Price: value plus a reasonable sum for the wear and tear of conscience in demanding it.

AMBROSE PIERCE

Price

PART SIX

Chapter 16 Pricing

IN PART SIX WE COVER an element of the marketing mix that is both easy and expensive to manipulate – price.

Price cutting is an easy way to attract customers quickly, but a poor route to long-term market success. The reason is that giving a 10 per cent price cut to a customer can mean taking a 50 per cent cut in profits. The industrialist Philip Armour explained that businesses often resort to price-cutting: 'Anybody can cut prices, but it takes brains to make a better article.'

Many internal and external pressures influence the price decision, from internal costs to government legislation. The examination of these in **Chapter 16** leads to *value-based pricing*, where a customer's perception of price, rather than costs, drives price. We then look at pricing strategies under a variety of situations, such as when launching a product, when changing prices and when pricing within a product range.

Buy sheep, sell deer.

ANON

CHAPTER sixteen

Pricing

Chapter objectives

After reading this chapter, you should be able to:

- Identify and define the internal and external factors affecting pricing decisions.
- Contrast general approaches to setting prices.
- Describe pricing strategies for imitative and new products and know when to use them.
- Explain how pricing is influenced by the product mix and show how companies determine a set of prices that maximises the profits of the total product mix.
- Discuss how companies adapt prices to meet different market circumstances and opportunities.
- Discuss the key issues relating to initiating and responding to price changes.

Mini Contents List

◀ SOURCE: Iceland Foods Plc. Advertising Archives.

Prelude case The Oresund Bridge: over or under, down and out, again and again

MARIA DEL MAR SOUZA FONTAN
Aston Business School, UK

This time it was supposed to be different. Governments have no problem commissioning grand projects that go under or over the sea, but they do have problems in keeping costs down and getting people to use the facility. Within a year of being opened it looked like the Oresund Bridge, which crosses the Oresund Straits between Copenhagen in Denmark and Malmö in Sweden, was going the way of similar attempts to join up bits of land.

There is a pattern in the joining of conspicuous bits of land:

1. The idea is so obvious that people start thinking about joining them long before the technology. Some designs for an Oresund Bridge date from 1886 when Napoleon planned to attack Britain using a tunnel under the English Channel.
2. Governments take over the prestige project that suffers cost overruns.
3. Too few people use the construction to cover its cost.
4. Some form of regular subsidy is sought.

Some designs for an Oresund Bridge date from 1886 and Napoleon planned to attack Britain using a tunnel under the English Channel.

The poor management structure during the construction of the Channel Tunnel linking England and France resulted in a two-year delay and a cost that reached €11 billion compared with the originally estimated €4.7 billion. Forecasts of the level of traffic using the tunnel were too optimistic, resulting in financial problems for Eurotunnel, the Channel Tunnel's operator. London & Continental, the consortium awarded the contract to build and operate the high-speed railway between London and the Channel Tunnel, was also in trouble, the number of passengers between London, Paris and Brussels being 50 per cent below forecasts. Eurotunnel is now seeking wide-ranging changes to the way the tunnel is funded to overcome 'fundamental structural problems in the cross-channel rail industry'. Basically, not enough people use the tunnel. Cross-channel travel is up but advanced ferries and luxurious ferries are biting increasingly into the market and people are increasingly using low-cost easyJet and Ryanair. A particular change in the market is the number of passengers who fly and then hire a car rather than shipping their own.

Embarrassing as they are, the Channel Tunnel's problems were minor compared with Japan's recent bridge building. Inaugurated in 1998, the Akashi Kaikyo Bridge is the longest suspension bridge in the world. It crosses the Akashi Straits and connects the city of Kobe to Awaji Island, and cost ¥800 billion (€8.5 billion). However, spectacular as it is to behold, locals and Japanese taxpayers wonder what it is for. Authorities claimed that some 37,000 cars would use the bridge each day, although only 100–200 a day ever used the ferry between Kobe and Awaji Island. The bridge was to bring all manner of economic opportunities to the residents of Awaji and the equally impoverished island of Shikoku. Although a great aesthetic and engineering success, people still do not want to go to Awaji. After an initial burst of enthusiasm, daily use remains little above the numbers who used the ferry.

Shortly after opening, it looked like the Oresund bridge-cum-tunnel was going the same way as its predecessors. Not only was its use far below forecast but also it looked like its use could go even lower. Novo Nordisk, a Danish drug firm that moved its HQ to Malmö to take advantage of the 'bridge effect', urged its Danish staff to limit their trips to Malmö by working more from home. Swedish furniture chain IKEA went even further and banned its employees from using the bridge on company business. They are told to make the crossing using the ferry. The ferry is a lot slower than the bridge but also a lot less expensive.

The Danish and Swedish governments initiated the Oresund Bridge project in 1991. The aim was to build a fixed link across the Oresund Region, which comprises Zealand, Lolland-Falster and Bornholm, on the Danish side, as well as Scania and Sweden. The construction of this bridge was to provide stronger and more intense cooperation regarding economy, education, research and culture between the two nations, as well as constituting the link to the European mainland for Sweden. In July 2000, the €1.5 billion bridge-cum-tunnel opened to traffic. The investment was to be recouped from the thousands of cars crossing the bridge every day. The link is changing local life. More Swedes are visiting the cafés and galleries of Copenhagen although Malmö does not seem so attractive to the Danes.

Economic reality is proving to be well short of expectations. Peaking at 20,000 crossings a day soon after opening, traffic fell to 6,000. Seventy-five per cent more people cross the straits than did before the construction but numbers are way below target. An advertising campaign aims to attract more people to use the bridge but price seems to be the problem. With many fewer cars

Exhibit 16.1 Oresund Bridge typical pricing (€)

Vehicle type	Length	Basic price	4-trip card	10-trip card	Business rate 7,501–10,000 trips (per trip)
Motorcycle	–	17	34	104	–
Private	Up to 6 m	32	64	192	12.10
Private	Up to 9 m	64	128	192	26.89
Lorries	9 m to 12 m	82.80	–	–	38.31

than expected crossing the bridge, the Danish and Swedish governments have to find a route to a better possible return on investment, by changing their pricing strategy.

There are currently two types of fares, depending on whether drivers pay at the toll station or whether they sign an agreement which offers discounts for frequent travellers. Motorists who cross the bridge only a few times a year will pay 'the cash price', whilst those who use the bridge regularly will be in position to benefit considerably from a subscription agreement (Exhibit 16.1). Following the tradition when bits of land are attempts to overcome 'fundamental structural problems' faced by the bridge, the Danish tax minister is proposing a tax deduction for people to cummute across the bridge in order to encourage greater use.[1]

Questions

1. Why do you think the forecasts for national or international prestige projects, including the Anglo-French Concorde, Britain's Millennium Dome and Humber Bridge, are so far off target? Is price *the* problem?
2. Since it looks like these prestige projects will never cover their costs, never mind produce a financial return on investment made, what criteria should be used in evaluating pricing alternatives?
3. Suggest an alternative pricing schedule for the Oresund Bridge, giving the reasons for your pricing decision.

Introduction

Companies today face a fierce and fast-changing pricing environment. The recent economic downturn has put many companies in a 'pricing vice'. One analyst sums it up this way: 'They have virtually no pricing power. It's impossible to raise prices, and often, the pressure to slash them continues unabated. The pricing pinch is affecting business across the spectrum of manufacturing and services – everything from chemicals and autos to hoteliers and phone services.'[2] It seems that almost every company is slashing prices, and that is hurting their profits.

Yet, cutting prices is often not the best answer. Reducing prices unnecessarily can lead to lost profits and damaging price wars. It can signal to customers that price is more important than the brand. Instead, companies should 'sell value, not price'.[3] They should persuade customers that paying a higher price for the company's brand is justified by the greater value it delivers. Most customers will gladly pay a fair price in exchange for real value. The challenge is to find the price that will let the company make a fair profit by harvesting the customer value it creates. According to one pricing expert, pricing involves 'harvesting your profit potential'.[4] If effective product development, promotion and distribution sow the seeds of business success, effective pricing is the harvest. Firms successful at creating customer value with the other marketing mix activities must still capture some of this value in the prices they earn. Yet, despite its importance, many firms do not handle pricing well.

In this chapter, we will focus on the problem of setting prices and the development of pricing strategies and programmes. First, we define price and evaluate the internal and external factors that marketers must consider when setting prices. Next, we examine general pricing approaches. Finally, we address pricing strategies available to marketers – new-product pricing strategies, product mix pricing strategies, price adjustment strategies based on buyer and situational factors, and price reaction strategies.

What is price?

All products and services have a price, just as they have a value. Many non-profit and all profit-making organisations must also set prices, be they for crossing some water (as in the prelude case) or the price of Madonna's Brixton Academy comeback celebration-cum-concert tickets for those who cannot get them officially. *Pricing* is controversial and goes by many names:

> Price is all around us. You pay *rent* for your apartment, *tuition* for your education and a *fee* to your physician or dentist. The airline, railway, taxi and bus companies charge you a *fare*; the local utilities call their price a *rate*; and the local bank charges you *interest* for the money you borrow . . . The guest lecturer charges an *honorarium* to tell you about a government official who took a *bribe* to help a shady character steal *dues* collected by a trade association. Clubs or societies to which you belong may make a special *assessment* to pay unusual expenses. Your regular lawyer may ask for a *retainer* to cover her services. The 'price' of an executive is a *salary*, the price of a salesperson may be a *commission* and the price of a worker is a *wage*. Finally, although economists would disagree, many of us feel that *income taxes* are the price we pay for the privilege of making money.[5]

In the narrowest sense, **price** is the amount of money charged for a product or service. More broadly, price is the sum of all the values that consumers exchange for the benefits of having or using the product or service. In the past, price has been the major factor affecting buyer choice. This is still the case in poorer countries, among less affluent groups and with commodity products. However, non-price factors have become more important in buyer-choice behaviour in recent decades.

Price—The amount of money charged for a product or service, or the sum of the values that consumers exchange for the benefits of having or using the product or service.

Historically, prices were set by negotiation between buyers and sellers. Through bargaining, they would arrive at an acceptable price. Individual buyers paid different prices for the same products, depending on their needs and bargaining skills. By contrast, fixed-price policies – setting *one* price for *all* buyers – is a relatively modern idea that evolved with the development of large-scale retailing at the end of the nineteenth century. F.W. Woolworth and other retailers advertised a 'strictly one-price policy' because they carried so many items and had so many employees.

Now, some 100 years later, the Internet promises to reverse the fixed pricing trend and take us back to an era of **dynamic pricing** – charging different prices depending on individual customers and situations. The Internet, corporate networks and wireless communications are connecting sellers and buyers as never before. Websites such as Compare.Net and PriceScan.com allow buyers to compare products and prices quickly and easily. Online auction sites such as eBay.com and Amazon.com Auctions make it easy for buyers and sellers to negotiate prices on thousands of items – from refurbished computers to antique tin trains. Sites like Priceline even let customers set their own prices. At the same time, new technologies allow sellers to collect detailed data about customers' buying habits, preferences and even spending limits, so they can tailor their products and prices.[6]

Dynamic pricing—Charging different prices depending on individual customers and situations.

Price is the only element in the marketing mix that produces revenue; all other elements represent costs. Price is also one of the most flexible elements of the marketing mix. Unlike product features and channel commitments, price can be changed quickly. At the same time, pricing and price competition is the number one problem facing many marketers. Yet, many companies do not handle pricing well. One frequent problem is that companies are too quick to cut prices in order to gain a sale rather than convincing buyers that their products or services are worth a higher price. Other common mistakes are: pricing that is too cost-oriented rather than customer-value oriented; prices that are not revised often enough to reflect market changes; pricing that does not take the rest of the marketing mix into account; and prices that are not varied enough for different products, market segments and buying occasions.

Factors to consider when setting prices

A company's pricing decisions are affected both by internal company factors and by external environmental factors (see Figure 16.1).[7]

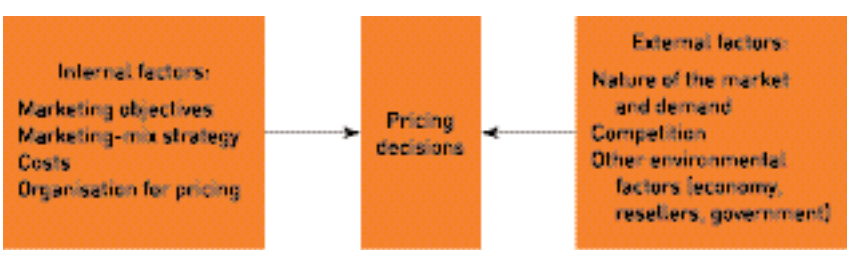


Figure 16.1 Factors affecting price decisions

Internal factors affecting pricing decisions

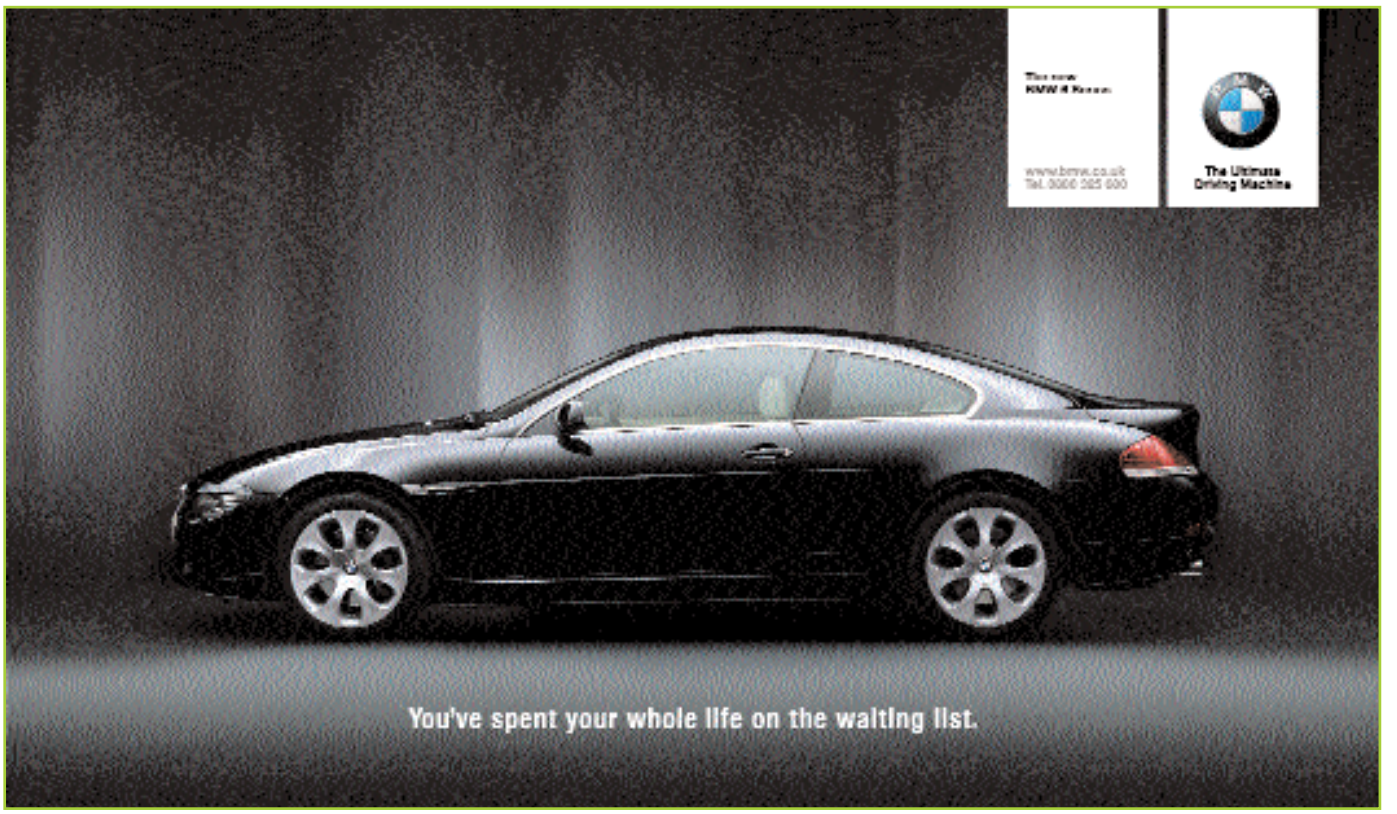
Internal factors affecting pricing include the company's marketing objectives, marketing-mix strategy, costs and organisation.

Marketing objectives

Before setting price, the company must decide on its strategy for the product. If the company has selected its target market and positioning carefully, then its marketing-mix strategy, including price, will be fairly straightforward. For example, when Toyota decided to produce its Lexus cars to compete with European luxury cars in the higher-income segment, this required charging a high price. Sleep Inn and Travelodge position themselves as motels that provide economical rooms for budget-minded travellers, a position that requires charging a low price. Thus pricing strategy is largely determined by past decisions on market positioning.

At the same time, the company may seek additional objectives. A firm that has clearly defined its objectives will find it easier to set price. Examples of common objectives are *survival*, *current profit maximisation*, *market-share maximisation* and *product-quality leadership*.

Companies set *survival* as their fundamental objective if they are troubled by too much capacity, heavy competition or changing consumer wants. To keep a factory going, a company may set a low price through periods of low demand, hoping to increase prices when demand



Marketing objectives: the price that BMW has set for its new 6 Series Coupé is consistent with its exclusive image and positioning – a car you've waited long enough for will not come 'cheap'.
SOURCE: BMW Great Britain. *Agency*: WCRS

recovers. In the public sector, such as with Britain's Millennium Dome, *survival* became the issue when government tired of demands for subsidy. In this case, profits are less important than survival. As long as their prices cover variable costs and some fixed costs, they can stay in business.[8] However, survival is only a short-term objective. In the long run, the firm must learn how to add value or face extinction.

Many companies use *current profit maximisation* as their pricing goal. They estimate what demand and costs will be at different prices and choose the price that will produce the maximum current profit, cash flow or return on investment. In all cases, the company wants current financial results rather than long-run performance. Other companies want to obtain *market-share leadership*. They believe that the company with the largest market share will enjoy the lowest costs and highest long-run profit. To become the market-share leader, these firms set prices as low as possible.

A variation of this objective is to pursue a specific *market-share gain*. Say the company wants to increase its market share from 10 per cent to 15 per cent in one year. It will search for the price and marketing programme that will achieve this goal.

Digital television transmission is set to make the current analogue television as outdated as 16 mm cine film or vinyl albums. It produces cinema-quality pictures while cramming hundreds of channels through the wavebands needed for a dozen analogue transmissions. Seeing its mould-breaking potential, satellite television company BSkyB was determined to fight for market leadership of digital television transmission. BSkyB's consortium of BT, HSBC and Matsushita subsidised its TV set-top converters by €1 billion, almost giving them away although they cost over €500 each to produce.

In pricing its set-top boxes below cost, BSkyB aims to increase its market share and long-term profitability by considering the long-term cash flows that result from the customer's subscription. In this case the income will come from access charges to BSkyB's channels.

A company might decide that it wants to achieve *product-quality leadership*. This normally calls for charging a high price to cover such quality and the high cost of R&D:

For example, Jaguar's limited edition XJ220 sold for £400,000 (€600,000) each, but had wealthy customers queuing to buy one. Pitney Bowes pursues a product-quality leadership strategy for its fax equipment. While Sharp, Canon and other competitors fight over the low-price fax machine market with machines selling at around €600, Pitney Bowes targets large corporations with machines selling at about €6,000. As a result, it captured some 45 per cent of the large-corporation fax niche. Less exotically, at the height of the 1990s baked bean price wars, Heinz's strategy was to set the price at 2p above the price of supermarket own-label baked beans. As retailers slashed prices, so did Heinz. At one point, retailers' cheapest can of beans cost as little as 3 pence. Heinz realised that this was crazy. So, it decided to price up rather than down. The company invested in the quality of the product; it added ring-pull ends on the cans for easy opening and reinvested in TV advertising. Heinz's market share went up.[9]

A company might also use price to attain other more specific objectives. It can set prices low to prevent competition from entering the market or set prices at competitors' levels to stabilise the market:

> Leading UK grocery retailers Sainsbury and Tesco used 'Essentials' and 'Everyday super value range' campaigns to counter the attack of discounters Aldi and Netto on the UK market. Originally projected to take 20 per cent of the grocery market by 2000, forecasters later predicted the discounters would take only 12 per cent.[10]

Prices can be set to keep the loyalty and support of resellers or to avoid government intervention. Prices can be reduced temporarily to create excitement for a product or to draw more customers into a retail store. One product may be priced to help the sales of other products in the company's line. Thus pricing may play an important role in helping to accomplish the company's objectives at many levels.

Non-profit and public organisations may adopt a number of other pricing objectives. A university aims for *partial cost recovery*, knowing that it must rely on private funds or endowments and public grants to cover the remaining costs. A non-profit hospital may aim for *full cost recovery* in its pricing. A non-profit theatre company may price its productions to fill the maximum number of theatre seats. A social service agency may set a *social price* geared to the varying income situations of different clients.

Marketing-mix strategy

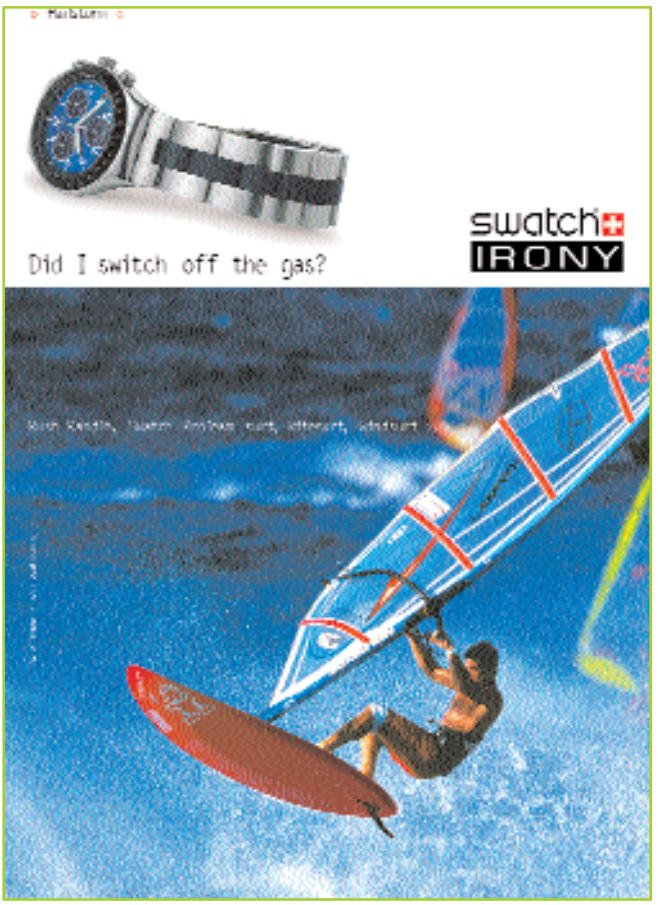
Price is only one of the marketing-mix tools that a company uses to achieve its marketing objectives. Price decisions must be coordinated with product design, distribution and promotion decisions to form a consistent and effective marketing programme. Decisions made for other marketing-mix variables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

Companies often make their pricing decisions first and then base other marketing-mix decisions on the prices that they want to charge. Here, price is a crucial product-positioning factor that defines the product's market, competition and design. The intended price determines what product features can be offered and what production costs can be incurred.

Target costing—A technique to support pricing decisions, which starts with deciding a target cost for a new product and works back to designing the product.

Many firms support such price-positioning strategies with a technique called **target costing**, a potent strategic weapon. Target costing reverses the usual process of first designing a new product, determining its cost and then asking 'Can we sell it for that?'. Instead, it starts with a target cost and works back:

> When starting up, Swatch surveyed the market and identified an unserved segment of watch buyers who wanted 'a low-cost fashion accessory that also keeps time'. Armed with this information about market needs, Swatch set out to give consumers the watch they wanted at a price they were willing to pay, and it managed the new product's costs accordingly. Like most watch buyers, targeted consumers were concerned about precision, reliability and durability. However, they were also concerned about fashion and affordability.

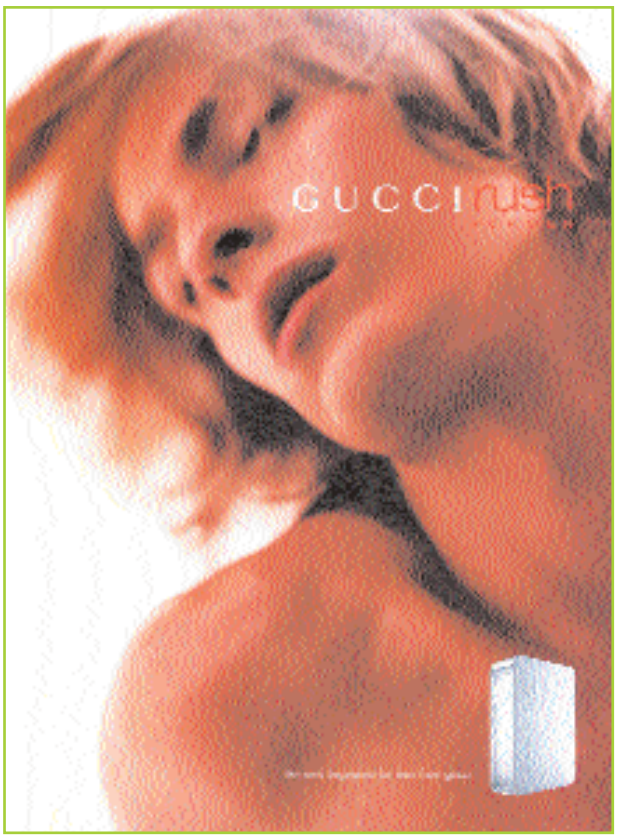


Target costing: by managing costs carefully, Swatch was able to create a watch that offered just the right blend of fashion and function at a price consumers were willing to pay.
SOURCE: Courtesy of Swatch Ltd.

To keep costs down, Swatch designed fashionable simpler watches that contained fewer parts and that were constructed from high-tech but less expensive materials. It then developed a revolutionary automated process for mass-producing the new watches and exercised strict cost controls throughout the manufacturing process. By managing costs carefully, Swatch was able to create a watch that offered just the right blend of fashion and function at a price consumers were willing to pay. As a result of its initial major success, consumers have placed increasing value on Swatch products, allowing the company to introduce successively higher-priced designs.[11]

Other companies de-emphasise price and use other marketing-mix tools to create *non-price* positions. Often, the best strategy is not to charge the lowest price, but rather to differentiate the marketing offer to make it worth a higher price.

London's City Airport and the airlines that fly from there do not compete on price. Instead they offer the retailing, speed of processing and convenience wanted by frequent-flying executives. In this case less means more. City's compact terminal has no burger bars, no video arcades and no air bridges.



Gucci's very strong image and reputation as a prestigious brand mean that customers are willing to pay for the fashion house's expensive fragrances.
SOURCE: Advertising Archives.

> Surveys show that City Airport's regular users prefer using the aircraft's own stairs and braving the English weather rather than wait, hunched under luggage racks while air bridges are connected.[12]

Thus the marketer must consider the total marketing mix when setting prices. If the product is positioned on non-price factors, then decisions about quality, promotion and distribution will strongly affect price. If price is a crucial positioning factor, then price will strongly affect decisions made about the other marketing-mix elements. Even so, marketers should remember that buyers rarely buy on price alone. Instead, they seek product and service offerings that give them the best value in terms of benefits received for the price paid.

Costs

Costs set the floor for the price that the company can charge for its product. The company wants to charge a price that both covers all its costs for producing, distributing and selling the product, and delivers a fair rate of return for its effort and risk. A company's costs may be an important element in its pricing strategy. Many companies work to become the 'low-cost producers' in their industries. Companies with lower costs can set lower prices that result in greater sales and profits.

Types of cost

Fixed costs—Costs that do not vary with production or sales level.

A company's costs take two forms, fixed and variable. **Fixed costs** (also known as overheads) are costs that do not vary with production or sales level. For example, a company must pay

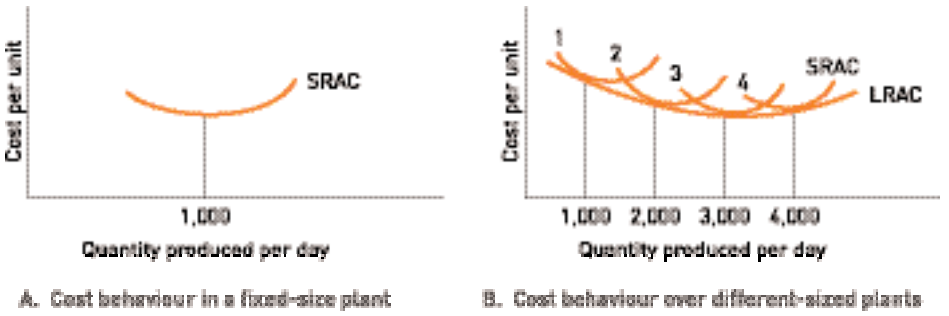


Figure 16.2 Cost per unit at different levels of production

each month's bills for rent, heat, interest and executive salaries, whatever the company's output. In many industries, such as airlines, fixed costs dominate. If an airline has to fly a sector with few passengers on board it can only save on the 15 per cent of its costs accounted for by cabin crew and passenger service. All other costs, including flight crew (7 per cent), fuel (15 per cent) and maintenance (10 per cent), are fixed.[13]

Variable costs vary directly with the level of production. Each personal computer produced involves a cost of computer chips, wires, plastic, packaging and other inputs. These costs tend to be the same for each unit produced, their total varying with the number of units produced.

Variable costs—Costs that vary directly with the level of production.

Total costs are the sum of the fixed and variable costs for any given level of production. Management wants to charge a price that will at least cover the total production costs at a given level of production. The company must watch its costs carefully. If it costs the company more than competitors to produce and sell its product, the company will have to charge a higher price or make less profit, putting it at a competitive disadvantage.

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

Costs at different levels of production

To price wisely, management needs to know how its costs vary with different levels of production. For example, consider Roberts, a maker of high-quality radios owned by the Irish domestic appliance company, Glen Dimplex. Glen Dimplex seeks to add new and innovative products to the Roberts range. It builds a plant to produce 1,000 Roberts luxury travel clocks per day. Figure 16.2A shows the typical short-run average cost curve (SRAC). It shows that the cost per clock is high if Roberts' factory produces only a few per day. But as production moves up to 1,000 clocks per day, average cost falls. This is because fixed costs are spread over more units, with each one bearing a smaller fixed cost. Roberts can try to produce more than 1,000 clocks per day, but average costs will increase because the plant becomes inefficient. Workers have to wait for machines, the machines break down more often and workers get in each other's way.

If Roberts believed it could sell 2,000 clocks a day, it should consider building a larger plant. The plant would use more efficient machinery and work arrangements. Also, the unit cost of producing 2,000 units per day would be lower than the unit cost of producing 1,000 units per day, as shown in the long-run average cost (LRAC) curve (Figure 16.2B). In fact, a 3,000-capacity plant would be even more efficient, according to Figure 16.2B. But a 4,000 daily production plant would be less efficient because of increasing diseconomies of scale – too many workers to manage, paperwork slows things down and so on. Figure 16.2B shows that a 3,000 daily production plant is the best size to build if demand is strong enough to support this level of production.

Costs as a function of production experience

Suppose Roberts runs a plant that produces 3,000 clocks per day. As Roberts gains experience in producing hand-held clocks, it learns how to do it better. Workers learn short-cuts and become more familiar with their equipment. With practice, the work becomes better

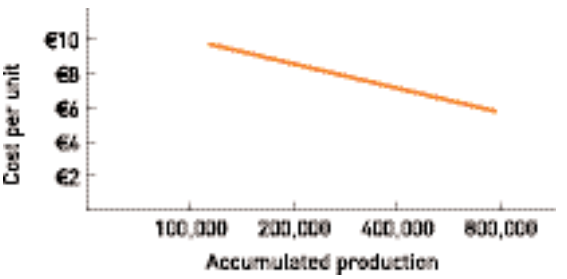


Figure 16.3 Cost per unit as a function of accumulated production: the experience curve

organised and Roberts finds better equipment and production processes. With higher volume, Roberts becomes more efficient and gains economies of scale. As a result, average cost tends to fall with accumulated production experience. This is shown in Figure 16.3.[14] Thus the average cost of producing the first 100,000 clocks is €10 per clock. When the company has produced the first 200,000 clocks, the average cost has fallen to €9. After its accumulated production experience doubles again to 400,000, the average cost is €7. This drop in the average cost with accumulated production experience is called the **experience curve** (or **learning curve**).

Experience curve (learning curve)—The drop in the average per-unit production cost that comes with accumulated production experience.

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

Some companies have built successful strategies around the experience curve. For example, during the 1980s, Bausch & Lomb consolidated its position in the soft contact lens market by using computerised lens design and steadily expanding its one Soflens plant. As a result, its market share climbed steadily to 65 per cent. Yet a single-minded focus on reducing costs and exploiting the experience curve will not always work. Experience curves became somewhat of a fad during the 1970s and, like many fads, the strategy was sometimes misused. Experience-curve pricing carries some serious risks. The aggressive pricing might give the product a cheap image. The strategy also assumes that competitors are weak and not willing to fight it out by meeting the company's price cuts. Finally, while the company is building volume under one technology, a competitor may find a lower-cost technology that lets it start at lower prices than the market leader, who still operates on the old experience curve.

Organisational considerations

Management must decide who within the organisation should set prices. Companies handle pricing in a variety of ways. In small companies, prices are often set by top management rather than by the marketing or sales departments. In large companies, pricing is typically handled by divisional or product line managers. In industrial markets, salespeople may be allowed to negotiate with customers within certain price ranges. Even so, top management sets the pricing objectives and policies, and it often approves the prices proposed by lower-level management or salespeople. In industries in which pricing is a key factor (such as in aerospace, steel and oil), companies will often have a pricing department to set the best prices or help others in setting them. This department reports to the marketing department or top management. Others who have an influence on pricing include sales managers, production managers, finance managers and accountants.

External factors affecting pricing decisions

Pricing decisions are affected by external factors such as the nature of the market and demand, competition and other environmental elements.

The market and demand

Whereas costs set the lower limit of prices, the market and demand set the upper limit. Both consumer and industrial buyers balance the price of a product or service against the benefits of owning it. Thus, before setting prices, the marketer must understand the relationship between price and demand for its product. In this section, we explain how the price–demand relationship varies for different types of market and how buyer perceptions of price affect the pricing decision. We then discuss methods for measuring the price–demand relationship.

Pricing in different types of market

The seller's pricing freedom varies with different types of market. Economists recognise four types of market, each presenting a different pricing challenge.

Under **pure competition**, the market consists of many buyers and sellers trading in a uniform commodity such as wheat, copper or financial securities. No single buyer or seller has much effect on the going market price. A seller cannot charge more than the going price because buyers can obtain as much as they need at the going price. Nor would sellers charge less than the market price because they can sell all they want at this price. If price and profits rise, new sellers can easily enter the market. In a purely competitive market, marketing research, product development, pricing, advertising and sales promotion play little or no role. Thus sellers in these markets do not spend much time on marketing strategy.

Pure competition—A market in which many buyers and sellers trade in a uniform commodity – no single buyer or seller has much effect on the going market price.

Under **monopolistic competition**, the market consists of many buyers and sellers that trade over a range of prices rather than a single market price. A range of prices occurs because sellers can differentiate their offers to buyers. Either the physical product can be varied in quality, features or style or the accompanying services can be varied. Each company can create a quasi-monopoly for its products because buyers see differences in sellers' products and will pay different prices for them. Sellers try to develop differentiated offers for different customer segments and, in addition to price, freely use branding, availability, advertising and personal selling to set their offers apart. For example, Ty's Beanie Babies have cultivated a distinctive appeal that has both stimulated demand and seen the price of some Beanies rocket.[15]

Monopolistic competition—A market in which many buyers and sellers trade over a range of prices rather than a single market price.

Under **oligopolistic competition**, the market consists of a few sellers that are highly sensitive to each other's pricing and marketing strategies. The product can be uniform (steel, aluminium) or non-uniform (cars, computers). There are few sellers because it is difficult for new sellers to enter the market. Each seller is alert to competitors' strategies and moves. If a steel company slashes its price by 10 per cent, buyers will quickly switch to this supplier. The other steel makers must respond by lowering their prices or increasing their services. An oligopolist is never sure that it will gain anything permanent through a price cut. In contrast, if an oligopolist raises its price, its competitors might not follow this lead. The oligopolist would then have to retract its price increase or risk losing customers to competitors.

Oligopolistic competition—A market in which there are a few sellers that are highly sensitive to each other's pricing and marketing strategies.

In a **pure monopoly**, the market consists of one seller. The seller may be a government monopoly (a postal service), a private regulated monopoly (a power company) or a private non-regulated monopoly (Microsoft Windows). Pricing is handled differently in each case. A government monopoly can pursue a variety of pricing objectives: set price below cost because the product is important to buyers who cannot afford to pay full cost; set price either to cover costs or to produce good revenue; or set price quite high to slow down consumption or to protect an inefficient supplier. In a regulated monopoly, the government permits the company to set rates that will yield a 'fair return', one that will let the company maintain and expand its operations as needed. Non-regulated monopolies are free to price at what the

Pure monopoly—A market in which there is a single seller – it may be a government monopoly, a private regulated monopoly or a private non-regulated monopoly.

market will bear. However, they do not always charge the full price for a number of reasons: a desire not to attract competition, a desire to penetrate the market faster with a low price, or a fear of government regulation.

Consumer perceptions of price and value

In the end, the consumer will decide whether a product's price is right. When setting prices, the company must consider consumer perceptions of price and how these perceptions affect consumers' buying decisions. Pricing decisions, like other marketing-mix decisions, must be buyer-oriented.

When consumers buy a product, they exchange something of value (the price) to get something of value (the benefits of having or using the product). Effective, buyer-oriented pricing involves understanding how much value consumers place on the benefits they receive from the product and setting a price that fits this value. These benefits can be actual or perceived. For example, calculating the cost of ingredients in a meal at a fancy restaurant is relatively easy. But assigning a value to other satisfactions such as taste, environment, relaxation, conversation and status is very hard. And these values will vary both for different consumers and in different situations.

> Functional confectionery, such as Clorets or Fisherman's Friend, offers tangible problem solutions that customers value. These products may cost little more to make than conventional sugar-based confectionery, such as Polo Mints or Rowntree's Fruit Pastilles, but customers value their physical performance. Makers of these products do not rely on consumers' perception of their brand's value, but convey the products on the pack and by promotions. For instance, the flavour, strength and packaging of Hall's Mentho-Lyptus is fine-tuned for local markets but remains true to its core benefit: throat soothing.

Thus the company will often find it hard to measure the values that customers will attach to its product. But consumers do use these values to evaluate a product's price. If customers perceive that the price is greater than the product's value, they will not buy the product. If consumers perceive that the price is below the product's value, they will buy it, but the seller loses profit opportunities.

Marketers must therefore try to understand the consumer's reasons for buying the product and set the price according to consumer perceptions of the product's value. Because consumers vary in the values they assign to different product features, marketers often vary their pricing strategies for different segments. They offer different sets of product features at different prices. For example, Philips offers €250 small 41 cm portable TV models for consumers who want basic sets and €1,200 68 cm 100-Hz Nicam stereo models loaded with features for consumers who want the extras.

Analysing the price–demand relationship

Each price the company might charge leads to a different level of demand. The relation between the price charged and the resulting demand level is shown in the demand curve in Figure 16.4A. The demand curve shows the number of units that the market will buy in a given time period at different prices that might be charged. In the normal case, demand and price are inversely related: that is, the higher the price, the lower the demand. Thus the company would sell less if it raised its price from P_1 to P_2. In short, consumers with limited budgets will probably buy less of something if its price is too high.

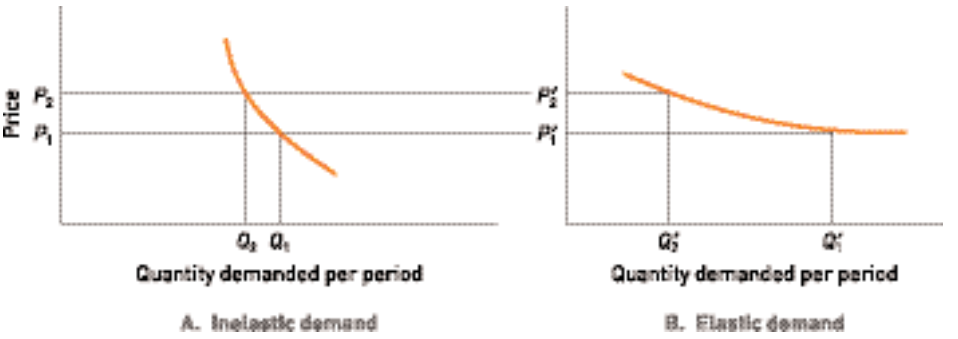


Figure 16.4 Inelastic and elastic demand

In the case of prestige goods, the demand curve sometimes slopes upward. Consumers think that higher prices mean more quality.

> When Gibson Guitars lowered its prices to compete more effectively with Japanese rivals like Yamaha and Ibanez the result was not what they expected. Gibson found that its instruments didn't sell as well at lower prices. 'We had an inverse [price–demand relationship]', noted Gibson's chief executive officer. 'The more we charged, the more product we sold.' Gibson's slogan promises: 'The world's finest musical instruments'. It turns out that low prices simply aren't consistent with 'Gibson's century-old tradition of creating investment-quality instruments that represent the highest standards of imaginative design and masterful craftsmanship'.[16]

However, even for prestige products, if the price is too high, demand will reduce.

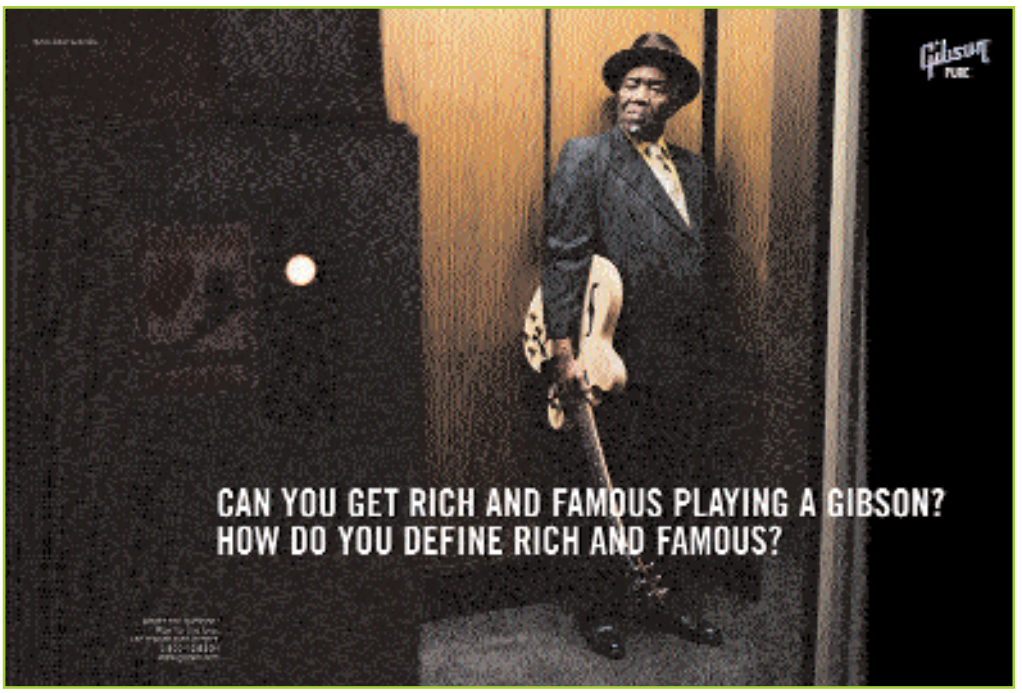
Most companies try to measure their demand curves by estimating demand at different prices. The type of market makes a difference. In a monopoly, the demand curve shows the total market demand resulting from different prices. If the company faces competition, its demand at different prices will depend on whether competitors' prices stay constant or change with the company's own prices. Here, we will assume that competitors' prices remain constant. Later in this chapter, we will discuss what happens when competitors' prices change.

In measuring the price–demand relationship, the market researcher must not allow other factors affecting demand to vary. For example, if Philips increased its advertising at the same time that it lowered its television prices, we would not know how much of the increased demand was due to the lower prices and how much was due to the increased advertising. The same problem arises if a holiday weekend occurs when the lower price is set – more gift-giving over some holidays causes people to buy more portable televisions. Economists show the impact of non-price factors on demand through shifts in the demand curve rather than movements along it.

Price elasticity of demand

Marketers also need to know **price elasticity** – how responsive demand will be to a change in price. Consider the two demand curves in Figure 16.4. In Figure 16.4A, a price increase from P_1 to P_2 leads to a relatively small drop in demand from Q_1 to Q_2. In Figure 16.4B, however, a similar price increase leads to a large drop in demand from Q_1' to Q_2'. If demand hardly changes with a small change in price, we say the demand is *inelastic*. If demand changes greatly, we say the demand is *elastic*. The price elasticity of demand is given by the following formula:

Price elasticity—A measure of the sensitivity of demand to changes in price.



The demand curve sometimes slopes upward: Gibson was surprised to learn that its high-quality instruments didn't sell as well at lower prices.
SOURCE: Courtesy of Gibson Guitar.

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

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

What determines the price elasticity of demand? Buyers are less price sensitive when the product they are buying is unique or when it is high in quality, prestige or exclusiveness. They are also less price sensitive when substitute products are hard to find or when they cannot easily compare the quality of substitutes. Finally, buyers are less price sensitive when the total expenditure for a product is low relative to their income or when another party shares the cost.[17]

If demand is elastic rather than inelastic, sellers will consider lowering their price. A lower price will produce more total revenue. This practice makes sense as long as the extra costs of producing and selling more do not exceed the extra revenue. At the same time, most firms want to avoid pricing that turns their products into commodities. In recent years, forces such as deregulation and the instant price comparisons afforded by the Internet and other technologies have increased consumer price sensitivity, turning products ranging from telephones and computers to new automobiles into commodities in consumers' eyes. Marketers need to work harder than ever to differentiate their offerings when a dozen competitors are selling virtually the same product at a comparable or lower price. More than ever, companies need to understand the price sensitivity of their customers and prospects and the trade-offs people are willing to make between price and product characteristics.

Action	Regular price	10% discount	Percentage change
Sales			
Price (€)	1.00	0.90	
Sales volume	100	105	
Sales value (€)	100.00	94.50	(5.5)
Cost of goods sold			
Unit cost (€)	0.50	0.50	
Sales (units)	100	105	
Cost (€)	50.00	52.50	5.0
Gross profit	50.00	42.00	(16.0)
Other trading expenses	40.00	40.00	0.0
Net profit	10.00	2.00	(80.0)
Return on sales (%)	10.0	2.1	

Table 16.1 How discounts influence sales and profits

Price influence on profits

Increasing *sales volume* in items sold is the driving force behind much marketing activity. There are good reasons for this: increased sales show success and a growing company, increased market share shows competitive success and, if sales do not match production, capacity will be underused or customers disappointed.

Unfortunately, when price is used to increase sales volume, *sales value* – the proceeds from sales – may reduce. *Sales value* and *sales volume* do not always move hand in hand. A company that increases sales by 5 per cent by cutting prices by 10 per cent increases sales volume but reduces sales value, as the example in Table 16.1 shows.

Gross profit is the difference between net proceeds from sales and the cost of goods sold. The costs are the variable costs incurred each time a product is made. They typically include raw materials, labour, energy and so on. The interplay between gross profit and price is dramatic. The once popular idea of 'everyday low prices' increased sales volumes and value, but not always by enough to cover lost margins. The example in Table 16.1 shows that the 10 per cent price cut has much more impact on *gross profits* than do sales.

Net profit is the surplus remaining after all costs have been taken. The gross profit shows the contribution made to the company by each unit sold, but neglects many other trading expenses incurred by a company. These included fixed costs like rates and staff, and strategic expenditure like research and development. Interest paid on debts is sometimes not included because this depends upon the capital structure of the company. The fixed cost means that *net profit* is more volatile than *gross profit* (see Table 16.1). This sensitivity encourages companies to convert some of their fixed costs into variable ones: for example, hiring trucks rather than buying them.

Net profit—The difference between the income from goods sold and all expenses incurred.

Return on sales (or *margin*) measures the ratio of profit to sales:

$$\text{Return on sales} = \frac{\text{Net profit}}{\text{Sales}}$$

This is useful in comparing businesses over time. During a four-year period a company may find both sales and net profit increasing, but are profits keeping pace with sales? In Table 16.1 the 10 per cent price promotion gives an increase in sales volume, but a big reduction in return on sales. The interplay between price, sales, profits and investment makes these and other ratios central to marketing decision making and control. Marketing Insights 16.1 introduces *Economic Value Added* (EVA), a measure that has become increasingly important in recent years.

marketing insights

16.1 Economic Value Added

Return on capital employed (ROCE)

Some companies, such as grocery chains, have low returns on sales but are profitable. They achieve this because the critical measure is return on capital employed. This is the product of return on sales (ROS) and the speed at which assets are turned over (the activity ratio):

$$\text{ROCE} = \text{ROS} \times \text{ACTIVITY} = \frac{\text{NP}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Assets}}$$

By turning over its assets four times each year, a supermarket can achieve a 20 per cent return on capital employed although its return on sales is only 5 per cent, while an exclusive clothes shop has very high margins but turns its assets over slowly.

$$\text{Supermarket ROCE} = \frac{5}{100} \times \frac{100}{25} = 20 \text{ per cent}$$

$$\text{Clothes shop ROCE} = \frac{40}{100} \times \frac{100}{300} = 13.3 \text{ per cent}$$

These are powerful ratios that can define how a company can do business. Aldi, the German discount grocery chain, succeeds with margins half those of many grocers. Its margins are very low (2–3 per cent), but it keeps its return on capital employed high by high stock turnover and keeping its other assets low.

There are two benefits from increasing asset turnover: improved return on capital employed, and reduced fixed costs. The firm that hires trucks rather than buying them reduces its fixed costs and, therefore, its sensitivity to volume changes. Also, by reducing its assets it increases its activity ratio and return on capital employed. Increased asset turnover is one of the direct benefits of just-in-time (JIT) and lean manufacturing. JIT cuts down the assets tied up in stock, and improves quality while lean manufacturing reduces investment in plant.

Capital cost covered (C^3)

Assets cost money and return on capital costs takes that into account. It is a powerful tool because it combines three critical business ratios:

$$C^3 = \text{ROS} \times \text{ACTIVITY} \times \text{CAPITAL EFFICIENCY}$$

$$= \frac{\text{NP}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Assets}} \times \frac{\text{Assets}}{\text{Cost of capital}}$$

The cost of capital is the average cost of debt and shareholder equity. For a supermarket the figure is 10 per cent per year. With assets of €25 million, the cost of capital is €25m × 0.10 = €2.5m, giving:

...16.1

$$C^3 = \frac{5}{100} \times \frac{100}{25} \times \frac{25}{2.5} = \frac{NP}{CC} = 2.0$$

In other words, the net profit is double the capital cost – the company is healthy. This ratio is more discriminating than the familiar distinction between profit and loss. If the capital cost covered is below zero, a firm is making a loss. A capital cost covered above zero indicates a profit. However, capital cost covered between zero and 1 shows that a firm is in profit but not adding value – its profit does not cover its cost of capital.

Economic Value Added (EVA)

EVA makes a direct comparison between the cost of capital and net profits. It is a simple idea that has hugely increased the value of companies using it. Many leading companies see EVA as a way of examining the value of their investments and strategy.

The supermarket's EVA is:

EVA = Net profit – Cost of capital = 5 – 2.5 = €2.5m

Profit, economic value added and capital cost covered are related concepts: profit shows how a company's trading is going, economic value added shows a company's wealth creation in monetary terms, while capital cost covered gives the rate of wealth creation.

Category	C^3	EVA	NP	Economic state
I	>1	>0	>0	A profitable company which is adding economic value
II	0–1	<0	>0	A company whose profits do not cover the cost of capital
III	<0	<0	<0	A loss-making company

The supermarket is a clear category I company. This contrasts with the clothes store whose capital, at 16.25 per cent, is more expensive because the clothes market is cyclical and fashion-dependent. Assets of €300 million give a capital cost of €48.75 million.

	C^3	EVA (€m)	NP (€m)	Category
Supermarket	2.0	2.5	5	I
Clothes store	0.8	(9.5)	40	II

Many of the *dot bombs* (dotcom companies that went bust) never strayed beyond being category III companies, never making any net profits (NP < 0) after having a high advertising spend with low margins and sales volume.

SOURCES: Ross Tieman, 'Innovation and business agility is vital to success', *Special Report FT Management: Customer Relations. Financial Times* (19 May 2003), p. II; Neil Buckley, 'Potential cost of selling it cheap every day', *Financial Times* (24 March 1994), p. 17; 'Valuing companies: a star to sail by?', *The Economist* (2 August 1997), pp. 61–3.

Competitors' costs, prices and offers

Another external factor affecting the company's pricing decisions is competitors' costs and prices, and possible competitor reactions to the company's own pricing moves. A consumer who is considering the purchase of a Canon camera will evaluate Canon's price and value against the prices and values of comparable products made by Nikon, Minolta, Pentax and others. In addition, the company's pricing strategy may affect the nature of the competition it faces. If Canon follows a high-price, high-margin strategy, it may attract competition. A low-price, low-margin strategy, however, may stop competitors or drive them out of the market.

Canon needs to benchmark its costs against its competitors' costs to learn whether it is operating at a cost advantage or disadvantage. It also needs to learn the price and quality of each competitor's offer. Once Canon is aware of competitors' prices and offers, it can use them as a starting point for its own pricing. If Canon's cameras are similar to Nikon's, it will have to price close to Nikon or lose sales. If Canon's cameras are not as good as Nikon's, the firm will not be able to charge as much. If Canon's products are better than Nikon's, it can charge more. Basically, Canon will use price to position its offer relative to the competition.

Other external factors

When setting prices, the company must also consider other factors in its external environment. *Economic conditions* can have a strong impact on the firm's pricing strategies.[18] Economic factors such as boom or recession, inflation and interest rates affect pricing decisions because they affect both the costs of producing a product and consumer perception of the product's price and value. The company must also consider what impact its prices will have on other parties in its environment. How will *resellers* react to various prices? The company should set prices that give resellers a fair profit, encourage their support and help them to sell the product effectively. The *government* is another important external influence on pricing decisions. Finally, *social concerns* may have to be taken into account. In setting prices, a company's short-term sales, market share and profit goals may have to be tempered by broader societal considerations.

General pricing approaches

The price that the company charges will be somewhere between one that is too low to produce a profit and one that is too high to produce any demand. Figure 16.5 summarises the primary considerations in setting price. Product costs set a floor to the price; consumer perceptions of the product's value set the ceiling. The company must consider competitors' prices and other external and internal factors to find the best price between these two extremes.

Companies set prices by selecting a general pricing approach that includes one or more of these three sets of factors – costs, consumer perception and competitors' prices. We will examine the following approaches: the *cost-based approach* (cost-plus pricing, break-even analysis and target profit pricing); the *buyer-based approach* (perceived-value pricing); and the *competition-based approach* (going-rate and sealed-bid pricing).

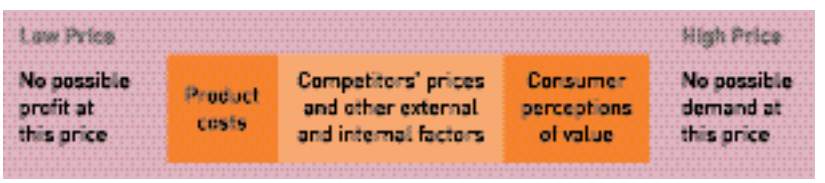


Figure 16.5 Primary considerations in price settings

Cost-based pricing

Cost-plus pricing

Cost-plus pricing—Adding a standard mark-up to the cost of the product.

Mark-up/mark-down—The difference between selling price and cost as a percentage of selling price or cost.

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

To illustrate *mark-up* pricing, suppose a toaster manufacturer had the following costs and expected sales:

Variable cost	€10
Fixed cost	€300,000
Expected unit sales	50,000

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

$$\text{Unit cost} = \text{Variable cost} + \frac{\text{Fixed costs}}{\text{Unit sales}} = €10 + \frac{€300{,}000}{50{,}000} = €16$$

Now suppose the manufacturer wants to earn a 20 per cent mark-up on sales. The manufacturer's mark-up price is given by:

$$\text{Mark-up price} = \frac{\text{Unit cost}}{1.0 - \text{desired return on sales}} = \frac{€16}{1.0 - 0.2} = €20$$

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

Does using standard mark-ups to set prices make logical sense? Generally, no. Any pricing method that ignores demand and competitors' prices is not likely to lead to the best price. Suppose the toaster manufacturer charged €20 but sold only 30,000 toasters instead of 50,000. Then the unit cost would have been higher, since the fixed costs are spread over fewer units and the realised percentage mark-up on sales would have been lower. Mark-up pricing works only if that price actually brings in the expected level of sales. Moreover, what if the firm's costs are too high compared to competitors' costs?

Brio, the Swedish toy producer and the largest toy distributor in Scandinavia, have seen a major drop in both profits and sales for its toys, in recent years. While the Brio brand symbolizes a high quality toy, robust enough to become a family heirloom to be passed down from brother to sister and to the next generation, parents see Brio toys as being far too expensive. Besides, these days, parents can buy basic toy products of the same quality from supermarket chains and furniture retailers like Ikea, who are churning out their own private-label wooden toys, notably train sets, at a fraction the price Brio charges. Brio realizes that in its quest to fulfil its vision of 'the good toy',

the company had ignored the question of whether parents were able to afford to buy it. The company had placed too much emphasis on the value (premium) of the toys and not enough on their cost![19]

Still, mark-up pricing remains popular for a number of reasons. First, sellers are more certain about costs than about demand. By tying the price to cost, sellers simplify pricing – they do not have to make frequent adjustments as demand changes. Second, when all firms in the industry use this pricing method, prices tend to be similar and price competition is thus minimised. Third, many people feel that cost-plus pricing is fairer to both buyers and sellers. Sellers earn a fair return on their investment, but do not take advantage of buyers when buyers' demand increases.

Break-even analysis and target profit pricing

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

Another cost-oriented pricing approach is **break-even pricing** or a variation called **target profit pricing**. The firm tries to determine the price at which it will break even or make the target profit it is seeking. Target pricing is used by General Motors, which prices its cars to achieve a 15–20 per cent profit on its investment. This pricing method is also used by public utilities, which are constrained to make a fair return on their investment. Target pricing uses the concept of a *break-even chart*, which shows the total cost and total revenue expected at different sales volume levels. Figure 16.6 shows a break-even chart for the toaster manufacturer discussed here. Fixed costs are €300,000 regardless of sales volume. Variable costs are added to fixed costs to form total costs, which rise with volume. The total revenue curve starts at zero and rises with each unit sold. The slope of the total revenue curve reflects the price of €20 per unit.

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

$$\text{Break-even volume} = \frac{\text{Fixed cost}}{\text{Price} - \text{Variable cost}} = \frac{€300{,}000}{€20 - €10} = 30{,}000$$

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

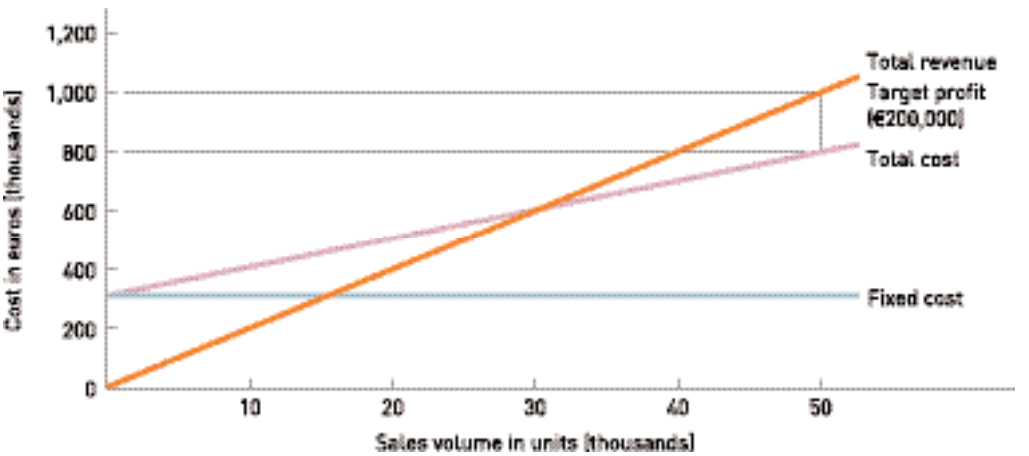


Figure 16.6 Break-even chart for determining target price

(1) Price (€)	(2) Unit demand needed to break even (000)	(3) Expected unit demand at given price (000)	(4) Total revenues = (1) × (3) (€000)	(5) Total cost* (€000)	(6) Profit = (4) – (5) (€000)
14	75	71	994	1,010	–16
16	50	67	1,072	970	102
18	37.5	60	1,080	900	180
20	30	42	840	720	120
22	25	23	506	530	–24

*Assumes a fixed cost of €300,000 and a constant unit variable cost of €10.

Table 16.2 Break-even volume and profits at different prices

The manufacturer should consider different prices and estimate break-even volumes, probable demand and profits for each. This is done in Table 16.2. The table shows that as price increases, break-even volume drops (column 2). But as price increases, demand for the toasters also falls off (column 3). At the €14 price, because the manufacturer clears only €4 per toaster (€14 less €10 in variable costs), it must sell a very high volume to break even. Even though the low price attracts many buyers, demand still falls below the high break-even point and the manufacturer loses money. At the other extreme, with a €22 price, the manufacturer clears €12 per toaster and must sell only 25,000 units to break even. But at this high price, consumers buy too few toasters and profits are negative. The table shows that a price of €18 yields the highest profits. Note that none of the prices produces the manufacturer's target profit of €200,000. To achieve this target return, the manufacturer will have to search for ways to lower fixed or variable costs, thus lowering the break-even volume.

Airbus Industries base their forecasts for their superjumbo A3XX on the superior breakeven that it will offer airlines who buy it. Although much larger than its major competitor, the Boeing B747–400, the A3XX operating cost means that it breaks even at a fraction of its total capacity.[20]

Aircraft	Boeing 747–400	Airbus A3XX
Passenger capacity	413	555
Break-even: passengers	290	323
Profitable seats: beyond break-even	123	232
Break-even: percentage of capacity	70%	58%

Value-based pricing

An increasing number of companies are basing their prices on the product's perceived value. **Value-based pricing** uses buyers' perceptions of value, not the seller's cost, as the key to pricing. Value-based pricing means that the marketer cannot design a product and marketing programme and then set the price. Price is considered along with the other marketing-mix variables *before* the marketing programme is set.

Value-based pricing—Setting price based on buyers' perceptions of product values rather than on cost.

Figure 16.7 compares cost-based pricing with value-based pricing. Cost-based pricing is product driven. The company designs what it considers to be a good product, totals the costs

Figure 16.7 Cost-based versus value-based pricing
SOURCE: *The Strategy and Tactics of Pricing*, 3rd edn by Thomas T. Nagle and Reed K. Holden (2002), p. 4. Reprinted by permission of Pearson Education, Inc., Upper Saddle River, NJ 07458.

of making the product and sets a price that covers costs plus a target profit. Marketing must then convince buyers that the product's value at that price justifies its purchase. If the price turns out to be too high, the company must settle for lower mark-ups or lower sales, both resulting in disappointing profits.

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

Consider Thorn selling its 10W 2D energy-saving electric light bulbs to a hotel manager. The SL18 costs far more to make than a conventional 60-watt tungsten light bulb, so a higher price has to be justified. Value pricing helps by looking at the hotel manager's total cost of ownership rather than the price of electric light bulbs. The life-cycle costs of the manager using a tungsten bulb for the 1,000 hours that they last includes the price of the bulb (60c), the labour cost of replacing it (50c) and electricity (€4.80). The life-cycle cost of the tungsten bulb is therefore €5.90. The Thorn 10W 2D bulb uses a sixth of the electricity of a conventional bulb and lasts eight times longer. Its life-cycle cost must therefore be compared with the cost of owning eight tungsten bulbs: 8 × €5.90 = €47.20. To work out the value of the Thorn bulb, its cost of ownership is also considered: changing the bulb 50c and electricity €6.40 (one-sixth the electricity costs of eight tungsten bulbs). The maximum value-based price of the Thorn bulb to the hotel manager is therefore:

Maximum value-based price = competitor's cost of ownership – own operating costs
= €47.20 – (€6.40 + 50c)
= €40.30

Using this evidence, Thorn can argue that it is worth the hotel manager paying a lot more than 60c to buy the energy-saving bulb. It is unrealistic to think that the manager would pay the full €40.30, but based on these figures, the actual price of €10.00 for the Thorn energy-saving bulb looks very reasonable. At first sight it seems hard to justify replacing a 60c tungsten bulb with a €10.00 energy-saving one, but value-based pricing shows the hotel manager is saving €30.00 by doing so. The value-based pricing using life-cycle costs can be used to justify paying a premium price on products, from low-energy light bulbs to airliners.[21]

A company using perceived-value pricing must find out what value buyers assign to different competitive offers. However, measuring perceived value can be difficult. Sometimes consumers are asked how much they would pay for a basic product and for each benefit added to the offer. Or a company might conduct experiments to test the perceived value of different product offers. If the seller charges more than the buyers' perceived value, the company's sales will suffer. Many companies overprice their products and their products sell poorly. Other companies underprice. Underpriced products sell very well, but they produce less revenue than they would if prices were raised to the perceived-value levels.

In recent years, several companies have adopted **value pricing** strategies – offering just the right combination of quality and good service at a fair price. In many cases, this has involved the introduction of less expensive versions of established brand-name products such as Travelodge and Holiday Express budget hotels. In other cases, such as IKEA and Wal-Mart, value pricing has involved redesigning existing brands in order to offer more quality for a given price or the same quality for less.

Value pricing—Offering just the right combination of quality and good service at a fair price.

In many business-to-business marketing situations, the pricing challenge is to find ways to maintain the company's *pricing power* – its power to maintain or even raise prices without losing market share. To retain pricing power – to escape price competition and to justify higher prices and margins – a firm must retain or build the value of its marketing offer. This is especially true for suppliers of commodity products, which are characterised by little differentiation and intense price competition. In such cases, many companies adopt *value-added* strategies. Rather than cutting prices to match competitors, they attach value-added services to differentiate their offers and thus support higher margins.

An important type of value pricing at the retail level is *everyday low pricing (EDLP)*. EDLP involves charging a constant, everyday low price with few or no temporary price promotions and special sales. The king of EDLP is Wal-Mart, who practically defined the concept. Except for a few sale items every month, Wal-Mart promises everyday low prices on everything it sells.[22] These constant prices eliminate week-to-week price uncertainty and can be contrasted to the 'high–low' pricing of promotion-oriented competitors. In *high–low pricing*, the retailer charges higher prices on an everyday basis but runs frequent promotions to lower prices temporarily on selected items below the EDLP level.

Retailers adopt EDLP for many reasons, the most important of which is that constant sales promotions are costly and have eroded consumer confidence in the credibility of everyday shelf prices. Consumers also have less time and patience for such time-honoured traditions as watching for supermarket specials and clipping coupons. However, to offer everyday low prices, a company must first have everyday low costs. If not, the company could not make money at the lower prices that it charges for the products that it sells.

Competition-based pricing

Consumers will base their judgements of a product's value on the prices that competitors charge for similar products. Here, we discuss two forms of competition-based pricing: *going-rate pricing* and *sealed-bid pricing*.

Going-rate pricing

In **going-rate pricing**, the firm bases its price largely on *competitors*' prices, with less attention paid to its *own* costs or to demand. The firm might charge the same as, more, or less than its chief competitors. In oligopolistic industries that sell a commodity such as steel, paper or fertiliser, firms normally charge the same price. The smaller firms follow the leader: they change their prices when the market leader's prices change, rather than when their own demand or costs change. Some firms may charge a bit more or less, but they hold the amount

Going-rate pricing—Setting price based largely on following competitors' prices rather than on company costs or demand.

of difference constant. Thus, minor petrol retailers usually charge slightly less than the big oil companies, without letting the difference increase or decrease.

> Going-rate pricing applies to complex products as well as commodities. Fierce competition between aerospace producers cut world aircraft prices by a fifth between 1996 and 1998. Manfred Bischoff, chief executive of Daimler-Benz's Dasa, cites Boeing as the chief culprit. 'There is a crumbling of prices in certain markets', he says. 'The price is dictated by Boeing. We are followers in this case.'[23]

Although it gives firms little control of their revenue, going-rate pricing can be quite popular. When demand elasticity is hard to measure, firms feel that the going price represents the collective wisdom of the industry concerning the price that will yield a fair return. They also feel that holding to the going price will prevent harmful price wars.

Sealed-bid pricing

In sealed-bid pricing, a firm bases its price on how it thinks competitors will price rather than on its own costs or on demand. Would-be suppliers can submit only one bid and cannot know the other bids. Sealed-bid auctions, where buyers submit secret bids, have always been common in business-to-business (B2B) marketing and some consumer markets, such as Scottish house buying. Governments also often use this method to procure supplies.

Until the advent of the Internet, haggling (one-to-one negotiations) and a non-negotiable price had grown to dominate pricing. Auctions existed in specialised markets, such as commodities, some specialised financial services, fine art and antiques. Now, led by eBay.com, online auctions for Beanie Babies and much more have become one of the most influential Internet innovations. Whereas conventional auctions needed the market to gather for an auction or have simultaneous telephone contact, the Internet's global reach and simultaneity are putting auctions at the centre of trading. If forecasters are correct, auctions are set to become an increasingly common part of everyone's life. B2B is currently the dominant form but consumer-based auctions, both B2C and C2C, are now running at an estimated €20 billion a year. Because of the growth in popularity of auctions, especially with the growth of the Internet, companies should be aware of the array of auction-type pricing procedures. Here, we discuss sealed-bid pricing as a form of auction-type pricing as well as address recent developments in auction-type pricing.

In the late nineteenth century the French economist Léon Walras likened the entire pricing mechanism to the operation of a 'Walrasian auctioneer' who calls out a price, sees how many buyers and sellers there are and, if they do not balance, makes adjustments until demand equals supply. In the non-negotiable price setting that dominated C2C markets, the 'adjustments' take place over time to match supply and demand. In auctions, as in haggling where buyers and sellers negotiate a price or walk away, prices are set during each transaction. Economists see auctions as an efficient way of matching supply and demand but they do introduce uncertainty into transactions. The sellers do not know the price they will receive and buyers have no guarantee of making a purchase. One of the most common forms of auction, sealed-bid pricing, is an example.

First-price sealed-bid pricing—Potential buyers submit sealed bids, and the item is awarded to the buyer who offers the best price.

First-price sealed-bid pricing occurs in two ways. Potential buyers may be asked to submit sealed bids, and the item is awarded to the buyer who offers the highest price. Conversely, firms may have to bid for a contract to supply goods or services that is awarded to the contender with the lowest price.

Company's bid (€)	Profit if bid wins (€) (1)	Assumed probability of bid winning (2)	Expected profit (€) (3) = (1) × (2)
9,500	100	0.81	81
10,000	600	0.36	216
10,500	1,100	0.09	99
11,000	1,600	0.01	16

Table 16.3 Effects of different bids on expected profit

In sealed-bid pricing, a firm bases its bid price on how it thinks competitors will bid. To win a contract, a contender has to price below other firms. Yet the firm cannot set its price below a certain level. It cannot price below cost without harming its position. In contrast, the higher the company sets its price above its costs, the lower its chance of getting the contract.

The net effect of the two opposite pulls can be described in terms of the *expected profit* of the particular bid (see Table 16.3). Suppose a bid of €9,500 would yield a high chance (say, 0.81) of getting the contract, but only a low profit (say, €100). The expected profit with this bid is therefore €81. If the firm bid €11,000, its profit would be €1,600, but its chance of getting the contract might be reduced to 0.01. The expected profit would be only €16. Thus the company might bid the price that would maximise the expected profit. According to Table 16.3, the best bid would be €10,000, for which the expected profit is €216.

Using expected profit as a basis for setting price makes sense for the large firm that makes many bids. In playing the odds, the firm will make maximum profits in the long run. But a firm that bids only occasionally or needs a particular contract badly will not find the expected-profit approach useful. The approach, for example, does not distinguish between a €100,000 profit with a 0.10 probability and a €12,500 profit with a 0.80 probability. Yet the firm that wants to keep production going would prefer the second contract to the first.

In **English auctions** the price is raised successively until only one bidder remains. This is the most common auction form, familiar from scenes of rare items, be it a Van Gogh or a pair of Madonna's pants, being sold by one of the great auction houses, such as Sotheby's or Christie's. These have joined eBay as providers of online auctions aimed at its network of regular dealers (sothebys.com) or, for smaller collectables ($100 to $100,000), at consumers (sothebys.amazon.com). One of the largest European operators, qxl.com, operates both B2C and C2C while on holidayauctions.net customers can bid for bargain late-break holidays.

English auction—Price is raised successively until only one bidder remains.

In **Dutch auctions** prices start high and are lowered successively until someone buys. These auctions originated in the Dutch wholesale flower markets. B2B online traders, such as Bidbusiness.co.uk and constrauction.com, use both English and Dutch auctions to sell industrial products.

Dutch auction—Prices start high and are lowered successively until someone buys.

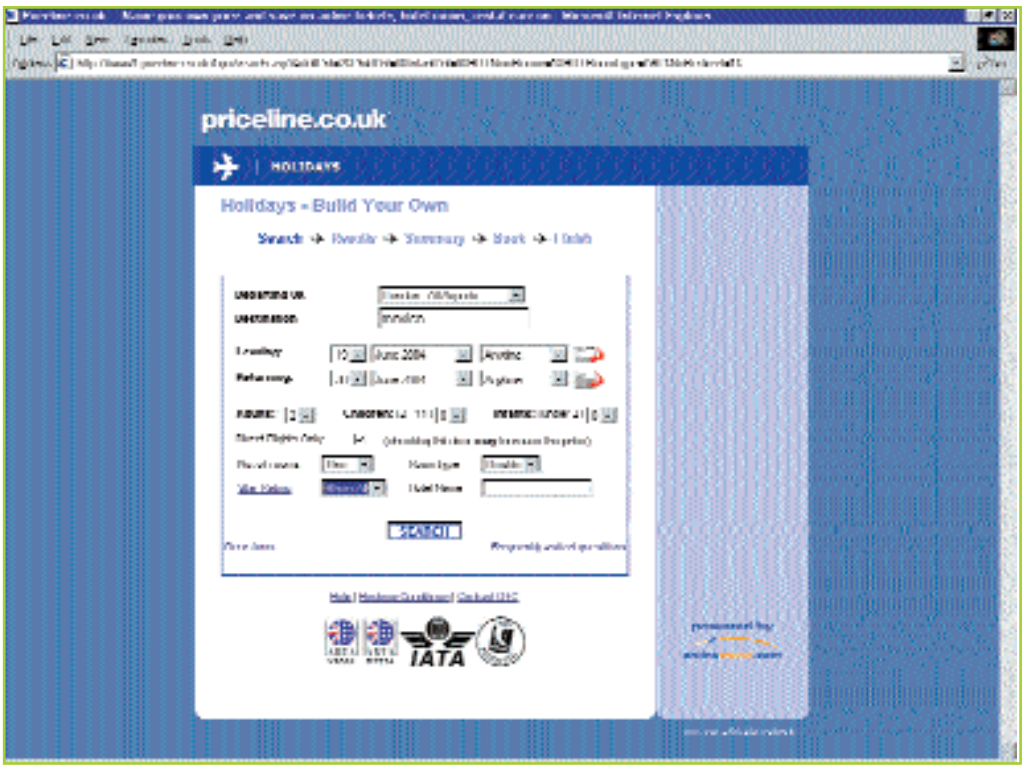
In **collective buying** increasing numbers of customers agree to buy as prices are lowered to the final bargain. The more customers join in, the lower the price becomes until a minimum demand is met. Letsbuyit.com and adabra.com offer each auction over a limited period for each option, then move on to the next batch. These sites often offer batches of products, say several items of kitchen equipment that are most suited to B2B markets.

Collective buying—An increasing number of customers agree to buy as prices are lowered to the final bargain price.

In a **reverse auction** customers name the price that they are willing to pay for an item and seek a company willing to sell. In pioneering their online service priceline.com takes advantage of two major trends: first, most industries being in a continual state of excess capacity and, second, customers being 'brand neutral' if they can get a good deal. Most of Priceline's business is in travel services and mortgages but it is moving into life insurance, groceries and second-hand goods.

Reverse auction—Customers name the price that they are willing to pay for an item and seek a company willing to sell.

Although economists see auctions as close to Adam Smith's 'invisible hand' that drives markets, there are few cool hands at auctions. Major art auctions are social, newsworthy and



Build your own holidays and save a fortune. More and more travellers are doing just that by using online services like Priceline.
SOURCE: www.priceline.com.

exciting events. Jim Rose, of QXL, has no doubt about why online auctions are similarly popular: 'They're fun, they're entertaining, and people describe it as "winning" something rather than "buying" it.' The 'winner's curse' is very apparent in some South-east Asian markets where to 'win', contenders pay more than high street prices. And how many people can attend an auction and not walk away with something they had no intention of buying! The **second-price sealed bid** method can reduce some of the stress. In this, sealed bids are submitted but the buyer pays a price equal to the second-best bid.[24]

Second-price sealed bid—Sealed bids are submitted but the contender placing the best bid pays only the price equal to the second-best bid.

We have explored the many internal and external factors that affect a company's pricing decisions and examined general approaches to setting prices. Next, we will look at the complex dynamics of pricing and the dynamic pricing strategies available to marketers. Price setting involves balancing conflicting interests and can be used to achieve a range of objectives. Even more, 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 product prices to reflect changes in costs and demand, and to 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.

New-product pricing strategies

Pricing strategies usually change as the product passes through its life-cycle. The introductory stage is especially challenging. We can distinguish between pricing a product that imitates existing products and pricing an innovative product that is patent protected.

A company that plans to develop an imitative new product faces a product-positioning problem. It must decide where to position the product versus competing products in terms of

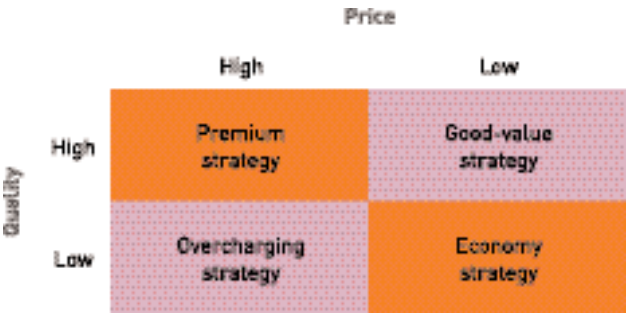


Figure 16.8 Four price-positioning strategies

quality and price. Figure 16.8 shows four possible positioning strategies. First, the company might decide to use a *premium pricing* strategy – producing a high-quality product and charging the highest price. At the other extreme, it might decide on an *economy pricing* strategy – producing a lower-quality product, but charging a low price. These strategies can coexist in the same market as long as the market consists of at least two groups of buyers, those who seek quality and those who seek price. Thus, Tag-Heuer offers very high-quality sports watches at high prices, whereas Casio offers digital watches at almost throwaway prices.[25]

The *good-value* strategy represents a way to attack the premium pricer. A leading grocery chain always uses the **strapline**: 'Good food costs less at Sainsbury's'. If this is really true and quality-sensitive buyers believe the good-value pricer, they will sensibly shop at Sainsbury's and save money – unless the premium product offers more status or snob appeal. Using an *overcharging* strategy, the company overprices the product in relation to its quality. In the long run, however, customers are likely to feel 'taken'. They will stop buying the product and will complain to others about it. Thus this strategy should be avoided.[26]

Strapline—A slogan often used in conjunction with a brand's name, advertising and other promotions.

Companies bringing out an innovative, patent-protected product face the challenge of setting prices for the first time. They can choose between two strategies: *market-skimming pricing* and *market-penetration pricing*.

Market-skimming pricing

Many companies that invent new products initially set high prices to 'skim' revenues layer by layer from the market, a strategy called **market-skimming pricing**.

Market-skimming pricing—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.

> Maaväl was launched in Sweden at Skr12 (€1.40), more than twice the price of ordinary yoghurt. Developed by Scotia and a consortium of 1,300 Swedish farmers, Maaväl contains Olibra, a 'nutriceutical' made of a patent combination of palm oil extract, oat oil and water. It encourages the small intestine to release chemicals that tell the brain that enough has been eaten, giving a 'prolonged feeling of fullness'. The high price indicates the product's uniqueness and special properties, and allows quicker recovery of development costs. Similar value-added, functional foods have proved profitable. Finland's Rasio has seen its share price increase tenfold since it launched Benecol, a cholesterol-lowering margarine. The success stimulated follow-ups with Benecol 'cream cheese type spread' and yogurt drink, and Flora pro.activ, a 'me-too' from Van den Bergh Foods.[27]

Consider another example – Intel. When Intel first introduces a new computer chip, it charges the highest price it can, given the benefits of the new chip over competing chips. It sets a price that makes it *just* worthwhile for some segments of the market to adopt computers containing the chip. As initial sales slow down and as competitors threaten to introduce similar chips, Intel lowers the price to draw in the next price-sensitive layer of customers.[28]

Market-penetration pricing

Market-penetration pricing—Setting a low price for a new product in order to attract large numbers of buyers and a large market share.

Rather than setting a high initial price to skim off small but profitable market segments, some companies use **market-penetration pricing**. They set a low initial price in order to *penetrate* the market quickly and deeply – to attract a large number of buyers quickly and win a large market share. The high sales volume results in falling costs, allowing the company to cut its price even further. For example, Dell used penetration pricing to sell high-quality computer products through lower-cost mail-order channels. Its sales soared when IBM, Compaq, Apple and other competitors selling through retail stores could not match their prices. The Bank of Scotland and Winterthur of Switzerland used their Direct Line, Privilege and Churchill subsidiaries to grab profits and share in the motor insurance market by selling direct to consumers at market-penetrating prices. The high volume results in lower costs that, in turn, allow the discounters to keep prices low.[29]

Several conditions favour setting a low price. First, the market must be highly price sensitive, so that a low price produces more market growth. Second, production and distribution costs must fall 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. For example, Dell faced difficult times when IBM and Compaq established their own direct distribution channels. However, competitive market-penetration pricing to gain share can be withering. Almost all the US's leading Internet service providers, including Mindspring, PSINet, Earthlink, BBN and Netcom, are losing money as they fight for market share and new customers.[30]

Product-mix pricing strategies

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 maximises the profits on the total product mix. Pricing is difficult because the various products have related demand and costs, and face different degrees of competition. Five *product-mix pricing* situations are summarised in Table 16.4.

Table 16.4 Product-mix pricing strategies

Product line pricing	Optional-product pricing	Captive-product pricing	By-product pricing	Product-bundle pricing
Setting price steps between product line items	Pricing optional or accessory products sold with the main product	Pricing products that must be used with the main product	Pricing low-value by-products to get rid of them	Pricing bundles of products sold together

Product line pricing

Companies usually develop product lines rather than single products. For example, Merloni's sells Indesit, Ariston and Scholte appliances with price and status ascending in that order. There are full ranges of Indesit to Ariston appliances, from washing machines to freezers, covering the first two price bands, while Scholte sells expensive built-in kitchen equipment. In **product line pricing**, management must decide on the price steps to set between the various products in a line.

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.

The price steps should take into account cost differences between the products in the line, customer evaluations of their different features, and competitors' prices. If the price difference between two successive products is small, buyers will usually buy the more advanced product. This will increase company profits if the cost difference is smaller than the price difference. If the price difference is large, however, customers will generally buy the less advanced products.

In many industries, sellers use well-established *price points* for the products in their line. Thus record stores might carry CDs at five price levels: budget, mid-line, full-line and imports, ascending in price and with discounted special promotions on current chart albums. The customer will probably associate low- to high-quality recordings with the first three price points. Even if the prices are raised a little, people will normally buy CDs at their own preferred price points. The seller's task is to establish perceived quality differences that support the price differences.

Optional-product pricing

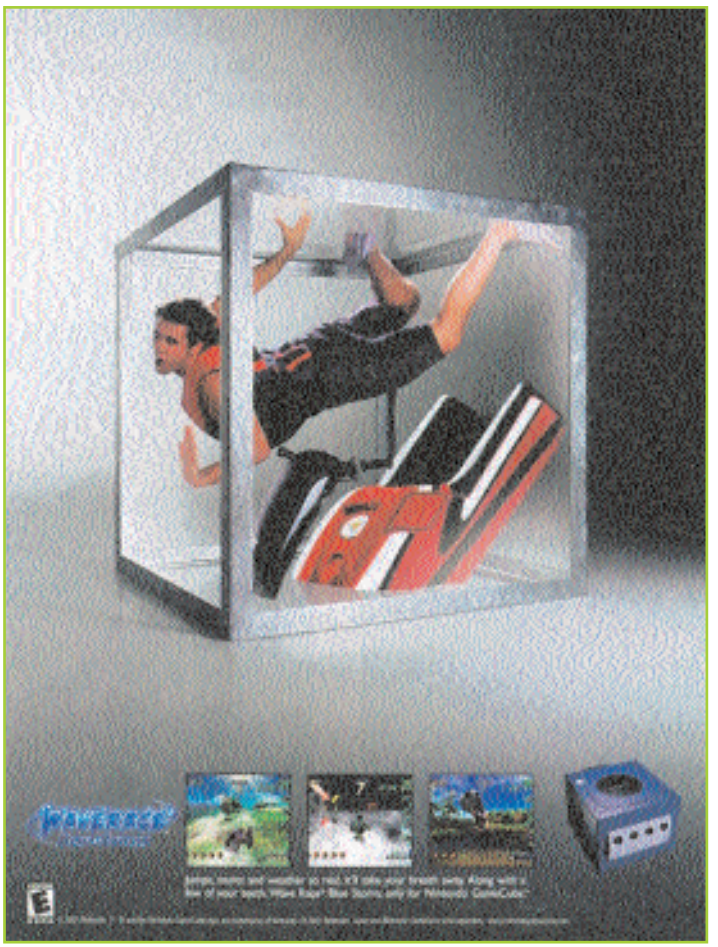
Many companies use **optional-product pricing** – offering to sell optional or accessory products along with their main product. For example, a Toyota Yaris customer may choose to add satellite navigation, a CD autochanger or a roof spoiler. Pricing these options is a sticky problem. Car companies have to decide which items to include in the base price and which to offer as options. BMW's basic cars once came famously under-equipped. Typically the 318i is about €20,000, but the customer then has to pay extra for a radio (prices vary), electric windows (€350), sun roof (€900) and security system (€550). The basic model is stripped of so many comforts and conveniences that most buyers reject it. They pay for extras or buy a better-equipped version. More recently, however, American and European carmakers have been forced to follow the example of the Japanese carmakers and include in the basic price many useful items previously sold only as options. The advertised price now often represents a well-equipped car.

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

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 razors, camera film, video games and computer software. Producers of the main products (razors, cameras, video game consoles and computers) often price them low and set high mark-ups on the supplies. Thus Gillette sells low-priced razors, but makes money on the replacement blades. Polaroid prices its instant cameras low (€40 for a Barbie Cam) because it makes its money on specialised films they need (€10). And Nintendo sells its game consoles at low prices but makes money on video game titles. In fact, whereas Nintendo's margins on its consoles run at a mere 1–5 per cent, margins on its game cartridges run close to 45 per cent. Video game sales contribute more than half the company's profits. Similarly, Sony and Microsoft recently dropped the prices of their PlayStation2 and Xbox game consoles by one-third despite the fact that the original prices were already set below cost. Despite losses on the game console, Sony makes

Captive-product pricing—Setting a price for products that must be used along with a main product, such as blades for a razor and film for a camera.



Captive-product pricing: Nintendo sells game consoles at reasonable prices and makes money on video game titles. SOURCE: Courtesy of Nintendo America, Inc. *agency*: Leo Burnett.

more than 60 per cent of its operating profit from the sale of PlayStation2 and its accompanying games.[31]

Two-part pricing—A strategy for pricing services in which price is broken into a fixed fee plus a variable usage rate.

In the case of services, this strategy is called **two-part pricing**. The price of the service is broken into a *fixed fee* plus a *variable usage rate*. Thus a telephone company charges a monthly rate – the fixed fee – plus charges for calls beyond some minimum number – the variable usage rate. Amusement parks charge admission plus fees for food and some rides. The service firm must decide how much to charge for the basic service and how much for the variable usage. The fixed amount should be low enough to induce usage of the service, and profit can be made on the variable fees.

By-product pricing

By-products—Items produced as a result of the main factory process, such as waste and reject items.

By-product pricing—Setting a price for by-products in order to make the main product's price more competitive.

In producing processed meats, petroleum products, chemicals and other products, there are often **by-products**. If the by-products have no value and if getting rid of them is costly, this will affect the pricing of the main product. Using **by-product pricing**, the manufacturer will seek a market for these by-products and should accept any price that covers more than the cost of storing and delivering them. This practice allows the seller to reduce the main product's price to make it more competitive. By-products can even turn out to be profitable. For example, many lumber mills have begun to sell bark chips and sawdust profitably as decorative mulch for home and commercial landscaping.

Product-bundle pricing

Using **product-bundle pricing**, sellers often combine several of their products and offer the bundle at a reduced price. Thus theatres and sports teams sell season tickets at less than the cost of single tickets; hotels sell specially priced packages that include room, meals and entertainment; computer makers include attractive software packages with their personal computers, and Internet service providers sell packages that include Web access, Web hosting, email and an Internet search programme. Price bundling can promote the sales of products that consumers might not otherwise buy, but the combined price must be low enough to get them to buy the bundle.

Product-bundle pricing—Combining several products and offering the bundle at a reduced price.

In other cases, *product-bundle pricing* is used to sell more than the customer really wants. Obtaining a ticket to a rock event is sometimes difficult, but tickets to international concerts bundled with flights, accommodation, etc., are often widely available.[32]

Price-adjustment strategies

Companies usually adjust their basic prices to account for various customer differences and changing situations. Table 16.5 summarises seven price-adjustment strategies: *discount and allowance pricing*, *segmented pricing*, *psychological pricing*, *promotional pricing*, *value pricing*, *geographical pricing* and *international pricing*.

Discount and allowance pricing

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

A **cash discount** is 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 per cent if the bill is paid within 10 days. The discount must be granted to all buyers meeting these terms. Such discounts are customary in many industries and help to improve the sellers' cash situation and reduce bad debts and credit-collection costs.

Cash discount—A price reduction to buyers who pay their bills promptly.

A **quantity discount** is a price reduction to buyers who buy large volumes. A typical example is Pilot Hi-Tecpoint pens from Staples Office Supplies at €6 for a pack of three, €10 for six and €18 for 12. Wine merchants often give '12 for the price of 11' and Makro, the trade

Quantity discount—A price reduction to buyers who buy large volumes.

Table 16.5 Price adjustment strategies

Discount and allowance pricing	Segmented pricing	Psychological pricing	Value pricing	Promotional pricing	Geographical pricing	International pricing
Reducing prices to reward customer responses such as paying early or promoting the product	Adjusting prices to allow for differences in customers, products and locations	Adjusting prices for psychological effect	Adjusting prices to offer the right combination of quality and service at a fair price	Temporarily reducing prices to increase short-run sales	Adjusting prices to account for the geographical location of customers	Adjusting prices in international markets

warehouse, automatically gives discounts on any product bought in bulk. Discounts provide an incentive to the customer to buy more from one given seller, rather than from many different sources. Price does not always decrease with the quantity purchased. More often than realised, people pay a **quantity premium**, a surcharge paid by buyers who purchase high volumes of a product.

Quantity premium—A surcharge paid by buyers who purchase high volumes of a product.

> In Japan it often costs more per item to buy a 12-pack of beer or sushi than smaller quantities because the larger packs are more giftable and therefore less price sensitive. Quantity surcharges can also occur when the product being bought is in short supply or in sets – for example, several seats together at a 'sold-out' rock concert or sports event – and some small restaurants charge a premium to large groups. Similarly, in buying antiques, it costs more to buy six complete place settings of cutlery than a single item. In this case the price will continue to increase with volume, eight place settings costing more than six, and 12 place settings costing more than eight.[33]

Functional discount (trade discount)—A price reduction offered by the seller to trade channel members that perform certain functions, such as selling, storing and record keeping.

Seasonal discount—A price reduction to buyers who buy merchandise or services out of season.

Trade-in allowance—A price reduction given for turning in an old item when buying a new one.

Promotional allowance—A payment or price reduction to reward dealers for participating in advertising and sales-support programmes.

Segmented pricing—Pricing that allows for differences in customers, products and locations. The differences in prices are not based on differences in costs.

A **trade discount** (also called a **functional discount**) is offered by the seller to trade channel members that perform certain functions, such as selling, storing and record keeping. Manufacturers may offer different functional discounts to different trade channels because of the varying services they perform, but manufacturers must offer the same functional discounts within each trade channel.

A **seasonal discount** is a price discount to buyers who buy merchandise or services out of season. For example, lawn and garden equipment manufacturers will offer seasonal discounts to retailers during the autumn and winter to encourage early ordering in anticipation of the heavy spring and summer selling seasons. Hotels, motels and airlines will offer seasonal discounts in their slower selling periods. Seasonal discounts allow the seller to keep production steady or stabilise capacity utilisation during the entire year.

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 car 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 programmes.

In stable markets, price adjustments have traditionally been relatively infrequent changes made as part of a strategy marketing or promotional programme. The Internet is changing that. In online trading, the ink on sticker prices often has no time to dry. Prices can change from hour to hour and from customer to customer. Marketing Insights 16.2 looks at these new pricing dynamics.

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. Segmented pricing takes several forms:

1. *Customer-segment pricing*. Different customers pay different prices for the same product or service. Museums, for example, will charge a lower admission for young people, the unwaged, students and senior citizens. In many parts of the world, tourists pay more to see museums, shows and national monuments than do locals.

Back to the future: pricing on the Web 16.2

marketing insights

At one time all prices were negotiated. The Web seems to be taking us back – into a new age of fluid pricing. 'Potentially, [the Internet] could push aside stickier prices and usher in an era of dynamic pricing', says *Business Week* writer Robert Hof, 'in which a wide range of goods would be priced according to what the market will bear – instantly, constantly.' Here's how.

Lower prices, higher margins

Web buying and selling can lower costs. Thanks to their Internet connections, buyers and sellers around the world can connect at almost no cost. Reduced inventory and distribution costs add to the savings. For example, by selling online and making its computers to order, Dell Computer reduces inventory costs and eliminates retail mark-ups. It passes on its savings as 'lowest price per $ for performance'.

Tailor offers to individuals

Web merchants can target prices to specific customers. For example, Amazon.com can assess each visitor's 'click-stream', the way the person navigates the website, then tailor products and prices to that shopper's behaviour. If visitors behave like a price-sensitive shopper, they may be offered a lower price. The Internet also lets sellers give some customers access to special prices. For example, CDnow emails a special website address with lower prices to certain buyers. If you don't know the secret address, you pay full price.

Change prices according to changes in demand or costs

With printed catalogues, such as Lands' End or Hawkshead, a price is a price until the next catalogue is printed. In contrast, online sellers can change prices hourly. This allows sellers to adjust to changing costs, offer promotions on slow-moving and unsold items or nudge prices upwards on hot-selling goods. Lastminute.com, the opportunistic dotcom, helps the leisure sector sell unbooked hotel rooms and unsold entertainment tickets and to fill flights close to their sell-by date. Many business marketers use their extranets, the private networks that link them with suppliers and customers, to get a precise handle on inventory, costs and demand at any given moment and adjust prices instantly.

...16.2

Negotiate prices online

Want to sell that antique pickle jar? Post it on eBay, the world's biggest online flea market. Want to dump that excess stock? Try adding an auction feature to your own website. Sharper Image claims it's getting 40 per cent of retail for excess goods sold via its online auction site, compared with only 20 per cent from liquidators.

Get instant price comparisons from thousands of vendors

Web shoppers can quickly compare information about products and vendors almost anywhere. Online comparison guides, such as Compare.Net, Kelkoo and PriceScan, give product and price comparisons at the click of a mouse. Compare.Net lets consumers do side-by-side comparison of items, provides a smart tips sections and an online glossary giving helpful tips and product information to aid in consumers' buying decision. Other sites offer intelligent shopping agents. MySimon, for instance, takes a buyer's criteria for a camcorder or collectable, then routes through sellers' sites to find the best match at the best price.

Negotiate lower prices

With market information and access comes buyer power. In addition to simply finding the vendor with the best price, customers armed with price information can often negotiate lower prices.

> UTC tried something new. Instead of haggling with dozens of individual vendors to secure printed circuit boards for various subsidiaries worldwide, it put the contract out on FreeMarkets, an online marketplace for industrial goods. Bids poured in from 39 suppliers, saving UTC over €11 million off its initial €27 million estimate.

Will dynamic pricing sweep the marketing world? 'Not entirely', says Hof. 'It takes a lot of work to haggle – which is why fixed prices happened in the first place.' However, he continues, 'Pandora's E-box is now open, and pricing will never be the same.'

SOURCES: Quotes and extracts from Robert D. Hof, 'Going, going, gone', *Business Week* (12 April 1999), pp. 30–2; Robert D. Hof, 'The buyer always wins', *Business Week* (22 March 1999), pp. EB26–EB28; and Stephen Manes, 'Off-Web dickering', *Forbes* (5 April 1999), p. 134. Also see Michael Krauss, 'Web offers biggest prize in product pricing game', *Marketing News* (6 July 1998), p. 8; Hazel Ward, 'Top of the shops', *e.business* (April 2000), pp. 69–71; Chris Nuttall, 'Lastminute becomes last word in travel', *Financial Times* (20 November 2003), p. 25; and Michael Rappa, 'Managing the digital enterprise. Case study: mySimon', available at http://digitalenterprise.org/cases/mysimon.html, accessed 18 February 2004.

Buying a sports utility vehicle, a DVD player or even a toe ring? Online shopping guides like Compare.Net and Pricescan.com enable buyers to make side-by-side comparisons of product features and prices at the click of a mouse.
SOURCE: (left) Dvdcompare.net/rewind.com; (right) Pricescan.com Inc.

2. *Product-form pricing*. Different versions of the product are priced differently, but not according to differences in their costs. For instance, the Dutch company Skil prices its 6434H electric drill at €100, which is €60 more than the price of its 6400H. The 6434H is more powerful and has more features, yet this extra power and features cost only a few more euros to build in.
3. *Location pricing*. Different locations are priced differently, even though the cost of offering each location is the same. For instance, theatres vary their seat prices because of audience preferences for certain locations, and EU universities charge higher tuition fees for non-EU students.
4. *Time pricing*. Prices vary by the season, the month, the day and even the hour. Public utilities vary their prices to commercial users by time of day and weekend versus weekday. Telephone companies offer lower 'off-peak' charges, electricity costs less at night and resorts give seasonal discounts.

For segmented pricing to be an effective strategy, certain conditions must exist. The market must be segmentable and the segments must show different degrees of demand. Members of the segment paying the lower price should not be able to turn round and resell the product to the segment paying the higher price. Competitors should not be able to undersell the firm in the segment being charged the higher price. Nor should the costs of segmenting and watching the market 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. Otherwise, in the long run, the practice should not lead to customer resentment and ill will.

Psychological pricing

Psychological pricing—A pricing approach that considers the psychology of prices and not simply the economics; the price is used to say something about the product.

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 and not simply the economics. For example, one study of the relationship between price and quality perception of cars found that consumers perceive higher-priced cars as having higher quality.[34] By the

same token, higher-quality cars are perceived as even higher priced than they actually are. When consumers 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. When consumers cannot judge quality because they lack the information or skill, price becomes an important quality signal. Psychological pricing is particularly apparent in airport duty-free shops where people buy expensive items in unfamiliar categories. In such outlets, exquisite malt whiskies are often sold inexpensively but inexperienced buyers are attracted by grandly packaged and overpriced blended whiskies.

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

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 company could display its product next to more expensive ones in order to imply that it belongs in the same class. Department stores often sell women's clothing in separate departments differentiated by price: clothing found in the more expensive department is assumed to be of better quality. Companies also can influence consumers' reference prices by stating high manufacturer's suggested prices, by indicating that the product was originally priced much higher or by pointing to a competitor's higher price.

Even small differences in price can suggest product differences. Consider a stereo priced at €400 compared to one priced at €399. The actual price difference is only €1, but the psychological difference can be much greater. For example, some consumers will see the €399 as a price in the €300 range rather than the €400 range. Whereas the €399 is more likely to be seen as a bargain price, the €400 price suggests more quality. Complicated numbers, such as €347.41, also look less appealing than rounded ones, such as €350. Some psychologists argue that each digit has symbolic and visual qualities that should be considered in pricing. Thus, 8 is round and even and creates a soothing effect, whereas 7 is angular and creates a jarring effect.[35]

Promotional pricing

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

With **promotional pricing**, companies will temporarily price their products below list price and sometimes even below cost. Promotional pricing takes several forms. Supermarkets and department stores will price a few products as *loss leaders* to attract customers to the store in the hope that they will buy other items at normal mark-ups. Sellers will also use *special-event pricing* in certain seasons to draw in more customers. Thus linens are promotionally priced every January to attract weary Christmas shoppers back into the stores. Manufacturers will 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 recently been popular with carmakers and producers of durable goods and small appliances.

Some manufacturers offer *low-interest financing*, *longer warranties* or *free maintenance* to reduce the consumer's 'price'. This practice has recently become a favourite of the car industry. The seller may simply offer *discounts* from normal prices to increase sales and reduce stocks. Some manufacturers may even offer 'zero-financing' in moves to capture customers.

Mitsubishi, the Japanese carmaker that is 37 per cent owned by DaimlerChrysler, is in dire straits. Much of its problems in the US, however, may be of its own making. To lure young, low-income buyers to its newly-launched line of mini-cars, Mitsubishi used 'zero, zero, zero' financing: no money down, no interest payments, and no repayment of principal for the first

year. For Mitsubishi, this was one ZERO too many. The company racked up huge losses as its young, impecunious buyers failed – surprise, surprise – to start to make payments when their year was up.[36]

Promotional pricing, therefore, can have adverse effects. Moreover, used too frequently and copied by competitors, price promotions can create 'deal-prone' customers who wait until brands go on sale before buying them. Equally, constantly reduced prices can erode a brand's value in the eyes of customers. Marketers sometimes use price promotions as a quick fix instead of sweating through the difficult process of developing effective longer-term strategies for building their brands. In fact, one observer notes that price promotions can be downright addicting to both the company and the customer: 'Price promotions are the brand equivalent of heroin: easy to get into but hard to get out of. Once the brand and its customers are addicted to the short-term high of a price cut it is hard to wean them away to real brand building. . . . But continue and the brand dies by 1000 cuts.'[37]

The frequent use of promotional pricing can also lead to industry price wars. Such price wars usually play into the hands of only one or a few competitors – those with the most efficient operations. For example, until recently, the computer industry avoided price wars. Computer companies, including IBM, Hewlett-Packard and Compaq, showed strong profits as their new technologies were snapped up by eager consumers. When the market cooled, however, many competitors began to unload PCs at discounted prices. In response, Dell, the industry's undisputed low-cost leader, started a price war that only it could win.

In mid-2000, Dell declared a brutal price war just as the industry slipped into its worst slump ever. The result was nothing short of a rout. While Dell chalked up $361 million (€429.6 million) in profits the following year, the rest of the industry logged $1.1 billion (€1.31 billion) in losses. Dell's edge starts with its direct-selling approach. By taking orders straight from customers and building machines to order, Dell avoids paying retailer markups, getting stuck with unsold PCs, and keeping costly inventories. For example, at any given moment, Dell's warehouses hold just four days of stock, compared with 24 days for competitors. That gives it a gigantic edge in a market where the price of chips, drives, and other parts typically falls 1 per cent a week. Moreover, Dell has mastered supply chain management. It requires suppliers to use sophisticated software that wires them straight into Dell's factory floor, allowing Dell's plants to replenish supplies only as needed throughout the day. That software alone saved Dell $50 million in the first six months of use. Since launching the price war, the price of a Dell computer has dropped more than 18 per cent, leaving competitors with few effective weapons. IBM has responded by outsourcing its PC production and sales. And H-P and Compaq merged in hopes of finding strength in numbers. Says Michael Dell, 'When we sell these products, we make money. When our competitors sell them, they lose money.'[38]

The point is that promotional pricing can be an effective means of generating sales in certain circumstances but can be damaging if taken as a steady diet.

Geographical pricing

A company must also decide how to price its products to customers located in different parts of the country 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:

Geographical pricing—Pricing based on where customers are located.

> Tromsø a.s. is a Norwegian paper products company selling to customers all over Europe. The cost of freight is high and affects the companies from whom customers buy their paper. Tromsø wants to establish a geographical pricing policy. It is trying to determine how to price a Nkr1,000 order to three specific customers: Customer A (Oslo), Customer B (Amsterdam) and Customer C (Barcelona).

FOB-origin pricing—A geographic 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 geographic pricing strategy in which the company charges the same price plus freight to all customers, regardless of their location.

Zone pricing—A geographic 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 geographic 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 location, regardless of the city from which the goods are actually shipped.

One option is for Tromsø to ask each customer to pay the shipping cost from the factory to the customer's location. All three customers would pay the same factory price of Nkr1,000 (€806), with Customer A paying, say, Nkr100 for shipping; Customer B, Nkr150; and Customer C, Nkr250. 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 Tromsø will be a high-cost firm to distant customers. If Tromsø's main competitor happens to be in Spain, this competitor will no doubt outsell Tromsø in Spain. In fact, the competitor would outsell Tromsø in most of southern Europe, whereas Tromsø would dominate the north.

Uniform delivered pricing is the exact 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 Nkr150. Uniform delivered pricing therefore results in a higher charge to the Oslo customer (who pays Nkr150 freight instead of Nkr100) and a lower charge to the Barcelona customer (who pays Nkr150 instead of Nkr250). On the one hand, the Oslo customer would prefer to buy paper from another local paper company that uses FOB-origin pricing. On the other hand, Tromsø has a better chance of winning over the Spanish customer. Other advantages of uniform delivered pricing are that it is fairly easy to administer and it lets the firm advertise its price nationally.

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, Tromsø might set up a Scandinavian zone and charge Nkr100 freight to all customers in this zone, a northern European zone in which it charges Nkr150 and a southern European zone in which it charges Nkr250. In this way, the customers within a given price zone receive no price advantage from the company. For example, customers in Oslo and Copenhagen pay the same total price to Tromsø. The complaint, however, is that the Oslo customer is paying part of the Copenhagen customer's freight cost. In addition, even though they may be within a few miles of each other, a customer just barely on the south side of the line dividing north and south pays much more than one that is just barely on the north side of the line.

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, Tromsø might set Oslo as the basing point

and charge all customers Nkr100 plus the freight from Oslo to their locations. This means that a Copenhagen customer pays the freight cost from Oslo to Copenhagen, even though the goods may be shipped from Tromsø. Using a basing-point location other than the factory raises the total price for customers near the factory and lowers the total price for customers far from the factory.

If all sellers used the same basing-point city, delivered prices would be the same for all customers and price competition would be eliminated. Industries such as sugar, cement, steel and cars used basing-point pricing for years, but this method has become less popular today. Some companies set up multiple basing points to create more flexibility: they quote freight charges from the basing-point city nearest to the customer.

Finally, the seller that 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 in order to get the desired business. The seller might reason that if it can get more business, its average costs will fall 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 geographic pricing strategy in which the company absorbs all or part of the actual freight charges in order to get the business.

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, Airbus 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 development of the wholesaling and retailing system. Consumer perceptions and preferences may also 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, Sony 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. Travellers abroad are often surprised to find that goods, which are relatively inexpensive at home, may carry outrageously higher price tags in other countries. A pair of Levi's selling for $30 (€35) in the US goes for about $63 in Tokyo and $88 in Paris. A McDonald's Big Mac selling for a modest $2.25 in the US costs $5.75 in Moscow. A Britney Spears CD sells for $15.99 in the US, but costs about $20 in the UK. Conversely, a Gucci handbag going for only $60 in Milan, Italy, fetches $240 in the US. 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 foreign markets – the additional costs of modifying the product, higher shipping and insurance costs, import tariffs and taxes, costs associated with exchange-rate fluctuations and higher channel and physical distribution costs.[39]

For example, Campbell found that its distribution costs in the UK were 30 per cent higher than in the US. US retailers typically purchase soup in large quantities – 48-can cases of a single soup by the dozens, hundred or carloads. In contrast, English grocers purchase soup in small quantities – typically in 24-can cases of *assorted* soups. Each case must be hand-packed for shipment. To handle these small orders, Campbell had to add a costly extra wholesale level to its European channel. The smaller orders also mean that English retailers order two or three times as often as their US counterparts, bumping up billing and order costs. These and

other factors caused Campbell to charge much higher prices for its soups in the UK.[40] Thus international pricing presents some special problems and complexities that are discussed in more detail in Chapter 6.

Price changes

After developing their price 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. In this case, the firm needs more business and cannot get it through increased sales effort, product improvement or other measures. It may drop its *follow-the-leader pricing* – charging about the same price as its leading competitor – and aggressively cut prices to boost sales. But as the airline, construction equipment 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 on to market share.

Another situation leading to price changes is falling market share in the face of strong price competition. Several industries – cars, consumer electronics, cameras, watches and steel, for example – lost market share to Japanese competitors who offered high-quality products at lower prices than Western competitors. In response, defending companies resorted to more aggressive pricing to hold on to their markets.

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. Bausch & Lomb used an aggressive low-cost, low-price strategy to become an early leader in the competitive soft contact-lens market.

Initiating price increases

In contrast, many companies have had to *raise* prices in recent years. They do this knowing that customers, dealers and even their own sales force may resent the price increases. Yet a successful price increase can greatly increase profits. For example, if the company's profit margin is 3 per cent of sales, a 1 per cent price increase will increase profits by 33 per cent if sales volume is unaffected.

A considerable factor in price increases is cost inflation. Rising costs squeeze profit margins and lead companies to make regular rounds of price increases. Companies often raise their prices by more than the cost increase in anticipation of further inflation. Another factor leading to price increases is over-demand: when a company cannot supply all its customers' needs, it can raise its prices, ration products to customers or both.

Companies can increase their prices in a number of ways to keep up with rising costs. Dropping discounts and adding higher-priced units to the line can raise prices almost invisibly. Or prices can be pushed up openly. Companies have learned to take care when passing price increases on to customers. The price increases should be supported with a

company communication programme telling customers why prices are being increased. The company sales force should help customers find ways to economise.

Where possible, the company should consider ways to meet higher costs or demand without raising prices. For example, it can shrink the product instead of raising the price, as confectionery manufacturers do. It can substitute less expensive ingredients or remove certain product features, packaging or services. Or it can 'unbundle' its products and services, removing and separately pricing elements that were formerly part of the offer. IBM, for example, now offers training and consulting as separately priced services.

Buyer reactions to price changes

Whether the price is raised or lowered, the action will affect buyers, competitors, distributors and suppliers, and may interest government as well. Customers do not always interpret prices in a straightforward way. They may view a price *cut* in several ways. For example, what would you think if Sony were suddenly to cut its DVD prices in half? You might think that these DVDs are about to be replaced by newer models or that they have some fault and are not selling well. You might think that Sony is in financial trouble and may not stay in the business long enough to supply future parts. You might believe that quality has been reduced. Or you might think that the price will come down even further and that it will pay to wait and see.

Similarly, a price *increase*, which would normally lower sales, may have some positive meanings for buyers. What would you think if Sony *raised* the price of its latest DVD model? On the one hand, you might think that the item is very 'hot' and may be unobtainable unless you buy it soon. Or you might think that the recorder is unusually good value. On the other hand, you might think that Sony is greedy and charging what the traffic will bear.

Competitor reactions to price changes

A firm considering a price change has to worry about the reactions of its competitors as well as 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.

How can the firm figure out the likely reactions of its competitors? If the firm faces one large competitor and if the competitor tends to react in a set way to price changes, that reaction can be easily anticipated. But if the competitor treats each price change as a fresh challenge and reacts according to its self-interest, the company will have to figure out just what makes up the competitor's self-interest at the time.

The problem is complex because, like the customer, the competitor can interpret a company price cut in many ways. It might think that the company is trying to grab a larger market share, that the company is doing poorly and trying to boost its sales or that the company wants the whole industry to cut prices to increase total demand.

When there are several competitors, the company must guess each competitor's likely reaction. If all competitors behave alike, this amounts to analysing 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 questions: Why did the competitor change the price? Was it to make more market share, to use excess capacity, to meet changing cost conditions or to lead an industry-wide price change? Is the price change temporary or

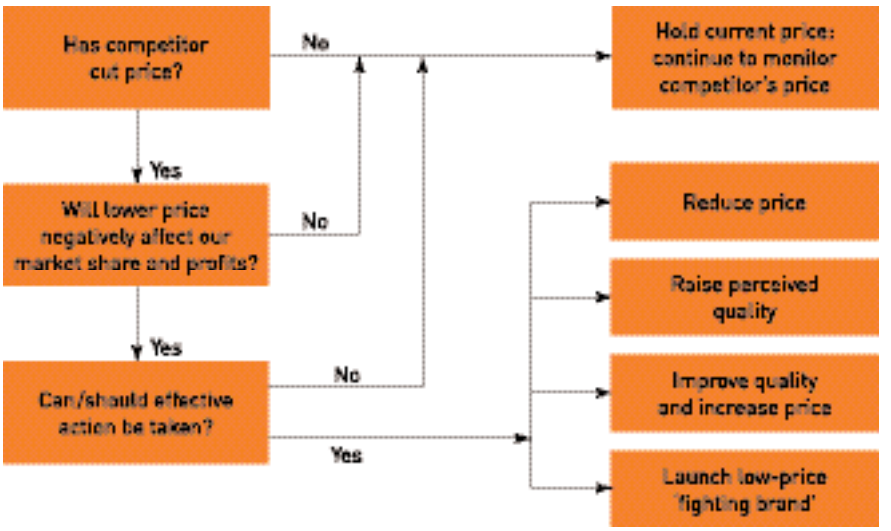


Figure 16.9 Assessing and responding to a competitor's price cut

permanent? What will happen to the company's market share and profits if it does not respond? Are other companies going to respond? What are the competitor's and other firms' responses to each possible reaction likely to be?

Besides these issues, the company must make a broader analysis. It has to consider its own product's stage in the life-cycle, its importance in the company's product mix, the intentions and resources of the competitor and the possible consumer reactions to price changes. The company cannot always make an extended analysis of its alternatives at the time of a price change, however. The competitor may have spent much time preparing this decision, but the company may have to react within hours or days. About the only way to cut down reaction time is to plan ahead for both possible price changes and possible responses from the competitor.

Figure 16.9 shows the ways in which a company might assess and respond to a competitor's price cut. Once the company has determined that the competitor has cut its price and that this price reduction is likely to harm company 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. It might decide that it should wait and respond when it has more information on the effects of the competitor's price change. For now, it might be willing to hold on to good customers, while giving up the poorer ones to the competitor. The argument against this holding strategy, however, is that the competitor may get stronger and more confident as its sales increase and the company might wait too long to act.

> By keeping the appeal of their products ahead of the competition and keeping costs down, Nokia has not only maintained profitability but increased its market share of the mobile phone market. According to Jorma Ollila, Nokia's chief executive: 'There was a belief among some in the market that new players entering the marketplace would disrupt the formula, but that has not happened.'[41]

If the company decides that effective action can and should be taken, it might make any of the following four responses.

1. *Reduce price*. The leader might drop its price to 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. Or it might worry that recapturing lost market share later would be too hard. Cutting 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 ultimately this will hurt long-run market share. The company should try to maintain its quality as it cuts prices.
2. *Raise perceived quality*. Like Nokia, a company might maintain its price but strengthen the perceived value of its offer. It could improve its communications, stressing the relative quality 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 quality than to cut price and operate at a lower margin.
3. *Improve quality and increase price*. The company might increase quality and raise its price, moving its brand into a higher price position. The higher quality justifies the higher price, which in turn preserves the company's higher margins. Or the company can hold the price on the current product and introduce a new brand at a higher price position.
4. *Launch low-price 'fighting brand'*. One of the best responses is to add lower-price items to the line or to create 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, when attacked on price by Fuji, Kodak introduced low-priced Funtime film. When challenged on price by store brands and other low-priced entrants, Nestlé turned a number of its brands into fighting brands, including Fussell's condensed milk. In response to price pressures, Miller cut the price of its High Life brand by 20 per cent in most markets and sales jumped 9 per cent in less than a year.[42]

Pricing strategies and tactics form an important element of a company's marketing mix. In setting prices, companies must carefully consider a great many internal and external factors before choosing a price that will give them the greatest competitive advantage in selected target markets. However, companies are not usually free to charge whatever prices they wish. Several laws restrict pricing practices and a number of ethical considerations affect pricing decisions. Pricing strategies and tactics also depend upon the way that we pay for things. Increasingly, what we spend does not depend on how much money we have on us or how much we earned that week. These days our money is rarely something we see or feel; it is the electronic transmission of data between files within banks or on the Internet:

Increasingly, people pay, for even small transactions, by credit card, debit card, prepaid smart cards or e-cash. People and companies are also turning to trading their skills and produce without using money. A plumber may do a job for you if you will mow his lawn for a week and babysit one night. But, if the plumber does not want anything you can provide, he could turn to clubs that trade credits. The plumber does the job for you, but he can use his credits to get goods or services from someone else.

Today, institutions like London's Capital Barter Corporation (CBC) orchestrate third-party deals for companies that offer their services for trade credits rather than cash. CBC's deals range from a £15 (€22) restaurant meal to a £15,000 stock of computers. The most popular items are airline tickets, photocopiers and computers. Barter is not just for small deals between small

firms – Lufthansa, Playtex and US Networks have all had deals worth €2 million or more. CBC and other barter companies, including The Bartering Company and Eurotrade, debit and credit their members' accounts in 'trade pounds'. Each member has a credit limit depending upon the size of the company and the tradability of its products.

And there is the Internet now which has its own money. New e-payment formats, including iClickCharge and Opass, cost retailers little and allow 'micropayments' down to €0.001. There are also creative variants like PayTrust that specialises in the electronic payment of subscribers' household bills. Most exotic of all is e-gold, where customers fund their online accounts by buying gold or other precious metals. Once purchased, this libertarian commodity is free of currency, purchases being paid for in units of weight of the metals.[43]

Summary

Despite the increased role of non-price factors in the modern marketing process, *price* remains an important element in the marketing mix. Many internal and external factors influence the company's pricing decisions. *Internal factors* include the firm's *marketing objectives*, *marketing-mix strategy*, *costs* and *organisation for pricing*.

The pricing strategy is largely determined by the company's *target market and positioning objectives*. Common pricing objectives include survival, current profit maximisation, market-share leadership and product-quality leadership.

Pricing decisions affect and are affected by product design, distribution and promotion decisions. Hence, they must be carefully coordinated with the other *marketing-mix* decisions when designing the marketing programme.

Costs set the floor for the company's price – the price must cover all the costs of making and selling the product, plus a fair rate of return. Management must decide who within the *organisation* is responsible for setting price. Top management usually sets pricing policies, but some pricing authority may be delegated to lower-level managers, including salespeople, production, finance and accounting managers.

External factors that influence pricing decisions include the nature of the market and demand; competitors' prices and offers; and factors such as the economy, reseller needs and government actions. The seller's pricing freedom varies with different types of market. Pricing is especially challenging in markets characterised by monopolistic competition oligopoly.

In the end, the consumer weighs the price against the perceived values of using the product – if the price exceeds the sum of the values, consumers will not buy the product. Consumers differ in the values they assign to different product features, and marketers often vary their pricing strategies for different price segments. When assessing the market and demand, the company estimates the demand curve, which shows the probable quantity purchased per period at alternative price levels. The more *inelastic* the demand, the higher the company can set its price. *Demand* and *consumer value perceptions* set the ceiling for prices.

Consumers also compare a product's price to the prices of *competitors'* products. The company can select one or a combination of three general pricing approaches: the *cost-based approach* (cost-plus pricing, break-even analysis and target profit pricing); the *value-based approach* (value-based pricing); and the *competition-based approach* (going-rate, sealed-bid pricing or auctions). With the advent of the Internet, online auctions look like becoming an increasingly common means of price setting.

Pricing is a dynamic process. Companies design a *pricing structure* that covers all their products. They change this structure over time and adjust it to account for different customers and situations. Pricing strategies usually change as a product passes through its life-cycle. There are several price-quality strategies for introducing an imitative product. In pricing innovative new products, a company can follow a *skimming policy* by initially setting high prices to 'skim' the maximum amount of revenue from various segments of the market. Or it can use *penetration pricing* by setting a low initial price to win a large market share.

When the product is part of a product mix, the firm searches for a set of prices that will maximise the profits from the total mix. The company decides on *price steps* for items in its product line and on the pricing of *optional products*, *captive products*, *by-products* and *product bundles*.

Companies apply a variety of *price-adjustment strategies* to account for differences in consumer segments and situations: *discount and allowance pricing*, *segmented pricing*, *psychological pricing*, *promotional pricing*, *value pricing*, *geographical pricing* and *international pricing*.

When a firm considers initiating a *price change*, it must consider customers' and competitors' reactions. Customers' perception of the price change influences their reactions. Competitors' reactions flow from a set reaction policy or a fresh analysis of each situation. The firm initiating the price change must also anticipate the probable reactions of suppliers, intermediaries and government. The firm 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. 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.

Discussing the issues

1. A health and leisure club in a major city has seen its membership renewal rate fall at a rate of 10 per cent per year for the past three years. Assume you are the managing director of the club. You are faced with a dilemma. On one hand, you are under great pressure to raise new membership and renewal subscription fees to compensate for falling revenues. However, you suspect that higher subscription rates will make matters worse. On the other hand, you might seek to attract new customers and retain existing club members by reducing new subscription and renewal rates. What internal and external pricing factors should you consider before you make your decision? Explain.
2. List and critically discuss the general approaches to pricing. Select examples of products that you regularly use. Notice the price of each of these items. For each item, state the main benefits you are looking for in using the product. Does the price communicate the total benefits sought? Does the product's price suggest good value? Do you think the manufacturer or retailer is overcharging or undercharging consumers for the product?

Why or why not? What pricing approach do you think is most appropriate for setting the price for these products?

3. Like Amazon.com and Egg, the Internet bank, many e-commerce operations offer prices well below those in the high street or retail outlets and are making huge losses. What are the Internet businesses hoping to achieve with their aggressive pricing? Is their price advantage likely to be maintained? Some companies are adopting the concept of dynamic pricing on the Internet. How is dynamic pricing used on the Internet and what are the benefits for e-commerce operations?
4. Companies often adjust their basic prices to allow for differences in customers, products and locations. Use examples to illustrate the various forms of price adjustment strategies. In your answer, discuss where relevant the advantages and disadvantages of specific price adjustment strategies.
5. Assume that you are the manager of a consumer electronics and home entertainment department store. Formulate rules that govern (a) initiating a price cut, (b) initiating a price increase, (c) a negative reaction from buyers to a price change by your company, (d) a competitor's response to your price change, and (e) your response to a competitor's price change. In your answer, explain the assumptions underlying your proposed rules.

Applying the concepts

1. Conduct a pricing survey of computer printers, including home, office and portable printers offered by different companies (e.g. Hewlett-Packard, Epson, Canon, Océ, Xerox as well as retailer own-brands). Where possible, visit the retail stores or the websites of the retail stores and companies concerned to get more information.
   (a) What patterns do you detect for the pricing of different brands and types of printers (e.g. home, office, portable, basic, advanced)? Are there differences in pricing at different locations (e.g. retail versus direct/online)?
   (b) What pricing approaches appear to be used by different companies and their retailers?
   (c) What internal and external factors are important to consider when deciding a pricing strategy in this industry?
2. Visit the online shopping sites of major retailers in Europe and the US and compare the prices of identical products for sale in both areas. (Examples to choose are CDs by European and American artists sold by Amazon.com in the US and the same CDs sold by their European operations, such as Amazon.co.uk.) How different are the prices and to what extent do the prices reflect the country of origin of the products? What are the barriers to the prices being forced to converge by people shopping online across borders? How do the prices compare with high-street prices and those from online price comparison websites?

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Concluding concepts 16
easyJet: easy come, easy go

Michael O'Leary, the ebullient chief executive of Ryanair, takes some beating. Not only has he created Europe's leading low-cost airline, but also in a market that attracts flamboyant extroverts Michael O'Leary puts Virgin's
Sir Richard Branson in the shade. To announce the opening of two additional bases at Rome Ciampina and Barcelona-Girona, he turned up dressed as the Pope.
His pronouncements were as exuberant as his look.
He announced he had overtaken British Airways in the previous month's short-haul traffic and declared Ryanair would double in size during the next decade, overtaking Europe's existing short-haul market leaders Air France, British Airways and Lufthansa.

'We make money with falling air fares. And we make stinking piles of money with rising fares. . . . We could be a monster, it's scary', declares Mr O'Leary. While regular airlines whined about the impact of 9–11, Ryanair's market share and cash mountain grew. 'With our business model', he proclaimed, 'we will soon be offering to
fly people across Europe for free.'

If you get it right, the low-cost formula is a route to high rewards in an airline industry better known for chronic loss makers. It has worked for 20 years for Southwest Airlines in the US, the original low-cost pioneer. By 2003, Ryanair had established itself as one of the world's most profitable airlines. It trades on a racy forward price/earnings ratio of more than 36, a level normally reserved for growth companies, not airlines.

Others follow Ryanair's business model. With easyJet, Stelios Hajiloannou, the son of a wealthy Greek ship-owner, is challenging Ryanair and is extending his pricing model to hire cars, with

easyCar. All these low-cost operations use a dynamic pricing mod
Book an easyCar Mercedes early and most days you will get an ex
prices can go up and down to achieve the best return. Mr Hajiloan
prices will vary hugely to match supply and demand. On the run-u

deal with film companies to get the flexibility he wants.

Established airlines are responding differently to the low-cost challenge. British Airways sold their low-cost airline, Go, after years of heavy losses but in the hope of making 'a small profit' in the year of the sale. According to their new chef executive, Rod Eddington, the new team at BA decided that Go does not fit in with his vision of running a profitable (high-cost) full-service airline. There have been enough casualties along the way to show that the low-cost model is far from being a one-way bet, however. In the UK collapse, KLM's did not run smoothly, and in the US a fatal crash ruined highly successful ValuJet.

To announce the opening of two additional bases, Ryanair's CEO dressed up as the Pope.

Virgin Express, Sir Richard Branson's Brussels and Nasdaq-listed attempt at setting up a no-frills carrier, provided further proof of the pitfalls waiting for operators that fail to control their costs. Its losses are still mounting. In contrast to its fast-growing rivals, it is retrenching by cutting routes and selling aircraft.

'In this business it's low-cost that wins', says Mr O'Leary. 'Ninety-nine per cent of people want the cheapest price. They don't want awards for the in-flight magazine or the best coffee. The brand, who cares? It has to be safe, on time and cheap. It's a bus service, it's transport.'

It is not all easy flying for established low-cost airlines, either. easyJet's high aircraft utilisation rate makes it especially vulnerable to delays; it may face difficulties protecting its name and branding; the business is subject to strong seasonal variations; it may not meet its growth targets; rapid growth may be difficult to manage; it will incur significant costs acquiring additional aircraft; it is exposed to fuel price fluctuations; and there are the well-publicised problems with landing charges at Luton airport, its main hub.

Whatever the risks put forward by careful investment bankers, most aviation analysts believe that it is easyJet and Ryanair that are the likely low-cost winners. Both airlines solely operate simple fleets and keep operations simple by offering no free food. Ray Webster, easyJet chief executive, says there are important differences between easyJet and Ryanair. Whereas Dublin-based Ryanair has flourished during much of its first decade using older second-hand aircraft, easyJet has chosen to use new aircraft, believing in the cost advantages to be gained from lower maintenance needs, the ability to achieve high utilisation levels, quick turnaround times and greater reliability of service.

Ryanair has been ruthless about offering the lowest fares available, and a vital part of its strategy is to fly to secondary airports with much lower charges. It has also been expanding its network to more leisure destinations. By contrast, easyJet uses more main airports that people want to use and that attract higher-paying business passengers as well as leisure travellers. As a result, easyJet is seeking to add greater depth to the network by using the growing fleet to increase frequencies rather than destinations. Because it started later than Ryanair, easyJet has also been able to avoid using travel agents as a key way of keeping distribution costs low.

Mr O'Leary is just as devoted a believer in the power of the Internet to cut sales and marketing costs, but says that at Ryanair these savings are still feeding through to the bottom line, whereas they have already been booked at easyJet. The Web also gives an 'amazing capacity to fill our aircraft very quickly and we can sell with very little advertising', says Mr O'Leary, who is planning to add more routes next year to secondary airports, where the costs are low. 'There is a huge floating population in London that just wants to fly somewhere. If you make it very cheap they just go for a weekend anyway', he says. Publicly he pours scorn on his rivals' strategies, but perhaps even Ryanair would be forced to admire the easyJet low-cost toilet strategy.

Both airlines are adding new Boeing 737 aircraft at a rapid pace to meet forecast growth rates. In the easyJet case, they order the aircraft with one toilet removed in order to cram in one more seat. 'There are no free meals or free drinks on board. If people have to pay, they consume less. There is less waste, the cabin crew themselves can do the clean up. We don't have to stock the galleys and clean the aircraft at the airport. And

people use the toilets less, so we can take one out.'

Having failed to take on the low-cost airlines at their own game, the established airlines are using their powerful political influence to hobble the new competition. Legislation forcing airlines to pay fixed penalties for delays will be particularly painful to the low-cost operators with little margin to cover fines and high utilisation that gives them less time to make up for delays.

Ryanair is particularly hit by the European Commission's upholding a complaint that they illegally received incentives granted by Belgium's Walloon government to encourage the airline to fly from Charleroi airport. Ryanair may repay €4m of concessions it received in cut-price landing fees and handling charges.

While Ryanair still reels from the Charleroi judgement, two more complaints hit the European Commission's desk, this time about two deals with French regional airports: Strasbourg and Pau. They expect additional complaints from Italy and Germany to follow.

The battle is not all one-sided. Ryanair's Michael O'Leary said the airline will soon be launching a series of 'state aid' complaints against flag-carrier airlines. The Assembly of European Regions has also complained that the European Commission's decision is 'a direct threat to the existence of European airports'. They explain that low-cost airlines have had 'enormous impact' on regional development, particularly tourism and small business. Giving the power back to the flag-carriers in their major airports will further concentrate activities and visitors in a few congested hubs, like Heathrow and Orly. Commenting on the failure of a fellow low-cost airline, a Ryanair spokesman said 'The fall of Air Littoral is a direct consequence of misguided French Government policy, which seeks to promote and protect the high fare airline Air France, while denying ordinary consumers choice, competition and access to low fares.' Wolfgang Kurth, chef executive of Germany's Hapag-Lloyd Express and president of the newly formed European Low Fares Airline Association (ELFAA), states their case. Low-cost airlines have 'enabled large numbers of consumers to travel at a fraction of the cost, allowed previously unprofitable airports to become viable and profitable entities, and also have benefited regional development and the growth of tourism.'

Questions

1. What is stimulating the growth of budget airlines and what explains the economics behind Michael O'Leary's claim that Ryanair could soon be flying people around Europe for free?
2. What allows Europe's new budget airlines to keep their costs down and which operator has the advantage?
3. Does the Internet have a distinct role in the budget airlines' operations?
4. How does the European Commission's claim that Charleroi priced their landing fees and handling charges too low for Ryanair square with ELFAA's claim that it is low-cost airlines that have allowed regional airports to thrive profitably? How do you think the regional airports arrived at their fees and charges?
5. What is the likely impact of easyJet's style on pricing when applied to cinemas? Could a similar pricing approach apply in other circumstances when price and demand do not match, such as major sporting events, rock concerts and inner-city parking?

SOURCES: Kevin Done, 'Budget airlines lured by hope of sky high profits', *Financial Times* (11 November 2000), p. 20; Kevin Done, 'Ryanair reveals expansion plans', *Financial Times* (5 December 2003); Kevin Done, 'Regions braced for Ryanair fallout', *Financial Times* (29 January 2004); Mary Watkins, 'Brussels outlaws Ryanair subsidy', *Financial Times* (3 February 2004); Kevin Done, 'Ryanair faces more complaints on airport subsidies', *Financial Times* (5 February 2004); Joanna Chung, 'EasyJet issues upbeat challenge to Ryanair', *Financial Times* (6 February 2004); www.easyjet.com; www.ryanair.co.uk. By pricing a car on www.easycar.com you will get a table that clearly shows how the hire charges adjust with supply and demand.