CHAPTER 11

Managing Pricing and Sales Promotions

Netflix has accompanied a series of price hikes with heavy investment in developing original content to complement the extended array of streaming programming it offers.
Source: M. Unal Ozmen/Shutterstock

Learning Objectives After studying this chapter you should be able to:

11.1 Describe the role that pricing plays in marketing management.

11.2 Identify the key psychological factors that influence how consumers perceive prices.
11.3 Explain the factors that a manager must consider when setting prices.
11.4 Discuss how to respond to competitive prices cuts.
11.5 Explain how to design and manage incentives.

Price is the one element of the marketing mix that produces revenue; the other elements produce costs. Price also communicates the company's intended value positioning of its product or brand. A well-designed and marketed product can still command a price premium and reap big profits. But new economic realities have caused many consumers to reevaluate what they are willing to pay for products and services, and companies have had to carefully review their pricing strategies as a result. One company that has caught the attention of consumers and businesses is Netflix, with its unorthodox pricing strategy.

Founded in 1997 by Reed Hastings and Marc Randolph, Netflix provides a subscription-based streaming service that offers online streaming of films and television programs. An over-the-top video content provider, Netflix distributes programming as a stand-alone product directly to viewers over the internet, bypassing traditional media carriers such as cable and broadcast television. Since its inception, the company's subscriber base has grown rapidly, reaching 74 million in the United States and 210 million worldwide in 2018. Starting at the very beginning, two of the key decisions that Netflix had to grapple with were selecting (and later developing) content that customers would be willing to pay for on an ongoing basis and setting a price that would appeal to customers while enabling Netflix to secure the desired content. As the competition from other streaming services (such as Amazon, Apple, and Hulu) intensified and licensing costs for original content increased, Netflix began to invest heavily in developing original content. In 2018 alone, Netflix had approximately 700 original shows, with more in the pipeline. To pay for new content, Netflix had to augment its services and pricing structure. Since the introduction of its streaming service in November 2010, Netflix has extended the portfolio of service offerings, while at the same time raising the price. Three years after the launch of the $7.99-a-month streaming service, it introduced a premium version priced at $11.99. A year later, in May 2014, Netflix introduced a lower-tier basic service priced at $7.99, while raising the price of its standard service to $8.99. The following year, Netflix raised the price of the standard service to $9.99, followed by another price increase to $10.99 in 2017 that was combined with raising the premium service price to $13.99. Then, in 2019, Netflix announced another price hike—the largest since the inception of its streaming services—with the basic subscription priced at $8.99, the standard subscription at $10.99 (increased to $12.99 in 2020), and the premium subscription at $15.99. This pricing structure reflects the company's belief that the consumer benefits provided by its streaming service outweigh the corresponding costs. "Price is all relative to value," said CEO Hastings. "We're continuing to increase the content offering and we're seeing that reflected in viewing around the world."[1]

Netflix adopted a content localization strategy to enter and expand in international markets across the globe. The company retains its premium pricing but adapted its prices for its audience in the Indian subcontinent. In 2016, Netflix launched its services in India to tap into opportunities provided by the huge Internet userbase, driven by high smart phone penetration and affordable mobile data service packs. Alongside content localization, Netflix also changed its pricing approach for a highly price-sensitive India market by introducing a mobile-only subscription plan for ₹199 in 2019. In India, Netflix's monthly subscription plans range between ₹499 to ₹799. The company has partnered with Reliance Jio, the largest mobile service provider, for free 'mobile-only subscription' to Jio's postpaid customers. This price penetration strategy helped Netflix grow rapidly.[2] As of July 2021, Netflix recorded 5 million subscribers accounting for 14% of market share of the OTT market in India.[3]

Pricing decisions are complex and must take into account many factors—the company, the customers, the competition, and the marketing environment. Holistic marketers know their pricing decisions must also be consistent with the firm's marketing strategy and with its target markets and brand positions. In this chapter, we provide concepts and tools to facilitate setting initial prices and adjusting prices over time and markets.

UNDERSTANDING PRICING

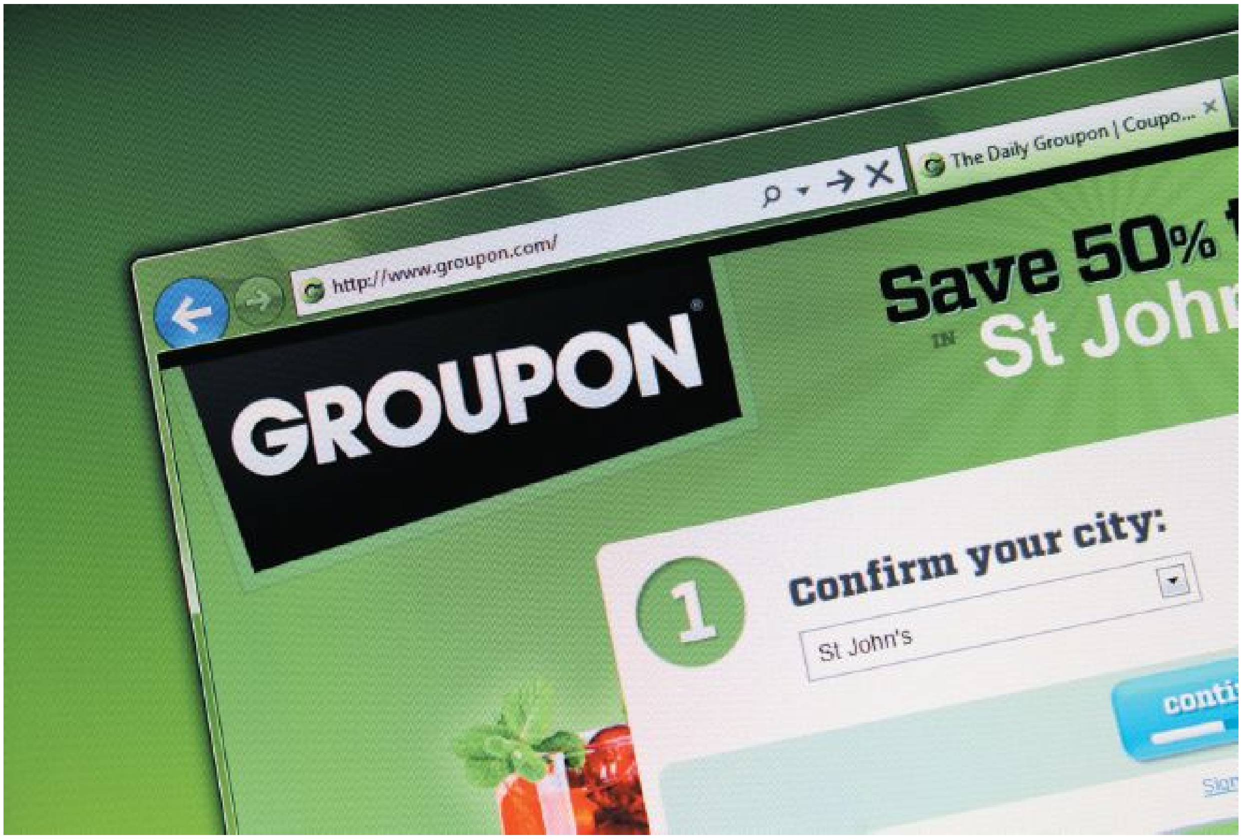
Price is not just a number on a tag. The prices you pay for goods and services perform many functions and come in many forms: rent, tuition, fares, fees, rates, tolls, retainers, wages, and commissions. Price also has many components. If you buy a new car, the sticker price may be adjusted by rebates and dealer incentives. Some firms allow customers to pay through multiple forms, such as using points, frequent flier miles, and bitcoins.

Throughout most of history, prices were set by negotiation between buyers and sellers. Bargaining is still a sport in some areas. 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 19th century. F.W. Woolworth, Tiffany & Co., John Wanamaker, and others advertised a "strictly one-price policy," an efficient approach because they carried so many items and supervised so many employees.

Traditionally, price has operated as a major determinant of buyer choice. Consumers and purchasing agents who have access to price information and price discounters put pressure on retailers to lower their prices. Retailers in turn put pressure on manufacturers to lower *their* prices. The result can be a marketplace characterized by heavy discounting and sales promotion.

For over 25 years, the internet has been changing the way buyers and sellers interact. The internet has enabled buyers to make instant price comparisons from thousands of vendors. Moreover, using smart mobile devices, customers can easily make price comparisons in stores before deciding whether to purchase, pressure the retailer to match or better the price, or buy elsewhere. Using promotional platforms such as Groupon, customers can also pool their resources to get better pricing.

> **Groupon** Groupon was launched in 2008 to help businesses leverage the internet and e-mail to use promotions as a form of advertisement. Specifically, the company sends its large base of subscribers a humorously worded daily deal—a specific percentage or dollar amount off the regular price—for a specific client's branded product or service. With these e-mailed discounts, Groupon offers client firms three benefits: increased consumer exposure to the brand, the ability to price-discriminate, and the creation of a "buzz factor." Groupon takes 40 percent to 50 percent of the revenues in each deal in the process. Many promotions are offered on behalf of local retailers such as spas, fitness centers, and restaurants, but Groupon also manages deals on behalf of some national brands. Some businesses have complained that Groupon attracts only deal-seekers and is not effective in converting them to regular customers. One study found that 32 percent of companies lost money and that 40 percent said they would not utilize such a promotion again, with restaurants faring the worst among service businesses and with spas and salons being the most successful. Groupon has tried to innovate in several ways. Leveraging its massive sales force to sell Groupon Now, the company enlists local businesses to offer time- and location-specific deals via the Web or smartphones. The iPhone app for the new service has two buttons, "I'm Bored" and "I'm Hungry," to trigger deals in real time. For businesses, the service is a way to boost traffic at otherwise slow times. Even a popular restaurant might still consider some mid-day and mid-week discounts, knowing it is rarely full then. After a hyped IPO, Groupon's stock has not performed well, and the company is still struggling to find the right business formula.[4]



Via a daily deal to its large subscriber base, Groupon attempts to help businesses, many of them local, tap into the burgeoning online market in exchange for a hefty percentage of sales.
Source: seewhatmitchsee/Alamy Stock Photo

In addition to empowering buyers, the internet also enables sellers to optimize their pricing. Thus, sellers now can monitor market demand and adjust prices accordingly. For example, Uber is using "surge" pricing, charging higher fares at times of high demand. In addition, companies are now able to offer custom-tailored sales promotions based on the profile of a given market segment or an individual buyer. Online retailers such as Amazon, Wayfair, and Target offer promotional incentives to consumers based on their demographic, psychographic, and behavioral characteristics. Likewise, many brick-and-mortar retail outlets use geolocation to offer promotions to customers who are in close proximity to the store.

Companies vary in the way they set their pricing. In many small companies, the owner sets prices. In large companies, division and product line managers do. Even here, top management sets general pricing objectives and policies and often approves lower management's proposals.

Where pricing is a key competitive factor, companies often establish a pricing department to set, or assist others in setting, appropriate prices. This department reports to the marketing department, the finance department, or top management. Others who influence pricing include sales managers, production managers, finance managers, and accountants. In B2B settings, pricing performance tends to improve when pricing authority is spread horizontally across the sales, marketing, and finance units and when there is a balance in centralizing and delegating that authority between individual salespeople and teams and central management.[5]

Many companies do not handle pricing well and fall back on "strategies" such as "We calculate our costs and add our industry's traditional margins." Other common mistakes are not revising prices often enough to capitalize on market changes; setting prices independently of the rest of the marketing program, rather than as an intrinsic element of market-positioning strategy; and not varying prices enough for different product items, market segments, distribution channels, and purchase occasions.

For any organization, effectively designing and implementing pricing strategies requires a thorough understanding of buyers' pricing psychology and a systematic approach to setting, adapting, and changing prices.

CONSUMER PSYCHOLOGY AND PRICING

Many economists traditionally assumed that consumers were "price takers" who accepted prices at face value or as a given. Marketers, however, recognize that consumers often actively process price information, interpreting it in the context of prior purchasing experience, formal communication (advertising, sales calls, and brochures), informal communication (friends, colleagues, or family members), point-of-purchase or online resources, and other factors.[6]

Purchase decisions are based on how consumers perceive prices and what they consider the current actual price to be—*not* on the marketer's stated price. Customers may have a lower price threshold, below which prices signal inferior or unacceptable quality, and an upper price threshold, above which prices are prohibitive and the product seems not to be worth the money. Different people interpret prices in different ways.

Consider the consumer psychology involved in buying a simple pair of jeans and a T-shirt. Why does a black T-shirt for women that looks pretty ordinary cost $275 from Armani but only $14.90 from the Gap and $7.90 from Swedish discount clothing chain H&M? Customers who purchase the Armani T-shirt are paying for a more stylishly cut T-shirt made of 70 percent nylon, 25 percent polyester, and 5 percent elastane with a "Made in Italy" label from a luxury brand known for suits, handbags, and evening gowns that sell for thousands of dollars. The Gap and H&M shirts are made mainly of cotton. Choices abound for pants to go with these T-shirts. The Gap sells its "Original Khakis" for $44.50, whereas Abercrombie & Fitch's classic button-fly chinos cost $70. But that's a comparative bargain compared to Michael Bastian's plain khakis for $480 or Giorgio Armani's for $595. High-priced designer jeans may use expensive fabrics such as cotton gabardine and require hours of meticulous hand-stitching to create a distinctive design, but equally important are the image and the sense of exclusivity they come with.[7]

Understanding how consumers arrive at their perceptions of prices is an important marketing priority. Here we consider three topics pertaining to the psychology of pricing—reference prices, image pricing, and pricing cues.

Reference Prices. Although consumers may have fairly good knowledge of price ranges, surprisingly few can accurately recall specific prices. When examining products, however, they often employ **reference prices**, comparing an observed price to an internal reference price they remember or an external frame of reference such as a posted "regular retail price."[8] Possible reference prices include "fair price" (what consumers feel the product should cost), typical price, last price paid, upper-bound price (reservation price, or the maximum most consumers would pay), lower-bound price (lower price threshold, or the minimum most consumers would pay), competitor price, expected future price, and usual discounted price.[9]

Abercrombie & Fitch’s consumer image enables it to charge higher prices than many of its rivals.
Source: Mark Waugh/Alamy Stock Photo

Sellers often attempt to manipulate reference prices. For example, a seller can situate its product among expensive competitors to imply that it belongs in the same class. Department stores will display women’s apparel in separate departments differentiated by price; dresses in the more expensive department are assumed to be of better quality.[10] Marketers also encourage reference-price thinking by stating a high manufacturer’s suggested price, indicating that the price was much higher originally, or by pointing to a competitor’s high price.

When consumers evoke one or more of these frames of reference, their perceived price can vary from the stated price. Research has found that unpleasant surprises—when perceived price is lower than the stated price—can have a greater impact on purchase likelihood than pleasant surprises.[11] Consumer expectations can also play a key role in price response. On internet auction sites such as eBay, when consumers know similar goods will be available in future auctions, they will bid less in the current auction.[12]

Clever marketers try to frame the price to signal the best value possible. For example, a relatively expensive item can look less expensive if the price is broken into smaller units, such as a $600 annual membership for "$50 a month," even though the totals are the same.[13]

Image Pricing. Many consumers use price as an indicator of quality. **Image pricing** is especially effective with ego-sensitive products such as perfumes, expensive cars, and designer clothing. A $100 bottle of perfume might contain $10 worth of scent, but gift givers pay $100 to communicate their high regard for the recipient.

Price and quality perceptions of cars interact. Higher-priced cars are perceived to possess high quality. Higher-quality cars are likewise perceived to be higher priced than they actually are. When information about true quality is available, price becomes a less significant indicator of quality. When this information is not available, price acts as a signal of quality.

Some brands adopt exclusivity and scarcity to signify uniqueness and justify premium pricing. Luxury-goods makers of watches, jewelry, perfume, and other products often emphasize exclusivity in their communication messages and channel strategies. High prices may actually increase demand among luxury-goods customers who desire uniqueness, because they then believe fewer other customers can afford the products.[14]

To maintain its air of exclusivity, Ferrari deliberately restricts sales of its iconic, $200,000-plus Italian sports car to below 7,000 despite growing demand in China, the Middle East, and the United States. But even exclusivity and status can vary by customer. Brahma beer is a no-frills light brew in its home market of Brazil but has thrived in Europe, where it is seen as “Brazil in a bottle.” Pabst Blue Ribbon is a retro favorite among U.S. college students, but its sales have exploded in China, where an upgraded bottle and claims of being “matured in a precious wooden cask like a Scotch whiskey” allow it to command a $44 price tag.[15]

Despite booming demand, Ferrari limits production and the number of sports cars that it sells to maintain the brand’s exclusivity.
Source: Ian Shaw/Alamy Stock Photo

Pricing Cues. Pricing cues are also important in the psychology of pricing. Many sellers believe prices should end in an odd number. Customers perceive an item priced at $299 to be in the $200 rather than the $300 range; they tend to process prices “left to right” rather than by rounding. Price encoding in this fashion is important if there is a mental price break at the higher, rounded price.

Another explanation for the popularity of "9" endings is that they suggest a discount or bargain, so if a company wants a high-price image, it should probably avoid the odd-ending tactic. One study showed that demand actually increased when the price of a dress *rose* from $34 to $39 but was unchanged when it rose from $34 to $44.[16]

Prices that end with 0 and 5 are also popular and are thought to be easier for consumers to process and retrieve from memory. "Sale" signs next to prices spur demand, but only if not overused. Thus total category sales are highest when some—but not all—items in a category have sale signs; past a certain point, sale signs may cause total category sales to fall.[17]

Pricing cues such as sale signs and prices that end in 9 are more influential when consumers' price knowledge is poor; when they purchase the item infrequently or are new to the category; and when product designs vary over time, prices vary seasonally, or quality or sizes vary across stores.[18] They are less effective the more they are used. Limited availability (for example, "three days only") also can spur sales among consumers actively shopping for a product.[19]

SETTING THE PRICE

A firm must set a price for the first time when it develops a new product, when it introduces its regular product into a new distribution channel or geographic area, and when it enters bids on new contract work. The firm must decide where to position its product on quality and price.[20]

Most markets have three to five price points or tiers. Marriott Hotels is good at developing different brands or variations of brands for different price points: JW Marriott (highest price), Marriott Marquis (high price), Marriott (high-medium price), Renaissance (medium-high price), Courtyard (medium price), TownePlace Suites (medium-low price), and Fairfield Inn (low price). Firms devise their branding strategies to help convey to consumers the price–quality tiers of their products or services.[21]

The firm must consider many factors in setting its pricing policy. The pricing process involves six main steps: defining the pricing objective;

determining demand; estimating costs; analyzing competitors' costs, prices, and offers; selecting a pricing method; and setting the final price.

DEFINING THE PRICING OBJECTIVE

An offering's price is determined by a firm's overall pricing objective. The clearer a firm's objective, the easier it is to set price. Four common pricing objectives are current profit, market penetration, market skimming, and quality leadership.

- **Short-term profit.** Many companies try to set a price that will *maximize current profits*. They estimate the demand and costs associated with alternative prices and choose the price that produces maximum current profit, cash flow, or rate of return on investment. This strategy assumes the firm knows its demand and cost functions, but in reality, these are difficult to estimate. Furthermore, in emphasizing current performance, the company may sacrifice long-run performance by ignoring the effects of other marketing variables, competitors' reactions, and legal restraints on price.
- **Market penetration.** Companies that choose **penetration pricing** want to *maximize their market share*. They believe a higher sales volume will lead to lower unit costs and higher long-run profit, so they set a very low price, assuming the market is price sensitive. Texas Instruments famously practiced this market-penetration pricing for years. The company would build a large plant, set its price as low as possible, win a large market share, experience falling costs, and cut its price further as costs fell.
- The following conditions favor adopting a market-penetration pricing strategy: (1) the market is highly price sensitive, and a low price stimulates market growth; (2) production and distribution costs fall with accumulated production experience; and (3) a low price discourages actual and potential competition.
- **Market skimming.** Companies unveiling a new technology favor setting high prices to *maximize market skimming*. In **market skimming**, a company is setting a relatively high price in an attempt to "skim the cream" off the market by making the offering affordable only to customers with the highest willingness to pay. Sony has been a frequent practitioner of market-skimming pricing, in which prices start high and slowly drop over time.
- Market skimming is beneficial under the following conditions: (1) a sufficient number of buyers signal a high current demand; (2) the high initial price does not attract more competitors to the market; and (3) the high price communicates the image of a superior product.
- **Quality leadership.** A company might aim to be the *quality leader* in the market. To maintain quality leadership, a company must charge a relatively high price in order to be able to invest in research and development, production, and service delivery. Brands such as Starbucks, Aveda, Victoria's Secret, BMW, and Viking have positioned themselves as quality leaders in their

> categories, combining quality, luxury, and premium prices with an intensely loyal customer base. Grey Goose and Absolut carved out a super-premium niche in the essentially odorless, colorless, and tasteless vodka category through clever on-premise and off-premise marketing that made the brands seem hip and exclusive.

Nonprofit and public organizations may have other pricing objectives. A university aims for partial cost recovery, knowing that it must rely on private gifts and public grants to cover its remaining costs. A nonprofit hospital may aim for full cost recovery in its pricing. A nonprofit theater company may price its productions to fill the maximum number of seats. A social service agency may set a service price geared to client income.

Whatever the specific objective, businesses that use price as a strategic tool will profit more than those that simply let costs or the market determine their pricing. For art museums, which earn an average of only 5 percent of their revenues from admission charges, pricing can send a message that affects their public image and the amount of donations and sponsorships they receive.

DETERMINING DEMAND

Each price will lead to a different level of demand and have a different impact on a company's marketing objectives. The normally inverse relationship between price and demand is captured in a demand curve: The higher the price, the lower the demand. For prestige goods, the demand curve sometimes slopes upward. Some consumers take the higher price to signify a better product. However, if the price is too high, demand may fall.

To estimate the demand for a company's offering, marketers need to know how responsive, or elastic, demand is to a change in price. **Price elasticity of demand** reflects the degree to which a change in price leads to a change in quantity sold. The lower the price elasticity, the less sensitive consumers are to price increases, and the more likely it is that raising the price can increase sales revenues.[22]

Consider the two demand curves in Figure 11.1. In demand curve (a), a price increase from $10 to $15 leads to a relatively small decline in demand from 105 to 100. In demand curve (b), the same price increase leads to a substantial drop in demand from 150 to 50. If demand hardly changes with a small change in price, we say it is *inelastic*. If demand changes considerably in response to changes in price, it is *elastic*.

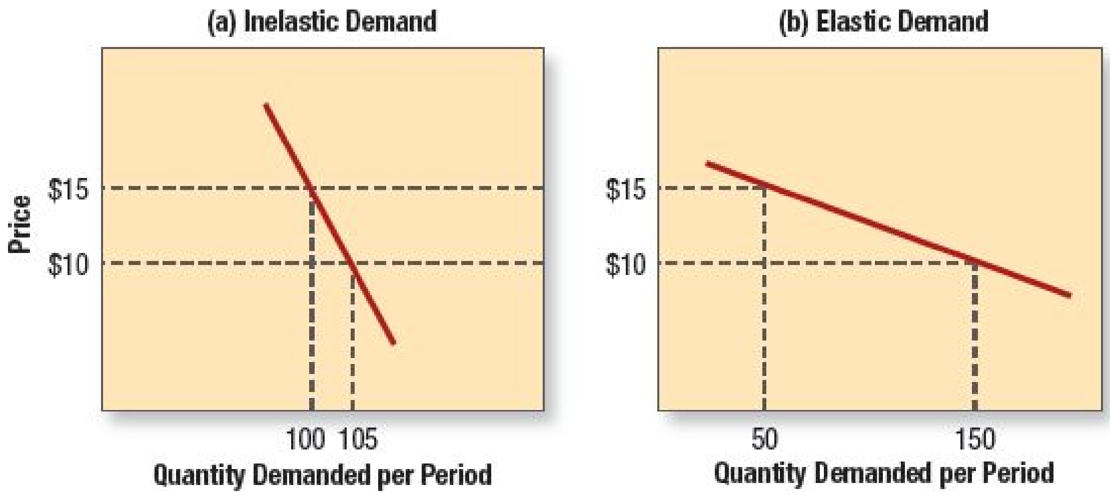


FIGURE 11.1
Inelastic and Elastic Demand

The higher the elasticity, the greater the volume growth resulting from a 1 percent price reduction. If demand is elastic, sellers will consider lowering the price to produce more total revenue. This makes sense as long as the costs of producing and selling more units do not increase disproportionately.

Price elasticity of demand depends on the magnitude and direction of the contemplated price change. It may be negligible with a small price change and substantial with a large price change. It may differ for a price cut than for a price increase, and there may be a **price indifference band** within which price changes have little or no effect.

Long-run price elasticity may differ from short-run elasticity. Buyers may continue to buy from a current supplier after a price increase but eventually switch suppliers; here demand is more elastic in the long run than in the short run. Or the reverse may happen: Buyers may drop a supplier after a price increase but return later. The distinction between short-run and long-run elasticity means that sellers will not know the total effect of a price change until time passes.

Generally speaking, price elasticity is low when (1) the product is distinctive and there are few or no substitutes or competitors; (2) consumers do not readily notice the higher price; (3) consumers are slow to change their buying habits; (4) consumers think the higher prices are justified by factors such as the cost of creating the product, product scarcity, and government taxation; (5) the expenditure is a smaller part of the buyer's total income or of the total cost of the end product; and (6) part or all of the cost is borne by another party.[23]

One comprehensive review of a 40-year period of academic research on price elasticity found that the average price elasticity across all products, markets, and time periods studied was –2.62.[24] In other words, a 1 percent decrease in prices led to a 2.62 percent increase in sales. Furthermore, price elasticity was higher for durable goods than for other goods and was higher for products in the introduction/growth stages of the product life cycle than for products in the mature/decline stages. Finally, promotional price elasticities were higher than actual price elasticities in the short run (although the reverse was true in the long run).

ESTIMATING COSTS

Demand sets a ceiling on the price the company can charge for its product. Costs set the floor. The company wants to charge a price that covers its cost of producing, distributing, and selling the product, including a fair return for its effort and risk.

Fixed, Variable, and Total Costs. A company's costs take two forms: fixed and variable. **Fixed costs** are costs that do not vary with production level or sales revenue. A company must pay bills each month for rent, heat, interest, salaries, and so on, regardless of output.

Variable costs vary directly with the level of production. For example, each tablet computer produced by Samsung incurs the cost of plastic and glass, microprocessor chips and other electronics, and packaging. These costs tend to be constant per unit produced, but they're called variable because their total varies with the number of units produced.

Total costs consist of the sum of the fixed and variable costs for any given level of production. **Average cost** is the cost per unit at that level of production; it equals total costs divided by production. Management wants to charge a price that will at least cover the total production costs at a given level of production.

To price intelligently, management needs to know how its costs vary with different levels of production. Take the case in which a company such as Samsung has built a fixed-size plant to produce 1,000 tablet computers a day. The cost per unit is high if few units are produced per day. As production approaches 1,000 units per day, the average cost falls because the fixed costs are spread over more units. Short-run average cost *increases* after 1,000 units, however, because the plant becomes inefficient: Workers must line up for machines, getting in each other's way, and machines break down more often.

If Samsung believes it can sell 2,000 units per day, it should consider building a larger plant. The plant will use more efficient machinery and work arrangements, and the unit cost of producing 2,000 tablets per day will be lower than the unit cost of producing 1,000 per day. In fact, a 3,000-capacity plant would be even more efficient, but a 4,000-daily production plant would be less so because of increasing diseconomies of scale: There are too many workers to manage, and paperwork slows things down. A 3,000-daily production plant is the optimal size if demand is strong enough to support this level of production.

There are more costs than those associated with manufacturing. To estimate the real profitability of selling to different types of retailers or customers, the manufacturer needs to use activity-based cost accounting instead of standard cost accounting.

Experience Curve Effects. Suppose Samsung runs a plant that produces 3,000 tablet computers per day. As the company gains experience producing tablets, its methods improve. Workers learn shortcuts, materials flow more smoothly, and procurement costs fall. The result is that average cost falls with accumulated production experience. Thus the average cost of producing the first 100,000 tablets is $100 per tablet, but when the company has produced the first 200,000 tablets, the average cost has fallen to $90. After its accumulated production experience doubles again to 400,000, the average cost is $80. This decline in the average cost with accumulated production experience is called the **experience curve**.

Now suppose three firms compete in this particular tablet market: Samsung, Firm A, and Firm B. Samsung is the lowest-cost producer at $80, having produced 400,000 units in the past. If all three firms sell the tablet for $100, Samsung makes a $20 profit per unit, A makes $10 per unit, and B breaks even. The smart move for Samsung would be to lower its price to $90. This will drive B out of the market, and even A may consider leaving. Samsung will pick up the business that would have gone to B (and possibly A). Furthermore, price-sensitive customers will enter the market at the lower price. As production increases beyond 400,000 units, Samsung's costs will drop still further and faster, more than restoring its profits, even at a price of $90.

Experience-curve pricing nevertheless carries major risks. Aggressive pricing might give the product a cheap image. It also assumes competitors are weak followers. The strategy leads the company to build more plants to meet demand, but a competitor may choose to innovate with a lower-cost technology. The market leader is now stuck with the old technology.

Most experience-curve pricing has focused on manufacturing costs, but all costs can be improved on, including marketing costs. If three firms are each investing a large sum of money in marketing, the firm that has been doing it longest might achieve the lowest costs. This firm can charge a little less for its product and still earn the same return, all other costs being equal.

ANALYZING COMPETITORS' PRICES

Within the range of possible prices identified by market demand and company costs, the firm must take competitors' costs, prices, and possible reactions into account. If the firm's offer contains features not offered by the nearest competitor, it should evaluate their worth to the customer and add that value to the competitor's price. If the competitor's offer contains some features not offered by the firm, the firm should subtract their value from its own price. Now the firm can decide whether it can charge more than, the same as, or less than the competitor.[25]

Companies offering the powerful combination of low price and high quality are capturing the hearts and wallets of consumers all over the world.[26] Value players such as Aldi, Lidl, JetBlue Airways, and Southwest Airlines are transforming the way consumers of nearly every age and income level purchase groceries, apparel, airline tickets, financial services, and other goods and services.

Traditional players are right to feel threatened. Upstart firms often rely on serving one or a few consumer segments, providing better delivery or just one additional benefit, and matching low prices with highly efficient operations to keep costs down. They have changed consumer expectations about the trade-off between quality and price.

One school of thought is that companies should set up their own low-cost operations to compete with value-priced competitors only if (1) their existing businesses will become more competitive as a result and (2) the new business will derive some advantages it would not have gained if it were independent.[27]

Low-cost operations set up by HSBC, ING, Merrill Lynch, and Royal Bank of Scotland—First Direct, ING Direct, ML Direct, and Direct Line Insurance, respectively—succeed in part thanks to synergies between the old and new lines of business. Major airlines have also introduced their own low-cost carriers. But Continental's Lite, KLM's Buzz, SAS's Snowflake, and United's Ted have all been unsuccessful, partly because of a lack of synergies. The low-cost operation must be designed and launched as a moneymaker in its own right, not just as a defensive play.

SELECTING A PRICING METHOD

Given the customers' demand schedule, the cost function, and competitors' prices, the company is now ready to select a pricing method. There are three major considerations in price setting: costs, competitors, and customers. Costs set a floor for the price. Competitors' prices and the price of substitutes provide an orienting point. Customers' assessment of unique features establishes the price ceiling.

Companies select a pricing method that includes one or more of these three considerations. We will examine five price-setting methods: markup pricing, target-rate-of-return pricing, economic-value-to-customer pricing, competitive pricing, and auction-type pricing.

Markup Pricing. The most elementary pricing method, **markup pricing**, is to add a standard markup to the product's cost. Construction companies submit job bids by estimating the total project cost and adding a standard markup for profit. Lawyers and accountants typically price by adding a standard markup on their time and costs.

Suppose a toaster manufacturer has the following costs and sales expectations:

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

The manufacturer's unit cost is then given by

$$\text{Unit cost} = \text{variable cost} + \frac{\text{fixed cost}}{\text{unit sales}} = \$10 + \frac{\$300{,}00}{\$50{,}000} = \$16$$

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

$$\text{Markup price} = \frac{\text{unit cost}}{(1 - \text{desired return on sales})} = \frac{\$16}{1-0.2} = \$20$$

The manufacturer will charge dealers \$20 per toaster and make a profit of \$4 per unit. If dealers want to earn 50 percent on their selling price, they will mark up the toaster 100 percent to \$40. Markups are generally higher on seasonal items (to cover the risk of not selling), specialty items, slower moving items, items with high storage and handling costs, and demand-inelastic items, such as prescription drugs.

Does the use of standard markups make logical sense? Generally, no. After all, buyers often do not care about a manufacturer's costs. In fact, any pricing method that ignores current demand, perceived value, and competition is not likely to lead to the optimal price. Still, markup pricing remains popular. First, sellers can determine costs much more easily than they can estimate demand. By tying the price to cost, sellers simplify the pricing task. Second, when all firms in the industry use this pricing method, prices tend to be similar and price competition is minimized. Third, many people feel cost-plus pricing is fairer to both buyers and sellers. Sellers do not take advantage of buyers when the latter's demand becomes acute, and sellers earn a fair return on investment.

Target-Rate-of-Return Pricing. In **target-rate-of-return pricing** (or target-return pricing), the firm starts with a rate-of-return objective (e.g., 10 percent of sales revenue) and then sets a price that will yield the desired rate of return. Because it does not take into account customer demand and competitive offerings, target-rate-of-return pricing is often used in regulated industries. For example, public utilities, which need to make a fair return on investment, often use this method.

Suppose the toaster manufacturer has invested $1 million in the business and wants to set a price to earn a 20 percent ROI, specifically $200,000. The target-return price is given by the following formula:

$$\text{Target@return price} = \text{unit cost} + \frac{\text{desired return} \times \text{invested capital}}{\text{unit sales}}$$

$$= \$16 + \frac{.20 \times \$1{,}000{,}000}{50{,}000} = \$20$$

The manufacturer will realize this 20 percent ROI, provided its costs and estimated sales turn out to be accurate. But what if sales don't reach 50,000 units? The manufacturer can prepare a break-even chart to learn what would happen at other sales levels (see Figure 11.2). Fixed costs are \$300,000 regardless of sales volume. Variable costs, not shown in the figure, rise with volume. Total costs equal the sum of fixed and variable costs. The total revenue curve starts at zero and rises with each unit sold.

The total revenue and total cost curves cross at 30,000 units. This is the break-even volume. We can verify it by the following formula:

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

The manufacturer, of course, is hoping the market will buy 50,000 units at \$20, in which case it will earn \$200,000 on its \$1 million investment; however, much depends on price elasticity and competitors' prices. Unfortunately, target-return pricing tends to ignore these considerations. The manufacturer needs to consider different prices and estimate their probable impacts on sales volume and profits.

Economic-Value-to-Customer Pricing. An increasing number of companies now base their price on the customer's economic value. **Economic-value-to-customer pricing** takes into account a host of inputs, such as the buyer's image of the product performance, the channel deliverables, the warranty quality, customer support, and softer attributes such as the supplier's reputation, trustworthiness, and esteem. Companies must deliver the value promised by their value proposition, and the customer must perceive this value. Firms use the other marketing program elements, such as advertising, the sales force, and the internet, to communicate and enhance perceived value in buyers' minds.

A seller can successfully charge a higher price than competitors if it can convince customers that it offers the lowest total cost of ownership. Marketers often treat the service elements in a product offering as sales incentives rather than as value-enhancing augmentations for which they can charge. In fact, one of the most common mistakes manufacturers tend to made is to offer all sorts of services to differentiate their products without charging for them.

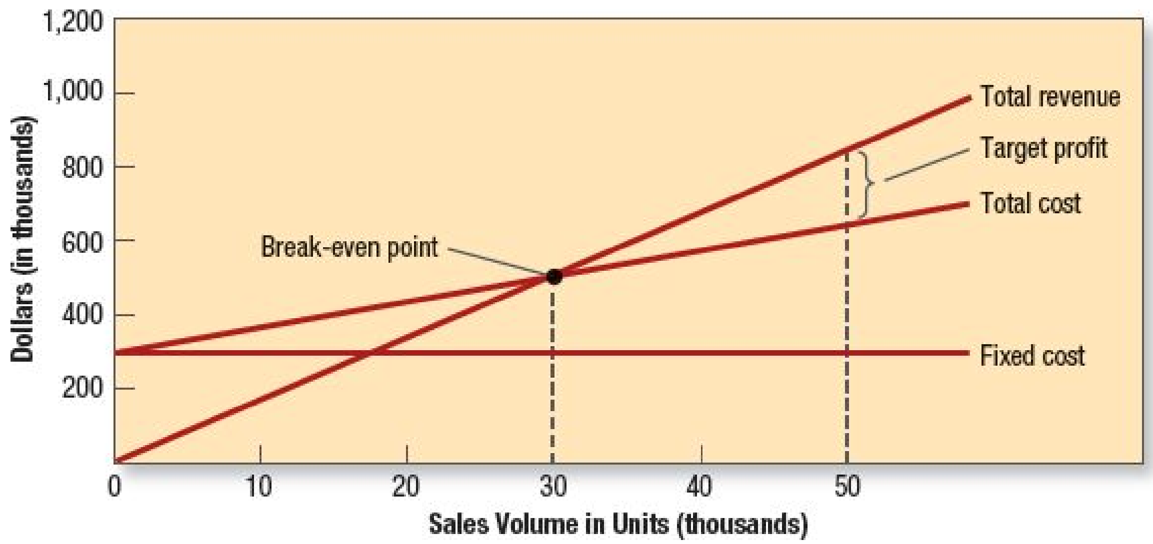


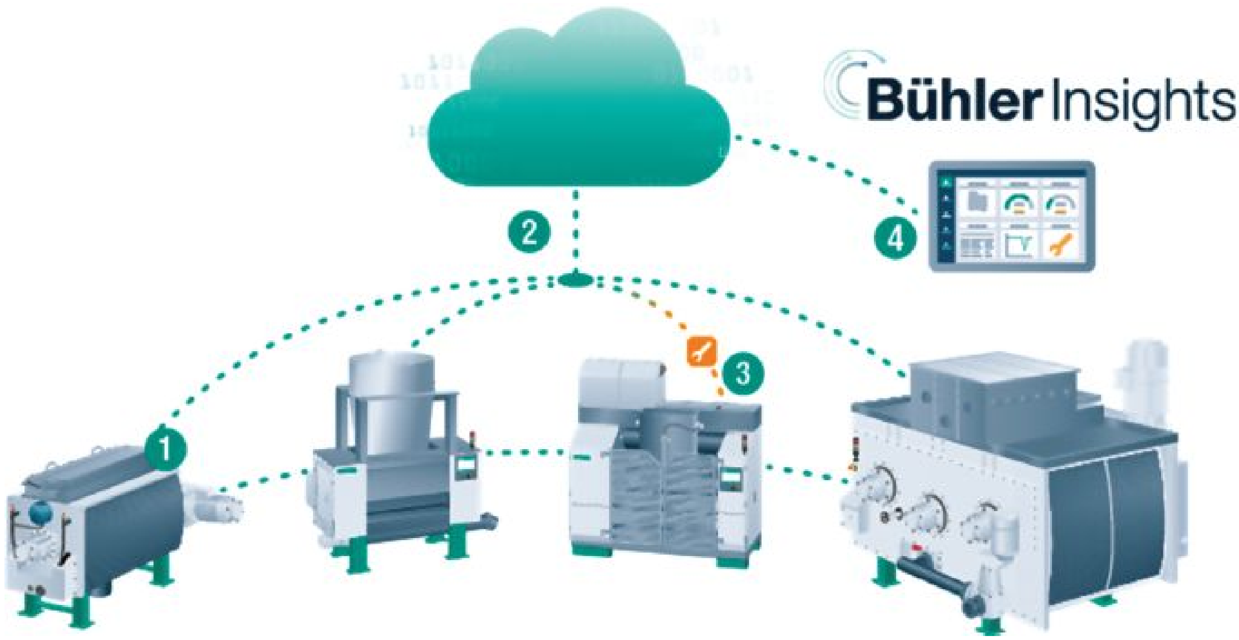
FIGURE 11.2
Break-Even Chart for Determining Target-Return Price and Break-Even Volume

Caterpillar uses perceived value to set prices on its construction equipment. It might price its tractor at $100,000, even though a similar competitor's tractor might be priced at $90,000. When a prospective customer asks a Caterpillar dealer why he or she should pay $10,000 more for the Caterpillar tractor, the dealer explains as follows:

$ 90,000	is the tractor's price if it is only equivalent to the competitor's tractor
$ 7,000	is the price premium for Caterpillar's superior durability
$ 6,000	is the price premium for Caterpillar's superior reliability
$ 5,000	is the price premium for Caterpillar's superior service
$ 2,000	is the price premium for Caterpillar's longer warranty on parts
$110,000	is the normal price to cover Caterpillar's superior value
	Discount
–$ 10,000	
$100,000	final price

The Caterpillar dealer is able to show that although customers are asked to pay a $10,000 premium for this tractor, they are actually getting $20,000 extra value! The customer chooses the Caterpillar tractor because he or she is convinced that its lifetime operating costs will be lower.

Ensuring that customers appreciate the total value of a product or service offering is crucial. Consider the experience of Buhler.



The additional value provided by Bühler Insights reinforces the brand's premium positioning and pricing while retaining its competitive edge.
Source: Buhler, used with permission

Bühler A leading global food processing company, Bühler is a trusted solutions provider known for its value-added services and solutions. Bühler Insights is a connected platform that optimizes a plant's efficiency by reducing maintenance times, energy consumption, and wastage for customers. Bühler Insights generates higher returns from plants with a structured approach that increases yield and thereby improves revenues. The Insights Gateway connects machines in the plant to the Insights Platform. An integrated dashboard provides secure access to real-time plant performance with analysis of historical data and trend detection. Troubleshooting and instant support minimize interruptions to production. These and other value-added solutions from Bühler help the company justify its pricing while maintaining a competitive advantage.[28]

Even when a company claims its offering delivers more total value, not all customers will respond positively. Some care only about price. But there is also typically a segment that cares about quality. Umbrellas are essential during the three months of near-nonstop monsoon rain in Indian cities such as Mumbai, and the makers of Stag umbrellas there found themselves in a bitter price war with cheaper Chinese competitors. After realizing that they were sacrificing quality too much, Stag's managers decided to increase quality with new colors, new designs, and features such as built-in high-power flashlights and prerecorded music. Despite higher prices, sales of the improved Stag umbrellas actually increased.[29]

The key to economic-value-to-customer pricing is to deliver more unique value than competitors and to demonstrate this to prospective buyers. Thus, a company needs to fully understand the customer's decision-making process. For example, Goodyear found it hard to command a price premium for its more expensive new tires, despite innovative features to extend tread life. Because consumers had no reference price to compare tires, they tended to gravitate toward the lowest-priced offerings. Goodyear's solution was to price its models on the basis of expected miles of wear, rather than their technical product features, making product comparisons easier.[30]

Competitive Pricing. In **competitive pricing** (or going-rate pricing), the firm bases its price largely on competitors' prices. All firms in industries that sell a commodity such as steel, paper, or fertilizer normally charge the same price. Smaller firms "follow the leader," changing their prices when the market leader's prices change, rather than when their own demand or costs change. Some may charge a small premium or discount, but they preserve the difference. Thus, minor gasoline retailers usually charge a few cents less per gallon than the major oil companies, without letting the difference increase or decrease. Competitive pricing is quite popular. Where costs vary and/or are difficult to measure, when the demand fluctuates, or when competitive response is uncertain, firms feel competitive pricing is a good solution because they believe it reflects the industry's collective wisdom.

Auction Pricing. Auction pricing is growing more popular, especially with scores of electronic marketplaces selling everything from pigs to used cars, as firms dispose of excess inventories or used goods. Here are the three major types of auctions and their separate pricing procedures:[31]

- **English auctions (ascending bids)** have one seller and many buyers. On sites such as eBay and Amazon.com, the seller puts up an item and bidders raise their offer prices until the top price is reached. The highest bidder gets the item. English auctions are used today for selling antiques, cattle, real estate, and used equipment and vehicles. Kodak and Nortel sold hundreds of patents for wireless and digital imaging via auctions, raising hundreds of millions of dollars.[32]
- **Dutch auctions (descending bids)** feature one seller and many buyers or one buyer and many sellers. In the first kind, an auctioneer announces a high price for a product and then slowly decreases the price until a bidder accepts. In the other, the buyer announces something he or she wants to buy, and potential sellers compete to offer the lowest price. SAP Ariba runs business-to-business auctions to help companies acquire low-priced items as varied as steel, fats, oils, name badges, pickles, plastic bottles, solvents, cardboard, and even legal and janitorial work.[33]
- **Sealed-bid auctions** let would-be suppliers submit only one bid without any knowledge of the other bids. The U.S. and other governments often use this method to procure supplies or grant licenses. A supplier will not bid below its cost but cannot bid too high for fear of losing the job. The net effect of these two pulls is the bid's *expected profit*.[34]

To buy equipment for its drug researchers, Pfizer uses online reverse auctions in which suppliers submit the lowest price they are willing to be paid. If the increased savings that a buying firm obtains in an online auction translate into decreased margins for an incumbent supplier, however, the supplier may feel the firm is opportunistically squeezing out price concessions. Online auctions with a large number of bidders can result in greater overall satisfaction for both parties, more positive future expectations, and fewer perceptions of opportunism.[35]

SETTING THE FINAL PRICE

Pricing methods narrow the range from which the company must select its final price. Companies usually do not set a single price but rather develop a pricing structure that reflects variations in geographic demand and costs, market-segment requirements, purchase timing, order levels, delivery frequency, guarantees, service contracts, and other factors. As a result of discounts, allowances, and promotional support, a company rarely realizes the same profit from each unit of a product that it sells.

The phenomenon of offering different pricing schedules to different consumers and dynamically adjusting prices is exploding. Merchants are adjusting process based on inventory levels, item velocity (how fast an item sells), competitors' pricing, and advertising. Even sports teams are adjusting ticket prices to reflect the popularity of the competitor and the timing of the game. Online merchants that sell their products on Amazon.com are changing their prices on an hourly or even minute-by-minute basis, in part so they can secure the top spot on search results.

Price discrimination occurs when a company sells a product or service at two or more prices that do not reflect a proportional difference in costs. In *first-degree price discrimination*, the seller charges each customer a separate price, depending on the intensity of his or her demand. In *second-degree price discrimination*, the seller charges less to buyers of larger volumes. With certain services such as cell phone service, however, tiered pricing results in consumers actually paying *more* with higher levels of usage.

In *third-degree price discrimination*, the seller charges different amounts to different consumer segments, as in the following cases:[36]

- **Customer-segment pricing.** Different customer segments pay different prices for the same product or service. For example, museums often charge a lower admission fee to students and senior citizens. When online travel agency Orbitz found that people using Apple Mac computers spent as much as 30 percent more a night on hotels, it began to show them different—and sometimes costlier—travel options than Windows users saw. Orbitz also considers a user's location and history on the site, as a well as a hotel's overall popularity and promotions.[37]
- **Product-form pricing.** Different versions of the product are priced differently, but not in proportion to their costs. Evian prices a 2-liter bottle of its mineral water as low as $1 but sells 5 ounces of the same water in a moisturizer spray for as much as $12.
- **Channel pricing.** Coca-Cola carries a different price depending on whether the consumer purchases it from a fine restaurant, a fast-food restaurant, or a vending machine.
- **Location pricing.** The same product is priced differently at different locations, even though the cost of offering it is the same at all locations. A theater varies its seat prices according to audience preferences for different locations. Some firms store computer IP addresses and zip codes and use their proximity to a competitor's store to adjust their prices.

- **Time pricing.** Prices vary by season, day, or hour. Restaurants charge “early bird” customers less, and some hotels charge less on weekends. Retail prices for roses increase by as much as 200 percent in the lead-up to Valentine’s Day.

The airline and hospitality industries use yield management systems and yield pricing, by which they offer discounted but limited early purchases, higher prices for late purchases, and the lowest rates for unsold inventory just before it expires. Airlines charge different fares to passengers on the same flight, depending on the seating class; the time of day (morning or night coach); the day of the week (workday or weekend); the season; the person’s employer, past business, or status (youth, military, senior citizen); and so on. That’s why, on a flight from New York City to Miami, you might pay $200 and sit across from someone who paid $1,290.

Constant price variation can be tricky, however, where consumer relationships are concerned. One way to make it work is to offer customers a unique bundle of products and services to meet their needs precisely, making it harder to make price comparisons. Another tactic that companies favor is to use variable prices as a reward rather than a penalty. Shipping company APL rewards customers who can better predict how much cargo space they’ll need with cheaper rates for booking early.

Although some forms of price discrimination are illegal (such as offering different prices for the same item to different customers within the same trade group), the practice is legal if the seller can prove its costs are different when selling different volumes or different qualities of the same product to different retailers. Predatory pricing—selling below cost for the purpose of obliterating competition—is unlawful, however.

For price discrimination to work, certain conditions must exist. First, the market must be segmentable, and the segments must show different intensities of demand. Second, members in the lower-price segment must not be able to resell the product to the higher-price segment. Third, competitors must not be able to undersell the firm in the higher-price segment. Fourth, the cost of segmenting and policing the market must not exceed the extra revenue derived from price discrimination. Finally, the practice must not breed customer resentment and ill will.

PRODUCT-MIX PRICING

Marketers must modify their price-setting logic when the product is part of a product mix. In **product-mix pricing**, the firm searches for a set of prices that maximize profits on the total mix. The process is challenging, because the various products have demand and cost interrelationships and are subject to different degrees of competition. We can distinguish six main situations calling for product-mix pricing: loss-leader pricing, optional-feature pricing, captive-product pricing, two-part pricing, by-product pricing, and product-bundling pricing.

- **Loss-leader pricing.** A company can set the price of a specific product or service in a way that maximizes the profitability of its entire product line. A common product-line pricing approach is **loss-leader pricing**. Supermarkets and department stores often drop the price on well-known brands to stimulate additional store traffic. This approach pays if the revenue on the additional sales compensates for the lower margins on the loss-leader items. Manufacturers of brands that retailers use as loss leaders typically object, because this practice can dilute the brand image and bring complaints from retailers who charge the list price. Manufacturers have tried to keep intermediaries from using loss-leader pricing by lobbying for retail-price-maintenance laws, but these laws have been revoked.
- **Optional-feature pricing.** Many companies offer optional products, features, and services with their main product. The pricing of options is a sticky problem, because companies must decide which to include in the standard price and which to offer separately. Many restaurants price their beverages high and their food low. The food revenue covers costs, and the beverages—especially liquor—produce the profit. This explains why servers often press hard to get customers to order drinks. Other restaurants price their liquor low and their food high to draw in a drinking crowd.
- **Captive pricing.** Some products require the use of ancillary or captive products. Manufacturers of razors often price them low and set high markups on razor blades. Movie theaters and concert venues often make more from concessions and merchandise sales than from ticket receipts.[38] Verizon may give a free cell phone to the person who commits to buying two years of phone service. If the captive product is priced too high in the aftermarket, however, counterfeiting and substitutions can erode sales. Consumers now can buy cartridge refills for their printers from discount suppliers and save 20 percent to 30 percent off the manufacturer's price.
- **Two-part pricing.** Service firms engage in two-part pricing, consisting of a fixed fee plus a variable usage fee. Cell phone users may have to pay a minimum monthly fee plus charges for

calls that exceed their allotted minutes. Amusement parks charge an admission fee plus fees for rides over a certain minimum. The service firm faces a problem similar to captive-product pricing—namely, how much to charge for the basic service and how much for the variable usage. The fixed fee should be low enough to induce purchase; profit can then come from the usage fees.

- **By-product pricing.** The production of certain goods—meats, petroleum products, and other chemicals—often yields by-products that should be priced on their value. Any income earned on the by-products will make it easier for the company to charge a lower price for its main product if competition forces it to do so. Formed in 1855, Australia's CSR was originally named Colonial Sugar Refining Company and forged its early reputation as a sugar company. The company began to sell by-products of its sugar cane; waste sugar cane fiber was used to manufacture wallboard. Today, through product development and acquisition, the renamed CSR has become one of the top 10 companies in Australia selling building and construction materials.
- **Product-bundling pricing.** Sellers often bundle products and features.[39] *Pure bundling* occurs when a firm offers its products only as a bundle. Providers of aftermarket products for automobiles increasingly are bundling their offerings in customizable three-in-one and four-in-one programs, especially second-tier products such as tire-and-wheel protection and paintless dent repair. A talent agency might insist that an in-demand actor can be signed to a film only if the film company also accepts other talent, such as directors or writers, that the agency represents. This is a form of *tied-in sales*. In *mixed bundling*, the seller offers goods both individually and in bundles, normally charging less for the bundle than if the items were purchased separately. A theater will price a season subscription lower than the cost of buying all the performances separately. Customers may not have planned to buy all the components, so savings on the price bundle must be enough to induce them to buy it.[40] Some customers want less than the whole bundle in exchange for a lower price.[41] These customers ask the seller to "unbundle" or "rebundle" its offer. If a supplier saves $100 by not supplying unwanted delivery and reduces the customer's price by $80, it has kept the customer happy while increasing its profit by $20.

INITIATING AND RESPONDING TO PRICE CHANGES

To gain market position, increase sales revenues, and grow profits, companies often take aggressive pricing actions, either lowering their prices, typically to lure competitors' customers, or raising prices to capture greater value from its current customers.

INITIATING PRICE CUTS

Several circumstances might lead a firm to cut prices. One is excess capacity: The firm needs additional business and cannot generate it through increased sales effort, product improvement, or other measures. Companies sometimes initiate price cuts in a drive to dominate the market through lower costs. Either the company starts with lower costs than its competitors, or it initiates price cuts in the hope of gaining market share and lower costs.

Cutting prices to keep customers or beat competitors often encourages customers to demand price concessions, however, and trains salespeople to offer them.[42] A price-cutting strategy can lead to other possible drawbacks, such as consumers assuming quality is low. Furthermore, low price buys market share but not market loyalty—the same customers will shift to any lower-priced firm that comes along. In addition, competitors might respond by lowering their prices even more, triggering a price war. There is also the possibility that higher-priced competitors will match the firm's lower prices but will have greater staying power because of lower cost structure.

Customers often question the motivation behind price changes.[43] They may assume that the item is about to be replaced by a new model, the item is faulty and is not selling well, the firm is in financial trouble, the price will come down even further, or the quality has been reduced. The firm must monitor these attributions carefully.

INITIATING PRICE INCREASES

A successful price increase can raise profits considerably. 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. Thus, if a company charged $10, sold 100 units, and had costs of $970, it generated a profit of $30, or 3 percent on sales. By raising its price by 10 cents (a 1 percent price increase), it could boost its profits by 33 percent, assuming the same sales volume.

A major circumstance provoking price increases is **cost inflation**, wherein rising costs unmatched by productivity gains squeeze profit margins and lead companies to regular rounds of price increases. Companies often raise their prices by more than the cost increase in anticipation of further inflation or government price controls, a practice called **anticipatory pricing**. Another factor leading to price increases is high demand that exceeds a company's production capabilities. When a company cannot supply all its customers, it can raise its prices, ration supplies, or both.

Although there is always a chance that a price increase can convey some positive meanings to customers—for example, that the item is "hot" and represents an unusually good value—consumers generally dislike higher prices. In passing price increases on to consumers, the company must avoid looking like a price gouger. Coca-Cola's proposed smart vending machines that would raise prices as temperatures rose and Amazon's dynamic pricing experiment that varied prices by purchase occasion both became front-page news. The more similar the products or offerings from a company, the more likely consumers are to interpret any pricing differences as unfair. Product customization and differentiation, as well as communications that clarify differences, are thus critical.[44]

Several techniques help avoid sticker shock and a hostile consumer reaction when prices rise. One is maintaining a sense of fairness, such as by giving consumers advance notice so they can do forward buying or shop around. Sharp price increases also need to be explained in understandable terms. Making low-visibility price moves first is also a good technique. Eliminating discounts, increasing minimum order sizes, and curtailing production of low-margin products are examples. And contracts or bids for long-term projects should contain escalator clauses based on such factors as increases in recognized national price indexes.

RESPONDING TO COMPETITORS' PRICE CHANGES

The introduction or change of any price can provoke a response from customers, competitors, distributors, suppliers, and even government. Competitors are most likely to react when the number of firms in the category is low, the product is homogeneous, and buyers are highly informed.

How can a firm anticipate a competitor's reactions? One way is to assume the competitor reacts in the standard way to a price being set or changed. Another is to assume that the competitor treats each price difference or change as a fresh challenge and reacts according to self-interest at the time. Now the company will need to research the competitor's current financial situation, recent sales, customer loyalty, and corporate objectives. If the competitor has a market share objective, it is likely to match price differences or changes.[45] If it has a profit-maximization objective, it may react by increasing its advertising budget or improving product quality.

The problem is complicated because the competitor can put different interpretations on lowered prices or a price cut: that the company is trying to steal the market, that it is doing poorly and trying to boost its sales, or that it wants the whole industry to reduce prices to stimulate total demand. When Walmart began to run ads claiming lower prices than Publix, the regional supermarket chain dropped its prices below Walmart's on roughly 500 essential items and launched its own advertising campaign in retaliation.[46]

How should a firm respond to a competitor's price cut? It depends on the situation. A firm needs to consider the following: (1) Why did the competitor change the price? To steal the market, to utilize excess capacity, to meet changing cost conditions, or to lead an industry-wide price change? (2) Does the competitor plan to make the price change temporary or permanent? (3) What will happen to the company's market share and profits if it does not respond? Are other companies going to respond? (4) What are the competitors' and other firms' likely responses to each possible reaction?

Market leaders often face aggressive price cutting by smaller firms trying to build market share. Using price, T-Mobile attacked AT&T and Verizon, AMD has attacked Intel, and Dollar Shave Club has attacked Gillette. Market leaders also face lower-priced store brands. Three possible responses to low-cost competitors are to further differentiate the product or service, to introduce a low-cost venture, or to reinvent oneself as a low-cost player.[47] The right strategy depends on the ability of the firm to generate more demand or cut costs.

An extended analysis of alternatives may not always be feasible when the attack occurs. The company may have to react decisively within hours or days, especially where prices change with some frequency and it is important to react quickly, such as in the meatpacking, lumber, or oil industries. It would make better sense to anticipate possible competitors' price changes and prepare contingent responses.

MANAGING INCENTIVES

Incentives are sales promotion tools, mostly short-term, designed to stimulate quicker or greater purchase of particular products or services by consumers or the trade.[48]

INCENTIVES AS A MARKETING DEVICE

Sales promotion expenditure increased as a percentage of budget expenditure for a number of years, with the fastest-growing area being digital coupons and discounts, redeemed via smartphone or downloaded to a consumer's printer. Digital coupons eliminate printing costs, reduce paper waste, are easily updatable, and have higher redemption rates. Many retailers are now offering customized coupons based on consumer purchase histories.[49]

Sales promotions can produce a high sales response in the short run but little permanent gain over the longer term. Price promotions usually do not build permanent total-category volume. Having turned to zero percent financing, hefty cash rebates, and special lease programs during sluggish economic times, auto manufacturers have found it difficult to wean consumers from discounts ever since.[50] Sales promotions often prompt consumers to engage in stockpiling—purchasing earlier than usual (purchase acceleration) or buying extra quantities. As a result, after the initial peak, sales often hit a post-promotion dip.[51] And while their impact on sales is often temporary, incessant price reductions, coupons, deals, and premiums can have a longer-term negative impact by devaluing the company's offering in buyers' minds.

Not all sales promotions are detrimental to the company’s brand image. Some sales promotion tools are *consumer franchise building*. They impart a selling message along with the deal, such as frequency awards, coupons that advertise product features, and premiums related to the product. Sales promotion tools that are typically *not* brand building include price-off packs, consumer premiums not related to a product, contests and sweepstakes, consumer refund offers, and trade allowances.

Promotional pricing has become the modus operandi of a large number of companies offering both products and services. Salespeople in particular are quick to give discounts to close a sale. But word can get around fast that the company’s list price is “soft,” and discounting becomes the norm, undermining the perceived value of the offerings. Some product categories self-destruct by always being on sale.

Some companies with overcapacity are tempted to give discounts or even begin to supply a retailer with a store-brand version of their product at a deep discount. Because the store brand is priced lower, however, it may start making inroads into sales of the manufacturer’s brand. Manufacturers should consider the implications of supplying retailers at a discount, because they may end up losing long-run profits in an effort to meet short-run volume goals.

Managers need to monitor the proportion of customers receiving discounts, the average discount, and any tendency for salespeople to rely too heavily on discounting. To this end, managers should conduct a **net price analysis** to arrive at the “real price” of the offering. The real price is affected not only by discounts but also by other expenses that reduce the realized price. Suppose the company’s list price is $3,000. The average discount is $300. The company’s promotional spending averages $450 (15 percent of the list price). Retailers are given co-op advertising money of $150 to back the product. In this case the company’s net price is $2,100, not $3,000.

MAJOR INCENTIVE DECISIONS

In using incentives, a company must establish its objectives, select the tools, develop the program, implement and control it, and evaluate the results.

Establishing the Objectives of Incentives. The objectives of incentives derive from basic marketing objectives for the offering. Depending on whether a manufacturer's promotional activity is focused on consumers or retailers, incentives have different objectives:

For *consumer* incentives, objectives include encouraging more frequent purchases or the purchase of larger-sized units among users, fostering trial of one's product among nonusers, and attracting switchers away from competitors' brands. If some of the brand switchers would not have otherwise tried the brand, incentives can yield long-term increases in market share.[52] Ideally, consumer incentives have short-run sales impact and long-run effects on brand equity.[53]

For *retailer* incentives, objectives include persuading the retailer or wholesaler to carry the brand; persuading the retailer or wholesaler to carry more units than the normal amount; inducing retailers to promote the brand by featuring, display, and price reductions; and motivating retailers and their sales clerks to push the product.

Defining the Size and Approach for Incentives. In deciding to use a particular incentive, marketers must first determine its *size*. The incentive must be meaningful to target customers if the promotion is to succeed. Second, the marketing manager must establish *conditions* for participation. Incentives might be offered to everyone or to select groups. Third, the marketer must decide on the *duration* of the promotion. Fourth, the marketer must choose a *distribution vehicle*. A 50-cents-off coupon can be distributed in the product package, in stores, by mail, online, or in advertising. Fifth, the marketing manager must establish the *timing* of the promotion. And finally, the *total sales promotion budget* must be set. The cost of a particular promotion consists of the administrative cost (printing, mailing, and promoting the deal) and the incentive cost (cost of premium or cents-off, including redemption costs), multiplied by the expected number of units sold. The cost of a coupon deal recognizes that only a fraction of consumers will redeem the coupons.

In addition to determining the size of incentives, a firm must decide how to allocate resources and, specifically, how much effort to devote to push activities and how much to pull activities.

A **push strategy** uses the manufacturer's sales force, trade promotion money, or other means to induce intermediaries to carry, promote, and sell the product to end users. This strategy is particularly appropriate when there is low brand loyalty in a category, brand choice is made in the store, the product is an impulse item, and product benefits are well understood.

In a **pull strategy** the manufacturer uses advertising, promotion, and other forms of communication to persuade consumers to demand the product from intermediaries, thus inducing the intermediaries to order it. This strategy is particularly appropriate when there is high brand loyalty and high involvement in the category, when consumers are able to perceive differences between brands, and when they choose the brand before they go to the store.

Top marketing companies such as Apple, Coca-Cola, and Nike skillfully employ both push *and* pull strategies. A push strategy is more effective when accompanied by a well-designed and well-executed pull strategy that activates consumer demand. On the other hand, without at least some consumer interest, it can be very difficult to gain much channel acceptance and support—and vice versa for that matter.

Selecting Consumer Incentives. The sales promotion planner should take into account the type of market, the sales promotion objectives, competitive conditions, and each tool's cost-effectiveness.[54] The main **consumer incentives** include the following:

- *Price reductions* are temporary price discounts that aim to foster sales. Price reductions can be initiated by the manufacturer seeking to increase sales or by the retailer trying to move the merchandise and clear the inventory. Price reductions can be framed in terms of specific monetary amounts or as a percentage.[55]
- *Coupons* are certificates entitling the bearer to a stated saving on the purchase of a specific product. They can be mailed, enclosed in or attached to other products, inserted in magazine and newspaper ads, e-mailed, or made available online.[56]

- *Cash refunds* provide a price reduction after purchase rather than at the retailer: The consumer sends a specified "proof of purchase" to the manufacturer, who "refunds" part of the purchase price by mail. Auto companies and other consumer-goods companies offer cash rebates to encourage purchase of the manufacturers' products within a specified time period. Rebates can help clear inventories without cutting the stated list price.[57]
- *Price packs* offer savings off the regular price of a product, flagged on the label or package. A *reduced-price pack* is a single package sold at a reduced price (such as two for the price of one). A *banded pack* is two related products banded together (such as a toothbrush and toothpaste).[58]
- *Premiums* (bonus offerings) are merchandise offered at a relatively low cost or free as an incentive to purchase a particular product. A premium can accompany the product (packed inside or affixed to the package), or it can be distributed via a different channel (such as by mail).
- *Frequency programs* provide rewards related to the consumer's frequency and intensity in purchasing the company's products or services.
- *Prizes* are offers of the chance to win cash, trips, or merchandise as a result of purchasing something. A *contest* calls for consumers to submit an entry to be examined by a panel of judges who will select the best entries. A *sweepstakes* asks consumers to submit their names in a drawing. A *game* presents consumers with something every time they buy—bingo numbers, missing letters—which might help them win a prize.[59]
- *Tie-in promotions* involve a scenario in which two or more brands or companies team up on coupons, refunds, and contests to increase pulling power.
- *Seasonal discounts* are price reductions for those who buy merchandise or services out of season. Hotels, motels, and airlines offer seasonal discounts in slow selling periods.
- *Financing* involves providing favorable financing terms in order to increase the attractiveness of an offering for consumers. Alternatively, sellers (especially mortgage banks and auto companies) offer extended payment terms by stretching loans over longer periods and thus lowering the monthly payments.

Selecting Trade Incentives. Manufacturers award money to distribution channel members in the form of trade incentives. Unlike consumer incentives that aim to create greater value for buyers, **trade incentives** aim to increase the attractiveness of the offering for the members of the distribution channel—wholesalers, retailers, and dealers. Specifically, manufacturers use a number of trade promotion tools:[60]

- *Allowances* are extra payments offered in return for the retailer's performing certain functions, such as promoting the offering at the point of sale, keeping a larger inventory to ensure product availability, and providing additional value-added services.

- *Free goods* are free merchandise to intermediaries who buy a certain quantity or who feature a certain flavor or size.
- *Price-off* is a straight discount off the list price on each case purchased during a stated time period.
- A *payment discount* is a price reduction to buyers who pay bills promptly. A typical example is "2/10, net 30," which means payment is due within 30 days but the buyer can deduct 2 percent by paying within 10 days.

The growing power of large retailers has increased their ability to demand trade promotions.[61] The manufacturer's sales force and its brand managers are often at odds here. The sales force says local retailers will not keep the company's products on the shelf unless they receive more trade promotion money, whereas brand managers want to spend their limited funds on consumer promotion and advertising.

Manufacturers, who often find it difficult to police retailers to make sure they are doing what they agreed to do, increasingly insist on proof of performance before paying any allowances. Manufacturers face several challenges in managing trade promotions. Some retailers are doing **forward buying** —that is, buying a greater quantity during the deal period than they can immediately sell. The manufacturer must then schedule more production than planned and bear the costs of extra work shifts and overtime. Other retailers are *diverting*—that is, buying more than needed in a region where the manufacturer offers a deal and shipping the surplus to their stores in non-deal regions. Manufacturers handle forward buying and diverting by limiting the amount they will sell at a discount or producing and delivering less than the full order in an effort to smooth production.

Selecting Sales Force Incentives. Companies spend billions of dollars on sales force promotion tools to gather leads, impress and reward customers, and motivate the sales force. **Sales force incentives** aim to encourage the sales force to support a new product or model, boosting prospecting and stimulating off-season sales. Sales contests are one popular type of sales force incentive. A sales contest aims at inducing the sales force or dealers to increase sales results over a stated period, with prizes (money, trips, gifts, or points) going to those who succeed.

The budgets that companies develop for incentive tools typically remain fairly constant from year to year. For many new businesses that want to make a splash with a targeted audience, especially in the B2B world, trade shows are an important tool, but the cost per contact is the highest of all communication options. The topic of managing sales force and personal selling is discussed in more detail in Chapter 15.

marketing INSIGHT

Ethical Issues in Prescription Drug Pricing

The United States spends nearly $330 billion a year on prescription drugs. In the past three decades, the share spent for pharmaceuticals nearly doubled, to reach about 10 percent of total health care spending. The U.S. government spends more on health care than it spends on any other single segment of the federal budget, including defense and Social Security. The United States spends more on drugs than any other country and twice as much as the average of the other major industrialized countries.

Pricing prescription drugs raises the ethical question of how much pharmaceutical companies should charge for their products. Some companies look at drug pricing from a purely financial perspective. To justify the decision to raise the price of nitrofurantoin (a drug listed by the World Health Organization as an “essential” medicine for lower urinary tract infections) from about $500 per bottle to more than $2,300. Nirmal Mulye, founder of Nostrum Pharmaceuticals, argued that his company had “a moral requirement to make money and sell the product for the highest price.”

Examples of companies raising the prices of proprietary drugs abound. EpiPen—a medical device for injecting a measured dose of epinephrine as an emergency treatment of serious allergic reactions to insect stings/bites, foods, drugs, or other substances—went from $100 for a two-pack in 2009 to $608 in 2016. With nearly a 90 percent market share, EpiPen accounted for about 40 percent of the profits of Mylan, its parent company. EpiPen was generating a net profit margin of about 55 percent, significantly higher than the company's overall profit margin of 8.9 percent.

Perhaps the most extreme example of purely profit-driven pricing is that of Turing Pharmaceuticals. After acquiring the rights to the 60-year-old Daraprim—the only medication available for treating several rare life-threatening diseases—the company increased the price from $13.50 per tablet to $750 per tablet, a 5,000 percent jump. Turing's actions resulted in a public outcry about price-gouging, followed by resignation of its CEO and a congressional inquiry into the company's pricing practices.[62]

Unlike pricing discretionary consumer products, pricing prescription drugs can have a direct impact on social welfare. Raising prices can lead to the inability of economically disadvantaged patients to afford critical medicine, causing them to skip doses of their medications, take smaller doses, or abandon treatment altogether. The societal impact of drug pricing calls for developing an approach that goes beyond merely optimizing corporate profits.

A particular challenge is the rather opaque process of drug pricing. To add transparency to prescription drug pricing, the American Marketing Association launched the TruthinRx campaign in 2016. This grassroots campaign enables patients and physicians to share their experiences with prescription drug pricing to gather public support for regulations requiring drug price transparency. The TruthinRx campaign is focusing on three major market players that significantly impact drug prices: (1) pharmaceutical companies that make and market drugs, (2) pharmacy benefit managers who work on behalf of health insurance companies or employers to negotiate upfront discounts on the prices of prescription drugs with pharmaceutical companies, and (3) health insurance companies that approve prescriptions, set co-pays, and work with pharmacy benefit managers to determine how much patients pay for drugs.[63]

SUMMARY

1. Price is the only marketing element that produces revenue; the others produce costs. Pricing decisions have become more challenging in a changing economic and technological environment.
2. Purchase decisions are based on how consumers perceive prices, rather than just on the offering's stated price. Understanding how consumers arrive at their perceptions of prices—and, specifically, the role of reference prices, price–quality inferences, and price endings—can help the company set the optimal market price.
3. In setting pricing policy, a company follows a six-step procedure. It selects its pricing objective. It estimates the demand curve, the probable quantities it will sell at each possible price. It estimates how its costs vary at different levels of output, at different levels of accumulated production experience, and for differentiated marketing offers. It examines competitors' costs, prices, and offers. It selects a pricing method, and it sets the final price.
4. When setting a price, a company can pursue different objectives: current profit, market penetration, market skimming, and leadership in product quality. The clearer a firm's objectives, the easier it is to set price.
5. The demand curve shows the market's probable purchase quantity at alternative prices, summing the reactions of many individuals with different price sensitivities. Marketers need to know how responsive, or elastic, demand is to a change in price.
6. Price setting is driven by three major considerations: costs, competitors, and customers. Costs set a floor for the price. Competitors' prices and the price of substitutes provide an orienting point. Customers' assessment of unique features establishes the price ceiling. Common price-setting methods include markup pricing, target-rate-of-return pricing, economic-value-to-customer pricing, competitive pricing, and auction pricing.
7. Marketers must modify their price-setting logic when the product is part of a product mix and the company's goal is to maximize the profits on

the total mix. Common scenarios for product-mix pricing include loss-leader pricing, optional-feature pricing, captive-product pricing, two-part pricing, by-product pricing, and product bundling.

8. To gain market position and grow profits, companies often take aggressive pricing actions, either lowering their prices, typically to lure competitors' customers, or raising prices to capture greater value from its current customers. Companies must anticipate competitor price changes and prepare contingent responses, which may include maintaining or changing price or quality.
9. The firm facing a competitor's price change must try to understand the competitor's intent and the probable duration of the change. A market leader attacked by lower-priced competitors can seek to better differentiate itself, to introduce its own low-cost competitor, or to transform itself completely.
10. Incentives consist of a collection of incentive tools, mostly short-term, designed to stimulate quicker or greater purchase of particular products or services by consumers or the trade. In using incentives, a company must establish its objectives, select the tools, develop the program, implement and control it, and evaluate the results.
11. In designing incentives, a firm must decide how much effort to devote to push strategies and to pull strategies. A push strategy uses the manufacturer's sales force, trade promotion money, or other means to induce intermediaries to carry, promote, and sell the product to end users. In a pull strategy, the manufacturer uses advertising and incentives to persuade consumers to demand the product from intermediaries, thus inducing the intermediaries to order it. Selecting the right mix of push and pull strategies is an important ingredient in securing trade support.

marketing SPOTINSIGHT

PRICELINE

Priceline launched in 1998 when Jay S. Walker first introduced its "Name Your Own Price" service for purchasing airline tickets online.

Priceline flipped the conventional system of purchasing goods by having the buyer “set” prices. Typically, sellers advertise a good in the marketplace at a specific price, and buyers decide whether they want it. Priceline designed a mechanism whereby customers logged on to the company website, posted an “advertisement” that indicated where they wanted to go, the dates of travel, and the price they were willing to pay. Priceline then searched the databases of partnered airlines for compatible tickets. Customers had to be flexible about the carrier and the time of day for their flight; they received their ticket and carrier information only after the transaction was completed.

At the start of its airline ticket service, Priceline partnered only with America West and TWA. A year after inception, Priceline had sold tickets to over 1 million individuals. Shortly after, big-name air carriers such as United, American, and Delta joined as partners. Priceline’s model of online bookings proved valuable to airlines, because the carrier is anonymous throughout the buying process and doesn’t have to dilute its brand by selling tickets at large discounts while also maintaining its own established prices. The model was also attractive to budget-conscious travelers because, on average, customers found lower prices than they otherwise would have through their own online searches.

Source: NetPhotos/Alamy Stock Photo

The company grew at a dramatic pace, and Priceline hired William Shatner to spearhead its advertising campaigns. Priceline spent millions to feature Shatner in newspaper and radio advertisements. Its advertising efforts proved successful in increasing brand awareness. Priceline became one of the top 10 best-known internet websites by 1999. Revenues in 1999 reached approximately $500 million, and Priceline's IPO was $12.9 billion, the highest first-day value at the time. Throughout that year, Priceline expanded its Name Your Own Price system to selling automobiles, hotel rooms, home financing, and even groceries. Priceline partnered with various companies and was on its way to becoming an internet megabrand.

Priceline took a nosedive when the dot-com bubble burst in the early 2000s. The stock lost over 99 percent of its value, falling from a peak of $974 to approximately $7. Jay Walker left the company as well, choosing to focus on a different company. To recover from the financial disaster, the company quit the non-travel businesses and ironically became profitable for the first time in 2001. In 2002, the company started to expand its travel operations beyond the Name Your Own Price model. Priceline acquired the European hotel-booking sites Active Hotels and

Booking.com in 2004 and 2005, respectively, a move that would eventually be hailed as one of the most successful acquisitions in internet history. Priceline acquired Agoda.com, an online travel agency in Southeast Asia, in 2007; Rentalcars.com, a car rental service, in 2010; Kayak, a meta-search company, in 2013; and OpenTable, a restaurant reservation service, in 2014. Priceline's business expansion caused its stock to surpass the peak it had reached in 1999.

Much of Priceline's success can be attributed to the company's focus on businesses in the most profitable segments of online travel. Hotels account for over 85 percent of Priceline's gross bookings, compared to 48 percent for Expedia, Priceline's closest competitor. The hotel market is less concentrated than air travel, so Priceline can generate more profit by concentrating on hotel bookings, for which it can charge a 15 percent to 20 percent commission, compared to about 3 percent for air bookings. In addition, much of Priceline's gross bookings are in Europe. In contrast to the United States, European hotel markets consist mostly of independent properties, which means that they have a more difficult time attracting customers. By properly indexing European hotels, Priceline achieves greater bargaining power in its commission.

Priceline's data analytics processes also create a competitive advantage. Priceline carefully researches how and where it purchases online ads. This approach across all of its businesses has created industry-leading advertising effectiveness. The company spends an average of $7.50 per booked hotel room, compared to $16.00 for Expedia. In addition, Priceline uses data analytics to maximize its website "conversions"—when a consumer moves from browsing the website to booking a service. Priceline's research of customer demographics and behaviors allows it to leverage personalized ads on websites and in e-mails. Priceline achieved the industry's highest conversion rate in 2019; the high conversion increases profit margins on each booking.

Priceline has led the online travel industry by a wide margin. Its market capitalization is over three times that of its next closest competitor. The foundation of Priceline's success is its focus on profitable market segments and rigorous dedication to data analytics, enables the company to achieve high profit margins.[64]

Questions

1. How important was the Name Your Own Price approach to Priceline's market success?
2. What are the pros and cons of the Name Your Own Price approach to setting an offering's price?
3. Is setting prices based on one's willingness to pay fair? Does it create value for customers? Does it create value for the firm?

marketing SPOTINSIGHT

UBER

The origins of Uber trace back to 2008, when Travis Kalanick and Garrett Camp, both start-up entrepreneurs, were having trouble finding a taxi on a snowy winter day. The two were inspired to create a smartphone app that would call a taxi cab. Returning to San Francisco, Camp bought the domain name UberCab.com, and the company officially launched two years later. UberCab was initially a private luxury car service for San Francisco and Silicon Valley executives. Interested customers first had to e-mail Kalanick for access to the application. After entering their payment information, customers were able to summon a private black car. Unlike traditional black car services, the UberCab app allowed passengers to track the arriving car's location and also guided the driver to the rider's destination.

Uber began building traction almost immediately after the app launched. Executives were particularly drawn by the sheer convenience of Uber. Most executives had to book an expensive private car well in advance. Uber allowed them to quickly book a ride wherever they were. UberBlack was priced lower than private limousines but was more expensive than a typical cab ride. By the end of the year, Uber had dropped the Cab from its name and had thousands of users riding around San Francisco. As Uber attracted more and more customers and drivers, investors also became interested in the company. In February 2011, Uber raised $11 million from venture-capital firm Benchmark. Convinced that the concept it had created could scale, Uber began to expand across the nation and worldwide. In May of 2011, Uber launched in New York City. Later that year, Uber launched its service in Paris.

Source: digitallife/Alamy Stock Photo

In 2012, Uber introduced a new service called uberX, a cheaper version that allowed drivers to use their personal vehicles instead of black cars to pick up passengers. The qualifications to be an uberX driver were much less strict than those for UberBlack, which required that drivers be licensed limousine operators and that their vehicles meet Uber’s criteria for a black car service. All uberX drivers needed were a driver’s license, auto insurance, and a clean driving record. UberX was priced at around 10 percent less than the cost of a traditional taxi. In 2014, Uber revealed its UberPOOL service, which paired riders who were going in the same direction so they could share a ride. Uber's version of carpooling saved customers around 50 percent of the cost of a taxi cab ride.

The key to Uber's success is its ease of use. Riders simply need to download the app, create an account, and enter their payment information. The app displays available drivers nearby. To summon one, riders simply input their destination and press a button to be matched with a driver. The customer can track the location of the matched driver, view the driver's name and car information, and look at the driver's quality rating. Customers are able to refuse drivers with low ratings. Like riders, drivers have the right to refuse customers with sufficiently low ratings. The driver app also shows locations with higher numbers of customers requesting rides. Within minutes of being matched with a driver, the customer can be on his or her way.

At the end of the ride, the cost is automatically deducted from the rider's payment method, with Uber retaining 25 percent of the fare in addition to a booking fee—a flat fee that covers regulatory, safety, and operational costs. Prices are determined by the time and distance of the ride. To balance supply and demand, Uber also charges a "Surge Pricing Premium" during times with high rider traffic, a practice that can multiply the normal fare by as much as seven times. Uber's surge pricing has been met with some customer dissatisfaction and concerns about price fairness. When the East Coast was experiencing heavy snow in 2013, customers submitted screen shots of their surged bills on social media; some were as high as $400 for a single ride. Despite customer concerns, Uber has retained surge pricing as a source of customer segmentation and as an incentive to attract drivers to specific locations during times of high demand.

Uber's rapid expansion across the world has been met with opposition from policy makers and the taxi industry. Many officials have questioned the legality of Uber's ride service and whether Uber should be subject to the same laws that taxi and limousine services are. Uber has been partially banned in France, Italy, and Finland, and in some other locations, such as Australia, Hong Kong, and Bulgaria, it has been banned altogether. Because uberX and UberPool's prices are often lower than the average taxi cab fare, taxi cab drivers have found themselves losing a significant portion of their customers. Many taxi drivers also find it unfair that they are required to undergo more stringent background checks and purchase a license (medallion) to legally drive customers, whereas Uber's requirements are much more relaxed.

Uber's growth in the decade after the company launched has been staggering. In 2019, Uber was available in over 700 metropolitan areas worldwide. Uber is estimated to have more than 100 million worldwide users, and it generated over $11 billion in revenue in 2018. Uber's combination of convenience and fair pricing has completely transformed transportation across the world. In addition to car ridesharing, Uber has branched off into food delivery service with the creation of UberEATS. The company has also announced plans to introduce an aerial ridesharing service called Uber Elevate.[65]

Questions

1. What were the key factors that contributed to Uber's phenomenal market success?
2. What was Uber's customer value proposition? What role did Uber's pricing play in its ability to attract riders?
3. Is surge pricing fair? What alternative strategies could Uber use to balance supply and demand?