## CHAPTER SIX: PRICING DECISIONS

### 6.1. Meaning of Price

All profit organizations and many non–profit organizations must set prices on their products or services. Price goes by many names. We pay rent for apartment, tuition for education, fee to physician or dentist, fare for transportation, interest for credit, premium for insurance, retainer for legal service, salary for executives, commission for a sales person, and wage for a worker. In the narrowest sense, price is the amount of money charged for a product or service. More broadly, price is the sum of all the values that consumers exchange for the benefits of having or using the product or service. Price is the only element in the mix that produces revenue; the other elements produce costs. Price is also one of the most flexible elements of the marketing mix. Unlike product feature and channel commitments, price can be changed quickly.

**6.2. Pricing Objectives and Factors Affecting Pricing Decision**

A company’s pricing decisions are affected by both internal company factors and external environmental factors.

**6.2.1. Internal factors affecting pricing decisions**

Firms have to consider the internal factors in setting their pricing policy. Factors include the company’s marketing objectives, marketing mix strategy, costs and organizational considerations.

1. **Marketing Objectives**

A firm may have various objectives and pricing contributions. And hence, the clearer a firm is about its objectives, the easier it is to set price. A company can pursue its various objectives through its pricing: survival, current profit maximization, market share leadership and product quality leadership.

**Survival** – Companies pursue survival, as their major objective if they are troubled / plagued by overcapacity, intense competition or changing customer wants. To keep the plant going a company will set a low price, hoping to increase demand in this case, profits are less important than survival. However, survival is only a short-term objective, in the long run, the firm must learn how to add value or face extinction.

**Current profit maximization-** Many companies use current profit maximization as their pricing goal.

They estimate what demand and costs will be at different prices and choose the price that will produce the maximum current profit, cash flow, or return on investment.

**Market share leadership** – companies may want to obtain market share leadership. They believe that the company with the largest market share will enjoy the lowest costs and highest long run profit. To become the market share leader; these firms set prices as low as possible.

**Product quality leadership-** A company might decide that it wants to achieve product quality leadership. This normally calls for charging a high price to cover such quality and high cost of R&D.

**Other specific objectives -**A company also might use price to attain other more specific objectives; it can set prices low to prevent competitor from entering the market or set prices at competitor’s levels to stabilize the market.Prices can be set to keep the loyalty and support of resellers or to avoid government intervention.

Non-profit and public organizations may adopt a number of other pricing objectives

* A university aims for partial cost recovery.
* A non-profit hospital may aim for full cost recovery in its pricing.
* A social service agency may set a social price geared to the varying income situation of different clients.

1. **Marketing mix strategy**

Price is only one of the marketing mix tools that a company uses to achieve its marketing objectives. Price decision must be coordinated with product design, distribution, and promotion decisions to form a consistent and effective marketing program. Decisions made for other marketing mix variables may affect pricing decision. Thus, the marketers must consider total marketing mix when setting prices. If the product is positioned on non-pricing factors, then decision about quality, promotion and distribution will strongly affect decision made about the other marketing mix elements.

1. **Costs**

Costs set the floor for the price that the company can charge for its product. Company wants charge a price that both covers all its costs for producing, distribution and selling the product and delivers a fair rate of return for its effort and risk. A company’s costs take two forms, fixed and variables costs. Fixed costs (overhead) are costs that do not vary with production or sales level, whereas variable costs vary directly with the level production.

TC = FC + VC Where TC = Total Cost

FC = Fixed Cost

VC = Variable Cost

1. **Organizational Considerations**

Management must decide who within the organization should set prices. Companies handle pricing in a variety of ways. In small companies prices often are set by top management rather than by the marketing or sales departments. In large companies, pricing typically is handled by divisional or product line managers. In industrial markets, sales people may be allowed to negotiate with customers within certain rages. Even so, top management sets the pricing objectives and policies, and it often approves the prices proposed by lower-level management or sales people.

**6.2.2. External Factors Affecting Pricing Decisions**

External factors that affect pricing decisions include the nature of the market, competition and other environmental elements.

1. **The Market**

The seller’s pricing freedom varies with different types of markets. Economists recognize four types of markets, each presenting a different pricing challenge.

* **Pure competition -**Under pure competition the market consists of many buyers and sellers trade in a uniform commodity (homogenous product). No single buyer or a seller has much effect on the going market price. A seller can’t charge more or less than the going price.
* **Monopolistic competition -** Under monopolistic competition the market consists of many buyers and sellers who trade over a range of prices rather than a single market price. A range of prices occurs because sellers can differentiate their offers to buyers. Either the physical product can be varied in quality, features, or style or the accompanying service can be varied.
* **Oligopolistic competition** – products are either uniform or differentiated. Under oligopolistic competition, the market consists of few sellers who are highly sensitive to each other’s pricing and marketing strategies. If the company cut its price by some percentage, buyers will quickly switch to this company. In contrast, if an oligopolist raises its price, its competitors might not follow this lead.
* **Pure monopoly-**In a pure monopoly the market consists of one seller. The seller may be a government monopoly, a private regulated monopoly, or a private non-regulated monopoly. Pricing is handled differently in each case.A government monopoly can pursue a variety of pricing objectives.
* It may set a price below cost because the product is important to buyers who cannot afford to pay full cost or
* The price might be set either to cover costs or to produce good revenue
* It can even be set quite high to slow down consumption.

In a regulated monopoly the government permits the company to set rates that will yield a “fair return”. Non-regulated monopolies are free to set price at what the market will bear.

1. **Competitors’ costs, prices and offers**

Another external factors affecting the company’s pricing decisions is competitors’ costs, and price and possible competitor’s reactions to the company’s pricing moves. The company needs to benchmark its costs against its competitors’ costs to learn whether it is operating at a cost advantage or disadvantage. The company also needs to learn the price and quality of competitors’ offers; it can use them as a starting point for its own pricing. If the firm’s offer is similar to a major competitor’s offer, then the firm will have to price close to the competitor or lose sales. If the firm’s offer is not as good as the competitor, the firm will not be able to charge as much. If the firm’s offer is superior, the firm can charge more than the competitor. The firm must be aware, however, the competitors might change their price in response to the firm’s price.

1. **Other external factor**

***Economic Conditions****-* can have a strong impact on the firm’s pricing strategies. Economic factors such as boom or recession, inflation and interest rates affect pricing decision because they affect both the costs of producing a product and consumer perceptions of the product’s price and value. ***Resellers-***The Company should set prices that give resellers a fair profit, encourage their supports and help them to sell the product effectively. The ***government*** is another important external influence on pricing decisions. Finally, ***social concerns***may have to be taken into account. In setting prices, a company’s short-term sales, market share and profit goals may have to be tempered by broader societal considerations.

### 6.3. General Approaches to Pricing

Companies set prices by selecting a general pricing approach that includes one or more of these three sets of factors – costs, consumer perception and competitors’ prices. We will examine the following approaches:

1. Cost based pricing (cost plus pricing, break-even analysis and target profit pricing).
2. The buyer based approach (perceived value pricing) and
3. The competition based approach (going rate and sealed bid pricing)
4. **Cost based pricing**
5. **Cost plus pricing (Markup pricing)**

The simplest pricing method is to add a standard markup to the cost of the product. To illustrate Markup pricing

Variable cost per unit $10

Fixed cost $300,000

Expected unit sales $50,000

The unit cost is given by:

Unit cost = variable cost +

= **= $16**

Now assume the manufacturer want to earn a 20% markup on sales. The manufacture’s market price is given by:

= $20

Does using standard mark-ups to set prices make logical sense? Generally, no! Any pricing method that ignores demand and competitors’ prices is not likely to lead to the best price.

1. **Break-Even Analysis and Target Profit Pricing**

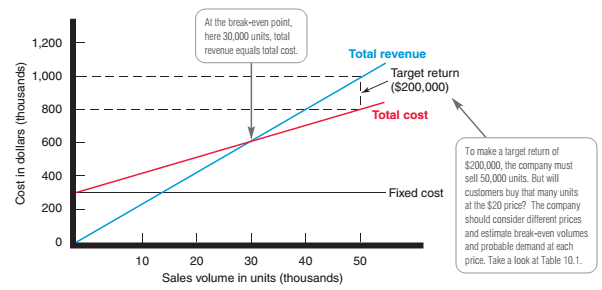
Another cost-oriented pricing approach is break-even pricing (or a variation called target return pricing). The firm tries to determine the price at which it will break even or make the target return it is seeking.

Target return pricing uses the concept of a break-even chart, which shows the total cost and total revenue expected at different sales volume levels. To illustrate, assume the above given information. Fixed costs are $300,000 regardless of sales volume. Variable costs are added to fixed costs to form total costs, which rise with volume. Figure 6.1 shows the total revenue curve starts at zero and rises with each unit sold. The slope of the total revenue curve reflects the price of $20 per unit.

The total revenue and total cost curves cross at 30,000 units. This is the break-even volume. At $20, the company must sell at least 30,000 units to break even, that is, for total revenue to cover total cost. Break-even volume can be calculated using the following formula:

Break even volume = = = 30,000

If the company wants to make a profit, it must sell more than 30,000 units at $20 each. Suppose a company has invested $1,000,000 in the business and wants to set a price to earn a 20 percent return, or $200,000. In that case, it must sell at least 50,000 units at $20 each. If the company charges a higher price, it will not need to sell as many toasters to achieve its target return. But the market may not buy even this lower volume at the higher price. Much depends on price elasticity and competitors’ prices.



*Fig. 6.1 Break-even chart*

1. **Value Based Pricing /buyer – Based Pricing**

Company sets its target price based on customer perceptions of the product value rather than on its cost. The targeted value and price then drive decisions about product design and what costs can be incurred. As a result, pricing begins with analyzing consumer needs and value perceptions, and price is set to match consumers’ perceived value.

A company using perceived-value pricing must find out what value buyers assign to different competitive offers. However, measuring perceived value can be difficult. Sometimes consumers are asked how much they would pay for a basic product and for each benefit added to the offer. Or a company might conduct experiments to test the perceived value of different product offers. If the seller charges more than the buyers’ perceived value, the company’s sales will suffer. Many companies overprice their products and their products sell poorly. Other companies underprice. Underpriced products sell very well, but they produce less revenue than they would if prices were raised to the perceived value levels.

1. **Competition based pricing**

Consumers will base their judgments of a product’s value on the prices that competitors charge for similar products. Let identify two forms of completion based pricing.

* **Going rate pricing-** Setting price based largely on following competitors’ price rather than on company costs or demand. The firm might charge the same, more, or less than its major competitors. The smaller firms follow the leader: they change their prices when the market leader’s prices change, rather than when their own demand or costs change. Some firms may charge a bit more or less, but they hold the amount of difference constant.
* **Sealed-bid pricing -** Setting price based on how the firm thinks competitors will price rather than on its own costs or demand. It used when a company bids for job. The firm wants to win a contract, and winning the contract requires pricing less than other firms.

**6.4.** **New product pricing strategies**

1. **Market Skimming Pricing**

Setting a high price for a new product to skim maximum revenues layer by layer from the segments willing to pay the high price; the company makes fewer but more profitable sales. Market skimming

makes sense only under certain conditions.

* The products quality and image must support its higher price and enough buyers must want the product at that price.
* The costs of producing a smaller volume cannot be so high that they cancel the advantage of charging more.
* Competitors should not be able to enter the market easily and undercut the high price.

1. **Market Penetration-Pricing**

Setting a low price for a new product in order to penetrate the market quickly and deeply to attract a large number of buyers quickly and win a large market share. The high sales volume results in falling costs, allowing the company to cut its price even further.

* The market must be highly price sensitive so that low price produces more market growth.
* Production and distribution cost must fall as sales volume increase.

**6.5. Pricing adjustment strategies**

Companies usually adjust their basic prices to account for various customer difference and changing situations. Here we examine the six price adjustment strategies.

1. **Discounts and Allowance Pricing**

**Discounts:** A straight reduction in price on purchase during a stated period of time. A discount takes many forms:

* **Cash discount -**A cash discount is a price reduction to buyer who pays their bills promptly. A typical example is 2/10 net 30, which means that although payment is due within 30 days, the buyer can deduct 2 per cent if the bill is paid within 10 days. Such discounts are customary in many industries and help to improve the seller's cash situations and reduce bad debts and credit collection costs.
* **Quantity discounts-** a quantity discount is a price reduction to buyers who buy large volumes.
* **A functional discount (trade discount)-**it is offered by the seller to trade channel members who perform certain functions such as selling, storage, and record keeping.
* **Seasonal discount-**A seasonal discount is a price reduction to buyers who merchandise or service

out of season. Seasonal discounts allow the seller to keep production steady or stabilize capacity utilization during the entire year.

* **Allowances:** Allowances are other types of reduction from the list price. They may take two forms such as **Trade in Allowance-**they are price reductions given for turning in an old item when buying a new one. And **Promotional allowance-**They are payments or price reductions to reward dealers for participating in advertising and sales support programs.

**2. Segmented (price discrimination) pricing**

Companies will often adjust their basic price to accommodate differences in customers, products, locations and so on. Price discrimination occurs when a company sells a product or service at two or more prices that do not reflect differences in costs. Price discrimination takes several forms.

* **Customer Segment Pricing**. Different customers pay different prices for the same product or service for example museums often charge a lower admission fee to students and senior cities.
* **Product forms pricing**. Different versions of the product are priced differently but not according to differences in their costs. (Different model with extra feature).
* **Location Pricing**. A company charges different prices for different locations even though the cost of offering each location is the same. For example, theaters vary their seat prices because of audience preferences for certain locations; universities charge higher tuition for out of country students.
* **Seasonal Pricing.** A firm varies its price by the season,the month, the day and even the hour. Public utilities vary their power rates to commercial users by time of day and weekend versus weekday. The telephone company offers lower off-peak charges, and resorts give seasonal discounts. A special form of time pricing is yield pricing.

**3. Psychological Pricing**

A pricing approach that considers the psychology of prices and not simply the economics; the price is used to say something about the product. For example, customers usually perceived higher priced products as having higher quality. A $100 bottle of perfume may contain $10 worth of scent but some people are willing to pay the $100 because this price indicates something special. Psychological prices work when people cannot judge quality because they lack the information of skill; price becomes an important quality signal. Even small difference in price can suggest product difference. Consider a product price at $300 compared to one priced at $299.95. The actual price difference is only 5 cents, but the psychological difference can but much greater. For example some consumers will see the $299.95 as bargaining price, whereas the $300 price suggests more quality. Some psychologists argue that each digit has symbolic and visual qualities that should be consider in pricing.

**4. Promotional Pricing**

With promotional pricing, companies will temporarily price their products below list price and sometimes even below costs to create buying excitement and urgency and to increase short run sales. Promotional pricing takes several forms.

1. **Loss leader pricing.** Here super markets and department stores drop the price on a few products to attract customers to the store in the hope that they will buy other items at normal markups.
2. **Special event pricing**. Sellers will establish special prices in certain seasons to draw in more customers.
3. **Cash rebates**. Consumers are offered cash rebates to encourage their purchase of the manufacturers without cutting the list price.
4. **Low interest financing**: instead of decreasing its product’s price, the company can offer customers low interest financing. A company may announce 3% financing and in some cases 0% financing to attract customers.
5. **Longer Payment terms**: sellers may stretch their loans over longer period and thus lower monthly payment.
6. **Warranties and service contracts**: the company can promote sales by adding a free warranty offer or service contract. Instead of charging for the warranty or service contract, it offers these free or at a reduced price.
7. **Psychological discounting**: this strategy involves putting an artificially high price on a product and then offering it at substantial savings;
8. **Geographical Pricing**

Geographical pricing involves the company in deicing how to price products to different customers’

located indifferent parts of the country or world. Should the company charge higher prices to distant customers to cover the higher shipping cost and risk losing their business? Or should it charge a lower price, hoping that a lower price, hoping that a lower price will generate higher sales volume.

1. **International Pricing**

Companies that market their products internationally must desire what prices to charge in the different countries in which they operate. In some cases, a company can set a uniform worldwide price. For example Boeing sells its jetliners at about the same price everywhere. However, most companies adjust their prices to reflect local market conditions and cost considerations.

The price that a company should charge in a specific country depends on many factors, including economic conditions, competitive situations, laws & regulations, development of the wholesaling and retailing system.

The end!!