Pricing Strategy

I. Demand Influences on Pricing Decisions

- Demand influences on pricing decisions concern primarily the nature of the target market and expected reactions of consumers to a given price or change in price.
- There are three primary considerations here—demographic factors, psychological factors, and price elasticity.

A. Demographic Factors

- Demographic factors that are particularly important for pricing decisions include the following:
  - Number of potential buyers
  - Location of potential buyers
  - Position of potential buyers (organizational buyers or final consumers)
  - Expected consumption rates of potential buyers
  - Economic strength of potential buyers
- These factors help determine market potential and are useful for estimating expected sales at various price levels.

B. Psychological Factors

- Psychological factors related to pricing concern primarily how consumers will perceive various price or price changes.
- There are three types of psychological pricing strategies.
  - First, there is *prestige pricing,* in which a high price is charged to create a signal that the product is exceptionally fine.
  - Second, there is *odd pricing,* or odd-even pricing, in which prices are set a few dollars or a few cents below a round number.
  - Third, there is *bundle pricing,* in which several products are sold together at a single price to suggest a good value.

C. Price Elasticity

- Both demographic and psychological factors affect price elasticity.
- *Price elasticity* is a measure of consumers' price sensitivity, which is estimated by dividing relative changes in the quantity sold by the relative changes in price:

$$e = \frac{\text{Percent change in quantity demanded}}{\text{Percent change in price}}$$

- Although price elasticity is difficult to measure, two basic methods are commonly used to estimate it:
  - First, price elasticity can be estimated from historical data or from price or

quantity data across different sales districts.
    - Second, price elasticity can be estimated by sampling a group of consumers from the target market and polling them concerning various price/quantity relationships.
- Both of these approaches provide estimates of price elasticity; but the former approach is limited to the consideration of price changes, whereas the latter is often expensive and there is some question as to the validity of subjects' responses.

II. Supply Influences on Pricing Decisions

- Supply influences on pricing decisions can be discussed in terms of three basic factors. These factors relate to the objectives, costs, and nature of the product.

A. Pricing Objectives

- Pricing objectives should be derived from overall marketing objectives, which in turn should be derived from corporate objectives.
- Because it is traditionally assumed that business firms operate to maximize profits in the long run, it is often thought that the basic pricing objective is solely concerned with long-run profits.
- However, the profit maximization norm does not provide the operating marketing manager with a single, unequivocal guideline for selecting prices.
- Research has found that the most common pricing objectives are:
    - Pricing to achieve a target return on investment
    - Stabilization of price and margin
    - Pricing to achieve a target market share
    - Pricing to meet or prevent competition

B. Cost Considerations in Pricing

- The price of a product usually must cover costs of production, promotion, and distribution.
- Cost-oriented pricing is the most common approach in practice, and there are at least three basic variations: markup pricing, cost-plus pricing, and rate-of-return pricing.
- *Markup pricing* is commonly used in retailing: A percentage is added to the retailer's invoice price to determine the final selling price.
- Closely related to markup pricing is *cost-plus pricing*, in which the costs of producing a product or completing a project are totaled and a profit amount or percentage is added on.
- *Rate-of-return pricing* is commonly used by manufacturers. With this method, price is determined by adding a desired rate of return on investment to total costs.
- Cost-oriented approaches to pricing have the advantage of simplicity, and many practitioners believe that they generally yield a good price decision. However, such approaches have been criticized for two basic reasons.
    - First, cost approaches give little or no consideration to demand factors.
    - Second, cost approaches fail to reflect competition adequately.

C. Product Considerations in Pricing

- Although numerous product characteristics can affect pricing, three of the most important are:
    - Perishability
    - Distinctiveness
    - Stage in the product life cycle

Perishability

- Some products, such as fresh meat, bakery goods, and some raw materials are physically perishable and must be priced to sell before they spoil.
- Typically, this involves discounting the products as they approach being no longer fit for sale.
- Products can also be perishable in the sense that demand for them is confined to a specific time period.

Distinctiveness

- Marketers try to distinguish their products from those of competitors and if successful, can often charge higher prices for them.
- While such things as styling, features, ingredients, and service can be used to try to make a product distinctive, competitors can copy such physical changes.
- Thus, it is through branding and brand equity that products are commonly made distinctive in customers' minds.

Life Cycle

- The stage of the life cycle that a product is in can have important pricing implications.
- With regard to the life cycle, two approaches to pricing are skimming and penetration price policies.
    - *A skimming policy* is one in which the seller charges a relatively high price on a new product.
    - *A penetration policy* is one in which the seller charges a relatively low price on a new product.

III. Environmental Influences on Pricing Decisions

- Environmental influences on pricing include variables that the marketing manager cannot control. Three of the most important of these are the Internet, competition, and government regulation.

A. The Internet

- One of the biggest influences on pricing decisions has been the development of the Internet. Prior to its development, it was difficult for consumers to compare prices effectively.
- Consumers would have to travel from store to store or call each store and try to find identical brands and models to compare prices.
- However, consumers now can simply go from store to store online and compare prices, or go to websites that do price comparisons for them and find the best deals (e.g., kayak.com and expedia.com).
- In sum, the Internet has made prices much easier for consumers and organizational buyers to compare and has forced marketers to be much more transparent in their pricing strategies.

B. Competition

- In setting or changing prices, the firm must consider its competition and how competition will react to the price of the product.
- Initially consideration must be given to such factors as:
    - Number of competitors
    - Market shares, growth, and profitability of competitors
    - Strengths and weaknesses of competitors
    - Likely entry of new firms into the industry
    - Degree of vertical integration of competitors
    - Number of products sold by competitors
    - Cost structure of competitors
    - Historical reaction of competitors to price changes
- These factors help determine whether the firm's selling price should be at, below, or above competition.
- Pricing a product at competition is called *going-rate pricing* and is popular for homogeneous products, since this approach represents the collective wisdom of the industry and is not disruptive of industry harmony.
- An example of pricing below competition can be found in *sealed-bid pricing*, in which the firm is bidding directly against competition for project contracts.
- A firm may price above competition because it has a superior product or because the firm is the price leader in the industry.

C. Government Regulations

- Prices of certain goods and services are regulated by state and federal governments. Public utilities are examples of state regulation of prices.
- The following list is a summary of some of the more important legal constraints on pricing.
    - *Price fixing* is illegal per se. Sellers must not make any agreements with competitors or distributors concerning the final price of goods.
        - The Sherman Antitrust Act is the primary device used to outlaw horizontal

    price fixing. Section 5 of the Federal Trade Commission Act has been used to outlaw price fixing as an unfair business practice.
  - *Deceptive pricing* practices are outlawed under Section 5 of the Federal Trade Commission Act.
    - An example of deceptive pricing would be to mark merchandise with an exceptionally high price and then claim that the lower selling price actually used represents a legitimate price reduction.
  - *Price discrimination* (the practice of charging different prices to different buyers for goods of like grade and quality) that lessens competition or is deemed injurious to it is outlawed by the Robinson-Patman Act.
    - Price discrimination is not illegal per se, but sellers cannot charge competing buyers different prices for essentially the same products if the effect of such sales is injurious to competition.
  - *Predatory pricing* involves charging a very low price for a product with the intent of driving competitors out of business.
    - It is illegal under the Sherman Act and Federal Trade Commission Act.

IV. A General Pricing Model

- It should be clear that effective pricing decisions involve considerations of many factors, and different industries may have different pricing practices.
- Figure 11.1 presents a general model for developing prices for products and services.

A. Set Pricing Objectives

- Given a product or service designed for a specific target market, the pricing process begins with a clear statement of the pricing objectives.
- These objectives guide the pricing strategy and should be designed to support the overall marketing strategy.
- Because pricing strategy has a direct bearing on demand for a product and the profit obtained, efforts to set prices must be coordinated with other functional areas.

B. Evaluate Product–Price Relationships

- As noted, the distinctiveness, perishability, and stage of the life cycle a product is in all affect pricing.
- In addition, marketers need to consider what value the product has for customers and how price will influence product positioning. There are three basic value positions.
  - First, a product could be priced relatively high for a product class because it offers value in the form of high quality, special features, or prestige.
  - Second, a product could be priced at about average for the product class because it offers value in the form of good quality for a reasonable price.
  - Third, a product could be priced relatively low for a product class because it offers value in the form of acceptable quality at a low price.
- Setting prices so that targeted customers will perceive products to offer greater value than competitive offerings is called *value pricing*.

C. Estimate Costs and Other Price Limitations

- The costs to produce and market products provide a lower bound for pricing decisions and a baseline from which to compute profit potential.
- If a product cannot be produced and marketed at a price to cover its costs and provide reasonable profits in the long run, then it should not be produced in its designed form. One possibility is to redesign the product so that its costs are lower.
- Other price limitations that need to be considered are government regulations and the prices that competitors charge for similar and substitute products.

D. Analyze Profit Potential

- Analysis in the preceding stages should result in a range of prices that could be charged. Marketers must then estimate the likely profit in pricing at levels in this range.
- At this stage, it is important to recognize that it may be necessary to offer channel members quantity discounts, promotional allowances, and slotting allowances to encourage them to actively market the product.
- *Quantity discounts* are discounts for purchasing a large number of units.
- *Promotional allowances* are often in the form of price reductions in exchange for the channel member performing various promotional activities, such as featuring the product in store advertising or on in-store displays.
- *Slotting allowances* are payments to retailers to get them to stock items on their shelves.

E. Set Initial Price Structure

- The price structure takes into account the price to various channel members, such as wholesalers and retailers, as well as the recommended price to final consumers or organizational buyers.

F. Change Price as Needed

- There are many reasons why an initial price structure may need to be changed. Channel members may bargain for greater margins, competitors may lower their prices, or costs may increase with inflation.
- In the short term, discounts and allowances may have to be larger or more frequent than planned to get greater marketing effort to increase demand to profitable levels.
- In the long term, price structures tend to increase for most products as production and marketing costs increase.