

Part 1: Defining Marketing and the Marketing Process (Chapters 1–2)

Part 2: Understanding the Marketplace and Consumers (Chapters 3–6)

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Pricing Understanding and Capturing Customer Value

Chapter Preview We now look at the second major marketing mix tool—pricing. If effective product development, promotion, and distribution sow the seeds of business success, effective pricing is the harvest. Firms successful at creating customer value with the other marketing mix activities must still capture some of this value in the prices they earn. In this chapter, we discuss the importance of pricing, dig into three major pricing strategies, and look at internal and external considerations

that affect pricing decisions. In the next chapter, we examine some additional pricing considerations and approaches.

For openers, let's examine the importance of pricing in online retailing. In case you haven't noticed, there's a war going on—between Walmart, by far the world's largest retailer, and Amazon.com, the world's largest online merchant. The weapon of choice? Prices. Only time will tell who will win on the Web. But for now, the two retailers, especially Walmart, seem determined to fight it out on price.

Amazon vs. Walmart: Fighting It Out Online on Price

Walmart to Amazon: "Let's Rumble" read the headline. Ali had Frazier. Coke has Pepsi. The Yankees have the White Sox. Now Walmart, the mightiest retail giant in history may have met its own worthy adversary: Amazon.com. In what is emerging as one of the main storylines of the post-recession shopping scene, the two heavyweight retailers are waging a war. The weapon of choice? Prices—not surprising given the two combatants' long-held low-cost positions.

The price war between Walmart and Amazon.com began prior to the past holiday season, with skirmishes over online prices for new books and DVDs. It then escalated quickly to video game consoles, mobile phones, and even toys. At stake: the fortunes of not only the two companies but also whole industries whose products they sell, both online and in retail stores. Price can be a potent strategic weapon, but it can also be a double-edged sword.

Amazon.com, it seems, wants to be the "Walmart of the Web"—our digital general store—and it's well on its way to achieving that goal. Although Walmart's overall sales total an incredible \$405 billion a year, 20 times Amazon's \$20 billion annually, Amazon.com's online sales are 12 times greater than Walmart's online sales. Moreover, Amazon attracts more than 70 million unique U.S. visitors to its Web site monthly, double Walmart's number. One analyst estimates that more than one-half of all U.S. consumers who look online for retail items start their search at Amazon.com.

Why does this worry Walmart? After all, online sales account for only 4–5 percent of its overall U.S. retail sales. Walmart

captures most of its business by offering affordable prices to Middle Americans in its more than 4,000 brick-and-mortar stores. By comparison, according to one analyst, Amazon.com sells mostly to "affluent urbanites who would rather click with their mouse than push around a cart."

But this battle isn't about now; it's about the future. Although still a small market by Walmart's standards, within the next decade, online sales will soar to an estimated 15 percent of total U.S. retail sales. And, increasingly, Amazon.com owns the online space. In the third quarter of last year, whereas overall retail sales plunged 4 percent in the struggling economy and e-commerce sales were flat, Amazon.com's sales skyrocketed 24 percent. Even more importantly, Amazon.com's electronics and general merchandise sales, which compete directly with much of the selection found in Walmart stores, zoomed 44 percent.

Amazon has shown a relentless ambition to offer more of almost everything on the Web. It started by selling only books online, but now it sells everything from books, movies, and musicals to consumer electronics, home and garden products, clothing, jewelry, toys, tools, and even groceries. It keeps expanding into new lines—last year it added separate hubs for outdoor and sporting goods and cell phones. Then, it purchased online shoe retailer Zappos.com. It's even beefing up its private-label selection, adding new lines of Amazon-branded goods. If Amazon.com's expansion continues and online sales spurt as predicted, the Web seller will eat further and further into Walmart's bread-and-butter store sales.

But Walmart isn't about to let that happen. Instead, it's taking the battle to Amazon.com's home territory—the Web. Through aggressive pricing, it is now fighting for every dollar consumers spend online. Walmart fired the first shot before last year's holiday shopping season. It announced that it would take online preorders for 10 soon-to-be-released hardback books—all projected best sellers by authors such as John Grisham, Stephen King, Barbara Kingsolver, and James Patterson—at an unprecedented low price of just \$10 each. (Actually, the new hardcover prices matched the \$9.99 price that Amazon was already charging for e-book versions of bestsellers, downloaded to its Kindle or other readers, but Walmart does not sell e-books.) To take it a step further, Walmart also cut prices by 50 percent on 200 other best sellers, undercutting Amazon's prices. When Amazon quickly announced that it would match Walmart's \$10 price on the 10 best sellers, the price war was on. Walmart dropped its price to \$9.00, Amazon.com did likewise, and Walmart lowered its prices yet again, to \$8.98.

These low book prices represented a 59–74 percent reduction off the list price, much more than the 30–40 percent reduction you might expect in traditional retail bookstores such as Barnes & Noble or Borders. In fact, Walmart and Amazon.com discounted these best sellers below costs—as so-called “loss-leaders”—to lure shoppers to their Web sites in hopes that they would buy other, more profitable items.

The book price war is having an impact beyond the two primary combatants—it's causing collateral damage across the entire book industry. “When your product is treated as a loss leader, it lowers its perceived value,” says one publishing executive. In the long run, that's not great for either the companies that publish the books or the retailers who sell them. Price carries messages about customer value, notes another publisher. Companies want to be careful about the messages they send. And it's not just books. If you compare prices at Walmart.com and Amazon.com, you'll find the price battle raging across a broad range of product categories.

Who will win the online battle for the hearts and dollars of online buyers? Certainly, low prices will be an important factor. And when it comes to low prices, Walmart appears to have the upper hand. With its huge size, it can negotiate better terms with its suppliers. And by combining its online and off-line operations, it can provide some unique services, such as free and convenient delivery and returns of Web orders to stores (Walmart's site gives you three buying op-



tions: online, in-store, and site-to-store). Walmart is even experimenting with drive-through windows where shoppers can pick up their Internet orders. But Amazon.com also has advantages, including a highly recognizable online brand, a sophisticated distribution network built specifically for Web shopping, an unparalleled online customer shopping experience, and fast and free shipping with Amazon Prime. And, of course, Amazon.com is no stranger to low prices.

In the long run, however, reckless price cutting will likely do more damage than good to both Walmart and Amazon.com. Price wars can turn whole product categories into unattractive, low-margin commodities (think DVDs, for example). And buying online is about much more than just getting the best prices, even in today's economy. In the end, winning online consumers will require offering not only the lowest prices but also the best customer value in terms of price and product selection, speed, convenience, and overall shopping experience.

For now, the two retailers, especially Walmart, seem determined to fight it out on price. Amazon.com's CEO, Jeff Bezos, has long maintained that there's plenty of room for all competitors in the big world of retailing. However, Paul Vazquez, president and CEO of Walmart.com, says that it's “only a matter of time” before Walmart dominates Web shopping. Pricing, he thinks, will be key. “Our company is based on low prices,” says Vazquez, laying down the challenge. “Even in books, we kept going until we were the low-priced leader. And we will do that in every category we need to. Our company is based on low prices.” Offering the low price “is in our DNA.”¹

Walmart, the world's largest retailer, and Amazon.com, the world's largest online merchant, are at war over the hearts and dollars of online shoppers. The weapon of choice? Prices. However, although price can be a potent strategic weapon, it can also be a double-edged sword.

Only time will tell who will win on the Web, Walmart or Amazon.com. But for now, the two retail giants, especially Walmart, seem determined to fight it out on price.

Objective OUTLINE

Objective 1

Answer the question “What is a price?” and discuss the importance of pricing in today’s fast-changing environment.

What Is a Price? (290)

Objective 2

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

Major Pricing Strategies (291–300)

Objective 3

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

Other Internal and External Considerations Affecting Price Decisions (300–306)



● **Pricing: No matter what the state of the economy, companies should sell value, not price.**

Price

The amount of money charged for a product or service; the sum of the values that customers exchange for the benefits of having or using the product or service.

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

Value-seeking customers have put increased pricing pressure on many companies. Thanks to recent economic woes, the pricing power of the Internet, and value-driven retailers such as Walmart, today’s more frugal consumers are pursuing spend-less strategies. In response, it seems that almost every company is looking for ways to cut prices.

Yet, cutting prices is often not the best answer. Reducing prices unnecessarily can lead to lost profits and damaging price wars. It can cheapen a brand by signaling to customers that price is more important than the customer value a brand delivers. ● Instead, no matter what the state of the economy, companies should sell value, not price. In some cases, that means selling lesser products at rock-bottom prices. But in most cases, it means persuading customers that paying a higher price for the company’s brand is justified by the greater value they gain.²

What Is a Price? (p 290)

In the narrowest sense, **price** is the amount of money charged for a product or a service. More broadly, price is the sum of all the values that customers give up to gain the benefits of having or using a product or service. Historically, price has been the major factor affecting buyer choice. In recent decades, nonprice factors have gained increasing importance. However, price still remains one of the most important elements that determines a firm’s market share and profitability.

Price is the only element in the marketing mix that produces revenue; all other elements represent costs. Price is also one of the most flexible marketing mix elements. Unlike product features and channel commitments, prices can be changed quickly. At the same time, pricing is the number-one problem facing many marketing executives, and many companies do not handle pricing well. Some managers view pricing as a big headache, preferring instead to focus on other marketing mix elements. However, smart managers treat pricing as a key strategic tool for creating and capturing customer value. Prices have a direct impact on a firm’s bottom line. A small percentage improvement in price can generate a large percentage increase in profitability. More importantly, as part of a company’s overall value proposition, price plays a key role in creating customer value and building customer relationships. “Instead of running away from pricing,” says an expert, “savvy marketers are embracing it.”³

Author Comment | Setting the right price is one of the marketer's most difficult tasks. A host of factors come into play. But finding and implementing the right price strategy is critical to success.

Major Pricing Strategies (pp 291–300)

The price the company charges will fall somewhere between one that is too high to produce any demand and one that is too low to produce a profit. **Figure 10.1** summarizes the major considerations in setting price. Customer perceptions of the product's value set the ceiling for prices. If customers perceive that the product's price is greater than its value, they will not buy the product. Product costs set the floor for prices. If the company prices the product below its costs, the company's profits will suffer. In setting its price between these two extremes, the company must consider several internal and external factors, including competitors' strategies and prices, the overall marketing strategy and mix, and the nature of the market and demand.

Figure 10.1 suggests three major pricing strategies: customer value-based pricing, cost-based pricing, and competition-based pricing.

Author Comment | Like everything else in marketing, good pricing starts with *customers* and their perceptions of value.

Customer Value-Based Pricing

In the end, the customer will decide whether a product's price is right. Pricing decisions, like other marketing mix decisions, must start with customer value. When customers buy a product, they exchange something of value (the price) to get something of value (the benefits of having or using the product). Effective, customer-oriented pricing involves understanding how much value consumers place on the benefits they receive from the product and setting a price that captures this value.

Customer value-based pricing uses buyers' perceptions of value, not the seller's cost, as the key to pricing. Value-based pricing means that the marketer cannot design a product and marketing program and then set the price. Price is considered along with all other marketing mix variables *before* the marketing program is set.

Figure 10.2 compares value-based pricing with cost-based pricing. Although costs are an important consideration in setting prices, cost-based pricing is often product driven. The company designs what it considers to be a good product, adds up the costs of making the product, and sets a price that covers costs plus a target profit. Marketing must then convince buyers that the product's value at that price justifies its purchase. If the price turns out to be too high, the company must settle for lower markups or lower sales, both resulting in disappointing profits.

Value-based pricing reverses this process. The company first assesses customer needs and value perceptions. It then sets its target price based on customer perceptions of value. The targeted value and price drive decisions about what costs can be incurred and the resulting product design. As a result, pricing begins with analyzing consumer needs and value perceptions, and the price is set to match perceived value.

It's important to remember that "good value" is not the same as "low price." For example, a Steinway piano—any Steinway piano—costs a lot. But to those who own one, a Steinway is a great value:⁴

A Steinway grand piano typically runs anywhere from \$40,000 to \$165,000. The most popular model sells for around \$72,000. But ask anyone who owns a Steinway grand piano, and they'll tell you that, when it comes to Steinway, price is nothing; the Steinway experience is everything. Steinway makes very high quality pianos; handcrafting

Customer value-based pricing
Setting price based on buyers' perceptions of value rather than on the seller's cost.

FIGURE | 10.1
Considerations in Setting Price

If customers perceive that a product's price is greater than its value, they won't buy it. If the company prices a product below its costs, profits will suffer. Between the two extremes, the "right" pricing strategy is one that delivers both value to the customer and profits to the company.

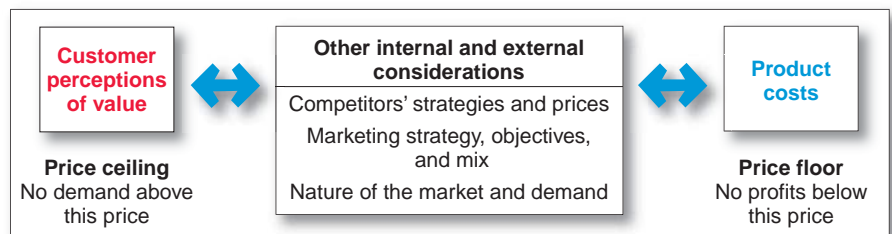
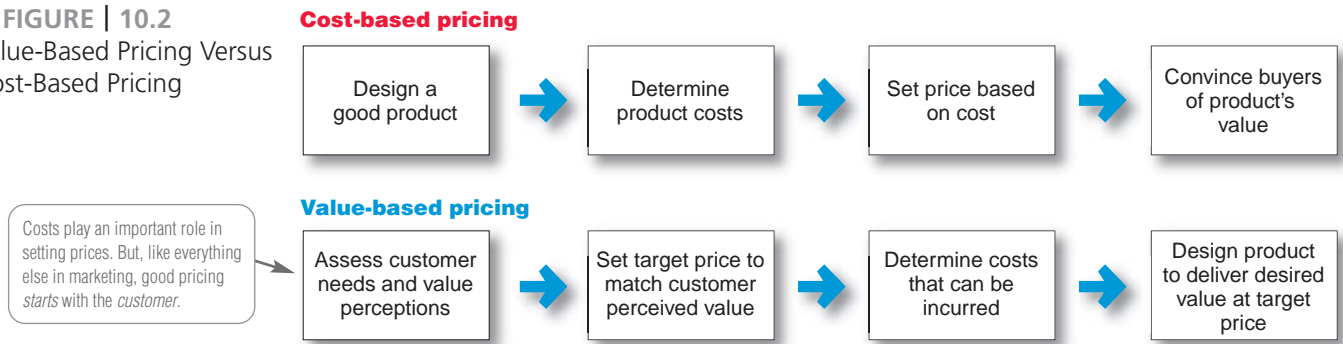


FIGURE | 10.2
Value-Based Pricing Versus
Cost-Based Pricing



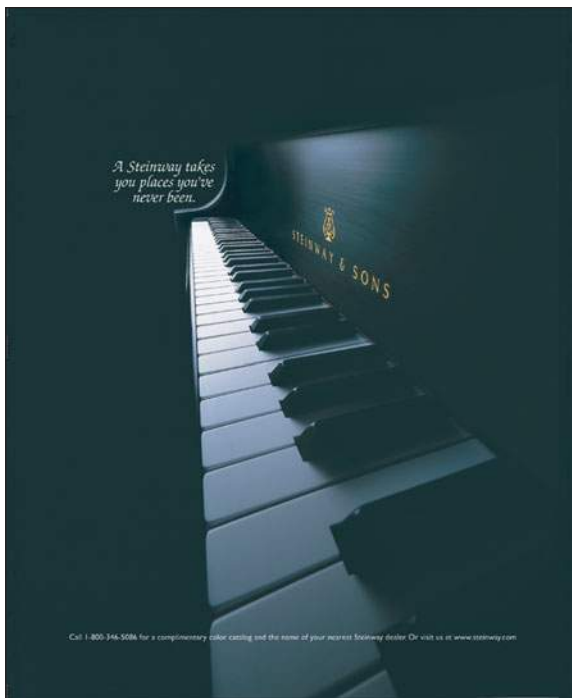
each Steinway requires up to one full year. But, more importantly, owners get the Steinway mystique. The Steinway name evokes images of classical concert stages and the celebrities and performers who’ve owned and played Steinway pianos across more than 155 years.

But Steinways aren’t just for world-class pianists and the wealthy. Ninety-nine percent of all Steinway buyers are amateurs who perform only in their dens. To such customers, whatever a Steinway costs, it’s a small price to pay for the value of owning one. “A Steinway takes you places you’ve never been,” says an ad. As one Steinway owner puts it, “My friendship with the Steinway piano is one of the most important and beautiful things in my life.” Who can put a price on such feelings?

Companies often find it hard to measure the value customers will attach to its product. For example, calculating the cost of ingredients in a meal at a fancy restaurant is relatively easy. But assigning value to other satisfactions such as taste, environment, relaxation, conversation, and status is very hard. Such value is subjective; it varies both for different consumers and different situations.

Still, consumers will use these perceived values to evaluate a product’s price, so the company must work to measure them. Sometimes, companies ask consumers how much they would pay for a basic product and for each benefit added to the offer. Or a company might conduct experiments to test the perceived value of different product offers. According to an old Russian proverb, there are two fools in every market—one who asks too much and one who asks too little. If the seller charges more than the buyers’ perceived value, the company’s sales will suffer. If the seller charges less, its products sell very well, but they produce less revenue than they would if they were priced at the level of perceived value.

We now examine two types of value-based pricing: *good-value pricing* and *value-added pricing*.



Perceived value: A Steinway piano—any Steinway piano—costs a lot. But to those who own one, a Steinway is a great value. “A Steinway takes you places you’ve never been.”

Good-value pricing

Offering the right combination of quality and good service at a fair price.

Good-Value Pricing

Recent economic events have caused a fundamental shift in consumer attitudes toward price and quality. In response, many companies have changed their pricing approaches to bring them in line with changing economic conditions and consumer price perceptions. More and more, marketers have adopted **good-value pricing** strategies—offering the right combination of quality and good service at a fair price.

In many cases, this has involved introducing less-expensive versions of established, brand-name products. To meet tougher economic times and more frugal consumer spending habits, fast-food restaurants such as Taco Bell and McDonald’s offer value meals and dollar menu items. Armani offers the less-expensive, more-casual Armani Exchange fashion line. Alberto-Culver’s TRESemmé hair care line promises “A salon look and feel at a frac-



● Good-value pricing: Ryanair appears to have found a radical new pricing solution, one that customers are sure to love: Make flying free!

tion of the price.” And every car company now offers small, inexpensive models better suited to the strapped consumer’s budget.

In other cases, good-value pricing has involved redesigning existing brands to offer more quality for a given price or the same quality for less. Some companies even succeed by offering less value but at rock-bottom prices. ● For example, passengers flying the low-cost European airline Ryanair won’t get much in the way of free amenities, but they’ll like the airline’s unbelievably low prices.⁵

Ireland’s Ryanair, Europe’s most profitable airline over the past decade, appears to have found a radical pricing solution: Make flying free! Before long, Ryanair promises, more than half of its passengers will pay nothing for their tickets. Remarkably, the airline already offers virtually free fares to one-fourth of its customers. What’s its secret? Ryanair’s frugal cost structure makes even the most cost-conscious competitor look like a reckless spender. In addition, however, Ryanair charges for virtually everything except the seat itself, from baggage check-in to seat-back advertising space. Once in the air, flight attendants hawk everything from scratch-card games to perfume and digital cameras to their captive audience. After arriving at some out-of-the-way airport, Ryanair will sell you a bus or train ticket into town. The airline even gets commissions from sales of Hertz rental cars, hotel rooms, ski packages, and travel insurance. Despite Ryanair’s sometimes pushy efforts to extract more revenue from each traveler, customers aren’t complaining. Most of the additional purchases are discretionary, and you just can’t beat those outrageously low prices.

An important type of good-value pricing at the retail level is *everyday low pricing* (EDLP). EDLP involves charging a constant, everyday low price with few or no temporary price discounts. Retailers such as Costco and the furniture seller Room & Board practice EDLP. The king of EDLP is Walmart, which practically defined the concept. Except for a few sale items every month, Walmart promises everyday low prices on everything it sells. In contrast, *high-low pricing* involves charging higher prices on an everyday basis but running frequent promotions to lower prices temporarily on selected items. Department stores such as Kohl’s and Macy’s practice high-low pricing by having frequent sales days, early-bird savings, and bonus earnings for store credit-card holders.

Value-added pricing

Attaching value-added features and services to differentiate a company’s offers and charging higher prices.



● Value-added pricing: Rather than dropping prices for its venerable Stag umbrella brand to match cheaper imports, Currims successfully launched umbrellas with funky designs, cool colors, and value-added features and sold them at even higher prices.

Value-Added Pricing

Value-based pricing doesn’t mean simply charging what customers want to pay or setting low prices to meet competition. Instead, many companies adopt **value-added pricing** strategies. Rather than cutting prices to match competitors, they attach value-added features and services to differentiate their offers and thus support higher prices. For example, at a time when competing restaurants lowered their prices and screamed “value” in a difficult economy, fast-casual chain Panera Bread has prospered by adding value and charging accordingly (see Real Marketing 10.1). ● Also consider this example:

The monsoon season in Mumbai, India, is three months of near-nonstop rain. For 147 years, most Mumbaikars protected themselves with a Stag umbrella from venerable Ebrahim Currim & Sons. Like Ford’s Model T, the basic Stag was sturdy, affordable, and of any color, as long as it was black. By the end of the twentieth century,

Real Marketing 10.1

Panera Bread Company: It's Not about Low Prices

In the restaurant business these days, “value” typically means one thing—“cheap.” When the economy dipped, so did fast-food restaurant prices, fare, and tactics. Now, casual restaurants are offering a seemingly endless hodgepodge of value meals, dollar items, budget sandwiches, and rapid-fire promotional deals that scream “value, value, value.” But one everyday eatery—Panera Bread—understands that, even in uncertain economic times, low prices often aren’t the best value. Instead, at Panera, value means wholesome food and fresh-baked bread, served in a warm and inviting environment, even if you have to pay a little more for it. Ronald Shaich, CEO of Panera, sums up this value-added concept perfectly. “Give people something of value and they’ll happily pay for it,” he says.

Shaich realized more than 25 years ago that people wanted something between fast food and casual dining. He perfected the “fast-casual” dining formula and opened Panera (Spanish for “bread basket”). Today, the bakery-café segment, which Shaich practically created, is the fastest growing sector in the fast-casual market. And Panera does bakery-café better than anyone else. In fact, Panera’s \$1.4 billion in sales more than doubles the combined sales of its next four competitors.

Why is Panera Bread so successful? Unlike so many competitors in the post-recession era, Panera isn’t about having the lowest prices. Instead, it’s about the *value* you get for what you pay, and what you get is a full-value dining experience.

At Panera, it all starts with the food, which centers around fresh-baked bread. When customers walk through the door, the first thing they see are massive displays of bread, all hand-formed and baked on-site. Bakers pass out warm bread samples to customers throughout the day. All new employees get “dough training,” and even employee meetings start with the staff breaking bread together—literally. Bread is so central to Panera’s DNA that the company’s R&D team will scrap new dishes if the bread feels like an afterthought.

Of course, the food at Panera goes well beyond bread. Fresh bagels, pastries, egg soufflés, soups, salads, sandwiches and pani-

nis, and coffee drinks and smoothies give customers full meal options any time of day. Menu items brim with upscale ingredients such as Gorgonzola cheese, fresh basil, chipotle mayonnaise, and applewood-smoked bacon (the kind you’d find at the Four Seasons, not Wendy’s). In all, Panera’s target audience is more Food Network than fast food. “We hit a chord with people who understand and respond to food,” says Scott Davis, chief concept officer. Our profile is “closer to what you’d find in a bistro than a fast-food joint.” And to all that good food, Panera adds first-rate customer service. According to one research firm, Panera Bread continually stands in the top 10 of restaurant chains for overall service excellence. Last year, Panera rated among *BusinessWeek’s* top 25 “Customer Service Champs.”

But good fast-casual food and outstanding service are only part of Panera’s value-

added proposition. Perhaps even more important is the Panera experience—one so inviting that people don’t want to leave. Comfortable booths, leather sofas and chairs, warm lighting, a fireplace, and free Wi-Fi all beg customers to relax and stay awhile. In fact, the local Panera has become a kind of community gathering spot. At any given moment, you’ll find a diverse group of customers hanging out together for a variety of reasons. One recent sample included a bride-to-be chatting with her wedding photographer, two businesspeople with laptops, a teacher grading papers, a church group engaged in Bible study, and a baker’s dozen of couples and families just enjoying each others’ company. Shaich knows that, although the food’s important, what he’s really selling is an inviting place to be. “In many ways,” he says, “we’re renting space to people, and the food is the price of admission.”

Rather than cutting back on value and lowering prices in difficult times, Panera is looking for ways to add even more value. Freshness remains a driving force. Shaich has improved the freshness of lettuce by cutting the time from field to plate in half and using only the hearts of romaine. Store ovens now produce warm bread throughout the day, rather than just in the wee hours of the morning. And the chain’s development labs are test-



Panera Bread understands that, even in uncertain economic times, low prices often aren’t the best value. Says Panera CEO Ronald Shaich, “Give people something of value and they’ll happily pay for it.”

ing a new grill that churns out paninis in half the time. “This is the time to increase the food experience, when the customer least expects it,” Shaich insists.

Panera’s strategy of adding value and charging accordingly has paid off handsomely, through good economic times and bad. At a time when most chains, including those that are slashing their prices, are struggling and closing stores, Panera is flourishing. Over the past five years, its sales have more than tripled, and profits have more than doubled, including six straight quarters of double-digit profit gains through the heart of the recent recession. This year, Panera plans to add 100 new stores to its current portfolio of 1,500 cafés.

“Most of the world seems to be focused on the Americans who are unemployed,”

says Shaich. “We’re focused on the 90 percent that are still employed.” Although everyone wants value, he insists, not everyone wants it in the form of a value meal. Anne Skrodzki, a 28-year-old Chicago attorney, agrees. She recently spent \$9.72 at Panera on a chicken Caesar salad and frozen lemonade. “I think it’s a pretty good value. The portions are generous. The food is high quality . . . I’ve also gotten used to coming here for the free Wi-Fi.”

The Panera Web site spells out the chain’s valued-added positioning this way: “We are Panera. We are bakers of bread. We are fresh from the oven. We are a symbol of warmth and welcome. We are a simple pleasure, honest and genuine. We are a life story told over dinner. We are a long lunch with an old friend. We are your weekday morning ritual. We are the kindest gesture of neighbors. We are home. We are family. We are friends.” Low prices? Not even on the radar.

Sources: Kate Rockwood, “Rising Dough: Why Panera Bread Is on a Roll,” *Fast Company*, October 2009, pp. 69–70; Emily Bryson York, “Panera: An America’s Hottest Brands Case Study,” *Advertising Age*, November 16, 2009, p. 16; Julie Jargon, “Slicing the Bread But Not the Prices,” *Wall Street Journal*, August 18, 2009, p. B1; Bruce Horowitz, “Panera Bakes a Recipe for Success,” *USA Today*, July 23, 2009, accessed at www.usatoday.com; and www.panerabread.com, accessed September 2010.

however, the Stag was threatened by cheaper imports from China. Stag responded by dropping prices and scrimping on quality. It was a bad move: For the first time since the 1940s, the brand began losing money.

Finally, however, Stag came to its senses. It abandoned the price war and started innovating. It launched designer umbrellas in funky designs and cool colors. Teenagers and young adults lapped them up. It then launched umbrellas with a built-in high-power flashlight for those who walk unlit roads at night and models with prerecorded tunes for music lovers. For women who walk secluded streets after dark, there’s Stag’s Bodyguard model, armed with glare lights, emergency blinkers, and an alarm. Customers willingly pay up to a 100 percent premium for the new products. Under the new value-added strategy, the Stag brand has now returned to profitability. Come the monsoon season in June, the grand old black Stags still reappear on the streets of Mumbai—but now priced 15 percent higher than the imports.⁶

The Stag example illustrates once again that customers are motivated not by price but by what they get for what they pay. “If consumers thought the best deal was simply a question of money saved, we’d all be shopping in one big discount store,” says one pricing expert. “Customers want value and are willing to pay for it. Savvy marketers price their products accordingly.”⁷

Cost-based pricing

Setting prices based on the costs for producing, distributing, and selling the product plus a fair rate of return for effort and risk.

Author Comment | Costs set the floor for price, but the goal isn’t always to *minimize* costs. In fact, many firms invest in higher costs so that they can claim higher prices and margins (think about Steinway pianos). The key is to manage the *spread* between costs and prices—how much the company makes for the customer value it delivers.

Cost-Based Pricing

Whereas customer-value perceptions set the price ceiling, costs set the floor for the price that the company can charge. **Cost-based pricing** involves setting prices based on the costs for producing, distributing, and selling the product plus a fair rate of return for its effort and risk. A company’s costs may be an important element in its pricing strategy.

Some companies, such as Ryanair and Walmart, work to become the “low-cost producers” in their industries. Companies with lower costs can set lower prices that result in smaller margins but greater sales and profits. However, other companies—such as Apple, BMW, and Steinway—intentionally pay higher costs so that they can claim higher prices and margins. For example, it costs more to make a “handcrafted” Steinway piano than a Yamaha production model. But the higher costs result in higher quality, justifying that eye-popping \$72,000 price. The key is to manage the spread between costs and prices—how much the company makes for the customer value it delivers.

Fixed costs (overhead)

Costs that do not vary with production or sales level.

Variable costs

Costs that vary directly with the level of production.

Total costs

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

Types of Costs

A company’s costs take two forms: fixed and variable. **Fixed costs** (also known as **overhead**) are costs that do not vary with production or sales level. For example, a company must pay each month’s bills for rent, heat, interest, and executive salaries—whatever the company’s output. **Variable costs** vary directly with the level of production. Each PC produced by HP involves a cost of computer chips, wires, plastic, packaging, and other inputs. Although these costs tend to be the same for each unit produced, they are called variable costs because the total varies with the number of units produced. **Total costs** are the sum of the fixed and variable costs for any given level of production. Management wants to charge a price that will at least cover the total production costs at a given level of production.

The company must watch its costs carefully. If it costs the company more than its competitors to produce and sell a similar product, the company will need to charge a higher price or make less profit, putting it at a competitive disadvantage.

Costs at Different Levels of Production

To price wisely, management needs to know how its costs vary with different levels of production. For example, suppose Texas Instruments (TI) built a plant to produce 1,000 calculators per day. **Figure 10.3A** shows the typical short-run average cost curve (SRAC). It shows that the cost per calculator is high if TI’s factory produces only a few per day. But as production moves up to 1,000 calculators per day, the average cost per unit decreases. This is because fixed costs are spread over more units, with each one bearing a smaller share of the fixed cost. TI can try to produce more than 1,000 calculators per day, but average costs will increase because the plant becomes inefficient. Workers have to wait for machines, the machines break down more often, and workers get in each other’s way.

If TI believed it could sell 2,000 calculators a day, it should consider building a larger plant. The plant would use more efficient machinery and work arrangements. Also, the unit cost of producing 2,000 calculators per day would be lower than the unit cost of producing 1,000 units per day, as shown in the long-run average cost (LRAC) curve (Figure 10.3B). In fact, a 3,000-capacity plant would be even more efficient, according to Figure 10.3B. But a 4,000-daily production plant would be less efficient because of increasing diseconomies of scale—too many workers to manage, paperwork slowing things down, and so on. Figure 10.3B shows that a 3,000-daily production plant is the best size to build if demand is strong enough to support this level of production.

Costs as a Function of Production Experience

Suppose TI runs a plant that produces 3,000 calculators per day. As TI gains experience in producing calculators, it learns how to do it better. Workers learn shortcuts and become more familiar with their equipment. With practice, the work becomes better organized, and TI finds better equipment and production processes. With higher volume, TI becomes more efficient and gains economies of scale. As a result, the average cost tends to decrease with accumulated production experience. This is shown in **Figure 10.4**.⁸ Thus, the average cost of producing the first 100,000 calculators is \$10 per calculator. When the company has produced the first 200,000 calculators, the average cost has fallen to \$8.50. After its accumu-

FIGURE | 10.3
Cost per Unit at Different Levels of Production per Period

What’s the point of all the cost curves in this and the next few figures? Costs are an important factor in setting price, and companies must understand them well!

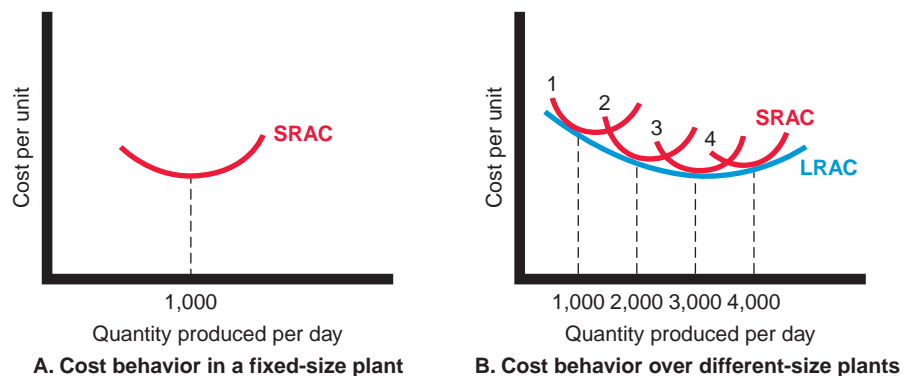
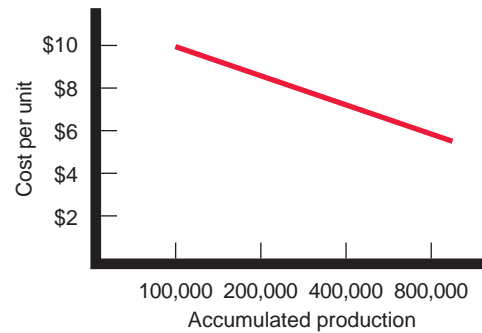


FIGURE | 10.4

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



Experience curve (learning curve)

The drop in the average per-unit production cost that comes with accumulated production experience.

lated production experience doubles again to 400,000, the average cost is \$7. This drop in the average cost with accumulated production experience is called the **experience curve** (or the **learning curve**).

If a downward-sloping experience curve exists, this is highly significant for the company. Not only will the company's unit production cost fall, but it will fall faster if the company makes and sells more during a given time period. But the market has to stand ready to buy the higher output. And to take advantage of the experience curve, TI must get a large market share early in the product's life cycle. This suggests the following pricing strategy: TI should price its calculators low; its sales will then increase, and its costs will decrease through gaining more experience, and then it can lower its prices further.

Some companies have built successful strategies around the experience curve. However, a single-minded focus on reducing costs and exploiting the experience curve will not always work. Experience-curve pricing carries some major risks. The aggressive pricing might give the product a cheap image. The strategy also assumes that competitors are weak and not willing to fight it out by meeting the company's price cuts. Finally, while the company is building volume under one technology, a competitor may find a lower-cost technology that lets it start at prices lower than those of the market leader, who still operates on the old experience curve.

Cost-Plus Pricing

Cost-plus pricing (markup pricing)

Adding a standard markup to the cost of the product.

The simplest pricing method is **cost-plus pricing** (or **markup pricing**)—adding a standard markup to the cost of the product. Construction companies, for example, submit job bids by estimating the total project cost and adding a standard markup for profit. Lawyers, accountants, and other professionals typically price by adding a standard markup to their costs. Some sellers tell their customers they will charge cost plus a specified markup; for example, aerospace companies often price this way to the government.

To illustrate markup pricing, suppose a toaster manufacturer had the following costs and expected sales:

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

Then the manufacturer's cost per toaster is given by the following:

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

Now suppose the manufacturer wants to earn a 20 percent markup on sales. The manufacturer's markup price is given by the following:⁹

$$\text{markup price} = \frac{\text{unit cost}}{(1 - \text{desired return on sales})} = \frac{\$16}{1 - .2} = \$20$$

The manufacturer would charge dealers \$20 per toaster and make a profit of \$4 per unit. The dealers, in turn, will mark up the toaster. If dealers want to earn 50 percent on the sales price, they will mark up the toaster to \$40 (\$20 + 50% of \$40). This number is equivalent to a *markup on cost* of 100 percent (\$20/\$20).

Does using standard markups to set prices make sense? Generally, no. Any pricing method that ignores demand and competitor prices is not likely to lead to the best price. Still, markup pricing remains popular for many reasons. First, sellers are more certain about costs than about demand. By tying the price to cost, sellers simplify pricing; they do not need to make frequent adjustments as demand changes. Second, when all firms in the industry use this pricing method, prices tend to be similar, so price competition is minimized. Third, many people feel that cost-plus pricing is fairer to both buyers and sellers. Sellers earn a fair return on their investment but do not take advantage of buyers when buyers' demand becomes great.

Break-Even Analysis and Target Profit Pricing

Break-even pricing (target return pricing)

Setting price to break even on the costs of making and marketing a product or setting price to make a target return.

Another cost-oriented pricing approach is **break-even pricing** (or a variation called **target return pricing**). The firm tries to determine the price at which it will break even or make the target return it is seeking.

Target return pricing uses the concept of a *break-even chart*, which shows the total cost and total revenue expected at different sales volume levels. **Figure 10.5** shows a break-even chart for the toaster manufacturer discussed here. Fixed costs are \$300,000 regardless of sales volume. Variable costs are added to fixed costs to form total costs, which rise with volume. The total revenue curve starts at zero and rises with each unit sold. The slope of the total revenue curve reflects the price of \$20 per unit.

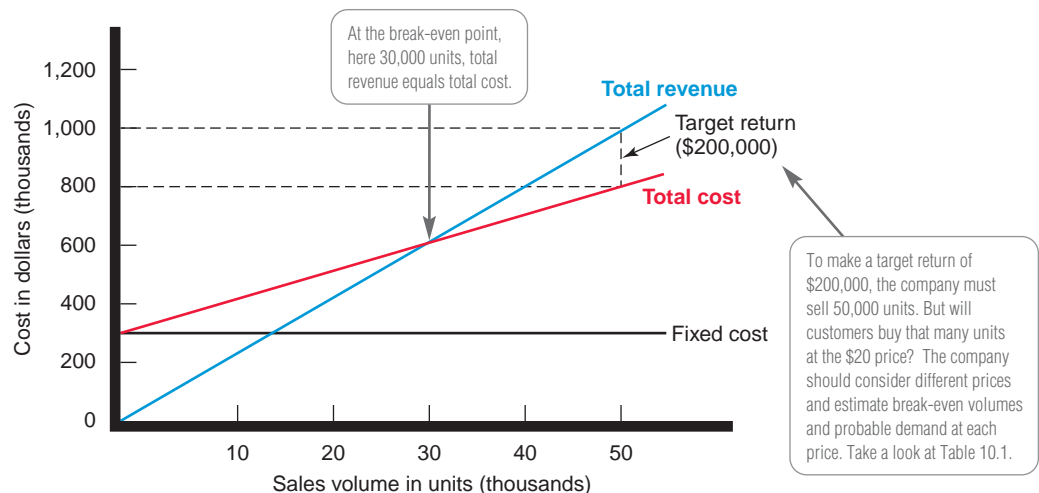
The total revenue and total cost curves cross at 30,000 units. This is the *break-even volume*. At \$20, the company must sell at least 30,000 units to break even, that is, for total revenue to cover total cost. Break-even volume can be calculated using the following formula:

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

If the company wants to make a profit, it must sell more than 30,000 units at \$20 each. Suppose the toaster manufacturer has invested \$1,000,000 in the business and wants to set a price to earn a 20 percent return, or \$200,000. In that case, it must sell at least 50,000 units at \$20 each. If the company charges a higher price, it will not need to sell as many toasters to achieve its target return. But the market may not buy even this lower volume at the higher price. Much depends on price elasticity and competitors' prices.

The manufacturer should consider different prices and estimate break-even volumes, probable demand, and profits for each. This is done in **Table 10.1**. The table shows that as price increases, the break-even volume drops (column 2). But as price increases, the demand for toasters also decreases (column 3). At the \$14 price, because the manufacturer clears only \$4 per toaster (\$14 less \$10 in variable costs), it must sell a very high volume to break even. Even though the low price attracts many buyers, demand still falls below the high break-even point, and the manufacturer loses money. At the other extreme, with a \$22 price, the manufacturer clears \$12 per toaster and must sell only 25,000 units to break

FIGURE | 10.5
Break-Even Chart for Determining Target-Return Price and Break-Even Volume



To make a target return of \$200,000, the company must sell 50,000 units. But will customers buy that many units at the \$20 price? The company should consider different prices and estimate break-even volumes and probable demand at each price. Take a look at Table 10.1.

● TABLE | 10.1 Break-Even Volume and Profits at Different Prices

Price	Unit Demand Needed to Break Even	Expected Unit Demand at Given Price	Total Revenue (1) × (3)	Total Costs*	Profit (4) – (5)
\$14	75,000	71,000	\$994,000	\$1,010,000	–\$16,000
16	50,000	67,000	1,072,000	970,000	102,000
18	37,500	60,000	1,080,000	900,000	180,000
20	30,000	42,000	840,000	720,000	120,000
22	25,000	23,000	506,000	530,000	–\$24,000

*Assumes fixed costs of \$300,000 and constant unit variable costs of \$10.

even. But at this high price, consumers buy too few toasters, and profits are negative. The table shows that a price of \$18 yields the highest profits. Note that none of the prices produce the manufacturer's target return of \$200,000. To achieve this return, the manufacturer will have to search for ways to lower the fixed or variable costs, thus lowering the break-even volume.

Author Comment In setting prices, the company must also consider competitors' prices. No matter what price it charges—high, low, or in-between—the company must be certain to give customers superior value for that price.

Competition-Based Pricing

Competition-based pricing involves setting prices based on competitors' strategies, costs, prices, and market offerings. Consumers will base their judgments of a product's value on the prices that competitors charge for similar products.

In assessing competitors' pricing strategies, the company should ask several questions. First, how does the company's market offering compare with competitors' offerings in terms of customer value? If consumers perceive that the company's product or service provides greater value, the company can charge a higher price. If consumers perceive less value relative to competing products, the company must either charge a lower price or change customer perceptions to justify a higher price.

Next, how strong are current competitors, and what are their current pricing strategies? If the company faces a host of smaller competitors charging high prices relative to the value they deliver, it might charge lower prices to drive weaker competitors from the market. If the market is dominated by larger, low-price competitors, the company may decide to target unserved market niches with value-added products at higher prices.

For example, ● Annie Bloom's Books, an independent bookseller in Portland, Oregon, isn't likely to win a price war against Amazon.com or Barnes & Noble—it doesn't even try.

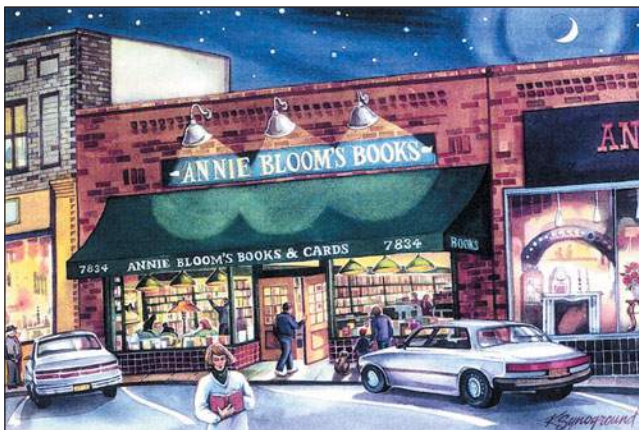
Instead, the shop relies on its personal approach, cozy atmosphere, and friendly and knowledgeable staff to turn local book lovers into loyal patrons, even if they have to pay a little more. Customers writing on a consumer review Web site recently gave Annie Bloom's five-star ratings, supported by the kinds of comments you likely wouldn't see for Barnes & Noble:¹⁰

Annie Bloom's is not the biggest bookstore, nor the most convenient to park at, nor are the prices incredibly discounted, nor is the bathroom easy to find . . . however, [i]t is one of the friendliest bookstores in town. It is just big enough for a solid hour of browsing. And it has a talented, smart, and long-term staff with incredible taste. . . . You'll find common best sellers here, but you'll also find all those cool books you heard about on NPR or in Vanity Fair that you never see featured at Barnes & Noble. [It's a] bookstore for the book crowd. . . . Good customer service here! Also, be nice to the cat. PS: [It] has a kid's play area in the back.

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

Competition-based pricing

Setting prices based on competitors' strategies, prices, costs, and market offerings.



● Pricing against larger, low-price competitors: Independent bookstore Annie Bloom's Books isn't likely to win a price war against Amazon.com or Barnes & Noble. Instead, it relies on outstanding customer service and a cozy atmosphere to turn booklovers into loyal customers.

concept but often difficult in practice: No matter what price you charge—high, low, or in-between—be certain to give customers superior value for that price.

Author Comment Now that we've looked at the three general pricing approaches—value-, cost-, and competitor-based pricing—let's dig into some of the many other factors that affect pricing decisions.

Other Internal and External Considerations Affecting Price Decisions (pp 300–306)

Beyond customer value perceptions, costs, and competitor strategies, the company must consider several additional internal and external factors. Internal factors affecting pricing include the company's overall marketing strategy, objectives, and marketing mix, as well as other organizational considerations. External factors include the nature of the market and demand and other environmental factors.

Overall Marketing Strategy, Objectives, and Mix

Price is only one element of the company's broader marketing strategy. Thus, before setting price, the company must decide on its overall marketing strategy for the product or service. If the company has selected its target market and positioning carefully, then its marketing mix strategy, including price, will be fairly straightforward. For example, when Honda developed its Acura brand to compete with European luxury-performance cars in the higher-income segment, this required charging a high price. In contrast, when it introduced the Honda Fit model—billed as “a pint-sized fuel miser with feisty giddy up”—this positioning required charging a low price. Thus, pricing strategy is largely determined by decisions on market positioning.

Pricing may play an important role in helping to accomplish company objectives at many levels. A firm can set prices to attract new customers or profitably retain existing ones. It can set prices low to prevent competition from entering the market or set prices at competitors' levels to stabilize the market. It can price to keep the loyalty and support of resellers or avoid government intervention. Prices can be reduced temporarily to create excitement for a brand. Or one product may be priced to help the sales of other products in the company's line.

Price is only one of the marketing mix tools that a company uses to achieve its marketing objectives. Price decisions must be coordinated with product design, distribution, and promotion decisions to form a consistent and effective integrated marketing program. Decisions made for other marketing mix variables may affect pricing decisions. For example, a decision to position the product on high-performance quality will mean that the seller must charge a higher price to cover higher costs. And producers whose resellers are expected to support and promote their products may have to build larger reseller margins into their prices.

Companies often position their products on price and then tailor other marketing mix decisions to the prices they want to charge. Here, price is a crucial product-positioning factor that defines the product's market, competition, and design. Many firms support such price-positioning strategies with a technique called **target costing**. Target costing reverses the usual process of first designing a new product, determining its cost, and then asking, “Can we sell it for that?” Instead, it starts with an ideal selling price based on customer-value considerations and then targets costs that will ensure that the price is met. For example, when Honda set out to design the Fit, it began with a \$13,950 starting price point and an operating efficiency of 33 miles per gallon firmly in mind. It then designed a stylish, peppy little car with costs that allowed it to give target customers those values.

Other companies deemphasize price and use other marketing mix tools to create *nonprice* positions. Often, the best strategy is not to charge the lowest price but rather differentiate the marketing offer to make it worth a higher price. For example, Bang & Olufsen (B&O)—known for its cutting-edge consumer electronics—builds more value into its products and charges sky-high prices. A B&O 50-inch BeoVision 4 HDTV will cost you \$7,500; a 65-inch model runs \$13,500, and a 103-inch model goes for \$93,050. A complete B&O entertainment system? Well, you don't really want to know the price. But target customers recognize B&O's very high quality and are willing to pay more to get it.

Target costing

Pricing that starts with an ideal selling price and then targets costs that will ensure that the price is met.



● Positioning on high price: Titus features its lofty prices in its advertising—
“suggested retail price: \$7,750.00.”

Some marketers even position their products on *high* prices, featuring high prices as part of their product’s allure. For example, Grand Marnier offers a \$225 bottle of Cuvée du Cent Cinquante-naire that’s marketed with the tagline “Hard to find, impossible to pronounce, and prohibitively expensive.” And Titus Cycles, a premium bicycle manufacturer, features its high prices in its advertising. ● One ad humorously shows a man giving his girlfriend a “cubic zirconia” engagement ring so that he can purchase a Titus Vuelo for himself. “Suggested retail price: \$7,750.00.”

Thus, marketers must consider the total marketing strategy and mix when setting prices. But again, even when featuring price, marketers need to remember that customers rarely buy on price alone. Instead, they seek products that give them the best value in terms of benefits received for the prices paid.

Organizational Considerations

Management must decide who within the organization should set prices. Companies handle pricing in a variety of ways. In small companies, prices are often set by top management rather than by the marketing or sales departments. In large companies, pricing is typically handled by divisional or product line managers. In industrial markets, salespeople may be allowed to negotiate with customers within certain price ranges. Even so, top management sets the pricing objectives and policies, and it often approves the prices proposed by lower-level management or salespeople.

In industries in which pricing is a key factor (airlines, aerospace, steel, railroads, oil companies), companies often have pricing departments to set the best prices or help others in setting them. These departments report to the marketing department or top management. Others who have an influence on pricing include sales managers, production managers, finance managers, and accountants.

The Market and Demand

As noted earlier, good pricing starts with an understanding of how customers’ perceptions of value affect the prices they are willing to pay. Both consumer and industrial buyers balance the price of a product or service against the benefits of owning it. Thus, before setting prices, the marketer must understand the relationship between price and demand for the company’s product. In this section, we take a deeper look at the price-demand relationship and how it varies for different types of markets. We then discuss methods for analyzing the price-demand relationship.

Pricing in Different Types of Markets

The seller’s pricing freedom varies with different types of markets. Economists recognize four types of markets, each presenting a different pricing challenge.

Under *pure competition*, the market consists of many buyers and sellers trading in a uniform commodity, such as wheat, copper, or financial securities. No single buyer or seller has much effect on the going market price. In a purely competitive market, marketing research, product development, pricing, advertising, and sales promotion play little or no role. Thus, sellers in these markets do not spend much time on marketing strategy.

Under *monopolistic competition*, the market consists of many buyers and sellers who trade over a range of prices rather than a single market price. A range of prices occurs because sellers can differentiate their offers to buyers. Sellers try to develop differentiated

offers for different customer segments and, in addition to price, freely use branding, advertising, and personal selling to set their offers apart. Thus, Toyota sets its Prius brand apart through strong branding and advertising, reducing the impact of price. It advertises that the third generation Prius takes you from “zero to sixty in 70% fewer emissions.” Because there are many competitors in such markets, each firm is less affected by competitors’ pricing strategies than in oligopolistic markets.

Under *oligopolistic competition*, the market consists of a few sellers who are highly sensitive to each other’s pricing and marketing strategies. Because there are few sellers, each seller is alert and responsive to competitors’ pricing strategies and moves.

In a *pure monopoly*, the market consists of one seller. The seller may be a government monopoly (the U.S. Postal Service), a private regulated monopoly (a power company), or a private nonregulated monopoly (DuPont when it introduced nylon). Pricing is handled differently in each case.

Analyzing the Price-Demand Relationship

Each price the company might charge will lead to a different level of demand. The relationship between the price charged and the resulting demand level is shown in the **demand curve** in **Figure 10.6**. The demand curve shows the number of units the market will buy in a given time period at different prices that might be charged. In the normal case, demand and price are inversely related—that is, the higher the price, the lower the demand. Thus, the company would sell less if it raised its price from P_1 to P_2 . In short, consumers with limited budgets probably will buy less of something if its price is too high.

Understanding a brand’s price-demand curve is crucial to good pricing decisions. ConAgra Foods learned this lesson when pricing its Banquet frozen dinners.¹¹

Demand curve

A curve that shows the number of units the market will buy in a given time period, at different prices that might be charged.



● The price-demand curve: When ConAgra raised prices on its Banquet frozen dinners, sales fell sharply. “The key component . . . is you’ve got to be at \$1,” says CEO Gary Rodkin, pictured above. “Everything else pales in comparison to that.”

ConAgra found out the hard way about the perils of pushing up the price of a Banquet frozen dinner. When it tried to recoup high commodity costs by hiking the list price last year, many retailers began charging up to \$1.25 a meal. The response from shoppers used to paying \$1? The cold shoulder. The resulting sales drop forced ConAgra to peddle excess dinners to discounters and contributed to a 40 percent drop in the company’s stock price for the year. ● It turns out that “the key component for Banquet dinners—the key attribute—is you’ve got to be at \$1,” says ConAgra’s CEO Gary Rodkin. “Everything else pales in comparison to that.” The price is now back to a buck a dinner. To make money at that price, ConAgra is doing a better job of managing costs. It tossed out pricey items such as barbecued chicken and country-fried pork in favor of grilled meat patties and rice and beans. It also shrank portion sizes while swapping in cheaper ingredients, such as mashed potatoes for brownies. Consumers are responding well to the brand’s efforts to keep prices down. Where else can you find dinner for \$1?

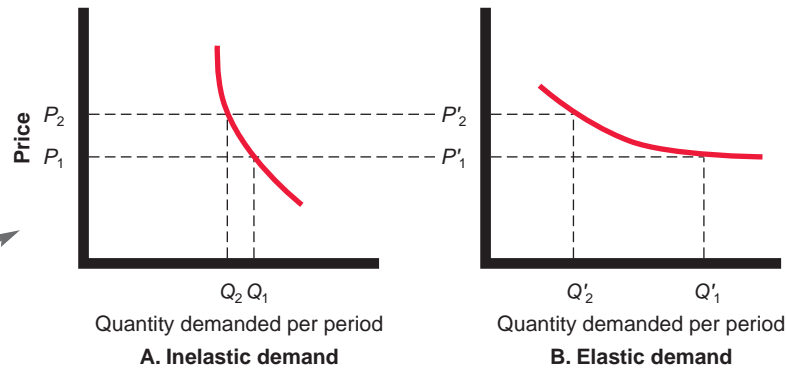
Most companies try to measure their demand curves by estimating demand at different prices. The type of market makes a difference. In a monopoly, the demand curve shows the total market demand resulting from different prices. If the company faces competition, its demand at different prices will depend on whether competitors’ prices stay constant or change with the company’s own prices.

Price Elasticity of Demand

Consider the two demand curves in Figure 10.6. In Figure 10.6A, a price increase from P_1 to P_2 leads to a relatively small drop in demand from Q_1 to Q_2 . In Figure 10.6B, however, the same price increase leads to a large drop in demand from Q'_1 to Q'_2 . If demand hardly

● FIGURE | 10.6
Demand Curves

Price and demand are related—no big surprise there. Usually, higher prices result in lower demand. But in the case of some prestige goods, the relationship might be reversed. A higher price signals higher quality and status, resulting in more demand, not less.



Price elasticity

A measure of the sensitivity of demand to changes in price.

changes with a small change in price, we say the demand is *inelastic*. If demand changes greatly, we say the demand is *elastic*. The **price elasticity** of demand is given by the following formula:

$$\text{price elasticity of demand} = \frac{\% \text{ change in quantity demanded}}{\% \text{ change in price}}$$

Suppose demand falls by 10 percent when a seller raises its price by 2 percent. The price elasticity of demand is therefore -5 (the minus sign confirms the inverse relation between price and demand), and demand is elastic. If demand falls by 2 percent with a 2 percent increase in price, then elasticity is -1 . In this case, the seller's total revenue stays the same: The seller sells fewer items but at a higher price that preserves the same total revenue. If demand falls by 1 percent when price is increased by 2 percent, then elasticity is $-\frac{1}{2}$, and demand is inelastic. The less elastic the demand, the more it pays for the seller to raise the price.

What determines the price elasticity of demand? Buyers are less price sensitive when the product they are buying is unique or when it is high in quality, prestige, or exclusiveness; substitute products are hard to find or when they cannot easily compare the quality of substitutes; and the total expenditure for a product is low relative to their income or when the cost is shared by another party.¹²

If demand is elastic rather than inelastic, sellers will consider lowering their prices. A lower price will produce more total revenue. This practice makes sense as long as the extra costs of producing and selling more do not exceed the extra revenue. At the same time, most firms want to avoid pricing that turns their products into commodities. In recent years, forces such as dips in the economy, deregulation, and the instant price comparisons afforded by the Internet and other technologies have increased consumer price sensitivity, turning products ranging from telephones and computers to new automobiles into commodities in some consumers' eyes.

Marketers need to work harder than ever to differentiate their offerings when a dozen competitors are selling virtually the same product at a comparable or lower price. More than ever, companies need to understand the price sensitivity of their customers and the trade-offs people are willing to make between price and product characteristics.

The Economy

Economic conditions can have a strong impact on the firm's pricing strategies. Economic factors such as a boom or recession, inflation, and interest rates affect pricing decisions because they affect consumer spending, consumer perceptions of the product's price and value, and the company's costs of producing and selling a product.

In the aftermath of the recent Great Recession, consumers have rethought the price-value equation. Many consumers have tightened their belts and become more value conscious. In the new, more-frugal economy, bemoans one marketer, "The frill is gone." Even more, consumers will likely continue their thrifty ways well beyond any economic recovery. As a result, many marketers have increased their emphasis on value-for-the-money pricing

strategies. “Value is the magic word,” says a P&G marketer. “In these economic times, people are . . . being much more thoughtful before making purchases. . . . Now, we’re going to be even more focused on helping consumers see value.”¹³

The most obvious response to the new economic realities is to cut prices and offer deep discounts. And thousands of companies have done just that. Lower prices make products more affordable and help spur short-term sales. However, such price cuts can have undesirable long-term consequences. Lower prices mean lower margins. Deep discounts may cheapen a brand in consumers’ eyes. And once a company cuts prices, it’s difficult to raise them again when the economy recovers. Consider companies such as Starbucks, Tiffany’s, or Whole Foods Market, which have spent years successfully positioning themselves on premium products at premium prices. In adapting to the new pricing environment, such firms face the difficult task of realigning their value propositions while staying true to their longer-term “more-for-more” positioning (see Real Marketing 10.2).

Rather than cutting prices, many companies are instead shifting their marketing focus to more affordable items in their product mixes. ● For example, whereas its previous promotions emphasized high-end products and pricey concepts such as creating dream kitchens, Home Depot’s more recent advertising pushes items like potting soil and hand tools under the tagline: “More saving. More doing. That’s the power of Home Depot.” Other companies are holding prices but redefining the “value” in their value propositions. For instance, Unilever has repositioned its higher-end Bertolli frozen meals as an eat-at-home brand that’s more affordable than eating out. And Kraft’s Velveeta cheese ads tell shoppers to “forget the cheddar, Velveeta is better,” claiming that a package of Velveeta is “twice the size of cheddar, for the same price.”¹⁴

Remember, even in tough economic times, consumers do not buy based on prices alone. They balance the price they pay against the value they receive. For example, according to a recent survey, despite selling its shoes for as much as \$150 a pair, Nike commands the highest consumer loyalty of any brand in the footwear segment.¹⁵ Customers perceive the value of Nike’s products and the Nike ownership experience to be well worth the price. Thus, no matter what price they charge—low or high—companies need to offer great *value for the money*.

Other External Factors

Beyond the market and the economy, the company must consider several other factors in its external environment when setting prices. It must know what impact its prices will have on other parties in its environment. How will *resellers* react to various prices? The company should set prices that give resellers a fair profit, encourage their support, and help them to sell the product effectively. The *government* is another important external influence on pricing decisions. Finally, *social concerns* may need to be taken into account. In setting prices, a company’s short-term sales, market share, and profit goals may need to be tempered by broader societal considerations. We will examine public policy issues in pricing at the end of Chapter 11.



More saving. More doing.™



● **Pricing and the economy:** Rather than just cutting prices, Home Depot shifted its marketing focus to more affordable items and projects under the tagline: “More saving. More doing.”

Real Marketing 10.2

Whole Foods Market: Price and Value in a Troubled Economy

Only a few years ago, consumers were flush with cash, and Whole Foods Market was thriving. The upscale grocery retailer was a model “more-for-more” marketer, offering premium value at premium prices. Under its motto, “Whole Foods, Whole People, Whole Planet,” it served up a gourmet assortment of high-quality grocery items, including a strong mix of natural and organic foods and health products. Its upscale, health-conscious customers were willing and able to pay higher prices for the extra value they got. Over the previous two decades, Whole Foods Market’s sales had soared, and its stock price had grown at an eye-popping compounded annual rate of 25 percent, peaking at almost \$80 a share.

Then came the Great Recession of 2008. People in all walks of life began rethinking the price-value equation and looking for ways to save. They asked tough questions, such as “I love the wonderful foods and smells in my Whole Foods Market, but is it worth the extra 30 percent versus shopping at Walmart?” All of a sudden, Whole Foods Market’s seemingly perfect premium marketing strategy looked less like a plum and more like a bruised organic banana. Even relatively affluent customers were cutting back and spending less. For the first time in its history, the company faced declines in same-store sales, and its stock price plunged to a shocking low of close to \$8. “The company had long touted its premium food offerings in its marketing, and that branding [was] now actually hurting them,” observed a retail analyst. Some customers even amended the company’s motto, making it “Whole Foods, Whole Paycheck.”

Hit hard by the economic downturn, Whole Foods Market faced difficult questions. Should it hold the line on the premium positioning that had won it so much success in the past? Or should it cut prices and reposition itself to fit the leaner times? On the one hand, it could simply batten down the hatches and wait for the economic storm to pass. But a wait-and-see strategy made little sense; the newfound consumer frugality probably will last for years to come. At the other extreme, Whole Foods could reshuffle its product as-

sortment, cut prices, and reposition downward to fit the new times. But that strategy would sacrifice most of what had made the upscale grocer unique over the years.

So Whole Foods Market decided to stick with its core up-market positioning but subtly realign its value proposition to better meet the needs of recession-rattled customers. It set out to downplay the gourmet element of its positioning while playing up the real value of the healthy but exciting food it offers. First, rather than dropping its everyday prices across the board, Whole Foods lowered prices on many basic items that customers demand most and bolstered these savings by offering significant sales on selected other items. It also started emphasizing its private-label brand, 365 Everyday Value.

Next, Whole Foods Market launched a new marketing program aimed at tempering the chain’s high-price reputation, reconnecting with customers, and convincing them that Whole Foods Market was, in fact, an afford-

able place to shop. To help consumers see the value, it beefed up its communications about private-label and sale items using newsletters, coupons, and its Web site. It assigned workers to serve as “value tour guides” to escort shoppers around stores pointing out value items. New ads featured headlines such as “No wallets were harmed in the buying of our 365 Everyday Value products,” and “Sticker shock, but in a good way.”

But the new marketing efforts did more than simply promote more affordable merchandise. They worked to convince shoppers that Whole Foods Market’s regular products and prices offer good value as well—that when it comes to quality food, price isn’t everything. As one tour guide notes, wherever you go, you’ll have to pay a premium for organic food. “Value means getting a good exchange for your money.” Such conversations helped to shift customers’ eyes off of price and back to value.

To strengthen customer relationships further in tighter times, Whole Foods Market also boosted its social media presence. It set up a Facebook page and dozens of Twitter accounts to address specific value and other topics related to every product category and every store. Videos on its Whole Tube YouTube channel advised customers to “waste not, want not.” At the official Whole Foods Market



When the economy dipped, rather than cutting everyday prices, Whole Foods set out to convince shoppers that it was, in fact, an affordable place to shop. It even assigned workers to serve as “value tour guides,” like the one above, to escort shoppers around stores pointing out value items.

blog—The Whole Story—customers learned about and exchanged views on organic and natural food, recipes, and other topics. Interestingly, customer conversations on this blog tended to focus more heavily on the “what you get” from Whole Foods Market than the “what you pay.” Customers more interested in the value side of the price-value equation could log onto The Whole Deal, an official blog that offers coupons, deals, budget-friendly recipes, and other things that help you make “wiser choices for your budget, the Earth, and your fellow Earthlings.” Whole Foods also offered iPhone and iPod apps, providing more than 2,000 recipes using Whole Foods Market natural and organic products and highlighting meals that feed a family of four for less than \$15.

How is the Whole Foods Market value realignment working out? So far, so good. By late 2010, the chain appeared to have regained its footing. Same-store sales and profits were growing once again, and its stock

price had recovered to over \$45 a share. Regarding the move to value offerings, says Whole Foods Market’s COO, “We did it early, we did it strong, and we’ve done it consistently.” Customers now “give us credit for being more competitive and for meeting their needs in these times, and now they can see the better deals, the better pricing, the better choices.”

Most important, however, Whole Foods Market has managed to realign its value proposition in a way that preserves all the things that have made it special to its cus-

tomers through the years. In all, things aren’t really much different inside a local Whole Foods Market these days. There are more sale items, and the private-label 365 Everyday Value brand is more prominently presented, but customers can still find the same alluring assortment of high-quality, flavorful, and natural foods wrapped in Whole Foods, Whole People, Whole Planet values. Thanks to the subtle shifts in its value strategy, however, customers might just appreciate the value side of the Whole Foods Market formula a little bit more.

Sources: Quotes and other information from Mike Duff, “Whole Foods Dropping Prices to Raise Its Prospects,” *R&FF Retailer*, November 2009, p. 14; “Whole Foods Market Reports First Quarter Results,” February 16, 2010, www.wholefoodsmarket.com/company/pdfs/Q110financial.pdf; Elliot Zwiebach, “Whole Foods ‘Bullish’ as Trends Improve,” *Supermarket News*, August 10, 2009, p. 1; David Kesmodel, “Whole Foods Net Falls 31% in Slow Economy,” *Wall Street Journal*, August 6, 2008, p. B1; Stuart Elliott, “With Shoppers Pinching Pennies, Some Big Retailers Get the Message,” *New York Times*, April 13, 2009, p. B6; “Whole Web,” *Progressive Grocer*, June 19, 2009, accessed at <http://progressivegrocer.com>; and information from <http://blog.wholefoodsmarket.com>, www.wholefoodsmarket.com/products/wholedeal/index.php, and www.wholefoodsmarket.com, accessed November 2010.

REVIEWING Objectives AND KEY Terms

Companies today face a fierce and fast-changing pricing environment. Firms successful at creating customer value with the other marketing mix activities must still capture some of this value in the prices they earn. This chapter examined the importance of pricing, general pricing strategies, and the internal and external considerations that affect pricing decisions.

Objective 1 Answer the question “What is a price?” and discuss the importance of pricing in today’s fast-changing environment. (p 290)

Price can be defined narrowly as the amount of money charged for a product or service. Or it can be defined more broadly as the sum of the values that consumers exchange for the benefits of having and using the product or service. The pricing challenge is to find the price that will let the company make a fair profit by getting paid for the customer value it creates.

Despite the increased role of nonprice factors in the modern marketing process, price remains an important element in the

marketing mix. It is the only marketing mix element that produces revenue; all other elements represent costs. More importantly, as a part of a company’s overall value proposition, price plays a key role in creating customer value and building customer relationships. Smart managers treat pricing as a key strategic tool for creating and capturing customer value.

Objective 2 Identify the three major pricing strategies and discuss the importance of understanding customer-value perceptions, company costs, and competitor strategies when setting prices. (pp 291–300)

Companies can choose from three major pricing strategies: customer value-based pricing, cost-based pricing, and competition-based pricing. *Customer value-based pricing* uses buyers’ perceptions of value as the basis for setting price. Good pricing begins with a complete understanding of the value that a product or service creates for customers and setting a price that captures that

value. Customer perceptions of the product's value set the ceiling for prices. If customers perceive that a product's price is greater than its value, they will not buy the product.

Companies can pursue either of two types of value-based pricing. *Good-value pricing* involves offering just the right combination of quality and good service at a fair price. EDLP is an example of this strategy. *Value-added pricing* involves attaching value-added features and services to differentiate the company's offers and support charging higher prices.

Cost-based pricing involves setting prices based on the costs for producing, distributing, and selling products plus a fair rate of return for effort and risk. Company and product costs are an important consideration in setting prices. Whereas customer value perceptions set the price ceiling, costs set the floor for pricing. However, cost-based pricing is product driven rather than customer driven. The company designs what it considers to be a good product and sets a price that covers costs plus a target profit. If the price turns out to be too high, the company must settle for lower markups or lower sales, both resulting in disappointing profits. If the company prices the product below its costs, its profits will also suffer. Cost-based pricing approaches include *cost-plus pricing* and *break-even pricing* (or target profit pricing).

Competition-based pricing involves setting prices based on competitors' strategies, costs, prices, and market offerings. Consumers base their judgments of a product's value on the prices that competitors charge for similar products. If consumers perceive that the company's product or service provides greater value, the company can charge a higher price. If consumers perceive less value relative to competing products, the company must either charge a lower price or change customer perceptions to justify a higher price.

Objective 3 Identify and define the other important internal and external factors affecting a firm's pricing decisions. (pp 300–306)

Other *internal* factors that influence pricing decisions include the company's overall marketing strategy, objectives, and marketing mix, as well as organizational considerations. Price is only one element of the company's broader marketing strategy. If the company has selected its target market and positioning carefully, then its marketing mix strategy, including price, will be fairly straightforward. Some companies position their products on price and then tailor other marketing mix decisions to the prices they want to charge. Other companies deemphasize price and use other marketing mix tools to create *nonprice* positions.

Other *external* pricing considerations include the nature of the market and demand and environmental factors such as the economy, reseller needs, and government actions. The seller's pricing freedom varies with different types of markets. Ultimately, the customer decides whether the company has set the right price. The customer weighs price against the perceived values of using the product: If the price exceeds the sum of the values, consumers will not buy. So the company must understand concepts such as demand curves (the price-demand relationship) and price elasticity (consumer sensitivity to prices).

Economic conditions can also have a major impact on pricing decisions. The Great Recession caused consumers to rethink the price-value equation. Marketers have responded by increasing their emphasis on value-for-the-money pricing strategies. Even in tough economic times, however, consumers do not buy based on prices alone. Thus, no matter what price they charge—low or high—companies need to offer superior value for the money.

KEY Terms

OBJECTIVE 1

Price (p 290)

OBJECTIVE 2

Customer value-based pricing (p 291)

Good-value pricing (p 292)

Value-added pricing (p 293)

OBJECTIVE 3

Cost-based pricing (p 295)

Fixed costs (overhead; p 296)

Variable costs (p 296)

Total costs (p 296)

Experience curve (learning curve; p 297)

Cost-plus pricing (markup pricing; p 297)

Break-even pricing (target return pricing; p 298)

Competition-based pricing (p 299)

Target costing (p 300)

Demand curve (p 302)

Price elasticity (p 303)



- Check your understanding of the concepts and key terms using the mypearsonmarketinglab study plan for this chapter.
- Apply the concepts in a business context using the simulation entitled **Pricing**.

DISCUSSING & APPLYING THE Concepts

Discussing the Concepts

1. What factors must marketers consider when setting prices? (AACSB: Communication)
2. Name and describe the two types of value-based pricing methods. (AACSB: Communication)
3. Describe the types of cost-based pricing and the methods of implementing each. (AACSB: Communication)
4. What is *target costing* and how is it different from the usual process of setting prices? (AACSB: Communication)
5. Discuss the impact of the economy on a company's pricing strategies. (AACSB: Communication)
6. Name and describe the four types of markets recognized by economists and discuss the pricing challenges posed by each. (AACSB: Communication)

Applying the Concepts

1. In a small group, discuss your perceptions of value and how much you are willing to pay for the following products:

automobiles, frozen dinners, jeans, and athletic shoes. Are there differences among members of your group? Explain why those differences exist. Discuss some examples of brands of these products that are positioned to deliver different value to consumers. (AACSB: Communication; Reflective Thinking)

2. Find estimates of price elasticity for a variety of consumer goods and services. Explain what price elasticities of 0.5 and 2.4 mean. (*Note:* These are absolute values, as price elasticity is usually negative.) (AACSB: Communication; Reflective Thinking)
3. In a small group, determine the costs associated with offering an online MBA degree in addition to a traditional MBA degree at a university. Which costs are fixed and which are variable? Determine the tuition (that is, price) to charge for a three-credit course in this degree program. Which pricing method is your group using to determine the price? (AACSB: Communication; Reflective Thinking)

FOCUS ON Technology

Would you shop around for the best price on a medical procedure? Most patients do not know the price of a medical procedure, and many might not care because they think insurance will cover it. But that is not always the case. Many patients are paying out of their own pockets for their health care. However, health-care costs and doctors' prices are now more transparent thanks to the Internet. Several Web sites arm patients with cost information, and others allow them to make price comparisons in their areas. They might even get a coupon for a price reduction from a participating provider.

1. Go to www.outofpocket.com/OOP/Default.aspx to determine the average cost for a colonoscopy. Using a source such as

www.newchoicehealth.com, determine the cost for a colonoscopy in your city and in a nearby city. What is the most and least expensive in each city? Are prices comparable to the national average? Why are there differences or similarities in the range of prices for the two cities? (AACSB: Communication; Use of IT; Reflective Thinking)

2. Health-care providers offer price deals through these types of Web sites. Debate the likelihood of consumers taking advantage of Internet price discounts for medical care. (AACSB: Communication; Reflective Thinking)

FOCUS ON Ethics

In airline pricing, \$5 here and \$10 there; it all starts to add up. Airlines are nickel-and-diming flyers right and left, except that there are more zeros after the fives and tens! Add-on fees contributed more than \$5 billion in airline revenue in 2009. Change your flight—that will cost upward of \$150. Check a bag—add another \$10 to \$25 and perhaps \$50 for a second bag if traveling overseas. Spirit Airlines even charges for carry-on bags! Taking a pet along? That's another \$50 to \$100. Hungry? \$10 or more, please. For \$10 to \$30, you can jump to the front of the check-in and se-

curity lines and board before other passengers. These fees are in addition to all the other taxes and fees imposed on flyers. A recent Government Accountability Office report, however, raises concerns over the disclosure of fees. Airlines are required to disclose only check-bag fees, making it harder for consumers to compare total costs when booking flights.

1. Go to www.delta.com and determine what it would cost to fly Delta Airlines from Atlanta to Denver for a one-week

roundtrip next month. What additional fees would you have to pay to change your flight, check one bag, bring your dog with you, and eat lunch while flying? (AACSB: Communication; Reflective Thinking)

2. How easy was it to determine the total cost of your flight? Should airlines be required to disclose all fees through an easier method? (AACSB: Communication; Ethical Reasoning)

MARKETING & THE Economy

Colgate-Palmolive

As the uncertain economy has made people more aware of their spending, many companies have slashed prices on their products and services. Still other companies successfully held prices steady, selling as much or more than they did before the economic bottom fell out. But Colgate-Palmolive is one of the fortunate few that has actually been able to *increase* prices during this more frugal era and reap benefits from doing so. Think about it—how grim would your budget have to get before you'd stop brushing your teeth or taking a shower? Economic conditions have relatively little impact on people's basic personal care habits, and brand preferences are deeply ingrained for these necessities. Based on an

accurate evaluation of customer buying habits, Colgate-Palmolive raised prices by an average of 7.5 percent without experiencing any dip in sales. Higher prices and stable volumes equal—cha-ching—higher profits. Indeed, Colgate-Palmolive saw its profits rise by 20 percent in 2008 and 17 percent in 2009, during the heart of the recent recession. It seems as though looking and smelling clean might just be recession-proof concepts.

1. Does the success of Colgate-Palmolive's price increases have anything to do with the economy?
2. In the longer term, as the economy recovers, what should Colgate-Palmolive anticipate in the wake of its price increases?

MARKETING BY THE Numbers

One external factor that manufacturers must consider when setting prices is reseller margins. Manufacturers do not have the final say concerning the price to consumers; retailers do. So manufacturers must start with their suggested retail prices and work back, subtracting out the markups required by resellers that sell the product to consumers. Once that is considered, manufacturers know at what price to sell their products to resellers, and they can determine what volume they must sell to break even at that price and cost combination. To answer the following questions, refer to Appendix 2.

1. A consumer purchases a computer for \$800 from a retailer. If the retailer's markup is 30 percent and the wholesaler's

markup is 10 percent, both based on their respective selling prices, at what price does the manufacturer sell the product to the wholesaler? (AACSB: Communication; Analytical Reasoning)

2. If the unit variable cost for each computer is \$350 and the manufacturer has fixed costs totaling \$2 million, how many computers must this manufacturer sell to break even? How many must it sell to realize a profit of \$50 million? (AACSB: Communication; Analytical Reasoning)

VIDEO Case

IKEA

Lots of companies have idealistic missions. But IKEA's vision, "To create a better everyday life for the many people," seems somewhat implausible. How can a company that makes furniture improve everyday life for the masses? Interestingly, the most important part of that strategy is price. For every product that it designs, from leather sofas to plastic mugs, IKEA starts with a target price. The target price is one that's deemed affordable, making the product accessible to the masses.

Only then does IKEA begin the grueling process of creating a high-quality, stylish, and innovative product that can be delivered to the customer for that target price. As IKEA points out, anyone can make high-quality goods for a high price or poor-quality goods for a low price. The real challenge is making high-quality

products at a low price. To do so requires a relentless focus on costs combined with a thirst for innovation. That has been IKEA's quest for more than 65 years.

After viewing the video featuring IKEA, answer the following questions about the company's pricing strategy:

1. What is IKEA's promise of value?
2. Referring to the Klippan sofa, illustrate how IKEA delivers its promise of value to consumers.
3. Based on the concepts from the text, does IKEA employ a value-based pricing approach or a cost-based pricing approach? Support your answer.

COMPANY Case

Southwest Airlines: Balancing the Price-Value Equation

It's the same plane going to the same place at exactly the same time. But these days, not all airline passengers are equal. Nor do they all pay equally. In fact, a person on any given flight has likely paid a different price for his or her ticket than the people on either side of them. No matter where they sit, however, all passengers seem to have one thing in common: Almost nobody's happy with what they get for what they pay. Tempers are flaring over rising air travel prices coupled with fewer amenities and less attentive customer service. Industry-wide, satisfaction ratings dropped last year for the third year in a row. Something is just not right with the airline price-value equation.

Most of us probably have had experiences like those of Doug Fesler, an executive at a medical research group in Washington, D.C.

He wasn't expecting much in the way of amenities on his American Airlines flight to Honolulu. In fact, knowing the airline no longer served free meals, he had packed his own lunch for the second leg of his flight from Dallas to Honolulu. But he said he was shocked at the lack of basic services and the overall condition of the cabin. On that flight, the audio for the movie was broken. The light that indicated when the bathroom was occupied was squirrely, causing confusion and, in some cases, embarrassingly long waits for passengers in need of the lavatory. And though food was available for purchase, the quantity of food was depleted before the flight attendants could serve the entire cabin, leaving some fellow passengers looking longingly at the snack he had packed.

His return flight was just as disappointing. This time the audio for the movie worked—but only in Spanish—and his seat refused to stay in the upright position. "I was just appalled," said Fesler. "You pay \$500 or \$600 for a seat, and you expect it to be functional." He said he has considered refusing to fly airlines with such poor service but added that "if you did that with every airline that made you mad, you'd never get anywhere in this country."

Certainly, these aren't the best of times for airlines. The long recession has had the dual effect of decreasing revenues while increasing costs. This has made it more difficult to maintain aircraft and provide the niceties that customers have come to expect.

In the midst of the turmoil, however, one airline in particular seems to be flying high. Southwest Airlines is setting records for customer loads and profitability. This isn't just a recent phenomenon for the most famous low-fare airline. Since it started flying in 1972, Southwest Airlines has never lost money, something no other U.S. airline can claim. And for 2009, Southwest was the only airline to carry more passengers than it did the year before. What's its secret? In short, it has been able to provide airline service that maximizes value by giving customers great benefits for the price paid.

THE SOUTHWEST FORMULA

From its humble beginnings, the airline has been known for a few things that truly classify it as a "no-frills" airline. For starters, it does not assign seats. Rather, passengers board on a first-come,

first-served basis, a procedure that customers prefer by a two-to-one ratio. It doesn't serve meals on any flights, only basic snacks. It flies only 737 narrow-body planes and doesn't have a first-class section. And it doesn't provide electronic entertainment, relying instead on humorous flight attendants to entertain passengers.

From the beginning, its main draw has been low prices. It has communicated very effectively to customers that the lack of amenities allows it to charge some of the lowest fares in the industry. In fact, this has long been a competitive advantage for Southwest. As the airline expanded into city after city, other airlines were forced to drop their fares to compete. That overall lowering of fares in markets that Southwest enters has become widely known as the "Southwest effect."

But during the mid-2000s, Southwest's cost advantage over other airlines narrowed considerably. The bigger carriers in the industry cut costs tremendously as fuel and labor costs rose. New low-fare carriers gained strength. Competition became leaner and better able to match Southwest's prices.

But Southwest didn't put all its eggs in the price basket. For years, it focused on providing the types of benefits that truly matter to air travel patrons. Gary Kelly, CEO since 2004, summarizes these benefits:

Ultimately, our industry is a customer-service business, and we have the best people to provide special customer service. Clearly, as the differences between air carriers narrow with respect to fares, we must execute in order to differentiate ourselves. But that's our core advantage. Since the U.S. Department of Transportation began collecting and publishing operating statistics, we've excelled at on-time performance, baggage handling, fewest complaints, and fewest canceled flights. Besides, we're still the low-cost producer and the low-fare leader in the U.S. We have no intention of conceding that position.

HOW TO INCREASE PROFITS

As the effects of the global recession tightened its grip on the travel industry, many major carriers struggled to find ways to cut costs and increase revenue. Northwest discovered that it could save \$2 million a year by cutting pretzels from its coach seating. American dropped \$30 million a year by eliminating free meal service on longer flights. In fact, in a move that extinguished any hope of hot meals returning to coach, the airline removed the rear galleys from its MD-80 aircraft and replaced them with four seats, an addition worth another \$34 million a year. Eliminating pillows was good for another million. The cutting of such amenities has made some traditional airlines even lower on frills than "no-frills" Southwest. After all, you can still get free snacks and a pillow on its flights. "I actually have more respect for Southwest Airlines in this area," says one experienced traveler. "They've never pretended to have more than they do."

But the most common—and perhaps annoying—new practice is the addition of baggage fees. Almost every airline now charges a fee of \$15 to \$35 for the first checked bag, even more for the second bag, and as much \$125 if you have to check a third bag. And that's only for the departing trip! Customers pay the same fees on the return. And Spirit Airlines recently announced the unthinkable. It will soon begin charging customers between \$30 and \$45 to stow carry-on bags in the overhead bin.

On this matter, Southwest has taken a stand. In a nationwide ad campaign, it has communicated to customers that “bags fly free.” In fact, it is the only U.S. carrier that does not charge for checking luggage. Despite criticism that Southwest has faced for not taking advantage of the revenue stream from charging for bags, the airline has chosen to side with customers. “At Southwest, we try to give you more, while all our competitors are taking away,” said Kelly.

Kelly couldn't be happier with the results of this campaign. He doesn't see it as a missed opportunity for revenue. In fact, he quickly points out that Southwest is the only airline that has actually gained customers. “We're beating the pants off everybody in terms of our revenue production. We have fewer seats offered every day, and we're carrying more passengers. We're defying gravity.” Kelly claims that Southwest has gained about \$1 billion in revenue this past year by taking market share from its rivals.

Although he is quick to point out that it is difficult to determine just how much of that revenue increase is due to its “bags-fly-free” campaign, Kelly thinks that this policy is the biggest factor in its current financial success. “We can't prove to you it is the source of the (market share) shift, but what we can prove is the awareness,” Kelly said. “The ad campaign has been very powerful. It has definitely penetrated the American traveler's consciousness. They definitely know that we don't charge for bags.” Kelly believes that the airline's increase in revenues from its higher load factors dwarfs what it could have collected in bag fees.

A STRONG VALUE EQUATION

In addition to charging fees for checking bags, airlines are continually searching for ways to squeeze any dollar they can from customers. Some airlines charge a fee if you want to sit in an aisle or window seat. There are now booking fees, fees for checking in online or at the airport, and fuel surcharges. One airline even hinted that it might begin charging customers to use the onboard lavatory. All these new ways to make money make it difficult for customers to easily determine the actual price of a ticket. They also

don't seem to be working as USAirways, Continental, United, Delta, and American combined lost almost \$4 billion in 2009.

If Southwest was beginning to lose its low fare advantage, it is now evident that the airline has found a new way to compete on price. By not adding new fees, it is driving home the message that it is once again the cheaper choice. Combined with the fact that it has not cut services, customers are eager to board its planes. The tried and true method of increasing customer benefits while decreasing costs is working better than ever for Southwest. And if Kelly has his way, it will continue to assert its competitive strength for years to come.

Questions for Discussion

1. What benefits do airline customers seek when they buy air travel tickets? Has Southwest done a better job than competitors of meeting the needs of these air travelers? In what ways?
2. How has Southwest executed value-based pricing?
3. What are the benefits and risks to airlines of cutting costs? What impact are these factors now having on airline pricing and profitability?
4. Does the airline's current strategy truly differentiate it from its competitors? Is the strategy sustainable?
5. What marketing recommendations, including pricing recommendations, would you make to Southwest as it moves into the next decade?

Sources: Dan Reed, “Southwest: ‘Bags Fly Free’ Pays Off,” *USA Today*, May 20, 2010, p. 1B; Susan Warren, “Keeping Ahead of the Pack,” *Wall Street Journal*, December 19, 2005, p. B1; Michelle Higgins, “Class Conflict,” *New York Times*, November 25, 2007, p. 5.1; Cheryl Hall, “Southwest's Chief Is Flying High,” *Los Angeles Times*, May 3, 2010, p. A19; William Pack, “Southwest Airlines Is Expecting a Better 2011,” *San Antonio Express-News*, April 8, 2010, p. 2C.