CHAPTER 13: DEVELOPING PRICING STRATEGIES AND PROGRAMS

- Price is the amount of money charged for a product or service, or the sum of all values that consumers exchange for the benefits of having or using the product or service. Price is the only element in the marketing mix that produces revenue. Others produce cost.
- Pricing is the process of determining what a company will receive in exchange for its products

Common pricing mistakes

- Companies base their prices on their costs and ignoring the customers’ perceptions of value.
- Companies base their prices on “the marketplace” taking traditional industry margins
- Failure to vary price by product item, market segment, distribution channels, and purchase occasion.
- Companies holding the prices at the same level for too long, ignoring changes in costs, market, competitive environment and in customers’ preferences.
- Setting price independent from the rest of the marketing mix

Consumer Psychology and Pricing

1) Reference Prices

- Comparing an observed price to an internal reference price or external frame of reference
- Sellers often try to manipulate reference prices
- Perceived price can vary from the stated price

2) Price-Quality inferences

- Consumers usually use price as an indicator of quality
- If information about true quality is on-hand, price is a less significant indicator of quality Consumer Psychology and Pricing

3) Price Endings

- Sellers usually believe prices should end in an odd number
- Consumers tend to process prices “left-to-right” rather than by rounding
- Sale signs next to prices encourage demand Consumer Psychology and Pricing

Example – Item priced as ‘Rs.2999 only’

Steps involved in setting the price

1) Selecting the pricing objective
2) Determining demand
3) Estimating costs
4) Analyzing Competitors’ costs, prices and offers
5) Selecting a pricing method
6) Selecting the final price

Step 1: Selecting the pricing objective

The company first decides where it wants to position its market offering. The clearer a firm's objectives, the easier it is to set price.

Five major objectives are:

a) Survival – This objective is pursued if they are plagued with over capacity or intense competition or changing customer wants. As long as prices cover variable costs and some fixed costs, the company stays in business.

b) Maximum current profit – Ideal when the demand and costs associated with alternative prices are known.

c) Maximum market share – The belief that a higher sales volume will lead to lower unit costs and higher long-run profit. They set the lowest price, assuming the market is price sensitive. The following conditions favor setting a low price. When the market is highly price sensitive, and a low price stimulates market growth. The production and distribution costs fall with accumulated production experience. A low price discourages actual and potential competition.

d) Maximum market skimming – Usually adopted by technology oriented companies while unveiling a new technology favor setting high prices to "skim" the market. Here prices start high and slowly drop over time.

e) Product-quality leadership – Products of services characterized by high levels of quality, taste and status

Step 2: Determining Demand

Each price will lead to a different level of demand and have a different impact on a company's marketing objectives. The normally inverse relationship between price and demand is captured in a demand curve. The higher the price, the lower the demand.

1) Understand factors that affect price sensitivity

Consumers are less price sensitive when:

- Product is more distinctive
- Buyers are less aware of substitutes
- Buyers cannot easily compare quality of substitutes
- The expenditure is a lower part of buyer's total income
- The expenditure is small compared to the total cost
- Part of the cost is borne by another party
- The product is used with assets previously bought
- The product is assumed to have more quality, prestige, or exclusiveness
- Buyers cannot store the product

2) Estimating demand curves

a) Surveys

b) Price experiments: can vary the prices of different products in a store or charge different prices for the same product in similar territories to see how the change effects sales

c) Statistical analysis: Through trend projection, regression analysis, etc.

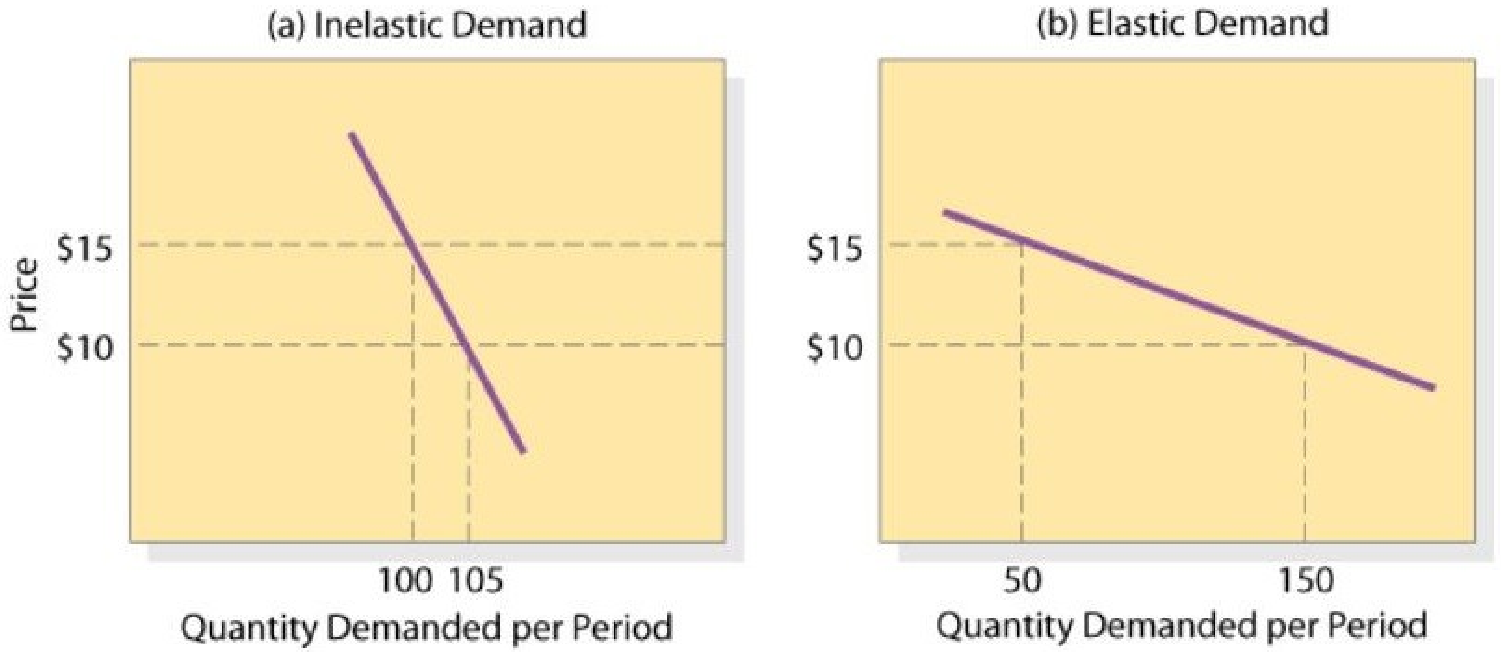
3) Price elasticity of demand

Elastic demand is the one when the response of demand is greater with a small proportionate change in the price. On the other hand, inelastic demand is the one when there is relatively a less change in the demand with a greater change in the price.

Demand is less elastic when:

- There are few or no substitutes/competitors
- Buyers do not readily notice the higher price
- Buyers are slow to change their buying habits and search for lower prices
- Buyers think higher prices are justified

Inelastic and Elastic Demand



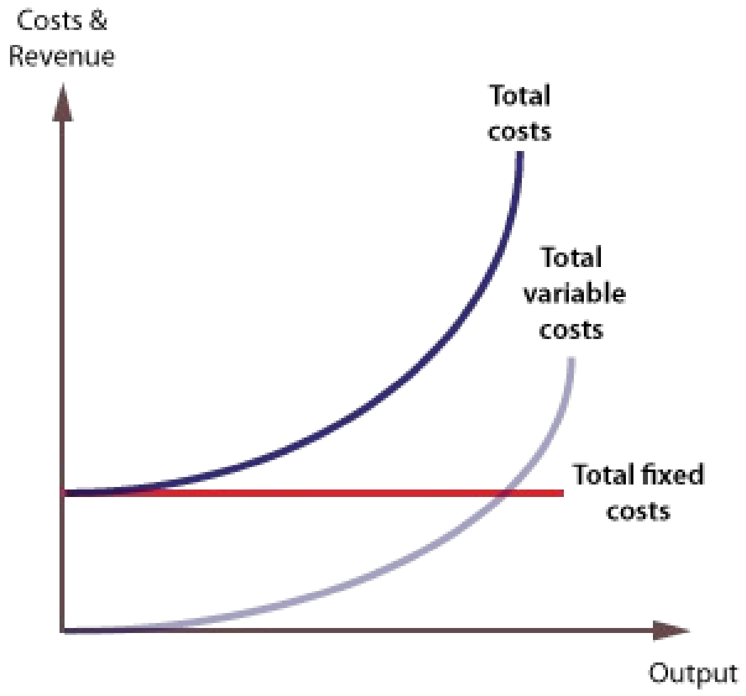
Step 3: Estimating Costs

Fixed costs/overhead: costs that don’t vary with production or sales revenue.

Variable costs: vary with the level of production.

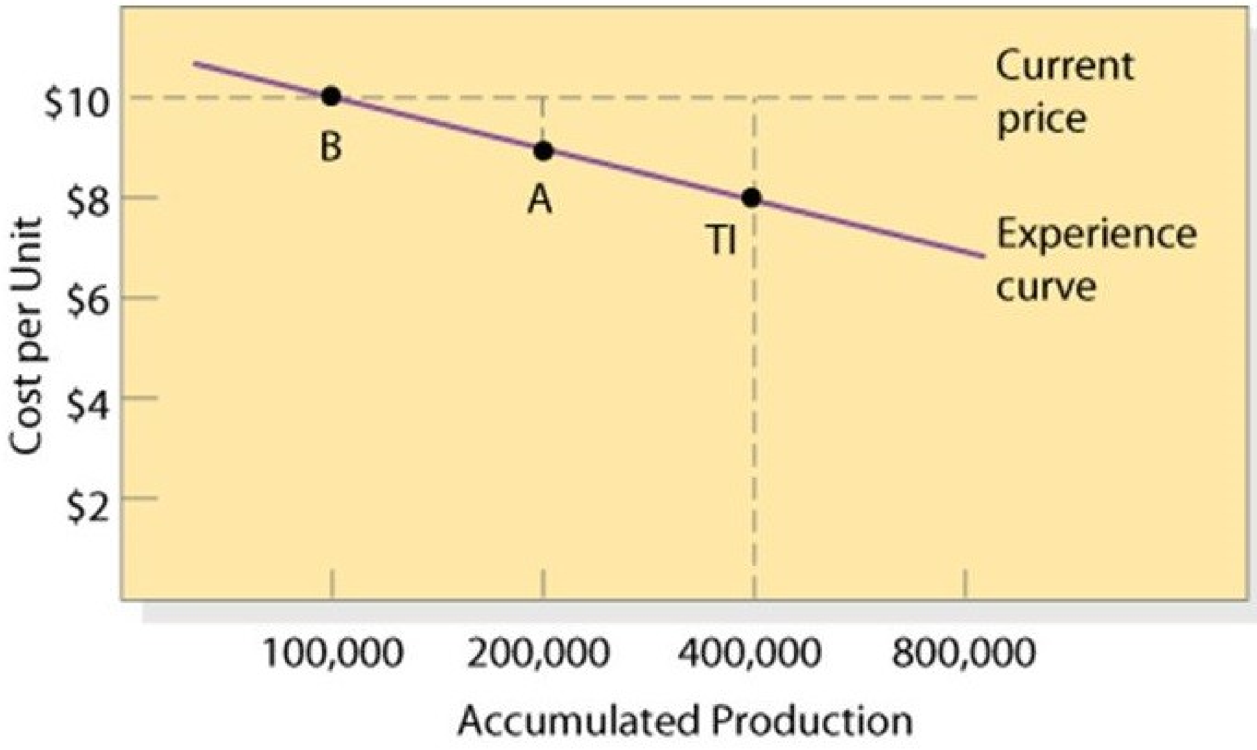
Total costs: sum of fixed and variable costs at a given level of production

Average cost: cost per unit at a given level of production = total cost/quantity of production



Accumulated production

An experience curve is a curve which represents that the more a firm produces of a particular good or service, the more it gains in efficiency. Thus, the cost of production decreases in proportion to the volume of products produced.



Step 4: Analyzing Competitors’ Costs, Prices and Offers

- The firm should benchmark its price against competitors, learn about the quality of competitors offering, & learn about competitor’s costs.

- Evaluate the features of the competitor’s products

- Anticipate a competitor’s reactions Setting the Price

Step 5: Selecting a pricing method

Mark-up pricing: The Mark-up pricing is the method of adding a certain percentage of a markup to the cost of the product to determine the selling price.

Variable cost per unit: Rs.30
Fixed Cost: Rs.5,00,000
Expected Unit Sales: 50,000 units

The manufacturer’s unit cost is given by:

Unit Cost = Variable cost + (Fixed cost/unit sales)

Thus, Unit cost = 30 + (500000/50000) = Rs.40

Once the cost is determined, the manufacturer decided to add a 20% markup on sales. The mark-up price is given by:

Mark-up price = unit Cost/(1-desired return on sales)

Thus, mark-up price = 40/(1-0.2) = Rs.50

Hence, the manufacturer must charge Rs.50 to earn a profit of Rs.10.

Target-Return Pricing: is a method wherein the firm determines the price on the basis of a target rate of return on the investment i.e. what the firm expects from the investments made in the venture.

Example, a pen manufacturer has invested 2 million in his venture and he expects to earn 20% as an ROI.

- Unit cost: Rs.20
  Expected sales: 50,000 units
- The Target-Return Pricing is given by:
- Target-Return Pricing = unit cost + (desired return x invested capital) /unit sales
- Target-Return Pricing = 20 + (0.20 x 2,000,000) / 50,000 = Rs.28

To earn the ROI of 20%, the company must sell the product at Rs.28, provided 50,000 units are sold.

Perceived-Value Pricing

In Perceived-Value Pricing method, a firm sets the price of a product by considering what product image a customer carries in his mind and how much he is willing to pay for it.

The perceived value is made up of several elements such as buyer’s experience with the product, service support, warranty quality, channel deliverables, customer support, supplier’s reputation, trustworthiness, etc.

Every company tries to enhance the perceived value in customer’s minds by adopting several marketing mix elements such as advertising, promotion, sales force, etc.

Many times, the customer is not aware of the cost incurred by the firm in producing the product, but what they only care is the final price and how much it varies from the competitor’s product.

The benefit of using this method is only when a company offers more value that its competitor.

Value pricing

Win loyal customer by charging a fairly low price for a high-quality offering. Value pricing not just a matter of simply setting lower prices, it is a matter of reengineering the company’s operations to be low-cost without sacrificing quality, to attract a large number of value conscious customers

Going-Rate Pricing: The firm bases its price largely on competitors' prices. (smaller firms "follow the leader").It is quite popular where costs are difficult to measure or competitive response is uncertain.

Auction-type pricing

a) English auctions (Ascending bids)

One seller many buyers. Seller puts an item and bidders raise the offer price until the top price is reached.

b) Dutch auctions (Descending bids)

- One seller many buyers: An auctioner announces high price then slowly decreases until a bidder accepts
- One buyer many sellers: Buyer announces something he/she wants to buy and potential sellers compete to offer lowest price.

c) Sealed bid auctions: Bidders can submit only one bid and therefore cannot adjust their bids based on competing bids. A variant of this method is two-bid system, where technical bids are first evaluated, based on pre-qualification/ short listing on technical grounds, commercial bids are considered.

Step 6: Selecting the final price

Selecting the final price requires consideration of additional factors

a) Impact of Other Marketing Activities .

The final price must take into account the brand image, promotional expenditures, margins for distributors, etc relative to the competition.

b) Company Pricing Policies.

The price must be consistent with company pricing policies in order to ensure that salespeople quote prices that are reasonable to customers and profitable to the company.

c) Gain and Risk Sharing Pricing.

In case buyers resist accepting a seller’s proposal because of a high perceived level of risk, the seller has the option of offering to absorb part or all the risk if it does not deliver the full promised value.

d) Impact of Price on Other Parties.

Considering the impact of price on other parties such as distributors, sales force, suppliers, competitors, retailers, government, etc

Adapting the price

Companies usually do not set a single price but rather develop a pricing structure that reflects variations in geographical demands and costs, market-segment requirements, purchase timing, order levels, etc.

1) Geographical pricing

About the pricing of the company's products to different customers in different geographical locations

Countertrade: Is undertaken when buyers lack sufficient hard currency to make payment and they want to offer other items in payment.

Types of countertrade:

a) Barter: The buyer and seller directly exchange goods with no money and no third party involved.

b) Compensation deal: The seller receives some percentage of the payment in cash and the rest in products

c) Buyback arrangement: Occurs when a seller sells a plant, technology or equipment to another country and agrees to take a certain percentage of the plant's output as partial payment for the contract.

d) Offset: The seller receives full payment in cash but agrees to spend a substantial amount of the money in that country within a stated time period.

2) Price Discounts and Allowances

Quantity discount: Price reduction to those buy in large volumes

Functional/Trade discounts: Discount offered by a manufacturer to trade-channel members if they will perform certain functions

Cash discount: A deduction granted to buyers for paying their bills within a specified period of time, (after first deducting trade and quantity discounts from the base price)

Seasonal discount: A price reduction to those who buy during off-season

Allowance: An extra payment designed to gain reseller participation in special programs. Example, promotional allowances.

3) Promotional pricing

The Promotional Pricing is a sales promotion technique, wherein the firm reduces the price of a product, but for a short period.

Loss-leader pricing: Loss leader brands or products are sold at very slim margins or at a loss. With the intention to attract customers into their premises, with the hope that those customers will end up buying other goods as well, once inside. with the conscious understanding that other products that gets sold will make up for the loss.

Special-Event Pricing: Companies offer discounts or special price during certain special events. Example – During festivals

Cash Rebates: The consumer goods companies such as Automobile companies, electronic companies, etc. offers the cash rebates on their items if purchased in a particular time period.

Low-interest financing: Instead of cutting its price, the company can offer products through low interest financing. Example through EMI.

Longer payment terms : sellers especially mortgage banks and auto companies stretch loans over longer periods and thus lower the monthly payment

Warranties and service contracts: The companies offer the extended warranties and free services of the product to the customers.

Psychological Discounting: Under this strategy, the companies artificially set the high price of the product and then offer it at substantial savings, such as an item was of RS 359, but now it is available at just Rs 299.

Special customer pricing

4) Differential pricing

Price discrimination

a) First degree price discrimination: Selling to each customer at a different price

b) Second degree price discrimination: Sellers charges less to buyers of larger volumes

c) Third degree price discrimination

- **Customer-Segment pricing:** Different group of people pays different prices for the same kind of a product on the basis of a segment they belong to.
- **Image pricing:** The companies can charge different prices for the same kind of a product on the basis of an image, a product enjoys in a market.
- **Product-form Pricing:** Different prices charged for different variants of the same product. E.g., The price of a car may vary because of different color or add-on features.
- **Location Pricing:** The companies charge different prices for the same product on the basis of different locations where it is offered. Eg- different price for different seats on the basis of where the seats are located in a theatre
- **Time Pricing:** Price varies by season, day or hour.
- **Channel pricing:** Here the strategy is to sell products to the consumers on the basis of the type of outlet where it is being sold.
- **Yield pricing:** offering different prices for the same product at different times. In somecases, for different locations as well.

Initiating and responding to price changes

A price-cutting strategy can lead to following traps

1. Low-quality trap: Consumers will assume that quality is low.

2. **Fragile-market share trap:** A low price buys market share but not market loyalty always. The same customers will shift to any lower- priced firm that comes along.

3. Shallow-pockets trap: The higher priced competitors may cut their prices and may have longer staying power because of deeper cash resources.
4. Price –war trap

Initiating Price Increases

The factors leading to price increase can be:

- Increase in cost inflation.
- Over demand when the company cannot supply to all of its customers, it can raise its prices, ration or cut supplies to customers or both.

The price can be increased in four ways:

Delayed quotation pricing: Here, the company does not set final price until product is finished or delivered.

Unbundling: The company under this plan maintains its price but removes or prices separately one or more elements that were part of the former offer, such as free delivery or installation.

Reduction of discounts: The company asks the sales force to offer its normal cash and quantity discounts at reduced rate.

Escalator clauses: The company requires the customer to pay today's price and all or part of any inflation increase that takes place before delivery. An escalator clause bases price increases on some specified price index. Escalator clauses are found in contracts for major industrial projects like infrastructure projects, aircraft buildings, etc.

Customer Reactions to price changes:

Consumers are more interested in knowing the cause or causes of price change.

A price cut can be interpreted in several ways:

1. The item or product is about to be replaced by a new model.
2. The item is faulty and it is not selling well.
3. The firm's financial position is badly affected.
4. The price will come down further.
5. The quality has been reduced.

A price hike may have some positive meanings:

1. The product is more technologically advanced
2. It has a high value because of quality.

Competitor reactions are common when:

– Few firms offer the product

– The degree of product homogeneity

– Buyers are highly informed

Market leader's responses to Price Changes

- Maintain price and profit margin
- Maintain price, add value
- Increase price, improve quality
- Launch a low-price fighter line
- Reduce price

THANK YOU