CHAPTER 9
PRICING STRATEGIES

PREVIEWING THE CONCEPTS – CHAPTER OBJECTIVES

1. Identify the three major pricing strategies and discuss the importance of understanding customer-value perceptions, company costs, and competitor strategies when setting prices.

2. Identify and define the other important internal and external factors affecting a firm's pricing decisions.

3. Describe the major strategies for pricing new products.

4. Explain how companies find a set of prices that maximizes the profits from the total product mix.

5. Discuss how companies adjust their prices to take into account different types of customers and situations.

6. Discuss the key issues related to initiating and responding to price changes.

CHAPTER OVERVIEW

Firms successful at creating customer value with the other marketing mix activities must capture this value in the prices they earn.

Despite its importance, many firms do not handle pricing well.

In this chapter, we begin with the question, "What is a price?" Next, we look at three major pricing strategies – customer value-based, cost-based, and competition-based pricing – and at other factors that affect pricing decisions.

Finally, we examine pricing strategies for new-product pricing, product mix pricing, price adjustments, and dealing with price changes.

INTRODUCTION

Companies today face a fierce and fast-changing pricing environment.

Yet, cutting prices is often not the best answer.

WHAT IS A PRICE?

In the narrowest sense, **price** is the amount of money charged for a product or service.

More broadly, **price** is the sum of all the values that customers give up in order to gain the benefits of having or using a product or service.

Price is the only element in the marketing mix that produces revenue.

Price is one of the most flexible marketing mix elements.

MAJOR PRICING STRATEGIES

Customer Value-Based Pricing

In the end, the customer will decide whether a product's price is right.

Customer value-based pricing uses buyers' perceptions of value, not the seller's cost, as the key to pricing.

Price is considered along with the other marketing mix variables *before* the marketing program is set.

Cost-based pricing is product driven.

"Good value" is not the same as "low price."

Two types of value-based pricing are *good-value pricing* and *value-added pricing*.

1. **Good-value pricing** involves offering just the right combination of quality and good service at a fair price.

Everyday low pricing (EDLP). EDLP involves charging a constant, everyday low price with few or no temporary price discounts.

High-low pricing involves charging higher prices on an everyday basis but running frequent promotions to lower prices temporarily on selected items.

2. **Value-added pricing** is the strategy of attaching value-added features and services to differentiate their offers and thus support higher prices.

Cost-Based Pricing

Whereas customer-value perceptions set the price ceilings, costs set the floor for the price that the company can charge.

Cost-based pricing involves setting prices based on the costs for producing, distributing, and selling the product plus a fair rate of return for effort and risk.

Types of Costs

Fixed costs (also known as overhead) are costs that do not vary with production or sales level.

Variable costs vary directly with the level of production. They are called variable because their total varies with the number of units produced.

Total costs are the sum of the fixed and variable costs for any given level of production.

Cost-Plus Pricing

The simplest pricing method is **cost-plus pricing (markup pricing) –** adding a standard markup to the cost of the product.

Does using standard markups to set prices make sense? Generally, no.

Markup pricing remains popular for many reasons.

1. Sellers are more certain about costs than about demand.
2. When all firms in the industry use this pricing method, prices tend to be similar and price competition is thus minimized.

Another cost-oriented 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.

Target return pricing uses the concept of a break-even chart, which shows total cost and total revenue expected at different sales volume levels.

The major problem with this analysis is that it fails to consider customer value and the relationship between price and demand.

Typically, as the *price* increases, *demand* decreases.

Competition-Based Pricing

Competition-based pricing involves setting prices based on competitors' strategies, costs, prices, and market offerings.

What principle should guide decisions about what price to charge relative to those of competitors? The answer is simple in concept but difficult in practice.

Be certain to give customers superior value for the price.

OTHER INTERNAL AND EXTERNAL CONSIDERATIONS AFFECTING PRICE DECISIONS

Overall Marketing Strategy, Objectives, and Mix

Price is only one of the marketing mix tools that a company uses to achieve its marketing objectives.

Price decisions must be coordinated with product design, distribution, and promotion decisions to form a consistent and effective integrated marketing program.

Companies often position their products on price and then tailor other marketing mix decisions to the prices they want to charge.

Target costing starts with an ideal selling price based on customer-value considerations, and then targets costs that will ensure that the price is met.

Companies may deemphasize price and use other marketing mix tools to create ***nonprice*** positions.

Organizational Considerations

In small companies, prices are often set by top management rather than by the marketing or sales departments.

In large companies, pricing is typically handled by divisional or product line managers.

In industrial markets, salespeople may be allowed to negotiate with customers within certain price ranges.

In industries in which pricing is a key factor, companies often have pricing departments to set the best prices or to help others in setting them.

The Market and Demand

Pricing in Different Types of Markets

Pure competition: The market consists of many buyers and sellers trading in a uniform commodity.

No single buyer or seller has much effect on the going market price.

In a purely competitive market, marketing research, product development, pricing, advertising, and sales promotion play little or no role. Thus, sellers in these markets do not spend much time on marketing strategy.

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 offers to buyers.

Oligopolistic competition: The market consists of a few sellers who are highly sensitive to each other's pricing and marketing strategies.

There are few sellers because it is difficult for new sellers to enter the market.

Pure monopoly: The market consists of one seller. The seller may be a government monopoly, a private regulated monopoly, or a private nonregulated monopoly.

Analyzing the Price-Demand Relationship

In a normal case, demand and price are inversely related; that is, the higher the price, the lower the demand.

In a monopoly, the demand curve shows the total market demand resulting from different prices.

If the company faces competition, its demand at different prices will depend on whether competitors' prices stay constant or change with the company's own prices.

Price Elasticity of Demand

Price elasticity: How responsive demand will be to a change in price.

If demand hardly changes with a small change in price, we say demand is ***inelastic***.

If demand changes greatly with a small change in price, we say the demand is ***elastic***.

The Economy

Economic conditions can have a strong impact on the firm's pricing strategies.

In the aftermath of the recent Great Recession, consumers have rethought the price-value equation. Many consumers have tightened their belts and become more value conscious.

The most obvious response to the new economic reality is to cut process. Rather than cutting prices, many companies are shifting their marketing to focus on more affordable items in their product mixes.

Remember, even in tough economic times, consumers do not buy based on price alone.

The key is to offer great *value for the money.*

Other External Factors

The company must also consider what impact its prices will have on other parties in its environment, such as *resellers* and the *government*.

Social concerns may have to be taken into account.

NEW-PRODUCT PRICING STRATEGIES

Market-Skimming Pricing

Market-skimming pricing (or **price skimming**) is setting high initial prices to "skim" revenues layer by layer from the market.

Market skimming makes sense under certain conditions.

1. The product's quality and image must support its higher price and enough buyers must want the product at that price.
2. The costs of producing a smaller volume cannot be so high that they cancel the advantage of charging more.
3. Competitors should not be able to enter the market easily and undercut the high price.

Market-Penetration Pricing

Market-penetration pricing is setting 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.

Several conditions must be met for this strategy to work.

1. The market must be highly price sensitive so that a low price produces more market growth.
2. Production and distribution costs must fall as sales volume increases.
3. The low price must help keep out the competition, and the penetration pricer must maintain its low-price position.

PRODUCT MIX PRICING STRATEGIES

In **product line pricing**, management must decide on the price steps to set between the various products in a line.

The price steps should take into account cost differences between the products in the line.

Optional product pricing is offering to sell optional or accessory products along with a main product.

In **captive product pricing,** companies make products that must be used along with a main product.

In the case of services, captive-product pricing is called ***two-part pricing***. The price of the service is broken into a ***fixed fee*** plus a ***variable usage rate*.**

Using **by-product pricing**, the company seeks a market for the by-products produced in the generation of some products and services.

Using **product bundle pricing**, sellers often combine several of their products and offer the bundle at a reduced price.

PRICE ADJUSTMENT STRATEGIES

Discounts include:

- ***Cash discount*** is a price reduction to buyers who pay their bills promptly.
- ***Quantity discount*** is a price reduction to buyers who buy large volumes.
- ***Functional discount*** (also called a ***trade discount***) is offered by the seller to trade-channel members who perform certain functions.
- ***Seasonal discount*** is a price reduction to buyers who buy merchandise or services out of season.

Allowances are a reduction 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.

Segmented pricing occurs when the company sells a product or service at two or more prices, even though the difference in prices is not based on differences in costs.

- ***Customer-segment pricing:*** different customers pay different prices for the same product or service.
- ***Product-form pricing:*** Different versions of the product are priced differently but not according to differences in their costs.
- ***Location-based pricing:*** A company charges different prices for different locations, even though the cost of offering each location is the same.
- ***Time-based pricing:*** A firm varies its price by the season, the month, the day, and even the hour.

Psychological pricing occurs when sellers consider the psychology of prices and not simply the economics.

One aspect of psychological pricing is **reference prices**—prices that buyers carry in their minds and refer to when looking at a given product.

With **promotional pricing**, companies will temporarily price their products below list price and sometimes even below cost to create buying excitement and urgency.

- ***Discounts:*** A reduction from normal prices to increase sales and reduce inventories.
- ***Special-event pricing:*** Pricing differently in certain seasons to draw more customers.
- ***Limited-time offers (flash sales):*** Create buying urgency and make buyers feel lucky to have gotten in on the deal.
- ***Cash rebates:*** Offered to consumers who buy the product from dealers within a specified time; the manufacturer sends the rebate directly to the customer.

Promotional pricing can have adverse effects.

1. Price promotions can create "deal-prone" customers who wait until brands go on sale before buying them.
2. Constantly reduced prices can erode a brand's value in the eyes of customers.
3. Promotional pricing can lead to industry price wars.

Geographical Pricing involves deciding how to price products for customers located in different parts of the country or world.

- **FOB-origin pricing:** The goods are placed ***free on board*** (hence, *FOB*) a carrier. At that point the title and responsibility pass to the customer, who pays the freight from the factory to the destination.
- **Uniform-delivered pricing** is the opposite of FOB pricing. Here, the company charges the same price plus freight to all customers, regardless of their location.
- **Zone pricing** falls between FOB-origin pricing and uniform-delivered pricing. 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 are actually shipped.
- **Freight-absorption pricing**. Using this strategy, the seller absorbs all or part of the actual freight charges in order to get the desired business.

Dynamic and Online Pricing

Dynamic Pricing is adjusting prices continually to meet the characteristics and needs of individual customers and situations.

Dynamic pricing is extremely prevalent online where the Internet seems to be taking us back to a new age of fluid pricing.

Dynamic pricing offers many advantages:

- Online sellers can mine their databases to gauge a specific shopper's desires, measure his or her means, and instantaneously tailor products to fit that shopper's behavior, and price products accordingly.

- Buyers can also negotiate prices at online auction sites and exchanges.

- Online buyers benefit from the Web and dynamic pricing. A wealth of price comparison sites—such as Yahoo! Shopping and PriceGrabber—offer instant product and price comparisons from thousands of vendors.

International Pricing

The price that a company should charge in a specific country depends on many factors, including economic conditions, competitive situations, laws and regulations, and development of the wholesaling and retailing system. Costs play an important role in setting international prices.

PRICE CHANGES

Initiating Price Changes

Initiating Price Cuts

Several situations may lead a firm to consider cutting its price.

- Excess capacity
- Falling demand in the face of strong price competition
- Desire to dominate market

Initiating Price Increases

A major factor in price increases is cost inflation.

When raising prices, the company must avoid being perceived as a price gouger.

One technique for avoiding this problem is to maintain a sense of fairness surrounding any price increase.

Buyer Reactions to Price Changes

Customers do not always view price changes in a straightforward or rational way. They may view price *cuts* or price *increases* in several ways.

Competitor Reactions to Price Changes

Competitors are most likely to react when the number of firms involved is small, when the

product is uniform, and when the buyers are well informed about products and prices.

Responding to Price Changes

The firm needs to consider several issues: Why did the competitor change the price? Is the price change temporary or permanent? What will happen to the company's market share and profits if it does not respond? Are other competitors going to respond?

1. The company could ***reduce its price*** to match the competitor's price.
2. The company could maintain its price but ***raise the perceived value*** of its offer.
3. The company could ***improve quality and increase price***, moving its brand into a higher price-value position.
4. The company could ***launch a low-price "fighter brand"***—adding a lower-price item to the line or creating a separate lower-price brand.

PUBLIC POLICY AND PRICING

Pricing Within Channel Levels

Federal legislation on ***price-fixing*** states that sellers must set prices without talking to competitors. Otherwise, price collusion is suspected.

Sellers are prohibited from using ***predatory pricing***—selling below cost with the intention of punishing a competitor or gaining higher long-run profits by putting competitors out of business.

Pricing Across Channel Levels

The Robinson-Patman Act seeks to prevent unfair ***price discrimination*** by ensuring that sellers offer the same price terms to customers at a given level of trade.

Laws prohibit ***retail (or resale) price maintenance***—a manufacturer cannot require dealers to charge a specified retail price for its product.

Although the seller can propose a manufacturer's ***suggested*** retail price to dealers, it cannot refuse to sell to a dealer who takes independent pricing action, nor can it punish the dealer by shipping late or denying advertising allowances.

Deceptive pricing occurs when a seller states prices or price savings that mislead consumers or are not actually available to consumers.

Other deceptive pricing issues include ***scanner fraud*** and ***price confusion***.

Self-Check Questions

9-1. Name and describe the two types of value-based pricing methods.

9-2. Name and describe the four types of markets and the challenges they pose with respect to setting prices.

9-3. What is captive-product pricing? What is this pricing tactic called in the case of services? Give examples.

9-4. Name and describe the two broad new product pricing strategies. When would each be appropriate?