UNIT – III

Lesson 3.1 - Pricing Decisions

Objectives

In this lesson, we will introduce you to the 2nd P of marketing – Price. While the other 3 Ps represent costs, this element in the marketing mix produces revenue. After you work out this lesson, you should be able to:

- Appreciate the importance of pricing decision
- Identify the considerations that come to bear on pricing decisions
- Understand why customers may be price sensitive

Learning Objectives

In this lesson, we will discuss the following

- Product costs
- Customer value
- Elements in the pricing decision

Introduction

A price is an expression of value. The value rests in the usefulness and quality of the product itself, in the image that is conveyed through advertising and promotion, in the availability of the product through wholesale and retail distribution systems, and in the service that goes with it. A price is the seller's estimate of what all of this is worth to potential buyers, recognizing the other options buyers will have for filling the need the product is intended to satisfy.

To the extent that the product or service finds markets and is profitable at given price levels, it provides a viable economic base for building and maintaining a business.

In the competitive marketplace, pricing is a game. The struggle for market share focuses critically on price. Pricing strategies of competing firms, therefore, are highly interdependent. The price one competitor sets is a function not only of what the market will pay but also of what other firms charge. Prices set by individual firms respond to those of competitors; they also are intended often to influence competitors' pricing behaviour. All of marketing comes to focus in the pricing decision.

A way to think about making a pricing decision is that price should be set somewhere between what the product costs to make and sell and its value to the customer. If price exceeds the perceived value of the product to potential purchasers, it has no market. If the price is below what the product costs to produce, the business cannot survive for very long. Where a price should be set between cost and customer value is a strategic decision.

Many factors can influence this decision, viz., competitors' product/ price strategies, governmentally imposed constraints and the seller's and the buyer's sense of what is fair. Finally the most important determinant of price is the marketer's objectives – what is the firm trying to do. The discussion on pricing objectives is taken up in the next lesson.

Product costs

Costs may be classified as variable, fixed and semi-fixed. Take the case of an airline. It may consider the annual depreciation on an aircraft as a fixed cost. Taking the plane off the ground to fly from one city to another incurs certain semi-fixed costs like the fuel, the compensation of flight personnel, the airport fees and so on. These costs are approximately the same for any given flight whether the plane is empty, half-loaded or completely full of passengers. The variable costs of the flight would include primarily the costs of food and beverage. They vary directly with the number of passengers.

If fixed and semi-fixed costs make up a larger portion of total costs, as in the airline example, pricing to get maximum capacity utilization is crucial. Until the seller covers fixed costs, money is lost. After fixed costs are covered, each incremental sale contributes proportionally large amounts to profits.

If variable costs are a relatively high percentage of total costs (which is quite likely in many manufacturing firms), pricing to maximize unit contribution (i.e. the difference between the unit variable cost and price) will be critical to profitability. Under these cost conditions, the manufacturer would naturally work to maximize unit prices and to reduce variable costs.

Above are two examples. In the first one, the objective of the airline's pricing strategy will be to generate enough total revenue to cover its fixed costs and above that to get maximum capacity utilization to make profits. In the second one, a manufacturer will price to cover its high variable costs per unit and get enough contribution to amortize fixed costs and make a profit.

Under certain conditions, firms may elect to price at less than full cost. In conditions of capacity underutilization, for instance, firms with high fixed costs may take business at prices that cover variable costs and make some incremental contribution to fixed costs (or overheads). The idea is to get through bad times, keep the factory running and hold some critical team of managers, skilled technicians and labour.

Pricing temporarily at less than full cost may also be used as a strategy to get a particularly large order. The expectation is that by taking the business, the firm may be able to reduce its unit costs and/or later raise its prices so as to make a profit on subsequent orders. Taking business below cost with the hope of offsetting near-term losses with longer-term profits may be a risky tactic, since there is no assurance that the losses can be made up.

Pricing near or below cost may also be done to gain a large market share. Generally pricing low to preempt market share is predicted on the assumption that unit costs will come down significantly as volume increases. This may happen through gaining manufacturing experience.

In fact, in many firms, a so-called experience or learning curve is used to calculate what the effect will be of volume growth on unit costs. To a large extent, learning curve experience reduces the variable cost component of unit costs. Labour gains in efficiency and purchases of materials and parts in larger volumes all result in lower prices and manufacturing process improvements produce cost savings.

Indeed, the fixed-cost component of unit costs may also come down with volume increases. Larger plants may be more cost efficient. Large-scale selling and advertising programs may also be more cost efficient. If product sales are particularly sensitive to heavy advertising, or the product requires widespread distribution or extensive field service support, fixed marketing expenditures for these purposes must usually be at a high level.

These so-called scale economies come in certain cost categories depending on the product, the processes used to manufacture it and the level of marketing spending required to be competitive. If significant scale economies are achievable, some competitors may be willing to price low enough to gain volume, thus preventing other competitors from going down the learning curve and hoping to emerge as low-cost producers with dominant market shares.

Product cost, then, is not a simple 'hard' number. How cost is calculated for pricing purposes is a matter of managerial judgment. It may be construed as full cost or as variable cost. It may be the cost levels being experienced or experience curve estimates of future costs. The interpretation of cost factors for pricing will depend greatly on product/market objectives.

Customer value

Some business managers set prices simply by adding a percentage over costs to provide an acceptable profit. That approach has two advantages. Price is simple to calculate and if a firm is a low-cost producer, relative to competitors, so-called 'cost-plus' pricing may seem to provide some protection from competitive attack. The trade-off for simplicity and security may be lost profits. In theory, the amount of profit that is sacrificed is the difference between what customers actually paid and what they would have been willing to pay. Compared with cost-plus pricing,

pricing according to the value of the product to the customer is more difficult and speculative. The challenge is to determine what the value of the product is in the customer's mind.

First, it is useful to distinguish between perceived value and potential value. Perceived value is what the buyer now recognizes. Potential value is what the buyer can be educated to see in the product. That is the task of marketing. It may be accomplished through advertising, personal selling and getting the buyer to try the product.

Second, product value may be perceived differently by different customer groups or market segments. Different segments may place different values on the several elements that make up the set of product (which in the broadest sense, includes the product or service itself, its brand image, its availability, and the service that the seller provides) attributes.

For example, a large firm may place little value on the technical service a supplier offers it (the large firm) has comparable or superior technical resources of its own. But a small company may be highly dependent on the supplier's technical services and place high value on them in making purchasing decisions.

A third factor to consider in establishing customer value is the options that a potential buyer may have. Clearly, if the buyer can purchase a product at a lower price from one source than another, the lower price sets the upper bound in the marketplace. But for the buyer to have such effective options, he/she must have knowledge of them.

Another option the customer has may be not to buy the product at all but to make-do with what one has. Given this choice, the buy-not buy decision may be made by comparing the outcome of one course of action with the other.

These actions are quantifiable. One may calculate the operative savings in either instance and relate this to the cost of buying new, as the case may be. The anticipated savings may be expressed as a percentage return on investment (ROI). This, the amount of realizable savings establishes the value of a product to the customer. Calculated for each of several possible uses for available funds, ROI measures may serve to

establish the buyer's purchasing priorities. The choice between buy-not buy, of course, may not always be easily quantified with reference to expected savings. Nevertheless, it is a real and important consideration.

Finally, the price set by the seller is often taken by the potential customer as one measure of the value of the product. It is often interpreted by buyers as the supplier's estimate of the worth of the product it sells. If the seller does not value the product highly, it is not likely that the buyer will. Therefore, pricing a product significantly below what the buyer might pay for its functional equivalent can be self-defeating. The buyer may infer that value is, in fact, connoted by price and choose the higher-priced option.

Value, then, for a given product tends to be a function of (1) the utility of its several attributes to the prospective buyer, (2) the options the buyer has and is aware of (i.e. the offerings of competing suppliers and the option of not buying at all), and (3) the extent to which the buyer perceives price itself as a measure of product value.

If the seller truly value-prices, then different prices would be charged for the product to different customer groups. It is referred as price discrimination. A relevant consideration in thinking about price as an expression of product value is how sensitive is the buyer to price. Price sensitivity will vary considerably among purchasers and, for the same purchaser, it will vary from one time and one set of circumstances to another. Buyers who can pass on the cost of the purchase are less sensitive to price than those who cannot.

Price sensitivity also relates to the performance standards by which the purchaser measures. Viewed differently, performance measures effectively establish the relative worth of different product attributes for the manager who has to make the decision and be judged for it. Another factor in price sensitivity is the uncertainty that attends switching from one supplier to a lower-priced source. Modest price differences are often insufficient to overcome the purchaser's uncertainties about an untried supplier's product quality, reliability and service.

Factors affecting price decisions:

There are a number of factors which influence the pricing decisions of marketers. While some of these are external or environmental factors (such as competition, demand conditions and so on), others are internal factors (like marketing objectives, cost conditions and so on).

Figure 3.1.1 represents these factors. The important factors affecting the pricing decision are the following.

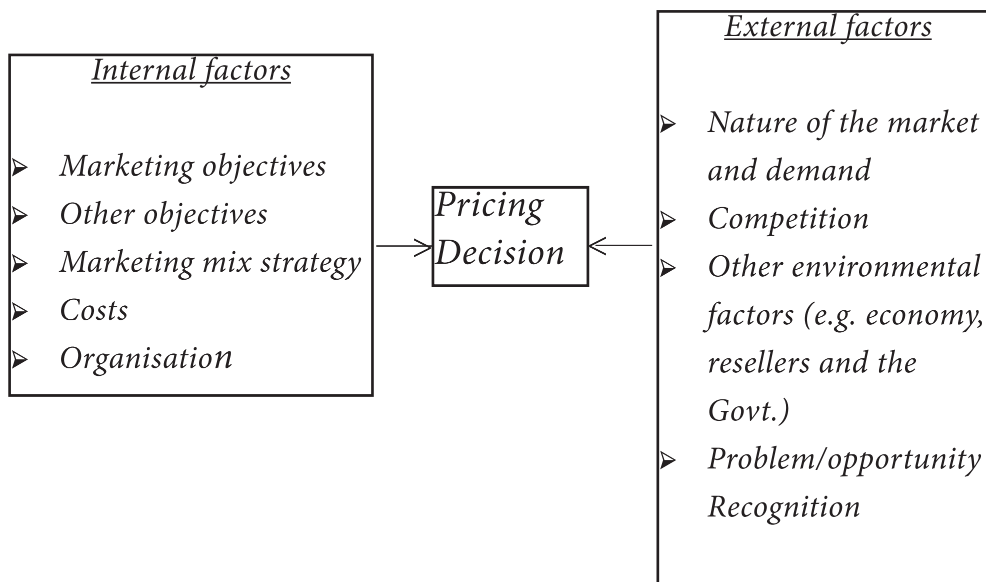

Figure 3.1.1 Factors affecting a firm's pricing decision

Internal factors

The internal factors, as the term implies, are mostly internal to the organization and therefore, largely controllable by the organization. They also have a direct bearing on the firm's pricing decision. The following are the important internal factors that must considered in pricing a firm's product/service.

- Marketing objectives – Before setting price, the firm must decide on its strategy for the product. This reiterates the idea that the corporate strategy must precede the marketing strategy and then marketing strategy must precede the pricing strategy. If the firm has selected its target market and positioning carefully, then its marketing-mix strategy (i.e. the 4 Ps) will be fairly straightforward.

For example

If the Coimbatore-based Paramount Airways decide to target the corporate/business travelers with its single-class airplanes, this suggests charging a high price. Whereas, a no-frills, low cost carrier would charge a low price, as dictated by its targeting and positioning.

Thus pricing strategy is largely determined by past decisions on marketing strategy. At the same time, the firm may seek additional objectives. The clearer a firm is about its marketing objectives, the easier it is to set price. Some of the common objectives include survival, current profit maximization, market-share leadership and product-quality leadership.

Other objectives

Sometimes a firm might set prices so low as to prevent competition from entering the market as they might lead the competition to regard the market as less attractive. Non-profit organizations may adopt a number of other pricing objectives such as full cost recovery, partial cost recovery or set a social price geared to the distributed income situations of different clients.

Marketing-mix strategy

Price is only one of the marketing-mix elements that a firm uses to achieve its marketing objectives. Therefore, logically pricing decisions must be coordinated with product design, distribution and promotion decisions to form a consistent and effective marketing program. Decisions made for other marketing-mix elements may affect pricing decisions.

For instance, the decision to position the product on quality plank will imply that the seller must charge a higher price to cover higher costs and/or to match the price-quality perception in the mind of the customers. It is common for marketers to design a price position wherein a target cost is set, then met and the target price is set. However some marketers deemphasize price and use other marketing-mix elements to create non-price positions.

The marketer must consider the total marketing mix when setting prices. If the product is positioned on non-price factors, then decisions about quality, promotion and distribution will strongly affect price. If price is a crucial positioning factor, then price will strongly affect decisions made about the others marketing-mix elements. In most cases, the company will consider all of the marketing-mix decisions together when developing the marketing program.

Costs

Though this topic was dealt with earlier in this lesson, some finer aspects related to costs are described here. Costs set the floor for the price that the firm can charge for its product. A firm's costs may be an important element in its pricing strategy. The firm wants to charge a price that both covers all its costs for producing, distributing and selling the product and delivers a fair rate of return for its effort and risk. The types of costs were explained earlier.

To price wisely, managers need to know how costs vary with different levels of production. The concept of economies of scale comes into play here. Also, costs vary as a function of production experience. There is a drop in the average cost with accumulated production experience and this is attributed to the experience curve or the learning curve.

Consider the semiconductor industry as an example. It has a strong experience curve effect. As a given chip is produced, manufacturing speeds go up, defect rates drop and costs plummet. These effects are seen dramatically in the PC market, where computing power increases and costs drop every year.

Organisation for pricing

Management must decide who within the organization should set prices. Firms handle pricing in a variety of ways. In small firms, prices are often set by top management rather than by the marketing or sales departments. In large firms, pricing typically is handled by product line managers. In industrial markets, salespeople may be allowed to negotiate with customers within certain price ranges.

Even so, top management sets the pricing objectives and policies, and it often approves the prices proposed by lower-level management or salespeople. In industries where pricing is a key factor, companies will often have a pricing department to set the best prices or help others in setting them. Others who have an influence on pricing decisions include sales managers, production managers, finance managers and accountants.

External factors

The external factors, as the term implies, are external to the organization and therefore, treated as uncontrollable by the organization. They have an indirect, but definite bearing on the firm's pricing decision. The following are the important external factors that must considered in pricing a firm's product/service.

Nature of the market and demand

While costs set the lower limit of prices, the market and demand set the upper limit. Buyers balance the price of a product or service against the benefits of owning it. Therefore, before setting prices, the marketer must understand the relationship between price and demand for his product. Price-demand relationship varies for different types of markets and how buyer perceptions of price affect the pricing decision. Economists recognize four types of markets, viz. pure competition, monopolistic competition, oligopolistic competition and pure monopoly. Each presents a different pricing challenge and pricing freedom.

Under pure competition, the market consists of many buyers and sellers trading in a uniform commodity. A seller cannot charge more than the going price because buyers can obtain as much as they need at the going price. Nor would sellers charge less than the market price because they can sell all they want at this price. Example: The prices of vegetables are subject to day-to-day variations because of supply and demand factors.

Under monopolistic competition, the market consists of many buyers and sellers who trade over a range of prices rather than a single market price. A range of prices occurs because sellers can differentiate their product/service offering to buyers. Buyers see differences in sellers' offerings and will pay different prices for them.

Toilet soaps, shampoos, hair oils, and fairness screams are in this competition. One would find the different brands in popular category in one price range and premium category in another range.

Under oligopolistic competition, the market consists of a few sellers who are highly sensitive to each other's pricing and marketing strategies. The product may be uniform (as a commodity) or non-uniform. Each seller is alert to competitors' strategies and moves. An oligopolist is never sure that it will gain anything permanent through a price cut or a price hike. In many a case they come to an agreement in price fixation.

Cement manufacturers offer a particular grade cement at almost similar prices because they have a common understanding to maintain prices.

In a pure monopoly, the market consists of one seller. The seller may be a government monopoly (the Indian Postal service), a private regulated monopoly (a power company) or a private non-regulated monopoly (e.g. Sify, when it introduced Virtual Private Networks for corporate users). Pricing is handled differently in each case.

A government monopoly can set the price below cost to make the product/service affordable, or set price to recover costs or set a high price to slow down consumption (an instance of demarketing). In a regulated monopoly, the government permits the firm to set rates that will yield a fair return. Non-regulated monopolies are free to price at what the market will bear. However, they will be careful not to attract competition nor invite government regulation.

Being government monopolies, Indian Railways and Indian Post and Telegraph fix the tariff keeping in mind the costs and affordability of consumers.

The price-demand relationship must also be studied before taking the price decision. Each price the firm might charge will lead to a different level of demand. The relation between the price charged and the resulting demand level is described as the Demand curve.

In the normal case, demand and price and inversely related. For 'prestige' goods, raising the price may result in more sales. In measuring

the price-demand relationship, the marketer must not allow other factors affecting demand to vary. They also need to know price elasticity, that is, how responsive demand will be to a change in price. If demand hardly changes with a small change in price, the demand is said to be inelastic. If demand changes greatly, it is said to be elastic. Price elasticity of demand is determined by many situations.

For example, buyers are less price sensitive when the product they are buying in unique or when it is high in quality, prestige or exclusiveness. They are also less price sensitive when substitute products are hard to find or when they cannot easily compare the quality of substitute products. Buyers are less price sensitive when the total expenditure for a product is low relative to their income or when the cost is shared by another party.

Competition

Another external factor affecting the company's pricing decisions is competitors' costs and prices and possible competitor reactions to the company's own pricing moves. For so-called commodities (i.e. virtually undifferentiated products), all competitors generally charge identical prices. If one goes above the market price, sales will drop off sharply; if one goes below, all others are likely to follow or risk significant reductions in market share. How much any individual firm is constrained by competitors' prices, therefore, depends largely on how differentiated its product is.

A product that is set apart from other market offerings by its functional design, appearance, brand image and the supplier's reputation for service and availability in ways that have value to customers can command a price premium. There are circumstances, however, in which firms will price over competitive levels even though the price differences are not really justified by superior product quality and service. A company may consciously elect, for example, not to meet competitive prices in a strategy of 'milking' the business, that is, yielding market share and gradually withdrawing from the market.

It may continue to sell profitably for some time to its loyal customers, in the mean time gradually cutting back on selling and promotional expenses until it eventually phases out of the market. Some companies may choose not to price competitively because to do so would

mean selling below cost. These so-called marginal firms eventually go out of business. Some large companies may not elect to meet the low price of a smaller competitor because to do so might mean giving up unit profits on a large sales base. It may be less costly in the short run to hold prices and give up some small percentage of market share.

In the long run, the smaller competitor encroaches increasingly on the market positions of its major competitors until it becomes, itself, a major factor. Under shortage conditions, some firms may price opportunistically above prevailing market levels, knowing that demand far exceeds available supply and that some buyers will pay the high price. Finally, some firms may unknowingly be underpriced by competitors on some of their products.

These products may be part of a broad line and the reporting system may not allow for monitoring the sales-profit performance of each item on the list. Thus the company may be losing sales and market position because of price and never realize, until too late, that the business has gone to more aggressive competitors. Generally, pricing strategies must inevitably be shaped with regard for present and future competition.

In this respect, there is significant pricing interdependency among firms in an industry with each being heavily influenced by others' strategies and tactics. Some firms follow price trends; others, the larger ones, seek to lead them. Accordingly, in contemplating price changes, the marketing manager will often seek to anticipate competitive responses.

Other environmental factors

When setting prices, the firm also must consider other factors in its external environment. Economic conditions can have a strong impact on the firm's pricing strategies. Economic factors such as inflation, boom or recession, and interest rates affect pricing decisions because they affect both the costs of producing a product and consumer perceptions of the product's price and value.

The firm also must consider what impact its prices will have on other parties in its environment. How will resellers react to various prices? The firm should set prices that give resellers a fair margin, encourage their

support, and help them to sell the product effectively. The government is another important external influence on pricing decisions. In regulated industries such as utilities, transport and so on, the government has the authority to approve or reject price changes. Finally, social concerns may have to be taken into account. In setting prices, a firm's short-term sales, market share and profit goals may have to be tempered by broader societal considerations.

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Lesson 3.2 - Pricing Objectives and Approaches

Objectives

In this lesson, we will introduce you to the pricing objectives and highlight the reasons because of which pricing has come to occupy center-stage in marketing rivalries. After you work out this lesson, you should be able to:

- Understand the different pricing objectives
- Identify the developments that have added to the importance of the pricing decision
- Classify the different pricing approaches

Learning Objectives

In this lesson, we will discuss the following:

- Situations that have pushed pricing to marketing center-stage
- Pricing objectives
- Cost-bases pricing approach
- Buyer-based pricing approach
- Competition-based pricing approach

Introduction

Ancient philosophers recognized the importance of price in an economic system. Some early written accounts refer to attempts to determine fair and just prices. Price continues to serve as a means of regulating economic activity. All the four factors of production, viz. natural resources, capital, human resources and entrepreneurship, depends on the prices that those factors receive. An individual firm's prices and the

resulting purchases by its customers determine how much revenue the firm receives. Prices, therefore, influence a firm's profits as well as its employment of the factors of production.

Traditionally, price has operated as the major determinant of buyer choice. This is still the case in the poorer economies and with commodity-type products. Although non-price factors have become more important in recent decades, price still remains one of the most important elements determining market share and profitability. Pricing has come to occupy center-stage in many marketing rivalries. Many reasons can be attributed to this. Some of them are outlined below:

- In some cases, product differentiation is getting blunted, thanks to the homogenization of technology. This is more relevant in the context of global business where the million dollar question is whether the firms should offer a standardized offering or a differentiated offering.

- There is intense inter-firm rivalry in some industries. It may be attributed to the removal of entry/exit barriers. Also the cost of fighting these marketing wars must be recovered and often, it is transferred to the customer.

- In certain industries, the products and the markets are mature. The only way to differentiate may be is through an augmented service or price cuts. Here again, pricing decisions are crucial to the survival of the firm.

- Customers' value perception correlates with the quoted price. To a customer, price always represents product's value. The price-quality perception must be taken into account during the product decision and the price decision.

- Inflation in the economy may also contribute to the significance of pricing decision in a marketing program. It lowers customer's purchasing power and increases input costs. As a result, the marketer has to make the price decision after careful evaluation.

Pricing objectives

Just as price is a component of the total marketing mix, pricing objectives also represent components of the organization's overall objectives. The objectives of the firm and its marketing organization guide the development of pricing objectives, which in turn lead to development and implementation of more specific pricing policies and procedures.

For example, a firm might set a major overall objective of becoming the dominant producer in its domestic market. It might then develop a marketing objective of achieving maximum sales penetration in each region, followed by a related pricing objective to set prices at levels that maximize sales. These objectives might lead to adoption of a low-price policy implemented by offering substantial price discounts to channel members.

While pricing objectives vary from firm to firm, they can be classified into four major groups:

(1) Profitability objectives

(2) Volume objectives

(3) Meeting competition objectives, and

(4) Prestige objectives

Profitability objectives include profit maximization and target-return goals. Volume objectives pursue either sales maximization or market-share goals.

Profitability objectives: Classical economic theory bases its conclusions on certain assumptions. It presumes that firms will behave rationally. Theorists expect that rational behaviour will result in an effort to maximize gains and minimize losses. Profits are a function of revenue and expenses.

$$\text{Profits} = \text{Revenue} - \text{Expenses}$$

Revenue is determined by the product's selling price and number of units sold:

Total revenue = Price * Quantity sold

A profit maximizing price, therefore, rises to the point at which further increases will cause disproportionate decreases in the number of units sold. A 10% price increase that results in only an 8% cut in volume will add to the firm's revenue. However, a 10% price hike that results in an 11% sales decline will reduce revenue. Profit maximization is identified as the point at which the addition to total revenue is just balanced by the increase in total cost.

Consequently, marketers set target return objectives – short-run or long-run goals usually stated as percentages of sales or investments. Target return objectives offer several benefits for marketers in addition to resolving pricing questions. For example, they serve as tools for evaluating performance. They also satisfy desires to generate 'fair' profits as judged by management, stockholders and the public.

Volume objectives

Many marketers argue that pricing behaviour actually seeks to maximize sales within a given profit constraint. They set a minimum acceptable profit level and then seek to maximize sales in the belief that the increased sales are more important than immediate high profits to the long-run competitive picture. Such a firm continues to expand sales as long as its total profits do not drop below the minimum return acceptable to management.

Another volume-related pricing objective – the market share objective – sets a goal to control a portion of the market for a firm's good or service. The company's specific goal may target maintaining its present share of a particular market or increasing its share. Volume-related goals such as sales maximization and market share objectives play important roles in most firms' pricing decisions.

Meeting competition objectives

A third set of pricing objectives seeks simply to meet competitor's prices. In many lines of business, firms set their own prices to match

those of established industry price leaders. These kinds of objectives de-emphasize the price element of the marketing mix and focus competitive rivalries more strongly on non-price variables.

Pricing is a highly visible component of a firm's marketing mix and an easy and effective tool for obtaining a differential advantage over competitors; still other firms can easily duplicate a price reduction themselves.

Because such price changes directly affect overall profitability in an industry, many firms attempt to promote stable prices by meeting competitors' prices and competing for market share by focusing on product strategies, promotional decisions and distribution – the non-price elements of the marketing mix. When price discounts become normal elements of a competitive marketplace, other marketing mix elements gain importance in purchase decisions.

In such instances, overall product value, not just price, determines product choice. Value pricing emphasizes benefits a product provides in comparison to the price and quality levels of competing offerings. This strategy typically works best for relatively low-priced goods and services. Value-priced products generally cost less than premium brands, but marketers point out that value does not necessarily mean cheap. Value is not just price, but also is linked to the performance and meeting expectations and needs of consumers.

The challenge for those who compete on value is to convince customers that low-priced brands offer quality comparable to that of a higher-priced product.

Prestige objectives

The final category of pricing objectives, unrelated to either profitability or sales volume, encompasses prestige objectives. Prestige pricing establishes a relatively high price to develop and maintain an image of quality and exclusiveness that appeals to status-conscious consumers. Such objectives reflect marketers' recognition of the role of price in creating an overall image for the firm and its goods and services.

General pricing approaches

The price the firm charges will be somewhere between on that is too low to produce a profit and one that is too high to produce any demand. Product costs set a floor to the price and consumer perceptions of the product's value set the ceiling. The firm must consider competitors' prices and other external and internal factors to find the best price between these two extremes. Firms set prices by selecting a general pricing approach that includes one or more of these three sets of factors. Let us examine the following approaches:

(1) Cost-based approach

(2) Buyer-based approach, and

(3) Competition-based approach

Cost-based approach

The simplest pricing method is cost-plus or markup pricing - adding a standard markup to the cost of the product. Markups vary greatly among different goods. Some common markups (on price, not cost) in supermarkets are 9% on baby foods, 14% on tobacco products, 27% on dried foods and vegetables and 50% on greeting cards.

Markups are generally higher on seasonal items (to cover the risk of not selling) and on specialty items, slower moving items, items with high storage and handling costs and items with inelastic demand. It must be noted that any pricing method that ignores current demand and competition is not likely to lead to the best price. Hence markup pricing only works if that price actually brings in the expected level of sales.

Advantages

(1) It covers all the costs

(2) It is designed to provide the target rate of margin

(3) It is generally a rational and widely accepted method

(4) It is an easy to comprehend and simple method

Disadvantages

1. The cost calculations are based on a predetermined level of activity. If the actual level of activity varies from this estimated level, the costs may vary, rendering this method unrealistic.
2. If the costs of the firm are higher than its competitors, this method would render the firm passive in relation to price.
3. Another drawback is that sometimes the opportunity to charge a high price is foregone.
4. It ignores the price elasticity of demand.
5. The cost-based pricing would not be helpful for some of the objectives or tasks like market penetration, fighting competition and so on.
6. It imparts an in-built inflexibility to pricing decisions.
7. Another cost-based pricing approach is break even pricing, or a variation called target profit pricing. The firm tries to determine the price at which it will break even or make the target profit it is seeking.

Buyer-based approach

An increasing number of firms are basing their prices on the product's perceived value. Perceived-value pricing uses buyers' perceptions of value, not the seller's cost, as the key to pricing. The company uses the non-price variables in the marketing mix to build up perceived value in buyers' minds. Price is set to match the perceived value. A company using perceived-value pricing must find out what value buyers assign to different competitive offers.

Sometimes consumers are asked how much they would pay for each benefit added to the offer. If the seller charges more than the buyers' perceived value, the firm's sales will suffer. Many firms overprice their products, and their products sell poorly. Other firms under-priced products sell very well, but they produce less revenue than they would if prices were raised to the perceived-value level.

Competition-based pricing

Many firms follow the dominant competitors, particularly the price leader, in setting the price. The main advantages of this method are:

1. It is a very simple method
2. It follows the main market trend
3. It has relevance to the competitive standing of the firm
4. Holding to the going price will prevent harmful price wars

The major disadvantages and limitations of following competitors are:

1. If the competitors' price decisions are unrealistic, the follower will also be going wrong on the price
2. The cost factors of the follower may not be similar to that of the competitors'
3. The pricing objective of the firm could be different from that of the competitors'
4. Sometimes the competitor may initiate price change for wrong reasons

Competition-based pricing approach may take the form of going-rate pricing or sealed-bid pricing. In going-rate pricing, the firm bases its price largely on competitors' prices, with less attention paid to its own cost or to demand. In oligopolistic industries that sell commodities, firms normally charge the same price. It is a popular pricing method.

When demand elasticity is hard to measure, firms feel the going price represents the collective wisdom of the industry concerning the price that will yield a fair return. Competition-based pricing is also used when firms bid for jobs. Using sealed-bid pricing, a firm bases its price on how it thinks competitors will price rather than on its own costs or on the demand.

The firm wants to win a contract and winning the contract requires pricing lower than other firms. Yet, the firm cannot set its price below a certain level. It cannot price below cost without hurting its position. In

contrast, the higher the firm sets its price above its costs, the less its chance of getting the contract.

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Lesson 3.3 - Pricing Policies and Constraints

Objectives

In this lesson, we will introduce you to Pricing policies and constraints. After you work out this lesson, you should be able to:

- Understand the procedure in formulating a pricing policy
- Identify the constraints that come to bear on pricing decisions
- Appreciate the nuances of pricing in industrial marketing

Learning Objectives

In this lesson, we will discuss the following:

- Pricing policy – as a 6-step procedure
- Pricing and product life cycle
- Pricing across the four product life cycle stages
- Distinguishing characteristics of pricing the industrial products/services
- Pricing on the Internet (Pricing in E-Commerce)

Introduction

Firms do their pricing in a variety of ways as discussed in the previous lesson. Executives complain that pricing is a big headache and one is wary of committing a go/drop error in the pricing decision. Pricing less than what the customer wants to pay and pricing more than what the customer wants to pay are both costly errors. 'There are two fools in every market: one asks too little, one asks too much', says a Russian Proverb. Many companies do not handle pricing well. Some common mistakes are:

- Price is not revised often enough to capitalize on market changes
- Price is set independently of the rest of the marketing mix rather than as an intrinsic element of market-positioning strategy
- Price is not varied enough for different product items, market segments, distribution channels and purchase occasions

The importance of pricing for profitability was demonstrated in a 1992 study by McKinsey & Company. Examining 2,400 companies, McKinsey concluded that a 1% improvement in price created an improvement in operating profit of 11.1%. By contrast, 1% improvements in variable cost, volume and fixed cost product profit improvements of only 7.8%, 3.3% and 2.3% respectively. Effectively designing and implementing pricing strategies requires a systematic approach to setting, adapting and changing prices.

Procedure for a pricing policy

A firm must set a price for the first time when it develops a new product, when it introduces its regular product into a new distribution channel or geographical area, and when it enters bids on new contract work. The firm has to consider several factors in setting its pricing policy. A useful 6-step procedure to develop the pricing policy is discussed below.

Selecting the pricing objective

The firm first decides where it wants to position its market offering. The clearer a firm's objectives, the easier it is to set price. A firm can pursue any of the objectives classified under four major groups, viz. profitability objectives, volume objectives, meeting competition objectives and prestige objectives. This was discussed in the previous lesson.

Determining demand

Each price will lead to a different level of demand and therefore have a different impact on a firm's marketing objectives. The relation between alternative prices and the resulting current demand is captured in a demand curve. In the normal case, demand and price are inversely related: the higher the price, the lower the demand. In the case of prestige

goods, the demand curve sometimes slopes upward. However, if the price is too high, the level of demand may fall. The demand curve sums the reactions of many individuals who have different price sensitivities. The first step is estimating demand is to understand what affects price sensitivity. Generally speaking, customers are most price sensitive to products that cost a lot or are bought frequently.

They are less price sensitive to low cost items or items they buy infrequently. They are also less price sensitive when price is only a small part of the total cost of obtaining, operating and servicing the product over its lifetime. Firms, of course, prefer customers who are less price sensitive. The following is a list of factors leading to less price sensitivity, as identified by Nagle and Holden.

- The product is more distinctive
- Buyers are less aware of substitutes
- Buyers cannot easily compare the quality of substitutes
- The expenditure is a smaller part of the buyer's total income
- The expenditure is small compared to the total cost of the end product
- Part of the cost is borne by another party
- The product is used in conjunction with assets previously bought
- The product is assumed to have more quality, prestige or exclusiveness
- Buyers cannot store the product

Most firms make some attempt to measure their demand curves using methods like statistical analysis, price experiments and surveys. In measuring the price-demand relationship, the marketer must control for various factors that will influence demand. The competitor's response will make a difference. Also, if the company changes other marketing mix factors besides price, the effect of the price change itself will be hard to isolate and measure.

Estimating costs

In the earlier discussion on costs, it was noted that demand sets a ceiling on the price, whereas costs set the floor. Also, the types of costs and the impact of economies of scale and learning curve on pricing was explained. To price intelligently, management needs to know how its costs vary with different levels of production. It is important to be aware of the risks presented by pricing based on the experience/learning curve. It assumes that competitors are weak followers.

It leads the company into building more plants to meet the demand, while a competitor may be innovating a lower-cost technology. Then the market leader will be stuck with the old technology. Today's firms try to adapt their offers and terms to different buyers. A manufacturer may negotiate different terms with different retail chains. One retailer may want daily delivery (to keep inventory lower) while another may accept twice-a-week delivery in order to get a lower price.

The manufacturer's cost will differ with each chain and so will its profits. To estimate the real profitability of dealing with different customers with differing requirements, the manufacturer needs to use activity-based cost (ABC) accounting instead of standard cost accounting. ABC accounting tries to identify the real costs associated with serving each customer. It allocates indirect costs like clerical costs, office expenses, supplies and so on, to the activities that use them, rather than in some proportion to direct costs. Both variable and overhead costs are tagged back to each customer. Another interesting costing concept is target costing.

Costs change with production scale and experience. They can also change as a result of a concentrated effort by designers, engineers and purchasing agents to reduce them through target costing. Market research is used to establish a new product's desired functions and the price at which the product will sell, given its appeal and competitors' prices. Deducting the desired profit margin from this price leaves the target cost that must be achieved. Each cost element - design, engineering, manufacturing, sales – must be examined and different ways to bring down costs must be considered.

The objective is to bring the final cost projections into the target cost range. If this is not possible, it may be necessary to stop developing the product because it could not sell for the target price and make the target profit.

Analysing competitors' costs, prices and offers

Within the range of possible prices determined by market demand and company costs, the firm must take competitors' costs, prices and possible price reactions into account. The firm should first consider the nearest competitor's price. If the firm's offer contains features not offered by the nearest competitor, their worth to the customer should be evaluated and added to the competitor's price.

If the competitor's offer contains some features not offered by the firm, their worth to the customer should be evaluated and subtracted from the firm's price. Now the firm can decide whether it can charge more, the same or less than the competitor. But competition can change their prices in reaction to the price set by the firm.

Selecting a pricing approach

Given the three Cs – the Customer's demand schedule, the cost function and the competitors' prices – the firm is now ready to select a price. Figure 3.3.1 summarizes the three major considerations in price setting. Costs set a floor to the price. Competitors' price and the price of substitutes provide an orienting point.

Customers' assessment of unique features establishes the price ceiling. Firms select a pricing approach that includes one or more of these three considerations. The pricing approaches are cost-based or buyer-based or competition-based. These approaches were discussed at length in the previous lesson.

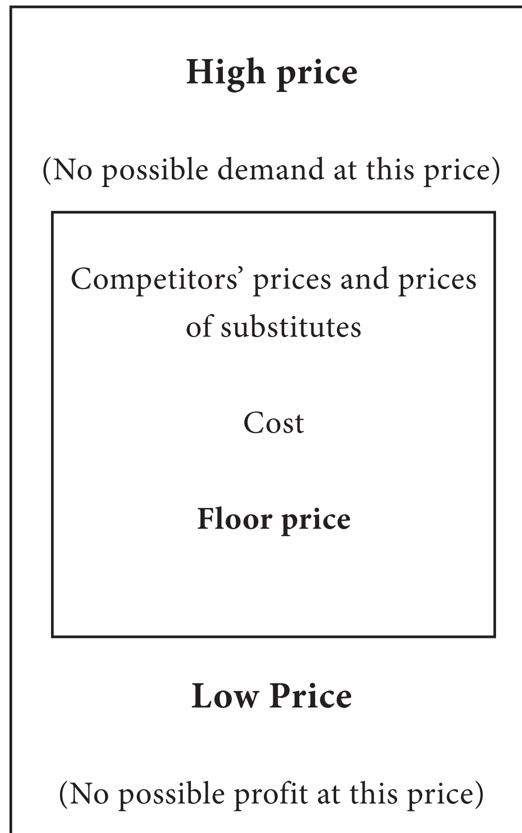

Figure 3.3.1 The three Cs model for price setting
(Source: Marketing Management, 12e, Kotler and Keller)

Selecting the final price

Pricing methods narrow the range from which the company must select its final price. In selecting that price, the company must consider additional factors, including the impact of other marketing activities, company pricing guidelines, gain-and-risk-sharing pricing and the impact of price on other parties. The final price must take into account the brand's quality and advertising relative to the competition.

The price must be consistent with the firm's pricing guidelines. When a firm establishes pricing penalties, it must be done judiciously so as not to unnecessarily alienate customers. Sometimes, buyers may resist accepting a seller's proposal because of a high perceived level of risk. The seller has the option of offering to absorb part or all of the risk if it does not deliver the full promised value.

Management must also consider the reactions of other parties to the contemplated price. For instance, the reaction of marketing intermediaries must be thought about. The reaction of the sales force must be taken note since they will be the ones to sell at that price in the marketplace. All these reactions might hold clues to fine tune the final price.

Pricing and Product Life Cycle

From a strategic point of view, the product life cycle provides a framework for thinking about pricing decisions. You may recall the discussion in Unit-2 about the product life cycle (Figure 3.3.2). Four phases may be identified in the product life cycle: introduction, growth, maturity and decline as shown in the figure below.

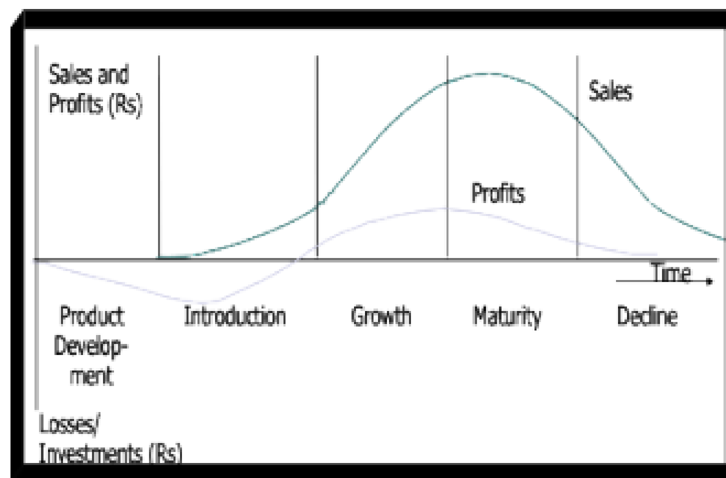

Figure 3.3.2 The Product Life Cycle curve

Each phase presents different opportunities and constraints on price.

Introduction phase

During the introduction phase, pricing can be a quandary, especially if you enjoy a temporary monopoly. In that situation, there may be no direct competitor and thus no benchmark for what buyers will tolerate or for their sensitivity to price differences. There may be indirect competitors (substitutes), however, and they can be used as starting points for the pricing decision.

The total economic value equation becomes relevant, wherein the price of the best alternative is known but the value of the performance differential of the new product is unknown. Customers themselves may have difficulty in sizing up the value of something that is new and different. They too lack benchmarks of value. In such instances, any of the following strategies may be adopted:

- Skimming: Some people will be happy to pay a high price for anything that is new and unique. This strategy, of course, is short term and contains dangers like attracting competition. IT companies offer their software products at high price as the life cycle for them is short. At the time of introduction, computers, mobile phones, washing machines, were high priced as the investment costs were high.

- Penetration pricing: A low price may have the threefold benefits of (1) getting established as the market share champion, (2) discouraging market entry by competitors, and (3) creating broad-based demand for the product. This is more suitable to consumer convenience products which can be sold in large volumes.

- Maruti –Udyog introduced Maruti -800 with the price tag of Rs.50,000 which subsequently was raised to Rs.1 lakh, as demand exceeded supply. Tatas are going launch the Nano car at Rs.1 lakh.

- Cost-plus: In a monopoly, the producer can administer its own price and cost-plus is one way of determining that price. However, product monopolies are short-lived.

Pricing decisions in this introductory phase are not only difficult but also deadly important. Putting too high a price on a newly introduced product may kill it in its infancy, undoing the work of many employees over a long period of development.

Growth phase

The growth phase is characterized by increasing unit sales and accelerating customer interest. If competitors have not yet surfaced (which is an unlikely event), skimming may be appropriate. All the deep-pocketed

buyers who simply had to be the first in their neighborhoods to own the product have already been skimmed in the introduction phase. So now, the price must be reduced gradually, skimming other market segments that are progressively more price sensitive.

A producer that enjoys prime position on the experience curve will also want to progressively reduce prices during this phase. Doing so will maintain its margins even as the strategy expands unit sales and punishes late-into-the-game rivals in the marketplace. Some of these rivals will either take a loss on every sale or simply wind up.

Mature phase

By the time a product enters this phase, growth in unit sales is leveling off and the remaining competitors are trying to find ways to differentiate their products. During this phase, one may see sellers offer different versions of the product, each version trying to colonize a targeted segment. Price is one of the factors used in this strategy (i.e. by developing and pricing good, better and best versions to expand the product line).

Decline phase

Competition gets ugly in this phase. Total demand for the product category is now visibly slipping, perhaps because of the appearance of superior substitutes or because of market saturation. Whatever the case, unit sales will continue to decline. Some companies will get out of the business entirely; those that remain will aggressively try to take business away from the rivals. Every player in the market is trying to harvest as much as possible from a contracting market. Price tactics include the following:

- Beat a retreat on price, but work overtime to reduce production costs. Success in the latter will maintain a decent profit margin
- Increase the price on the few remaining units in inventory. This is because there may be a small number of customers who still rely on that particular product. This is particularly true of replacement parts. Here the seller hopes that the higher price will compensate for fewer sales. When the inventory is exhausted, the product line is terminated.

Pricing is one of the linchpins of marketing strategy and success. How is the company making its pricing decisions? Are these decisions appropriate for the current phase of the product life cycle? The most reliable method of pricing is to get inside the heads of customers, because how they value the firm's products relative to those of competitors and substitutes matters more than anything else.

Pricing in industrial (business-to-business) markets

As Lesson 1.1 outlined the differences between consumer marketing and industrial marketing, those differences can further be explained based on the distinguishing characteristics of industrial pricing. Some of those characteristics are listed below:

- The true price as industrial customer pays is often different from the list price because of factors like delivery and installation costs, discounts, training costs, trade-in allowance, financing costs and so on.

- Pricing is not an independent variable. It is highly intertwined with product, promotion and distribution strategies.

- Price for industrial products cannot be set out without considering other products that are compliments or substitutes sold by the firm. Cross elasticities exist, where the price of one item affects sales of other items.

- Prices can be changed in numerous ways such as changing the quantity of goods and services provided by the seller, changing the premiums and discounts that are offered, changing the time and place of payment, and so on. This implies that pricing is often a more flexible decision than product or distribution decisions.

- Industrial prices are established, in many cases, by competitive bidding on a project-by-project basis. In a number of cases, prices are resolved through negotiation.

- Industrial pricing is often characterized by an emphasis on fairness. Industrial buyers, who are experienced and able to estimate the

vendors' approximate production costs expect the price increases to be justifiable on the basis of either the cost increases or product improvements.

- Industrial prices are affected by a host of economic factors such as inflation, interest rate changes, exchange rate fluctuations and so on. This problem is particularly critical for the marketer locked into a long term contract with no escalation cause.

Pricing on the Internet

E-Commerce has been arguably the Web's hottest application. Yet the Internet is more than simply a new 'marketspace'. Internet-based technologies are actually changing the rules of the market. Here is a short list of how the Internet allows sellers to discriminate between buyers and buyers to discriminate between sellers.

Buyers can …

- Get instant price comparisons from thousands of vendors – Consumers now regularly check online prices, compare them with those in their local stores and may well take a peek at what customers in other places/countries are paying and order from overseas. Consumers also may unbundle product information from the transaction themselves. For instance, someone might use the Internet to research on a holiday destination, but visit a travel agency to get some procedural requirements done, go home to use a search engine to find the lowest airfare to that destination. Sites like PriceScan.com lure thousands of visitors a day, most of them corporate buyers. Intelligent shopping agents (known as 'bots') take price comparison a step further and seek out products, prices and reviews from as many as 2,000 merchants.
- Name their price and have it met – Taking the example of Priceline.com, the customer states the price he wants to pay for an airline ticket, hotel or car rental and Priceline checks whether any seller is willing to meet that price. Consumers can fix their own prices, and sellers can use it too. Airlines can fill in demand for empty seats and hotels welcome the chance to sell vacant rooms at near zero marginal cost. Volume-aggregating sites combine the orders

of many customers and press the supplier for a deeper discount.

- Get products free – Open Source, the free software movement that started with Linux, will erode margins for just about any company doing software. Open Source software is popping up everywhere. The biggest challenge confronting major software producers is now: how to compete with programs that can be had free?

Sellers can …

- Monitor customer behaviour and tailor offers to individuals – Although shopping agent software and price comparison web sites provide published prices, consumers may be missing out on the special deals they can get with the help of new technologies. GE Lighting, which gets 55,000 pricing requests a year, has Web programs that evaluate about 300 factors that go into a pricing quote, such as past sales and discounts, so that it can reduce processing time from up to 30 days to 6 hours.

- Give certain customers access to special prices – CDNOW, an online vendor of music albums, emails certain (loyal) buyers a special website address with lower prices. Unless you know the secret address, you pay full price. Business marketers are already using extranets to get a precise handle on inventory, costs and demand at any given moment in order to dynamically adjust prices.

Bother buyers and sellers can …

- Negotiate prices in online auctions and exchanges – Want to sell hundreds of excess and slightly worn widgets? Post a sale on ebay.co.in (formerly, Bazee.com). Want to purchase air tickets at a bargain price? Go to air ticket auctions at Rediff.com. Thanks to the Internet, pricing is no longer a rigid entity of marketing. It is the era of dynamic pricing in many categories.

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Lesson 3.4 - Pricing Methods

Objectives

In this lesson, we will introduce you to the Pricing dynamics. This lesson examines the major dynamic pricing strategies available to the marketer. After you work out this lesson, you should be able to understand:

- The new product pricing strategies for products in the introductory stage of the product life cycle
- The product-mix pricing strategies for related products in the product mix
- The price-adjustment strategies that account for customer differences and changing situations.

Learning Objectives

In this lesson, we will discuss the following:

- New Product pricing strategies
  - Market Skimming pricing
  - Market Penetration pricing
- Product Mix pricing strategies
  - Product-line pricing
  - Optional-product pricing
  - Captive-product pricing
  - By product pricing
  - Product-bundle pricing
- Price Adjustment strategies
  - Discount and allowance pricing

- Discriminatory pricing
- Psychological pricing
- Value pricing
- Promotional pricing
- Geographical pricing
- International pricing

Introduction

Firms translate pricing objectives into pricing decisions in two major steps. First, someone must accept responsibility for making pricing decisions and administering the resulting pricing structure. Second, someone must set the overall pricing structure – that is, basic prices and appropriate discounts for channel members, quantity purchases, and geographic and promotional considerations. Hence a firm sets not a single price, but rather a pricing structure that covers different items in its line. This pricing structure changes over time as products move through their life cycles. The company adjusts product prices to reflect changes in costs and demand and to account for variation in buyers and situations.

New Product Pricing Strategies

Pricing strategies usually change as the product passes through its life cycle as illustrated in the previous lesson. The introductory stage is especially challenging. Firms bringing out an innovative patent-protected product can choose between two options, viz. market-skimming pricing and market-penetration pricing.

Market-skimming pricing: Many firms that invent new products initially set high prices to 'skim' revenues layer by layer from the market. At product introduction in the marketplace, the firm may charge the highest price it could given the benefits of its new product over competing products. The firm sets a price that made it just worthwhile for some affordable segments of the market to adopt the new product.

After the initial sales slowdown, the firm may lower the price to draw in the next price sensitive layer of the customers. In this way, a

firm skims a maximum amount of revenue from the various segments of the market. It is important to note that skimming works well only under certain conditions.

The quality and image must support its higher price and enough buyers must want the product at that price. Also the cost of producing a small volume cannot be so high that they cancel the advantage of charging more. In the mean time, competitors should not be able to enter the market easily and undercut the price. A skimming strategy offers several benefits to the markets, as listed below:

- It allows a manufacturer to quickly recover its research and development costs.
- It also allows a firm to maximize revenue from a new product before competitors enter the field.
- A skimming strategy offers a useful tool for segmenting a product's overall market on a price basis.
- It permits marketers to control demand in the introductory stages of a product's life cycle and then adjust productive capacity to match demand.

The chief disadvantage of skimming strategy is: it attracts competition. Potential competitors see innovative firms reaping big financial gains and decide to enter the market. This new supply forces the price even lower than its eventual level under a sequential skimming procedure. However, if patent protection or other proprietary ability allows a firm to exude competitors from its market, it may continue a skimming strategy for a relatively long period.

Market-penetration pricing

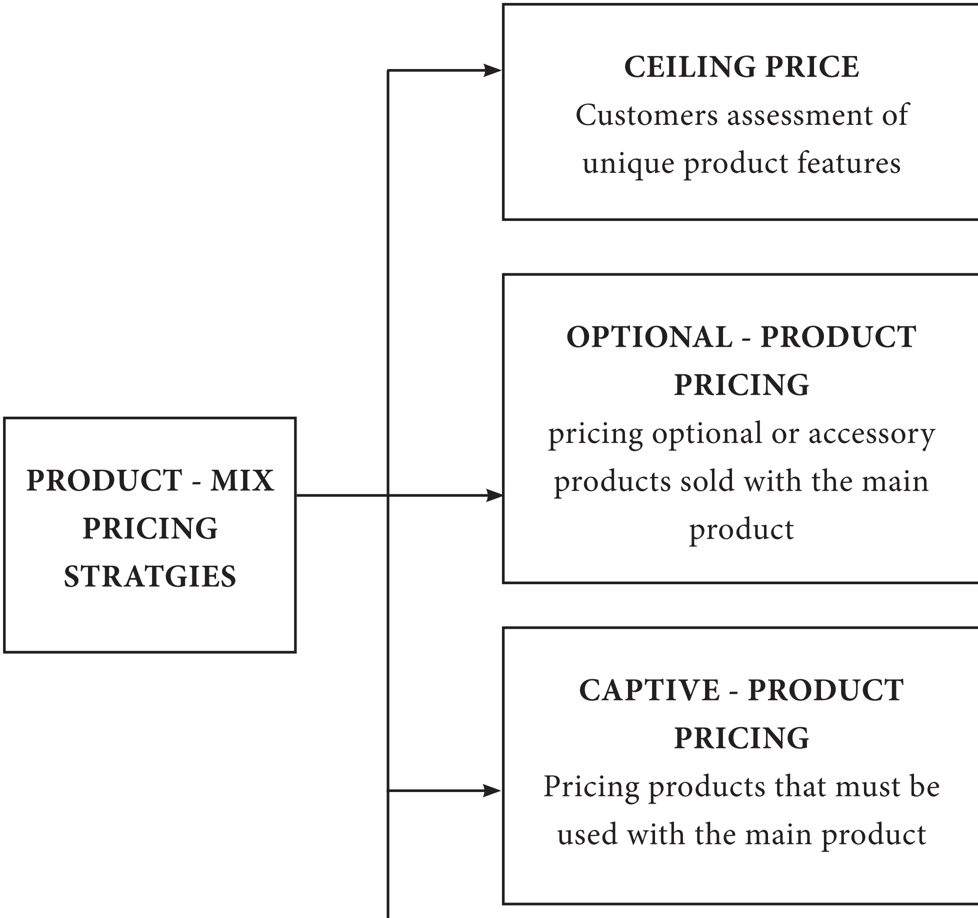
Rather than setting a high initial price to skim off small but profitable market segments, some firms set a low initial price in order to penetrate the market quickly and deeply – to attract a large number of buyers quickly and win a large market share. A penetration pricing strategy may also extend over several stages of the product life cycle as the firm seeks to maintain a reputation as a low-price competitor. Since many firms begin penetration pricing with the intention of increasing prices in

the future, success depends on generating many consumer trial purchases. Penetration pricing works well under the following conditions:

- A good or service experiences highly elastic demand
- The market is highly price sensitive and a low price stimulates market growth
- Production and distribution costs fall with accumulated production experience
- A low price helps discourage actual and potential competition

Product-Mix pricing

The strategy for setting a product's price often has to be changed when the product is part of a product mix. In this case, the firm looks for a set of prices that maximizes the profits on the total product mix. This pricing is difficult because the various products have related demand and costs and face different degrees of competition. The following section outlines the five product-mix pricing situations depicted in Figure 3.4.1



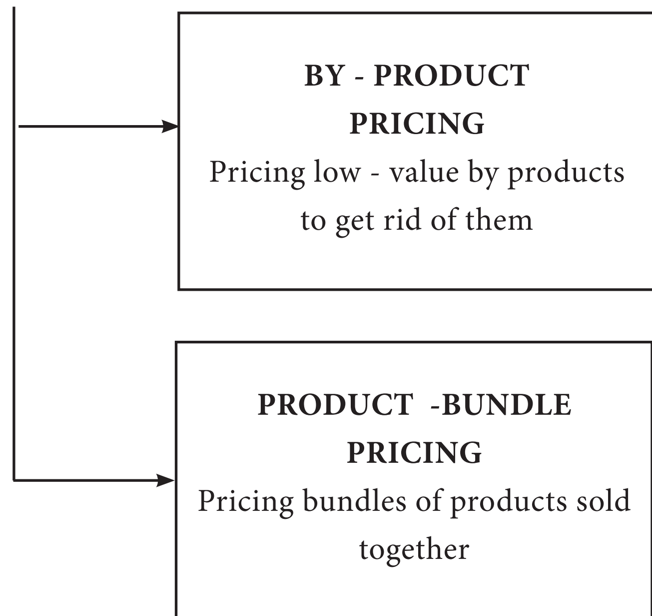


Figure 3.4.1 Product Mix pricing strategies Product-line pricing

Since most firms market multiple product lines, an effective pricing strategy must consider the relationships among all of these products instead of viewing each is isolation. In product line pricing, management must decide on the price steps to set between the various products. The price steps should take into account cost differences between the products, customer evaluations of their different features and competitors' prices.

In many industries, marketers use well-established price points for the products in their line. The customer will probably associate low, average and high quality with the price points. The marketers task is to establish perceived quality differences that support the price differences.

Optional-product pricing

Many firms use this strategy by offering to sell optional or accessory products along with their main product. These firms have to decide which items to include in the base price and which to offer as options. Often the basic model which is stripped of many comforts and conveniences sought by the customers gets rejected.

Captive-product pricing

Firms that make products that must be used along with a main product are using this pricing strategy. Producers of the main products often price them low and set high markups of the supplies. For a competitor who does not sell these supplies, he will have to price his product higher in order to make the same overall profit.

In case of services, this strategy is called two-part pricing where the price of the service is broken into a fixed fee plus a variable usage rate. The service firm must decide how much to charge for the basic service and how much for the variable usage. The fixed amount should be low enough to induce usage of the service and profit can be made on the variable usage fees.

By-product pricing

In producing certain products, there are by-products. If these by products have no value and if getting rid of them is costly, this will affect the pricing of the main product. Using by-product pricing, the manufacturer will seek a market for these by-products and should accept any price that covers more than the cost of storing and delivering them. This practice allows the marketer to reduce the main product's price to make it more competitive.

Product-bundle pricing

Using this strategy, marketers combine several of their products and offer the bundle at a reduced price. Price bundling can promote the sales of products consumers might not buy otherwise, but the combined price must be low enough to get them to buy the bundle.

Price-adjustments

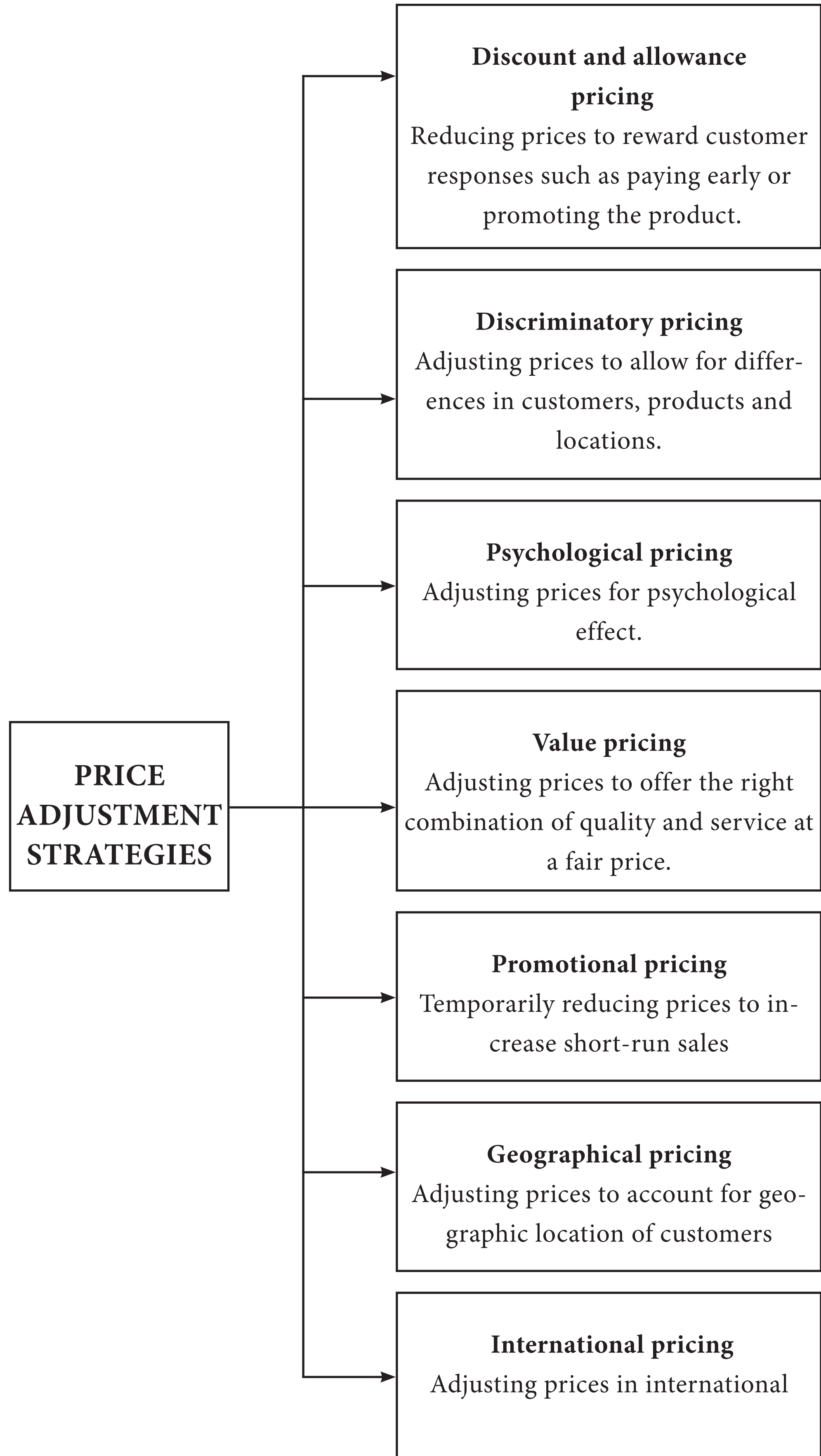


Figure 3.4.2 Price adjustment strategies

Firms usually adjust their basic prices to account for various customer differences and changing situations. Figure 3.4.2 summarizes seven price-adjustment strategies.

Discount and allowance pricing

Most firms adjust their basic price to reward customers for certain responses, such as cash payment, early payment of bills, volume purchases and off-season buying. Some of those adjustments are described below:

- Cash discounts – A cash discount is a price reduction to buyers who pay their bills promptly. The discount must be granted to all buyers meeting these terms. Such discounts are customary in many industries and help to improve the sellers' cash situation and reduce bad debts and credit collection costs.

- Quantity discounts – A quantity discount is a price reduction to buyers who buy large volumes. It must be offered to all customers and must not exceed the seller's cost savings associated with selling large quantities. These savings include lower selling, inventory and transportation expenses. Discounts provide an incentive to the customer to buy more from one given seller, rather than from many different sources.

- Functional discounts – A functional discount (also called trade discount) is offered by the seller to trade channel members who perform certain functions, such as selling, storing and record keeping. Manufacturers may offer different functional discounts to different trade channels because of the varying services they perform, but manufacturers must offer the same functional discounts within each trade channel.

- Seasonal discounts – A seasonal discount is a price reduction to buyers who buy out of season. It allows the seller to keep productions steady during the entire year.

- Allowances – They are another type of reductions from the list price. Trade-in allowances are price reductions given for turning in an old item when buying a new one. Promotional allowances are

payments or price reductions to reward dealers for participating in advertising and sales-support programs.

Discriminatory pricing

Firms will often adjust their basic prices to allow for differences in customers, products and locations. In discriminatory pricing, the firm sells a product or service at two or more prices, even though the difference in prices is not based on differences in costs. Discriminatory pricing takes many forms as indicated below:

- Customer-segment pricing – Different customers pay different prices for the same product or service. Electricity power tariffs are different to industrial and domestic consumers.
- Product-form pricing - Different versions of the product are priced differently, but not according to differences in their costs. Book publishers offer same book at different prices- hard bound at high prices and paper packs at low prices.
- Location pricing – Different locations are priced differently, even though the cost of offering in each location is the same. Hotel chains charge tourists differently at different locations for the same type of accommodation
- Time pricing - Prices vary by the season, month, day and even hour. Museums and parks charge higher prices on Sundays and lower prices on week days.

Psychological pricing

It applies the belief that certain prices or price ranges make products more appealing to buyers than others. In using psychological pricing, sellers consider the psychology of prices and not simply the economics.

- Pricing based on perceptions – The relationship between price and quality perceptions indicate that consumers perceive higher-priced products as having higher quality. When consumers cannot judge quality because they lack the information or skill, prices becomes an important quality signal. In case of cloth, if

fabric is smooth and attractive in colour, high prices are fixed as consumers cannot judge the real quality. Hotels maintain good ambience to charge high prices.

- Reference pricing – Reference prices are those prices that buyers carry in their minds and refer to when looking at a given product. It might be formed by noting current prices, remembering past prices or assessing the buying situation. Sellers can influence or use these consumers' reference prices when setting price. Colour TVs are supposed to be higher in price with reference to black and white TVs. Consumers will judge the price by finding how much high it is when compared to B-W TV.

- Odd pricing – In odd pricing, marketers set prices at odd numbers just under round numbers. An odd ending conveys the notion of a discount or bargain to the customer. Bata pricing is famous for this. Instead of pricing at Rs 1000/- they price it as Rs. 999.99

Value pricing

During slow-growth times, many firms adjust their prices to bring them into line with economic conditions and with the resulting fundamental shift in consumer attitudes toward quality and value. Value pricing is offering just the right combination of quality and good service at a fair price. In many cases, value pricing has involved redesigning existing brands in order to offer more quality for a given price or the same quality for less.

Bajaj Auto Ltd has its slogan which reads: Value for money, indicating that their products are budget sensitive.

Promotional pricing

In promotional pricing, a lower-than-normal price is used as a temporary ingredient in a firm's selling strategy. Some promotional pricing arrangements form part of recurrent marketing initiatives. Some may be to introduce a promotional model or brand with special pricing to begin competing in a new market. Promotional pricing takes several forms and some of them are described below.

- Loss-leader pricing – It happens when retailers drop price on well-known brands to stimulate store traffic in the hope that customers will buy other items also, at normal mark-ups.
- Special-event pricing – Sellers use special-event pricing in certain seasons to draw in more customers. The seasonal need of the customers is capitalized on by the sellers using this pricing strategy. Festivals, new year days, and national celebrations and sports events form the occasions. At the time of Olympics, TVs and mobile phones are offered at lower prices to stimulate demand.
- Cash rebates – Manufacturers will sometimes offer cash rebates to consumers who buy the product from dealers within a specified time. Cash rebates during festival seasons are common in case of clothing especially the Khadi products.
- Low-interest financing, longer payment times, longer warranties – all these represent the promotional incentives offered by the sellers to the buyers. Since they provide some flexibility and also bring down the perceived risks (in case of longer warranties), buyers are motivated to make the buying decision. Automobile companies arrange 0% interest financing in India to their buyers. .
- Psychological discounting – The seller may simply offer discounts from normal prices to increase sales and reduce inventories. For the buyer, the motivation to buy below normal prices may be compelling. Super markets show two prices on the label. –list price and the retail shop price with discount.

Geographical pricing

Geographical considerations strongly influence prices when costs must cover shipping heavy, bulky, low-unit-cost materials. Buyers and sellers can distribute transportation expenses in several ways: (1) The buyer pays all transportation charges; (2) The seller pays all transportation charges; or (3) the buyer and the seller share the charges. This choice has particularly important effects for a firm seeking to expand its geographic coverage to distant markets. The seller's pricing can implement several alternatives for handling transportation costs.

- FOB-origin pricing – It means that the goods are placed free on board (FOB) a carrier, at which point the title and responsibility pass to the customer, who pays the freight from the factory to the destination. Though it looks fair, the disadvantage is that the firm will be a high-cost firm to distant customers.

- Uniform delivered pricing – It is the exact opposite of FOB pricing. The company charges the same price plus freight to all customers, regardless of their location. An advantage is that it is fairly easy to administer and it lets the firm advertise its price nationally.

- Zone pricing – It falls between FOB-origin pricing and uniform delivered pricing. The company sets up two or more zones. All customers within a given zone pay a single total price; the more distant the zone, the higher the price.

- Basing-point pricing – The seller selects a given city as a 'basing point' and charges all customers the freight cost from that city to the customer location, regardless of the city from which the goods actually are shipped.

- Freight-absorption pricing – The seller who is anxious to do business with a certain customer or geographical area might use freight-absorption pricing. This strategy involves absorbing all or part of the actual freight charges in order to get the desired business. It is used for market penetration and to hold on to increasingly competitive markets.

International pricing

A wide variety of internal and external conditions can affect a marketer's global pricing strategies. Internal influences include the firm's goals and marketing strategies, the costs of developing, producing and marketing its products, the nature of the products and the firm's competitive strengths. External influences include general conditions in international markets, especially those in the firm's target markets, regulatory limitations, trade restrictions, competitors' actions, economic events, customer characteristics and the global status of the industry. In

general, a firm can implement one of three export pricing strategies, as described below.

- Standard worldwide price – Exporters often set standard worldwide prices, regardless of their target markets. This strategy can succeed if foreign marketing costs remain low enough that they do not impact overall costs, or if their prices reflect average unit costs. A firm that implements a standard pricing program must monitor the international marketplace carefully, however, to make sure that domestic competitors do not undercut its prices.

- Dual pricing – It distinguishes prices for domestic and export sales. Some exporters practice cost-plus pricing to establish dual prices that fully allocate their true domestic and foreign costs to product sales in those markets. Others opt for flexible cost-plus pricing schemes that allow marketers to grant discounts or change prices according to shifts in the competitive environment or fluctuations in the international exchange rate.

- Market-differentiated pricing – It makes even more flexible arrangements to set prices according to local marketplace conditions. Effective market-differentiated pricing depends on access to quick, accurate market information.

Activity

Read the Pricing lesson's learning goals that follow and consider the questions for each goal. Answering these questions will reinforce your understanding of the key concepts in this unit and allow you to check how well you have achieved these learning goals. Where a blank appears before a question, answer with true or false; for multiple choice questions, circle the letter of the correct answer.

Major categories of pricing objectives

1. _ _ _ _ Pricing objectives include all of the following except

    a. profit maximization objectives
    b. meeting competitors' prices
    c. market-share objectives

d. quality performance objectives
e. prestige objectives

2. _ _ _ _ Profits are
a. the most important objective for a firm
b. the result of supply and demand
c. a function of revenue and expenses
d. depend primarily on the quantity of product sold

The concept of price elasticity and its determinants

3. _ _ _ _ Elasticity measures the responsiveness of manufacturers and distributors to inventory levels

4. _ _ _ _ If customers can easily find close substitutes for a good or service, producers tend to encounter elastic demand for it.

Major cost-plus approaches to price setting

5. _ _ _ _ Cost-plus pricing methods include incremental cost pricing and full cost pricing

6. _ _ _ _ Full cost pricing bases decisions on competition and demand for the product

Major issues related to price determination in international marketing

7. _ _ _ _ Global pricing strategies almost always depend on demand in the domestic market

8. _ _ _ _ A firm's global pricing strategy reflects its global marketing strategy

Comparing alternative pricing strategies

9. _ _ _ _ Marketers often practice penetration pricing in industries with few products and little competition

10. _ _ _ _ A skimming pricing strategy sets a high market-entry price for a product with little or no initial competition

Pricing policy decisions that marketers must make

11. _ _ _ _ Marketers follow pricing policies in making long-term competing pricing decisions

12. _ _ _ _ Pricing policy choices includes psychological pricing, price flexibility, product line pricing and promotional pricing

Relating price to consumer perceptions of quality

13. _ _ _ _ In general, consumers perceive a high price as a symbol of high quality

14. _ _ _ _ Price limits are directly associated with supply and demand

15. _ _ _ _ The concept of price limits suggests that unusually low prices may indicate poor quality

Price negotiations

16. _ _ _ _ Buyers and sellers negotiate prices most often when
    a. Multiple suppliers compete for an order
    b. Only one available supplier can fill an order
    c. Contracts over unchanging and routine purchases
    d. Prices are set once and remain unchanged

Alternative strategies for pricing exports

17. _ _ _ _ Firms almost always implement the same pricing strategies for domestic and export sales

18. _ _ _ _ Market-differentiated pricing allows a firm to price its products according to local marketplace conditions

Answer key

1. d
2. c
3. F
4. T
5. T
6. F
7. F
8. T
9. F
10. T
11. F
12. T
13. T
14. F
15. T
16. a
17. F
18. T

Glossary of terms

Price:
The exchange value of a good or service

Profit maximization:
The point at which the additional revenue gained by increasing the price of a product equals the increase in total costs

Target return objective:
A short-run or long-run pricing practice intended to achieve a specified return on either sales or investment

Value pricing
A pricing strategy that emphasizes benefits a product provides in comparison to the price and quality levels of competing offerings

Demand:

A schedule of the amounts of a firm's product that consumers will purchase at different prices during a specified time period

Supply

A schedule of the amounts of a good or service that a firm will offer for sale at different prices during a specified time period

Elasticity:

A measure of the responsiveness of buyers and suppliers to changes in price

Cost-plus pricing:

The practice of adding a percentage or specified amount (as markup) to the base cost of a product to cover unassigned costs and provide a profit

Price skimming

A pricing strategy involving the use of a high entry price relative to competitive offerings

Penetration pricing:

A pricing strategy involving the use of a relatively low entry price as compared with competitive offerings to help secure initial market acceptance

Psychological pricing:

A pricing policy based on the belief that certain prices or price ranges make a good or service more appealing than others to buyers

Product line pricing:

The practice of setting a limited number of prices for a selection of merchandise

Promotional pricing:

A technique that temporarily lowers prices below normal levels in a temporary marketing campaign

By-product pricing:

Setting a price for by-products in order to make the main product's price more competitive

Captive-product pricing:

Setting a price for products that must be used along with a main product

FOB-origin pricing

A geographic pricing strategy in which goods are placed free on board a carrier; the customer pays the freight from the factory to the destination

Going-rate pricing:

Setting price based largely on following competitors' prices rather than on firm's costs or demand

Mark-up:

The percentage of the cost or price of a product added to cost in order to arrive at a selling price

Product-bundle pricing:

Combining several products and offering the bundle at a reduced price

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Case study: Dynamic pricing – smart pricing?

DHL used to have one-price-fits-all list prices for shipping packages in the United States and around the world, and when potential customers called for rates DHL scared them off by asking for more than FedEx or UPS. With Web pricing tools, DHL tested the market by offering cold callers different prices to see how low prices could go and still make a profit. In the end, DHL wound up changing hundreds of prices.

There were plenty of surprises. Most prices did go down, but the company did not have to match the competition. In fact, by lowering prices a bit, DHL's "ad hoc" business not only stabilized but it also grew. For instance, of people who called to get a quote, 17% actually shipper prior to the pricing overhaul. The new prices have increased the ratio to nearly 25%.

Constant price revision, however, can be tricky where consumer relationships are concerned. Research shows it tends to work best in situations where there is no bond between the buyer and the seller. One way to make it work is to offer customers a unique bundle of products and services to meet their needs precisely, making it harder for them to make price comparisons.

This tactic is being used to sell software, which is vulnerable to price wars because the cost of producing more copies is near zero. Application service providers are 'renting' their software and support by the month instead of selling an unlimited-use license.

The tactic most companies favour, however, is to market perfect pricing as a reward for good behaviour rather than as a penalty. For instance, shipping company APL, Inc., rewards customers who can better predict how much cargo space they will need with cheaper rates for booking early. Customers are getting savvier about how to avoid buyer's remorse.

They are changing their buying behaviour to accommodate the new realities of dynamic pricing – where prices vary frequently by channels, products, customers and time.

Questions

1. Under what conditions will dynamic pricing be smart and successful pricing?
2. Explain the success of DHL's ad-hoc business from a pricing perspective.

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