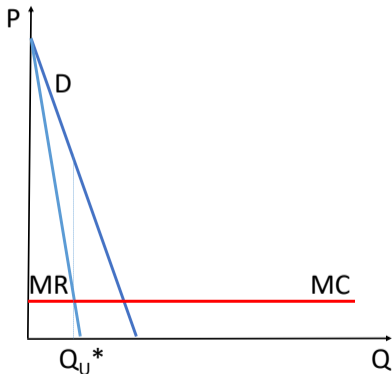
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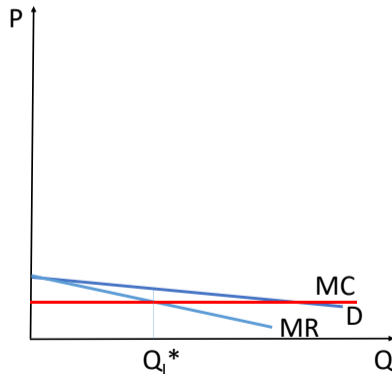
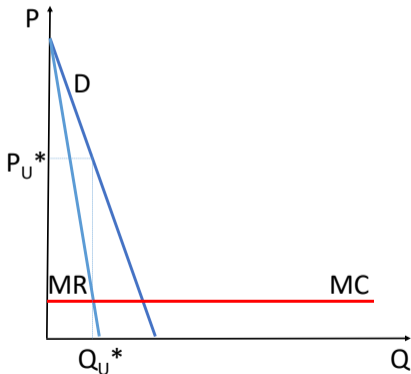
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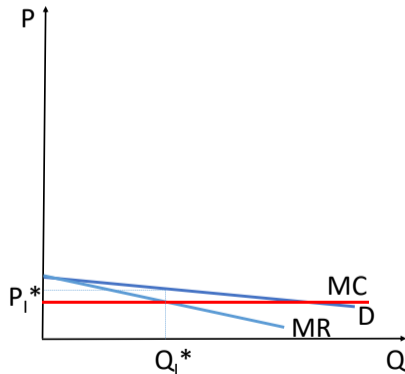
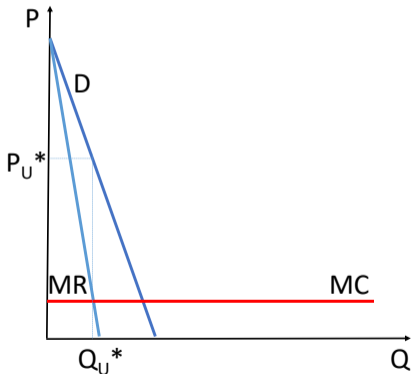
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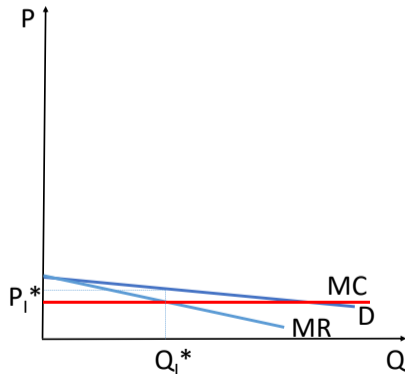
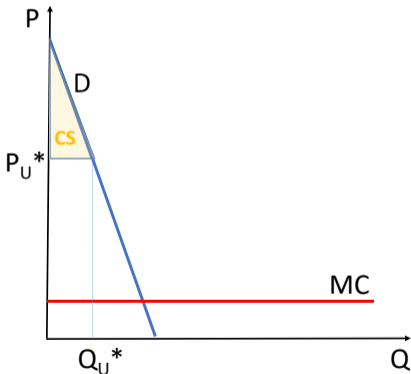
Quantity Discount: Buy  $Q_I$  or more units, pay  $P_I$ . Otherwise, pay  $P_U$ .

Less elastic demand vs more elastic demand



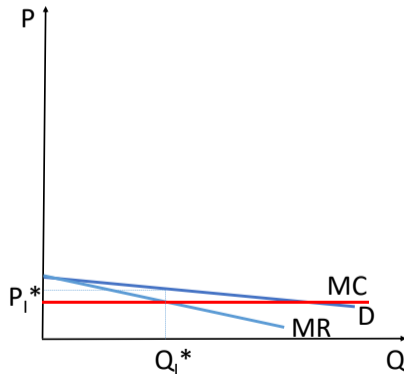
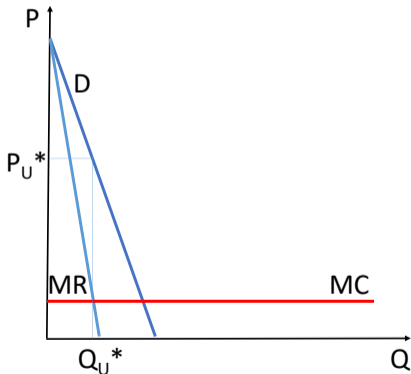
# Original CS for More Inelastic Consumers

Less elastic demand vs more elastic demand



# Would right panel customers ever want to pay $P_U^*$ ?

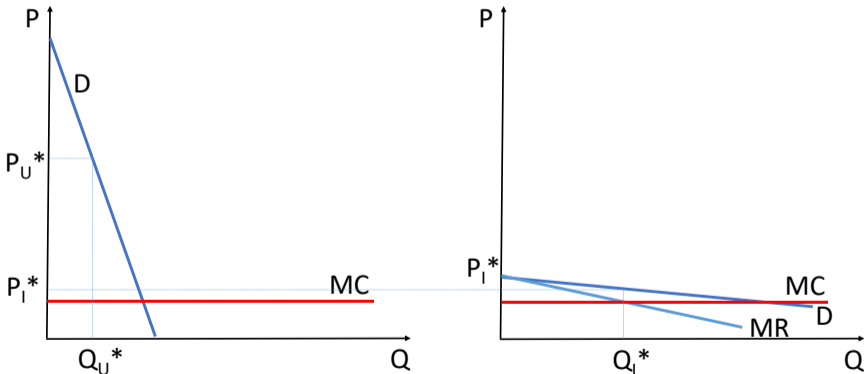
Less elastic demand vs more elastic demand





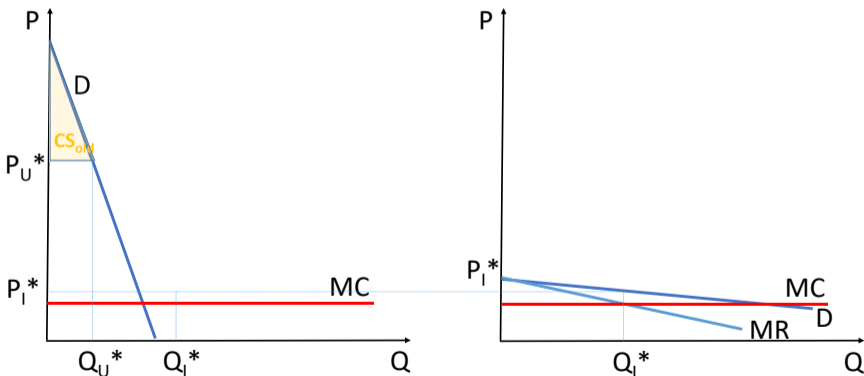
# Would Left Panel Consumers Want to Pay $P_I$ if They Must Buy $Q_I$ ?

Less elastic demand vs more elastic demand



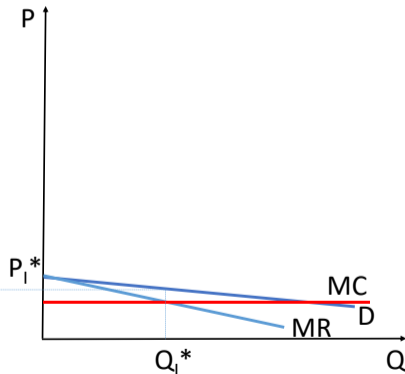
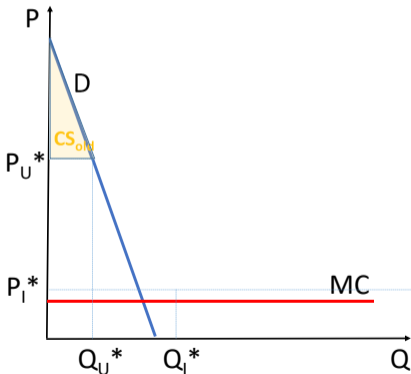
# Reminder: Consumers Always Get This Surplus

Less elastic demand vs more elastic demand



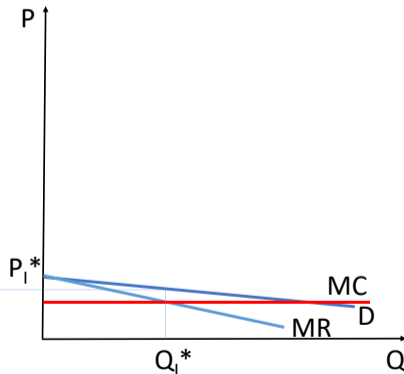
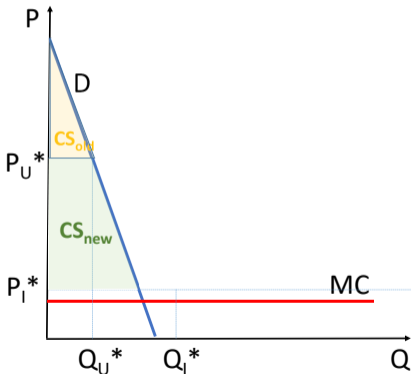
# What Additional Surplus Do They Get at $P_I$ ?

Less elastic demand vs more elastic demand



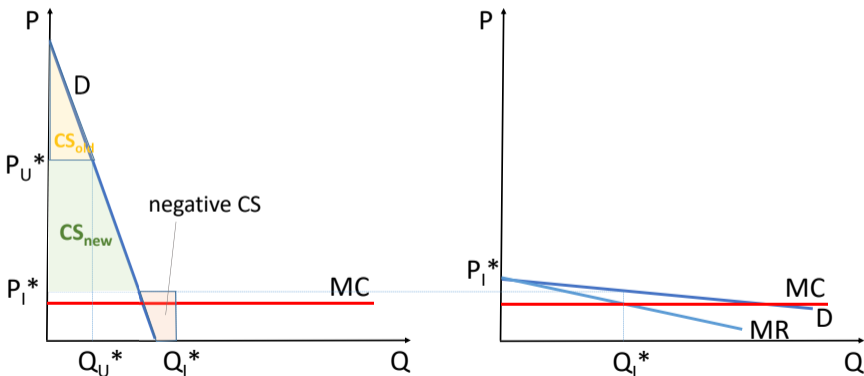
# What About the Requirement to Purchase $Q_I$ ?

Less elastic demand vs more elastic demand



# Incentive Compatible?

Less elastic demand vs more elastic demand



## Summary of Logical Steps

How to find  $\pi$  maximizing price with market power

1. Find MR
2. Find  $Q^*$  where  $MR = MC$
3. Find  $P^*$  from demand curve

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Is it incentive compatible?

- For each group, find CS under proposed plan
- For each group, find CS if they choose non-targeted plan

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How to find  $\pi$  maximizing price with market power

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Is it incentive compatible?

- For each group, find CS under proposed plan
- For each group, find CS if they choose non-targeted plan
- Find which CS is larger
  - if  $CS_{targeted} > CS_{non-targeted} \Rightarrow$  incentive compatible
  - if  $CS_{targeted} < CS_{non-targeted} \not\Rightarrow$  incentive compatible



## In-Class Problem: Implementing Pricing Strategy, 1 of 2

Suppose you have a convenience store that sells soft drinks and has market power. You have two types of consumers: high demanders, with  $P_H = 0.35 - \frac{1}{100}Q_H$  and low demanders with  $P_L = 0.25 - \frac{1}{100}Q_L$ , where  $Q$  is in ounces. There are no fixed costs and marginal cost is \$0.05 per ounce of soda.

1. If you can determine which type is which, what price will you charge each type?
  - 1.1 find  $\pi$  maximizing  $Q$
  - 1.2 find  $P$
2. What pricing strategy is this?
3. How much profit do you make for each consumer type?

Many thanks to **Oregon State** for this problem.

## Answer: When You Can Segment

Low demanders: find  $MR$ , set  $= MC$

$$MR = \frac{1}{4} - \frac{1}{50}Q$$

$$MR = MC$$

$$\frac{5}{100} = \frac{1}{4} - \frac{1}{50}Q$$

$$Q = 10$$

Then find price, in demand curve

$$P = \frac{1}{4} - \frac{1}{100}Q$$

$$= \frac{1}{4} - \frac{1}{100}10$$

$$= \frac{15}{100}$$

$$= \$0.15$$

## Answer: When You Can Segment

Low demanders: find  $MR$ , set =  $MC$

$$\begin{aligned} MR &= \frac{1}{4} - \frac{1}{50}Q \\ MR &= MC \\ \frac{5}{100} &= \frac{1}{4} - \frac{1}{50}Q \\ Q &= 10 \end{aligned}$$

Then find price, in demand curve

$$\begin{aligned} P &= \frac{1}{4} - \frac{1}{100}Q \\ &= \frac{1}{4} - \frac{1}{100}10 \\ &= \frac{15}{100} \\ &= \$0.15 \end{aligned}$$

High demanders: find  $MR$ , set =  $MC$

$$\begin{aligned} MR &= \frac{35}{100} - \frac{1}{50}Q \\ MR &= MC \\ \frac{5}{100} &= \frac{35}{100} - \frac{2}{100}Q \\ Q &= 15 \end{aligned}$$

Then find price, in demand curve

$$\begin{aligned} P &= \frac{35}{100} - \frac{1}{100}Q \\ &= \frac{35}{100} - \frac{1}{100}(15) \\ &= \frac{20}{100} \\ &= \$0.20 \end{aligned}$$

## Answer: Profit per Customer

Low demanders,  $P = 0.15$ ,  $Q = 10$

$$\begin{aligned}\pi &= PQ - (MC)Q \\ &= (0.15)(10) - 10(0.05) \\ &= 1\end{aligned}$$

## Answer: Profit per Customer

Low demanders,  $P = 0.15$ ,  $Q = 10$

$$\begin{aligned}\pi &= PQ - (MC)Q \\ &= (0.15)(10) - 10(0.05) \\ &= 1\end{aligned}$$

High demanders,  $P = 0.20$ ,  $Q = 15$

$$\begin{aligned}\pi &= PQ - (MC)Q \\ &= (0.20)(15) - (0.05)(15) \\ &= 3 - 0.75 \\ &= 2.75\end{aligned}$$

## In-Class Problem: Implementing Pricing Strategy, 2 of 2

Suppose you have a convenience store that sells soft drinks and has market power. You have two types of consumers: high demanders, with  $P_H = 0.35 - \frac{1}{100} Q_H$  and low demanders with  $P_L = 0.25 = \frac{1}{100} Q_L$ , where  $Q$  is in ounces. There are no fixed costs and marginal cost is \$0.05 per ounce of soda.

**Now suppose you can't tell which type is which!**

1. Suppose you charge the high price to everyone. How many ounces do you sell per customer?
2. What quantity discount can you offer to segment the market?
3. Draw a picture to show whether the firm could gain surplus, relative to the high price, by offering a quantity discount.

Many thanks to [Oregon State](#) for this problem.

## In-class Problem Answers

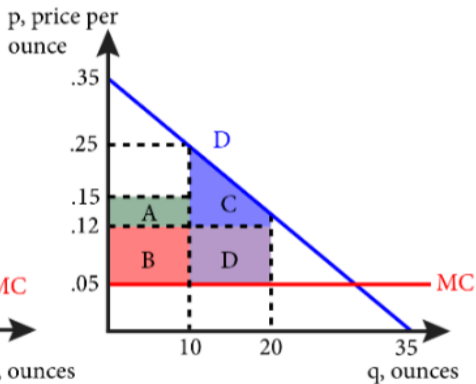
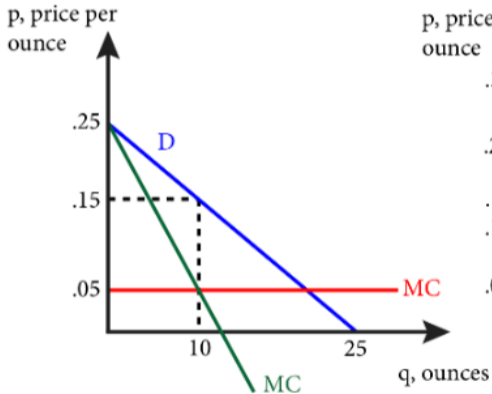
1. Suppose you charge the high price to everyone. How many ounces do you sell per customer?
  - High guys same as before
  - Low guys: plug into demand curve

$$\begin{aligned}P_L &= \frac{25}{100} - \frac{1}{100}Q \\ \frac{20}{100} &= \frac{25}{100} - \frac{1}{100}Q \\ Q &= 5\end{aligned}$$

Does that make sense?

2. What quantity discount can you offer to segment the market?
  - For  $Q > 10$ , we need to charge a little less than \$0.15 if you buy 20 ounces
3. Draw a picture to show whether the firm could gain surplus, relative to the high price, by offering a quantity discount. next page!

## Picture for Surplus





# Versioning

versioning ≡

“pricing strategy in which the firm offers different product options designed to attract different types of consumers”

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Examples?

# Versioning

versioning ≡

“pricing strategy in which the firm offers different product options designed to attract different types of consumers”

Examples?

- different airline restrictions – but not classes, which is a different product
- new editions of existing software

Implications?

- firm makes more profit by dividing the market

# Bundling

## Requirements for Price Discrimination via Bundling

1. Firm has market power and can prevent resale
2. A firm sells a secondary product and consumers' demand for that product is negatively correlated with their demand for the first product

# What is Bundling?

- Selling more than one product together for a single price
- What do you buy in bundles?

## Bundling When Demand is Positively Correlated

	ESPN	truTV	bundle
Madison	\$9.00	\$1.00	\$10.00
Dakota	\$10.00	\$1.50	\$11.50

## Bundling When Demand is Positively Correlated

Does the cable company increase surplus by bundling?

- Assume  $MC = 0$
- Max  $\pi$  without bundling?

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  - find highest price for bundle
  - add up total profit  $2(\$10.00)$

## Bundling When Demand is Negatively Correlated

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 $2(\$9.00) + 2(\$1.00) = \$20$
- Max  $\pi$  with bundling?
  - find highest price for bundle
  - add up total profit  $2(\$10.50) = \$21$

## Mixed Bundling

Call our previous strategy “pure bundling”. What is mixed bundling?

- Sell products as a bundle
- And sell them individually

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Call our previous strategy “pure bundling”. What is mixed bundling?

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When is this a good idea?

- “when the marginal cost of producing some of the components is high relative to consumers’ willingness to pay”

# Ticketmaster Strategies for Taylor Swift Tickets

Taylor Swift's first tour in four years went on sale last year

- Verified fan program
  - weeks before sale date, give name, email and phone
  - verify buyers' identity through media
  - get codes for fan-only presale
  - purchase tix \$40 to \$449
- Additional VIP packages: \$199 to \$899
- Purchase signed CD or exclusive vinyl from TS website  $\implies$  better position in concert line
- Preferential access to those with a Capital One card
- Dynamic pricing: "The performer negotiates, through a representative, how many seats will be priced dynamically and what Ticketmaster will charge for them."

Thanks to [WSJ](#), Nov. 15, 2022, and *The New Republic* on [dynamic pricing](#).

# What are these strategies?

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- Segmenting

## What are these strategies?

- Segmenting
  - pre-sale sorts those with inelastic demand from elastic demand
- Trying to approach perfect price discrimination
  - dynamic pricing

## On Variation in Gas Prices in LA

Reporter speaks to customers at a very expensive gas station. They say

- “Because I’m on the clock and using a company card and I’m delivering to a client, I’m just using whatever’s closest,” he said, “but if I was using my own personal card, Costco’s the only way to go.”



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  - mixed bundling
  - note: probably negative economic profits when we include land value

## Recap of Today

- Pricing strategy basics
- Perfect price discrimination
- Segmenting
- Indirect price discrimination
- Bundling
- Ex. 1: Taylor Swift and Ticketmaster debacle
- Ex. 2: Gas stations in Los Angeles

## Next Class

- No class next week
- Public goods and externalities
- Part of Chapter 17
- Part of reading packet
- Public good podcasts