Certified Pricing Professional™


Professional Pricing Society™

# Exam Study Guide

*Second Edition*

**Certified Pricing Professional Study Guide**
$2^{nd}$ Edition Printing: July, 2008



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# Introduction to the CPP Study Guide

Dear Candidate:

Congratulations on completing the six prerequisite credits for the Certified Pricing Professional (CPP) Exam! We commend you for your efforts in this continuing professional education program.

Your participation in this course signals to your peers, employers, and even to your employees that you are committed to serious professional development, and your successful completion of the CPP Exam will formally validate your proficiency in the latest pricing solutions and methodologies.

We at the Professional Pricing Society have developed this comprehensive study guide to help you prepare for the CPP Exam. The study guide has been divided into two primary sections, each with seven modules:

I. **Subject Matter Expertise for Pricing**

II. **Managing the Pricing Function**

Each of the fourteen modules in this study guide contains three important supplemental sections: "PPS References" (which list key core PPS articles),"Additional References" (which list optional reading for exceptionally serious pricers), and "Review Questions" (which have been designed to help you understand the types of questions that will appear on the CPP Exam). The answer key for all of the review questions is provided at the end of the study guide.

The CPP Exam has been designed so that *75%* of the questions derive directly from the study guide content, *20%* of the questions from the "PPS References," and *5%* from life experience.

If you carefully read the material presented in this study guide, familiarize yourself with the articles listed in the "PPS References," and successfully complete the "Review Questions" provided for each module, then you should be thoroughly prepared for at least *95%* of the CPP Exam questions.

We wish you the best of luck with your final preparations for the CPP Exam.
Please do not hesitate to let us know if you have any questions.

Julie R. Martin

Director of Certification and Education
The Professional Pricing Society

## Acknowledgements

The Professional Pricing Society would like to take a moment to acknowledge the many people who have been instrumental in the development of this Certified Pricing Professional program. This has been a truly collaborative effort.

Dr. Richard Lancioni's team of enthusiastic, cooperative, and dedicated doctoral students from the Temple University School of Business were the primary authors of the first edition of this study guide. Suzanne Chehayeb Makarem, David DiRusso and Ellen Thomas never ceased to amaze us with their ability to condense and present the incredibly broad (and often complicated) material from the discipline of pricing.

The Professional Pricing Society Board of Advisors was kind enough to provide critical feedback for early drafts of the text to help ensure quality control. We must thank all of these individuals for their time and excellent recommendations: Eric G. Mitchell, Jerold (Jerry) M. Bernstein, Janelle Brechon, Xan Chamberlain, Marty Coalson, Jim Geisman, Stacey Schaeffer, Richard Lancioni, Scott Hornick, Gary Ritzert, and Laura Preslan. Their thoughtful and timely participation in the development process was invaluable to this program.

The Simon Graduate School of Business from the University of Rochester has also been instrumental in the continued development of this program. The thorough review of the material by Dr. Greg Shaffer and his team of graduate students helped to shape the second edition of the study guide, and their input will surely continue to influence future editions. We send them our sincere gratitude.

Michael Hamrick and his team from *Perfect Pitch Concepts* (a professional copywriting and website development company based in Atlanta, GA) have done a wonderful job with the significant revisions to the text and graphics for this latest second edition. We think you will agree that their improvements to the overall quality of writing and the phrasing of key concepts throughout the study guide have significantly strengthened the CPP program.

The final acknowledgement must be to Eric Mitchell, the President of the Professional Pricing Society. It has been his vision for over twenty years to provide a true certification program to support the pricing community. His vision of building an organization of like-minded individuals that could support each other with strong educational programs, enhanced networking opportunities, and a formal certification program is now a reality.

We offer a truly sincere "thank you" to all of those above for their help in bringing this program this far, and we hope you will all be with us as the program continues to evolve.

Sincerely,

The Professional Pricing Society

# CPP Study Guide Contents

## PART I: SUBJECT MATTER EXPERTISE FOR PRICING



## PART II: MANAGING THE PRICING FUNCTION



## SUPPLEMENTAL MATERIALS

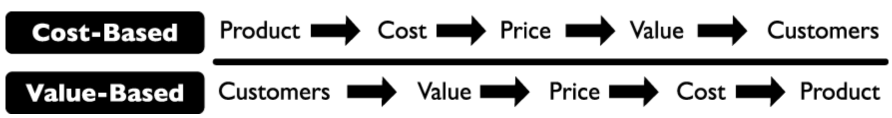
# Module 1:
# Foundations of Pricing and Pricing Management

# Introduction

Among the "4P's of Marketing" (Pricing Strategies, Production Costs, Product Distribution & Promotional Costs), pricing is the *only* element that produces revenues instead of costs. Firms do not typically establish specific prices for individual items. They instead devise broad, adaptive pricing structures that may include techniques such as discounts, promotional pricing, and discriminatory pricing.

When selecting pricing methods, firms consider the "3C's of Marketing" (Costs, Customers, and Competitors). Some recommended pricing methodologies include *Mark-up* pricing, *Target-Return* pricing, *Perceived Value* pricing, *Value* pricing, *Going-Rate* pricing, and *Auction-Type* pricing.[6] While pricing has the potential to be a powerful tool for achieving strategic business goals, traditional pricing practices such as *Cost-Plus* pricing, *Customer-Driven* pricing, and *Competitor-Driven* pricing can limit a company's ability to drive profitable growth.

*Cost-Plus* pricing suffers from the assumption that unit costs can be determined before price, and that prices do not impact demand (ultimately affecting production costs). Cost-based pricing limits profitability through inaccurate pricing, but it can also lead to the "death spiral." This phenomenon occurs when prices increase to cover costs (which reduces demand, which then increases production costs further, and so forth). Notice how this pattern of *cost-based* pricing differs from the *value-based* structure that will be strongly advocated throughout this course:




*Customer-Driven* pricing is based on customers' willingness to pay, but this willingness might be unknown to the buyers (especially when the product is new and its features are not yet fully understood). The strategic pricing practices outlined in this course will focus on *communicating* the ultimate value of a product to customers rather than creating pricing structures based primarily on what they claim to be willing to pay.

*Competitor-Driven* pricing is dictated by competitive conditions and it might lead to an excessive focus on market share and diminished emphasis on increasing profits.

To surpass the limitations of traditional pricing structures, companies should adopt *strategic* pricing. Strategic pricing synthesizes information from disparate functional areas such as finance, accounting, marketing, and sales to produce optimal pricing decisions. For example, while marketing managers have the responsibility to *anticipate* the market value created using customer and competitor data, the sales department is ultimately responsible for *communicating* this value to the customer. These departments must work with each other as well as the finance department, which can then set appropriate financial objectives based on incremental profitability.[9]

Pricing is both an art and a science. Pricers must ground their work in quantitative approaches while also employing sound judgment in dealing with the more ambiguous, qualitative issues that are common in pricing problems. Successful pricing strategies should always follow the three guiding principles of strategic pricing by being *value-based*, *proactive*, and *profit-driven*.[9]

## The Concept of Price

**Price** is the amount of resources (typically understood as money, goods, or services) that must be sacrificed in order to acquire some other resource. Price ought to reflect the **Value** of the desired resource, or its relative worth, merit, or importance. A truly value-aligned price will account for a transaction's full value.

$$\textbf{Value-Aligned Price} = \frac{\text{Quantity of resources received by the } \textit{Seller}}{\text{Quantity of resources received by the } \textit{Buyer}}$$

The value-aligned price is not technically a price, but a ratio illustrating the value of a product or service, usually in terms of the money paid (for example, $3 for one box of cereal). If sellers primarily focus on what a buyer pays (and neglect the value that is provided), then it is unlikely that they will create truly value-aligned prices. However, if buyers only focus on what they are paying, they may not understand the full value of what they are receiving. Therefore, it is important that both parties in any transaction understand the relationship between the value of a product or service and its price.

Pricing practices are not limited to simply changing the amount of resources received by the seller.[8] It is possible to alter the price of a good or service by changing the following: [8]

- Quantity of resources paid by the buyer
- Quantity of resources received by the buyer
- Quality of resources received by the buyer
- Premiums or discounts applied for quantity variations
- Time and place of the transaction
- Time and place of the payment
- Acceptable forms of payment

In order to modify the price of a good or service in any of the above ways, it is necessary to first understand the basic rules of pricing. These rules require knowledge in five areas: the firm's *objectives*, *customers*, *competitors, industry*, and its *costs*.[14]

One must also understand the fundamental types of prices. There is a **List Price** (the quoted price of a good or service), **Invoice Price** (the price after volume, trade, and cash discounts), and **Pocket Price** (the price after all allowances, refunds, and discounts).[14]

In addition to these fundamentals of pricing, there are some trends that have made pricing even more challenging in recent years. These trends include customers who are less familiar with what they are buying, competition shifting from channel and product-based segmentation to price-based segmentation, and the emergence of sophisticated pricing structures and capabilities.[15]

## Price and the Economy

In a free market economy, pricing plays a central role in allocating resources and determining *what* is produced, *how* it is produced, and *for whom* it is produced. Pricing impacts demand, and the distribution of goods, services, and income.[1]

Popular economic theory assumes that the primary objective of the firm is to "maximize profits" and that all decisions of output quantities are made to ensure that the firm meets this objective. However, managers have personal objectives that interact with environmental factors to produce a set of broader objectives that are not easily reduced to making profits. Although profits are certainly important, making *satisfactory* profits is a more common and realistic objective than *maximizing* profits.[8]

Corporate pricing objectives include profitability objectives such as maximizing profits and achieving target return on investment (ROI). Profitability objectives are based on four major elements: price per unit, variable and fixed costs, production volume, and monetary sales mix.

Volume-based objectives such as market share, competitive objectives such as stable prices, and non-price competition are other types of corporate objectives. Each type can be appropriate under specific circumstances that are determined by the nature of the market, the cost and production systems of the firm, and the managerial orientation of the firm.

The degree of power a firm has over prices is determined by the market structure in which it operates. Under a perfect monopoly, the firm has a considerable level of control over price (constrained somewhat by government regulations). This control is significantly lower when the firm operates under imperfect competition (such as an oligopoly). Under a system of perfect competition, no single firm can wield complete control over price.[8]

## Price and the Firm

For the firm, price is the only source of revenue among the "4P's of Marketing" and it ultimately determines the firm's profitability. Pricing is becoming increasingly important due to the proliferation of product substitutes, increased competition, advances in technology, and other environmental factors that necessitate smarter, faster, and more frequent pricing decisions.[8]

In a recessionary environment, it is best to focus on prices rather than costs. A small change in price can affect profitability by a much larger proportion, especially when considering that a decrease in costs tends to have a smaller impact on operating profits. Furthermore, price elasticity plays a crucial role in determining the impact of a price change. There have fortunately been technological advancements that allow firms and researchers to estimate price elasticities more accurately.[3]

### Reactive vs. Proactive Pricing

**Reactive Pricing** practices are based on internal costs, selling methods, and reacting to competitors. Two of the following types of strategies are outlined below:

- *Cost-Based*: use cost-plus pricing, or drop low-margin products
- *Selling-Based*: alter cash and quantity discounts, or drop marginal customers

**Proactive Pricing** practices consider the complete customer perception of value and the effect that pricing has on market demand. These practices require an understanding of "how pricing works" and "how customers perceive prices and price changes." [8]

## Initial Pricing Discretion

The initial pricing discretion is essentially the difference between what buyers are willing to pay (based on the perceived value of the product or service) and the minimum cost-based price of the product or service. Thus, the price ceiling and floor are initially determined by two major decision considerations: the perceived value for customers and direct variable costs, respectively. Competitive factors, corporate objectives, and regulatory constraints can also help narrow this pricing discretion considerably.[8]

## Price Considerations for the Firm

There are certain **Demand Implications** that the firm should consider when making any price decision:

- **The Price Sensitivity of Consumers:**
  Price elasticity for *secondary* demand (demand of the firm's offering) is higher than price elasticity for *primary* demand (demand for the product in general). It is also affected by the direction of a price change, the brand, and the current stage of the product's life cycle (PLC).
- **The Effects of a Specific Product Line on Overall Demand:**
  Own-price as well as cross-price elasticities should be considered. The strategy of eliminating low-margin or low-volume products might have undesirable repercussions if the removed product was generating traffic for other products.
- **Other Demand Considerations:**
  It is important to pay attention to the final customers when selling products to intermediaries, and to study the likelihood of competitive entry into the market.

In addition to the demand implications described above, there are also **Cost Implications** of different price decision strategies:

- **The Experience Curve Assumption:**
  Various factors are necessary for the experience curve cost reductions to result from increased volume. If all of these factors are not carefully considered, cost-plus pricing or volume-oriented pricing may inaccurately assume that increased volume will *automatically* lead to experience curve cost reductions.
- **The Elimination of Low-Margin Products:**
  The importance of incremental vs. joint costs and the contribution per resource unit must not be discounted. For instance, one consequence of eliminating Product A (which has low incremental costs and mostly joint costs) might be a limited ability to increase production of *other* products once Product A is eliminated.
- **Maximizing Contribution Margins:**
  When faced with scarce resources, focusing on "maximizing the contribution per resource unit" can be a better strategy than focusing on maximizing profit margins and ignoring low-margin products.

There are other factors to consider when shaping pricing strategies, such as marketing and distribution implications, the role of the product life-cycle (PLC), and whether or not sales force management and compensation programs align with the strategy of the firm (these programs should minimize turnover while coordinating pricing and selling decisions).[8]

# Price and the Bottom Line

Many companies have recently undergone serious changes in their structures, strategies, and operations in order to remain competitive and maximize their profits. Yet, few companies understand the importance of setting the *optimal* price and the substantial increases in operating profitability that can be achieved from even minor improvements in pricing practices.[7]

## Demand Sensitivity Measures

Consider the **Price Elasticity of Demand** for Product A:

$$\mathbf{E_D = (\Delta Q/\Delta P) * (P_1/Q_1)} \quad \mathbf{(1)}$$

$E_D$ = Price elasticity of demand
$\Delta Q$ = Change in quantity demanded
$\Delta P$ = Change in price
$P_1$ = Original price
$Q_1$ = Original quantity

For an inelastic demand ($-1 < E_D < 0$) or a perfectly inelastic demand ($E_D = 0$), total revenue increases or decreases in the *same* direction of a corresponding price change. However, when the demand is elastic ($-\infty < E_D < -1$) or perfectly elastic ($E_D = -\infty$), a small price increase would lead to revenue loss while a small price decrease would lead to higher revenues.

Now consider the **Income Elasticity of Demand** for Product A:

$$\mathbf{E_I = (\Delta Q/\Delta I) * (I/Q)} \quad \mathbf{(2)}$$

$E_I$ = Income elasticity of demand
$\Delta Q$ = Change in quantity demanded
$\Delta I$ = Change in income
$I$ = Original income
$Q$ = Original quantity

If $E_I < 0$, then the value of the product is perceived to be low and demand will decrease as household income increases. If $E_I > 1$, then the value of the product is perceived to be high and demand will increase as household income increases. But if $0 < E_I < 1$, demand will increase with increased household income, but the former increases at a *higher rate* than the latter, so the product becomes *proportionally* less important in the household's total consumption.

Finally, we shall examine the **Cross-Price Elasticity of Demand** for Product A (given a change in the price of Product B):

$$\mathbf{E_C = (\Delta Q_A/\Delta P_B) * (P_B/Q_A)} \quad \mathbf{(3)}$$

$E_C$ = Cross-price elasticity of demand (for A given change in price of B)
$\Delta Q_A$ = Change in quantity sold for A
$\Delta P_B$ = Change in price for B
$P_B$ = Initial price for B
$Q_A$ = Initial quantity sold for A

If $E_C < 0$, then the two goods A and B are complementary; whereas, if $E_C > 0$, the two products are substitutes.[8]

Price elasticity changes with the brand's position, and the direction and the magnitude of change. It also changes over similar products and different market segments. For instance, buyers are generally more sensitive to price increases than to price decreases, and less sensitive when either occurs in the market leader. Over brands in the same product category, price elasticity varies with price levels and purchase frequency.

Consumers are generally more price sensitive to products with higher costs because of the higher financial investment required. Also, they are more price sensitive to frequently purchased products since they can easily observe price changes over time and often have the option to wait for discounts and stockpile the product.

Extreme prices become more elastic in respect to the market as the price shifts towards the market average. Cross-price elasticity also witnesses an asymmetric effect when one product is more sensitive to a change in the price of another product than vice versa.[8, 14]

## Revenue Concepts

$$\mathbf{TR = P * Q} \tag{4}$$

TR = Total revenue
P = Price
Q = Quantity sold

$$\mathbf{AR = TR/Q = P} \tag{5}$$

AR = Average revenue
TR = Total revenue
Q = Quantity sold
P = Price

$$\mathbf{MR = \Delta TR/\Delta Q = [P_1 * (E_D+1)] / E_D} \tag{6}$$

MR = Marginal revenue
AR = Average revenue
$\Delta$TR = Change in total revenue
$\Delta$Q = Change in quantity sold
$P_1$ = Original price
$E_D$ = Price elasticity of demand

## Reference Price

A **Reference Price** is a concept that results from the comparative evaluation of prices by consumers. It is formed from the following information:

- The range of prices last paid
- The current perceived average market price
- The perceived fair price

- The expected price

Internal memory factors combine with external market cues to form the reference price to which prices are often compared before final purchase.

## Pricing Thresholds

There are a variety of pricing thresholds the consumers utilize when making purchase decisions. For every consumer, there is an acceptable price range for every product, which will be referred to as the *Absolute Price Threshold*. The upper price threshold or upper bound of that range is referred to as the *Reservation Price*. The degree to which buyers are sensitive to relative price difference is referred to as the *Differential Price Threshold*.

Weber's Law allows us to actually measure buyer sensitivity to price changes:

$$\Delta S/S = K \quad \textbf{(\textit{not always equal, see explanation below})} \qquad (7)$$

| | |
|---|---|
| S | = Original stimulus |
| ΔS | = Change in a stimulus |
| K | = Constant value for product or brand |

In the context of pricing and buyer sensitivity, the original stimulus is price. Hence, a change in stimulus would be a discount or a price increase. The value of K is unique for every product and every brand; the higher the value of K, the less sensitive consumers are to a price change. When the ratio of "ΔS/S" is larger than K, consumers are more likely to notice the change in price.

## Target Pricing and Costing

**Target Pricing** is a thorough pricing management technique that is implemented in order to avoid launching low-margin products that are not capable of generating a sufficient return on investment (ROI).

Target pricing is based on segmenting the marketplace and targeting the most profitable segments. For this technique to succeed, the entire value chain (from sourcing and production, to delivery processes and retail outlets) must be designed in a way that enables the achievement of target profits. Unlike cost-plus pricing, target pricing requires the manufacturer to use base initial reasoning on customer needs

There are *four* critical areas of target pricing.

- The Operating Process
- Operational Parameters (technological development, quality, and value for money)
- Strategic Market Definition (defining customers and competitors)
- Market Focus (whereby the target is a profit-management and cost-control tool)

Target pricing aims at maximizing profits rather than minimizing costs by focusing on customer needs. The target cost is a fixed commitment, and it guides the allocation of costs according to customer-preferred features and level of functionality. Value engineering and lean management are at the basis of target pricing and costing.[10]

## Perceived Value Pricing

$$\text{Perceived Value of a Product} = \frac{\text{Perceived Benefits}}{\text{Perceived Sacrifice}}$$

The process of building perceived value can be broken into five components. We refer to these as the "5C's of Value," which are further explored in *Module 3*:

1) **Create** Value for Customers
2) **Comprehend** Value to Customers
3) **Communicate** Value to Customers
4) **Convince** Customers They Must Pay For Value
5) **Capture** Value with Strategic Pricing Based on Value, Not Costs

The complete economic value of an offering is its reference value (the price of the best alternative to purchasing the offering) plus its **Differentiation Value** (the economic value of whatever differentiates the offering from the alternative). To calculate the economic value of a product or service, a firm must have information about its competitors' market prices. Information about production costs or about the price it is going to charge for its product is not necessary.

There are three types of economic value drivers:

- **Cost Drivers** (which save customers both time and money)
- **Revenue Drivers** (which allow customers to generate more revenue)
- **Psychological Value Drivers** (such as the feeling a customer gets from a brand)

The premium a company can charge for a differentiated product offering extra effectiveness is not necessarily proportional to that added effectiveness, and it can even be much greater. An exception to this principle occurs when the customer can make up for that effectiveness by purchasing a larger quantity of an alternative product.[9]

Offerings that facilitate shorter times to market or enhanced performance of products would enable B2B customers to generate more revenues. Such drivers would therefore be *revenue-based* economic value drivers. Alternatively, benefits such as increased productivity or lower employee turnover would be *cost-based* economic value drivers.

Price, value, and quality are three key factors that can lead to a sustainable competitive advantage and to success in turbulent environments. Before the late 90's, price was ignored as a strategic tool in achieving competitive advantage. Wielding price as a strategic tool requires the understanding of customer perceived value and the use of customer-driven pricing procedures.

Some of the advantages of perceived value pricing techniques such as the **Economic Value Analysis (EVA)** are as follows:

- Provides the company with the opportunity to be proactive and customer-oriented
- Positions the firm as a provider of superior products
- Allows the firm to meet customer expectations of value profitably

The perceived value of a product is the price the customer is willing to pay for the net benefit that the product delivers. The EVA technique measures the perceived value for a product relative to closely competing products with *reference* value.

The reference value includes all life-cycle costs the buyer would incur by purchasing and using an alternative product. To gain a competitive advantage, a firm must provide a product-price combination that has total life-cycle costs lower than the reference product. Popular EVA Techniques include *Forbus and Mehta's EVC Pricing Model* and the *Stochastic EVA Model*.[17]

## Major Pricing Errors

Many pricing managers suffer from some of the key pricing errors listed below. It is important to incorporate the lessons of this module into a strategic pricing structure and avoid the following common errors:

- Failure to recognize the relationship between price and perceived value
- Failure to distinguish between absolute price and relative price
- Failure to recognize the importance of reference price and how it is formed

The most important pricing principle is that prices should always be set to reflect the perceptions of value that are possessed by customers.[8]

## Improving Pricing Decisions

**Price Bands**, or the ranges of prices consumers pay in practice, are generally too wide because of ad hoc pricing practices that tend to create uncritical customers who tend to simply look for the lowest prices. Despite its great potential for generating growth and profits, pricing is generally under managed in the firm. In order to optimize profit potential through pricing, managers must master five strategic areas. Fact-based modeling based on econometric techniques can be used to improve all of the following areas:[4]

- **Price Cut Decisions:**
  The effectiveness of price cuts is often over-estimated, and they are commonly used because they are easy to implement. Most customers tend to value brands and certain product features more than low price despite claims the contrary.

- **Product Portfolios:**
  Product offerings can be improved using *menu choice modeling* to offer customers the ability to select from components offered, allowing them to select components based on the attributes they most value. Menu choice modeling serves not only as an effective customization tool but also provides the benefit of collecting data about customers' habits and perceived value for various attributes.

- **New Products:**
  When introducing new products to the market, it is essential that companies take great care in setting an initial price. Changing prices later on is sometimes difficult to accomplish, and there is an opportunity cost for lost profit potential for any time a product is on the market without its optimal price.

- **Market Segmentation:**
  This is a strong tool for increasing profitability by grouping customers according to price elasticity levels rather than implementing uniform pricing.
- **Package-Pricing:**
  Pricers should improve the way they deal with add-ons to maximize the benefits they are able to offer.

# Pricing Organization

## The 3 Levels of Price Management

The three distinct levels of price management are briefly described below: [7, 14]

- **Transaction (or Price Structure) Management:**
  This level focuses on managing the exact price charged for each transaction. This can involve rebates, discounts, and other tactics. At this level of price management, managers should determine the attractiveness of a sale by the *Pocket Price* rather than the *Invoice Price*.
- **Product/Market Strategy:**
  This level focuses on consumer perceptions. It involves segmentation, targeting, and positioning. The main focus here is on *appropriate* price positioning (relative to competitors) and on setting the correct target price for each product in a manner that preserves a balance between perceived benefits and price differences.
- **Industry Strategy (or Traditional Economic):**
  This level deals with retrieving necessary information and constantly evaluating this information to speculate on industry-wide characteristics and fluctuations that might influence prices (both in the short-term and long-term). At this level, the effects of future supply and demand conditions on price levels are analyzed. Companies that excel at this level of price management tend to have a better understanding of the trends and underlying drivers in their industry than other competitors.

## Organizing Pricing

Many people work with pricing but no one *owns* it. Ineffective management of pricing decisions is primarily due to the fragmentation of the pricing process across different functions of the organization. The mismanagement of pricing leads to decisions based on inadequate information, a disharmony between pricing strategies and applied tactics, and the use of inappropriate incentive structures. The organization of pricing decisions should occur in four core areas:

- **Structure and Responsibility:**
  Responsibility should be assigned to a formal unit for gathering information about trends, competitors, and the market in order to enable the technical skills necessary to optimize pricing decisions. The responsibility for implementing and auditing pricing decisions and actions must also be assigned.

- **Policies and Procedures:**
  Proper organization should include policies to manage long-term as well as daily pricing decisions.
- **Incentives and Compliance:**
  Incentives should match the pricing strategy. They should be based on the contribution margin and the realization of optimal prices (rather than volume or gross-revenue targets).
- **Platforms and Tools:**
  Organizational functions should aligned and coordinated using standardized platforms for performance metrics.[5]

Organizations must build pricing capabilities into their structure, culture, processes, systems, and strategies. These capabilities can be best built by integrating interdependent business units as well as by aligning performance measures, compensation plans, and decision processes.

A company can organize prices according to the following elements:

- Distinct *customers* (for better differentiation)
- Distinct *competitors* (for clearer focus)
- Distinct *resources* (for smarter allocation)
- Distinct *economies or profit margins* (for a more tactical approach)

A centralized pricing management approach is best suited for homogeneous markets with few products, high standardization, and big orders. Whereas, decentralized pricing management at each business unit level is better suited for fragmented markets with many product lines, low standardization, and small order volume.[11]

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## Review Questions

1. An IT firm overpriced its new software (which provides users with unlimited access to music downloads) because it speculated that consumers would highly value the product. At which price management level does this firm fail?

   (a) Transaction
   (b) Product/market strategy
   (c) Industry strategy
   (d) Consumer/product strategy
   (e) All of the above

2. What is the objective of the firm in common economic theory?

   (a) Secure long-term profits
   (b) Secure short-term and long-term cash flows necessary for survival
   (c) Maximize profits
   (d) Maximize market share
   (e) All of the above

3. Which of the following is NOT an advantage of Stochastic Economic Value Analysis (EVA) pricing technique?

   (a) It strengthens the corporate image
   (b) It decreases the psychological risks associated with pricing
   (c) It heightens managers' sensitivity to customers' perceptions of product value
   (d) It increases profit margins
   (e) It makes it easier for salespeople to communicate the product value to consumers

4. In the cycle of Value-Based pricing, the __________ comes first.

   (a) Product
   (b) Cost
   (c) Customer
   (d) Price
   (e) Value

5. In considering an observed price, consumers often compare it to a __________ price based on internal memory information about past prices and external cues (such as a posted "regular retail price").

   (a) Historical
   (b) Reference
   (c) Promotional
   (d) Everyday low price
   (e) None of the above

6. Which of the following statements about Economic Value is FALSE?

   (a) It can be calculated without the knowledge of an offering's production costs
   (b) It can be calculated without the knowledge of prices charged by competitors in the marketplace
   (c) It can be calculated without the knowledge of the differentiation sources a firm's product has relative to competitive offerings
   (d) It can be calculated without the knowledge of price that will be charged for the product
   (e) b and c

7. What is the role of Price in the Economy?

   (a) To transmit information
   (b) To provide an incentive for allocating resources efficiently
   (c) To distribute income
   (d) a and b
   (e) a, b, and c

8. Find the price elasticity of demand for a digital camera with the following information: Original Price = $1,200; Original Annual Sales = 5,000 units; New Price = $1,050; and New Annual Sales = 5,500 units.

   (a) Ed = -0.80
   (b) Ed = -0.64
   (c) Ed = 0.80
   (d) Ed = 0.30
   (e) None of the above

9. The degree of power a firm has on price is almost "nil" under which situation?

   (a) Perfect monopoly
   (b) Imperfect competition
   (c) Oligopoly
   (d) Perfect competition
   (e) The firm always has a high degree of power when setting prices

10. A 1% increase in price realization can often have an impact on profits that is four times greater than a 1% reduction in fixed costs.

    (a) True
    (b) False

# Module 2: The Role of Costs in Pricing

# Introduction

Understanding costs is vital to designing successful pricing strategies. It is important for managers to recognize relevant, incremental, and avoidable costs. It is also crucial for managers to learn costing methods for pricing, to be able to calculate contribution margins, and to understand how these margins change.

Cost information should play an important role in determining the types and quantities of products to produce but not in setting prices.[11] Optimal pricing practices should focus on the customer's willingness to pay for value, instead of simply adding a profit margin onto production costs. Customers are not generally focused on the cost of a product when they are considering what they will pay for it. While cost information should not be completely neglected when setting prices, it should certainly not be given paramount importance.

Many companies make the mistake of only using costs to set prices, and the most commonly used pricing method is *cost-plus* pricing. This method is common because of the notion of the "Just Price" (which suggests that prices ought to reflect the company's costs in order to be fair to consumers). Moreover, many organizations look to cost-plus pricing because obtaining and quantifying cost data is much easier than obtaining consumer data. However, as this module will explain, attempting to account for all costs related to a product does not always necessarily lead to *just* pricing. While costs should not dictate price, they can be used to indicate whether a product can be produced and sold profitably.[10]

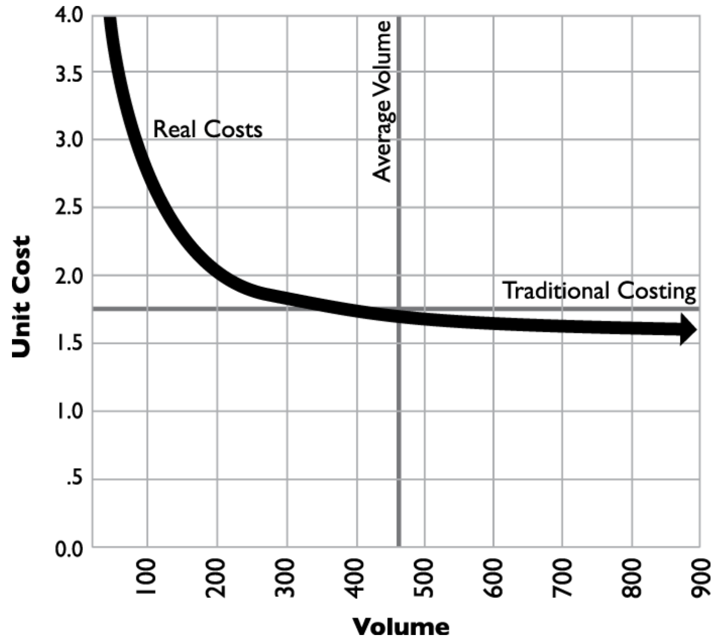
In setting prices, companies could *underprice* (and potentially make an unprofitable sale), *overprice* (and potentially lose a sale that would have been profitable at a lower price), or price correctly. Underpricing and overpricing are largely caused by cost estimation errors due to: [1]

- A lack of qualified cost accounting personnel
- A lack of communication between cost accounting personnel and pricing personnel
- The use of inadequate, old-fashioned cost accounting techniques

Once companies start producing and selling multiple products or services, the distortion of cost data becomes almost inevitable. Cost accounting systems that allocate costs uniformly among all products frequently understate profits on high volume items and overstate profits on lower volume, specialty items.[7] Traditional cost accounting methods concentrate on variable unit costs of material and labor, classifying all other costs as overhead. Overhead costs are usually allocated to products on per-unit basis, which leads to costs being fixed over a wide range of output levels. The problem is that unit costs rarely remain fixed across this wide range.

*Exhibit 2.1* shows the difference between costs under traditional cost accounting methods and modern cost accounting methods ("real costs"). We can see that at lower levels of output, the difference between actual costs and traditionally estimated costs is quite significant, which could easily lead to poor pricing decisions by managers.[1]

**Exhibit 2.1: Real Costs vs. Fixed Traditional Costs**




**Activity-Based Costing (ABC)** is another tool that can enhance cost analysis.[1] ABC systems are based on collecting accurate data on direct labor and material costs, as well as examining indirect resources. Tracing costs from resources to activities, and then to products or services allows for a much more robust understanding of costs.[7]

**Activity-Based Pricing (ABP)** applies activity-based costing to a pricing strategy. It is a method that uses knowledge about customer demand and costs of specific selling circumstance to establish a price that will generate a specifically planned profit. ABC allows the company to project costs corresponding to the various sales volumes.[8]

The objectives of Activity-Based Pricing (ABP) are to:[1]

- Establish prices with knowledge of the complete costs to produce a product.
- Plan the amount of profit to be achieved at the time the price is set.
- Never unintentionally sell a product at a loss.
- Optimize profitability by providing management with the necessary information to make responsible pricing decisions.

This module will examine different accounting methods of cost estimation and discuss the roles of contribution margins and costs in developing optimal pricing strategies.

## Types of Costs

The first step in dealing with costs is to classify them in order to recognize the effect of volume (or activity level) on profits and to identify the sources of profit. If costs are overly mixed and reduced to a unit cost number (which companies often use in breakeven analysis to find the appropriate price), significant pricing errors may occur. Cost classification should not be limited to *variable* and *fixed* costs, because no cost is inherently fixed or variable.[10] In this section, four important cost types will be discussed: *relevant*, *incremental*, *avoidable*, and *opportunity* costs.

Once these four cost types have been defined, the module will explore two important general classifications of total costs; the ***variable*** costing classification of total costs is broken down into variable and fixed costs, while the ***absorption*** costing classification of total costs is broken down into direct, indirect, and common costs.

## Relevant Costs

When examining costs, pricers should always begin with relevant costs, which determine the impact of pricing decisions on profits. **Relevant Costs** are incremental (not average) and avoidable (not sunk). Many management errors can occur when estimating relevant costs, which can have detrimental effects on profits.[11] Sunk costs have already been incurred (or will be incurred *regardless* of the product considered) and cannot be recovered to any significant degree. To fully understand relevant costs, one must also understand incremental and avoidable costs.

When estimating relevant costs, managers should avoid the following common mistakes:[11]

- **Using Average Variable Costs to Estimate Unit Cost:**
  Only incremental costs associated with the specific units sold should be considered.
- **Calculating Depreciation Costs Based on Historical Data (or Book Value):**
  Relevant depreciation cost is equal to the change in current market value of the asset resulting from its use. In other words, relevant depreciation is the decline in the asset's resale value.
- **Classifying Single Costs as Either Purely Incremental or Not:**
  Most single costs are partly incremental *and* non-incremental, not one or the other.
- **Overlooking Opportunity Costs:**
  There are opportunity costs to most decisions, and these must be factored into any responsible cost analysis.

## Incremental Costs

**Incremental Costs** represent the portion of costs that change because of a pricing decision. A decrease or increase in total costs as a result of a change in quantity sold (if caused by a change in price) would be an example of this. If costs are classified as variable, fixed, and semi-fixed (or semi-variable), then these costs will be incremental or non-incremental following the rules below:

- Variables costs are *always incremental.*
- Fixed costs are only incremental when the pricing decision determines whether the company will continue to produce a certain product for certain customers. For instance, some fixed costs might result from implementing a new version of the product at a different price level (these fixed costs would be considered incremental).
- Most costs are considered "**Semi-Fixed Costs**" which are only fixed for a certain quantity produced, beyond which point they become variable. These costs are incremental for decisions that would expand sales beyond a certain point.

When evaluating a pricing decision, it might be misleading to focus on **Average Costs**, or costs that include all costs and not solely the costs that are incremental to the decision. Average costs include fixed costs that are not *true* costs of a sale. Thus, low-price sales are not necessarily low-profit yielding because they can make large contributions to profits when they add a small amount to incremental costs. Companies can still make profits even if they set prices below average costs.[11]

## Avoidable Costs

**Avoidable Costs** have either not yet been incurred or are costs that have been incurred but can be reversed. Unlike sunk costs, avoidable costs are critical to sound pricing decisions. Examples of avoidable costs include the rental costs of buildings and equipment (only those that are *not* long-term), costs of delivering a product, and costs of replacing sold items in inventory. Rental costs *could* be sunk costs if the company is unable to sublet the building or equipment. Assets are considered sunk costs when they have no resale value, but most assets have some resale value and their costs are therefore a mixture of avoidable and sunk costs.

Managers should be aware that the "next in, first out" cost flow assumption (NIFO) more accurately represents avoidable costs vs. sunk costs for pricing decisions than other accounting methods of calculating costs (such as "last in, first out" or LIFO).

NIFO enables companies to distinguish between *historical* costs (sunk and irrelevant) and *future* costs (avoidable). Companies should base pricing decisions on avoidable costs instead of historical costs. By doing this, pricers can adjust the company's prices when the costs of raw materials increase or decrease to ensure long-term profitability.[11]

## Opportunity Costs

Overlooking opportunity costs is another error that managers should avoid. This type of cost occurs when a firm can invest assets in various opportunities. Assuming the firm can only utilize its assets to pursue *one* (or some) of these opportunities, the **Opportunity Costs** of the adopted option represent the contribution, revenues, or income that the firm forgoes by *not* pursuing the other option(s) with those assets. In other words, there are lost opportunities when pursuing any project in lieu of others. Opportunity costs are always important and should be carefully considered (even though they generally do not appear on the Income Statement).[11]

## Fixed and Variable Costs

**Variable Costing** classifies total costs into their fixed and variable components. Whereas, **Fixed Costs** are incurred over a period in which production or sales levels do not significantly change (within a given range). These fixed costs include quantities of unexpired assets or expenses that do not change in proportion to the activity of a business within the relevant period or the scale of production.

Fixed costs include, but are not limited to, overhead (such as, rent and insurance) and can also include direct costs such as payroll (especially salaries). Fixed costs should not be confused with sunk costs. From a purely economic perspective, fixed costs are not necessarily *invariant*. It is important to understand that fixed costs are "fixed" only within a certain range of activity or over a certain period of time. Given enough time, all costs become variable.

Furthermore, not all indirect costs are necessarily fixed costs. For example, advertising expenses are indirect costs that are variable over a slightly longer time frame. They may not be adjustable in the short term, but may be easily adjusted over a longer time frame.

**Variable Costs** vary directly with the activity level of the firm. They are *always* incremental. Furthermore, they might be direct costs (such as the cost of material used to produce a good) or indirect costs (such as variable manufacturing overhead costs).

There are also **Semi-Variable Costs** (or *semi-fixed* costs), which have both variable and fixed characteristics. The **High-Low Method** for calculating the total variable costs (which can be used to separate the variable and fixed components of semi-variable costs) is provided below (1), as is the formula for calculating the **Variable Cost per Unit** (2):[12]

$$\mathbf{VC = C_H - C_L} \qquad \mathbf{(1)}$$

$C_H$ = Total cost for *highest* output month
$C_L$ = Total cost for *lowest* output month
VC = Total variable costs for the difference in units between the months

$$\mathbf{VC_U = \Delta C \div \Delta Q} \qquad \mathbf{(2)}$$

$\Delta Q$ = Quantity for highest output month- quantity for lowest output month
$\Delta C$ = Cost for highest output month - cost for lowest output month
$VC_U$ = Variable cost per unit

## Direct and Indirect Costs

**Absorption Costing** is based on the assumption that costs can be divided into direct and indirect components, with direct costs being *measured* and indirect costs being *estimated*.

**Direct Costs** are expenditures that can be measured quantitatively and *specifically* traced to a particular product (such as specific materials, labor, and directly relevant salaries).

**Indirect Costs** cannot be specifically traced to particular products in a cost-effective manner (these are costs that would require an unacceptable amount of resources in order to be effectively allocated, such as maintenance, utilities, and general materials). Instead, indirect costs are traced to particular products using estimation methods. [12]

**Common Costs**, or general expense costs, cannot be objectively traced to the appropriate business segment. These costs, including general research and development costs, support a variety of activities or profit segments and are not affected if one product in the line is discontinued.[10]

## Accounting Methods and Cost Estimation

In traditional accounting, major cost categories include: cost of goods sold, selling costs, general and administrative expenses, and non-operating expenses. This categorization is similar to classifying costs into variable costs, fixed costs, and other costs that are not reflected on the Income Statement.[8]

Accounting methods can be very influential to managers trying to maximize profits. In fact, managers tend to sequentially follow traditional accounting statements in the way that they attempt to first maximize sales revenues, then gross profits, and finally operating and net profits. However, this method may ultimately *increase* long-term expenses (such as selling or interest expenses). To avoid such mistakes, managers can adopt a managerial costing system to guide their decision process. The following table illustrates the fundamental differences between the two systems:

| Traditional Income Statement | Managerial Costing System |
|---|---|
| **Sales Revenues**<br>- Cost of Goods Sold | **Sales Revenues**<br>- Incremental, Avoidable, Variable Costs |
| **= Gross Profit**<br>- Selling Expenses<br>- Depreciation<br>- Administrative Overhead | **= Total Contribution**<br>- Incremental, Avoidable, Fixed Costs |
| **= Operating Profit**<br>- Interest Expense | **= Net Contribution**<br>- Other Fixed Sunk Costs |
| **= Pre-tax Profit**<br>- Taxes | **= Pre-tax Profit**<br>- Taxes |
| **= Net Profit** | **= Net Profit** |

From the above table, it is clear that the managerial costing system puts more emphasis on incremental costs (which are relevant to the decision and ultimately have an effect on profitability). This system allows managers to avoid forgoing potential net profits when they focus on maximizing gross profit; by maximizing the net contribution they will in turn maximize net profits.[11]

### Activity-Based Costing (ABC)

The use of broad averages to allocate overhead costs to specific products often results in either over-costing or under-costing. Over-costing occurs when a higher level of resources per unit is allocated to a product than it actually consumes, while under-costing occurs when a lower level of resources per unit is allocated to a product than it actually consumes.[9]

Traditional cost accounting methods tend to allocate **Average Costs** over a range of products, which is not useful to managers because it contradicts the marginal theory of value. **Activity-Based Costing (ABC)** offers a solution to this problem by assigning the cost of *resources* (such as time, materials, floor space, and equipment) to cost *objects* (such as products, product lines, and customers).

ABC techniques allow companies to have a competitive advantage by establishing prices based on the *complete* costs of a product. These techniques also enable companies to plan the amount of profit at the time of pricing, avoid unintentionally selling a product at a loss, and optimize profitability. ABC focuses on overhead costs and uses cost data in a less aggregated and more specific format than traditional costing methods.[8]

The main principle behind activity-based costing is that costs are generated by activities related to products and services. Activities are attached to products via **Cost Drivers,** which can be any activity that causes a cost to be incurred (such as hours). ABC allocates semi-fixed costs according to **Activity Drivers**, which are specific units that reflect the proportion of resources from the cost driver pool that are used by specific activities (number of hours worked, for example). ABC produces more accurate results than absorption costing. It also allows for a better estimation of support costs allocated to manufactured products and/or customers. It provides realistic estimates that distinguish between high-cost and low-cost products and/or customers.[12]

Instead of using broad percentages to allocate costs, ABC seeks to identify cause-and-effect relationships to accurately assign costs. Once the costs of the activities have been identified, they are attributed to each product based on the extent that each product utilizes the activity. In this way, ABC often identifies areas of high overhead costs per unit and draws attention to finding ways to reduce the costs (or to charge more for costly products).

Cost accountants traditionally add a general percentage to the direct costs to account for indirect costs. As the percentage of overhead costs rises, this technique becomes increasingly inaccurate because not all products share the indirect costs equally. For example, one product might require significantly more time in one machine than another product, but since the amount of direct labor and materials might be the same, the additional cost for the extra use of the machine would not be counted if the same general percentage is added to all products.

When multiple products share common costs, there is a danger of one product subsidizing another. Like manufacturing industries, financial institutions also have diverse products that can create cross-product subsidies. Since personnel expenses represent the largest single component of non-interest expense in financial institutions, these costs must also be attributed more accurately to products and customers. ABC (even though it was developed for manufacturing) is a useful tool for doing this.

Direct labor and materials are relatively easy to trace specifically to a product, but it is much more difficult to allocate indirect costs. Where products use common resources differently, some sort of weighting is necessary for an accurate cost allocation process. The measure of the use of a shared activity by each of product is known as the cost driver. For example, the activity cost driver of bank tellers can be allocated to customer transactions by measuring how long each transaction takes at the counter and then by measuring the number of each type of transaction.

Even in ABC, some overhead costs are difficult to assign to products and customers, for example the chief executive officer's salary. These costs are termed “business sustaining” and are not assigned to products or customers because there is no meaningful method to do so. This lump of unallocated overhead costs must nevertheless be funded by contributions from each of the products. However, these overhead costs are *significantly* less than they would be if ABC were not utilized.

Although some may argue that costs that cannot be traced to activities should still be generally allocated to products, it is important to understand that the only purpose of ABC is to provide information to management. Therefore, there is no need to assign any cost in an unsystematic manner. Management accountants can use many methods to represent these costs on internal reporting statements.

The Activity-Based Costing **(**ABC) Process has the following steps:

1) Identify the different activities performed by the business.
2) Calculate the total cost of each activity over the financial period (this is the **Cost Pool**). For example, indirect labor and distribution costs would not be in the same activity-cost pool because their cost drivers are very dissimilar. A cost driver of indirect labor would include direct labor hours, whereas a cost driver of distribution costs might include cubic feet of cargo moved.
3) Identify the *costs drivers* or causes of each activity.
4) Calculate the cost driver rate (the proportion of average cost *per* occurrence of a cost driver).
5) Assign the proportional cost of each activity to different products based on the extent to which each product has caused the activity to occur (by using the cost driver rate).

The hierarchy of activities in ABC is as follows: [12]

- **Unit Level** (Machine hours)
- **Batch Level** (Purchase orders for materials)
- **Product Level** (Machinery maintenance or maintenance hours)
- **Facility Level** (Site security)

There are two types of costs that should *not* be allocated to products under activity-based costing: The costs of excess capacity and research and development for entirely new products (R&D). Unlike R&D for improvement of existing products, these costs are not related to activities consumed by current products.

Despite its many advantages, Baker (2006) believes that ABC has a major flaw in common with traditional costing methods: The cost allocation process is inward-looking and does not consider the value added to the product or the customer's point of view in terms of preferences. "It is the value and the price that ultimately drive costs."[6]

## Contribution Margin and Pricing

One major myth in strategic pricing is the belief that the primary goal of pricing is to cover total costs. Prices should not merely be a combination of total costs and some target margin. The goal of pricing should be to maximize the total contribution margin, because this is the part of price that affects total profitability.[3]

The **Percent Contribution Margin (%CM)** is the proportion of price that adds profit or generates loss.

$$\%CM = \frac{(\text{Total Contribution Margin} * 100)}{\text{Sales Revenues}}$$

**This is true only if variable costs are constant for all units*

Otherwise, when variable costs are not constant for all units, we calculate the Dollar Contribution Margin ($CM).

| | | | | |
|---|---|---|---|---|
| | Price | | %CM = | <u>$CM</u> |
| *if…* | <u>- Variable Cost (for unit)</u> | *then…* | | Price |
| | ***$CM*** | | | |

Knowing each product's contribution margin is necessary for the company to devise strong pricing strategies. In general, products with a high contribution margin (low percentage of variable costs) provide the company with the ability to compete on price (or offer discounted prices), while low contribution margin products may offer the opportunity for premium pricing.[11]

For short-term decisions, fixed costs are assumed to be constant and the contribution is used to cover fixed costs. This type of cost analysis is referred to as "variable costing," which is a very powerful tool (despite its simplicity) that is also the basis for performing break-even analyses. It is used to calculate the effect of production and sales level on profitability. In the short-term, the following is true:

| | | | |
|---|---|---|---|
| | Sales Revenues | | Total Contribution |
| *if…* | <u>- Total Variable Costs</u> | *then…* | <u>- Total Fixed Costs</u> |
| | ***Total Contribution*** | | ***Net Profit*** |

## Role of Costs in Developing a Pricing Strategy

One significant problem with costs is that they often serve as the basis for a company's entire pricing strategy when the company uses cost-plus pricing ("Cost + Margin Required = Price"). Another problem is that cost can be defined many ways. A cost-plus pricing strategy ignores marketplace dynamics and utilizes no assessment of the product's value.[2]

Competition keeps profit margins low (usually in single digit numbers) which usually makes the gap between price and cost nominal. This is one reason why costs are important and should certainly be considered when making pricing decisions. Price and cost are interdependent with sales volume. Price affects the number of units sold, which in turn affects the cost per unit, and the cost per unit ultimately becomes a factor in price, creating a complete cycle.[8]

In a business where fixed costs are high, companies usually need to increase volume. When devising a pricing strategy however, managers should be aware of the change in their cost structure so that they can change their strategy accordingly. Over time, many fixed costs become variable and this may cause fixed costs to be overestimated. This might make a strategy of increasing sales volume through lower prices inappropriate. Changes in cost structure might be due to several factors, including outsourcing of business functions, an increase in the price of raw material, or even a misclassification of certain variable costs as fixed (such as customer service).[3]

Many companies create prices by utilizing absorption costing, where the full absorption cost for a manufacturing company is calculated as follows:

|  |  |
|---|---|
|  | Direct Material Costs |
|  | Direct Labor Costs |
|  | Variable Production Overhead |
|  | Fixed Production Overhead |
|  | Administrative Overhead |
| + | Marketing Overhead |
| **=** | **Full Absorption Cost** |

The profit margin depends on the corporate business plan, where the expected return on capital is usually stated. In this case, the required profit might be calculated as follows:

**Required Profit** = Total Capital * Return on Capital (or Investment)

This required profit is added to total costs to find the required total revenue (sales in dollars). With this information, unit sales can be derived. Companies that follow full cost-plus pricing, select a price that will cover total costs *plus* a mark-up to this absorption cost. The mark-up percentage value can be calculated as follows:

$$\textbf{Mark-Up} = \frac{\text{Required Profit}}{\text{Total Costs}}$$

Then, the Selling Price would be:[12]

**Selling Price** = Absorption Cost per Unit * (1+Mark-Up)

When devising a pricing strategy, it is not only important to understand the firm's costs but also to be aware of the differences between its costs and those of its competitors (as well as the sources of those cost differences). Manocchi describes the "weighted competitive cost differentials" approach to identifying sources of cost differences and applying those differences to the cost structure of a product or service. This approach does not require the company to know the details of competitors' costs; the data needed is limited to *sources* of cost differences. There are seven steps to Manocchi's approach: [4]

1) Develop a cost structure, considering costs relevant to the decision or product in hand.
2) Identify potential sources of cost differences by checking efficient and inefficient use of resources that provide the company with a competitive advantage or disadvantage.
3) Assess the competitors' differences by comparing relative positions by using data from published financial reports and marketing and management presentations to investors.
4) Quantify the impact of efficiencies and inefficiencies and estimate their effects on the overall cost structure.
5) Apply the effects to the cost structure by calculating the total cost differential (or the sum) of structural and strategic cost differences
6) Validate against benchmarks.
7) Re-calibrate and re-estimate as necessary.

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## Review Questions

1. Since Cost-plus pricing is purely quantitative, it leads to setting "just" prices.

   (f) True
   (g) False

2. Which type of accounting tries to identify the total costs associated with serving each customer by allocating indirect costs to the activities that use them? Based on this information, today's companies adapt their offers and terms to different buyers.

   (a) Cost accounting
   (b) Experience cost
   (c) Target costing
   (d) Direct product profitability
   (e) Activity-based cost

3. Activity-Based Pricing (ABP) allows companies to project their profits at the time the price is set.

   (a) True
   (b) False

4. Activity-Based Costing (ABC) helps identify various activities that explain why costs are incurred.

   (a) True
   (b) False

5. Designing an ABC system requires that:

   (a) The job bid process be redesigned
   (b) A cause-and-effect relationship exists between resource costs and individual activities
   (c) An adjustment be made to the product mix
   (d) Both b and c are correct
   (e) None of the above

6. Under-costing a particular product may result in:

   (a) Loss of market share
   (b) Lower profits
   (c) Operating inefficiencies
   (d) Understating total product costs

7. Traditional cost systems distort product costs because:

   (a) They do not know how to identify the appropriate units
   (b) Competitive pricing is ignored
   (c) They emphasize financial accounting requirements
   (d) They apply average support costs to each unit of product
   (e) All of the above

8. Which of the following is NOT an objective of Activity-Based Pricing (ABP)?

   (a) Establish price with knowledge of full real costs to produce a product
   (b) Plan the amount of profit to be achieved at the time the price is set
   (c) Never unintentionally sell a product at a loss
   (d) Establish price based on rote formulas that accurately describe the relationship between price and costs
   (e) All of the above are objectives of ABP

9. Low contribution margin products offer the opportunity for premium pricing.

   (a) True
   (b) False

10. Company X has total annual fixed costs of $1 million and the variable cost per unit is $80. It prices its products by adding 40% mark-up to its absorption cost. What is the price of each unit if the company's estimated sales volume is 50,000 units?

   (a) $80
   (b) $100
   (c) $120
   (d) $140
   (e) None of the above

# Module 3:
# Pricing and Customers

## Introduction

The primary purpose of a business is to generate value for customers. The test of a company's success lies not within its own walls, but rather in its external impact. Since these results are ultimately all external, there is no such thing as an internal "profit center." There are only internal costs, activities, and effort centers.

The "4P's of Marketing" (Product, Promotion, Place, and Price) require that managers look outside of the organization and ask, "What do our customers value, and how can we increase that value?" Where cost accountants focus their efforts on the internal cost centers of the firm, marketing executives must instead focus beyond the confines of the business to its customers. Becoming better cost accountants will not help create value for customers, nor will this assist in capitalizing upon that value through strategic pricing. To do this, a firm must turn to value-based pricing practices.

## The 5C's of Value-Based Pricing

For pricing to become a core competency in any business, pricers must incorporate the **"5C's of Value"** into their practices:[9]

1) **Create** Value for Customers
2) **Comprehend** Value to Customers
3) **Communicate** Value to Customers
4) **Convince** Customers They Must Pay For Value
5) **Capture** Value with Strategic Pricing Based on Value, Not Costs

These five components determine the capacity any business possess to produce wealth, and will drive long-term internal profits.

### 1. Create Value for Customers

It is important to constantly gauge the value expectations of customers. They can change quickly or gradually, depending on the type of market and competitive situations a firm faces. In consumer product markets, for example, the value expectations can change suddenly if the competition is intense and the technology changes quickly (in industries such as consumer electronics, toys, computers, and automobiles).

Continuous market research, market surveys, and other techniques for gathering customer feedback are essential in order to quickly gauge, develop, and then deliver value expectations to consumers. In ideal conditions, when the firm's value delivery is quick and exceeds expectations, price is of less importance to customers making purchase decisions.

In other words, customers can be encouraged to focus on *value* instead of price when making product or service decisions. Naturally, the losers in these markets are companies that are slow to deliver value to customers. These companies often resort to intense price cutting in an effort to increase sales and, as a result, usually end up with lower profits.

## 2. Comprehend Value to Customers

Value is one of the most overused terms in the professional community, but a thorough comprehension of the value that a product or service provides to customers is crucial to a successful pricing strategy. Value is essentially the economic impact (in monetary terms) that a product or service has on a customer's business, relative to the price of the next best competitive offering.

Economic value is a quantified estimate of the product's impact on a customer's revenue or costs. Many products have multiple appealing features, but B2B customers are ultimately persuaded to pay only for the features that make a difference in their business results.

Value is understood in *relation* to other product alternatives. During the purchase process, customers must weigh the value each product creates and the price they are being asked to pay. By quantifying the differential value between two products, firms can facilitate purchase decisions and justify the prices charged.

Economic value can incorporate both positive and negative differential values. For the value assessment to be realistic, it must acknowledge if any competitor's product features create a greater economic impact. Dishonesty or misrepresentation in this regard may cause the customers to discount the rest of the firm's value assessment as marketing hype.

## 3. Communicate Value to Customers

Before a company can deliver value it must first effectively *communicate* it to customers. For B2B customers, this can be accomplished by targeting important aspects or inefficiencies within the customer's business operations that would be directly enhanced with the proposed service or product solution. These solutions must provide a *clearly* differentiated value. The offerings must be more than mere replications of competitors; customers must recognize the specific value in the firm's product or service. The ability to communicate this differentiation is critical in gaining pricing power.

It is important that the value propositions of a product or service provide some sort of tangible or measurable quality. Many commercial services providers miss this mark with value propositions that are either merely rhetorical or fail to address the customer's real business or economic needs. By offering tangible or measurable value propositions, the customer will be more willing to engage in a professional dialogue. This increases the likelihood of making a sale, but these clear value propositions also enable higher prices for the product or service. Intangible or generic value propositions achieve no such benefits.

Firms that launch general brand campaigns as the foundation for their B2B customer acquisition and retention strategies are at a significant competitive disadvantage. Brand campaigns may work well in B2C markets, where a company's "image" can be persuasive, but image is rarely compelling to a large business customer. If a brand campaign is launched, it is important that the firm supports the campaign with substantive and clearly communicated service or product differentiation to ensure success within a B2B context.

Effective points of differentiation include value statements that address real customer business problems and provide a positive bottom-line impact. Validating customer business issues and priorities requires a systematic program of interviewing the right individuals within the organization who can recognize the value offered and are willing to pay a higher price for the incremental benefits. For example, low to mid-level managers (or back-office operations managers) may focus only on the price when evaluating a solution, while senior managers (or managers that interact with customers) may be better able to appreciate the business value of the proposed solution.

To illustrate this point, let us consider a hypothetical example. Suppose a firm has a five-page value statement, and its competitors are delivering roughly the same value propositions. The firm is in the middle of negotiations with a purchasing agent, who is unlikely to provide any information on the value requirements of the final client other than price, and there is a relatively equal chance that the customer will choose any of the potential options. However, now suppose that this firm identifies an operational requirement the client has for reliable and timely product shipments. The firm's value proposition is altered to provide stronger focus on their ability to provide superior performance on this dimension. The customer who had previously focused exclusively on price, now chooses the firm with the clearly differentiated value proposition that best aligns with its own business needs and even places the final order at a *15% price premium*.

## 4. Convince Customers They Must Pay For Value

If customers are not convinced that they must pay for value, they will view low-cost as the only differentiator and will be content to let suppliers compete to offer the lowest price.

Research and years of working with clients reveals that the most effective way to get customers to pay for value is to offer added value propositions that appeal to their firms. Generally, most customers would like vendors to offer additional services and solution packages, and are willing to pay for such benefits. To capitalize upon this, firms must:

- Recognize that some customers *will* pay for this added value, some will *not* pay for the added value, and that some will simply attempt to "play poker" in the hopes of negotiating value at a lower price
- Understand the needs of each customer individually, and then develop solutions and value propositions that address these needs.
- Pass the "acid test" of value by demonstrating value to customers in tangible, economic terms.

## 5. Capture Value with Strategic Pricing Based on Value, Not Costs

The final "C" of value pricing is to capture the value the company provides through strategic pricing based on value, not simply costs. Companies committed to providing high value products and services to their customers will work very hard and spend a lot of money to do so, but they may still fail to generate the profits and revenues the firm deserves. The reason for this failure is that firms tend to judge the success of their value strategy based on cost & profit metrics such as ROI, ROA, ROS, and sales volume increments. Instead they should use measures such as customer satisfaction, customer loyalty, strategic marketing, and other value-added metrics.

**Customer Value Accounting** combines traditional cost and profit measures with value-added measures to provide a comprehensive analysis for measuring the value differences among competing products. This technique accounts for cost of use, product performance, residual value, parts replacement, trade-in value, customer satisfaction during usage and ownership, and ease of maintenance and repair. These dimensions are then rated and charted in a way that directly compares each of the competing products. This competitive value analysis should become the basis for pricing products, rather than focusing merely on traditional costs.

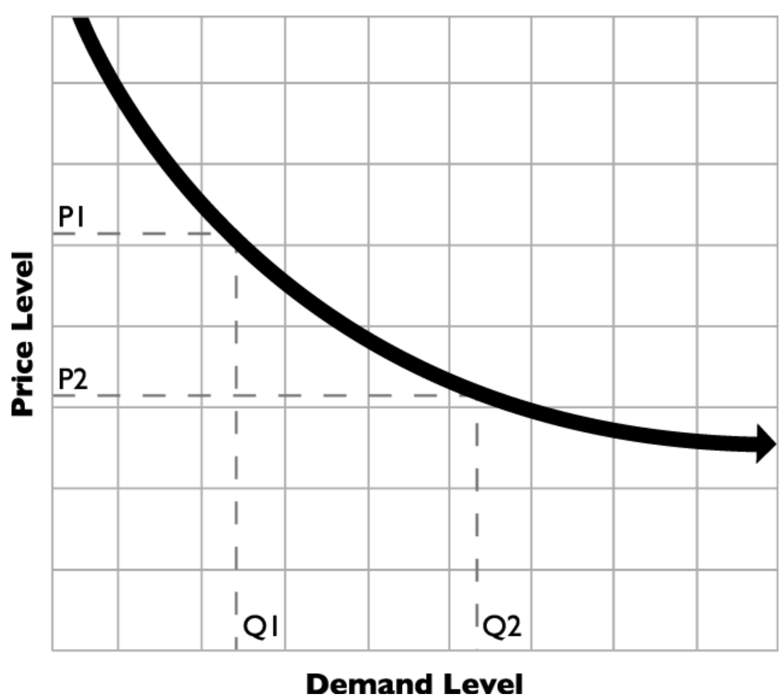
## Demand Elasticity and Cross Elasticity

**Demand Elasticity** is the responsiveness of the demand for a company's products or services based on certain criteria (price in this case). This is an important factor in developing a pricing strategy for a firm. In general, if demand for a product or service changes significantly with minor changes in price, the product category is considered to be **Elastic** with respect to price. If no significant volume changes occur despite major price changes, the category is **Inelastic** with respect to price. On the one hand, the greater the price elasticity the *closer* a firm should price its products to similar competitive products. On the other hand, the lower the price elasticity the *further* a firm can price its products from similar competitive products.

### The Price-Demand Relationship

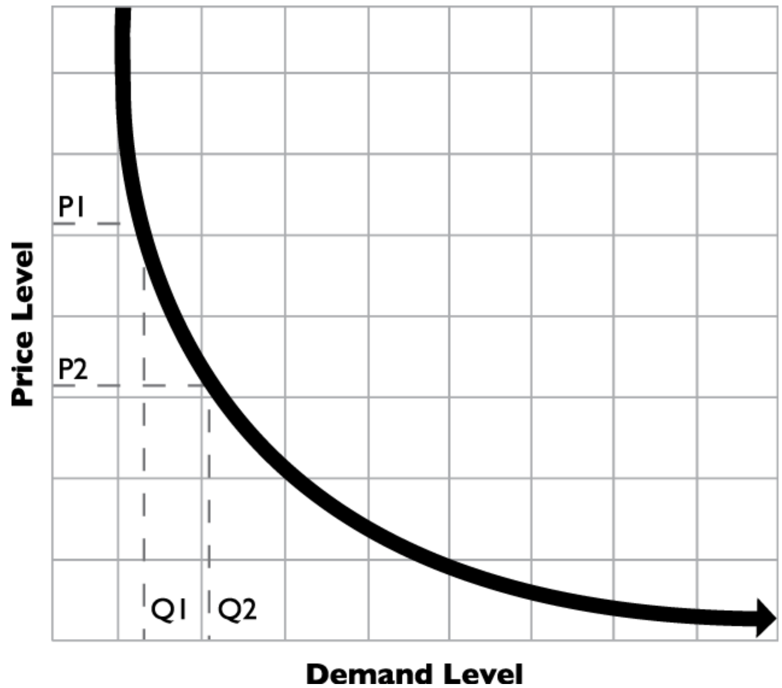
At each price point a firm may set for its products, a corresponding demand level will be typically be generated. As shown in *Figure 3.1*, the demand level on horizontal axis (x) has a corresponding price level on the vertical axis (y). The demand curve represents the market demand quantity for a product or service at a particular price level. Generally, the higher the price level, the less the firm will sell, and vice versa.

**Figure 3.1: Elastic Market Demand Curve**



The above curve illustrates *elastic* demand, which exists then prices changes have a dramatic impact on demand. The next figure illustrates an *inelastic* demand, which exists when price changes only minimally affect demand.

**Figure 3.2: Inelastic Market Demand Curve**




When the price falls from P1 to P2, the demand level (Q1 to Q2) for the firm's products increases but by a smaller percentage than the corresponding decrease in price level (compared with the elastic demand curve). Thus, price changes for inelastic products and services have a minimal effect on the demand level in the market. Price elasticity of demand is represented by the following formula:

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

Price elasticity of demand is affected by the value and unique nature of a product or service. The more unique a product is, the *less* sensitive its demand is to price change (increasing its *inelasticity*). By contrast, the less unique a product tends to be, the *more* sensitive its demand is to price change (increasing its *elasticity*). Companies that do not understand the value or unique nature of their products will often under-price them.

The closer a product resembles competitive products, the lower the price differences buyers will tolerate. Moreover, the closer the product differences between any two brands, the greater the probability that the category is price-elastic, and that brand-switching will occur when products go on sale.

It is not enough for a product to be unique. The sources of product uniqueness must be both recognized *and* valued by buyers. The majority of products sold through mass merchandise stores, grocery stores, chain stores, and vending outlets are easily substituted with similar products from competing brands.

### Cross-Price Elasticity of Demand

In economics, the **Cross-Price Elasticity of Demand** (or cross-elasticity of demand) gauges the dependency of the demand for one good on the price of *another* good.

It is measured as the percentage change in the demand for the first good that occurs in response to a percentage change in the price of the second good. For example, if in response to a 10% increase in the price of fuel the quantity demanded of new cars that are fuel *inefficient* decreases by 20%, the cross-elasticity of demand would be **-20% ÷ 10% = -2**. In this example, the two goods, fuel and fuel inefficient cars, are **Complements** (one is used with the other). In these cases the cross-elasticity of demand will be *negative*. In the case of perfect complements, the cross-elasticity of demand is *negative* ∞.

Where the two goods are **Substitutes**, the cross-elasticity of demand will be *positive* (as the price of one goes up the quantity demanded of the other will increase). For example, in response to an increase in the price of fuel the demand for new fuel-efficient hybrids will also rise (instead of spending money on fuel, it is invested in the hybrid as a substitute). In the case of perfect substitutes, the cross elasticity of demand is *positive* ∞.

In cases of **Perfect Independence** of products or services, the cross-elasticity demand will be *zero*. As the price of one good changes, there will be no change in quantity demanded of the other good.

## Price Elasticity and Estimating Market Response

Understanding price elasticity is helpful in estimating the market and proposing competitive responses to a price change. In commodity markets the price response to a change in price will be rapid and widespread, since firms in such markets will quickly attempt to prevent any changes in their respective market share positions. In markets with low elasticity levels, response to a change in price will be minimal, since demand in these markets is more affected by value changes than price changes. Understanding the value levels of the respective competitive products will enable pricing managers to better develop overall pricing strategies and generate higher profits for the firm.

The following questions should be answered when using elasticity to estimate market response:

- Do the pricing decisions support the long-term positioning of the product?
- For a specific offering in a category, what price will maximize the company's overall profitability in the entire category?
- When introducing a new product or extending an existing product, how will it impact existing products?
- How can price bundles of products/services be developed to enhance profitability?
- How pricing and bundled offerings be tailored to meet the unique needs of the most valuable customers?
- How can branded products effectively compete with lower priced or generic offerings?
- How can the specific benefits for which customers are willing to pay more be best determined?

- What will be the impact of competitive responses to new offerings and how would that change the optimal offering/price?
- If market constraints force downward pressure on prices, how can offerings be priced to minimize the impact on overall positioning and long-term profitability?

## Forecasting Demand and Price Setting

"Forecasting is the practice of estimating future demand by predicting what buyers are likely to do under a given set of future conditions."[11] Forecasting is an important element in setting market prices and in responding to competitive price changes (although very few products and services can be forecasted with *exact* precision). Demand forecasting generally involves a three-stage process: (1) the development of an environmental forecast, (2) an industry forecast, and (3) a company forecast. Furthermore, accurate forecasting involves the collection of three types of information: [10]

- **What buyers *say* they will do:**
  This type information is collected from surveys of buyers' intentions, composite sales force opinions, and estimates and expert opinions on trends in a market.
- **What buyers *actually* do:**
  This data is compiled by actual test markets.
- **What buyers *have done* in the past:**
  This data is collected from past sales analysis and leading market indicators.

**Buyer Purchase Intention** research is used to develop a purchase probability scale based on the consumer's current and future personal finances, buying intentions, and expectations about the economy. In industrial markets, various organizations conduct their own surveys on buyer intentions to purchase plants, equipment, and materials.

**Sales Force Estimates** are used to predict expected sales levels and effective prices in individual territories. These estimates are aggregated across all sales territories to develop a composite forecast. Companies rarely accept these forecasts without making some adjustments.

**Expert Opinion Data** is collected from dealers, wholesalers, distributors, consultants, and trade associations to develop industry-wide sales and pricing forecasts.

**Test Market Data** is used to corroborate the forecast data collected using the purchase intention, sales force estimates, and expert opinion forecasting methods.

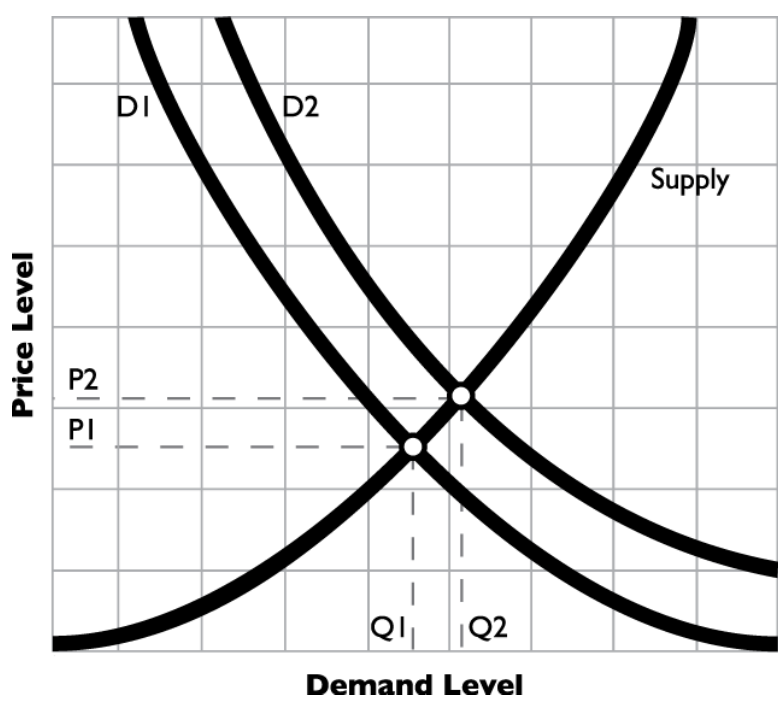
**Past-Sales Data** incorporates past sales and pricing history into a forecast. Long-term historical data is used to incorporate different factors into the pricing forecast such as general pricing trends, pricing cycles, seasonal pricing changes, and any instability trends.[11]

## Price Response Curve

The partial equilibrium supply and demand model in microeconomic theory (originally developed by Alfred Marshall) attempts to document, explain, and predict the price and quantity of goods sold in competitive markets. The price response curve is one of the most fundamental models utilized in developing pricing strategies. It is a basic building block in a wide range of more detailed economic models and theories. The theory of supply and demand is important in the functioning of a market economy in that it explains the mechanism by which many resource allocation decisions are made. However, unlike general equilibrium models, supply schedules in this partial equilibrium model are fixed, as the long run reciprocal relationship between demand and supply is ignored.

In general, the price response curve illustrates the fact that whenever goods are traded in a market at a price that causes consumers to demand more goods than firms are prepared to supply, a shortage results, which tends to increase the price of the goods. Those consumers that are prepared to pay more will bid up the market price. Conversely, prices will tend to fall when the quantity *supplied* exceeds the quantity *demanded*. This price/quantity adjustment mechanism causes the market to approach an equilibrium point, a point at which there is no longer any impetus to change. This theoretical point of stability is defined as the point where producers are prepared to sell exactly the same quantity of goods as the consumers want to buy.

**Figure 3.3: Price Response Curve**




The price response curve (theory of supply and demand) illustrates how product availability (*supply*) and the desires of those with purchasing power (*demand*) correlate with one another at different price levels. The graph depicts an increase in demand (from

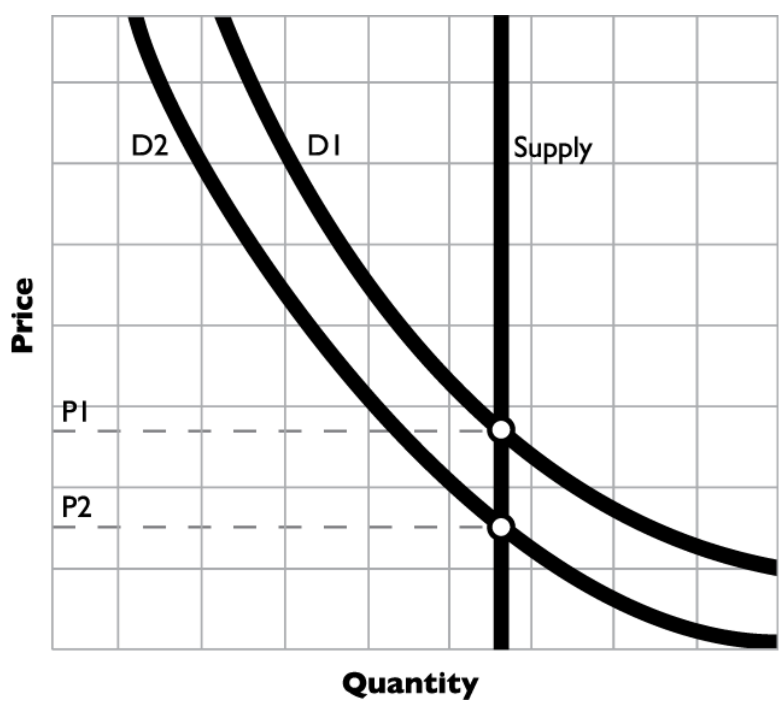
D1 to D2) along with an increase in Price and Quantity required to reach a new market-clearing equilibrium point on the supply curve. The **Supply Curve** is a schedule showing the total quantity of a good that sellers want to sell at each price.

## Inelastic Supply

It is sometimes the case that the supply curve is vertical (or inelastic), or that the quantity supplied is fixed regardless of the market price. For example, the amount of land in the world can be considered fixed. No matter how much someone might be willing to pay for a piece of land, additional land cannot be created. Regardless of demand, the same quantity of land will exist. In this respect, land can be represented by a vertical supply curve, giving it zero elasticity (for example, no matter how large the change in price, the supply will not change). On the other hand, the supply of *useful* land can be increased in response to demand (by irrigation or other types of development). Therefore, in this case, a purely a vertical supply curve is an over-simplification.

Nearly vertical supply curves are more common in short-term situations. For example, if the Super Bowl occurs next week, increasing the number of seats in the stadium is impractical. The supply curve of tickets can be considered vertical in this case. If the event organizers underestimated demand, then it may very well be that the price that they set is *below* the equilibrium price. In this case, there will likely be people who paid the lower price and who only value the ticket at that price, but there will also likely be people who could not get tickets even though they were willing to pay more. If some of the people who value the tickets less sell them to people who are willing to pay more (or scalp the tickets), then the effective market price will rise to the equilibrium price.

**Figure 3.4: Vertical Inelastic Supply Curve**



When demand D1 is in effect, the price will be P1. When D2 is occurring, the price will be P2. Notice that at both values the quantity is fixed at Q. Since the supply is fixed, any shifts in demand will only affect price.

## Reference Price Influences

**Reference Prices** are generally defined as price guides; in other words, these guides are reference points buyers use to gauge the price they are paying for a good or service as compared to the available alternatives. Reference pricing helps buyers determine whether they are paying too much for a product or service or whether they are getting a "bargain" relative to other purchasing options. The Internet has been an excellent source of reference price information for both consumer and industrial buyers. It has helped consumers to become "wise shoppers." For industrial buyers it has made them become more effective negotiators when buying products and services for their companies.

To use reference price influences effectively, a company should start with a price band analysis for one product or service across all sales people and transactions. This can be accomplished in a straightforward manner using spreadsheets or simple databases.

## Price/Quality Relationship

The **Price/Quality Relationship** refers to the perception by most consumers that a relatively high price is a sign of good quality. The belief in this relationship is most important with complex products that are difficult to test, and experience-based products that cannot be tested until used (such as most services). The greater the uncertainty surrounding a product, the more consumers depend on the price/quality hypothesis (increasing the premium they are willing to pay). The classic example of this is the pricing of the snack cake Twinkies, which were perceived as possessing less quality when the price was lowered. Excessive reliance on the price/ quality relationship by consumers can lead to the raising of prices on many products and services, even those of comparatively low quality, which in turn would cause the price/quality relationship to lose credibility.

**Premium Pricing** (also called prestige pricing) is the strategy of pricing at, or near, the high end of the possible price range. People will buy a premium priced product because:

- **They believe the high price is an indication of good quality:**
  This is a direct result of the price/quality relationship discussed above.
- **They believe it to be a sign of self-worth ("I am worth it"):**
  The purchase authenticates the consumer's social status by signaling to others membership in an exclusive group.
- **They require *flawless* performance in this application:**
  The cost of product malfunction is too high to buy anything but the best (like a heart pacemaker).

The term **Goldilocks Pricing** is commonly used to describe the practice of providing a "gold-plated" version of a product at a premium price in order to make lower priced options look more reasonably priced. For example, encouraging customers to perceive business-class airline seats as a good value by offering an even higher priced first-class option. Similarly, third-class railway carriages in Victorian England are said to have been built without windows not to punish third-class customers, but rather to motivate those who could afford second-class seats to pay for them instead.

The name derives from the Goldilocks story, in which Goldilocks chose neither the hottest nor the coldest porridge, but instead the one that was "just right". More technically, this form of pricing exploits a normal psychological aversion to extremes.

## Switching Costs

The term **Switching Costs** (or barriers) is used in pricing, strategic management, and marketing to describe any impediment to a customer changing suppliers. In many markets, consumers are forced to incur costs when switching from one supplier to another. These costs are called switching costs and can manifest in a variety of ways.

Switching costs can be quite broad in scope. They can include the costs associated with switching suppliers, or costs that would be *duplicated* if switching suppliers (like having to re-pay a setup fee to with a new supplier). Switching costs can also arise for several different reasons.

Examples of switching costs that might arise from changing to a new mobile phone carrier might include the effort needed to inform friends and relatives about a new telephone number, learning how to use the interface of a new mobile phone brand, or the time lost due to the paperwork when switching carriers.

Types of switching costs include: exit fees, search costs, learning costs, cognitive effort, emotional costs, equipment costs, installation fees, start-up costs, financial risk, psychological risk, and social risk. Some of these costs are easy to estimate. Exit fees include contractual obligations that must be paid to the current supplier and compensatory damages that may be awarded for breach of contract. Often, vendors combine sign-up incentives with penalties for early cancellation. Careful buyers who read the fine print should not be surprised by exit fees. Some effort and expense should be expected when locating an alternative supplier and learning how to use a new product.

Psychological, emotional, and social costs of switching are often overlooked or underestimated by both buyers and sellers. There are several rules of thumb to help understand why many consumers do not immediately switch from a product they currently use to the latest innovative improved product, even if the cost difference is minimal.

1) People are sensitive to the relative advantages and disadvantages of any change from the status quo. A “new and improved” product must offer enough incremental value to *outweigh* these switching costs in order for customers to actually switch. Different sensitivities to the existence of these costs will affect this threshold.
2) Different people have different reference points. For example, a traveling salesman would value the advantages of a mobile phone over a landline from a much different perspective than a homebound, fixed-income, retiree might.
3) People exhibit loss aversion. The pain of giving up a benefit is much more significant than the pleasure of gaining that benefit. For example, DIVX technology

may have failed, in part, because it did not offer the typical consumer a strong benefit to offset the perceived sacrifice of unlimited viewing time and the cost of having to hook into a phone line.

Where switching costs are prohibitively high, the situation can be perceived as a *monopoly* from a buyer's perspective (where there is a single seller), as a *monopsony* from a seller's perspective (where there is a single buyer), and as a *bilateral monopoly* from both perspectives (where there is a single seller and a single buyer).

### Competition, Collective Switching Costs, and Market Performance

Switching costs affect competition. When a rational consumer faces switching costs, he or she will not switch to the supplier offering the lowest price if the switching costs (in terms of monetary cost, effort, time, uncertainty, and other reasons) outweigh the price differential between the two suppliers. If this happens, the consumer is said to be locked-in to the supplier. If a supplier manages to lock-in consumers, the supplier can raise prices to a certain point without fear of losing customers because the effects of lock-in (such as time and effort) prevent the consumer from switching.

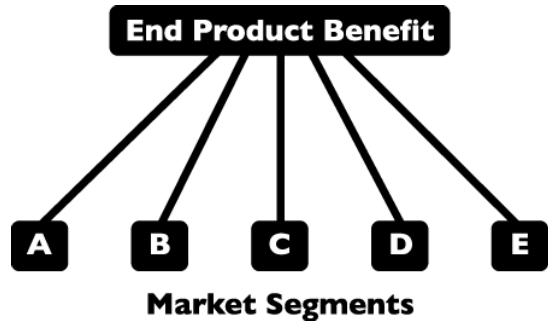
## End-Benefit Segmentation Effect

**End-Benefit Segmentation** is a method used in developing pricing strategies that includes the product's economic value to the customer in the price of the product or service. It recognizes that customers buy the same products for different reasons and places different values on particular product features. For example, the access control industry markets the same product for two different value sets. Banks, factories, and airports install access control systems for security reasons (to protect their assets against theft), whereas sports stadiums, concert arenas, and mass transit systems install similar equipment to cut costs by eliminating manual ticket handling (or perhaps generate additional revenue).

One of the recommended approaches to end-benefit price segmentation is for a company to decide whether it wants to have a limited number of products offered to many segments or many products offered to a limited number of segments. It is in the best interests of a business not to offer many product lines to too many segments (as this would dilute their focus and resources), but this still happens relatively often.

Although the approach in *Figure 3.5* may not apply to every situation, it illustrates the benefits of exercising as much market segment focus as is practical. The one-to-many model suggests that a firm should keep a sharp focus and make use of economies of scale throughout the supply chain.

**Figure 3.5: End-Benefit Price Segmentation**




## Size of Purchase Effect

If the quantity of product demanded does not equal the quantity supplied in a market, prices will be adjusted. If there is a market *surplus* or glut (excess supply), then prices will *fall* in order to encourage more purchases and reduce the surplus. A surplus in the market might also lead to a simultaneous reduction in the quantity supplied to the market. Market *shortages* (excess demand) cause prices to *rise* in order to encourage fewer purchases, thus reducing the overall demand. The degree of disequilibrium between supply and demand that results from market purchasing (when an oversupply or scarcity is produced) is referred to as the **Size of Purchase Effect**.

The "Short Side" of the market is dominant in each of these situations. Limited demand constrains supply during a market surplus and limited supply constrains demand during a market shortage. An example of this market dynamic can be found in the market for crude oil. As the price drops, supply is curtailed to maintain price stability. As the price increases (if brought about by an increase in demand), supply is increased.

## Shared-Cost Situation & Fair Price Comparison

Whenever a purchase might involve the following factors, the seller may be willing to share the costs of purchasing the product, or to create a **Shared Cost Situation**:

- **High Costs of Initial Installation:**
  The seller may volunteer to share the costs of installation with the buyer or even provide free installation for the buyer. This lowers the purchase costs for the buyer and makes it easier for the seller to close the deal.
- **A New Product Introduction:**
  The seller may be willing to lower the price to get the buyer to try the new product. This tactic is used if the buyer perceives there to be a risk in buying the new product.
- **Free Product and Free Installation:**
  The seller may agree to offer the product for free to the buyer if the buyer will allow the seller to use his or her facility as a showcase for other interested customers and act as an advocate of the product by extolling its advantages.

The above shared-cost strategies are often used to "grease the wheels" in the marketing and pricing strategies of firms, but often only in cases where the customers are large enough to have a significant influence on the purchase behavior of other buyers.

Buyers will typically make **Fair Price Comparisons** when reviewing potential purchases to see how the proposed price relates to alternative purchase options in the marketplace. These comparisons directly affect the purchase decision. Due to the great amount of information available on the Internet, buyers now enjoy an unprecedented level of price transparency within industrial as well as consumer markets.

## Managing Price Perceptions and Sensitivity

Developing an effective pricing strategy requires that a company understands the price perceptions and price sensitivities of its customers. Implementing a pricing policy that separates the value component from the cost component is an ideal way to manage pricing perceptions and sensitivity.

This allows customers to see the cost component while differentiating the incremental value that is delivered. The process begins with a strong comprehension of the economic impact the products have on the business of each customer (or on a customer's life in B2C relationships) compared with any alternative purchase options that are available.

Before discussing price with a customer, a company should craft a pricing policy that clearly communicates the value to be delivered as well as the fairness of the price. To accomplish this, companies must conduct thorough research and understand the value of their products and services, as well as the value offered by competitors.

When differentiating the value from the cost components, it is important to communicate clearly and openly with customers. Frequently, it is not a price increase that creates customer discontent, but rather the perception that another customer is paying less. This discontent can be managed by implementing pricing policies based on the following:

- **Integrity:**
  The price a customer is asked to pay is fair for the value the customer receives. Price points must pass the "red face test," meaning that price differences among customers can be explained *without embarrassment* by differences in value delivery.
- **Discipline:**
  No special deals or rebates are negotiated with customers. It should be clear that if customers insist on lower prices, they will always receive lower value.
- **Fairness:**
  Customers must understand there is consistency in pricing policy implementation; no other customer gets a lower price while receiving the same value.

A significant amount of each customer interaction (including sales, support, and management) should be devoted to reinforcing the value communication: "*This* is why you buy from us." The constant reminder of the firm's value delivery is aimed at reducing customer price sensitivity and ultimately at fully capitalizing upon the value the company provides.

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## Review Questions

1. For pricing to become a core competency in any business, the business must understand the "5C's of Value."
   (a) True
   (b) False

2. Value is a quantifiable estimate of a product's impact upon which of the following?
   (a) A company's sales force
   (b) The leadership potential of the firm's senior management
   (c) A customer's revenue and costs
   (d) None of the above

3. Firms that launch brand campaigns as the major initiative for their B2B customer acquisition and retention strategies are at a significant competitive disadvantage.
   (a) True
   (b) False

4. When value is absent from the customer relationship, customers will generally:
   (a) View low-cost as the only value delivered by their supplier and will be happy to let multiple vendors duke it out with low prices
   (b) Force the seller to expand its product line
   (c) Seek distributors from whom to buy
   (d) None of the above.

5. Elasticity or the responsiveness of the demand for a company's products or services is generally considered to be an important factor in developing a pricing strategy.
   (a) True
   (b) False

6. Which of the following generally affects the price elasticity of demand?
   (a) The value and unique quality of a product or service.
   (b) The size of a company's sales force.
   (c) The existence of a pricing committee in a firm.
   (d) None of the above

7. Developing a forecast generally involves a three-stage process: (1) the development of an environmental forecast; (2) followed by an industry forecast; and then (3) a broad economic forecast.
   (a) True
   (b) False

8. Sales force estimates are used to predict which of the following?

(a) Expected customer purchases in the individual territories of sales personnel
(b) What prices sales personnel expect to charge customers
(c) How many discounts a sales person will offer individual customers
(d) a & b only
(e) None of the above

9. When the supply curve is vertical, it reflects an inelastic market.

(a) True
(b) False

10. Customers will buy a premium priced product because:

(a) They believe the high price is an indication of good quality
(b) They believe it to be a sign of self worth
(c) Because there are no discounts available
(d) They want to please the seller
(e) a & b only
(f) None of the above

# Module 4: Pricing and Competition

## Introduction

In the absence of competition, estimating the impact that a price change will have on sales is simply a matter of analyzing the price sensitivity of buyers. Pricing a product in a competitive market, however, is a much more complex task. Competitors can disrupt the sales estimates of pricing managers by changing the prices of their own products. When a competitor's price changes, the buyer's alternative to purchasing a product changes as well (along with the price buyers are willing to pay).

The intensity of price competition and its importance in formulating a pricing strategy can vary greatly among different products. There are several factors that set the stage for intense price competition:

1) **High Inter-Brand Price Sensitivity:**
   This occurs when the majority of the sales gained from a price cut come from the competitors of the firm.
2) **Low Competitive Barriers to Entry and Growth:**
   If new competitors can easily enter the market, the costs of increasing their market share will be nearly the same as the costs incurred by existing firms trying to protect their market share.
3) **Consumer Perception that there are Few Differences Between Products:**
   When few differences are perceived between any two products in a market, purchase decisions tend to be more heavily price based.
4) **Industries that have Fallen into the Commodity Trap:**
   When manufacturers in an industry believe that price is the only determinant of sales they have fallen into the commodity trap.

High inter-brand price sensitivity, low competitive barriers, and products that are perceived and treated as commodities only create the *potential* for intense price competition. Whether intense price competition will actually occur is another matter. The presence of differentiated brands with low inter-brand price sensitivity may reduce the likelihood and the intensity of price competition.

The greater the potential for price competition, the more important it is for a firm to evaluate competitors and how likely they are to use price in their marketing strategy. Pricing professionals must ask themselves, "What price changes are my competitors likely to make and how will they respond to my own price changes?"

## Pricing and Competitive Positioning

**Competitive Positioning** is the practice of "arranging for a product to occupy a clear, distinctive, and desirable place relative to competing products in the minds of customers."[11] What sets a product, service, and company apart from those of competitors in the minds of customers? What value is provided and how is it different from the alternatives in the market?

Before positioning a product or service, a firm must identify possible competitive advantages upon which it might build. A competitive advantage is anything that allows a firm to offer the customer a greater value proposition than its competitors. This advantage can be based on price, product, services, channels, people, or sometimes an overall brand image. Firms can justify higher prices by offering a more benefits than competitors. In many cases, multiple firms will go after the same competitive position and each will have to find unique ways to differentiate themselves. After choosing the competitive advantage that the best suits the firm, an overall positioning strategy must be developed to support it.

There are five basic positioning strategies, each offering a different value proposition to customers. Kotler defines these strategies as offering: More for more, more for the same, more for less, the same for less, and less for less. These strategies illustrate the relationship between price and benefits (or value), as well as the integral role that price plays. Companies do not become strong competitors through pricing alone, but by having a total competitive advantage that competitors cannot easily duplicate.

Any strategy based on price alone is rarely sustainable. There are four conditions when it may make sense to compete solely on price, or times when the rewards of aggressive pricing are large enough to justify the risks of the practice:

1) **A firm has a substantial incremental cost advantage (or can achieve one with a low-price strategy):**
   An example of this is in markets that have an "experience curve." In other words, by pricing low and accumulating volume faster than competitors a firm reduces its costs and creates a competitive advantage through low pricing.
2) **A firm can effectively target only a small segment of a competitor's market:**
   When this is the case, it may be safe to assume that a competitor will not feel the need to respond and a firm can compete on price.
3) **Subsidizing losses in one market for profits in complementary products:**
   A firm may be able to establish a price difference that competitors cannot match by relying on increased profits in other product areas. For example, Amazon originally justified its low pricing on books because it was building a body of loyal customers that would buy other products.
4) **Overall industry changes in pricing:**
   Sometimes price competition will expand the market enough so that lower margins and competitor reactions do not hinder industry profitability. The firm that undertakes this course of action assumes it knows better than competitors, and that it is leading the industry towards pricing that is in everyone's best interest.

Price is a particularly poor competitive tool for larger companies. When such companies discount prices to protect existing customers from smaller competitors, they are often needlessly cutting price. A superior strategy is to leverage competitive advantages in other non-price areas (such as advertising, distribution, or product innovation).

The more a firm is able to differentiate itself from its competition and develop a value proposition that customers desire, the better able it will be to command a premium price. Since price is the easiest way to make marginal sales, a firm that continually competes on price is only pursuing short-term solutions. When a firm constantly needs to make price discounts, it is a sign that the firm is either targeting the wrong customer segment or that it is not developing a viable value proposition that differentiates it from the competition.

## Competitive Reaction Strategies

Firms that compete in price-competitive markets will eventually find themselves needing to react to the price changes of competitors. When this is the case, the firm must analyze the competitive situation and formulate a response. Developing a competitive reaction strategy involves more than just deciding whether or not to respond with price. It also involves deciding how to adapt the overall competitive strategy to the new situation.

Nagle recommends that when reacting to competition, it is important to "think before you act". Too often managers will focus only on price. But there are several questions a firm must ask before an appropriate reaction strategy can be chosen: [14]

- What is the realistic avoidable sales loss?
- Is there a response that would cost less than this preventable sales loss?
- If the firm responds with price, will the competitors cut prices again to maintain the price differential (or can they)?
- Will the final cost of a price war cost less than the avoidable sales loss (including all subsequent price cuts)?
- When there is a new competitor, some sales will be lost regardless of pricing strategy. Is the firm's position in other markets, geographical or product, threatened if a competitor gains market share in the attacked market?
- Is the threat to any at-risk markets great enough to justify the cost of a price-based response?

There are two things to consider when thinking about responding to a competitor with price. These considerations are the *strength* of the competitor (in terms of competitive advantage rather than market share), and the *cost* of a price reaction. When possible responses are less costly than simply allowing a competitor to take sales, a price response might be justifiable. Reaction strategies may include adapting to the competition, changing the competition, or eliminating the competition in order to minimize adverse effects on the firm's long-term profits. Nagle and Hogan outline some possible competitive reaction strategies as well as appropriate times to implement them in the table below. [15]

| Competitor is strategically: | Weaker | Neutral or Stronger |
|---|---|---|
| Price reaction is too costly | IGNORE | ACCOMODATE |
| Price reaction is cost-justified | ATTACK | DEFEND |

### Attack: Going Below the Competition

Attack-based responses can be justified when the price-cutting competitor is weaker and the costs of the attack are acceptable. This is a rare situation because weak competitors do not generally start competing on price unless they have made some sort of miscalculation. The miscalculation convinces the competitor to use price as a weapon, despite a weak competitive position. These types of misjudgments do occur, although they are rare. When a firm realizes a price-cutting competitor is vulnerable, pricing below the competition may drive them from the market.

## Defend: Meeting the Competition

Strong competitors (or competitors of equal strength) are much more likely to cut their prices than weak competitors. When a relatively strong firm cuts price and the cost of retaliation is less than the cost of lost sales, it may be best to respond by matching the competitor's price cut. Because the competitor is strong, the amount of sales at risk might be great and a strong competitive defense would be justified. The purpose of a defensive response is not to eliminate the competitor but rather to convince the competitor that an aggressive pricing strategy is not in its financial best interest and to refrain from resorting to such tactics both now and in the future.

However, before responding to a competitor's price cut, it is important to carefully consider whether the competitor is willing (and more importantly *able*) to cut prices even further. It would be unwise to match a price cut if the competitor will only quickly re-establish the price differential by further reducing prices. This is especially dangerous with competitors who cut price because they have a small market share and no other way to attract customers. Such competitors have little to lose by continuing to cut prices in order to maintain an advantage.

## Accommodate: Raising the Price

A strong price-cutting competitor that gains market share is a threat to the survival of the firm. But if a reciprocal response will cost more than the loss in sales that would be prevented, then this is *not* the most appropriate long-term response to the competitor. The firm must instead adapt itself (or accommodate itself) to the change in the competitive environment with a tactic other than price-cutting, which requires certain changes in firm's overall competitive strategy.

When Sears was faced with competition from Wal-Mart, they had the option to match, beat, or ignore Wal-Mart's low prices. Instead, Sears actively changed its competitive strategy to more effectively compete. This is not the same as ignoring or confronting a competitor who is cutting price. This approach seeks to find a new competitive strategy to minimize the impact of the price-cutting threat. Finding a new competitive strategy based on non-price-based value differentiation helps protect against competitor price movement and can even support *increased* prices.

## Ignore: Status Quo Pricing

When a price-cutting competitor is weak and retaliation is not cost-effective, one reaction is to simply ignore the competitor's change and maintain status quo pricing (by maintaining existing prices). This is appropriate when facing a competitor with no competitive product or cost advantages. In this case, the amount of sales at risk is small and will most likely remain so. When a competitor is weak and the cost of a price reaction is high, ignoring the threat is a reasonable response.

There are cases when firms may be tempted to attack rather than ignore a competitor who has reduced prices and poses no significant threat. This is often called the "deep pockets" strategy. This strategy is based on the confidence that the firm will prevail in any price war with the competitor. Even though such a strategy appears to be a safe bet, it suffers from some significant flaws.

The larger firm will most likely defend its market share successfully. However, the real winner is the firm that maintains *profitability*. If profitability is sacrificed in a price war, it may actually counteract the benefits gained by preserving the firm's market share. It is also unwise to assume that eliminating a competitor will eliminate competition. While it is often true that weak competitors who serve small price-sensitive segments will open doors for stronger competitors (since they can use the weaker competitor's base to grow themselves), this is not always the case. Attacking weak competitors only makes sense when an industry is unprofitable, and it is not likely that a new entrant will replace an old competitor.

### Targeted Response

It is also possible to respond to a price-cutting competitor with something other than one of the across-the-board strategies described in the table above. These targeted strategies can potentially reduce the cost of the strategic response:

1) **Focus on Certain Market Segments:**
   A reactive price cut might target only the customers that would be attracted to the competitor's original price cut. Alternatively, a "flanking" offer could be developed that is only attractive (or even only available) to price-sensitive customer segments.
2) **Target the Incremental Volume at Risk:**
   For example, the firm might decide to discount purchases in excess of 80% of expected purchases, or purchases from the previous year.
3) **Focus on a Particular Geographic Area or Product Line:**
   It might be wise to concentrate on a geographic or product area in which the competitor stands to lose the most strategic ground from reactive price cuts.
4) **Additional Options:**
   Alternative options include educating a competitor's customer base about the new customer discounts they are offering, leveraging any competitive advantages to increase the value offered (instead of decreasing prices), or raising the cost of the competitor's discount by using strategies such as price-matching.

## Offensive and Defensive Pricing

Offensive pricing establishes price leadership as the basis for competition. These tactics may utilize penetration pricing, experience-curve pricing, and promotional discounting. An offensive pricing strategy must be based on supporting cost advantages derived from design, economies of scale, supply chain, or perhaps superior technology. One danger of using offensive pricing is that price leadership may not be sustainable. Another notable danger of this strategy is that it may inadvertently initiate a price war.

Defensive pricing seeks to defend market position from the pricing of an offensive competitor. Occasionally managers who find the market share of their brand decreasing will want to quickly increase price in the hopes of gaining lost revenue. Transit managers traditionally fall into this category. However, other mangers normally believe an aggressive price decrease is needed to regain market share.

Firms on the offense often attack using promotional discounts. Occasionally, these discounts are targeted towards consumers new to the market, but they are usually targeted towards consumers who regularly purchase another brand. The objective of the discount is to educate consumers about the attributes of the discounted brand so it is no longer an unknown alternative. In this case, a competitive promotional discount can be a threat.

When a firm is faced with the threat of a competitor offering sales promotions aimed at its customers, it is tempting to implement a defensive pricing strategy and match the discounts. Firms perceive their market share to be threatened and believe that defensive pricing will neutralize a competitor's promotional pricing. But a defensive strategy does not necessarily require price cuts to be effective, and in fact there are a few considerations that might diminish the overall effectiveness of any defensive pricing strategy.

Only a segment of a firm's customers will ultimately respond to a competitor's sales promotion. Since the firm does not know which segments are in danger of switching, any defensive price cuts must usually be offered to all customers segments. This puts the defending firm at a cost disadvantage if the competitor happens to have a smaller market share, or if the competitor is only targeting one of its small customer segments.

In instances where the costs of a competing product are primarily incremental and avoidable, new firms are able to offer price discounts at little cost until customers respond and try the product. If the defending firm has a higher proportion of fixed costs, then the cost of a defensive pricing strategy will be relatively higher than it would be for its competitor. Therefore, to the extent that costs are incremental and avoidable, a firm promoting a new brand can repeatedly offer attractive deals at little cost until they are successful; whereas, the established firm may bear much more significant costs in repeatedly defending against them.

Frequent discounting or "dealing" can also tarnish a brand's image (or the perceived brand value), and ultimately reduce buyer loyalty. Unless the established brand is positioned as an economy product, the firm may have difficulty re-establishing its former price without losing some loyal customers in the process.

Defensive pricing may be advisable when product costs are overwhelmingly fixed for both the competitor and the defending firm. In this case, a new firm offering a promotional deal on a new brand will incur the same costs as the defending firm even if it makes no sales. There are also instances when a firm's premium image in the market has such a minor relationship with its customers' price sensitivity that the firm need not worry about diminishing its perceived brand value.

In light of these considerations, while it may be reasonable for new brands with small market share to use sales promotions to induce new customers, it does not seem wise for established brands to react to such promotions with defensive pricing. Established brands should not ignore these threats. However, even in the best circumstances, defensive sales promotions are costly. A defending firm should always look first to other more cost effective tools to counter a competitor's price deal.

## Developing the Competitive Response Plan

For effective pricing initiatives, it is important to anticipate the price changes competitors might initiate as well as their responses to the pricing initiatives of others.

The need for pricers to consider probable competitive responses when planning price changes for their own firms is somewhat obvious. In relatively stable commodity industries (and near-commodity industries), the behavior of established competitors tends to be predictable. When pricing behavior is unpredictable, a **Competitor Pricing Analysis (CPA)** is essential. Nagle defines the three necessary steps for a CPA (either implicit or explicit): identify the potential for price competition for each product, classify each competitor's likely strategy, and evaluate the consequences of competitors' strategies.

Identifying the potential for price competition will likely be based on available objective data as well as managerial judgment. If price changes are frequent, then past experience may reveal the effect of one brand's prices on the sales of competing brands. If past experience is not readily available, then market research can collect additional data.

The classification of each competitor's likely pricing behavior should begin with a study of past behavior and any stated intentions. Of course, a competitor's strategy can change along with market conditions (or a variety of other reasons). Because of the complex factors that drive the strategies of competitors, it can be extremely unreliable to rely solely on the past behaviors of a competitor to predict their future actions.

Michael Porter offers four additional competitor characteristics to consider when predicting competitive behavior. To the extent that it is possible to identify these characteristics, predicting future pricing behavior will be more accurate:

- Future goals for the company as a whole and for individual products
- Current business strategy
- Firm's assumptions about itself and the industry
- Capabilities, including both its distinct strengths and weaknesses

Competitor pricing behavior can be classified as one of four general types:

1) **Cooperative:**
   Changes price along with other firms to maintain differentials in prices. Adjusts output as necessary to maintain traditional market share.

2) **Adaptive:**
   Takes price changes as given and adjusts prices accordingly. Attempts to increase sales when prices increase and to reduce sales when prices decline (assuming it cannot influence the pricing structure by actions).

3) **Opportunistic:**
   Initiates price cuts, delays, or even foregoes meeting price increases (and always meets price decreases quickly). Attempts to use any change in pricing to maintain or increase its sales at the expense of competitors.

4) **Predatory:**
   Initiates large price cuts to inflict harm on financially weaker competitors. Attempts to increase sales as much as possible at the expense of targeted competitors.

After considering the general characteristics of competing firms in an industry, it is important to evaluate the consequences their strategies will have on the ability of the pricer's firm to achieve its own goals and objectives. The answers to the following questions will guide pricing managers in selecting a pricing strategy that is appropriate for the competitive environment their firms face: [14]

*What specific actions is each competitor likely to initiate, and how would each action likely affect the sales of the pricing manager's firm?*

- Will opportunistic competitors initiate new price cuts or similarly choose *not* to increase their prices in reaction to price increases from their competitors?
- Will opportunistic competitors cut prices *covertly* to avoid competitive reactions, or will they do so with public fanfare to maximize the immediate impact of the action?
- Will adaptive competitors significantly expand their sales if industry prices increase or will they maintain their current sales levels?
- Will any adaptive competitors drop out of the market if prices decline?
- Will predatory competitors target industry members for education or elimination, and what would be the overall impact of any potential industry crossfire?

*What effect will the reactions of competitors have on any price changes the pricing manager's firm might initiate?*

- Will any competitors match an opportunistic price cut?
- Will any competitors become predatory in response to an opportunistic price cut?
- Which competitors (if any) would need to follow a price increase in order for the price increase to be profitable?
- What would be the financial impact of competitive cooperation with a price increase (or lack of cooperation) on the sales of the firm?

## Managing Price Information

Previous discussions have treated competitive pricing behavior as if it were a purely external factor. To a large extent this is true. However, the pricing behavior of a competitor is not *entirely* beyond the control of the firm. The behavior of competitors depends partly upon their evaluation of the capabilities and intentions of *their* competitors. To some extent, a firm has control over the way it is perceived by its competitors through its management of pricing information.

The decision to reduce price in order to gain customers may have unexpected long-term effects depending on how competitors interpret such an action. Without any additional information, a competitor will most likely see a price cut as an attempt to grow market share, which may lead the competitor to implement defensive price cuts of its own. However, if a price cut is seen as a response to an offer the competitor previously made, the competitor will likely perceive the price cut as a defensive measure. Managing price information and sending certain messages can help reduce future opportunism and stabilize industry prices.

### Communicating and Pre-Announcing Price Information

Most firms recognize the value of collecting competitive intelligence but fail to understand the value that might be realized by purposely revealing similar information to competitors. Selectively communicating price information is often a useful move, unless it would diminish a first-mover advantage into a new market.

One of the most important times to communicate intentions is *before* a planned a price increase. Even when a price increase is in the best interest of all suppliers, firms often fail to get competitors to participate in the price increase. Some competitors do not increase their prices in the hopes of gaining sales through lower prices. For other competitors, price increases may not be a sensible option (particular competitors with lower costs).

Firms should publicly explain the industry need for higher prices and whenever possible announce their own price increases well in advance of the effective date. This "toe in the water" approach allows a firm to withdraw from the increase if others do not join in. Repeated use of this approach might signal competitors that new price increases will not occur without them. It is important that the actions of the firm are not entirely dependant upon the actions of competitors though in order to avoid collusion.

When a firm is planning to reduce prices for non-opportunistic reasons, it is important to announce the reasons in advance and avoid misunderstandings. One non-opportunistic reason a firm may choose to reduce price is to stem market share erosion. If a product loses its competitive advantage and can no longer command a premium price, competitors may allow price cuts in order to maintain industry stability. However, these competitors must be assured with reliable sales data that this is the only intention of the firm.

Another non-opportunistic reason a firm may choose to reduce prices is to expand market size. It is important to communicate that the intention of the firm is not to capture more of the existing market. For example, new products with less *value* may be introduced using lower prices as a way to attract new customers to the market. Advertising the reduced value is one way to signal competitors of this intention.

Even if a firm intends to cut prices for opportunistic reasons, it can attempt to influence competitors with honestly stated intentions and clear explanations of how it plans to support the price reduction. For example, if a firm has developed a new state-of-the-art production process that will give it the lowest incremental production costs in the industry, then giving interviews and issuing press releases to communicate this information will show competitors that they cannot win in a price war.

Firms can also communicate their willingness and ability to defend any attack on their markets. The policy communicated may be one of mutually assured destruction. If a firm is threatened by a competitor's pricing moves, it may diminish its risk by clearly communicating its commitment to defend itself. This type of "saber rattling" can be effective if competitors believe it is backed with financial strength and strong intentions. Competitors who see a firm that has the will and the strength to protect its markets will be significantly more likely to avoid any challenges. This type of communication is also useful after an attack has begun. If a competitor attacks on price in a lucrative market segment, a firm can retaliate with "a limited time" offer in the affected market. This signals that although the new price is not a permanent change, it can remain in effect until the initial attack has stopped.

Communicating price information costs a firm practically nothing and can have a significant impact on the behavior of competitors. Many firms use this tactic not only to communicate actual intentions, but also to bluff and mislead competitors. While bluffing may occasionally be a beneficial strategy, the more that communications are honest the more credibility the firm will acquire. Bluffing can undermine a firm's credibility, thereby diminishing the firm's most efficient tool for influencing competitive behavior.

Communication should also be consistent. If a firm only selectively reacts to opportunistic price cuts, then competitors will suspect that the firm is not committed (or able) to defend its market. If competitors believe a firm is weak, they are more likely to test it.

## Price Wars

In the battle to capture customers, firms will use a wide range of tactics to fight off competitors. Price is increasingly the weapon of choice, and what often begins as an isolated battle frequently deteriorates into a full-blown price war. **Price Wars** occur when firms compete to increase market share by decreasing price. One competitor lowers its price and others then lower their prices to match. If one of the firms reduces its price below the original price cut, then a new round of reductions begins.

What causes price wars? Sometimes they are started intentionally, such as when a firm tries to strategically enter a new market, works to increase its market share, or simply wants to change the way business is done in the market. Sometimes price wars begin when a new firm (or a firm that introduces an improved product) fails to set a price premium that reflects the *value* that buyers receive. As customers of other firms discover this, competitors begin to lose sales. Since they are unable to respond quickly enough with their own new products or product improvements, they attempt to re-establish value equivalence by reducing their prices. This can launch a price war.

One of the most common reasons for a price war is that sellers misread the intentions of a competitor or misread changes in demand or market share. When a seller reduces its prices, a competitor generally defensively reacts with a "they're not going to get away with that" attitude. However, it is entirely possible that the price reduction may be temporary. Perhaps the seller seeks to reduce excess inventory or requires that specific requirements be satisfied in order to receive the lower price. The lower price may even be accompanied by a decrease in value.

If demand grows less than the percentage that a firm expected, there may be a perception that the firm's market share has declined. Even if the firm actually experienced a larger increase than its competitors (effectively increasing its market share), it might incorrectly perceive the need to lower prices to regain the "lost" market share. Some firms overreact to the limited and focused price reductions of others with broad price reductions across the board. This initiates an all out war when only a minor skirmish might have been necessary.

Some industries are more prone to price wars than others because of reasons such as these:

- When a product is an undifferentiated commodity, price plays an important role and this leads to more competition based on price.
- Shorter product lifecycles tend to spawn more price wars as competitors fight for market position with each innovation cycle.
- The more competitors there are in the market and the more transparent prices are, the more likely it will be that certain competitors will price aggressively.
- Low capacity utilization or declining market size will increase the desperation of competitors to increase their volume.
- When an industry has only a few large customers, they tend to exert strong price pressure on all competitors.

- Risk also increases when switching costs are low, price sensitivity is high, or when costs are unstable or declining.

In highly competitive industries, lack of information (or false information) can also fuel a price war. Would an opportunist be likely to cut prices if competitors were *certain* to retaliate? Price information can also help prevent price wars that are started from sources other than competitors, such as purchasing agents looking for a better price. A purchasing agent may falsely claim to have received a better price from a competitor. If purchasing agents do not secure their desired price with these false claims, some may go so far as to feed the perception by giving away orders to these fictitious cheaper competitors. The only way to prevent a downward spiraling price war brought on by such a situation is to monitor the prices of competitors closely enough to know if a buyer is lying.

## Dangers of Price Wars

Many firms believe that reducing prices is an effective way to gain market share. But reducing prices can all too often trigger a self-destructive price war unless a firm has a significant cost advantage (30% or more).[10] Price reductions are almost always copied because no firm wants to lose customers, volume, or market share. Firms should go to *tremendous* lengths to avoid a price war.

Price wars can be economically devastating and psychologically debilitating, and they can take an extraordinary toll on an individuals, firms, and overall industry profitability. The list of industries torn apart by price wars is extensive and constantly growing. These wars rarely have winners and very few healthy survivors. No matter who may "win," the combatants *all* seem to end up worse off than before. Yet price wars are becoming increasingly common, and uncommonly fierce.

The primary dangers associated with a price war are listed below:

- The price advantage rarely lasts long, and often fades quickly. Slashing prices is just about the easiest strategy for other competitors to imitate.
- Profits are extremely sensitive to price changes and it is unlikely that demand will increase nearly enough to offset the drop in prices, particularly when competitors slash their own prices even further in retaliation.
- A price war distorts customer price expectations and reference points. These price perceptions remain damaged long after the price war has ended.
- During price wars, customers become more sensitive to price and less sensitive to value. The benefits perceived in a superior product will be lost during a price war. Customers are bombarded with price messages and inevitably become more price sensitive and less value sensitive.
- Firms may hope that a price war will result in an industry shakeout (or that weak competitors will be eliminated), but this rarely happens. The government tends to adopt a pejorative view of this and may consider it to be predatory pricing. Also, emotional reasons can sometimes cause weak firms to remain in a business years after it stops making economic sense for them to do so. Usually failed competitors do not actually leave the market, but are instead acquired by other firms (or live on in bankruptcy protection). Even if a weak competitor does drop out, its capacity very often remains active within the industry.

Preventing and avoiding price wars should be a high strategic priority because they can greatly reduce the profitability of the firm (as well as the entire industry), they rarely provide a firm with a sustainable advantage, and they often result in irreparable damage.

## Staying Out of Price Wars

Given all the dangers of price wars, why are they so prevalent? On rare occasions a firm may pursue a price war as component of a sound overall strategy. For example, when a firm invests in a new cost-cutting technology it may slash prices to gain market share and prevent competitors from obtaining the technology.

Other times it may be wise to participate in a price war are when:

- A firm has a cost advantage.
- A firm can identify a large and growing segment of price sensitive customers.
- A firm's pockets are deeper than those of its competitors.
- A firm can achieve economies of scale by expanding the market.
- A rival can be neutralized or eliminated because of high barriers to market entry and re-entry.

However, these situations are *rare*. Most price wars are started accidentally by misunderstood information, poor judgment, or market changes.

An important element to staying out of a price war is to strategically mange the pricing process. Firms should adopt long-term perspectives while anticipating how competitors and customers may behave. There are several ways to stop price wars before they start. A firm should attempt to do the following:

*Avoid strategies that force competitors to respond with lower prices.*

- Encourage *constructive* (not destructive) competition by staying away from strategies that shift the playing field from value to price.
- Keep customers focused on differences in value (or benefits). Do not overemphasize price in advertising.
- Pass up initiatives designed to quickly steal market share away from one or two main competitors. Gaining market share *gradually* can reduce the risk of starting a price war. The more quickly market share is stolen from competitors, the higher the likelihood they will respond with aggressive price moves.
- If a small firm operates in an industry prone to price wars, the firm should look for a product niche, segment niche, or distribution niche that is too small or specialized for the larger competitors to exploit. In other words, the firm can hide by exploiting underserved niche segments.

*Make sure competitors are aware of the rationale behind pricing policies and that strategic intentions are clearly revealed.*

- Price-matching or EDLP strategies may communicate that a firm intends to avoid a price war. Sometimes declarations of low price or ending the use of promotions can communicate the desire to compete on dimensions other than price.

*Make sure competitors know that the costs of the firm are low.*

- Reveal the cost structure of the firm. This sends out a warning about the possible consequences of a price war.
- Firms with relatively low variable costs have an advantage in a price war. Competitors cannot sustain a price below their variable costs for the long-term.
- Firms with low variable costs should be strategic with price cuts to avoid damaging the perception of quality, as well as triggering a price war.

*Effectively communicate the firm's belief in the horrors of price wars and the virtues of value-based competition.*

After prices have been cut, there are other strategies that might help avoid escalation:

1) **Avoid Possible Misreads:**
   Make sure to understand the qualifiers and comparability of competitor prices. Do not react until the reason behind their price cuts are understood. If the reasoning is not understood, it would *not* be wise to react with a price cut. The price of a delayed reaction will be far lower than that of a misread that triggers a price war.

   Collect and analyze information to better understand the competitors. Understanding competitors' pricing strategies requires an understanding of their past pricing moves, as well as an estimation of their cost structure, capacity utilization, and actual pricing structure. It is important to know actual transaction prices for competitors, because list price is rarely what buyers pay.

2) **Avoid Overreaction:**
   Once the reasoning behind a competitor's price cut is understood, it is best to avoid the automatic temptation to simply mimic the action. Quite often the best response is no response. If a response is required however, use a tactic other than price if possible (such as increasing benefits), and make the price response as limited and strategic as possible.

3) **Communicate Prices Effectively and Reduce Misreads by Competitors:**
   If an action is taken that might be seen as price slashing by the firm's competitors, it is best to clearly describe all qualifiers and limitations of the action (and to offer an explanation if appropriate).

   Firms should send signals regarding estimates of future growth, excess inventory, reasons for a price change, as well as any other information that might diminish the risk of competitors misreading their actions.

Another way firms can avoid a price war is to educate customers about the risk of poor quality. For example, customers in the medical industry may be very risk adverse and sensitive to performance. In this situation, the firm can focus on its own quality and reliability. Firms can also emphasize any negative consequences of sacrificed value. It is also sometimes possible for firms to simply appeal for help from the government, customers, vendors, channel partners, independent sales representatives, or others if a price war threatens the survival of the firm.

Perhaps the single largest driver of price cuts and the resulting price wars is excess capacity. The temptation to revive idle plants through increased demand brought about by reducing prices is often tempting. It is important to consider other options first. For example, the packaged goods industry will often sell off-brand or private label versions of their products at a lower price. Airlines will sell discounted seats through consolidators and auction houses. However, selling low-priced but functionally equivalent products through unrelated brand names (or in foreign markets) may still trigger price wars. There are times it may be best to leave idle plants alone. In fact, an idle plant may act as a deterrent if competitors know the firm is capable of flooding the market with cheaper products in the event of a price war.

There are four key areas that must be analyzed to properly understand the causes and characteristics of a price war. If these areas are carefully examined, a firm will often find that it has other options (such as defusing the situation, fighting the war on several fronts, or retreating altogether):

- **Customer Issues:**
  These may include price sensitivity and any customer segmentation that might result from a price change
- **Company Issues:**
  The cost structures, company capacity, capabilities, and strategic positioning of the *firm* should all be carefully considered.
- **Competitor Issues:**
  The cost structures, company capacity, capabilities, and strategic positioning of the *competitors* should also be carefully considered.
- **Contributor Issues:**
  Any other players in the industry must be examined.

When managers understand the causes and characteristics of price wars, they can make responsible decisions about when and how to *fight*, when to *run*, or even when to *start* one. Most managers are fully aware of the risks of price wars and carefully plan their response. Nagle reminds us that the destructive force of price wars can be so severe and linger so long that the only certain way to come out ahead is to stay out of them. "In the absence of a competitive advantage, it is suicidal to drive growth with price." [15]

## Defending Against Price Wars

If all preventative measures fail and a firm finds itself in the middle of a price war, what can be done to retreat and limit the damage? First, attempt everything discussed previously regarding how to prevent a price war. This information provides ideal practices to follow, and are generally more likely to elicit a positive competitive response.

If this information fails, Garda and Marn recommend two aggressive (but riskier) ways to retreat from the war: [10]

1) **Seek Long-Term Contracts**
   - Try to remove major customers from the crossfire by signing them early to extended supply contracts.

2) **Actively Engage the Enemy**
   - Whenever the competitor makes an aggressive price move, the firm should immediately, and publicly match it.

- If a competitor goes after a big customer, a firm should response by going after one of the competitor's customers.
- Communicate to the competitor that price aggression is a no-win proposition.

Although direct retaliatory price cuts should generally be used as a last resort, there are times when it will not be possible to avoid them. When simple retaliatory price cuts are chosen as a defense in a price war, a firm should implement them quickly and clearly. This will tell the competitor that their sales gain from a price cut will be temporary and will discourage competitors from making additional cuts in the future.

On some occasions, the proper course of action will be retreat. In these cases, businesses choose not to fight price wars but rather to concede some market share. The firm views this as a desirable alternative to a long and costly battle.

Despite the fact that price wars are generally harmful to the entire industry, diplomatic resolutions of price wars are generally not possible. Any sign of overt diplomacy is a form of price collusion and may fall under regulatory oversight. As a result, firms often use subtle forms of diplomacy that use market forces to discipline renegade companies that threaten industry profitability.

It is never too early to prepare a defense against price wars. Price leadership is one way to reduce industry-wide competition. Price leaders tend to avoid price cuts as a way to gain market share and tend to respond quickly to renegade companies who cut price. Price leaders are reliable enforcers of price regimes based on their cost structure.

## Competitive Intelligence and Price Information

To counter threats, managers must have good market, competitor, and customer information. Competitive intelligence investigates a firm's competitive environment. Information must be collected, interpreted, distributed, and utilized. Competitive intelligence initiatives are being conducted all the time, and most firms are probably targets of such efforts. However, the cost of gathering competitive intelligence is high in terms of money and time.

Competitive intelligence requires "constant aggressive primary and secondary data collection, triangulation and analysis and application of information to business decision making supported by people, processes, and tools." [9] Some valuable sources of this information are provided below.

**Information that can be collected Internally:**

- Intranet

**Information that must be collected from the Field:**

- Sales force
- Channels and Suppliers
- Market research firms
- Trade associations
- Internet

**Information collected from Published Data:**

- Government publications
- Speeches
- Articles

Perhaps the most important (and ongoing) source of information is a firm's sales force. The sales force has the most direct contact with customers and therefore has the best access to customer perceptions of competitors. Many companies require their sales forces to include competitor pricing in their call reports. Having this current information can help companies spot trends and reduce response time.

To be successful in collecting competitive intelligence from the sales force, the first step a firm must take is to find out what information is already available. Available information may come from internal data such as call reports, won-lost reports, and sales records. These types of records could help pinpoint red flags and trends. For example, the actions of a competitor may not seem important in one territory but might take on a different meaning entirely when seen in multiple territories.

The next step is to introduce the sales force to the importance of information sharing. After this has been accomplished, a plan must be put in place for collecting and organizing the data. Asking the sales force to forward any price lists or customer input they receive on discounts and pricing policies can help in this initiative. However, it is important that this data not be limited to pricing information. The sales force should be encouraged to forward *any* competitive data they find. This type of information may include a new type of manufacturing facility, a change in product launch strategy, or a new distributor incentive program.

A second valuable source of competitive intelligence can be found in trade shows. Most marketers understand the importance of using trade shows to gather information on competitors and their activities; however, few companies have articulated a plan to optimize their data-gathering processes. The sales team and other employees can acquire better competitive intelligence at trade shows if they are provided with specific objectives.

In addition to the sales force, employees from other departments are good sources of competitor information. Accounting, procurement, HR, manufacturing, and others attend professional meetings with competitor counterparts and may have bits of information that are significant pieces of the overall "competitive landscape." The role the pricer plays in gathering competitive intelligence is to "put together the puzzle by getting all the pieces." The puzzle will include pricing input, but should go well beyond this in order to provide a more robust strategy for maintaining a competitive advantage.

Favored customers are also a good source of information. Customers who are loyal to the company (possibly because of high quality or service) may provide information in order to prevent their competitors from getting lower prices from other sources.

Other good sources of information about competitor's current pricing moves and future intentions include trade associations, independent industry monitoring organizations, securities analysts, distributors, and technical consultants that advise customers on large purchases.

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## Review Questions

1. When exposed to a price war or price aggressive competition, a company should *not* immediately react by simply cutting its own prices.

   (a) True
   (b) False

2. Delivering more value and satisfaction to customers than competitors is required to gain what?

   (a) Competitive advantage
   (b) Competitor analysis
   (c) Benchmarking
   (d) Market focus
   (e) None of the above

3. A company that pursues ______ leadership will react much more strongly to a competitor's _____ manufacturing breakthrough than to the same competitor's advertising increase.

   (a) High-cost; cost reducing
   (b) Low-cost; cost reducing
   (c) High-cost; cost inflation
   (d) Low-cost; cost structure
   (e) Low-cost; cost inflation

4. When collecting competitive intelligence, the temptation to focus strictly on price and just learn about dollar and cents is strong among which of the following?

   (a) Financial planners
   (b) Large share firms
   (c) Market nicher's
   (d) Inexperienced intelligence gatherers
   (e) Professional pricers

5. Which of the following establishes price leadership as the basis for competing?

   (a) Value-based pricing
   (b) Offensive pricing
   (c) Real-time pricing
   (d) Product differentiation
   (e) Defensive pricing

6. If a competitor is strategically weaker and the cost of reacting to a price cut is justified, which of the following would be the most appropriate reaction strategy to a price cut?

   (a) Ignore
   (b) Attack
   (c) Defend
   (d) Run away
   (e) Accommodate

7. When communicating price information, "saber rattling" can be effective only when:

   (a) Competitors believe it is backed with financial strength and firm intentions
   (b) Competitors believe consumers will flee
   (c) Consumers believe it is backed by organization structure
   (d) Consumers believe competitors will respond in-kind
   (e) Consumers are pro-saber

8. Revealing cost structure to competitors is one way to prevent price wars.

   (a) True
   (b) False

9. Sources of competitive information include all of the following EXCEPT:

   (a) Channels
   (b) Web sites
   (c) Speeches
   (d) Trade associates
   (e) Checking for goodwill

10. The three steps needed to undertake a competitor pricing analysis (CPA) are:

   (a) Target, position, segment
   (b) Position, classify, expand
   (c) Identify, classify, evaluate
   (d) Identify, evaluate, position
   (e) Position, classify, expand

# Module 5: Segmentation, Products, and Pricing

## Introduction

Segmentation is the division of a market into groups of customers who share common needs or characteristics. Individuals who are in the same segment are similar to each other in terms of one or more key attributes. The goal of segmentation is to develop strategically relevant customer segments.[11] Segmentation can be used in pricing to estimate willingness to pay across groups or situations, identify bundling opportunities, or to analyze variations in price sensitivity.

There are a number of widely used segmentation techniques. The key attributes used as the basis of segmentation can range from the behavioral and demographic characteristics of the consumer to the total profit that a group of consumers yield to the company. While pricing managers tend to focus more on the latter, they also commonly utilize analytic techniques such as conjoint and discrete choice analyses to determine preferences for products (which can have a significant impact on profitability). Segmentation recognizes that not all customers are equal. Charging different prices for customers based on the unique value they place on a product is one of the most effective ways to increase profits.

Once a market has been segmented, pricing strategies differ depending on the targeted segments. Industrial segments, consumer segments, high-end offerings, low-end offerings, new products, and familiar products will all require different strategies.

Segmentation methods for both consumer and industrial markets are important knowledge areas for the CPP Certification. Knowing how to segment markets by using the correct segmentation strategy will be a source of higher prices and increased profits for firms. This knowledge will also lead to an improved understanding of the relationship between pricing and marketing in firms.

## Types of Market Segmentation Methods

### Demographic Segmentation

With **Demographic** segmentation, the market is divided into groups on the basis of variables such as age, family size, family life cycle, gender, income, religion, race, social class, nationality, generation, education, and occupation. Demographic variables are the most popular way to distinguish customer segments. One of the reasons that demographic segmentation is so popular is that consumer desires, preferences, and usage rates are often associated with demographic variables that are relatively easy to quantify.[18]

Despite its popularity, many managers have found that simple demographic segmentation is not comprehensive enough to form complete pricing strategies. Other factors must be considered when grouping consumers into effective segments.

### Value-Based Segmentation

In **Value-Based** segmentation, segments are determined by revenue or profit metrics. The key attributes that demarcate these segments are channel and profit.[11] Value segmentation is based on more than the market-focused drivers of value to a firm’s customers. It allows firms to rank segments in terms of potential profitability based on the total economic value each segment receives.

Value segmentation is superior to other segmentation methods because it does not merely describe who the buyers are. Instead, it objectively measures the motivations for buying and the underlying value that motivates customers.[24]

## Psychographic Segmentation

In **Psychographic** segmentation, buyers are divided into different groups on the basis of lifestyle, personality, or values. This type of segmentation can be beneficial due to the fact that many people within the same demographic segment can exhibit varying psychographic profiles.[18] Because of this, psychographic information can be an insightful compliment to demographic information.

The major drawback to this approach is that psychographic information about a firm's customer base is not static. Consumer values and lifestyles are subject to change over time. A firm must continuously monitor their customers in order to maintain reliable psychographic information. Because of the dynamic nature of these psychographic characteristics, it is generally unwise to base a pricing strategy solely upon them.

## Price Segmentation

Economists often refer to **Price** segmentation as price discrimination. This is due to the fact that segmentation pricing draws on a theory of price discrimination by setting different prices to capture different points of the demand curve. This approach can be used to capture more consumer surplus and increase profitability.

Perfect price discrimination would require more customer information than any firm could possibly collect and process. Moreover, it would also require the prevention of secondary market arbitrage attempts between customer segments. Perfect price discrimination is therefore only a theoretical model. Nevertheless, by tapping into variations in price sensitivity economists believe that price segmentation can extract additional consumer surplus and increase total profit margins.

Price segmentation is not strictly an economic phenomenon. If customers want a superior product or service but consider the price premium too high, then the problem may be one of customer misperception of the product or service's value rather than an economic reality. Thus, marketing variables are a key consideration in price segmentation.

Price segmentation is similar to market segmentation, except that the focus is on individual and inter-group variations in price sensitivity as well as variations in the response to pricing levels.[10] In order for a firm to have an economic basis for price segmentation, they must have some degree of pricing power in the marketing. They must also face different elasticities of demand from different segments while maintaining a strategy for keeping the segments separate.

The essence of price structure is segmentation pricing, or the creation of a menu that sets different prices for different customer segments. Price segmentation assumes heterogeneity in buyer price sensitivity and willingness to pay. Firms should always establish prices for different customers, not for different products. Variations in price sensitivity can relate to personal or situational customer attributes.

Segmentation pricing primarily focuses on what the customer is willing to pay. This amount is influenced by the perceived value as well as the customer's price sensitivity. The two primary ways to achieve segmentation pricing are through metrics and fences.[21]

**Fences** are the policies and rules customers must accept in return for a specific price and value configuration the seller offers. Segmentation fences work well when the segmentation criteria are easily verifiable (such as a buyer's age or location of purchase). **Metrics** frame the terms of exchange, or what the buyer pays for what is received.

Any given segmentation pricing menu will involve a variety of metrics and fences, to reflect the different segments that are willing to pay different amounts for many different value configurations.

### Geographic Segmentation

**Geographic** segmentation divides the market into different geographical units (such as nations, counties, and cities). Many companies operate in a number of geographical areas and should pay specific attention to local variations.

Different pricing, promotional, and advertising strategies can be implemented in different regions as deemed necessary by the specific characteristics of the consumers in each region. Such strategies can be focused as narrowly as is needed.[17]

## Pricing in Consumer Market Segments

The keys to successful consumer segmentation are to understand the entire purchase decision process (from deeply held core attitudes, to need states, to choice of channel, to final purchase), and also to account for as many of these factors as possible in the segmentation process. In order to effectively segment consumer markets, a pricer must possess a fundamental understanding of consumer purchase occasions, need states, and demographics.[13]

**Need States** describe what the consumer is trying to accomplish with a particular purchase. These can override attitudes, or they can serve to reinforce them. Segmentations built purely upon needs may neglect underlying motivations or demographic factors that are necessary to relate different purchases. Need states are easy to act upon, unlike other variables such as firm characteristics or customer demographics.

**Purchase Occasions** describe when and where a consumer purchases a product. The channel options available at the time, product assortment, price, and how the brands are shelved all interact with the specific need consumers are trying to fulfill, their demographic characteristics, as well as their core beliefs.[13]

> "For a firm who deals with multiple brands in the consumer market, it is possible for them to undermine profitability by competing with it. This happens because after using objective criteria for establishing prices an individual product

> manager may decide to 'price promote' the product without considering the effect of discounting one brand on the sales of a firm's other brands. To combat this, firms must find a metric that tracks with differences in value or a fence that enables price discounts to stay targeted where needed to make the sale." [2]

Above all, pricers should focus on segmentation that is *actionable*. A simple way to do this is to use self-selection. The basic idea of self-selection is to reverse the roles of a company and its customers. Instead of trying to actively find and reach target customer segments, the company identifies the segments and creates ways for those customers to reach out to the company instead (placing coupons to appeal to price sensitive segments is a common example of this tactic).

## Pricing in Industrial Market Segments

There are key differences between pricing in industrial market segments and pricing in consumer segments. At the heart of these differences is the presence of a direct sales force, which can drastically alter set prices when negotiating with the customer.

Companies in B2B markets commonly have more reactive pricing processes because (by selling directly) they can more easily get away with inconsistent rules. Many avoid fixed-price policies and strict criteria for discounting, relying instead on arbitrary policies that make any price negotiable (as long as the sale meets some minimum profit criteria).[2] This practice can have a significantly negative impact on profits.

To combat this undesirable effect, prices and discounts should be set according to policy in order to create prices that customers perceive with high integrity. The sales force should be informed as to how each product contributes to profitability and should be rewarded based on the *profitability* of the goods sold (not just sales volume). Managers must also know that the standardization of pricing policy empowers the sales force and better equips them for difficult negotiations.

In order for firms to establish optimal prices, knowledge of selling costs *and* any other costs involved in serving the customer are necessary. All component costs of the final product must be careful examined. Knowledge of the customer should also be obtained and used to the advantage of the firm. Customers will pay more for products and service solutions that meet their particular value expectations.

Value may vary among different customer segments for similar products (or even the same exact products), so there must be a constant flow of segmentation information in order to develop and maintain an effective pricing strategy in the industrial marketplace.[18]

## Pricing, Branding, and Product Management

In marketing, a brand is the symbolic embodiment of all the information associated with a product or service. A brand typically includes a name, logo, and other visual elements such as images or symbols. More importantly, it encompasses the set of *expectations* associated with a product or service. These expectations are held by employees, distributors, people who sell or supply the product or service, and ultimately to the consumers of the firm.

Typically, success in branding is measured through overall *awareness*, how favorably customers view the company, or sometimes the lead sources that support the sales force or storefront. All are credible measures, but unless the brand intends to operate in a vacuum they must be supplemented by some measure of how the brand is contributing to corporate profits (by the effect that the expectations inherent in the brand have on the final price of the products or services).

Sophisticated pricing strategies are becoming more important than ever to pricing and product managers. Companies now exercise more pricing discretion, and pricing managers should have a foundational background in statistics and sales forecasting. The most significant analytic framework is the **Product Life Cycle (PLC)**. Strategies, market segments, and the differentiating features and attributes of a product will all change throughout the PLC. Price, product, place, and promotion elements should also change accordingly. Pricing and product managers must predict the triggers for these changes as the product moves through launch, growth, maturity, decline, and possibly through recycling. They must also consider different market segments at each stage of the PLC.

Pricing & product managers must think more strategically, more broadly, and farther into the future. Segmentation will become increasingly sophisticated and difficult as pricing and product managers move beyond traditional demographic characteristics. Managing the PLC means more than just accelerating product launches. A mature brand may generate greater total income streams over time than it does during the six or more years of its market exclusivity. Pricing must become more *strategic* than tactical.

Customer-driven marketing strategies will be the touchstone for future pricing and product managers. What additional products might the firm sell to its customers? How might the firm retain customers for longer periods of time, or have them enter into exclusive purchasing arrangements? Pricing and product managers should be asking such questions as well as directing their marketing efforts towards finding ways to achieve these goals.

Pricing and product managers ought to be grounded in activity-based cost pricing. ABC pricing enables product managers to transform natural expense accounts such as salaries, occupancy, and advertising into functional accounts (how many assets and resources are each of the profit centers using?), and to start allocating those assets and charge appropriate prices. The firm may also use contract service organizations only in certain segments or may charge full salaries for reps, which might reduce the profitability of a market segment because sales costs would be entirely variable. An ABC analysis will spot such a misallocation.

Current marketers rank branding as less important than advertising efficacy, safety, convenience, dosage, tolerance, compliance, and cost. But sooner or later, those measurable characteristics will be matched by the competition. Intangible variables such as trust, reliability, and value may be more difficult to communicate, but may be significantly more effective over time in differentiating a product.[9]

## Price Bundling and Unbundling Strategies

**Price Bundling** is when manufacturers charge a single price for multiple units of the same product or when single units of various products are bundled together for one price. Previous research indicates that product-line pricing strategies such as bundling are more likely to be used by firms that sell substitute or complementary products.[21]

Bundling can have a significant effect on how consumers associate prices with individual products, and even how the products are used. Consumers tend to allocate a lower cost to each bundled unit in a service. This suggests that consumers may also be more willing to consume a product that is sold as part of a bundle. It has also been discovered that services which sold in bundles that cannot be inventoried (such as gym memberships and sporting events) are foregone by consumers more readily.[22]

If price bundling is the process of grouping products together for sales, *unbundling* is simply the process of offering the products separately (such as offering individual sodas through a vending machine). However, unbundling can take on many other forms as well. Price unbundling can be applied to consumer costs in order to make a product or service seem more attractive. For example a healthcare company could boast that its service costs only $5/day, which consumers are likely to find more attractive than $1,825/year.

Another unbundling strategy is to remove a feature or service that differentiates a firm from its competitors, but one that is a feature the customer claims not to value. By taking away a feature or service a firm effectively lowers the price of the core product. This allows consumers who were formerly unwilling (or unable) to purchase the firm's product to now do so (while still offering the removed component to consumers who *are* willing and able to purchase it).[20]

## Pricing Barriers to Market Entry

When firms are considering whether or not to venture into a market, they should consider the **Market Entry Barriers**. An industry is more likely to have new entrants when the entry barriers of the market are low.

Barriers can come in many forms. The need for large financial resources, the high brand equity of existing brands in the market, or the economies of scale obtained by existing firms are all common market entry barriers. Existing firms in an industry may also benefit from experience curves when their cumulative experience in producing and marketing a product reduces their unit costs below those of inexperienced firms. Entry barriers add to the costs of doing business in a new market and make it more difficult to compete.

Markets that require large investments in fixed costs or advertising and are also already populated by firms with lower production costs (due to economies of scale or experience curves) can be nearly impossible for new competitors to profitably enter. In general, higher entry barriers will diminish the likelihood that new firms will enter a market.

# Private Label Pricing

**Private Label** sales are growing every year for several reasons. Private label products have a higher gross margin and retailers believe that this will increase their profits. More importantly, there have been significant improvements in private label product quality and packaging in the last several years. Additionally, retailers are starting to understand that consumers cannot buy these private label products in the stores of competitors. This uniqueness helps to retain customers, which is every retailer's objective.

Historically, private label products were merely imitations of leading national brands. They claimed to equal the quality of national brands, but this was rarely the case. Packaging for private labels was poor and left much to be desired. Private label products are typically priced between 20%-70% *lower* than national brands. Even with these discounts, private label products usually achieve higher gross margin percentages.

The world of private labels has changed greatly in recent years, and the pricing should reflect these changes. Today, the standard private label product must *truly* be equal to (or better than) the national brand in quality. If the consumer determines that the product performs in an acceptable fashion, then the quality will be perceived as equal. The packaging for private labels must also be competitive and current in design.

In addition to the standard private label products, there have been a number of new developments. **Gourmet** or unique products have now entered the marketplace. These are products for which there is no national brand equivalent (a good example of a retailer offering gourmet or unique private label products is Trader Joe's). In recent years, the market has seen growth in the super premium segment, which are private label products with quality that *exceeds* the national brands.

## Private Label Pricing Philosophies

Two dominant pricing philosophies are based on velocity and size. The **Velocity Philosophy** establishes a *lower* selling price for *faster* selling items. The **Size Philosophy** establishes a *lower* price per unit for *larger* packages. A minimum and maximum gross margin range for the product category governs these two philosophies.

Private label products are typically priced based on the leading item in the product category. Since leading items are priced based on competition, philosophy, and gross margin range, the effect is that private label products are *reflective* and not independently priced. This presents a significant opportunity for private labels.

Comparing competitive prices offers limited value for pricing private label products. Very few consumers actually compare private label prices against comparable private label products. The reason for this is that it is extremely difficult for consumers to make an accurate quality comparison.

While the product might be exactly the same (or even produced by the same manufacturer), the consumer is unable to determine this. For example, each mattress retailer has a unique cover and stock number for the same product from the same manufacturer. This makes it extremely difficult for the consumer to perform any *direct* price comparisons.

Private label pricing should primarily be driven by the value proposition:

**Value** = Price ÷ Quality

Customers make purchase decisions based on the value proposition. Higher quality with lower prices results in the greatest value. Many private label purchase decisions are based on comparisons against national brands, and the greater overall value usually triumphs.

The second driver is market share. Greater private label market share will decrease the price discount that is necessary to beat the leading national brand in a consumer purchase decision. Conversely, a smaller private label market share will increase the discount that is needed. Since the majority of supermarkets do not wish to carry *only* private labels, an ideal private label market share would fall within the range of 30%-35%.

## Target Discount and Premium Rates

For the **Standard** private label item, a 10%-15% *discount* compared with the leading national brand is recommended. If the leading national brand is routinely sold below cost (as a loss leader) this rule may not necessarily apply. To discount greater than fifteen percent does not appear to increase sales, and *clearly* will not increase profits. The discount should be adjusted based on the market share of the item.

Gourmet or unique items require a different pricing approach. Due to the unique value they offer, their prices should not be based on the leading national brand. Here more than ever, the concept of *value-based* pricing should be utilized. The old adage of "whatever the market will bear" tends to apply to these products.

The best approach to discovering this market threshold is through field research. Ask consumers what value they receive (or perceive that the product would provide), and use this data as a basis for pricing decisions. Another approach is to perform price sensitivity research. Charge a different price in different stores, and then compare the tracked unit sales with other stores and categories.

Pricing **Super Premium** private label products can be difficult. Since these products are of higher quality than the leading national brand, they could be priced higher. A more conservative approach is to price super premium products *equal with* the national brand. This approach will increase the perceived value for the consumer, and give the firm a competitive advantage.

As a general rule, super premium private label should be priced at a 0%-10% *premium* compared to the national brand. This range is greatly dependent on the quality and performance features of the product relative to those of the national brand.

The last group is **Second-Tier** private label products. These products have not vanished from the market, nor should they. The assortment for these products is based on the store's image and customer income level. Second-tier private label products are not generic, as there appears to be virtually no market for truly generic products. These are primarily commodity products where differences in product performance are difficult for the consumer to discern.

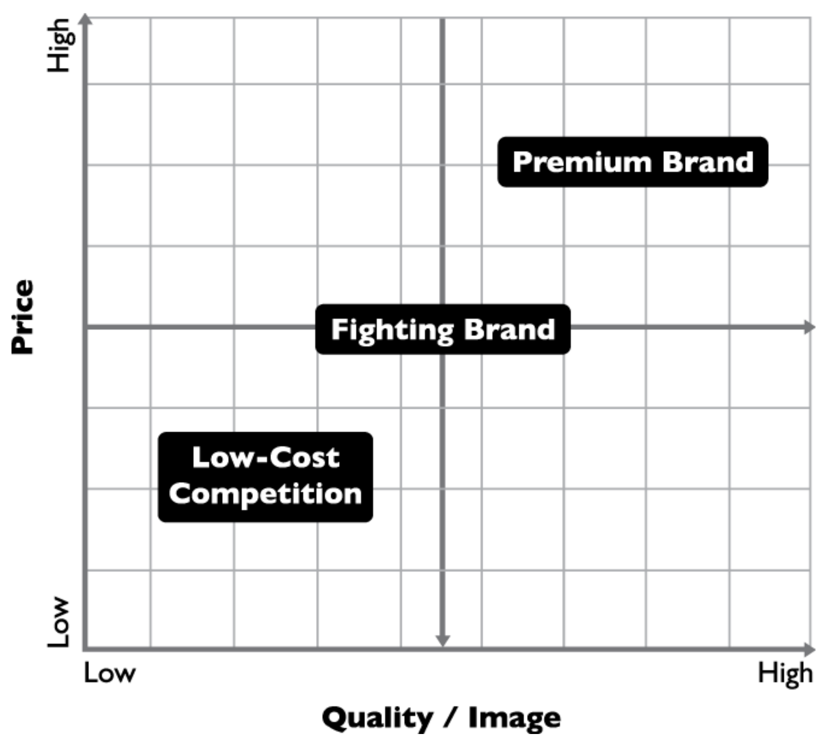
Second-tier private label items typically have the greatest discount versus the national brand. The problem is that discounts that are too large tend to portray unacceptably low quality (making the product seem generic), and subsequently not worth the consumer's hard-earned money. The pricing strategy for these products should be a range of 15%-25% *discount* compared with the leading national brand.[3]

## Brand Positioning

Firms attempt to create an image or identity that communicates its unique benefits in the minds of its target market through **Brand Positioning**. A brand's position should be distinctive and desirable relative to the positions held by competitors in the minds of consumers. Firms will acquire a brand position whether or not they choose to be proactive, reactive, or passive in the process. However, a firm can exert significant positive influence on the perceived brand position through careful strategic actions and marketing.

In planning a brand's position, a perceptual positioning map is sometimes used to illustrate consumer perceptions of a brand versus competing products on important purchase dimensions. A positioning map template that can be used to plot different brands according to dimensions of price, quality, or image is provided in *Figure 5.1*. Other buying dimensions include such elements as convenience, selection, or performance.

**Figure 5.1: Brand Positioning Map**




The position a brand occupies in the mind of consumers can be located anywhere along the value proposition continuum. Segments with differing needs and price elasticities exist in every market, and firms can successfully compete to win each of these segments through a well-planned positioning strategy.

Some firms find it easy to choose a positioning strategy. For example, a firm that is well-known for quality in certain segments will strive for this position in a new segment if there are enough consumers in the segment that seek high quality. But in many cases multiple firms will compete for the same position. When this happens, firms have to work especially hard to differentiate themselves. Three positions a firm may choose for its product include *good*, *better*, and *best*.

### Good Position

Positioning at the relatively "low" end requires careful price calculations to convey a compelling price-to-value relationship. Prices often must be lower than existing alternatives while still ensuring profitability for the firm. A firm has four variables that it must juggle: price, performance, costs, and profits. In the low-end market, competitors are constantly tracking each other's prices and cost profiles.

### Better Position

Although not the "best" position, positioning in the slightly more upscale "better" market tends to diminish the role that price plays in consumer purchase decisions. The focus with this brand position is more on benefits (or value) than low prices.

### Best Position

Positioning at the "high" end can be approached two ways, depending on whether or not the high-end and low-end products are linked. If they are not linked, the high-end product is a stand-alone purchase, and success is dependent primarily on the quality and presentation of the product. What truly defines the high-end is an even greater focus on value as opposed to price.

For this position, price does not guide marketing strategy; instead, price is used to support value and brand. A high price helps to communicate high quality. The attraction of the high-end is that very small increments in value can justify significant increases in price. The key to this position is to avoid sending inappropriate price signals by allowing price to drift too high or too low.

When there *are* links between high-end and low-end products, pricing strategy becomes more important and firms must take into account the relationship between market positions. An example of a market with links between low-end and high-end products is the camera industry.[14] Nikon became very successful in the high-end camera market by creating families of less expensive and more expensive products. Virtually all Nikon lens worked with Nikon bodies so that a consumer who started with a low-end body could upgrade without having to purchase new lenses. This strategy created very high costs for customers switching from Nikon.

## Value Equivalence Lines

As this course has continuously emphasized, customers do not make purchase decisions based exclusively on price but rather on the total value of the purchase. This value is the net of the perceived benefits that a product provides minus the perceived price (or cost to the customer). Perceptual mapping is the analytical framework that embodies this concept and it has important pricing implications.

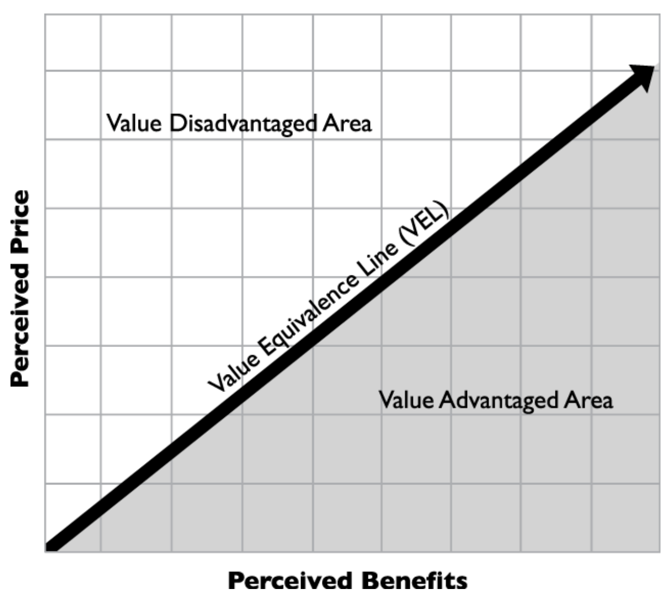
Strategic pricing requires the management of trade-offs between benefits and price. In planning strategy, pricers may prepare perceptual positioning maps. These maps illustrate consumer perceptions of the pricers' brands compared with those of competing products.

The fact that the firm must deal with consumer "perceptions" is important to note; since the benefits of the firm are *perceived* by customers, they are more difficult to manage. Many benefits are subjective in nature and cannot be objectively quantified. Even when benefits are clearly measured, there may be discrepancies between perception and reality.

There are two primary methods for understanding the product or service benefits that consumers perceive. The first is based on in-depth direct questioning (such as interviews and focus groups), and the second is research that is based on trade-off comparisons (such as conjoint analysis and discrete choice analysis). The consumer perception of price can be just as difficult to understand. The manner in which prices are structured, communicated, and collected can shift a customer's perception of what the true price is.

Once the meaning of perceived price and benefit is understood, a perceptual map can provide insight into how a firm is positioned in terms of benefit and pricing strategy. An example of a perceptual map is shown below. In this simple example, perceived price defines the vertical Y axis and perceived benefits define the horizontal X axis. Product offerings for different firms can fall anywhere on the spectrum, depending upon the combination of perceived benefits and price.

**Figure 5.2: Value Equivalence Line (VEL)**




If a market is stable, market share is not shifting among competitors, and perceived prices and benefits are accurately measured, then competitor offerings will fall along a diagonal called the **Value Equivalence Line (VEL)**. At any desired price or benefit level there is a clear choice of which product to buy, with each offering being precisely *worth* its price.

If the market is unstable and market shares are in flux, then competitive offerings might be positioned anywhere off of the VEL. Offerings that are positioned above the VEL would be in a *Value Disadvantaged* position (by offering the same benefits at a higher price than competitors, the firms would most likely stand to *lose* market share). On the other hand, offerings that are positioned below the VEL would be in a *Value Advantaged* position (by offering the same benefits at a lower price than competitors, the firms would most likely stand to *gain* market share). Over time, competitors above the line will lose market share while those below the line will gain it.

It is important to remember that understanding perceived benefits, perceived prices, and how the two are positioned on a perceptual map is only a snapshot of where firms stand at a particular moment. A perceptual map reflecting the dynamic, real world would be in a state of constant flux. Competitors may change their positions by raising or lowering prices, adding or subtracting benefits, or a combination of the two. Consumer perceptions can also be altered in a relatively short amount of time. In response to a dynamic perceptual map, managers have two basic options: they may either move along the VEL or move off of it (preferably within the value-advantaged territory).

A final piece of understanding comes from putting customers on the perceptual map. Customers are not spread evenly along the line. Typically they are clustered at various points on the VEL, with some positions commanding higher demand than others.

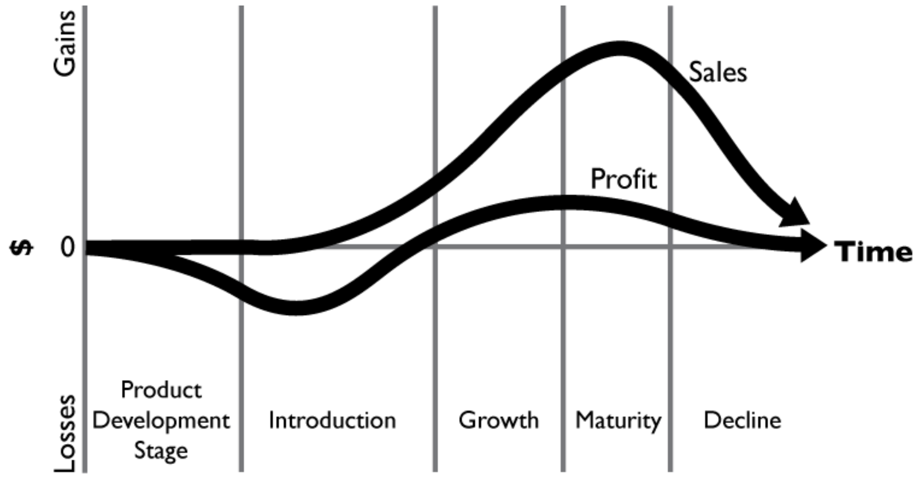
## Product Life Cycle Pricing

In product portfolio pricing, managers must determine the price levels to establish for the various products in the portfolio. These price levels must account for cost differences, customer evaluations of their different features, and the prices of competitive offerings. However, they must also account for the **Product Life Cycle (PLC)**.

When a firm introduces a new product, it hopes the product will have a long and profitable life. The firm does not expect the product to sell forever, but assumes it will follow a certain cycle. A product typically passes through five distinct and fairly predictable phases: Development, Introduction, Growth, Maturity, and eventually Decline.

These phases are accompanied by changes in sales and market conditions over time, which is why the PLC can be viewed as "the course of a product's sales and profits over its lifetime."[17] In most cases, the PLC is seen as a bell-shaped curve that demonstrates the rise and fall of a product's sales volume and profit throughout its lifecycle. The *typical* PLC is illustrated in *Figure 5.3*.[18]

**Figure 5.3: Product Life Cycle**




Not *all* products exhibit this same pattern. In fact, researchers have identified a variety of relatively common product life cycle patterns (ranging from six to seventeen unique patterns). For example, a “Recycling” pattern occurs when a product enters decline and a promotional push sends it into another pattern of growth, while a “Fad” pattern occurs when a product is enthusiastically adopted, peaks early, and declines rapidly. A considerable amount of research has been carried out using syndicated data from retailers and manufacturers to develop life cycle profiles associated with various types of markets. There is software available that incorporates these and other prevalent PLC profiles.

Despite the best effort of vendors, the shape a PLC is often very difficult to predict. The lengths of stages can also be difficult to predict. Products may move in and out of stages very quickly or may linger stages for over a century. Even though many products do not always follow a common pattern, there is value in the PLC as an analytical framework nevertheless. At the corporate level, it can help mangers better understand the future and adopt a long-range view of planning. It can also offer a useful look at the *dynamic* evolution of product categories, product versions, or branded products over time.

The degree to which buyers are sensitive to price variations tends to depend on the PLC stage of the product. Thus, price elasticity is dynamic over the life cycle (although the *direction* of this elasticity variance is industry-specific). This indicates the importance of a dynamic pricing strategy. During a product’s life cycle, the nature of costs and profits will also continuously change.

Recognition of the different life stages provides insight into the degree of competition (both in terms of the number of competitors and the scope of competitive activities). The “4P’s of Marketing” will change over the life of the product, and pricing managers must anticipate stage transitions so that marketing strategies, segmentation, and pricing tactics can be adapted as appropriate. Pricing and product managers must consider different market segments at each stage of the PLC.

The appropriate pricing strategy for any product depends on its PLC stage because the underlying principles of pricing vary with these stages. Pricing strategies should be dynamic in order to incorporate the movement of the product through its life cycle. Generally speaking, pricing will start higher and then decrease as competition increases.

## Development

The development stage is not always considered when discussing the PLC. However, it is worth noting in this course because it is relevant to pricing strategy. The development stage begins when the firm finds and develops a new product idea. During development, sales are nonexistent, investment costs are high, and profits are negative.

Decisions that are made about form and structure of the product during this developmental stage will define the product's pricing floor throughout the entire lifecycle of the product. This stage will directly influence all future pricing decisions.

The payoff period will not begin until the product development stage of the life cycle ends, but it will continue as long as the product remains on the market.

## Introduction

The introduction stage begins when the new product is initially launched. Introduction takes time, and sales growth is usually slow. Profits are nonexistent because of the heavy expenses incurred when introducing a product, such as funds needed to attract distributors and to promote the product. This stage is sometimes referred to as market development.

Consumers differ in their readiness to try new products. During the introduction stage, thought leaders or "innovators" are the most important segment to target. Innovators are defined as the 2.5% of the potential product adopters who are the first to try a new product. They are adventurous and usually eager to try new concepts.

Introductory pricing is the focus at this stage. Pricing objectives should focus on *establishing the value* of the product to customers and the entire marketplace. This usually results in higher prices that not only establish a proper reference point, but also generate sufficient profit contributions for funding investments in market education, incentives for new product trial, customer service, and continued support. However, introductory pricing is easier to conceptualize than achieve. Pricing too high at launch may result in a new product not reaching the volume needed to maintain short-term profitability. Whereas, pricing too low at launch may result in a new product getting volume but not delivering sufficient profits.

In this stage of the PLC, buyers generally lack sufficient knowledge of the product's benefits, and thus are more price-sensitive. As noted above, initial market awareness is minimal and market acceptance is slow. Production and promotional costs are high. Furthermore, there are very few competitors (if any). If the firm is the only seller of the newly introduced product, competition will be minimal even if there are functional substitutes. If there are direct competitors, they will not be a threat at this point because gains in market development far outweigh any loses due to competitive rivalry.

Early marketing efforts are geared towards generating primary demand, or demand for the product itself. There may be some problems in setting up widespread distribution at this point of the life cycle. Pricing strategy should signal product value to the buyers, but educating buyers about the full value of the new product or service is the most critical element in generating sustainable sales growth.

## Growth

The growth stage is a period of rapid market acceptance and quickly increasing product sales. At this stage, profitability also begins to improve significantly. Early customers (or innovators) were satisfied with the product and new consumers are now beginning to purchase it. Promotional pricing should become the new pricing strategy.

Buyers are now better informed about product attributes. This is due to either personal experience, or from communication with early innovators (commonly referred to as word of mouth). The product begins to make rapid gains in sales during this stage because the rate of market acceptance accelerates. Consumers are now increasingly responsive to lower prices. If product diffusion over a wide number of consumers affects future sales, reducing price can increase the rate of market growth and a product's long-term profitability.

The growth stage is usually accompanied by improved economies of scale. Fixed costs are spread over a larger production volume, causing unit costs to decline. This allows a firm to cut price while maintaining profit margins. New competitors enter who are attracted by the opportunities being generated, and they might offer new product features that will ultimately expand the market.

Competition increases as other firms introduce new versions of the product. Competitors look to stimulate secondary demand by emphasizing differentiated products. The increased number of competitors does not necessitate increased *price* competition though, due to industry-wide expansion. The market expands and new market segments open up. Prices tend to remain in place or fall slightly depending on how fast the market demand increases (although some price cutting to drive out some competitors may occur).

After the introduction phase, a number of competitors appear who are producing and selling similar products and an average market price begins to emerge. Normally, a wide range of market prices exists early in the growth phase, but that window narrows as the product approaches maturity.

Two key challenges during this stage are how to deal with new low-cost competitors and how to prolong the growth stage (and delay the onset of maturity and decline). In the first case, a firm may have limited protection from competition during the growth phase because of patents or other types of competitive advantages, but these types of protection will eventually erode. The firm may choose to offer a low-priced offering itself as a way to counter lower-cost competitors. In the second case, a firm can sustain growth by improving product quality or adding new features. Since it will be easier to obtain distribution in the growth stage, a firm may choose to enter new market segments and distribution channels.

In the growth stage, pricing objectives should focus on reflecting and strengthening the competitive advantage of the firm through well-articulate product differentiation and/or low cost leadership for price sensitive customers

## Maturity

During the maturity stage, sales growth begins to slow down or taper off because the majority of potential buyers have accepted the product. Profits begin to stabilize or decline because the market is crowded with sellers and competition has intensified. The maturity stage usually lasts longer than previous stages. Many pricing mangers spend their time coping with the problems associated with pricing a mature product. Regular pricing is necessary during the maturity stage.

The slowdown in growth comes from many competitors selling many products. The extra market capacity leads to increased competition. Competitors often begin decreasing prices, increasing promotion, and investing in better versions of the product. At this point, price tends to drop more rapidly than costs. Weaker competitors and high-cost sellers tend to exit the market and the industry moves towards being composed of mostly well-established firms.

Eventually the rate of market acceptance decreases as the number of potential new customers declines, while pressures caused by excess capacity lead to some price competition. There is also further price competition brought on by private label brands (such commodity offerings are most often found in mature markets). Customers have more knowledge about competitive offerings, and supplier positions and marketing strategies strive to create customer preference and loyalty. Brand switching is fed by pricing strategies such as special offers, better credit terms, expanded services, and increased discounts.

Most sales come from repeat purchasers and who are familiar with the product. Products and production methods are standardized and customers are fully aware of the similarities and differences among brands. An increasing homogeneity of products allows consumers to better make comparisons among competitors. Therefore, price sensitivity is at its highest in this stage of the PLC and pricing objectives should focus on penetrating more of the price sensitive segments that have emerged through new channels (including discount stores, direct mail, or the Internet) or perhaps on unbundled product offerings that appeal to more knowledgeable, price-sensitive customers.

Competition puts pressure on firms to decrease prices because firms grow by attracting sales from competitors. The industry is no longer expanding and continued growth requires an increase in market share, so competition for market share is intense. At this stage, profitability depends on competitive positioning based on either cost leadership or differentiation (and aggressive exploitation of the selective competitive position).

As a product moves into maturity, it is necessary to review past pricing decisions and determine if it is time for a price change. Market conditions do not generally warrant a price increase, so the pricing decision is usually to either maintain or reduce prices. It is important to know the signs that a product is slipping into maturity. If a product is about to slip into the commodity category, it is often desirable to reduce prices promptly. Additional effective pricing strategies may include unbundling related products, improving demand estimation, improving control and utilization of costs, expanding the product line, or re-evaluating distribution channels.

## Decline

The decline stage is characterized by reduced buyer demand and excess capacity, and there is typically a decrease in sales and profit. Sales fall as customers turn to newer or better products. Private labels earn an increasing percentage of the market share and profits for the firm in the stage of decline tend to be minimal. Some firms are able to continue to offer a profitable product through product improvements or by isolating a small (but profitable) segment.

During this phase, capacity will be cut and prices will fall slightly when costs are mostly variable (or if capital can be easily moved to more promising markets). If costs are mostly fixed and sunk, however, average costs will soar as falling demand causes price competition to become fierce (as firms try to gain as much of the market as possible in order to remain profitable). During the declining stage, direct costs are very important factors in the pricing decision. At this point, competition has generally driven prices nearly down to direct costs, and only sellers who were able to maintain or reduce direct costs during maturity are likely to remain.

In the stage of decline, pricing objectives should focus on harvesting profits from loyal customers who are not price sensitive, as well as on rationalizing costs as sales volume declines throughout the market. It is also important to manage and track competitive interactions and it may be advisable to use price to encourage weaker competitors to exit the market. Firms in a declining market should still avoid price wars, but reducing prices may enable the firm to maintain sales volume while firms that are not able to compete in a declining market may leave. Phase-out or discount pricing may be necessary as well.

Three options are available during this stage: *retrench* to the strongest product line and price to defend market share in that line, *harvest* the entire business by pricing for maximum cash flow, or *consolidate* the position of the firm by price cutting (with the goal to drive out weak competitors and capture their market share).

## Pricing New Products

New products are unique in that they are “new to the world” or “new to the market.” Buyers find the concept of such products foreign because they are so new and unique that they do not yet have a place in their lifestyle or business. Setting the price of a new product is one of the most challenging pricing decisions. Usually, there is little information on demand, costs, or competition. Many new products fail not because of pricing but because they do not offer the value customers are seek or they are not available at the right time or place.

Successful launches of innovative new products are dependent on the customer education process. Consumers are educated about truly innovative products by seeing and hearing about the experiences of others. Long-term success depends upon the number of initial buyers or early adopters. Demand typically does not accelerate until the innovators adopt the product (roughly 2.5% of potential buyers). Obtaining these initial sales is often the hardest part of introducing an innovative new product.

During the introduction stage, a firm’s primary goal is to educate the consumer about the new product’s value using effective pricing and communication. For example, an effective way to educate might be through free samples if the new product is something that is frequently purchased, has a low incremental production cost, and possesses benefits that are clear after a single use. For innovative products that involve large dollar expenditures per purchase, education generally occurs through a large, well-trained direct sales force.

The most difficult pricing problems occur when the product is so unique that it is fundamentally different than any other product on the market. When the product is so innovative, uncertainty can surround the pricing decision. The market is undefined, the demand is unknown, and the value of the product is not yet fully understood. Buyers are uncertain about the offerings of the product, if new and improved versions will be offered, or if prices will soon fall.

Customers are more receptive to new value communications, price metrics, policies, and price points with new products. Therefore, new product launches offer a good opportunity to introduce value-based pricing to the market. Consumers are prepared for change, and they may even expect it. At the same time, consumers have less knowledge about new product value. They perceive a greater risk, and therefore possess greater price sensitivity. The challenge with new product pricing is to account for this temporarily heightened price sensitivity while maintaining high enough prices to maximize profits. Of course, this balance will change over the lifecycle of a product. When pricing an innovative new product, it is important to recognize that customer's initial price sensitivity is not tied to long-term price sensitivity.

Pricing a new product requires the assignment of a price premium to the superiority of the new product. However, the value placed on this superiority is filled with uncertainty. Will the product work, will it fulfill its promised superiority, will it be reliable and durable, and how soon will it become obsolete? While these uncertainties will influence the price customers are willing to pay, the *perceived* superiority premium ultimately defines the differential performance characteristics of the new product in terms of dollars.

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## Review Questions

1) Every product seems to go through a Product Life Cycle (PLC). Which of the following is NOT a major challenge presented by the PLC?

   (a) It is difficult to plot the stages as a product goes through the stages
   (b) A firm must be good at developing new products to replace aging ones
   (c) The firm must be good at adapting its pricing strategies
   (d) All products eventually decline
   (e) Both a and c

2) Which of the following pricing methods is likely to be used earlier than others in the PLC?

   6) Harvest pricing
   7) Competitive bid pricing
   8) Floor pricing
   9) Segment pricing
   10) Discount pricing

3) Cost-based pricing by low-cost producers is most likely to occur in which stage of the PLC?

   (a) Introduction
   (b) Development
   (c) Maturity
   (d) Growth
   (e) Elaboration

4) Which stage of the PLC is characterized by targeting customers who are considered innovators?

   (a) Development
   (b) Growth
   (c) Introduction
   (d) Penetration
   (e) Reference

5) The PLC concept can be used at different levels. Which is not one of the levels?

   (a) Product class
   (b) Product form
   (c) Product image
   (d) Brand
   (e) None of the above

6) Commodity offerings are most often found in mature markets.

(a) True
(b) False

7) Segmentation pricing draws on theory of ___________, setting different prices to tap different points on a demand curve and capture more consumer surplus (while increasing profitability).

(a) Price discrimination
(b) Price elasticity
(c) Penetration pricing
(d) Extraction pricing
(e) None of the above

8) Consumers will position products with or without the help of the firm.

(a) True
(b) False

9) Private label brand sales are growing every year. Which of the following is a reason for this?

(a) They have a higher gross margin
(b) The significant improvement in product quality and packaging.
(c) They are unique in that consumers cannot buy these products in the stores of competitors
(d) a and c
(e) All of the above

10) In general, when barriers to market entry are high, new entrants are numerous.

(a) True
(b) False

# Module 6:
# Science of Pricing

## Introduction

Understanding the science of pricing and the important analytical methods utilized in price estimation (such as break-even analysis, price optimization, and demand forecasting) are necessary for certification as a Certified Pricing Professional.

Pricing decisions usually consist of compromises between external forces (such as overall customer willingness to pay and market competition) and internal forces (such as internal costs and company capacity). By integrating these disparate characteristics into an “optimal blend” of market-driven phenomena and cost analysis techniques, it is possible to craft powerful and strategic pricing methodologies.

Tools such as break-even analysis can be used to quantify the potential profitability of a price change through a simple process:

1) Establish a baseline.
2) Calculate incremental break-even quantity of a price change.
3) Determine the ability to reach that break-even point under current market conditions.

The first step in effectively pricing products is to understand how a change in sales (following a price change) will affect a product’s profitability.[17] “Pricing is rapidly becoming more science than art.” The *science* component of fundamental pricing techniques should allow a company to find out what specifically happens to profits if pricing is increased or decreased by 1%.[5]

Nearly all executives have an excuse for their inability to control pricing. Some believe that the market strictly controls prices, whereas others believe that raising prices will result in an inevitable backlash from either customers, who will refuse to purchase the product, or from competitors, who will undercut the new price. Whatever the excuse, there seems to be an underlying assumption that even corporate executives cannot control the prices of their own goods. Even the highly respected management guru Jack Welch was quoted in 1996 as saying, “There is no pricing power at all.”

Of course, these notions are incorrect. Managers do have control over prices although many believe otherwise. Prices *can* be set in a scientific manner, but relevant data must first be correctly gathered and analyzed in order ensure successful implementation.[6] Some firms may suffer from having too little or too much data to analyze, but this can be addressed. Once the relevant data is collected, it can be normalized to reduce redundancy, and a pricing manager can perform an appropriate analysis of the firm’s current product portfolio. With adequate knowledge of the portfolio, the negative effects of cannibalization and cross-elasticity can be minimized, resulting in higher profitability.

The goal of pricing tools such as revenue analysis and price optimization is to “ensure that the firms have the right prices in place for all of their products, for all of their customers, and for all their channels at all times.” Since pricing decisions are becoming more tactical and operational in nature, there is a need to quickly make strategic decisions and also to develop tools to support this.[18]

There are a number of price optimization software packages available to assist managers in the task of achieving optimal profitability. Once the optimal mix of prices is discovered, a prudent manager must take steps to ensure price integrity and exercise adequate control over the sales force to ensure that the set price is enforced. Through the use of optimization technologies, pricing managers may notice less frequent negotiations between sales personnel and customers (leading to higher profitability).

There still will be competitors who will undercut firms that are brave enough to increase prices, and there will be customers who will refuse to pay. However, through scientific pricing, a manager can take steps to ensure that only the *least* profitable customers defect, and that competitors achieve only *minimal* profitability from undercutting prices.

The financial impact of a price improvement can be more significant than the impact of an improvement in fixed costs, volume, or variable costs (especially on operating profits). Improving pricing is the "fastest and most effective way to increase profits." This alone justifies the need for scientific pricing tools as well as pricing and revenue optimization.

## Basic Pricing Science Tools

### Break-Even Analysis

"Break-even analysis is a simple and easily understandable method of examining the relationship between fixed costs, variable costs, and price."[16] Traditional break-even analysis seeks to evaluate the profitability of a product or an investment.

A price reduction is profitable only when the volume effect (contribution gained due to higher quantity sold) *exceeds* the price effect (contribution lost due to lower price). Similarly, a price increase is profitable only when the volume effect (contribution lost due to lower sales) is *lower* than the price effect (contribution gained due to higher price).

The break-even point is one of the simplest analytical tools in pricing management. It provides a dynamic view of the relationships between sales, costs, and profits. Being able to express break-even sales as a percentage of actual sales, managers can better estimate when break-even sales will be achieved.

The break-even point is where total costs equal sales. Profits are made for every sale above the break-even point. *Figures 6.1 and 6.2* illustrate break-even analysis graphs for different cost scenarios.

**Figure 6.1: Break-Even Analysis for Variable Costs**

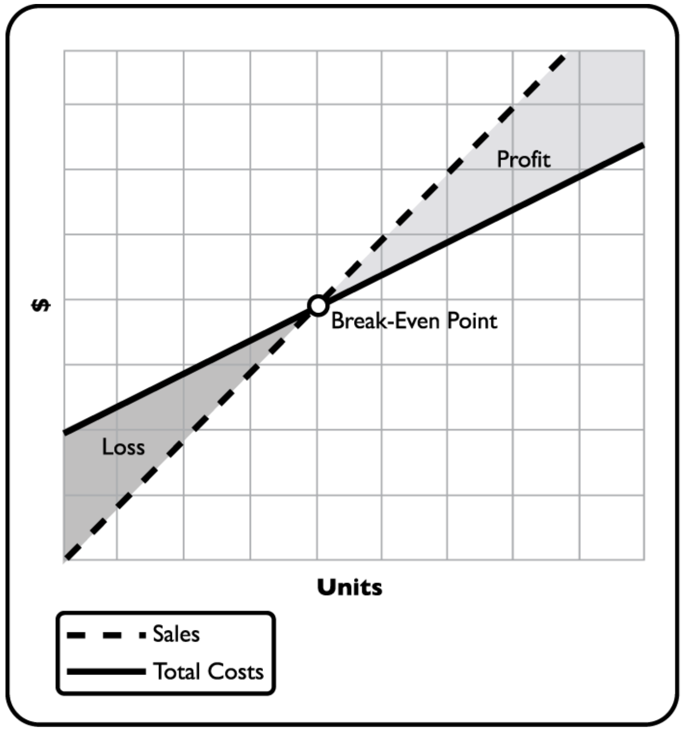
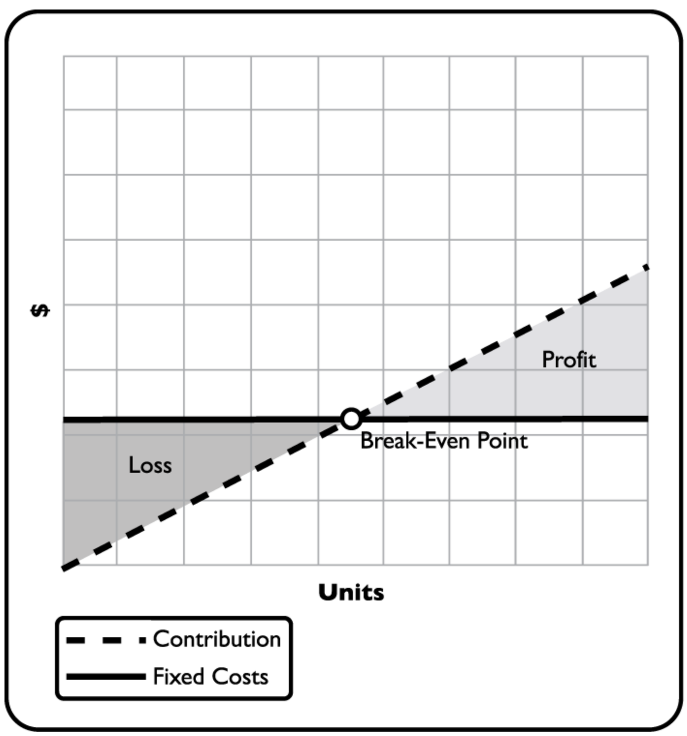



**Figure 6.2: Break-Even Analysis for Fixed Costs**



# Cannibalization, Affinity, and Cross-Elasticity

## Cannibalization

**Cannibalization** is the process by which one product or service sold by a firm gains a portion of its revenue by diverting sales from another product or service sold by the firm. To predict the effects of cannibalization, a manager must know the contribution margin of each of the products and the cannibalization rate. The cannibalization rate is the percentage of sales for the new product that were drawn from the old product.[13]

Companies must also carefully consider how new product introductions will affect their current products. If an older product remains viable, a company might try to manage cannibalization problems by giving its new product a higher release price (targeting a smaller segment of customers). By contrast, if a product line is being retired, a lower release price for a new offering may be appropriate to shift customers to it as quickly as possible. Portfolio management seeks to understand cannibalization and avoid an introduction that dilutes product line profitability. Also, the introduction of a new product often presents the opportunity to optimize the pricing of the total product line.[10]

Cannibalization must be carefully considered when developing a pricing strategy. Some companies develop a dual-brand strategy, for which they segment the market into higher end and lower end consumers. If the company already employs a higher-end brand and wishes to promote a lower-end brand in order to attract more customers, the company must first decide on an acceptable level of cannibalization.

## Affinity/Measurement

**Affinity Marketing** connects products or services provided by a third party to a group of individuals that are linked by a common interest, background, or occupation. By using the shared affinity these individuals have in common, it is possible not only for a third party provider to increase sales, but also for the host affinity marketing entity to capitalize upon revenues (either by co-branding or perhaps through endorsements).

The concept of affinity marketing originated within the financial services industry. Credit card companies would form partnerships with other companies or institutions (such as universities). The institution would get its name on the card and each time one of those cards is charged, the institution would get a small percentage of it. Now affinity has grown across a number of industries. In many instances, organizations attempt to convert an affinity that customers have for a profession or hobby into a loyalty to associated organizations.

Within e-commerce, affinity marketing generally translates into sharing referrals by using banner and text ads in an attempt to drive customers to other sites. This focuses upon the individual proclivities and interests of site visitors, typically through personalized content or by targeting keywords.

## Cross-Price Elasticity of Demand

The **Cross-Price Elasticity of Demand** measures the responsiveness of demand a product has to a change in the price of another product. If elasticity is negative then the products are *complementary*, and if it is positive they are *substitutes*. The effects of cross-elasticity are apparent when a firm has product lines involving multiple products at different price points. If a firm has three products at different price points (low, medium, and high), consumers might be influenced to purchase the products at the high and medium price points if the price of the lowest priced product is adjusted. However, pricers may encounter difficulty in using this tactic because finance departments tend to resist it based on the belief that it will lower margin contributions.[8]

Database management (DBM) can be used to determine the effect of cross-elasticity on products in a firm's portfolio. This uses a series of advance algorithms run on computers that analyze Point of Sale (POS) data on every Stock-Keeping Unit number (SKU) at every store. The algorithms churn through billions of demand curves to obtain the optimum balance of prices that can be achieved. DBM can be used to reach a variety of goals, such as increasing sales volume price perception or net profit.

The more advanced strains of DBM can determine the cross-elasticity effects of price changes on competitive, substitute, and complementary products.[3] DBM and other research methods should be used to analyze the effects of cross-elasticity not just between a firm's own product lines but with its competitor's as well. The effects of cross-elasticity are not limited to a single brand or firm, so the price levels of competing firms should still be considered when setting prices for individual products.[15]

## Data Scarcity

Data can be scarce for a several reasons. Sometimes there is simply no information readily available to the pricing manager, and other times there is an overabundance of raw, unreadable information. When information is not available, it is best to determine what data is needed the most by using a pricing process map to analyze current costs, prices discounts, and profits. By systematically analyzing each key area, pricing managers can understand which parts of the processes are working and where more data is needed.

If customer-based data is needed, pricing managers can implement satisfaction surveys to obtain the necessary data. Once this data is collected and key product match-ups are identified, the data can be used to create competitive-value price waterfalls in order to estimate the differences in value among competitors' offerings in the market (which can assist in setting prices).

When tracking competitive information, discounts should be specifically noted because they can often give insight into a competitor's strategy. A firm's sales force can also be used to quickly obtain basic data concerning competitors. Information concerning costs can be obtained somewhat easily from the finance departments of firms because of Sarbanes-Oxley compliance requirements.

If there is an overabundance of data, automation may be used to mine the data in order to isolate important and relevant data points. Some reports show that 90% of a pricer's time is spent on tasks that could have been automated. Iterative searches through large amounts of data should be processed by computers whenever possible.[21]

## The Pricing Process

For profitable pricing, a company should establish a **Pricing Process** that integrates the strategic goals of the company in a manner that satisfies all of the departments concerned (sales, marketing, finance, and operations). Nagle and Hogan (2006) suggest a price-setting process that works for most kinds of services, products, and market contexts. The basis for this three-stage process is that "prices should be set to focus on customer segments – NOT products."

In general, the three stages of the pricing process can be described as follows: [17]

1) **Preliminary Segment Pricing**:
   A firm sets baseline prices that reflect value assessments and strategic objectives. At this stage, the company should consider how much differential value should be captured for each segment, how the competitors will react to potential prices, and how to adjust segment prices in a way that accounts for different price sensitivities among segments.
2) **Price Optimization:**
   The firm refines prices using an iterative process that balances price, cost, and market response. At this stage, the firm should consider the trade-offs between long-term objectives and short-term market responses to prices. It should also figure out the best way to estimate customer responses to potential price changes.
3) **Implementation:**
   The firm sets final prices and ensures acceptance by customers and organizational departments. At this stage, the firm should find ways to *empower* the sales force to implement the prices (and ensure they are accepted), *communicate* price changes to customers, and *raise prices* on under-valued products.

### Price Optimization

**Price Optimization**, the second stage of the price setting, is the process of finding the ideal price of an item to maximize profit and unit sales.[2] It is an iterative process of adjusting price and maximizing profits by analyzing the trade-offs among price, volume, and cost. The three primary steps of price optimization are:

- Select price points in the preliminary segment price range.
- Conduct a profitability analysis to evaluate the effects of price variation on customer response (and consequently, on costs and margins).
- Set the final prices.

Profitability analyses can be done in a variety of ways. Sometimes it is best to use a practical incremental break-even analysis using a spreadsheet (best for infrequent price changes and a large number of transactions). Occasionally, a more sophisticated simulation involving precise modeling of customer and competitor reactions (allowing for risk management) is a better choice. Other times it may be best to use automated price optimization using tools such as controlled price experimentation, purchase intention surveys, structured inference, or incremental implementation of price changes. The most suitable types of analysis or tools depend on the market conditions, the products sold, and the availability of data. However, regardless of how the data is analyzed, managerial judgment remains a crucial component in any pricing decision.[17]

## Price Optimization Tools

Price optimization tools analyze customer buying behavior and market supply to provide recommendations for list prices, customer-specific negotiated discounts, markdowns, and other pricing elements to maximize profit potential. Optimization tools go beyond many other technologies by suggesting specific price points rather than simply presenting data. These tools can even break down a product into relevant characteristics such as size, color, and functionality.

A wide array of price optimization tools that are available to companies is described below. It is up to pricing managers to determine which tools should be applied in order to achieve maximal profit.

- **List Price Optimization Tools:**
  List price optimization tools attempt to model the expected demand elasticity for new products. They break a product down into characteristics such as size, color, and functionality in order to predict how the market will react to a new offering.
- **Transaction Optimization Tools:**
  Transaction optimization tools recommend discount mixes offered to customers for individual orders. These tools use historical data, market conditions, and competitive behavior to suggest price and discount levels that can maximize the margin of each sale. They are useful for identifying cross-selling and up-selling opportunities and for cutting negotiation time between salespeople and customers.
- **Markdown Optimization Tools:**
  Markdown optimization tools help companies decide when to cut prices and by how much to clear inventory while maximizing profits. They are particularly useful on products with short life cycles (as well as seasonal and perishable goods). The software not only estimates the shift in margin and demand brought by the lower prices, it also accounts for factors such as carrying costs, marketing costs, and seasonal effects.[15]
- **Supply Cognizant Pricing Optimization:**
  Recognizes supply factors and extends them to deal and transaction levels (such as capacity, inventory, cost of service).
- **Life Cycle Pricing Optimization:**
  Optimizes pricing across product life cycles and manages product transitions.
- **Market/Demand Pricing Optimization:**
  Considers price and cross-elasticities, demand forecasts, channel interactions, and customer and market segmentations.
- **Solution/Configuration Pricing Optimization:**
  Optimizes pricing for a product configuration or a product and service bundle/solution.[7]

## Demand Forecasting

In most markets, total demand and company demand are unstable. Forecasting is the art of anticipating how buyers are likely to behave under a given set of conditions. There are several types of specialized forecasting firms that can assist in predicting customer behavior:

- **Futurist Research Firms:**
  Firms that produce speculative scenarios.
- **Marketing Research Firms:**
  Firms that develop forecasts by interviewing customers and distributors.
- **Specialized Forecasting Firms:**
  Firms that produce long-range forecasts of particular macro-environment components such as population, natural resources, and technology.

Buyers should be interviewed because their behavior is very important to forecasting. Purchase probability scales can be very useful in this regard. A respondent is asked to rate his or her probability of purchasing a product or service in a given time period. Buyer-intention surveys are particularly useful in estimating demand for industrial products, consumer durables, new products, and product purchases that require advanced planning.

If interviewing buyers is impractical due to time or monetary constraints, a firm's sales representatives can be used to estimate their future sales. Each sales rep could be used to estimate how much each current and prospective customer will buy of each of the company's products. However, data reported by sales reps can be subject to considerable bias due to their own personal successes or failures, and they are also usually unaware of larger economic developments. Because of this, the data may need to be modified after collection. Expert opinions gathered from dealers are subject to the same bias.

A past-sales analysis can be used to forecast sales. Various forms of analyses can be used to forecast sales using this method. Some of these methods include:

- **Time-Series Analysis:**
  This breaks down past time series into four components and projects each of them into the future. The components are *Trend*, *Cycle*, *Seasonal*, and *Erratic*.
- **Exponential Smoothing:**
  This projects the next period's sales by combining an average of past sales and the most recent sales. Greater weight is given to the most recent sales.
- **Statistical Demand Analysis:**
  This measures the impact level of each set of causal factors on the sales level.
- **Econometric Analysis:**
  This builds equations that describe a system and fits the parameters statistically.

If the information collected from the sales force and buyers is not enough, expert opinions may be gathered from dealers, distributors, suppliers, and trade associations. In the event that buyers do not plan their purchases well enough to perform reliable analyses or experts are unavailable, a direct market test may be used. A direct market test may be a good tactic whenever a new product is introduced, an existing product is distributed through a new channel, or when an existing product is distributed in a new territory. Firms may also purchase forecasts from any of the forecasting firms listed previously in this section.[14]

## Constrained Production

Pricing under limited or constrained production requires a firm to possess a strong understanding of which customers are the most profitable. For many firms, a small number of customers engage in a great deal of business and should receive priority service when production is constrained. This will allow a firm to maintain the profitability gained from those customers.

With the inability to achieve profit through a high market share strategy, price should be increased. Depending upon the degree of the increase, a number of customers will likely defect. However, as noted before, those customers with the highest profitability can be given better service in order to sustain a competitive advantage. Even though some other customers will be lost, research has noted that a 1% increase in price can yield a 10%-12% increase in operating profit, which can easily make up for the decreased volume of sales.[1]

## Principles of Revenue Management

Revenue management was popularized in the mid-1980's by the airline industry, and has since spread to numerous other industries. **Revenue Management** can be defined as the dynamic adjustment of prices and product availability in order to maximize the profit generated by a set of resources. It can also be any software or consulting services that improve the consistency of sales and quality of profits from growing customers.[2]

Many companies in various industries have found revenue management tools to be useful in expanding customer bases and obtaining greater profitability. Traditional revenue management systems approach customer segments and seek answers to such questions as:

1. How many customers of this segment will buy this product at a particular moment?
2. How many customers will buy this product at this price?

There are some weaknesses to traditional revenue management. Demand is predicted for each type of product, for each delivery period. Resources and products are then priced and allocated to each market segment in order to optimize revenue or profit. Traditional Revenue Management does not consider a customer's history and lifetime value (LTV) when pricing and providing product availability, and it also tends to conflict with **Customer Relationship Management (CRM)**. Revenue management will restrict product availability to customers with discounts, whereas CRM will satisfy the demands of high-value customers for greater recognition, more differentiated service, and higher discounts. This discrepancy often creates a conflict between Sales and Revenue Management departments.

Revenue management needs price flexibility to match supply and demand, whereas CRM determines costs by giving priority to satisfying customers who request price stability. Revenue managers seek to leverage opportunities that offer the ability to charge a higher price, while the CRM approach focuses more upon developing relationships with customers by offering discounts and promotions. This can frequently force companies to decide between optimizing short-term revenue or customer lifetime value. B2B contracts generally fall outside the scope of traditional revenue management systems.

### Revenue Management is a 5-Step Process:

1) **Segment Markets and Build Fences:**
   Market segments are defined by how customers respond to different product/price offerings, rather than on product features alone. Effective fences must be built

between market segments to prevent customers who are willing to buy high value at a high price from getting that same value at a lower price.

2) **Forecast Demand:**
Sophisticated forecasting algorithms are used to forecast the demand for each product (segment combination). This is one of the most difficult and also most important facets of revenue management. As stated earlier, it has been shown that as little as 10% improvement in forecasting accuracy can lead to a 1% gain in revenue.

3) **Learn and Predict Customer Behavior:**
On the Internet, companies have access to an unprecedented amount of data about customer actions. This data can be used to predict an individual customer's response to a given product price offering, and also to predict the value of selling that product at a given price, to a given customer, at a given time.

4) **Optimize Revenue:**
It is important to optimize revenue from a product inventory by satisfying the expected demand at the highest possible value for customers.

5) **Communicate Decisions:**
Once the other steps have been completed, it is crucial that the decisions made are effectively communicated to the various distribution channels. Different channels may use different control mechanisms. Most traditional channels will sell each product or service at a particular price until it is sold out; whereas, online channels offer the possibility of a direct and targeted dialog with customers, enabling a customized product/ price offering for each customer. If correctly implemented, revenue management can manage these complexities to optimize net revenue.[9]

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## Review Questions

1. Pricing under limited or constrained production requires a firm to have a strong understanding of which customers are the most profitable.

    (a) True
    (b) False

2. Forecasts can be built on information bases such as:

    (a) What people say
    (b) What people do
    (c) What people have done
    (d) All of the above
    (e) None of the above

3. Firms may buy forecasts from outside sources such as:

    (a) Marketing research firms
    (b) Specialized forecasting firms
    (c) Futurist research firms
    (d) All of the above
    (e) Both a and b are correct

4. A type of analysis that builds equations that describe a system and fits the parameters statistically is called:

    (a) Conjoint analysis
    (b) Econometric analysis
    (c) Discriminant analysis
    (d) Time series analysis
    (e) None of the above

5. The goal of Revenue Management is to extract the maximum revenue from product and product lines.

    (a) True
    (b) False

6. Traditional revenue management has no major weaknesses that a pricing manager should consider.

    (a) True
    (b) False
    (c) Not enough information to answer the question

7. Above the break-even point, profit contribution per unit is realized.

   (a) True
   (b) False

8. The three main steps of price optimization are to: 1) select price points in the preliminary segment price range, 2) conduct a profitability analysis using an iterative process to evaluate the effects of price variation on customer response, and consequently on costs and margins, and to 3) set the final prices.

   (a) True
   (b) False

9. Revenue management is a 5-Step process.

   (a) True
   (b) False

10. Exponential smoothing projects the next period's sales by combining an average of past sales and the most recent sales. Greater weight is given to the most recent sales.

   (a) True
   (b) False

# Module 7:
# Developing the Pricing Strategy

## Introduction

What precisely is a *pricing strategy*? It is technically defined as "managing customers' expectations to induce them to pay for the value they receive. Pricing strategy is the coordination of multiple activities to achieve a common objective: profitable prices." [3]

If firms only consider pricing when establishing prices, then it is merely a procedural tactic. However, if firms think of pricing as a means of *capturing value*, pricing can become a powerful strategic tool. Understanding price bands will help further explain the difference between pricing as a tactic and pricing as a strategy.

Price bands exist in nearly every industrial market, and can be seen when a large number of purchase prices for a particular product are plotted on a graph. Something close to a normal distribution curve occurs, illustrating the mean, upper, and lower bounds of prices charged for most products. Tactical and strategic pricing concepts relate to price bands in the following manner: [15]

> **Pricing Tactics** are considered to be any move meant to shift a firm's position within the *existing* price band. A firm takes its market share from a slice of the price band, generally opting for higher volume at lower prices or vice versa.
>
> **Pricing Strategies** seek to shift the firm's relative competitive position as well as the actual price band. Shifting the price band may mean changing the product, the targeted segment, the distribution channel, or the sales strategy.

Developing a pricing strategy is one of the most prominent challenges confronting managers. Price sends a message about customer value as well as company objectives, and it can also have a rapid and dramatic impact on profitability. Yet, pricing has historically been one of the least emphasized strategic issues for management. Price was often taken for granted; in place of a competitive pricing strategy, firms have tended to use overly simplistic rules while placing far too much emphasis on cost-based formulae.

Managers are now beginning to adopt a more serious approach to developing pricing strategies. Business leaders are actively searching for new approaches to solve pricing problems, and firms are adopting more sophisticated approaches to managing price. Price is quickly becoming a matter of strategic importance for many companies.

There are now numerous pricing strategies available to managers. These strategies are tools that build demand, hold off competitors, and grow profitability. The ideal pricing strategy will be somewhat adaptive to market changes. Although, pricing strategies generally fall into two very broad categories: *reactive* and *proactive* pricing (sometimes referred to as "conventional" and "strategic" pricing respectively).

## Reactive Pricing

**Reactive Pricing** involves “mimicking the price moves of competitors, responding after the fact to customer signals, and adjusting prices only after a change in regulations or new technological breakthrough that radically affects costs.” [8]

Firms tend to follow such conventional pricing strategies because they fear that impulsive pricing initiatives will have extremely negative consequences (such as leading to an all out price war). Firms have a tendency to play it safe and price defensively. They keep a close eye on competitors and try to avoid any pricing moves that will cost them orders or threaten their position with marginal accounts.

Adopting a reactive pricing strategy may allow a firm to avoid the pitfalls of reckless price leadership, but it can also come with high costs. These costs may come from lost profits if pricing is too low (money “left on the table”), or lost orders if pricing is too high.

Reactive pricing is more common in firms competing in B2B markets. This is due to the fact that by selling directly B2B firms can get away with inconsistent pricing rules more easily. Many B2B firms avoid fixed-price policies and strict guidelines for discounting, preferring instead to make all prices negotiable (as long as it meets a minimum profit level). Firms generally believe that reactive decisions enable faster responses to changing market conditions. Experience usually contradicts this notion.

## Proactive Pricing

**Proactive Pricing** is taking a “leadership role not only in changing prices but in being the first to introduce new pricing structures and payment schemes. It also reflects more aggressiveness in pricing, as well as speed in adjusting prices to reflect new opportunities.” [8]

Two essential prerequisites for proactive pricing are an understanding of how pricing works and how customers perceive prices and price changes. Understanding how pricing works is difficult because of the involvement of suppliers, salespeople, distributors, competitors, and customers. Basic microeconomic theory does not adequately describe the realities of business. Understanding how customers perceive prices and price changes is also a highly complex issue.

Successful proactive pricers focus on the concept of value, not current price. They consider the effects a pricing decision will have on buyer perception of prices and also how perceptions of value are developed. With the deliberate gathering and careful analysis of pricing information, proactive pricers can become aggressive strategists.

Proactive pricing offers a way to reduce the risks of rash price initiatives and the hidden costs associated with a reactive pricing strategy. In order to successfully implement proactive pricing strategies, managers must create prices that customers perceive to have high integrity and set prices and discount levels by policy (rather than as reactions to individual customer reactions).

In addition to contributing to major decisions regarding the amount, structure, and timing of product prices, proactive pricers have developed many tools and concepts that yield insight on a daily basis in their application to individual customer orders.

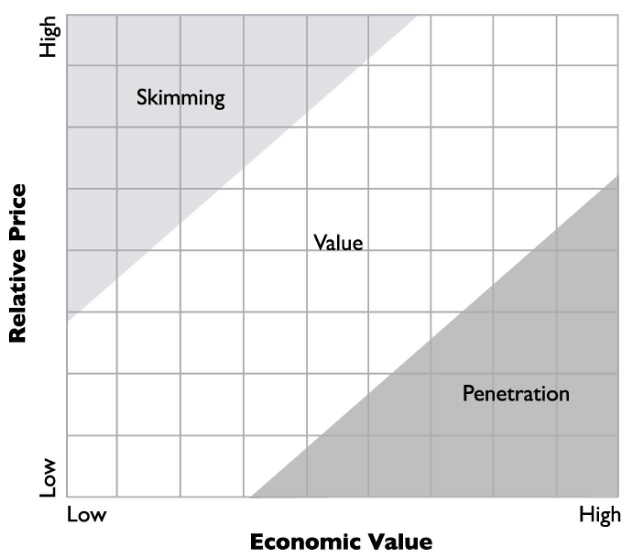
## Types of Pricing Strategy

Before a firm decides a price to charge, it must identify the desired role that price will play in the overall product marketing strategy. Will price restrict the firm's market to only exclusive buyers, will it be used as the primary marketing tool to attract buyers, or will it take a neutral or secondary role to other aspects of the marketing mix? When a firm develops its pricing strategy, there are three generic strategies it might adopt depending on the role pricing will play in marketing the product: *Skim Pricing*, *Penetration Pricing*, and *Value Pricing (*or *Neutral Pricing)*. Skim pricing or "skimming" calls for setting a relatively high price. Value pricing sets the price neither high nor low but on par with the value offered. Penetration pricing calls for setting a relatively low price in the hopes of leading the firm to a position of market dominance.

When a price is defined as either high, low, or on par with value, it is important to remember that this amount is "relative to the product's value for customers and that of similar competitors." [14] Skim prices are not necessarily high, and penetration prices are not necessarily low in absolute terms. Each is *relative* to the values those prices represent.

The following diagram illustrates the relationships between the three generic pricing strategies and the relative economic value of the products to the typical, potential customer.[13] Any of these strategies is theoretically possible at any level of economic value.

**Figure 7.1: Pricing Strategies**




Before choosing a strategy, it is important for a firm to understand its current cost structure, market competitors, and the price sensitivity of its customers (as well as potential changes to each of these). It is also worth noting there is not always a single strategy for all sales of a product. Most products are purchased by different market segments with varying price sensitivities. This is why effective pricing often requires a strategy of **Segmented Pricing**, or using different strategies for different market segments.

## Skim Pricing

In any market there is a segment of buyers that is relatively price insensitive because it places a high value on the offering. **Skim Pricing** (or "skimming") targets this segment by capturing high margins at the expense of large sales volume. The firm is not as interested in market share as it is in capitalizing upon the value a smaller market segment perceives within its products or services. By definition, skim pricing sets prices that are "high in relation to what most buyers in a segment can be convinced to pay." [14]

Whenever selling to relatively price-insensitive customers is more profitable than selling to a larger market at a lower price, skim pricing is needed to capture this additional profit. Skim pricing strategies take longer to diffuse products in the marketplace, but they tend to capture a larger portion of the consumer surplus through early adapters (those customers who most value the product).

Buyers who are price insensitive place a value on the product's attributes that differentiate it. They are not buyers who will "pay any price," but rather buyers who will pay to get what they see as a very high value product. Because of this, skim pricing generally requires greater communication in justifying the high price. In some cases, it may be necessary to guarantee the product. If this is cost prohibitive, it may be necessary to only price at a level that reflects what can be communicated and accepted by the buyer.

The following are some examples of when a skimming strategy may be appropriate: [9]

- When the offering performs better than existing alternatives
- When there are early adapters who value the product highly and have more inelastic demand curves
- When a high price will signal high quality
- When a high price will signal to any actual and potential competitors the firm does not want a price war
- When a firm does not have the capacity to meet expected demand
- The skim price acts as a "reservation" or walk-away price for the firm during launch of a test market, giving the firm a choice of when it decides to reduce prices

Skim pricing is generally only considered practical when economies of scale are small. However, this is not always the case. If a niche can be targeted and grown, skim pricing may make sense even with large production economies. Skim pricing may also make sense when a firm has a line of lower priced products that buyers can turn to if the skim price of the premium product is too high.

For skim pricing to work, the competitive environment must be strong. A firm must have some competitive advantage that offers long-term profitability, despite the fact that the skim prices will attract many competitors offering lower priced alternatives. Of course, a skim strategy can be appropriate even when a firm is poorly positioned to fend off competition. It may allow a firm to generate profits initially, but can later be reevaluated if competitors attempt to duplicate the offering.

Some products represent significant changes in the performance of a product or service. For such products, setting relatively high prices with large promotional expenditures during market development, and lower prices at later stages often proves successful.

There are several potential disadvantages to using a skimming strategy. Skim prices do not induce customers to try new products, which increases the time necessary for the product to diffuse and become generally accepted in the marketplace. Also, if skim pricing generates windfall profits, it is virtually guaranteed to attract competitors.

## Sequential Skimming

Like skim pricing, **Sequential Skimming** begins with a price that attracts the least price-sensitive buyers first. After selling to those buyers, this market segment will have been exhausted. In order to maintain sales, the firm must then reduce its price just enough to sell to the next level of price-sensitive buyers (or the next most profitable segment). The firm continues this practice until all opportunities for skimming are exhausted, either because the price is low enough to attract even the most price-sensitive customer or the price cannot be dropped any further without negatively affecting profitability or the credibility of the firm.

This strategy is appropriate under a number of circumstances, especially when a brand relies heavily on providing intangible value or offers products and services with low repurchase rates. Examples include long-lived durable goods and products that are purchased only once (such as tickets to sporting events or performances).

Theoretically, firms could sequentially skim using many increments in order to ensure that no customers pay less than the absolute maximum they are willing to pay. Realistically, buyers would be very likely to catch on and simply postpone purchases to obtain a lower price. A better policy would be to lower prices less frequently, making the buyer bear a cost for waiting. A firm can also introduce less attractive models as it cuts its price. This allows a company to bring larger segments into the market.

There are times when sequential skimming may be appropriate for products that are non-durable or frequently purchased. Some examples of this might include a firm that wants to build production capacity gradually (perhaps to learn as it expands), when a firm needs the extra cash flow in order to grow, or if a product has a number of different uses and it makes sense to focus on only one use at a time.

## Value Pricing

**Value Pricing** is defined as "offering just the right combination of quality and good service at a fair price." [11] Pricing structures are either linked to the value received by the target customer or to the perceived value of a firm's offering relative to its competitors. In general, value pricing occurs when prices are set on the basis of fair value for *both* the service provider and the consumer.

Value prices are not necessarily the same as those of competitors, nor are they necessarily set in relation to the prices of competitors. Like skim and penetration pricing, value prices are defined relative to the perceived value of the product. A product's value to the customer is based on the customer's best alternative (or reference value) plus the value of whatever differentiates the product from its alternative. Differentiation value can have both positive and negative elements, meaning that a value price could theoretically be *any* price (including the highest or the lowest in the market).

Value pricing does not attempt to use price as a tool to gain or restrict market share. For this, it defers to other marketing tools that may be more powerful or cost-effective. Value pricing may be less proactive than skimming or penetration pricing strategies, but is not necessarily *easier* to implement than the other strategies. In fact, it may be far simpler to choose a price that is high enough to skim or low enough to penetrate than it is to find a price that strikes a balance between the two methodologies.

Firms generally adopt a value strategy by default, when a market is such that it will not support a skimming or penetration strategy. If there is not a significant segment of price-insensitive buyers that will pay a premium, the market may be such that all products are seen as substitutes. It may also be the case that a firm is new to a market, and penetration pricing will have a negative effect on a buyer's perception of product quality. Perhaps, the industry may be comprised of competitors who are likely to have a strong response to any price cut, setting off a price war. Generally speaking, value pricing is common in industries where customers are price-sensitive (making skimming difficult) and competitors are volume-sensitive (making penetration difficult).

Value pricing may also be used to promote a particular product line. A popular new product or hard-to-find product might support skim pricing, but firms may choose value pricing in order to promote an entire line of products, or support sales of complementary products.

## Penetration Pricing

**Penetration Pricing** occurs when a firm sets prices "low enough to attract and hold a large base of customers." [14] Penetration prices are not necessarily *cheap*. Instead, they are low in relation to the value the target segment perceives in the offering. In other words, the price is set below the value the product offers to the customer base. Penetration pricing offers a trade-off between higher sales volume and higher margins, and it can be an effective strategy for new entrants into particular markets especially.

The following is a summary of when a penetration strategy may be appropriate: [9]

- When demand is relatively elastic and very sensitive to price changes
- When economies of scale or scope can be achieved in producing large quantities
- When the threat of competitive imitation is very strong
- When a low introductory price may prevent competitors from entering the market
- When there is not a large segment willing (or able) to pay a higher price
- When products are involved that can only be easily judged by customers before or after use

Penetration pricing may also be appropriate when there is an experience or learning curve associated with the early stages of the PLC. There is effectively a drop in the average per unit cost accompanying accumulated production experience. When a downward sloping experience curve exists, per unit production costs will not only fall, but they may fall at a faster rate if the company makes and sells more during a given period of time. On average, it has been found that each doubling of production will be accompanied by a 20% decline in per unit costs.[14] This decline in costs can be significant in the early stages of production.

To take full advantage of the experience curve, the market must be ready to absorb the higher output, and the firm must obtain a large market share early in the PLC. If product prices are initially low, sales will increase as costs decrease (from gained experience), enabling prices to then be lowered further. However, the firm that fails to take advantage of this effect will be at a competitive disadvantage against those further along the curve.

Penetration prices can also be useful during other stages of the PLC. It is often utilized after a steady customer base is established in order to drive sales. Even in this case, price is set relative to the value of the product rather than the pricing strategy of competitors.

This strategy will only work in later stages of the PLC if a large share of the market is willing to change brands in response to low prices. Not all buyers must be price-sensitive, just enough to justify pricing low. It is not always the case that a market will respond to low prices, and it is also important to be aware of the impact low prices can have on a brand (low prices may negatively impact the long-term appeal of a brand).

In order to justify penetration pricing, a firm must understand the volume gain necessary to make it worthwhile (based on a firm's cost structure). When incremental costs are low (including variable costs and incremental fixed costs), penetration pricing is more attractive. This is because the contribution from each additional sale will be high. A price cut will not lead to a large cut in contribution. The lower the contribution per sale, the higher the increase in gained volume must be for penetration pricing to be profitable.

It is possible for penetration pricing to succeed without high contribution margins if the lower price and higher volumes create sufficient variable cost economies. This allows the seller to offer penetration prices without suffering from lower margins.

In order for penetration pricing to be successful, competitors must allow the firm to set prices low enough to attract a large segment of the market. If competitors quickly lowered their own prices in reaction this would detract from the value of the original penetration prices, foiling the strategy. Consequently, it only makes sense to pursue a penetration pricing strategy when the competitive landscape is such that other firms are unable or unwilling to cut their prices (which tends to occur when the firm has significant cost and/or resource advantage that will make them a winner of any price war). Also, it is important to remember that when a firm has a broad line of complementary products it may choose to sell one as a loss-leader with penetration pricing in order to support the sales of other products. Finally, it may be that a firm is so small it can significantly increase its sales without effecting competitors enough to provoke a response.

Penetration pricing may also be successful if a firm can attract new customers without threatening a competitor's current customer base. For this to work, the firm must minimize inter-brand price sensitively while exploiting primary price-sensitivity. An example would be to offer a product with such reduced services or inflexible delivery schedules that it seems unattractive to many customers of competitors, but attractive to a new segment of the population.

### Niche Pricing

Most industries include firms that serve market niches. Niche marketers are suppliers of specialty or differentiated products with unique performance that appeal to a small segment or "niche" in the marketplace. Instead of targeting a small share of the market, these firms target a large share of a small segment of the market.

Niche marketing can be highly profitable. The reason for this is that the firms pursuing niche markets understand their target customers well enough to satisfy their needs better than other firms. These firms are more effective at fine-tuning their offerings and prices to meet the needs of a small and carefully defined segment. Due to the resulting added value, niche pricing can include substantial markups over costs.

Because niches are smaller they generally only attract a small number of competitors. Due to the high value the customers perceive and the lack of competitive intensity, there is a lot of strategic pricing freedom for the niche marketer.

## The Tactics of Discount Pricing

Most discussion on developing a pricing strategy centers on a base price (or list price). **List Prices** are significant because they are a firm's "stake in the ground as to the value of a service or product in the market."[10] In many markets, list prices are what companies actually charge, and these prices are advertised in order to influence customer behavior. Even when list prices do not serve as absolute prices, firms and customers still expect them to stay relatively constant so that competitive signaling can occur when list prices do happen to change (instead of discount prices that are harder to observe).

Discounting takes up where list prices leave off. It is the recognition that one size does not fit all, that list price is not best for all situations and customers. Firms may use discounts to adjust list price sometimes in order to reward customers for certain behavior (such as volume purchases or off-season buying), as well as to implement several strategies discussed in this course.

### Volume Discounts

The primary way firms discount prices is based on the volume (or unit) of an individual transaction, the cumulative volume for a specified period of time, or the account size. Some firms calculate the discount on the volume of all purchases. Other firms calculate the discount on the volume by product or product class.

Most quantity or volume discounting is designed to reward high-volume customers. These customers are usually more price-sensitive. Volume discounts are most common when selling products to business customers, but they are also seen in some consumer products.

**Non-Cumulative Discounts:**

*Non-Cumulative* volume discounts are granted for "volume purchase measured either in units or dollars in a single point of time." [12] This tends to encourage large, single orders, which might be beneficial to the seller for numerous reasons:

- If sellers can convince buyers to place larger orders, there will be fewer orders to process and ship and fewer sales calls to make. The costs of selling and servicing an account do not generally increase proportionally with the volume of purchases.
- Longer production runs may also be possible, qualifying manufacturers for their own volume discounts on raw material purchases.
- The cost of carrying goods in inventory may be shifted to the buyer, thereby reducing operating costs for the seller.
- Volume discounts may lead to the perception of profit sharing between channel members and help to reinforce channel cooperation.

It is suggested that when discounting to distributors, firms should consider discounts only on incremental sales volume.[7] Volume allowance tier programs help a firm resist continual price pressure by making the distributor somehow earn additional discounts. Discounting can be used as a reward when distributors achieve certain sales revenue targets.

When deciding how to structure a volume discount, the buyer behavior that the discount would encourage is important to consider. Non-cumulative discounts reward customers for nothing other than large, single deals. To achieve this, large firms may decide to centralize purchasing and small firms may join buying groups. It should be noted that not all volume is equally valuable (for example seasonal sales) and that many argue that policies should reward customers for loyalty rather than not just size.

When developing a non-cumulative discounting strategy, the following questions should be carefully considered and resolved:

- What is the minimum quantity to be purchased before any discount is applied?
- What should the number of breaks or additional discounts for larger purchases be?
- What is the maximum quantity for qualifying for additional discounts?
- What level of discount should be offered at each quantity level?

**Cumulative Discounts:**

*Cumulative* volume discounts are defined as a reduction in the price to be paid for purchases that "exceed a given level of volume over a specific period of time." [12] This may also be called a deferred discount, patronage discount, or accumulation discount.

Cumulative discounts offer a discount on cumulative units or sales volume over time, which is a form of **Nonlinear Pricing** (in other words, a customer's total purchases over a month or year instead of on the amount purchased at any single time).[12] Cumulative discounts do not have the benefit of encouraging large orders. They encourage buyers to become committed to a seller over a discount period in order to qualify for the savings. This imposes an implied switching cost and thereby bonds the purchaser to the seller.

One implication of offering cumulative discounts that should be considered, regardless of order volume, is the customer behavior it encourages. With non-cumulative volume discounts, customers are rewarded for centralized purchasing. This means that purchasing decisions are often shifted away from individuals who understand the value that is delivered. Customers are also rewarded for joining other companies in buying groups. Buying groups will qualify for larger discounts and will spend more time evaluating all alternative suppliers. Cumulative discounts offer a lower price while simultaneously encouraging customers to keep purchasing activities decentralized and independent.

Sometimes the nature of the product makes it advantageous to encourage smaller orders (such as perishable products, large consumer durables, or heavy equipment). When this is the case, smaller orders can be more practical, and cumulative discounts benefit both the buyer and seller.

## Seasonal Discounts

A seasonal discount is a “price reduction to buyers who buy products out of season.” [11] These discounts may be based on the specific time, day, or month a purchase is made.

Many industries experience price fluctuations and go through seasonal price cycles. In some cases it may make sense to adjust list price along with these cycles, and in others this may not be so easily accomplished. When it is difficult to fluctuate list prices, seasonal discounting can offer a firm pricing flexibility. It can be seen as discounting in advance of expected changes in demand and price levels in order to reduce seasonal sales variations.

Clothing is a traditional example of when seasonal discounting may be appropriate. List prices cannot be changed because they are used as a reference point for the quality of the product. But since price-sensitivity changes with seasons, discounts may be used to increase sales while preserving the original list price.

Seasonal discounting is useful for any industry facing a predictable decline in value at a particular point in time. It requires an understanding of price elasticities and costs.

## Managing Discounts

Discounting can be an effective pricing tool; firms will always negotiate discounts to get orders from large customers. However, it is also the single most abused tool. Dangers of discounting include destruction of price levels, customer confusion, and damage to brand.

Every firm that negotiates with its customers is going to leave some “money on the table,” money that may be recovered through effective discount management. Managing discounts requires monitoring and control. Unnecessary discounting should be avoided while ensuring that discounts can occur when they are needed.

Firms can be more profitable if they actively seek to understand, quantify, and control revenues being lost to discounts. Successful management requires a proactive, systematic approach based on information and knowledge. Good information about discount practices can assist firms in anticipating and managing net revenues. Without a system and solid information, any positive results will be short-lived and can even cause other significant problems in the future.

The following summarizes the times when it is imperative for a firm to adopt proactive discount management: [4]

**When discounts are significant relative to sales:**

- Invoiced amounts vary widely from full list price
- Unknown amounts of product "thrown in" to "sweeten the pot"
- Service or support revenues given away while getting little in return

**When discount details are not actively reviewed or analyzed:**

- Discounts are a single line item deducted from full list price on invoices
- Discount details or reports are not reviewed regularly
- Detailed targets are not established

**When the causes of discounts are accepted without challenge:**

- Inconsistent or inadequate negotiating skills
- Absence of guidelines and incentives
- End-of-quarter "specials" to meet quota
- Problems communicating value or ROI

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## Review Questions

1. In penetration pricing, the company's objective is to ________, believing that higher sales volume will lead to lower unit costs and higher long-run profits.

   (a) block competitive launches
   (b) maximize their market share
   (c) minimize their market share
   (d) maximize volume
   (e) none of the above

2. Skimming strategies make sense under all of the following conditions EXCEPT:

   (a) High price communicates high value
   (b) High initial price blocks competition from entering the market
   (c) Unit costs of producing a small number of units is high
   (d) Product is a "me-too" and contains no new technology or points of difference
   (e) A sufficient number of buyers have a high, current demand

3. Resellers who purchase large quantities over time but do not like to place large individual orders can be rewarded using ________.

   (a) Niche discounts
   (b) Shared-costs
   (c) Cumulative discounts
   (d) Value discounts
   (e) Bundling

4. Which of the following is a favorable condition for implementing a penetration pricing strategy?

   (a) Price-sensitive customers
   (b) Quality-sensitive customers
   (c) Sustainable advantage
   (d) Few substitutes
   (e) Few competitors

5. A company with a proactive pricing strategy is one that always responds to competitors by lowering its prices.

   (a) True
   (b) False

6. The goal of a pricing strategy is to:

   (a) Get the highest price possible for the product
   (b) Grow revenue and share as fast as possible
   (c) Align with the business strategy while helping to realize the sales and marketing objectives
   (d) All of the above
   (e) None of the above

7. Pricing high and continually reducing price just enough to sell to each level of price sensitive customer is often referred to as which of the following?

   (a) Strategic reducing
   (b) Strategic modeling
   (c) Sequential skimming
   (d) Sequential discounting
   (e) Forward reductions

8. Value pricing does not depend on the price of competitors' offerings.

   (a) True
   (b) False

9. One of the dangers associated with discounting is:

   (a) Damage to the brand
   (b) Destruction of price levels
   (c) Customer confusion
   (d) Loss of profitability
   (e) a, b, and c

10. Most industrial markets operate within a price band. The price band is defined by the upper, mean, and lower bounds of prices charged for a particular product. When firms use pricing to move their position within the price band, this is defined as:

   (a) Pricing tactics
   (b) Pricing management
   (c) Optimization
   (d) Pricing strategy
   (e) Strategic management

# Module 8:
# Communicating Price

## Introduction

Effectively communicating prices to customers and buyers is essential to the development of any successful pricing strategy. Professional pricers must understand how price can be effectively used in product-line pricing, in developing successful sales promotion campaigns, and in advertising campaigns.

Determining prices that optimize firm profitability and competitive advantage is only the first step. The firm is legally obligated to then effectively communicate price changes to a number of stakeholders. An organization must consider the impact of a price change upon the marketplace, the regulatory environment, as well as a firm's own sales force. In the United States there are numerous (and some relatively ambiguous) laws that heavily restrict a firm from publicly communicating tentative price changes, making the process of changing prices much more complex. However, there are a number of tactics that can be used to effectively communicate price in order to meet these legal requirements.

## The Sales Force

Pricing messages should be communicated and reinforced to every important stakeholder in order to build credibility and transparency in the firm's practices. This will increase support for the pricing strategy of the firm and show the integrity of the pricing structure to employees as well as customers. When an organization decides to increase prices, it is likely to receive opposition from the firm's sales force. It is critical that executive level managers exercise strong resolve and internal controls when price increases are executed.

Sales personnel working on commission typically understand that price increases could potentially increase their own income. If existing customers purchase the same quantity at a higher price, the salesperson will net a higher commission. However, many salespeople also believe that it will be more difficult to acquire new customers with a higher price, and that demanding a higher price from existing customers can damage or terminate what might be a long-standing relationship with a key account.

Upper level managers must be involved in communicating pricing decisions. The sales force needs to hear why the price increase is necessary from a strategic perspective and why it will be enforced. Stakeholders must be informed that the new set price is not simply a starting point for negotiations, but the *actual* target goal for every salesperson.

The sales force must be monitored to ensure that the price increase is being honored during negotiations. The company should communicate to the sales force that their desired sales levels are still achievable even with the increased price. Having a top salesperson close a sale with a major customer while maintaining the higher price can help reinforce this communication. Such a strategy might be necessary due to the fact that most salespeople will be reluctant to risk their large, long-standing accounts by enforcing a higher price for the same offering during negotiations. Another strategy might be to offer bonuses to salespeople who sell the product at the new target price.

Decreased prices generally do not boast the same resistance from the sales force as increased prices do. Oftentimes, the salesperson needs only assurance that the decreased price will result in higher sales, which should have little effect on commission levels.

Communicating price to both the sales force and to customers can become an especially complex process during uncertain times (such as a post-merger period). Many managers might be inclined to shy away from any changes that would add further uncertainty to such periods. However, such an environment also offers a short window of opportunity to reestablish good pricing conduct in the market. Frequent press releases, internal newsletters, bulletins, or client meetings can extend the window of opportunity and create a more accepting climate for any moves that may be necessary.[7]

## The Customer

Companies that segment customers must be especially careful to communicate price in an effective manner. If key differences exist among consumers in the same segment, some customers will likely view the new offer as too expensive while others will see it as an excellent deal. Similarly, some might think it has a wealth of benefits while others find it lacking. Effective segmentation gives managers the ability to develop differentiated communication strategies and offerings that are better fits for each segment. The frequency with which price is communicated to a customer can also have a strong impact on how sensitive customer segments are to the same change in net price.[7]

Price communications should be developed in a way that price levels are clear to customers and competitors, and the reasons behind price changes can be easily understood. To avoid price wars with competitors, it is best to include a clear description of all qualifiers and limitations during normal communications with the market. A firm is legally permitted to communicate prices or pricing intentions publicly to customers in order to give them information necessary for their own budgeting. However, the firm must also be sure to make these communications clear due to the fact that ambiguous or generally non-specific pricing intention information can be considered signaling.[7]

Management will be interested to know the annualized impact of a pricing action, while the sales personnel will be more interested to know which customers in their territory will be impacted, which items are being affected, effective dates, and the magnitude of the change. Customer service teams should also be informed of price changes since they serve as the everyday connection to the customer.

Customers should be extended a fair amount of time between being notified of an upcoming price adjustment and the implementation of the new prices. This gives customers time to place final orders at the current price levels before the new prices take effect or to delay purchases if the new prices are more favorable. A *30-day* notification period is fairly standard in B2B markets (however this can change by industry and relationships a firm may have with existing customers). It is best to send an official letter that outlines the parameters of the price change, including a customized price schedule for each customer impacted by the change.

Lowered prices are generally well accepted by customers for obvious reasons. However, raised prices should *not* be communicated to customers as an effort to increase profits. The raised prices should instead be attributed to external factors such as supplier costs, maintenance costs, inflation, increased quality or increased service. Customers generally need some acceptable logic behind price increases in order to remain customers.

The frame of perspective through which the price is communicated can either support or hinder sales when managing price variance, price changes, and price negotiations. The issue of *framing* raises three practical questions for executives considering pricing:

- How can the price variances be framed as a win-win versus a cost?
- How can price changes be communicated as necessary steps to remain competitive rather than gratuitous profit taking?
- How can value be used to set the frame of reference when considering price?

The ability to communicate increased value to the customer is fundamental to properly framing price increases. Consumers are value seekers, and when they perceive an offer as providing value, their frame of reference shifts towards maximizing that value. However, if the good is perceived as a commodity or a cost of doing business, customers will tend to purchase solely on cost.

Communicating the price first and then following through with a description of the value encourages customers to focus on the price and seek discounts throughout the discussion. For this reason, it is best to instead *begin* by communicating the added value associated with the increased cost, *then* follow up with information about the increased cost itself. By leading with a description of the value of an offer then following through with the price, the sales and marketing effort can focus on how the offering of the firm provides additional value to the customer. This value-focused framing enables the customer to perceive the price as a small cost to pay in order to receive the value that is offered.

Value framing also shifts price negotiation from a one-dimensional challenge to a multidimensional opportunity. In a price-focused negotiation, the primary issue between the buyer and seller is where the price will lie between the seller's minimum and the buyer's maximum. Value-focused negotiation requires that all price variances be associated with value variances so that any price concession must be accompanied by the removal of value from the offering. Value negotiation can even *enhance* profitability.[3]

The pricing manager must also consider laws relevant to communicating price. In the United States, for example, it is considered unlawful if a firm publicly communicates its pricing intentions without a clear commercial purpose (since this might be seen as explicit market collusion), especially if the pricing intentions are dependent upon the reactions of competitors.

A firm may publicly communicate pricing intentions legally if it is for the purpose of giving customers needed information for their own budgeting, or to inform shareholders of a likely impact on earnings. While signaling price changes to *customers* is acceptable and recommended in certain situations, signaling to *competitors* is considered illegal.[7]

## Pricing and Promotion

**Promotion** is considered to be any activities that "communicate the merits of the product and persuade target customers to buy it."[5] The most prominent forms of promotion are *advertising*, *personal selling*, and often *sales promotion*. Regardless of the form, effective pricing should always be used to complement a successful promotion.

The most notable element of pricing and promotion is the impact promotional spending has on price sensitivity. Not only do discounts and coupons effectively alter the price, but advertising also has an effect.

Final pricing decisions should take into account how aggressive a promotional campaign will be. In the case of bringing a new product to market, consumers do not fully understand the benefits or price-value relationship of the product. These must be communicated through promotion. When customers don't understand the value they receive they are more price-sensitive. Advertising and selling should focus on product features and not assume that customers completely understand why they should buy the product or how they will benefit economically from it.

Unfortunately, there are times when firms develop unique products and then attempt to use price rather than promotion to develop the market. When a product's advantage is not obvious to buyers, a low price is meaningless. It does not serve as an incentive for buyers to try the product. A low price only appears to be a bargain to those who know and appreciate the advantages offered.

To develop a market for a product with strong advantages over the competition (but not necessarily obvious ones), a firm needs a promotional effort that will communicate these benefits and ensure that the buyers realize them when using the product.

It is important to remember that a low price in relation to product value can only be a bargain if the buyer appreciates the value. Furthermore, a high price in relation to competition is not a drawback if a strong promotional effort communicates that the value of the product is *worth* the higher price.

## Advertising

**Advertising** is defined as any paid form of non-personal presentation and promotion of ideas, goods, or services by an identified sponsor.[5] Advertising can reach masses of geographically dispersed buyers at a low cost per exposure. It also enables the seller to repeat a message many times. Unfortunately, this form of promotion is impersonal and cannot be as directly persuasive as personal selling. Advertising is a one-way communication with the audience, and it can generally be very expensive overall.

The coordination of advertising with pricing is essential because advertising directly influences price sensitivity in a twofold manner. Advertising can reduce price sensitivity by highlighting product differentiation or it can increase price-sensitivity by focusing exclusively on price. Grocery advertisements and discount warehouse clubs make consumers aware of their prices before the consumer decides where to shop. This knowledge of alternatives generally makes consumers more price-sensitive.

Firms using a penetration pricing strategy often rely on advertising to make the claim they offer equal value at a lower cost. When a firm has a cost advantage, it makes sense to use advertising with the goal being to make consumers more sensitive to the price aspect of the purchase decision.

## Personal Selling

**Personal Selling** involves a personal presentation by a sales force member for the purpose of making sales and building customer relationships.[5] The ability of the individuals involved to observe each other's needs facilitates quick adjustments during the buying process. It is the most effective tool at certain stages, particularly when developing the preferences, convictions, and actions of buyers.

For most industrial products and many large consumer durables, the major promotional tool is not advertising but personal selling. Personal selling can range from the minimally trained salesperson (who simply records orders) to the technically trained expert (who spends days or weeks with customers to develop solutions to their problems). Selecting the appropriate level of personal selling effort is important in pricing a product so that it realizes its full profit potential.

Products that are relatively generic or differentiated in ways that are obvious to the consumer generally require less personal selling strategies because little communication is required. When selling costs are kept low, the seller can offer lower prices.

Products with unique features need higher effort personal selling strategies to ensure that the features and value are adequately communicated. A skilled sales force will explain the product's features and provide additional information that will often reduce price sensitivity. This enhanced communication will allow a firm to establish differentiated values for unique products and sell at higher prices.

## Sales Promotion

**Sales Promotions** are short-term incentives that encourage the purchase or sale of a product or service.[5] These include a wide assortment of tools such as coupons, contests, cents-off deals, premiums, and more. The goal of a promotion is to attract consumer attention, offer incentives to purchase, and dramatize product offerings to boost sales. Advertising focuses on selling the product, but sales promotion focuses on selling it *now*.[5]

Sales promotion effects are normally short-lived and are often not as effective as advertising or personal selling in building long-term preference. However, promotions are essential to one of the most important strategic goals of pricing (especially when the product is innovative); ensuring consumer trials. A buyer's first purchase can be more than a mere sale. It is an opportunity to educate the buyer about the product. Only consumers who are familiar with a product become loyal users, and attracting first time buyers is the first step in building long-term sales. Sellers can secure trial from potential buyers through various sales promotions.

Promotional tools that cut prices (even to an unprofitable level) are justified because the firm often benefits from first time buyers by more than just the individual sale's revenue. A buyer who likes the product becomes a repeat customer at the regular price. Thus, promotional price cuts might be considered as an investment in future sales.

Sales promotions most often take the form of trial offers, coupons, rebates, or free samples. To understand why manufacturers use these methods instead of just cutting the price, it is necessary to examine the objectives of the firm:[8]

- The manufacturer wants the promotional price cut to benefit the end customer. If a company simply cuts its wholesale price, the savings might not be passed along.
- The manufacturer wants the price-cut to be perceived as a special, exceptional offer in order to minimize the perception that the product may be of lower quality.
- The manufacture wants to direct the price-cut to first-time buyers and minimize the extent to which repeat buyers can take advantage of it.

**Trial Offers** are price cuts that are clearly defined as temporary and are most often used for products that are new to the market. Common examples are when manufacturers of packaged goods offer trial sizes of their product or when industrial manufacturers offer product sampling through leases.

**Coupons** offer a discount to consumers while clearly marking a higher regular price. They limit the number of discount purchases repeat buyers can make, and they can be distributed in a manner that increases the probability that only first time buyers will use them. They can also make buyers aware of a product that is not yet stocked and put pressure on stores to place an order.

However, coupons also have disadvantages. The cost of coupons to the manufacturer greatly exceeds the discount the consumer receives. Also, they are not very convenient to use, and their redemption rate can be low among some demographic groups. Because they are not convenient to use, they offer the additional advantage of allowing price discrimination by self-selection. In theory, every customer has access to the discount but in practice only the more elastic segment of the population ever takes advantage of it.

**Rebates** serve the same purpose as coupons, while offering an operational advantage. They are usually processed directly by the manufacturer or service provider and therefore don’t rely on the retail chain (they also have a lower administrative cost than coupons).

Rebates can impose a cost on the consumer, but they also allow a firm to use quantity restrictions and build mailing lists of customers who may be more responsive to future promotions. Another advantage of a rebate promotion is that even though many consumers may purchase a product because of the rebate they often fail to redeem it.

**Free Samples** are the most effective and also the most costly sales promotional tool. A much larger percentage of the market will try a free sample than will redeem a coupon, which induces trial much faster. The high cost of free samples makes them a profitable sales promotion only for products that are either frequently re-purchased or those with very high contribution margins.

The combination of price and any form of sales promotion is effective to the extent that it either induces new product trial or the desirable behavior of channel partners without undermining the credibility of the product price. It should be cautioned that some firms become addicted to pricing and sales promotion. This often occurs when a firm has no thoughtful policies in place to keep promotion from being misused.

Sales promotions can cause damage when they are too frequent or offer discounts that are too great. When large deals are offered on a regular basis, brand images suffer and consumers become less brand-loyal. What may start as a temporary tactic to induce sampling can become a permanent necessity to retain market share. Many contend that promotions only motivate low-loyalty, price-based buyers (or existing customers to stock up) and that they do not induce enough customers to switch from competitive brands. Misuse can stem from sacrificing long-term profitability to meet short-term goals.

## The Psychology of Price Points

A consumer's response to price is based on more than just economics and rational calculation. It is determined not only by evaluation of the price and product, but also by perception of the whole purchase situation. This is why one part of strategic pricing must be to better understand the psychology behind prices to communicate them in a way that will influence the perception of the total purchase situation.

Even when buyers perceive prices and purchase situations accurately, they often do not evaluate them in a perfectly rational manner. This does not mean buyers are irrational, just that they tend to conserve their resources by using convenient but imperfect decision rules. A firm that understands those decision rules is better able to communicate prices in ways that lead buyers to evaluate them positively.

### The Use of Numbers in Pricing

A casual look at any retail price tag will reveal a prevalent use of odd numbers in pricing. Odd pricing is the practice of choosing a price that ends in an odd number (1, 3, 5, 7, and 9) or pricing just under a round number (99, 98). Odd prices are also sometimes referred to as "psychological prices."

According to a study conducted in 1997, approximately 60% of prices in advertising material end in the digit "9," 30% end in the digit "5," 7% end in the digit "0," and the remaining seven digits combined accounted for only slightly more than 3% of prices.[6] Whichever pricing methods retailers may use, there is a definite bias towards odd price endings. This phenomenon was also found to occur internationally.

Although the exact origin of odd pricing is uncertain, it is often speculated to have began because shopkeepers wanted to ensure there was a record of the transaction. A $9.99 price tag would require the cashier or shop assistant to ring up the sale, open the register, and hand the customer their change. A $10 price tag could allow the assistant to pocket the bill rather than ring up the sale.

Psychologically speaking, the use of odd numbers may have a more profound impact on influencing the buyer's perception of price. The belief is that a price of $1.99, $19.95, or $6,995 to perceived to be significantly less than $2, $20, or $7,000 (respectively).

Odd prices are not based on any strict mathematical calculations or long-standing economic theory. However, retailers have a general belief that odd pricing will increase demand and that the effects of odd pricing will produce higher-than-expected demand at the price level concerned. In other words, the demand curve is assumed to spike upwards at odd price points. This means that buyers will buy less as prices are lowered until a critical price is reached. In the vicinity of this critical or odd price, buyers will purchase more.

Odd pricing based on psychological pricing theory is derived from one or more of the following hypotheses:

- Consumers ignore the least significant digits rather than round properly. The cents are seen but may be subconsciously ignored. This effect may be further enhanced when the cents are printed in smaller font: **$9$^{.99}$**.
- Fractional prices suggest that goods are marked at the lowest possible price.
- Consumers are accustomed to odd prices, and other prices seem unusual.

The first bullet addresses the theory that consumers have a limited capacity for storing information. Because consumers are bombarded with a continuous flow of information on price, they store only the most relevant information, the first digits of a number. Therefore, when a price is marked $9.99, a consumer will recall the price as $9.00, then maybe that it is $9.90, but rarely take the time to consider it to be $9.99. The reasoning behind why a consumer will not take the time to round the price up to $10.00 is based on memory processing time. Rounding up requires an additional decision compared with storing the first digits and because of the vast amount of information a consumer is presented with, pricing information must be stored very quickly. The fastest way to do so is to save the extra step and simple store the first digits.

The next item in the list suggests that consumers perceive odd pricing as evidence that goods are marked at the lowest possible price. The more specific a statement is, the more inclined consumers are to believe that it is not arbitrary. Therefore, odd prices may portray an image of honesty that would not be portrayed by slightly higher rounded figures.

Finally, the odd pricing effect may simply be a result of marketplace conditioning. Consumers expect to see odd prices and when they do not it is considered unusual. Other possible explanations for the effect of odd pricing include the theory that "circles attract the eye" (therefore consumers would be drawn to the number "9"). There is also a theory that customers simply like to receive change after making a purchase.

Despite the intuitive nature of these theories, some are somewhat speculative. The theory behind odd pricing is controversial. Some studies show that buyers (even young children) have an understanding of true cost and relative value, and that they do behave rationally. However, research continues to be largely inconclusive on this topic.

For typical cash transactions, odd pricing imposes intangible costs on the retailer (printing fractional prices), the cashier (producing change), and the customer (storing the change). These factors are less relevant with increased usage of credit and debit cards.

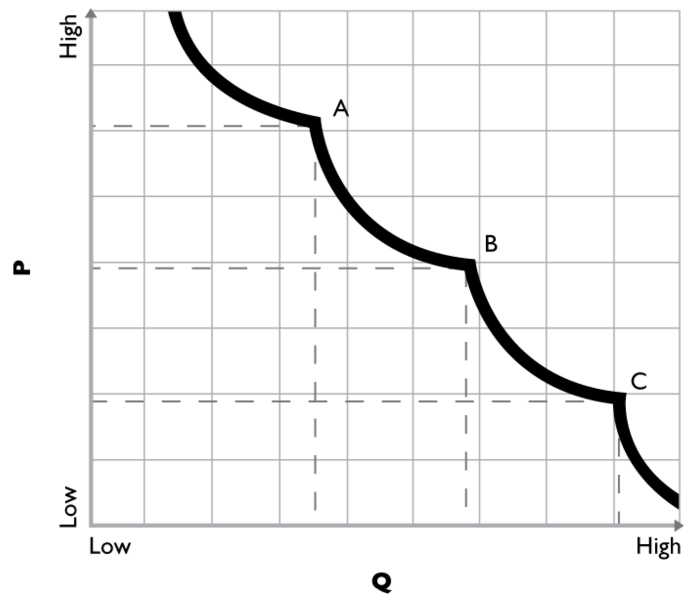
There are specific cases when odd pricing is not an ideal strategy. Research indicates that odd pricing can communicate a low-price and low-quality image. As some retailers work to differentiate themselves from discounters, they intentionally price in even numbers in an attempt to reinforce their brand image of quality and sophistication.

## Price Pointing

In many industries, sellers use well-established price points for the products in their line. This is called **Price Pointing** and it is based on what consumers expect to pay based on their previous experience. There are peaks in demand at particular price points that the buyer anticipates.

Price points are the prices at which demand is relatively high, as illustrated by the graph in *Figure 8.1* below:

**Figure 8.1: Price Points**




There are three reasons that price points exist:

1. **Substitution Price Points:**
   - Price points will occur at the price of a close substitute.
   - When a product's price rises above the cost of a close substitute, the quantity demanded will drop.

2. **Customary Price Points**
   - Consumers are used to paying a certain amount for a type of product.
   - Increasing the price beyond that amount will decrease demand.

3. **Perceptual Price Points**
   - This is also known as psychological pricing or odd number pricing.
   - Raising a price above $0.99 will cause demand to fall a disproportionate amount because $1.00 is perceived to be a significantly higher price

A firm using cost-plus pricing and ignoring the psychological aspects of pricing is not optimizing prices. It is important for a firm to think in terms of price points and then conduct price point testing. If a firm decides to raise prices above a certain price point threshold, it might be unwise to exceed the threshold by only a small amount. Instead, prices should be raised to the next logical price point threshold.

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## Review Questions

1. The judgment of price acceptability depends not only on buyer price expectations, but also on information provided in promotions or advertisements.

   (a) True
   (b) False

2. When a firm develops a unique product, the best way to expand the market is through which of the following?

   (a) Pricing strategy
   (b) Promotion
   (c) Logistics
   (d) Supply chain management
   (e) Branding

3. In order to avoid price pressure from customers, a firm must communicate what customers are *buying* rather than what the firm is *selling*. This begins with advertising and selling scripts that emphasize which of the following?

   (a) Competitor short-comings
   (b) Augmented services
   (c) Digital support
   (d) Benefits the customer can achieve from the offering
   (e) Demand forecasting

4. Which of the following is an advantage that advertising has to offer?

   (a) It is a two-way communication between buyer and seller
   (b) Overall, it is an inexpensive promotional tool
   (c) A firm can finely tune who is targeted
   (d) It offers low cost per exposure
   (e) It often closes the sale

5. Which of the following is typically the most effective type of sales promotion?

   (a) Coupons
   (b) Free samples
   (c) Premiums
   (d) Cents-off deals
   (e) Contests

6. When executing price increases, the sales force must be monitored to ensure that the price increase is being followed and defended during negotiations.

   (a) True
   (b) False
   (c) Not enough information to answer the question

7. Which of the following most concerns company management during a pricing change?

   (a) Annualized impact of the pricing action
   (b) Which customers in the territory will be impacted
   (c) Which items are being affected
   (d) Effective dates
   (e) Magnitude of the change
   (f) All of the above

8. Members of customer service teams are generally not qualified to communicate price changes, so they do not need to be made aware of upcoming price changes.

   (a) True
   (b) False
   (c) None of the above

9. Communicating to the customer that raised prices are necessary to increase the firm's profitability is generally an effective strategy.

   (a) True
   (b) False
   (c) Not enough information to answer the question

10. To avoid price wars with competitors, it is best to include a clear description of all qualifiers and limitations during normal communications with the market.

   (a) True
   (b) False
   (c) Not enough information to answer the question

# Module 9:
# Pricing in the Distribution/Supply Channel

## Introduction

Developing pricing strategies for the firm's distribution channels can be a difficult process. Some possible reasons for this include:

- Each channel member has different pricing goals (distributors, retailers, manufacturers).
- There are various commission rates and markups levied by each channel member on the channel price.
- Each channel member has different marketing and pricing strategies of their own.
- Each member has a propensity to pursue its own channel pricing strategy.

Consistency in pricing is important in a distribution-channel pricing program. However, hybrid distribution models are common in most companies. The use of different distribution channels can often result in channel conflicts. Pricing should be balanced between channels in these mixed distribution models.

If this is not the case, the resulting channel conflicts may contribute to value destruction because ineffective pricing can favor specific channels and change the channel mix. If managed effectively, pricing can be a powerful tool in channel management.

## Equivalent Channel Pricing

One way of managing distribution pricing is through **Equivalent Channel Pricing (ECP)** which involves managing prices uniformly across all channels of distribution. This is a good way to manage channels to the advantage of a firm, allowing the firm to capture the full value potential of a channel pricing strategy.

Generally, a good balance in channel pricing is often difficult to achieve because of factors like dealer consolidations and emerging distribution alternatives. Such new alternatives may be seen by management as a good way to increase revenue while reducing costs. However, this is often not the case.

A firm should look at three factors in evaluating its channel strategy: **Cost-to-Serve (CTS)**, value added, and price. Considering all of them will give a company an indication of not only the profitability of its distribution channels, but also an idea of which ones are adding *value* to the end customer.

To do so, the firm needs a comprehensive understanding of its CTS each channel member as well as an understanding of the real competitive advantages that each channel offers. This can be done by carefully analyzing the sales and business processes of each channel.

## Distribution Channel Structures

The primary types of channel structures are shown in *Figure 9.1*, with each having its own set of value added services, costs, profitability, and pricing alternatives.

**Figure 9.1: Distribution Channel Structures:**


## Direct Distribution Channels

**1 Level Channels** provide a high degree of value-added service for customers and several advantages for the firm. These advantages include:

- Direct-delivery to customer sites
- Low-cost distribution
- Direct pricing with low CTS economies of scale
- High profitability with gross margins, ranging from 25%-200%

## Multi-Tier Distribution Channels

**2 Level Channels** have a high degree of value-added service for customers and offer more customized distribution alternatives for manufacturers and distributors. The primary factors for consideration in this type of channel structure are as follows:

- Quantity stock deliveries and consolidated load alternatives to customer sites
- Moderate to low cost distribution through cooperative inventory programs with distributors in the channel
- Moderate levels of profitability due to an increase in the CTS
- Cooperative distributor program pricing

**3 Level Channels** provide customers with a wide assortment of products due to the multiple levels of distributors in the channel. The primary factors for consideration in this type of channel structure are as follows:

- Smaller shipments to more defined target markets
- Higher CTS
- High product prices due to the multiple levels of distribution in the channel
- Cooperative distributor program pricing
- Moderate levels of profitability due to an increase in the CTS

### International Distribution Channels

**4 Level Channels** provide customers in international markets access to products. The primary factors for consideration in this type of channel structure are as follows:

- Allows firms access to international markets
- Highest CTS of all of the channels of distribution
- Involves complex distributor program pricing
- Moderate levels of profitability due to an increase in the CTS
- Highest prices because of the multiple levels of distribution in the channel

## Pricing in Retail Channels

Pricing at the end of the distribution channel, or the retail level, requires that the retailer develop a pricing policy that is consistent, and is based on four important factors:

1. The target market of the retailer
2. The market position the retailer occupies on the local or national levels
3. The product and service assortment the retailer markets to customers
4. The existing and future market competition the retailer will face

The ideal goal of pricing at the retail level in a distribution channel is to achieve high markups *and* high sales volumes. Unfortunately, both of these goals are not typically attainable. Retail pricing generally focuses on high markups at lower sales volumes (department store strategy) or lower markups at higher volumes (Wal-Mart strategy).

### Price, Value, and Consistency at the Retail Level

Pricing at the retail level often involves frequent changes in prices to attract consumers through sales and special promotions. Retailers may also utilize strategies with less frequent price changes in order to signal higher quality and avoid the impression in the marketplace that they are interested in serving consumers who are only "chasing prices." Frequent price changes may confuse consumers who are searching for *appropriate* prices, and not necessarily the lowest ones. In fact, frequent price changes can even make a retailer appear dishonest, as customers try to interpret the motives behind the price changes. Hence, the consistency of a seller's prices over time (even in the presence of shop-bots) may be desirable from the consumer standpoint.

Retailers who market brand name products should avoid frequent changes in price, since it frequently dilutes the perceived value of the brands. Changing prices too frequently at the retail level in a channel may cause the consumer to shop around more frequently and consider purchasing from online retailers as well as “brick and mortar” stores.

Consumers generally know that price is not the defining factor in a retail purchase. They want to be assured they are buying high-quality products and therefore seek information about its features, benefits, and the services offered by the retailer (including on-time delivery and a manufacturer’s guarantee). These factors lie at the heart of a company's brand image and are often more important than the having lowest price.

## Quantity Discounts in Distribution Channels

Managing a channel pricing strategy usually requires a firm to incorporate discounts into its pricing programs for distributors (wholesalers) and retailers in the channel. There are typically two factors that determine the extent of discount usage in a channel pricing program: improving control and coordination, and controlling inventory surpluses.

### Improving Control and Coordination

Improved pricing management control in the channel of distribution is achieved if the producer, distributor, and retailer work towards the common goal of maximizing total supply chain profits. To accomplish this, the manufacturer sets the channel pricing policy and encourages all channel members to participate in the program. This is not difficult to achieve if all of the channel members understand the program and the role they will play.

Sometimes the necessary level of cooperation is not always realized, and firms in the distribution channel are vertically integrated in a backward or forward direction. Forward vertical integration involves the manufacturer buying out the distributor and/or retailer in the channel. Backward vertical integration involves either the retailer or distributor buying out the manufacturer. Both integration strategies are primarily attempting to control channel pricing and discount programs.

### Controlling Inventory Surpluses

Minimizing inventory levels is important if the long-term profitability of the channel members is to endure in competitive markets. The most frequently used pricing tactic for accomplishing this goal is the quantity discount. These discounts serve as an incentive for distributors, retailers, and customers to purchase large quantities of products.

Low inventory levels are important to the survival of a channel of distribution, since inventory can account for as much as 50% of operating costs in a distribution channel. To control high inventories in distribution channels, discounts may be used for surplus inventory during specific time periods. In certain situations the producer may even require the distribution channels to perform specific actions to qualify for certain discounts (such as picking up the inventory in their own trucks or conducting special promotions and sales). These discount programs help producers shift inventory to retailers and consumers, thereby diminishing their own inventory costs and selling prices.

Managing channel pricing through discounts will not always guarantee success. Many distributors may not pass the discount on to their retail customers (nor they to the final consumers) to spur inventory reductions throughout the entire channel.

Some distributors or retailers often use discounts to stockpile their inventory and exploit the temporary reduction in channel prices. This practice of channel buying is referred to as **Forward Buying**. The action generally helps them decrease their future cost of goods sold and increase their long-term profitability. However, if forward buying is poorly timed, it can also increase the inventory flow in the channel and may increase their inventory costs.

## Distribution Agility and Pricing

**Distribution Agility** refers to the flexibility that manufacturers, distributors, retailers, and customers have in working together to store, transport, handle, service, and price goods. To be agile in pricing, a distribution channel must be characterized by a number of different factors that may include:

- Being sensitive to the market
- Utilizing technology to share information among channel members
- Using process integration among the channel firms
- Structuring the channel of distribution as a network

### Market Sensitivity

**Market Sensitivity** is the ability of the channel members to price their products according to changing demand patterns in the market. Companies tend to set channel prices based on market forecasts rather than on current market demand. The drawback of using forecasts exclusively is that channel members will have limited feedback on *actual* movements in market demand. The result is that the channel prices would tend to be inaccurate and in frequent need of modification.

Technological innovations over the past several years have made it easier to capture data on demand at all levels in the channel of distribution. This has resulted in more accurate and up-to-date channel pricing. Efficient consumer response systems and POS systems are now enabling distribution channel members to be in closer contact with customer demand at all levels in the distribution channel.

### Information Technologies

**Information Technologies** in distribution channels are a critical component for the development and implementation of effective pricing strategies at all levels in the channel. They enable distribution pricing strategies to become virtual, and for prices to be based on market demand information rather than inventory information. Channel pricing no longer seeks to reduce inventory levels, but rather to maximize profits through prices that reflect the actual market demand conditions at all levels in the channel of distribution.

### Process Integration

Shared information among channel members can make the pricing channel strategy of the firm more effective and realistic. Process integration allows for enhanced collaboration, joint product development, and shared information between buyers and sellers in a distribution channel. The result is that the value of the products and services each channel member buys from one another are sold at prices that allow each channel member to make satisfactory profits.

### Distribution Channel Networks

The concept of a *networked* channel of distributors recognizes that multiple firms in a distribution channel are no longer able to successfully face market competition by standing alone. It is beneficial to develop channel-spanning pricing strategies that allow each firm in the channel to compete as a group against outside competitors.

For example, Wal-Mart has created channel networks that enable the company to compete effectively against other large retail competitors. Such channel programs are ushering in the era of “network competition” where the winners will be the distribution channels that can better organize, coordinate, and manage their pricing strategies and relationships with suppliers based on the delivery of products and services that add value for customers.

## Pricing and Distribution Channel Performance

When pricing through distribution, a firm must price in a way that motivates distributors to sell its products or services. However, if it is to increase market-share, maximize profitability, establish market entry barriers, or to increase sales volume, the firm must also be cautious that the distributors are adhering to the pricing objectives.

Of course, distributors in the distribution channel should be allowed some "room" to make a profit. Therefore, selling through distribution requires consideration of a host of typical pricing factors for each distributor:

- Overall distributor profit performance
- The effectiveness of its sales force in new business development
- Its success in market sales penetration
- Its success with using discount sales programs to generate new business
- Its ability to keep inventories at low levels
- Its success in launching new products developed by producers

An area that is frequently overlooked by firms in pricing effectively in distribution channels is to analyze how their distribution partners generate profits. Two key elements will give a firm an idea as to how effective distributor pricing strategies are and if they can be sustained over the long term.

The first element is an examination of the product mix that the distributors are marketing. If some distributors are only pushing the high-volume (or low-value) products of a producer, it may indicate that they are avoiding value added product strategies in their sales program and focusing solely on low price as a volume-generating tool. Frequently, distributors do this because they do not understand value-added marketing or have not properly trained their sales force in value-added selling techniques.

Another important element is the distributors’ incentive programs. Some programs may be too rewarding and provide disproportionate incentives for low-value product sales than it does for high-value product sales. It is important that such programs be revised to create a more balanced mix of products to better capitalize on higher-value, more profitable items.

## Distributor Behaviors and Pricing in Distribution

The overall relationship a company has with its distributors is important to the success of a distribution-channel pricing program. Just as a company builds effective internal business relationships, it is important to do the same with its distributors in its distribution channel. This can be a challenge depending on the particular distributors since some may employ "street-bully" or devious tactics to get what they want.

To better understand the pricing behavior of a channel distributor, a firm should ask a few important questions of its distributors:

- Are the distributors concerned about (or do they even understand) the value of the firm’s products?
- Do they use discounts too frequently to close sales?
- Do they continually make unreasonable demands, such as continuously asking for deep discounts or allowances?
- Is the distributor a good team player for the pricing group and sales force of the firm? (This is at the core of most channel pricing strategy problems)
- Is the distributor sales force cooperative or just a bunch of “cowboys” when it comes to pricing?

To work effectively with distributors, a firm also must understand their challenges and issues as well as the behaviors they may exhibit to obtain the best pricing. They may impose unreasonable time pressures.

For example, some tactics include distributors claiming to " need it now," threatening to take their business elsewhere, engaging in bullying with new or less experienced sales representatives, or claiming that the pricing of the firm lacks flexibility. There are a few things that can be done to better handle these common problematic behaviors.

The firm can get to know the distributors better by joining their sales force on account calls to better understand the challenges, issues, and concerns they are facing. Sales and pricing training programs can also be used to better educate the distributor’s sales representatives about the sales and pricing strategies of the supplier.

The firm must also determine whether the distributor is a loyal ally or a hindrance to a channel pricing strategy. Is the distributor generating significant sales revenue for a firm, or should the firm shift towards an implementation of the 80/20 rule (where 20% of distributors would drive 80% of the producer’s business)? Another important question is whether or not the distributor is moving the supplier’s product and selling its value, or if it is it frequently offering the products of competitors to its customers.

## The Company Sales Force and Distributor Pricing

The sales force of a company can be a critical ally in working effectively with distributors. First, it is important to know whether the members of the sales team understand how to price effectively in general. Second, do they understand how to effectively *execute* the company’s pricing program? If not, then they should be educated about the basics of pricing and the tactics that distributors might use.

Another important question to ask is whether the supplier’s sales force is aware of the strategic implications in giving haphazard price quotes to distributors? The supplier’s sales force should be informed about how this might affect long-term profitability, sales, other customers, customer segments/regions, and complimentary products.

Often, the supplier's sales representatives may simply be unaware of how to develop an effective working relationship with the distributor in the distribution channel. If this problem is widespread, then the pricing group should begin to seek ways to remedy it.

In addition to attending national or regional sales meetings on an annual basis, it may be necessary to devise and conduct pricing education classes for the supplier's sales force. Training classes can be scheduled on a periodic basis, and the distributor's management team should be included to encourage their sales representatives to support the pricing strategies and tactics of the supplier.

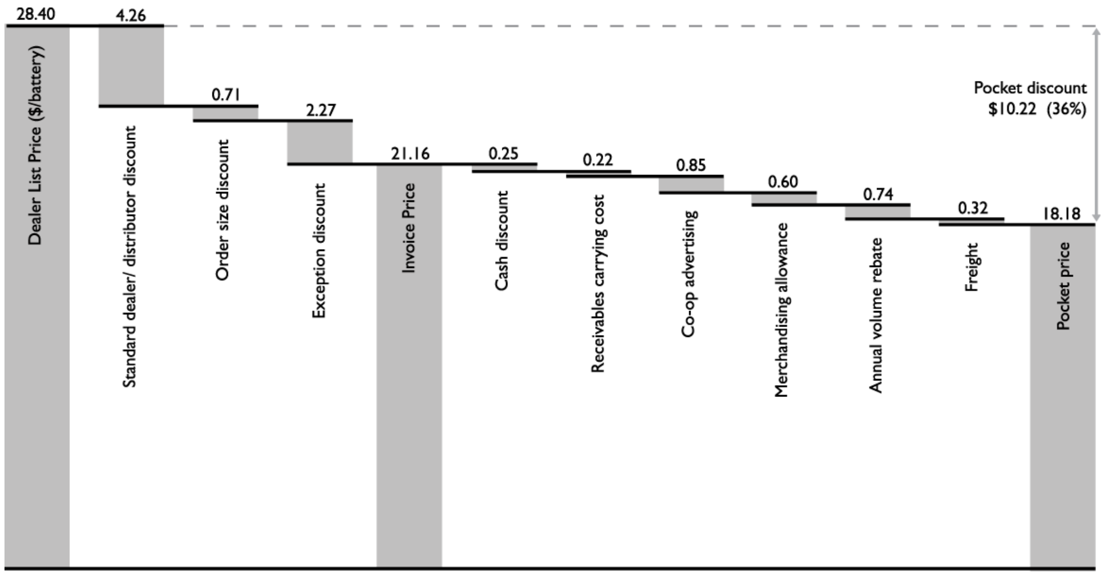
This training should also include the development of a continual supplier-distributor sales and pricing communication program so that the sales representatives of the distributor are kept informed of new or revised corporate pricing strategies in a timely manner. Such communications should include a discussion of the producer's pricing strategies as well as distributor pricing tactics. This will encourage information exchange and enable the supplier's sales force to better understand the challenges and issues involved in working with distributors. It will also enable the distributors to better understand daily challenges the supplier's pricing group faces in adhering to corporate pricing policies and strategies.

## Distribution Pricing Waterfall and Revenue Leakage

One of the important challenges in distribution pricing is to avoid **Revenue Leakage**. This can occur when a supplier provides list price discounts to its distributors. Each time a discount is given, revenue "leaks" from the supplier's revenue stream.

The burden is primarily on the sales force to develop and maintain a good working relationship with distributors so that the leakage is minimized until the final or pocket price is negotiated. It is very important that the pricing group be able to implement strategic pricing tactics through distribution and arrive at a pocket price that is mutually beneficial for both the supplier and the distributor. Distributors usually do not pay list price, but it is important to control price discounting to distributors, as the pricing waterfall chart in *Figure 9.2* demonstrates.[12, 13]

**Figure 9.2: Distribution Channel Pricing Waterfall**




Here, the list price is $28.40 and the distributor eventually pays a pocket price of $18.18 for the product. The result is a total discount of $10.22 or a 36% reduction from list. The supplier should examine each one of these revenue leaks and question whether the distributors in its distribution channels should qualify for them. The goal is to minimize revenue leaks and maximize profits for both the supplier and distributors.

The pricing waterfall illustrates how the difference between list price and pocket price can result in a significant reduction to bottom-line profitability. As a pricing professional, it is important to understand this concept in order to effectively manage discounts and significantly improve profitability. In addition, it is also important that the sales force understands the ramifications of these discount leakages, however large or small. The sales force is important in managing these leakages with distributors.

Educating the sales force about the pricing waterfall concept is an important factor in helping them more effectively manage the discounts they offer distributors. It can also encourage more critical judgment as to how the decisions of the sales force will affect company profitability. However, there are a few alternatives for minimizing these revenue leakages:

**Leverage the Advantage of the Company:**
Is the supplier an incumbent? Try to capitalize on that by reminding distributors of the company's excellent customer service or inventory supply. Offer additional value-added services, such as priority scheduling and delivery (try and obtain a premium for these when possible). Attempt to offer these quality services in lieu of continual price reductions.

**Discount Incremental Sales Volume Only:**
Consider volume allowance tier programs. Hold firm against continual price pressures by making the distributor somehow earn additional discounts. If certain sales revenue targets (tiers) are achieved by distributors, reward them with corresponding percentage discounts on that incremental sales tier only.

**Obtain Something in Return for Price Concessions:**
If the distributor asks for continual price reductions, consider adjusting their payment terms (net 15-day instead of net 30-day). It may also be a good idea to reward positive changes in distributor behavior, such as offering a discount if they implement an Electronic Data Interchange (EDI) or telephone service support in order to reduce or even eliminate on-site sales visits.

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## Review Questions

1. Equivalent Channel Pricing involves managing prices ____________.

    (a) Across all distribution channels except direct channels
    (b) And creating discounts that can be applied to all distributor accounts
    (c) Uniformly across all channels of distribution channels
    (d) None of the above

2. In balancing prices across distribution channels, a firm should look at which of the following?

    (a) Cost-to-Serve, value-added, and full truckload shipments to distribution channel customers
    (b) Cost-to-Serve, value-added, and price
    (c) Channel structure, and the number of distributor sales reps
    (d) All of the above

3. 2 Level Channels generally offer quantity stock deliveries and consolidated load alternatives to customer sites.

    (a) True
    (b) False

4. 3 Level Channels have the simplest distributor _________.

    (a) Channel management training program for supplier sales representatives
    (b) Discounts for supplier firms
    (c) Consolidated stock delivery programs
    (d) Pricing programs
    (e) None of the above

5. Retail pricing in the distribution channel requires that the retailer do which of the following?

    (a) Price to its target market
    (b) Set discounts that will increase consumer demand
    (c) Develop pricing strategies that are rigid for short periods of time
    (d) Bundle price all of its product offerings to make them more attractive to consumers

6. Discounts generally are good for which of the following?

    (a) Helping distributor sales representative's close deals with retail accounts
    (b) Helping improve value-added marketing in the distribution channel
    (c) Helping control inventory levels in a channel
    (d) None of the above
    (e) a and c only

7. Agile pricing in a distribution channel refers to which of the following?

   (a) The use of process integration between the channel members
   (b) Structuring the channel distributors as a network
   (c) Being sensitive to the market
   (d) All of the above

8. A distributor channel network recognizes that firms in a distribution channel can no longer stand alone in meeting market competition.

   (a) True
   (b) False

9. In pricing through distribution a firm should look at which of the following?

   (a) The effectiveness of the distributor sales force in new business development
   (b) Trying to knock the competitors "out of the market"
   (c) Setting margin levels high to stimulate the sales efforts of the distributors
   (d) The overall cost structure of the distribution channel

10. Excessive revenue leakage occurs when the supplier offers a limited number of carefully controlled discounts in the distribution channel.

   (a) True
   (b) False

# Module 10:
# Researching Price

## Introduction

The role of price in a purchase decision is highly complex and is subject to substantial variability over time. In order for a firm to create a profitable and sustainable competitive advantage in the marketplace, pricers must develop a system that provides *continuous* information about markets, competitors, current customers, and prospective buyers.

By managing pricing research data with well-designed information systems, firms can achieve a thorough understanding of the external drivers of price. This research is not always easy to conduct because data may be inconsistently formatted, difficult to obtain from certain sources, or may be too massive in scope to effectively organize.

If pricing managers rely solely on mathematical models and cost accounting, prices will generally be *lower* than the optimal level. Effective pricing research should also yield insight into customer and market behavior, specifically in the following areas:

- How customers and competitors react to prices
- The degree of market sensitivity to *price levels* and *price differences*
- How the market assesses the value received from the product or service

Managers from every type of industry can use pricing research to find the optimal price for products over various customer segments.[10] Price changes based on data gathered from research are more likely to create sustainable profitability for a firm than most "gut-instinct" price changes.[3]

Quality pricing research should involve numerous divisions in a firm that may include marketing, sales, finance, and research. Pricing research carries significant costs, and these should be factored into pricing decisions along with direct labor and material costs.

Each individual research method varies in terms of the nature of the data collected, investment of time, and overall monetary investment. Research methods must be designed to collect the necessary information, but must also be completed in a timely manner so that the results remain reflective of quickly changing market conditions.

It is the responsibility of the pricing manager to select the research methodology that is the best fit with the pricing strategy of the firm and that also provides an acceptable return on the investment of resources. This module will provide an overview of some major qualitative and quantitative pricing research methods so that pricing managers can more effectively conduct market research that achieves maximum long-term value.

## Fundamentals of Pricing Research

There are a number of ways in which price can be researched. Extensive research may be necessary in certain situations. However, if potential price variations are slight or if price promotions are an option for the pricing manager, then econometric data and market experience alone may be sufficient foundations for pricing decisions.

Any pricing research endeavor should be prudently executed. Results may be highly unreliable in a market where there is an overabundance of competitors (which may create confusion for customers), where price is fixed for all customer segments, or when the price of individual components in a portfolio is obscured by bundling or restrictions.

Pricing research must provide respondents with a consistent frame of reference, unless the research is specifically studying the effect of varying the frame of reference on responses. When comparing multiple brands of equal price, it is important to somehow establish each respondent's preference.

Effective pricing research can be used to answer a number of questions:

- How are competitors likely to react to a particular price change, relative price difference, or pricing tactic?
- Do customers perceive that substitute products or services are available?
- Are customers aware of prices for this product category?
- Are there different groups of customers with different levels of price-sensitivity?
- Does the product or service perform a particular function, solve a problem, or provide pleasure for customers?
- How easy or difficult is it for buyers to determine the relative quality of the product or service before purchase?
- How do customers purchase the product?
- Have the past pricing moves of competitors been unexpected?
- Do buyers tend to search for alternatives before purchase?
- To what extent have the pricing strategies and tactics of competitors affected the sales volume of the firm in the past?
- Whom do customers perceive to be the major competitors of the firm?
- Do buyers tend to search for alternatives before making a purchase?

## Quantitative Research Methods

**Quantitative Research** can be highly effective, assuming that an adequate sample is taken and the correct form of analysis is used. Because data gathering can consume a significant amount of resources, it is of the utmost importance that this process be properly executed.

In order to answer fundamental pricing questions, a variety of quantitative research methods might be utilized, and many of these methods are briefly discussed in this section. These methods can be broken down into three fundamental types of quantitative methodologies:[9]

- **Monadic Design:**
  Respondents are exposed to a single price point for any given product.
- **Comparative Design:**
  Respondents are asked to compare two or more prices.
- **Declarative Design:**
  Respondents are asked to provide an acceptable price for one product or more.

## Test Markets

**Test Markets** provide the opportunity for a firm to study actual market reactions to price changes in limited segments (individual stores or regions). Feedback is gathered from these test market customers in order to predict market reactions beyond the test segment.

In order to ensure that feedback is not biased by poorly designed surveys or questionnaires, it is important to carefully design the methodology for collecting this feedback.

> "To take an accurate measure of the benefits a product offers — and thereby find its true price ceiling — market research must be designed to elicit more open-ended feedback than can usually be acquired through multiple-choice questionnaires or trade-off techniques, both of which can limit responses." [8]

A key aspect of a successful in-market test is the ability to isolate the impact of extraneous variables in order to obtain reliable results. This type of test is generally the best method for researching impulse-driven purchasing decisions.

## In-Store Research

**In-Store Research** obtains pricing data directly from the customer during or immediately after the purchase. With new technologies, some firms have enabled real-time testing, which enables customer responses to be obtained and analyzed immediately (this can also cost as little as 5% of the price of traditional testing).

This information can be gathered online, through a call center, or through price recommendations given to the sales force during personal negotiations. Real-time testing is generally the cheapest form of research for samples greater than 200 respondents.[11]

## Surveys

**Surveys** are a common method of estimating price sensitivity, brand preferences, and purchase intentions. Surveys are essentially questionnaires that can be completed via personal interview, telephone, online, or by mail.

Many issues arise with survey research. A key problem is that respondents may be subjected to considerable bias, which can significantly distort the results. This bias can occur when a respondent offers answers they believe the interviewer desires to hear, or answers that are socially desirable.

To combat this effect, surveys should be as private as possible, and confidentiality should be assured. Online surveys can provide reliable responses in a comparatively quick amount of time, while providing a certain level of convenience, privacy, and perceived confidentiality.

Surveys also tend to elicit responses from consumers when they are not particularly interested in purchasing that type of product. This may cause them to give minimal thought to their responses.[10]

### Experiments

**Experiments** afford the opportunity to isolate and control various factors that influence demand. They also provide the ability to observe a consumer's reaction to the factors being tested.

No experiment can fully replicate the natural purchasing environment because there are a number of factors that cannot be controlled. Competitive moves such as advertising and promotions are difficult to replicate in lab experiments, and these factors can have significant impacts on consumer behavior.

Field experiments can be used to provide a more accurate representation of the natural buying environment. The availability of optical scanning equipment greatly increases the speed and accuracy of obtaining sales volume data. Nevertheless, this method usually involves a much higher investment in time and money to obtain accurate results than comparable lab experiments.[10]

Pricing managers should be aware that data acquired from field experiments can be affected by a number of factors such as competition, weather, and advertisements.

### Consumer Panels

In **Consumer Panels**, households are selected to record their purchases by brand and price. This can be accomplished by having the members of that household record their purchases on their own (using a purchasing diary) or by having their purchases scanned at a store's checkout counter.

The data can be aggregated on a weekly or bi-weekly basis, and can accumulate quickly to provide a robust database for managers. But unless the panel is well constructed using a representative sample, the data is unlikely to represent the general population. Respondents may also forget to make entries or may make incorrect entries, which can hurt the reliability off the data.[10]

## Qualitative Research Methods

**Qualitative Research** in pricing can be used when there is not a large enough sample to produce an adequate quantitative analysis, or when the exchange being studied is too complex to be captured using quantitative analysis. Qualitative research may include focus groups and personal interviews.[5]

Many firms have discovered that certain forms of qualitative analysis are useful when faced with strict time and monetary constraints and can be helpful in determining which issues should be further researched with quantitative analysis.

### Focus Group Interviews

A **Focus Group Interview** is an unstructured, free-flowing interview with a small group of people. It is not a rigidly constructed question-and-answer session, but a flexible format that encourages discussion of particular products or pricing issues.

The primary advantages of focus group interviews are that they are brief, easy to execute, quickly analyzed, and can often be completed in less than a week at a substantially lower cost than other attitude measurement techniques. However, the sample will not be representative of the population, no matter how carefully it is chosen. Because of this limitation, focus groups can never fully take the place of quantitative analysis.[12]

### Personal Interviews

**Personal Interviews** provide direct communication and allow interviewers to ask respondents questions in face-to-face situations. This method is versatile, allows for complex answers, and can increase the probability of getting completed questionnaires.

Personal interviews can be used for quantitative research (if the interviewer fills out a questionnaire based on the answers provided) or for qualitative research (if the interviewer asks open-ended questions to extract deeper responses).[12]

## Estimating Price-Level Sensitivity

Some practitioners criticize the measurement of price-sensitivity because they believe that it seeks the following short-term objectives without adequately addressing more substantial long-term pricing issues:

- Permission to charge higher prices for added value (without loss of sales)
- Confirmation that discount pricing will increase revenues
- Reassurance that a discount is an adequate concession for product deficits

Despite criticisms concerning its use, price-sensitivity measurement has been established as a useful tool for pricing managers. Obtaining consumer responses to only single-price scenarios makes it more difficult to determine the relative price-sensitivity of buyers. This price-sensitivity can be measured in a number of ways that are briefly discussed below.

### Direct Question Approach

The **Direct Question Approach** is the simplest approach to determine upper and lower price thresholds of a customer. This poses the following two questions to respondents:

1) What is the *highest* price that you would pay for a product or brand?
2) What is the *lowest* price that you would pay for a product or brand?

Once this data is collected, the proportion of consumers that are likely to make a purchase at a given price level can be calculated. The cumulative frequency distributions for prices that are too low and too high are developed, and the median values are used to estimate the lower and upper price limits.

Direct questioning is convenient, but it is also subject to bias. For example, when facing a direct question about preferred or acceptable sets of prices, buyers often indicate the lowest price option because they feel it to be an acceptable answer. Also direct questioning may create the notion that there is *supposed* to be a certain price that is too low or too high.[10]

## Price-Sensitivity Meter

The **Price-Sensitivity Meter (PSM)** poses four questions to respondents:

1) At what price would you consider a product/brand to be so inexpensive that you would have serious doubts about its quality?
2) At what price would you still feel a new product/brand was inexpensive yet have no doubts about its quality?
3) At what price would you begin to feel the product/brand was expensive but still worth buying because of its quality?
4) At what price would you feel that the product/brand is so expensive that it is not worth buying no matter what the quality?

These questions can be asked in a number of ways and the PSM uses the same analysis methodology as direct questioning in its initial phases. By using a PSM approach however, the results are graphed to determine an acceptable price range.[10]

## Price Categorization

The **Price Categorization** approach requires consumers to sort a set of prices for products into groups according to how the prices are similar or dissimilar to each other (in terms of consumer preferences). A wide range of prices (as many as 50) should be used with this technique. The analysis of these results is similar to the direct questioning analysis.

A participant may be asked to rate price ranges for a new pair of Nike Sneakers that all fall between $10-$250. For each range ($10-$47, $48-$59, etc…), the participant will be asked to rate his or her feelings using options such as the following:

(a) Unacceptably high
(b) Acceptably high
(c) Most acceptable
(d) Acceptably cheap
(e) Unacceptably cheap

**A consumer may rate $10-$47 as being "too cheap," or $48-$59 as "acceptably low."*

## Magnitude Scaling

**Magnitude Scaling** elicits information about the *intensity* of judgments and how respondents make price-quality or price-value judgments. By using several product/price combinations, a scale can be developed for the proportional differences in perception among price and different product attributes.

The most widely used form of this scaling is numeric estimation. Using numeric estimation, a respondent is instructed to assign numbers to a product or price relative to a reference product or price. Underlying this approach is the fundamental assumption that people can provide meaningful information about the magnitude of their perceptions.

Suppose that respondents purchase a Dell Laptop computer as a reference product. They are given time to test the product and are then asked to identify and then rate the product *features* (weighs 2.8 pounds, 18-inch screen) and *benefits* (easy to carry, easy to view) that are important to them. They would then be asked to assign an overall reference value of "10" to the product.

To test a Gateway Laptop computer, the product would be described to the respondents (for example, it weighs 3.0 pounds and has a 20-inch screen). The respondents would then be asked to rate the Gateway computer as *higher than 10* (if they think the is better), or *lower than 10* (if they think it is inferior), or *exactly 10* (if they think it is the same). For example, respondents may answer "11" (if they think the Gateway computer is 10% better than the Dell Laptop) or "5" (if they think it is half as good as the Dell Laptop computer).

The respondents are finally asked to provide the price they paid for the Dell Laptop computer and to indicate an acceptable price for the Gateway Computer. Data from several respondents would be gathered, a scale created, and the data would ultimately be processed using regression analysis.

## Estimating Sensitivity to Price Differences

Price-sensitivity can be measured with historic purchase data, market studies or internal expert judgment. It may sometimes be necessary to specifically design research studies to measure sensitivity for certain products or brands.

Sensitivity to price differences is important when deciding whether to change a product price (demand price elasticity) or when attempting to establish a price differential for a product relative to competitive alternatives (cross-price elasticity). Non-buyers must be identified during the survey to ensure that price elasticity estimates are not understated.

If respondents are required to respond to questions in survey research by selecting alternatives at different prices, they will likely overstate price elasticity estimates unless they can easily and accurately imagine the products, or are provided with product images.

### Sequential Preferences: Two Brands

For **Sequential Preference** analysis, respondents are asked to indicate their brand preference as the price of one brand is changed. This can be accomplished by keeping the price for one brand constant (for example $10) and comparing it with another brand using a series of price points. The second product brand would be listed at different prices throughout the sequence of questions, usually with the price of the two brands initially equal to each other. Preferences for each product should be established when they are initially the same price.[10]

### Trade-Off Analysis

Buyers make trade-offs when choosing a product to buy. This is due to the fact that consumers are usually considering multiple products on multiple dimensions, and also considering the reference price for the product.

Pricing managers must also understand the concept of **Loss Aversion**, which states that people generally *dislike losses* more than they *like gains*. This means that costs are likely to be more heavily considered than gains when considering a product purchase.

## Full Profile Approach (Conjoint Analysis)

In profile analysis, **Factors** are the product or service attributes that provide the relative benefits buyers derive from acquiring and using the product. **Levels** are the number of different options available for a particular factor, and **Utility** is the quantified degree of preference a person has for a particular factor.[10]

The **Full Profile Approach** (or Conjoint Analysis) provides a quantitative estimate of the contribution that each attribute makes to the purchase decision by varying them over as many levels as is reasonable. This analysis reveals the relative importance of price to other attributes and provides a measure of the sensitivity to each attribute (which can help estimate price elasticity).

## Limited Profile Approach

The **Limited Profile Approach** is much like the full profile approach, except that it focuses on a limited subset of attributes that buyers perceive to be important. These factors are varied in alternative scenarios, and the feedback is analyzed in the same manner as the full profile approach.[10]

## Buyer Response

**Buyer Response** measures are used to indicate whether or not a market is price-sensitive.[1] The following items represent some basic tendencies in buyers throughout the market: [3]

- Demographic data is often the *most effective* way to predict customer response.
- Consistent with prospect theory from economics, price *increases* have a stronger effect on consumers than price *decreases*.
- Cannibalization is a significant issue in buyer response because market share changes originating from a price change can affect other brands of similar size.
- Temporary changes in price will often yield a temporary increase in market share.

Another good predictor of buyer response is **Behavior-Based Modeling**. Traditional psychographic and demographic data can be useful in targeting segments, but modeling customer preferences is often best done through analyzing buying behaviors. The best pricing strategists are learning to use more sophisticated research and analysis techniques to identify behavior patterns that are likely to repeat themselves. These quantitative models predict how incremental changes in the offering (including price and non-price attributes) affect purchase behavior.[2]

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## Review Questions

1) If one relies solely on mathematical models and cost accounting in order to price, which of the following will most likely be true of the resulting prices?

   (a) Higher than optimal
   (b) Lower then optimal
   (c) Profit-optimizing
   (d) None of the above

2) Which of the following industries is well suited to pricing research?

   (a) B2B
   (b) B2C
   (c) Services
   (d) Manufacturing
   (e) None of the above
   (f) All of the above

3) Pricing for new products should start immediately after the research and development stage since the product would be ready to enter the market by then.

   (a) True
   (b) False

4) Getting relevant pricing information from a customer is only useful when entering new markets.

   (a) True
   (b) False

5) Which of the following questions can pricing research answer?

   (a) How are competitors likely to react to a particular price change, relative price difference, or pricing tactic?
   (b) Do customers perceive that substitute products or services are available?
   (c) Are customers aware of prices for this product category?
   (d) Are there different groups of customers with different levels of price sensitivity?
   (e) All of the above

6) When correctly employed, focus group interviews can fully replace quantitative analysis.

   (a) True
   (b) False
   (c) Not enough information to answer the question

7) High quality experiments can perfectly simulate the natural purchasing environment.

(a) True
(b) False
(c) Sometimes true

8) Which of the following is the simplest approach to estimating the upper and lower price thresholds of a customer?

(a) Direct question approach
(b) Price sensitivity meter
(c) Price categorization
(d) Magnitude scaling
(e) None of the above

9) What data is most effective in predicting customer response?

(a) Demographic
(b) Psychographic
(c) Behavioral
(d) Anticipatory
(e) None of the above

10) Which approach asks respondents to sort a set of prices for products into groups according to similarity or dissimilarity?

(a) Price Hierarchy
(b) Price Scaling
(c) Price Categorization
(d) Pricing Placement Analysis
(e) None of the above

# Module 11:
# Internet Pricing

# Introduction

*"To be successful in the online marketplace, today's retailers must align their pricing strategies with their brands and ensure that their operations are in line with the current capabilities that information technology offers for competitive advantage."* [1]

As traditional retailers expand, they must build new storefronts and distribution infrastructures. In doing so, they must also accept that they will be entering increasingly smaller market segments after already having penetrated larger ones. Online storefronts, however, have instant reach. The cost of acquiring an online customer in Cleveland, OH is the same as finding one in Fargo, ND.[4] This presents a clear cost advantage for firms, but pricing products on the Internet can be a difficult task due to the proliferation of competitors (all of which are just as accessible). Major websites such as eBay have also significantly expanded the market for used goods (or C2C transactions), placing even greater pressure on managers to reduce prices.

Both companies *and* consumers now have a tremendous amount of access to pricing information. Obtaining a clearer picture of the delivery costs of actual products and services of individual firms is now within easy reach. This price transparency has the potential to damage existing brands that charge a premium for products and services and is likely to reduce the average selling price of goods and services (ultimately decreasing the reference prices that consumers use in their purchase decisions).

According to a recent survey of pricing managers, the Internet is a vastly underutilized tool in the pricing strategies of most firms. Almost half of the respondents claim that their firms use the Internet from a pricing viewpoint and simply mimic their traditional channel pricing strategies. Several key statistics from this study are provided below:[9]

- 6% Use this channel to test prices.
- 30% Do not price anything on the Internet.
- 7% Do not have any Internet Pricing strategy.
- 9% Use the Internet to sell excess inventory and obsolete products and services.
- 7% Use the Internet to signal the market.
- 4% Use the Internet to expand differential pricing.
- 9% Use the Internet to attract the most price sensitive segments of the market.

Beyond these statistics, the Internet has undoubtedly revolutionized the business world, becoming both a burden and an opportunity for pricing managers. Perhaps because of the added complexity and difficulty this information-laden channel can often create for pricing decisions, it remains an underutilized asset. According to McKinsey analyst Walter Baker:

> “Improved pricing represents a large and as-yet untapped opportunity for pure plays and for traditional offline companies that have ventured onto the Internet. Getting pricing right has emerged as one of the ultimate keys to the success of e-businesses, but few companies have even begun to explore the opportunities."[10]

## Transparency

Sellers have an interest in keeping their costs somewhat hidden. This allows them to charge premium prices for products based on their brand name or other quality cues. Buyers have an interest in discovering the costs of products sold because it allows them to determine who is charging "fair" prices and to make more informed decisions.

The Internet provides a tremendous amount of easily accessible information for customers who wish to research product and service costs. Online customer ratings are available that detail information about the purchase and post-purchase experiences of others. There are also specialized search engines (or search bots) that can comb the Internet to find the lowest prices for certain products.

Every time a consumer purchases a branded product at a reduced price, they are much less willing to pay full price again because of perceived unfairness. This sometimes occurs outside of the e-commerce realm with private label product comparisons. When consumers purchase a private label brand (such as a store brand version of Kellogg's Corn Flakes), they compare it to the price and quality of the national brand. Many consumers notice that there is often very little difference in quality despite the wide gap in prices between the private label and national brands. The customer may eventually believe that the national brand is priced unfairly high and then begin to purchase the private label brands. In the late 1990's this forced many cereal producers to drastically reduce prices. [11]

The type of **Cost Transparency** that is provided by the Internet is a real threat for most companies today. The Internet has created an abundance of free and easily obtainable information, which has allowed consumers to determine the production costs of various items. This makes it much more difficult for companies to impose larger price premiums. Cost transparency causes four key problems:

1. Severely impairs a seller's ability to obtain and maintain high margins
2. Turns products and services into commodities
3. Weakens customer loyalty to brands
4. Damages company reputations by creating perceptions of price unfairness

The Internet makes costs transparent by:

- **Eroding the Premium for Risk Mitigation:**
  In the past, when consumers had little knowledge of a certain kind of product they were more inclined to select a well-known national brand. The national brand could then charge a price premium for mitigating this risk.

- **Making Searches More Efficient:**
  Customers no longer have to rely on newspaper ads or physical trips to the store to compare prices. Now a customer can quickly and easily search for information and prices using powerful search tools like Google.

- **Lowering the Perceived Price Floor:**
  Buyer-led pricing and reverse auctions allow consumers to see the price floor more easily than they can with traditional shopping. Websites such as Priceline.com and eBay.com allow consumers to name their own price for products. Due to the high volume of sellers on these sites, this usually results in lower prices charged to the consumer, which in turn can lower a customer's reference price.

- **Encouraging Highly Rational Shopping:**
  Sensory cues that appeal to people's emotions (such as words, images, and sounds) are much less effective on the Internet. The key strength of the Internet is its ability to transfer a great deal of information to consumers in a way that enables them to make more rational decisions about their purchases.

Combating cost transparency is difficult. Some of the methods and techniques of Internet pricing outlined in the next section can be very helpful. Managing long-term cost transparency requires that companies accurately price based on the true value offered by the product. Even with intensive promotions, advertising and positive word of mouth, the degree of impact that any brand name can have on price premiums is very likely to significantly diminish over time. Nevertheless, a company that offers innovative products that are clearly differentiated from competitors can still confidently charge premiums.

## Methods and Techniques of Internet Pricing

Implementing selective or custom pricing is much more difficult with the Internet. If not carefully executed, it can be met with significant customer dissatisfaction and defection. The e-commerce paradigm, which emphasizes building a customer base over making profits, is changing the way customers think about costs. Many companies are offering strong promotions to obtain customers, giving away mobile phones, computers, or many other types of products to get customers to sign up for a service. However, some companies have a tendency to take this strategy too far.

A few Internet Service Providers (ISP) have attempted to offer free Internet access to customers by forcing them to view numerous advertisements instead of paying for the service. This strategy (and other similar promotional offerings mentioned in the previous paragraph) are often prone to failure since segments of consumers are able to exploit the system, drastically increasing the total costs of the strategy without contributing the expected revenue (for example, by either hacking the special ISP free-access software or installing pop up blockers on web browsers to deactivate or hide advertisements).[2]

While the Internet has increased the complexity of pricing decisions, knowledge of the basic techniques of Internet pricing can give the pricing manager the tools needed to make effective decisions in the online business environment.

### Buyer Determined Prices

Some online companies provide *search bots* that are capable of scouring the Internet to find a range of prices and providers for particular products or services. Sites such as Priceline.com allow customers to specify their own prices, giving sellers the option to accept or reject them. These tools essentially allow consumers to choose their own price when shopping online. While this goes against many of the principles of scientific pricing, it can be effective in attracting consumers.

## Price Lining/Tiered Pricing

Offering different products or services at various price points to meet different customer needs is a well-known practice. Higher price points are generally accompanied by increased service levels or enhanced value offerings. This technique is heavily employed offline but can be very useful in the online environment as well since price is *not* the only consideration for consumers when making online purchasing decisions. Value added offerings such as increased service and security can be very effective in convincing customers to pay a higher price premium.

## Dynamic Pricing

Companies that do not use dynamic pricing online are not optimizing their profit. There are different costs associated with serving certain customers due to their geographic location, service requirements, purchasing habits, and various other factors. Companies can leverage this by requiring customers to sign into e-commerce sites with their postal codes. This information can then be used to dynamically customize prices for customers.

Dynamic pricing offers companies new opportunities to maximize the amount of return that each customer yields. It can also increase the return on assets by stimulating demand during periods of lower sales by making better use of existing technology. For example, dynamic pricing strategies are least valuable when customer demand for products is predictable and willingness to pay is similar among customers. Time-based pricing exploits the differences in customer willingness to pay at different times. The Internet enables customized pricing strategies for the needs of different customer segments.

Dynamic pricing is not a good strategy for all companies. Effective dynamic pricing is based on a responsive and adaptive pricing system that defers to human judgment over automated pricing rules. Companies must be able to anticipate whether or not customers will be responsive to dynamic pricing. If not, a stable pricing strategy should be used.

An intelligent pricing organization will experiment to determine the best pricing model for the context of specific customer segments and adapt the model accordingly. Because customers do not want to feel cheated, companies are better off having consistent prices across channels for the same product unless they substantially vary the offer. Companies can avoid price discrimination (selling the same product at the same time to different customers at different prices), by significantly changing product service attributes.[6]

The following general guidelines should be adopted when employing dynamic pricing: [7]

- **Use Dynamic Pricing Selectively:**
  Pricing decisions require managerial time and attention, which can be scarce resources in the organization. This is why pricing should be aligned with a brand strategy. Companies that want to use price to their competitive advantage must first develop sense-and-respond capabilities that will enable them to anticipate future demand patterns and customer willingness to pay for different products and services. Fortunately, current technology provides a number of inexpensive solutions for tracking and generating insight into *customer* behaviors, while comparison tools and bots make it possible to automatically monitor *competitor* pricing in the retail sector.

- **Develop Internal Capabilities for Dynamic Pricing:**
  This includes establishing a baseline performance level that offers insight into critical-parts inventory, and identifying opportunities for clearance pricing or supply inflexibilities that may be addressed through dynamic merchandising or rationing and segmentation. To create such a baseline, companies must integrate their front-end and back-end systems, and set up optimal data warehousing and integration capabilities across multiple company processes.
- **Build Dynamic Enterprise Pricing Capabilities:**
  Companies not familiar with dynamic pricing that are confronting changing market segmentation will need to build dynamic pricing capabilities. This will require recruiting new expertise and securing an executive-level commitment for the use of new pricing models as well as a reassessment of the value generated by specific customer segments (this latter consideration may encounter substantial resistance from sales forces). Implementing dynamic pricing will also require careful and thoughtful consideration of the dynamically priced merchandise and the frequency of any price changes.

### Bundling

Products that are sold in bundled form make it difficult for buyers to ascertain the costs of any single item in the bundle. Companies can bundle a number of services with their products sold online or they can bundle them with groups of other products. Some services that can be easily bundled with online purchases are free shipping, free shipping insurance, or extended warranties. Pricing managers are encouraged to develop a bundling strategy that is most effective for them. For example, Amazon.com has a useful system of bundling. When customers add an item to their cart, Amazon presents them with a number of popular complementary goods based on previous sales and purchase history. The bundled price of the products and the total savings to the consumer are both displayed.

## Pricing in Online Auction Channels

Auctioning can take many forms. The form most widely used online is the English auction, but there are a number of other common auction types: [1]

### English Auctions

In an English auction, the price is raised successively until only a single bidder remains. This is also sometimes called the *oral* or *ascending bid* auction, and it is the most commonly used auction form.

### Dutch Auctions

In a Dutch auction, the auctioneer calls out an initial high price and then lowers the bid successively until some bidder accepts the current bid.

## First-Price Sealed Bid

In this model, potential buyers submit a single sealed bid. The item is awarded to the buyer who submits the highest bid. Governments commonly use this auction type in awarding procurement contracts.

## Second-Price Sealed Bid

Buyers submit a single sealed bid, and the item is awarded to the buyer who submits the highest bid. However, the price the winner pays is *not* equal to his or her own bid, but to the *second-highest* bid. Second-price sealed bid auctions have useful theoretical properties, but are not widely used in practice.

## Reverse Auctions

The purpose of a reverse auction is to drive the price downward. Instead of multiple buyers competing with higher prices against each other (which occurs in the typical forward auction), reverse auctions involve multiple sellers competing with lower prices against each other until no seller is willing to make a lower bid.

As an example, Visteon's $150 million auction was for printed wire boards for climate control and braking systems in automobiles. The auction was hosted by A.T. Kearney and allowed bidders, using an Internet browser, to see the lowest bid but not the identity of the bidder. CIO Bent says that in addition to faster turnaround time, Visteon secured the components from a broader and more competitive base of suppliers (which are also screened for their ability to meet quality and delivery requirements). Bent claimed that the company saw “double-digit savings."

## Internet Auctions

Internet auctions are online bazaars. Some are channels of B2C activity, where a website operator physically controls the merchandise for sale and accepts payment for the goods. But most specialize in C2C activity where individual sellers (or small businesses perhaps) auction their items directly to consumers. In these auctions, the seller has the merchandise rather than the hosting website of the auction.

The C2C sites require sellers to register and obtain an account before they can place items for bid. Sellers also must agree to pay a fee every time they conduct an auction. Many sellers set a time limit on bidding and, in some cases a **Reserve Price** (the lowest price they will accept for an item). Bidders sometimes collude explicitly in "rings," or implicitly by signaling each other to rig the process or deter "outsider" entrants. New participants often underbid, expecting incumbents to overbid. When the bidding closes at the scheduled time, the highest bidder "wins." If no one bids at or above the reserve price, the auction closes without a "winner." At the end of a successful person-to-person auction, the buyer and seller communicate usually by email to arrange for payment and delivery.[13]

Using an exchange to set the price of a transaction plays into the human penchant towards competition. Promoting the competitive and playful aspects of an online auction boosts its popularity. There may be a tendency for Internet users to compete for winning an auction;

akin to the desire to win a race or any other contest, it is typically fun for participants to see if their bid won (not to mention the fact that auctions often save them money).

There are a few legal considerations to consider when using online auctions. Federal law requires that Internet auction sellers ship their items to buyers within 30 days if a time frame is not specified. There is also the problem of **Bid Shielding**, which occurs when fraudulent buyers submit very high bids to discourage others from bidding, and then retract their bids at the last minute so that their cohorts will get the item at a lower price.[14]

### Intermediary Channels

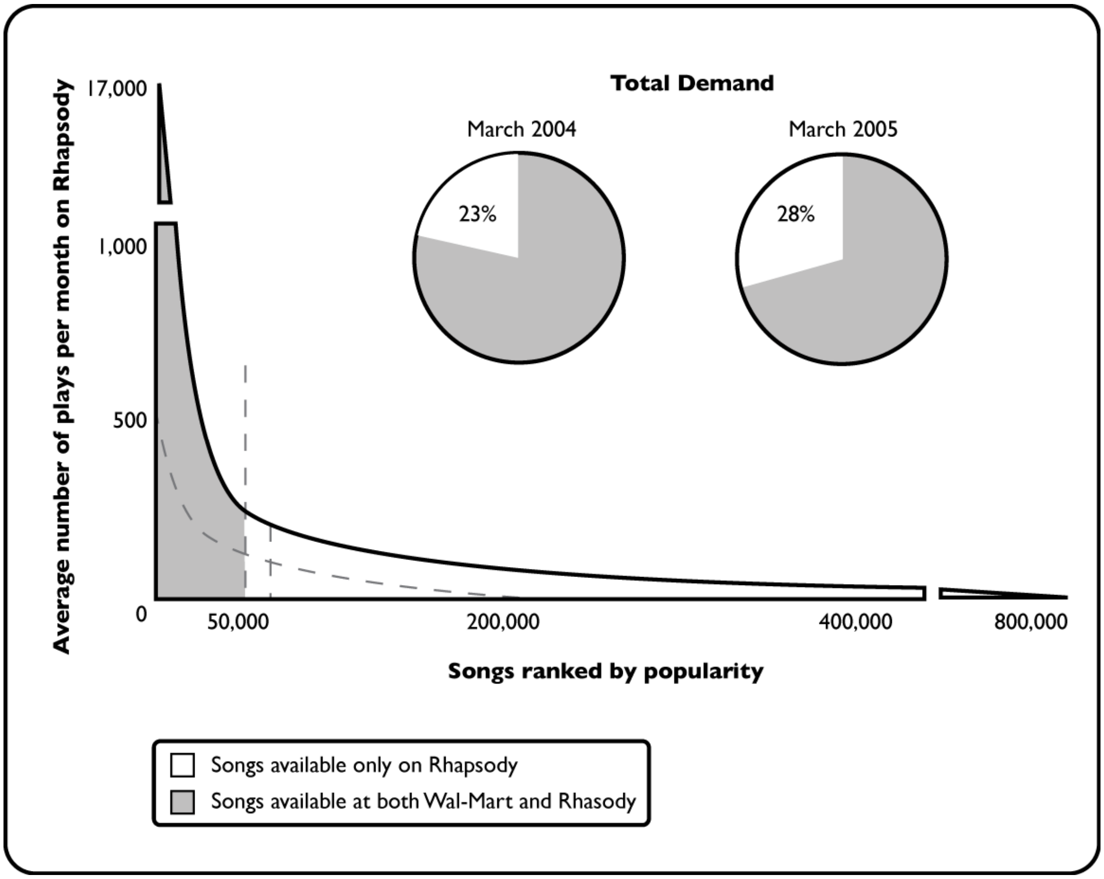
There is also a new breed of Internet player who undercuts the competition and creates its own market opportunity by providing information for little or no charge that traditional players sold at a premium. For example, the value of stock quotes has greatly diminished now that they are freely available online. Intermediaries such as E*TRADE and Schwab have taken the exchange function away from full-service brokers who used to supply the quotes. In this case, the new middleman offers a lower cost transaction to a better-informed investor. The power of instant communication destroys the power of middlemen to hide real prices. It creates new intermediaries who will control the distribution of basic goods. New middlemen equipped with Internet technology may redefine distribution channels that are inherently inefficient (such as wholesale-retail chains).

## The Long Tail in Pricing

Chris Anderson first coined the phrase “The Long Tail.” He notes in his book that while there are a handful of web logs (blogs) with *many* links going into them, there are millions of web logs (or a long tail when graphed on a chart) which have a *handful* of links going into them. Anderson described the effects of the long tail on current and future business models. Anderson argued that products with low demand or low sales volume could collectively make up a market share that rivals or exceeds the relatively few current bestsellers and blockbusters, if the store or distribution channel is large enough. Examples of such mega-stores include the online retailer Amazon.com and the online movie rental service Netflix. The Long Tail presents potential opportunities that the Internet often enables businesses to successfully penetrate.

*Figure 11.1* depicts the way that online music distributor Rhapsody was able to capitalize upon the large volume of less-frequently purchased songs that comprises the Long Tail.[14]

**Figure 11.1: Rhapsody Data from 2004 vs. 2005**




The term **Long Tail Effect** is derived from the graph that is created when plotting popularity in respect to inventory. It is clear from the example provided in *Figure 11.1* that as time passes more songs are created, but traditional retailers must dispose of the old ones to accommodate new inventory. Alternatively, online companies can stores *all* songs (which is demonstrated by the growth in the proportion of songs only offered by Rhapsody from 2004 to 2005). Eventually, the total volume of low popularity items exceeds the volume of high popularity items.

The key factor that determines whether a sales distribution has a Long Tail is the cost of inventory storage and distribution. Where inventory storage and distribution costs are nominal, it becomes economically viable to sell relatively unpopular products. When storage and distribution costs are high, only the most popular products can be sold.

A traditional movie rental store has limited shelf space. To maximize its profits, it must stock only the most popular movies to ensure that no shelf space is underutilized. Because Netflix stocks movies in centralized warehouses, its storage costs are far lower and its distribution costs are the same for a popular or unpopular movie. Netflix is therefore able to build a viable distribution model that stocks a far wider range of movies than a traditional movie rental store. The economics of storage and distribution enable Netflix to capitalize upon the Long Tail Effect in its market. Netflix has found that "unpopular" movies are rented more in aggregate than “popular” movies.

The Long Tail has possible implications for culture and politics. Where the opportunity cost of inventory storage and distribution is high, only the most popular products are sold. But where the Long Tail exists, minority tastes can be catered to, and individuals can be offered greater choice. In situations where popularity is currently determined by the lowest common denominator, a Long Tail model may even ultimately broaden the scope of culture in modern society.

Often presented as a phenomenon of interest primarily to mass market retailers and web-based businesses, the Long Tail Effect also has implications for producers of content, especially those whose products could not (for economic reasons) find a place in pre-Internet distribution channels controlled by book publishers, record companies, movie studios, and television networks. From the perspective of content producers, the Long Tail has enabled a tremendous amount of creativity to be distributed to the market.

The Long Tail may threaten established businesses since only the most popular products are generally offered in the absence of Long Tail business models. When the cost of inventory storage and distribution fall, a wide range of products becomes available. This can in turn reduce demand for the most popular products.[14]

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## Review Questions

1. Price Transparency is likely to do which of the following?

    (a) Reduce selling price of goods and services
    (b) Increase selling price of goods and services
    (c) Increase consumer's reference price of goods and services
    (d) Decrease consumer's reference price of goods and services
    (e) Both a and d correct
    (f) Both b and c are correct

2. When fraudulent buyers submit very high bids to discourage other bidders from competing for the same item, and then retract those bids so that people they know can get the item at a lower price, what has occurred?

    (a) Bid shielding
    (b) Shill bidding
    (c) Bid siphoning
    (d) None of the above
    (e) All of the above

3. Federal law requires that Internet auction sellers ship their items to buyers within ___ days if a time frame is not specified.

    (a) 10
    (b) 15
    (c) 30
    (d) 45
    (e) 90

4. The key factor that determines whether a sales distribution has a Long Tail is the cost of inventory storage and distribution.

    (a) True
    (b) False
    (c) Not enough information to answer the question

5. Online buyers have an interest in discovering the costs of products sold because it allows them to make more informed decisions.

    (a) True
    (b) False
    (c) Not enough information to answer the question

6. The quality of private label brands is of little importance due to the fact that the differences in price with national brands is so great that consumers will always think that private label brands have inferior quality.

   (a) True
   (b) False
   (c) Not enough information to answer the question

7. Cost transparency can do which of the following?

   (a) Damage company reputations by creating perceptions of price unfairness
   (b) Weaken customer loyalty to brands
   (c) Turn products and services into commodities
   (d) All of the above
   (e) Only a and b are correct

8. Dynamic pricing brings a better return on assets by stimulating demand during periods of low sales to make better use of a company's existing technology.

   (a) True
   (b) False
   (c) Not enough info to answer the question

9. Effective dynamic pricing is based on a responsive and adaptive pricing regime that defers to automated pricing rules instead of human judgment.

   (a) True
   (b) False
   (c) Not enough info to answer the question

10. ________ auctions use progressively *lower* bids, as opposed to English auctions.

   (a) Turkish
   (b) Dutch
   (c) Arabic
   (d) None of the above

# Module 12:
# Global Pricing

# Introduction

The global marketplace is becoming an increasingly complex venue for conducting business. When attempting to gain significant market positions in foreign countries, companies face competitive pressures from domestic *and* foreign rivals. Given this challenge, it is becoming more important for professional pricing managers to understand the various international pricing strategies and competitive influences in foreign markets.

To highlight the magnitude of the international pricing challenges for US firms, total US exports rose at an annual rate of 11.2% from 1970 to 2005. This sustained growth rate is higher than that of any other country in the world. Global e-commerce is becoming an important facet of business strategy for firms around the world; enabling significant changes to occur over very short periods of time.

In 2005, US *industrial* exports amounted to more than $600 billion while *consumer* exports amounted to approximately $475 billion. International demand for US industrial goods has increased at a faster rate than for consumer goods. This international growth has provided US pricing managers with a number of challenges.

Unless firms are able to differentiate their products from others in international markets, they will face more competition than in their domestic markets. Selling products internationally also involves costs that differ from those incurred by domestic sales. These costs include product modifications required by the laws of importers' countries, tariffs, costs associated with special packaging, transportation costs (especially for exports), and additional paperwork costs.

Pricing products in international markets is generally more difficult because of the disparate uncertainties of particular foreign markets. For the most part, very little has been written to help US pricing managers understand the complexities of the international pricing process. Listed below are some important topics every US pricing manager should be familiar with:

- Foreign market price controls
- Foreign market competition
- Local market production and labor costs
- Anti-dumping laws and controls
- Currency conditions in foreign markets

The pricing strategies used in international markets can generally be classified into four categories: *Competition-Based*, *International-Based*, *Cost-Based*, and *Demand-Based* strategies. Each category contains specific international operational pricing strategies that are important for pricing managers to understand.

# Competition-Based Pricing

## Parity Pricing

**Parity Pricing** is a competitive pricing strategy that uses a price range believed to be acceptable and appropriate by most buyers. Parity pricing tends to be "middle of the road," where prices are neither significantly above nor significantly below market price. A firm adopting parity pricing wants to be recognized as a *fair* dealer.

Parity pricing may also occur when a firm matches prices set by other firms. In the absence of a price leader, a firm will match the international market prices of the countries in which it is marketing its products. Parity pricing is also known as "pricing to market," and it is used in international markets where the firm lacks a significant market share.

# International-Based Pricing

## Transfer Pricing

In **Transfer Pricing**, a multinational firm sells its products to another subsidiary or division of itself in another country. The price charged is essentially "transferred" to the foreign division.

Transfer pricing strategies are used to achieve a variety of objectives in international pricing. They coordinate the allocation of pricing decisions for a firm's products and more efficiently allocate in-house profits across the firm's divisions and subsidiaries in international markets. They also relocate profits to international markets for tax purposes, hidden self-financing programs, market penetration, and the repatriation of capital.

Transfer pricing between divisions or subsidiaries in foreign markets will vary depending on such factors as taxation rates (for example, higher income tax rates in the home country of the parent firm will often lead to lower transfer taxes) as well as the desire to minimize the profitability of subsidiaries as a barrier to entry. Transfer pricing is also used when different subsidiaries in foreign markets are operating as profit centers.

## Counter-Trade Pricing Strategies

**Counter-Trade Pricing** is used in conjunction with business transactions involving foreign countries that have either centrally controlled or undeveloped economies. This strategy has allowed US firms to market products in otherwise inaccessible countries.

Counter-trade pricing is a complex strategy that can increase the cost of business in foreign markets. The process involves the payment (in whole or part) of assets other than cash to the local government or private organizations (such as promises of goods or services to the buyers from foreign sellers). This is useful in countries where the exchange of cash for goods and services could be problematic due to the instability of currency, high degree of inflation, or corruption in the foreign market. Some type of barter often accompanies any currency used in counter-trade pricing transactions.

Generally, counter-trade pricing is composed of concurrent contracts. Such contracts stipulate reciprocal commitments from the parties involved. For example, a contract may require an exporting firm to make a purchase from an importing firm.

Counter-trade is typically more appropriate for industrial rather than consumer goods in foreign markets. Companies engaged in counter-trade pricing tend to have similar characteristics and are often in the chemical, transportation, and manufacturing businesses.

## Standardized Pricing Strategies

An ongoing debate in international pricing is the use of **Standardized Pricing** in foreign markets. This involves the utilization of domestic pricing strategies in foreign markets, including offering the same discounts, rebates, and specialized pricing programs used in the US for foreign markets. A few of the many reasons for this practice are listed below:

1. Applying current domestic pricing strategies in foreign markets without any differentiation is relatively easy.
2. Firms often do not understand the cultural and demographic differences in foreign markets that should affect pricing practices.
3. Firms often do not understand the local laws that govern pricing by foreign firms.
4. US firms tend to launch products in foreign markets without adequate market planning.

Standardized pricing works best in countries with similar cultures. It is effective for US firms in Western Europe, Australia, and Japan, although many firms are now experimenting with standardized pricing in China as well. Several factors are involved in determining the success of standardized pricing in foreign markets. Crucial factors include the similarity of local distribution channels and local consumer buying practices, as well as the ability of the firm to competitively respond to local market price changes.

Firms with poorly organized pricing systems and those new to the practice of marketing products in foreign markets often use standardized pricing to manage their international pricing activities. This is especially true for US pricing managers in European markets because of the perception that "what works in the US should certainly work in Europe."

Standardized pricing is best utilized by US firms in the following circumstances:

1. The product has a brand that is highly recognizable in foreign markets.
2. The product is already marketed in a similar fashion on a worldwide basis (such as McDonalds, Starbucks, and Coca Cola).
3. The products have high levels of perceived value for international buyers, and price is not a significant factor in buying the products.
4. The laws of the local country allow foreign firms to implement their own pricing strategies without any interference.
5. The economy of the local country is highly developed and similar in structure to that of the US (such as Australia, UK, or Taiwan).
6. Competitive response strategies utilized in the US can also be used in the local country.

## Adaptive Pricing Strategies

With **Adaptive Pricing**, the firm considers the differences in each international market and adapts prices based on their particular environments. This strategy depends on an accurate analysis of factors in the local market such as:

1. Regional and national laws that regulate the pricing strategies of foreign firms
2. Trading and commercial pricing factors and practices
3. Interest rates
4. Inflation rates and trends
5. Consumer behavior (shopping practices and customs)
6. Political influences affecting how foreign firms price their products
7. Laws affecting how discounts and rebates are used

Adaptive international pricing is necessary when the culture of the country is sufficiently different from the US to warrant that all aspects of the marketing strategy must be modified to meet local social, economic, and cultural standards. When entering foreign markets, neither maximizing market share nor maximizing short-term profits should be the primary goal. One of the most effective ways to build market share is by adapting the pricing of the US firm to the local market, and then developing pricing strategies to undercut the local competition through aggressive pricing (driving production costs down through higher volumes). This methodology was typical for many decades as successful foreign companies practiced adaptive pricing within the US, especially Japanese firms (who made adaptive international pricing an integral part of their global business strategy).

A good example of an adaptive pricing strategy was illustrated in an executive seminar at the Harvard Business School. In this case, there were groups of American, European, and Japanese managers working to price an innovation new product from the building materials industry. The manufacturing costs of the product were approximately $50 but the product would save builders approximately $1,000 (all figures USD). How then should the product be priced?

The Europeans proposed a value-oriented approach and suggested charging the customer $600, and the Americans were a little more aggressive with a price of $500. Both groups clearly attempted to capitalize upon a substantial proportion of the net value provided to the customers.

The Japanese team proposed a different strategy. They recommended an introductory price of $100 (only twice the marginal cost). The Japanese executives explained that they chose to capitalize upon a smaller proportion of the net value provided to the customers so that they might capture 90%-100% of the local market share, paving the way for future market dominance within just a few short years.

The Japanese managers also expected that costs would decrease further with these higher sales volumes, increasing unit margin from the initial $50 to $70-$80. Of course, the volumes they expected were considerably larger than those of the Americans or Europeans. Their aim was to first understand local market conditions and then use their significant cost advantage over existing substitutes to beat the competition.

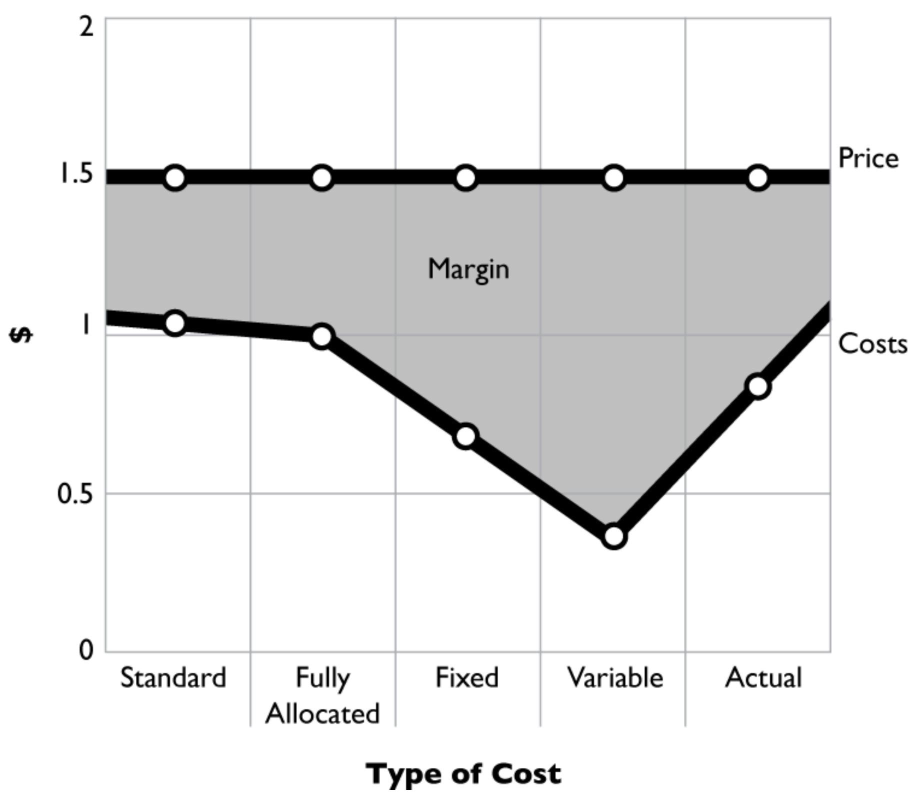
# Cost-Based Pricing

## Cost-Plus

With **Cost-Plus Pricing**, international prices are determined by calculating all of the fixed, variable, direct, and indirect costs associated with manufacturing products and then adding a mark-up or profit. The mark-up can be a predetermined percentage (in the case of a profit maximization objective) or a varying percentage (in the case of a sales maximization objective).

Using cost-plus pricing in international markets can create an unrealistic picture of the actual price a firm should charge for its products and lead to several problems. It often becomes the basis for a company's *entire* pricing strategy in international markets (the dangers of this have been thoroughly stressed throughout this course). Another difficulty is in defining the type of cost (such as standard, average, fixed, variable, or fully allocated). Using standard cost for pricing in international markets may leave the balance sheet looking anemic, whereas using only variable cost may show a misleadingly strong performance.

**Figure 12.1: Cost Variance**




Cost-plus pricing may seem logical in developing an international pricing strategy at first, but there are several reasons that it is problematic. This strategy may lead to seemingly irrational price points in the marketplace.

Suppose that a company produces widgets that come in 3, 6, and 8 inches costing respectively 50, 55, and 40 cents to produce (the drop in cost for the 8 inch widget results from certain manufacturing efficiencies or production techniques). Simply adding a fixed profit margin to these costs would result in the larger widget being the least expensive, creating a difficult position for a sales force to explain to consumers.

Cost-plus pricing also ignores a myriad of dynamics in the international marketplace. The level of supply and demand is disregarded (unless it directly affects production quantities and costs). More importantly, the value of the product in the international market is not at all considered in its price.

"Cost" can also be an emotional word in international pricing management, sometimes capable of setting meetings off course merely by being mentioned. This is primarily because it means different things to different people based on their beliefs, backgrounds, and their roles in the company.

Financial managers perceive cost to be the sum of material, labor, and overhead (fully burdened cost is also known as fully allocated cost) that is partially shared by *every* item produced by the company.

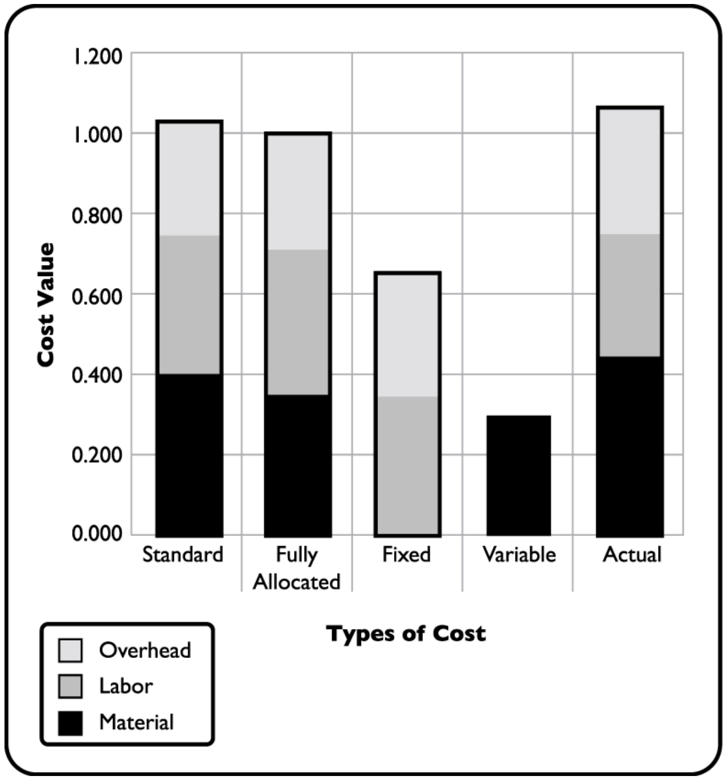
Accounting managers perceive cost to be the sum of standard material, standard labor, and a standardized value for overhead. These values are all standardized by using average values to absorb (or mathematically smooth out) any major variations or fluctuations that may occur during a specified period of time.

The CEO may tend to focus on only variable costs. This tactic may be problematic in some instances however. Labor in a company that maintains a specified work force size regardless of production volume is considered *fixed*. In a company that hires and lays off workers in response to volume fluctuations labor is considered *variable*.

There may also be cultural or linguistic issues involved with basing pricing strategies around cost. Especially in most international markets, there is typically a great deal of confusion generated by the word itself since many people use the word interchangeably with "price" (as in asking "How much does that cost?" instead of "What is that item's price?"). This potential communication breakdown, along with the various other definition discrepancies discussed above, can easily create confusion and uncertainty when basing international pricing strategies around cost-based principles.

*Figure 12.2* demonstrates the significant variance that can occur depending on the way that costs are perceived and allocated.

**Figure 12.2: Cost Definitions**




## Demand-Based Pricing

### International Price Skimming

**International Price Skimming** sets initial product prices high with the intention of maximizing short-term profits in foreign markets. When new products are introduced into international markets, the demand for these products tends to be inelastic (relative to the demand for products in the maturity stage of its PLC). Exploiting the inelasticity of international products is crucial to international skim pricing. This strategy is also used when there is limited competition, significant market entry barriers, or relevant product differentiation for products in foreign markets.

Implementing international skim pricing strategies requires a careful and comprehensive analysis of the foreign market. Mercedes-Benz has been successful with its skim strategy around the world because of strong brand recognition and a reputation for quality, and Coca-Cola has also been successful through its international emphasis on value and quality. Price skimming tends to work best in foreign markets where the product has a higher perceived value than local brands.

Starbucks uses price skimming as an introductory short-term strategy in all of its foreign markets. The company does not advertise in new foreign markets, but relies on word of mouth to communicate the value of its brand. Once it establishes new coffee shops in foreign markets, the company relies on the local “buzz” and attention it creates to attract customers (and it never offers discounts). The brand quality is greater than the price charged as a result, and the company can eventually shift from a short-term skimming strategy to a long-term premium pricing strategy.

Some factors that make a foreign price skimming strategy possible include:

- Strong brand recognition on the part of local customers in the foreign market.
- High levels of perceived value in the product.
- Ability to quickly exit the market and extract profits.
- Lack of local laws regulating foreign skim pricing.
- High level of technology in the product.
- No local product alternatives.

## International Premium Pricing Strategies

**International Premium Pricing** involves setting prices high to reflect the value of the product, brand, technology, product benefits, or quality to international customers because they are generally price insensitive for premium products. Unlike price skimming, this strategy focuses on creating a position to maximize *long-term* profits.

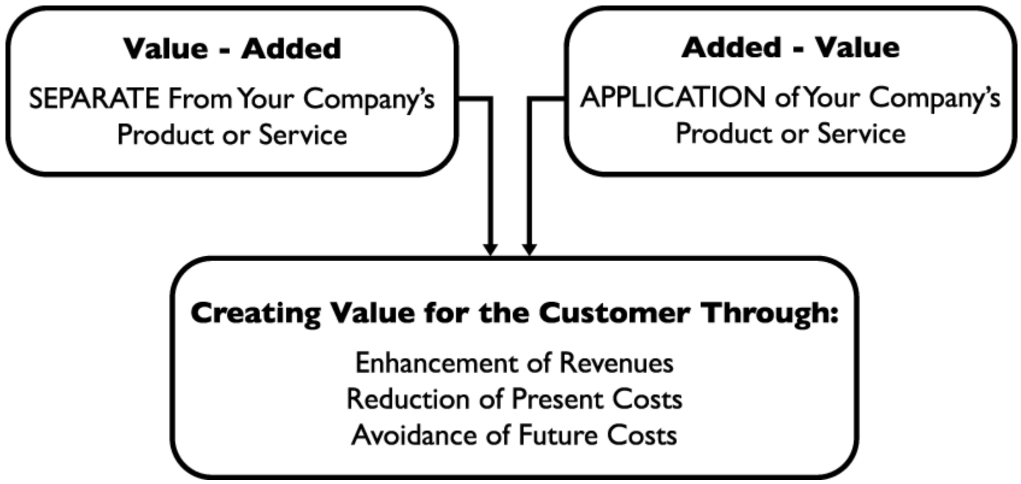
International premium pricing strategies seek to develop relationships with customers that transcend the traditional limitations of particular products and price. Firms that utilize these innovative **Value-Added** strategies seek to enhance long-term profitability for themselves as well as their customers in a spirit of "international mutual self interest."

A *value-added* pricing strategy should not be confused with an *added-value* sales strategy for marketing particular products and services in international markets. While many companies use the terms interchangeably, the difference is significant. Both ultimately provide value by improving the bottom line for the customer, but *added-value* is based on quantifiable, tangible benefits that a customer receives from specific products or services. For example, if a product has lower installation or lifetime maintenance costs, the value originates directly from the product and would thus be considered *added-value*.

The *added-value* approach does indeed create value, and it is desirable to position products and services in this way. But international customers typically do not perceive particular product or service offerings to be significantly differentiated from local competitors, and there is even an increasingly prevalent perception of product and service parity in many international markets. Even if an international supplier has sophisticated technology or tremendously valuable products, its strongest competitors are likely to have comparable offerings. If they do not, it will likely not be long before they create them and eliminate any competitive advantage the original supplier previously possessed.

*Value-added*, on the other hand, is the supplier's entire organizational value that is at the core of its premium pricing strategies. The supplier develops broader projects and programs that contribute *high value* and enhance income for B2B customers in one of three ways: increasing their revenues, reducing their costs, or helping them avoid future cost spikes. A premium *value-added* pricing strategy achieves these goals by leveraging organizational core competencies or areas of special expertise. Regardless of how many of these objectives are achieved, the result will improve the bottom line for customers.

**Figure 12.3: Value-Added vs. Added-Value**




Firms that engage in genuine *value-added* pricing strategies have the ability to charge premiums for their products and services, or alternatively to avoid the need for competitive price reductions. These suppliers often charge a premium because the discernible financial value that is routinely delivered significantly exceeds the price premium.

Customers engaging in such enlightened *value-added* relationships with multiple suppliers are typically at the forefront of their industries. While these customers may pay a premium for particular products or services, their overall cost of doing business is relatively lowered as a result of working with these strategically aligned suppliers.

## Additional Pricing Strategies

### Gray Market Trading

**Gray Market Trading** occurs when products from well-known brands are exported internationally and distributed to companies or individuals outside of proper business channels who then resell them at prices equal to or below market prices.

### Parallel Importing

**Parallel Importing** occurs in international markets either when a product is in short supply, when there is price skimming, or when high product markups are prevalent. Common examples include French champagne that is sold in the US and pharmaceutical sales in Europe (where the prices for drugs can vary widely from country to country).

### Dumping

**Dumping** is the sale of a product that has been legally imported and then priced below its normal market price. Dumping is illegal in most international markets and is classified as an "unfair trade practice" by the US Government. The US Department of Commerce, in conjunction with the International Trade Commission, is responsible for enforcing **Anti-Dumping Laws** in the US.

### Barter

**Barter** is one of the oldest international pricing practices. In its simplest form, it is the exchange goods and services between firms. No money is exchanged in a barter transaction, although the firms involved often establish a shadow price (or worth) for the exchanged items. Barter relationships between countries may involve a single transaction or may cover a wide range of goods and services over a long period of time.

### Triangular Trading/Swap

**Triangular Trade** (or **Swapping**) involves the use of a third party in a barter transaction where one of the parties involved in the deal does not wish to accept the items offered by the other. The third-party agent finds another party who will accept the items being traded. Swapping generally reduces the risk in barter trade deals and enables the trading parties to quickly agree on shadow prices for items involved in the exchange.

### Offset

**Offset** describes reciprocal trading arrangements between countries. One country buys the exports of another in exchange for the other country buying its own exports in return. An example of this would be if Saudi Arabia agrees to purchase equipment from Lockheed-Martin or Boeing only if they agree to build a local plant or to purchase exported products from the Saudi Arabian market.

### Pricing Commodities

One of the most difficult pricing tasks international firms face is setting prices for commodity products. The definition of an international commodity product is the same as a regular commodity product: products are commodities when competitive offerings are virtually identical and are differentiated only by price. Commodity prices often fluctuate daily and are subject to international supply and demand levels. This daily fluctuation is responsible for "floating prices."

## Factors Affecting International Pricing

International pricing strategies are influenced by eight important factors:

1. Environmental determinants (government intervention, exchange rates)
2. Individual company factors (firm size, foreign market share)
3. Country of origin
4. PLC stage of the products
5. Product price-sensitivity
6. Product differentiation
7. The economic structures of foreign markets (monopoly, pure competition)
8. Tariffs and Quotas

## Government Intervention and Exchange Rates

Foreign government intervention is one of the greatest risks in international business. Intervention can come in many forms, including price controls, anti-trust legislation, non-tariff trade barriers, and financial reporting controls on all foreign firms. Exchange rates can also pose a significant problem for international pricers in the form of unstable currencies and fluctuating prices.

## Firm Size and Market Share

In international trade, small firms tend to price products differently than large companies. Larger companies are more likely to price based on thorough cost and competitive market analyses than relying on “gut reactions” (as smaller companies are more likely to do). Larger firms also have access to great amounts of capital to cover short-term losses, enabling them to price more for long-term profits.

## Product Life Cycle and Price Elasticity

Stages of the PLC and price elasticity can affect how a product is priced in foreign markets. Products that are mature (such as commodities) are very price-sensitive. Any change in the demand or supply levels for these products will quickly affect existing price strategies in the market. The implementation of premium pricing or price skimming strategies will not be viable in such cases. This high price-sensitivity means that any change in price will also cause a sudden change in the demand-supply equilibrium.

## Market Structure

The structure of an international market is important because it affects the ways in which firms price their products and services. Price leadership is common in an oligopoly, but in competitive markets all firms influence prices and no single firm dominates. In foreign market monopolies, as in domestic monopolies, single firms control prices and profits.

## Tariffs

Foreign countries use tariffs to control the flow of products into their markets. **Tariffs** are direct levies that are added to the price of imported products. This makes the products relatively more expensive in the foreign market than they would be in the supplier’s own market. The US placed a tariff on all foreign steel in 2004 to protect the US industry from being undercut by foreign producers such as Italy, Portugal, China and Taiwan. Tariffs are enforced for long or short periods of time depending upon the specific trade situation.

## Quotas

**Quotas** are similar to tariffs in that they are used to restrict the flow of goods into markets. They are different in that they simply limit the total quantity that can be exported to a foreign country. The limits are either voluntarily set by the exporting country or established by law in the importing country. As with tariffs, specific trade situations will determine the specific nature and duration of any enforced quotas.

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## Review Questions

1. Total US international exports of industrial goods amounted to more than

    (a) $2 trillion dollars in 2005
    (b) $600 billion dollars in 2005
    (c) $3 trillion dollars over the last 5 years
    (d) None of the above

2. Little information has been published about which of the following international pricing areas?

    (a) Foreign pricing controls.
    (b) Counter-trade pricing.
    (c) Tariffs and exports
    (d) Competitive practices in foreign markets
    (e) All of the above.

3. Which of the following statements tends to be true of parity pricing?

    (a) It occurs when firms charge higher prices in international markets
    (b) It is oriented towards the pricing strategies of larger international firms
    (c) It tends to be more middle of the road in international markets
    (d) It is more oligopolistic in nature
    (e) b and c

4. What is transfer pricing?

    (a) An external pricing practice used by international firms
    (b) When a firm sells its products internally to other divisions or subsidiaries
    (c) When an international firm transfers its marketing to another country
    (d) When cross-border negotiations occur for a firm in selected foreign markets
    (e) None of the above

5. Counter-trade pricing has limited the marketing of US products in several foreign markets because of its complexity.

    (a) True
    (b) False

6. In international markets, which of the following is true of high *value-added* products?

    (a) Priced lower than the prevailing prices charged in those markets
    (b) Marketed in smaller quantities
    (c) Price inelastic
    (d) None of the above

7. What is an important factor to consider in adaptive, international pricing?

   (a) The shopping behavior of consumers
   (b) The long-term stability of the foreign market
   (c) The bundle pricing potential in foreign markets
   (d) All of the above

8. An international *value-added* pricing strategy is essentially the same as an international *added-value* sales strategy.

   (a) True
   (b) False

9. Grey market trading is a practice that generally benefits which of the following?

   (a) The supplier of the product in a foreign market
   (b) The consumer in a foreign market
   (c) The supplier *and* the consumer in a foreign market
   (d) None of the above

10. Which of the following is an important factor that should affect a firm's international pricing strategy?

   (a) Existing tariffs & quotas in the foreign market
   (b) Price sensitivity
   (c) Stage in the life cycle
   (d) Country of origin
   (e) All of the above

# Module 13:
# Pricing Implementation and Organization

# Introduction

Establishing a formal pricing organization can certainly help maximize revenues and profits. Moreover, due to recent market changes (such as the ones listed below), it is becoming increasingly *necessary* for long-term survival:

- **Guerilla Procurement Organizations:**
  A growing number of international guerilla procurement organizations have mastered the art of driving prices down. Executives are finally realizing the need for a way to effectively compete against these profit-draining powerhouses.
- **International Price Discrepancies:**
  As suppliers expand internationally, many lack sufficient pricing policies to explain significant price discrepancies for different regions (such as why a certain item may be priced 40% higher in one country than in another).
- **The Growth of China:**
  The proliferation of high quality, low cost products from China has had an enormous impact on almost every industry. Many domestic companies are now scrambling for ways to compete against this new international market leader.
- **Lightning-Fast Innovation:**
  New technologies and processes have dramatically reduced the time required for new product development cycles in most industries. There is now less time to capitalize upon new values provided to customers before competitors successfully replicate them.

Most firms are not properly equipped to handle the volume, complexity, and interdependent nature of modern pricing issues, and very few firms have created pricing organizations that can actually *thrive* in spite of the market changes described above (in addition to the challenges of highly aggressive customers and competitors).

Disparate functional areas such as Marketing, Finance, and Sales should all contribute to pricing decisions. In the absence of a formally coordinated process however, each of these divisions ends up constraining potential pricing benefits by placing too much emphasis on their respective disciplines (focusing only on customers, costs, or competitors). If pricing decisions are simply made by the division with the most power in the firm, the result will be unbalanced pricing initiatives that do not maximize the revenue potential of the firm.

A company with an uncoordinated pricing process is likely to encounter a number of potentially crippling problems:

- Little or no control over discounts
- Continuous negotiation with customers over prices
- The loss of added-value for products and services
- Loss of market share
- Continuous erosion of profits both in the short and long term
- The eventual transition of products and services into commodities
- The eventual decline in all prices due to continual price haggling
- Inability to develop an effective competitive price response strategy
- Inability to manage the "waterfall" effect in distribution channels

## Managing Downstream Pricing Effects

Product specifications, development plans, and marketing strategies are frequently established before price is ever formally considered. Without a clear organizational structure, poor pricing policies are bound to result in significant financial losses.

If management does not perceive pricing to be a valuable business function, it may make the common mistake of burying it within the "4P's of Marketing." The importance of pricing in the firm has been stressed throughout this course. The reasons are clear why pricing should be treated as a distinct business function, which systematically draws upon the interdepartmental resources of the firm. The downstream consequences of poor pricing procedures and policies can be financially and strategically devastating.

Suppose that a multi-billion dollar technology firm develops a superior new product, but the management team cannot agree on its price. The Marketing department suggests a *moderate* price point (based on the "willingness-to pay" ascertained through customer research), the Finance department suggests a *high* price point (to recoup significant R&D expenditures), while the Sales department suggests a *low* price point (to convince customers to switch). The departments vigorously debate for months, and senior management finally selects a moderate price point based ultimately on instinct.

Without a systematic approach or formal policy regarding the decision, the sales force has a difficult time justifying the price to customers (especially in light of a number of lower priced competitive alternatives). In response, management decides to increase discounts in the hopes of increasing sales. This decreases the perceived value while failing to increase sales, because the fundamental pricing policy is not systematically justifiable. The product does not sell as expected, and the firm's efforts in bringing the product to market ultimately fail to generate optimal profits.

To be successful in highly competitive modern markets, companies must be willing to invest in the processes, people, and technology needed to build sufficient pricing systems.

### Create a Disciplined Pricing Organization

Many firms have complex combinations of internal divisions and product lines that make the idea of a purely centralized pricing organization impractical. However, it is usually best even for these firms to establish a centralized pricing unit that is empowered to manage macro-pricing issues (such as broad corporate pricing strategies and policies). This centralized unit should set goals and establish measurement systems in order to preserve price integrity throughout the firm.

Once this centralized pricing unit has established the necessary internal guidelines and standards, it will then be possible for various decentralized operating units within the many divisions of the firm to support a better-coordinated pricing effort. These decentralized units should focus on specific pricing decisions that more closely involve customers and markets (such as value creation, the design of the offering, price setting, and negotiation tactics).

The centralized unit should be responsible for addressing the complex pricing issues of the firm, while ensuring that downstream decision making processes are relatively simple and efficient for decentralized units.

## Align Strategic Goals with Individual Incentives

Once pricing processes have been organized, the strategic goals of the firm must be properly aligned with incentives for its individual stakeholders.

If the incentives for the sales force are linked to sales volume without any tie to revenue, there are several problems that might arise. In addition to volume-based incentives providing no true motivation for selling more *profitable* products, there is a chance (in extreme cases) that sales force members might place phantom orders (where sales personnel records a sale, receives a commission, and then quietly cancels or significantly reduces the order months after the fact).

Poor marketing incentives may result in promotional blitzes that generate short (but ultimately unprofitable) increases in sales volume. It is also possible that Finance departments may strive for target margins on new products and inadvertently limit the ability of marketing and sales personnel to pursue strategically important sales on lower margin items (which might increase capacity utilization and total profitability).

Profitable growth is the key performance measure upon which all performance measures and individual incentives should be based. Measurement systems that focus only on sales volume or market share may be insufficient, or may even adversely affect the profitability of the firm in the long-term. While these traditional performance measures should not necessarily be eliminated, they must be complimented with holistic profitability metrics to ensure that the incentives of the individual workers and the firm are properly aligned.

## Invest in Pricing Analysis Systems

It is difficult to make good decisions about customer value, competitor pricing, sales trends, or profitability with poor or inadequate information. Since modern technologies and vendors now provide excellent programs and data to support strategic pricing decisions, there is no need to attempt such important decisions without reliable data. There are numerous vendors that provide systems to support three fundamental pricing functions: pricing analysis, price optimization, and deal management. This data can significantly amplify the capabilities of pricing managers in the firm.

Analytical tools, when integrated with the broader organizational pricing process, are vital to making timely decisions. However, great care must be exercised to ensure that these tools are not used *in lieu of* an interdepartmental pricing process. If management attempts to implement sophisticated pricing software without a strong pricing strategy already in place, the organization will discover that it is only able to make *the same poor pricing decisions, but more quickly*. Analytical software must support pricing decisions and not be expected to replace disciplined pricing organization within the firm.

### Develop Pricing Leadership

Since pricing is a relatively new corporate discipline, it can be difficult to find experienced leadership. It is often possible to cultivate pricing leadership from resources currently within the firm. Many companies with successful pricing leadership build their capabilities by recruiting individuals who have credibility across multiple core functional areas (who will be more capable of working with the decentralized pricing units throughout the organization). These individuals are then trained on key pricing concepts such as waterfall analysis, price banding, economic value estimation (EVE®), value assessments, and price segmentation.

Finding capable leadership for the pricing organization is the first step. Next, it is imperative that the senior leadership of the firm be educated on their own roles in managing price. Executives commonly unravel years of pricing integrity by agreeing to unprofitable deals in order to meet short-term financial goals, or because they cannot decide whether to focus on increased market share or greater profits. For many executives, pricing strategy can be a blind spot that must be addressed if pricing is to be successful.

## The Hurdles of Developing the Pricing Plan

Developing a value-added pricing program requires that a company develop a comprehensive plan to integrate all of the components of the pricing process into a single document, detailing how the value-added strategy of the company will be implemented. This document should include the key areas of price *timing*, *execution*, *control*, *setting*, and *implementation*. The prices charged for industrial and consumer products should reflect the value-added content of the marketed products and services.

Developing a successful pricing plan requires that a company commit to a set of objectives, a course of action, an operational strategy, and a set of control measures.

The plan must usually be coordinated with all other activities involved in market planning, which involves "analyzing marketing opportunities; researching and selecting target markets; designing marketing strategies; planning marketing programs; and organizing, implementing, and controlling the marketing effort."[7]

Putting a pricing plan in place may not be easy due to many organizational hurdles. Two factors in particular make it difficult to establish a centralized pricing plan: the perception that pricing is too dependent on the other elements in the marketing mix and should not be an independent business function, and the logistical difficulty in establishing a pricing organization in a firm.[8]

### The Perceived Interdependency of Pricing

The pricing process in a firm involves numerous strategic choices concerning market targets, products, and distribution channels (each of which impacts the optimal pricing strategy). The level of product quality, the target customer segment, and the functions of intermediaries can all affect pricing as well.[8] It is often believed that pricing cannot be an independent managerial function because it depends upon so many other elements in the marketing process.

Critics note that pricing decisions must be coordinated with other operational areas in the firm, far more extensively than the other marketing elements of product, distribution, or promotion. Every part of the marketing process affects pricing in a variety of ways.

The area of distribution, for example, involves numerous decisions that have an effect on pricing. These decisions include the type of channel, the distribution intensity, the channel configuration, the needs and motivations of the channel intermediaries, the margins at each level in the channel, the power and influence of each channel member, and the role of the channel captain. Each factor influences pricing policy, and several steps must be executed in order to properly establish a pricing program (as *Figure 13.1* illustrates).[7]

**Figure 13.1: Traditional Steps in Establishing A Pricing Policy**


The product area has a similar relationship with pricing. The product mix, the number of product lines, the over product portfolio of the firm, the stage in the product life cycle, the brand level, the brand position of a product, and the level of product quality can all affect the pricing strategy of a firm. For example, a high quality product may necessitate one type of pricing strategy, while a medium or lower quality product may require another type of pricing strategy. The same situation exists for private-branded products sold to retailers that also require a different type of pricing strategy

## Developing a Pricing Organization

Along with the issue of perceived interdependency, there is also an organizational concern in assigning the responsibility of pricing to one department (or in creating a pricing organization specifically to manage a pricing strategy).

The foundation for this concern is based on the idea that many management groups in a firm have an interest and major stake in developing and implementing pricing decisions. These include sales, marketing, senior management, finance, manufacturing, and even customer service. With such a large organizational franchise, it seems difficult to believe that a single pricing group could be created to adequately represent *all* of these interests.

To illustrate this problem, business managers often reference the complex task of analyzing a market situation to determine the level of price change responsiveness. The following questions must be resolved in this type of analysis: [8]

1) How large is the product-market in terms of buying potential?
2) What are the market segments, and what targeting strategy will be used?
3) How sensitive is demand in the segment to changes in price?
4) How important are non-price factors, such as features and performance?
5) What are the estimated sales at different price levels?

Getting detailed, accurate, and timely answers to all of the above questions is an interdepartmental effort. A single pricing department or group could not do it alone. Answering these questions involves the cooperation and interaction of sales, marketing, finance, accounting, marketing research, forecasting, and others in order to attain a holistic understanding of these important issues before any pricing decision can be made.

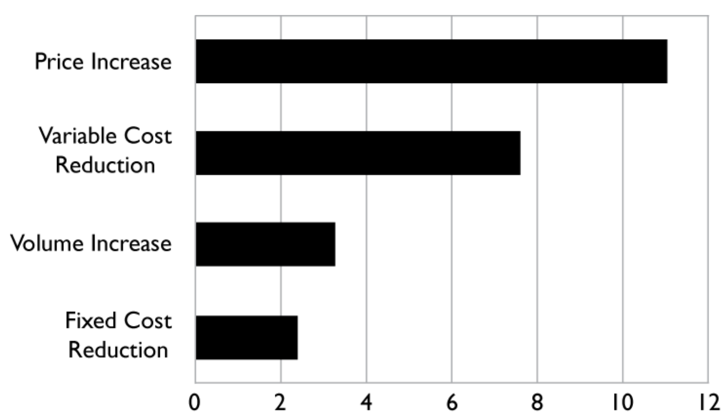
## Types of Pricing Organizations

One of the greatest challenges to implementing any formal pricing organization in the firm is the successful integration of disparate divisions and business data. Most firms tend to flatten the organizational pyramid by reducing the vertical layers between management levels, in order to achieve cost reductions and faster execution of pricing decisions. However, it is more important that business units and managers be horizontally integrated with one another so that all necessary information (such as business strategies, marketing efforts, product development) can be efficiently incorporated into pricing decisions.

It may be possible to enhance horizontal integration through the use of information systems, but even these infrastructural improvements are often not enough to bring managers together for effective pricing collaboration. It is typically necessary for a firm to implement some sort of formal pricing organizational structure to manage and facilitate pricing decisions. This organization can be centralized, decentralized, or center-led. It may also be sufficient to take less formal approaches in some instances, such as creating a permanent pricing committee or delegating pricing responsibilities to certain executives.

A well-implemented pricing program can leverage limited resources, while significantly improving profitability. If a company increases *sales* volume by 1% it might generate a 3% increase in profit, whereas a 1% increase in *price* might generate an 11% increase in profit. Factors such as reducing variable cost and fixed expenses can impact profitability as well, but no other factors have quite as much leverage as price.

**Figure 13.2: Profit Improvement Percentage from a 1% Change in Key Areas**



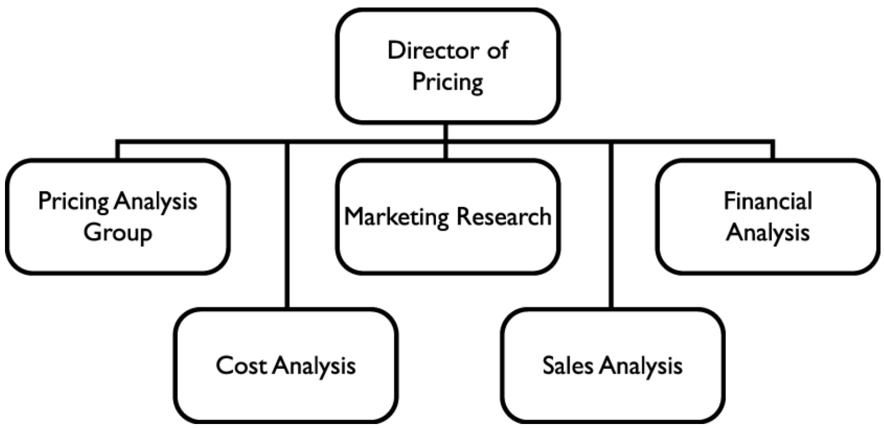
## Centralized Pricing Organizations

In a **Centralized Pricing Organization**, a firm utilizes a single management system to coordinate pricing decisions for all divisions of the firm. As the single owner of pricing, the centralized team can drive price consistency across the product portfolio and ensure company-wide compliance of policies. This structure is best suited for businesses that have similar products and customer segments throughout their internal business units.

Some key advantages of centralized pricing systems are listed below: [1]

- Reduction of systems required to manage pricing strategies (resulting in consolidated IT resources, reduction in administrators, and overall cost savings)
- Standardization of content and processes across the entire pricing process
- Ability to easily align employee objectives with corporate objectives
- Simplified reporting and improved accuracy (through consolidation and standardization of systems)
- Ability to speak to customers about price and discounts in a unified voice
- Ability to use price to effectively allocate limited supply or to drive demand to certain products where there is excess inventory

**Figure 13.3: Example of *Centralized* Pricing Organization**




## Decentralized Pricing Organization

**Decentralized Pricing Organization** may utilize several management systems to develop different pricing strategies for the firm. The primary benefit of decentralized pricing organization is the ability to manage disparate pricing information, all of which can be applied to specific market segments and target markets.

Decentralized pricing groups should be used when business units are autonomous and do not share customers or product features (such as GE's aircraft engine and health-care divisions, which have very distinct sources of supply, products, and customer bases).

Some key advantages of decentralized pricing systems are listed below: [1]

- Increased control of pricing at the target market level
- Local division or sales groups tend to understand their specific competitive and pricing needs much better than corporate management.
- Local division or sales groups tend to be able to make pricing decisions more quickly when meeting competitive price challenges, rather than depending decisions from corporate management.
- When making pricing decisions, local division or sales groups tend to understand their own costs better than corporate management.
- Ability to more easily create discount programs customized for local markets
- Ability to manage local pricing programs better than corporate management
- Ability to adjust prices to changes in individual customer order volumes

**Figure 13.4: Example of Decentralized Pricing Organizational**


## Center-Led Pricing Organization

**Center-Led Pricing** represents a hybrid of the centralized and decentralized models. In a center-led model, ultimate pricing authority resides with each business unit. However, a centralized pricing team manages analysis, ensures price compliance, coordinates pricing meetings, and designs pricing-related business processes.

This structure is appropriate when coordination among business units is necessary and a purely centralized pricing team is not feasible. These groups are best used in companies with a strong business-unit orientation or when division-specific culture, operational issues, or P&L responsibility indicate that final pricing authority should not be located in a centralized pricing team. This structure allows autonomy while ensuring that pricing issues are coordinated across business units.

Some key advantages of center-led pricing systems are listed below: [1]

- Driving price and revenue management activities systematically across business units and up to the executive level
- Providing consistent, rigorous analytical support
- Driving consensus on issues requiring broader, cross-unit review

# Implementing a Pricing Organization

The benefits of managing price through formal pricing teams are clear. AMR Research has concluded that constructive pricing behaviors and initiatives can typically achieve the following types of increased financial gains: [1]

- Contribution Margin up to 50%
- Gross Margin by 10%-15%
- Revenue by 1%-2%

## Fundamentals of Pricing Organization

Clear *ownership* of pricing enables structured and constructive interactions between stakeholders (such as marketing, sales and finance groups). By establishing a clear owner, conflict resolution between groups will be easier to manage, and decisions will be made more efficiently. While a pricing team may exclusively own price, it should always process and incorporate perspectives from other divisions as necessary. [1]

*Consistent* guidelines, policies, and pricing metrics will increase the likelihood that list prices and discounts send meaningful signals to the market. A high-performance pricing team will ensure that pricing guidelines and discounts are defined and followed, and that any exceptions are managed within the context of these guidelines. [1]

Finally, a pricing team should *align the interests* of individual groups within the company with broader corporate interests. This helps to prevent the rise of fiefdoms that might inadvertently subvert company goals. An empowered pricing team can ensure that overall company goals are placed above the interests of any particular individual or group.[1]

## Matching Design to Market Dynamics

One of the fundamental decisions when building a successful pricing team is selecting its organizational structure. A structure that works for one company might have disastrous consequences at another. Before an appropriate structure is selected, the fundamental business dynamics within a given market must be understood. The key attributes to consider are discussed below. [1]

**Customer Commonality** is the level at which customers are shared across business units or a product portfolio. If the same customers purchase products across the product portfolio, the pricing decision must take the entire relationship with the customer into account rather than focus solely on individual products or transactions.[1]

**Product Feature Commonality** refers to the degree to which the functionality of the products are similar, and the degree to which manufacturing resources are shared across a product portfolio. If all of the products in a company portfolio have similar attributes, a single team should manage prices to ensure price consistency. However, if the products have a wide range of attributes that are managed by distinct business units, then each individual business unit may need to manage prices. In terms of manufacturing resources, if all products come from a single factory or products use the same raw materials, then the pricing decision must consider inherent trade-off between supply and price and make the best decision for the company as a whole.[1]

**Proximity to an Exchange** refers to how the degree of influence a trading-based marketplace has on product prices. For example, mortgage prices are greatly influenced by the cost of capital, which depends on prices and yields of the underlying instruments as determined by the financial markets. The volatility of these markets and the speed required to capitalize on opportunities suggest that a more coordinated pricing team is necessary to ensure changes are understood and opportunities are captured. [1]

**Channel Structure** is the number of outlets in which a company's products are sold. The more channels a company has, the more important it is to have a coordinated effort to ensure cross-channel price consistency. [1]

These four dynamics are interrelated and must therefore be analyzed in aggregate to best determine the optimal organizational design of a pricing team. Consider a situation in which a company serves different customers in different channels. Even though there are multiple sales channels (implying the need for centralized pricing), these channels are serving different customers (implying the need for decentralized pricing). The number of channels in such a case is not as critical as customer commonality when determining the best pricing team structure. This example illustrates why multiple dynamics must be considered and weighed against one another. [1]

## Additional Requirements for Pricing Organizations

**This entire section is directly quoted from the first article in the references section, with only minimal editorial enhancements added. Any changes are noted by the inclusion of brackets**

### Developing Clear Executive Support

Pricing is where strategy meets reality; it is at the intersection of company vision and market desires. Due to the far-reaching impact of pricing, it is important that the pricing team has the authority and capacity to drive and defend its decisions with all stakeholders. Since effective pricing is anchored in the company vision, executive commitment to pricing discipline is required.

Pricing is anchored in the company vision insofar as it represents the perceived economic value of the firm's products to its customers. This vision is manifested in the pricing strategies set by company executives.

The pricing strategies set at the executive level should focus on articulating clear price and discount guidelines that are relevant to the markets the company serves. The details of the implementation, management and analysis of these policies fall to the pricing team. One approach the company leadership can take is to form a "pricing council" to review and ratify the decisions of the pricing team. This council provides the necessary bridge between strategy and execution, and should consist of executives in the areas of pricing, finance, marketing, sales and product management – even operations, for companies with inventory management challenges. The exact membership depends on which executives in the company have insight or impact on the pricing decision.

The pricing council should have a standing meeting in which the pricing team presents its strategic and key operational analyses to the pricing council, which then either accepts the analysis or requests additional work. Areas of focus for the council include the implications of supporting different price points, changing discount structures, and modifying customer tiering.

The council should not focus on reviewing and approving individual deals. This should be done at lower levels of the organization using the strategy articulated [by] the council. There will be exceptions in which a significant deal is reviewed by the council, but these should be few and far between.

## Delivering Profit Improvement

Once in place, pricing teams can deliver significant improvement to companies, including:

**Cross-Product Interaction:** It is the rare company that does not have to cope with the cross-product interaction of price changes to their products (cross elasticity). A thorough analysis of this issue ensures that a price change will have a positive overall impact on the company, and yield significant benefit to the bottom line.

**Pricing Coordination:** As stated before, the pricing team manages a corporation's regular pricing council meeting. This support role ensures coordination among all relevant parties and provides profitability improvement through corporate pricing alignment.

**Discount Guidelines:** Reining in rogue sales agent who are discounting on their own initiative can improve the bottom line dramatically by eliminating profit-eroding behavior. [*Sentence re-worded for clarity*]

However, pricing teams are only able to deliver such improvements when they focus on three main responsibilities: analysis of data, support of processes and enforcement of policies and decisions.

## Analysis

Perhaps the initial focal point for any pricing team is analysis that facilitates informed decisions. These analyses must include strategic, operational and tactical considerations so that a more holistic and complete view can be considered.

**Strategic Analysis:** Strategic analysis examines the long-term impact of high-level decisions by examining the impact of changing the fundamental pricing model, (such as the impact of moving to an everyday low-price model). [*Sentence re-worded for clarity*] These analyses provide information required for executives to make informed decisions.

**Operational Analysis:** Operational analysis examines the near-term impact of price decisions. The setting of monthly, supply-aware price targets is a typical example. Once this analysis is complete and ratified, the resulting price list can be sent to the sales team to be executed upon. These operational analyses are generally much [more episodic, or time bound] than strategic analyses.

**Tactical Analysis:** Finally, tactical analysis looks at the immediate impact of an individual transaction or deal. One such example is deal analysis/management. Deals can be examined against established guidelines to determine if they are acceptable or not.

A well-run pricing organization concurrently executes several versions of each type of analysis. Of course, different decision makers will be the recipients of different analyses. For example, the output from a strategic analysis should be tailored to the CEO and executive team, while deal analysis should be tailored to the needs of business unit and sales leadership.

## Support

The next key function of the pricing team is to support a variety of groups in the corporation that can alter price. This support takes the form of owning pricing-related meetings; ensuring business processes are up-to-date, accurate and followed; and general coordination around pricing.

This support role is critical, since it ensures all stakeholders are involved in decision-making and are also given specific, actionable data to facilitate pricing decisions. For example, the pricing team should take input from the sales force regarding the current pricing practices and then provide the sales force with price targets and guidelines for each product, once the strategy is set and the analyses complete.

By providing this support role, the pricing team is able to coordinate pricing processes and initiatives for the company. This ensures broad party alignment and efficient processes.

## Enforcement

Finally, a pricing team should play an enforcement role within the company. This enforcement can take many forms, including:

- Analyzing an individual deal to ensure compliance with the published price and discounting guidelines
- Reviewing salesperson-discounting behaviors to validate discounting practices
- Ensuring customers follow through on contractual commitments for volumes or market share

The pricing team should review orders on an exception basis to ensure compliance with the established pricing and discounting guidelines. If an order fails to meet the guidelines, it should be rejected and sent back to the salesperson for renegotiation. Companies with "deal desks" that review and approve individual deals are already providing enforcement at this level. In some situations, these teams can be integrated into pricing teams (especially for those that have centralized organization). For situations in which direct integration is not feasible, a strong collaborative relationship should exist between the two with ultimate pricing authority resting with the pricing team.

This enforcement role is critical as it gives the pricing team the authority to enforce price compliance and adherence to pricing guidelines, and drives course corrections as necessary. In doing this a company can develop a sales-force-wide initiative for price discipline and eliminate maverick discounts, which can improve ASPs by over 50%. Without providing this support, the pricing team would be unable to protect the established policies and guidelines, causing price control to slip away.

## Price Waterfalls

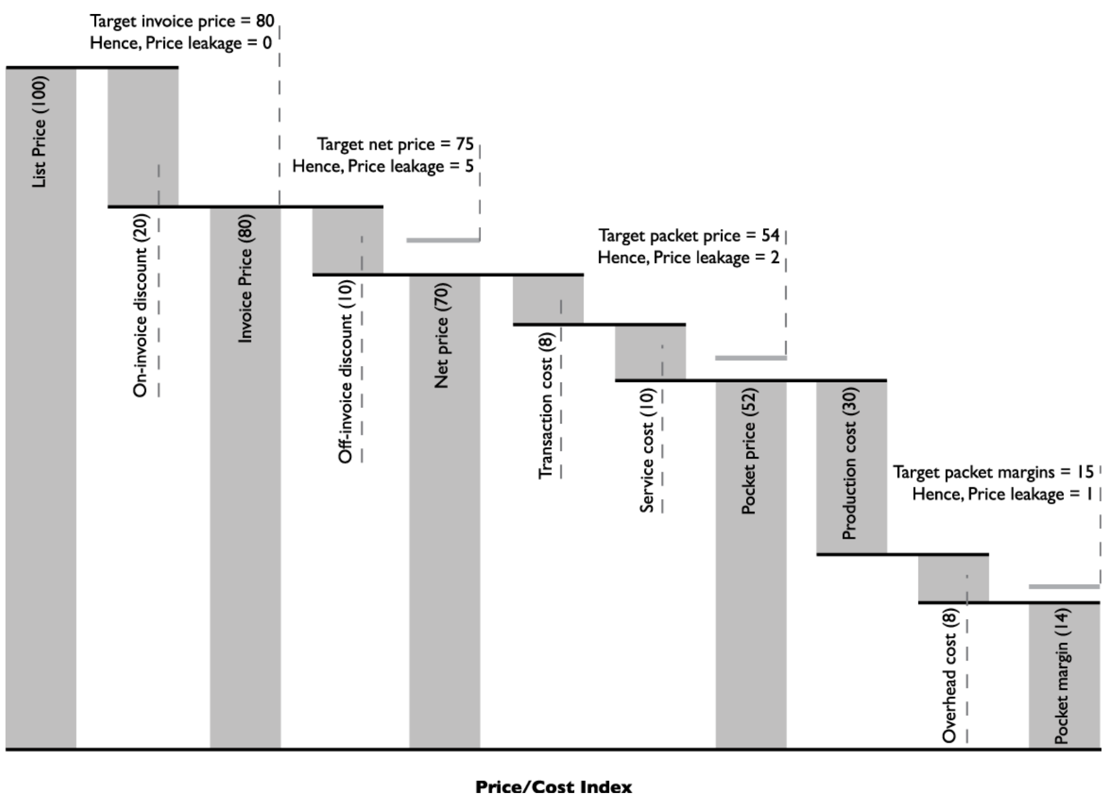
Price waterfalls provide a powerful way to visualize transaction pricing performance, and can be important tools for any type of price organization because of their ability to standardize pricing data. Perhaps better than any other framework, they allow managers to quickly grasp the extent of price erosion that occurs from the initial price to the final price realized by the firm (as a result of various discounts, rebates, and special customer costs).

In theory, every element of the price waterfall has a direct relation to an increase or decrease in value. In practice, price and value often become disassociated. In other words, list price may not truly reflect the value delivered to a particular segment (just an expedited shipping charge may not capture the complete value of a faster delivery).

A **Discretionary Discount** provides a theoretical way to equalize value with a competitive offering. In practice, the discretionary discount represents guesswork at best, and a cave-in (or profit sink) at worst. By explicitly incorporating value into a price waterfall, a firm can address these areas more effectively.

The price waterfall provides a measure of the realized net and pocket prices (not just the price that is printed on the invoice) against the defined target prices. Creating a price waterfall requires gathering, organizing, and synthesizing price and cost-related data.

**Figure 13.5: A Sample Price Waterfall**




The price waterfall enables the organization to achieve the best price in every transaction by identifying revenue leakage at different price levels (list price, invoice price, net price, pocket price, and pocket margin).

## Preparation Phase

A price waterfall should be developed and implemented by an inclusive project team, made up of marketing, sales, and finance personnel (IT personnel may be involved if the waterfall system will impact the company's technical infrastructure). Input from all of these divisions will be essential since they will all utilize the waterfall.

The duration of a price waterfall project depends on several factors. These may include the current pricing system, data availability, and any necessary change management efforts. Experience indicates that it usually takes at least one year to go from concept development to final implementation, so it is important to select a team that can effectively collaborate and will be accepted throughout the organization.

## Concept Development Phase

The primary goal of a price waterfall system should be to identify and eliminate profit leakages. Other popular goals may involve segmenting customers based on profitability, developing service strategies based on cost-to-serve, or creating new performance measures for the sales force based on transaction profitability. Price waterfall systems can be used to develop a disciplined process for matching particular products with particular existing customer segments, as well as determining the optimal prices and distribution channels for maximizing profits.

During the concept development phase, the specific goals of the price waterfall should be clearly defined and accepted by all stakeholders of the firm. These specific goals will be necessary to determine the design structure and level of detail for the price waterfall. If the goals and required waterfall elements are not properly defined in this preliminary stage, it may be impossible to measure critical information once the waterfall has been implemented. There are also certain costs involved with gathering and analyzing data for price waterfalls, which are often related to the level of detail that is built into the structure. A thorough understanding of the benefit of the desired goals will also help firms better justify the scope and cost of their desired waterfall structures.

Every price waterfall design should begin with a careful examination of the list price (or gross price) to determine which price and cost elements should be included in the structure (and how they should be defined). List prices should reflect the overall value of the product, based on input from various divisions of the firm. It is important that list prices are designed in a way that factors any discounts, rebates, or standard services that are given to customers.

To ensure that all discounts are reflected in the price waterfall, it is important to define distinct elements for both *on-invoice* discounts and *off-invoice* discounts (such as allowances, rebates, conditions, terms, or bonuses). Most companies focus on the **Invoice Price**, which is the difference between the list price and all on-invoice discounts. The invoice price does not necessarily reflect the full worth or profitability of a transaction because it does not include any off-invoice discounts or specific customer costs. It should still be an element on the price waterfall because the sales force commonly uses it during negotiations. By including the list price and invoice price on the price waterfall, members of the sales force can better understand how these elements relate to the total profitability of a particular transaction.

It is important to include a **Net Price** on the price waterfall as well, since this deducts *both* on-invoice and off-invoice discounts from the list price (or simply deducts off-invoice discounts from the invoice price). Off-invoice discounts can vary greatly between customers and sales representatives (especially if sales incentives are linked only to on-invoice discounts), and can significantly affect the profitability of the firm. By including net price information on the price waterfall (meaning that all off-invoice discounts are specifically outlined), management will be better able to track all discounts and more accurately measure the profitability of specific sales transactions.

Finally, the **Pocket Price** represents the total amount that is earned in a transaction. This amount includes on-invoice discounts, off-invoice discounts, and all specific customer costs that are involved in a sales transaction. These customer costs include *transaction costs* (such as freight, rush order costs, special costs for non-standard orders) and *service costs* (such as the sales team, customer service, training, promotions, or the cost of credit).

Organizations with more sophisticated cost allocation systems may drill down to the **Pocket Margin**, which equals the pocket price minus all overhead and production costs (fixed and variable) that are incurred for specific sales transactions. The difficulty in specifying pocket margins obviously lies in the ability to efficiently and accurately allocate broad organizational costs to specific transactions (see the cost accounting and activity-based costing information discussed in *Module 2* for more information).

A price waterfall requires sufficient and reliable data in order to positively contribute to the pricing decisions of the firm. It is important that the any centralized pricing business units regularly interact with the other divisions of the firm to continuously gather and analyze data, as well as make continued efforts to improve the quality and completeness of the collected data. Securing support from top-level management will help to ensure that all business units are diligent in gathering and reporting data. However, it is ideal to convince stakeholders throughout the firm of the value and necessity of a price waterfall framework, since this will make them more likely to actively adopt and implement it.

## Implementation and Measurement Phases

The key implementation aspects of a price waterfall initiative are *software deployment* and *employee training*. Organizations requiring a cost-effective solution typically utilize existing business warehouse/ERP systems with an MS Excel-based front-end. Whereas, organizations seeking a robust system will need to obtain pricing software from specialist vendors such as PROS Pricing Solution, Vendavo, and Zilliant (or build a full-fledged system internally). Once a software solution is selected, then the organization will need to train the people who will work with the system. Comprehensive change management is required to make sure that everyone understands the new price waterfall system (both its concept and application) and is convinced of its benefits.

To measure the success of a price waterfall implementation, **Key Performance Indicators (KPI)** should be defined for both the implementation process and its outcome. *Process KPI's* may include the number of people working with the waterfall system, number of products included, the percentage and quality of total cost measured, or the number of complaints received by IT support about the price waterfall software. It is important to define and monitor target values for process KPI's.

*Outcome KPI's* are used to analyze the financial impact of the price waterfall system. Organizations can define a variety of outcome KPI's, but should specifically create KPI's that are capable of indicating the *quality* of transactional pricing. For example, an organization could create a 90% compliance target for pocket price (meaning that 90% of transactions should realize the specified target pocket price). Outcome KPI's should be applied to both the marketing and sales functions to ensure that the right prices are implemented. The simple act of tracking and reporting KPI's such as these on a regular basis will improve pricing discipline throughout the organization.

## Benefits of Price Waterfalls

There are numerous benefits to utilizing price waterfalls. Four of the primary benefits are listed below.

1) **Higher Profits:**
   The primary function of a price waterfall is to pinpoint revenue leakages and optimize prices for every transaction. In *Figure 13.5*, there is no price leakage at the invoice price level, but there is a price leakage of 6 index points at the net price level. Identifying and eliminating this price leakage (created by off-invoice discounts) would increase the pocket margin from 14 points to 20 points (a 43% improvement in profitability for the transaction).

2) **Better Control:**
   The price waterfall can be used as the basis of a disciplined, data-driven approach to measuring the effectiveness of the pricing process (using by tracking outcome KPI's).

3) **Improved Planning:**
   Price waterfalls systematically divide price into distinct components, allowing firms to specifically measure targets for distinct price components. In *Figure 13.5*, the customer costs for the transaction were 18 points (the net price minus the pocket price). If the customer costs were expected to be 22 points and the discrepancy continues to occur over several transactions, then this would challenge assumptions that were made during the initial planning. By working with such specific pricing data over extended periods of time, it is likely that the marketing and planning skills of the firm will become significantly refined.

4) **Value-Based Negotiation:**
   By providing such specific pricing component data to the sales force (usually up to the pocket price level), it is possible that they will be able to utilize this information for value-based negotiations with customers. The highly detailed information will ensure that all discounts are standardized, and that any other price reductions are specifically linked to reductions in the overall value of the offering. This will not only enhance the perceived pricing *integrity* and fairness of the firm, but it will also ensure that profitability is maintained throughout the sales negotiation.

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## Review Questions

1. Establishing a pricing organization in a firm is necessary in order for a firm to deal with the following factors:

   (a) Competing Against Procurement Guerillas
   (b) Selling to International Customers
   (c) Lightning-Fast Innovation
   (d) All of the above

2. Too often, firms determine a product's specifications, development plans, and marketing strategy before considering its price.

   (a) True
   (b) False

3. In establishing a pricing organization in a firm, which one of the following procedures is correct?

   (a) Establish a centralized (or coordinating) pricing function that created and manages macro pricing policies and strategies for operating groups to follow.
   (b) Set up a pricing committee to oversee the pricing process of the sales force.
   (c) Establish a centralized price authority headed by the CEO of the firm.
   (d) Set up a centralized organization within the finance department as the principle pricing coordinator in the firm.
   (e) None of the above.

4. Most pricing processes do not require the establishment of a price setting methodology in a firm.

   (a) True
   (b) False

5. Which of the following is one of the largest misconceptions that managers have about implementing a pricing organization?

   (a) Pricing should be the sole responsibility of senior management, and there is no need for a large centralized pricing organization.
   (b) A single pricing group cannot be created to represent all of the interests in a company.
   (c) The process is so complex and intricate that it must be located at the divisional and market segment levels to be most effective.
   (d) All of the above.
   (e) None of the above.

6. Price waterfalls provide a powerful way to visualize transaction pricing performance.

   (a) True
   (b) False

7. The price waterfall is only as good as which of the following?

   (a) Structure of the discounts used in the firm.
   (b) Integrity of the IT system used to analyze the data.
   (c) Input data.
   (d) The sales forecast.

8. The benefits of a centralized pricing organization include which of the following advantages?

   (a) Promotion of standardization across the entire pricing process.
   (b) Realization of significant cost savings advantages.
   (c) Reduction in number of administrators.
   (d) Standardization of content.
   (e) All of the above

9. In a pricing committee, the establishment of a clear owner of pricing creates structured and constructive interactions between non-stakeholders of the firm.

   (a) True
   (b) False

10. Why should the pricing team review orders on an exception basis?

   (a) To ensure compliance with the established pricing and discounting guidelines.
   (b) To ensure that all distributors in the distribution channel offer discounts to their customers.
   (c) To ensure that profit levels are maximized across the firm.
   (d) To ensure that senior managers understand how customer orders are handled within the company.

# Module 14:
# Negotiation Strategies

## Introduction

Pricing plays a critical role in negotiation strategies. Knowing the different types of negotiation strategies, the relationship between bidding and prices, and the different types of bidding structures (or auction types) is imperative for professional pricers.

Shell defines negotiation as "an interactive communication process that may take place whenever we want something from someone else or another person wants something from us."[13] Negotiation may involve the purchase of a product or service, a contract dispute, or even a strategic alliance between companies. Agreement is achieved through different degrees of negotiation in various situations, which can range from complicated formal processes to simple verbal agreements.

Capturing the best total value (more than simply the best price) in a negotiation is about forming relationships, establishing trust, influencing others, and knowing what the other side desires (and what they are willing to do to get it). Given the role negotiation plays in virtually every business area, it is important to understand a few key tactics and strategies.

While negotiation may often be neglected in sales training, buyers are increasingly trained in negotiation strategies and techniques (especially in larger companies). Hence, it is more necessary than ever for sales personnel to be properly trained in negotiations. Nagle notes that "sending a salesperson in to negotiate a price with a business without the right communication tools is like sending a football player in to the game without pads and a helmet – he would be forced to give up a lot of ground or get hurt."[11]

Not knowing specific negotiation strategies, combined with the sales mentality to close a sale by meeting any customer demand, can put the average salesperson at a costly disadvantage. It is the sales manager's job to ensure that every person on the sales team is a strong negotiator, which requires reading, training, and continuous practice.[6] Important negotiations are complex, subtle, and sophisticated; the requisite body of knowledge, skills, and techniques to meet this challenge is not easily mastered. Nevertheless, good negotiators are *made*, not born.

## Price Negotiation and Sales Management

There are distinct objectives for each stage of the negotiation process. A few of these objectives are listed below:

**Prior to Negotiations:**

- Establish objectives for the negotiation.
- Gather information about the customer or vendor (such as profile, past behavior, or company culture).
- Decide value components that can be removed to reduce price.
- Plan negotiation strategy and tactics.

**During Negotiations:**

- Ask questions to engage the buyer.
- Discover any buyer needs that may surface.
- Employ proactive selling tactics and use counter-tactics when necessary.
- Develop a compromise position if necessary.

**After Negotiations:**

- Review what was accomplished (the deal and the terms).
- Plan and prepare for any necessary renegotiations.
- Follow up if there are questions left unanswered.

## Preparations and Questions

Thorough preparation is an exceptionally vital component to any successful negotiation, since the party with the *most knowledge* will ultimately determine the price through value-based negotiations. Classic pitfalls of negotiation include not adequately researching the company, the buying situation, or the buyers. Not having a set of tactics or counter-tactics and not cultivating a relationship buyers before a negotiation are also common problems.

Good questions during the negotiation process are also critical. They can trigger the impulse for buyers to reveal important facts, stimulate thinking, put the seller in more control, and facilitate active listening. One way to highlight the importance of questioning is to consider the **Negotiation Critical Ratio**, which is the number of arguments divided by the number of questions (this should *always* be less than one).

## Reserve Prices

Preparing for price negotiations begins with the development of a **Reserve Price** or bottom line threshold. This is a fundamental bargaining concept upon which negotiation theory is built. The reservation price is the minimum acceptable level that is required to say "Yes" in a negotiation, and if it cannot be achieved it is best to walk away.

When the parties in a negotiation have reservation prices that *permit* an agreement to be achieved, the range that exists is referred to as a **Positive Bargaining Zone**. However, if the reservation prices make an agreement *impossible*, then the range between the points would be a **Negative Bargaining Zone** (such as when a buyer simply does not have enough funds to meet the seller's minimum). Negotiators tend to underestimate the size of the range in situations with positive bargaining zones.

Although it is important to be aware of the bottom line, it must not become the dominant reference point during a negotiation. When this happens, negotiated prices tend to be just above this minimum acceptable level.

## Switching Threats

Threats of all sorts are used during sales negotiations, but perhaps the most significant threat is for buyers to move their business to a competitor if prices are not lowered. The more important the customer, the more disconcerting this threat can be. Customers understand power, and the resulting damage from shifting large volumes to a competitor.

Not all threats to switch suppliers are sincere. However, threats from significant customers may be so intimidating that managers will automatically grant price concessions when they are made. Once price concessions are made, the negotiation is lost. Managers will be forced to continue negotiating price until they can find a way to shift to a different game.

To counter threats, managers must have good information about the market, competitors, and customers. In the heat of negotiations, managers may make decisions based on instinct. While this intuition can play a role in management decisions, research has shown that informed judgment is almost always preferable. Preparing for the negotiation will help ensure that instincts will not dictate behavior. Managers who do not develop a plan for countering threats are more likely to make costly price concessions.

Customers may threaten switching suppliers but may not be financially capable of doing so if there are significant switching costs. Financial switching costs have the most leverage in negotiations, but some customers also face psychological switching costs (a supplier change is perceived as risky and would negatively affect existing relationships). Understanding a customer's switching costs can help identify the best moves in a negotiation. Highlighting switching costs may cause a customer to reconsider threats.

The sales force should be trained to focus on value instead of price. Business purchases are mainly influenced by the economic value delivered by products and services, and educating customers about the value delivered should be an important part of any negotiation strategy. In a price-focused negotiation, the single issue between buyer and seller is where the price will lie in the positive bargaining zone. In comparison, value focused negotiation requires that all price variances to be associated with value concessions. In other words, any price reduction must be accompanied by the removal of value from the offering.

Sacrificing value to receive a lower price creates a “penalty box” for customers who try to threaten their way to price reductions.[2] The problem for suppliers who respond to threats with price negotiations is that there is no penalty for customers forcing price concessions. Removing value from the offer places some of the burden in the price reductions onto the customer. Potential value reductions are best decided *prior* to negotiations, and price concessions should never be made without equivalent sacrifices by the customer.

A firm that caves into threats and power plays will lead its customers to believe that prices are determined by the perceived risk of losing their business. This encourages customers to adopt dysfunctional buying behaviors (such as threats) to increase the perception of that risk. The best way to counteract this is to have transparent, firm policies. This will help reduce undesirable customer behavior and increase the integrity of the firm’s pricing. Sales representatives can certainly convey the ability to negotiate better prices, but *only* based on criteria strictly specified by organizational policy.

## Pricing and Bidding

Fixed pricing is common in a broad range of transactions (especially in retail sales) and works well when a product is commonly used and understood. In order to set a fixed price, the seller must know (or have a reasonable estimate of) the value that buyers place on an item. However, when products are unfamiliar or market prices are unstable, fixed prices do not work as well. In such cases, it is more likely that bidding auctions, negotiations, or price haggling may occur.

Competitive bidding is a complex process, but its formality tends to enhance the perceived legitimacy and fairness of the final price. It requires a critical assessment of customers and competitors, as well as some scientific analysis. Normally, when the quality and services of suppliers are equal, the customer chooses the lowest bidder.

### Expected Immediate Profits

The theory of competitive bidding states that the optimal bid will produce the highest expected immediate profits. By calculating the immediate profits for a variety of different bids, a firm is more likely select the most appropriate bid:

$$\mathbf{E_B = P * (B-C)}$$

| | |
|---|---|
| $E_B$ | = Expected contribution of bid level |
| P | = Probability of winning contract at a given bid level |
| B | = Bid amount |
| C | = Cost of offering |

In practice, the greatest difficulty in competitive bidding is determining the probabilities of winning a bid at different price levels (the "P" variable in the equation above). The firm must also estimate the number and identity of likely bidders, as well as the amount they are likely to bid, since this will affect the probability of winning the bid. Typically, the more profitable the bid opportunity appears to be, the greater number of competitive bidders that will be involved.

Because bid amounts are so closely linked with cost estimates, low bidders can only profit from a winning bid if they have low costs to support their bid. Sometimes a firm will underestimate the costs of a deal and will suffer from the "winner's curse" (winning the bid but losing money in the process).

### Selective Bidding

When offered an opportunity to bid on a contract, a firm may first conduct an analysis of the opportunity. By bidding selectively, a firm will save time and money (on things such as formal cost estimates, engineering proposals, and even printing the bids). Some firms use a screening committee to evaluate bid opportunities in terms of potential growth, firm capabilities, and potential competition.

It is also important to determine if the firm has the necessary skills and capabilities to complete the bid as promised. If major skills must be acquired, the firm must also consider the cost of acquiring them.

Whether a firm should ultimately place a bid on an opportunity depends on the firm's objectives (which may include immediate profits, keeping the firm busy, or gaining entry to a new industry). However, it is also helpful to consider the objectives of *competitors* whenever possible.

### War Games

Major bids may require additional pricing processes. Regardless of industry, a focused team effort is almost always the best way to price major, non-standard bids for existing products or services. If the scope of the proposal is broad, and the uncertainty and value of the bid are high, more elaborate pricing mechanisms may be warranted.

One elaborate and somewhat unconventional approach is to conduct **War Games**, where a company aggressively simulates the bidding experience in order to determine its competitive strengths and weaknesses, as well as to accurately gauge its readiness to not only *win* the bid, but also to *fulfill* the bid.

### Timing of Bids

The manner in which the bidding process is executed can send a strong message. Concessions, process precision, and timing are all capable of affecting and auction's tone.

If a bidder places higher bids in rapid succession, it may signal that the final bid will likely continue to rise if the seller holds out. If a bidder places lower bids in rapid succession, it may signal that the final purchase price will continue to drop if the seller holds out.

Depending on the situation, rapid responses can either signal that a firm is truly willing to walk away from a negotiation, or that it is desperate and in a strategically weak position.

## The Structure of Competitive Bidding

In a broad sense, Monroe defines competitive bidding as a form of auction.[12] A bidding auction is feasible when there is more that one potential buyer and a single seller for a product or service (or more than one potential seller for a single buyer). There are many forms of auctions and bidding structures, each requiring varying degrees of management. Auctions may be sealed (with private bids) or open (with public bids), and they may allow either conditional or absolute commitment bids. Auctions may consist of multiple bidding rounds or a single "sudden death" round of bidding.

With any bidding auction it is important to consider all auction costs, inform all potential bidders of the pending auction, and to guide bidders with their offers and terms whenever possible (to help ensure that the bids are thoroughly prepared and carefully drafted). The ideal auction format will typically depend upon the purchase situation, and several specific auction styles have been described in *Module 11*.

Auctions are increasingly occurring in online environments. The global value of goods and services managed through online sourcing solutions was estimated to be over $750 billion in 2004.[9] A reason for the increased use of online auction channels is that they are more efficient and less expensive than traditional approaches. Traditional bidding processes can demand much more time and resources to execute, while largely automated online bidding processes can reduce the purchasing cycle by up to 35%.[9] Online reverse auctions are particularly popular in the commercial and industrial market, and therefore may be especially relevant to pricing negotiations.

In **Reverse Auctions**, buyers provide a group of potential vendors with specifications for a desired product or service. The competing vendors then place bids and drive down their prices until the buyer accepts a bid. The primary dangers for vendors are that overly cautious bidding may result in the loss of the auction, while overly aggressive bidding may leave them with the "winner's curse." Reverse auctions can be a daunting proposition for vendors not only because of the potential for getting caught in an underbidding frenzy, but also because they tend to make buyers significantly more price-sensitive.

Despite the potential drawbacks of reverse auctions, some vendors must participate to deal with certain customers. These customers primarily use reverse auctions for two reasons: to purchase commodity goods at the cheapest possible price, and to tempt sellers of differentiated goods and services to sacrifice their differentiation value in the heat of competitive bidding. It is imperative for vendors in these situations to have a firm grasp on their reservation price (or walk away price) so that they do not end up securing an unprofitable deal. It is also important to establish realistic goals for what can and cannot be accomplished during the auction, and to understand how public bids can drive demand and influence competitors.

> "A common tactic used by buyers to attain low bids during a reverse auction is to publish broad offering specifications that enable the largest number of vendors to participate. As a result, suppliers with marginal quality are placed on the same playing field as suppliers with high quality forcing the high quality vendors to discount heavily in order to win. Incumbents can often circumvent this process by influencing the offering specifications to exclude those marginal suppliers and create an auction with some integrity. When an auction is clearly an attempt to gain unjustified price discounts, a message can be sent to the customer by logging into the auction and bidding current prices or not bidding at all. The ultimate negotiating threat is always going to be to not negotiate."[1]

When a firm has an offering that provides significant competitive value to customers, then it should focus on preempting the auction or influencing bid specifications in its favor. If the firm does not win the reverse auction, it may be beneficial to maintain the relationship with the customer in case the winner fails to deliver as promised. There may also be future opportunities to work with the customer, so cultivating a positive relationship after a defeat may eventually bear fruit.

Reverse auctions have become inevitable in many markets, but it is typically buyers who are not interested in long-term relationships that use them. It is best to avoid intentionally winning an auction at a loss (by going below the reservation price) in the hopes of developing a relationship with a customer, as this rarely proves to be effective. Although there is no magic formula for winning a reverse auction, a well planned and carefully executed approach can help limit price erosion and maintain profitability.

## Types of Negotiation Strategies

When entering a negotiation, involved parties will rarely ever see things the same way. Negotiation strategy centers on developing the appropriate tactics and counter-tactics to persuade others to a particular position or way of thinking. Some common tactics and counter-tactics are briefly described below.

### Fat Words/Skinny Words

The negotiation tactic of **Fat Words/Skinny Words** focuses on drilling into abstract words (fat words) or more specific words (skinny words) that are used during the course of a negotiation. If someone says, "These conditions are impossible to meet," then the other party might counter by asking, "Can you please explain what you mean by 'impossible' in this context?" The other side may be caught off guard while trying to explain the term, or may even realize that "impossible" was an inaccurate word to use in the first place.

### Reversing

The tactic of **Reversing** calls for answering a question with a question. This allows a negotiator to maintain control of the conversation. Someone might ask, "Why can the terms of your program not be changed?" The other side could reverse the questions by asking, "How are these terms difficult for you?"

When subjected to this tactic, a good counter-tactic is to simply expose what the other side is doing. In response, the original party might simply ask, "When are you going to answer my questions?"

### Flinching

The tactic of **Flinching** means reacting verbally or visually to something that has just been said. If someone says, "That will cost an extra thousand dollars," then the other party might respond with a look of shock, and incredulously exclaim, "An extra thousand dollars!"

When subjected to this tactic, a good counter is (again) to simply expose the tactic (perhaps even by overtly complimenting the quality and believability of the flinch). In response to the flinch provided above, the original party might simply say, "Nice reaction, but perhaps you can explain what you think is so outlandish about asking for this extra money for the value we are providing?" This can even be an opportunity to bring the focus of the negotiation back to the value of the offering.

### Additional Strategies

There are also many other negotiating tactics that include the following: calling for a private meeting in the middle of negotiations, introducing unexpected information or demands, planting false information or notes, never agreeing to the first offer (so the other party does not regret making an overly conservative initial offer), or deliberately making the negotiation more complex in order to generate a one-sided agreement.

Negotiators should attempt to learn as much about these tactics as possible, although this exceeds the scope of the CPP course. With proper training, any negotiator can learn how to best use key negotiation tactics and counter-tactics.

Some additional negotiation fundamentals are provided below:

- It is usually best to tackle the big issues last.
- Arguing usually does not secure victory.
- People tend to believe what they see in writing.
- It is acceptable to ask for more than is deserved, or more than the target price.
- Agreement is facilitated when people believe it is in their best interests.
- It is beneficial to develop a detached attitude toward the outcome.

As a final note, when developing a negotiation strategy, an important concept to consider is the **Paradox of Influence**. This stipulates that before someone can be influenced, they must first feel that they have successfully influenced the other party. This suggests that the ability to *influence* is directly linked with one's own willingness to *be influenced*. Without this paradox, it will be more difficult to get others to be open during negotiations.

Palmer suggests ten steps to follow in order to influence others:[7]

1) Invest the time in meeting with the other parties. Sit down with them and be sensitive to the demands of their schedules.
2) Focus and be an attentive and active listener. This flatters the speaker and fosters concentration on the issue at hand.
3) Ask questions and take a concerted interest in the other parties. What are their accomplishments, their challenges? Write questions out ahead of time.
4) Negotiations are opportunities to build relationships, not interrogate witnesses. It can be beneficial to reveal brief personal information (this should be consistent with what the other parties have revealed).
5) Ask for opinions. Ask questions that start with *what*, *where*, *when*, *how*, *who*, and *why* (be careful not to come across as confrontational).
6) Listen actively. Use body language, take notes, and encourage conversation with words like "interesting" and "then what?" Take notes about what was said.
7) Summarize, paraphrase what the other parties have said and then ask if it is correct.
8) Now try to persuade. Ask for commitment. Ask if the other side is ready to discuss the ideas and value propositions being offered.
9) Present ideas as alternatives without challenging the other person's ideas directly.
10) Ask for the other person's "help". If they say no, look disappointed but do not say anything. When they fill the silence with a counteroffer, try asking for more.

If the above steps are practiced and the paradox of influence is mastered, one's ability to persuade most people will dramatically improve.

## Managing Expectations

Expectations are linked to several factors that include previous successes and failures in similar negotiations, prevailing market prices and standards, past practices of the other party, knowledge about alternatives and frames of reference, the potential for a future relationship, and the personalities involved in the actual negotiation.

In order to legitimate high expectations, specific and reasonable goal setting must be combined with *commitment*. Expectations should come from an overall understanding of the goals of the exchange and should be derived from what is thought to be a fair and reasonable outcome, which too often goes unstated or even unidentified.

Goals give *direction* to negotiations. Expectations give *weight* and conviction to statements made during negotiations. Increasing the time spent on preparations and the amount of information gathered will help to reinforce the practicality of realistic goals, causing expectations to grow more secure. The goal of an effective negotiator is to have expectations that are high enough to present a challenge, but realistic enough to promote positive working relationships.

To improve negotiation skills, it is important to carefully consider the full range of fair and reasonable outcomes. Expected results should generally fall within the high end of that range (rather than merely hovering close to the reserve price).

Negotiated outcomes are fundamentally dependent upon expectations, planning, and motivation.[9] In fact, research reveals that people who *expect more* from negotiations generally *get more*, and that sales personnel tend to be more persuasive when they are truly committed to achieving a specific goal.[13]

As Lyndon B. Johnson once said, “What convinces is conviction.”

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## Review Questions

1) Your "Negotiation Critical Ratio" is the number of one's arguments divided by the number of one's questions, and it should always be less than one.

   (a) True
   (b) False

2) It is wise for negotiators to be argumentative because victory is often determined by who can articulate the most cogent arguments.

   (a) True
   (b) False

3) The party with the most knowledge ultimately determines the price.

   (a) True
   (b) False

4) Information and valuation differences are not that important when negotiating.

   (a) True
   (b) False

5) The "paradox of influence" states which of the following?

   (a) Only those with the most power can be influential.
   (b) Influence is derived from high quality product offerings.
   (c) Before you can influence someone else, you must first convince them that they have influenced you.
   (d) Before you can influence someone else, you must first argue your point
   (e) Influence can be bought.

6) During a negotiation, it is advisable to do which of the following?

   (a) Begin discussing value
   (b) Distrust the other side
   (c) Bid early and often
   (d) Employ pro-active tactics
   (e) All of the above

7) For sealed second-price auctions, all of the following statements are true EXCEPT:

(a) Bidders submit bids simultaneously.
(b) Bidders do not know the bids of other participants.
(c) The price paid is the second highest bid.
(d) The winner is the participant who submits the highest bid.
(e) There is no exception; all of the above statements are true.

8) Customers use reverse auctions for the following reason(s):

(a) To grow price transparency
(b) To purchase commodity goods at the most efficient price
(c) To tempt sellers of differentiated goods to relinquish their premium
(d) b and c
(e) a and b

9) Which of the following statements is true?

(a) The threat to move business to a competitor is often made through the customer's purchasing organization.
(b) If a supplier is truly differentiated and providing value to the customer, then the impact of the value delivery is rarely realized in purchasing.
(c) Managers must cultivate allies where value is realized, (such as in operations or technical functions).
(d) The objective for creating relationships with allies where value is realized is to force purchasing to acknowledge value delivery.
(e) All of the above statements are true.

10) Management skills can affect price and compensate for differences in negotiating power.

(a) True
(b) False

# Index

## *W*

# Answer Key – Revised 10/12/09

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**Please note:**
*Module 9, Question 3 *(This is one of those on the fence questions. It is more true than false)*
**Module 11, Question 9
***Module 12, Question 6 (*The answer could also be D "None of the above." Given that there is much diversity in international markets, it would be hard to say that international markets are generally inelastic because it depends on the brand, competitive conditions, etc.)*