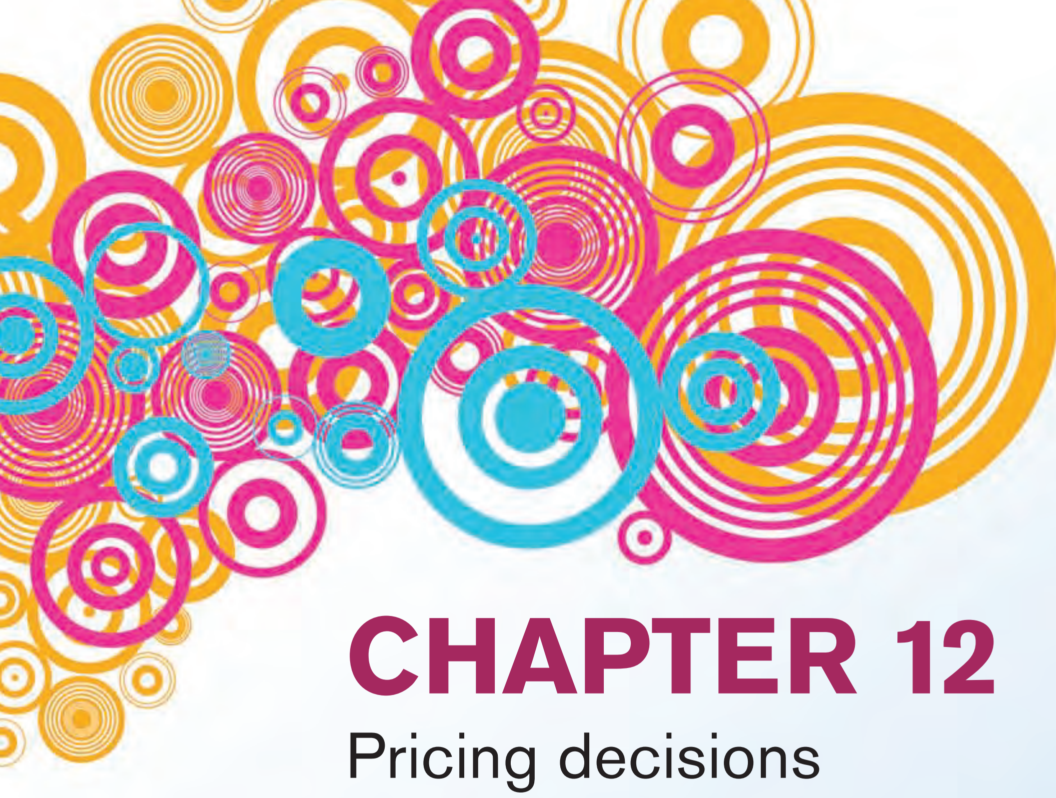


CHAPTER 12
Pricing decisions

LEARNING OBJECTIVES

After studying this chapter you should be able to:

- understand why an appropriate customer value proposition is a useful guide to pricing strategy
- explain how cost-based pricing methods work and what their primary drawbacks are
- formulate pricing decisions for services
- explain how internal and external variables influence pricing decisions
- explain why and how prices escalate in different distribution channels
- discuss the strategic options in determining the price level for a new product
- undertake a break-even analysis
- explain what is meant by experience curve pricing
- evaluate reasons why base prices change over time in both business and consumer markets
- understand the implications of the Internet for pricing behaviour in the market, particularly price 'customisation'

12.1 INTRODUCTION

Pricing is the only element of the marketing mix to generate revenue. However, price affects not only the profit through its impact on revenue, it also affects the quantity sold through its influence on demand. Price has an interactive effect on the other elements of the marketing mix, so pricing decisions must be integrated with the other three Ps of the marketing mix. Price is the only area of the global marketing mix where policy can be changed rapidly without large direct cost implications. In addition, overseas consumers are often sensitive to price

changes made in other areas of the firm's marketing programme. It is thus important that management realises that constant fine tuning of prices in overseas markets should be avoided and that many problems are not best addressed by changing prices.

Generally, pricing policy is one of the most important yet often least recognised of all the elements in the marketing mix. The other elements in the marketing mix all lead to costs. The only source of profit to the firm comes from revenue, which in turn is dictated by pricing policy. In this chapter, we focus on a number of pricing issues of special interest to international marketers.

The objective of marketing is not simply to sell a product but to create value for the customer and the seller. Consequently, marketers should price products fairly, to reflect the value produced as well as received. Innovative marketers create value by offering, for example, a better product, faster delivery, better service, easier ordering, and more convenient locations. The greater the value perceived by customers, the more often they demand a company's products, and the higher the price they are willing to pay.

12.2 PRICING FROM AN ECONOMIST'S PERSPECTIVE

Market demand and market growth are often dependent on price level. With high prices at the beginning of the product life cycle, consumers simply cannot enter the market. As the price of mobile phones, CD players and computers decrease, more consumers enter these markets.

Ideally, the price maker would like information about the following two interrelated questions:

- What will be the quantity demanded at any given price?
- What will the effect of changes in price be on sales volume?

Figure 12.1 illustrates the principal issues with the help of a simple demand curve. It shows how market demand for a product varies as a function of price change. We normally refer to

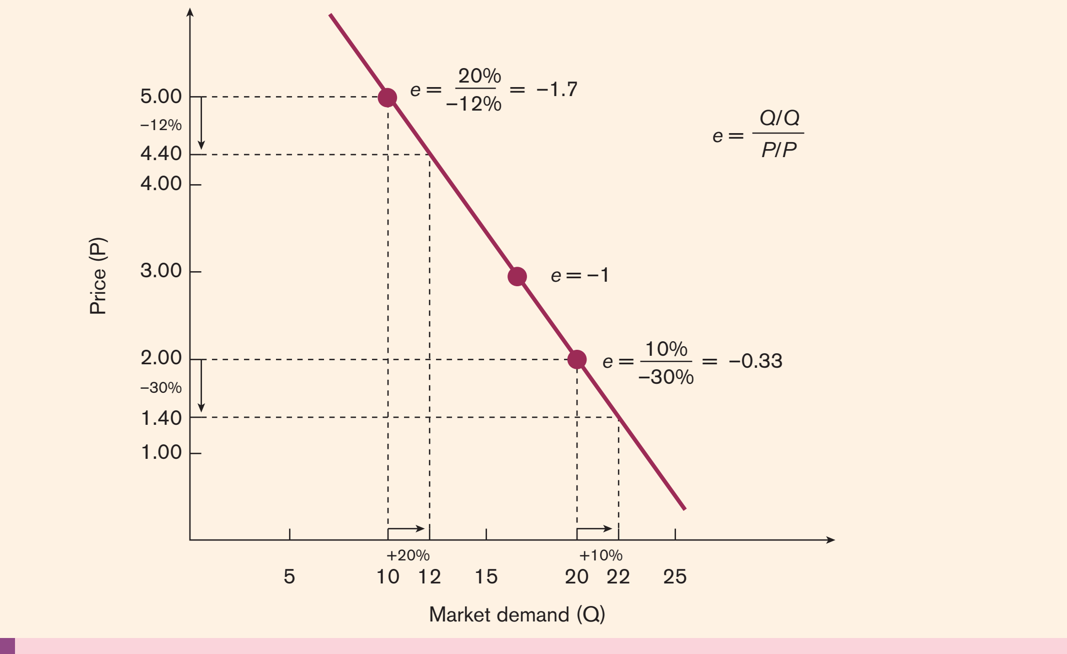


Figure 12.1 Price elasticity on the demand curve

this as *price elasticity* of demand. It is important to distinguish between the demand curve for the industry as a whole and that faced by the individual company. In this chapter, the individual firm is analysed. Formally, price elasticity of demand can be calculated as follows:

$$\text{price elasticity of demand: } e = \frac{\text{percentage change in quantity demand}}{\text{percentage change in price}}$$

$$= \frac{\Delta Q/Q}{\Delta P/P}$$

Figure 12.1 shows that at each price along the diagonal demand curve, there is a different level of price elasticity.

Measures of price elasticity commonly range through:

$e < 1$ Relatively price-inelastic − quantity demanded rises (falls) by a smaller percentage than price falls (rises).

$e = 1$ Neutral price elasticity − quantity demanded rises (falls) by the same percentage that price falls (rises).

$e > 1$ Relatively price-elastic − quantity demanded rises (falls) at a greater rate than price falls (rises).

While, by definition, the ratio usually has a negative sign (this is because as prices rise, demand usually falls), it is customary, in illustrating elasticities, to drop the sign (only mentioning the numerical value).

A business might continue to lower prices to grow demand, but when the price elasticity reaches −1.0, the sales revenue will have reached its maximum. At this point, raising or lowering prices will result in lower overall sales revenue. This is the price point at which a not-for-profit organisation doing fund-raising events would be able to maximise the revenues received, if that is their objective. However, a business wanting to maximise profits may price above or below this price point, as we shall see in Section 12.3. Here, the optimum price change is dependent on the contribution margin.

The relationship between the price of one product and the quantity demanded of another is an important measure. It is known as the cross-price elasticity of demand (CPE). In this case:

- products are substitutes for one another if CPE > 0;
- products are complements to one another if CPE < 0.

Competitor price response

Many managers might ask, 'What will my competitors do in response to my price change?' If a business lowers prices to gain market share, and competitors follow, there is likely to be very little real gain. And at reduced margins, with a limited increase in volume, total contribution is likely to go down. On the other hand, if a business raises prices to improve margins and competitors do not follow, the business could lose market share and total contribution would be lower, even though margins are higher.

In any given market, competitor response to price change is going to depend on a variety of supply and demand forces, as outlined in Figure 12.2. As the forces shift from the left to the right, they will contribute to the likelihood of a full and fast competitor response to a price cut. Overall, there is generally a high degree of price interdependence among competing firms (Docters *et al.*, 2008).

Lambin (1976) showed that the average competitor price response elasticity was 0.71. This means that if a business lowered its prices by 10 per cent, it could expect competitors to lower prices by 7.1 per cent.

	Probability of full and fast competitive response to price cut		
Competitor characteristics/internal forces:	**Low**		**High**
Variable cost structure	High	←→	Low
Capacity utilisation	Full	←→	Low
Product perishability	None	←→	High
Product differentiation	High	←→	None
Competitor financial position	Poor	←→	Strong
Strategic importance	Low	←→	High
Demand forces:			
Price elasticity	Inelastic	←→	Elastic
Efficiency in price shopping	Low	←→	High
Customer loyalty	High	←→	Low
Market growth rate	High	←→	Low
Complementary products	None	←→	Important
Substitute products	None	←→	Many

Figure 12.2 Forces favouring competitive price response
Source: Adapted from Best, R. J. (2000) *Market-based Management*, 2nd ed., Prentice Hall, Upper Saddle River, NJ, p. 186. Reproduced with permission.

EXHIBIT 12.1
Johnny Walker whisky faced positive price elasticity in Japan

In Japanese markets, perceived value is a principal influence on product success. The images of quality significantly outweigh the actual value of the product, as quality is predominantly associated with high prices. This is demonstrated by the domination of Mercedes and BMW in the foreign import market. Johnny Walker whisky also represented images of high status. In an attempt to gain market share from its main rival Chivas, it reduced its price. Japanese consumers perceived the reduction in price to be a reduction in quality and status, resulting in a drastic decline in sales.

Source: Adapted from Marsh (2000), p. 200.

12.3 PRICING FROM AN ACCOUNTANT'S PERSPECTIVE

Break-even analysis
The calculation of the quantity needed to be sold to cover total costs.

Break-even pricing
Setting price to break even on the costs of making and marketing a product; or setting price to make a target profit.

In contrast to the economist's focus on demand, the accountant's approach to pricing is often based essentially on costs. **Break-even analysis** and **break-even pricing** are generally viewed as accounting concepts, but are extremely useful in evaluating the profit potential and risk associated with a pricing strategy, or any marketing strategy. The purpose of this section is to examine, from a marketing viewpoint, the usefulness of break-even volume.

For a given price strategy and marketing effort, it is useful to determine the number of units that need to be sold in order to break even, i.e. produce a net profit equal to zero. The break-even point is normally represented as that level of output where the total revenue from sales of a product or service matches exactly the total costs of its production and marketing (break-even quantity). Such an analysis of cost–revenue relationships can be very useful to the pricing decision maker.

One use of break-even analysis is to compare the break-even volumes associated with different prices for a product. A simplified example of this is shown in Figure 12.3.

The effect of charging a higher price is to steepen the total revenue curve and as a consequence lower the break-even volume. The pricing decision maker can then assess the effect of

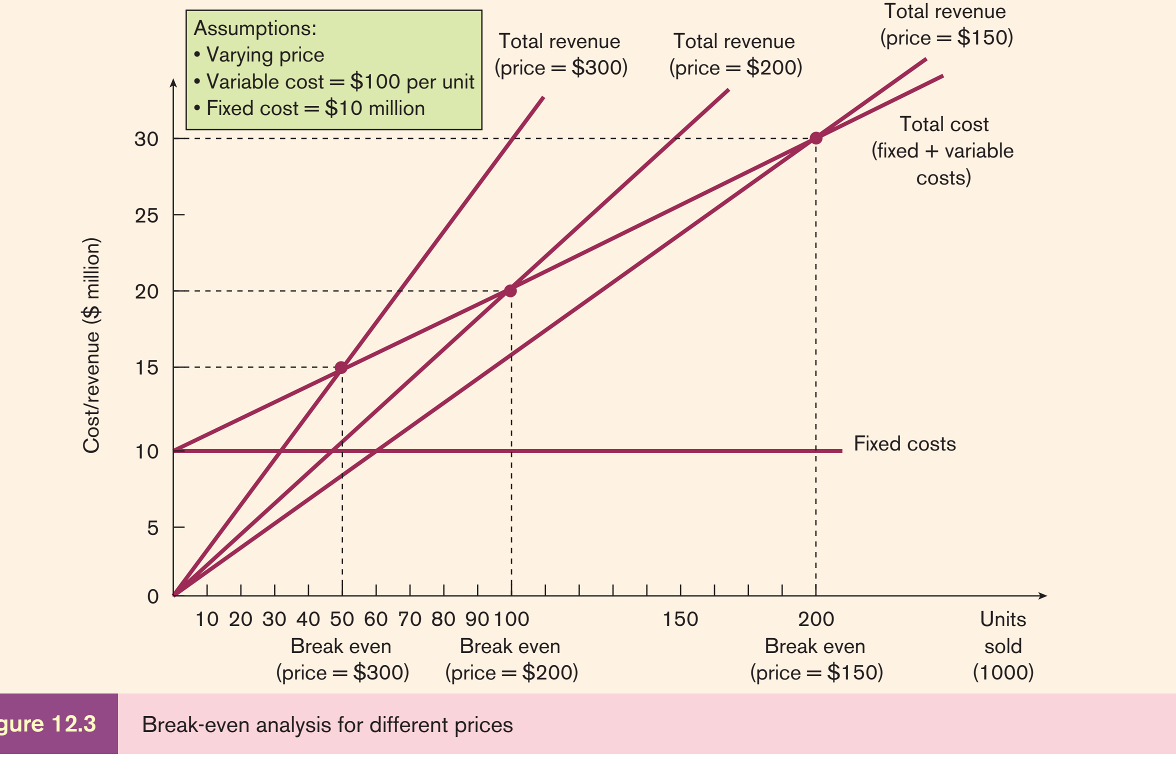


Figure 12.3 Break-even analysis for different prices

charging different prices in terms of what these different prices and break-even volumes mean to the company. Specifically, the information given by a break-even chart is:

- profit or losses at varying levels of output;
- break-even points at varying levels of price;
- effect on break-even point and profits or losses if costs change.

The break-even volume is the volume needed to cover the fixed costs on the basis of a particular contribution per unit. Although break-even volume can be estimated graphically, as illustrated in Figure 12.3, it can be computed more directly as follows:

$$\text{selling price} - \text{variable cost per unit} = \text{contribution per unit}$$

$$\text{break-even volume} = \frac{\text{fixed costs}}{\text{contribution per unit}}$$

The notion of contribution per unit is also a valuable addition to the price maker's armoury. It illustrates that, in the short term at least, it may pay a company to sell a product at a price that is less than the full cost of producing it. Remember that fixed costs are those that do not vary with the level of output. If a company produces and sells nothing, it will still incur these costs. At any price above the variable cost of producing each product, the company is receiving a contribution towards those fixed costs. In the long run, of course, a company must cover all its costs through the prices it sets on its products.

Break-even market share

Because break-even volume is an unconstrained number, the reasonableness of the break-even volume should be considered further. Because market share is constrained between 0 and 100 per cent, break-even market share provides a better framework from which to judge

profit potential and risk. To compute break-even market share requires only that we divide the break-even volume by the size of the total market:

$$\text{break-even market share} = \frac{\text{break-even volume}}{\text{total market}} \times 100$$

If the total market for a product were 1 million units per year, then the break-even market share would be as follows using the three prices from Figure 12.3:

$$\text{Break-even market share (price} = \$300) = \frac{50{,}000}{1{,}000{,}000} \times 100 = 5\%$$

$$\text{Break-even market share (price} = \$200) = \frac{100{,}000}{1{,}000{,}000} \times 100 = 10\%$$

$$\text{Break-even market share (price} = \$150) = \frac{200{,}000}{1{,}000{,}000} \times 100 = 20\%$$

Of course management would feel much better if the break-even share was only 5 per cent instead of 20 per cent. In this example reducing the price by 50 per cent (from $300 to $150) would mean that the market share should be increased by 400 per cent.

It is clear that neither the economist's model of price setting (with help from the demand curve and price elasticity) nor the accountant's contribution of break-even analysis is in itself a sufficient basis on which to determine prices. Nevertheless, taken together, they do point to a clear-cut and universal assumption for delineating pricing decisions which can be incorporated into a more realistic and marketing-oriented approach to pricing. This more market-oriented approach to pricing will be discussed in the following sections.

12.4 A PRICING FRAMEWORK

An SME which markets its products for the first time, with little knowledge of the market that it is entering, is likely to set a price that will ensure that the sales revenue generated at least covers the cost incurred. It is important that firms recognise that the cost structures of a product are very significant, but they should not be regarded as the sole determinants when setting prices.

Pricing policy is an important strategic and tactical competitive weapon that, in contrast to the other elements of the global marketing mix, is highly controllable and inexpensive to change and implement. Therefore, pricing strategies and actions should be integrated with the other elements of the global marketing mix.

Figure 12.4 presents a general framework for international pricing decisions. According to this model, factors affecting international pricing can be broken down into two main groups (internal and external factors) and four sub-groups, which we will now consider in more detail.

Firm-level factors

International pricing is influenced by past and current corporate philosophy, organisation and managerial policies. The short-term tactical use of pricing in the form of discounts, product offers and reductions is often emphasised by managers at the expense of its strategic role. Yet pricing has played a very significant part in the restructuring of many industries, resulting in the growth of some businesses and the decline of others. In particular, Japanese firms have approached new markets with the intention of building market share over a period of years by reducing price levels, establishing the brand name, and setting up effective distribution and servicing networks. The market share objective of the Japanese firms has usually been accomplished at the expense of short-term profits, as international Japanese firms have

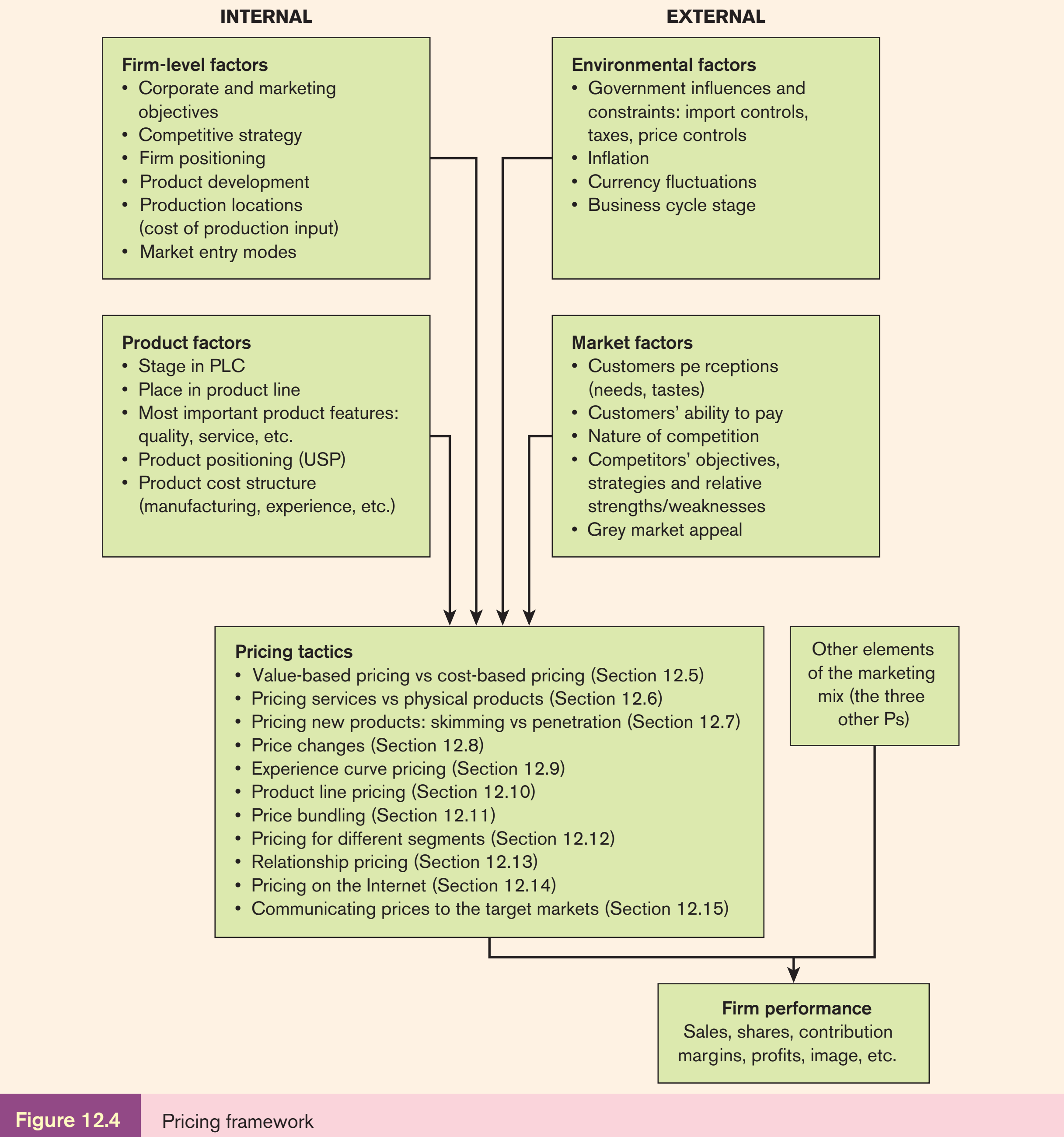


Figure 12.4 Pricing framework

consistently taken a long-term perspective on profit. They are usually prepared to wait much longer for returns on investment than some of their Western counterparts.

The choice of foreign market entry mode also affects the pricing policy. A manufacturer with a subsidiary in a foreign country has a high level of control over the pricing policy in that country.

Product factors

Key product factors include the unique and innovative features of the product and the availability of substitutes. These factors will have a major impact on the stage of the product

lifecycle, which will also depend on the market environment in target markets. Whether the product is a service, a manufactured product or a commodity sold into consumer or industrial markets is also significant.

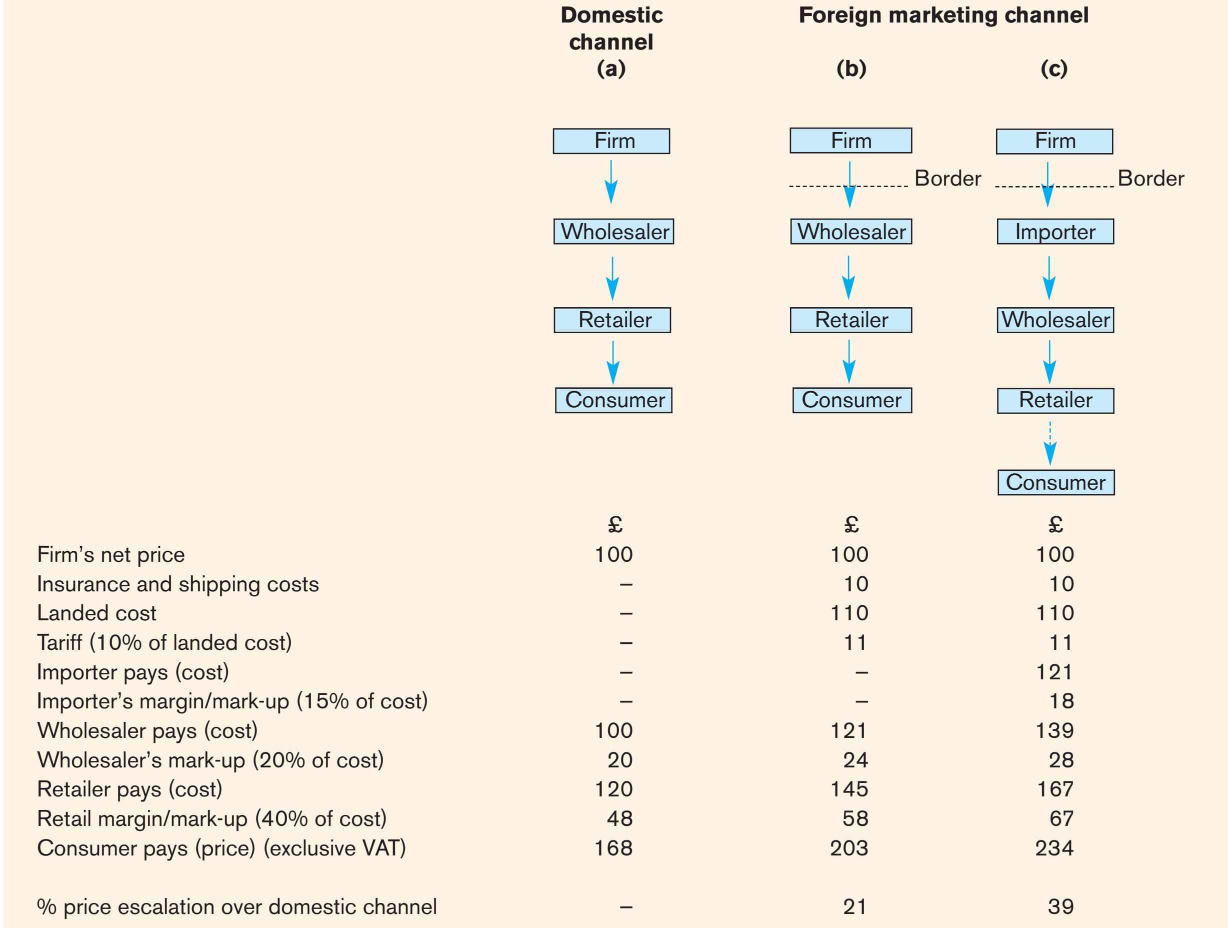
The extent to which the organisation has had to adapt or modify the product or service, and the level to which the market requires service around the core product, will also affect cost and thereby have some influence on pricing.

Costs are also helpful in estimating how rivals will react to the setting of a specific price, assuming that knowledge of one's own costs helps in the assessment of competitors' reactions. Added to the above is the intermediary cost, which depends on channel length, intermediary factors and logistical costs. All these factors add up and lead to **price escalation** through the distribution channel.

Price escalation
The tendency of prices to creep upwards when marketing products and services abroad through several middlemen.

The example in Figure 12.5 shows that, due to additional shipping, insurance and distribution charges, the exported product costs 21 per cent more in the export market than at home. If there is an additional distribution link (an importer), the product will cost 39 per cent more abroad than at home.

Many marketers are not aware of rapid price escalation; they are preoccupied with the price they charge to the importer. However, the final consumer price should be of vital concern because it is on this level that the consumer can compare prices of different competitive products and it is this price that plays a major role in determining the foreign demand.



	(a) £	(b) £	(c) £
Firm's net price	100	100	100
Insurance and shipping costs	–	10	10
Landed cost	–	110	110
Tariff (10% of landed cost)	–	11	11
Importer pays (cost)	–	–	121
Importer's margin/mark-up (15% of cost)	–	–	18
Wholesaler pays (cost)	100	121	139
Wholesaler's mark-up (20% of cost)	20	24	28
Retailer pays (cost)	120	145	167
Retail margin/mark-up (40% of cost)	48	58	67
Consumer pays (price) (exclusive VAT)	168	203	234
% price escalation over domestic channel	–	21	39

Figure 12.5 Example of price escalation
Source: Hollensen, S. (2001) *Global Marketing: A Market Responsive Approach*, 2nd ed., Financial Times-Prentice Hall, Harlow, p. 450. Reproduced with permission.

Price escalation is not the only problem for marketers. It affects all firms involved in cross-border transactions. Companies that ship substantial amounts of goods and materials to subsidiaries in other countries are exposed to many of the additional charges that cause price escalation.

The following management options are available to counter price escalation:

- rationalising the distribution process by, e.g. reducing the number of links in the distribution process, either by doing more in-house or by circumventing some channel members;
- lowering the export price from the factory (firm's net price), thus reducing the multiplier effect of all the **mark-ups**;
- establishing local production of the product within the export market to eliminate some of the cost;
- pressuring channel members to accept lower profit margins. This may be appropriate if these intermediaries are dependent on the manufacturer for much of their turnover.

Mark-up
A mark-up expressed as a percentage of the cost of an item.

It may be dangerous to overlook traditional channel members. In Japan, for example, the complex nature of the distribution system, which often involves many different channel members, makes it tempting to consider radical change. However, existing intermediaries do not like to be overlooked, and their possible network with other channel members and the government may make it dangerous for a foreign firm to attempt to cut them out.

Environmental factors

The environmental factors are external to the firm and thus uncontrollable variables in the foreign market. The national government control of exports and imports is usually based on political and strategic considerations.

Generally, import controls are designed to limit imports in order to protect domestic producers or reduce the outflow of foreign exchange. Direct restrictions commonly take the form of **tariffs**, quotas and various **non-tariff trade barriers**. Tariffs directly increase the price of imports unless the exporter or importer is willing to absorb the tax and accept lower profit margins. Quotas have an indirect impact on prices. They restrict supply, thus causing the price of the import to increase.

Tariff
A tax levied by a government against certain imported products. Tariffs are designed to raise revenue or to protect domestic firms.

Non-tariff trade barriers
Non-monetary barriers to foreign products, such as biases against a foreign company's bids, or product standards that go against a foreign company's product features.

Since tariff levels vary from country to country, there is an incentive for exporters to vary the price somewhat from country to country. In some countries with high customs duties and high price elasticity, the base price may have to be lower than in other countries if the product is to achieve a satisfactory volume in these markets. If demand is quite inelastic, the price may be set at a high level, with little loss of volume, unless competitors are selling at lower prices.

Government regulations on pricing can also affect the firm's pricing strategy. Many governments tend to have price controls on specific products related to health, education, food and other essential items. Another major environmental factor is fluctuations in the exchange rate. An increase (revaluation) or decrease (devaluation) in the relative value of a currency can affect the firm's pricing structure and profitability.

Market factors

One of the critical factors in the market is the purchasing power of the customers (the customer's ability to pay). The pressure of competitors may also affect international pricing. The firm has to offer a more competitive price if there are other sellers in the market. Thus, the nature of competition (e.g. **oligopoly** or **monopoly**) can influence the firm's pricing strategy.

Oligopoly
A market structure characterised by a small number of sellers who control the market.

Monopoly
Exists if there is one seller in the market, such as a state-owned company, e.g. a local electricity supplier, postal service company or a gas company. The seller has the control over the market and can solely determine the price of its product.

Under conditions approximating pure competition, the price is set in the marketplace and tends to be just enough above costs to keep marginal producers in business. Thus, from the point of view of the price setter, the most important factor is costs. The more easily a product can be substituted, the closer prices must be, and the greater the influence of costs in determining prices (assuming that there is a large enough number of buyers and sellers).

Under a monopoly or imperfect competition, the seller has some discretion to vary the product quality, promotional efforts and channel politics in order to adapt the price of the total product to serve preselected market segments. Nevertheless, the freedom to set prices is still limited by what competitors charge, and any price differentials from competitors must be justified in the minds of customers on the basis of differential utility: that is, perceived value.

When considering how customers will respond to a given price strategy, Nagle (1987) has suggested nine factors which influence the sensitivity of customers to prices. Price sensitivity is reduced when:

- the product is more distinctive;
- there is greater perceived quality of products;
- consumers are less aware of substitutes in the market;
- there is difficulty in making comparisons (e.g. in the quality of services such as consultancy or accountancy);
- the price of a product represents a small proportion of total expenditure of the customer;
- the perceived benefit for the customer increases;
- the product is used in association with a product bought previously, so that, for example, components and replacements are usually extremely highly priced;
- costs are shared with other parties;
- the product or service cannot be stored.

In the following sections we discuss the different pricing strategies that are available.

12.5 MARKET VALUE-BASED PRICING VERSUS COST-BASED PRICING

To arrive at the proper balance between the needs of the market and the needs of the firm, it is important to understand value-based pricing. Value-based pricing recognises that price reflects value, not simply costs. Traditionally, firms assessed the costs of doing business, added a profit, and arrived at the price. Once it was set, the marketer's job was to convince customers that the product was worth it. If the marketer was not successful, then the price was lowered. If demand turned out to be higher than anticipated, then the price was raised. An important point is that the customer was the last person to be considered in this chain of events.

Value-based pricing begins by understanding customers and the competitive marketplace. The first step is to look at the value customers perceive in owning the product and to examine their options for acquiring similar products and brands.

Although cost-based pricing is easier, it ignores the customer and the competition. Marketers know that it is impossible to predict demand or competitors' actions simply by looking at their own costs. Consequently, cost-based pricing is becoming less popular.

Because prices send powerful messages, it is extremely important that they reflect the customer value the company delivers. Customer value is derived from the product itself, the services surrounding it, the company–customer interaction, and the image the customer associates with the product. Volvo, for example, has captured buyers at relatively high prices for years because of a reputation for durability and safety.

The firm is likely to incur higher costs when producing increased value. For example, it often costs more to make better products, create better distribution systems, or develop service facilities. The trick is to find a balance between what customers are willing to pay and the costs associated with the strategy.

It is not easy to establish precisely what price both buyers and seller agree is fair. We need to look at how customer value is derived, recognising that people place different values on the products they buy as well as the relationship they have with companies. Several pricing strategies may work. It all depends on how price is perceived, how competitors act, and how a strategy is designed and implemented.

12.6 PRICING SERVICES VERSUS PHYSICAL PRODUCTS

The intangibility of service performance and the invisibility of the necessary facilities and labour makes it harder for customers to see what they are getting for their money than when they purchase a physical product (Indounas, 2009; Hinterhuber, 2008).

Intangibles like services are inherently more difficult to price than goods, because it is harder to calculate the financial costs involved in serving a customer than it is to identify the labour, materials, machine time, storage and shipping costs associated with producing a physical product. The **variability** of both inputs and outputs means that units of service may not cost the same to produce, nor may they be of equal value to customers – especially if the variability extends to greater or lesser quality. Making matters even more complicated, it is not always easy to define a unit of service, raising questions as to what should be the basis of service pricing.

Variability
The characteristic of services referring to the fact that services are heterogeneous – that is, the quality of delivered services can vary widely.

A very important distinction between goods and services is that many services have a much higher ratio of fixed costs to variable costs than is found in manufacturing firms. Service businesses with high fixed costs include those with an expensive physical facility (such as a hotel, a hospital, a college or a theatre) or a network (such as a telecommunications company, an Internet provider, a railway). On the other hand, the variable costs of serving one extra customer may be minimal. Under these conditions, managers may feel that they have tremendous pricing flexibility and it is tempting to price very low in order to make an extra sale. However, there can be no profit at the end of the year unless all fixed costs have been recovered.

Another factor that influences service pricing concerns the importance of the time factor, since it may affect customer perceptions of value. In many instances, customers may be willing

EXHIBIT 12.2
Pricing in the airline business

As the marginal cost of carrying a passenger, rather than having the seat unfilled, is very low – meals, some extra fuel, and airport and over-flying charges – the price can be brought down to a sufficiently low level to sell those remaining seats as departure time approaches. However, experience also shows that associated with ticket flexibility there will be some passengers who do not turn up. The precise number is uncertain, but airlines typically overbook to allow for the passengers who do not turn up, though they run a risk of bumping passengers on to other flights at often relatively high prices if there are more passengers than available seats.

The pricing of scheduled airline tickets is complex, with features that are little appreciated by the traveller. For instance, irrespective of the product factors or service provision the price typically charged per kilometre is uniform neither for different passengers on a single flight nor in comparison with distance flown on other routes. The reason for this is that there are many categories of fare, which enables airlines to practise differential pricing by having special requirements or conditions. The principal methods are the amount of flexibility associated with the ticket, the period prior to flight when it was purchased and certain characteristics of the passenger, perhaps age or occupation.

Ticket flexibility on a scheduled flight enables the passenger to substitute another flight without notice or penalty and to book a flight virtually on demand. The desirability of doing this depends on the urgency of changing plans and the availability of alternative flights and it is possible to have reservations on many flights, where only one will be used. Arising from the airlines' responsibility to provide such flexibility, enough capacity must be provided, thereby increasing costs. Typically this degree of flexibility is intended for the business traveller whose fare is paid by an employer.

Source: Adapted from Driver (2001).

to pay more for a service delivered quickly than for one delivered more slowly. Sometimes greater speed increases operating costs, too – reflecting the need to pay overtime or use more expensive equipment.

12.7 PRICING NEW PRODUCTS

Skimming vs penetration pricing

The strategic decision of pricing new products can be best understood by examining the policies at the boundaries of the continuum – from *skimming* (high initial price) to *penetration* (low initial price).

Skimming

Skimming price
A relatively high price, often charged at the beginning of a product's life. The price is systematically lowered as time goes by.

Skimming pricing, which is appropriate for a distinctly new product, provides the firm with an opportunity to profitably reach market segments that are not sensitive to the high initial price. As a product ages, as competitors enter the market, and as organisational buyers become accustomed to evaluating and purchasing the product, demand becomes more price elastic. The policy of using skimming at the outset, followed by penetration pricing as the product matures, is termed *time segmentation*. A skimming policy enables the marketer to capture early profits, then reduce the price to reach segments that are more price sensitive. It also enables the innovator to recover high developmental costs quicker.

Problems with skimming are as follows:

- Having a small market share makes the firm vulnerable to aggressive local competition.
- Maintenance of a high-quality product requires a lot of resource (promotion, after-sales service) and a visible local presence, which may be difficult in distant markets.
- If the product is sold more cheaply at home or in another country, a **grey market** (**parallel import**) is likely.

Grey markets
The marketing of authentic, legally trademarked goods through unauthorised channels.

Parallel importing
When importers buy products from distributors in one country and sell them in another to distributors who are not part of the manufacturer's normal distribution; caused by big price differences for the same product between different countries.

Penetration price
A low introductory price meant to quickly establish a product in the market.

Penetration

Penetration pricing is appropriate when there is high price elasticity of demand, strong threat of imminent competition, and opportunity for a substantial reduction in production costs as volume expands. Drawing upon the experience effect, a firm that can quickly gain substantial market share and experience can gain a strategic advantage over competitors. The viability of this strategy increases with the potential size of the future market. By taking a large share of new sales, experience can be gained when there is a large market growth rate. Of course, the value of additional market share differs markedly between industries and often among products, markets and competitors within a particular industry. Factors to be assessed in determining the value of additional market share include the investment requirements, potential benefits of experience, expected market trends, likely competitive reaction, and short- and long-term profit implications.

Penetration pricing can be effective for fixed periods of time and in the right competitive situation, but many firms overuse this approach and end up creating a market situation where everyone is forced to lower prices continually, driving some competitors from the market and guaranteeing that no one realises a good return on investment. Managers can prevent the fruitless slide into kamikaze pricing by implementing a value-driven pricing strategy for the most profitable customers (Holden and Nayle, 1998).

Japanese companies have used penetration pricing intensively to gain market leadership in a number of markets, such as cars, home entertainment products and electronic components.

Figure 12.6 summarises the main features of skimming and penetration pricing. Because neither is likely to achieve strong buyer loyalty in competitive markets, most companies use pricing approaches that fall somewhere between these extremes.

	Skimming	Penetration pricing
Definition	Setting a relatively high price during the initial stage of a product's life. A strategy designed to obtain a relatively high price from relatively few consumers, who have the resources and desire to buy irrespective of price.	Setting a relatively low price during the initial stage of a product's life. A strategy that seeks the maximum number of buyers by charging low prices.
Objectives	To serve customers who are not price conscious while the market is at the upper end of the demand curve and competition has not yet entered the market. To recover a significant portion of promotional and research and development costs through a high margin.	To discourage competition from entering the market by quickly taking a large market share and by gaining a cost advantage through realising economies of scale.
Requirements	Heavy promotional expenditure to introduce product, educate consumers, and induce early buying. Relatively inelastic demand at the upper end of the demand curve. Lack of direct competition and substitutes. If companies perceive they can obtain a monopoly position for a short time, then they may skim to generate profits that provide investment capital for further innovations. To sustain skimming, companies must offer unusual products of the highest quality or artistic value.	Product must appeal to a market large enough to support the cost advantage. Demand must be highly elastic in order for the firm to guard its cost advantage.
Expected results	Market segmented by price-conscious and not so price-conscious customers. High margin on sales that will cover promotion and research and development costs. During the first stages in the PLC, the firm is able to create a price umbrella because the competition cannot match the firm's relative advantage, as shown here. Cost per unit Price Cost Time As the demand for a high-priced segment is saturated, price can be lowered to systematically attract more customers until prices reach a level affordable to most potential customers.	High sales volume and large market share. Low margin on sales. Lower unit costs relative to competition due to economies of scale. A cost leadership position can enable a business to use penetration pricing to build market share and discourage competition from either entering the market or staying in the market. In this situation, the market leader is simply further down the cost curve and is able to price at a lower level and still maintain a satisfying contribution. If costs are sensitive to volume, then these will drop dramatically as share increases relative to competitors. This is a way to keep rivals from entering the market. Cost per unit Price Cost Time
Illustrative examples/ problems	In the pharmaceutical industry many prescription drugs (like Pfizer's Viagra) are patented. Under this protection, the holder may create higher-than-normal prices. However, many times this strategy does not produce loyal customers, since subsequent entrants eventually offer better value at a lower price. In the past, IBM dominated personal computer sales, but as smaller companies entered the market it had to price more competitively.	Compaq Computer was an early entry in the personal computer market. Compaq priced aggresively to build market share in a market where all computer manufacturers could offer the same product. In these instances, product differentiation is minimal, customers are price-sensitive, there are many competitors or substitutes, and competitor entry is easy. The price leader can often both gain an early cost advantage with a large volume and charge lower prices, discouraging competitors from entering the market. The problem with penetration pricing is that losses are likely, especially in the short term. Because profit margins tend to be very small, demand must meet expectations in order to generate enough earnings. Furthermore, when customers buy only because of price, loyalty tends to be low. They are likely to switch to competition offering an even lower price or innovations of higher value at a higher price.

Figure 12.6 Two new product pricing strategies

Market pricing

If similar products already exist in the target market, market pricing may be used. The final customer price is based on competitive prices. This approach requires the exporter to have a thorough knowledge of product costs, as well as confidence that the product life cycle is long enough to warrant entry into the market. It is a reactive approach and may lead to problems if sales volumes never rise to sufficient levels to produce a satisfactory return. Although firms typically use pricing as a differentiation tool, the global marketing manager may have no choice but to accept the prevailing world market price.

From the price that customers are willing to pay, it is possible to make a so-called retrograde calculation where the firm uses a 'reversed' price escalation to calculate backwards (from market price) to the necessary (ex-factory) net price. If this net price can create a satisfactory contribution margin, then the firm can go ahead.

12.8 PRICE CHANGES

Price changes on existing products are called for when a new product has been launched or when changes occur in overall market conditions (such as fluctuating foreign exchange rates).

Table 12.1 shows the percentage sales volume increase or decrease required to maintain the level of profit. An example shows how the table functions. A firm has a product with a contribution margin of 20 per cent. The firm would like to know how much the sales volume should be increased as a consequence of a price reduction of 5 per cent, if it wishes to keep the same total profit contribution. The calculation is as follows:

Before price reduction

Per product	sales price	£100
	variable cost per unit	£80
	contribution margin	£20

Total contribution margin: 100 units @ £20 = £2000

After price reduction (5%)

Per product	sales price	£95
	variable cost per unit	£80
	contribution margin	£15

Total contribution margin: 133 units @ £15 = £2000

As a consequence of a price reduction of 5 per cent, a 33 per cent increase in sales is required. If a decision is made to change prices, related changes must also be considered. For example, if an increase in price is required, it may be accompanied, at least initially, by increased promotional effort.

When changing prices, the degree of flexibility enjoyed by decision makers will tend to be less for existing products than for new products. This follows from the high probability that the existing product is now less unique, faces stronger competition and is aimed at a broader segment of the market. In this situation, the decision maker will be forced to pay more attention to competitive and cost factors in the pricing process (Davidson and Simonetto, 2005).

The timing of price changes can be nearly as important as the changes themselves. For example, a simple tactic of announcing price increases after competitors can produce the perception among customers that you are the most customer-responsive supplier. The extent of the time lag can also be important (Matthyssens *et al.*, 2009).

Table 12.1 Sales volume increase or decrease (%) required to maintain total profit contribution

Price reduction (%)	Profit contribution margin (price – variable cost per unit as % of the price)								
	5	10	15	20	25	30	35	40	50
	Sales volume increase (%) required to maintain total profit contribution								
2.0	67	25	15	11	9	7	7	5	4
3.0	150	43	25	18	14	11	9	8	6
4.0	400	67	36	25	19	15	13	11	9
5.0		100	50	**33**	25	20	17	14	11
7.5		300	100	60	43	33	27	23	18
10.0			200	100	67	50	40	33	25
15.0				300	150	100	75	60	43

Price increase (%)	Profit contribution margin (price – variable cost per unit as % of the price)								
	5	10	15	20	25	30	35	40	50
	Sales volume reduction (%) accepted to maintain total profit contribution								
2.0	29	17	12	9	7	6	5	5	4
3.0	27	23	17	13	11	9	8	7	6
4.0	44	29	21	17	14	12	10	9	7
5.0	50	33	25	20	17	14	12	11	9
7.5	60	43	33	27	23	20	18	16	13
10.0	67	50	40	33	29	25	22	20	17
15.0	75	60	50	43	37	33	30	27	23

Source: Hollensen, S. (2001) *Global Marketing: A Market Responsive Approach*, 2nd ed., Financial Times-Prentice Hall, Harlow, p. 454. Reproduced with permission.

In one company, an independent survey of customers (Garda, 1995) showed that the perception of being the most customer-responsive supplier was generated just as effectively by a six-week lag in following a competitor's price increase as by a six-month lag. A considerable amount of money would have been lost during the unnecessary four-and-a-half-month delay in announcing a price increase.

12.9 EXPERIENCE CURVE PRICING

Price changes usually follow changes in the product's stage in the life cycle. As the product matures, more pressure will be put on the price to keep the product competitive despite increased competition and less possibility of differentiation.

Let us also bring the cost aspect into the discussion. The experience curve has its roots in a commonly observed phenomenon called the learning curve, which states that as people repeat a task they learn to do it better and faster. The learning curve applies to the labour portion of manufacturing cost. The Boston Consulting Group extended the learning effect to cover all the value-added costs related to a product – manufacturing plus marketing, sales, administration, etc.

The resulting experience curves, covering all value chain activities (see Figure 3.1 in Chapter 3), indicate that the total unit cost of a product in real terms can be reduced by a certain percentage with each doubling of cumulative production. The typical decline in cost is 30 per cent (termed a 70 per cent curve), although greater and lesser declines are observed.

If we combine the experience curve (average unit cost) with the typical market price development within an industry, we will have a relationship similar to that shown in Figure 12.7.

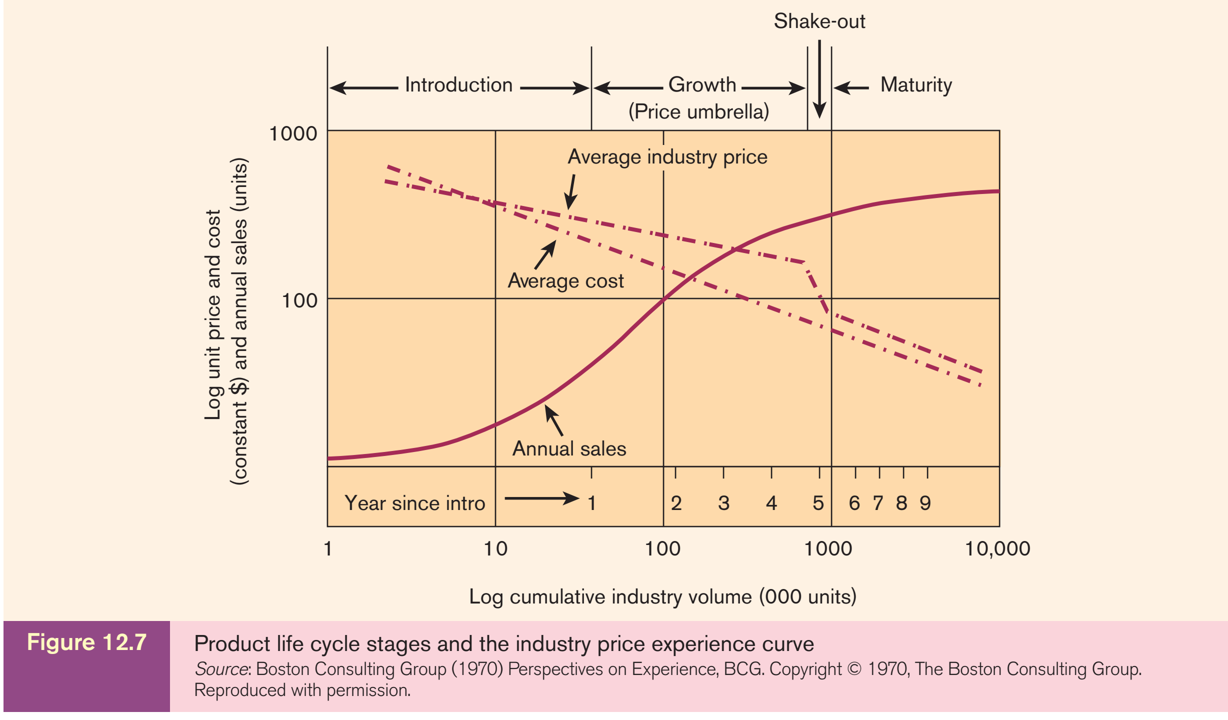


Figure 12.7 Product life cycle stages and the industry price experience curve

Source: Boston Consulting Group (1970) Perspectives on Experience, BCG. Copyright © 1970, The Boston Consulting Group. Reproduced with permission.

Figure 12.7 shows that, after the introduction stage (during part of which the price is below the total unit cost), profits begin to flow. Because supply is less than demand, prices do not fall as quickly as costs. Consequently, the gap between costs and prices widens, in effect creating a price umbrella, attracting new competitors. However, the competitive situation is not a stable one. At some point the umbrella will disappear as one or more competitors reduce prices in an attempt to gain market share. The result is that a shake-out phase will begin: inefficient producers will be shaken out by rapidly falling market prices, and only those with a competitive price/cost relationship will survive. Experience curve pricing is seen in many industries, e.g. in the pharmaceutical and medical area (Brown *et al.*, 2008; Rao, 2008; Brown *et al.*, 2007).

12.10 PRODUCT LINE PRICING

As a business adds more product to its product line, it enhances sales growth but also increases the chances of cannibalisation of existing product sales. It is necessary to know both a product's price elasticity and the degree to which there is a cross-elasticity with other products. Products that have a *positive* cross-elasticity are *substitutes;* lowering the price of one product will decrease the demand for the other product. Products that have a *negative* cross-elasticity are *complementary* products; lowering the price for one product will increase the demand for both products. Because the margins may be different for alternative products in a product line, one has to give careful consideration to any price change to ensure that the total profits are increased for the entire product line.

A firm may add to its product line – or even develop a new product line – to fit more precisely the needs of a particular market segment. If both the demand and the costs of individual product line items are interrelated, production and marketing decisions about one product line item inevitably influence both the revenues and costs of the others.

Are specific product line items substitutes or complements? Will a change in the price of one item enhance or retard the usage rate of this or other products in key market segments? Should a new product be priced high at the outset in order to protect other product line items

(for example, potential substitutes) and in order to give the firm time to update other items in the line? Such decisions require knowledge of demand, costs, competition and strategic marketing objective.

Product line pricing
Setting the price steps between various products in a product line based on cost differences between the products, customer evaluations of different features, and competitors' prices.

With **product line pricing**, the various items in the line may be differentiated by pricing them appropriately to indicate, for example, an economy version, a standard version and a superior version. One of the products in the line may be priced to protect against competitors or to gain market share from existing competitors.

Products with less competition may be priced higher to subsidise other parts of the product line, so as to make up for the lost contribution of such fighting brands. Some items in the product line may be priced very low to serve as **loss leaders** and induce customers to try the product. A special variant of this is the so-called buy in, follow on strategy (Weigand, 1991). A classic example of this strategy is the razor blade link where Gillette, for example, uses penetration pricing on its razor (buy in) but skimming (relatively high price) on its razor blades (follow on). Thus, the linked product or service – the follow on – is sold at a significant contribution margin. This inevitably attracts others who try to sell follow on products without incurring the cost of the buy in.

Loss leader
A product priced below cost to attract consumers, who may then make additional purchases.

Other examples of the strategy are as follows:

- Telephone companies sell mobile phones at a near giveaway price, hoping that the customer will be a heavy user of the profitable mobile telephone network.
- Nintendo often sells its game consoles at below cost but makes a handsome profit on the game software.

This kind of pricing is a particularly attractive strategy if it not only generates future sales but also creates an industry platform or standard to which all other rivals must use or conform (that is, a technological path dependency).

12.11 PRICE BUNDLING

Price bundling
A strategy whereby the price of a group of products is lower than the total of the individual prices of the components. An example is selling a new car with an 'options package'.

Products can be **bundled** or unbundled for pricing purposes. The bundled approach gives a single price for the entire offering. Bundling can be defined as the sale of two or more separate products in one package at a discount. For example, the direct online seller of PCs, Dell, markets to consumers who may want to buy a portable computer system consisting of a basic laptop, a modem and a CD writer. It could sell these products as separate items, but they choose also to sell them as a price bundle by giving a discount to consumers if they buy all three products together (Arora, 2008; Stremersch and Tellis, 2002).

Many physical goods and services unite a core product with a variety of supplementary products at a set price. This has become a popular marketing strategy (Johnson *et al.*, 1999).

Manufacturers of industrial goods, such as machine tools, electronic components and chemical substances, frequently offer their products at a system price in conjunction with an assortment of services. In the service sector, travel companies bundle flights, rental cars, accommodation and events into one package. Strategically this bundling activity is designed to benefit the consumer by reducing administration costs and consequently transaction costs.

Should such service packages be priced as a whole (referred to as the bundle), or should each element be priced separately? To the extent that people dislike having to make many small payments, bundled pricing may be preferable. But if customers do not like being charged for product elements they may not use, itemised pricing may be preferable.

Many firms offer an array of choices. Telephone subscribers, for instance, can select from several service options, ranging from paying a small monthly fee for basic service and then extra for each phone call made, or paying a higher flat rate and getting a certain number of local, regional or long-distance calls free. At the top of the scale is the option that provides business users with unlimited access to long-distance calls over a prescribed area – even

internationally. Bundled prices offer a service firm a certain guaranteed revenue from each customer, while giving the latter a clear idea in advance of how much the bill will be. Unbundled pricing provides customers with flexibility in what they choose to acquire and pay for, but may also cause problems. For instance, customers may be put off by discovering that the ultimate price of what they want is substantially higher than the advertised base price that attracted them in the first place.

12.12 PRICING FOR DIFFERENT SEGMENTS

Marketers very often have different marketing programmes for different consumer segments.

Geographic segments

It is possible that price sensitivity varies across geographic regions. For example, some grocery retailers have different price zones and prices are likely to vary across those zones. Competition and consumer profiles may differ between geographic segments. Products can be positioned with a high price in one country and a low price in another. This can be attributed to the pricing structure of international markets, viewed here as a major determinant of the product pricing policy.

Europe was a price differentiation paradise as long as markets were separated. But it is becoming increasingly difficult to retain the old price differentials. There are two developments which may force companies to standardise prices across European countries:

- international buying power of cross-European retail groups;
- parallel imports/grey markets. Because of differentiated prices across countries, buyers in one country are able to purchase at a lower price than in another country. As a result there will be an incentive for customers in lower-price markets to sell goods to higher-price markets in order to make a profit.

Simon and Kucher (1993) suggest a price 'corridor' (Figure 12.8). The prices in the individual countries may only vary within that range. Figure 12.8 is also interesting in the light of the

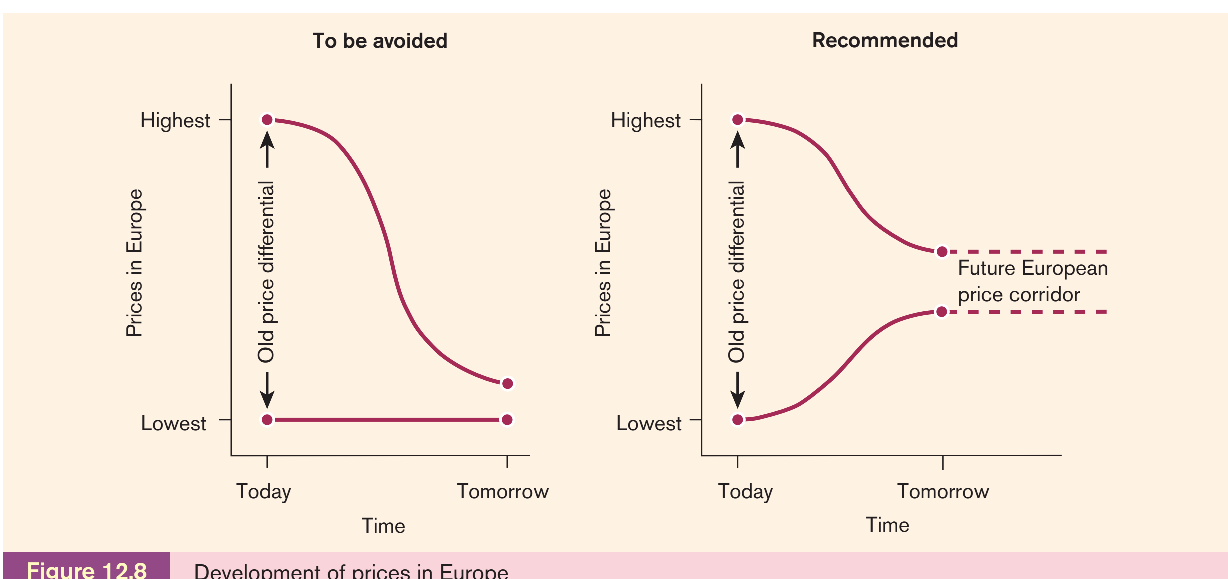


Figure 12.8 Development of prices in Europe
Source: Simon, H. and Kucher, E. (1993) The European pricing bomb: and how to cope with it, *Marketing and Research Today*, February: 25–36. Reproduced with permisssion from ESOMAR.

euro, which was fully implemented in January 2002, when new euro notes and coins were circulated. But this does not mean that a uniform price across Europe is required. Price differences which can be justified by transport costs, short-term exchange rate fluctuations, etc., may still be maintained.

They recommend that business in smaller countries should be sacrificed, if necessary, in order to retain acceptable pricing levels in the big markets such as France, Germany, the UK and Italy. For example, for a pharmaceutical manufacturer it is more profitable not to sell in the Portuguese pharmaceutical market than to accept a price reduction of 10 per cent in the German market due to parallel imports from Portugal.

Usage segments

It is common for marketers to recognise high-volume users and reward them with different prices. For example, regular customers at a particular store who carry the store's frequent shopper card will receive discounts at the checkout that other shoppers will not receive.

Time segments (off-peak pricing)

The most common form of usage segmentation pricing is based on the time of usage. Long-distance phone companies, electricity utilities, hotels, bars, restaurants, amusement parks and cinemas all use off-peak demand pricing. For firms like these, demand for their products and services fluctuates over time, and they cannot store their production. Consequently, they have periods of under-utilisation and often low incremental variable costs. At off-peak times, such companies welcome any additional revenue, as long as it makes some contribution toward their high fixed costs.

Off-peak pricing explains post-Christmas sales and end-of-season fashion sales. Unfortunately, some price sensitive shoppers learn when these sales occur and wait for them. This has the effect of reducing the overall average selling price and contribution margin.

Demographic segments

A concert hall might provide special prices for students or children to encourage attendance, or may give discounts to senior citizens. This is a common strategy used by museums, athletic events and amusement parks.

Family recreational air travel is much more price sensitive than business travel. Because of this, airlines charge less for children and offer early booking discounts that effectively exclude businesspeople from purchasing such tickets. As with all forms of price discrimination, segment pricing works best when buyers in the high-priced target segment cannot buy the product or service directly or indirectly (through resale) at the lower price.

12.13 RELATIONSHIP PRICING

When developing and maintaining long-term customer relationships, pricing strategy has an important role to play. Pricing low to win new business is not the best approach if a firm is seeking to attract customers who will remain loyal – those who are attracted by cut-price offers can easily be enticed away by another offer from a competitor. More creative pricing strategies focus on giving customers both price and non-price incentives to consolidate their business with a single supplier.

However, a strategy of discounting prices for large purchases can often be profitable for both parties, since the customer benefits from lower prices while the supplier may enjoy

lower variable costs resulting from economies of scale. An alternative to volume discounting on a single service is for a firm to offer its customers discounts when two or more services are purchased together. The greater the number of different services a customer purchases from a single supplier, the closer the relationship is likely to be and the greater the exit barriers for the partners in the relationship. Both parties get to know each other better, and it is more inconvenient for the customer to shift its business.

Pricing is becoming more fluid. Even before the advent of the online medium, industrial markets and third-world bazaars have long followed a customised pricing mechanism based on bargaining and discount schedules. The online medium has made it feasible to apply flexible pricing more broadly. Online prices can be tailored to specific users and raised or lowered instantly for assessing price elasticity at different prices. The ability to create truly fluid pricing is only limited by customer acceptance. Technology is now available to vary pricing in ways that were not possible in the past. New in-store technology allows supermarkets to customise pricing based on specific times of the day through digital price labels or even to tailor discounts and coupons to individuals based on their past purchasing patterns.

Due to the influence of the online medium, we expect that all firms will be called upon to revamp their pricing strategies completely. The fixed one-price strategy of the past has been completely eroded over the past few years. In the years ahead, 'dynamic pricing' that takes advantage of instantaneous market conditions will become the norm. Interestingly, these developments do not necessarily mean that prices will decline. The convenience, time-saving aspects and product matching features of online markets can increase the price a customer is willing to pay.

When customers become familiar and comfortable with a retail website it reduces their incentive to shift to other sites for lower prices. Further, if a company understands the customer (e.g. by tracking and understanding what customers do while visiting its website) and facilitates the creation of a co-production process to produce a product and service tailored to the customer's need, there is relatively little opportunity or incentive for customers to compare other shops based on price. Customisation of the product or service adds so much value and strengthens the relationship that the price becomes a less important factor.

Establishing global pricing contracts (GPCs)

As globalisation increases, the following is heard frequently among global suppliers and global customers: 'Give me a global pricing contract (GPC) and I'll consolidate my worldwide purchase with you.' Increasingly, global customers are demanding such contracts from suppliers. For example, in 1998, General Motor's Powertrain Group told suppliers of components used in GM's engines, transmissions and subassemblies to charge GM the same for parts from one region as they did for parts from another region.

Suppliers do not need to lose out when customers globalise. The most attractive global pricing opportunities are those that involve suppliers and customers working together to identify and eliminate inefficiencies that harm both. Sometimes suppliers do not have a choice. They do not want to shut themselves out of business with their largest and fastest-growing customers.

Suppliers and customers have different advantages and disadvantages with global pricing contracts. Table 12.2 illustrates some of them.

One chemicals manufacturer concentrated on relationships with a few select customers. It found out that its strength lay in value-added services but that potential customers in emerging markets were more concerned with price. The select customers, however, were interested in money-saving supply and inventory management initiatives developed jointly with the supplier.

Global customers' demands for detailed cost information can also put suppliers at risk. Toyota, Honda, Xerox and others force suppliers to open their books for inspection. Their

Table 12.2 Global pricing contracts (GPCs): advantages and disadvantages

	Customers	Suppliers
Advantages	• Lower prices worldwide coupled with higher levels of service. • Standardisation of products and services offered across markets. • Efficiencies in all processes, including new product development, manufacturing, inventory, logistics and customer service. • Faster diffusion of innovations globally.	• Easily gain access to new markets and grow the business. • Consolidate operations and achieve economies of scale. • Work with industry leaders and influence market development by using them as showcase accounts. • Collaborate with customers and develop strong relationships that are difficult for potential competitors to break into. • Rectify price and service anomalies in a customer relationship across country markets.
Disadvantages	• Customer might be less adaptable to local market variance and changes over time. • Supplier might not have capabilities to provide consistent quality and performance across markets. • Supplier might use customer's over-dependence to extract higher prices. • Local managers might resist global contracts and prefer dealing with local suppliers. • Costs of monitoring global contracts might outstrip the benefits.	• Local managers sometimes resist change, and supplier may get caught in the crossfire between customer's HQ and country. • Supplier might lose the ability to serve other attractive customers. • Customer might not be able to deliver on promises. • Customer might take advantage of cost information shared in the relationship. • Supplier might become over-dependent on one customer, even when there are other more attractive customers to serve. • Supplier might have a conflict with existing channels of distribution in the new markets.

Source: Narayandas, D., Quelch, J. and Swartz, G. (2000) Prepare your company for global pricing, *MIT Sloan Management Review*, Fall: 61–70. Copyright © 2000 by Massachusetts Institute of Technology. All rights reserved. Distributed by Tribune Media Services.

stated objectives are to help suppliers identify ways to improve processes and quality while reducing costs – and to build trust. But, in an economic downturn, the global customer might also seek price reductions and supplementary services.

12.14 PRICING ON THE INTERNET

The virtual value chain offers different options on products and services to customers. The extra value obtained by the customer can be billed at a different price option. With the simplest mass-produced products, a flat price may be appropriate. However, when customers can order from different sources to customise their choice, the Internet company, which is responsible for assembling this choice, may charge different prices. In the case of digital products, these options can also be extended with regard to time and place. For example, at peak times, when most of the customers are likely to log on to the site, the company may charge a premium price to minimise the Internet traffic. During off-peak hours the company may reduce the price of the products or services to keep the optimum level of Internet traffic on the site. Similarly, customers may have the option to obtain the product through the regular mail at a different price from when they directly download the product/service. Price variations can also be employed based on the need for the product or the service. For example, a customer who wants to search for and read a particular piece of information is likely to pay less than a person who will download and print the information. Similarly, a customer who wants to review only the summary of the information is likely to pay less than a person who needs

the complete information. A customer who needs immediate access to new pieces of information is likely to be charged a higher price than a customer who can accept some delay in accessing the information.

A virtual value chain makes it easier for customers to compare the prices of similar offerings by different companies. Not only can customers obtain the price of the offerings, but they can also understand the prices charged for add-on features. With this information, customers can quickly customise their selections in products and services. Consequently, the Internet will lead to increased price competition and the standardisation of prices across borders.

The ability to compare prices across all suppliers using the Internet and online shopping services will lead to increased price competition. Finally, the price of providing Internet-based services (especially information-based services) often contains little marginal costs. Thus, the ability of technology to offer services at a cheaper cost would make it difficult to determine the appropriate price for a consumer (Allen and Fjernestad, 2001).

Among the most popular applications of the Internet is the online auction in the consumer market. Online auctions attract thousands, sometimes millions, of bidders who compete with each other for items ranging from computer-related products to antiques. Companies such as eBay and Amazon.com have entered into the online auction business in a big way (Massad and Tucker, 2000).

In the B2B market many companies are likely to adopt online auctions as part of their ongoing purchasing process or perhaps even outsource the bulk of purchasing aided by new technology. It is an attractive technological solution for reducing costs, but it does not help uncover the root causes of poor cost management worked out by the buying firm (Emiliani, 2000).

12.15 COMMUNICATING PRICES TO THE TARGET MARKETS

Customers in the B2B market must be very price conscious. Each item they buy contributes to their costs and thus to their profits and competitiveness. Many of them keep extensive records using formalised purchasing systems designed to obtain the best value for the price. Consumers in the B2B market tend to be less aware of actual prices.

Consequently, the final task, once each of the other issues has been addressed, is to decide how the organisation's pricing policies can best be communicated to the target market(s). People need to know the price for some product offerings well in advance of purchase; they may also need to know how, where and when that price is payable. This information must be presented in ways that are intelligible and unambiguous, so that customers will not be misled and question the ethical standards of the firm.

Managers must decide whether or not to include information on pricing in advertising for the service. It may be appropriate to relate the price to the costs of competing products or to show alternative ways of spending one's money. Certainly, salespeople and customer service representatives should be able to give prompt, accurate responses to customer queries about pricing, payment and credit. Good signage at retail points of sale will save staff members from having to answer basic questions on prices.

12.16 SUMMARY

In this chapter we have considered the role of pricing decisions in overall company and marketing strategies. Price setting is a complex decision which involves many factors. To establish a price, the manager must identify the firm's objectives and analyse the behaviour of demand, costs and competition.

A good deal of basic microeconomic theory is devoted to the relationship between price and demand. While many of the principles that have been developed have relevance to what happens in the real world, there are nevertheless many factors (other than demand and cost) that have to be taken into account.

Pricing strategies must balance the needs of both the customer and the firm. Value-based pricing, which includes the concepts of value in use and value in exchange, is increasingly popular. Since customers seeking differing types of value and competition have a broad range of choices in how to price, other strategies are viable as well. In devising a pricing strategy, it is important to identify a customer value proposition that matches the capabilities of the organisation. Pricing new products offers a different set of challenges. In general, two main opposing strategies are seen:

Total quality management (TQM) Programmes designed to constantly improve the quality of products services and marketing processes.

- *skimming*: high price, to skim off the short-term profit;
- *penetration*: low price, to maximise long-term market share.

Practical pricing tactics may include experience curve pricing, product line pricing, price bundling, pricing on the Internet, etc.

CASE STUDY 12.1

Harley-Davidson

Is the image justifying the price level in a time of recession?

Source: © Robert Convery/Alamy

Harley-Davidson's mission statement is: 'We fulfil dreams through the experience of motorcycling.'

History

The Harley-Davidson Motorcycle Company (www.harley-davidson.com) was founded in 1903. Harley-Davidson (H-D) soon became the world's leading manufacturer of motorcycles, based on a reputation of quality and reliability. After the Second World War, and the demise of the American Indian motorcycle, Harley-Davidson became the sole US manufacturer of motorcycles. In 1969, Harley-Davidson was sold to American Machine and Foundry (AMF).

AMF almost tripled production to 75,000 units annually over a four-year period to meet the increase in demand. Unfortunately, product quality deteriorated significantly as over half the motorcycles that came off the assembly line had parts missing and dealers had to repair them in order to make sales. Little money was invested in improving design or engineering. The motorcycles leaked oil, vibrated and could not match the excellent performance of the Japanese products.

During this time, Honda was beginning to penetrate the American motorcycle market and gain a significant market share. Honda manufacturing plants incorporated the principles of **total quality management (TQM)**. Honda began producing motorcycles with constantly improving quality at a time when the quality of Harley-Davidson was drastically decreasing. By the early 1980s Honda almost totally dominated the world motorcycle market.

Japanese manufacturers also moved into the heavyweight motorcycle market and began selling Harley look-alike motorcycles. Yamaha was the first company to do so and was soon followed by the three other major Japanese manufacturers, Honda, Suzuki and Kawasaki. Their products looked so similar to Harley-Davidson's that it was

difficult to tell the difference without reading the name on the petrol tank. The Japanese companies also copied the style of the Harley-Davidson advertisements.

In order to stay in business while the necessary changes in design and production were being accomplished, the executives turned to William G. Davidson, Harley's styling vice president. Known as 'Willie G.' and a grandson of one of the company's founders, he designed a number of new models by combining components from existing models. These included the Super Glide, the Electra Glide the Wide Glide and the Low Rider. Each model was successful and other executives credit Davidson's skill with saving the company.

In 1982, Harley-Davidson faced new problems. Overall demand for motorcycles dropped dramatically and Harley-Davidson's share of this smaller market also continued to drop. The company had a large inventory of unsold products and could not continue in business with its level of production and expenses. Production was cut drastically, and more than 1,800 of the 4,000 employees were made redundant.

In 1983, President Reagan increased the tariffs on large Japanese motorcycles from 4.4 per cent to 49.4 per cent, but these would decline each year and be effective for only five years. While this did reduce the number of imports and gave Harley-Davidson some protection, Japanese manufacturers found ways to evade most of the tariffs, for example by assembling more of their heavyweight bikes in their US plants. In 1983, Harley-Davidson's share of the heavyweight motorcycle market slipped to 23 per cent, the lowest ever, although it did earn a slight profit.

In 1998 H-D moved to expand its presence within the motorcycle industry when it acquired the outstanding shares of the Buell Motorcycle Company. While sharing components and technology with H-D, the performance-oriented Buell is intended to attract younger and non-traditional riders to the H-D family.

Harley-Davidson today

The company now has a new direction. Harley-Davidson is now out of survival. H-D spent a lot of time putting together its business process, values, issues, mission statement . . . all those things H-D believes in. H-D wants to get everyone pointed in the same direction (Milligan and Carbone, 2000).

Much of the value of a Harley resides in its tradition – the look, sound and heritage that have made it an All-American symbol. The bikes represent something very basic – a desire for freedom, adventure and individualism.

Harley-Davidson Inc. is the parent company for the following three companies.

1. Harley-Davidson Motor Company, the only major US-based motorcycle manufacturer, produces heavyweight motorcycles and offers a complete line of motorcycle parts, accessories, clothing and general merchandise. Strategic licensing of the Harley-Davidson brand helps create future generations of Harley-Davidson enthusiasts. The US market launch of the Fisher-Price Power Wheels® Ride-On-Toy, a four-wheeled, battery-operated children's toy, became the most successful Power Wheels introduction in the last ten years.
2. Buell Motorcycle Company produces sport and sport-touring motorcycles.
3. Harley-Davidson Financial Services Inc. (HDFS) provides wholesale and retail financing, insurance and credit card programmes to Harley-Davidson dealers and customers. In the United States, HDFS financed 53.5 per cent of the new Harley-Davidson motorcycles retailed by independent dealers during 2008. The wholesale division of HDFS provides dealers with financing for motorcycles and related products, and store expansion or renovation.

The Buell does not appear to be cannibalising Harley-Davidson sales because it is a very different kind of bike. The rider's position is thrust forward to create a racing feeling, while the Harley-Davidson is designed more for riders who want to cruise. Nor is a Buell as big or as heavy as a Harley-Davidson, and it is easier to manoeuvre. Harley-Davidson faces the task of attracting younger customers, as its average customer's age increases and sales decrease. Part of reshaping their image includes releasing new Buell motorcycles designed for young professional men and women.

The average US retail purchaser of a new Harley-Davidson motorcycle is a married male in his mid to late forties (nearly two-thirds of US retail purchasers of new Harley-Davidson motorcycles are between the ages of 35 and 54) with a median household income of approximately $87,000. Nearly three-quarters of the US retail sales of new Harley-Davidson motorcycles are to buyers with at least one year of education beyond high school and 32 per cent of the buyers have college/graduate degrees. Approximately 12 per cent of US retail motorcycle sales of new Harley-Davidson motorcycles are to female buyers.

Formed in 1983, the company-sponsored Harley's Owner Group or HOG® has over 1 million members worldwide as of 2005. The Buell Riders Adventure Group or BRAG® is an 11,000-member-strong counterpart to HOG®. Both groups sponsor events including national rides and rallies. The company also sponsors racing activities. Harley's buyers aren't locked into any social

class. You are just as likely to find a CEO on a Harley as a worker off the assembly line. Harley owners are loyal, with 90 per cent of buyers reporting the intention of purchasing another Harley bike. Clearly image sells to this demographic: Harley ranks near the 100th percentile on the Brand Asset Valuator scale for such qualities as authentic, rugged, daring, dynamic, distinctive and high performance. As one Harley owner put it: 'What Harley-Davidson appeals to me is that we all think we're cooler than we really are' (Bronson and Beaver, 2004).

Harley-Davidson is trying to soften its bad-guy image to make biking more mainstream. It is encouraging the spread of Harley-Davidson owner groups, supporting charities and taking toys to hospitals. But the company does not want to change its image too much. There are some upscale neurosurgeons and bankers who are riding Harleys because they want people to think there is a little bad in them. H-D does not want to completely squash that image (Holstein, 2000).

The motorcycle market in the three main regions of the world is shown in Table 12.3. For the fiscal year ended 2008, total Harley-Davidson motorcycle shipments were 303,500 units compared with 204,592 units in 2000, a 48 per cent increase. However, it was a decrease compared to 2007 when the number of sold units was 330,600. Of the total H-D shipments in 2008, 68 per cent went to USA and 16 per cent to Europe. Of the rest, Japan, Canada and Australia were the biggest H-D markets. Total Buell motorcycle shipments were 13,119 in 2008, compared to 10,189 units in 2000, a 29 per cent gain.

Harley-Davidson motorcycle net revenue in 2008 was US$5,594 million compared to US$2,250 million in 2000.

The total market in North America has fallen from 543,000 units in 2006 to 480,000 units in 2008. On the other hand, the European market has increased from 361,000 in 2006 to 397,000 in 2008. During the same period H-D's market share has decreased from 50 per cent to 46 per cent, whereas the European market share has remained stable around 10 per cent.

Distribution

In the United States, H-D distributes its motorcycles and related products to 686 independently owned full-service Harley-Davidson dealerships.

In the European region H-D distributes all products sold to 383 independent dealers or distributors through its European subsidiary located in Oxford, England, or through one of its sales offices in the United Kingdom, France, Germany, Italy, Netherlands, Spain, Switzerland or South Africa.

In the Asia-Pacific region, H-D distributes all products sold to 205 independent dealers in Japan and Australia through H-D owned subsidiaries in those countries, and all products sold to independent dealers for the remaining Asia-Pacific.

Dealerships can be found in 36 European/Middle Eastern/African countries, 8 Asian countries and 15 Latin America countries. Most dealerships sell only Harley-Davidson and Buell products.

Table 12.3 Registrations of heavyweight motorcycles (over 650cc), 2008

	North America	Europe	Asia-Pacific
Total industry (1000s)	480	397	80
Market share	%	%	%
Harley-Davidson/Buell	46	10	25
Honda	15	14	19
Yamaha	9	14	13
Kawasaki	8	12	15
Suzuki	13	17	12
BMW	2	15	5
Ducati	1	6	4
Triumph	2	7	1
Others	4	5	6
Total	**100**	**100**	**100**

Source: *Harley-Davidson Financial Report 2008*, including 10-K report.

Competitors

All of Harley-Davidson's major competitors have their headquarters outside the US, most in Japan. Most of the major competitors are operating units of larger diversified companies, e.g. Honda, Yamaha, Kawasaki, Suzuki and BMW. At least one of H-D's major competitors, Honda, manufactures its largest motorcycles in the US. A major exception to the larger diversified company rule is Ducati, an Italian company that is a major in the European performance market.

The following characterises the most important competitors (Bronson and Beaver, 2005).

Honda

Honda is one of the leaders in the motorcycle industry with 15 per cent of the North American market, 14 per cent of the European market, and 19 per cent of the Asian-Pacific market. Honda combines excellent engineering and quality with highly automated manufacturing to achieve significant economies of scale. Honda has been able to leverage its low-cost advantage into global leadership.

Honda is a diversified company that at one time surpassed Chrysler and Toyota in sales to become the third largest automobile company in the US. In addition to motorcycles and automobiles Honda manufactures ATVs, outboard motors, generators, lawn care equipment and other power products. Honda has a presence in the financial services industry, providing financing options for motorcycle and automobile dealers and consumers. Honda's niche in the US motorcycle market is touring bikes. With up to 1500cc water-cooled engines, Honda's touring bikes are high quality, refined, comfortable and fuel-efficient.

Honda's corporate culture is egalitarian with all employees, including the president, wearing the same uniform and sharing the same facilities. Input is sought from all levels of the company. Honda encourages creativity and is widely regarded as being the leader in 4-cycle gasoline engine technology. The company goes to considerable lengths to structure its operations around the needs of local markets. Honda is committed to continuing its leadership position through attention to markets, continual improvement and the introduction of new models and technologies.

Yamaha

Yamaha has manufacturing facilities, distribution and R&D operations in many international markets. Yamaha focuses on tailoring its products to local market conditions. Yamaha Motor Company has a diverse product line including outboard motors, boats, personal watercraft, generators, golf cars, ATVs, snowmobiles, outdoor power equipment, race kart engines, accessories, apparel and motorcycles. Yamaha produces a full line of motorcycles ranging from scooters to heavyweights; however, their competitive advantage focuses on speed and high-performance racing bikes. Yamaha's motorcycle sales are strong globally. Their target market throughout the world is the young and thrill-seeking consumer who sees riding and speed as a sport.

Kawasaki

Kawasaki is a world leader in the transportation equipment and industrial goods industries with diverse product lines in each category. Kawasaki Motors is focused on motorcycles, all-terrain vehicles, jet ski watercraft, utility vehicles, rail cars, wheels, robots and engines for consumer products such as lawnmowers. Kawasaki is well known for providing a wide range of products that offer high-performance and low-maintenance attributes. Kawasaki offers multiple models of motorcycles, which makes them competitive in many different facets of the industry including touring bikes, sports bikes, off-road bikes, dual-purpose bikes, street bikes and police bikes.

Kawasaki has a large international presence with production facilities in South-East Asia, China, Europe and the United States. They have their strongest market position in Asia Pacific.

Suzuki

Suzuki manufactures automobiles, commercial vehicles, outboard motors and ATVs. Suzuki is the third largest manufacturer of motorcycles, lagging behind only Honda and Yamaha. Motorcycles comprise around 20 per cent of the company's total sales. Suzuki motorcycles have a significant international presence with sales in over 190 countries; 80 per cent of Suzuki's total motorcycle sales are in offshore markets. Suzuki began using joint manufacturing efforts in foreign countries in 1993 and uses direct sales subsidiaries to reach customers. Suzuki uses cost-reduction activities to achieve their ongoing goal of providing a low-cost product. Efficiency is the backbone of Suzuki's low-cost position in the industry.

BMW

BMW's focus is on putting their best efforts into a small range of products, which makes their products unique in quality, style and performance. Their motorcycle production concentrates on three different series

stressing superior quality. BMW's strategy is based on premium pricing and building the best motorcycle that money can buy by setting the standard in technology, environment and safety in all of their product offerings. Each of their motorcycles portrays the traditional motorcycle image; however, the BMW brand also includes elements of sophistication and class in their products. All of BMW's motorcycles have high resale values; however, their high price level limits their market share.

BMW is the only manufacturer of cars and motorcycles worldwide that concentrates on premium standards and outstanding quality for all of its product lines. Throughout their quest and their commitment to enhancing their international presence, BMW has expanded with 23 car production and assembly plants located in seven countries and BMW has marketing subsidiaries in 33 countries. BMW is synonymous with high quality and performance, which is reinforced by strong brand recognition and customer loyalty, for those who can afford it.

Ducati

Ducati is representative of Harley-Davidson's European competition. Ducati has adopted a cyberspace model (www.ducati.com) selling motorcycles, accessories and clothing online. The company promotes its cyberspace model through participation in motorcycle racing where Ducati has dominated the world Superbike Championships for over ten years. Unlike Harley-Davidson, Ducati does not build bikes on the basis on nostalgia and comfort; rather Ducati sells style and performance based on technologically advanced designs. Ducatis are race-proven bikes, sold for use on the street – the ultimate café racer. Like Harley-Davidson, Ducati employs a premium pricing strategy. Ducati customers tend to be younger and somewhat less affluent; consequently, sales vary more with the economic cycle.

H-D lacks significant scale in comparison to its competitors in the market. Many of its competitors such as Bayerische Motoren Werke AG (BMW) and Honda Motor Company Limited are much larger in size, operation and coverage. BMW, for instance, recorded revenues of US$77 million during fiscal year 2007, and Honda Motor Company Limited recorded revenue of US$94 billion during the same period. Harley- Davidson, in contrast, recorded revenues of around $6 billion in 2007. Lack of scale limits the company's ability to compete effectively with larger players, which can also utilise synergies from other parts of their operations, e.g. from their automobile businesses.

Pricing

The price competition is getting tougher. Compared to similar models from Honda, Harley-Davidson still has about a 30 per cent price premium.

Harley-Davidson's premium pricing limits the number of younger buyers. Two-thirds of its customers are between the ages of 35 and 54. Recently H-D has redesigned some of its bikes to better accommodate female riders. The percentage of female buyers has reached 12 per cent and continues to move slowly upward. H-D also offers motorcycle rider education courses, where 40 per cent of the participants are women.

Harley-Davidson owners still wear T-shirts saying 'I'd rather push a Harley than drive a Honda.'

Today, Harley-Davidson's overseas business outside the USA is around 30 per cent of its annual total. Europeans like cruiser bikes, but maybe not the Harley-Davidson prices. In fact some Harley-Davidson bikes have recently been shipped back from Europe due to lack of demand.

QUESTIONS

1. What are the main reasons for Harley-Davidson's enormous success over the last 15 years?
2. Describe Harley-Davidson's general pricing strategy. What does the company's positioning have to do with its pricing strategy?
3. Should Harley-Davidson alter its price, given that there are strong price pressures from rivals?
4. What should Harley-Davidson do to improve its market share in Europe?

SOURCES

Bronson, J. W. and Beaver, G. (2004) Strategic change in the face of success? Harley-Davidson, Inc., *Strategic Change*, 13(4): 205–18; Bronson, J. W. and Beaver, G. (2005) Harley-Davidson and the international market for luxury goods, (http://road.uww.edu/road/bronsonj/788%20WEB/Web%20Cases%20&%20Readings/H-D&LuxuryGoods_080106.doc); Harley-Davidson Inc. (2009) *2008 Harley-Davidson Annual Report*, including Form 10-K; Holstein, W. (2000) Rebels with a cause: Harley revamps itself in a drive for new, young hog riders, *US News & World Report*, 19: 46–7; Klayman, B. (2005) Harley-Davidson CEO sees strong growth, *Reuters* (http://go.Reuters.co.uk/newsArticle.jhtml); Milligan, B. and Carbone, J. (2000) Harley-Davidson win by getting suppliers on board, *Purchasing*, 5 (21 September): 52–65.

QUESTIONS FOR DISCUSSION

1 What is value-based pricing? How does it differ from cost-based pricing?
2 a) What does the economist contribute to the pricing decision?
  b) What does the accountant contribute to the pricing decision?
3 What are skimming and penetration pricing?
4 What is umbrella pricing?
5 List three aspects of product line pricing.
6 Why is cost-based pricing particularly problematic in service industries?
7 How does competition affect a company's prices? Briefly describe a major competitor-based pricing approach.
8 Many firms enter a market as price leaders, but they end up dominating the bottom end of the market. What could be the reasons for this change?

REFERENCES

Allen, E. and Fjernestad, J. (2001) E-commerce marketing strategies: an integrated framework and case analysis, *Logistics Information Management*, 14(1): 14–33.

Arora, R. (2008) Price bundling and framing strategies for complementary products, *Journal of Product & Brand Management*, 17(7): 475–84.

BBC (1996) *Branded: Heinz Case*, BBC TV.

Best, R. J. (2000) *Market-based Management*, 2nd edn, Prentice Hall, Harlow.

Brennan, R., Canning, L. and McDowell, R. (2007) Price-setting in business-to-business markets, *The Marketing Review*, 7(3): 207–34.

Brown, A., Meenan, B. J. and Young, T. P. (2007) Medical device prices follow the experience curve, *Journal of Medical Marketing*, 7(3): 203–12.

Brown, A., Meenan, B. J., Dixon, D., Young, T. P. and Brennan, M. (2008) Application of the experience curve to price trends in medical devices: implications for product development and marketing strategies, *Journal of Medical Marketing*, 8(3): 241–55.

Curtis, J. (2001) Body Shop plans to scale down its political activity, *Marketing*, 26 July: 3.

Czepiel, J. A. (1992) *Competitive Marketing Strategy*, Prentice Hall, Englewood Cliffs, NJ.

Czinkota, M. R. and Kotabe, M. (1999) Bypassing Japan's marketing barriers, *Marketing Management*, 8 (Winter): 33–43.

Davidson, A. and Simonetto, M. (2005) Pricing strategy and execution: an overlooked way to increase revenues and profits, *Strategy & Leadership*,33(6): 25–33.

Docters, R., Schefers, B., Korman, T. and Durman, C. (2008) The neglected demand curve: how to build one and how to benefit, *Journal of Business Strategy*, 29(5): 19–25.

Driver, J. C. (2001) Airline marketing in regulatory context, *Marketing Intelligence Planning*, 19(2): 125–35.

Emiliani, M. L. (2000) Business-to-business online auctions: key issues for purchasing process improvement, *Supply Chain Management: An International Journal*, 5(4): 176–86.

Freedonia Group (2000) *World Major Household Appliances Report*, Freedonia Press, Cleveland, OH.

Garda, R. A. (1995) Tactical pricing, in S. J. Paliwoda and J. K. Ryans (eds) *International Marketing Reader*, Routledge, London.

Hinterhuber, A. (2008) Customer value-based pricing strategies: why companies resist, *Journal of Business Strategy*, 41–50.

Holden, R. K. and Nayle, T. T. (1998) Kamikaze pricing, *Marketing Management*, 7(2): (Summer): 30–9.

Hollensen, S. (2001) *Global Marketing: A Market Responsive Approach*, 2nd edn, Financial Times/Prentice Hall, Harlow.

Holstein, W. (2000) Rebels with a cause: Harley revamps itself in a drive for new, young hog riders, *US News & World Report*, 19: 46–7.

Indounas, K. (2009) Successful industrial service pricing, *Journal of Business & Industrial Marketing*, 24(2): 86–97.

Johnson, M. D., Hermann, A. and Baner, H. H. (1999) The effects of price bundling on consumer evaluations of product offerings, *International Journal of Research in Marketing*, 16: 129–42.

Lambin, J. (1976) *Advertising, Competition and Market Conduct in Oligopoly Over Time*, North Holland-Elsevier, Amsterdam.

Marsh, G. (2000) International pricing: a market perspective, *Marketing Intelligence & Planning*, 18(4): 200–5.

Massad, V. J. and Tucker, J. M. (2000) Comparing bidding and pricing between in-person and online auction, *Journal of Product & Brand Management*, 9(5): 325–32.

Matthyssens, P., Vandenbempt, K. and Goubau, C. (2009) Value capturing as a balancing act, *Journal of Business & Industrial Marketing*, 24(1): 56–60.

Milligan, B. and Carbone, J. (2000) Harley-Davidson win by getting suppliers on board, *Purchasing*, 5 (21 September): 52–65.

Nagle, T. T. (1987) *The Strategies and Tactics of Pricing*, Prentice Hall, Englewood Cliffs, NJ.

Narayandas, D., Quelch, J. and Swartz, G. (2000) Prepare your company for global pricing, *Sloan Management Review*, Fall: 61–70.

Rao, S. K. (2008) An innovative approach to developing and managing biopharmaceutical pricing strategy, *Journal of Medical Marketing*, 8(2): 94–100.

Simon, H. and Kucher, E. (1993) The European pricing bomb: and how to cope with it, *Marketing and Research Today*, February: 25–36.

Stremersch, S. and Tellis, G. J. (2002) Strategic bundling of products and prices: a new synthesis for marketing, *Journal of Marketing*, 66 (January): 55–72.

Weigand, R. E. (1991) Buy in: follow on strategies for profit, *Sloan Management Review*, Spring: 29–38.