Fixed to Flexible

Four Simple Lessons about Cost, Price, Margin and The Options Available to The 21st Century Business.

by Todd Sattersten

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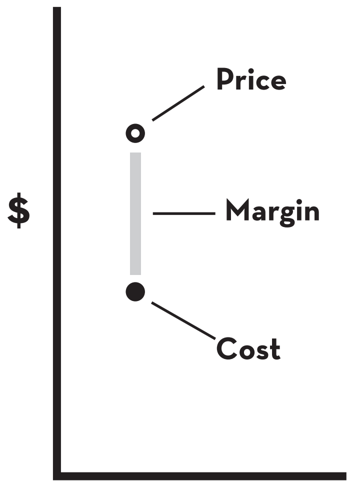
Introduction

Fifty years ago, most of your choices were fixed. There was one grocery store in town with two brands of flour. Your television had a dial with ample room on its face for the one of three networks you'd be watching that night. Go back a little further and you can find names like Rockefeller and Carnegie who amassed fortunes by controlling oil and steel options.

Now the baking aisle stocks dozens of types of flour from all-purpose to self-rising to the oxymoronic white-wheat. Your television now needs a second or even third electronic box to manage the hundreds of networks and to record what you can't watch in person. And the lessons of steelmakers were picked up by software developers, but the story seems to be ending differently.

Fixed has been replaced with flexible. Control of a product category, distribution channel or branding message no longer exists. While this is being heralded as a boon for customers, companies have been slower to adapt to the new terrain. Companies with multi-national presence and individuals with multitudes of projects both need to create a new set of strategies.

This ebook collects the commercial aspects of cost, price, and margin and presents a variety of alternatives about how to make your way in the world of infinite of choice.



The Players

This ebook is about two points and the distance between them.

Price is the amount you can charge for the product or service you provide. Nothing difficult there.

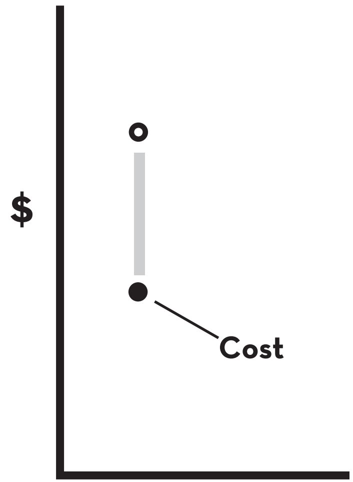
Cost is the debt you incur for providing that product or service to your customer. To complicate things a little, we are going to define cost as a combination of the variable costs (e.g. materials) and the proper allocation of fixed costs (e.g. rent). This forces us to straddle the fence between economics and accounting and bend the rules of both.

The space between price and cost is margin. Accountants like to use the word profit. Stock market analysts talk about earnings. They all mean the same thing: what's left over after all is said and done.

By its nature, margin is a secondary measurement, one that we can know only by first knowing price and cost, but margin is also the most important measure in any business.

PART I
Costs Go Down

Costs Out At All Costs



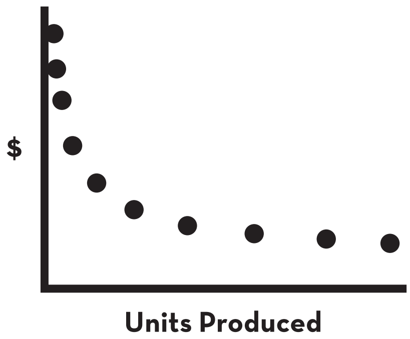
Ryanair CEO Michael O'Leary buys one kind of plane: Boeing 737s. They are the cheapest aircraft to operate on the routes his airline flies throughout Europe.

U.S. carriers imported O'Leary's policy of making passengers pay extra to check baggage. He's betting those additional fees will persuade you to bring carry-on luggage, which means no gate agents needed for check-in. It's cheaper that way.

When he floated the idea of charging customers to use the bathroom during a flight, people reacted strongly. O'Leary would want you to realize that if he can nudge you to use the restroom at the airport, he "[...] could take out maybe two of the three toilets on board, add six extra seats and reduce fares across the aircraft by another three or four percent."

It's not only his planes where O'Leary wants to streamline costs, Ryanair flies in and out of secondary hubs throughout Europe to take advantage of lower landing fees. Decide to fly to Frankfurt and you'll fly into Frankfurt-Hahn Airport, that despite its name is located 120 kilometers west of the city. Once there, you'll be unloaded onto the tarmac, so Ryanair doesn't have to pay the airport gate fees.

O'Leary has reduced, eliminated, and in some cases charged you back, every cost he can.



Costs Are Always Falling

Michael O'Leary understands a fundamental law of business.

The more we do business, the less it costs to do it. More time spent under the car hood means less time spent on diagnosis and repair. More cloth cut means less scrap in the trash. More miles flown, the less it costs to fly.

Experience curves are a well-established phenomenon. During World War II, engineers at Wright-Patterson Air Force Base found for every doubling of aircraft output, the amount of labor required to build an airplane dropped between ten and fifteen percent. These sorts of reductions in costs have been experienced in industries ranging from steel to milk bottles. Bain & Company has researched over 100 products and found that experience curve costs drop between twenty and thirty percent for each doubling of units that are produced.

Moore's Law is certainly the most well-known manifestation of experience curves. Gordon Moore and his colleagues first observed in 1965 the performance of integrated circuits was doubling every eighteen months. This phenomenon has continued for more than forty years and has become a rule of thumb for microprocessor speed, memory capacity, and pixels in digital cameras. Measuring the experience curve for storage capacity in hard drives shows costs have dropped forty-seven percent for every doubling of terabytes produced, or a five percent price drop every quarter for the last twenty years.

Falling Cost of Atoms

Contrary to the underlying economic evidence of falling costs, we are programmed to believe everything gets more expensive. Every month, the government reports inflation in the economy and prices are always going up. Paul Ehrlich made the same mistake.

Ehrlich wrote the 1968 book, *The Population Bomb*, which argued that the world was headed towards mass starvation due to overpopulation and insufficient resources. Instead, the opposite occurred.

"The cost of feeding ourselves has dropped from one-third of the average U.S. household income in 1955 to less than 15 percent today," says Chris Anderson in *Free*. The use of fertilizer, pesticides, and herbicides has increased agricultural capacity nearly a hundredfold, the experience curve at work on the global food supply.

Ehrlich stood by his thesis and even made a famous bet with economist Julian Simon. Ehrlich claimed the cost of certain raw materials would soar in the 1980's, while Simon believed their costs would drop. Copper, nickel, chrome, tin, and tungsten served as the basis for a $10,000 wager. Simon won the bet hands down: all the metals fell in price, in some cases by more than 50%. And, Anderson writes, "Simon believed—rightly so—that human ingenuity and the learning curve of science and technology [read: experience curve] would tend to create new resources faster than we used them."

Atoms Got Cheaper…

	1980	1990	Change
Chromium	1,260	1,110	-12%
Copper	4,419	3,383	-23%
Nickel	12,300	11,100	-10%
Tin	36,900	10,600	-71%
Tungsten	18,500	8,480	-54%

Source: USGS

Falling Costs of Bits

If You Had Ten Dollars, You Could...

Send One Book of Atoms Anywhere in the U.S.

OR

100,000 Books of Bits Anywhere in The World

Netflix made a subtle change to their website in December of 2009. The "Watch Instantly" option was moved to the first position on its row of website navigation tabs. The DVD rental company has always been about convenience, but this change from sending discs in the mail to streaming video over the Internet is no small deal.

Netflix ships 2.2 million DVDs every day and the round trip ticket for each of those discs costs 84 cents. Netflix will spend close to $600 million this year in getting discs to their customers. That gives the movie rental company a pretty big incentive to pursue alternatives delivery methods.

The cost to stream the same gigabyte of Hollywood magic over the Internet:

5 CENTS.

If Netflix can convert 10% of their volume from postal to digital, $60 million falls to the bottom line.

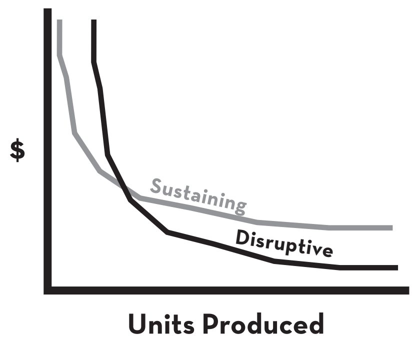
Case Study: Evernote

Phil Libin runs a company called Evernote, a service that stores and organizes information. Take a picture of the microbrew you are drinking and email it to Evernote for storage. Scan your utility bills and store them on Evernote's servers versus your shoebox. Everything you upload is searchable, even the text in the images.

Libin recently shared that it costs only 9 cents a month to provide this service of digital memory to each customer.

Bits are cheap.

Disruption



My son is in first grade and he is learning the basic elements of addition. Every week his teacher tests his progress—40 problems in 60 seconds. We have been doing problem sets at home. There are quite a few steps in answering 1+6. Reading the numbers. Recalling or calculating the sum. Recording the answer. Knowing the answer isn't much problem; it's writing the numbers. We have been practicing 4's and 8's over and over and his scores are getting better.

Experience curves slope downward for the same reason. We figure out how to get better at the individual pieces and arrange those pieces in the order that makes the most sense. The curve levels out as we squeeze out every last bit of productivity.

Occasionally something comes along that renders the original process irrelevant. For example, the calculator is a disruptive technology when compared to human computation. Airplanes are disruptive to every other choice of transport when traveling more than 300 miles. And steelmaker Nucor disrupted the steel industry. Rather than building a huge integrated plant that consumed iron ore, Nucor built electric arc furnaces that melted recycled steel.

In the beginning, the quality of the steel was poor and could only be used in particular situations, but the cost to produce steel was lower and they quickly dominated those markets. In time, Nucor proceeded down the experience curve with electric arc technology, improving quality at the still lower costs, adding high-margin sheet steel products. Electric arc furnaces now produce 50% of the steel produced.

The lesson: Watch out for the cheaper way.

Unit of One

In 2005, I decided to self-publish a book. The book titled *More Space* was a collection of essays written by bloggers. A debate was raging at the time about whether bloggers deserved the same recognition as mainstream media journalists and the publication of this physical book was going to be my way of demonstrating the unseen equality.

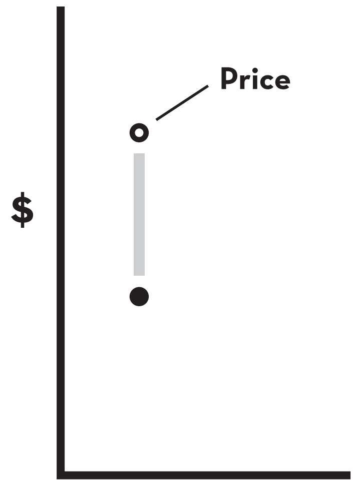
The first copy of my bound manifesto cost $10,000; the next two thousand copies were essentially free. It's the same with most commercial production—expensive set-ups followed by low cost, high volume output.

Five years later, I could publish the same book for $30.

Print on demand companies like Lulu and Blurb have eliminated the need for capital to launch a book project. Magcloud has done the same thing for magazines, charging 20 cent per page. A start-up in the United Kingdom called Newspaper Club is about to start offering 12 page tabloids in quantities as low as 5 copies for $50.

"Unit of One" technologies are just as important as incremental drops in costs gotten from experience curves. On demand process creates more opportunities for experimentation, both artistically and commercially, because the customer decides how many to make and the unit cost *is* the project cost.

PART II
Price Is A Signal



The Reason for Everything

Three headlines from The Wall Street Journal on January 4th, 2010:

- "Late Surge in Car Sales Raises Hopes for 2010"
- "'Avatar' Tops $1 Billion Globally"
- "When Did Buying Tickets Get So Complicated?"

They all have one thing in common: price is punch line.

Strong December car sales were a result of a rebate General Motors was offering their retail partners. The $7000 incentive successfully encouraged dealerships to purchase discontinued Saturn and Pontiac models and move them into their service fleets.

Avatar reached its revenue milestone so quickly in part from the $2 premium paid by customers watching the film in 3-D, which 75% percent of U.S. theaters carried.

The New York Mets offer an astounding 190 price points for single game tickets with 38 different seat locations and five pricing tiers based on the popularity of the game. Complicated is an understatement.

Price is a signal saying...
Dealers buy these cars.
A movie in 3-D is cooler.
We have the perfect choice we have for you, Mets Fans.

The Power of Price

McKinsey did some analysis in the 90's and found a 1% increase in price translated into an 11% percent increase in profits. Of all the levers available to a manager to pull, price has the greatest effect on the bottom line.

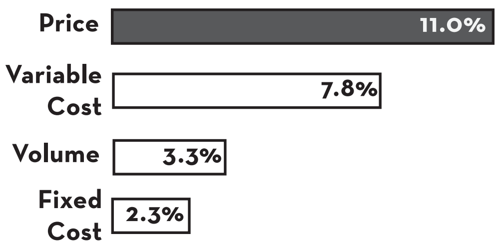
Apple completely understands the power of pricing, as every one of their products sits at the premium end of their respective categories.

Take the iPhone. AT&T is paying somewhere between $500 and $600 for each iPhone they sell. A good comparison is the products from RIM: analysts estimate carriers pay around $400 for each Blackberry sold. Apple is able to maintain a 20% to 30% price premium over the next class competitor.

This translated into big news in November when research firm Strategy Analytics reported that the top handset maker in the world, Nokia, earned an estimated $1.1 billion with 35% global market share, while Apple earned $1.6 billion with 2.5% market share.

Here that is one more time: one point six billion dollars in profit on two point five percent market share.

What 1% does to operating profits…



Two Prices

Remember Phil Libin and Evernote from Part 1?

Evernote charges two prices for their digital information storage service. The first is $0 with constraints around the amount of storage and file types. The second price is $5 a month, and after becoming a paying customer, the limitations are pretty much removed.

Libin's 'freemium' strategy of offering both free and paid versions has allowed his company to amass two million users, a number that has doubled in the last six months.

How many make the jump from free to paid? Right now, 31,000 people pay to use Evernote. The other 1.97 million use it for free.

Anchoring

Take a minute and answer this two-part question:

1. Is the percentage of African nations in the United Nations higher or lower than 65?

2. What is the percentage of African nations in the United Nations?

This was one of the queries that Amos Tversky and Daniel Kahneman posed in their 1974 paper in Science called "Judgment Under Uncertainty: Heuristics and Biases." It turns out that the answer you provide to the second question is heavily swayed by that first question.

The average estimate for question two was above 45 percent. When question one was lowered from 65 percent to 10 percent, the average estimation of question two was dropped to 25 percent.

This effect that Tversky and Kahneman described is known as 'anchoring' and has been confirmed in hundreds of experiments. Real estate agents value homes based on the asking price. Negotiators make more profit on their transactions when they provide the anchor and then make the first offer. And retailers are smart to show the original price alongside the sale price than show the sale price alone.

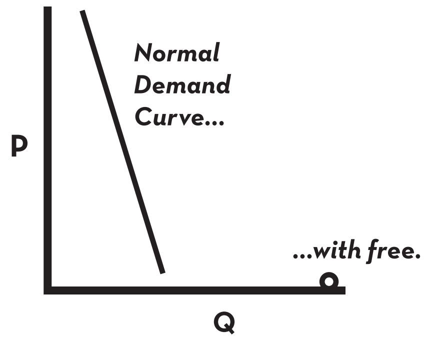
We also remember anchors for a long time. Remember one dollar gasoline? Amazon in many ways has already won the battle with publishers having sold millions of ebooks for $9.99, creating the de facto price point.

Average Estimated Purchase Price for Home in Tuscon

Listing Price	Real Estate Agents
$119,900	$111,454
$129,900	$123,209
$139,900	$124,653
$149,900	$127,318

Source: "Experts, Amateurs, and Real Estate," Northcraft and Neale, 1987

The Reason Free Works



Imagine, as a reward for reading this ebook, I offered a free $15 gift certificate to Amazon.com, or you could buy a $25 Amazon gift certificate for the cost of $7.

Which would you choose?

Behavioral economist Dan Ariely's experiments show that chances are pretty high you would choose the free offer even though purchasing the gift certificate provides a greater benefit ($18 versus the free $15).

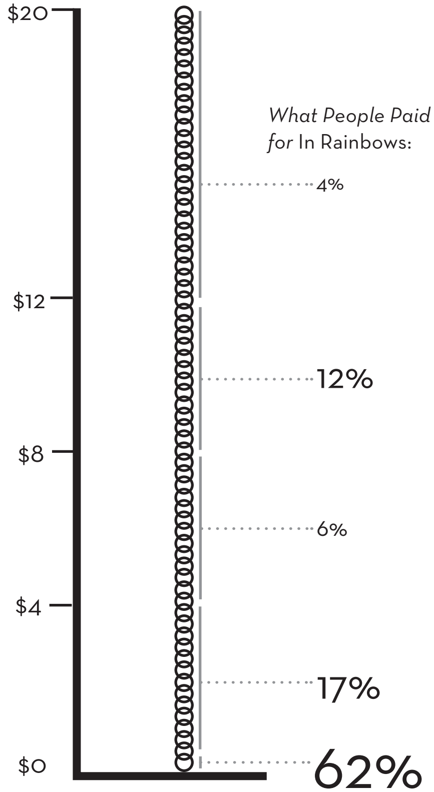
Ariely performed a similar experiment with chocolate, something most people have a hard time turning down. He offered subjects the choice between a 14¢ Lindt truffle and 1¢ Hershey Kiss, subjects choose the truffle at a ratio of three to one, but lower the price of each candy by a penny and the ratio flips with the free Hershey Kiss chosen 75% of the time.

Free removes all the risk: no buyer's remorse.

Ariely refers to this as the certainty effect.

A Pricing Utopia

Pricing Infinitum



Like the hackneyed phrase, you can't please all of the people all of the time, when it comes to price, no matter what you charge, you are going to leave money on the table. Some customers will pass because the cost is too high, while others would have paid more.

In October 1, 2007, Radiohead announced their new album *In Rainbows* was complete and would be released to the public in 10 days. Instead of releasing it with their long-time label EMI, the band released their album on their own website as both digital download and $80 premium discbox that included two CDs, two vinyl records, photos and lyric book.

What made the whole project so remarkable was that Radiohead let their customers choose the price they wanted to pay for the digital download. This offering was a real-world experiment of a logical extreme; Radiohead created a pricing utopia with an infinite number of choices for the customer.

Radiohead has been vague about the actual results. In 2008, they reported 3 million purchases of *In Rainbows* in all of its formats were made via their website. comScore's analysis found a 60/40 split between those who downloaded the album for free and those who paid for it with an average price of around $6.

In Rainbows has become more well-known for the sales method than the music itself.

The Construction of Value

“Whoever you are holding me now in hand,
Without one thing all will be useless,
I give you fair warning before you attempt me further,
I am not what you supposed, but far different.”

-Walt Whitman, Leaves of Grass

How much would you pay for a digital memory?

That is the “product” Evernote is selling. But how do you know the value of something you didn’t know you needed? Because of this conundrum, Evernote is making a smart move offering the paid version alongside the free version of their service. Another of Dan Ariely’s experiments tells us why.

Ariely invited his students to a personal poetry reading of Walt Whitman’s *Leaves of Grass*. The researcher set a ticket price of two dollars and a mere 3% of his students were interested in attending the event.

After the initial dismal response, Ariely made a second offer and told his students he would to do the reading for free. The response rate jumped to 35%. This is not unlike his chocolate experience: free wins out.

But, to a second set of students, Ariely reversed the offer and told students he would pay them $2 to attend the reading. 59% said yes and when Ariely again changed the offer to a free event, only 8% said they were still interested.

Ariely’s oratory skills or the quality of Whitman’s poetry have little to do with this. The trouble for the students was that they had no preconceived notion of the value of hearing their instructor recite verse. The results show how easily any experience can be manipulated from positive to negative.

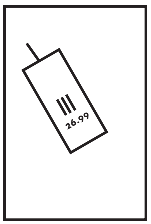
Evernote uses the powerful effects of free to attract prospects and provides the $5 paid plan to create positive value in the eyes of those prospects, an important anchor for how much they should value it.

Nuance of Price

The variety and complexity of methods available to determine pricing are myriad.

Two recent books cover the terrain better than this short ebook.

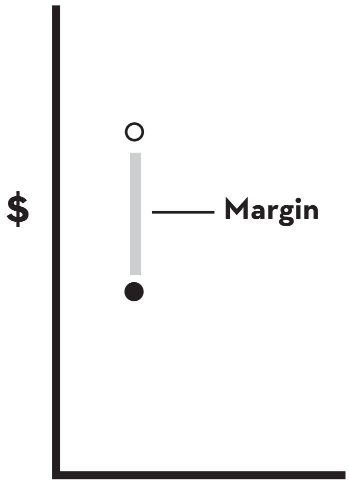
The 1% Windfall: How Successful Companies Use Price to Profit and Grow by Rafi Mohammed (Harper Business, March 2010): If you grabbed a blank sheet of paper and started a list of pricing tactics you could use, how many do you think you'd come up with? Mohammed covers 40 of them in detail and provides a broader framework for how they fit into an overall pricing strategy. This book is a toolbox stocked with the nuts and bolts of pricing.



Priceless: The Myth of Fair Value (and How To Take Advantage of It) by William Poundstone (Hall and Wang, January 2010): Recent books like *Predictably Irrational* and *Nudge* have covered some of this territory, but Poundstone shows a particular skill at telling the history and stories of the characters who created the field of behaviorial economics. Readers will enjoy their journey from psychophysics to prospect theory to menu design. I did and the book heavily influenced this section.

PART III
Margin Is A Choice

The Single Most Important Number



> In my opinion, gross profit [margin] is the single most important number in any new business. It determines everything else about the business—the amount of capital you need, the volume of sales, the overhead you can afford, the time it will take to determine viability itself.

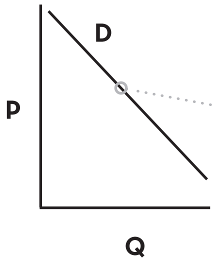
–Norm Brodsky and Bo Burlingham in *The Knack*.

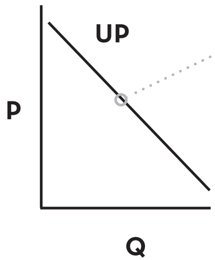
Price and cost are two numbers you have control over. The space in between is the margin. And the margin tells you just how hard your business life is going to be. Bigger margin? Easier life. But how do you get that margin? Either by lowering costs or by raising prices, or both.

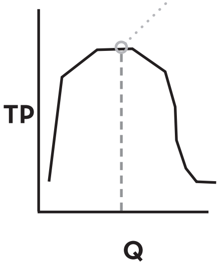
A person's weight is a good analogy. You have complete control over the amount of calories you eat and the amount of calories you burn. Stepping on the scale gives you a single number that tracks how you are doing with your inputs and your outputs.

(In the case of business though, we want fat margins, not skinny ones.)

Margin Maximization







Economists, in keeping with their homo economicus view of the world, believe companies will always charge the price that makes them the most money. Here is their simple 3-step process:

1. Develop demand curve with prices and associated units.
2. Calculate unit profit for all prices: Unit Price – Incremental Cost.
3. Find maximum total profits: max(Total Revenue – Total Cost)

This is a useful exercise, but when is the last time you determined your pricing using a profit maximization model? Isn't it just a lot like guessing?

Bob Pritchett at Logos Bible Software uses this method every day. Or perhaps I should say his customers do.

One part of Bob's business converts out-of-print texts into electronic documents for religious scholars. Rather than guessing at the price or potential demand, his company has created a marketplace where customers can declare what they would pay to have the work made available. The bids are accumulated and when enough bids are placed to cover the cost of production, Bob's people go to work.

The process gives Bob real data from which to create a demand curve and determine what retail price will maximizes profits.

The Constant Game of Roshambo

Marty Neumeier provides a concrete metaphor about business and margins.
He says the marketplace is a big game of Rock, Paper, Scissors.

Startups are the ***scissors***, with their sharp focus cutting away profitable bits and pieces of markets.

A successful pairs of scissors grow into a medium sized ***rock*** with increased size and strength.

The exceptional rock flatten out into a ***paper*** company with an all encompassing brands and scale.

You know how the game goes:
Scissors beat paper.
Rock beats scissors.
Paper beats rock.

And around it goes,
with every turn, a choice.

The Maney Continuum

Technology writer Kevin Maney makes a keen observation: He says successful companies always make a strategic choice between providing convenience and fidelity.

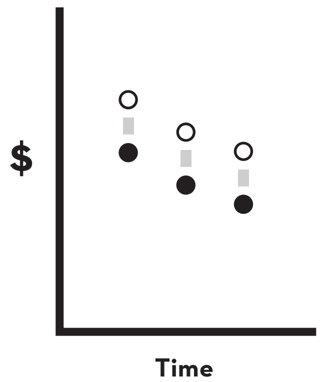
Wal-Mart delivers convenience. The big box retailer makes it easy to buy from them through their "everyday low prices", focused product lines, and near ubiquitous presence.

Harvard University delivers fidelity. The "product" is really an experience. The Ivy League school possesses an aura of exclusivity and prestige. Being a Harvard graduate forms part of the customer's identity.

Maney is clear though. Companies must make a choice. The dual pursuit of convenience and fidelity causes companies to chase a value mirage and over time these companies are sucked into a place of increasing irrelevance where customers understand less and less why they need those products. Marketing expert John Moore believes this is what has happened to Starbucks as the company has moved away from their fidelity based roots but not fully embraced being a provider of convenience.

If this sounds familiar, convenience versus fidelity is just another way of describing transactional versus relationship-driven businesses. A company's choice of a strategic path heavily impacts cost, price, and margin.

Convenience



In competitive markets, companies battle with one another to supply the demand. This battle normally comes to be fought on price and, as a result, price drops (and drops).

Economists will tell you that, in these efficient markets, the price of a given product settles at a point roughly equivalent to the cost of creating the product.

Cost serves as a minimum threshold for how low prices can fall in the long run. If the price drops below the cost, there is no incentive for companies to supply the market.

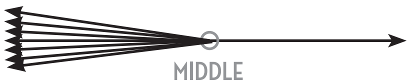
Convenience players such as Amazon are betting on that. They are riding the experience curve in order to lower costs and bring lower prices to the market.

When Amazon entered the book market, they looked at the 50% margin that publishers offer retailers and built a new model based on giving much of that back to the customer. Lower prices and the near infinite shelf space of the web created a powerful competitor that didn't need high rent retail space or expensive inventory waiting for customers. Convenience also sits at the core of the Kindle, with Amazon's relentless pressure to push ebook pricing under $10 and well-described by the product's tagline: "Books in 60 Seconds" .

As CEO Jeff Bezos has said, "There are two kinds of companies—those that work to raise prices and those that work to lower them."

Edgecraft

The Edges



Maney's definition of fidelity is more simply explained in Seth Godin's *Free Prize Inside*. In most of his writing, Godin is more concerned with creating fidelity rather than towing the price or value, and as such, he encourages companies need to get out of the middle and create something worth talking about.

Godin's definition of fidelity is the "free prize":

> "[T]he element that transcends the utility of the original idea and adds a special, unique element worth paying extra for, worth commenting on."

Seth then provides forty pages of examples from what unplugged did for MTV to what putting local leaders in "jail" did for the March of Dimes to what Michael Graves did for teapots.

Godin does not completely rule out the convenience side of Maney's continuum as he talks about free prize. He mentions time, convenience, and doing less as avenues you can pursue to stand out, but because cost is the bottom line, there is less to play with there than in using your ingenuity and creativity to gain the edge.

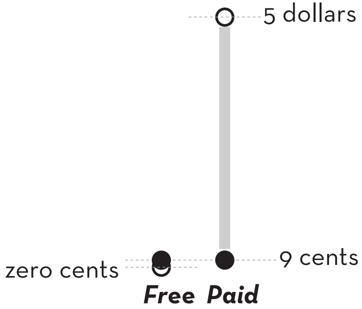
Employ better design.
Treating customer unequally.
Use sensuality.
Add variety.
Have fun!

What's your edge?

Margins in the Digital Realm

Remember, the cost for Evernote to serve a customer is 9¢ per month and there are two million of them right now. 31,000 customers pay a $5 monthly fee for additional features.

This is exactly what Chris Anderson is talking about when he says, “Free is the business model of the 21st century.” A little algebra shows how difficult these new business models are. The equation below shows the revenues on the left and the costs on the right.

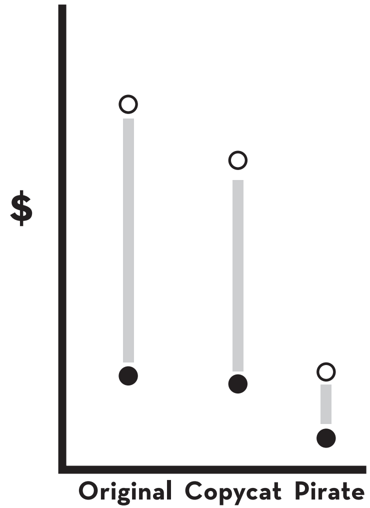


$$(\$5.00)*(1.5\%)*X = \$0.09*X$$

The trouble is that Evernote isn’t making enough money; their costs exceed their revenues by $300,000 per year.

Evernote is not without options. On the revenue side, they could raise their conversion rate above 1.8% or raise their monthly fee to $6 per month for their premium services. More likely, CEO Phil Libin is going to rely on Moore’s Law and watch their costs drop. Evernote only needs a little more than a penny drop to make the math work.

The tale of Evernote creates all sorts of interesting questions. What business in the world of atoms could you serve 2 million people at a cost of less than $1 each? And at the same time, what business do you know that can have 2 million people using them and 98.5% of that 2 million using the service for free?



Copycats and Pirates

Recently *The Guardian* published a photo essay about book piracy in Peru. Within the twelve-picture story, I saw fake versions of *Rich Dad, Poor Dad*, *Emotional Intelligence*, and *Who Moved My Cheese?*, alongside the novels of Dan Brown and Stephanie Meyer.

Discussions about copycats and pirates often end up as dismissals arguing weak creative skills or a lack of morals respectively. But that's not the case: unwanted alternatives enter the market because of the math.

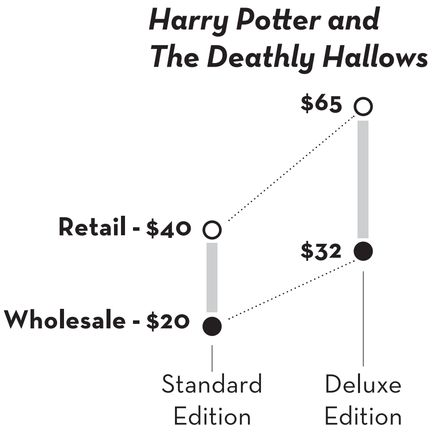
Copycats see attractive margins. When Apple proved there was a market for hand-held computers, Palm, Blackberry, and now Google, began selling replicas in the product segment. In publishing, if one young adult vampire love story works, there must certainly be a market for a dozen more.

Pirates see markets that can't be served by original or even copycat products. Walk down Canal Street in New York City and you'll see the fake Gucci being sold to folks who weren't going to buy the real stuff anyway. Napster took off because there were a bunch of college kids who wanted music they didn't have the means to buy. Licensing rights to publish foreign titles in Peru doesn't work when the cost of a book amounts to 20% of an average worker's weekly wage.

The distance between price and cost creates space for substitutes, legal or not.

PART IV
You Have Options

The Magic of Two Editions

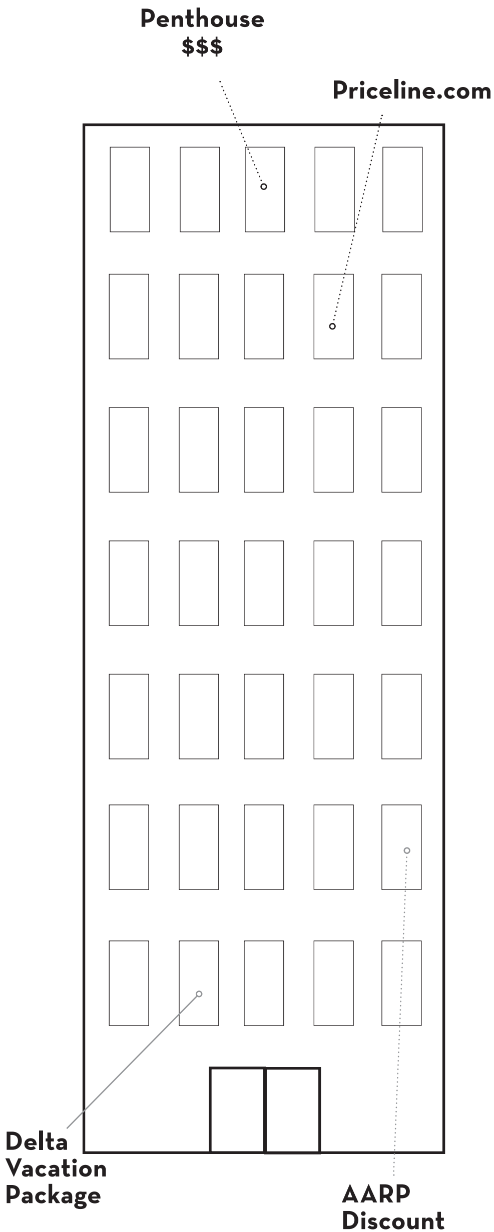


On July 21st, 2007, publishing history was made. The final installment of J.K. Rowling's heptalogy, *Harry Potter and The Deathly Hallows*, went on sale at midnight and in less than 24 hours became the fastest-selling book ever, generating an estimated $170 million in sales. The top movie that weekend, *Evan Almighty*, grossed a mere $31 million.

Everyone knew the last book in the Harry Potter series was going to be huge and to capture some of the additional value in the market, the publishers put out two versions of the book: the standard edition and a deluxe edition. For an additional $25 beyond the standard edition's $40 retail price, the reader got some extras: foil stamped slipcase and color end pages and with never before seen works by series illustrator Mary GrandPre.

When *The Deathly Hallows* became available for pre-order in February 2007, the books jumped to #1 and #2 respectively on Amazon's best-seller list. Nielsen's Bookscan shows the deluxe edition sold over 100,000 copies, while the standard edition has sold over 8,000,000 copies. There is no real comparison, except when we consider margin.

By offering the upscale edition of *The Deathly Hallows*, Scholastic, the U.S. publisher of the Harry Potter series, increased their unit margin by over 50% and generated an additional $1.2 million in sales. They also created an opportunity for their retail partners to participate in those higher margins, as most booksellers sold the standard edition at or below cost because of extreme price competition during the book's release.



Economic Alternatives

Price discrimination is the word economists use to describe charging different people different prices for the identical product or service. The term versioning has become popular in recent years for the similar technique of selling a core product while varying the offered attributes. In both cases, businesses offer a variety of products at a range of prices.

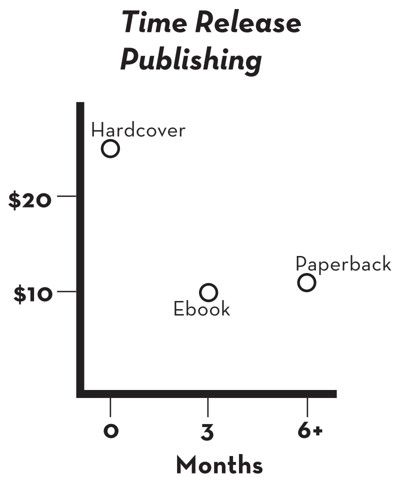
The travel industry is best known for this. On the one side, business travelers pay for the privilege to fly when it best suits their schedule. On the other side, leisure travelers have more flexibility and are often willing to adjust dates and times in exchange for a lower price.

The airlines balance all of these needs while doing what is most important to them: filling the plane. Hotel rooms and cruise ship cabins also suffer from the constraint of time: there is no day old shelf for balconies with a suite.

Researchers James Langenfeld and Wenqing Li found that cruise lines offer 58 different combinations of cabin class, air status and discount status. Rafi Mohammed reports that full service hotels offer as many as 500 possible room rates based on factors like volume discounts to corporate clients, number of rooms still available as arrival dates approach, and opaque travel agencies that offer lower rates without using the hotel's name.

Price discrimination requires some constraints so that buyers don't engage in arbitrage, selling reservations to others and collapsing all prices. Airlines make tickets non-refundable and charge high exchange fees. Cruise lines limit offers to specific geographic markets requiring travelers fly from a given airport.

Travel companies use a variety of methods to create numerous offerings that attract customers and maximize margins. Let's talk about some of the methods.



Urgency Creates Options

Media companies use price discrimination as well, but the underlying economics of their business are different. Publishers spend hundreds of thousands of dollars acquiring, editing, and designing a manuscript. The cost of producing television programs runs in the millions. Acquiring a script, hiring actors, building sets and rendering special effects makes the cost of a full length feature movie run into the tens and now even hundreds of millions of dollars.

But once produced, the cost to copy and distribute is minimal. The unit cost of physical media like a book or DVD runs one to two dollars, and as we saw earlier, the digitization of media has reduced the supply chain costs to a fraction of a penny.

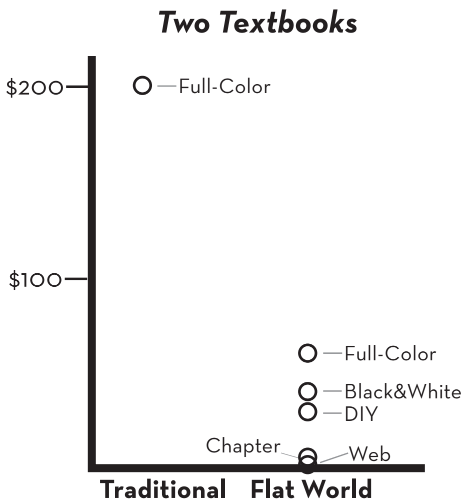
Publishers and studios use a profit maximization strategy based on release windows. In publishing, the expensive hardcover is released first, followed by the more reasonable paperback six months to a year later, and if popular enough, another cheaper mass paperback edition. Customers segment themselves based on how strong they feel the need to read the book, and with each version, publishers reduce the price to induce more customers to buy.

Recently, publishers have been challenged by Amazon's decision to sell ebooks for $9.99. Unable to control their retail partner, a number of publishers have chosen to add another release window, delaying the release of ebooks for anywhere from one to four months after the hardcover publication in an effort to maintain those premium priced sales during the initial release of the book.

Versioning In Publishing

Five years ago, academic publishing editors would create revenue projections on new projects for three years, the expected time a new edition would generate sales. Today, whatever sales are made on a new edition happen in the first year. The used book market has gotten very efficient at finding new homes for old textbooks. Recycling at its best—if you are a student, but not if you are a publisher.

Flat World Knowledge has created a model that could potential change all of that.



The New-York based textbook publisher starts by publishing all of their products using a Creative Commons Share/Remix license. This allows instructors to use the materials as they see fit for their classes.

Students are offered a variety of versions and allowed to choose the one that best fits their needs. To start, all of Flat World's books are available for free to read on their website. For $1.99, students can print out the chapter they are assigned or print out the whole book for a higher price. The print-your-own rights for *Organization Behavior* by Talya Bauer and Berrin Erdogan would set you back $24.95. If the student wanted Flat World to print them a copy, the black and white version would be $29.95 and the full color edition $59.95.

Flat World has created a completely different cost structure using online distribution and print-on-demand technology, and implemented an equally novel pricing scheme offering not one product but a family of products to satisfy a variety of needs students may have. This versioning strategy also reduces the chances of a used market forming with the possibility of frequent revisions from authors and through low price points (including free).

The Fixed Costs

Every online discussion about free and the spread of digital includes a thread asking: how will the creator be paid for time and effort?

Certainly the fixed cost of the creation is the riskiest part of the venture. If you build a house and decide you need to move, there is a market for the dwelling. Intellectual property, in the vast majority of instances, doesn't have much value to another creator.

Publishers (including music labels and Hollywood studios) are the exception in that they search out quality, pay for production, and then profit from capitalizing on the creation when amplifying it through their channels.

Another way to lower the risk of fixed investment is through creating more offerings. Start by offering a free sample, allowing everyone to experience the work. Give early fans a set of low-priced products to entice interaction. In addition to industry-standard products, offer premium ones as well.

When Topspin Media works with a musician, they start with web-based applications that play songs and videos of the artist and can be shared in emails and on blogs. The widget always directs fans to a central site where three offers are made. Normally there is an inexpensive digital download, a higher quality CD, and a premium vinyl edition--and sometimes tickets to live performances are an added item.

The Story

The story of cost is that it always trends down. You can count on it.
The story of price is that it is more flexible than you think.
The story of margin is that it is a stark choice between opposing strategies
The story of options is that you have many more than you realize.

Thanks for reading.

Thanks to...

...Sally Haldorson who made sure I was saying what I really meant.
...Joy Stauber who put up with my million questions as I learned InDesign.
...Ray Bard, Andrea Learned, and Kate Mytty, and Alan Webber who all read early drafts and told me things I needed to hear.

Four Things About Todd Sattersten

- He lives in Waukesha, Wisconsin with his wife Amy and three kids Ethan, Zach, and Alexa.
- He co-wrote a book with Jack Covert called *The 100 Best Business Books of All-Time: What They Say, Why They Matter, and How They Can Help You* (Portfolio, Feb 2009).
- His cool projects list includes stewardship of ChangeThis, launching InBubbleWrap, and self-publishing More Space.
- He is easily found online.
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  You can send a tweet: @toddsattersten
  You can read his blog: www.toddsattersten.com