When talk is free: The effects of pricing plans on consumer demand

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From banks to telecom providers, various industries are moving to pricing plans that offer a certain amount of "free" service. Bank customers are allowed a certain number of free ATM withdrawals each month, and cell phone users receive free minutes. These three-part plans—which also include a regular (usually monthly) access fee as well as a usage fee if the customer exceeds the free allotment—are replacing older two-part plans that charged an access fee and a usage price for every unit of consumption.

Recent studies show that consumers tend to respond to free products or services differently from how they respond to the same goods when they are charged for them. In fact, when evaluating free products or services, consumers do not simply subtract costs from benefits, but instead perceive the benefits associated with free products as being higher than they would otherwise. This leads to increased demand, which has important implications for businesses. For example, when AOL replaced its pay-per-use plan for dial-up Internet access with flat-rate plans, demand soared beyond the company's expectations.

A new study, forthcoming in the Journal of Marketing Research, takes a more detailed look at how demand changes when consumers switch from a two-part to a three-part pricing plan. Building on evidence that shows that the free component of a plan triggers a positive emotional response, the research shows that when consumers switch to a three-part plan—i.e., a plan with free allotment—demand increases beyond what would be predicted based on the change in budget constraints alone—even for usage beyond the allotment.

The study, by Eva Ascarza, assistant professor of marketing at Columbia Business School, and Anja Lambrecht and Naufel Vilcassim of London Business School, drew on data from more than 5,800 customers of a mobile phone service provider based in South Asia. The provider introduced a three-part plan in addition to its existing two-part plans, allowing researchers to observe the same set of customers under two different pricing regimes—first, when only two-part plans were available; and later, when consumers were able to switch to three-part plans.

After switching to three-part plans, more than 80 percent of consumers used more than expected based on their previous usage, the researchers found. This effect increased the mobile phone company's revenue from these customers by 19.7 percent. If the company reduced the fee charged for switching between plans, it could see an even greater increase in total revenue, the study showed.

These findings have significant implications for businesses, the researchers explain. Firms may significantly underestimate the revenue effect from introducing three-part plans if they do not account for the effect on customer preferences. In addition, when changing pricing plan structures, firms may need to adjust their service capacity.

Furthermore, the study shows that the structure of pricing plans not only increases their monetary value for customers, but also affects the perceived characteristics of the service.

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