Chapter 11

Developing Pricing Strategies and Programs

In this chapter, we will address the following questions:

1. How do consumers process and evaluate prices? (Page 174)
2. How should a company set prices initially? (Page 176)
3. How should a company adapt prices to meet varying circumstances and opportunities? (Page 184)
4. When and how should a company initiate a price change and respond to a competitor's price changes? (Page 187)

Marketing Management at Ryanair

Profits for discount European air carrier Ryanair have been sky-high thanks to its revolutionary business model. Founder Michael O'Leary thinks like a retailer, charging passengers for almost everything—except their seat. A quarter of Ryanair's seats are free, and O'Leary wants to double that within five years, with the ultimate goal of making all seats free. Passengers currently pay only taxes and fees of about $10 to $24, with an average one-way fare of roughly $52. Everything else is extra: checked luggage ($9.50 per bag) and snacks ($5.50 for a hot dog, $3.50 for water). Other strategies cut costs or generate outside revenue. More than 99 percent of tickets are sold online, and its Web site offers travel insurance, hotels, ski packages, and car rentals. This formula works for Ryanair: The airline flies 58 million people to more than 150 airports each year. Ryanair enjoys net margins of 25 percent, more than three times Southwest's 7 percent. Some industry pundits even refer to Ryanair as "Walmart with wings"![1]

Price is the one element of the marketing mix that produces revenue; the other elements produce costs. Price also communicates the company's intended value positioning of its product or brand. But new economic realities have caused many consumers to reevaluate what they are willing to pay, and companies have had to carefully review their pricing strategies as a result. Pricing decisions must take into account many factors—the company, the customers, the competition, and the marketing environment. In this chapter, we discuss concepts and tools to facilitate the setting of initial prices and adjusting prices over time and markets.

Understanding Pricing

Price is not just a number on a tag. It comes in many forms and performs many functions, whether it's called rent, tuition, fares, fees, rates, tolls, or commissions. Price also has many components. Throughout most of history, prices were set by negotiation between buyers and sellers. Setting one price for all buyers is a relatively modern idea that arose with the development of large-scale retailing at the end of the nineteenth century. Tiffany & Co. and others advertised a "strictly one-price policy" because they carried so many items and supervised so many employees.

Pricing in a Digital World

Traditionally, price has operated as a major determinant of buyer choice. Consumers and purchasing agents who have access to price information and price discounters put pressure on retailers to lower their prices. Retailers in turn put pressure on manufacturers to lower their prices. The result can be a marketplace characterized by heavy discounting and sales promotion.

Downward price pressure from a changing economic environment coincided with some longer-term trends in the technological environment. For some years now, the Internet has been changing the way buyers and sellers interact. Buyers can instantly compare prices from thousands of vendors, check prices at the point of purchase, name their own price, and even get products free. Sellers can monitor customer behavior, tailor offers to individual buyers, and give certain customers access to special prices. Both buyers and sellers can negotiate prices in online auctions and exchanges or in person.

A Changing Pricing Environment

Pricing practices have changed significantly, thanks in part to a severe recession in 2008–2009, a slow recovery, and rapid technological advances. But the new millennial generation also brings new attitudes and values to consumption. Often burdened by student loans and other financial demands, members of this group (born between about 1977 and 1994) are reconsidering just what they really need to own and often choosing to rent, borrow, and share.

Some say these new behaviors are creating a **sharing economy** in which consumers share bikes, cars, clothes, couches, apartments, tools, and skills and extracting more value from what they already own. As one sharing-related entrepreneur noted, "We're moving from a world where we're organized around ownership to one organized around access to assets." In a sharing economy, someone can be both a consumer and a producer, reaping the benefits of both roles.[2] Trust and a good reputation are crucial in any exchange but imperative in a sharing economy. Most platforms that are part of a sharing-related business have some form of self-policing mechanism such as public profiles and community rating systems, sometimes linked with Facebook.

How Companies Price

In small companies, the boss often sets prices. In large companies, division and product line managers do. Even here, top management sets general pricing objectives and policies and often approves lower management's proposals.

Where pricing is a key competitive factor (railroads, oil companies), companies often establish a pricing department to set or assist others in setting appropriate prices. This department reports to the marketing department, finance department, or top management. In B-to-B settings, research suggests that pricing performance improves when pricing authority is spread horizontally across the sales, marketing, and finance units and when there is a balance in centralizing and delegating that authority between individual salespeople and teams and central management.[3]

Common pricing mistakes include not revising price often enough to capitalize on market changes; setting price independently of the rest of the marketing program rather than as an intrinsic element of market-positioning strategy; and not varying price enough for different product items, market segments, distribution channels, and purchase occasions. For any organization, effectively designing and implementing pricing strategies requires a thorough understanding of consumer pricing psychology and a systematic approach to setting, adapting, and changing prices.

Consumer Psychology and Pricing

Marketers recognize that consumers often actively process price information, interpreting it from the context of prior purchasing experience, formal communications (advertising, sales calls, and brochures), informal communications (friends, colleagues, or family members), point-of-purchase or online resources, and other factors.[4] Purchase decisions are based on how consumers perceive prices and what they consider the current actual price to be—*not* on the marketer's stated price. Customers may have a lower price threshold, below which prices signal inferior or unacceptable quality, and an upper price threshold, above which prices are prohibitive and the product appears not worth the money.

Three key topics for understanding how consumers arrive at their perceptions of prices are reference prices, price–quality inferences, and price endings.

- **Reference prices.** Although consumers may have fairly good knowledge of price ranges, surprisingly few can accurately recall specific prices.[5] When examining products, they often employ **reference prices,** comparing an observed price to an internal reference price they remember or an external frame of reference such as a posted "regular retail price."[6] Marketers encourage this thinking by stating a high manufacturer's suggested price, indicating that the price was much higher originally, or pointing to a competitor's high price.[7] Clever marketers try to frame the price to signal the best value possible. For example, a relatively expensive item can look less expensive if the price is broken into smaller units, such as a $500 annual membership for "under $50 a month," even if the totals are the same.[8]
- **Price-quality inferences.** Many consumers use price as an indicator of quality. Image pricing is especially effective with ego-sensitive products such as perfumes, expensive cars, and designer clothing. When information about true quality is available, price becomes a less significant indicator of quality. For luxury-goods customers who desire uniqueness, demand may actually increase price because they then believe fewer other customers can afford the product.[9]
- **Price endings.** Customers perceive an item priced at $299 to be in the $200 range rather than the $300 range; they tend to process prices "left to right" rather than by rounding.[10] Price encoding in this fashion is important if there is a mental price break at the higher, rounded price. Another explanation for the popularity of "9" endings is that they suggest a discount or bargain, so if a company wants a high-price image, it should probably avoid the odd-ending tactic.[11]

Setting the Price

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 must decide where to position its product on quality and price.

Firms devise their branding strategies to help convey the price-quality tiers of their products or services to consumers.[12] Having a range of price points allows a firm to cover more of the market and to give any one consumer more choices. "Marketing Insight: Trading Up, Down, and Over" describes how consumers have been shifting their spending in recent years.

The firm must consider many factors in setting its pricing policy.[13] Table 11.1 summarizes the six steps in the process.

Step 1: Selecting the Pricing Objective

Five major pricing objectives are: survival, maximum current profit, maximum market share, maximum market skimming, and product-quality leadership. 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. To *maximize current profits,* a firm estimates the demand and costs

marketing insight

Trading Up, Down, and Over

Michael Silverstein and Neil Fiske, the authors of *Trading Up*, have observed a number of middle-market consumers periodically "trading up" to what they call "New Luxury" products and services "that possess higher levels of quality, taste, and aspiration than other goods in the category but are not so expensive as to be out of reach." Three main types of New Luxury products are:

- *Accessible super-premium products* (such as Kettle gourmet potato chips), which carry a significant price premium but are still relatively low-ticket items in affordable categories.
- *Old Luxury brand extensions* (such as the Mercedes-Benz C-class), which retain their cachet while extending historically high-priced brands down-market.
- *Masstige goods*, such as Kiehl's skin care products, which are "based on emotions" and are priced between average middle-market brands and super-premium Old Luxury brands.

To trade up to brands that offer these emotional benefits, consumers often "trade down" by shopping at discounters for staple items or goods that deliver quality and functionality. The recent economic downturn increased the prevalence of trading down. As the economy improved and consumers tired of putting off discretionary purchases, retail sales picked up. Trading up and down has persisted, however, along with "trading over" or switching spending from one category to another, buying a new home theater system, say, instead of a new car.

Sources: Cotten Timberlake, "U.S. 2 Percenters Trade Down with Post-Recession Angst," www.bloomberg.com, May 15, 2013; Anna-Louise Jackson and Anthony Feld, "Frugality Fatigue Spurs Americans to Trade Up," www.bloomberg.com, April 13, 2012; Walker Smith, "Consumer Behavior: From Trading Up to Trading Off," *Branding Strategy Insider,* January 26, 2012; Bruce Horovitz, "Sale, Sale, Sale: Today Everyone Wants a Deal," *USA Today*, April 21, 2010, pp. 1A–2A; Michael J. Silverstein, *Treasure Hunt: Inside the Mind of the New Consumer* (New York: Portfolio, 2006); Michael J. Silverstein and Neil Fiske, *Trading Up: The New American Luxury* (New York: Portfolio, 2003).

TABLE 11.1 Steps in Setting a Pricing Policy

1. Selecting the Pricing Objective
2. Determining Demand
3. Estimating Costs
4. Analyzing Competitors' Costs, Prices, and Offers
5. Selecting a Pricing Method
6. Selecting the Final Price

associated with alternative prices and chooses the price that produces maximum current profit, cash flow, or rate of return on investment. However, the company may sacrifice long-run performance by ignoring the effects of other marketing variables, competitors' reactions, and legal restraints on price.

Some companies want to *maximize their market share,* believing a higher sales volume will lead to lower unit costs and higher long-run profit. With **market-penetration pricing,** firms set the lowest price, assuming the market is price sensitive. This strategy is appropriate when (1) the market is highly price sensitive and a low price stimulates market growth; (2) production and distribution costs fall with accumulated production experience; and (3) a low price discourages actual and potential competition.

Companies unveiling a new technology favor setting high prices to *maximize market skimming.* **Market-skimming pricing,** in which prices start high and slowly drop over time, makes sense when (1) a sufficient number of buyers have a high current demand; (2) the unit costs of producing a small volume are not so high that they cancel the advantage of charging what the traffic will bear; (3) the high initial price does not attract more competitors to the market; and (4) the high price communicates the image of a superior product.

A company might aim to be the *product-quality leader* in the market.[14] 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.

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.

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. The higher the price, the lower the demand. For prestige goods, the demand curve sometimes slopes upward. 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, summing 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.

A seller can successfully charge a higher price than competitors if it can convince customers that it offers the lowest *total cost of ownership* (TCO). Marketers often treat the service elements in a product offering as sales incentives rather than as value-enhancing augmentations for which they can charge. In fact, pricing expert Tom Nagle believes the most common mistake manufacturers make is to offer services to differentiate their products without charging for them.[15]

Estimating Demand Curves Most companies attempt to measure their demand curves using several different methods. They may use surveys to 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 exaggerate their willingness to pay for new products or services.[16] Price experiments can vary the prices of different products in a store or of the same product in similar territories to see how the change affects sales. Also, statistical analyses of past prices, quantities sold, and other factors can reveal their relationships.

In measuring the price-demand relationship, the market researcher must control for various factors that will influence demand.[17] The competitor's response will make a difference. Also, if the company changes other aspects of the marketing program besides price, the effect of the price change itself will be hard to isolate.

Price Elasticity of Demand Marketers need to know how responsive, or elastic, demand is to a change in price. If demand hardly changes with a small change in price, we say it is *inelastic*. If demand changes considerably, it 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 to 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 band within which price changes have little or no effect. 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. 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.

Consumers tend to be more sensitive to prices during tough economic times, but that is not true across all categories.[18] One comprehensive review of a 40-year period of academic research on price elasticity yielded interesting findings.[19] Price elasticity magnitudes were higher for durable goods than for other goods and higher for products in the introduction/growth stages of the product life cycle than in the mature/decline stages. Also, promotional price elasticities were higher than actual price elasticities in the short run (though the reverse was true in the long run).

Step 3: Estimating Costs

Whereas 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 such as rent and salaries that do not vary with production level or sales revenue. **Variable costs** vary directly with the level of production. For example, each 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.

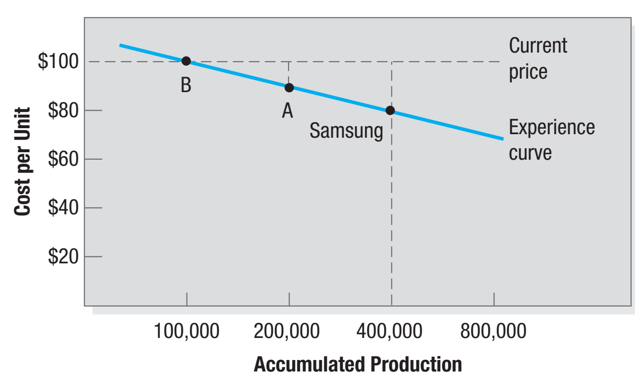
Total costs consist of the sum of the fixed and variable costs for any given level of production. **Average cost** is the cost per unit at that level of production; it equals total costs divided by production. Management wants to charge a price that will at least cover the total production costs at a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

To price intelligently, management needs to know how its costs vary with different levels of production. The cost per unit is high if few units are produced per day. As production increases, the average cost falls because the fixed costs are spread over more units. Short-run average cost *increases* after a certain point, however, because the plant becomes inefficient (due to problems such as machines breaking down). By calculating costs for plants of different sizes, a firm can identify the optimal size and production level. To estimate the real profitability of selling to different types of retailers or customers, the manufacturer needs to use *activity-based cost (ABC)* accounting instead of standard cost accounting.

Accumulated Production Suppose Samsung runs a plant that produces 3,000 tablet computers per day. As the company gains experience producing tablets, its methods improve. Workers learn shortcuts, materials flow more smoothly, and procurement costs fall. The result, as Figure 11.1 shows, is that average cost falls with accumulated production experience. Thus the average cost of producing the first 100,000 tablets is $100 per tablet. When the company has produced the first 200,000 tablets, the average cost has fallen to $90. After its accumulated production experience doubles again to 400,000, the average cost is $80. This decline in the average cost with accumulated production experience is called the **experience curve** or *learning curve*.

Now suppose three firms compete in this particular tablet market, Samsung, A, and B. Samsung is the lowest-cost producer at $80, having produced 400,000 units in the past. If all three firms sell the tablet for $100, Samsung makes $20 profit per unit, A makes $10 per unit, and B breaks even. The smart move for Samsung would be to lower its price to $90. This will drive B out of the market, and even A may consider leaving. Samsung will pick up the business that

FIGURE 11.1 Cost per Unit as a Function of Accumulated Production: The Experience Curve



would have gone to B (and possibly A). Furthermore, price-sensitive customers will enter the market at the lower price. As production increases beyond 400,000 units, Samsung's costs will drop still further and faster, more than restoring its profits, even at a price of $90.

Experience-curve pricing nevertheless carries major risks. Aggressive pricing might give the product a cheap image. It also assumes competitors are weak followers. The strategy leads the company to build more plants to meet demand, but a competitor may choose to innovate with a lower-cost technology. The market leader is now stuck with the old technology.

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. Cost cutting cannot go so deep as to compromise the brand promise and value delivered.

Step 4: Analyzing Competitors' Costs, Prices, and Offers

Within the range of possible prices identified by market demand and company costs, the firm must take competitors' costs, prices, and possible 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.[20]

Step 5: Selecting a Pricing Method

The company is now ready to select a price. Figure 11.2 summarizes the three major considerations in price setting: Costs set a floor to the price. Competitors' prices and the price of substitutes provide an orienting point. Customers' assessment of unique features establishes the price ceiling. We will examine seven price-setting methods: markup pricing, target-return pricing, perceived-value pricing, value pricing, EDLP, going-rate pricing, and auction-type pricing.

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. Suppose a toaster manufacturer has the following costs and sales expectations:

Variable cost per unit	$10
Fixed costs	$300,000
Expected unit sales	50,000

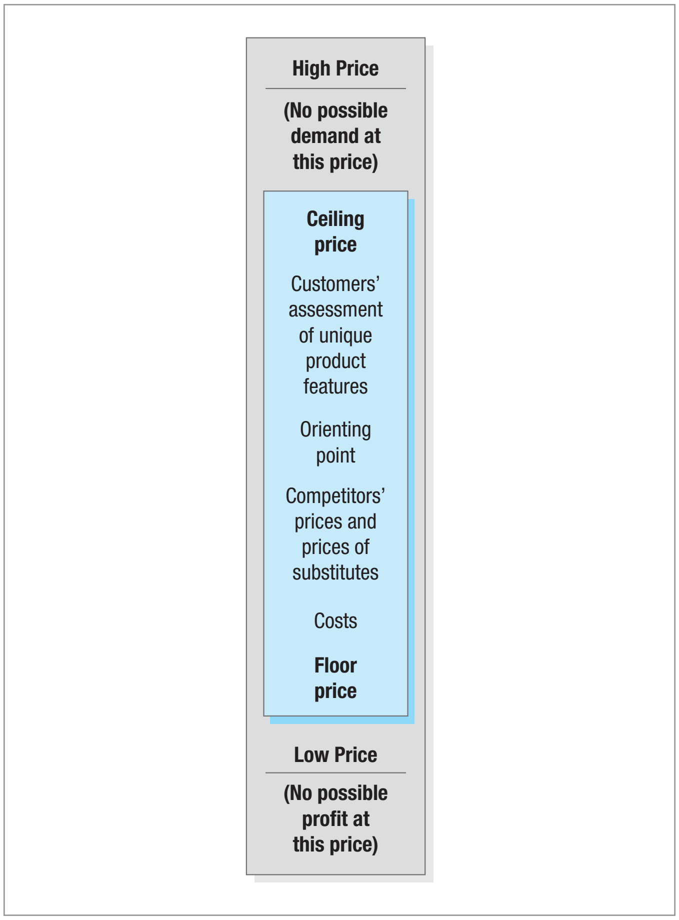
The manufacturer's unit cost is given by:

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

If the manufacturer wants to earn a 20 percent markup on sales, its markup price is given by:

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

FIGURE 11.2 The Three Cs Model for Price Setting



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.

Generally, the use of standard markups does not make logical sense. 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 because sellers can determine costs much more easily than they can estimate demand. By tying the price to cost, sellers simplify the pricing task. Also, when all firms in the industry use this pricing method, prices tend to be similar and price competition is minimized. Finally, many people feel cost-plus pricing is fairer to both buyers and sellers.

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:

$$\text{Target-return price} = \text{unit cost} + \frac{\text{desired return} \times \text{invested capital}}{\text{unit sales}}$$

$$= \$16 + \frac{.20 \times \$1{,}000{,}000}{50{,}000} = \$20$$

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 11.3). Fixed costs are stable, 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:

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

If the manufacturer sells 50,000 units at \$20, 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. It should also search for ways to lower its fixed or variable costs because lower costs will decrease its required break-even volume.

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

FIGURE 11.3 Break-Even Chart for Determining Target-Return Price and Break-Even Volume

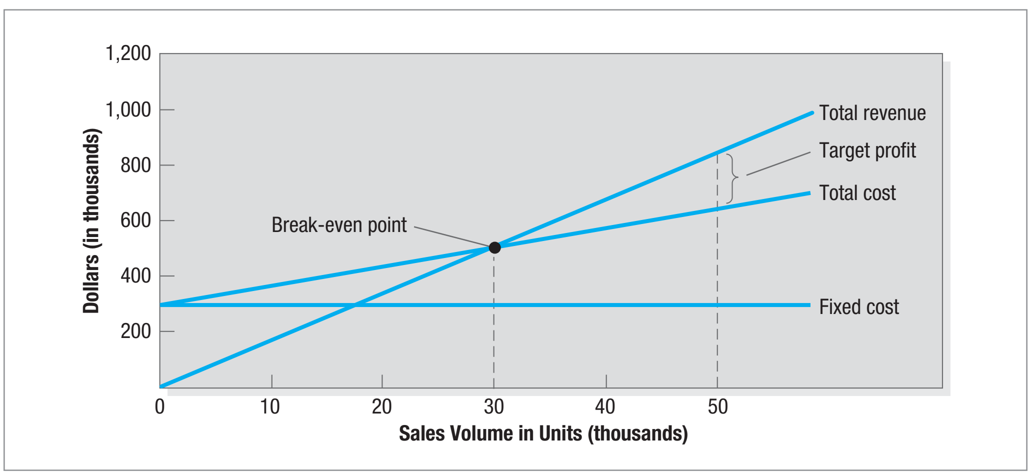


image of product performance, channel deliverables, warranty quality, customer support, and the supplier's reputation. Companies must deliver the value promised by their value proposition, and the customer must perceive this value. Firms use other marketing program elements, such as advertising, the sales force, and the Internet, to communicate and enhance perceived value in buyers' minds.

Even when a company claims its offering delivers more total value, not all customers will respond positively. Some care only about price. But there is also typically a segment that cares about quality. The key to perceived-value pricing is to deliver more unique value than competitors and to demonstrate this to prospective buyers.

Value Pricing Companies that adopt **value pricing** win loyal customers by charging a fairly low price for a high-quality offering. This requires reengineering the company's operations to become a low-cost producer without sacrificing quality to attract a large number of value-conscious customers.

EDLP A retailer using **everyday low pricing (EDLP)** charges a constant low price with little or no price promotion or special sales. Constant prices eliminate week-to-week price uncertainty and the high-low pricing of promotion-oriented competitors. In **high-low pricing,** the retailer charges higher prices on an everyday basis but runs frequent promotions with prices temporarily lower than the EDLP level.[21] The most important reason retailers adopt EDLP is that constant sales and promotions are costly and have eroded consumer confidence in everyday prices. Some consumers also have less time and patience for clipping coupons. Yet promotions and sales do create excitement and draw shoppers, so EDLP does not guarantee success and is not for everyone.[22]

Going-Rate Pricing In **going-rate pricing,** the firm bases its price largely on competitors' prices. Smaller firms "follow the leader," changing their prices when the market leader's prices change. Some may charge a small premium or discount, but they preserve the difference. Going-rate pricing is quite popular. Where costs are difficult to measure or competitive response is uncertain, firms feel it is a good solution because they believe it reflects the industry's collective wisdom.

Auction-Type Pricing *Auction-type pricing* is growing more popular, especially with electronic marketplaces. *English auctions*, with ascending bids, have one seller and many buyers; bidders raise their offers until the highest bidder gets the item. There are two types of *Dutch auctions*, which feature descending bids. In the first, an auctioneer announces a high price and then slowly decreases the price until a bidder accepts. In the other, the buyer announces something he or she wants to buy, and potential sellers compete to offer the lowest price. In *sealed-bid auctions,* would-be suppliers submit only one bid; they cannot know the other bids. The U.S. government often uses this method to procure supplies. A supplier will not bid below its cost but cannot bid too high for fear of losing the job. The net effect of these two pulls is the bid's *expected profit*.

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 take into account the brand's quality and advertising relative to the competition. When Paul Farris and David Reibstein examined the relationships among relative price, relative quality, and relative advertising for 227 consumer businesses, they found that brands with average relative quality but high relative advertising budgets could charge premium prices because consumers were willing to pay more for known products.[23] 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.

Company Pricing Policies The price must be consistent with company pricing policies. Although companies may establish pricing penalties under certain circumstances, they should use them judiciously and try not to alienate customers. Many companies set up a pricing department to develop policies and establish or approve decisions. The aim is to ensure 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 they perceive a high level of risk, such as in a big computer hardware purchase or a company health plan. The seller then has the option of offering to absorb part or all the risk if it does not deliver the full promised value. An increasing number of companies, especially B-to-B marketers, may have to stand ready to guarantee any promised savings but also participate in the upside if the gains are much greater than expected.

Impact of Price on Other Parties How will distributors and dealers feel about the contemplated price?[24] 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? For example, it is illegal for a company to set artificially high "regular" prices, then announce a "sale" at prices close to previous everyday prices.

Adapting the Price

Companies usually do not set a single price but rather develop a pricing structure that reflects variations in geographical demand and costs, market-segment requirements, purchase timing, order levels, delivery frequency, guarantees, service contracts, and other factors. As a result of discounts, allowances, and promotional support, a company rarely realizes the same profit from each unit of a product that it sells. Here we will examine several price-adaptation strategies: geographical pricing, price discounts and allowances, promotional pricing, and differentiated pricing.

Geographical Pricing (Cash, Countertrade, Barter)

In geographical pricing, the company decides how to price its products to different customers in different locations and countries. Should the company charge higher prices to distant customers to cover higher shipping costs or a lower price to win additional business? How should it account for exchange rates and the strength of different currencies?

Another question is how to get paid. This issue is critical when buyers lack sufficient hard currency to pay for their purchases. Many want to offer other items in payment, a practice known as **countertrade,** and U.S. companies are often forced to accept if they want the business. One form of countertrade is *barter,* in which the buyer and seller directly exchange goods, with no money and no third party involved. A second form is a *compensation deal,* in which the seller receives some percentage of the payment in cash and the rest in products. A third form is a *buyback agreement,* as when the firm sells a plant, equipment, or technology to a company in another country and agrees to accept as partial payment products manufactured with the supplied equipment. A fourth form of countertrade is *offset,* where the firm receives full payment in cash for a sale overseas but agrees to spend a substantial amount of the money in that country within a stated time period.

Price Discounts and Allowances

Most companies will adjust their list price and give discounts and allowances for early payment, volume purchases, and off-season buying (see Table 11.2). Companies must do this carefully or find their profits much lower than planned.[25] Some product categories self-destruct by always being on sale. Manufacturers should consider the implications of supplying retailers at a discount because they may end up losing long-run profits in an effort to meet short-run volume goals. Upper management should conduct a *net price analysis* to arrive at the "real price" of the offering, which is affected by discounts and other expenses.

Promotional Pricing

Companies can use several pricing techniques to stimulate early purchase:

- **Loss-leader pricing.** Stores often drop the price on well-known brands to stimulate store traffic. This pays if the revenue on the additional sales compensates for the lower loss-leader margins. Manufacturers of loss-leader brands typically object because this practice can dilute the brand image and bring complaints from retailers who charge the list price.
- **Special event pricing.** Sellers establish special prices in certain seasons to draw in more customers, such as back-to-school sales.
- **Special customer pricing.** Sellers offer special prices exclusively to certain customers, such as members of a brand community.

TABLE 11.2 Price Discounts and Allowances

Discount:	A price reduction to buyers who pay bills promptly. A typical example is "2/10, net 30," which means payment is due within 30 days and the buyer can deduct 2 percent by paying within 10 days.
Quantity Discount:	A price reduction to those who buy large volumes. A typical example is "$10 per unit for fewer than 100 units; $9 per unit for 100 or more units." Quantity discounts must be offered equally to all customers and must not exceed the cost savings to the seller. They can be offered on each order placed or on the number of units ordered over a given period.
Functional Discount:	Discount (also called *trade discount*) offered by a manufacturer to trade-channel members if they perform certain functions, such as selling, storing, and record keeping. Manufacturers must offer the same functional discounts within each channel.
Seasonal Discount:	A price reduction to those who buy merchandise or services out of season. Hotels and airlines offer seasonal discounts in slow selling periods.
Allowance:	An extra payment designed to gain reseller participation in special programs. *Trade-in allowances* are granted for turning in an old item when buying a new one. *Promotional allowances* reward dealers for participating in advertising and sales support programs.

- **Cash rebates.** Auto companies and others offer cash rebates to encourage purchase of the manufacturers' products within a specified time period, clearing inventories without cutting the stated list price.
- **Low-interest financing.** Instead of cutting its price, the company can offer low-interest financing.
- **Longer payment terms.** Sellers, especially mortgage banks and auto companies, stretch loans over longer periods and thus lower the monthly payments. Consumers often worry less about the cost (the interest rate) of a loan and more about whether they can afford the monthly payment.
- **Warranties and service contracts.** Companies can promote sales by adding a free or low-cost warranty or service contract.
- **Psychological discounting.** This strategy sets an artificially high price and then offers the product at substantial savings; for example, "Was $359, now $299." The Federal Trade Commission and Better Business Bureau fight illegal discount tactics.

Promotional-pricing strategies are often a zero-sum game. If they work, competitors copy them and they lose their effectiveness. If they don't work, they waste money that could have been put into other marketing tools, such as building up product quality and service or strengthening product image through advertising.

Differentiated Pricing

Companies often adjust their basic price to accommodate differences among customers, products, locations, and so on. **Price discrimination** occurs when a company sells a product or service at two or more prices that do not reflect a proportional difference in costs. In first-degree price discrimination, the seller charges a separate price to each customer depending on the intensity of his or her demand. In second-degree price discrimination, the seller charges less to buyers of larger volumes. In third-degree price discrimination, the seller charges different amounts to different classes of buyers. Examples include: charging students and senior citizens lower prices; pricing different versions of the product differently; pricing the same product at different levels depending on image differences; charging differently for a product sold through different channels; pricing a product differently at different locations; and varying prices by season, day, or time of day.

The airline and hospitality industries use yield management systems and *yield pricing*, offering discounted but limited early purchases, higher-priced late purchases, and the lowest rates on unsold inventory just before it expires. Airlines charge different fares to passengers on the same flight depending on the seating class, the time of day, the day of the week, and so on.

The phenomenon of offering different pricing schedules to different consumers and dynamically adjusting prices is exploding. Online merchants selling their products on Amazon .com are changing their prices on an hourly or even minute-by-minute basis, in part so they can secure the top spot on search results.[26] Even sports teams are adjusting ticket prices to reflect the popularity of the competitor and the timing of the game.[27]

Price discrimination works when (1) the market is segmentable and the segments show different intensities of demand; (2) members in the lower-price segment cannot resell the product to the higher-price segment; (3) competitors cannot undersell the firm in the higher-price segment; (4) the cost of segmenting and policing the market does not exceed the extra revenue derived from price discrimination; (5) the practice does not breed customer resentment and ill will; and (6) the particular form of price discrimination is not illegal.[28]

Initiating and Responding to Price Changes

Companies often need to cut or raise prices.

Initiating Price Cuts

Several circumstances might lead a firm to cut prices. One is *excess plant capacity*: The firm needs additional business and cannot generate it through increased sales effort, product improvement, or other measures. Companies sometimes initiate price cuts in a *drive to dominate the market through lower costs.* Either the company starts with lower costs than its competitors, or it initiates price cuts in the hope of gaining market share and lower costs.

Cutting prices to keep customers or beat competitors often encourages customers to demand price concessions, however, and trains salespeople to offer them.[29] A price-cutting strategy can lead to other possible traps. Consumers might assume quality is low, or the low price buys market share but not market loyalty—because customers switch to lower-priced firms. Also, higher-priced competitors might match the lower prices but have longer staying power because of deeper cash reserves. Finally, lowering prices might trigger a price war.[30]

Initiating Price Increases

A successful price increase can raise profits considerably. If the company's profit margin is 3 percent of sales, a 1 percent price increase will increase profits by 33 percent if sales volume is unaffected. A major circumstance provoking price increases is *cost inflation.* Rising costs unmatched by productivity gains squeeze profit margins and lead companies to regular rounds of price increases. Companies often raise their prices by more than the cost increase, in anticipation of further inflation or government price controls, in a practice called *anticipatory pricing.*

Another factor leading to price increases is *overdemand.* When a company cannot supply all its customers, it can raise its prices, ration supplies, or both. Although there is always a chance a price increase can carry some positive meanings to customers—for example, that the item is "hot" and represents an unusually good value—consumers generally dislike higher prices. To avoid sticker shock and a hostile reaction when prices rise, the firm should give customers advance notice so they can do forward buying or shop around. Sharp price increases also need to be explained in understandable terms.

Anticipating Competitive Responses

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.[31] If it has a profit-maximization objective, it may react by increasing its advertising budget or improving product quality.

Responding to Competitors' Price Changes

In responding to competitive price cuts, the company must consider the product's stage in the life cycle, its importance in the company's portfolio, the competitor's intentions and resources, the market's price and quality sensitivity, the behavior of costs with volume, and the company's alternative opportunities. In markets characterized by high product homogeneity, the firm can enhance its augmented product or meet the price reduction. If the competitor raises its price in a homogeneous product market, other firms might not match it if the increase will not benefit the industry as a whole. Then the leader will need to roll back the increase.

In nonhomogeneous product markets, a firm should consider why the competitor changed the price. Was it to steal the market, to utilize excess capacity, to meet changing cost conditions, or to lead an industry-wide price change? Is the competitor's price change temporary or permanent? What will happen to the company's market share and profits if it does not respond? Are other companies going to respond? And how are competitors and other firms likely to respond to each possible reaction?

Executive Summary

Price is the only marketing element that produces revenue; the others produce costs. Consumers often actively process price information within the context of prior purchasing experience, formal and informal communications, point-of-purchase or online resources, and other factors. In setting pricing policy, a company follows six steps: (1) select the pricing objective; (2) determine demand; (3) estimate costs; (4) analyze competitors' costs, prices, and offers; (5) select a pricing method; and (6) select the final price. Price-adaptation strategies include geographical pricing, price discounts and allowances, promotional pricing, and discriminatory pricing. Price-setting methods include markup pricing, target-return pricing, perceived-value pricing, value pricing, EDLP, going-rate pricing, and auction-type pricing.

A price decrease might be brought about by excess plant capacity, declining market share, a desire to dominate the market through lower costs, or economic recession. A price increase might be brought about by cost inflation or overdemand. Companies must carefully manage customer perceptions when raising prices. Also, they should anticipate competitor price changes and prepare contingent responses, including maintaining or changing price or quality. When facing competitive price changes, the firm should try to understand the competitor's intent and the likely duration of the change.

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