

PRICE DISCRIMINATION IN A LIFETIME VALUE FRAMEWORK:
WHEN IS CUSTOMER LIFETIME VALUE MAXIMIZATION AN
OPTIMAL STRATEGY?

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Abstract

Both game theory and relationship-marketing literature suggest that firms should set different prices for their existing versus their new customers. In addition, these prices can be set to maximize short-term profits or customer lifetime value (CLV). We develop a two-period analytical model of behavior-based price discrimination in which consumers are heterogeneous in their switching costs and in which long-life customers could be more (less) valuable than first-time customers. The results show that firms face two opposing forces when setting equilibrium prices. On the one hand, loyal customers have higher switching costs; therefore firms are motivated to charge them a higher price than to first-time customers. On the other hand, when loyal customers are more profitable than first-time customers, they are more costly to lose due to overcharging. We also find that depending on the specification of the profits derived from long-life customers, a short-term profit maximization strategy could be more desirable for both firms than a CLV maximization strategy.