

Cream skimming – a question of pricing in a competitive marketplace.

This is an informal discussion, no math, just a few ideas.

THE ICE MAN COMETH

Consider in the early 1900's the ice man who delivered blocks of ice to customers who lived in walk-up apartment buildings. Clearly it took him less time and effort to deliver to the customer on the 1st floor than the one on the 5th floor. Presuming that his price reflected both material costs (the ice) and some average delivery time could he perhaps offer a discount to the first floor customer and thus attract more first floor business allowing him to stop servicing the 5th floor customer. (Or similarly a price penalty for the 5th floor customer.) What of competition – would there be a price war?

If he got a “jump” on the competition by offering this discount perhaps he could corral sufficient 1st floor customers to sell his wagonload thus finishing his route more quickly while making the same revenue.

TELEPHONE INSTALLATION

You are the phone company, you charge a flat fee to connect new telephone service to any customer. This fee may be regulated thus changing it is difficult or not desirable.

“New” service most often means (re-)connecting a new tenant or homeowner who has moved into a residence that previously had phone service. It may also mean adding additional service (a second line) at an existing customer’s location or in a worse case it may involve providing connectivity to a new location far from existing connections (say a development of new homes built on what was once a farm.)

Connection may simply require entering data on a computer at the central office. It may require dispatching a technician to inspect and reconnect wires in a home and / or the adjacent telephone pole. It may require running additional wires from the pole or within the home. Or in a worst case it may require building infrastructure – running wires and poles to our distant new housing development.

Does flat fee pricing make sense in this case? (1) Is the phone company recouping its costs? (2) Are some customers subsidizing other customers? (3) Is it simply a matter of convenience to charge a flat fee? or (4) Would the first new home in the development need to pay an exorbitant price for all that infrastructure.

Could a competitor come along and only do “easy” connections at a lower price?

LONG LINES

(To over simplify)

A nationwide provider (NP) of communication lines charges a flat, mileage-based price. (There are regulatory issues involved.) A regional competitor (RC) similarly charges a flat mileage based price. Neither can price discriminate based on other factors. NP bases its price on average costs, which in part reflecting having to provide communication lines in dense urban areas at great(er) expense. RC similarly charges based on its average costs, but RC only does business in more rural areas thus its average cost is lower.

Over time RC undercuts NPs pricing in its region, thus NP loses its share of “cheaper to service” customers and thus its average cost keeps climbing. As this continues, more and more RCs crop up, eventually leaving NP with only the “worst” areas and the highest costs. This is an example of what I call “cream skimming”, going after the low hanging fruit.

HOSPITAL AND CLINICS

Hospitals for the most part must see all patients regardless of cost or ability to pay. Some hospitals try to attract more “profitable” customers and discourage less profitable ones. For example, some hospitals have closed their emergency rooms because they were bleeding money. But in most cases, hospitals have to run a 24 x 7 x 365 operation with expensive staff and equipment.

Assumption: Same day procedures involving well insured patients are profitable. For example, someone coming in for a colonoscopy or bringing their child in for a Myringotomy (“ear tubes” due to repeated infections) is a financially attractive patient / customer.

Doctors realize this and thus they band together and build a small, specialized clinic that only does scheduled colonoscopies or “ear tubes” or whatever. They thus “skim the cream” from the hospital enriching themselves and contributing to the hospital’s downward spiral into greater and greater debt.

BARBERSHOP

Should the barber charge more or less to cut the hair of a balding customer? I believe that as time goes by and hair goes away I deserve an ever-increasing discount. This is meant to be funny 😊

Business Implications: Are you the NP or the RC? Are you the hospital or the clinic? Are you the customer who’s subsidizing or being subsidized?

Social Implications: Specific to the hospital / clinic situation – this is a bag of worms. What is the societal cost of hospitals losing money? My community had three hospitals when I first moved in ten years ago. It’s down to one, and that one’s losing money.