



Pricing Strategies for Hybrid Bundles: Analytical Model and Insights

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Abstract

Retailers are increasingly offering hybrid bundles—products that combine both good(s) and service(s). Some hybrid bundles, such as Lowe's flooring that combines flooring material (good) and flooring installation (service) are sold in traditional stores, while others, such as Best Buy's bundle that includes a computer (good) and tech support (service) are also offered online. The pricing strategy of a hybrid bundle is critical to its success. While pricing strategies for a goods bundle have been well-studied, those for a services bundle have been underexplored. Hybrid bundles, which fundamentally differ from bundles of goods or bundles of services, primarily with regard to quality variability and scalability, have received even less attention. Drawing from the pricing and bundling literatures for both goods and services, we develop an analytic model of optimal pricing for hybrid bundles by a monopolist retailer. We derive and illustrate many useful propositions, several of which are counter-intuitive. Our results show that an increase in quality variability of the service is associated with a higher optimal hybrid bundle price and a lower optimal price of the good, but a lower overall bundle profit. Our findings also reveal that the optimal price of the service (good) in a hybrid bundle is higher (lower) when the good has diminishing unit cost and the service has constant unit cost (i.e., the good is more scalable than the service). Our results also show that higher unit costs incurred to achieve lower service quality variability can result in higher (lower) profits when the cost increase is low (high). We discuss important implications of these insights for researchers and practitioners.

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Introduction

Retailers are increasingly developing and marketing hybrid bundles—products that combine both good(s) and service(s). Hybrid bundles are prevalent in both traditional and online retail environments. For instance, in the traditional space, Lowe's flooring sells as a hybrid offering both the flooring material, such as carpet, and the flooring installation. Similarly, in the online space, Best Buy sells computers and tech support together in a single offering.

We formally define a hybrid bundle as a single retailer's offering that combines one or more goods with one or more services, creating greater customer benefit than if the good(s) and service(s) were available separately.¹ This definition is adapted from a definition of a hybrid innovation, which is essentially a

hybrid bundle that is new to the firm introducing that bundle (Shankar, Berry, and Dotzel 2009). Our hybrid bundle definition contains two key criteria. First, the same retailer must sell both the good and the service. This criterion ensures that the retailer receives revenues from both the good and the service. This criterion also eliminates simple complementary goods or services that are sold by different parties. Second, when a customer uses the good and service together, the benefit he/she receives is greater than the benefit he/she receives from using the good and service separately.

Hybrid bundles differ from bundles of goods or bundles of services in at least three important ways. First, unlike goods, most services offered by retailers are people-intensive; thus, quality variability, that is, differences in expected quality among consumers, is typically greater for services than it is for goods. Second, because most services' delivery involves people, services' scalability—the ability to sell high volumes at low unit cost—is lower than the scalability of goods. Thus, within a hybrid bundle, the levels of quality variability and scalability are mixed, whereas within a bundle of pure goods and a bundle of pure services, the levels of quality variability and scalability are

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¹ For expositional ease, we use the terms, customer and consumer, interchangeably throughout the paper.

similar. These differences have important pricing implications for hybrid bundles. Third, hybrid bundles differ from traditional bundles in the way the prices are presented to the consumer. For hybrid bundles, prices are often provided with separate prices for the good and the service. For example, in a hybrid bundle from Lowe's, the price of the good (flooring) is presented as a price per square foot, while the price of the service (installation) is listed separately as either a price per square foot or as a flat price. In contrast, traditional bundles often give a single price for the bundle. For example, the price of Microsoft Office, a traditional bundle, containing word processing, spreadsheet and database management software components is presented as a single bundle price, without a breakout of the prices of the components. Therefore, determination of the optimal prices of the components is more relevant for hybrid bundles than for traditional bundles.

The pricing of a hybrid bundle is critical to its success. Consider once again Lowe's hybrid bundle that includes the flooring material (the good) and the installation (the service). Over the years, Lowe's has used many different prices for the service component in its quest to be successful, from a unit square foot price to a per room price to a whole house price. The frequent price changes beg the question: Is Lowe's optimally pricing its hybrid bundles? Many hybrid bundles are initially offered in a monopoly setting. Furthermore, many hybrid bundles such as home improvement bundles are offered by marketers, who behave like monopolists in their local geographical markets. Therefore, it is important to determine the optimal pricing strategies for hybrid bundles in a monopoly.²

Despite the importance of hybrid bundle pricing, little is known about it. The bundling literature in marketing has primarily examined bundles of goods, but some research considers factors relevant to quality variability (a critical dimension in a hybrid bundle) and complementarity (e.g., Balachander, Ghosh, and Stock 2010; Basu and Vitharana 2009; Ghosh and Balachander 2007; Kopalle, Krishna, and Assunção 1999; Venkatesh and Kamakura 2003). The bundling-related literature in operations management (e.g., Bala and Carr 2009; Bitran and Ferrer 2007; Rabinovich, Maltz, and Sinha 2008) has also not examined hybrid bundles but addressed component cost, which is germane to scalability (another key dimension in a hybrid bundle). However, prior research has not explicitly addressed the pricing of a combination of goods and services. Importantly, the effects of differential quality variability and scalability across goods and services on optimal hybrid bundle pricing have not been explored. These effects have important implications for pricing the good, the service and the hybrid bundle.

To address these gaps in research, we examine three main research questions. First, how does greater quality variability of a service relative to that of a good affect the monopolist's optimal pricing strategies for hybrid bundles? Second, how does lower

scalability of the service relative to that of the good influence the monopolist's hybrid bundle pricing strategies? Third, how do potential cost increases due to a reduction in quality variability impact the monopolist's pricing strategies for hybrid bundles?

Our research extends the literatures on bundling and pricing in three important ways. First, extant research focuses on either the bundling of goods or the bundling of services, but not on the bundling of a good and a service together. Our research offers important insights into the optimal pricing of hybrid bundles. Second, our research is the first to provide insights into the effects of the distinctive characteristics of services (namely, greater quality variability and lower scalability relative to goods) on optimal bundle pricing. Third, it is the first to analyze the combined effects of quality variability and scalability in conjunction with autonomy of the good and the service on the joint pricing decisions of these components in the hybrid bundle.

Conceptual Development and Relevant Literature

The inherent differences between the service and good components drive a hybrid bundle's pricing (Shankar, Berry, and Dotzel 2009). The first main difference, quality variability, is from the demand perspective. Variability in the quality of a service may differ from that for a good. Many services are people-intensive and involve human actors in the production of the service. The performance of these actors may exhibit greater variability in outcome than goods (Berry 1980; Murray and Schlacter 1990). In contrast, for most goods, customer expectations of variance in quality should be considerably smaller. Consider again a representative hybrid bundle—flooring (the good) and installation (the service) from home improvement stores. In this bundle, the quality variability is likely greater for the service than the good because of the people-intensive nature of the installation process. In addition, consumers' expectations of quality will also likely vary more for the service than the good because prior to purchase, consumers are generally unfamiliar and uncertain about the skills and attitudes of the people who would install the flooring. In contrast, consumers can touch and feel the actual quality of the flooring, the good. Consumers' expectations of quality will be inevitably related to their willingness to pay (Bolton, Grewal, and Levy 2007). Thus, greater variability in consumers' expectations of service quality translates to greater variability in consumers' reservation prices for those services. Fig. 1a represents this scenario graphically.

The second major difference is from the supply perspective, and it is scalability or economies of scale.³ Economies of scale exist when unit production costs decrease as the number of units produced increases (Tirole 1988). Most people-intensive services have lower scalability than goods (Johnson and Selnes 2004). This situation results in very different cost structures for goods and services as shown by the graph of total variable costs in Fig. 1b. Unlike a good, for a service in a hybrid bundle, scalability may be hard to achieve because cost savings from serving an additional customer may be very small. For a home

² Although hybrid bundles are offered in monopoly and competitive contexts, because little is known about the hybrid bundle pricing, a natural place to start is a monopoly setting. We do not have any reason a priori to believe our findings will substantively differ in a competitive setting.

³ We use the terms scalability and economies of scale interchangeably.

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