10

Manage Pricing Decisions

Chapter Questions

- How do consumers process and evaluate prices?
- How should a company set prices initially for products or services?
- How should a company adapt prices to meet varying circumstances and opportunities?
- When should a company initiate a price change?
- How should a company respond to a competitor's price challenge?

Synonyms for Price

- Rent
- Tuition
- Fee
- Fare
- Rate
- Toll
- Premium
- Honorarium
- Special assessment
- Bribe
- Dues
- Salary
- Commission
- Wage
- Tax

Common Pricing Mistakes

- Determine costs and take traditional industry margins
- Failure to revise price to capitalize on market changes
- Setting price independently of the rest of the marketing mix
- Failure to vary price by product item, market segment, distribution channels, and purchase occasion

Consumer Psychology and Pricing

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"

Possible Consumer Reference Prices

- "Fair price"
- Typical price
- Last price paid
- Upper-bound price
- Lower-bound price
- Competitor prices
- Expected future price
- Usual discounted price

Consumer Perceptions vs. Reality for Cars

Overvalued Brands

- Land Rover
- Kia
- Volkswagen
- Volvo
- Mercedes

Undervalued Brands

- Mercury
- Infiniti
- Buick
- Lincoln
- Chrysler

Price-quality inferences and Price endings (cont'd)

❖**Price-Quality Inferences**

➢ Many consumers use price as an indicator of quality

➢ Some companies adopt exclusivity and scarcity to justify premium prices

❖**Price Endings**

➢ Many sellers believe that prices should end in an odd number.

➢ Research has shown that consumers tend to process prices in a "left-to-right" manner rather than by rounding.

➢ Pricing cues like "sale" signs and prices that end in a 9 are less effective the more they are employed

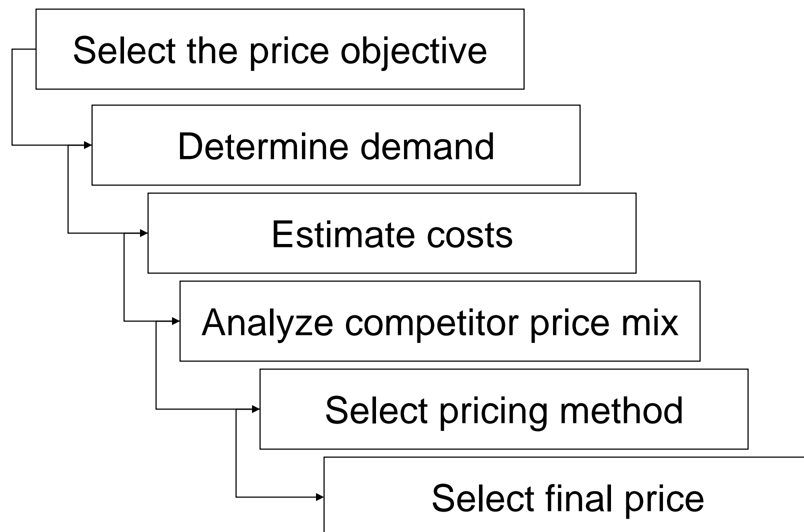
Price Cues (cont'd)

- "Left to right" pricing ($299 versus $300)
- Odd number discount perceptions
- Even number value perceptions
- Ending prices with 0 or 5
- "Sale" written next to price

When to Use Price Cues

- Customers purchase item infrequently
- Customers are new
- Product designs vary over time
- Prices vary seasonally
- Quality or sizes vary across stores

Steps in Setting Price



Step 1: Selecting the Pricing Objective

❖**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.

❖**Maximum current profits**: Survival is a short-run objective; in the long run, the firm must learn how to add value or face extinction. Many companies try to set a price that will maximize current profits.

❖**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.

❖**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.

Step 2: Determining Demand

Price Sensitivity

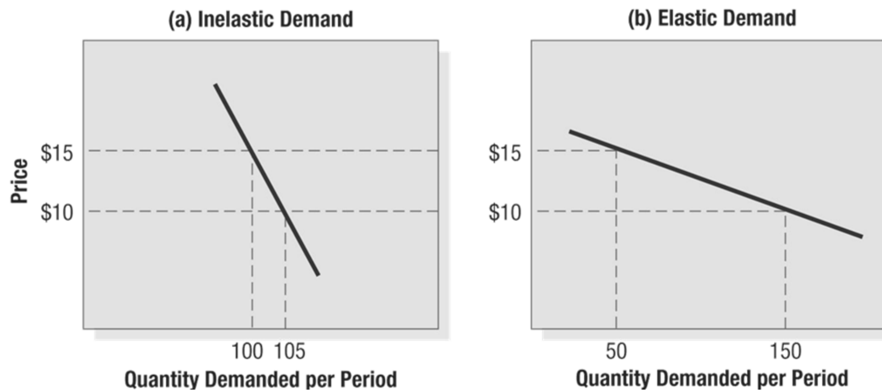
Estimating Demand Curves

Price Elasticity of Demand

- Each price will lead to a different level of demand and therefore have a different impact on a company's marketing objectives. The relation between alternative prices and the resulting current demand is captured in a **demand curve.**
- **Price Sensitivity**
- The demand curve shows the market's probable purchase quantity at alternative prices. The first step in 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.
- Customers 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 (total cost of ownership—TCO).
- Companies prefer customers who are less price-sensitive.

Figure 1: Inelastic and Elastic Demand

•If demand hardly changes with a small change in price, we say the demand is inelastic.
•If demand changes considerably, demand is elastic.



Factors Leading to Less Price Sensitivity

- The product is more distinctive
- Buyers are less aware of substitutes
- Buyers cannot easily compare the quality of substitutes
- Expenditure is a smaller part of buyer's total income
- Expenditure is small compared to the total cost
- Part of the cost is paid by another party
- Product is used with previously purchased assets
- Product is assumed to have high quality and prestige
- Buyers cannot store the product

Step 3: Estimating Costs Cost Terms and Production

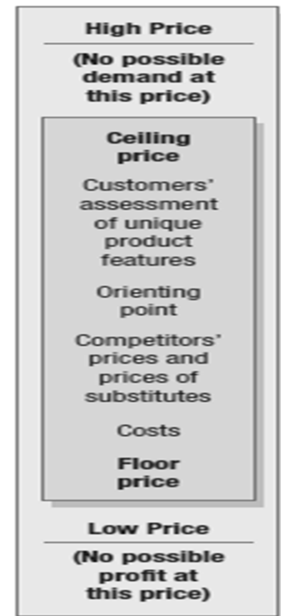
- **Fixed costs**
  - (also known as overhead) are costs that do not vary with production or sales revenue. A company must pay bills each month for rent, heat, interest, salaries, and so on regardless of output.
- **Variable costs**
  - vary directly with the level of production.
- **Total costs**
  - 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.
- **Cost at different levels of 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***.

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.
  - The firm should first consider the nearest competitor's price.
  - The introduction of any price or the change of any existing price can provoke a response from customers, competitors, distributors, suppliers, and even the government.
  - 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.

Fig 2: The Three Cs Model for Price-Setting

The figure summarizes the three major considerations in price setting:
***C**osts set a floor to the price.*
***C**ompetitors' prices and the price of substitutes provide an orienting point.*
***C**ustomers' assessment of unique features establishes the price ceiling.*



Step 5: Selecting a Pricing Method

- **Markup pricing**: The most elementary pricing method is to add a standard markup to the product's cost
- **Target-return pricing**: In target-return pricing, the firm determines the price that would yield its target rate of return on investments (ROI). Target-return pricing tends to ignore price elasticity and competitors' prices.
- **Perceived-value pricing**: They must deliver the value promised by their value proposition, and the customer must perceive this value.
- **Value pricing**: win loyal customers by charging a fairly low price for a high-quality offering.
  - Value pricing is 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.
- **Going-rate pricing**: the firm bases its price largely on competitor's prices
- **Auction-type pricing** is growing more popular, especially with the growth of the Internet.

Step 6: Selecting the Final Price

- **Impact of other marketing activities:** The final price must take into account the brand's quality and advertising relative to the competition.
- **Company pricing policies**: The price must be consistent with company pricing policies.
  - Many companies set up a pricing department to develop policies and establish or approve pricing decisions.
- **Gain-and-risk sharing pricing**: Buyers may resist accepting a seller's proposal because of a high-perceived level of risk
- **Impact of price on other parties**: Management must also consider the reactions of other parties to the contemplated price. For example,
  - How will distributors and dealers feel about it?
  - Will the sales force be willing to sell at that price?

Price-Adaptation Strategies

- Geographical Pricing
- Discounts/Allowances
- Promotional Pricing
- Differentiated Pricing

Price-Adaptation Strategies

- **Geographical pricing** involves the company in deciding how to price its products to different customers in different locations and countries.
- **Discounts / Allowances**

- A **cash discount** is a price reduction to buyers who pay bills promptly. A typical example is "2/10, net 30," which means that payment is due within 30 days and that the buyer can deduct 2 percent by paying the bill within 10 days.
- A **quantity discount** is a price reduction to those who buy large volumes.
- A **functional or trade discount** is offered by a manufacturer to trade channel members if they will perform certain functions, such as selling, storing, and record keeping. Manufacturers must offer the same functional discounts within each channel.
- A **seasonal discount** is a price reduction to those who buy merchandise or services out of season.
- An **allowance** is 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.

Promotional Pricing Tactics

- **Loss-leader pricing** means that supermarkets and department stores often drop the price on well-known brands to stimulate additional store traffic. This pays if the revenue on the additional sales compensates for the lower margins on the loss-leader items.
- **Special event pricing** means that sellers will establish special prices in certain seasons to draw in more customers. Special customer pricing means sellers will offer special prices exclusively to certain customers.
- **Cash rebates** mean that auto companies and other consumer-goods companies offer cash rebates to encourage purchase of the manufacturers' products within a specified time period.
- **Low-interest financing** means that instead of cutting its price, the company can offer customers low interest financing.
- **Longer payment terms:** Sellers, especially mortgage banks and auto companies, stretch loans over longer periods and thus lower the monthly payments.
- **Warranties and service contracts:** Companies can promote sales by adding a free or low-cost warranty or service contract.
- Using **psychological discounting** is a strategy that sets an artificially high price and then offers the product at substantial savings; for example, "Was $359, now $299."

Differentiated Pricing

- Companies often adjust their basic price to accommodate differences in 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 who buy a larger volume.
  - In third-degree price discrimination, the seller charges different amounts to different classes of buyers: Customer-segment pricing; Product-form pricing; Image pricing; Channel pricing; Location pricing; Time pricing; (*see next slide*)
- Some forms of price discrimination are illegal. **Price discrimination is legal** if the seller can prove that its costs are different when selling different volumes or different quantities of the same product to retailers.
- **Predatory pricing**—selling below cost with the intent of destroying competition - is unlawful.

Differentiated Pricing (cont'd)

- **Customer segment pricing** means that different customer groups pay different prices for the same product or service.
- **Product form pricing** means that different versions of the product are priced differently, but not proportionately to their costs. Evian prices a 48 ounce bottle of its mineral water at $2.00 and 1.7 ounces of the same water in a moisturizer spray at $6.00.
- **Image pricing**: Some companies price the same product at two different levels based on image differences.
- **Channel pricing** means charging a different price depending on where the consumer buys the product.
- **Location pricing** means the same product is priced differently at different locations even though the cost of offering it at each location is the same.
- **Time pricing** means that prices are varied by season, day, or hour.

Table 1: Should we raise prices?

	Before	After	
Price	$ 10	$10.10	(a 1 percent price increase)
Units sold	100	100	
Revenue	$1000	$1010	
Costs	–970	–970	
Profit	$ 30	$ 40	(a 33⅓ percent profit increase)

It can be worthwhile to raise prices. 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. This situation is illustrated in Table 14.6. The assumption is that a company charged $10 and sold 100 units and had costs of $970, leaving a profit of $30, or 3 percent on sales. By raising its price by 10 cents (a 1 percent price increase), it boosted its profits by 33 percent, assuming the same sales volume.

Methods for Increasing Prices

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. It can increase price in the following ways, each of which has a different impact on buyers.

- **Delayed quotation pricing** means that the company does not set a final price until the product is finished or delivered. This pricing is prevalent in industries with long production lead times, such as industrial construction and heavy equipment.
- **Escalator clauses** are used when the company requires the customer to pay today's price and all or part of any inflation increase that takes place before delivery. An escalator clause bases price increases on some specified price index.
- **Unbundling** means the company maintains its price but removes or prices separately one or more elements that were part of the former offer, such as free delivery or installation. Car companies sometimes add higher-end audio entertainment systems or GPS navigation systems as extras to their vehicles.
- **Reduction of discounts** means that the company instructs its sales force not to offer its normal cash and quantity discounts.

Brand Leader Responses to Competitive Price Cuts

- Maintain price
- Maintain price and add value
- Reduce price
- Increase price and improve quality
- Launch a low-price fighter line

- **Review Question**

➢ Identify and briefly explain the pricing methods