

# **Managing Price Decisions**

Lecture Notes

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## KEY IDEAS

1. A marketer must *understand the cost structure* of a product (costs and the nature of the costs involved) because it will determine long-term profit forecasts of various proposed prices, and because the constant drive to reduce costs requires an understanding of cost structure
2. The positioning-pricing approach will determine the base price
3. *Cost-based price* setting is common, but true costs are hard to determine and competition dictates many pricing decisions
4. Demand curves have *price points* around which demand changes significantly. Such price points are created by competitive substitutes, customs, and buyer perception
5. *Consumers do not always trade off price against quality*; sometimes price helps signal and determine quality
6. Price changes should be based on their effect on long-term profit contribution and not on sales
7. The standard competitive response is to *match prices quickly* as they go down but to react less immediately as prices go up.
8. Discounts, payment terms, and a number of other tactics are used to offer *different prices to different customers in different buying situations*
9. Price promotions are used as an *inducement to try a new product*, without the introductory low price hurting the long-term quality image of the product
10. Price promotions of mature brands *encourage loyal customers to stock up* and customers loyal to other brands to *switch*
11. *Price promotions are expensive* because they involve extra marketing management, extra advertising, inventory management, and implementation expenses. They can also lead to a chronic promotions war, which may be difficult

to stop

**A. PRICING OBJECTIVES AND DECISION MAKING**

1. **To support a product's positioning strategy**
  - a. QFD for designing cost and price
  - b. QA for positioning and price
2. **To achieve the financial goals of the enterprise**
  - a. The level of sales and market share needed for break-even and profit
3. **To fit the realities of the marketplace environment**
  - a. The 5E market environment
  - b. The rest of the marketing mix

**B. COST-BASED PRICING**

1. **Turnkey pricing in retailing**
2. ***Cost-plus pricing***
  - a. Advantages:
    - profit expectations are clear
    - it is fair to base price on long-term costs
    - costs are measurable and known
    - cost rules are easy to administer
    - cost rules stabilize prices in the market
  - b. Disadvantages:
    - costs cannot be known at the time prices are set
    - In some situations, a product can be sold at less than average cost and still contribute to overhead recovery and profits
    - cost-based rules are economically inefficient
    - costs are often "managed" and political
    - the cost rule is based on the wrong perspective: product rather than the customer

**C. DEMAND PRICE-POINT ANALYSIS**

Demand analysis uses *positioning strategy* to address the following questions:

- a. Given the product's positioning, *how sensitive* is the target market to variations in price?
- b. Do price points exist around which the target market is particularly price sensitive?

**1. *Kinked demand curve:***

- a. Economists usually represent the functional relationship between sales and price as  $Q=f(p)$  as a smooth curve
- b. Marketers usually find kinks in the curve surrounding price points.

**2. *Perceptual price points***

- a. The number of digits in a price
- b. Ending with a nine

**3. *Customary price points***

- a. Convenience and currency denominations

**4. *Substitute price points***

- a. Competitor's prices are price points
- b. Product differentiation can influence the perception of price points

**D. PENETRATION PRICING**

1. Results in *faster adoption* and *market penetration*
2. Creates *early adopter goodwill*
3. Creates tremendous *cost reduction and cost control*; pressures from the very outset
4. *Discourages competitive entry*
5. The resulting *higher stock-turn* in the channel creates more channel support
6. Penetration pricing of a secondary or export market is often based on marginal costing

**E. PRICE SKIMMING**

1. A high-priced, many featured product is introduced and profits are skimmed
2. When demand levels off, lower-priced, fewer-featured products targets customers who seek differentiation, but will not/cannot pay the higher price

**F. PRICE QUALITY SIGNALING**

1. **Quality assurance pricing (is likely to happen when:**
  - a. Product performance varies
  - b. search and inspection do not provide adequate certainty regarding product performance
  - c. the cost of search and shopping is high compared to the cost of the product
  - d. true performance cannot be clearly tested through trial
  - e. the cost of malfunction is high
  - f. the cost of remedying poor performance is high
2. **Prestige pricing**
  - a. when buyers want the very best, product performance and image appeal increases more than price sensitivity
  - b. buyer behavior:
    - personal confidence reassurance

- the status of exclusivity

**G. CHANGES FROM THE BASE PRICE: PRICE TACTICS AND PROMOTIONS**

**1. The relationship between price and contribution**

- a. contribution is the difference between price and average cost multiplied by unit sales
- b. profit is contribution minus fixed costs
- c. the effect of a change in price
  - lowering price decreases the contribution margin by the amount of the price decrease
  - in a price sensitive market, a price decrease increases unit sales
  - if the increase in unit sales is large enough, the total percentage of sales increases total contribution

**H. RESPONDING TO A COMPETITOR'S PRICE CHANGE**

**1. The price increase case:**

- a. a firm can change with the competitor as costs rise
- b. price shadowing: gaining some market share before increasing price

**2. The price decrease case:**

- a. immediate reactions to rival cutting price
- b. increase quality, service, and or differentiation to protect core market and let the marginal price sensitive customers go

**I. PRICE TACTICS THAT CREATE A PRICE SCHEDULE**

**1. Price shading**

- a. shading off the list price occurs when:
  - it allows the seller to attract large buyers or important customers by *offering more favorable terms*
  - *seasonal fluctuations* occur in supply and demand
  - the salesperson identifies a variation in the customer's level of market knowledge
  - the customer haggles
- b. the sales force should be well aware of the companies price shading guidelines to avoid margin and profit erosion

2. **Volume discounting**
  - a. price discrimination based on volume
  - b. JIT contracts may include discounts on volume over time
  
3. **Payment terms**
  - a. price discrimination for rapid payment
  - b. graduated terms
  - c. prepayment terms
  - d. receivables auditing needs to be good and often
  
4. **Tied pricing**
  - a. accessory products can be discounted when tied to original equipment
  - b. contractual tied pricing that forces an unwanted or less preferred product on the buyer is illegal
  - c. captured pricing (e.g., low initial admission prices, high food/drink prices)
  - d. loss leader pricing (e.g., grocery store specials)
  
5. **Segment pricing**
  - a. e.g., age discounts
  
6. **Geographical market pricing**
  - a. FOB pricing favors customers closest to the supplier
  - b. uniform delivery pricing favors those furthest from the supplier
  - c. zone pricing segments uniform delivery pricing into defined areas to lessen the effect
  
7. **Usage segment discounting**
  - a. volume discounting in non-durable goods/services markets
  - b. may be seasonal
  
8. **Off-peak demand pricing**
  - a. can increase demand during off-peak time slots
  - b. can flatten demand curve
  - c. there is the risk of losing profit if consumer's lose interest after postponing the buying decision
  
9. **Antisegmentation pricing**
  - a. bundling products

- b. is less sensitive to individual demand than other pricing schemes
- c. this pricing is vulnerable to competitive niching

## **J. MANAGING PRICE PROMOTIONS**

### **1. Promoting a new brand**

- a. consumer learning
  - price promotion is behavior re-enforcement
  - repeated exposures transfers positive emotions to the product
- b. Free trial strategy
  - expensive to provide and deliver
  - reach mechanisms:
    - direct mail
    - delivery services
    - localized campaigns
    - special events
    - with media promotions
    - tied to purchase of another product

### **2. Promoting a mature brand**

- a. attracting switchers
- b. encourages stocking up
- c. markets where price promotions on low-involvement items encourages frequent switching can weaken brand equity
- d. buyers may anticipate promotion schedules and only buy at discount

### **3. The timing of promotions**

- a. to reduce inventory (late in the season)
- b. to gain market share or stock turn (early in the season)
- c. retailers can schedule promotions of competing products to alternate to encourage a consistent flow of customers

4. **The advantages of coupons and rebates**
  - a. usage rate percentage is low
  - b. retailer profiteering is by passed:
    - no forward buying
    - no diverting
  - c. even unused coupons and rebates gain a company brand name reinforcement and positive transference
  
5. **Promotional differentiation**
  - a. the best promotions are ones not easily copied by the competition
  
6. **Sales promotion problems:**
  - a. increased price sensitivity
  - b. reduced loyalty
  - c. increased cost and difficulty of doing business
  - d. cannot stop the cycle unless all competitors also stop
  - e. strategic product differentiation is the only viable alternative
  
7. **Changing goals and incentives:**
  - a. self-policing using profitability studies of promotions can clarify the utility of promotions
  - b. keeping production capacity close to maximum can reduce the seductive appeal of promotions
  
8. **Changing channel behavior:**
  - a. special allowances paid to seller for proven performance rather than expected performance
  - b. channel analysis can predict order quantity tolerances which, when implemented as order restrictions to the reseller, reduce product diverting
  
9. **Changing competitor behavior**
  - a. the market leader can instigate a scale-back or cessation of a promotion war
    - public announcement of unilateral move to stop
    - retaliatory promotions against non-complying competitors
  - b. changing the nature of the market by product differentiation

## **K. PRICING TACTICS IN THE GLOBAL MARKETPLACE**

- 1. Unique export pricing issues:**
  - a. tariffs
  - b. "consultant's commissions" - bribes to government officials
  - c. special climate and transport packaging
- 2. Marginal pricing**
  - a. advantage: it enables penetration pricing
  - b. disadvantage: subsidization of growth in the export market by the domestic market
- 3. Problem of production capacity and future export pricing**
- 4. The conservative approach:**
  - a. rigid cost-plus pricing from the outset
  - b. including added profit margin to accommodate risk
  - c. this may position a product poorly in a price sensitive market
- 5. Cost of distribution:**
  - a. lack of on-site control increases difficulty
  - b. direct contact with end users is necessitated
  - c. length of channel increases the number of intermediaries adding their margins without value
  - d. VAT is becoming more common
- 6. Financing terms:**
  - a. greater risk of nonpayment
  - b. currency fluctuations
    - exchange rates
    - quoting in U.S. dollars
    - hedging
  - c. countertrade keeps the money in the host country for the short-term
  - d. long-term investment in the host country can stabilize financing problems. Profit will increase if these investments are made when the dollar is strong against the host country's currency