Pricing Products

Pricing Strategies

Previewing the Concepts

In the last chapter, you explored the many internal and external factors that affect a firm's pricing decisions and examined three general approaches to setting prices. In this chapter, we'll look at pricing strategies available to marketers—new-product pricing strategies, product mix pricing strategies, price-adjustment strategies, and price reaction strategies.

Most U.S. airlines are facing tough times these days. One of the biggest issues is figuring out how to price their services in the face of fierce competition, high fuel costs, and already-disgruntled passengers. But Ryanair—Europe's original, largest, and most profitable low-fares airline—appears to have found a radical new pricing solution: Fly *free*! But surely this strategy is doomed to failure. How can Ryanair make money on free tickets?

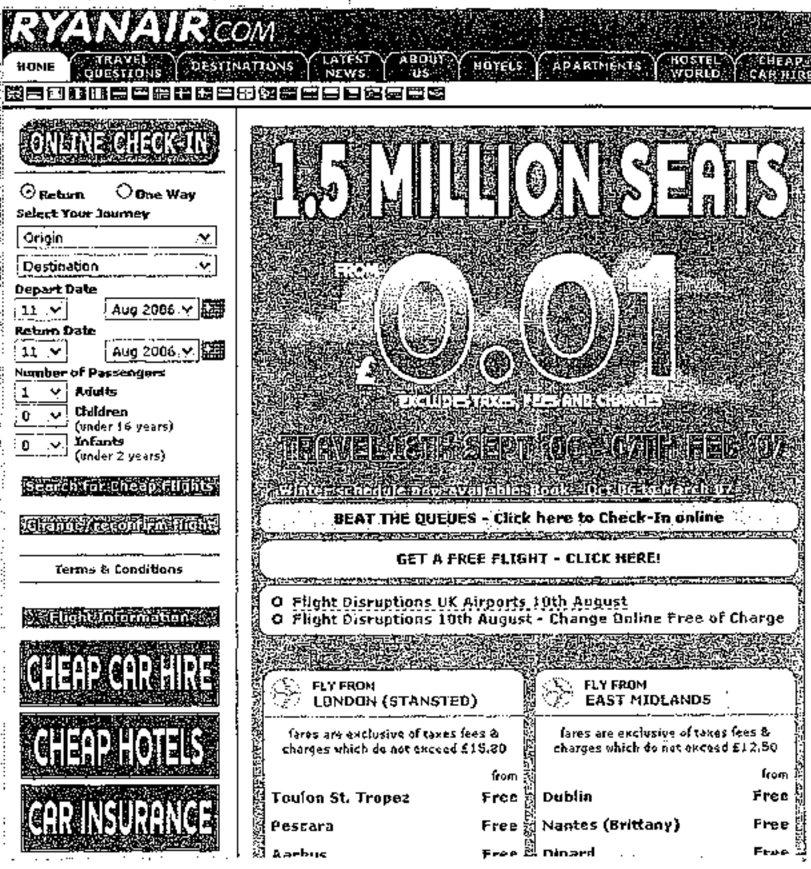
The major airlines are facing very difficult pricing strategy decisions in these tough air-travel times. Pricing strategies vary widely. Some airlines offer no-frills flights and charge rock-bottom prices (Southwest, JetBlue, Frontier). Others offer luxury and charge higher prices to match (Virgin, Singapore Airlines). But most airlines haven't yet figured it out, leaving air-travel passengers generally grumpy when it comes to the topic of airline ticket prices. For example, when Northwest Airlines recently charged full fares but still cut basic perks (such as free magazines, pillows, and pretzels) and tacked on irksome new charges for things competitors provide for free (such as in-flight snacks and aisle seats), it dropped to dead last in the industry's customer satisfaction ratings.

But now, one airline appears to have found a radical new pricing solution, one that customers are sure to love: Make flying *free*! That's right, Michael O'Leary, chief executive of Ireland's Ryanair, Europe's most profitable airline, wants to make air travel free. Not free as in free from regulation, but free as in zero cost. By the end of the decade, he promises, "more than half of our passengers will fly free." The remarkable thing is, few analysts think his prediction is far-fetched: Ryanair already offers free fares to a quarter of its customers.

Even without free flights, Ryanair has become one of Europe's most popular carriers. Last year it flew 35 million passengers to more than 100 European destinations, while its customers paid an average fare of just $53. The airline enjoyed revenues of $1.7 billion, up 20 percent over the previous year, at a time when most competitors were stuck in a holding pattern. Even more impressive, Ryanair reaped an industry-leading 22 percent net profit margin. (By comparison, profitable Southwest Airlines' net margin was 7.2 percent.) "Ryanair has the strongest financials in the European airline industry," says an airlines analyst.

The secret? Ryanair's austere cost structure makes even cost-conscious Southwest look like a reckless spender. In addition, the Irish airline puts a price on virtually everything except tickets, from baggage check-in to seat-back advertising space. As a result, last year Ryanair collected $265 million—15.6 percent of overall revenues—from sources other than ticket sales. "We weren't the first to figure this out," O'Leary says. "But we do it better than everybody else."

The similarities to the Southwest model are hardly coincidental. In 1991, when Ryanair was just another struggling European regional carrier, CEO O'Leary went to



Dallas to meet Southwest executives and look for lessons he could take back to Ireland. The visit prompted a wholesale reconsideration of how the airline did business. Following Southwest's lead, Ryanair embraced a single type of aircraft—the venerable Boeing 737. Likewise, it focused on smaller, secondary airports and began to offer open (unassigned) passenger seating.

But Ryanair has since taken the low-cost pricing model even further. An accountant who spent several years at big-four global accounting firm KPMG, O'Leary is *maniacal* about keeping costs down. "We want to be known as the Wal-Mart of flying," he says. Like the retail giant, each time Ryanair comes up with a new way to cut costs by a few million dollars—for example, by removing seat-back pockets to reduce weight and cleaning expense—O'Leary passes the savings along to customers in the form of lower fares.

It also means charging passengers *for* practically every amenity they might consume. There are no free peanuts or beverages on Ryanair flights; 27 million passengers bought in-flight refreshments on the airline last year, generating sales of $61 million, or an average of $2.25 per person. Last March, Ryanair eliminated its free checked-bag allowance and began charging $3.50 per piece—a "revenue-neutral" fee that was offset by cutting ticket prices by an average of $3.50. Ryanair expects the move to save $36 million a year by reducing fuel and handling costs.

The airline is just as aggressive in its efforts to develop new sources of revenue. Today, 98 percent of Ryanair's passengers book their flights online, and the company's Web site sees roughly 15 million unique visitors a month—making it Europe's most popular travel site. The airline uses that traffic as a marketing tool for related services; each time a passenger books a rental car or a hotel room, Ryanair earns a percentage of the sale. Linking customers to such services brought in more than $100 million last year.

O'Leary is also starting to turn his planes into media and entertainment venues. He's offered advertisers the opportunity to repaint the exteriors of Ryanair's planes, effectively turning them into giant billboards. (Hertz, Jaguar, and Vodafone have purchased space on the fuselages of Ryanair's 737s.) For passengers seeking distraction,

Objectives

1. describe the major strategies for pricing imitative and new products
2. explain how companies find a set of prices that maximize the profits from the total product mix
3. discuss how companies adjust their prices to take into account different types of customers and situations
4. discuss the key issues related to initiating and responding to price changes

Ryanair intends to offer in-flight gambling in 2007, with the airline earning a tiny cut off of each wager. O'Leary thinks gambling could double Ryanair's profits over the next decade, but he's not stopping there. He also envisions a day when the airline can charge passengers for the ability to use their cell phones at 35,000 feet. And he's expressed interest in partnering with operators of airport parking lots and concession stands to capture a bigger slice of the cash that passengers spend on the ground getting to and from his planes.

Add it all up—relentless cost cutting on the operations side, combined with innovative efforts to extract more revenue from each traveler—and O'Leary's plan to give away half of Ryanair's seats by 2010 starts to look quite sane. Sure, taking to the skies on Ryanair may feel more like riding in a subway car than an airplane, but you can't beat the prices. And financially-strapped U.S. carriers should take note: Flying people from here to there for free could truly be liberating. For Ryanair, not even the sky's the limit.[1]

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

This chapter examines the major dynamic pricing strategies available to marketers. In turn, we look at *new-product pricing strategies* for products in the introductory stage of the product life cycle, *product mix pricing strategies* for related products in the product mix, *price-adjustment strategies* that account for customer differences and changing situations, and strategies for initiating and responding to *price changes*.[2]

New-Product Pricing Strategies

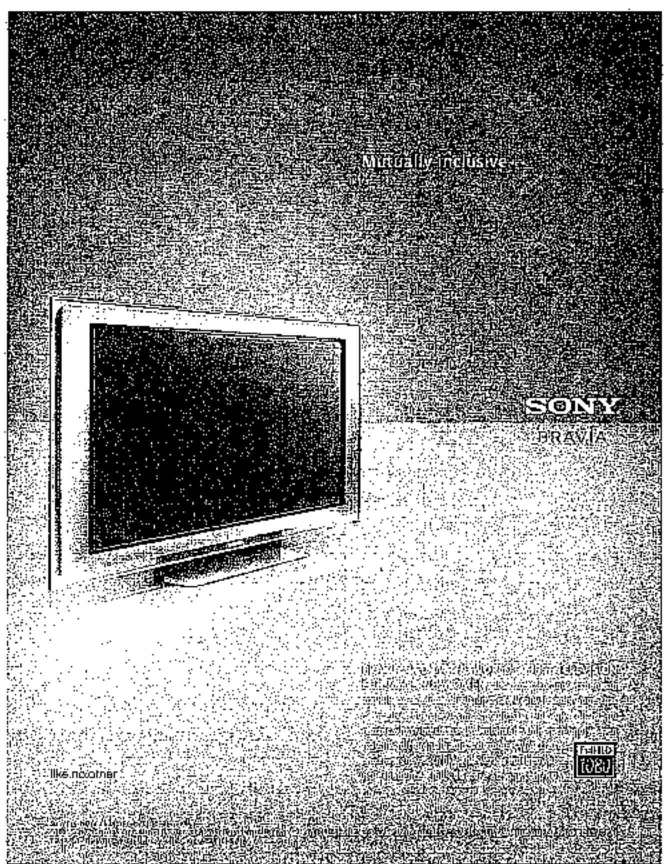
Pricing strategies usually change as the product passes through its life cycle. The introductory stage is especially challenging. Companies bringing out a new product face the challenge of setting prices for the first time. They can choose between two broad strategies: *market-skimming pricing* and *market-penetration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

Market-Skimming Pricing

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

Many companies that invent new products set high initial prices to "skim" revenues layer by layer from the market. Sony frequently uses this strategy, called **market-skimming pricing**. When Sony introduced the world's first high-definition television (HDTV) to the Japanese market in 1990, the high-tech sets cost $43,000. These televisions were purchased only by customers who could afford to pay a high price for the new technology. Sony rapidly reduced the price over the next several years to attract new buyers. By 1993 a 28-inch HDTV cost a Japanese buyer just over $6,000. In 2001, a Japanese consumer could buy a 40-inch HDTV for about $2,000, a price that many more customers could afford. An entry level HDTV set now sells for less than $500 in the United States, and prices continue to fall. In this way, Sony skimmed the maximum amount of revenue from the various segments of the market.[3]

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



Market-skimming pricing: Sony priced it's early HDTVs high, then reduced prices gradually over the years to attract new buyers.

Market-Penetration Pricing

Rather than setting a high initial price to skim off small but profitable market segments, some companies use **market-penetration pricing**. They set a low initial price in order to *penetrate* the market quickly and deeply—to attract a large number of buyers quickly and win a large market share. The high sales volume results in falling costs, allowing the company to cut its price even further. For example, Wal-Mart and other discount retailers use penetration pricing. And Dell used penetration pricing to enter the personal computer market, selling high-quality computer products through lower-cost direct channels. Its sales soared when IBM, Apple, and other competitors selling through retail stores could not match its prices.

Several conditions must be met for this low-price strategy to work. First, the market must be highly price sensitive so that a low price produces more market growth. Second, production and distribution costs must fall as sales volume increases. Finally, the low price must help keep out the competition, and the penetration pricer must maintain its low-price position—otherwise, the price advantage may be only temporary. For example, Dell faced difficult times when IBM and other competitors established their own direct distribution channels. However, through its dedication to low production and distribution costs, Dell has retained its price advantage and established itself as the industry's number-one PC maker.

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

Product Mix Pricing Strategies

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

Product Line Pricing

Companies usually develop product lines rather than single products. For example, Snapper makes many different lawn mowers, ranging from simple walk-behind versions starting at

TABLE 11.1
Product Mix Pricing Strategies

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

Product line pricing. Gramophone sells a complete line of high quality sound systems, ranging in price from $5,000 to $120,000.

$349.00, to elaborate "Yard Cruisers" and lawn tractors priced at $2,200 or more. Each successive lawn mower in the line offers more features. And Gramophone makes a complete line of high-quality sound systems, ranging in price from $5,000 to $120,000. In **product line pricing**, management must decide on the price steps to set between the various products in a line.

The price steps should take into account cost differences between the products in the line, customer evaluations of their different features, and competitors' prices. In many industries, sellers use well-established *price points* for the products in their line. Thus, men's clothing stores might carry men's suits at three price levels: $185, $325, and $495. The customer will probably associate low-, average-, and high-quality suits with the three price points. Even if the three prices are raised a little, men normally will buy suits at their own preferred price points. The seller's task is to establish perceived quality differences that support the price differences.

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

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

Optional-Product Pricing

Many companies use **optional-product pricing**—offering to sell optional or accessory products along with their main product. For example, a car buyer may choose to order alloy wheels and a CD changer. Refrigerators come with optional ice makers. And an iPod buyer can also choose from a bewildering array of accessories, everything from travel chargers and FM transmitters to external speakers and armband carrying cases.

Pricing these options is a sticky problem. Automobile companies must decide which items to include in the base price and which to offer as options. Until recent years, General Motors' normal pricing strategy was to advertise a stripped-down model at a base price to pull people into showrooms and then to devote most of the showroom space to showing option-loaded cars at higher prices. The economy model was stripped of so many comforts and conveniences that most buyers rejected it. Then, GM and other U.S. car makers followed the examples of the Japanese and German automakers and included in the sticker price many useful items previously sold only as options. Most advertised prices today represent well-equipped cars.

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

Captive-Product Pricing

Companies that make products that must be used along with a main product are using **captive-product pricing**. Examples of captive products are razor blade cartridges, video games, and printer cartridges. Producers of the main products (razors, video game consoles, and printers) often price them low and set high markups on the supplies. Thus, Gillette sells low-priced razors but makes money on the replacement cartridges. HP makes very low margins on its printers but very high margins on printer cartridges and other supplies. Sony and other video games makers sell game consoles at low prices and obtain the majority of their profits from the video games. Last year alone, total industry sales of consoles were $190 million, compared with total games sales of nearly $6.1 billion.[4]

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

In the case of services, this strategy is called *two-part pricing*. The price of the service is broken into a *fixed fee* plus a *variable usage rate*. Thus, at Six Flags and other amusement parks, you pay a daily ticket or season pass charge plus additional fees for food and other in-park features. Theaters charge admission and then generate additional revenues from concessions. And cell phone companies charge a flat rate for a basic calling plan, then charge for minutes over what the plan allows. The service firm must decide how much to charge for the basic service and how much for the variable usage. The fixed amount should be low enough to induce usage of the service; profit can be made on the variable fees.

By-Product Pricing

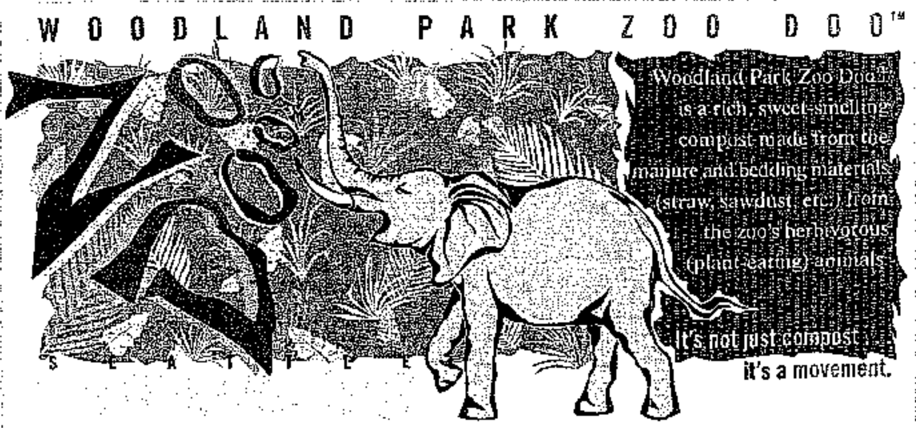
By-product pricing
Setting a price for by-products in order to make the main product's price more competitive.

In producing processed meats, petroleum and agricultural products, chemicals, and other products, there are often by-products. If the by-products have no value and if getting rid of them is costly, this will affect the pricing of the main product. Using **by-product pricing**, the manufacturer will seek a market for these by-products and should accept any price that covers more than the cost of storing and delivering them.

By-products can even turn out to be profitable. For example, papermaker MeadWestvaco has turned what was once considered chemical waste into profit-making products.

> MeadWestvaco created a separate company, Asphalt Innovations, which creates useful chemicals entirely from the by-products of MeadWestvaco's wood-processing activities. In fact, Asphalt Innovations has grown to become the world's biggest supplier of specialty chemicals for the paving industry. Using the salvaged chemicals, paving companies can pave roads at a lower temperature, create longer-lasting roads, and more easily recycle road materials when roads need to be replaced. What's more, salvaging the by-product chemicals eliminates the costs and environmental hazards once associated with disposing of them.[5]

Sometimes, companies don't realize how valuable their by-products are. For example, most zoos don't realize that one of their by-products—their occupants' manure—can be an excellent source of additional revenue. But the Zoo Doo Compost Company has helped many zoos understand the costs and opportunities involved with these by-products. Zoo Doo licenses its name to zoos and receives royalties on manure sales. So far, novelty sales have been the largest segment, with tiny containers of Zoo Doo (and even "Love, Love Me Doo" valentines) available in 160 zoo stores and 700 additional retail outlets. You can also buy Zoo Doo products online ("the easiest way to buy our crap," says Zoo Doo) or even send a friend (or perhaps a foe) a free Poopy Greeting via e-mail. Other zoos sell their by-products on their own. For example, the Woodland Park Zoo in Seattle sponsors annual Fecal Fests, selling processed manure by the trash can and truck load to lucky lottery winners. In all, the zoo creates 1 million pounds of compost each year, saving $60,000 a year in disposal costs.[6]



By-products can be profitable: Woodland Park Zoo in Seattle sponsors annual Fecal Fests, selling processed manure by the trash can and truck load to lucky lottery winners. "It's not just compost . . . it's a movement."

Product Bundle Pricing

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

Using **product bundle pricing**, sellers often combine several of their products and offer the bundle at a reduced price. For example, fast-food restaurants bundle a burger, fries, and a soft drink at a combo price. Resorts sell specially priced vacation packages that include airfare, accommodations, meals, and entertainment. And Comcast and other cable companies bundle cable service, phone service, and high-speed Internet connections at a low combined price. Price bundling can promote the sales of products consumers might not otherwise buy, but the combined price must be low enough to get them to buy the bundle.[7]

Price-Adjustment Strategies

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

Discount and Allowance Pricing

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

Discount
A straight reduction in price on purchases during a stated period of time.

The many forms of **discounts** include a *cash discount*, a price reduction to buyers who pay their bills promptly. A typical example is "2/10, net 30," which means that although payment is due within 30 days, the buyer can deduct 2 percent if the bill is paid within 10 days. A *quantity discount* is a price reduction to buyers who buy large volumes. Such discounts provide an incentive to the customer to buy more from one given seller, rather than from many different sources.

A *functional discount* (also called a *trade discount*) is offered by the seller to trade-channel members who perform certain functions, such as selling, storing, and record keeping. A *seasonal discount* is a price reduction to buyers who buy merchandise or services out of season. For example, lawn and garden equipment manufacturers offer seasonal discounts to retailers during the fall and winter months to encourage early ordering in anticipation of the heavy spring and summer selling seasons. Seasonal discounts allow the seller to keep production steady during an entire year.

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

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

Segmented Pricing

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

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

TABLE 11.2
Price-Adjustment Strategies

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

Product-form pricing: Evian water in a 1-liter bottle might cost you 5 cents an ounce at your local supermarket, whereas the same water might run $2.28 an ounce when sold in 5-ounce aerosol cans as Evian Brumisateur Mineral Water Spray moisturizer.

Segmented pricing takes several forms. Under *customer-segment* pricing, different customers pay different prices for the same product or service. Museums, for example, may charge a lower admission for students and senior citizens. Under *product-form pricing*, different versions of the product are priced differently but not according to differences in their costs. For instance, a 1-liter bottle (about 34 ounces) of Evian mineral water may cost $1.59 at your local supermarket. But a 5-ounce aerosol can of Evian Brumisateur Mineral Water Spray sells for a suggested retail price of $11.39 at beauty boutiques and spas. The water is all from the same source in the French Alps, and the aerosol packaging costs little more than the plastic bottles. Yet you pay about 5 cents an ounce for one form and $2.28 an ounce for the other.

Using *location pricing*, a company charges different prices for different locations, even though the cost of offering each location is the same. For instance, theaters vary their seat prices because of audience preferences for certain locations, and state universities charge higher tuition for out-of-state students. Finally, using *time pricing*, a firm varies its price by the season, the month, the day, and even the hour. Some public utilities vary their prices to commercial users by time of day and weekend versus weekday. Resorts give weekend and seasonal discounts.

Segmented pricing goes by many names. Robert Cross, a long-time consultant to the airlines, calls it *revenue management*. According to Cross, the practice ensures that "companies will sell the right product to the right consumer at the right time for the right price." Airlines, hotels, and restaurants call it *yield management* and practice it religiously. The airlines, for example, routinely set prices hour-by-hour—even minute-by-minute—depending on seat availability, demand, and competitor price changes.

Continental Airlines launches more than 3,200 flights every day. Each flight has between 10 and 20 prices. Continental starts booking flights 330 days in advance, and every flying day is different from every other flying day. As a result, at any given moment, Continental may have nearly 7 million prices in the market. It's a daunting marketing task—all of those prices need to be managed, all of the time. For Continental, setting prices is a complex process of balancing demand and customer satisfaction against company profitability.[8]

> The airlines know full well that we are puzzled by the frantic pricing and repricing that they do—puzzled, that is, when we aren't infuriated. "I do not set the prices," says Jim Compton, senior vice president of pricing and revenue management at Continental Airlines. "The market sets prices." That's point one. Point two: "I have a really perishable product. It's gone when the door of the plane closes. An empty seat is lost revenue." The most valuable airline seat is the one that somebody must have an hour before takeoff and is willing to pay almost any price for. An airline seat gets more profitable with time—right up to the moment it goes from being worth $1,000 one-way to being worth $0.
>
> Here's how Compton and his colleagues think about this: You want to sell every seat on the plane, except that you also want to have a handful left at the very end, for your most profitable (not to mention most grateful) customers. The airlines could easily sell out every seat, every flight, every day. They'd price 'em pretty low, book 'em up, and wait for takeoff. But that would mean there'd never be any seats available two or three weeks before a flight took off. How exasperated would customers be to call and find no seats three days out? When you understand that dilemma, all of a sudden, airline prices don't seem so exploitive. Although all of the seats on that New York-Miami flight are going to the same place, they aren't the same product. You pay less when you commit to a ticket four weeks in advance; Continental assumes a risk for holding a seat until the end—and wants to be paid a lot to balance the times when saving that last seat for you means that the seat flies empty.

For segmented pricing to be an effective strategy, certain conditions must exist. The market must be segmentable, and the segments must show different degrees of demand. The costs

of segmenting and watching the market cannot exceed the extra revenue obtained from the price difference. Of course, the segmented pricing must also be legal. Most importantly, segmented prices should reflect real differences in customers' perceived value. Otherwise, in the long run, the practice will lead to customer resentment and ill will.

Psychological Pricing

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

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

In using **psychological pricing**, sellers consider the psychology of prices and not simply the economics. For example, consumers usually perceive higher-priced products as having higher quality. When they can judge the quality of a product by examining it or by calling on past experience with it, they use price less to judge quality. But when they cannot judge quality because they lack the information or skill, price becomes an important quality signal:

> Some years ago, Heublein produced Smirnoff, then America's leading vodka brand. Smirnoff was attacked by another brand, Wolfschmidt, which claimed to have the same quality as Smirnoff but was priced at one dollar less per bottle. To hold on to market share, Heublein considered either lowering Smirnoff's price by one dollar or holding Smirnoff's price but increasing advertising and promotion expenditures. Either strategy would lead to lower profits and it seemed that Heublein faced a no-win situation. At this point, however, Heublein's marketers thought of a third strategy. They *raised* the price of Smirnoff by one dollar! Heublein then introduced a new brand, Relska, to compete with Wolfschmidt. Moreover, it introduced yet another brand, Popov, priced even *lower* than Wolfschmidt. This clever strategy positioned Smirnoff as the elite brand and Wolfschmidt as an ordinary brand, producing a large increase in Heublein's overall profits. The irony is that Heublein's three brands were pretty much the same in taste and manufacturing costs. Heublein knew that a product's price signals its quality. Using price as a signal, Heublein sold roughly the same product at three different quality positions.

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

Psychological pricing: What do the prices marked on this tag suggest about the product and buying solution.

Another aspect of psychological pricing is **reference prices**—prices that buyers carry in their minds and refer to when looking at a given product. The reference price might be formed by noting current prices, remembering past prices, or assessing the buying situation. Sellers can influence or use these consumers' reference prices when setting price. For example, a company could display its product next to more expensive ones in order to imply that it belongs in the same class. Department stores often sell women's clothing in separate departments differentiated by price: Clothing found in the more expensive department is assumed to be of better quality.

For most purchases, consumers don't have all the skill or information they need to figure out whether they are paying a good price. They don't have the time, ability, or inclination to research different brands or stores, compare prices, and get the best deals. Instead, they may rely on certain cues that signal whether a price is high or low. For example, the fact that a product is sold in a prestigious department store might signal that it's worth a higher price.

Interestingly, such pricing cues are often provided by sellers. A retailer might show a high manufacturer's suggested price next to the marked price, indicating that the product was originally priced much higher. Or the retailer might sell a selection of familiar products for which consumers have accurate price knowledge at very low prices, suggesting that the store's prices on other, less familiar products are low as well. The use of such pricing cues has become a common marketing practice (see Real Marketing 11.1).

Real Marketing

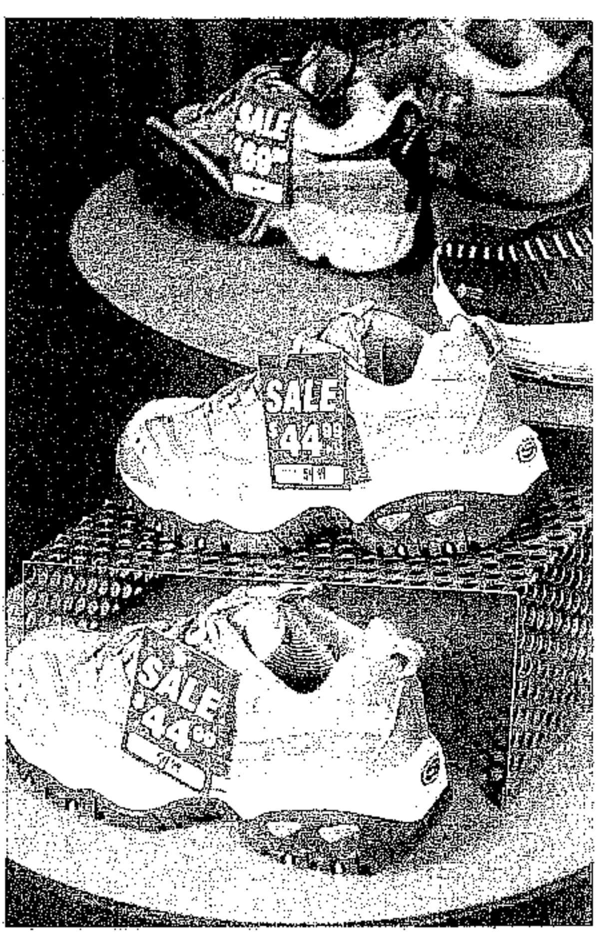
It's Saturday morning and you stop by your local supermarket to pick up a few items for tonight's backyard barbeque. Cruising the aisles, you're bombarded with price signs, all suggesting that you just can't beat this store's deals. A 10-pound bag of Kingsford Charcoal Briquets goes for only $3.99 with your frequent shopper card ($4.39 without the card). Cans of Van Camps Pork & Beans are 4 for $1.00 (4 for $2.16 without the card). An aisle display hawks big bags of Utz potato chips at an "everyday low price" of just $1.99. And a sign atop a huge mass of Coke 12-packs advertises 2 for $7.

These sure look like good prices, but *are* they? If you're like most shoppers, you don't really know. In a recent *Harvard Business Review* article, two pricing researchers conclude, "for most of the items they buy, consumers don't have an accurate sense of what the price should be." In fact, customers often don't even know what prices they're actually paying. In one recent study, researchers asked supermarket shoppers the price of an item just as they were putting it into their shopping carts. Fewer than half the shoppers gave the right answer.

To know for sure if you're paying the best price, you'd have to compare the marked price to past prices, prices of competing brands, and prices in other stores. For most purchases, consumers just don't bother. Instead, they rely on a most unlikely source. "Remarkably, . . . they rely on the retailer to tell them if they're getting a good price," say the researchers. "In subtle and not-so-subtle ways, retailers send signals [or pricing cues] to customers, telling them whether a given price is relatively high or low." In their article, the researchers outline the following common retailer pricing cues.

- *Sale Signs.* The most straightforward retail pricing cue is a sale sign. It might take any of several familiar forms: "Sale!" "Reduced!" "New low price!" "Price after rebate!" or "Now 2 for only . . . !" Such signs can be very effective in signaling low prices to consumers and increasing sales for the retailer. The researchers' studies in retail stores and mail-order catalogs reveal that using the word "sale" beside a price (even without actually varying the price) can increase demand by more than 50 percent.

  Sales signs can be effective, but overuse or misuse can damage both the seller's credibility and its sales. Unfortunately, some retailers don't always use such signs truthfully. Still, consumers trust sale signs. Why? "Because they are accurate most of the time," say the researchers. "And besides, customers are not that easily fooled." They quickly become suspicious when sale signs are used improperly.
- *Prices Ending in 9.* Just like a sale sign, a 9 at the end of a price often signals a bargain. You see such prices everywhere. For example, browse the Web sites of discounters such as Target, Best Buy, or PetsMart: It's almost impossible to find even one price that *doesn't* end in 9 (really, try it!). "In fact, this pricing tactic is so common," say the researchers, "you'd think customers would ignore it. Think again. Response to this pricing cue is remarkable." Normally, you'd expect that demand for an item would fall as the price goes up. Yet in one study involving women's clothing, raising the price of a dress from $34 to $39 *increased* demand by a third. By comparison, raising the price from $34 to $44 yielded no difference in demand.



Pricing cues such as sales signs and prices ending in 9 can be effective in signaling low prices to consumers and increasing sales for the retailer.

  But are prices ending in 9 accurate as pricing cues? "The answer varies," the researchers report. "Some retailers do reserve prices that end in 9 for their discounted items. For instance, J. Crew and Ralph Lauren generally use 00-cent endings on regularly priced merchandise and 99-cent endings on discounted items. Comparisons of prices at major department stores reveal that this is common, particularly for apparel. But at some stores, prices that end in 9 are a miscue—they are used on all products regardless of whether the items are discounted."
- *Signpost Pricing (or Loss-Leader Pricing).* Unlike sale signs or prices that end in 9, signpost pricing is used on frequently purchased products about which consumers tend to have accurate price knowledge. For example, you probably know a good price on a 12-pack of Coke when you see one. New parents usually know how much they should expect to pay for disposable diapers.

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Research suggests that customers use the prices of such "signpost" items to gauge a store's overall prices. If a store has a good price on Coke or Pampers or Tide, they reason, it probably also has good prices on other items.

Retailers have long known the importance of signpost pricing, often called "loss-leader pricing." They offer selected signpost items at or below cost to pull customers into the store, hoping to make money on the shopper's other purchases. For instance, Best Buy often sells recently released DVDs at several dollars below wholesale price. Customers get a really good deal. And although Best Buy loses money on every DVD sold, the low DVD prices increase store traffic and purchases of higher-margin complementary products, such as DVD players.

- *Pricing-Matching Guarantees.* Another widely used retail pricing cue is price matching, whereby stores promise to meet or beat any competitor's price. Best Buy, for example, says "we'll meet or beat any local competitor's price, guaranteed!" If you find a better price within 30 days on something you bought at Best Buy, the retailer will refund the difference plus 10 percent. Tweeter, a New England consumer-electronics retailer, even offers a self-enforced price-matching policy. When Tweeter finds a competitor advertising a lower advertised price, it mails a check for the difference to any customers who paid a higher price at Tweeter in the previous 30 days.

Evidence suggests that customers perceive that stores offering price-matching guarantees have overall lower prices than competing stores, especially in markets where they perceive price comparisons to be relatively easy. But are such perceptions accurate? "The evidence is mixed," say the researchers. Consumers can usually be confident that they'll pay the lowest price on eligible items. However, some manufacturers make it hard to take advantage of price-matching policies by introducing "branded variants"—slightly different versions of products with different model numbers for different retailers. "When Tweeter introduced its highly effective automatic price-matching policy," the researchers note, "only 6 percent of its transactions were actually eligible for refunds."

Used properly, pricing cues can help consumers. Careful buyers really can take advantage of signals such as sale signs, 9-endings, loss-leaders, and price guarantees to locate good deals. Used improperly, however, these pricing cues can mislead consumers, tarnishing a brand and damaging customer relationships.

The researchers conclude: "Customers need price information, just as they need products. They look to retailers to provide both. Retailers must manage pricing cues in the same way that they manage quality. . . . No retailer . . . interested in [building profitable long-term relationships with customers] would purposely offer a defective product. Similarly, no retailer who [values customers] would deceive them with inaccurate pricing cues. By reliably signaling which prices are low, companies can retain customers' trust—and [build more solid relationships]."

Sources: Quotes and other information from Eric Anderson and Duncan Simester, "Mind Your Pricing Cues," *Harvard Business Review,* September 2003, pp. 96–103. Also see Joydeep Srivastava and Nicholas Lurie, "Price-Matching Guarantees as Signals of Low Store Prices: Survey and Experimental Evidence," *Journal of Retailing,* volume 80, issue 2, 2004, pp. 117–128; Bruce McWilliams and Eilen Gerstner, "Offering Low Price Guarantees to Improve Customer Retention," *Journal of Retailing,* June 2006, pp. 105–113; Manoj Thomas and Vicki Morvitz, "Penny Wise and Pound Foolish: The Double-Digit Effect in Price Cognition," *Journal of Consumer Research,* June 2005, pp. 54–64; and Heyong Min Kim and Luke Kachersky, "Dimensions of Price Salience: A Conceptual Framework for Perceptions of Multi-Dimensional Prices," *Journal of Product and Brand Management,* 2006, vol. 15, no. 2, pp. 139–147.

Even small differences in price can signal product differences. Consider a stereo priced at $300 compared to one priced at $299.99. The actual price difference is only 1 cent, but the psychological difference can be much greater. For example, some consumers will see the $299.99 as a price in the $200 range rather than the $300 range. The $299.99 will more likely be seen as a bargain price, whereas the $300 price suggests more quality. Some psychologists argue that each digit has symbolic and visual qualities that should be considered in pricing. Thus, 8 is round and even and creates a soothing effect, whereas 7 is angular and creates a jarring effect.[9]

Promotional Pricing

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

With **promotional pricing**, companies will temporarily price their products below list price and sometimes even below cost to create buying excitement and urgency. Promotional pricing takes several forms. Supermarkets and department stores will price a few products as *loss leaders* to attract customers to the store in the hope that they will buy other items at normal markups. For example, supermarkets often sell disposable diapers at less than cost in order to attract family buyers who make larger average purchases per trip. Sellers will also use *special-event pricing* in certain seasons to draw more customers. Thus, linens are promotionally priced every January to attract weary Christmas shoppers back into stores.

Manufacturers sometimes offer *cash rebates* to consumers who buy the product from dealers within a specified time; the manufacturer sends the rebate directly to the customer. Rebates have been popular with automakers and producers of durable goods and small appli-

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

ances, but they are also used with consumer packaged goods. Some manufacturers offer *low-interest financing, longer warranties,* or *free maintenance* to reduce the consumer's "price." This practice has become another favorite of the auto industry. Or, the seller may simply offer *discounts* from normal prices to increase sales and reduce inventories.

Promotional pricing, however, can have adverse effects. Used too frequently and copied by competitors, price promotions can create "deal-prone" customers who wait until brands go on sale before buying them. Or, constantly reduced prices can erode a brand's value in the eyes of customers. Marketers sometimes use price promotions as a quick fix instead of sweating through the difficult process of developing effective longer-term strategies for building their brands. In fact, one observer notes that price promotions can be downright addicting to both the company and the customer: "Price promotions are the brand equivalent of heroin: easy to get into but hard to get out of. Once the brand and its customers are addicted to the short-term high of a price cut, it is hard to wean them away to real brand building. . . . But continue and the brand dies by 1,000 cuts."[10]

The frequent use of promotional pricing can also lead to industry price wars. Such price wars usually play into the hands of only one or a few competitors—those with the most efficient operations. For example, until recently, the computer industry avoided price wars. Computer companies, including IBM, Hewlett-Packard, and Gateway, showed strong profits as their new technologies were snapped up by eager consumers. When the market cooled, however, many competitors began to unload PCs at discounted prices. In response, Dell, the industry's undisputed low-cost leader, started a brutal price war that only it could win. The result was nothing short of a rout. IBM has since sold off its PC unit to Lenovo, and Gateway struggles with razor thin profit margins. HP PC profit margins average just 3.9 percent compared to Dell's 6.4 percent. Dell has emerged atop the worldwide PC industry.[11]

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

Geographical Pricing

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

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

> The Peerless Paper Company is located in Atlanta, Georgia, and sells paper products to customers all over the United States. The cost of freight is high and affects the companies from whom customers buy their paper. Peerless wants to establish a geographical pricing policy. It is trying to determine how to price a $100 order to three specific customers: Customer A (Atlanta), Customer B (Bloomington, Indiana), and Customer C (Compton, California).

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

One option is for Peerless to ask each customer to pay the shipping cost from the Atlanta factory to the customer's location. All three customers would pay the same factory price of $100, with Customer A paying, say, $10 for shipping; Customer B, $15; and Customer C, $25. Called **FOB-origin pricing,** this practice means that the goods are placed *free on board* (hence,

FOB) a carrier. At that point the title and responsibility pass to the customer, who pays the freight from the factory to the destination. Because each customer picks up its own cost, supporters of FOB pricing feel that this is the fairest way to assess freight charges. The disadvantage, however, is that Peerless will be a high-cost firm to distant customers.

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

Uniform-delivered pricing is the opposite of FOB pricing. Here, the company charges the same price plus freight to all customers, regardless of their location. The freight charge is set at the average freight cost. Suppose this is $15. Uniform-delivered pricing therefore results in a higher charge to the Atlanta customer (who pays $15 freight instead of $10) and a lower charge to the Compton customer (who pays $15 instead of $25). Although the Atlanta customer would prefer to buy paper from another local paper company that uses FOB-origin pricing, Peerless has a better chance of winning over the California customer. Other advantages of uniform-delivered pricing are that it is fairly easy to administer and it lets the firm advertise its price nationally.

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

Zone pricing falls between FOB-origin pricing and uniform-delivered pricing. The company sets up two or more zones. All customers within a given zone pay a single total price; the more distant the zone, the higher the price. For example, Peerless might set up an East Zone and charge $10 freight to all customers in this zone, a Midwest Zone in which it charges $15, and a West Zone in which it charges $25. In this way, the customers within a given price zone receive no price advantage from the company. For example, customers in Atlanta and Boston pay the same total price to Peerless. The complaint, however, is that the Atlanta customer is paying part of the Boston customer's freight cost.

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

Using **basing-point pricing**, the seller selects a given city as a "basing point" and charges all customers the freight cost from that city to the customer location, regardless of the city from which the goods are actually shipped. For example, Peerless might set Chicago as the basing point and charge all customers $100 plus the freight from Chicago to their locations. This means that an Atlanta customer pays the freight cost from Chicago to Atlanta, even though the goods may be shipped from Atlanta. If all sellers used the same basing-point city, delivered prices would be the same for all customers and price competition would be eliminated. Industries such as sugar, cement, steel, and automobiles used basing-point pricing for years, but this method has become less popular today. Some companies set up multiple basing points to create more flexibility: They quote freight charges from the basing-point city nearest to the customer.

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

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

Dynamic Pricing

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

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

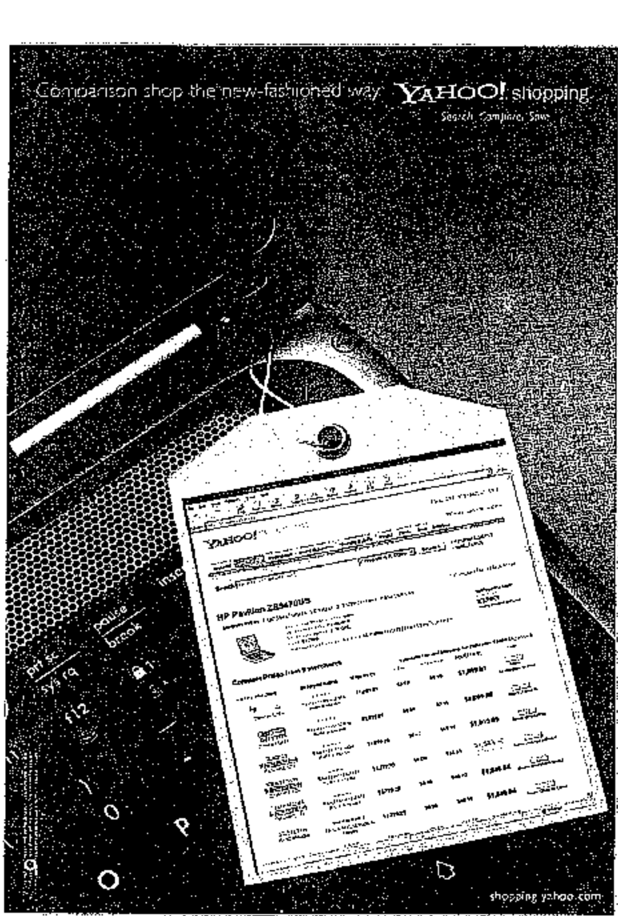
For example, think about how the Internet has affected pricing. From the mostly fixed pricing practices of the past century, the Web seems now to be taking us back—into a new age of fluid pricing. "Potentially, [the Internet] could push aside sticker prices and usher in an era of dynamic pricing," says one writer, "in which a wide range of goods would be priced according to what the market will bear—instantly, constantly."[12]

Dynamic pricing offers many advantages for marketers. For example, Internet sellers such as Amazon.com can mine their databases to gauge a specific shopper's desires, measure his or her means, instantaneously tailor products to fit that shopper's behavior, and price products accordingly. Catalog retailers such as L.L. Bean or Spiegel can change prices on the fly according to changes in demand or costs, changing prices for specific items on a day-by-day or even hour-by-hour basis.

Many direct marketers monitor inventories, costs, and demand at any given moment and adjust prices instantly. For example, Dell uses dynamic pricing to achieve real-time balancing of supply and demand for computer components. Author Thomas Friedman describes Dell's dynamic pricing system this way:[13]

> [Dell's] supply chain symphony—from my order over the phone to production to delivery to my house—is one of the wonders of the flat world. . . . Demand shaping goes on constantly. . . . It works like this: At 10 A.M. Austin time, Dell discovers that so many customers have ordered notebooks with 40-gigabyte hard drives since the morning that its supply chain will run short in two hours. That signal is automatically relayed to Dell's marketing department and to Dell.com and to all the Dell phone operators taking orders. If you happen to call to place your Dell order at 10:30 A.M., the Dell representative will say to you, "Tom, it's your lucky day! For the next hour we are offering 60-gigabyte hard drives with the notebook you want—for only $10 more than the 40-gig drive. And if you act now, Dell will throw in a carrying case along with your purchase, because we so value you as a customer." In an hour or two, using such promotions, Dell can reshape the demand for any part of any notebook or desktop to correspond with the projected supply in its global supply chain. Today memory might be on sale, tomorrow it might be CD-ROMS.

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



Buyers benefit from the Web and dynamic pricing. Sites like Yahoo! Shopping give instant product and price comparisons from thousands of vendors, arming customers with price information they need to get the lowest prices.

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

Dynamic pricing can also be controversial. Most customers would find it galling to learn that the person in the next seat on that flight from Gainesville to Galveston paid 10 percent less just because he or she happened to call at the right time or buy through the right sales channel. Amazon.com learned this some years ago when it experimented with lowering prices to new customers in order to woo their business. When regular customers learned through Internet chatter that they were paying generally higher prices than first-timers, they protested loudly. An embarrassed Amazon.com halted the experiments.

Dynamic pricing makes sense in many contexts—it adjusts prices according to market forces, and it often works to the benefit of the customer. But marketers need to be careful not to use dynamic pricing to take advantage of certain customer groups, damaging important customer relationships. Especially in the online retail environment, customer loyalty can be fragile. According to one online retail researcher, "A consumer [can] switch in a heartbeat. Price shopping is done as a matter of course, and it wouldn't be all that hard [for a consumer] to identify [himself or herself] as someone else just to see the price on that site. Get caught, and you're dead."[14]

International Pricing

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

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

Companies that market products internationally must decide what prices to charge in the different countries.

Costs play an important role in setting international prices. Travelers abroad are often surprised to find that goods that are relatively inexpensive at home may carry outrageously higher price tags in other countries. A pair of Levi's selling for $30 in the United States might go for $63 in Tokyo and $88 in Paris. A McDonald's Big Mac selling for a modest $2.90 here might cost $6.00 in Reykjavik, Iceland, and an Oral-B toothbrush selling for $2.49 at home may cost $10 in China. Conversely, a Gucci handbag going for only $140 in Milan, Italy, might fetch $240 in the United States. In some cases, such *price escalation* may result from differences in selling strategies or market conditions. In most instances, however, it is simply a result of the higher costs of selling in another country—the additional costs of product modifications, shipping and insurance, import tariffs and taxes, exchange-rate fluctuations, and physical distribution.

For example, Campbell found that distribution in the United Kingdom cost 30 percent more than in the United States. U.S. retailers typically purchase soup in large quantities—48-can cases of a single soup by the dozens, hundreds, or carloads. In contrast, English grocers purchase soup in small quantities—typically in 24-can cases of *assorted* soups. Each case had to be hand-packed for shipment. To handle these small orders, Campbell had to add a costly extra wholesale level to its European channel. The smaller orders also meant that English retailers ordered two or three times as often as their U.S. counterparts, bumping up billing and order costs. These and other factors caused Campbell to charge much higher prices for its soups in the United Kingdom.[15]

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

Price Changes

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

Initiating Price Changes

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

Initiating Price Cuts

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

A company may also cut prices in a drive to dominate the market through lower costs. Either the company starts with lower costs than its competitors, or it cuts prices in the hope of gaining market share that will further cut costs through larger volume. Bausch & Lomb used an aggressive low-cost, low-price strategy to become an early leader in the competitive soft contact lens market. And Dell used this strategy in the PC market.

Initiating Price Increases

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

When raising prices, the company must avoid being perceived as a price gouger. Customers have long memories, and they will eventually turn away from companies or even whole industries that they perceive as charging excessive prices. There are some techniques for avoiding this problem. One is to maintain a sense of fairness surrounding any price increase. Price increases should be supported by company communications telling customers why prices are being raised. Making low-visibility price moves first is also a good technique: Some examples include dropping discounts, increasing minimum order sizes, and curtailing production of low-margin products. The company sales force should help business customers find ways to economize.

Wherever possible, the company should consider ways to meet higher costs or demand without raising prices. For example, it can consider more cost-effective ways to produce or distribute its products. It can shrink the product or substitute less expensive ingredients instead of raising the price, as candy bar manufacturers often do. Or it can "unbundle" its market offering, removing features, packaging, or services and separately pricing elements that were formerly part of the offer. IBM, for example, now offers training and consulting as separately priced services.

Buyer reactions to price changes: What would you think if the price of Joy was suddenly cut in half?

Buyer Reactions to Price Changes

Customers do not always interpret price changes in a straightforward way. They may view a price *cut* in several ways. For example, what would you think if Joy perfume, "the costliest fragrance in the world," were to cut its price in half? Or what if Sony suddenly cut its PC prices drastically? You might think that the computers are about to be replaced by newer models or that they have some fault and are not

selling well. You might think that Sony is abandoning the computer business and may not stay in this business long enough to supply future parts. You might believe that quality has been reduced. Or you might think that the price will come down even further and that it will pay to wait and see.

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

Competitor Reactions to Price Changes

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

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

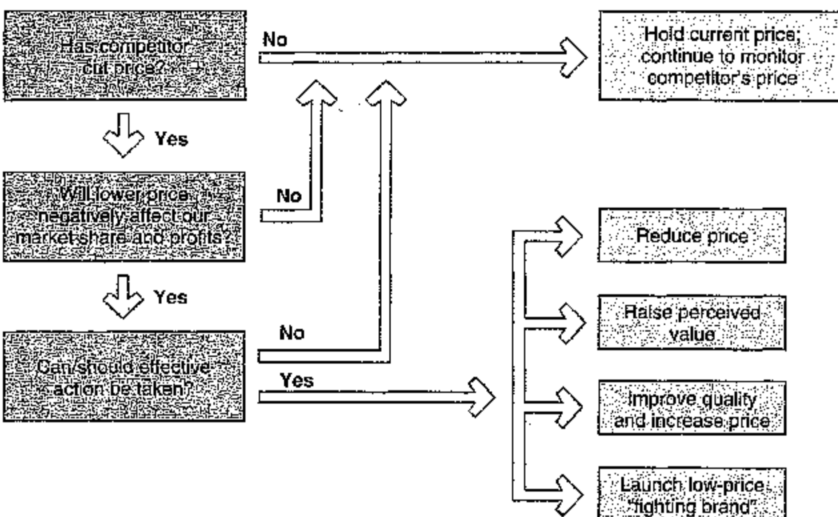
The company must guess each competitor's likely reaction. If all competitors behave alike, this amounts to analyzing only a typical competitor. In contrast, if the competitors do not behave alike—perhaps because of differences in size, market shares, or policies—then separate analyses are necessary.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

Responding to Price Changes

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

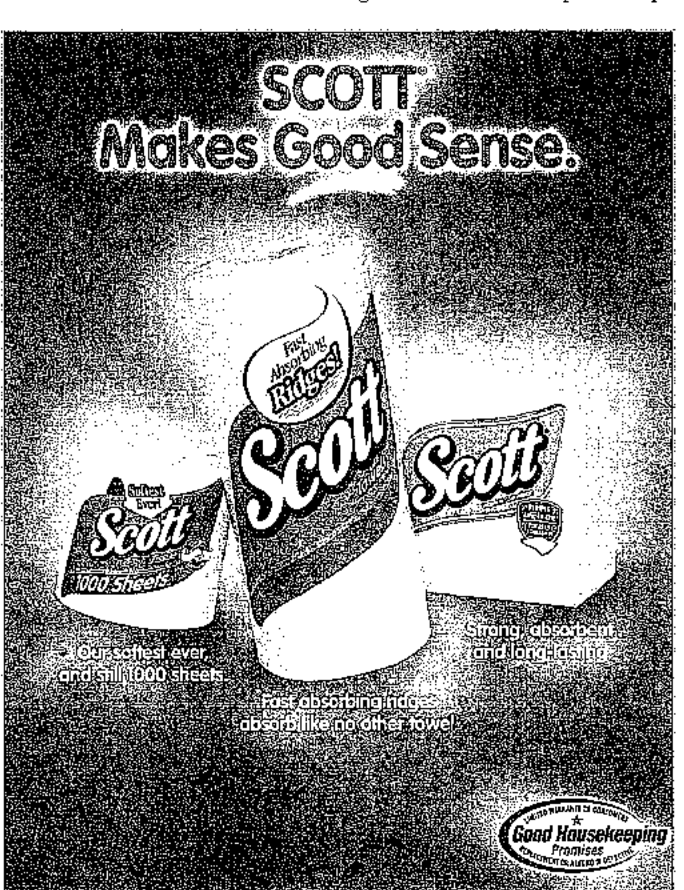
Figure 11.1 shows the ways a company might assess and respond to a competitor's price cut. Suppose the company learns that a competitor has cut its price and decides that this price cut is likely to harm company sales and profits. It might simply decide to hold its current price and profit margin. The company might believe that it will not lose too much market share, or that it would lose too much profit if it reduced its own price. Or it might decide that

FIGURE 11.1
Assessing and responding to competitor price changes



it should wait and respond when it has more information on the effects of the competitor's price change. However, waiting too long to act might let the competitor get stronger and more confident as its sales increase.

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



Fighting brands: Kimberly-Clark offers its value-priced Scott brand as "the Bounty killer." It scores well on customer satisfaction but sells for a lower price than P&G's Bounty. "Scott makes good sense."

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

Finally, the company might *launch a low-price "fighting brand"*—adding a lower-price item to the line or creating a separate lower-price brand. This is necessary if the particular market segment being lost is price sensitive and will not respond to arguments of higher quality. Thus, when challenged on price by Southwest Airlines and JetBlue, Delta created low-fare Song airlines and United created Ted. To counter store brands and other low-price entrants, Procter & Gamble turned a number of its brands into fighting brands, including Luvs disposable diapers, Joy dishwashing detergent, Charmin Basic toilet paper, and Camay beauty soap. In turn, P&G competitor Kimberly-Clark positions its value-priced Scott Towels brand as "the Bounty killer." It advertises that "Scott makes good sense." The brand scores well on customer satisfaction measures but sells for a lower price than P&G's Bounty brand. The Scott products Web site offers printable coupons to support the brand's good-value positioning.

Public Policy and Pricing

Price competition is a core element of our free-market economy. In setting prices, companies are not usually free to charge whatever prices they wish. Many federal, state, and even local laws govern the rules of fair play in pricing. In addition, companies must consider broader societal pricing concerns (see Real Marketing 11.2). The most important pieces of legislation affecting pricing are the Sherman, Clayton, and Robinson-Patman acts, initially adopted to curb the formation of monopolies and to regulate business practices that might unfairly restrain trade. Because these federal statutes can be applied only to interstate commerce, some states have adopted similar provisions for companies that operate locally.

Figure 11.2 shows the major public policy issues in pricing. These include potentially damaging pricing practices within a given level of the channel (price-fixing and predatory pricing) and across levels of the channel (retail price maintenance, discriminatory pricing, and deceptive pricing).[16]

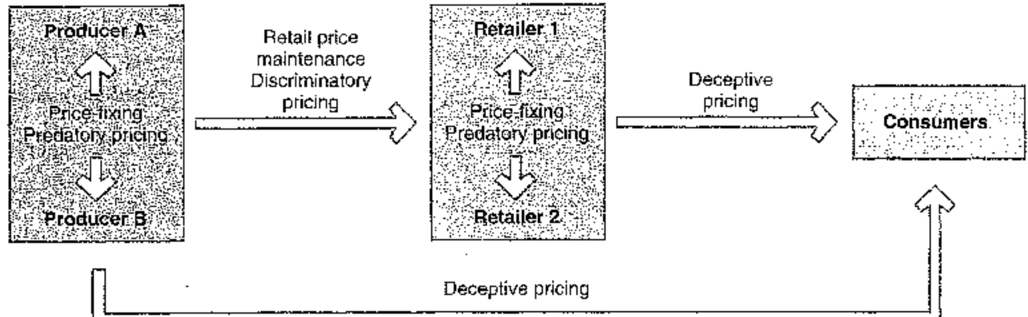


FIGURE 11.2 Public policy issues in pricing
Source: Adapted with permission from Dhruv Grewal and Larry D. Compeau, "Pricing and Public Policy: A Research Agenda and Overview of Special Issue," *Journal of Public Policy and Marketing*, Spring 1999, pp. 3–10, Figure 1.

Pricing Within Channel Levels

Federal legislation on *price-fixing* states that sellers must set prices without talking to competitors. Otherwise, price collusion is suspected. Price-fixing is illegal per se—that is, the government does not accept any excuses for price-fixing. Companies found guilty of such practices can receive heavy fines. Recently, governments at the state and national levels have been aggressively enforcing price-fixing regulations in industries ranging from gasoline, insurance, and concrete to credit cards, CDs, and computer chips. For example, Samsung and two other computer memory-chip makers agreed to pay $160 million to settle a suit alleging a four-year pricing-fixing conspiracy to artificially constrict the supply of D-Ram (dynamic random access memory) chips to computer makers such as Dell and Apple. This control of the supply helped keep prices artificially high, producing higher profits for the conspiring companies. Since that settlement, U.S. state and federal governments have filed additional price-fixing lawsuits against various computer memory-chip makers.[17]

Sellers are also prohibited from using *predatory pricing*—selling below cost with the intention of punishing a competitor or gaining higher long-run profits by putting competitors out of business. This protects small sellers from larger ones who might sell items below cost temporarily or in a specific locale to drive them out of business. The biggest problem is determining just what constitutes predatory pricing behavior. Selling below cost to sell off excess inventory is not considered predatory; selling below cost to drive out competitors is. Thus, the same action may or may not be predatory depending on intent, and intent can be very difficult to determine or prove.

In recent years, several large and powerful companies have been accused of predatory pricing. For example, Wal-Mart has been sued by dozens of small competitors charging that it lowered prices in their specific areas to drive them out of business. In fact, the State of New York passed a bill requiring companies to price gas at or above 98 percent of cost to "address the more extreme cases of predatory pricing by big-box stores" such as Wal-Mart. Yet, in North Dakota, the same gas pricing proposal was rejected because state representatives did not view the practice as predatory pricing.[18]

Pricing Across Channel Levels

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

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

Real Marketing

The U.S. pharmaceutical industry has historically been one of the nation's most profitable industries. Since the mid-1990s, annual industry revenues have grown by an average of 10 percent per year, a trend that few industries can match. As the world's second-largest pharmaceuticals company, GlaxoSmithKline (GSK) has played a large role in the industry's success. It produces a medicine cabinet full of well-known prescription drugs that combat infections, depression, skin conditions, asthma, heart and circulatory disease, and cancer. It also makes dozens of familiar over-the-counter remedies, from Contac, Nicorette, and Sensodyne to Tagamet and Tums.

GlaxoSmithKline is doing very well in a high-performing industry. Its sales last year grew by 7 percent; earnings per share grew 18 percent. Around the world, more than 1,100 prescriptions are written for GSK products every minute. And with more drugs in its research and development pipeline than most of its competitors, it appears that GSK's future will be just as bright.

Most consumers appreciate the steady stream of beneficial drugs produced by pharmaceutical companies like GlaxoSmithKline. However, with the prices of many of the most important drugs skyrocketing, others protest that the industry's huge success may be coming at consumers' own expense—literally.

In most situations, we applaud companies for strong profit performance. However, when it comes to pharmaceuticals firms, critics claim that healthy profits may not be so healthy for consumers. Learning that GlaxoSmithKline is reaping big profits leaves a bad taste in the mouths of many consumers—it's like learning that the oil companies are profiting as gas prices soar. Although most consumers appreciate the steady stream of beneficial drugs produced by the U.S. pharmaceutical companies, they sense that the industry's huge success may be coming at their own expense—literally.

Americans spend more than $200 billion a year on prescription medications, nearly half of worldwide spending, and this spending is expected to exceed $450 billion by 2015. Prescription prices have risen rapidly over the years and healthcare costs continue to jump. An AARP survey of 193 brand-name prescription drugs found that their average wholesale prices increased 3.9 percent over just the first three months of 2006, almost four times the general inflation rate. The prices of many of the most important drugs are skyrocketing. High drug prices have sent many consumers, especially seniors with limited budgets and fixed incomes, to Mexico or Canada in search of cheaper alternatives. Says one senior after a visit to Mexico, "If we couldn't get cheap meds, I wouldn't live."

The critics claim that competitive forces don't operate well in the pharmaceutical market, allowing GSK and other companies to charge excessive prices. Unlike purchases of other consumer products, drug purchases cannot be postponed. And consumers don't usually shop for the best deal on medicines—they simply take what the doctor orders. Because physicians who write the prescriptions don't pay for the medicines they recommend, they have little incentive to be price conscious. Finally, because of patents and FDA approvals, few competing brands exist to force lower prices, and existing brands don't go on sale. The critics claim that these market factors leave pharmaceutical companies free to practice monopoly pricing resulting in unfair practices and price gouging.

To add insult to injury, the critics say, drug companies pour $7.5 billion a year into direct-to-consumer advertising and another $16 billion into sampling. These marketing efforts dictate higher prices at the same time that they build demand for more expensive remedies. Even when doctors or pharmacists recommend less-expensive generic drugs, consumers may pay substantial markups. Pharmacies may look like good guys when they encourage the use of generics to save consumers money, but they also pocket a handsome profit. One recent study found that drugstores and pharmacies are marking up the price of some generics by more than 1,000 percent.

As a pharmaceuticals industry leader, GlaxoSmithKline has borne its share of the criticism. For example, as the largest producer of AIDS-fighting antiretroviral drugs, GSK has been accused of pricing its drugs out of the reach of the poor people who need them the most. And the company recently settled claims by the U.S. Department of Justice and 40 states alleging that it had inflated the wholesale prices of drugs used by cancer patients and others. Thus, the severest critics say, GSK may be profiting unfairly—or even at the expense of human life.

But there's another side to the drug-pricing issue. Industry proponents point out that, over the years, GSK has developed a steady stream of medicines that transform people's lives. Developing such new drugs is a risky and expensive endeavor, involving legions of scientists, expensive technology, and years of effort with no certainty of success. The pharmaceuticals industry invests nearly $50 billion a year in R&D—GSK alone invested $5.4 billion last year. GSK now has 149 prescription drugs and vaccines under development. On average,

(continues)

each new drug takes 15 years to develop at a cost of close to $800 million. Then, 70 percent of new drugs never generate enough revenue to recover the cost of development. Although the prices of prescription drugs seem high, they're needed to fund the development of important future drugs.

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

And so the controversy continues. As drug prices climb, GSK and the industry are facing pressures from the federal government, insurance companies, managed-care providers, and advocacy groups to exercise restraint in setting prices. Rather than waiting for tougher legislation on prices—or simply because it's the right thing to do—GSK has undertaken several initiatives to make drugs available to those who need but can't afford them. For some years now, it has priced its HIV/AIDS and malaria medicines at cost to customers and not-for-profit organizations in developing countries. In the United States and other developed countries, GSK sponsors patient assistance programs and discount cards that provide prescription medicines to low-income, uninsured patients free or at minimal cost. And GSK regularly donates free medicines in response to disaster relief efforts around the globe.

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

Sources: Milt Freudenheim, "Drug Prices Up Sharply This Year," *New York Times*, June 21, 2006, p. C1; "Drug Spending to Soar, but Not as Quickly as Expected," *Formulary*, April 2006, p. 203; Jane Wardell, "GlaxoSmithKline Sees 25 Percent Profit Rise," *Associated Press Online*, April 27, 2006; Joel Millman, "Not Your Generic Smugglers—American Seniors Flock to Border Town for Cheap Prescriptions," *Wall Street Journal*, March 20, 2003, p. D.3; Cole Ollinger, "A Tough Pill to Swallow," *Manufacturing Business Technology*, February 2006, pp. 22–23; "GSK to Settle Pricing Claims," *The News & Observer*, August 11, 2006, p. 2D; and information from www.gsk.com, December 2006.

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

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

Deceptive pricing concerns: The widespread use of checkout scanners has led to increasing complaints of retailers overcharging their customers.

Comparison pricing claims are legal if they are truthful. However, the FTC's *Guides Against Deceptive Pricing* warns sellers not to advertise a price reduction unless it is a saving from the usual retail price, not to advertise "factory" or "wholesale" prices unless such prices are what they are claimed to be, and not to advertise comparable value prices on imperfect goods.[19]

Other deceptive pricing issues include *scanner fraud* and price confusion. The widespread use of scanner-based computer checkouts has led to increasing complaints of retailers overcharging their customers. Most of these

overcharges result from poor management—from a failure to enter current or sale prices into the system. Other cases, however, involve intentional overcharges. *Price confusion* results when firms employ pricing methods that make it difficult for consumers to understand just what price they are really paying. For example, consumers are sometimes misled regarding the real price of a home mortgage or car leasing agreement. In other cases, important pricing details may be buried in the "fine print."

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

Reviewing the Concepts

Pricing decisions are subject to an incredibly complex array of environmental and competitive forces. A company sets not a single price, but rather a *pricing structure* that covers different items in its line. This pricing structure changes over time as products move through their life cycles. The company adjusts product prices to reflect changes in costs and demand and to account for variations in buyers and situations. As the competitive environment changes, the company considers when to initiate price changes and when to respond to them.

1. Describe the major strategies for pricing imitative and new products.

Pricing is a dynamic process. Companies design a *pricing structure* that covers all their products. They change this structure over time and adjust it to account for different customers and situations. Pricing strategies usually change as a product passes through its life cycle. The company can decide on one of several price-quality strategies for introducing an imitative product, including premium pricing, economy pricing, good value, or overcharging. In pricing innovative new products, it can use *market-skimming pricing* by initially setting high prices to "skim" the maximum amount of revenue from various segments of the market. Or it can use *market-penetrating pricing* by setting a low initial price to penetrate the market deeply and win a large market share.

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

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

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

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

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

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

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

Reviewing the Key Terms

Allowance 312
Basing-point pricing 318
By-product pricing 311
Captive-product pricing 311
Discount 312
Dynamic pricing 318
FOB-origin pricing 317
Freight-absorption pricing 318
Geographical pricing 317
Market-penetration pricing 309
Market-skimming pricing 308
Optional-product pricing 310
Product bundle pricing 312
Product line pricing 310
Promotional pricing 316
Psychological pricing 314
Reference prices 314
Segmented pricing 312
Uniform-delivered pricing 318
Zone pricing 318

Discussing the Concepts

1. Why would Palm choose market-skimming pricing rather than market-penetration pricing for a new line of smartphones?
2. Why is product bundle pricing effective?
3. Psychological pricing is a pricing-adjustment strategy often used by retailers. Explain this pricing strategy. How it is tied to the concept of reference prices?
4. Discuss the difficulties an international company would encounter if it set a uniform worldwide price for a commodity-type product.
5. Continental Cruise Lines is increasing the price for its Boston-to-Bermuda five-day cruise from $700 per person to $1,000 per person. How might consumers interpret this price increase? How might Continental reduce possible negative reactions?
6. Lawful price discrimination by sellers is a common practice. Discuss the conditions under which price discrimination practice becomes unlawful.

Applying the Concepts

1. Visit the Web sites of two wireless phone companies (say, Sprint and Cingular). Compare their pricing strategies for cellular services. What types of product-mix and price-adjustment strategies do you observe?
2. Promotional pricing generates a sense of urgency and excitement. However, recognizing the dangers of this pricing approach, your boss has requested that you design an alternative pricing strategy that will generate the greater long-term sales and customer loyalty. What pricing strategy do you recommend? Will this strategy work as well as promotional pricing in the short term? Explain.
3. You are an owner of a small independent chain of coffee houses competing head-to-head with Starbucks. The retail price your customers pay for coffee is exactly the same as at Starbucks. The wholesale price you pay for roasted coffee beans has increased by 25 percent. You understand that you cannot absorb this increase and that it must be passed on to your customers. However, you are concerned about the consequences of an open price increase. Discuss three alternative price-increase strategies that address your concerns.

Focus on Technology

Space travel for the average person once seemed probable only in science fiction stories. But on April 28, 2001, the world saw its first true paying civilian astronaut when Dennis Tito, a California multimillionaire, became the first-ever space tourist. Tito traveled on a Russian Soyuz capsule and proved that an everyday citizen could endure this trip. Tito's trip, along with advances in rocket technology, accelerated the opportunities for space tourism. A pioneer in this area, Virgin Group founder Richard Branson has established Virgin Galactic, which will begin offering a fleet of space ships for travel into outer space. Virgin Galactic, which will set up its world headquarters in New Mexico, plans to build a $200-million spaceport on a 27-square-mile area in the southern part of the state. Virgin Galactic is already collecting refundable deposits of $20,000 for the first year of travel. The deposits will be applied to the full fare of $200,000 for each trip into outer space. Visit www.virgingalactic.com to learn more about space tourism.

1. How should a company go about setting price for a new, high-technology product or service? What new-product pricing strategy is Virgin Galactic using for its space trips?
2. How might the entrance of a competitor affect the pricing?
3. How might Virgin Galactic bundle other products with space travel?

Focus on Ethics

Technology products, especially high-speed Internet delivery services, differ in their prices throughout the world. Such geographical price adjustments are often justified on the basis of increased communication costs in local markets. But in rare instances, prices are lowered in a country based on an initiative by corporate leaders, even if the country's infrastructure would support high prices. For example, in June 2006, Microsoft and South Africa's largest cellular operator, MTM, announced a project to offer cheap Internet connections throughout Africa. According to Microsoft cofounder and CEO Bill Gates, mobile connectivity is a key to growth in this country, and the current structure causes high prices in urban areas and makes connectivity prohibitive in rural areas. The Microsoft-MTM program offers affordable options for consumers who purchase Internet connectivity and a PC running Microsoft's Windows starter edition software.

1. What are the benefits of this program to Microsoft?
2. What do you think of this program? Does it present any ethical issues?
3. What pricing strategies from the chapter are involved in this initiative?

Video Case GE

When you think of GE, you might think first of products such as appliances and light bulbs. But GE is much, much more. The giant $150 billion company also owns NBC, provides commercial and consumer financial services, develops and markets medical imaging equipment, and provides fundamental technology to build infrastructure in developing countries—all under its tagline "imagination at work."

Despite all of its growth and success, however, several years ago GE found its appliances business in decline. Prices were dropping and GE's brands stood largely undifferentiated from others on the market. In response, GE applied its considerable marketing muscle to revamp, rebrand, and reprice its entire appliances line. Rather than accepting lower prices, GE invested heavily in new-product innovation to add more customer value that would support higher prices and margins. In addition to its core mass-market GE appliance brand, the company added the GE Monogram and GE Profile lines. GE Profile targeted the upper quartile of the market, offering "the marriage of style and innovation" with "the best in contemporary design matched with the latest kitchen technologies." GE Monogram targeted the ultrahigh end of the market, offering built-in products with "depth and breadth of design choices that allow you to customize your home and make it your own." The result? The average retail price paid for GE appliance products has increased more than 15 percent. At the same time, GE's appliances business has delivered five years of double-digit earnings growth.

After viewing the video featuring GE, answer the following questions about pricing strategies.

1. Which of the product-mix pricing strategies discussed in the book most closely describes GE's approach?
2. How did the new positioning statements for the Monogram and Profile lines affect pricing decisions?
3. Visit the Web site for GE's three appliance brands, GE, GE Profile, and GE Monogram. How do the sites support the positioning and pricing of the three brands?

Company Case ExxonMobil: Achieving Big Profits During Hard Times

One fine spring day in 2006, Joe Tyler watched the gas pump dials spin as he filled up his 1998 Toyota at the neighborhood Exxon station. What he saw shocked him right down to the core of his wallet. It had just cost him $30.30 to fill up his economy car. How could this be? Sure, the tank was completely empty and took almost 11 gallons. And, yes, gas prices were on the rise. But at $2.77 per gallon, this was the first time that a fill-up had cost him more than $30.

Joe usually didn't even look at his gas receipts. Even though gas prices had risen dramatically over the past few years, it was still relatively cheap by world standards; still cheaper than bottled water. And his Toyota rolled along consistently at 32-34 miles per gallon. Until now, Joe didn't think that his gas expenses were affecting his budget all that much. But crossing the $30 line gave him a wakeup call. Although it was far less than the $100 fill-ups he's heard about for SUV drivers in places like Los Angeles, it didn't seem that long ago that he'd routinely filled his tank for less than $10. In 1998, gas prices were really low. In fact, he remembered once paying only $.88 a gallon to fill this same car. Now, he was starting to feel the frustration expressed by so many other gas buyers. What had happened?

About the same time that Joe was waking up to high gas prices, a man named Lee Raymond probably wasn't too concerned about how much it cost him to fill up his own car—or his jet for that matter. After 13 years, Mr. Raymond had just retired as the chairman and CEO of ExxonMobil. Including all his pension payoffs and stock options, Raymond's retirement package was valued at a mind-boggling $400 million. And why not? While at the helm of the giant oil company, Raymond had kept ExxonMobil at or near the top of the Fortune 500 list year after year. Upon his retirement, ExxonMobil had reclaimed the number-one position from Wal-Mart after four years at number-two with revenue of $340 billion, the most ever posted by any company in the world. The company's 2005 annual profits of $36 billion was also a record and represented a 44 percent increase over the prior year. ExxonMobil's fourth-quarter revenues alone exceeded the annual gross domestic product of some major oil-producing nations, including the United Arab Emirates and Kuwait.

Was it just a coincidence that ExxonMobil and the other major oil companies were posting record numbers at a time when consumers were getting hit so hard? Most consumers didn't think so—and they cried "foul." In an effort to calm irate consumers, politicians and consumer advocates were calling for action. Maria Cantwell (D-WA) was one of four U.S. senators who backed legislation that would give the government more oversight of oil, gas, and electricity markets. "Right now excuses from oil companies on why gas prices are so high are like smoke and mirrors," Senator Cantwell said. "The days of Enron taught us the painful lesson that fierce market manipulation does happen, and I don't want American consumers to have to experience that again."

Several state attorneys general also launched investigations. Even the Bush administration demanded a federal investigation into gasoline pricing. In a speech to the country, President Bush said, "Americans understand by and large that the price of crude oil is going up and that [gas] prices are going up, but what they don't want and will not accept is manipulation of the market, and neither will I."

(case continues)

Just as many of these investigations were beginning, and as the market heated up for the summer of 2006, the FTC reported on its investigation of fuel markets in the wake of the 2005 hurricanes, Katrina and Rita. Although it had found various examples of price gouging, most were explainable, and it found no evidence of widespread market manipulation.

DEMAND AND SUPPLY: IS IT REALLY THAT SIMPLE?

Although many parties disagree on where to place the blame for skyrocketing gas prices, there is a high level of consistency among economists and industry observers. They agree that crude oil and even gasoline are commodities. Like corn and pork bellies, there is little if any differentiation in the products producers are turning out. And even though ExxonMobil has tried hard to convince customers that its gasoline differs from other brands based on a proprietary cocktail of detergents and additives, consumers do not generally perceive a difference. Thus, the market treats all offerings as the same.

Walter Lukken, a member of the U.S. Commodity Futures Trading Commission, has stated publicly what many know to be true about the pricing of commodities. In a testimony before Congress on the nature of gasoline prices, Mr. Lukken said, "the commission thinks the markets accurately reflect tight world energy supplies and a pickup in growth and demand this year." But is it really as simple as demand and supply?

Let's look at demand. In 1995, when oil was cheap, global demand was around 70 million barrels a day (mbd). Ten years later, world consumption had risen to 84 mbd and was expected to rise another 2 mbd in 2006. Many environmentalists point the finger at the driving habits of North Americans and their gas-swilling SUVs—with good reason. The United States continues to be one of the world's leading petroleum consumers, with an appetite that grows every year. And as much as U.S. consumers cry about high gas prices, they've done little to change how much gas they consume.

However, although the United States consumes more gas than any other country, this consumption has grown only moderately. Over the past decade, the rise in global demand for oil has been much more the result of the exploding needs of emerging economies. The biggest contributors are China and India, which together account for 37 percent of the world's population. Both countries have a growing appetite for oil that reflects their rapid economic growth. With manufacturing and production increasing and with more individuals trading in bicycles for cars, China and India have the fastest-growing economies in the world, with annual growth rates of 10 percent and 8 percent, respectively.

Now, let's look at supply. Recent spikes in the global price of crude are occurring at a time when rising demand coincides with constrained supply. Supply constraints exist at various levels of production, including drilling, refining, and distributing. In the past decade, oil companies have had little incentive to invest in exploration and to expand capacity. Oil has been cheap, and environmental regulations created more constraints. Oil-producing countries claim that they are producing at or near capacity. Many analysts support this, noting that global consumption of oil is pressing up against the limits of what the world can produce.

Similar constraints place limits on other stages of the supply chain. For example, U.S. refineries no longer have the capacity to meet the country's demand for petroleum-based fuels. And as regulations dictate more gasoline blends for different regions, refineries feel an even greater pinch and distribution lines experience bottlenecks.

But as much as supply and demand account for fluctuations in gas prices, there is a third factor. At a time when supply is stretched so tightly across a growing level of demand, price volatility may result more from the global petroleum futures trading than from anything else. Modern futures markets function on speculation. When factors point to a rise in prices, traders buy futures contracts in hopes of profiting. When oil seems overvalued, they sell. The net effect of all the buying and selling is a constant tweaking of oil prices, which reflects both the fundamental supply-demand situation as well as the constantly changing risk of a major political crisis or natural disaster.

Some policymakers and consumer advocates have pointed to speculative futures trading as a cause of high gas prices. But according to Walter Lukken, "Blaming the futures markets for high commodity prices is like blaming a thermometer for it being hot outside." Although it is true that the oil futures trading can artificially inflate prices in the short term, economists have found that such activities have more of a stabilizing effect in the long run. Speculators absorb risk, often stepping in when nobody else wants to buy or sell. In fact, as with other commodities, the more traders in a given commodity market, the smaller the gap between the buying and selling price for petroleum. This reduces costs for companies at all stages of the value chain, which should ultimately lower prices for customers. Accordingly, if not for the global oil futures market, price spikes and crashes would probably be even bigger and occur more frequently.

THE ANATOMY OF THE PRICE OF A GALLON OF GAS

Consumers like Joe Tyler wonder not only what makes the price of gas go up, but just how much of the price of each gallon they buy goes into big oil's pockets. They might be surprised to learn the breakdown on the price of a gallon of gas. Roughly 75 percent of the retail price of gas covers sales taxes and the cost of crude. In the United States, the excise tax on gasoline varies from state to state, averaging about 40 cents a gallon in 2005. Between 2004 and 2006, the price of crude more than doubled to more than $70 a barrel. Thus, it should come as no surprise that gasoline prices have risen in tandem.

Refining, distribution, and marketing costs account for most of the rest of the price. This leaves less for oil companies than most consumers might imagine. In 2005, the oil industry as a whole made a net profit of 8.5 percent. Although this was higher than the average for all industries, it was less than half the profit margins for health care, finan-

cial services, and pharmaceuticals. Still, the absolute profits for big oil companies are among the highest of all industries. ExxonMobil representatives are quick to point out a simple reason: scale. ExxonMobil had the highest profits in 2005 because it had the highest revenues. And when a company like General Motors (number three on the Fortune 500) actually loses more than $10 billion, ExxonMobil's $36 billion net profit really stands out.

Given the nature of commodity pricing, it should be clear that the cost of producing crude has nothing to do with the price. ExxonMobil can't just add 10 percent onto the price of producing oil. Neither can OPEC. Thus, as market forces drive up the price of crude, ExxonMobil's cost remains relatively stable. Thus, good times for oil companies and good times for consumers occur at opposite ends of the price spectrum.

WHAT TO DO?

If gas prices are determined in the way that so many experts say, it seems odd that so many people point the finger of scandal. Yet, given the impact of gas prices on personal budgets and national economies, it is understandable that people want answers. But even if the investigations were to actually produce evidence of wrongdoing, many experts believe that this would only distract from examining the real factors that govern the price of oil.

Proposed solutions for gas price woes span a very broad spectrum. At one end, some call for extreme government intervention and regulation. On the other end are those who suggest that no action be taken. "I don't think the government should be involved, trying to change the supply-and-demand equation here," said Evan Smith, a fund manager with U.S. Global Investors in San Antonio. "I really don't think anything they might do will [make] much of a difference anyway." In a time of such turmoil, ExxonMobil must consider not only how it might help alleviate the problem, but how actions by others might impact its operations.

Questions for Discussion

1. Which, if any, of the pricing strategies discussed in the chapter are being applied by ExxonMobil and other oil companies? Could they adopt any other strategies?
2. Discuss buyer reactions to changes in the gas prices. How can you explain these reactions?
3. How should ExxonMobil react to gasoline price changes by other large and small oil companies? Can ExxonMobil keep its prices stable (or even lower them) when the market price is increasing? Should it?
4. Consider the public policy issues within and across channel levels of the oil industry. Is ExxonMobil acting illegally or irresponsibly by reaping record profits while consumers are hurting at the pumps?
5. How would you "fix" the problem of rising gas prices? Consider solutions for different groups, including governments, corporations, nonprofit groups, and consumers. What are the advantages and disadvantages of your proposed solutions?

Sources: Harold Brubaker, "Why Prices Are Sky High," *Philadelphia Enquirer*, April 26, 2006; Patricia Hill, "Market Fuel Prices Drop, Relief Ahead as Demand Slows and Supplies Rise," *Washington Times*, April 28, 2006, p. A01; Katherine Reynolds Lewis, "Oil Market Is Running on Fear," *New Orleans Times-Picayune*, May 6, 2006, p. M1; "High Gasoline Prices Not Due to Manipulation, Regulators Say," *Calgary Herald*, April 28, 2006, p. E5; Robert J. Samuelson, "The Oil Factor," *Newsweek*, May 8, 2006, p. 37; John W. Schoen, "OPEC Says It Has Lost Control of Oil Prices," accessed online at www.msnbc.com, May 16, 2006; John W. Schoen, "Why Do Gas Pump Prices Rise Faster than Costs?" accessed online at www.msnbc.com, April 28, 2006; "Exxon Dethrones Wal-Mart atop Fortune 500," *Associated Press*, April 3, 2006, accessed online at www.msnbc.com; and "High Oil Prices Drive Up Exxon Mobil's Profit," *Associated Press*, May 3, 2006, accessed online at www.msnbc.com.