

Pricing strategies

LEARNING OBJECTIVES

After reading this chapter you will:

- appreciate the strategic significance of pricing decisions in marketing strategy
- understand the approaches to pricing of the economist and accountant, together with their contributions and limitations in the context of the price setting process
- apply a framework to pricing decisions based around the key inputs to these decisions
- understand the main pricing methods and their relative advantages and disadvantages

INTRODUCTION

The price of a company's products and services represents the vehicle for that company to achieve its financial objectives. It is through price and volume that revenue is generated. Price equates to the financial sacrifice that the customer is willing to make to purchase the product or service desired.

The important criterion of pricing is problematical to marketers. This is attributed to the uncertainty associated with pricing decisions as it is a complicated area of decision making. It is with a view to examining this problem and the ways in which it can be resolved that this chapter is framed. The pressures of today's market environment place increasing burdens on management. It is important, therefore, that the decision maker has a framework for making pricing decisions. We start by examining the traditional economist's view of price to illustrate both the shortcomings and potential contributions of this approach as a prelude to discussing more strategic pricing approaches for the decision maker.

THE ECONOMIST'S VIEW OF PRICING

Traditionally the economist has looked at price and pricing decisions from the perspective of price being determined by the interplay of demand and supply. At a broader level, the economist views pricing decisions as an 'allocatory' mechanism, with prices being used as the signal to solve the basic problems of an economic society; namely, the allocation of scarce resources between competing users and individuals in that society so that resources are used in the most effective way. From the perspective of the price setter, traditional economic theory suggests that the 'optimum' price is one that equates marginal costs to marginal revenue so as to 'maximize' profits.

This summary of the economist's view of price and pricing decisions is most striking by its lack of relevance to the practising marketing manager. In short, although the economist has some useful concepts to offer the marketing manager when it comes to setting prices (for example the relationship between demand and price) much of what traditional economics has to offer in this area of decision making is not helpful.

The main problems associated with bringing together the theoretical and practical side of pricing can be explained by the apparent reluctance of the economist to take full cognizance of the implications associated with the setting of either a particular price, or an overall pricing strategy, when considered in the context of an organization and its overall corporate and marketing objectives. Essentially, the economist's viewpoint is based on a set of assumptions which, in many cases, are unrealistic and hence would be difficult to apply in the business environment.

An example of such an assumption is when the individual customer is considering the price of a given product. Economic theory suggests that the customer will act in a totally rational economic manner, such that his or her total utility (or satisfaction) is maximized. In deciding whether or not to 'try' the product our 'totally rational' consumer will carefully equate whether or not buying the product at the asking price set will maximize his or her utility. In making this judgement, the economist 'assumes' that the consumer has 'perfect information' about both the prices and utility of all other competitive products in the market, and that price is the only consideration in choice. Clearly these are unrealistic assumptions.

Another example of unrealistic, and unhelpful, assumptions is that which we mentioned earlier in our introductory summary of the economist's concepts of pricing; namely the assumption of 'profit maximization'. Although profits are an essential element of long-run survival in many organizations, and as such are likely to be enshrined in overall corporate and marketing objectives, these are much more likely to be couched in terms of a required level of profits rather than 'profit maximization'. Most importantly, it is well known that there are many other objectives a company might pursue through its pricing strategies. For example, if a company wanted to maximize market share or simply survive, a different set of prices would be delivered than if the objectives were to maximize profits. Again, we can see that the assumptions of the traditional economist, as to the objectives of the price setting exercise, are somewhat restrictive and unhelpful to the practical price setter.

Set against this seemingly dismissive view of the economist's approach to pricing decisions is the fact that in some areas the economist has provided a number of useful concepts and tools for the marketing practitioner when it comes to making pricing decisions. In particular, the economist has made an important, if only partial, contribution to price setting in the area of the relationship between price and demand. Notwithstanding this, it is unsurprising that a gulf has opened between the theoretical/economist viewpoint and the practical/marketing side of pricing. It is important that we develop a structure for strategic pricing decisions that is helpful to marketing and which can be implemented in the 'real world' of business and it is to this that we now turn our attention.

A FRAMEWORK FOR PRICING DECISIONS: KEY INPUTS

The starting point for developing a pricing structure is the delineation of a framework for pricing decisions. Specifically, we need to establish key inputs to pricing decisions. Although there are a myriad of considerations for arriving at a price for a product or service, the following are considered to be key inputs for the pricing decision maker that are now discussed:

- company and marketing objectives;
- demand considerations;
- cost considerations;
- competitor considerations.

Company and marketing objectives

Pricing decisions are salient to the achievement of corporate and marketing objectives, so it is essential that pricing objectives and strategies are consistent with and supportive of these objectives. Oxenfeldt,¹ in Table 5.1, illustrates both the potential range of pricing objectives and their clear relationship to overall corporate and marketing objectives.

This selection from an even wider range of possible pricing objectives which Oxenfeldt¹ delineates, illustrates the fact that the pricing decision maker must establish what objectives the pricing strategy is to achieve. The continued link between corporate objectives and pricing strategies is confirmed in a more recent studies by Kehagias *et al.*² and Indounas and Avlonitis.³ We can also see that according to the precise objectives, we might arrive at very different prices for our product and services. Where a company has multiple objectives, pricing strategies may need to consider trade-offs between different possible price levels, such that these different objectives are met.

In addition to these broader corporate objectives, pricing decisions must also reflect and support specific marketing strategies. In particular, pricing strategies need to be in line with market targeting and positioning strategies, which were outlined in Chapter 3. Clearly, if a company produces a high quality product or service aimed at the prestige end of the market, it would not be sensible to set a low price even if cost efficiency allowed this. Pricing, therefore, must be consistent with the other elements of the marketing mix and the selected positioning strategy. Effectively, the selection of company and market objectives, market targets and the formulation of a positioning strategy constrains or delineate the range of pricing strategies and specific price levels.

An example of how price must reflect and support the overall positioning strategy of the company is the price set for the Aston Martin DBS. The car is positioned at the top end of the market and with just 500 made in the UK for sales worldwide the emphasis is on exclusivity. Many people still associate Aston Martin with the James Bond character, 007, again emphasizing the racy and prestigious image intended. Prices start at £160,000.

TABLE 5.1 Pricing and corporate/marketing objectives

Pricing to maximize long-run profits;
Pricing to maximize short-run profits;
Pricing to expand market share;
Pricing to maintain a price leadership position;
Pricing to discourage potential new entrants;
Pricing to avoid the attention of government and legislators;
Pricing to establish and maintain dealer loyalty;
Pricing to improve corporate image;
Pricing to improve the sales of weaker products.

Demand considerations

A key parameter affecting pricing decisions is customer based. The upper limit to the price to be charged is set by the market, unless the customer must purchase the product and we are the sole supplier. In competitive markets, demand, i.e. the price customers are willing and able to pay, is a major consideration in the selection of pricing strategies and levels. It is in analysis and interpretation of demand and demand schedules that the economist has much to offer the marketer in terms of concepts and techniques.

Ideally, the marketing manager needs to know the **demand schedule** for products and services to be priced. The demand schedule relates prices to quantities demanded and can be illustrated by the use of a diagram shown in Figure 5.1.

The demand curves in Figure 5.1 indicate the number of units that can be sold at any given price. In addition, the slope of the demand curve is directly related to the price sensitivity of demand. Demand curve D_1 slopes less steeply than D_2 where demand is more price-sensitive. Even simple demand curves represent powerful tools for pricing decision makers, showing, as they do, both the number of units that can be sold at any given price and the effect on this quantity of any changes in price. However, price is only one of the determinants of the demand for a product or service. In addition to price the following represent some additional factors which combine to determine demand:

- income/budget of the purchaser;
- attributes of the product;
- tastes of the purchaser;
- price of other products;
- the time it takes to deliver.

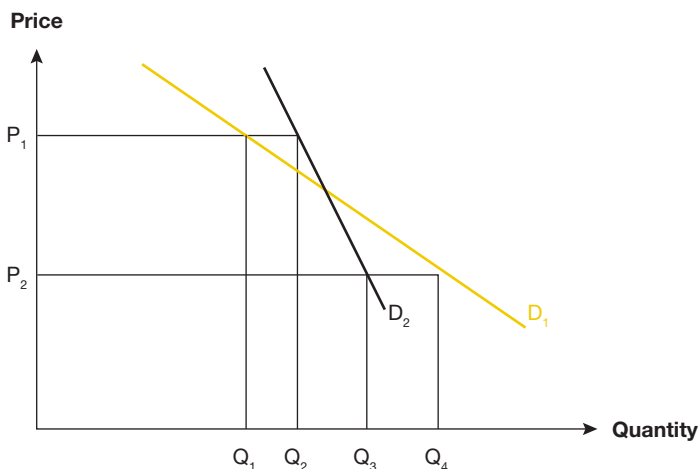


FIGURE 5.1 Examples of simple demand curves

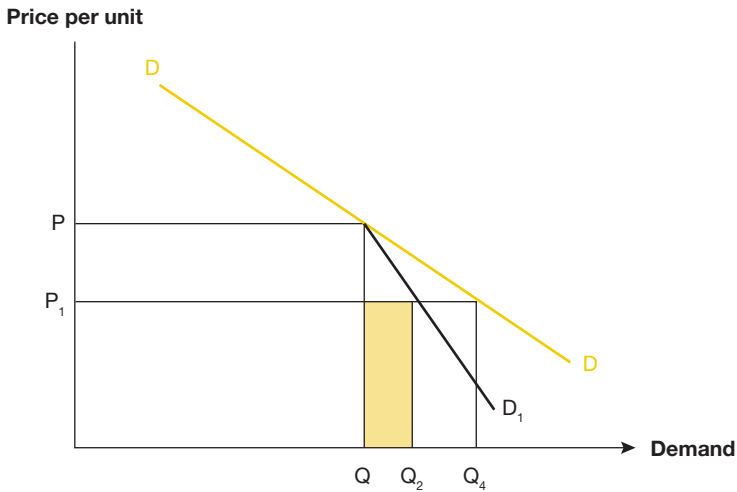


FIGURE 5.2 Oligopoly

Although the views put forward by economists are sometimes difficult to envisage in reality, they are useful in terms of being able to relate to in marketing terms because these theoretical positions tend to relate to certain kinds of marketing behaviour. With this background in mind, an industry or service provision that more or less equates to perfect competition, oligopoly (as explained in Figure 5.2) and monopoly is:

- perfect competition – the restaurant trade;
- oligopoly – motor cars; petrol
- monopoly – the electricity generating industry.

Figure 5.2 explains the theory of oligopoly:

At price P the law of demand states that quantity Q will be demanded. If the price is then reduced to P_1 , then Q_1 will be demanded, so $Q-Q_1$ will be the additional amount demanded. However, in a situation of oligopoly where price as an instrument of competition is less effective, then the demand curve will kink to D_1 and the dark area covered by $Q-Q_2$ will be the additional amount demanded. A price reduction in these circumstances is less effective as customers will have been 'pre-sold' their existing products through non-price factors like advertising and branding; this is termed 'non-price competition'.

Income/budget of the purchaser

The ability of the purchaser to buy products and services according to individual income level and purchasing power converts the purchaser's needs and wants into actual purchasing. The economist refers to this willingness to purchase as 'effective demand'. For an organizational buyer, the ability to purchase is directly related to budget requirements and constraints set on the purchaser.

Attributes of the product

Demand for a product or service and the price the customer is willing to pay, is related to the attributes of competitive products being offered. Demand for a product is closely related to how the customer perceives the various attributes of competitive products. These attributes include physical/tangible attributes e.g. quality features and packaging, and 'non-tangible' attributes, such as brand/corporate image and status.

Tastes of the buyer

Related to attributes, another factor affecting demand is the tastes of the buyer. Although a somewhat nebulous concept, 'tastes' are a powerful influence on demand. Changes in taste can give rise to the growth of entirely new markets and the demise of mature ones.

The growth in popularity of hybrid powered cars over recent years is an illustration of changes in taste. However, their demise might be just as rapid as a result of negative publicity surrounding their use e.g. the relatively short range and difficulties of recharging vehicles.

'Tastes' can be of an industrial nature such as being associated with variables like emphasis on productivity improvements, quality management and employee care and protection.

All's Fair

One of the fastest growing areas in retailing in recent years has been the growth of 'fair trade' products. The Fairtrade Foundation was established in 1992 with the aim of providing a better deal for the poor and disadvantaged in their trading with large multinationals. In particular, the foundation exists to help farmers, growers and producers in the developing parts of the world. For example, it is a fact that in the past coffee growers have received a poor deal from their large and powerful customers. Small farmers, with few resources, were required to sell their crops for extremely low prices and often at a loss. The foundation wanted to remedy this by helping negotiate better terms and conditions for their members.

A key part of this initiative was the establishment of a 'Fairtrade' label. Under this label, brands could demonstrate to customers that the suppliers of the product had received a fair deal, usually meaning a fair price. Strict conditions were imposed for a brand to qualify for the Fairtrade label. The real issue was whether customers would be prepared to pay the inevitably higher prices which fair trade brands required. The answer has been a resounding yes. Many people apparently are prepared to pay a price premium to protect developing world suppliers.

As a result the market for fair trade products in the UK has boomed and includes such well known brands as Clippper Teas, Green & Black's chocolate, Starbucks coffee and the Body Shop. UK supermarkets now have their own brand range of Fairtrade products, underlining that it is here to stay. In July 2009, Cadbury re-launched its Dairy Milk bar as a certified Fairtrade product.

Price of other products

The price of competitive products is a key area affecting demand. Inevitably buyers tend to consider prices of substitute products when evaluating the effect of prices on demand. However, if the consumer has to spend more disposable income on essential items due to increases in the prices of these items, e.g. food and mortgage repayments, then the consumer's disposable income demand for other apparently unrelated products can be affected. Clearly, in the case of substitute products, how the price of one item compares to the price of another is central to the selection process of the buyer. In the current recessionary climate this is of heightened relevance as witnessed by increased numbers of price comparison websites.

The time factor

When discussing demand for a product or service, we must consider the time factor, i.e. demand must be specified for a given time period. For example, it is conventional to distinguish between 'short', 'medium' and 'long run' time horizons when discussing demand. Demand can vary over these different time periods. The time period must be explicit when evaluating demand concepts in the context of marketing.

From the perspective of the pricing decision maker, it is essential to assess sensitivity of demand. From discussion of the slopes of the demand curves shown in Figure 5.1, the slope of the demand curve indicates what the effect on quantity demanded will be for any given change in price. This effect is referred to as the **price elasticity of demand**.

Elasticity of demand

Price elasticity of demand means demand for a product is **inelastic** if consumers will pay almost any price for the product and very **elastic** if consumers will only pay within a narrow band of prices. Inelastic demand means a producer can raise prices without affecting demand too much, and elastic demand means consumers are price sensitive and will not buy if prices rise too much.

A medical cure that will save a person's life has inelastic characteristics in that the person whose life is at risk will pay anything for the cure, so price is inelastic. However, demand for cars is elastic because if prices rise too much consumers will switch to alternatives like shared lifts or public transport or car hire.

Elasticity can be expressed by:

$$E = \frac{\% \text{ change in quantity demanded}}{\% \text{ change in any demand determinant}}$$

The demand for a product to be responsive, or not, to changes in price can be summarized as a function of:

- the number and closeness of substitutes;
- the necessity of the purchase to the buyer;

- the importance of product performance to the buyer;
- the cost of switching suppliers.

The number and closeness of substitutes

Of all determinants of price elasticity of demand, this is probably the most important. If the product is in competition with a number of others that are similar in quality, perform similar functions and are being offered at a lower price, then it follows that demand for the lower priced product will be greater.

The marketer can modify price-sensitivity of demand for the company's products and services by differentiating them from those of competitors. For example, the market can be 'desensitized' to differences in price by, say, better quality or improved packaging. Unless a company is in a position to compete and win purely on price, every effort should be made to gain a competitive edge by differentiating products from close substitutes.

The market for detergents and cleaning products such as washing powders, washing up liquids and bleaches is extremely competitive. To avoid competing purely on price, companies have made substantial efforts to differentiate their brands from those of competitors. An example of a brand successfully differentiated from its competitors is Fairy Liquid. For many years Fairy Liquid successfully based its differentiation on its 'kindness' to the hands of the user. When other brands began to blur this differentiation through their marketing efforts, introducing their own claims for gentleness in use, Fairy Liquid switched the differentiation to one of the brand being both long established and more effective and, by implication, better value for money compared to its competitors.

The necessity of the purchase

Some product categories are essential purchases for the consumer, whereas others can be classified as luxuries. For example, food, water and electricity are 'essentials'. Total market demand for products and services in this category tends to be less sensitive to changes in price than products and services we count as luxuries. We should note though that individual products and brands, even within the 'necessities' category, can be extremely price-sensitive where there are available substitutes. In addition we should note that what is a 'luxury' for one consumer may be a 'necessity' (or utility good) for another, depending on disposable income, attitudes and lifestyles.

For example, many of us only buy flowers for special occasions and even then might balk at paying more than say £40. In 2009, French President, Nicolas Sarkozy and his wife Carla Bruni were reported as spending over £660 per day on flowers.

The importance of product performance

In certain industrial markets, where the buyer is primarily concerned with performance specifications, demand will tend to be inelastic with regard to price. If a situation arises where the product fails and the buyer would suffer severe penalties in the form of cost, production time or convenience, then demand would be inelastic to price.

Cost of switching suppliers

Hutt and Speh⁴ have pointed to the importance of ‘switching costs’ in industrial markets. For example, in some situations an industrial user of a component part may align certain part specifications of its products to that of the supplier. The firm may have also made a heavy investment in tooling charges or in installing a supplier’s equipment, e.g. a dedicated computer system. The cost here of turning to another supplier would probably be prohibitive and not in the best interests of the purchasing organization.

Cross elasticity of demand

As far as demand is concerned, products can be related in any one of a number of ways. First, they may be competing products or substitutes, in which case, an increase in the purchase of one product may result in a decrease in the demand of another. Next, when products are of a complementary nature, an increase in demand for one product may result in an increase in demand for another. Finally, when two products are of an independent nature then a purchase of one product will have no effect on the demand of another. **Cross elasticity of demand** is a measure for interpreting the relationship between products. It measures the percentage change in the quantity demanded of a product to a percentage change in the price of another product, shown by:

$$S_{xy} = \frac{\% \text{ change in quantity of } y}{\% \text{ change in price of } x}$$

Possible shapes of demand curves

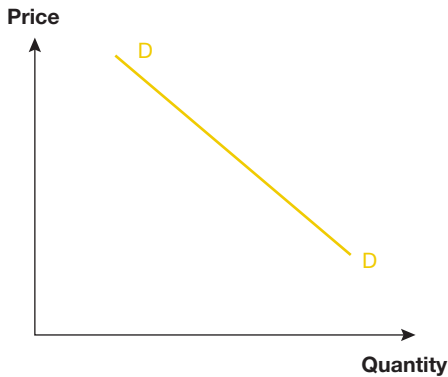
Marketers need to be aware of the way customers react to a given price level, which in turn is related to the shape of the demand curve. In fact there are a number of possible shapes for demand curves. Each curve illustrates sets of customers reacting to a change in price by plotting the price of the product against the level of sales. In plotting these curves, all other factors are kept constant in line with the assumptions of the microeconomic theory of pricing. A variety of possible shapes for demand curves are shown in Figure 5.3 (a)–(d).

Figure 5.3(a) is a traditional economic demand curve. Assuming ‘rationality’ on the part of consumers, the lower the price, the higher the quantity demanded. The majority of markets are characterized by this shape of demand curve.

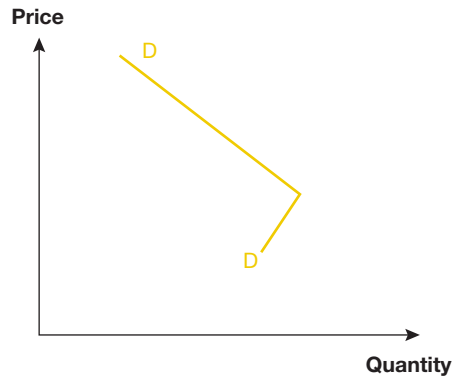
Figure 5.3(b) also shows a frequently encountered demand curve, though one that is often not appreciated by pricing decision makers who use traditional economic principles. Here, lowering the price of a product increases demand up to a point, but below this threshold, the desirability of the product, and hence demand, decreases due to suspicion of ‘poor quality’ signalled by the lower prices. Such suspicions may or may not be justified, but it is customer perceptions that count.

Figure 5.3(c) shows a market where regardless of price charged, demand remains unchanged. This seemingly ‘unrealistic’ market situation is a characteristic of markets where the customer must purchase the product and where there is only one supplier of that product i.e. a monopolistic situation.

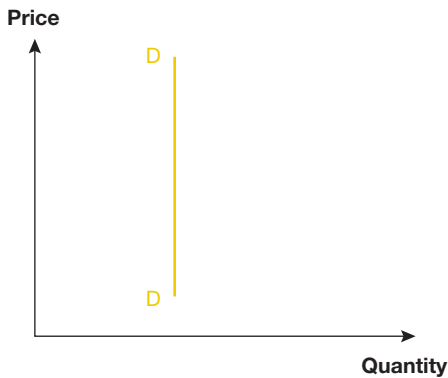
Figure 5.3(d) illustrates a market where increased prices result in increases in demand. Markets where this might occur are those where the consumer is eager to signal that the product is affordable



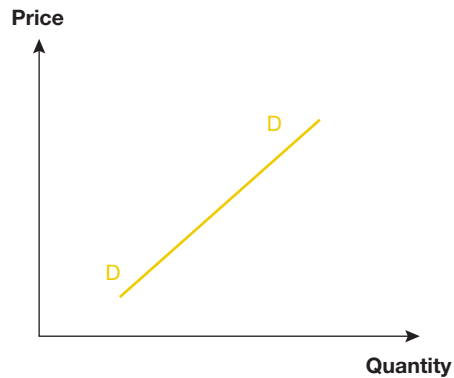
(a) Conventional economic man



(b) Price as an indicator of quality



(c) Price does not feature in demand



(d) Price as an indicator of prestige

FIGURE 5.3 Possible shapes of demand curves

with the higher price being an indicator of the prestige and status of the buyer. An example here is well known brands of perfume.

An understanding of price/volume relationships is crucial to pricing decision making. In practice, particularly for new products, estimating these relationships can be difficult. It is essential in analysing demand to examine the buyer's 'perception of value' as the key to demand and pricing decisions; a factor we return to later.

COST CONSIDERATIONS

If demand considerations effectively set the upper limits to price, then cost considerations determine the lower limits. Relevant up-to-date cost information is essential to formalize pricing strategy. Accurate information allows the pricing decision maker to identify costs on a specific basis directly

related to each product, activity or customer. In this way, management is able to make informed decisions about pricing to target market segments.

Relevant cost information is information which is presented and analysed in such a way as to be pertinent and helpful to marketing decision making. In particular, the cost analysis should enable the marketer to distinguish between fixed and variable costs and the relationship between these and volume. The importance and use of the distinction between fixed and variable costs is illustrated by a breakeven chart shown in Figure 5.4.

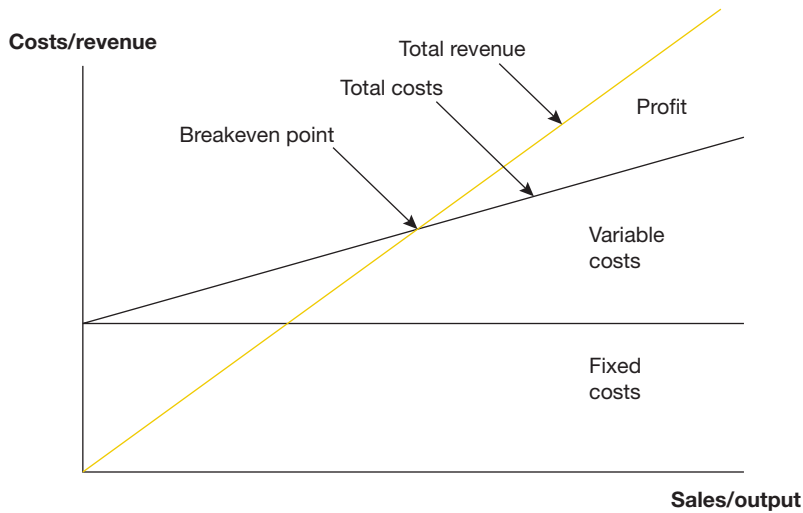


FIGURE 5.4 Simple breakeven chart

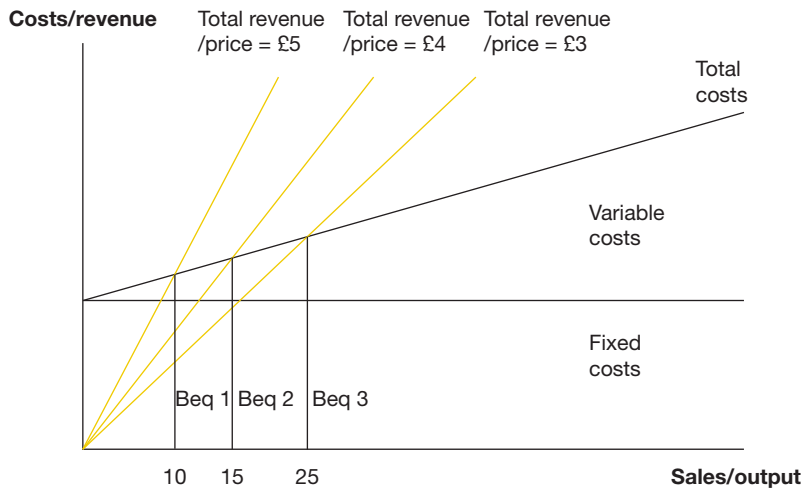


FIGURE 5.5 Breakeven versus different prices

Fixed costs are those that do not vary with levels of output, examples being rates, heating, lighting and security of premises and are represented by the horizontal fixed cost curve in Figure 5.4. **Variable costs** directly relate to production and sales and include labour and direct materials. Increases in output or sales lead to a proportional increase in these costs. Taken together, fixed and variable costs combine to give total costs. The remaining information contained in a breakeven chart is the revenue curve. This shows the total revenue that will accrue to the company at a given price-quantity combination.

The **breakeven point** is the point at which total revenue exactly matches the total costs, i.e. there is neither profit nor loss. This information on cost/revenue relationships is useful to the pricing decision maker e.g. when comparing breakeven points associated with different possible prices for a product. This idea is shown in Figure 5.5. The effect of charging a higher price is to steepen the total revenue curve and as a consequence lower the breakeven quantity. The decision maker can then evaluate the effect of charging different prices in terms of what these different prices and breakeven points mean to the company. Specifically, the information in a breakeven chart includes:

- profit (or losses) at varying levels of output;
- breakeven point at varying prices;
- effect on breakeven points and profits (or losses) if costs change.

Breakeven points can also be calculated using the following information:

Selling price per unit – variable cost per unit = contribution per unit

$$\frac{\text{Total fixed costs}}{\text{Breakeven quantity} = \text{Unit contribution}}$$

e.g. Selling price	=	£20
Variable costs	=	£10
Fixed costs	=	£50,000
Contribution	=	20 – £10 = £10.

$$\therefore \text{Breakeven quantity} = \frac{50,000}{10} = 5000 \text{ units.}$$

The notion of **contribution** is a valuable addition to the pricing decision. It illustrates that in the short run at least, it may be advantageous to sell a product at a price that is less than the full cost of producing it. The distinction between fixed costs and variable costs is particularly useful where a company is attempting to penetrate a market with a new product. It is also useful in times of recession where prices have to be cut to maintain demand. The essential issue is to cover variable costs as a minimum and have a clear understanding of the contribution to fixed costs and profits.

Although fixed, variable and total costs are of major importance to pricing decisions it is also useful to consider how these costs change with different volumes of output, i.e. economies of scale and experience curve effects that we considered earlier.

If a company has a downward sloping experience curve, i.e. costs fall as a function of production experience, then the company might then adopt an aggressive pricing strategy based on increasing volume through low prices. There are risks such as aggressive competitor reaction and the creation of a down-market image.

Although costs are just one of the inputs to pricing decisions, in many organizations they are given more emphasis than any other factors in setting prices. Cost-based pricing is criticized, but it is still a widely used approach. Before looking at cost-based and other approaches to pricing along with their respective merits, we need to look at the final key input to pricing decisions: competitors.

COMPETITOR CONSIDERATIONS

It is increasingly recognized that in today's competitive environment, effective strategic marketing plans are as much about being competitor-oriented as customer-oriented, as evidenced in the following quote from Porter:⁵

Competition is at the core of the success or failure of firms. Competition determines the appropriateness of a firm's activities that can contribute to its performance, such as innovations, a cohesive culture, or good implementation. Competitive advantage is the benefit derived through competitive strategy aimed at establishing a profitable and sustainable position against the forces that determine industry competition.

Business can be compared to running a competitive race, with all the awards going to the winner. It behoves the marketing manager to make a careful analysis of the company's competitors before devoting resources to marketing strategies. This involves examination of competitors so the planner can develop and sustain superior competitive performance. This deceptively simple statement belies the fact that to do this we must establish where competition stems from now and in the future. We also have to consider and appraise competitors' present and likely future objectives and strategies as well as their likely reactions to the competitive moves we might make.

The marketing strategist must also widen the focus to include in the analysis not only 'competition' in the more traditional sense, but also the competitive structure of the industry. This includes the assessment of factors such as barriers to entry and exit and hence, for example, the threat of new entrants; the assessment of potential substitute products or services; the bargaining power of suppliers and the bargaining power of buyers. In short, competitor analysis is complex and multifaceted. Consider how we might seek to conceptualize the competitive structure of an industry, starting with the more traditional approach based on the number of sellers (competitors) and degree of product differentiation in a market.

No pricing decision can be taken in isolation from the nature and extent of prevailing or latent competition in any industry. The most important considerations with regard to competitor pricing include:

- competitors' prices, including discounts, credit terms and terms of trade;
- competitors' resources, especially financial;

- competitors' costs and profit margins;
- likely competitor responses to our pricing strategies and decisions;
- likely potential competitors and barriers to market industry entry;
- substitutes from other industries;
- competitor marketing strategies, especially targeting, positioning and product differentiation.

Three of the most important competitor considerations which directly affect the extent to which an industry will be price competitive are:

- the number of competitors;
- the degree of product differentiation between competitors;
- freedom of entry.

For example, where there is only one supplier, i.e. a monopoly, then the pricing decision maker has substantial discretion over price. On the other hand, where products are undifferentiated, price competition is likely to be fierce. Finally, where competitors can enter an industry with relative ease, then the price setter will have less discretion over price and may be forced to set lower prices than might otherwise be the case in order to deter new entrants.

We have outlined four key inputs to pricing decisions: company, cost, customers and competitor factors. There are many other considerations, ranging from those involving distributor and channel arrangements to possible legal considerations in price setting. We now consider how prices might be set, i.e. pricing methods.

PRICING METHODS

There are several methods through which a company can set prices. We can distinguish between three broad categories according to the emphasis that predominates as the basis for price setting:

- internal cost-based methods;
- competitor-based methods;
- customer value-based methods.

Internal cost-based methods of pricing

The most widely used method for determining prices involves setting prices predominantly on the basis of the company's costs. This method is referred to as '**cost-plus**' pricing. In its simplest form it involves a company calculating average costs of production and then allocating a specified mark-up, which may be related to rate of return required by the company, to arrive at the selling price.

The major advantage of this method is its simplicity. However, despite its widespread use, it has been criticized. Before we examine the basis of these criticisms we need to examine further the mechanics of cost-plus pricing, as well as some of the reasons why this apparently 'simple' approach to pricing may be more complex than it seems at first glance.

As we have seen, the mechanics of cost-plus pricing involve calculating variable costs per unit and adding to this an allocation of the total fixed costs. The first problem with cost-plus pricing is in both the calculation and allocation of these fixed costs. Lancaster and Massingham⁶ highlight these problems as follows:

Both the calculation of total fixed costs and the methods of allocating this total between products give rise to serious problems when using this method of pricing. For example, the amount of fixed costs which will be added to each product, and consequently the price clearly depends on the number of products produced. In turn, the number of products that a firm will produce will, ignoring stockholding, be a function of how many it can sell. How many will be sold, in turn, depends upon the price charged. Pricing in this way then is nonsensical; it means that for a given production capacity, if a company finds that it is selling less and cuts its production its market prices will need to increase. This, in turn, will probably lead to fewer sales, a further cut-back in production and even higher prices. To say the least this is an unsatisfactory state of affairs.

In many multi-product companies the allocation of fixed and semi-variable costs to individual products is often arbitrary. In practice, total fixed costs are allocated on the basis of either a standard volume or a forecast level of output.

A second problem with cost-plus pricing is in determining mark-up. Often the percentage mark-up is derived from a pre-determined target rate of profit or return. The problem with such pre-determined mark-up rates is that they take no account of demand conditions. Where rigid percentage mark-ups are applied, particularly where these are based on internally determined requirements for profit, cost-plus has major disadvantages:

- it ignores demand and market conditions;
- it ignores competitors and competitive considerations;
- it ignores factors such as target marketing and positioning;
- it ignores potential substitutes.

With these disadvantages there must be good reason why cost-plus remains widely used by companies and the advantages are as follows:

- The pricing decision maker does not have to consider the difficult (if essential) area of demand and price sensitivity.
- Where other companies are using cost-plus pricing, and provided they have similar costs and mark-ups, it can lead to price stability.
- It is claimed that because prices are directly related to costs it is 'fair' to both competitors and customers.

None of these potential advantages can compensate for the fact that cost-plus pricing, in its most rigid form, is not market oriented, and can lead to significant strategic disadvantages in the market.

Variations on cost-plus pricing

It would be strange if companies had not realized the problems of cost-plus pricing. Thus a number of variants on this approach, although still based on costs, may be needed.

Marginal or direct cost pricing is where prices are based not on full costs that include fixed costs, but direct or marginal costs. Fixed costs are not charged to production as they are treated as a period charge and written off to the profit and loss account. In this way, the problems associated with having to cover costs, and the methods of having to allocate fixed costs, are avoided. This makes use of the notion of 'contribution' discussed earlier. Needless to say, in the long run all costs, including fixed costs, must be covered, but marginal cost pricing does at least allow a company to take advantage of market opportunities and to use price as a more strategic tool of marketing. This approach is particularly useful for services marketing where the service cannot be stored, i.e. is highly perishable, such as cinema seats or hotel bedrooms. Prices can then be based on making a contribution to fixed costs by charging prices which cover variable, but not total costs.

EasyJet and Ryanair make good use of marginal-cost pricing in their marketing strategies. These operators cover their variable costs when selling an airline seat rather than let the plane fly with empty seats. Provided of course that there are enough 'full price' paying passengers, this is an effective way of not only making a contribution to profits, but at the same time making life difficult for cost-plus competitors.

Another example of marginal cost pricing can be found in the hotel industry. Hoteliers know that if a hotel room is not sold on a particular evening then the revenue that letting the room would generate for that evening is lost for ever. This is due to the service product characteristic of 'perishability', i.e. a service cannot be stored and sold again on another occasion. This makes it imperative that demand and supply of services be balanced and matched. Price is the primary mechanism for achieving this match. In the case of the hotel reducing the price of unsold rooms, this allows the marketer to generate some contribution and the room should be let at a discount if the full price cannot be achieved. Marginal pricing, especially for services, makes sense and is popular. However, it necessarily leads to price variations which as Palmer and McMahon-Beattie⁷ show can lead to customer dissatisfaction and mistrust.

Variable mark-up pricing is an alternative to the fixed mark-up system of traditional cost plus pricing, and here the percentage added to costs can be varied. This approach has advantages over the fixed mark-up approach:

- mark-up, and hence prices, can be varied to take account of demand, competition and market conditions;
- mark-up can take account of marketing objectives and strategies;
- overall it represents a much more flexible approach.

Despite these variations on rigid cost-plus pricing, it is a fact that cost-based pricing is an indication of a company that has failed to appreciate the significance of the marketing concept. This is not to deny the importance of costs, and cost information in pricing decisions, but costs are perhaps better used in an evaluative, rather than a decision-making role when it comes to setting prices.

Competition-based pricing as a method of determining a price uses the price set by competitors to orient the pricing decision. This method is based on assumptions, including that of product image and the position of the company, as being the same or similar to those of the competition. This can be improved upon with a more sophisticated method, involving setting a differential between the company operating it and the competition. The marketer may, for example, set a price 5 per cent below that of the market leader to allow for the market leader's stronger reputation within the industry. This approach to pricing has the disadvantage of being somewhat passive in nature, which tends to restrict the management of the company in terms of individualistic flair and style. Another drawback of this method, known as **going rate** pricing, is that it tends to ignore the company's own cost and demand situation. Going rate pricing is popular in markets where costs are difficult to measure or the response of competitors is uncertain.

Going rate pricing is used extensively in the university sector to price undergraduate degree programmes. For government-funded universities, easily the largest sector, upper limits to fees are set by the government. However, there is no lower limit to these fees. Universities can charge what they want below the upper limit. Notwithstanding difference in costs, objectives, competitive structures and so on, virtually every University charge exactly the same price for their products.

Although it is vital to consider competitors' prices and costs, this information should be used to influence decisions on price rather than as a 'formula' for setting it.

Customer value-based pricing is a market-oriented method. Although complex in nature and application, this method moves away from a focus on costs or competition and concentrates on customers. With this approach, prices are determined on the basis of the perceived value of the product to the customer. The basic idea is that when customers purchase a product they go through a complex process of balancing benefits against costs.

In consumer product markets, the 'benefits' the customer derives correspond to the economist's notion of 'utility' or satisfaction and may include both functional and psychological elements. For example, the customer may derive satisfaction, and hence value, from the quality of a product, or a particular product feature such as a satellite navigation system built into a new car. An example of a psychological element of value might be the benefit which the customer derives from the status of a prestigious brand name. Clearly, the more benefits the customer perceives a product as offering, the more value that customer will place on this product and the more the customer will be prepared to pay. Again, we should note that it is the customer's perception of value that matters and not that of the supplier.

Needless to say, a customer will not purchase a product where costs are seen as being greater than benefits. It is important to stress that costs may include more than just the purchase price, and it is the customer's perception of these costs that is used in the evaluation process. For example, in assessing the cost of, say, a new car it is not just the initial purchase cost, but also maintenance, insurance, fuel and depreciation costs that the purchaser may consider. In addition, just as there are psychological benefits, so too are there psychological costs. For example, a new car purchaser may well consider the costs of 'loss of status' if an otherwise 'good value for money' purchase might be ridiculed by peer groups. Certain Eastern European car manufacturers faced this problem in trying to market their models in parts of Western Europe.

The Czech company, Skoda, in their advertising, actually acknowledged this problem as initially, the brand was regarded as a joke, but this is no longer the case. Effective marketing has now made

the Skoda car a success story of recent years. Product improvements, the backing of German group, Volkswagen and a repositioning of the brand have served to make Skoda one of the best value cars in the market. Although the car is still low priced compared to some of its competitors, this low price base has been turned to advantage by the company by building the value for money aspect. Customers who were attracted to this car become brand loyal and saw themselves as being astute in their choice. After all, they argued, they were securing the advantages of a Volkswagen product at a Skoda price.

Basically, the marketer must determine what the market will bear i.e. the highest price the customer will pay which is:

$$\text{Benefits} - \text{Costs other than price} = \text{Highest price the customer will pay}$$

For the pricing decision maker the difficulty in this method is in measuring how the customer perceives the product the company is offering against the competition.

One method that can be used is to weigh product attributes against those of the competition. First, the customer is asked questions concerning different attributes of a product, e.g. quality and delivery. The customer is then asked how important each criterion is, e.g. the customer might think that after-sales service is more important than delivery and would then give this criterion a higher rating than delivery. The customer is next asked how the organization fares in comparison to other companies in the market place on these criteria. The customer's perceived value of different competitive offerings can then be calculated.

Let us assume that competitor C has the highest overall value rating over competitors A and B. On this basis that company should be able to charge higher prices than competitors A and B for the product. If, say, the average price for this particular product in the industry is £10.00 and the average value rating is 36.5 then company C should be able to charge $£10 \times 36.5 \div 33.3 = £11.00$ approximately, and still be competitive. If all three companies set their prices proportional to their value rating, then they would all be offering the same value to price. However, if company C sets a price of less than £11.00 it should begin to steal market share from its competitors because it will be perceived to be offering better value for money. This illustrates just one method of analysing how the customer perceives the relative benefits of the products on offer.

Taking this approach a stage further, it is useful to establish the Economic Value of a product to a Customer (EVC). **Economic value pricing**, sometimes also referred to as performance pricing, is a powerful pricing tool that is used principally in pricing industrial products. It requires extensive market research to allow the pricing decision maker to analyse:

- how the customer uses the product;
- the financial benefits the product offers to the customer in each usage situation;
- costs involved over the lifetime of usage of the product;
- the cost/benefit trade-off.

How the customer uses the product – Different customers may use the 'same' product in different ways and make different cost/benefit evaluations e.g. one contractor may run earth-moving machinery 24 hours a day and place a premium on a machine which offers greater reliability and

parts back-up to minimize 'down time'. Another, perhaps smaller, contractor in the same business might only operate its machines 12 hours a day, but may not be able to afford a permanent team of mechanics. This contractor is likely to place more emphasis (i.e. value) on supplier/dealer servicing facilities. In short, the marketer must study and understand how the product fits into the operation of the customer.

Benefits – When we understand how the customer will use the product we can proceed to evaluate the 'cost out' of financial benefits of the product to the customer. Focusing on benefits helps develop a more detailed picture of the overall desirability of the product. When analysing benefits the product gives, it is useful to break them into core product benefits and augmented product benefits. Core attributes could be quality, reliability or other functional aspects. The augmented attributes could be delivery, service, guarantees and maintenance offered by the supplier. Focusing solely on physical and core attributes can lead marketers into the trap of marketing features of the product as opposed to benefits the product has to offer.

Costs – Just as benefits can be a group of core and augmented attributes, perceived in differing ways by different customers, so the same can be said for costs, in that costs are not just the price the customer forgoes. One aspect of this is when a buyer decides to change from an existing supplier to a cheaper source. The buyer may be thinking of lowering cost, but in fact the opposite may be the case as the alternative products may not be of as good quality as the previous products, or the new supplier may not be able to deliver the goods on time. The lost time from reject products and subsequent breakdown in the production runs can make savings achieved on price irrelevant. Total lifetime operating costs, including residual value of the product, should be calculated for each customer.

Trade-off between benefits and costs – If the customer makes a trade-off between costs and benefits it would seem sensible for the selling company to do the same. The simplest method is by analysing only the core attributes and price. Once again, it is important therefore that the selling company looks at the use of the product and evaluates this in conjunction with costs and benefits offered.

As the customer looks at price as part of the overall product package, so too must the marketer. If the firm wishes to adopt a value-based approach to pricing it must follow certain guidelines:

- a commitment to the philosophy that the customer chooses products by measuring product benefits against product costs;
- an understanding that benefits involve more than the core attributes, and in many choice situations it is augmented product benefits that differentiate products;
- a realization that costs involve more than just the purchase price alone;
- an awareness that different customers view costs and benefits differently.

Despite the inherent wisdom of value-based pricing evidence shows it is still resisted by many companies (Hinterhuber⁸). Certainly customer/value-based pricing involves more analysis, time and effort than cost-based or competitor-based pricing, but it is essentially marketing oriented. Because of this, value-based pricing is useful in guiding other elements of marketing strategy. For example:

- 1 Value-based pricing can help in market segmentation and targeting, with marketing efforts being focused on those parts of the market (customer groups) where the perceived value of a company's offering is highest.

- 2 Value-based pricing can point the way to developing effective promotional and selling strategies. The customer must be made aware of, and convinced about, any extra value that your products or services can potentially offer.
- 3 Value-based pricing can be used in the early stages of designing and developing new products and services with a conscious effort being made to 'build in' value to the product or service for the envisaged target market.
- 4 Many agree that value based pricing represents the truly marketing-oriented approach to pricing, but as Ingenbleek⁹ shows it is still poorly researched and understood.

Other considerations in setting prices

We have discussed inputs to pricing decisions and merits of different pricing methods. In arriving at a final price, other considerations may influence the decision, such as:

Price/quality relationships

In the absence of other information, price is often used as a singular indicator of quality. The pricing decision maker must be careful to ensure, particularly for a new product, that a low initial price does not put off customers because they suspect the quality.

'Psychological pricing'

It is now recognized that pricing sends many complex signals to customers. Moreover these price signals don't always mean the same thing to each customer. As a result, they are often interpreted and acted upon in different ways. There are behavioural forces at work with respect to price involving psychological factors such as perception, learning and personality. These behavioural forces have led to the notion of considering the psychology of pricing processes. Examples include:

Odd pricing: Often prices are set to end in an odd number (e.g. £4.99 instead of £5.00). There is some evidence that customers then see the product as falling into the lower priced category (i.e. £4.00) rather than the higher one to which it is actually much nearer.

Price and perceptions of quality: Price is often used by potential customers as an indication of quality, particularly where they are unfamiliar with a brand or supplier. This means that a low price may be taken as a sign of low quality and vice versa for a high price meaning it is possible to price a product too low.

Price and social status: Related to price as an indicator of quality, the marketer needs to be aware that some customers will connect the prices they and other people pay as being an indicator of status. Again, some customers may be deterred by low prices even if they know it represents the best possible value, because they feel it detracts from their social status.

Other products in the line/mix

In a multi-product company many products have interrelated costs and/or demand. When setting a price on an individual product in the line, consideration should be given to the overall profitability

of the product mix, e.g. we might decide to set a lower price on an individual product than we might otherwise do because it helps to sell other, perhaps more profitable, items in the line.

Other elements of the marketing mix

As with all marketing mix elements, it is important that pricing reflects, and is consistent with, other elements of the mix. A high quality, expensively packaged product may be looked at with some 'suspicion' by potential buyers if it carries a 'bargain' price tag.

Product life cycle

The competitive situation for a product changes throughout the life cycle of a product. Each different phase in the cycle may require a different strategy. Pricing plays a particularly important role in this respect. Care should be used in interpreting the possible strategic implications of each of the life cycle stages.

Pricing in the introductory stage of the life cycle – With an innovatory product, developers can expect to have a competitive edge for a period of time. With innovatory new products, a company can elect to choose between two pricing strategies:

- price skimming: the setting of a high initial price, that is lowered in successive stages;
- price penetration: the setting of a low initial price.

Price skimming is where the setting of a high initial price can be interpreted as an assumption by management that eventually competition will enter the market and erode profit margins. The company sets a high price so as to 'milk' the market and achieve maximum profits available in the shortest period of time. This 'market skimming' strategy involves the company estimating the highest price the customer is willing or able to pay, which will involve assessing the benefits of the product to the potential customer. This strategy has been successfully carried out by firms marketing innovative products that have substantial consumer benefits. An example of price skimming was Apple's iPod. Launched in 2005, the initial price was set at £450. It now is possible to purchase variants of the iPod for less than £100.

After the initial introduction stage of the product the company will lower the price of the product in successive stage so as to draw in the more price-conscious customers. When a company adopts this strategy the following variables are usually present:

- demand for the product is high;
- the high price will not attract early competition;
- High price gives the impression to the buyer of purchasing a high quality product from a superior firm.

Price penetration is where setting a low price or a 'market penetration strategy' is carried out by companies whose prime objective is to capture a large market share in the quickest time period possible. Conditions which prevail in such circumstances include:

- demand for the product is price sensitive;
- a low price will discourage competitors from entering the market;
- there are potential economies of scale and/or significant experience curve effects and manufacture has to be large scale from the outset;
- a manufacturer will be prepared to wait longer to recoup capital investment costs.

Pricing in the growth stage For a period of time after introduction, the market will continue to grow. The fact that new companies are entering the market means the market will be divided between competing companies, but as the market is still growing, new companies may not take any sales away from the innovator for some time. When new companies come in to the market they tend to emphasize non-product attributes of their product, as opposed to the innovator. If this occurs, the innovating company will usually lower the price of its own product so as to discourage competition.

Pricing at the maturity stage As the market for the product continues to expand and develop, the use of the product becomes more widespread, and with the entrance of new competitors, the price of the product will become increasingly important in competitive strategy. A new supplier entering the market or an existing company can only increase market share by taking share away from other companies. The means for achieving this is often on the basis of price competition, since by the time the market reaches maturity stage, product differentiation and other forms of differentiation may have been eroded.

Pricing in the decline stage During this stage, price-cutting initiated in the maturity stage will tend to continue. At this stage, a careful appraisal of profit margins will need to be made. Prices may be eroded to the point where either total or even only marginal costs are no longer being covered. As we considered in Chapter 4, at this stage in the product life cycle, decisions as to whether to harvest or divest the product need to be made. These decisions will need to take account of possible ways of reducing costs to try and maintain profit margins.

Other interested parties

Pricing decisions will need to take account of various other parties that might be interested in, or be affected by, the pricing decision. For example, there may be legal aspects to pricing decisions, with possibly government departments and/or 'watchdog' bodies playing a key role in pricing decisions. For example, some privatized companies in the UK, such as gas, electricity and water companies, have to meet stringent regulatory requirements with respect to their pricing. A further 'interested party' to take account of in pricing decisions is the distributor. Where products and services are marketed using intermediaries we need to remember that in many markets the final selling price may not be determined by the producer, but by intermediaries. There is now no longer resale price maintenance which means that a supplier to a retailer can only recommend (not stipulate) a retail price. The final price is set by the retailer who adds a mark-up, so to this extent the supplier can try to influence the final market price. The extent that intermediaries are free to set prices effectively means that the marketer has little control over final price.

In addition, we must also determine factors like credit terms and discounts as part of pricing strategy. Many branded product marketers have sometimes been incensed by their inability to force

distributors to sell their brands at the prices they would like. Tesco supermarket chain sold Levi jeans at a lot less than the manufacturer's 'recommended' prices. Challenged by Levis, Tesco won the right to sell the brand at these reduced prices in their stores subject to certain conditions being met. Perfume houses, haute couture clothing brands, books and over-the-counter pharmaceuticals are examples where the branded marketer has effectively lost control over prices charged.

This does not mean that unless you own or control the channel of distribution that planning and managing pricing and much of what we have discussed in this chapter are unimportant. In fact, just the opposite is the case. The increasing power of intermediaries to control price in many markets means that the brand marketer must increasingly search for ways to counteract this power. One of the most powerful tools is to use dominant brands. Even the most influential retailers would not like to lose some of the best known and best selling brands from their shelves. They know that such brands command price premiums and serve to attract customers to shop at their stores. Brand marketers must also work closely with distributors to mutually agree price and promotional campaigns. Another way to gain control over price is to market direct to customers. Needless to say, with the popularity of the Web, this is the route that many marketers are choosing to go.

PRICING/MARKETING STRATEGIES FOR DIFFERENT COMPETITIVE POSITIONS

It is suggested that a company's competitive position in an industry is one of the most important determinants of marketing strategies. A significant contribution to thinking in this area has stemmed from the work of the Arthur D. Little Consultancy Company. They suggest the following alternative categories of competitive position for a company in an industry. Associated with each category of alternative competitive position we have given a brief indication of some of possible implications for strategic marketing:

Dominant: As the term suggests, the dominant competitor in an industry is the company which overtly or tacitly controls all competitors. Dominance may stem from a number of factors such as size/resources, control of raw materials, control of distribution channels and control of technologies. Needless to say, the dominant company is in a strong position as it can exercise considerable choice over pricing strategies.

Strong: These companies do not dominate the market, but their size and strength enables them to exercise considerable discretion over their marketing strategies. Although other competitors cannot be ignored, strong competitors are understandably treated with caution by other companies.

Favourable: These competitors in a market have particular strengths which enable them to compete effectively even though they may not be amongst the largest and strongest companies. Often their favourable position derives from a particular aspect of their marketing such as a strong brand name or a reputation for technological innovation. Often such strengths may be used to lever a stronger position within a market. Companies in this position can in the long run, become strong or even dominant in a market.

Tenable: Although these competitors can make profits and survive, they are often at the mercy of dominant, strong and favourable competitors. Companies in this position have no particular significant differential advantages over their competitors and must follow the market leaders in much of their elements of marketing strategy including pricing.

Weak: These competitors are at a considerable disadvantage in the market. Their weakness may stem from factors such as small size, weak brands or poor quality. Weak competitors must improve in those areas where their weaknesses are significant or they will be driven out of the market.

Non-viable: As the term implies these competitors should not be in the market as they are in no position to compete, nor do they have any avenues left that will enable them to improve their position, so they should leave the industry before they are forced out.

An alternative perspective on competitor position and marketing strategies is proposed by Kotler and Keller¹⁰ who distinguish between the strategies available to the following types of competitor in an industry:

- **Market leader** or a company with the largest market share. This competitive market position can give a company significant cost and power advantages. There is strong evidence that market leaders invariably have the highest rates of return on capital employed. Market leaders may shape prices, industry standards and methods of competing in a market and are often a competitive target for other companies, so they should make every effort to maintain market leadership by, for example, expanding the total market through new uses or more frequent usage. Market leaders tend to benefit disproportionately from increases in overall market size, which strengthens their market share position. The market leader must do everything in its power to defend its market share against market challenges and constantly seek to innovate.
- **Market challengers** are companies that market leaders need to defend their position against. They might be second in market share terms or lower, but they are distinguished by their desire to become market leaders. Market challengers often take advantage of the potential for complacency by market leaders. Many companies have risen from relatively low market shares to become dominant market leaders. This is particularly pronounced in the case of many Japanese companies. They must seek to outperform the market leader in some way which may involve finding new ways to attract customers in a market and attacking the weaknesses of the market leader.
- **Market followers** are companies that do not want to challenge for market leadership, but prefer instead to follow the strategies of the market leader. This does not necessarily mean that they will do exactly the same as the market leader with respect to price, but it means that their strategies are primarily shaped by the market leader. There are disadvantages to being a market follower although many companies have found that this is a viable and profitable strategy.
- **Market nichers** concentrate on specialist parts of the market that larger companies have either consciously or unconsciously ignored. This strategy is useful for the smaller company and is called 'concentrated marketing' as discussed in Chapter 3.

An interesting development in the formulation of marketing and pricing strategies has taken these notions of competitive market positions, and the importance of building strategies around these and relative competitor strengths, and linked them to some of the concepts and techniques developed by military strategists when considering techniques of warfare. In part, this in itself is recognition of extreme competition in many markets, and the notion that companies must either 'kill' or 'be killed' by competitors. This notion of marketing as 'war' involves using the concepts of military strategists and thinkers such as Carl von Clausewitz¹¹ and Basil Liddell-Hart¹² and applying these

to marketing plans and strategies As Kolar and Toporisc¹³ show, the concept of marketing as warfare and the application of principles of battlefield command have now become popular amongst marketing academics and practitioners.

PRICING OF SERVICES

Lancaster and Withey¹⁴ suggest that the basic methods of price determination and alternative pricing strategies, such as market skimming versus market penetration, apply equally to services. You will recall that the perishability of services means that the careful matching of demand and supply is crucial. Because of this, we should expect to find that a much more flexible approach to pricing and margins is appropriate for services. Differential pricing with different prices for different market segments is widely used in the pricing of services to try to ensure a matching of demand and supply.

We should also note that the intangible nature of service products also tends to heighten the use by customers of price as an indicator of quality.

CLUES TO EFFECTIVE PRICING STRATEGIES

It is interesting to observe that many companies fail to price effectively, even when they employ effective marketing strategies. A reason is that they do not apply to their pricing decisions the same fundamental principles of marketing that they apply to other marketing decisions. Success in marketing comes from understanding how customers evaluate marketing decisions, since the customer's response to those decisions will ultimately determine their success or failure.

Shrewd managers reason that by creating exceptional value through careful attention to customers, they can reduce the importance of price in the buying decision. They also acknowledge that price is of primary importance to their companies and conclude that it is appropriate to evaluate product, promotion and distribution strategies from a customer perspective while evaluating pricing from the company's perspective. However, there is a tendency to forget about the customer when pricing, focusing instead on the company's need to cover costs, to maintain cash flow, or to achieve a target rate of return. Clearly, this is a strategic mistake and goes a long way towards explaining why many pricing decisions are ineffective from a strategic marketing point of view.

The customer's goal is to obtain the most value for their money. For commodities, that often means buying the cheapest offering. For differentiated products, that often means paying a little more for the perceived superiority of a particular brand. Whether the product is common or unique, customers will base their decisions on the value of the transaction to themselves rather than to the selling firm. A few pence difference in price may be of great importance to a firm selling millions of units, while being of little consequence to a customer who buys just one, yet that will not stop potential customers from rejecting any price that is a few pence more than they are willing to pay. Customers are not concerned with the seller's need to cover production costs, to improve cash flow or to meet a target rate of return. Their concern is to get value for money.

An effective pricing strategy cannot be achieved unless it is co-ordinated with other elements of marketing strategy. The crucial relationship between pricing and other aspects of marketing is particularly important with new products.

Pricing depends as much on good judgement as on precise calculation, but since it relies on reasoning, there is no justification for pricing decisions based on intuition. Good judgement requires understanding. One must comprehend the factors that make some pricing strategies succeed and others fail. The manager must understand how costs, price sensitivity and competition determine a product's pricing environment. In some companies when the time arrives to make a pricing decision, managers simply meet at specified times and make a decision. They do not study the firm's costs to find out how they will change with changes in sales. They do not talk first to potential buyers to learn what role price will play in their purchase decisions, and they do not analyse past behaviour and likely actions of competitors. Consequently, the pricing process becomes internally oriented and ignores key information necessary to setting effective prices. All too often price is considered and implemented as an essentially tactical decision. There are times when price can, and indeed has to be, used tactically, particularly when reacting to competitors' price changes. Even then, the marketer must know when to follow competitor price changes and when to ignore them, so tactical pricing decisions need careful consideration before they are implemented.

DEVELOPMENTS AND FURTHER ISSUES IN PRICING CONCEPTS AND PRACTICE

It is tempting to think that pricing is one of the less dynamic areas of the marketing mix. One might think, pricing is either cost-based, demand-based or competitor-based and considerations in pricing decisions are in many ways just the same as they were decades ago. In fact pricing is just as dynamic as any of the other elements of the marketing mix.

Below is a brief summary of some the more important developments affecting pricing:

The Internet and pricing

As with all areas of the marketing mix the Internet is affecting how marketers approach pricing. One facet of this is the increased ability of customers to compare and contrast prices. The Internet moves us close to the notion of 'perfect information' on prices central to the economist's notion of perfect competition. Markets may still not be perfectly competitive with respect to price, but it is much more difficult now for the marketer to avoid extensive price comparisons. As we saw earlier in the chapter, the Internet through direct distribution allows the brand marketer to potentially regain some control over pricing decisions. Yan¹⁵ shows that for the marketer who sells through a mixture of online and traditional retail channels there can be real issues of integration and control in price setting.

Increased legislation and regulation

In many countries marketing's power to set and control prices to consumers has been substantially reduced. We have already discussed this in the context of the growing power of the retailer to set prices. In addition, in many markets there is substantial legislation and regulations relating to price setting. For example, in many countries the price of pharmaceutical products is regulated and

controlled. Similarly, through 'quangos' and consumer protection bodies, prices of many essential products and services such as gas, electricity, water and public transport are controlled. Finally, and overarching all this, is increased regulation pertaining to pricing in and between trading blocks such as the EC. For example, changes in legislation and the atmosphere concerning competition have meant that European car distributors and franchisees now have almost limitless freedom over the prices charged for cars they sell on behalf of the major car companies.

The Single European Currency

Staying with developments in the EU, one of the most significant developments affecting marketing pricing strategies in Europe is the single Euro currency. At the moment only Denmark and the UK have opted out, and some newer European Union countries will join when they fulfil the right conditions to join the single currency. There are arguments both for and against joining, but undoubtedly the single currency is a major factor in setting prices.

Price comparisons and negotiating

Modern consumers are more motivated and sophisticated in their desire to compare and contrast prices to obtain best value for money and shop around to get the best deal. Bargaining and negotiation is now commonplace in the UK even at the retail level. Moreover, as we have noted, developments in communication and IT are facilitating the ease with which customers can compare and contrast prices all made possible through the Internet.

Methods of payment

Finally in our brief overview of developments in pricing, marketers have increased their efforts looking for new ways to make it easier for customers to buy and make payment. Recent years have witnessed a plethora of financing and payment schemes for purchasing expensive consumer durables. Cars, jewellery, holidays and homes can be purchased using a myriad of payment methods like leasing, leasing and buyback schemes, tracker mortgages and timeshare all of which are examples of strategies designed to make it less 'painful' for customers when it comes to paying. These help to justify the contention that pricing is perhaps one of the most dynamic elements of the marketing mix.

SUMMARY

Pricing decisions are more than just a 'mechanical' exercise of adding margins for profit to costs. Price setting must become an integral part of the marketing strategy of the company and must be consistent with corporate and marketing objectives and other elements of the mix. In addition to these inputs to pricing decisions, the marketer must also consider demand, cost and competitors.

Although cost-based and competitor-based pricing methods can be used, they suffer from major weaknesses. The most useful approach is a marketing-oriented one that does not neglect

costs and competitors, but is one that is essentially based on customers and their perceptions of value.

A whole set of complex factors affect pricing decisions, making this in fact one of the most complex and difficult areas of strategic market planning. If anything, this complexity is compounded by the dynamic nature of pricing with so many developments affecting the pricing process.

KEY TERMS

Demand schedule	163	Contribution	171
Price elasticity of demand	166	Cost-plus pricing	173
Inelastic (demand)	166	Marginal or direct-cost pricing	175
Elastic demand	166	Variable mark-up pricing	175
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CASE STUDY

ACME Engineering

Pamela Spencelayh has been the accountant at ACME Engineering for over 20 years. During that time one of her responsibilities has been to help set prices for new products launched by the company. In her view this has never posed problems.

As an experienced cost and management accountant, Spencelayh has taken the approach of estimating the average cost of producing any new product and then simply adding on a pre-determined mark-up for profit set by the managing director in line with required rates of return. In her and the company's view, this

pricing method has worked well and has a number of advantages. She feels it is the simplest method and it 'ensures' that costs are covered and a profit is made. Finally, she sees it as a 'fair' method of pricing which can be justified both to customers and the outside world.

Over this 20-year period not all new products launched by the company have been successful. Of the unsuccessful ones, no one has ever blamed price as being a reason for failure. The view has been taken that price could not be wrong if it was based on a factual assessment of average cost with a fair margin for profit added.

... continued

CASE STUDY ... continued

Spencelayh has never had to think or consider the effect of price on product success and failure, and has left these considerations to the design team and the marketers who are, after all, collectively responsible for new products.

Things have now changed. As a result of appointing a new marketing manager who has had a new innovative product developed quickly, Spencelayh found her position as regards pricing decisions challenged. The new marketing manager has simply asked Spencelayh for some cost estimates. When she asked how these were going to be used and proposed a price for the new product based on these

estimates, she was told that the new product would be priced using a customer-value based method. Spencelayh had never heard of this.

It was explained that for the new product it was necessary to establish the economic value of the product to the customer (EVC) and that Spencelayh was expected to help in the costing side of this exercise. She was now extremely worried. Not only did she wonder why it was not sufficient to use cost-plus, but she had no idea what establishing the economic value of the product to a customer meant and what information and analysis would be required to establish the EVC.

CASE STUDY QUESTIONS

- 1 What arguments can be used in this context to justify a customer-value based pricing method as opposed to the simpler cost-plus method?
- 2 What information and analyses will be required by Spencelayh to assess the EVC of the new product, and what problems might there be in using this approach to pricing?

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