

Pricing Products

Understanding and Capturing Customer Value

Previewing the Concepts

Next, we look at a second major marketing mix tool—pricing. According to one pricing expert, pricing lets a company “get paid for the value it creates for customers.”¹ 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’ll look at internal and external considerations that affect pricing decisions and examine general pricing approaches. In the next chapter, we dig into pricing strategies.

Pricing decisions can make or break a company. For openers, consider Toys ‘R’ Us, whose low-cost, everyday-low-price strategy years ago helped it to sweep aside smaller competitors and become the nation’s largest toy seller. But what goes around comes around. Once-dominant Toys ‘R’ Us is now fighting for survival in the toy market against an even more ruthless low-price competitor. (Can you guess which one?!)

Finding the right pricing strategy and implementing it well can be critical to a company’s success—even to its survival. Perhaps no company knows this better than giant toy retailer Toys ‘R’ Us. More than three decades ago, Toys ‘R’ Us taught smaller independent toy retailers and department-store chains in its industry a hard pricing lesson, driving many of them to extinction. In recent years, however, Toys ‘R’ Us has gotten a bitter taste of its own pricing medicine in return.

In the late 1970s, Toys ‘R’ Us emerged as a toy retailing “category killer,” offering consumers a vast selection of toys at everyday low prices. The then-prevalent smaller toy stores, and toy sections of larger department stores, soon fell by the wayside because they couldn’t match Toys ‘R’ Us’s selection, convenience, and low prices. Throughout the 1980s and early 1990s, Toys ‘R’ Us grew explosively to become the nation’s largest toy retailer, grabbing as much as a 25 percent share of the U.S. toy market.

However, in the 1990s, Toys ‘R’ Us’s heady success seemed to vanish almost overnight with the emergence of—you guessed it—Wal-Mart as a toy retailing force. Wal-Mart offered toy buyers an even more compelling value proposition. Like Toys ‘R’ Us, it offered good toy selection and convenience. But on prices, it did Toys ‘R’ Us one better. Wal-Mart offered not just *everyday low prices* on toys, it offered *rock-bottom* prices.

Says one analyst, “With its mammoth stores, diverse array of products, and super efficient supply chain, Wal-Mart can provide consumers good quality, high levels of choice and convenience, and [incredibly low] prices.” What’s more, he continues, “Because it is a mass retailer with a broad, diverse inventory, Wal-Mart can afford to use toys as a loss-leader, losing money on toy purchases to lure in customers who then purchase higher-margin goods. Focused retailers such as Toys ‘R’ Us just don’t have that luxury.” In 1998, Wal-Mart pushed Toys ‘R’ Us aside to become the country’s largest toy seller.

Toys ‘R’ Us fought back by trying to match Wal-Mart’s super low prices, but with disastrous results. Consider this *Business Week* account of the 2003 Christmas season:

He sings, he dances, he shakes it all about. For thousands of toddlers, Hokey Pokey Elmo was one of the great things about Christmas, 2003. But for Toys ‘R’ Us, Elmo was the fuzzy red embodiment of all that went wrong. He was just too cheap. In October, two months before the heart of the holiday rush, Wal-Mart stores surprised all of its competition by dropping Elmo’s price from \$25 to \$19.50, a full \$4.50 below what many retailers had paid for it. Within days,

Toys 'R' Us dropped its price to \$19.99. The price war dominated all the way down the toy aisle. "Our choice was short-term profit vs. long-term market share; we chose to protect market share," says [former] CEO John Eyer, who thinks all stores could have sold out of the popular doll at \$29.99.

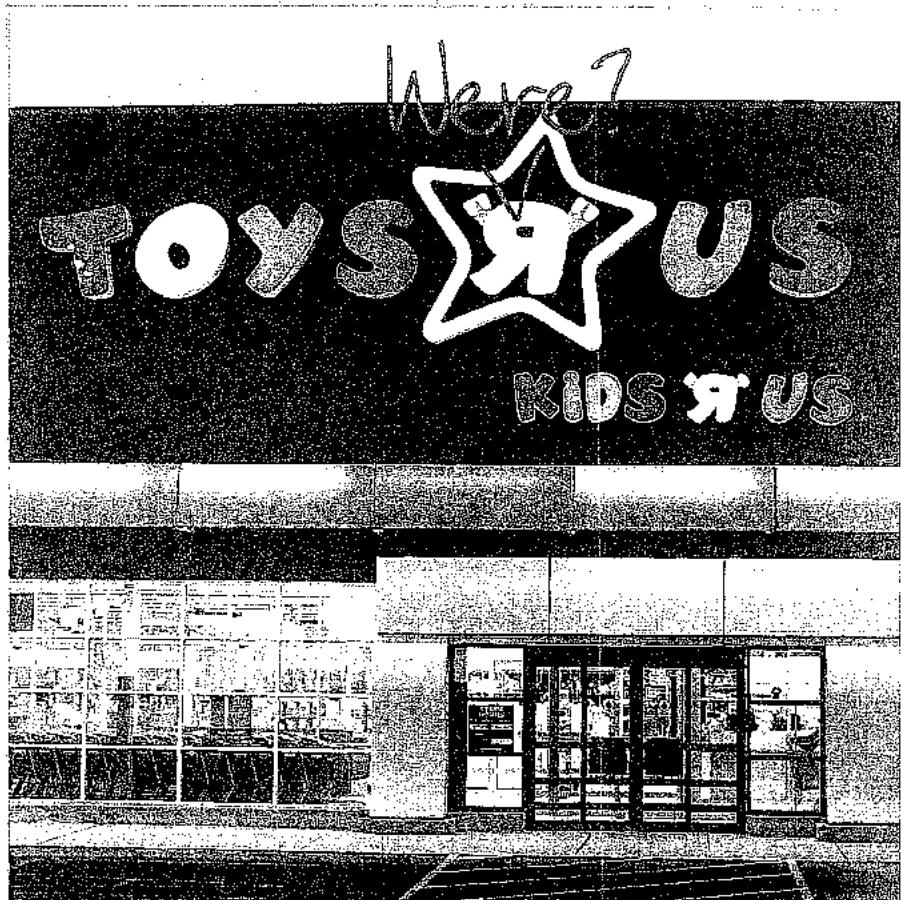
That's profit Toys 'R' Us couldn't afford to lose. The holiday season [its third disappointing one in a row] resulted in a 5 percent drop in sales at Toys 'R' Us stores open at least a year. Net income for the year fell 27 percent. Wal-Mart, on the other hand, [was] all smiles. . . . CEO Lee Scott called 2003 "an excellent toy season" and toys "a very profitable category with a very strong gross margin."

Clearly, Toys 'R' Us has little hope of competing on price with Wal-Mart. "I wouldn't want to play that game," says [an industry expert].

By early 2005, Wal-Mart held a 25 percent share of the toy market; Toys 'R' Us's share had fallen to 15 percent. Later that year, new ownership took Toys 'R' Us private. Despite rumors that the once-dominant toy retailer would exit the toy business altogether and focus on its growing and profitable Babies 'R' Us unit, the new owners vowed to remain a player in the toy industry.

However, Toys 'R' Us is now playing out a dramatically new game plan. For starters, management has closed nearly 100 underperforming stores to cut costs, and it's refocusing its marketing strategy. For example, the chain has stepped back from cut-throat price wars that it simply can't win. Instead, it's dropping slow-selling products and emphasizing top-selling brands and higher-margin exclusive items, such as special Bratz or Barbie dolls sold only at its stores.

And in an effort to differentiate itself from the likes of Wal-Mart and Target, Toys 'R' Us is making a big push to improve store atmospheres, shopper experiences, and customer service. It's cleaning up its stores, uncluttering its aisles, and hiring more helpful employees who can offer customers toy-buying advice. Says CEO Gerald Storch, "When you go to a large, multiproduct discount chain, you'll be lucky to find someone who can point you to the toy department or will even take you there, much less answer specific questions. When a customer comes in our



Objectives

After studying this chapter, you should be able to:

1. answer the question "What is price?" and discuss the importance of pricing in today's fast-changing environment.
2. discuss the importance of understanding customer value perceptions when setting prices.
3. discuss the importance of company and product costs in setting prices.
4. identify and define the other important internal and external factors affecting a firm's pricing decisions.

store, our people can tell them what's a great toy for a ten-year-old boy for their birthday, because all we do is toys." Storch hopes that brighter, less-cluttered stores and better service will support higher prices and margins.

Still, Toys 'R' Us faces an uphill battle in its efforts to win back the now-price-sensitive toy buyers it helped to create decades ago. Consider this example.

Aurore Boone of Alpharetta, Georgia, was recently at her local Wal-Mart checking out kids' bikes. She shops at Toys 'R' Us to see what's on the shelves, but of the roughly \$500 she and her husband Mark spend on toys a year, more than half goes to Wal-Mart, the rest to stores such as Target. It's cheaper, and she can do her other shopping there, too.

It isn't a matter of whether Toys 'R' Us can *sell* toys—with more than \$11 billion in sales, the company remains one of the world's largest retailers. It's a matter of whether Toys 'R' Us can sell toys *profitably* (despite big sales, it's still posting losses). And to do that, it must find the right customer value and pricing formulas. As *Business Week* concludes: "It's a harsh new world for Toys 'R' Us, which, as the industry's original 800-pound gorilla, wiped out legions of small toy stores in the '60s and '70s with its cut-price, no-frills, big-box outlets. Now, having taught consumers that toys should be cheap, the chain is finding that they learned the lesson all too well."²

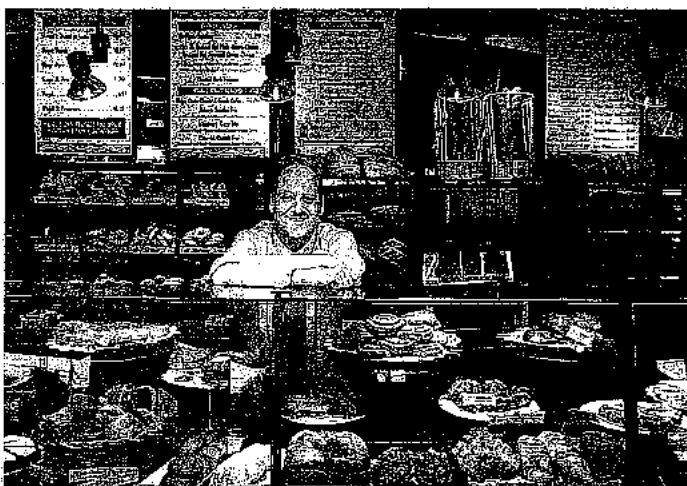
Companies today face a fierce and fast-changing pricing environment. Increasing customer price consciousness has put many companies in a "pricing vise." "Thank the Wal-Mart phenomenon," says one analyst. "These days, we're all cheapskates in search of a spend-less strategy."³ In response, it seems that almost every company is looking for ways to slash 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 the price is more important than the customer value a brand delivers. Instead, companies should sell value, not price. They should persuade customers that paying a higher price for the company's brand is justified by the greater value they gain. The challenge is to find the price that will let the company make a fair profit by getting paid for the customer value it creates. "Give people something of value," says Ronald Shaich, CEO of Panera Bread Company, "and they'll happily pay for it."⁴

In this chapter and the next, we focus on the process of setting prices. This chapter defines prices, looks at the factors marketers must consider when setting prices, and examines general pricing approaches. In the next chapter, we look at pricing strategies for new-product pricing, product mix pricing, price adjustments for buyer and situational factors, and price changes.

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.



■ Pricing: The challenge is to harvest the customer value the company creates. Says Panera's CEO, pictured here, "Give people something of value, and they'll happily pay for it."

What Is a Price?

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 customers give up in order to gain the benefits of having or using a product or service. Historically, price has been the major factor affecting buyer choice. In recent decades, non-price factors have gained increasing importance. However, price still remains one of the most important elements determining a firm's market share and profitability.

Price is the only element in the marketing mix that produces revenue; all other elements represent costs. Price is also one of the most flexible marketing mix elements. Unlike prod-

uct features and channel commitments, prices can be changed quickly. At the same time, pricing is the number-one problem facing many marketing executives, and many companies do not handle pricing well. One frequent problem is that companies are too quick to reduce prices in order to get a sale rather than convincing buyers that their product's greater value is worth a higher price. Other common mistakes include pricing that is too cost oriented rather than customer-value oriented, and pricing that does not take the rest of the marketing mix into account.

Some managers view pricing as a big headache, preferring instead to focus on the other marketing mix elements. However, smart managers treat pricing as a key strategic tool for creating and capturing customer value. Prices have a direct impact on a firm's bottom line. According to one expert, "a 1 percent price improvement generates a 12.5 percent profit improvement for most organizations."⁵ More importantly, as a part of a company's overall value proposition, price plays a key role in creating customer value and building customer relationships. "Instead of running away from pricing," says the expert, "savvy marketers are embracing it."

Factors to Consider When Setting Prices

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

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

Value-Based Pricing

Good pricing begins with a complete understanding of the value that a product or service creates for customers. Value-based pricing uses buyers' perceptions of value, not the seller's cost, as the key to pricing. Value-based pricing means that the marketer cannot design a product and marketing program and then set the price. Price is considered along with the other marketing mix variables *before* the marketing program is set.

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

Value-based pricing reverses this process. The company sets its target price based on customer perceptions of the product value. The targeted value and price then drive

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

FIGURE 10.1
Considerations in setting price

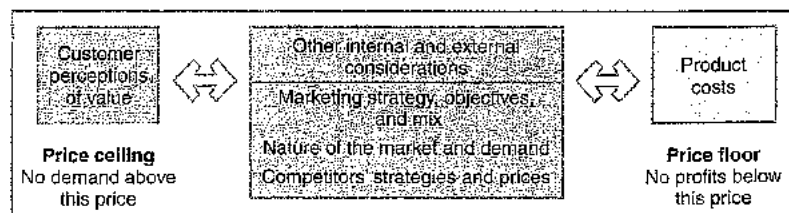
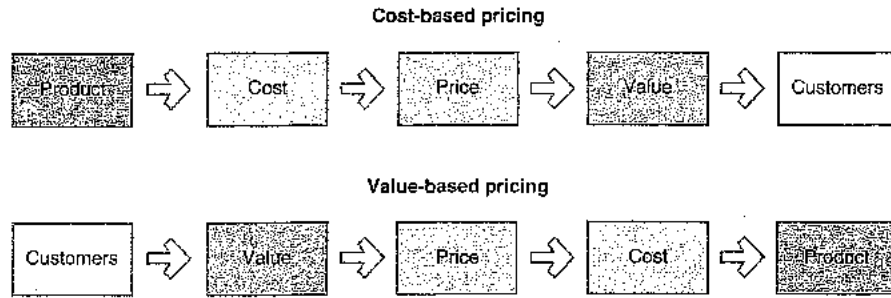


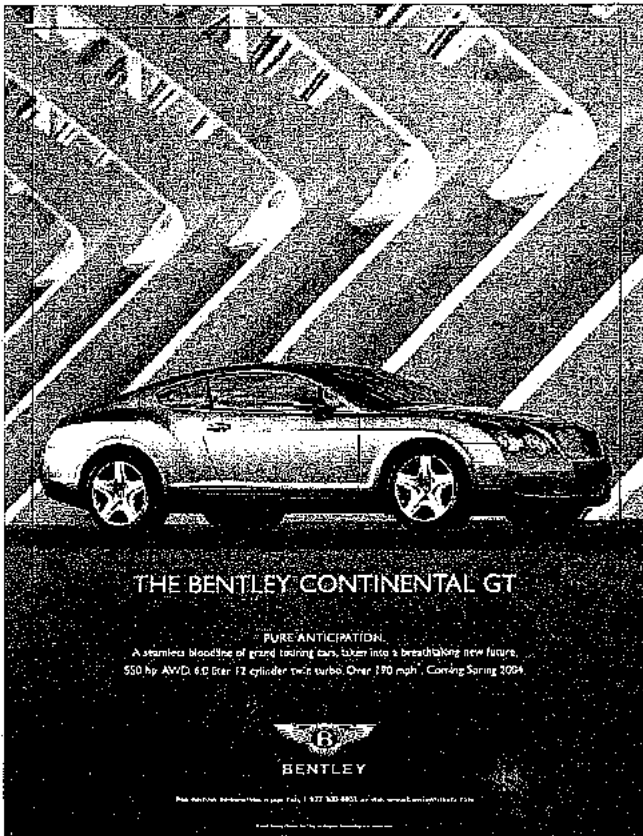
FIGURE 10.2**Value-based pricing versus cost-based pricing**

Source: Thomas T. Nagle and Reed K. Holden, *The Strategy and Tactics of Pricing*, 3rd ed. (Upper Saddle River, NJ: Prentice Hall, 2002), p. 4. Reproduced by permission of Pearson Education, Inc., Upper Saddle River, New Jersey.



decisions about product design and what costs can be incurred. As a result, pricing begins with analyzing consumer needs and value perceptions, and price is set to match consumers' perceived value.

It's important to remember that "good value" is not the same as "low price." For example, prices for a Hermes Birkin Bag start at \$6,000—a less expensive handbag might carry as much, but some consumers place great value on the intangibles they receive from a one-of-a-kind handmade bag that has a year-long waiting list. Similarly, some car buyers consider the luxurious Bentley Continental GT automobile a real value, even at an eye-popping price of \$150,000:



Value-based pricing: "Good value" is not the same as "low price." Some car buyers consider the luxurious Bentley Continental GT automobile a real value, even at an eye-popping price of \$150,000.

Stay with me here, because I'm about to [tell you why] a certain automobile costing \$150,000 is not actually expensive, but is in fact a tremendous value. Every Bentley GT is built by hand, an Old World bit of automaking requiring 160 hours per vehicle. Craftsmen spend 18 hours simply stitching the perfectly joined leather of the GT's steering wheel, almost as long as it takes to assemble an entire VW Golf. The results are impressive: Dash and doors are mirrored with walnut veneer, floor pedals are carved from aluminum, window and seat toggles are cut from actual metal rather than plastic, and every air vent is perfectly chromed. . . . The sum of all this is a fitted cabin that approximates that of a \$300,000 vehicle, matched to an engine the equal of a \$200,000 automobile, within a car that has brilliantly incorporated . . . technological sophistication. As I said, the GT is a bargain. [Just ask anyone on the lengthy waiting list.] The waiting time to bring home your very own GT is currently half a year.⁶

A company using value-based pricing must find out what value buyers assign to different competitive offers. However, companies often find it hard to measure the value customers will attach to its product. For example, calculating the cost of ingredients in a meal at a fancy restaurant is relatively easy. But assigning 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 different situations.

Still, consumers will use these perceived values to evaluate a product's price, so the company must

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

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

Good-Value Pricing

During the past decade, marketers have noted a fundamental shift in consumer attitudes toward price and quality. Many companies have changed their pricing approaches to bring them into line with changing economic conditions and consumer price perceptions. More and more, marketers have adopted **good-value pricing** strategies—offering just the right combination of quality and good service at a fair price.

In many cases, this has involved introducing less-expensive versions of established, brand name products. Fast-food restaurants such as Taco Bell and McDonald's offer "value

menus." Armani offers the less-expensive, more casual Armani Exchange fashion line. Procter & Gamble created Charmin Basic—it is "slightly less 'squeezably soft' but it's a lot less pricey than Procter & Gamble's other toilet paper." It's "Soft. Strong. Sensible."⁷ In other cases, good-value pricing has involved redesigning existing brands to offer more quality for a given price or the same quality for less.

An important type of good-value pricing at the retail level is *everyday low pricing (EDLP)*. EDLP involves charging a constant, everyday low price with few or no temporary price discounts. In contrast, *high-low pricing* involves charging higher prices on an everyday basis but running frequent promotions to lower prices temporarily on selected items. In recent years, high-low pricing has given way to EDLP in retail settings ranging from Saturn car dealerships to Giant Eagle supermarkets to furniture store Room & Board.

The king of EDLP is Wal-Mart, which practically defined the concept. Except for a few sale items every month, Wal-Mart promises everyday low prices on everything it sells. In contrast,

Kmart's recent attempts to match Wal-Mart's EDLP strategy failed. To offer everyday low prices, a company must first have everyday low costs. However, because Kmart's costs are much higher than Wal-Mart's, it could not make money at the lower prices and quickly abandoned the attempt.⁸

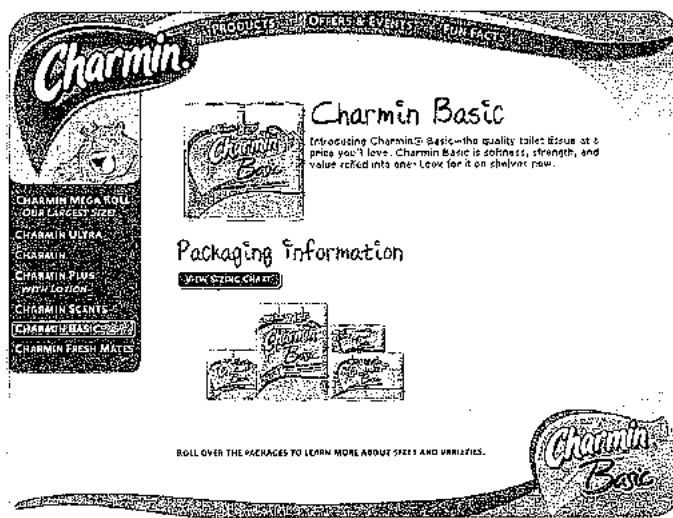
Value-Added Pricing

In many business-to-business marketing situations, the challenge is to build the company's *pricing power*—its power to escape price competition and to justify higher prices and margins without losing market share. To retain pricing power, a firm must retain or build the value of its market offering. This is especially true for suppliers of commodity products, which are characterized by little differentiation and intense price competition. If companies "rely on price to capture and retain business, they reduce whatever they're selling to a commodity," says an analyst. "Once that happens, there is no customer loyalty."⁹

To increase their pricing power, many companies adopt **value-added pricing** strategies. Rather than cutting prices to match competitors, they attach value-added features and services to differentiate their offers and thus support higher prices (see Real Marketing 10.1). "Even in today's economic environment, it's not about price," says a pricing expert. "It's about keeping customers loyal by providing service they can't find anywhere else."¹⁰

Good-value pricing

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



Good-value pricing: Procter & Gamble's Charmin Basic is still "squeezably soft" but it's a lot less pricey than P&G's other toilet paper. It's "the quality toilet tissue at the price you'll love."

Value-added pricing

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

Real Marketing

10.1 When a company finds its major competitors offering a similar product at a lower price, the natural tendency is to try to match or beat that price. Although the idea of undercutting competitors' prices and watching customers flock to you is tempting, there are dangers. Successive rounds of price-cutting can lead to price wars that erode the profit margins of all competitors in an industry. Or worse, discounting a product can cheapen it in the minds of customers, greatly reducing the seller's power to maintain profitable prices in the long term.

So, how can a company keep its pricing power when a competitor undercuts its price? Often, the best strategy is not to price below the competitor, but rather to price above and convince customers that the product is worth it. The company should ask, "What is the value of the product to the customer?" and then stand up for what the product is worth. In this way, the company shifts the focus from price to value.

But what if the company is operating in a "commodity" business, in which the products of all competitors seem pretty much alike? In such cases, the company must find ways to "decommoditize" its products—to create superior value for customers. It can do this by developing value-added features and services that differentiate its offer and justify higher prices and margins. Here are some examples of how suppliers are using value-added features and services to give them a competitive edge:

- 1. **Caterpillar:** Caterpillar charges premium prices for its heavy construction and mining equipment by convincing customers that its products and service justify every additional cent—or, rather, the extra tens of thousands of dollars. Caterpillar typically reaps a 20 to 30 percent price premium over competitors that can amount to an extra \$200,000 or more on one of those huge yellow million-dollar dump trucks.

When a large potential customer says, "I can get it for less from a competitor," the Caterpillar dealer doesn't discount the price. Instead, the dealer explains that, even at the higher price,

Cat offers the best value. Caterpillar equipment is designed with modular components that can be removed and repaired quickly, minimizing machine downtime. Caterpillar dealers carry an extensive parts inventory and guarantee delivery within 48 hours anywhere in the world, again minimizing downtime. Cat's products are designed to be rebuilt, providing a "second life" that competitors cannot match. As a result, Caterpillar used-equipment prices are often 20 percent to 30 percent higher. Beyond its high-quality equipment and maintenance, Caterpillar offers a wide range of value-adding services, from financing and insurance to equipment training and investment management advice.

In all, the dealer explains, even at the higher initial price, Caterpillar equipment delivers the lowest total cost per cubic yard of earth moved, ton of coal uncovered, or mile of road graded over the life of the product—guaranteed! Most customers seem to agree with Caterpillar's value proposition—the market-leading company dominates its markets with a more than 37 percent worldwide market share. And the big cat just keeps purring. In the past two years, sales are up 60 percent and profits have rocketed 250 percent. Despite its higher prices, demand is so strong that Caterpillar is having trouble making equipment fast enough to fill orders.

- 2. **Pioneer Hi-Bred International:** A major producer of commercial seeds and other agricultural products often thought of as commodities, DuPont subsidiary Pioneer Hi-Bred International (PHI) hardly acts like a commodity supplier. Its patented hybrid seeds yield 10 percent more crops than competitors' seeds. PHI's researchers harvest tens of thousands of test plots worldwide each year to perfect product yields and traits.

But beyond producing a superior product, PHI also provides a bundle of value-added services. For example, it equips its sales reps with laptop PCs and software that allow them to provide farmers with customized information and advice. The rep can plug in the type of hybrid that a farmer is using, along with infor-

Company and Product Costs

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

A company's costs take two forms, fixed and variable. **Fixed costs** (also known as **overhead**) are costs that do not vary with production or sales level. For example, a company must pay each month's bills for rent, heat, interest, and executive salaries, whatever the company's output. **Variable costs** vary directly with the level of production. Each PC produced by Hewlett-Packard involves a cost of computer chips, wires, plastic, packaging, and other inputs. These costs tend to be the same for each unit produced. They are called variable because their total varies with the number of units produced. **Total costs** are the sum of the fixed and variable

Cost-based pricing

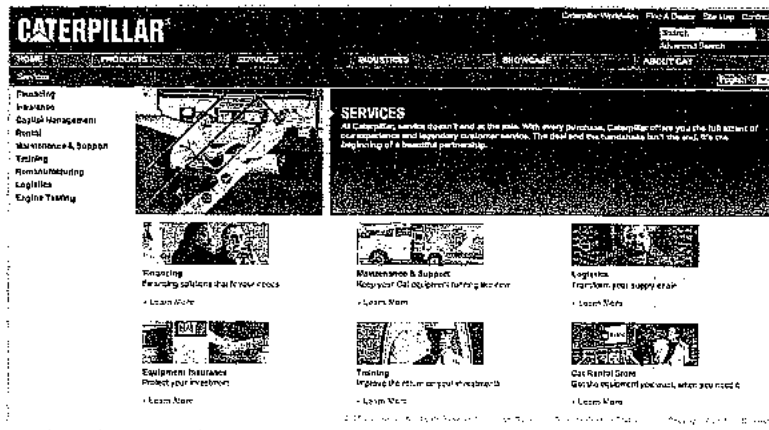
Setting prices based on the costs for producing, distributing, and selling the product plus a fair rate of return for effort and risk.

Fixed costs (overhead)

Costs that do not vary with production or sales level.

Variable costs

Costs that vary directly with the level of production.



Value added: Caterpillar offer its dealers a wide range of value-added services—from guaranteed parts delivery to investment management advice and equipment training. Such added value supports a higher price.

mation about pricing, acreage, and yield characteristics, and then advise the farmer on how to do a better job of farm management. The reps can also supply farmers with everything from agricultural research reports to assistance in comparison shopping. To add even more value, PHI offers farmers crop insurance, financing, and marketing services.

Backing its claim "We believe in customer success" with superior products and value-added services gives PHI plenty of pricing power. Despite charging a significant price premium—or perhaps because of it—the company's share of the North American corn market has grown from 35 percent during the mid-1980s to its current level of 44 percent.

Microsystems Engineering Company: "The way we sell on value is by differentiating ourselves," says Mark Beckman, director of

sales for Microsystems, a software company. "My product is twice as much as my nearest competitor's, but we sell as much as—if not more than—our competition." Rather than getting into price wars, Microsystems adds value to its products by adding new components and services. It builds close, value-added relationships with customers. "We foster strong working relationships with our clients," declares the company's Web site, "and have built our industry-leading reputation on going the extra mile for them." As a result, customers "get more for their money," says Beckman. "We get the price because we understand what people want." When customers see the extra value, price becomes secondary. Ultimately, Beckman asserts, "let the customer decide whether the price you're charging is worth all the things they're getting." What if the answer is no? Beckman would suggest that dropping

the price is the last thing you want to do. Instead, look to the value of value added.

Sources: William F. Kerdy, "The Price Is Too High," *Selling Power*, April 2006, pp. 30-33; Ian Brat, "Caterpillar Posts 38% Profit Rise, Raises Outlook on Strong Demand," *Wall Street Journal*, July 22, 2006, p. A2; Michael Arndt, "Cat Claws Its Way into Services," *BusinessWeek*, December 5, 2005, pp. 56-59; Erin Stout, "Keep Them Coming Back for More," *Sales & Marketing Management*, February 2002, pp. 51-52; "Global Construction & Farm Machinery: industry Profile," Datamonitor, June 2006, accessed at www.datamonitor.com; and information accessed online at www.pioneer.com, www.caterpillar.com, and www.microsystems.com/about.php, December 2006.

Total costs

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

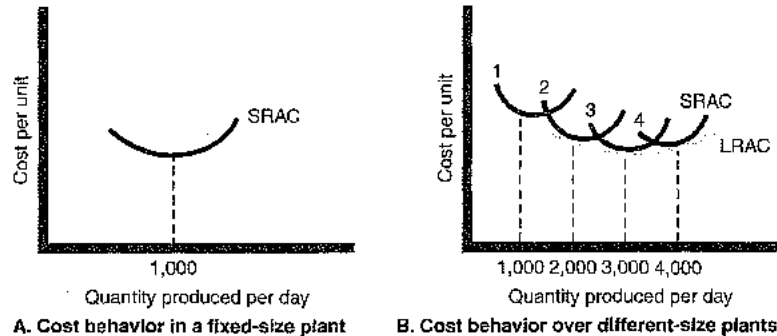
costs for any given level of production. Management wants to charge a price that will at least cover the total production costs at a given level of production.

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

Costs at Different Levels of Production

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

FIGURE 10.3
Cost per unit at different
levels of production per
period



A. Cost behavior in a fixed-size plant

B. Cost behavior over different-size plants

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

Costs as a Function of Production Experience

Suppose TI runs a plant that produces 3,000 calculators per day. As TI gains experience in producing calculators, it learns how to do it better. Workers learn shortcuts and become more familiar with their equipment. With practice, the work becomes better organized, and TI finds better equipment and production processes. With higher volume, TI becomes more efficient and gains economies of scale. As a result, average cost tends to fall with accumulated production experience. This is shown in Figure 10.4.¹¹ Thus, the average cost of producing the first 100,000 calculators is \$10 per calculator. When the company has produced the first 200,000 calculators, the average cost has fallen to \$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 the **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, but it will fall faster if the company makes and sells more during a given time period. But the market must stand ready to buy the higher output. And to take advantage of the experience curve, TI must get a large market share early in the product's life cycle. This suggests the following pricing strategy: TI should price its calculators low; its sales will then increase, and its costs will decrease through gaining more experience, and then it can lower its prices further.

Some companies have built successful strategies around the experience curve. For example, Bausch & Lomb solidified its position in the soft contact lens market by using computerized lens design and steadily expanding its one Soflens plant. As a result, its market share climbed steadily to 65 percent.

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

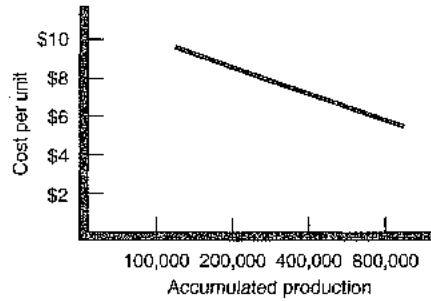
Cost-Based Pricing

Cost-plus pricing

Adding a standard markup to the cost of the product.

The simplest pricing method is **cost-plus pricing**—adding a standard markup to the cost of the product. Construction companies, for example, submit job bids by estimating the total project cost and adding a standard markup for profit. Lawyers, accountants, and other professionals typically price by adding a standard markup to their costs. Some sellers tell their cus-

FIGURE 10.4
Cost per unit as a function
of accumulated production:
The experience curve



tomers they will charge cost plus a specified markup; for example, aerospace companies price this way to the government.

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

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

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

$$\text{Unit Cost} = \text{Variable Cost} + \frac{\text{Fixed Costs}}{\text{Unit Sales}} = \$10 + \frac{\$300,000}{50,000} = \$16$$

Now suppose the manufacturer wants to earn a 20 percent markup on sales. The manufacturer's markup price is given by:¹²

$$\text{Markup Price} = \frac{\text{Unit Cost}}{1 - \text{Desired Return on Sales}} = \frac{\$16}{1 - .2} = \$20$$

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

Does using standard markups to set prices make sense? Generally, no. Any pricing method that ignores demand and competitor prices is not likely to lead to the best price. Such cost-plus pricing wrongly assumes that prices can be set without affecting sales volume. In our toaster example, suppose that consumers saw the \$40 retail price as too high relative to competitors' prices, reducing demand to only 30,000 toasters instead of 50,000. Then the producer's unit cost would have been higher because the fixed costs are spread over fewer units, and the realized percentage markup on sales would have been lower. Markup pricing works only if that price actually brings in the expected level of sales.

Still, markup pricing remains popular for many reasons. First, sellers are more certain about costs than about demand. By tying the price to cost, sellers simplify pricing—they do not 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 minimized. Third, many people feel that cost-plus pricing is fairer to both buyers and sellers. Sellers earn a fair return on their investment but do not take advantage of buyers when buyers' demand becomes great.

Break-Even Analysis and Target Profit Pricing

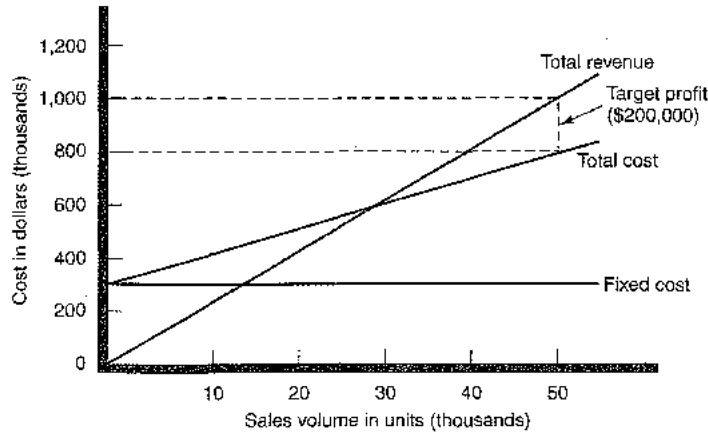
Break-even pricing (target profit pricing)

Setting prices to break even on the costs of making and marketing a product, or setting prices 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. Such pricing is used by General Motors, which prices its automobiles to achieve a 15 to 20 percent 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 10.5 shows a break-even chart for the toaster manufacturer discussed here. Fixed costs are \$300,000 regardless of sales volume. Variable costs are added to fixed costs to form total costs, which rise with volume. The total

FIGURE 10.5
Break-even chart for determining target price



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 the price to earn a 20 percent return, or \$200,000. In that case, it must sell at least 50,000 units at \$20 each. If the company charges a higher price, it will not need to sell as many toasters to achieve its target return. But the market may not buy even this lower volume at the higher price. Much depends on the price elasticity and competitors' prices.

The manufacturer should consider different prices and estimate break-even volumes, probable demand, and profits for each. This is done in Table 10.1. The table shows that as price increases, 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 produce the manufacturer's target profit of \$200,000. To achieve this target return, the manufacturer will need to search for ways to lower fixed or variable costs, thus lowering the break-even volume.

TABLE 10.1
Break-Even Volume and Profits at Different Prices

(1) Price	(2) Unit Demand Needed to Break Even	(3) Expected Unit Demand at Given Price	(4) Total Revenue (1) × (3)	(5) Total Costs*	(6) Profit (4) - (5)
\$14	75,000	71,000	\$ 994,000	\$1,010,000	-\$16,000
16	50,000	67,000	1,072,000	970,000	102,000
18	37,500	60,000	1,080,000	900,000	180,000
20	30,000	42,000	840,000	720,000	120,000
22	25,000	23,000	506,000	530,000	-\$24,000

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

Other Internal and External Considerations Affecting Price Decisions

Customer perceptions of value set the upper limit for prices, and costs set the lower limit. However, in setting prices within these limits, the company must consider a number of other internal and external factors. Internal factors affecting pricing include the company's overall marketing strategy, objectives, and marketing mix, as well as other organizational considerations. External factors include the nature of the market and demand, competitors' strategies and prices, and other environmental factors.

Overall Marketing Strategy, Objectives, and Mix

Price is only one element of the company's broader marketing strategy. Thus, before setting price, the company must decide on its overall marketing strategy for the product or service. If the company has selected its target market and positioning carefully, then its marketing mix strategy, including price, will be fairly straightforward. For example, when Toyota developed its Lexus brand to compete with European luxury-performance cars in the higher-income segment, this required charging a high price. In contrast, when it introduced its Yaris model—"the car that you can afford to drive is finally the car you actually want to drive"—this positioning required charging a low price. Thus, pricing strategy is largely determined by decisions on market positioning.

General pricing objectives might include survival, current profit maximization, market share leadership, or customer retention and relationship building. At a more specific level, a company can set prices to attract new customers or to profitably retain existing ones. It can set prices low to prevent competition from entering the market or set prices at competitors' levels to stabilize the market. It can price to keep the loyalty and support of resellers or to avoid government intervention. Prices can be reduced temporarily to create excitement for a brand. Or one product may be priced to help the sales of other products in the company's line. Thus, pricing may play an important role in helping to accomplish the company's objectives at many levels.

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

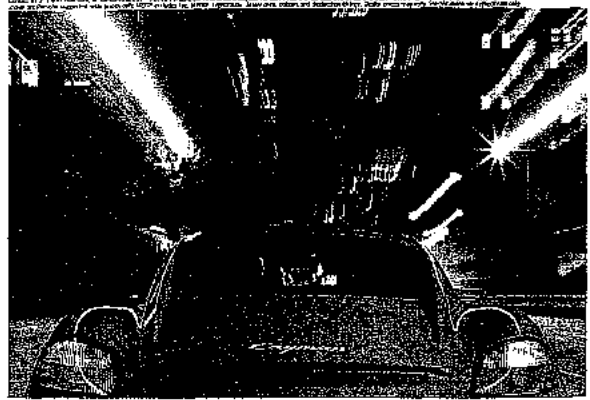
Companies often position their products on price and then tailor other marketing mix decisions to the prices they want to charge. Here, price is a crucial product-positioning factor that defines the product's market, competition, and design. Many firms support such price-positioning strategies with a technique called **target costing**, 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 an ideal selling price based on customer-value considerations and then targets costs that will ensure that the price is met.

P&G used target costing to price and develop its highly successful Crest SpinBrush electric toothbrush:

P&G usually prices its goods at a premium. But with Crest SpinBrush, P&G reversed its usual thinking. It started with an attractive low market price and then found a way to make a profit at that price. SpinBrush's inventors first came up with the idea of a low-priced electric toothbrush while walking through their local Wal-Mart, where they saw Sonicare, Interplak, and other electric toothbrushes priced at more than \$50. These pricy brushes held only a fraction of the overall toothbrush market. A less-expensive electric toothbrush, the designers reasoned, would have huge potential. They decided on a target price of just \$5, batteries included—only \$1 more than the most expensive manual brushes—and set out to design a brush they could sell at that price. Every design element was carefully considered with the targeted price in mind. To meet the low price, P&G passed on the usual lavish new-product launch campaign. Instead, to give SpinBrush more point-of-sale impact, it relied on "Try Me" packaging that allowed consumers to turn the brush on in stores. Target cost pricing has made Crest SpinBrush one of P&G's most successful new products ever. It has now become the nation's best-selling toothbrush, manual or electric, with a more than 40 percent share of the electric toothbrush market.¹³

Target costing


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



A devil on both shoulders.

With blissfully dark intentions, the new Cayman just begs to be driven. Beneath sculpted curves sits a 2.7-liter, 245-hp mid-mount engine yearning to run. Its rigid body ready to respond instantly to your will. Never has bad felt so good. Porsche. There is no substitute.

The new Cayman. Starting at \$49,400.



PORSCHE

Positioning on high price: Porsche proudly advertises its curvacious Cayman as "Starting at \$49,400."

Other companies deemphasize price and use other marketing mix tools to create *nonprice* positions. Often, the best strategy is not to charge the lowest price, but rather to differentiate the marketing offer to make it worth a higher price. For example, Viking builds more value into its kitchen appliance products and charges a higher price than many competitors. Customers recognize Viking's higher quality and are willing to pay more to get it.

Some marketers even *feature* high prices as part of their positioning. For example, Grand Marnier offers a \$225 bottle of Cuvée du Cent Cinquantenaire that's marketed with the tagline "Hard to find, impossible to pronounce, and prohibitively expensive." Porsche proudly advertises its curvacious Cayman as "Starting at \$49,400." And Steinway offers "the finest pianos in the world," with a price to match. Steinway's grand pianos can cost as much as \$165,000 (see Real Marketing 10.2).

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

Organizational Considerations

Management must decide who within the organization should set prices. Companies handle pricing in a variety of ways. In small companies, prices are often set by top management rather than by the marketing or sales departments. In large companies, pricing is typically

handled by divisional or product line managers. In industrial markets, salespeople may be allowed to negotiate with customers within certain price ranges. Even so, top management sets the pricing objectives and policies, and it often approves the prices proposed by lower-level management or salespeople.

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

The Market and Demand

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

Practical Application: Types of Markets The seller's pricing freedom varies with different types of markets. Economists recognize four types of markets, each presenting a different pricing challenge.

Under *pure competition*, the market consists of many buyers and sellers trading in a uniform commodity such as wheat, copper, or financial securities. No single buyer or seller has much effect on the going market price. A seller cannot charge more than the going price,

Real Marketing

10.4 A Steinway piano—any Steinway piano—costs a lot. A Steinway grand piano typically runs anywhere from \$40,000 to \$165,000. The most popular model sells for around \$72,000. But Steinway buyers aren't looking for bargains. In fact, it seems, the higher the prices, the better. High prices confirm that a Steinway is the very best that money can buy—the epitome of hand-crafted perfection. As important, the Steinway name is steeped in tradition. It evokes images of classical concert stages, sophisticated dinner parties, and the celebrities and performers who've owned and played Steinway pianos across more than 150 years. Since its founding in 1853, the company's motto has been "The Instrument of the Immortals." When it comes to Steinway, price is nothing, the Steinway experience is everything.

To be sure, Steinway & Sons makes pianos of very high quality. With 115 patents to its credit, Steinway & Sons has done more than any other manufacturer to advance the art of piano building. Steinway pioneered the development of a one-piece piano rim produced out of 17 laminations of veneer. It invented a process for bending a single 22-foot-long strip of these laminated sheets inside a massive piano-shaped vise. It's this strong frame that produces Steinway's distinctive clear tones. Steinway & Sons has continued perfecting this design, and today a Steinway piano's 243 tempered, hard-steel strings exert 35 tons of pressure—enough force to implode a three-bedroom house if the strings were strung between attic and cellar.

In addition to cutting-edge technology, Steinway & Sons uses only the finest materials to construct each piano. Rock maple, spruce, birch, poplar, and four other species of wood each play a crucial functional role in the physical and acoustical beauty of a Steinway. The expansive wooden soundboard, which turns the string vibrations into sound, is made from select Alaskan Sitka spruce—one grade higher than aircraft grade. Through delicate handcraftsmanship, Steinway transforms these select materials into pianos of incomparable sound quality. From start to finish, it takes 450 skilled workers more than a year to handcraft and assemble a Steinway piano from its 12,000 component parts. Thus, Steinway is anything but mass market. Each year, Steinway's factories in Astoria, New York, and Hamburg, Germany, craft approximately 5,000 pianos. (By comparison, Yamaha produces 100,000 pianos per year.)

Steinway's precision quality alone would command top dollar, but Steinway buyers get much more than just a well-made piano. They also get the Steinway mystique. Owning or playing a Steinway puts you in some very good company. Fully 98 percent of piano soloists with the world's major symphony orchestras prefer playing on a Steinway. More than 90 percent of the world's concert pianists, some 1,300 in all, bear the title of Steinway Artist—an elite club of Steinway-owning professional musicians. Steinway customers include composers and professional musicians (from Van Cliburn to Billy Joel), upscale customers (from Lamar Alexander to Paula Zahn), and heads of state (the 25,000th Steinway was sold to Czar Alexander of Russia, and Piano No. 300,000 graces the East Room of the White House, replacing Piano No. 100,000, which is now in the Smithsonian).

But Steinways aren't just for world-class pianists and the wealthy. Ninety-nine percent of all Steinway buyers are amateurs who perform only in their dens. "We see a lot of corporate executives and physi-



A Steinway piano costs a lot, but buyers aren't looking for bargains. When it comes to a Steinway, price is nothing, the Steinway experience is everything.

cians buying Steinway grands," says a Steinway marketer. "But it is not unusual at all for a middle-income person to come in and buy a grand." The high prices don't appear to stop even the most cash-poor enthusiasts. Steinway offers a finance plan that lets them pay for their grand piano over a 12-year period.

Performers of all kinds sing Steinway's praises. "Steinway is the only piano on which the pianist can do everything he wants. And everything he dreams," declares premier pianist and conductor Vladimir Ashkenazy. At the other end of the performing spectrum, contemporary singer-songwriter Randy Newman puts it this way: "I have owned and played a Steinway all my life. It's the best Beethoven piano. The best Chopin piano. And the best Ray Charles piano. I like it, too." Whereas some people want a Porsche in the garage, others prefer a Steinway in the living room—both cost about the same, and both make a statement about their owners.

Even in the worst of times, Steinway & Sons has held true to its tradition and image—and to its premium prices. Although the company is no longer owned by the Steinway family, its current owners still prize and protect the brand's exclusivity. When they bought the troubled company in 1984, new management was burdened with 900 pianos of excess inventory. But rather than slashing prices to

(continues)

make a quick profit at the risk of tarnishing the brand, managers restored the company's health by holding the line on prices and renewing its commitment to quality. Through such actions, Steinway has retained its cult-like following and continues to dominate its market. Despite its very high prices—or more likely because of them—Steinway enjoys a 95 percent market share in concert halls.

So, you won't find any weekend sales on Steinway pianos. Charging significantly higher prices continues to be a cornerstone of the company's "much more for much more" value proposition. And high prices have been good for Steinway & Sons. Although the company accounts for only 3 percent of all U.S. pianos sold each year, it captures 25 percent of the industry's sales dollars and close to 35 percent of the profits.

To customers, whatever a Steinway costs, it's a small price to pay for the experience of owning one. Just ask the collector who recently commissioned a nine-foot re-creation of the famous Steinway Alma-Tadema piano built in 1887. The price for his dream Steinway? An eye-popping \$675,000! Classical pianist Krystian Zimerman sums up his Steinway experience this way: "My friendship with the Steinway

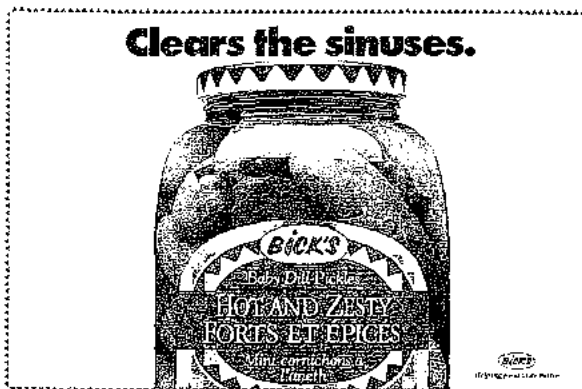
piano is one of the most important and beautiful things in my life." Who can put a price on such feelings?

Sources: See Rosemary Barnes, "The Price of Perfection: Steinway Piano Commands a Premier Price," *Knight Ridder Tribune Business News*, February 26, 2005, p. 1; Andy Serwer, "Happy Birthday Steinway," *Fortune*, March 17, 2003, p. 94; "Books and Arts: Making the Sound of Music; Piano Manufacturers," *The Economist*, June 7, 2003, p. 102; Brian T. Majeski, "The Steinway Story," *Music Trades*, September 2003, p. 18; "The Most Famous Name in Music," *Music Trades*, September 2003, p. 118-130; Stephan Wilkinson, "High-Strung. Powerful. Very Pricey," *Popular Science*, March 1, 2003, p. 32; "Steinway Musical Instruments, Inc.," *Hoover's Company Capsules*, Austin, July 2006, p. 48052; Michael Z. Wise, "Piano Versus Piano," *New York Times*, May 9, 2004; Lisa Gschwandtner, "Keys to Success," *Selling Power*, July-August 2006, p. 50; James Barron, *Piano: The Making of a Steinway Concert Grand* (New York: Times Books, 2006); and quotes and information found at www.steinway.com, December 2006.

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.

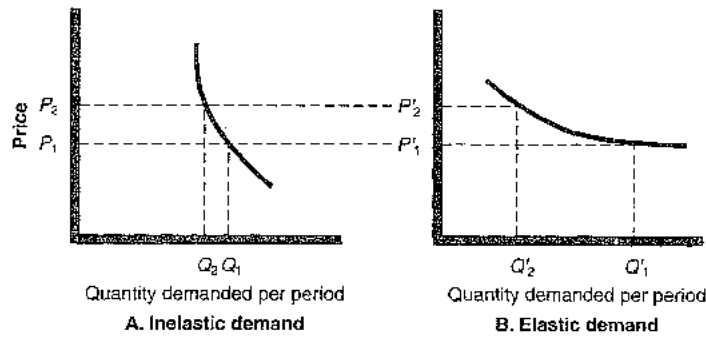
Under *monopolistic competition*, the market consists of many buyers and sellers who trade over a range of prices rather than a single market price. A range of prices occurs because sellers can differentiate their offers to buyers. Either the physical product can be varied in quality, features, or style, or the accompanying services can be varied. 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, advertising, and personal selling to set their offers apart. Thus, pickle maker Bick's differentiates its pickles from dozens of other brands through strong branding and advertising, reducing the impact of price. Because there are many competitors in such markets, each firm is less affected by competitors' pricing strategies than in oligopolistic markets.

Under *oligopolistic competition*, the market consists of a few sellers who are highly sensitive to each other's pricing and marketing strategies. The product can be uniform



2 Monopolistic competition: Pickle marketer Bick's sets its pickles apart from dozens of other brands using both price and nonprice factors.

FIGURE 10.6
Demand curves



(steel, aluminum) or nonuniform (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 percent, buyers will quickly switch to this supplier. The other steelmakers must respond by lowering their prices or increasing their services.

In a *pure monopoly*, the market consists of one seller. The seller may be a government monopoly (the U.S. Postal Service), a private regulated monopoly (a power company), or a private nonregulated monopoly (DuPont when it introduced nylon). Pricing is handled differently in each case. In a regulated monopoly, the government permits the company to set rates that will yield a "fair return." Nonregulated monopolies are free to price at what the 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.

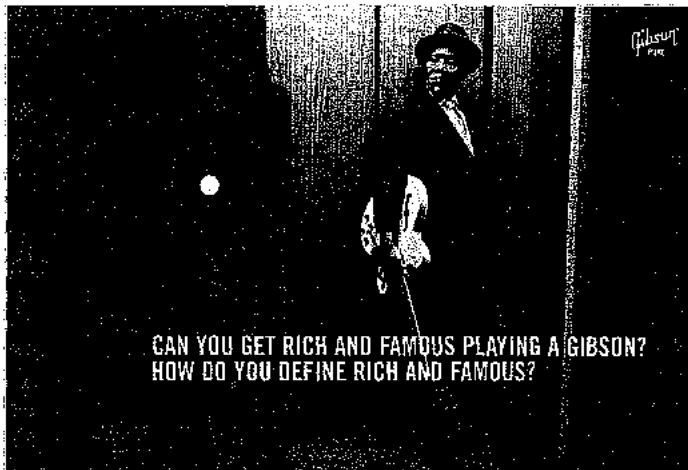
Demand curve

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

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

In the case of prestige goods, the demand curve sometimes slopes upward. Consumers think that higher prices mean more quality. For example, Gibson Guitar Corporation once toyed with the idea of lowering its prices to compete more effectively with Japanese rivals such as Yamaha and Ibanez. To its surprise, 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. "The more we charged, the more product we sold." At a time when other guitar manufacturers have chosen to build their instruments more quickly, cheaply, and in greater numbers, Gibson still promises guitars that "are made one-at-a-time, by hand. No shortcuts. No substitutions." 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."¹⁴ Still, if the company charges too high a price, the level of demand will be lower.

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

the total market demand resulting from different prices. If the company faces competition, its demand at different prices will depend on whether competitors' prices stay constant or change with the company's own prices.

Price elasticity

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

MARKETING BY THE NUMS Marketers also need to know **price elasticity**—how responsive demand will be to a change in price. Consider the two demand curves in Figure 10.4. In Figure 10.4A, 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 10.4B, however, the same 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:

$$\text{Price Elasticity of Demand} = \frac{\% \text{ Change in Quantity Demanded}}{\% \text{ Change in Price}}$$

Suppose demand falls by 10 percent when a seller raises its price by 2 percent. Price elasticity of demand is therefore -5 (the minus sign confirms the inverse relation between price and demand) and demand is elastic. If demand falls by 2 percent with a 2 percent increase in price, then elasticity is -1 . In this case, the seller's total revenue stays the same: The seller sells fewer items but at a higher price that preserves the same total revenue. If demand falls by 1 percent when price is increased by 2 percent, then elasticity is $-1/2$ 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 the cost is shared by another party.¹⁵

If demand is elastic rather than inelastic, sellers will consider lowering their prices. A lower price will produce more total revenue. This practice makes sense as long as the extra costs of producing and selling more do not exceed the extra revenue. At the same time, most firms want to avoid pricing that turns their products into commodities. In recent years, forces such as 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. In the words of marketing consultant Kevin Clancy, those who target only the price sensitive are "leaving money on the table."

Even in the energy marketplace, where you would think that a kilowatt is a kilowatt is a kilowatt, some energy companies are beginning to wake up to this fact. They are differentiating their power, branding it, and marketing it on considerations other than price. For example, Green Mountain Energy Company targets consumers who are not only concerned with the environment but are also willing to support those attitudes with their choice of electricity providers. Green Mountain offers electricity made from cleaner, renewable sources such as water, wind, solar, and biomass. By positioning itself as "the nation's leading brand of cleaner electricity products," Green Mountain differentiates itself from com-



By positioning itself as "the nation's leading brand of cleaner electricity products," Green Mountain differentiates itself from comparably priced utilities and competes successfully against "cheaper" brands that focus only on more price-sensitive consumers.

parably priced utilities and competes successfully against “cheaper” brands that focus only on more price-sensitive consumers.¹⁶

Competitors’ Strategies and Prices

In setting its prices, the company must also consider competitors’ costs, prices, and market offerings. Consumers will base their judgments of a product’s value on the prices that competitors charge for similar products. A consumer who is thinking about buying a Canon digital camera will evaluate Canon’s customer value and price against the value and prices of comparable products made by Kodak, Nikon, Sony, 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 and value against competitors’ costs and value. It can then use these benchmarks as a starting point for its own pricing.

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

Next, how strong are current competitors and what are their current pricing strategies? If the company faces a host of smaller competitors charging high prices relative to the value they deliver, it might charge lower prices to drive weaker competitors out of the market. If the market is dominated by larger, low-price competitors, the company may decide to target unserved market niches with value-added products at higher prices. For example, your local independent bookstore isn’t likely to win a price war against Amazon.com or Barnes & Noble. It would be wiser to add special customer services and personal touches that justify higher prices and margins.

Finally, the company should ask, How does the competitive landscape influence customer price sensitivity?¹⁷ For example, customers will be more price sensitive if they see few differences between competing products. They will buy whichever product costs the least. The more information customers have about competing products and prices before buying, the more price sensitive they will be. Easy product comparisons help customers to assess the value of different options and to decide what prices they are willing to pay. Finally, customers will be more price sensitive if they can switch easily from one product alternative to another.

What principle should guide decisions about what price to charge relative to those of competitors? The answer is simple in concept but often difficult in practice: No matter what price you charge—high, low, or in between—be certain to give customers superior value for that price.

Other External Factors

When setting prices, the company also must consider a number of other factors in its external environment. *Economic conditions* can have a strong impact on the firm’s pricing strategies. Economic factors such as boom or recession, inflation, and interest rates affect pricing decisions because they affect both consumer perceptions of the product’s price and value and the costs of producing a product.

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. We will examine public policy issues in pricing in the next chapter.

We’ve now seen that pricing decisions are subject to an incredibly complex set of customer, company, competitive, and environmental forces. In the next chapter, we’ll examine specific pricing strategies available to marketers.

Reviewing the Concepts

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

1. Answer the question "What is price?" and discuss the importance of pricing in today's fast-changing environment.

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

Despite the increased role of nonprice factors in the modern marketing process, price remains an important element in the marketing mix. It is the only marketing mix element that produces revenue; all other elements represent costs. Price is also one of the most flexible elements of the marketing mix. Unlike product features and channel commitments, price can be raised or lowered quickly. Even so, many companies are not good at handling pricing—pricing decisions and price competition are major problems for many marketing executives. Pricing problems often arise because managers are too quick to reduce prices, prices are too cost oriented rather than customer-value oriented, or prices are not consistent with the rest of the marketing mix.

2. Discuss the importance of understanding customer value perceptions when setting prices.

Good pricing begins with a complete understanding of the value that a product or service creates for customers and setting a price that captures the value. Customer perceptions of the product's value set the ceiling for prices. If customers perceive that the price is greater than the product's value, they will not buy the product. *Value-based pricing* uses buyers' perceptions of value, not the seller's cost, as the key to pricing.

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

3. Discuss the importance of company and product costs in setting prices.

The price the company charges will fall somewhere between one that is too high to produce any demand and one that is too low to produce a profit. Whereas customer perceptions of value set the ceiling for prices, company and product costs set the floor. If the company prices the product below its costs, its profits will suffer. *Cost-based pricing* involves setting prices based on the costs for producing, distributing, and selling the product plus a fair rate of return for effort and risk.

Costs are an important consideration in setting prices. However, cost-based pricing is product driven rather than customer driven. The company designs what it considers to be a good product and sets a price that covers costs plus a target profit. If the price turns out to be too high, the company must settle for lower markups or lower sales, both resulting in disappointing profits. The company must watch its costs carefully. If it costs the company more than it costs competitors to produce and sell its product, the company must charge a higher price or make less profit, putting it at a competitive disadvantage.

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 costs at a given level of production. To price wisely, management also needs to know how its costs vary with different levels of production and accumulated production experience. Cost-based pricing approaches include *cost-plus pricing* and *break-even pricing* (or target profit pricing).

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

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

Common pricing objectives might include survival, current profit maximization, market share leadership, or customer retention and relationship building. Price decisions must be coordinated with product design, distribution, and promotion decisions to form a consistent and effective marketing program. Finally, in order to coordinate pricing goals and decisions, management must decide who within the organization is responsible for setting price.

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

Reviewing the Key Terms

Break-even pricing (target profit pricing) 291

Cost-based pricing 288

Cost-plus pricing 290

Demand curve 297

Experience curve (learning curve) 290

Fixed costs (overhead) 288

Good-value pricing 287

Price 284

Price elasticity 298

Target costing 293

Total costs 289

Value-added pricing 287

Value-based pricing 285

Variable costs 288

Discussing the Concepts

1. The chapter points out that many companies do not handle pricing well. Beyond focusing too much on cost, what are some of the other difficulties that marketers have in setting prices?
2. What are the differences between cost-based and value-based pricing?
3. Four recent MBA graduates are starting their own financial services firm. They plan to promote a "good value" pricing strategy to their customers. Would you recommend this pricing strategy?
4. How would the risks of experience curve pricing apply to a new manufacturer of ink-jet printers?
5. Pricing is based on customer perceptions of value and costs in addition to other internal factors. Discuss these other internal factors and how they might affect the pricing of a new Sony MP3 player.
6. Explain why elasticity of demand is such an important concept to marketers who sell a "commodity" product.

Applying the Concepts

1. Visit *U.S. News & World Report* at http://www.usnews.com/usnews/edu/college/rankings/bvrankindex_brief.php for a list of schools that offer the best value. How is value defined here? Is this a valid definition of value?
2. Given the following information, calculate the number of meals a restaurant would need to sell to break even:
 - ▣ Average meal price = \$10.35
 - ▣ Meals sold = 8,560
 - ▣ Food = \$27,653
 - ▣ Food labor = \$18,386
 - ▣ Management = \$4,855
 - ▣ Supplies = \$3,133
 - ▣ Maintenance = \$2,213
 - ▣ Marketing = \$1,650
 - ▣ Insurance/legal = \$1,904
 - ▣ Waste management = \$988
 - ▣ Utilities = \$3,159
 - ▣ Rent = \$3,360
3. What does the following positioning statement suggest about the firm's marketing objectives, marketing-mix strategy, and costs? "No one beats our prices. We crush competition."

Focus on Technology

Internet users have become used to receiving "for free" information. With some online revenues razor thin, many Internet operations are interested in moving to more of a "for fee" model. But customers resist paying and marketers are looking for creative ways to blend the models. Consider Google, one of the most visited sites on the Internet and the top search engine. To produce user fees, Google has supplemented its free search with a service called Google Answers (www.google.answers.com). This service, introduced in 2006, offers more than 500 carefully screened researchers to answer your questions. The user pays a nonrefundable listing fee of \$.50 per question and sets a price that reflects how much he or she would pay for a well-researched answer. The user is charged this price only if the question is answered satisfactorily. Google pays three-

quarters of the revenue to the researcher who answers the question and keeps the other 25 percent. Fees start at \$2.50 and average around the \$75 point. A recent review of questions shows a \$5 fee to answer a question on whether an artist is working on a new album and a fee of \$150 to find the portion of the music industry's revenues derived from independent artists.

1. Is Google Answers using cost-based or value-based pricing? Explain.
2. What are Google's objectives with this product?
3. How will increased competition affect Google's marketing strategy for this product?

Focus on Ethics

Independent retailers have difficulty competing against megastores such as Wal-Mart, Toys "R" Us, and Best Buy. The larger retailers can usually offer lower prices due to operational efficiencies. They make up for their lower margins with much higher sales volumes. But what happens when one of these megaretailers prices items below its costs to compete with independent retailers? Best Buy, long accused by independent music stores of using music as a loss leader, may have crossed the line into predatory pricing when it priced independent label CDs (indies) below its own wholesale cost. In 2006, Best Buy ran a promotion including a week-long sale on 20 indie titles at \$7.99, about \$2 below wholesale prices. Marketwide, indie CD sales soared during the week of the sale, up 65 percent from the previous week. The problem, according to the independent retailers, was that little of that

surge came from independent stores. Music label executives claimed that they were unaware that Best Buy would be selling their CDs below the \$9.99 wholesale price and were concerned about the future of the independent retailers.

1. How does the pricing of music CDs fit with Best Buy's broader marketing-mix strategy?
2. Comment on the elasticity of demand for indie music. Do you think Best Buy broke even on the music?
3. Was Best Buy's promotion legal? Was it ethical? Explain.

See: Todd Martens, "Best Buy Promo Raises Ire," *Billboard*, February 18, 2006, p. 10.

Video Case

Song

Trying to replicate the success enjoyed by competitors such as Southwest and Jet Blue, Delta launched a new experiment: a separately branded airline called Song. The pricing strategy behind this low-cost airline involved more than simple discounting. Song implemented an upfront pricing structure that took the mystery out of buying airline tickets. In addition, the airline offered amenities such as healthy gourmet organic food, vibrant colors, leather seats, and in-flight satellite television. Song even enlisted designer Kate Spade to craft fashionable new uniforms for its flight attendants.

In the end, however, Delta could not sustain both Song and parent Delta airlines. When Delta declared bankruptcy in late 2005, it announced that it would merge Song back into the Delta fleet, thereby reducing the costs of marketing two separate airlines. It would use Song airplanes for its own flights, but it would also incorporate Song's successes back into Delta's operations. According to Delta, "Song's ideas and innovations will continue to play a vital role in the refreshment and

reinvigoration of the Delta product and experience." Delta plans to incorporate successful Song innovations, including zone boarding, faster aircraft turn times, all-leather seats, designer uniforms, improved food options, simplified fare structure, and upgraded online presence.

After viewing the video featuring Song Airlines, answer the following questions about pricing considerations and strategies.

1. How did Song lower fixed costs? How did the company lower variable costs?
2. Which of the external factors discussed in the text do you believe had the largest impact on Song's pricing decisions?
3. What pricing approach did Delta use when setting prices for passenger tickets on Song flights?
4. Can Delta successfully employ the lessons learned from Song?

Company Case

Southwest Airlines: Waging War in Philly

BATTLE STATIONS!

In March 2004, US Airways CEO David Siegel addressed his employees via a Webcast. "They're coming for one reason: They're coming to kill us. They beat us on the West Coast, they beat us in Baltimore, but if they beat us in Philadelphia, they are going to kill us." Siegel exhorted his employees on, emphasizing that US Airways had to repel Southwest Airlines when the no-frills carrier began operations at the Philadelphia International Airport in May—or die.

On Sunday, May 9, 2004, at 5:05 A.M. (yes, A.M.), leisure passengers and some thrift-minded business people lined up to secure seats on Southwest's 7 A.M. flight from Philadelphia to Chicago—its inaugural flight from the new market. Other passengers scurried to get in line for a flight to Orlando. And why not? One family of six indicated it bought tickets for \$49 each way, or \$98 round trip. An equivalent round-trip ticket on US Air would have cost \$200.

Southwest employees, dressed in golf shirts and khaki pants or shorts, had decorated the ticket counters with lavender, red, and gold balloons and hustled to assist the throng of passengers. As the crowd blew noisemakers and hurled confetti, Herb Kelleher, Southwest's quirky CEO, shouted, "I hereby declare Philadelphia free from the tyranny of high fares!"

At 6:59 a.m., Southwest Flight 741 departed for Chicago.

WAR ON!

Was Southwest's entry into the Philadelphia market worth all this fuss? After all, US Air was firmly entrenched in Philadelphia, the nation's eighth-largest market, offering more than 375 flights per day and controlling two-thirds of the airport's 120 gates. Further, in 2004, little Southwest

served a total of 58 cities and 59 airports in 30 states and was offering only 14 flights a day from Philly out of only two gates. And until its entry into Philadelphia, Southwest had a history of entering smaller, less-expensive, more out-of-the-way airports where it didn't pose a direct threat to the major airlines like US Air. Did Southwest really have a chance?

Southwest was used to that question. In 1971, when Kelleher and a partner concocted a business plan on a cocktail napkin, most people didn't give Southwest much of a chance. Its strategy completely countered the industry's conventional wisdom. Southwest's planes flew from "point to point" rather than using the "hub-and-spoke" pattern that is the backbone of the major airlines. This allowed more flexibility to move planes around based on demand. Southwest served no meals, only snacks. It did not charge passengers a fee to change same-fare tickets. It had no assigned seats. It had no electronic entertainment, relying on comic flight attendants to entertain passengers. The airline did not offer a retirement plan; rather, it offered its employees a profit-sharing plan. Because of all this, Southwest had much lower costs than its competitors and was able to crush the competition with low fares.

For 32 years, Southwest achieved unbelievable success by sticking to this basic no-frills, low-price strategy. Since it began operations in 1972, it was the only airline to post a profit every year. In 2003, just prior to taking the plunge in Philly, the company earned \$442 million—more than all the other U.S. airlines combined. In the three prior years, Southwest had earned \$1.2 billion, while its competitors lost a combined \$22 billion. In May 2003, for the first time, Southwest boarded more domestic customers than any other airline. From 1972 through 2002, Southwest had the

nation's best-performing stock—growing at a compound annual rate of 26 percent over the period. Moreover, while competing airlines laid off thousands of workers following the September 11 tragedy, Southwest didn't lay off a single employee. In 2004, its cost per average seat mile (CASM—the cost of flying one seat one mile) was 8.09 cents, as compared with between 9.42 to 11.18 for the big carriers.

THE MAJORS: LOW ON AMMUNITION

In the early 2000s, the major (or legacy) airlines, such as US Air, Delta, United, American, and Continental, faced three major problems. First, "little" Southwest was no longer little. Second, other airlines, such as JetBlue, AirTran, ATA, and Virgin Atlantic, had adopted Southwest-like strategies. In fact, JetBlue and America West had CASMs of 5.90 and 7.72 cents, respectively. In 1990, discount airlines flew on just 159 of the nation's top 1,000 routes. By 2004, that number had risen to 754. As a result, the majors, who had always believed they could earn a 30 percent price premium, were finding it hard to get a 10 percent premium, if that. Third, and most importantly, the major airlines had high cost structures that were difficult to change. They had more long-service employees who earned higher pay and received expensive pension and health benefits. Many had unions, which worked hard to protect employee pay and benefits.

ATTACK AND COUNTERATTACK

US Air had experienced Southwest's attacks before. In the late 1980s, Southwest entered the California market, where US Air had a 58 percent market share on its routes. By the mid-'90s, Southwest had forced US Air to abandon those routes. On the Oakland to Burbank route, average one-way fares fell from \$104 to just \$42 and traffic tripled. In the early '90s, Southwest entered Baltimore Washington International Airport, where US Air had a significant hub and a 55 percent market share. By 2004, US Air had only 4.9 percent of BWI traffic, with Southwest ranking number one at 47 percent.

Knowing it was in for a fight in Philly, US Air reluctantly started to make changes. In preparation for Southwest's arrival, it began to reshape its image as a high-fare, uncooperative carrier. It spread out its scheduling to reduce congestion and the resulting delays and started using two seldom-used runways to reduce bottlenecks. The company also lowered fares to match Southwest's and dropped its requirement for a Saturday-night stayover on discounted flights. US Air also began some new promotion tactics. It launched local TV spots on popular shows such as "Friends," "American Idol," and "Frasier" to promote free massages, movie tickets, pizza, and flowers.

On the other side, Southwest knew that Philadelphia posed a big challenge. Philadelphia International was one of the biggest airports it had ever attempted to enter. And with US Air's strong presence, it was also one of the most heavily guarded. Finally, the airport was known for its delays, congestion, bureaucracy, and baggage snafus, making Southwest's strategy of 20-minute turnarounds very difficult.

Therefore, Southwest unveiled a new promotion plan for Philly. Ditching its tried-and-true cookie-cutter approach,

the airline held focus groups with local travelers to get their ideas on how it should promote its service—a first for Southwest. As a result, the airline developed a more intense ad campaign and assigned 50 percent more employees to the airport than it typically had for other launches. Southwest also recruited volunteers to stand on local street corners handing out free inflatable airline hats, luggage tags, and antenna toppers. The airline used billboards, TV, and radio to trumpet the accessibility of its low fares as well as its generous frequent-flier program.

THE BATTLE RAGES ON

Two short years after Southwest began service to Philadelphia, the market took on a dramatically different look. Southwest had boosted daily nonstop flights from 14 to 53. It had added service to 11 new cities and quadrupled its number of gates from two to eight, with its eye on four more. The number of Southwest employees in Philly approached 200, a huge increase over its post-launch total of fewer than 30.

But the external impact of Southwest's first two years in Philadelphia was a classic example of what has come to be known as "the Southwest effect"—a phenomenon in which all carriers' fares drop and more people fly. In Philadelphia, the intense competition brought on by Southwest's arrival caused airfares on some routes to drop by as much as 70 percent. In 2005, airline passenger traffic for Philadelphia International was up 15 percent over 2004. The airport attributed much of that increase to Southwest. In all, by the end of 2005, Southwest had captured 10 percent of total passenger traffic. In turn, US Airways' share fell about five percentage points.

Just as US Air was absorbing Southwest's blows in Philadelphia, the underdog airline struck again. In May of 2005, Southwest started service to Pittsburgh, another major US Air hub. Shortly thereafter, Southwest announced that it would also soon enter Charlotte, NC, US Air's last stronghold.

Still, although it appears that Southwest is on cloud nine, many factors are forcing the nation's most profitable air carrier to change flight plans. First, the best-known discount airline has more competition than ever before. Upstarts such as Frontier, AirTran, and JetBlue are doing very well with Southwest's model. And they are trumping Southwest's low fares by adding amenities such as free TV and XM satellite radio at each seat.

Even the legacy carriers are now in better positions to take on Southwest's lower fares. All of the major airlines have ruthlessly slashed costs, mostly in the areas of wages and pensions. Some, like US Air, have used bankruptcy to force steep union concessions. In fact, Southwest now has some of the highest paid employees in the industry. And although Southwest still enjoys a big advantage in total costs over the major carriers, these big airlines have narrowed their cost disadvantage from 42 percent to 31 percent. With the wind now at their backs, these competitors could soon decrease the cost gap to as little as 20 percent.

(case continues)

(case continued)

Being the low-cost leader has some disadvantages. Because Southwest already has such a lean cost structure, it has much less room for improvement. For example, travel agent commissions have been at zero for some time (Southwest doesn't work through agents). Sixty-five percent of Southwest customers already buy their tickets online, minimizing its expense for call centers. And Southwest is losing another of its traditional cost advantages. For years, though some smartly negotiated fuel-hedging contracts, Southwest has enjoyed fuel prices far below those paid by the rest of the industry. But the most lucrative of those contracts are expiring. At a time when fuel prices are surging for the entire industry, this means that Southwest's fuel expenses are rising faster than those of its competitors. In the first quarter of 2006, Southwest's paid 63 percent more for fuel than it did for the year-earlier period.

As these factors have quickly turned the tables on Southwest, some analysts are questioning the company's current strategic direction. "Slowly, Southwest is becoming what its competitors used to be," says industry consultant Steven Casley. Serving congested hub airports, linking with rivals through code sharing, and hunting the big boys on their own turf are all things that Southwest would previously have never considered.

But Gary Kelly, Southwest's new CEO, defends the company's actions. "Hey, I can admit it, our competitors are getting better," says Kelly. "Sure, we have an enormous cost advantage. Sure, we're the most efficient. The problem is, I just don't see how that can be indefinitely sustained without some sacrifice." Kelly has hinted that such sacrifices could include modest fare increases and more conservative labor contracts. In direct contrast to its well-known "first-come" boarding policy, Southwest is even experimenting with an assigned-seating system. And when asked if he was worried about Southwest losing its competitive advantage, Mr. Kelly responded confidently:

We know people shop first for fares, and we've got the fares. [But] ultimately, our industry is a customer-service business, and we have the best people to provide that special customer service . . . that's our core advantage. Since the U.S. Department of Transportation began collecting and publishing operating statistics, we've excelled at on-time performance,

baggage handling, fewest complaints, and fewest canceled flights. Besides, we're still the low-cost producer and the low-fare leader in the U.S. We have no intention of conceding that position.

By almost any measure, Southwest is still the healthiest airline in the business. However, that might be like saying it's the least sick patient in the hospital. As the industry as a whole has suffered in the post-September 11th world, Southwest's 2005 earnings of \$313 million were half of what the company made in 2000. The airline's stock prices hover at around \$15 a share, more than 30 percent below 2001 levels. And as the other patients get better, Southwest may have to find some new medicine.

Questions for Discussion

1. How do Southwest's marketing objectives and its marketing mix strategy affect its pricing decisions?
2. Discuss factors that have affected the nature of costs in the airline industry since the year 2000. How have these factors affected pricing decisions?
3. How do the nature of the airline market and the demand for airline service affect Southwest's decisions?
4. What general pricing approaches have airlines pursued?
5. Do you think that Southwest will be able to continue to maintain a competitive advantage based on price? What will happen if other carriers match the low-price leader?

Sources: Chris Walsh, "A Philadelphia Success Story: Southwest's Quick Growth in City Shows Its Potential in Denver," *Rocky Mountain News*, December 30, 2005, p. 1B; Susan Warren, "Keeping Ahead of the Pack," *Wall Street Journal*, December 19, 2005, p. B1; Barney Gimbel, "Southwest's New Flight Plan," *Fortune*, May 16, 2005, accessed at www.fortune.com; "Let the Battle Begin," *Air Transport World*, May 2004, p. 9; Micheline Maynard, "Southwest Comes Calling, and a Race Begins," *New York Times*, May 10, 2004; Melanie Trotman, "Destination: Philadelphia," *Wall Street Journal*, May 4, 2004, p. B1; Andy Serwer and Kate Bonamicci, "Southwest Airlines: The Hottest Thing in the Sky," *Fortune*, March 8, 2004, p. 86.