

LESSON 8: PRICING STRATEGY

8.1: DEFINITION & UNDERSTANDING PRICE

Price is defined as the sum of money that is charged when a person purchases a product or the total value that the person has to give up in exchange for the benefit that the person gets from the product. In an exchange process, price is important to a firm as part of the product offering. Price needs to be set right in order for a company to attract customers as it will influence whether the customer will make purchases or not.

$$\begin{aligned} - \text{ Profit} &= (\text{Selling price} \times \text{Units sold}) - \text{Total costs} \\ &= \text{Total Revenues} - \text{Total Costs} \end{aligned}$$

8.2: PRICE SETTING

Step 1: Selecting the Pricing Objective

The company first decides where it wants to position its market offering. The clearer a firm's objectives, the easier it is to set price. Five major objectives are: survival, maximum current profit, maximum market share, maximum market skimming, and product-quality leadership.

Survival: Companies pursue survival as their major objective if they are plagued with overcapacity, intense competition, or changing consumer wants. As long as prices cover variable costs and some fixed costs, the company stays in business. Survival is a short-run objective; in the long run, the firm must learn how to add value or face extinction.

Maximum Current Profit: Many companies try to set a price that will maximize current profits. They estimate the demand and costs associated with alternative prices and choose the price that produces maximum current profit, cash flow, or rate of return on investment. This strategy assumes the firm knows its demand and cost functions; in reality, these are difficult to estimate. In emphasizing current performance, the company may sacrifice long-run performance by ignoring the effects of other marketing variables, competitors' reactions, and legal restraints on price.

Maximum Market Share: Some companies want to maximize their market share. They believe a higher sales volume will lead to lower unit costs and higher long-run profit. They set the lowest price, assuming the market is price sensitive.

Maximum Market Skimming: Companies unveiling a new technology favor setting high prices to maximize market skimming. Market skimming makes sense under the following conditions: (1) A sufficient number of buyers have a high current demand; (2) the unit costs of producing a small volume are high enough to cancel the advantage of charging what the traffic will bear; (3) the high initial price does not attract more competitors to the market; (4) the high price communicates the image of a superior product.

Product-Quality Leadership: A company might aim to be the product-quality leader in the market. Many brands strive to be "affordable luxuries"—products or services characterized by high levels of perceived quality, taste, and status with a price just high enough not to be out of consumers' reach.

Other Objectives: Nonprofit and public organizations may have other pricing objectives. A university aims for partial cost recovery, knowing that it must rely on private gifts and public grants

to cover its remaining costs. A nonprofit hospital may aim for full cost recovery in its pricing. A nonprofit theater company may price its productions to fill the maximum number of seats. A social service agency may set a service price geared to client income. Whatever the specific objective, businesses that use price as a strategic tool will profit more than those that simply let costs or the market determine their pricing.

Step 2: Determining Demand

Each price will lead to a different level of demand and have a different impact on a company's marketing objectives. The normally inverse relationship between price and demand is captured in a demand curve (see Figure 8.1): The higher the price, the lower the demand. For prestige goods, the demand curve sometimes slopes upward. One perfume company raised its price and sold more rather than less! Some consumers take the higher price to signify a better product. However, if the price is too high, demand may fall.

Price Sensitivity: The demand curve shows the market's probable purchase quantity at alternative prices. It sums the reactions of many individuals with different price sensitivities. The first step in estimating demand is to understand what affects price sensitivity. Generally speaking, customers are less price sensitive to low-cost items or items they buy infrequently. They are also less price sensitive when (1) there are few or no substitutes or competitors; (2) they do not readily notice the higher price; (3) they are slow to change their buying habits; (4) they think the higher prices are justified; and (5) price is only a small part of the total cost of obtaining, operating, and servicing the product over its lifetime.

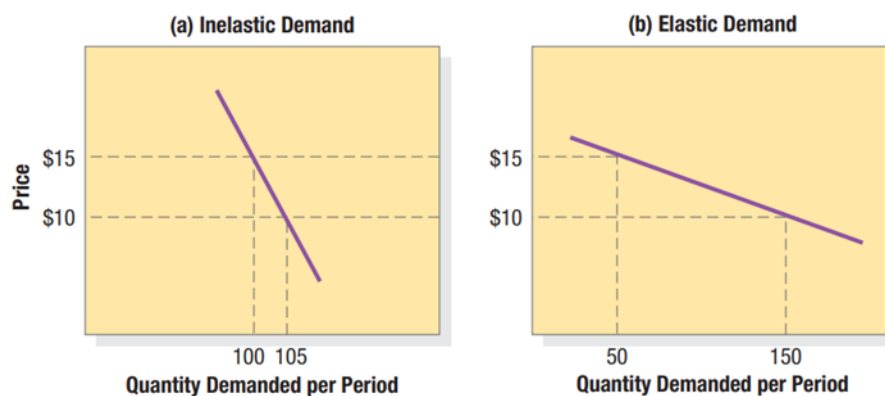


Figure 8.1: Inelastic and Elastic Demand

Estimating Demand Curves: Most companies attempt to measure their demand curves using several different methods.

1. **Surveys** can explore how many units' consumers would buy at different proposed prices. Although consumers might understate their purchase intentions at higher prices to discourage the company from pricing high, they also tend to actually exaggerate their willingness to pay for new products or services.
2. **Price experiments** can vary the prices of different products in a store or charge different prices for the same product in similar territories to see how the change affects sales
3. **Statistical analysis** of past prices, quantities sold, and other factors can reveal their relationships. The data can be longitudinal (over time) or cross-sectional (from different

locations at the same time). Building the appropriate model and fitting the data with the proper statistical techniques calls for considerable skill, but sophisticated price optimization software and advances in database management have improved marketers' abilities to optimize pricing.

Price Elasticity of Demand: Marketers need to know how responsive, or elastic, demand is to a change in price. Consider the two demand curves in Figure 14.1. In demand curve (a), a price increase from \$10 to \$15 leads to a relatively small decline in demand from 105 to 100. In demand curve (b), the same price increase leads to a substantial drop in demand from 150 to 50. If demand hardly changes with a small change in price, we say the demand is inelastic. If demand changes considerably, demand is elastic.

The higher the elasticity, the greater the volume growth resulting from a 1 percent price reduction. If demand is elastic, sellers will consider lowering the price. A lower price will produce more total revenue. This makes sense as long as the costs of producing and selling more units do not increase disproportionately.

Price elasticity depends on the magnitude and direction of the contemplated price change. It may be negligible with a small price change and substantial with a large price change. It may differ for a price cut versus a price increase, and there may be a price indifference band within which price changes have little or no effect.

Finally, long-run price elasticity may differ from short-run elasticity. Buyers may continue to buy from a current supplier after a price increase but eventually switch suppliers. Here demand is more elastic in the long run than in the short run, or the reverse may happen: Buyers may drop a supplier after a price increase but return later. The distinction between short-run and long-run elasticity means that sellers will not know the total effect of a price change until time passes.

Step 3: Estimating Costs

Demand sets a ceiling on the price the company can charge for its product. Costs set the floor. The company wants to charge a price that covers its cost of producing, distributing, and selling the product, including a fair return for its effort and risk. Yet when companies price products to cover their full costs, profitability isn't always the net result.

Types of Costs and Levels of Production: A company's costs take two forms, fixed and variable. **Fixed costs**, also known as overhead, are costs that do not vary with production level or sales revenue. A company must pay bills each month for rent, heat, interest, salaries, and so on regardless of output.

Variable costs vary directly with the level of production. For example, each hand calculator produced by Texas Instruments incurs the cost of plastic, microprocessor chips, and packaging. These costs tend to be constant per unit produced, but they're called variable because their total varies with the number of units produced.

Total costs consist of the sum of the fixed and variable costs for any given level of production. **Average cost** is the cost per unit at that level of production; it equals total costs divided by production. Management wants to charge a price that will at least cover the total production costs at a given level of production.

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 establishes a new product's desired functions and the price at which it will sell, given its appeal and competitors' prices. This price less desired profit margin leaves the target cost the marketer must achieve. The firm must examine each cost element—design, engineering, manufacturing, sales—and bring down costs so the final cost projections are in the target range.

Step 4: Analyzing 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. If the firm's offer contains features not offered by the nearest competitor, it should evaluate their worth to the customer and add that value to the competitor's price. If the competitor's offer contains some features not offered by the firm, the firm should subtract their value from its own price. Now the firm can decide whether it can charge more, the same, or less than the competitor.

The introduction or change of any price can provoke a response from customers, competitors, distributors, suppliers, and even government. Competitors are most likely to react when the number of firms is few, the product is homogeneous, and buyers are highly informed.

How can a firm anticipate a competitor's reactions? One way is to assume the competitor reacts in the standard way to a price being set or changed. Another is to assume the competitor treats each price difference or change as a fresh challenge and reacts according to self-interest at the time. Now the company will need to research the competitor's current financial situation, recent sales, customer loyalty, and corporate objectives. If the competitor has a market share objective, it is likely to match price differences or changes. If it has a profit-maximization objective, it may react by increasing its advertising budget or improving product quality.

The problem is complicated because the competitor can put different interpretations on lowered prices or a price cut: that the company is trying to steal the market, that it is doing poorly and trying to boost its sales, or that it wants the whole industry to reduce prices to stimulate total demand.

Step 5: Selecting a Pricing Method

Given the customers' demand schedule, the cost function, and competitors' prices, the company is now ready to select a price. We will examine six price-setting methods: markup pricing, target-return pricing, perceived-value pricing, value pricing, going-rate pricing, and auction-type pricing.

1. **Markup Pricing:** The most elementary pricing method is to add a standard markup to the product's cost. Construction companies submit job bids by estimating the total project cost and adding a standard markup for profit. Lawyers and accountants typically price by adding a standard markup on their time and costs.

<i>Variable cost per unit</i>	\$10
<i>Fixed costs</i>	\$300,000
<i>Expected unit sales</i>	50,000

Suppose a toaster manufacturer has the following costs and sales expectations: The manufacturer's unit cost is given by:

$$\text{Unit cost} = \text{variable cost} + \frac{\text{fixed cost}}{\text{unit sales}} = \$10 + \frac{\$300,00}{50,000} = \$16$$

Now assume the manufacturer wants to earn a 20 percent markup on sales. The manufacturer's markup price is given by:

$$\text{Markup price} = \frac{\text{unit cost}}{(1 - \text{desired return on sales})} = \frac{\$16}{1 - 0.2} = \$20$$

The manufacturer will charge dealers \$20 per toaster and make a profit of \$4 per unit. If dealers want to earn 50 percent on their selling price, they will mark up the toaster 100 percent to \$40. Markups are generally higher on seasonal items (to cover the risk of not selling), specialty items, slower-moving items, items with high storage and handling costs, and demand-inelastic items, such as prescription drugs. Does the use of standard markups make logical sense? Generally, no. Any pricing method that ignores current demand, perceived value, and competition is not likely to lead to the optimal price. Markup pricing works only if the marked-up price actually brings in the expected level of sales.

Still, markup pricing remains popular. First, sellers can determine costs much more easily than they can estimate demand. By tying the price to cost, sellers simplify the pricing task. Second, where all firms in the industry use this pricing method, prices tend to be similar and price competition is minimized. Third, many people feel that cost-plus pricing is fairer to both buyers and sellers. Sellers do not take advantage of buyers when the latter's demand becomes acute, and sellers earn a fair return on investment.

2. **Target-Return Pricing:** In target-return pricing, the firm determines the price that yields its target rate of return on investment. Public utilities, which need to make a fair return on investment, often use this method. Suppose the toaster manufacturer has invested \$1 million in the business and wants to set a price to earn a 20 percent ROI, specifically \$200,000. The target-return price is given by the following formula:

$$\begin{aligned} \text{Target-return price} &= \text{unit cost} + \frac{\text{desired return} \times \text{invested capital}}{\text{unit sales}} \\ &= \$16 + \frac{.20 \times \$1,000,000}{50,000} = \$20 \end{aligned}$$

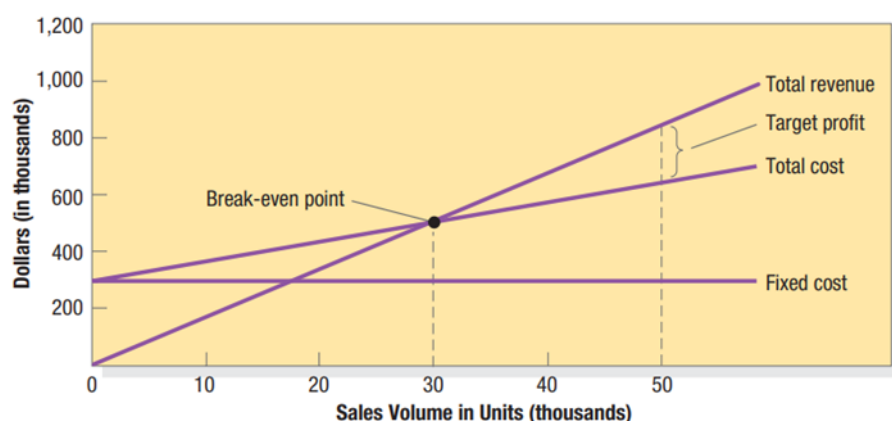


Figure 8.2: Break-Even Chart for Determining Target-Return Price and Break-Even Volume

The manufacturer will realize this 20 percent ROI provided its costs and estimated sales turn out to be accurate. But what if sales don't reach 50,000 units? The manufacturer can prepare a break-even chart to learn what would happen at other sales levels (see Figure 8.2). Fixed

costs are \$300,000 regardless of sales volume. Variable costs, not shown in the figure, rise with volume. Total costs equal the sum of fixed and variable costs.

The total revenue curve starts at zero and rises with each unit sold. The total revenue and total cost curves cross at 30,000 units. This is the break-even volume. We can verify it by the following formula:

$$\text{Break-even volume} = \frac{\text{fixed cost}}{(\text{price} - \text{variable cost})} = \frac{\$300,000}{\$20 - \$10} = 30,000$$

The manufacturer, of course, is hoping the market will buy 50,000 units at \$20, in which case it earns \$200,000 on its \$1 million investment, but much depends on price elasticity and competitors' prices. Unfortunately, target-return pricing tends to ignore these considerations. The manufacturer needs to consider different prices and estimate their probable impacts on sales volume and profits. The manufacturer should also search for ways to lower its fixed or variable costs, because lower costs will decrease its required break-even volume.

3. **Perceived-Value Pricing:** An increasing number of companies now base their price on the customer's perceived value. Perceived value is made up of a host of inputs, such as the buyer's image of the product performance, the channel deliverables, the warranty quality, customer support, and softer attributes such as the supplier's reputation, trustworthiness, and esteem. Companies must deliver the value promised by their value proposition, and the customer must perceive this value. Firms use the other marketing program elements, such as advertising, sales force, and the Internet, to communicate and enhance perceived value in buyers' minds.
4. **Value Pricing:** In recent years, several companies have adopted value pricing: They win loyal customers by charging a fairly low price for a high-quality offering. Value pricing is thus not a matter of simply setting lower prices; it is a matter of reengineering the company's operations to become a low-cost producer without sacrificing quality, to attract a large number of value-conscious customers. Value pricing can change the manner by which a company sets prices too. One company that sold and maintained switch boxes in a variety of sizes for telephone lines found that the probability of failure—and thus maintenance costs—was proportional to the number of switches customers had in their boxes rather than to the dollar value of the installed boxes. The number of switches could vary in a box, though. Therefore, rather than charging customers based on the total spent on their installation, the company began charging based on the total number of switches needing servicing.
5. **Going-Rate Pricing:** In going-rate pricing, the firm bases its price largely on competitors' prices. In oligopolistic industries that sell a commodity such as steel, paper, or fertilizer, all firms normally charge the same price. Smaller firms "follow the leader," changing their prices when the market leader's prices change rather than when their own demand or costs change. Some may charge a small premium or discount, but they preserve the difference. Thus, minor gasoline retailers usually charge a few cents less per gallon than the major oil companies, without letting the difference increase or decrease. Going-rate pricing is quite popular. Where costs are difficult to measure or competitive response is uncertain, firms feel

the going price is a good solution because it is thought to reflect the industry's collective wisdom.

6. **Auction-Type Pricing:** Auction-type pricing is growing more popular, especially with scores of electronic marketplaces selling everything from pigs to used cars as firms dispose of excess inventories or used goods. pulls are the bid's expected profit. To buy equipment for its drug researchers, Pfizer uses reverse auctions in which suppliers submit online the lowest price they are willing to be paid. If the increased savings a firm obtains in an online auction translates into decreased margins for an incumbent supplier, however, the supplier may feel the firm is opportunistically squeezing out price concessions. Online auctions with a large number of bidders, greater economic stakes, and less visibility in pricing result in greater overall satisfaction, more positive future expectations, and fewer perceptions of opportunism.

Step 6: 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 policies, gain-and-risk-sharing pricing, and the impact of price on other parties.

Impact of Other Marketing Activities

The final price must consider the brand's quality and advertising relative to the competition. In a classic study, Paul Farris and David Reibstein examined the relationships among relative price, relative quality, and relative advertising for 227 consumer businesses and found the following:

- Brands with average relative quality but high relative advertising budgets could charge premium prices. Consumers were willing to pay higher prices for known rather than for unknown products.
- Brands with high relative quality and high relative advertising obtained the highest prices. Conversely, brands with low quality and low advertising charged the lowest prices.
- For market leaders, the positive relationship between high prices and high advertising held most strongly in the later stages of the product life cycle.

These findings suggest that price is not necessarily as important as quality and other benefits.

Company Pricing Policies

The price must be consistent with company pricing policies. Yet companies are not averse to establishing pricing penalties under certain circumstances. Many companies set up a pricing department to develop policies and establish or approve decisions. The aim is to ensure that salespeople quote prices that are reasonable to customers and profitable to the company.

Gain-And-Risk-Sharing Pricing

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 the risk if it does not deliver the full promised value. Some recent risk-sharing applications include big computer hardware purchases and health plans for big unions.

Impact of Price on Other Parties

How will distributors and dealers feel about the contemplated price? If they don't make enough profit, they may choose not to bring the product to market. Will the sales force be willing to sell at that price? How will competitors react? Will suppliers raise their prices when they see the company's price? Will the government intervene and prevent this price from being charged?

POINTS TO PONDER

1. Despite the increased role of nonprice factors in modern marketing, price remains a critical element of marketing. Price is the only element that produces revenue; the others produce costs. Pricing decisions have become more challenging, however, in a changing economic and technological environment.
2. In setting pricing policy, a company follows a six-step procedure. It selects its pricing objective. It estimates the demand curve, the probable quantities it will sell at each possible price. It estimates how its costs vary at different levels of output, at different levels of accumulated production experience, and for differentiated marketing offers. It examines competitors' costs, prices, and offers. It selects a pricing method, and it selects the final price.

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