- ***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 affects sales. Another approach is to use the Internet. An e-business could test the impact of a 5 percent price increase by quoting a higher price to every 40th visitor, to compare the purchase response. However, it must do this carefully and not alienate customers or be seen as reducing competition in any way (and thus violate the Sherman Antitrust Act).[38]
- ***Statistical analysis*** of past prices, quantities sold, and other factors can reveal their relationships. The data can be longitudinal (over time) or cross-sectional (from different locations at the same time). Building the appropriate model and fitting the data with the proper statistical techniques calls for considerable skill, but sophisticated price optimization software and advances in database management have improved marketers' abilities to optimize pricing.

One large retail chain was selling a line of "good-better-best" power drills at $90, $120, and $130, respectively. Sales of the least and most expensive drills were fine, but sales of the midpriced drill lagged. Based on a price optimization analysis, the retailer dropped the price of the midpriced drill to $110. Sales of the low-priced drill dropped 4 percent because it seemed less of a bargain, but the sales of the midpriced drill increased by 11 percent. Profits rose as a result.[39]

In measuring the price-demand relationship, the market researcher must control for various factors that will influence demand.[40] The competitor's response will make a difference. Also, if the company changes other aspects of the marketing program besides price, the effect of the price change itself will be hard to isolate.

PRICE ELASTICITY OF DEMAND Marketers need to know how responsive, or elastic, demand is to a change in price. Consider the two demand curves in Figure 14.1. In demand curve (a), a price increase from $10 to $15 leads to a relatively small decline in demand from 105 to 100. In demand curve (b), the same price increase leads to a substantial drop in demand from 150 to 50. If demand hardly changes with a small change in price, we say the demand is *inelastic.* If demand changes considerably, demand is *elastic.*

The higher the elasticity, the greater the volume growth resulting from a 1 percent price reduction. If demand is elastic, sellers will consider lowering the price. A lower price will produce more total revenue. This makes sense as long as the costs of producing and selling more units do not increase disproportionately.[41]

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

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

One comprehensive study reviewing a 40-year period of academic research that investigated price elasticity yielded interesting findings:[42]

- The average price elasticity across all products, markets, and time periods studied was –2.62. In other words, a 1 percent decrease in prices led to a 2.62 percent increase in sales.
- Price elasticity magnitudes were higher for durable goods than for other goods, and higher for products in the introduction/growth stages of the product life cycle than in the mature/decline stages.
- Inflation led to substantially higher price elasticities, especially in the short run.
- Promotional price elasticities were higher than actual price elasticities in the short run (although the reverse was true in the long run).
- Price elasticities were higher at the individual item or SKU level than at the overall brand level.

Step 3: Estimating Costs

Demand sets a ceiling on the price the company can charge for its product. Costs set the floor. The company wants to charge a price that covers its cost of producing, distributing, and selling the product, including a fair return for its effort and risk. Yet when companies price products to cover their full costs, profitability isn't always the net result.

TYPES OF COSTS AND LEVELS OF PRODUCTION A company's costs take two forms, fixed and variable. **Fixed costs**, also known as **overhead**, are costs that do not vary with production level or sales revenue. A company must pay bills each month for rent, heat, interest, salaries, and so on regardless of output.

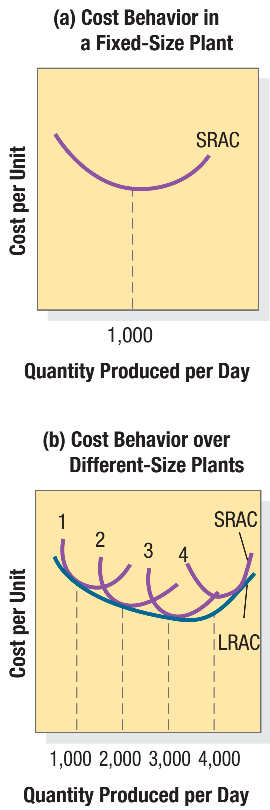
Variable costs vary directly with the level of production. For example, each hand calculator produced by Texas Instruments incurs the cost of plastic, microprocessor chips, and packaging. These costs tend to be constant per unit produced, but they're called *variable* because their total varies with the number of units produced.

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

To price intelligently, management needs to know how its costs vary with different levels of production. Take the case in which a company such as TI has built a fixed-size plant to produce 1,000 hand calculators a day. The cost per unit is high if few units are produced per day. As production approaches 1,000 units per day, the average cost falls because the fixed costs are spread over more units. Short-run average cost *increases* after 1,000 units, however, because the plant becomes inefficient: Workers must line up for machines, getting in each other's way, and machines break down more often (see △ Figure 14.2(a)).

If TI believes it can sell 2,000 units per day, it should consider building a larger plant. The plant will use more efficient machinery and work arrangements, and the unit cost of producing 2,000 calculators per day will be lower than the unit cost of producing 1,000 per day. This is shown in the long-run average cost curve (LRAC) in Figure 14.2(b). In fact, a 3,000-capacity plant would be even more efficient according to Figure 14.2(b), but a 4,000-daily production plant would be less so because of increasing diseconomies of scale: There are too many workers to manage, and paperwork slows things down. Figure 14.2(b) indicates that a 3,000-daily production plant is the optimal size if demand is strong enough to support this level of production.

There are more costs than those associated with manufacturing. To estimate the real profitability of selling to different types of retailers or customers, the manufacturer needs to use activity-based cost (ABC) accounting instead of standard cost accounting, as described in Chapter 5.

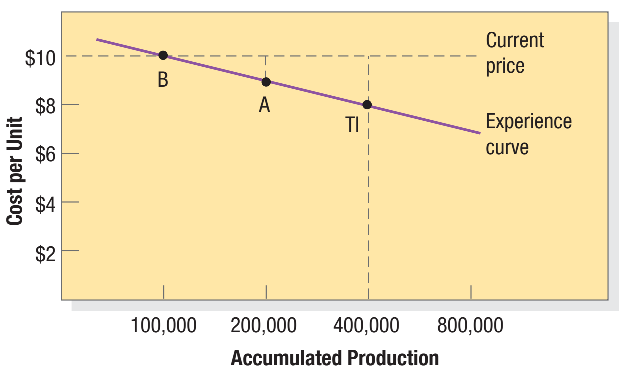


|Fig. 14.2| △

Cost per Unit at Different Levels of Production per Period

ACCUMULATED PRODUCTION Suppose TI runs a plant that produces 3,000 hand calculators per day. As TI gains experience producing hand calculators, its methods improve. Workers learn shortcuts, materials flow more smoothly, and procurement costs fall. The result, as △ Figure 14.3 shows, is that average cost falls with accumulated production experience. Thus the average cost of producing the first 100,000 hand calculators is $10 per calculator. When the company has produced the first 200,000 calculators, the average cost has fallen to $9. After its accumulated production experience doubles again to 400,000, the average cost is $8. This decline in the average cost with accumulated production experience is called the **experience curve** or **learning curve**.

Now suppose three firms compete in this industry, TI, A, and B. TI is the lowest-cost producer at $8, having produced 400,000 units in the past. If all three firms sell the calculator for $10, TI



|Fig. 14.3| △

Cost per Unit as a Function of Accumulated Production: The Experience Curve makes $2 profit per unit, A makes $1 per unit, and B breaks even. The smart move for TI would be to lower its price to $9. This will drive B out of the market, and even A may consider leaving. TI will pick up the business that would have gone to B (and possibly A). Furthermore, price-sensitive customers will enter the market at the lower price. As production increases beyond 400,000 units, TI's costs will drop still further and faster and will more than restore its profits, even at a price of $9. TI has used this aggressive pricing strategy repeatedly to gain market share and drive others out of the industry.

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

Most experience-curve pricing has focused on manufacturing costs, but all costs can be improved on, including marketing costs. If three firms are each investing a large sum of money in marketing, the firm that has used it longest might achieve the lowest costs. This firm can charge a little less for its product and still earn the same return, all other costs being equal.[43]

TARGET COSTING Costs change with production scale and experience. They can also change as a result of a concentrated effort by designers, engineers, and purchasing agents to reduce them through **target costing**.[44] Market research establishes a new product's desired functions and the price at which it will sell, given its appeal and competitors' prices. This price less desired profit margin leaves the target cost the marketer must achieve.

The firm must examine each cost element—design, engineering, manufacturing, sales—and bring down costs so the final cost projections are in the target range. When ConAgra Foods decided to increase the list prices of its Banquet frozen dinners to cover higher commodity costs, the average retail price of the meals increased from $1 to $1.25. When sales dropped significantly, management vowed to return to a $1 price, which necessitated cutting $250 million in other costs through a variety of methods, such as centralized purchasing and shipping, less expensive ingredients, and smaller portions.[45]

Companies can cut costs in many ways.[46] With General Mills, it was as simple as reducing the number of varieties of Hamburger Helper from 75 to 45 and the number of pasta shapes from 30 to 10. Dropping multicolored Yoplait lids saved $2 million a year. Some companies are applying what they learned from making affordable products with scarce resources in developing countries such as India to cutting costs in developed markets. Cisco blends teams of U.S. software engineers with Indian supervisors. Other companies such as Aldi take advantage of the global scope.

ConAgra learned the importance to its customers of keeping its Banquet frozen dinners priced at $1.

Aldi

Aldi Germany's Aldi follows a simple formula globally. It stocks only about 1,000 of the most popular everyday grocery and household items, compared with more than 20,000 at a traditional grocer such as Royal Ahold's Albert Heijn. Almost all the products carry Aldi's own exclusive label. Because it sells so few items, Aldi can exert strong control over quality and price and simplify shipping and handling, leading to high margins. With more than 8,200 stores worldwide currently, Aldi brings in almost $60 billion in annual sales.[47]

Step 4: Analyzing Competitors' Costs, Prices, and Offers

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

The introduction or change of any price can provoke a response from customers, competitors, distributors, suppliers, and even government. Competitors are most likely to react when the number of firms is few, the product is homogeneous, and buyers are highly informed. Competitor reactions can be a special problem when these firms have a strong value proposition, as Green Works did.

Green Works

Green Works Although the natural cleaner market was pioneered by Seventh Generation and method cleaning products, Clorox Green Works now commands 42 percent market share. The Green Works product line consists of 10 natural cleaners using biodegradable ingredients, packaged in recyclable materials, and not tested on animals. The first major new Clorox brand in more than 20 years, it doubled the size of the natural cleaning category with its strategy of "delivering a line of affordable products that are good for consumers, good for retailers, and good for the environment." The company charges only a 10 percent to 20 percent premium over conventional cleaners, versus the premium of 40 percent or more charged by other natural cleaners. Launch marketing efforts included the use of viral marketing and social media, prominent TV coverage in shows like *Ellen* and *Oprah*, collaborations with retail customers such as Safeway and Walmart in product development and in-store promotion, and an endorsement from and cause marketing program with the Sierra Club (resulting in a donation of $645,000 to the organization in 2009).[48]

How can a firm anticipate a competitor's reactions? One way is to assume the competitor reacts in the standard way to a price being set or changed. Another is to assume the competitor treats each price difference or change as a fresh challenge and reacts according to self-interest at the time. Now the company will need to research the competitor's current financial situation, recent sales, customer loyalty, and corporate objectives. If the competitor has a market share objective, it is likely to match price differences or changes.[49] If it has a profit-maximization objective, it may react by increasing its advertising budget or improving product quality.

The problem is complicated because the competitor can put different interpretations on lowered prices or a price cut: that the company is trying to steal the market, that it is doing poorly and trying to boost its sales, or that it wants the whole industry to reduce prices to stimulate total demand.

|Fig. 14.4|

The Three Cs Model for Price Setting

Step 5: Selecting a Pricing Method

Given the customers' demand schedule, the cost function, and competitors' prices, the company is now ready to select a price. Figure 14.4 summarizes the three major considerations in price setting: Costs set a floor to the price. Competitors' prices and the price of substitutes provide an orienting point. Customers' assessment of unique features establishes the price ceiling.

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

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

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

Suppose a toaster manufacturer has the following costs and sales expectations:
The manufacturer's unit cost is given by:

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

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

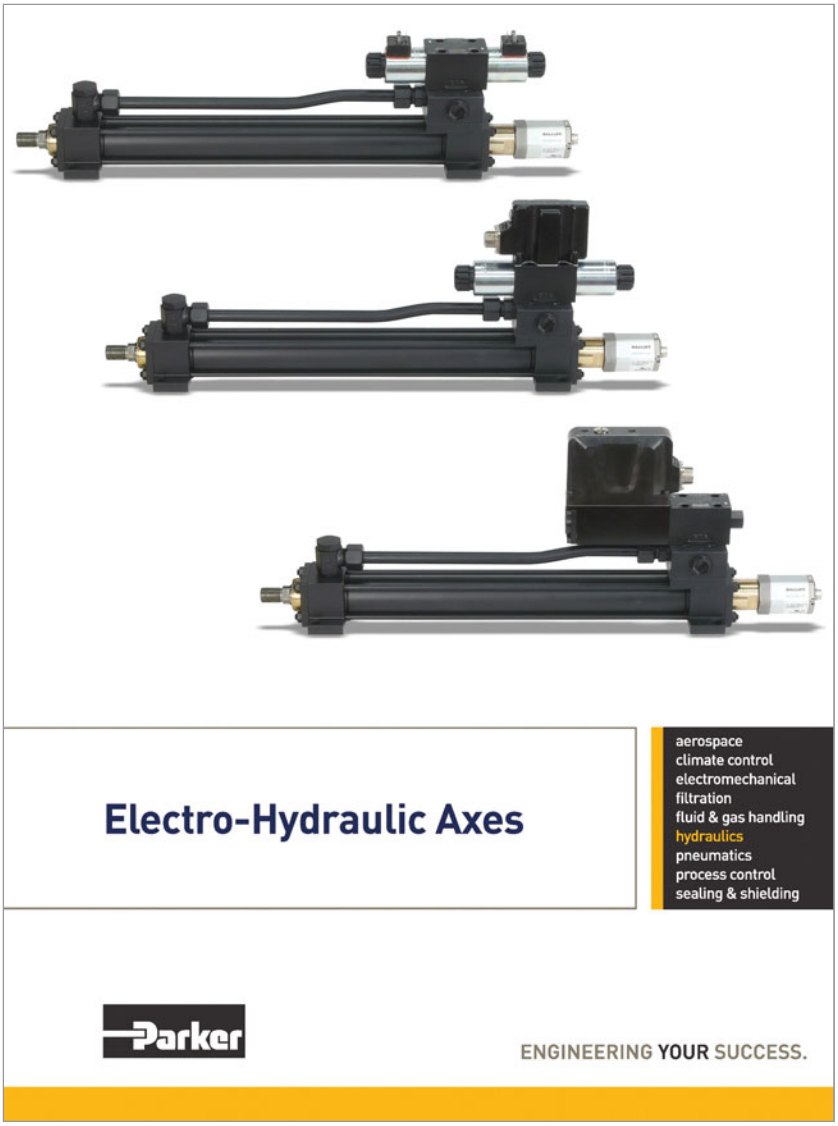
$$\text{Markup price} = \frac{\text{unit cost}}{(1 - \text{desired return on sales})} = \frac{\$16}{1 - 0.2} = \$20$$

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

Does the use of standard markups make logical sense? Generally, no. Any pricing method that ignores current demand, perceived value, and competition is not likely to lead to the optimal price. Markup pricing works only if the marked-up price actually brings in the expected level of sales. Consider what happened at Parker Hannifin.

Parker Hannifin When Donald Washkewicz took over as CEO of Parker Hannifin, maker of 800,000 industrial parts for the aerospace, transportation, and manufacturing industries, pricing was done one way: Calculate how much it costs to make and deliver a product and then add a flat percentage (usually 35 percent). Even though this method was historically well received, Washkewicz set out to get the company to think more like a retailer and charge what customers were willing to pay. Encountering initial resistance from some of the company's 115 different divisions, Washkewicz assembled a list of the 50 most commonly given reasons why the new pricing scheme would fail and announced he would listen only to arguments that were not on the list. The new pricing scheme put Parker Hannifin's products into one of four categories depending on how much competition existed. About one-third fell into niches where Parker offered unique value, there was little competition, and higher prices were appropriate. Each division now has a pricing guru or specialist who assists in strategic pricing. The division making industrial fittings reviewed 2,000 different items and concluded that 28 percent were priced too low, raising prices anywhere from 3 percent to 60 percent.[50]

Still, markup pricing remains popular. First, sellers can determine costs much more easily than they can estimate demand. By tying the price to cost, sellers simplify the pricing task. Second, where



With a stronger focus on customer value and competitive pressures, Parker Hannifin was able to simplify its approach to the pricing of its thousands of products.

all firms in the industry use this pricing method, prices tend to be similar and price competition is minimized. Third, many people feel that cost-plus pricing is fairer to both buyers and sellers. Sellers do not take advantage of buyers when the latter's demand becomes acute, and sellers earn a fair return on investment.

TARGET-RETURN PRICING In **target-return pricing**, the firm determines the price that yields its target rate of return on investment. Public utilities, which need to make a fair return on investment, often use this method.

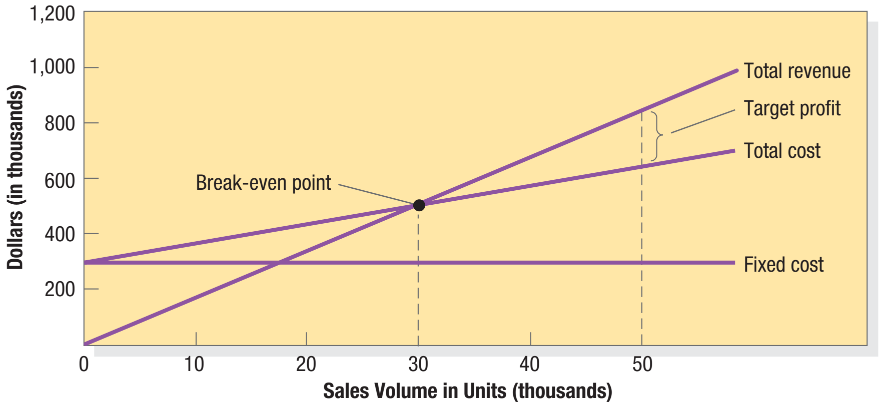
Suppose the toaster manufacturer has invested $1 million in the business and wants to set a price to earn a 20 percent ROI, specifically $200,000. The target-return price is given by the following formula:

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

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

|Fig. 14.5|

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



The manufacturer will realize this 20 percent ROI provided its costs and estimated sales turn out to be accurate. But what if sales don't reach 50,000 units? The manufacturer can prepare a break-even chart to learn what would happen at other sales levels (see Figure 14.5). Fixed costs are $300,000 regardless of sales volume. Variable costs, not shown in the figure, rise with volume. Total costs equal the sum of fixed and variable costs. The total revenue curve starts at zero and rises with each unit sold.

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

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

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

The manufacturer should also search for ways to lower its fixed or variable costs, because lower costs will decrease its required break-even volume. Acer has been gaining share in the netbook market through rock-bottom prices made possible because of its bare-bones cost strategy. Acer sells only via retailers and other outlets and outsources all manufacturing and assembly, reducing its overhead to 8 percent of sales versus 14 percent at Dell and 15 percent at HP.[51]

PERCEIVED-VALUE PRICING An increasing number of companies now base their price on the customer's **perceived value**. Perceived value is made up of a host of inputs, such as the buyer's image of the product performance, the channel deliverables, the warranty quality, customer support, and softer attributes such as the supplier's reputation, trustworthiness, and esteem. Companies must deliver the value promised by their value proposition, and the customer must perceive this value. Firms use the other marketing program elements, such as advertising, sales force, and the Internet, to communicate and enhance perceived value in buyers' minds.[52]

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

$90,000	is the tractor's price if it is only equivalent to the competitor's tractor
$7,000	is the price premium for Caterpillar's superior durability
$6,000	is the price premium for Caterpillar's superior reliability
$5,000	is the price premium for Caterpillar's superior service

$2,000	is the price premium for Caterpillar's longer warranty on parts
$110,000	is the normal price to cover Caterpillar's superior value
– $10,000	discount
$100,000	final price

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

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

PACCAR PACCAR Inc., maker of Kenworth and Peterbilt trucks, is able to command a 10 percent premium through its relentless focus on all aspects of the customer experience to maximize total value. Contract Freighters trucking company, a loyal PACCAR customer for 20 years, justified ordering another 700 new trucks, despite their higher price, because of their higher perceived quality—greater reliability, higher trade-in value, even the superior plush interiors that might attract better drivers. PACCAR bucks the commoditization trend by custom-building its trucks to individual specifications. The company invests heavily in technology and can prototype new parts in hours versus days and weeks, allowing more frequent upgrades. PACCAR was the first to roll out hybrid vehicles in the fuel-intensive commercial trucking industry (and sell at a premium). The company generated $1 billion of profit on $15 billion of revenue in 2008—its 70th consecutive year of profitability—bolstered by record European sales and $2.3 billion in sales of aftermarket parts.[53]

Because of its high standards for quality and continual innovation, PACCAR can charge a premium for its trucks.

Even when a company claims its offering delivers more total value, not all customers will respond positively. Some care only about price. But there is also typically a segment that cares about quality. The makers of Stag umbrellas in India—umbrellas are essential in the three months of near-nonstop monsoon rain in cities such as Mumbai—found themselves in a bitter price war with cheaper Chinese competitors. After realizing they were sacrificing quality too much, Stag's managers decided to increase quality with new colors, designs, and features such as built-in high-power flashlights and prerecorded music. Despite higher prices, sales of the improved Stag umbrellas actually increased.[54]

The key to perceived-value pricing is to deliver more unique value than the competitor and to demonstrate this to prospective buyers. Thus a company needs to fully understand the customer's decision-making process. For example, Goodyear found it hard to command a price premium for its more expensive new tires despite innovative new features to extend tread life. Because consumers had no reference price to compare tires, they tended to gravitate toward the lowest-priced offerings. Goodyear's solution was to price its models on expected miles of wear rather than their technical product features, making product comparisons easier.[55]

The company can try to determine the value of its offering in several ways: managerial judgments within the company, value of similar products, focus groups, surveys, experimentation, analysis of historical data, and conjoint analysis.[56] Table 14.4 contains six key considerations in developing value-based pricing.

VALUE PRICING In recent years, several companies have adopted **value pricing**: They win loyal customers by charging a fairly low price for a high-quality offering. Value pricing is thus not a

TABLE 14.4 A Framework of Questions for Practicing Value-Based Pricing

1.	What is the market strategy for the segment? (What does the supplier want to accomplish? What would the supplier like to have happen?)
2.	What is the differential value that is *transparent* to target customers? (*Transparent* means that target customers easily understand how the supplier calculates the differential value between its offering and the next best alternative, and that the differential value can be verified with the customer's own data.)
3.	What is the price of the next best alternative offering?
4.	What is the cost of the supplier's market offering?
5.	What pricing tactics will be used initially or eventually? ("Pricing tactics" are changes from a price that a supplier has set for its marketing offering—such as discounts—that motivate customers to take actions that benefit the supplier.)
6.	What is the customer's expectation of a "fair" price?

Source: James C. Anderson, Marc Wouters, and Wouter Van Rossum, "Why the Highest Price Isn't the Best Price," *MIT Sloan Management Review* (Winter 2010), pp. 69–76.

matter of simply setting lower prices; it is a matter of reengineering the company's operations to become a low-cost producer without sacrificing quality, to attract a large number of value-conscious customers.

Among the best practitioners of value pricing are IKEA, Target, and Southwest Airlines. In the early 1990s, Procter & Gamble created quite a stir when it reduced prices on supermarket staples such as Pampers and Luvs diapers, liquid Tide detergent, and Folgers coffee to value price them. To do so, P&G redesigned the way it developed, manufactured, distributed, priced, marketed, and sold products to deliver better value at every point in the supply chain.[57] Its acquisition of Gillette in 2005 for $57 billion (a record five times its sales) brought another brand into its fold that has also traditionally adopted a value pricing strategy.

Gillette

Gillette In 2006, Gillette launched the "best shave on the planet" with the six-bladed Fusion—five blades in the front for regular shaving and one in the back for trimming—in both power and nonpower versions. Gillette conducts exhaustive consumer research in designing its new products and markets aggressively to spread the word. The company spent over $1.2 billion on research and development after the Fusion's predecessor, the Mach3, was introduced. About 9,000 men tested potential new products and preferred the new Fusion over the Mach3 by a two-to-one margin. To back the introduction, Procter & Gamble spent $200 million in the United States and over $1 billion worldwide. The payoff? Gillette enjoys enormous market leadership in the razor and blade categories, with 70 percent of the global market, and sizable price premiums. Refills for the Fusion Power cost $14 for a four-pack, compared to $5.29 for a five-pack of Sensor Excel. All this adds up to significant, sustained profitability for corporate owner P&G.[58]

Value pricing can change the manner by which a company sets prices too. One company that sold and maintained switch boxes in a variety of sizes for telephone lines found that the probability of failure—and thus maintenance costs—was proportional to the number of switches customers had in their boxes rather than to the dollar value of the installed boxes. The number of switches could vary in a box, though. Therefore, rather than charging customers based on the total spent on their installation, the company began charging based on the total number of switches needing servicing.[59]

An important type of value pricing is **everyday low pricing (EDLP)**. A retailer that holds to an EDLP pricing policy charges a constant low price with little or no price promotions and special sales. Constant prices eliminate week-to-week price uncertainty and the "high-low" pricing of promotion-oriented competitors. In **high-low pricing**, the retailer charges higher prices on an everyday basis but runs frequent promotions with prices temporarily lower than the EDLP level.[60] These two strategies have been shown to affect consumer price judgments—deep discounts (EDLP) can lead customers to perceive lower prices over time than frequent, shallow discounts (high-low), even if the actual averages are the same.[61]

In recent years, high-low pricing has given way to EDLP at such widely different venues as Toyota Scion car dealers and upscale department stores such as Nordstrom, but the king of EDLP is surely Walmart, which practically defined the term. Except for a few sale items every month, Walmart promises everyday low prices on major brands.

EDLP provides customer benefits of time and money. Toyota believes its Gen Y target dislikes haggling because it takes too long. These buyers collect a lot of information online anyway, so Toyota cut the time to sell Scions from the industry average of 4.5 hours to 45 minutes requiring fewer managers to approve negotiated prices and less advertising of sales.[62] Some retailers base their entire marketing strategy around *extreme* everyday low pricing.

Dollar Stores Once-unfashionable "dollar stores" such as Dollar General, Family Dollar, Big Lots, and Dollar Tree are gaining popularity, partly fueled by an economic downturn. In 2008, these four biggest players in the category generated $26 billion in sales with 20,000 stores and gross margins of 35 percent to 40 percent. These ultradiscounters are not dollar stores in a strict sense of the word—they sell many items over $1, although most are under $10. They have, however, developed a simple, successful formula for drawing shoppers from Target and even Walmart: Build small, easy-to-navigate stores in expensive real estate locations with parking handy; keep overhead low by limiting inventory to mostly inexpensive overstocks, odd lots, and buyouts; and spend sparingly on store décor and get free word-of-mouth publicity. Because most customers pay in person and in cash, dollar stores can avoid the expense of processing a lot of credit card purchases and elaborate Internet marketing or supporting a significant e-commerce presence online.[63]

The most important reason retailers adopt EDLP is that constant sales and promotions are costly and have eroded consumer confidence in everyday shelf prices. Consumers also have less time and patience for past traditions like watching for supermarket specials and clipping coupons. Yet, promotions do create excitement and draw shoppers, so EDLP does not guarantee success. As supermarkets face heightened competition from their counterparts and alternative channels, many find the key is a combination of high-low and everyday low pricing strategies, with increased advertising and promotions.

Even though not everything it sells costs less than a dollar, Family Dollar has become one of the hottest retailers in recent years.

GOING-RATE PRICING In **going-rate pricing**, the firm bases its price largely on competitors' prices. In oligopolistic industries that sell a commodity such as steel, paper, or fertilizer, all firms normally charge the same price. Smaller firms "follow the leader," changing their prices when the market leader's prices change rather than when their own demand or costs change. Some may charge a small premium or discount, but they preserve the difference. Thus minor gasoline retailers usually charge a few cents less per gallon than the major oil companies, without letting the difference increase or decrease.

Going-rate pricing is quite popular. Where costs are difficult to measure or competitive response is uncertain, firms feel the going price is a good solution because it is thought to reflect the industry's collective wisdom.

AUCTION-TYPE PRICING Auction-type pricing is growing more popular, especially with scores of electronic marketplaces selling everything from pigs to used cars as firms dispose of excess inventories or used goods. These are the three major types of auctions and their separate pricing procedures:

- ***English auctions (ascending bids)*** have one seller and many buyers. On sites such as eBay and Amazon.com, the seller puts up an item and bidders raise the offer price until the top price is reached. The highest bidder gets the item. English auctions are used today for selling antiques, cattle, real estate, and used equipment and vehicles. After watching eBay and other ticket brokers, scalpers, and middlemen reap millions by charging what the market would bear, Ticketmaster has overhauled the way it sells tickets to try to gain more of the multi-billion-dollar ticket resale industry. It now runs auctions for 30 percent of major music tours including popular artists such as Christina Aguilera and Madonna and allows some customers to resell their seats on its Web site.[64]
- ***Dutch auctions (descending bids)*** feature one seller and many buyers, or one buyer and many sellers. In the first kind, an auctioneer announces a high price for a product and then slowly decreases the price until a bidder accepts. In the other, the buyer announces something he or she wants to buy, and potential sellers compete to offer the lowest price. FreeMarkets.com—later acquired by Ariba—helped Royal Mail Group plc, the United Kingdom's public mail service company, save approximately £2.5 million (almost $4 million), in part via an auction where 25 airlines bid for its international freight business.[65]
- ***Sealed-bid auctions*** let would-be suppliers submit only one bid; they cannot know the other bids. The U.S. government often uses this method to procure supplies. A supplier will not bid below its cost but cannot bid too high for fear of losing the job. The net effect of these two pulls is the bid's *expected profit*.[66]

To buy equipment for its drug researchers, Pfizer uses reverse auctions in which suppliers submit online the lowest price they are willing to be paid. If the increased savings a firm obtains in an online auction translates into decreased margins for an incumbent supplier, however, the supplier may feel the firm is opportunistically squeezing out price concessions.[67] Online auctions with a large number of bidders, greater economic stakes, and less visibility in pricing result in greater overall satisfaction, more positive future expectations, and fewer perceptions of opportunism.

Step 6: Selecting the Final Price

Pricing methods narrow the range from which the company must select its final price. In selecting that price, the company must consider additional factors, including the impact of other marketing activities, company pricing policies, gain-and-risk-sharing pricing, and the impact of price on other parties.

IMPACT OF OTHER MARKETING ACTIVITIES The final price must take into account the brand's quality and advertising relative to the competition. In a classic study, Paul Farris and David Reibstein examined the relationships among relative price, relative quality, and relative advertising for 227 consumer businesses and found the following:[68]

- Brands with average relative quality but high relative advertising budgets could charge premium prices. Consumers were willing to pay higher prices for known rather than for unknown products.
- Brands with high relative quality and high relative advertising obtained the highest prices. Conversely, brands with low quality and low advertising charged the lowest prices.
- For market leaders, the positive relationship between high prices and high advertising held most strongly in the later stages of the product life cycle.

These findings suggest that price is not necessarily as important as quality and other benefits.

COMPANY PRICING POLICIES The price must be consistent with company pricing policies. Yet companies are not averse to establishing pricing penalties under certain circumstances.[69]

Airlines charge $150 to those who change their reservations on discount tickets. Banks charge fees for too many withdrawals in a month or early withdrawal of a certificate of deposit. Dentists, hotels, car rental companies, and other service providers charge penalties for no-shows who miss appointments or reservations. Although these policies are often justifiable, marketers must use them judiciously and not unnecessarily alienate customers. (See "Marketing Insight: Stealth Price Increases.")

Many companies set up a pricing department to develop policies and establish or approve decisions. The aim is to ensure that salespeople quote prices that are reasonable to customers and profitable to the company.

Marketing Insight

Stealth Price Increases

With consumers resisting higher prices, companies are trying to figure out how to increase revenue without really raising prices. They often resort to adding fees for once-free features. Although some consumers abhor "nickel-and-dime" pricing strategies, small additional charges can add up to a substantial source of revenue.

The numbers can be staggering. The telecommunications industry has been aggressive at adding fees for setup, change-of-service, service termination, directory assistance, regulatory assessment, number portability, and cable hookup and equipment, costing consumers billions of dollars. Fees for consumers who pay bills online, bounce checks, or use automated teller machines bring banks billions of dollars annually.

When credit card companies were faced with a set of reforms in 2009 to some of their most reviled practices—including abrupt interest rate changes and late payment fees—they responded with new ways to raise revenue, such as rate floors for variable rate cards, higher penalty fees for overdue payments at lower balance thresholds, and inactivity fees for not using cards.

This explosion of fees has a number of implications. Given that list prices stay fixed, they may understate inflation. They also make it harder for consumers to compare competitive offerings. Although various citizens' groups have tried to pressure companies to roll back some of these fees, they don't always get a sympathetic ear from state and local governments, which have been guilty of using their own array of fees, fines, and penalties to raise necessary revenue.

Companies justify the extra fees as the only fair and viable way to cover expenses without losing customers. Many argue that it makes sense to charge a premium for added services that cost more to provide, rather than charging all customers the same amount whether or not they use the extra service. Breaking out charges and fees according to the related services is a way to keep basic costs low. Companies also use fees as a means to weed out unprofitable customers or get them to change their behavior.

Ultimately, the viability of extra fees will be decided in the marketplace, and by the willingness of consumers to vote with their wallets and pay the fees, or vote with their feet and move on.

Sources: Alexis Leondis and Jeff Plungis, "The Latest Credit Card Tricks," *Bloomberg BusinessWeek*, December 28, 2009 & January 4, 2010, p. 95; Brian Burnsed, "A New Front in the Credit Card Wars," *BusinessWeek*, November 9, 2009, p. 60; Kathy Chu, "Credit Card Fees Can Suck You In," *USA Today,* December 15, 2006; Michael Arndt, "Fees! Fees! Fees!" *BusinessWeek,* September 29, 2003, pp. 99–104; "The Price Is Wrong," *Economist,* May 25, 2002, pp. 59–60.

GAIN-AND-RISK-SHARING PRICING Buyers may 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. Some recent risk-sharing applications include big computer hardware purchases and health plans for big unions.

Baxter Healthcare, a leading medical products firm, was able to secure a contract for an information management system from Columbia/HCA, a leading health care provider, by guaranteeing the firm several million dollars in savings over an eight-year period. An increasing number of companies, especially business marketers who promise great savings with their equipment, may have to stand ready to guarantee the promised savings but also participate in the upside if the gains are much greater than expected.

IMPACT OF PRICE ON OTHER PARTIES How will distributors and dealers feel about the contemplated price?[70] If they don't make enough profit, they may choose not to bring the product to market. Will the sales force be willing to sell at that price? How will competitors react? Will suppliers raise their prices when they see the company's price? Will the government intervene and prevent this price from being charged?

U.S. legislation states that sellers must set prices without talking to competitors: Price-fixing is illegal. Many federal and state statutes protect consumers against deceptive pricing practices. For example, it is illegal for a company to set artificially high "regular" prices, then announce a "sale" at prices close to previous everyday prices.

Adapting the Price

Companies usually do not set a single price but rather develop a pricing structure that reflects variations in geographical demand and costs, market-segment requirements, purchase timing, order levels, delivery frequency, guarantees, service contracts, and other factors. As a result of discounts, allowances, and promotional support, a company rarely realizes the same profit from each unit of a product that it sells. Here we will examine several price-adaptation strategies: geographical pricing, price discounts and allowances, promotional pricing, and differentiated pricing.

Geographical Pricing (Cash, Countertrade, Barter)

In geographical pricing, the company decides how to price its products to different customers in different locations and countries. Should the company charge higher prices to distant customers to cover the higher shipping costs, or a lower price to win additional business? How should it account for exchange rates and the strength of different currencies?

Another question is how to get paid. This issue is critical when buyers lack sufficient hard currency to pay for their purchases. Many buyers want to offer other items in payment, a practice known as **countertrade**. U.S. companies are often forced to engage in countertrade if they want the business. Countertrade may account for 15 percent to 20 percent of world trade and takes several forms:[71]

- ***Barter.*** The buyer and seller directly exchange goods, with no money and no third party involved.
- ***Compensation deal.*** The seller receives some percentage of the payment in cash and the rest in products. A British aircraft manufacturer sold planes to Brazil for 70 percent cash and the rest in coffee.
- ***Buyback arrangement.*** The seller sells a plant, equipment, or technology to another country and agrees to accept as partial payment products manufactured with the supplied equipment. A U.S. chemical company built a plant for an Indian company and accepted partial payment in cash and the remainder in chemicals manufactured at the plant.
- ***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. PepsiCo sold its cola syrup to Russia for rubles and agreed to buy Russian vodka at a certain rate for sale in the United States.

Price Discounts and Allowances

Most companies will adjust their list price and give discounts and allowances for early payment, volume purchases, and off-season buying (see Table 14.5).[72] Companies must do this carefully or find that their profits are much lower than planned.[73]

TABLE 14.5 Price Discounts and Allowances

Discount:	A price reduction to buyers who pay bills promptly. A typical example is "2/10, net 30," which means that payment is due within 30 days and that the buyer can deduct 2 percent by paying the bill within 10 days.
Quantity Discount:	A price reduction to those who buy large volumes. A typical example is "$10 per unit for fewer than 100 units; $9 per unit for 100 or more units." Quantity discounts must be offered equally to all customers and must not exceed the cost savings to the seller. They can be offered on each order placed or on the number of units ordered over a given period.
Functional Discount:	Discount (also called *trade discount*) offered by a manufacturer to trade-channel members if they will perform certain functions, such as selling, storing, and record keeping. Manufacturers must offer the same functional discounts within each channel.
Seasonal Discount:	A price reduction to those who buy merchandise or services out of season. Hotels, motels, and airlines offer seasonal discounts in slow selling periods.
Allowance:	An extra payment designed to gain reseller participation in special programs. *Trade-in allowances* are granted for turning in an old item when buying a new one. *Promotional allowances* reward dealers for participating in advertising and sales support programs.

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

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

Only people with higher incomes and higher product involvement willingly pay more for features, customer service, quality, added convenience, and the brand name. So it can be a mistake for a strong, distinctive brand to plunge into price discounting to respond to low-price attacks. At the same time, discounting can be a useful tool if a company can gain concessions in return, such as the customer agreeing to sign a longer contract, order electronically, or buy in truckload quantities.

Sales management needs to monitor the proportion of customers receiving discounts, the average discount, and any salespeople over-relying on discounting. Higher levels of management should conduct a **net price analysis** to arrive at the "real price" of the offering. The real price is affected not only by discounts, but by other expenses that reduce the realized price (see "Promotional Pricing"). Suppose the company's list price is $3,000. The average discount is $300. The company's promotional spending averages $450 (15 percent of the list price). Retailers are given co-op advertising money of $150 to back the product. The company's net price is $2,100, not $3,000.

Promotional Pricing

Companies can use several pricing techniques to stimulate early purchase:

- ***Loss-leader pricing.*** Supermarkets and department stores often drop the price on well-known brands to stimulate additional store traffic. This pays if the revenue on the additional sales compensates for the lower margins on the loss-leader items. Manufacturers of loss-leader brands typically object because this practice can dilute the brand image and bring complaints from retailers who charge the list price. Manufacturers have tried to keep intermediaries from using loss-leader pricing through lobbying for retail-price-maintenance laws, but these laws have been revoked.
- ***Special event pricing.*** Sellers will establish special prices in certain seasons to draw in more customers. Every August, there are back-to-school sales.
- ***Special customer pricing.*** Sellers will offer special prices exclusively to certain customers. Road Runner Sports offers members of its Run America Club "exclusive" online offers with price discounts twice those for regular customers.[74]
- ***Cash rebates.*** Auto companies and other consumer-goods companies offer cash rebates to encourage purchase of the manufacturers' products within a specified time period. Rebates can help clear inventories without cutting the stated list price.
- ***Low-interest financing.*** Instead of cutting its price, the company can offer customers low-interest financing. Automakers have used no-interest financing to try to attract more customers.
- ***Longer payment terms.*** Sellers, especially mortgage banks and auto companies, stretch loans over longer periods and thus lower the monthly payments. Consumers often worry less about the cost (the interest rate) of a loan, and more about whether they can afford the monthly payment.
- ***Warranties and service contracts.*** Companies can promote sales by adding a free or low-cost warranty or service contract.
- ***Psychological discounting.*** This strategy sets an artificially high price and then offers the product at substantial savings; for example, "Was $359, now $299." Discounts from normal prices are a legitimate form of promotional pricing; the Federal Trade Commission and Better Business Bureaus fight illegal discount tactics.

Promotional-pricing strategies are often a zero-sum game. If they work, competitors copy them and they lose their effectiveness. If they don't work, they waste money that could have been put into other marketing tools, such as building up product quality and service or strengthening product image through advertising.

Differentiated Pricing

Companies often adjust their basic price to accommodate differences in customers, products, locations, and so on. Lands' End creates men's shirts in many different styles, weights, and levels of quality. As of January 2010, a men's white button-down shirt could cost as little as $14.99 or as much as $79.50.[75]

Price discrimination occurs when a company sells a product or service at two or more prices that do not reflect a proportional difference in costs. In first-degree price discrimination, the seller charges a separate price to each customer depending on the intensity of his or her demand.

In second-degree price discrimination, the seller charges less to buyers of larger volumes. With certain services such as cell phone service, however, tiered pricing results in consumers paying *more* with higher levels of usage. With the iPhone, 3 percent of users accounted for 40 percent of the traffic on AT&T's network, resulting in costly network upgrades.[76]

In third-degree price discrimination, the seller charges different amounts to different classes of buyers, as in the following cases:

- ***Customer-segment pricing.*** Different customer groups pay different prices for the same product or service. For example, museums often charge a lower admission fee to students and senior citizens.
- ***Product-form pricing.*** Different versions of the product are priced differently, but not proportionately to their costs. Evian prices a 48-ounce bottle of its mineral water at $2.00 and 1.7 ounces of the same water in a moisturizer spray at $6.00.
- ***Image pricing.*** Some companies price the same product at two different levels based on image differences. A perfume manufacturer can put the perfume in one bottle, give it a name and image, and price it at $10 an ounce. The same perfume in another bottle with a different name and image and price can sell for $30 an ounce.
- ***Channel pricing.*** Coca-Cola carries a different price depending on whether the consumer purchases it in a fine restaurant, a fast-food restaurant, or a vending machine.
- ***Location pricing.*** The same product is priced differently at different locations even though the cost of offering it at each location is the same. A theater varies its seat prices according to audience preferences for different locations.
- ***Time pricing.*** Prices are varied by season, day, or hour. Public utilities vary energy rates to commercial users by time of day and weekend versus weekday. Restaurants charge less to "early bird" customers, and some hotels charge less on weekends.

The airline and hospitality industries use yield management systems and **yield pricing**, by which they offer discounted but limited early purchases, higher-priced late purchases, and the lowest rates on unsold inventory just before it expires.[77] Airlines charge different fares to passengers on the same flight, depending on the seating class; the time of day (morning or night coach); the day of the week (workday or weekend); the season; the person's employer, past business, or status (youth, military, senior citizen); and so on.

That's why on a flight from New York City to Miami you might pay $200 and sit across from someone who paid $1,290. Continental Airlines launches 2,000 flights a day and each has between 10 and 20 prices. The carrier starts booking flights 330 days in advance, and every flying day is different from every other flying day. At any given moment the market has more than 7 million prices. And in a system that tracks the difference in prices and the price of competitors' offerings, airlines collectively charge 75,000 different prices a day! It's a system designed to punish procrastinators by charging them the highest possible prices.

The phenomenon of offering different pricing schedules to different consumers and dynamically adjusting prices is exploding.[78] Many companies are using software packages that provide real-time controlled tests of actual consumer response to different pricing schedules. Constant price variation can be tricky, however, where consumer relationships are concerned. Research shows it's most effective when there's no bond between the buyer and the seller. One way to make it work is to offer customers a unique bundle of products and services to meet their needs precisely, making it harder to make price comparisons.

The tactic most companies favor, however, is to use variable prices as a reward rather than a penalty. For instance, shipping company APL rewards customers who can better predict how much cargo space they'll need with cheaper rates for booking early. Customers are also getting savvier about how to avoid buyer's remorse from overpaying. They are changing their buying behavior to

The likelihood is extremely high that every passenger shown in this airport lobby is paying a different price, even if they are all on the same flight.

accommodate the new realities of dynamic pricing—where prices vary frequently by channels, products, customers, and time.

Most consumers are probably not even aware of the degree to which they are the targets of discriminatory pricing. For instance, catalog retailers such as Victoria's Secret routinely send out catalogs that sell identical goods at different prices. Consumers who live in a more free-spending zip code may see only the higher prices. Office product superstore Staples also sends out office supply catalogs with different prices.

Although some forms of price discrimination (in which sellers offer different price terms to different people within the same trade group) are illegal, price discrimination is legal if the seller can prove its costs are different when selling different volumes or different qualities of the same product to different retailers. Predatory pricing—selling below cost with the intention of destroying competition—is unlawful, though.[79]

For price discrimination to work, certain conditions must exist. First, the market must be segmentable and the segments must show different intensities of demand. Second, members in the lower-price segment must not be able to resell the product to the higher-price segment. Third, competitors must not be able to undersell the firm in the higher-price segment. Fourth, the cost of segmenting and policing the market must not exceed the extra revenue derived from price discrimination. Fifth, the practice must not breed customer resentment and ill will. Sixth, of course, the particular form of price discrimination must not be illegal.[80]

Initiating and Responding to Price Changes

Companies often need to cut or raise prices.

Initiating Price Cuts

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

Cutting prices to keep customers or beat competitors often encourages customers to demand price concessions, however, and trains salespeople to offer them.[81] A price-cutting strategy can lead to other possible traps:

- ***Low-quality trap.*** Consumers assume quality is low.
- ***Fragile-market-share trap.*** A low price buys market share but not market loyalty. The same customers will shift to any lower-priced firm that comes along.
- ***Shallow-pockets trap.*** Higher-priced competitors match the lower prices but have longer staying power because of deeper cash reserves.
- ***Price-war trap.*** Competitors respond by lowering their prices even more, triggering a price war.[82]

Customers often question the motivation behind price changes.[83] They may assume the item is about to be replaced by a new model; the item is faulty and is not selling well; the firm is in financial trouble; the price will come down even further; or the quality has been reduced. The firm must monitor these attributions carefully.

Initiating Price Increases

A successful price increase can raise profits considerably. If the company's profit margin is 3 percent of sales, a 1 percent price increase will increase profits by 33 percent if sales volume is unaffected. This situation is illustrated in Table 14.6. The assumption is that a company charged $10 and sold 100 units and had costs of $970, leaving a profit of $30, or 3 percent on sales. By raising its price by 10 cents (a 1 percent price increase), it boosted its profits by 33 percent, assuming the same sales volume.

A major circumstance provoking price increases is *cost inflation.* Rising costs unmatched by productivity gains squeeze profit margins and lead companies to regular rounds of price increases. Companies often raise their prices by more than the cost increase, in anticipation of further inflation or government price controls, in a practice called *anticipatory pricing.*

Another factor leading to price increases is *overdemand.* When a company cannot supply all its customers, it can raise its prices, ration supplies, or both. It can increase price in the following ways, each of which has a different impact on buyers.

- ***Delayed quotation pricing.*** The company does not set a final price until the product is finished or delivered. This pricing is prevalent in industries with long production lead times, such as industrial construction and heavy equipment.
- ***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, such as aircraft construction and bridge building.
- ***Unbundling.*** The company 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. Car companies sometimes add higher-end audio entertainment systems or GPS navigation systems as extras to their vehicles.
- ***Reduction of discounts.*** The company instructs its sales force not to offer its normal cash and quantity discounts.

TABLE 14.6 Profits Before and After a Price Increase

	Before	After	
Price	$10	$10.10	(a 1% price increase)
Units sold	100	100	
Revenue	$1,000	$1,010	
Costs	–970	–970	
Profit	$30	$40	(a 33 1/3% profit increase)

Although there is always a chance a price increase can carry some positive meanings to customers—for example, that the item is "hot" and represents an unusually good value—consumers generally dislike higher prices. In passing price increases on to customers, the company must avoid looking like a price gouger.[84] Coca-Cola's proposed smart vending machines that would raise prices as temperatures rose and Amazon.com's dynamic pricing experiment that varied prices by purchase occasion both became front-page news. The more similar the products or offerings from a company, the more likely consumers are to interpret any pricing differences as unfair. Product customization and differentiation and communications that clarify differences are thus critical.[85]

Generally, consumers prefer small price increases on a regular basis to sudden, sharp increases. Their memories are long, and they can turn against companies they perceive as price gougers. Price hikes without corresponding investments in the value of the brand increase vulnerability to lower-priced competition. Consumers may be willing to "trade down" because they can no longer convince themselves the higher-priced brand is worth it.

Several techniques help consumers avoid sticker shock and a hostile reaction when prices rise: One is maintaining a sense of fairness around any price increase, such as by giving customers advance notice so they can do forward buying or shop around. Sharp price increases need to be explained in understandable terms. Making low-visibility price moves first is also a good technique: Eliminating discounts, increasing minimum order sizes, and curtailing production of low-margin products are examples, and contracts or bids for long-term projects should contain escalator clauses based on such factors as increases in recognized national price indexes.[86]

Given strong consumer resistance, marketers go to great lengths to find alternate approaches that avoid increasing prices when they otherwise would have done so. Here are a few popular ones.

- Shrinking the amount of product instead of raising the price. (Hershey Foods maintained its candy bar price but trimmed its size. Nestlé maintained its size but raised the price.)
- Substituting less-expensive materials or ingredients. (Many candy bar companies substituted synthetic chocolate for real chocolate to fight cocoa price increases.)
- Reducing or removing product features. (Sears engineered down a number of its appliances so they could be priced competitively with those sold in discount stores.)
- Removing or reducing product services, such as installation or free delivery.
- Using less-expensive packaging material or larger package sizes.
- Reducing the number of sizes and models offered.
- Creating new economy brands. (Jewel food stores introduced 170 generic items selling at 10 percent to 30 percent less than national brands.)

Responding to Competitors' Price Changes

How should a firm respond to a competitor's price cut? In general, the best response varies with the situation. The company must consider the product's stage in the life cycle, its importance in the company's portfolio, the competitor's intentions and resources, the market's price and quality sensitivity, the behavior of costs with volume, and the company's alternative opportunities.

In markets characterized by high product homogeneity, the firm can search for ways to enhance its augmented product. If it cannot find any, it may need to meet the price reduction. If the competitor raises its price in a homogeneous product market, other firms might not match it if the increase will not benefit the industry as a whole. Then the leader will need to roll back the increase.

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

Market leaders often face aggressive price cutting by smaller firms trying to build market share. Using price, Fuji has attacked Kodak, Schick has attacked Gillette, and AMD has attacked Intel.

Brand leaders also face lower-priced store brands. Three possible responses to low-cost competitors are: (1) further differentiate the product or service, (2) introduce a low-cost venture, or (3) reinvent as a low-cost player.[87] The right strategy depends on the ability of the firm to generate more demand or cut costs.

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

Summary

1. Despite the increased role of nonprice factors in modern marketing, price remains a critical element of marketing. Price is the only element that produces revenue; the others produce costs. Pricing decisions have become more challenging, however, in a changing economic and technological environment.
2. In setting pricing policy, a company follows a six-step procedure. It selects its pricing objective. It estimates the demand curve, the probable quantities it will sell at each possible price. It estimates how its costs vary at different levels of output, at different levels of accumulated production experience, and for differentiated marketing offers. It examines competitors' costs, prices, and offers. It selects a pricing method, and it selects the final price.
3. Companies usually set not a single price, but rather a pricing structure that reflects variations in geographical demand and costs, market-segment requirements, purchase timing, order levels, and other factors. Several price-adaptation strategies are available: (1) geographical pricing, (2) price discounts and allowances, (3) promotional pricing, and (4) discriminatory pricing.
4. Firms often need to change their prices. A price decrease might be brought about by excess plant capacity, declining market share, a desire to dominate the market through lower costs, or economic recession. A price increase might be brought about by cost inflation or overdemand. Companies must carefully manage customer perceptions when raising prices.
5. Companies must anticipate competitor price changes and prepare contingent responses. A number of responses are possible in terms of maintaining or changing price or quality.
6. The firm facing a competitor's price change must try to understand the competitor's intent and the likely duration of the change. Strategy often depends on whether a firm is producing homogeneous or nonhomogeneous products. A market leader attacked by lower-priced competitors can seek to better differentiate itself, introduce its own low-cost competitor, or transform itself more completely.

Applications

Marketing Debate

Is the Right Price a Fair Price?

Prices are often set to satisfy demand or to reflect the premium that consumers are willing to pay for a product or service. Some critics shudder, however, at the thought of $2 bottles of water, $150 running shoes, and $500 concert tickets.

Take a position: Prices should reflect the value consumers are willing to pay *versus* Prices should reflect only the cost of making a product or delivering a service.

Marketing Discussion

Pricing Methods

Think about the pricing methods described in this chapter—markup pricing, target-return pricing, perceived-value pricing, value pricing, going-rate pricing, and auction-type pricing. As a consumer, which do you prefer to deal with? Why? If the average price were to stay the same, which would you prefer a firm to do: (1) set one price and not deviate or (2) employ slightly higher prices most of the year but offer slightly discounted prices or specials for certain occasions?

Marketing Excellence

>>eBay

In 1995, Pierre Omidayar, a French-Iranian immigrant, wrote the code for an auction Web site where everyone would have equal access to a single global marketplace. Omidayar couldn't believe it when a collector bought the first item, a broken laser pointer, for $14.83.* Soon the site grew into a broader auction site where consumers could auction collectibles such as baseball cards and Barbie dolls. The momentum continued when individuals and small businesses discovered that eBay was an efficient way to reach new consumers and other businesses. Large companies began using eBay as a means of selling their bulk lots of unsold inventory. Today, people can buy and sell virtually any product or service, on the world's largest online marketplace. From appliances and computers to cars and real estate, sellers can list anything as long as it is not illegal or violates eBay's rules and policies.

eBay's success truly created a pricing revolution by allowing buyers to determine what they would pay for an item; the result pleases both sides because customers gain control and receive the best possible price while sellers make good margins due to the site's efficiency and wide reach. For years, buyers and sellers used eBay as an informal guide to market value. Even a company with a new-product design that wanted to know the going price for anything from a copier to a new DVD player checked on eBay.

eBay has evolved to also offer a fixed-price "buy it now" option to those who don't want to wait for an auction and are willing to pay the seller's price. Sellers can also use the fixed price format with a "best offer" option that allows the seller to counteroffer, reject, or accept an offer.

The impact of eBay's global reach is significant. In 2009, over $60 billion worth of goods was sold on eBay—that's almost $2,000 worth every second. The site has 405 million registered and 90 million active users and receives 81 million unique visitors a month. More than 1 million members make their living from the site. Yet eBay itself doesn't buy any inventory or own the products on its site. It earns its money by collecting fees: an insertion fee for each listing plus a final-value fee based on the auction or fixed price. For example, if an item sells for $60.00, the seller pays 8.75 percent on the first $25.00 ($2.19) plus 3.5 percent on the remaining $35.00 ($1.23). Therefore, the final-value fee for the sale is $3.42. This pricing structure was developed to attract high-volume sellers and deter those who list only a few low-priced items. With eBay's expansion into a wide range of other categories—from boats and cars and travel and tickets to health and beauty and home and garden—collectibles now make up only a small percentage of eBay sales.

eBay's business model is based on connecting individuals who otherwise would not be connected. It was the first example of online social networking, years before Twitter and Facebook existed, and consumer trust is a key element of its success. While skeptics initially questioned whether consumers would buy products from strangers, Omidayar believed people are innately good, and eBay's originators did two things well: they worked hard to make their Web site a community, and they developed tools to help reinforce trust between strangers. The company tracks and publishes the reputations of both buyers and sellers on the basis of feedback from each transaction. eBay extended its feedback service in 2007 by adding four different seller categories: items as described, communication, shipping time, and shipping and handling rate. The ratings are anonymous but visible to other buyers. Sellers with the highest rankings appear at the top of search results.

eBay's millions of passionate users also have a voice in all major decisions the company makes through its Voice of the Customer program. Every few months, eBay brings in as many as a dozen sellers and buyers and asks them questions about how they work and what else eBay needs to do. At least twice a week the company holds hour-long teleconferences to poll users on almost every new feature or policy. The result is that users (eBay's customers) feel like owners, and they have taken the initiative to expand the company into ever-new territory.

eBay continues to expand its capabilities to build its community and connect people around the world by adding services, partnerships, and investments. The company acquired PayPal, an online payment service, in 2002 after eBay members made it clear that PayPal was the preferred method of payment. The acquisition lowered currency and language barriers and allowed merchants to easily sell products around the world. eBay also acquired Skype Internet voice and video

*Some falsely believe that eBay was created to help Omidayar's girlfriend find and collect Pez candy dispensers. That story, however, was created by an employee to help generate initial interest in the company.

communication service in 2005, which allowed buyers and sellers to communicate over voice or video free and generated additional ad revenue for eBay. However, in 2009 eBay sold a majority stake in Skype to focus more on its e-commerce and payments businesses, leading the company to acquire Shopping.com, StubHub, Bill Me Later, and others. eBay now has a presence in 39 markets around the world.

Although eBay was a darling in the dot-com boom and has achieved tremendous success since then, it is not without challenges. These include a worldwide recession, increased competition from Google, and difficulties as it expands globally into tough markets such as China. Its CEO, Meg Whitman, retired in 2008 after leading the company for 10 years and was replaced by John Donahue. Under its new leadership, the company continues to focus on one of its founding beliefs: a strong commitment to and investment in technologies that help people connect. Recent efforts to adopt mobile applications, integrate with iPhones, and become more green have helped take the company to the top of such lists such as *Newsweek*'s Greenest Companies in America and *Fortunes* 100 Best Companies to Work For in back-to-back years.

Questions

1. Why has eBay succeeded as an online auction marketplace while so many others have failed?
2. Evaluate eBay's fee structure. Is it optimal or could it be improved? Why? How?
3. What's next for eBay? How does it continue to grow when it needs both buyers and sellers? Where will this growth come from?

Sources: Douglas MacMillan, "Can eBay Get Its Tech Savvy Back?" *BusinessWeek*, June 22, 2009, pp. 48–49; Catherine Holahan, "eBay's New Tough Love CEO," *BusinessWeek*, February 4, 2008, pp. 58–59; Adam Lashinsky, "Building eBay 2.0," *Fortune*, October 16, 2006, pp. 161–64; Matthew Creamer, "A Million Marketers," *Advertising Age*, June 26, 2006, pp. 1, 71; Clive Thompson, "eBay Heads East," *Fast Company* (July–August 2006): 87–89; Glen L. Urban, "The Emerging Era of Customer Advocacy," *MIT Sloan Management Review* (Winter 2004): 77–82; www.ebay.com.

Marketing Excellence

>>Southwest Airlines

Southwest Airlines entered the airline industry in 1971 with little money but lots of personality. Marketing itself as the LUV airline, the company featured a bright red heart as its first logo and relied on outrageous antics to generate word of mouth and new business. Flight attendants in red-orange hot pants served Love Bites (peanuts) and Love Potions (drinks).

As Southwest grew, its advertising showcased its focus on low fares, frequent flights, on-time arrivals, top safety record, and how bags fly free. Throughout all its communication efforts, Southwest uses humor to poke fun at itself and convey its warm, friendly personality. One TV spot showed a small bag of peanuts with the words, "This is what our meals look like at Southwest Airlines. . . . It's also what our fares look like." Its ongoing "Wanna Get Away?" campaign uses embarrassing situations to hit a funny bone with consumers. And its tagline: "Ding! You are now free to move around the country" is a self-parody of its in-flight announcements. This lighthearted attitude carries over to the entertaining on-board announcements, crews that burst into song in the terminal, and several personalized aircrafts, including three painted as flying killer whales, "Lone Star One" painted like the Texas flag, and "Slam Dunk One," symbolizing the airline's partnership with the NBA.

Southwest's business model is based on streamlining its operations, which results in low fares and satisfied consumers. The airline takes several steps to save money and passes the savings to customers through low fares. It flies over 3,100 short, "point-to-point" trips in a day—shuttling more passengers per plane than any other airline. Each aircraft makes an average of 6.25 flights a day, or almost 12 hours each day. Southwest can accomplish such a feat because it avoids the traditional hub-and-spoke system and has extremely fast turnaround service. In its early years, it turned planes around in less than 10 minutes. Today, its turnaround averages 20 to 30 minutes—still the best in the industry and half the industry average. Southwest's unique boarding process helps. Instead of assigned seating, passengers are assigned to one of three groups (A, B, C) and a number when they check in. The number refers to where they stand in line at the gate. Group A boards first, and once on board, passengers may sit anywhere they like.

Southwest grows by entering new markets other airlines overprice and underserve. The company believes it can bring fares down by one-third to one-half whenever it enters a new market, and it expands every market it serves by making flying affordable to people who could not afford it before. Southwest currently serves 68 cities in 35 states, usually secondary cities with smaller airports that have lower gate fees and less congestion—another factor that leads to faster turnaround and lower fares.

Another unique cost savings strategy is Southwest's decision to operate Boeing 737s for all its flights. This simplifies the training process for pilots, flight attendants, and mechanics, and management can substitute aircraft, reschedule flight crews, or transfer mechanics quickly.

Jet fuel is an airline's biggest expense. According to the industry's trade group, Air Transport Association, jet fuel now accounts for 40 percent of an airplane ticket versus 15 percent just eight years ago. Southwest's biggest cost savings technique and competitive advantage has long been its program to hedge fuel prices by purchasing options years in advance. Many of its long-term contracts allow the airline to purchase fuel at $51 per barrel, a significant savings especially during the oil shocks of the 2000s that drove oil past $100 per barrel. Analysts estimate that Southwest has saved more than $2 billion with fuel hedging.

Because lighter planes use less fuel, Southwest makes its planes lighter by, for instance, power-washing their jet engines to remove dirt each night. It carries less water for bathrooms and has replaced its seats with lighter models. Southwest consumes approximately 1.5 billion gallons of jet fuel each year so every minor change adds up. The airline estimates that these changes saved $1.6 million in fuel costs over just three months.

Southwest has pioneered services and programs such as same-day freight service, senior discounts, Fun Fares, and Ticketless Travel. It was the first airline with a Web site, the first to deliver live updates on ticket deals, and the first to post a blog. Despite its reputation for low fares and no-frills service, Southwest wins the hearts of customers. It consistently ranks at the top of lists of customer service for airlines and receives the lowest ratio of complaints per passenger.

Southwest has been ranked by *Fortune* magazine as the United States' most admired airline since 1997, the fifth-most admired corporation in 2007, and one of the top five best places to work. Its financial results also shine: the company has been profitable for 37 straight years. It has been the only airline to report profits every quarter since September 11, 2001, and one of the few with no layoffs amid a travel slump created by the slow economy and the threat of terrorism.

Although the hot pants are long gone, the LUVing spirit remains at the heart of Southwest. The company's stock symbol on the NYSE is LUV, and red hearts can be found across the company. These symbols embody the Southwest spirit of employees "caring about themselves, each other, and Southwest's customers." "Our fares can be matched; our airplanes and routes can be copied. But we pride ourselves on our customer service," said Sherry Phelps, director of corporate employment. That's why Southwest looks for and hires people who generate enthusiasm. In fact, having a sense of humor is a selection criterion it uses for hiring. As one employee explained, "We can train you to do any job, but we can't give you the right spirit." And the feeling is reciprocated. When Southwest needed to close reservation centers in three cities in 2004, it didn't fire a single employee but rather paid for relocation and commuting expenses.

Questions

1. Southwest has mastered the low-price model and has the financial results to prove it. Why don't the other airlines copy Southwest's model?
2. What risks does Southwest face? Can it continue to thrive as a low-cost airline when tough economic times hit?

Sources: Barney Gimbel, "Southwest's New Flight Plan," *Fortune*, May 16, 2005, pp. 93–98; Melanie Trottman, "Destination: Philadelphia," *Wall Street Journal*, May 4, 2004; Andy Serwer, "Southwest Airlines: The Hottest Thing in the Sky," *Fortune*, March 8, 2004; Colleen Barrett, "Fasten Your Seat Belts," *Adweek*, January 26, 2004, p. 17; Jeff Bailey, "Southwest Airlines Gains Advantage by Hedging on Long-Term Oil Contracts." *New York Times,* November 28, 2007; Michelle Maynard, "To Save Fuel, Airlines Find No Speck Too Small," *New York Times,* June 11, 2008; Daniel B. Honigan, "Fred Taylor Leads Southwest Airlines' Customers to New Heights of Customer Satisfaction," *Marketing News*, May 1, 2008, pp. 24–26; Matthew Malone, "In for a Landing," *Condé Nast Portfolio*, August 2008, pp. 91–93; www.southwest.com.

PART 6 **Delivering Value**

Chapter 15

With a novel pricing and distribution scheme for DVD rentals, Netflix founder Reid Hastings has found heaps of success.

In This Chapter, We Will Address the Following Questions

1. What is a marketing channel system and value network?
2. What work do marketing channels perform?
3. How should channels be designed?
4. What decisions do companies face in managing their channels?
5. How should companies integrate channels and manage channel conflict?
6. What are the key issues with e-commerce and m-commerce?

Designing and Managing Integrated Marketing Channels

Successful value creation needs successful value delivery. Holistic marketers are increasingly taking a value network view of their businesses. Instead of limiting their focus to their immediate suppliers, distributors, and customers, they are examining the whole supply chain that links raw materials, components, and manufactured goods and shows how they move toward the final consumers. Companies are looking at their suppliers' suppliers upstream and at their distributors' customers downstream. They are looking at customer segments and considering a wide range of new and different means to sell, distribute, and service their offerings.

Convinced that DVDs were the home video medium of the future, Netflix founder Reed Hastings came up with a form of DVD rental distribution in 1997 different from the brick-and-mortar stores used by market leader Blockbuster. Netflix's strong customer loyalty and positive word of mouth is a result of the service's distinctive capabilities: modest subscription fees (as low as $9 a month), no late fees, (mostly) overnight mail delivery, a deep catalog of over 100,000 movie titles, and a growing library of over 12,000 movies and television episodes. The service also has proprietary software that allows customers to easily search for obscure films and discover new ones. To improve the quality of its searches, Netflix sponsored a million-dollar contest that drew thousands of entrants. The winning team consisted of seven members with diverse backgrounds and skills whose solution was estimated to make Netflix's recommendations twice as effective. With new competition from Redbox's thousands of DVD-rental kiosks in McDonald's and other locations, Netflix is putting more emphasis on streaming videos and instantaneous delivery mechanisms. But it still sees growth in DVD rentals from its over 11 million subscriber base. Netflix's success has also captured Hollywood's attention. Its online communities of customers who provide and read reviews and feedback can be an important source of fans for films.[1]

Companies today must build and manage a continuously evolving and increasingly complex channel system and value network. In this chapter, we consider strategic and tactical issues with integrating marketing channels and developing value networks. We will examine marketing channel issues from the perspective of retailers, wholesalers, and physical distribution agencies in Chapter 16.

Marketing Channels and Value Networks

Most producers do not sell their goods directly to the final users; between them stands a set of intermediaries performing a variety of functions. These intermediaries constitute a marketing channel (also called a trade channel or distribution channel). Formally, **marketing channels** are sets of interdependent organizations participating in the process of making a product or service available for use or consumption. They are the set of pathways a product or service follows after production, culminating in purchase and consumption by the final end user.[2]

Some intermediaries—such as wholesalers and retailers—buy, take title to, and resell the merchandise; they are called *merchants*. Others—brokers, manufacturers' representatives, sales agents—search for customers and may negotiate on the producer's behalf but do not take title to the goods; they are called *agents*. Still others—transportation companies, independent warehouses, banks, advertising agencies—assist in the distribution process but neither take title to goods nor negotiate purchases or sales; they are called *facilitators*.

Channels of all types play an important role in the success of a company and affect all other marketing decisions. Marketers should judge them in the context of the entire process by which their products are made, distributed, sold, and serviced. We consider all these issues in the following sections.

The Importance of Channels

A **marketing channel system** is the particular set of marketing channels a firm employs, and decisions about it are among the most critical ones management faces. In the United States, channel members collectively have earned margins that account for 30 percent to 50 percent of the ultimate selling price. In contrast, advertising typically has accounted for less than 5 percent to 7 percent of the final price.[3] Marketing channels also represent a substantial opportunity cost. One of their chief roles is to convert potential buyers into profitable customers. Marketing channels must not just *serve* markets, they must also *make* markets.[4]

The channels chosen affect all other marketing decisions. The company's pricing depends on whether it uses online discounters or high-quality boutiques. Its sales force and advertising decisions depend on how much training and motivation dealers need. In addition, channel decisions include relatively long-term commitments with other firms as well as a set of policies and procedures. When an automaker signs up independent dealers to sell its automobiles, it cannot buy them out the next day and replace them with company-owned outlets. But at the same time, channel choices themselves depend on the company's marketing strategy with respect to segmentation, targeting, and positioning. Holistic marketers ensure that marketing decisions in all these different areas are made to collectively maximize value.

In managing its intermediaries, the firm must decide how much effort to devote to push versus pull marketing. A **push strategy** uses the manufacturer's sales force, trade promotion money, or other means to induce intermediaries to carry, promote, and sell the product to end users. A push strategy is particularly appropriate when there is low brand loyalty in a category, brand choice is made in the store, the product is an impulse item, and product benefits are well understood. In a **pull strategy** the manufacturer uses advertising, promotion, and other forms of communication to persuade consumers to demand the product from intermediaries, thus inducing the intermediaries to order it. Pull strategy is particularly appropriate when there is high brand loyalty and high involvement in the category, when consumers are able to perceive differences between brands, and when they choose the brand before they go to the store.

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

Hybrid Channels and Multichannel Marketing

Today's successful companies typically employ hybrid channels and multichannel marketing, multiplying the number of "go-to-market" channels in any one market area. **Hybrid channels** or **multichannel marketing** occurs when a single firm uses two or more marketing channels to reach customer segments. HP has used its sales force to sell to large accounts, outbound telemarketing to sell to medium-sized accounts, direct mail with an inbound number to sell to small accounts, retailers to sell to still smaller accounts, and the Internet to sell specialty items. Philips also is a multichannel marketer.

Philips

Philips Royal Philips Electronics of the Netherlands is one of the world's biggest electronics companies and Europe's largest, with sales of over $66 billion in 2009. Philips's electronics products are channeled toward the consumer primarily through local and international retailers. The company offers a broad range of products from high to low price/value quartiles, relying on a diverse distribution model that includes mass merchants, retail chains, independents, and small specialty stores. To work most effectively with these retail channels, Philips has created an organization designed around its retail customers, with dedicated global key account managers serving leading retailers such as Best Buy, Carrefour, Costco, Dixons, and Tesco. Like many modern firms, Philips also sells via the Web through its own online store as well as through a number of other online retailers.[5]

In multichannel marketing, each channel targets a different segment of buyers, or different need states for one buyer, and delivers the right products in the right places in the right way at the least cost. When this doesn't happen, there can be channel conflict, excessive cost, or insufficient demand. Launched in 1976, Dial-a-Mattress successfully grew for three decades by selling mattresses directly over the phone and, later, the Internet. A major expansion into 50 brick-and-mortar stores in major metro areas was a failure, however. Secondary locations, chosen because management considered prime locations too expensive, could not generate enough customer traffic. The company eventually declared bankruptcy.[6]

On the other hand, when a major catalog and Internet retailer invested significantly in brick-and-mortar stores, different results emerged. Customers near the store purchased through the catalog less frequently, but their Internet purchases were unchanged. As it turned out, customers who liked to spend time browsing were happy to either use a catalog or visit the store; those channels were interchangeable. Customers who used the Internet, on the other hand, were more transaction focused and interested in efficiency, so they were less affected by the introduction of stores. Returns and exchanges at the stores were found to increase because of ease and accessibility, but extra purchases made by customers returning or exchanging at the store offset any revenue deficit.

Companies that manage hybrid channels clearly must make sure their channels work well together and match each target customer's preferred ways of doing business. Customers expect *channel integration*, which allows them to:

- Order a product online and pick it up at a convenient retail location
- Return an online-ordered product to a nearby store of the retailer
- Receive discounts and promotional offers based on total online and offline purchases

Here's a company that has carefully managed its multiple channels. We discuss the topic of optimal channel integration in greater detail later.

REI Outdoor supplier REI has been lauded by industry analysts for the seamless integration of its retail store, Web site, Internet kiosks, mail-order catalogs, value-priced outlets, and toll-free order number. If an item is out of stock in the store, all customers need to do is tap into the store's Internet kiosk to order it from REI's Web site. Less Internet-savvy customers can get clerks to place the order for them at the checkout counters. And REI not only generates store-to-Internet traffic, it also sends Internet shoppers into its stores. If a customer browses REI's site and stops to read an REI "Learn and Share" article on backpacking, the site might highlight an in-store promotion on hiking boots. Like many retailers, REI has found that dual-channel shoppers spend significantly more than single-channel shoppers, and tri-channel shoppers spend even more.[7]

REI's in-store Internet kiosk gives customers a convenient way to order out-of-stock items.

Value Networks

A supply chain view of a firm sees markets as destination points and amounts to a linear view of the flow of ingredients and components through the production process to their ultimate sale to customers. The company should first think of the target market, however, and then design the supply chain backward from that point. This strategy has been called **demand chain planning**.[8]

A broader view sees a company at the center of a **value network**—a system of partnerships and alliances that a firm creates to source, augment, and deliver its offerings. A value network includes a firm's suppliers and its suppliers' suppliers, and its immediate customers and their end customers. The value network includes valued relationships with others such as university researchers and government approval agencies.

A company needs to orchestrate these parties in order to deliver superior value to the target market. Oracle relies on 5.2 million developers and 400,000 discussion forum threads to advance its products.[9] Apple's Developer Connection—where folks create iPhone apps and the like—has 50,000 members at different levels of membership.[10] Developers keep 70 percent of any revenue their products generate, and Apple gets 30 percent.

Demand chain planning yields several insights.[11] First, the company can estimate whether more money is made upstream or downstream, in case it can integrate backward or forward. Second, the company is more aware of disturbances anywhere in the supply chain that might change costs, prices, or supplies. Third, companies can go online with their business partners to speed communications, transactions, and payments; reduce costs; and increase accuracy. Ford not only manages numerous supply chains but also sponsors or operates on many B2B Web sites and exchanges.

Managing a value network means making increasing investments in information technology (IT) and software. Firms have introduced supply chain management (SCM) software and invited such software firms as SAP and Oracle to design comprehensive *enterprise resource planning* (ERP) systems to manage cash flow, manufacturing, human resources, purchasing, and other major functions within a unified framework. They hope to break up departmental silos—where each department only acts in its own self interest—and carry out core business processes more seamlessly. Most, however, are still a long way from truly comprehensive ERP systems.

Marketers, for their part, have traditionally focused on the side of the value network that looks toward the customer, adopting customer relationship management (CRM) software and practices. In the future, they will increasingly participate in and influence their companies' upstream activities and become network managers, not just product and customer managers.

The Role of Marketing Channels

Why would a producer delegate some of the selling job to intermediaries, relinquishing control over how and to whom products are sold? Through their contacts, experience, specialization, and scale of operation, intermediaries make goods widely available and accessible to target markets, usually offering the firm more effectiveness and efficiency than it can achieve on its own.[12]

Many producers lack the financial resources and expertise to sell directly on their own. The William Wrigley Jr. Company would not find it practical to establish small retail gum shops throughout the world or to sell gum by mail order. It is easier to work through the extensive network of privately owned distribution organizations. Even Ford would be hard-pressed to replace all the tasks done by its almost 12,000 dealer outlets worldwide.

Channel Functions and Flows

A marketing channel performs the work of moving goods from producers to consumers. It overcomes the time, place, and possession gaps that separate goods and services from those who need or want them. Members of the marketing channel perform a number of key functions (see Table 15.1).

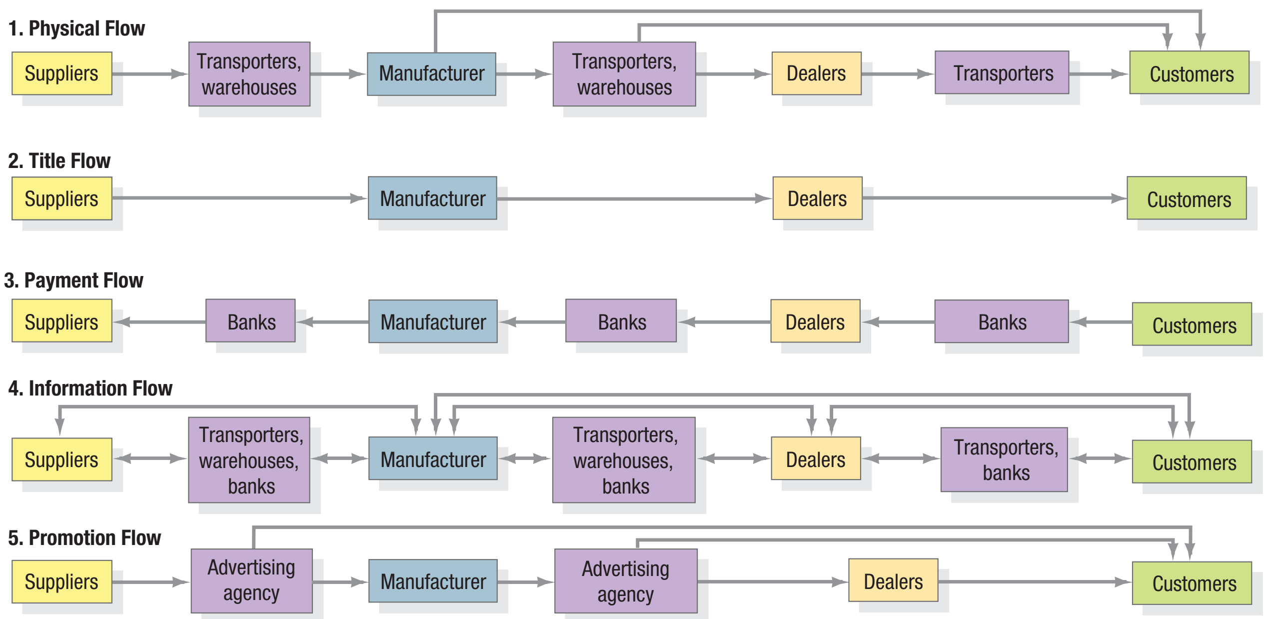
Some of these functions (storage and movement, title, and communications) constitute a *forward flow* of activity from the company to the customer; other functions (ordering and payment) constitute a *backward flow* from customers to the company. Still others (information, negotiation, finance, and risk taking) occur in both directions. Five flows are illustrated in Figure 15.1 for the marketing of forklift trucks. If these flows were superimposed in one diagram, we would see the tremendous complexity of even simple marketing channels.

A manufacturer selling a physical product and services might require three channels: a *sales channel,* a *delivery channel,* and a *service channel.* To sell its Bowflex fitness equipment, the Nautilus Group historically has emphasized direct marketing via television infomercials and ads, inbound/outbound call centers, response mailings, and the Internet as sales channels; UPS ground service as the delivery channel; and local repair people as the service channel. Reflecting shifting consumer buying habits, Nautilus now also sells Bowflex through commercial, retail, and specialty retail channels.

TABLE 15.1 Channel Member Functions

• Gather information about potential and current customers, competitors, and other actors and forces in the marketing environment.
• Develop and disseminate persuasive communications to stimulate purchasing.
• Negotiate and reach agreements on price and other terms so that transfer of ownership or possession can be affected.
• Place orders with manufacturers.
• Acquire the funds to finance inventories at different levels in the marketing channel.
• Assume risks connected with carrying out channel work.
• Provide for the successive storage and movement of physical products.
• Provide for buyers' payment of their bills through banks and other financial institutions.
• Oversee actual transfer of ownership from one organization or person to another.

The question for marketers is not *whether* various channel functions need to be performed—they must be—but rather, *who* is to perform them. All channel functions have three things in common: They use up scarce resources; they can often be performed better through specialization; and they can be shifted among channel members. Shifting some functions to intermediaries lowers the producer's costs and prices, but the intermediary must add a charge to cover its work. If the intermediaries are more efficient than the manufacturer, prices to consumers should be lower. If consumers perform some functions themselves, they should enjoy even lower prices. Changes in channel institutions thus largely reflect the discovery of more efficient ways to combine or separate the economic functions that provide assortments of goods to target customers.



|Fig. 15.1|

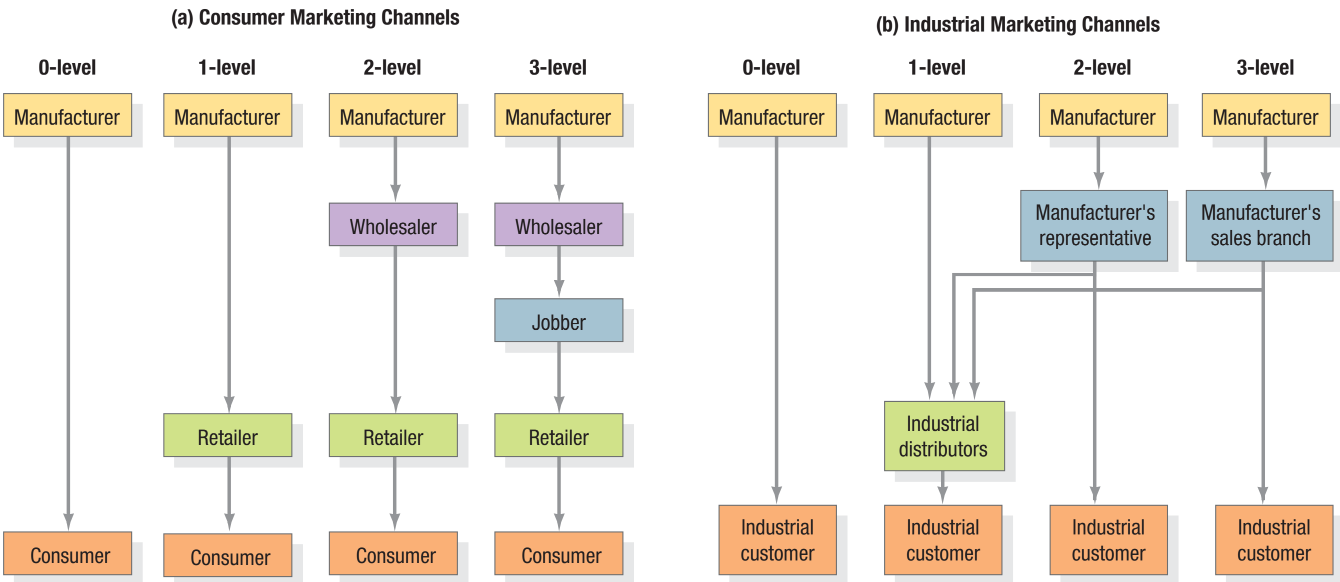
Five Marketing Flows in the Marketing Channel for Forklift Trucks

Bowflex fitness equipment is sold through a variety of channels.

Channel Levels

The producer and the final customer are part of every channel. We will use the number of intermediary levels to designate the length of a channel. Figure 15.2(a) illustrates several consumer-goods marketing channels of different lengths.

A **zero-level channel**, also called a **direct marketing channel**, consists of a manufacturer selling directly to the final customer. The major examples are door-to-door sales, home parties, mail order, telemarketing, TV selling, Internet selling, and manufacturer-owned stores. Traditionally, Avon sales representatives sell cosmetics door-to-door; Franklin Mint sells collectibles through mail order; Verizon uses the telephone to prospect for new customers or to sell enhanced services to existing customers; Time-Life sells music and video collections through TV commercials or

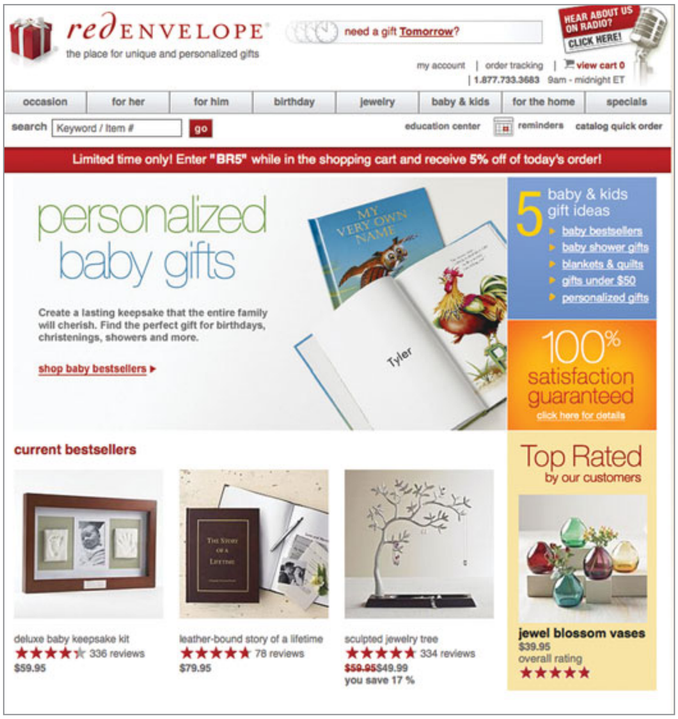


|Fig. 15.2|

Consumer and Industrial Marketing Channels longer "infomercials"; Red Envelope sells gifts online; and Apple sells computers and other consumer electronics through its own stores. Many of these firms now sell directly to customers in more ways than one, via online, catalogs, etc.

A *one-level channel* contains one selling intermediary, such as a retailer. A *two-level channel* contains two intermediaries. In consumer markets, these are typically a wholesaler and a retailer. A *three-level channel* contains three intermediaries. In the meatpacking industry, wholesalers sell to **jobbers**, essentially small-scale wholesalers, who sell to small retailers. In Japan, food distribution may include as many as six levels. Obtaining information about end users and exercising control becomes more difficult for the producer as the number of channel levels increases.

Figure 15.2(b) shows channels commonly used in B2B marketing. An industrial-goods manufacturer can use its sales force to sell directly to industrial customers; or it can sell to industrial distributors who sell to industrial customers; or it can sell through manufacturer's representatives or its own sales branches directly to industrial customers, or indirectly to industrial customers through industrial distributors. Zero-, one-, and two-level marketing channels are quite common.



RedEnvelope has built an online gift powerhouse.

Channels normally describe a forward movement of products from source to user, but *reverse-flow channels* are also important (1) to reuse products or containers (such as refillable chemical-carrying drums), (2) to refurbish products for resale (such as circuit boards or computers), (3) to recycle products (such as paper), and (4) to dispose of products and packaging. Reverse-flow intermediaries include manufacturers' redemption centers, community groups, trash-collection specialists, recycling centers, trash-recycling brokers, and central processing warehousing.[13] Many creative solutions have emerged in this area in recent years, such as Greenopolis.

Greenopolis is a novel recycling system that offers financial and environmental benefits to consumers and companies.

Greenopolis Launched by Waste Management Corporation after it acquired the Code Blue Recycling company, Greenopolis is a new company with an entirely different recycling system that allows consumers and a consortium of consumer packaged goods (CPG) companies to "close the loop" in the recovery and reuse of postconsumer material. With its mantra, "Rethink. Recycle. Reward," Greenopolis consists of (1) an extensive set of interactive, on-street recycling kiosks in various retail settings, (2) a number of material reprocessing facilities, (3) a menu of consumer recycling rewards, and (4) a significant online community and social media network. Participating CPG companies use the Greenopolis symbol on their product packaging. The kiosk system is designed to collect those products, track and reward consumers who bring them, and put packaging into reuse or reprocessing. An important feature is that Greenopolis is fully accountable. Innovative kiosk technology allows consumers to follow their recycling contribution, as well as the rewards they earn from the partnering companies. CPG companies, in turn, are able to measure their share of recovery. By achieving sufficient scale and accessibility in the marketplace and making recycling fun, easy, and personally rewarding to consumers, Greenopolis aims to improve recycling rates and make an important environmental difference.[14]

Service Sector Channels

As Internet and other technologies advance, service industries such as banking, insurance, travel, and stock buying and selling are operating through new channels. Kodak offers its customers four ways to print their digital photos—minilabs in retail outlets, home printers, online services at its Ofoto Web site, and self-service kiosks. The world leader with 80,000 kiosks, Kodak makes money both by selling the units and by supplying the chemical and paper they use to make the prints.[15]