

# Pricing Strategies

**Chapter Preview** In the previous chapter, you learned that price is an important marketing mix tool for both creating and capturing customer value. You explored the three main pricing strategies—customer value-based, cost-based, and competition-based pricing—and the many internal and external factors that affect a firm’s pricing decisions. In this chapter, we’ll look at some additional pricing considerations: new-product pricing, product mix pricing, price adjustments, and initiating

and reacting to prices changes. We close the chapter with a discussion of public policy and pricing.

For openers, we look at Trader Joe’s, whose unique price and value strategy has made it one of the nation’s fastest-growing, most popular food stores. Trader Joe’s understands that success comes not only from what products you offer customers or the prices you charge. It comes from offering the combination of products and prices that produces the greatest customer *value*—what customers get for the prices they pay.

## Trader Joe’s: A Special Twist on the Price-Value Equation— Cheap Gourmet

**A**s they prepared to open the new Trader Joe’s store in Chapel Hill, North Carolina, manager Greg Fort (the “captain”) and his Hawaiian-shirt-clad employees (the “crew”) scurried about, stocking shelves, hanging plastic lobsters, and posting hand-painted signs in preparation for the expected tidal wave of 5,000 customers who would descend on the store on opening day. A veteran of two other store openings, Fort knew that customers would soon be lined up 10 deep at checkouts with carts full of Trader Joe’s exclusive \$2.99 Charles Shaw wine—aka “Two-Buck Chuck”—and an assortment of other exclusive gourmet products at impossibly low prices. Fort also knew that he would have to spend time explaining Trader Joe’s prices to new customers. “These are our everyday prices, not grand-opening specials,” he’d tell them. “There’s no need to buy a year’s worth in one visit!”

Trader Joe’s isn’t really a gourmet food store. Then again, it’s not a discount food store either. It’s actually a bit of both. One of America’s hottest retailers, Trader Joe’s has put its own special twist on the food price-value equation—call it “cheap gourmet.” It offers gourmet-caliber, one-of-a-kind products at bargain prices, all served up in a festive, vacation-like atmosphere that makes shopping fun. “When you look at food retailers, there is the low end, the big middle, and then there is the cool edge—that’s Trader Joe’s,” says one food marketing expert. Whatever you call it, Trader Joe’s inventive price-value positioning has earned it an almost cultlike following of devoted customers who love what they get from Trader Joe’s for the prices they pay.

Trader Joe’s describes itself as an “island paradise” where “value, adventure, and tasty treasures are discovered, every day.” Shoppers bustle and buzz amid cedar-plank-lined walls and fake palm trees as a ship’s bell rings out occasionally at checkout, alerting them to special announcements. Unfailingly helpful and cheery associates in aloha shirts chat with customers about everything from the weather to menu suggestions for dinner parties. Customers don’t just shop at Trader Joe’s; they experience it.

Shelves bristle with an eclectic assortment of gourmet-quality grocery items. Trader Joe’s stocks only a limited assortment of about 2,000 specialty products (compared with the 45,000 items found in an average Safeway). However, the assortment is uniquely Trader Joe’s, including special concoctions of gourmet packaged foods and sauces, ready-to-eat soups, fresh and frozen entrees, snacks, and desserts—all free of artificial colors, flavors, and preservatives. Trader Joe’s is a gourmet foodie’s delight, featuring everything from wasabi peas, organic strawberry lemonade, dark-chocolate-dipped spiced dry mango, and fair trade coffees to chile lime chicken burgers and triple-ginger ginger snaps. “Where else can you find Soy & Flax Cereal clusters, Gin-

**Trader Joe’s understands that success comes not only from what products you offer customers or the prices you charge. It comes from offering the combination of products and prices that produces the greatest customer value.**

ger Cats Cookies, and Jalapeño Blue Corn Bread Mix?” asks one shopper.

Another thing that makes Trader Joe’s products so special is that you simply can’t get them anywhere else. More than 80 percent of the store’s brands are private label goods, sold exclusively by Trader Joe’s. If asked, almost any customer can tick off a ready list of Trader Joe’s favorites that they just can’t live without—a list that quickly grows. “People get hooked on something and they keep coming back for it. That’s how it starts,” says a Trader Joe’s store captain. “They end up filling up their baskets, then entire carts. That’s the most common complaint that we hear. They came in for one or two things, and ended up with a whole cart full of stuff.”

A special store atmosphere, exclusive gourmet products, helpful and attentive associates—this all sounds like a recipe for high prices. Not so at Trader Joe’s. Whereas upscale competitors such as Whole Foods Market charge upscale prices to match their wares (“Whole Foods, Whole Paycheck”), Trader Joe’s amazes customers with its relatively frugal prices. The prices aren’t all that low in absolute terms, but they’re a real bargain compared with what you’d pay for the same quality and coolness elsewhere. “At Trader Joe’s, we’re as much about value as we are about great food,” says the company. “So you can afford to be adventurous without breaking the bank.”

How does Trader Joe’s keep its gourmet prices so low? It all starts with lean operations and a near-fanatical focus on saving money. To keep costs down, Trader Joe’s typically locates its stores in low-rent, out-of-the-way locations, such as suburban strip malls. Its small store size and limited product assortment results in reduced facilities and inventory costs. Trader Joe’s stores save money by eliminating large produce sections and expensive on-site bakery, butcher, deli, and seafood shops. And for its private label brands, Trader Joe’s buys directly from suppliers and negotiates hard on price. “We buy in huge quantities straight from our distributors, which cuts out the middle man and lets us offer the lowest possible prices,” says the store manager.

Finally, the frugal retailer saves money by spending almost nothing on advertising. Trader Joe’s unique combination of quirky products and low prices produces so much word-of-mouth promotion that the company doesn’t really need to advertise. The closest thing to an official promotion is the company’s Web site or a newsletter mailed out to people who opt in to receive it. Trader Joe’s most potent promotional



weapon is its army of faithful followers. Trader Joe’s customers have even started their own fan Web site, [www.traderjoesfan.com](http://www.traderjoesfan.com), where they discuss new products and stores, trade recipes, and swap their favorite Trader Joe’s stories.

Thus, finding the right price-value formula has made Trader Joe’s one of the nation’s fastest-growing and most popular food stores. Its more than 350 stores in 25 states now reap annual sales of more than \$8 billion, up more than 77 percent in just the previous four years. Trader Joe’s stores pull in an amazing \$1,780 per square foot, more than twice the supermarket industry average. *Consumer Reports* recently ranked Trader Joe’s, along with Wegmans, as the best supermarket chain in the nation.

It’s all about value and price—what you get for what you pay. Just ask Trader Joe’s regular Chrissi Wright, found early one morning browsing her local Trader Joe’s in Bend, Oregon.

Chrissi expects she’ll leave Trader Joe’s with eight bottles of the popular Charles Shaw wine priced at \$2.99 each tucked under her arms. “I love Trader Joe’s because they let me eat like a yuppie without taking all my money,” says Wright. “Their products are gourmet, often environmentally conscientious and beautiful . . . and, of course, there’s Two-Buck Chuck—possibly the greatest innovation of our time.”<sup>1</sup>

**Trader Joe’s unique price-value strategy has earned it an almost cultlike following of devoted customers who love what they get for the prices they pay.**

**As we** learned in the previous chapter, pricing decisions are subject to a complex array of company, environmental, and competitive forces. To make things even more complex, a company does not set a single price but rather a *pricing structure* that covers different items in its line. This pricing structure changes over time as products move through their life cycles. The company adjusts its prices to reflect changes in costs and demand and account for variations in buyers and situations. As the competitive environment changes, the company considers when to initiate price changes and when to respond to them.

This chapter examines additional pricing approaches used in special pricing situations and adjusting prices to meet changing situations. We then look at *new-product pricing* for products in the introductory stage of the product life cycle, *product mix pricing* for related

# Objective OUTLINE

## Objective 1

Describe the major strategies for pricing new products.

**New-Product Pricing Strategies** (314–315)

## Objective 2

Explain how companies find a set of prices that maximizes the profits from the total product mix.

**Product Mix Pricing Strategies** (315–319)

## Objective 3

Discuss how companies adjust their prices to take into account different types of customers and situations.

**Price-Adjustment Strategies** (319–325)

## Objective 4

Discuss the key issues related to initiating and responding to price changes.

**Price Changes** (325–328)

## Objective 5

Overview the social and legal issues that affect pricing decisions.

**Public Policy and Marketing** (328–332)

products in the product mix, *price adjustment tactics* that account for customer differences and changing situations, and strategies for initiating and responding to *price changes*.<sup>2</sup>

**Author Comment** | Pricing new products can be especially challenging. Just think about all the things you need to consider in pricing a new cell phone, say the first Apple iPhone. Even more, you need to start thinking about the price—along with many other marketing considerations—at the very beginning of the design process.

## New-Product Pricing Strategies (pp 314–315)

Pricing strategies usually change as the product passes through its life cycle. The introductory stage is especially challenging. Companies bringing out a new product face the challenge of setting prices for the first time. They can choose between two broad strategies: *market-skimming pricing* and *market-penetration pricing*.

### Market-Skimming Pricing

Many companies that invent new products set high initial prices to “skim” revenues layer by layer from the market. Apple frequently uses this strategy, called **market-skimming pricing** (or **price skimming**). When Apple first introduced the iPhone, its initial price was as much as \$599 per phone. The phones were purchased only by customers who really wanted the sleek new gadget and could afford to pay a high price for it. Six months later, Apple dropped the price to \$399 for an 8GB model and \$499 for the 16GB model to attract new buyers. Within a year, it dropped prices again to \$199 and \$299, respectively, and you can now buy an 8GB model for \$99. In this way, Apple skimmed the maximum amount of revenue from the various segments of the market.

Market skimming makes sense only under certain conditions. First, the product’s quality and image must support its higher price, and enough buyers must want the product at that price. Second, the costs of producing a smaller volume cannot be so high that they cancel the advantage of charging more. Finally, competitors should not be able to enter the market easily and undercut the high price.

### Market-Penetration Pricing

Rather than setting a high initial price to skim off small but profitable market segments, some companies use **market-penetration pricing**. Companies set a low initial price to *penetrate* the market quickly and deeply—to attract a large number of buyers quickly and

### Market-skimming pricing (price skimming)

Setting a high price for a new product to skim maximum revenues layer by layer from the segments willing to pay the high price; the company makes fewer but more profitable sales.

### Market-penetration pricing

Setting a low price for a new product to attract a large number of buyers and a large market share.



● **Penetration pricing:** To lure famously frugal Chinese customers, IKEA slashed its prices. The strategy worked. Weekend crowds at its cavernous Beijing store are so big that employees need to use megaphones to keep them in control.

win a large market share. The high sales volume results in falling costs, allowing companies to cut their prices even further. ● For example, the giant Swedish retailer IKEA used penetration pricing to boost its success in the Chinese market.<sup>3</sup>

When IKEA first opened stores in China in 2002, people crowded in but not to buy home furnishings. Instead, they came to take advantage of the freebies—air conditioning, clean toilets, and even decorating ideas. Chinese consumers are famously frugal. When it came time to actually buy, they shopped instead at local stores just down the street that offered knockoffs of IKEA’s designs at a fraction of the price. So to lure the finicky Chinese customers, IKEA slashed its prices in China to the lowest in the world, the opposite approach of many Western retailers there. By increasingly stocking its Chinese stores with China-made products, the retailer pushed prices on some items as low as 70 percent below prices in IKEA’s outlets outside China. The penetration pricing strategy

worked. IKEA now captures a 43 percent market share of China’s fast-growing home wares market alone, and the sales of its seven mammoth Chinese stores surged 25 percent last year. The cavernous Beijing store draws nearly six million visitors annually. Weekend crowds are so big that employees need to use megaphones to keep them in control.

Several conditions must be met for this low-price strategy to work. First, the market must be highly price sensitive so that a low price produces more market growth. Second, production and distribution costs must decrease as sales volume increases. Finally, the low price must help keep out the competition, and the penetration pricer must maintain its low-price position. Otherwise, the price advantage may be only temporary.

**Author Comment** Most individual products are part of a broader product mix and must be priced accordingly. For example, Gillette prices its Fusion razors low. But once you buy the razor, you’re a captive customer for its higher-margin replacement cartridges.

## Product Mix Pricing Strategies (pp 315–319)

The strategy for setting a product’s price often has to be changed when the product is part of a product mix. In this case, the firm looks for a set of prices that maximizes its profits on the total product mix. Pricing is difficult because the various products have related demand and costs and face different degrees of competition. We now take a closer look at the five product mix pricing situations summarized in ● **Table 11.1:** *product line pricing, optional product pricing, captive product pricing, by-product pricing, and product bundle pricing.*

### Product Line Pricing

Companies usually develop product lines rather than single products. For example, Rossignol offers seven different collections of alpine skis of all designs and sizes, at prices that range from \$150 for its junior skis, such as Fun Girl, to more than \$1,100 for a pair from its Radical racing collection. It also offers lines of Nordic and backcountry skis, snowboards, and ski-related apparel. In **product line pricing**, management must determine the price steps to set between the various products in a line.

The price steps should take into account cost differences between products in the line. More importantly, they should account for differences in customer perceptions of the value of different features. For example, Quicken offers an entire line of financial management software, including Starter, Deluxe, Premier, Home & Business, and Rental Property versions priced at \$29.99, \$59.99, \$89.99, \$99.99, and \$149.99, respectively. Although it costs Quicken no more to produce the CD containing the Premier version than the CD containing the Starter version, many buyers happily pay more to obtain additional Premier features, such as financial-planning and investment-monitoring tools. Quicken’s task is to establish perceived value differences that support the price differences.

#### Product line pricing

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

● TABLE | 11.1 Product Mix Pricing

Pricing Situation	Description
Product line pricing	Setting prices across an entire product line
Optional product pricing	Pricing optional or accessory products sold with the main product
Captive product pricing	Pricing products that must be used with the main product
By-product pricing	Pricing low-value by-products to get rid of them
Product bundle pricing	Pricing bundles of products sold together

**Optional product pricing**

The pricing of optional or accessory products along with a main product.

**Optional Product Pricing**

Many companies use **optional product pricing**—offering to sell optional or accessory products along with the main product. For example, a car buyer may choose to order a global positioning system (GPS) and Bluetooth wireless communication. Refrigerators come with optional ice makers. And when you order a new PC, you can select from a bewildering array of processors, hard drives, docking systems, software options, and service plans. Pricing these options is a sticky problem. Companies must decide which items to include in the base price and which to offer as options.

**Captive product pricing**

Setting a price for products that must be used along with a main product, such as blades for a razor and games for a videogame console.

**Captive Product Pricing**

Companies that make products that must be used along with a main product are using **captive product pricing**. Examples of captive products are razor blade cartridges, videogames, and printer cartridges. Producers of the main products (razors, videogame consoles, and printers) often price them low and set high markups on the supplies. For example, when Sony first introduced its PS3 videogame console, priced at \$499 and \$599 for the regular and premium versions, it lost as much as \$306 per unit sold. Sony hoped to recoup the losses through the sales of more lucrative PS3 games.

**By-product pricing**

Setting a price for by-products to make the main product's price more competitive.

However, companies that use captive product pricing must be careful. Finding the right balance between the main product and captive product prices can be tricky. For example, despite industry-leading PS3 videogame sales, Sony has yet to earn back its losses on the

PS3 console. Even more, consumers trapped into buying expensive captive products may come to resent the brand that ensnared them. This happened in the inkjet printer and cartridges industry (see Real Marketing 11.1).<sup>4</sup>

In the case of services, captive product pricing is called *two-part pricing*. The price of the service is broken into a *fixed fee* plus a *variable usage rate*. ● Thus, at Six Flags and other amusement parks, you pay a daily ticket or season pass charge plus additional fees for food and other in-park features.



● Captive-product pricing: At Six Flags, you pay a daily ticket or season pass charge plus additional fees for food and other in-park features.

**By-Product Pricing**

Producing products and services often generates by-products. If the by-products have no value and if getting rid of them is costly, this will affect pricing of the main product. Using **by-product pricing**, the company seeks a market for these by-products to help offset the costs of disposing of them and help make the price of the main product more competitive.

# Real Marketing

## Kodak: A Whole New Concept in Printer Pricing and Economics

HP, Epson, Canon, and Lexmark have long dominated the \$50 billion printer industry with a maddening “razor-and-blades” pricing strategy (as in give away the razor and then make your profits on the blades). They sell printers at little or no profit. But once you own the printer, you’re stuck buying their grossly overpriced, high-margin replacement ink cartridges.

For example, you can pick up a nifty little HP multifunction inkjet printer for only \$69.99. But the HP tricolor inkjet cartridge that goes with it costs \$28.99. And a 100-count pack of HP four-by-six-inch photo paper costs another \$22.99. The price per ounce of inkjet printer ink can exceed the per-ounce price of an expensive perfume, premium champagne, or even caviar. By one estimate, if you bought a gallon of the stuff at those prices, it would cost you a horrifying \$4,731.

The big manufacturers have seemed content with this captive product pricing strategy. In fact, they pull in four times more revenues from ink cartridges and paper than from the printers themselves. Customers don’t like being held hostage and having to pay through the nose for ink and paper—some are outraged by it. But what can they do? Only HP cartridges work with HP printers. Buying another brand isn’t the answer, either—all of the manufacturers pursue the same pricing strategy.

Enter Kodak—with a unique solution. Kodak recently introduced its first line of printers—EasyShare All-in-One printers—with a revolutionary pricing strategy that has turned the entire inkjet printer industry upside-down. In a twist on typical industry practice, Kodak sells its printers at premium prices with no discounts and then sells the ink cartridges for less. EasyShare printers sell for \$129.99 to \$299.99, depending on features, about \$50 higher than comparable printers sold by competitors. However, EasyShare black and color ink cartridges go for just \$9.99 and \$14.99, respectively, about half the prevailing competitor prices. It’s a whole new concept in printer pricing and economics.

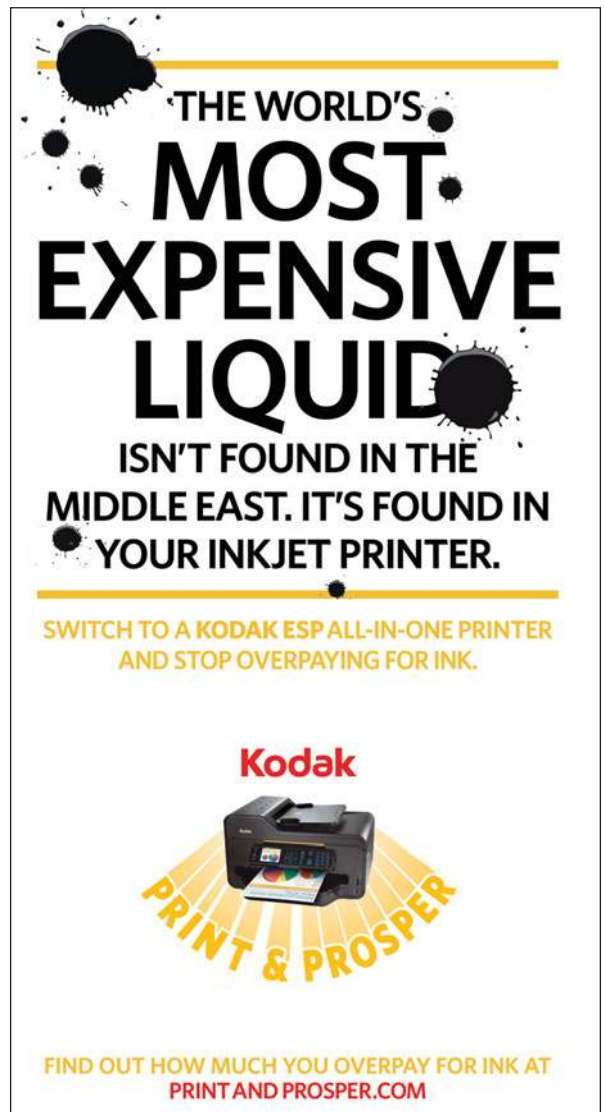
To make the strategy work, Kodak first had to create a new kind of inkjet printer. It de-

veloped an innovative technology that uses tiny nozzles to squirt pigment ink drops that are just a few atoms in size. EasyShare printers take about 55 seconds to produce a four-by-six-inch print, longer than some competitive printers that do it in 32 seconds. But the resulting photos take up to 90 years to fade versus dye-based inks that can begin to fade in as little as a year.

Moreover, Kodak found a way to contain all the printing electronics within the EasyShare printer itself, whereas rivals include some of the electronics in the cartridges. This lets Kodak charge less for the cartridges. As a result, according to one independent lab study, Kodak’s new printers “whomped” rival’s printers in price per printout. The study showed that consumers using an EasyShare printer can save on average of \$110 a year based on printing four pages per day compared to using a competitor’s printer.

Thus, Kodak had the right printer and the right ink prices. Now, all it had to do was to reeducate consumers about printer pricing—about the benefits of paying more up front to reduce long-run printing costs. To do this, Kodak launched a “Think Ink” marketing campaign, built around the visual image “ThINK,” with the first two letters in black and the last three in gold. The campaign asked this pivotal question: “Is it smarter to save money on a printer or save money on ink? (Hint: You only buy the printer once.)”

The THINK campaign began with online viral efforts, centered on a series of popular “Inkisit” videos, featuring two dorky guys, Nathan and Max, who love to print photos but who don’t like the ink’s high cost. In the videos, posted on YouTube and an entertaining Kodak microsite, they asked enthusiastically, “Have you ever thought about what life would be like if ink was cheaper?” Then came the bread-and-butter “ThINK” media campaign, targeting budget-conscious consumers who want to print at home but have limited this activity because of high ink costs.



**THE WORLD'S MOST EXPENSIVE LIQUID ISN'T FOUND IN THE MIDDLE EAST. IT'S FOUND IN YOUR INKJET PRINTER.**

**SWITCH TO A KODAK ESP ALL-IN-ONE PRINTER AND STOP OVERPAYING FOR INK.**

**Kodak**

**PRINT & PROSPER**

**FIND OUT HOW MUCH YOU OVERPAY FOR INK AT [PRINTANDPROSPER.COM](http://PRINTANDPROSPER.COM)**

**Kodak's revolutionary pricing sells printers at full prices but ink cartridges for less. At Kodak's Print & Prosper Web site, you can even calculate how much you're overpaying for ink with your current printer.**

The ThINK campaign tackled the very difficult task of shifting consumer value perceptions away from initial printer prices and toward prices per print. “Our strategy,” said a Kodak marketing executive, “is to crystallize for consumers that they’re not only buying a printer today but also buying into three to four years of ink purchases.” The campaign sent shockwaves through the inkjet printer industry and its “razor-and-blades” pricing mentality.

Kodak’s most recent ad campaign rants that “Last year, America paid \$5 billion too much for inkjet printer ink.” And the Kodak “Print & Prosper” Web site proclaims that Kodak printers use only “fairly priced ink.” The site even provides an “overpayment calculator,” which lets visitors calculate how much they are overpaying for ink with their current printer versus a Kodak EasyShare printer. “When buying a printer, it’s easy to be se-

duced by low prices and cheap bundles,” says the site. “Some people end up paying more for ink than they do for their printer. Switch to Kodak, and you can print more and pay less.”

It’s still too soon to tell whether Kodak’s revolutionary pricing strategy is working, but the early results are promising. The company exceeded its sales forecasts and sold 780,000 EasyShare printers in its first year. Last year, p. C1, while competitors’ sales plunged nearly 24 percent, Kodak’s sales of printers and sup-

plies jumped 44 percent. Competitors are now scrambling to introduce their own lower-priced cartridges and longer lasting inks.

As one observer concludes, Kodak “Has its priorities straight: Great-looking photos that last a lifetime,” with affordable per-print prices in the bargain. “It makes a world-rocking point about the razor-blades model that’s lined the coffers of the inkjet industry for years. If you’re mad as hell, you don’t have to take it anymore.”

**Sources:** Quotes and other information from Beth Snyder Bulik, “Kodak Develops New Model: Inexpensive Printer, Cheap Ink,” *Advertising Age*, March 12, 2007, p. 4; David Pogue, “Paying More for Printer, But Less for Ink,” *New York Times*, May 17, 2007, p. C1; “Consumer Launch Campaign of the Year 2008,” *PRweek*, March 10, 2008, p. S11; Stuart Elliott, “Are You Fed Up? This Ad’s for You,” *News and Observer* (Raleigh), May 15, 2009, p. 1; Greg Tarr, “Kodak Targets Value Items,” *TWICE*, September 10, 2009, p. 4; “Eastman Kodak Company: Kodak Works with FTC to Enhance Messaging on Inkjet Savings Claim,” *Economics Week*, January 8, 2010, p. 12; and [www.kodak.com/global/mul/consumer/print/en\\_ca/index.html](http://www.kodak.com/global/mul/consumer/print/en_ca/index.html), accessed November 2010.



● **By-product pricing:** “There’s green and money to be made in animal poop!” exclaims Dan Corum, the Woodland Zoo’s enthusiastic compost and recycling coordinator (also known as the prince of poo, the emperor of excrement, the GM of BM, or just plain Dr. Doo).

The by-products themselves can even turn out to be profitable—turning trash into cash. ● For example, Seattle’s Woodland Park Zoo has learned that one of its major by-products—animal poo—can be an excellent source of extra revenue.<sup>5</sup>

“What happens to all that poo at the zoo?” asks a recent video about the Woodland Park Zoo. Not long ago, the answer was that it had to be hauled away to the landfill at a cost of about \$60,000 a year. But now, the zoo carefully collects all that poo, turns it into compost, and sells it under its Zoo Doo and Bedspreed brands, pitched as “the most exotic and highly prized compost in the Pacific Northwest, composed of exotic species feces contributed by the zoo’s non-primate herbivores.” Customers can buy these coveted compost products by the bucket at the zoo’s store. The zoo also sponsors annual FecalFests, where lucky lottery winners can buy the processed poo by the trash can or truck full. “There’s green *and* money

to be made in animal poop!” exclaims Dan Corum, the Woodland Zoo’s enthusiastic compost and recycling coordinator (also known as the prince of poo, the emperor of excrement, the GM of BM, or just plain Dr. Doo). Selling Zoo Doo keeps it out of the landfill, so it’s good for the planet. It’s also good for the zoo, saving disposal costs and generating \$15,000 to \$20,000 in annual sales.

## Product Bundle Pricing

### Product bundle pricing

Combining several products and offering the bundle at a reduced price.

Using **product bundle pricing**, sellers often combine several products and offer the bundle at a reduced price. For example, fast-food restaurants bundle a burger, fries, and a soft drink at a “combo” price. Bath & Body Works offers “three-fer” deals on its soaps and lo-

tions (such as three antibacterial soaps for \$10). And Comcast, Time Warner, Verizon, and other telecommunications companies bundle TV service, phone service, and high-speed Internet connections at a low combined price. Price bundling can promote the sales of products consumers might not otherwise buy, but the combined price must be low enough to get them to buy the bundle.

**Author Comment** | Setting the base price for a product is only the start. The company must then adjust the price to account for customer and situational differences. When was the last time you paid the full suggested retail price for something?

## Price Adjustment Strategies (pp 319–325)

Companies usually adjust their basic prices to account for various customer differences and changing situations. Here we examine the seven price adjustment strategies summarized in **Table 11.2: discount and allowance pricing, segmented pricing, psychological pricing, promotional pricing, geographical pricing, dynamic pricing, and international pricing.**

### Discount

A straight reduction in price on purchases during a stated period of time or of larger quantities.

### Allowance

Promotional money paid by manufacturers to retailers in return for an agreement to feature the manufacturer's products in some way.

### Segmented pricing

Selling a product or service at two or more prices, where the difference in prices is not based on differences in costs.

## Discount and Allowance Pricing

Most companies adjust their basic price to reward customers for certain responses, such as the early payment of bills, volume purchases, and off-season buying. These price adjustments—called *discounts* and *allowances*—can take many forms.

The many forms of **discounts** include a *cash discount*, a price reduction to buyers who pay their bills promptly. A typical example is “2/10, net 30,” which means that although payment is due within 30 days, the buyer can deduct 2 percent if the bill is paid within 10 days. A *quantity discount* is a price reduction to buyers who buy large volumes. A seller offers a *functional discount* (also called a *trade discount*) to trade-channel members who perform certain functions, such as selling, storing, and record keeping. A *seasonal discount* is a price reduction to buyers who buy merchandise or services out of season.

**Allowances** are another type of reduction from the list price. For example, *trade-in allowances* are price reductions given for turning in an old item when buying a new one. Trade-in allowances are most common in the automobile industry but are also given for other durable goods. *Promotional allowances* are payments or price reductions to reward dealers for participating in advertising and sales support programs.

## Segmented Pricing

Companies will often adjust their basic prices to allow for differences in customers, products, and locations. In **segmented pricing**, the company sells a product or service at two or more prices, even though the difference in prices is not based on differences in costs.

**TABLE | 11.2** Price Adjustments

Strategy	Description
Discount and allowance pricing	Reducing prices to reward customer responses such as paying early or promoting the product
Segmented pricing	Adjusting prices to allow for differences in customers, products, or locations
Psychological pricing	Adjusting prices for psychological effect
Promotional pricing	Temporarily reducing prices to increase short-run sales
Geographical pricing	Adjusting prices to account for the geographic location of customers
Dynamic pricing	Adjusting prices continually to meet the characteristics and needs of individual customers and situations
International pricing	Adjusting prices for international markets





● **Product-form pricing:** Evian water in a one-liter bottle might cost you 5 cents an ounce at your local supermarket, whereas the same water might run \$2.28 an ounce when sold in five-ounce aerosol cans as Evian Brumisateur Mineral Water Spray moisturizer.

Segmented pricing takes several forms. Under *customer-segment pricing*, different customers pay different prices for the same product or service. Museums and movie theaters, for example, may charge a lower admission for students and senior citizens. Under *product-form pricing*, different versions of the product are priced differently but not according to differences in their costs. ● For instance, a one-liter bottle (about 34 ounces) of Evian mineral water may cost \$1.59 at your local supermarket. But a five-ounce aerosol can of Evian Brumisateur Mineral Water Spray sells for a suggested retail price of \$11.39 at beauty boutiques and spas. The water is all from the same source in the French Alps, and the aerosol packaging costs little more than the plastic bottles. Yet you pay about 5 cents an ounce for one form and \$2.28 an ounce for the other.

Using *location-based pricing*, a company charges different prices for different locations, even though the cost of offering each location is the same. For instance, state universities charge higher tuition for out-of-state students, and theaters vary their seat prices because of audience preferences for certain locations. Tickets for a Saturday night performance of Green Day's *American Idiot* on Broadway start at \$32 for a seat in the rear balcony, whereas orchestra center seats go for \$252. Finally, using *time-based pricing*, a firm varies its price by the season, the month, the day, and even the hour. Movie theaters charge matinee pricing during the daytime. Resorts give weekend and seasonal discounts.

For segmented pricing to be an effective strategy, certain conditions must exist. The market must be segmentable, and segments must show different degrees of demand. The costs of segmenting and reaching the market cannot exceed the extra revenue obtained from the price difference. Of course, the segmented pricing must also be legal.

Most importantly, segmented prices should reflect real differences in customers' perceived value. Consumers in higher price tiers must feel that they're getting their extra money's worth for the higher prices paid. By the same token, companies must be careful not to treat customers in lower price tiers as second-class citizens. Otherwise, in the long run, the practice will lead to customer resentment and ill will. For example, in recent years, the airlines have incurred the wrath of frustrated customers at both ends of the airplane. Passengers paying full fare for business or first class seats often feel that they are being gouged. At the same time, passengers in lower-priced coach seats feel that they're being ignored or treated poorly.

## Psychological Pricing

Price says something about the product. For example, many consumers use price to judge quality. A \$100 bottle of perfume may contain only \$3 worth of scent, but some people are willing to pay the \$100 because this price indicates something special.

In using **psychological pricing**, sellers consider the psychology of prices, not simply the economics. For example, consumers usually perceive higher-priced products as having higher quality. When they can judge the quality of a product by examining it or by calling on past experience with it, they use price less to judge quality. But when they cannot judge quality because they lack the information or skill, price becomes an important quality signal. For example, who's the better lawyer, one who charges \$50 per hour or one who charges \$500 per hour? You'd have to do a lot of digging into the respective lawyers' credentials to answer this question objectively; even then, you might not be able to judge accurately. Most of us would simply assume that the higher-priced lawyer is better.

Another aspect of psychological pricing is **reference prices**—prices that buyers carry in their minds and refer to when looking at a given product. The reference price might be formed by noting current prices, remembering past prices, or assessing the buying situation. Sellers can influence or use these consumers' reference prices when setting price. For example, a grocery retailer might place its store brand of bran flakes and raisins cereal priced at

### Psychological pricing

Pricing that considers the psychology of prices, not simply the economics; the price says something about the product.

### Reference prices

Prices that buyers carry in their minds and refer to when they look at a given product.



● **Psychological pricing:** What do the prices marked on this tag suggest about the product and buying situation?

### Promotional pricing

Temporarily pricing products below the list price, and sometimes even below cost, to increase short-run sales.

\$1.89 next to Kellogg’s Raisin Bran priced at \$3.20. Or a company might offer more expensive models that don’t sell very well to make their less expensive but still-high-priced models look more affordable by comparison.<sup>6</sup>

In the midst of the recent recession, Ralph Lauren was selling a “Ricky” alligator bag for \$14,000, making its Tiffin Bag a steal at just \$2,595. And Williams-Sonoma once offered a fancy bread maker for \$279. Then it added a \$429 model. The costly model flopped, but sales of the cheaper one doubled.

For most purchases, consumers don’t have all the skill or information they need to figure out whether they are paying a good price. They don’t have the time, ability, or inclination to research different brands or stores, compare prices, and get the best deals. ● Instead, they may rely on certain cues that signal whether a price is high or low. Interestingly, such pricing cues are often provided by sellers, in the form of sales signs, price-matching guarantees, loss-leader pricing, and other helpful hints.<sup>7</sup>

Even small differences in price can signal product differences. For example, in a recent study, people were asked how likely they were to choose among LASIK eye surgery providers based only on the prices they charged: \$299 or \$300. The actual price difference was only \$1, but the study found that the psychological difference was much greater. Preference ratings for the providers charging \$300 were much higher. Subjects perceived the \$299 price as significantly less, but it also raised stronger concerns about quality and risk.<sup>8</sup> Some psychologists even argue that each

digit has symbolic and visual qualities that should be considered in pricing. Thus, eight is round and even and creates a soothing effect, whereas seven is angular and creates a jarring effect.

## Promotional Pricing

With **promotional pricing**, companies will temporarily price their products below list price and sometimes even below cost to create buying excitement and urgency. Promotional pricing takes several forms. A seller may simply offer *discounts* from normal prices to increase sales and reduce inventories. Sellers also use *special-event pricing* in certain seasons to draw more customers. Thus, large-screen TVs and other consumer electronics are promotionally priced in November and December to attract holiday shoppers into the stores.

Manufacturers sometimes offer *cash rebates* to consumers who buy the product from dealers within a specified time; the manufacturer sends the rebate directly to the customer. Rebates have been popular with automakers and producers of cell phones and small appliances, but they are also used with consumer packaged goods. Some manufacturers offer *low-interest financing*, *longer warranties*, or *free maintenance* to reduce the consumer’s “price.” This practice has become another favorite of the auto industry.

Promotional pricing, however, can have adverse effects. Used too frequently and copied by competitors, price promotions can create “deal-prone” customers who wait until brands go on sale before buying them. Or, constantly reduced prices can erode a brand’s value in the eyes of customers. Marketers sometimes become addicted to promotional pricing, especially in difficult economic times. They use price promotions as a quick fix instead of sweating through the difficult process of developing effective longer-term strategies for building their brands. But companies must be careful to balance short-term sales incentives against long-term brand building. One analyst advises:<sup>9</sup>

When times are tough, there’s a tendency to panic. One of the first and most prevalent tactics that many companies try is an aggressive price cut. Price trumps all. At least, that’s how it feels these days. 20% off. 30% off. 50% off. Buy one, get one free. Whatever it is you’re selling, you’re offering it at a discount just to get customers in the door. But aggressive pricing strategies can be risky business. Companies should be very wary of risking their brands’ perceived quality by resorting to deep and frequent price cuts. Some discounting is unavoidable in a tough economy, and consumers have come



● **Promotional pricing:** Companies offer promotional prices to create buying excitement and urgency.

### Geographical pricing

Setting prices for customers located in different parts of the country or world.

#### FOB-origin pricing

A geographical pricing strategy in which goods are placed free on board a carrier; the customer pays the freight from the factory to the destination.

#### Uniform-delivered pricing

A geographical pricing strategy in which the company charges the same price plus freight to all customers, regardless of their location.

#### Zone pricing

A geographical pricing strategy in which the company sets up two or more zones. All customers within a zone pay the same total price; the more distant the zone, the higher the price.

#### Basing-point pricing

A geographical pricing strategy in which the seller designates some city as a basing point and charges all customers the freight cost from that city to the customer.

to expect it. But marketers have to find ways to shore up their brand identity and brand equity during times of discount mayhem.

● The point is that promotional pricing can be an effective means of generating sales for some companies in certain circumstances. But it can be damaging for other companies or if taken as a steady diet.

## Geographical Pricing

A company also must decide how to price its products for customers located in different parts of the United States or the world. Should the company risk losing the business of more-distant customers by charging them higher prices to cover the higher shipping costs? Or should the company charge all customers the same prices regardless of location? We will look at five **geographical pricing** strategies for the following hypothetical situation:

The Peerless Paper Company is located in Atlanta, Georgia, and sells paper products to customers all over the United States. The cost of freight is high and affects the companies from whom customers buy their paper. Peerless wants to establish a geographical pricing policy. It is trying to determine how to price a \$10,000 order to three specific customers: Customer A (Atlanta), Customer B (Bloomington, Indiana), and Customer C (Compton, California).

One option is for Peerless to ask each customer to pay the shipping cost from the Atlanta factory to the customer's location. All three customers would pay the same factory price of \$10,000, with Customer A paying, say, \$100 for shipping; Customer B, \$150; and Customer C, \$250. Called **FOB-origin pricing**, this practice means that the goods are placed *free on board* (hence, *FOB*) a carrier. At that point the title and responsibility pass to the customer, who pays the freight from the factory to the destination. Because each customer picks up its own cost, supporters of FOB pricing feel that this is the fairest way to assess freight charges. The disadvantage, however, is that Peerless will be a high-cost firm to distant customers.

**Uniform-delivered pricing** is the opposite of FOB pricing. Here, the company charges the same price plus freight to all customers, regardless of their location. The freight charge is set at the average freight cost. Suppose this is \$150. Uniform-delivered pricing therefore results in a higher charge to the Atlanta customer (who pays \$150 freight instead of \$100) and a lower charge to the Compton customer (who pays \$150 instead of \$250). Although the Atlanta customer would prefer to buy paper from another local paper company that uses FOB-origin pricing, Peerless has a better chance of winning over the California customer.

**Zone pricing** falls between FOB-origin pricing and uniform-delivered pricing. The company sets up two or more zones. All customers within a given zone pay a single total price; the more distant the zone, the higher the price. For example, Peerless might set up an East Zone and charge \$100 freight to all customers in this zone, a Midwest Zone in which it charges \$150, and a West Zone in which it charges \$250. In this way, the customers within a given price zone receive no price advantage from the company. For example, customers in Atlanta and Boston pay the same total price to Peerless. The complaint, however, is that the Atlanta customer is paying part of the Boston customer's freight cost.

Using **basing-point pricing**, the seller selects a given city as a "basing point" and charges all customers the freight cost from that city to the customer location, regardless of

the city from which the goods are actually shipped. For example, Peerless might set Chicago as the basing point and charge all customers \$10,000 plus the freight from Chicago to their locations. This means that an Atlanta customer pays the freight cost from Chicago to Atlanta, even though the goods may be shipped from Atlanta. If all sellers used the same basing-point city, delivered prices would be the same for all customers, and price competition would be eliminated.

Finally, the seller who is anxious to do business with a certain customer or geographical area might use **freight-absorption pricing**. Using this strategy, the seller absorbs all or part of the actual freight charges to get the desired business. The seller might reason that if it can get more business, its average costs will decrease and more than compensate for its extra freight cost. Freight-absorption pricing is used for market penetration and to hold on to increasingly competitive markets.

### Freight-absorption pricing

A geographical pricing strategy in which the seller absorbs all or part of the freight charges to get the desired business.

## Dynamic Pricing

Throughout most of history, prices were set by negotiation between buyers and sellers. *Fixed price* policies—setting one price for all buyers—is a relatively modern idea that arose with the development of large-scale retailing at the end of the nineteenth century. Today, most prices are set this way. However, some companies are now reversing the fixed pricing trend. They are using **dynamic pricing**—adjusting prices continually to meet the characteristics and needs of individual customers and situations.

### Dynamic pricing

Adjusting prices continually to meet the characteristics and needs of individual customers and situations.

For example, think about how the Internet has affected pricing. From the mostly fixed pricing practices of the past century, the Internet seems to be taking us back into a new age of fluid pricing. The flexibility of the Internet allows Web sellers to instantly and constantly

adjust prices on a wide range of goods based on demand dynamics (sometimes called *real-time pricing*). In other cases, customers control pricing by bidding on auction sites such as eBay or negotiating on sites such as Priceline. Still other companies customize their offers based on the characteristics and behaviors of specific customers:<sup>10</sup>

The screenshot shows the Priceline.com homepage. At the top, there are navigation links for flights, hotels, cars, vacation packages, cruises, activities, pricebreaker deals, city guides, rewards, and groups. Below this, there are two main sections: 'shop for discount travel' and 'freshly negotiated travel deals'. The 'shop for discount travel' section includes a search form with fields for 'from (city or airport)', 'to (city or airport)', 'departing', 'returning', 'number of tickets', and 'seating class'. It also features a 'search now!' button and a 'name your own price' section with three options: 'save up to 40% on flights', 'save up to 50% on hotels', and 'save up to 40% on cars'. The 'freshly negotiated travel deals' section features a large 'SAVE UP TO 50% ON FLIGHTS' banner and a list of flight deals you might like, including Raleigh to Las Vegas (\$247), Raleigh to Chicago (\$199), Raleigh to Boston (\$119), Raleigh to New York City (\$159), and Raleigh to Seattle (\$242).

Dynamic pricing: The Internet seems to be taking us back into a new age of fluid pricing. At Priceline.com, you can “name your own price.”

It’s an offer you can’t resist: fly Alaska Airlines to Honolulu for \$200 round trip. But what you might not know is that the offer was designed especially for you. Alaska Airlines has introduced a system that creates unique prices and ads for people as they surf the Internet. The system identifies consumers by their computers, using a small piece of code known as a cookie. It then combines detailed data from several sources to paint a picture of who’s sitting on the other side of the screen. When the person clicks on an ad, the system quickly analyzes the data to assess how price-sensitive customers seem to be. Then, in an instant, one customer gets an offer for a flight from Seattle to Portland for \$99 and another is quoted \$109. Or someone who had visited Alaska Airlines’ site frequently but then abruptly stopped visiting might be greeted with the \$200 Hawaii offer. “I guarantee you there are a lot of people who will say yes to that,” says Marston Gould, director of customer relationship management and online marketing for Alaska Airlines.

Dynamic pricing offers many advantages for marketers. For example, Internet sellers such as Amazon.com can mine their databases to gauge a specific shopper’s desires, measure his or her means, instantaneously tailor products to fit that shopper’s behavior, and price products accordingly. Catalog retailers such as L.L.Bean or Spiegel can change prices

Dynamic pricing offers many advantages for marketers. For example, Internet sellers such as Amazon.com can mine their databases to gauge a specific shopper’s desires, measure his or her means, instantaneously tailor products to fit that shopper’s behavior, and price products accordingly. Catalog retailers such as L.L.Bean or Spiegel can change prices

on the fly according to changes in demand or costs, changing prices for specific items on a day-by-day or even hour-by-hour basis. And many direct marketers monitor inventories, costs, and demand at any given moment and adjust prices instantly.

Consumers also benefit from the Internet and dynamic pricing. A wealth of price comparison sites—such as Yahoo! Shopping, Bizrate.com, NexTag.com, Epinions.com, PriceGrabber.com, mySimon.com, and PriceScan.com—offer instant product and price comparisons from thousands of vendors. Epinions.com, for instance, lets shoppers browse by category or search for specific products and brands. It then searches the Web and reports back links to sellers offering the best prices along with customer reviews. In addition to simply finding the best product and the vendor with the best price for that product, customers armed with price information can often negotiate lower prices.

In addition, consumers can negotiate prices at online auction sites and exchanges. Suddenly the centuries-old art of haggling is back in vogue. Want to sell that antique pickle jar that's been collecting dust for generations? Post it on eBay, the world's biggest online flea market. Want to name your own price for a hotel room or rental car? Visit Priceline.com or another reverse auction site. Want to bid on a ticket to a Coldplay show? Check out Ticketmaster.com, which now offers an online auction service for concert tickets.

Dynamic pricing makes sense in many contexts; it adjusts prices according to market forces, and it often works to the benefit of the customer. But marketers need to be careful not to use dynamic pricing to take advantage of certain customer groups, damaging important customer relationships.

## International Pricing

Companies that market their products internationally must decide what prices to charge in the different countries in which they operate. In some cases, a company can set a uniform worldwide price. For example, Boeing sells its jetliners at about the same price everywhere, whether in the United States, Europe, or a third-world country. However, most companies adjust their prices to reflect local market conditions and cost considerations.

The price that a company should charge in a specific country depends on many factors, including economic conditions, competitive situations, laws and regulations, and the development of the wholesaling and retailing system. Consumer perceptions and preferences also may vary from country to country, calling for different prices. Or the company may have different marketing objectives in various world markets, which require changes in pricing strategy. For example, Samsung might introduce a new product into mature markets in highly developed countries with the goal of quickly gaining mass-market share—this would call for a penetration-pricing strategy. In contrast, it might enter a less-developed market by targeting smaller, less price-sensitive segments; in this case, market-skimming pricing makes sense.

Costs play an important role in setting international prices. Travelers abroad are often surprised to find that goods that are relatively inexpensive at home may carry outrageously higher price tags in other countries. A pair of Levi's selling for \$30 in the United States might go for \$63 in Tokyo and \$88 in Paris. A McDonald's Big Mac selling for a modest \$3.57 in the United States might cost \$5.29 in Norway, and an Oral-B toothbrush selling for \$2.49 at home may cost \$10 in China. Conversely, a Gucci handbag going for only \$140 in Milan, Italy, might fetch \$240 in the United States. In some cases, such *price escalation* may result from differences in selling strategies or market conditions. In most instances, however, it is simply a result of the higher costs of selling in another country—the additional costs of operations, product modifications, shipping and insurance, import tariffs and taxes, exchange-rate fluctuations, and physical distribution.



● **International pricing:** To lower prices in developing countries, Unilever developed smaller, more affordable packages that put the company's premier brands within the reach of the cash-strapped customers.

Price has become a key element in the international marketing strategies of companies attempting to enter emerging markets, such as China, India, and Brazil. ● Consider Unilever's pricing strategy for developing countries:

There used to be one way to sell a product in developing markets, if you bothered to sell there at all: Slap on a local label and market at premium prices to the elite. Unilever—the maker of such brands as Dove, Lipton, and Vaseline—changed that. Instead, it built a following among the world's poorest consumers by shrinking packages to set a price even consumers living on \$2 a day could afford. The strategy was forged about 25 years ago when Unilever's Indian subsidiary found its products out of reach for millions of Indians. To lower the price while making a profit, Unilever developed single-use packets for everything from shampoo to laundry detergent, costing just pennies a pack. The small, affordable packages put the company's premier brands within reach of the world's poor. Today, Unilever continues to woo cash-strapped customers with great success. For example, its approachable pricing helps explain why Unilever now captures 70 percent of the Brazil detergent market.<sup>11</sup>

Thus, international pricing presents some special problems and complexities. We discuss international pricing issues in more detail in Chapter 19.

**Author Comment** When and how should a company change its price? What if costs rise, putting the squeeze on profits? What if the economy sags and customers become more price-sensitive? Or what if a major competitor raises or drops its prices? As Figure 11.1 suggests, companies face many price-changing options.

## Price Changes (pp 325–328)

After developing their pricing structures and strategies, companies often face situations in which they must initiate price changes or respond to price changes by competitors.

### Initiating Price Changes

In some cases, the company may find it desirable to initiate either a price cut or a price increase. In both cases, it must anticipate possible buyer and competitor reactions.

#### Initiating Price Cuts

Several situations may lead a firm to consider cutting its price. One such circumstance is excess capacity. Another is falling demand in the face of strong price competition or a weakened economy. In such cases, the firm may aggressively cut prices to boost sales and market share. But as the airline, fast-food, automobile, and other industries have learned in recent years, cutting prices in an industry loaded with excess capacity may lead to price wars as competitors try to hold onto market share.

A company may also cut prices in a drive to dominate the market through lower costs. Either the company starts with lower costs than its competitors, or it cuts prices in the hope of gaining market share that will further cut costs through larger volume. Lenovo uses an aggressive low-cost, low-price strategy to increase its share of the PC market in developing countries.

#### Initiating Price Increases

A successful price increase can greatly improve profits. For example, if the company's profit margin is 3 percent of sales, a 1 percent price increase will boost profits by 33 percent if the sales volume is unaffected. A major factor in price increases is cost inflation. Rising costs squeeze profit margins and lead companies to pass cost increases along to customers. Another factor leading to price increases is overdemand: When a company cannot supply all that its customers need, it may raise its prices, ration products to customers, or both. Consider today's worldwide oil and gas industry.

When raising prices, the company must avoid being perceived as a *price gouger*. ● For example, when gasoline prices rise rapidly, angry customers often accuse the major oil companies of enriching themselves at the expense of consumers.



● Initiating price increases: When gasoline prices rise rapidly, angry consumers often accuse the major oil companies of enriching themselves by gouging customers.

Customers have long memories, and they will eventually turn away from companies or even whole industries that they perceive as charging excessive prices. In the extreme, claims of price gouging may even bring about increased government regulation.

There are some techniques for avoiding these problems. One is to maintain a sense of fairness surrounding any price increase. Price increases should be supported by company communications telling customers why prices are being raised.

Wherever possible, the company should consider ways to meet higher costs or demand without raising prices. For example, it can consider more cost-effective ways to produce or distribute its products. It can shrink the product or substitute less-expensive ingredients instead of raising the price, as ConAgra did in an effort to hold its Banquet frozen dinner prices at \$1. Or it can “unbundle” its market offering, removing features, packaging, or services and separately pricing elements that were formerly part of the offer.

### Buyer Reactions to Price Changes

Customers do not always interpret price changes in a straightforward way. A price *increase*, which would normally lower sales, may have some positive meanings for buyers. For example, what would you think if Rolex *raised* the price of its latest watch model? On the one hand, you might think that the watch is even more exclusive or better made. On the other hand, you might think that Rolex is simply being greedy by charging what the traffic will bear.

Similarly, consumers may view a price *cut* in several ways. For example, what would you think if Rolex were to suddenly cut its prices? You might think that you are getting a better deal on an exclusive product. More likely, however, you’d think that quality had been reduced, and the brand’s luxury image might be tarnished.

A brand’s price and image are often closely linked. A price change, especially a drop in price, can adversely affect how consumers view the brand. ● Tiffany found this out when it attempted to broaden its appeal by offering a line of more affordable jewelry:<sup>12</sup>

Tiffany is all about luxury and the cachet of its blue boxes. However, in the late 1990s, the high-end jeweler responded to the “affordable luxuries” craze with a new “Return to Tiffany” line of less expensive silver jewelry. The “Return to Tiffany” silver charm bracelet quickly became a must-have item, as teens jammed Tiffany’s hushed stores clamoring for the \$110 silver bauble. Sales skyrocketed. But despite this early success, the bracelet fad appeared to alienate the firm’s older, wealthier, and more conservative clientele, damaging Tiffany’s reputation for luxury. So, in 2002, the firm began reemphasizing its pricier jewelry collections. Although high-end jewelry has once again replaced silver as Tiffany’s fastest growing business, the company has yet to fully regain its exclusivity. Say’s one well-heeled customer: “You used to aspire to be able to buy something at Tiffany, but now it’s not that special anymore.”



● Price changes: A brand’s price and image are often closely linked, and a change in price can adversely affect how consumers view the brand. Tiffany found this out when it attempted to broaden its appeal by offering a line of more affordable jewelry.

### Competitor Reactions to Price Changes

A firm considering a price change must worry about the reactions of its competitors as well as those of its customers. Competitors are most likely to react when the number of firms involved is small, when the product is uniform, and when the buyers are well informed about products and prices.

How can the firm anticipate the likely reactions of its competitors? The problem is complex because, like the customer, the competitor can interpret a company price cut in many ways. It might think the company is trying to grab a larger market share or that it’s doing poorly and trying to boost its sales. Or it might think that the company wants the whole industry to cut prices to increase total demand.

The company must guess each competitor’s likely reaction. If all competitors behave alike, this amounts to analyzing only a typical competitor. In contrast, if the competitors do not behave alike—perhaps because of differences in size, market shares, or policies—then separate analyses are necessary. However, if some competitors will match the price change, there is good reason to expect that the rest will also match it.

## Responding to Price Changes

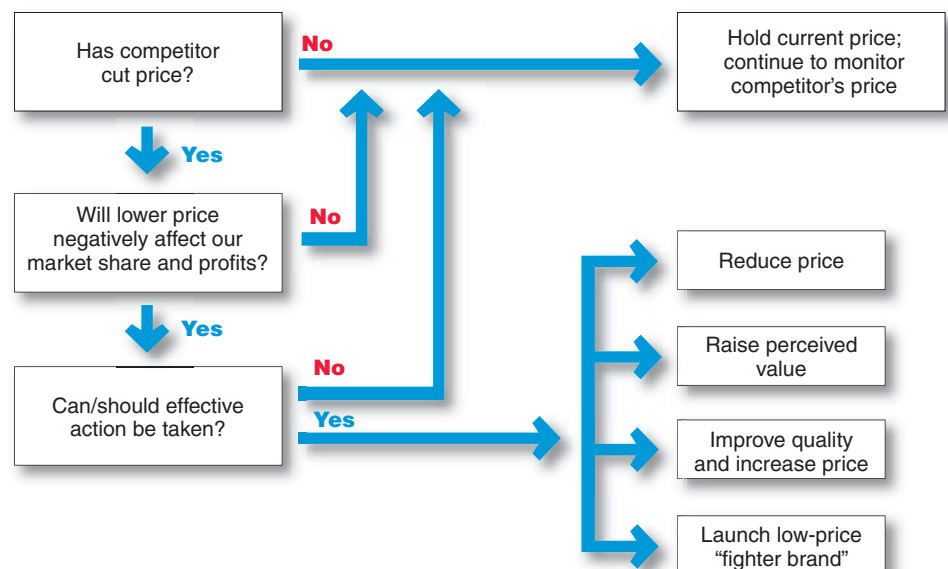
Here we reverse the question and ask how a firm should respond to a price change by a competitor. The firm needs to consider several issues: Why did the competitor change the price? Is the price change temporary or permanent? What will happen to the company’s market share and profits if it does not respond? Are other competitors going to respond? Besides these issues, the company must also consider its own situation and strategy and possible customer reactions to price changes.

● **Figure 11.1** shows the ways a company might assess and respond to a competitor’s price cut. Suppose the company learns that a competitor has cut its price and decides that this price cut is likely to harm its sales and profits. It might simply decide to hold its current price and profit margin. The company might believe that it will not lose too much market share, or that it would lose too much profit if it reduced its own price. Or it might decide that it should wait and respond when it has more information on the effects of the competitor’s price change. However, waiting too long to act might let the competitor get stronger and more confident as its sales increase.

If the company decides that effective action can and should be taken, it might make any of four responses. First, it could *reduce its price* to match the competitor’s price. It may decide that the market is price sensitive and that it would lose too much market share to the lower-priced competitor. Cutting the price will reduce the company’s profits in the short run. Some companies might also reduce their product quality, services, and marketing communications to retain profit margins, but this will ultimately hurt long-run market share. The company should try to maintain its quality as it cuts prices.

Alternatively, the company might maintain its price but *raise the perceived value* of its offer. It could improve its communications, stressing the relative value of its product over that of the lower-price competitor. The firm may find it cheaper to maintain price and spend money to improve its perceived value than to cut price and operate at a lower margin. Or, the company might *improve quality and increase price*, moving its brand into a higher price-value position. The higher quality creates greater customer value, which justifies the higher price. In turn, the higher price preserves the company’s higher margins.

● **FIGURE | 11.1**  
Assessing and Responding to Competitor Price Changes



When a competitor cuts prices, a company’s first reaction may be to drop its prices as well. But that is often the wrong response. Instead, the firm may want to emphasize the “value” side of the price-value equation.





● **Fighter brands:** To compete with budget bus lines, Greyhound rolled out BoltBus, which offers lots of amenities at low prices that today's budget-conscious intercity commuters find very appealing.

Finally, the company might *launch a low-price "fighter brand"*—adding a lower-price item to the line or creating a separate lower-price brand. This is necessary if the particular market segment being lost is price sensitive and will not respond to arguments of higher quality. Thus, to compete with a growing number of budget bus services, rather than dropping its own fares on select, highly competitive routes, Greyhound Lines rolled out the BoltBus fighter brand, which provides service between New York City and other cities in the northeastern United States. ● BoltBus offers amenities such as Wi-Fi, reserved seating, a clean bathroom, and extra legroom, all at low fares that today's budget-conscious intercity commuters find very appealing. For example, the one-way BoltBus fare from New York City to Washington, DC, runs just \$16 to \$20, compared to the regular \$31 to \$58 Greyhound fare.<sup>13</sup>

To counter store brands and other low-price entrants in a weakened economy, P&G turned a number of its brands into fighter brands. Luvs disposable diapers give parents "premium leakage protection for less than pricier brands." And P&G offers popular budget-priced basic versions of several of its major brands. For example, Charmin Basic is "the quality toilet tissue at a price you'll love," and Bounty Basic is "practical, not pricey." Tide Basic gives you "Big Value. Basic Clean." at a 20 percent lower price. However, companies must use caution when introducing fighter brands. Such brands can tarnish the image of the main brand. And although they may attract budget buyers away from lower-priced rivals, they can also take business away from the firm's higher-margin brands.<sup>14</sup>

**Author Comment** Pricing decisions are often constrained by social and legal issues. For example, think about the pharmaceuticals industry. Are rapidly rising prescription prices justified? Or are the drug companies unfairly lining their pockets by gouging consumers who have few alternatives? Should the government step in?

## Public Policy and Marketing (pp 328–332)

Price competition is a core element of our free-market economy. In setting prices, companies usually are not free to charge whatever prices they wish. Many federal, state, and even local laws govern the rules of fair play in pricing. In addition, companies must consider broader societal pricing concerns. In setting their prices, for example, pharmaceutical firms must balance their development costs and profit objectives against the sometimes life-and-death needs of drug consumers (see Real Marketing 11.2).

The most important pieces of legislation affecting pricing are the Sherman Act, the Clayton Act, and the Robinson-Patman Act, initially adopted to curb the formation of monopolies and regulate business practices that might unfairly restrain trade. Because these federal statutes can be applied only to interstate commerce, some states have adopted similar provisions for companies that operate locally.

● **Figure 11.2** shows the major public policy issues in pricing. These include potentially damaging pricing practices within a given level of the channel (price-fixing and predatory pricing) and across levels of the channel (retail price maintenance, discriminatory pricing, and deceptive pricing).<sup>15</sup>

## Pricing within Channel Levels

Federal legislation on *price-fixing* states that sellers must set prices without talking to competitors. Otherwise, price collusion is suspected. Price-fixing is illegal per se—that is, the government does not accept any excuses for price-fixing. Companies found guilty of such practices can receive heavy fines. Recently, governments at the state and national levels have been aggressively enforcing price-fixing regulations in industries ranging from gasoline, insurance, and concrete to credit cards, CDs, and computer chips.

# Real Marketing 11.2

## GlaxoSmithKline: No Easy Answers in Pharmaceutical Pricing

The U.S. pharmaceutical industry has historically been one of the nation's most profitable industries. Annual revenues have grown at a growth rate that few industries can match. As the world's second-largest pharmaceutical company, GlaxoSmithKline (GSK) has played a large role in the industry's success. It produces a medicine cabinet full of well-known prescription drugs that combat infections, depression, adverse skin conditions, asthma, heart and circulatory disease, and cancer. It also makes dozens of familiar over-the-counter remedies, from Contac, Panadol, Nicorette, Aquafresh, and Sensodyne to Tagamet and Tums.

GSK is doing very well in a high-performing industry. In most situations, we applaud companies for such strong performance. However, when it comes to pharmaceutical firms, critics claim, healthy sales and profits may not be so healthy for consumers. Learning that companies like GSK are reaping big profits leaves a bad taste in the mouths of many consumers. It's like learning that the oil companies are profiting when gas prices rocket upward. Although most consumers appreciate the steady stream of beneficial drugs produced by pharmaceutical companies, they worry that the industry's huge success may be coming at their own expense—literally.

Americans spend more than \$300 billion a year on prescription medications, nearly half of worldwide spending. Prescription prices have risen rapidly over the years, and health-care costs continue to jump. Last year, while many other industries were cutting prices and many recession-weary consumers struggled just to make ends meet, the pharmaceutical industry raised wholesale prices for brand-name prescription drugs by 9 percent in the United States, adding up to \$10 billion to its revenues.

The critics claim that competitive forces don't operate well in the pharmaceutical market, allowing GSK and other companies to charge excessive prices. Unlike purchases of other consumer products, drug purchases cannot be postponed. And consumers don't usually shop for the best deals on medicines; they

simply take what the doctor orders. Because physicians who write the prescriptions don't pay for the medicines they recommend, they have little incentive to be price conscious. Finally, because of patents and Food and Drug Administration (FDA) approvals, few competing brands exist to force lower prices, and existing brands don't go on sale.

The critics claim that these market factors leave pharmaceutical companies free to practice monopoly pricing, resulting in unfair practices and price gouging. To add insult to injury, the critics say, drug companies pour more than \$4 billion a year into direct-to-consumer advertising and another \$18 billion into sampling. These marketing efforts dictate higher prices at the same time that they build demand for more expensive remedies. Thus, the severest critics say, GSK and the other big drug companies may be profiting unfairly—even at the expense of human life—by promoting and pricing products beyond the reach of many people who need them.

But there's another side to the drug-pricing issue. Industry proponents point out that, over the years, the drug companies have developed a steady stream of medicines that transform people's lives. Developing such new drugs is a risky and expensive endeavor, involving legions of scientists, expensive technology, and years of effort with no certainty of success. The pharmaceutical industry invests nearly \$50 billion a year in R&D; GSK alone invested \$5 billion last year. GSK now has 134 drug projects under development. On average, each new drug takes 12–15 years to develop and typically costs \$850 million. Seventy percent of new drugs never generate enough revenue to recover the cost of development. Although the prices of prescription drugs seem high, they're needed to fund the development of important future drugs. Additionally, a publically held company like GSK has a bona fide responsibility to return a profit to shareholders.

A recent GSK ad notes that it took 15 years to complete all the tests and find the exact right compound for a new heart medicine, at a cost of more than the price of a space shuttle mission. Profits from the heart drug will help to fund critical research on diseases such as multiple sclerosis and Alzheimer's. The ad concludes: "Inventing new medicines isn't easy, but it's worth it. . . . Today's medicines finance tomorrow's miracles."



**Responsible pricing:** Most consumers understand that they'll have to pay the price for beneficial drugs. They just want to be treated fairly in the process.

As for all that expensive prescription drug advertising, the industry argues that the ads have strong information value: They help educate people about treatments and encourage them to get help for conditions of which they might not otherwise have been aware.

And so the controversy continues. As drug prices climb, GSK and the industry are facing pressures from the federal government, insurance companies, managed-care providers, and advocacy groups to exercise restraint in setting prices. Rather than waiting for tougher legislation on prices—or simply because it's the right thing to do—GSK has undertaken several initiatives to make drugs available to those who need but can't afford them.

For example, internationally, GSK employs tiered-pricing—selling its medicines in different countries at varying prices based on the ability to pay in each country. People in the poorest countries pay the least, typically one-fifth or less the price in industrialized countries. GSK sells its malaria vaccine, sold almost exclusively in developing countries, at little or no profit to keep prices as low as possible. The company also reinvests 20 percent of the

profits from selling drugs in lesser-developed countries (LDCs) to strengthen healthcare infrastructure in those countries. And GSK regularly donates free medicines in response to disaster relief efforts around the globe. "I want GSK to be a very successful company but not at the expense of leaving the population of Africa behind," says GSK's CEO.

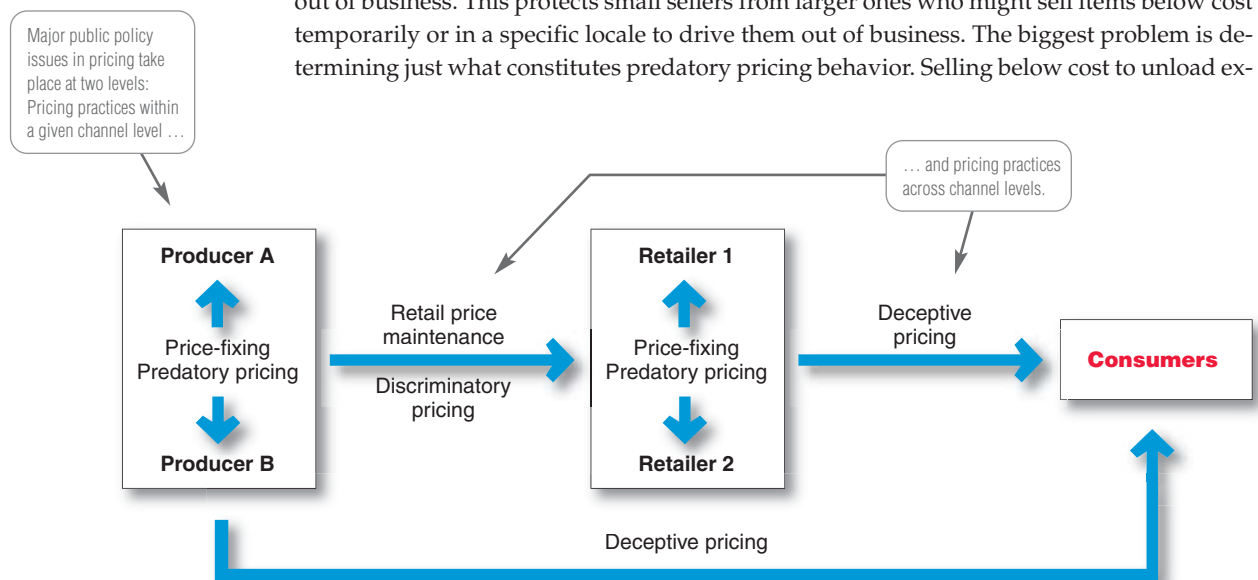
Tiered pricing is an admirable solution, but it's fraught with challenges. For one thing, it requires that consumers in industrialized countries foot the massive bill for medications to LDCs—for example, 80 percent of GSK's vaccines go to LDCs. Tiered pricing also overlooks the fact that there are many poor people in even the wealthiest countries who can't afford to pay for prescription drugs. That's why

in the United States and other developed countries, GSK sponsors patient assistance programs and discount cards that provide prescription medicines to low-income, uninsured patients free or at minimal cost.

In all, pharmaceuticals pricing is no easy issue. For GSK, it's more than a matter of sales and profits. In setting prices, short-term financial goals must be tempered by broader societal considerations. GSK's heartfelt mission is "to improve the quality of human life by enabling people to do more, feel better, and live longer." Accomplishing this mission won't come cheap. Most consumers understand that. One way or another, they know, they'll have to pay the price. All they really ask is that they be treated fairly in the process.

**Sources:** Linda A. Johnson, "Drugmakers Boost Consumer Ad Spending 2 Percent in '09," March 2, 2010, <http://abcnews.go.com/Business/wireStory?id=10024145>; Andrew Jack, "GSK Gives Price Pledge on Malaria Vaccine," *Financial Times*, January 21, 2010, accessed at [www.ft.com](http://www.ft.com); Duff Wilson, "Drug Makers Raise Prices in Face of Health Care Reform," *New York Times*, November 15, 2009; Congressional Budget Office "Promotional Spending for Prescription Drugs," *Economic and Budget Issue Brief*, December 2, 2009; "Drug Company Reaches out to Poor," *Financial Chronicle*, February 10, 2010, [www.mydigitalfc.com/news/drug-company-reaches-out-poor-589](http://www.mydigitalfc.com/news/drug-company-reaches-out-poor-589); and information from [www.gsk.com](http://www.gsk.com), accessed November 2010.

Sellers are also prohibited from using *predatory pricing*—selling below cost with the intention of punishing a competitor or gaining higher long-run profits by putting competitors out of business. This protects small sellers from larger ones who might sell items below cost temporarily or in a specific locale to drive them out of business. The biggest problem is determining just what constitutes predatory pricing behavior. Selling below cost to unload ex-



**FIGURE | 11.2**  
Public Policy Issues in Pricing

Source: Based on Dhruv Grewal and Larry D. Compeau, "Pricing and Public Policy: A Research Agenda and Overview of the Special Issue," *Journal of Public Policy and Marketing*, Spring 1999, pp. 3–10.



● **Predatory pricing:** Some critics charge that the big-box stores like Best Buy price CDs as loss leaders to drive music competitors out of business. But is it predatory pricing or just plain good marketing?

cess inventory is not considered predatory; selling below cost to drive out competitors is. Thus, the same action may or may not be predatory depending on intent, and intent can be very difficult to determine or prove.

In recent years, several large and powerful companies have been accused of predatory pricing. However, turning an accusation into a lawsuit can be difficult. ● For example, many music retailers have accused Walmart and Best Buy of predatory CD pricing. Since 2007 alone, CD sales have plummeted almost 20 percent each year, putting music-only retailers such as Tower Records, Musicland, and a megamall full of small mom-and-pop music shops out of business. Many industry experts attribute slumping CD sales to new music distribution strategies—mainly digital downloads. Others, however, blame the big-box stores for pricing CDs as loss leaders to drive competitors out of business. Low CD prices don't hurt Walmart; it derives less than 2 percent of its sales from CDs, and low-priced CDs pull customers into stores, where they buy other products. Such pricing tactics, however, cut deeply into the profits of music retailers. Still, no predatory pricing charges have ever been filed against Wal-

mart or Best Buy. It would be extremely difficult to prove that such loss-leader CD pricing is purposefully predatory as opposed to just plain good marketing.<sup>16</sup>

## Pricing Across Channel Levels

The Robinson-Patman Act seeks to prevent unfair *price discrimination* by ensuring that sellers offer the same price terms to customers at a given level of trade. For example, every retailer is entitled to the same price terms from a given manufacturer, whether the retailer is Sears or your local bicycle shop. However, price discrimination is allowed if the seller can prove that its costs are different when selling to different retailers—for example, that it costs less per unit to sell a large volume of bicycles to Sears than to sell a few bicycles to the local dealer.

The seller can also discriminate in its pricing if the seller manufactures different qualities of the same product for different retailers. The seller has to prove that these differences are proportional. Price differentials may also be used to “match competition” in “good faith,” provided the price discrimination is temporary, localized, and defensive rather than offensive.

Laws also prohibit *retail (or resale) price maintenance*; a manufacturer cannot require dealers to charge a specified retail price for its product. Although the seller can propose a manufacturer's *suggested* retail price to dealers, it cannot refuse to sell to a dealer that takes independent pricing action nor can it punish the dealer by shipping late or denying advertising allowances. For example, the Florida attorney general's office investigated Nike for allegedly fixing the retail price of its shoes and clothing. It was concerned that Nike might be withholding items from retailers who were not selling its most expensive shoes at prices the company considered suitable.

*Deceptive pricing* occurs when a seller states prices or price savings that mislead consumers or are not actually available to consumers. This might involve bogus reference or comparison prices, as when a retailer sets artificially high “regular” prices and then announces “sale” prices close to its previous everyday prices. For example, Overstock.com recently came under scrutiny for inaccurately listing manufacturer's suggested retail prices, often quoting them higher than the actual price. Such comparison pricing is widespread.

Comparison pricing claims are legal if they are truthful. However, the FTC's *Guides Against Deceptive Pricing* warns sellers not to advertise a price reduction unless it is a savings from the usual retail price, “factory” or “wholesale” prices unless such prices are what they are claimed to be, and comparable value prices on imperfect goods.<sup>17</sup>

Other deceptive pricing issues include *scanner fraud* and price confusion. The widespread use of scanner-based computer checkouts has led to increasing complaints of retailers overcharging their customers. Most of these overcharges result from poor management—from a failure to enter current or sale prices into the system. Other cases, however, involve intentional overcharges.

Many federal and state statutes regulate against deceptive pricing practices. For example, the Automobile Information Disclosure Act requires automakers to attach a statement on new vehicle windows stating the manufacturer's suggested retail price, the prices of optional equipment, and the dealer's transportation charges. However, reputable sellers go beyond what is required by law. Treating customers fairly and making certain that they fully understand prices and pricing terms is an important part of building strong and lasting customer relationships.

## REVIEWING Objectives AND KEY Terms

In this chapter, we examined some additional pricing considerations—new-product pricing, product mix pricing, price adjustments, and initiating and reacting to prices changes. A company sets not a single price but rather a *pricing structure* that covers its entire mix of products. This pricing structure changes over time as products move through their life cycles. The company adjusts product prices to reflect changes in costs and demand and account for variations in buyers and situations. As the competitive environment changes, the company considers when to initiate price changes and when to respond to them.

### Objective 1 Describe the major strategies for pricing new products. (pp 314–315)

Pricing is a dynamic process, and pricing strategies usually change as the product passes through its life cycle. The introductory stage—setting prices for the first time—is especially challenging. The company can decide on one of several strategies for pricing innovative new products: It can use *market-skimming pricing* by initially setting high prices to “skim” the maximum amount of revenue from various segments of the market. Or it can use *market-penetrating pricing* by setting a low initial price to penetrate the market deeply and win a large market share. Several conditions must be set for either new-product pricing strategy to work.

### Objective 2 Explain how companies find a set of prices that maximizes the profits from the total product mix. (pp 315–319)

When the product is part of a product mix, the firm searches for a set of prices that will maximize the profits from the total mix. In *product line pricing*, the company determines the price steps for the entire product line it offers. In addition, the company must set prices for *optional products* (optional or accessory products included with the main product), *captive products* (products that are required for using the main product), *by-products* (waste or residual products produced when making the main product), and *product bundles* (combinations of products at a reduced price).

### Objective 3 Discuss how companies adjust their prices to take into account different types of customers and situations. (pp 319–325)

Companies apply a variety of *price adjustment strategies* to account for differences in consumer segments and situations. One is *discount and allowance pricing*, whereby the company establishes cash, quantity, functional, or seasonal discounts, or varying types of allowances. A second strategy is *segmented pricing*, where the company sells a product at two or more prices to accommodate different customers, product forms, locations, or times. Sometimes companies consider more than economics in their pricing decisions, using *psychological pricing* to better communicate a product's intended position. In *promotional pricing*, a company offers discounts or temporarily sells a product below list price as a special event, sometimes even selling below cost as a loss leader. Another approach is *geographical pricing*, whereby the company decides how to price to distant customers, choosing from such alternatives as *FOB-origin pricing*, *uniform-delivered pricing*, *zone pricing*, *basing-point pricing*, and *freight-absorption pricing*. Finally, *international pricing* means that the company adjusts its price to meet different conditions and expectations in different world markets.

### Objective 4 Discuss the key issues related to initiating and responding to price changes. (pp 325–328)

When a firm considers initiating a *price change*, it must consider customers' and competitors' reactions. There are different implications to *initiating price cuts* and *initiating price increases*. Buyer reactions to price changes are influenced by the meaning customers see in the price change. Competitors' reactions flow from a set reaction policy or a fresh analysis of each situation.

There are also many factors to consider in responding to a competitor's price changes. The company that faces a price change initiated by a competitor must try to understand the competitor's intent as well as the likely duration and impact of the change. If a swift reaction is desirable, the firm should preplan its reactions to different possible price actions by competitors. When facing a

competitor's price change, the company might sit tight, reduce its own price, raise perceived quality, improve quality and raise price, or launch a fighting brand.

**Objective 5** Overview the social and legal issues that affect pricing decisions. (pp 328–332)

Many federal, state, and even local laws govern the rules of fair pricing. Also, companies must consider broader societal pricing con-

cerns. The major public policy issues in pricing include potentially damaging pricing practices *within* a given level of the channel, such as price-fixing and predatory pricing. They also include pricing practices *across* channel levels, such as retail price maintenance, discriminatory pricing, and deceptive pricing. Although many federal and state statutes regulate pricing practices, reputable sellers go beyond what is required by law. Treating customers fairly is an important part of building strong and lasting customer relationships.

## KEY Terms

### OBJECTIVE 1

Market-skimming pricing (p 314)  
Market-penetration pricing (p 314)

### OBJECTIVE 2

Product line pricing (p 315)  
Optional product pricing (p 316)  
Captive product pricing (p 316)  
By-product pricing (p 316)  
Product bundle pricing (p 318)

### OBJECTIVE 3

Discount (p 319)  
Allowance (p 319)  
Segmented pricing (p 319)  
Psychological pricing (p 320)  
Reference prices (p 320)  
Promotional pricing (p 321)  
Geographical pricing (p 322)

FOB-origin pricing (p 322)

Uniform-delivered pricing (p 322)  
Zone pricing (p 322)  
Basing-point pricing (p 322)  
Freight-absorption pricing (p 323)  
Dynamic pricing (p 323)



- 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 Strategies**.

## DISCUSSING & APPLYING THE Concepts

### Discussing the Concepts

1. Compare and contrast market-skimming and market-penetration pricing strategies and discuss the conditions under which each is appropriate. (AACSB: Communication; Reflective Thinking)
2. Name and briefly describe the five product mix pricing decisions. (AACSB: Communication)
3. Explain how discounts and allowances differ from promotional pricing. (AACSB: Communication; Reflective Thinking)
4. Compare and contrast the geographic pricing strategies that companies use for customers located in different parts of the country or the world. Which strategy is best? (AACSB: Communication; Reflective Thinking)
5. What factors influence the prices a company charges in different countries? (AACSB: Communication)
6. Why would a company consider increasing its price? What precautions must be taken to avoid being perceived as a price gouger? (AACSB: Communication)

### Applying the Concepts

1. Identify three price-comparison shopping Web sites and shop for a specific model of a digital camera on all three sites. Compare the price ranges given at each site. Based on your search, determine a fair price for the camera. (AACSB: Communication; Use of IT)
2. Convert U.S.\$1.00 to the currencies of five other countries. (You can do this at [www.xe.com](http://www.xe.com).) What implications do currency exchange rates hold for setting prices in other countries? (AACSB: Communication; Use of IT; Reflective Thinking)
3. One psychological pricing tactic is just-below pricing. It is also called "9-ending" pricing because prices usually end in the number 9 (or 99). In a small group, have each member select five different products and visit a store to find the price of those items. Is there a variation among the items and stores with regard to 9-ending pricing? Why do marketers use this pricing tactic? (AACSB: Communication; Reflective Thinking)

## FOCUS ON Technology

The Internet is great for selling products and services. But don't make a pricing mistake online! Intercontinental Hotels mistakenly priced rooms at one of its four-star hotels near Venice, Italy, for 1 euro per night instead of the actual price of 150 euros per night. Internet users booked 1,400 nights before the mistake was realized. Intercontinental Hotels honored the reservations at a cost of 90,000 euros to the company. In Taiwan, an eight-hour online pricing snafu on Dell's Web site created tremendous problems for the company, such as 40,000 orders for a laptop computer priced at about one-fourth the intended price. Unlike Intercontinental Hotels, however, Dell refused to honor the erroneous price and of-

fered a discount instead. The Taiwanese government disagreed, ordered Dell to honor orders for erroneously priced products, and fined the company.

1. Find two other examples of online pricing mistakes. How did the companies handle the problems resulting from the pricing errors? (AACSB: Communication; Reflective Thinking)
2. Research ways in which marketers protect against the consequences of online pricing errors and write a brief report summarizing what you learn. (AACSB: Communication; Reflective Thinking)

## FOCUS ON Ethics

You'd think that the farther you fly, the more expensive your airfare would be. According to U.S. Department of Transportation data, however, that's not the case. For example, the average cost of a 280-mile flight from Boston to Philadelphia was \$342, which is \$1.22 per mile. A 2,602-mile flight from Boston to Long Beach, California, cost \$169, or \$0.06 per mile! That's the average cost; fliers sitting next to each other likely paid different prices. Many factors influence the pricing of airfares; distance has minor impact, even though two major expenses—fuel and labor—increase the longer the flight. In this example, one factor might be that the Boston-Philadelphia route averages 484 passengers per day, while the Boston-Long Beach route averages only 330 passengers per day. Airlines claim they are just charging what the market will bear.

1. Should airlines be required to charge standard prices based on distance and equal airfares for passengers seated in the same class (such as coach or business class) on the same flight? What will likely happen to prices if the government requires airlines to base fares only on distance and passenger class? (AACSB: Communication; Ethical Reasoning; Reflective Thinking)
2. What factors account for the variation in airfares? Should airlines be permitted to get as much as they can for a seat? (AACSB: Communication; Reflective Thinking)

## MARKETING & THE Economy

### Pizza Hut

Restaurants of all kinds have scrambled to keep customers coming in during recent difficult economic times. Pizza Hut is in an unusual spot. It isn't exactly fast food, but it isn't quite full-service fare either. Pizza Hut has never been perceived as being on the low end of pizza prices. As the economy sagged, all these factors cooled down business for the red-roofed purveyor of pies. So Pizza Hut did what many companies did. It cut prices. At first, it shocked the pizza category with its "\$10 any" promotion—any pizza, any size, any crust, any toppings, for just \$10.

Customers really responded to the limited time offer. But as soon as the price deal ended, Pizza Hut's incremental promotional revenues disappeared. So the company has made more perma-

nent adjustments to the new frugality reality. To increase customer loyalty, it has introduced everyday low prices. Most medium pizzas cost \$8, most large pizzas cost \$10, and most specialty pizzas cost \$12; these price cuts represent up to 50 percent reductions from previous pricing. Under this new pricing, Pizza Hut expects that revenues will increase significantly. But the new pricing mechanism will require some time before it proves itself.

1. What are the implications of Pizza Hut's big price cuts for its brand image?
2. Can customer loyalty be generated through low prices?
3. Can Pizza Hut sustain such dramatically lower prices and still remain profitable?

## MARKETING BY THE Numbers

The recently weak economy caused many consumers to switch to lower-priced products. Although P&G had sales of \$77 billion in 2009, many of its relatively expensive brands, such as Tide detergent and Secret deodorant, were stranded on store shelves. So, in

2010, P&G did the unthinkable: It slashed prices on many of its products, such as batteries (13.3 percent), liquid laundry detergents (5.1 percent), shampoos (5.4 percent), and conditioners (6.6 percent). The price cuts come at a cost, however, and sales

must increase considerably just to break even or make the price cuts profitable.

1. P&G's average contribution margin before the price cuts was 20 percent. Refer to Appendix 2 and calculate the new contribution margin if prices are reduced 10 percent. (AACSB: Communication; Analytical Reasoning)

2. What level of total sales must P&G capture at the new price levels to maintain the same level of total contribution before the price reduction (that is, total contribution = \$15.4 billion, which is 20 percent of \$77 billion in sales)? (AACSB: Communication; Analytical Reasoning)

## VIDEO Case

### Smashburger

Hamburgers are America's favorite food. Consumers spend more than \$100 billion on beef sandwiches every year. Despite America's infatuation with burgers, however, there is considerable dissatisfaction with hamburger quality and value among consumers. Many customers are not happy with what is available at market-leading fast-food outlets. They want a better burger, and they won't hesitate to pay a higher price to get one. Enter Smashburger. Started just a few years ago in Denver, Colorado, Smashburger is now a rapidly expanding chain of more than 100 stores in 17 states. And all this growth occurred during a severe economic downturn despite Smashburger's average lunch check of \$8. Many customers pay as much as \$10 or \$12 for a burger, fries,

and shake. The Smashburger video shows how this small start-up has pulled off a seemingly impossible challenge. After viewing the video, answer the following questions.

1. Describe customer dissatisfaction with fast-food hamburger options. Why do people continue to consume burgers if they are not satisfied?
2. What effect does Smashburger's premium price have on consumer perceptions? How did a restaurant with a premium-priced product and little track record take off during a recession?
3. Is Smashburger's success based on novelty alone or will it continue to succeed?

## COMPANY Case

### Payless ShoeSource: Paying Less for Fashion

When you think of New York's Fifth Avenue, what retailers come to mind? Tiffany? Gucci? Armani? One name that probably *doesn't* come to mind is Payless. But for the past few years, Payless ShoeSource has been operating one of its low-priced shoe stores on the famed avenue of luxury retailing. In fact, Payless is now well on its way to placing stores in more than 100 higher-end malls around the country.

Although the discount shoe peddler still focuses on selling inexpensive shoes to the masses, Payless is moving upscale. It's on a mission to "democratize fashion"—to make truly fashionable products more accessible by applying its cost-effective model to a product portfolio infused with well-known brand labels and some of the hottest high-end designers in the business. Sound like a hair-brained scheme? You might change your mind after hearing the whole story.

Founded in 1956 in Topeka, Kansas, Payless grew rapidly based on what was then a revolutionary idea: selling shoes in a self-service environment. Fifty years later, it had become the largest shoe retailer in the Western Hemisphere, with over 4,500 stores in all 50 states and throughout the Americas. Targeting budget-minded families, Payless was serving up more than 150 million pairs of shoes each year, approximately one in every ten pairs of shoes purchased in America.

While all seemed rosy for the choose-it-yourself shoe store, by 2005, Payless was losing market share and closing stores. The retail landscape had changed, and giant discount one-stop shops like Walmart, Target, and Kohl's had become the vendors of choice for budget-conscious shopper's buying shoes. Said one industry in-

sider, "You can no longer produce the same boring shoes year after year and hope that price alone will get customers to your door." With thrift as its only positioning point, Payless had lost its edge.

### AN IMAGE OVERHAUL

To reverse its sliding market share, Payless had to engineer a completely new strategy. To get things started, it hired a new CEO, Matt Rubel, who came with extensive experience with high-end brands like Cole Haan and J.Crew. Rubel knew that Payless would have to design shoes that *Sex and the City's* Carrie Bradshaw would drool over but at prices that Roseanne could afford. It had to change its image from the dusty dungeon of cheap footwear into the fun, hip merchant of fashion. "We have the ability to make shoes at the most affordable prices anywhere in the world, and we want to marry that with the greatest creativity," said Rubel. The overall objective of Rubel's strategy was to not only give the brand image a makeover but also position Payless in such a way that a slight price increase would seem like a bargain.

Rubel wasted no time in making big changes. The strategic plan that he drafted was based on four major components.

**Expanding the Brand Portfolio.** Rubel implemented a "House of Brands" strategy, shifting the product line from one consisting almost entirely of store brands to one dominated by well-known national brands. Payless now sells shoes under numerous brand names that it either owns or licenses, including Airwalk, Champion, Dexter, Dunkman (endorsed by Shaquille O'Neal), American Eagle, Hello Kitty, Star Wars, and various Disney brands. Rubel also acquired the Stride Rite chain and all its associated brands, including Keds, Sperry Top-Sider, Tommy Hilfiger, and Saucony. To organize the new corporate structure and keep track of all the brands,



Rubel created a holding company (Collective Brands) as an umbrella over Payless, Stride Rite, and all the licensing activities for the company's brands.

**The Payless Design Team.** To develop products that would resonate better with consumers, Payless stepped up its emphasis on fashion. The Payless Design Team, an in-house design group, dedicated itself to developing original footwear and accessory designs to keep new styles on target with changing fashion trends. Top designers from Kenneth Cole and Michael Kors were hired as full-time employees to head the new team.

**Designer Collections.** In perhaps the biggest move to raise the caché of the brand, Rubel started what he called "Designer Collections." Aiming for the highest levels of haute couture, Payless has forged relationships with three top New York-based designers—Lela Rose, Stacey Bendet, and Christian Siriano. The three are designing everything from pumps to boots to handbags under the brands Lela Rose, alicé + olivia, and Christian Siriano. A fourth designer, Isabel Toledo, will soon have products on Payless shelves. Toledo was an underground designer until Michelle Obama chose to wear some of her creations on the day her husband was inaugurated president of the United States.

After signing its first designer, Payless did something very out of character for a discount brand. It took its designs to the runway of New York's Fashion Week, the invitation-only event where designers debut fall fashions for the industry. In another first, Payless began running full-page ads in *Elle*, *Vogue*, and *W*, featuring the tagline, "Look Again."

The benefits of such alliances are plentiful. The designers get tremendous exposure, a large customer base, and the power and budget of a mass retailer. Payless gets brand caché, almost certain to transform its outdated image. And consumers get runway styles they can afford.

**Fun Inspiring Store Formats.** To reflect the new image and communicate change to consumers, Payless redesigned its logo for the first time in 20 years. It then launched new "Fashion Lab" and "Hot Zone" store formats. Both were a drastic improvement, making the stores more open, light, and airy, with a more satisfying consumer experience built around style and design rather than price. Of the new store atmosphere, Rubel said, "It makes the \$12 shoe look like a \$20 shoe." Rubel hopes that the new formats will not only attract more customers but also entice customers to pay a little bit more than they have in the past. All the new stores now have one of the two new formats, and old stores are being progressively remodeled.

## STROKE OF GENIUS? OR DESTINED FOR FAILURE?

Can the "luxury-meets-low-price" strategy work? Or will this go down as a disaster of two drastically different worlds that collided, crashed, and burned? "There's nothing cool about shopping at Payless," says skeptic Marian Salzman, a trends forecaster at a major ad firm. "It gets the cash-strapped working girl." But Rubel refutes this view, quickly pointing out that its shoppers have median household incomes that are higher than those of both Walmart and Target. "All we've done is bring Payless into the 21st century. We're . . . speaking with greater clarity to who our customer already is."

Maxine Clark, former president of Payless and now chief executive officer of Build-A-Bear Workshop, also recognizes the potential of the new strategy. "The customer who wants to buy Prada will not

come to Payless. But this will energize the old customers who they lost and attract new ones." Mardi Larson, head of public relations, claims that the trendy new image is perfect for existing customers. "We target the 24-year-old demographic, because women in their 40s who shop for their family are nostalgic about that time in their lives, while [at the same time] teenagers aspire to that age group."

But what about that potential new customer? Does this risky venture into high-fashion stand a chance of appealing to those who have never crossed the threshold of a Payless store? Rubel admits going after new customers. The "cheap chic" approach is attempting to lure 20-to-30-year-old women who are looking for something trendy. Given that such fashion-conscious females buy 50 percent more shoes than most current customers, going after new customers make sense.

Perhaps Lela Rose's Fashion Week experience best illustrates why Payless might just succeed in attracting this previously out-of-reach customer:

When actresses Sophia Bush (*One Tree Hill*) and Brittany Snow (*Hairspray*) landed backstage in Lela Rose's showroom at New York Fashion Week, they swooned over the designer's new shoe collection that was about to debut on the runway. Rose, best known for \$1,500 frocks, happily handed pairs of navy peep-toe pumps and polka-dot round-toe pumps over to the young celebs, who would soon be flaunting them on the sidelines of the catwalk. "Did they know they were Payless shoes?" says Rose, who's now designing her fifth exclusive line for the discounter. "Absolutely. They didn't care. They looked cute to them and that's all that mattered."

Additionally, Payless is not the first to try this new direction. In fact, co-branded designer lines for discount retailers date back decades. But in recent years, the trend is proliferating. Karl Lagerfeld has designed for Britain's H&M, Vera Wang has teamed up with Kohl's, Ralph Lauren has put store brands on JCPenney's shelves, and Todd Oldham has stepped out with Old Navy, to name just a few.

Although many ventures such as these *have* failed miserably, some have been wildly successful. Lela Rose claims that she would never have considered her arrangement with Payless if it hadn't been for the success of Target's alliance with Isaac Mizrahi. Mizrahi's couture career was pretty much on the rocks. Then he started designing preppy cashmere sweaters, cheerful jersey dresses, and trendy trench coats for Target, all priced at under \$40. With the low-rent strategy, Mizrahi became more popular and famous than ever. After that, he once again had high-end retailers knocking on his door. Since Mizrahi's successful entry to the mainstream, more than two dozen designers have cobranded with mass retailers.

## PAYING LESS OR PAYING MORE?

There's more in it for Payless than just making the brand more attractive to both old and new customers. The company is looking to move its average price point up a notch or two. Whereas "higher price" is a relative term when most of a store's product line is priced below \$15, higher margins are higher margins. Rubel has suggested that, in many cases, price increases may be as little as \$0.50 per pair of shoes. But the expansion of its brand portfolio to include famous labels will certainly give Payless greater pricing flexibility. And the designer collections will allow for some of the highest priced products that have ever graced its shelves—think \$25 for pumps and up to \$45 for boots. Whereas that is a substantial price increase from average, it's a bargain for fashion-conscious consumers.

Yet just as Rubel's strategy began to gain steam, so did the worst global recession since the Great Depression. Like retailers everywhere, Payless took a hit. But while many retailers suffered catastrophic losses, existing store sales at Payless fared much better. And after profits sunk briefly to a loss of \$60 million in 2008, Payless posted a net profit of \$88 million for 2009. Payless recently opened its first stores in the Eastern Hemisphere in Saudi Arabia, Kuwait, and the United Arab Emirates. Russia is next on its agenda.

With the expansion, wholesaling, and licensing activities of Rubel's plan, Payless is poised to return to a growth trajectory. Low production costs continue to provide a competitive advantage that will boost profits. And in good times as well as bad, Payless has struck a formula for value that customers love. It remains confident that its strategy to democratize fashion will produce great results, regardless of future economic conditions.

### Questions for Discussion

1. Which of the different product mix pricing strategies discussed in the text applies best to Payless's new strategy? Discuss this in detail.
2. How do concepts such as psychological pricing and reference pricing apply to the Payless strategy? In what ways does the strategy deviate from these concepts?
3. Discuss the benefits and risks of the new strategy for both Payless and the designers with whom it partners. Which of these two stands to lose the most?
4. Consider the scale on which Payless operates. How much of a price increase does Payless need to achieve to make this venture worthwhile?

**Sources:** Sigal Ratner-Arias, "Payless Snags Top Designer," *The Spectator*, April 13, 2010, p. G9; Jonathan Birchall, "Payless Moves into Russia," *Financial Times*, September 2, 2009, p. 19; Gene Marcial, "The Shine on Collective's Shoes," *BusinessWeek*, April 13, 2009, p. 61; Danielle Sacks, "The Fast 50 Companies," *Fast Company*, March, 2008, p. 112; Maria Puente, "Top Designers Go Down-Market," *USA Today*, September 26, 2007, p. 11B; Bruce Horowitz, "Payless Is Determined to Put a Fashionably Shod Foot Forward," *USA Today*, July 28, 2006, p. 1B; Nicole Zerillo, "Payless Launches 'I Love Shoes,'" *PR Week*, March 10, 2008, p. 3; [www.payless.com](http://www.payless.com), accessed July 2010.