

9

PRICING Mastering Pricing Concepts

Starting Point

Go to www.wiley.com/college/Hiam to assess your knowledge of the basic pricing concepts.

Determine where you need to concentrate your effort.

What You'll Learn in This Chapter

- ▲ How pricing affects customer perceptions of your product or service
- ▲ Factors to consider when setting a price
- ▲ How to avoid illegal pricing practices
- ▲ Understanding discount structures and general pricing approaches

After Studying This Chapter, You'll Be Able To

- ▲ Demonstrate ways to raise prices while increasing sales
- ▲ Effectively employ special offers and discounts
- ▲ Interpret customer perceptions of pricing

Goals and Outcomes

- ▲ Estimate how price sensitive your customers are
- ▲ Predict the redemption rate for your marketing offer
- ▲ Set prices that take into account multiple factors

INTRODUCTION

Establishing a price is one of the toughest things anybody does in business. In this chapter, we'll take you through the pricing process logically, step by step. Price setting has many factors, including customer perceptions and your own objectives. The pricing process generally has five steps.

9.1 The Facts of Price

Some marketers believe that businesses fail most often for two simple reasons: Their prices are too high, or their prices are too low! Getting the price just right is the hardest task marketers face, but finding the right pricing approach makes success a lot easier. The bottom line of all marketing activities is that the customer needs to pay — willingly and, you hope, rapidly — for your products or services.

But how much will they pay? Should you drop your prices to grow your market? Or would raising the price and maximizing profits be better? What about discounts and special promotional pricing? Getting the price part of your marketing plan right is hard. And several trends have been forcing prices downward:

- ▲ Foreign competition has put pressure on American companies. Foreign-made products are often higher in quality but cheaper to produce.
- ▲ Competitors try to gain market share by lowering prices. Customers may be more price sensitive than ever.
- ▲ New products are far more common today than in the past. Pricing new products is tougher, because there's no history to draw upon.
- ▲ Technology has caused rapid turnover of products. Marketers face pressure to price products to recover cost more quickly.

Most companies fall prey to the myth that customers choose a product based only on its list price. They set their list prices lower than they need to. Or when they need to boost sales, they do so by offering discounts or free units. If you insist on selling on the basis of price, your customers buy on the basis of price.

But alternatives always exist. To raise your price and still sell more, you can:

- ▲ **Build brand equity.** Better-known brands command a premium price.
- ▲ **Increase quality.** People talk up a good product, and that word of mouth earns it a 5 to 10 percent higher price than the competition.
- ▲ **Use prestige pricing.** Giving your product a high-class image can boost your price 20 to 100 percent.

- ▲ **Create extra value through time and place advantages.** Customers consider the available product worth a lot more than one you cannot get when you need it. (That's why a cup of coffee costs twice as much at the airport — are you really going to leave the terminal, get in a taxi, and go somewhere else to save a couple of bucks?)

Sure, price is important, but it doesn't have to be the only thing — unless the marketer doesn't know this price fact.

9.1.1 Exploring the Impact of Pricing on Sales

You need to estimate how price-sensitive your customers are. **Price sensitivity** is the degree to which purchases are affected by price level.

The following list is a series of qualitative indicators of price sensitivity. Ask the following questions about your customer, product, and market. Then add up the number of “yes” answers and see which way they lean. This study isn't scientific, but it gives you a good idea.

- ▲ **Does the customer view the price as reasonable?** If you are operating within an expected price range, customers aren't very price sensitive. Outside of the expected price range, they become more sensitized.
- ▲ **Is the product valuable at (almost) any price?** Some products are unique, and customers know that finding a cheaper substitute may be hard. That lowers price sensitivity.
- ▲ **Is the product desperately needed?** I do not care how much fixing a broken arm at the emergency ward of a hospital costs — if my arm is broken! And I'm not too price sensitive about roadside repair and towing services if I've broken down on the highway at night. These products meet essential needs. But if your product is a nonessential, meaning they do not have to have it right now, the customer is more price sensitive.
- ▲ **Are substitutes unavailable?** If the customer purchases in a context where substitute products aren't readily available, price sensitivity is lower. Shopping for price requires that substitutes at different prices be available. (For example, if you are the only local company offering plumbing repairs on weekends, you can command a high price for your services.)
- ▲ **Is the customer unaware of substitutes?** What the customer doesn't know costs him. And shopping is a complex, information-dependent behavior. The Internet makes it easier to compare prices — but not everything is convenient to buy that way. Not everyone is willing to shop around.

- ▲ **Does the customer find comparing options difficult?** Even where options exist, the consumer can have much difficulty comparing some products. What makes one doctor better than another? It's hard to say. The technical complexity of their work, plus the fact that you cannot consume medical care until after you make the purchase decision, makes comparing options hard. And that difficulty makes health-care consumers less price sensitive — and doctors richer.
- ▲ **Does the product seem inexpensive to customers?** Customers do not worry too much about price when they feel like they're getting a good value. However, if customers feel the pinch on their pocketbooks when they buy, they pay close attention to prices. That's why you negotiate so hard when you buy a car or a house. Even products that cost far less can seem expensive if they're at the high end of a price range. For example, you are more price sensitive if you shop for a fancy, high-performance laptop computer than for a simple, basic desktop unit because the former probably costs 50 to 100 percent more than the latter, making the laptop expensive by comparison.

The more of these that apply, the less price sensitive your customer is. If more than one is true, you probably can raise prices without hurting sales significantly. You can supplement your estimate of price sensitivity (from this list) with actual tests.

For example, if you think a 5-percent increase in prices won't affect sales, you can try that increase in a test market or for a short period of time, holding the rest of your marketing constant. If you were right, you can roll out the increase in your entire market.

9.1.2 Finding Profits without Changing Prices

When you think about profits, you may assume that your focus should be on the price. But many factors drive your company's cash flows and profits, not just the list price of your products. If your manager tells you to figure out how to raise prices because profits are too low, do not assume she's going at it from the right angle.

Lowering a price is easier than raising it. In general, you want to set price a bit high and see what happens. You can take back any price increase with a subsequent price cut. You can take back price increases much more easily (if they do not work) than price decreases. Customers may not be as price sensitive as you fear. They may tolerate an increase better than you think, and they may not respond to a discount as much as you need them to in order to make that decrease profitable. They may assume that price correlates with quality — in which case, they do not buy your product unless the price is high enough.

Instead of assuming that cutting your price is the only way to boost profits, try experimenting with a price increase. Be a contrarian. If that doesn't work, here are some ways to boost profits without raising prices:

FOR EXAMPLE

Apple iPod – High Price, High Sales

This is a success story every marketer would love to duplicate. Apple's iPod MP3 player so dominates the market, that the word iPod is better known than the generic name for the product, MP3 Player. At this writing, iPod had 70 percent of the MP3 Player market, and its combination of brand equity with the Apple name, award-winning advertising, and high quality (an intuitive product design that others have tried but failed to duplicate) enables it to command higher prices — yet still sell more than its lower priced rivals.

- ▲ Check to see how quickly you are making collections — are vendors paying in 65 days? If so, cutting that time by 25 days may make up the needed profits without any price increase.
- ▲ All the discounts and allowances your company offers affect its revenues and profits, so you look at these factors before you assume that price is the culprit. Are customers taking advantage of quantity discounts to stock up inexpensively and then not buying between the discount periods? If so, you have a problem with your sales promotions, not your list prices.
- ▲ If you are in a service business that charges a base price, plus fees for special services and extras, then look hard at the way you assess fees. Perhaps your company is failing to collect the appropriate fees, in some cases.
- ▲ Maybe your fee structure is out of date and doesn't reflect your cost structure accurately. For example, a bank that charges a low price for standard checking accounts, plus a per-check processing fee, may find its profits slumping as customers switch to automated checking over the bank's computers — because banks often set the introductory fees for this service low or waive them to stimulate trials. If so, the problem isn't with the base price of a checking account, it's with the nature of the fee structure.

**SELF-CHECK**

- Define price sensitivity.
- Name four ways to sell more, even at a high price.
- Name four ways to boost profits without raising prices.

9.2 Factors to Consider When Setting a Price

Setting prices may seem complicated at first, but when you understand all the factors you need to consider, the process begins to make sense. (Figure 9-1 illustrates the process that you should use.)

9.2.1 Step 1: Figure Out Who Sets Prices

This step isn't obvious. You, as the marketer, can set a list price. But the consumer may not ultimately pay your price. Distributors, wholesalers, and retailers all take their markups. Furthermore, the manufacturer generally doesn't have the legal right to dictate the ultimate selling price. The retailer gets that job. So your list price is really just a suggestion, not an order. If the retailer doesn't like the suggested price, the product sells for another price.

Start by determining who else may be setting prices along with you, and involve them in your decision making by asking some what they think about pricing. You may have constraints to consider that you must know before you start.

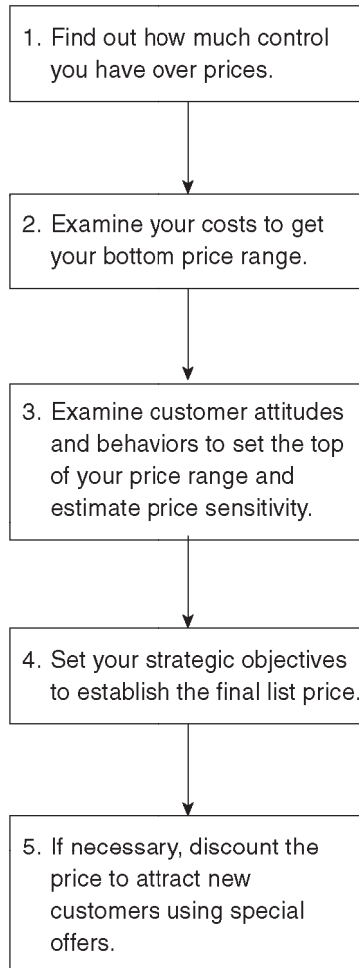
For example, if you are setting the price for a new book, you find that the big bookstore chains in the United States expect a 60 percent discount off the list price. Knowing that, you can set a high enough list price to give you some profit, even at a 60 percent discount rate. But if you do not realize that these chains expect much higher discounts than other bookstores, you may be blind-sided by their requirement.

Marketers who operate in or through a multilevel distribution channel (meaning that they have distributors, wholesalers, rack jobbers [companies that keep retail racks stocked], retailers, agents, or other sorts of intermediaries) need to establish the *trade discount structure*. **Trade discounts** (also called *functional discounts*) are what you give your intermediaries.

These discounts are a form of cost to the marketer, so know the discount structure before you move on. Usually, marketers state the discount structure as a series of numbers, representing what each of the intermediaries get as a discount. But you take each discount off the price left over from the discount before it, not off the list price. Here's how to compute prices and discounts in a complex distribution channel:

1. Say that you discover that the typical discount structure in the market where you want to introduce your product is 30/10/5. What does that mean? If you start with a \$100 list price, the retailer pays at a discount of 30 percent off the list price ($0.30 \times \$100 = \70). The retailer, who pays \$70 for the product, marks it up to (approximately) \$100 and makes about \$30 in gross profit.

Figure 9-1



A helpful pricing process.

2. The discount structure figures tell you that other intermediaries exist — one for each discount listed. The distributor, who sells the product to the retailer, has a discount of 10 percent off the price that she charges the retailer (that's $0.10 \times \$70 = \7 of gross profit for the distributor). This distributor must have paid $\$70 - \7 , or $\$63$, for the product to another intermediary (probably a manufacturer's representative or wholesaler). The marketer sells to this intermediary. And the 30/10/5 formula shows that this intermediary receives a 5 percent discount: $0.05 \times \$63 = \3.15 in profit for him.

3. Subtracting again, you can also determine that the marketer must sell the product to this first intermediary at $\$63 - \3.15 , or $\$59.85$. You, as the marketer, must give away more than 40 percent of that $\$100$ list price to intermediaries if you use this 30/10/5 discount structure. And so you have to calculate any profit you make from a $\$100$ list price as costs subtracted from your net of $\$59.85$. That's all you ever see of that $\$100!$

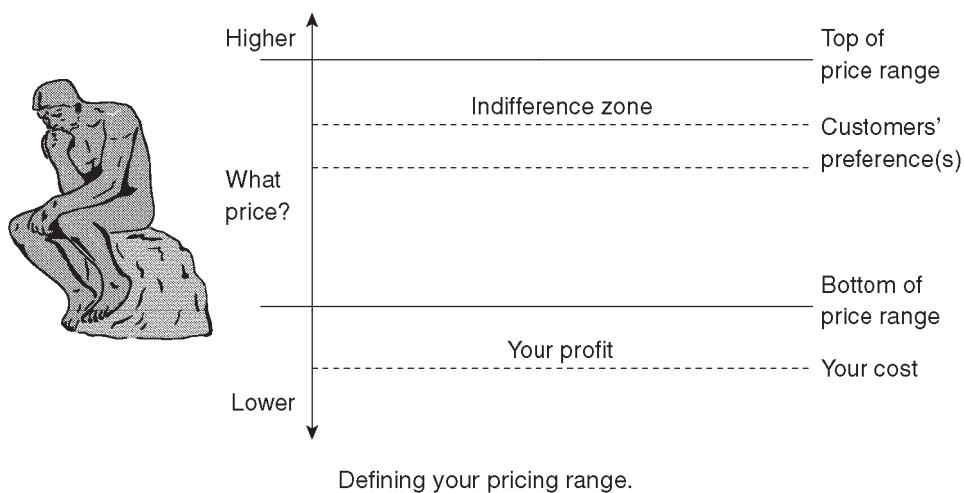
9.2.2 Step 2: Examine Your Costs

How do you know your costs? You may not have accurate information on the true costs of a specific product or service. Take some time to try to estimate what you are actually spending, and remember to include some value for expensive inventories if they sit around for a month or more.

After you examine your costs carefully, you should have a fairly accurate idea of the least amount you can charge. That charge is, at a bare minimum, your actual costs. Sometimes you want to give away a product for less than cost in order to introduce people to it — but do not use this ploy to take customers from competitors or you could be sued for dumping. See Section 9.4.

More often, you need a price that includes the cost plus a profit margin — say, 20 or 30 percent. So that means you have to treat your cost as 70 or 80 percent of the price, adding in that 20 or 30 percent margin your company requires. This cost-plus-profit figure is the bottom of your pricing range (see Figure 9-2). Now you need to see if customers permit you to charge this price — or perhaps even allow you to charge a higher price!

Figure 9-2



9.2.3 Step 3: Evaluate Customer Perception of Price

Your costs and profit requirements impose a lower limit on price. But your customers' perceptions impose an upper limit. You must define both of these limits to know your possible price range. So you need to figure out what the market will bear.

In Figure 9-2, the price that customers favor is the customers' preference. Note that customer preference may not be the upper limit. If customers aren't too price sensitive, they may not notice or care if you set your price somewhat higher than their preferred price. The **indifference zone** is the difference between the customer's desired price and a noticeably higher price. Within the indifference zone, customers are indifferent to both price increases and price decreases. However, the zone gets smaller (on a percent basis) as the price goes up.

How big or small is the zone of indifference in your product's case? Go back to the price-sensitivity list. The zone is small if your customers are highly price sensitive, and the zone is large if they aren't that price sensitive. Just make some assumptions that seem reasonable for now. At worst, your errors may be random, in which case they cancel each other out.

You can also get at customer preference by looking at the current pricing structure in your market:

- ▲ What are people paying for comparable products?
- ▲ Does a downward trend exist in the prices of comparable products?
- ▲ An upward trend?
- ▲ Or are they stable?

Go shopping to figure out the existing price structure; you get excellent clues as to how customers may react to different prices for your product. You need at least back-of-the-envelope figures for the customers' preferred price and how much higher you can price without drawing attention. That means you have established the top of your price range.

The simplest approach to pricing is to set your price at the top of the range. As long as the price range is above the bottom limit (as long as your preferred price plus the indifference zone is equal to or greater than your cost plus your required profit), you are okay. But you cannot always set your price at the top of the range. Keep reading to find out why.

9.2.4 Step 4: Examine Secondary Influences on Price

Your costs and the customers' upper limits are the two primary considerations in setting a price range. But you need to consider many other factors, too. These factors may influence your decision by forcing you to price in the middle or bottom of the price range rather than at the top, for example.

Carefully examine each of the following:

- ▲ **Consider competitive issues.** Do you need to gain market share from a close competitor? If so, either keep price at parity and do aggressive marketing, or adjust your price to be slightly (but noticeably) below the competitor's price.
- ▲ **Consider likely future price trends.** Are prices trending downward in this market? Then you need to adjust your figures down a bit to stay in synch with your market. Similarly, currency fluctuations may affect your costs and, thus, your pricing options. If you are concerned that you may take a hit from the exchange rate, better to be safe and price at the high end of the range.
- ▲ **Consider product-line management** — it may dictate a slightly lower or higher price. For example, you may need to price a top-of-the-line product significantly higher than others in its line just to make it clear that this product is a step above its competition.

9.2.5 Step 5: Set Your Strategic Objectives

Your pricing strategy will have certain objectives. Your objectives in pricing can be one or more of the following:

- ▲ **Survival:** If revenue falls below cost for a long period of time, the firm cannot survive.
- ▲ **Profit:** Closely linked to survival. Making a certain profit may be a pricing objective for a firm. For many businesses, long-term profitability allows the business to satisfy its stockholders. Lower-than-expected or no profits will drive down stock prices and may prove disastrous.
- ▲ **Sales:** Profit requires sales. Marketing aims to increase sales, which is done by managing demand.
- ▲ **Market share:** Firms must maintain an adequate share of the market so that their sales volume will keep the firm going. Many marketers price near the bottom of their price range to increase their market share.
- ▲ **Image:** Price is a highly visible communicator of image. The right price can convey good value, reliability, fairness, and stability.

Ideally, you would price at the top of the range and use the extra revenues to invest in quality and brand-building marketing promotions in order to increase market share (see Section 2.1 for details on these and other strategy options).

- ▲ **Price wars:** These occur when a business believes that price cutting produces increased market share, but it does not have a true cost advantage.

Typically, price wars are overreactions to threats that either aren't there at all or are not as big as they seem. If you can stick to nonprice competition, rather than price competition, you ought to because it is more difficult to match nonprice characteristics. And profits are safer that way.

Yet, you may not be able to do that. If you are in a highly competitive market, you may have to go along.

- ▲ **Competitive pricing:** Pricing relative to an important competitor or set of competitors.

Decide which competing products the customers may view as closest to yours and then make your price sufficiently higher or lower to differentiate your product. How much difference is enough depends on the size of the customers' indifference zone.

Should you price above or below a tough competitor? That decision depends on whether you offer more or fewer benefits and higher or lower quality. If you offer your customer less or about the same, you need to make your price significantly lower so that you look like a better value. If you offer greater benefits, you can make your price a little higher to signal this fact — but not too high because your product must seem like a better value.

In general, a business can price itself to match its competition, price higher, or price lower. Each has its own strategy:

- ▲ **Pricing to meet competition.** Sometimes you should just price exactly at the competitor's price. You may want to match prices if you plan to differentiate your product on the basis of some subtle difference, because this way, customers focus their attention on the difference rather than on price. This strategy means that you use price as an indicator or baseline. The key is to have an accurate definition of your competition and knowledge of competitors' prices. A maker of handcrafted shoes is not in competition with mass producers and will be unprofitable if it tries to compete with mass producers on price because it will have higher production costs.
- ▲ **Pricing above competitors.** Profits will be good, but the marketing mix must be strategically used for this to work. You must have a clear advantage on some nonprice element of the marketing mix. You must prove to customers that your product justifies a premium price. To appear significantly superior to the competition, make sure that your prices are significantly higher. Do not put a prestigious image at risk by underpricing.

FOR EXAMPLE

Tiffany Goes Downmarket

Tiffany & Company risked its prestigious name and lost some of its luxury image when it was acquired by Avon. Why? Avon tried to mass-market the Tiffany name by putting it on a line of inexpensive jewelry. Millions of dollars of losses later, Avon sold out and Tiffany went back to success — by going back to exclusively high prices.

- ▲ **Pricing below competitors.** This strategy works if the market is price-sensitive and/or your company's cost structure is lower than competitors. Costs can be cut by increasing efficiency, by economies of scale, or by reducing credit, delivery, and advertising. A high market share later will probably provide more profits, so low pricing is an investment strategy. With certain volume goals — such as needing to run a factory near its capacity level — pricing in the low end of the range will maximize unit sales, even if doing so doesn't maximize net profits per unit.

SELF-CHECK

- Define trade discounts, the indifference zone, price wars, and competitive pricing.
- Name the five steps in the pricing process.
- List some possible pricing objectives.

9.3 General Pricing Approaches

Why play with the price? If you think the price should be lower, why not just cut the price permanently? As explained in Section 12.3 under Sales Promotions, a price cut is easy to do, but hard to undo. A special offer allows you to temporarily discount the price while still maintaining the list price at its old level. When the offer ends, the list price is the same — you haven't given anything away permanently.

Here are some cases in which maintaining your list price can be important:

- ▲ When your reason for wanting to cut the price is a short-term one, like wanting to counter a competitor's special offer or respond to a new product introduction.

- ▲ When you want to experiment with the price (to find out about customer price sensitivity) without committing to a permanent price cut until you see the data.
- ▲ When you want to stimulate consumers to try your product, and you believe that after they try it, they may like the product well enough to buy it again at full price.
- ▲ When your list price needs to stay high in order to signal quality (**prestige pricing**) or be consistent with other prices in your product line (**price-lining strategy** — see Section 6.5.4).
- ▲ When your competitors are all offering special lower prices and you think you have no choice because consumers have come to expect special offers.

9.3.1 Coupons and Other Special Offers

Many marketers have trained their customers to expect special offers and only buy in response to them. This mistake is the biggest and dumbest one that marketers make, and they've been making it for many years.

Consequently, customers purchase many product categories on the basis of price more than on the basis of quality and benefits. As a result, the rates of coupon redemptions keep climbing in the United States, Canada, and many European countries. Ultimately, special offers take up a bigger and bigger share of marketing budgets every year and often eat unnecessarily into profits.

What happens when competitors get too focused on making and matching each other's special offers? They flood the customers with price-based promotions. Sometimes marketers will reduce prices temporarily, by offering discounts or special offers. **Special offers** are temporary inducements to make customers buy on the basis of price or price-related factors. Special offers play with the price, giving consumers (or intermediaries) a way to get the product for less — at least while the offer lasts.

Special promotions can, and do increase customer sensitivity to price. They encourage people to become price switchers, thus reducing the size of the core customer base and increasing the number of fringe customers. So special offers have the potential to erode brand equity, reduce customer loyalty, and cut your profits. This slope is slippery, and you can easily lose your footing on it!

But you still may have legitimate reasons to use special offers, or you may not have the power to change practices in your market. You can offer coupons, refunds, premiums (or gifts), extra products for free, free trial-sized samples, **rebates**, sweepstakes and other event-oriented premium plans, and so on — just check with your lawyers to make sure that the promotion is legal. (You cannot mislead consumers. A sweepstakes or contest has to be open to all, not tied to product purchase. See Section 9.4 for more on marketing legal caveats.)

If you are promoting to the trade, as marketers collectively term intermediaries like wholesalers and retailers, then you can also offer your intermediaries things like free-goods deals, buy-back allowances, display and advertising allowances, and help with their advertising costs (called **cooperative**, or **co-op advertising**).

- ▲ A large (and growing) majority of all special offers takes the form of *coupons*. A **coupon** is any certificate entitling the holder to a reduced price.

That's a pretty broad definition — giving you a lot of room for creativity. To get a good feel for the options and approaches to coupons, just collect a number of recent coupons from your own and other industries.

9.3.2 Estimating Redemption Rates and Costs

Designing a coupon isn't the hard part. The hard part comes when you try to guess the redemption rate. The **redemption rate** is the percentage of people who use the coupon.

And you raise the stakes when you use big offers, which are riskier to forecast. As we explain in Section 12.3.1, in North America, customers redeem a little over 3 percent of coupons (and the average coupon offers a bit under 40 cents off list price). So you can use that as a good starting point for your estimate. But the range is wide — some offers are so appealing, and so easy to use, that customers redeem 50 percent of those coupons. For others, the redemption rate can be close to zero.

So how do you find out if your coupon will have a high or low redemption rate?

- ▲ **Look at your offer compared to others.** Are you offering something more generous or easier to redeem than you have in the past? Than your competitors do? If so, you can expect significantly higher than average redemption rates — maybe twice as high or higher.
- ▲ **Look at your past data for excellent clues.** If you have ever used coupons before, your company should have rich information about response rates. Just be sure that you examine past offers carefully to pick ones that truly match the current offer before assuming the same response rate can be repeated.
- ▲ **Look at price sensitivity.** A lower price isn't always better. Your offer really just shifts the price on a temporary basis — at some cost to the customer because of the trouble they need to go to in order to redeem the coupon. So the real new price is something less than the discount you offer on the coupon — adjust it a little to reflect how much the customer thinks it costs him to redeem the coupon. Now ask yourself if this real price is lower than the list price enough to alter demand. Does the price fall outside of most customers' indifference zones or not?

Many coupons do not shift the price very far beyond the indifference zone — that's why they generally attract those fringe customers who buy on price but do not attract the core customers of other brands. And that's why redemption rates are only a few percent, on average. However, if your coupon does shift the price well beyond the indifference zone, you are likely to see a much higher redemption rate than usual.

Coupon deals gone wild is the most common reason for marketers to lose their jobs. So always check the offer against what you know of customer perception and price sensitivity to make sure that you aren't accidentally shifting the price so far that everyone and her brother wants to redeem coupons. Say you believe that 4 percent of customers will redeem a coupon offering a 10 percent discount on your product.

To estimate the cost of your coupon program:

1. Decide whether this 4 percent of consumers accounts for just 4 percent of your products' sales over the period in which the coupon applies. Probably not. They may stock up in order to take advantage of the special offer. And so you have to estimate how much more than usual consumers will buy.
2. If you think they'll buy twice as much as usual (that's a pretty high figure, but it makes for a simple illustration), just double the average purchase size. Four percent of customers, buying twice what they usually do in a month (if that's the term of the offer), can produce how much in sales?
3. Now, apply the discount rate to that sales figure to find out how much the special offer may cost you.

Is the promotion worth the money? That's for you to decide. Some marketers have their cake and eat it too when it comes to special offers. They use what they call self-liquidating premiums, which do not cost them any money at all in the long run.

- ▲ A **premium** is any product that you give away to customers or sell at a discount as a reward for doing business with you (see Section 12.3.2 for ideas on how to use premiums).
- ▲ A **self-liquidating premium** is one that customers end up paying for — at least, they cover your costs on that product.

Say you run a contest in which some of the customers who open your packaging are instant winners, able to send away for a special premium by enclosing their winning ticket plus \$4.95. If your direct costs for the premium you send them are \$4.95, you do not have to pay out of pocket for what the customer may see as a fun and valuable benefit.

9.3.3 Customers' Price Perceptions

When setting prices, perception can be the same as reality. You need to think as your customers think. Even if your profit margins are slim, if the consumer sees your price as too high, you have a problem. This is where odd-even pricing can come in.

If the top of your price range for a new child's toy is \$10, you probably want to drop it down to \$9.99 or \$9.89. Why? If they're price sensitive at all, they will buy considerably more of the lower-priced product, even though the price difference amounts to only pennies. Why? People tend to perceive prices ending in 9 as cheaper — generally 3 to 6 percent cheaper in their memories than the rounded-up price.

The only problem is that customers sometimes associate this pricing with cheap products that have worse quality. Do not use odd-even pricing when your customers are more quality sensitive than price sensitive. For instance, odd-even pricing may cheapen the image of an original work of art.

- ▲ **Price lining.** Adjustment of your price to make it fit into your product line, or into the range of products sold by your retailers or distributors.

See Section 6.5.4 for more on this concept. The idea is to fit your product into a range of alternatives, giving the product a logical spot in customers' minds. It's generally effective for buyers and sellers.

Prices must be far enough apart so that buyers can see definite quality differences among products. Customers want and expect a wide assortment of products, and small price differences are confusing. For example, if ties are priced at \$15, \$15.35, and \$15.75, customers cannot judge quality differences.

From your perspective, price lining offers several benefits:

- ▲ It's simple and efficient.
- ▲ It allows you to have smaller inventories.
- ▲ As costs change, prices can stay the same, while quality changes.
- ▲ Price lines make the salesperson's job easier.

You can consider costs to be the only factor, or at the other end of the spectrum, you can completely disregard costs.

- ▲ **Cost-based pricing.** Using your costs as the only basis for your pricing without taking other factors into consideration.
- ▲ **Value-based pricing.** Only the customer's perception determines your price.

FOR EXAMPLE

Better and Cheaper?

Some competitors try to convince customers that their product is better but costs less than the competitors' products. Nobody believes this claim — unless you present evidence. If you do, customers will love you — we all hope to get more for less, after all! The following scenarios are all variations of this possibility:

- ▲ A new antiwrinkle cream may work better but cost less if you've discovered a new formula.
- ▲ A retailer may be able to sell the same brands for a cheaper price because it has larger stores that do more sales volume of business.

With value-based pricing, the cost becomes whatever you think your product is worth to that customer at that time.

Value-based pricing asks two questions:

- ▲ **What is the highest price I can charge and still make the sale?** To answer this, you need to know how price sensitive consumers are and what sort of knowledge they have about competitors' prices. Also, if you have a market leader determining the price for your market, you'll have trouble raising your price.
- ▲ **Am I willing to sell at that price?** Your costs may not make it possible for you to sell at that price, but you may be able to cut costs without affecting quality. However, you may be constrained by legal considerations. (See Section 9.4.)

As long as you have — and can communicate to the customer — a plausible argument, you can undercut the competitor's price at the same time that you claim superior benefits. But make sure that you back up the claim, or the customer assumes that your lower price means the product is inferior.

Set a price that's consistent with your quality. Do not accidentally cheapen the perceived quality of your service by setting your price too low. **Price bundling** is when you group similar or complementary products and charge a total price that is lower than if they were sold separately.

A very popular pricing strategy, this can be a way of selling a less-popular product by combining it with popular ones. Industries such as financial services and telecommunications are big users of price bundling. The customer perceives a better value in many cases. This works when the increased sales generated compensates for the lower profit margin.

9.3.4 Pricing a New Product

When introducing a new product, two different pricing strategies are possible.

- ▲ **Skimming the market.** Selling the product at such a high price that only the very wealthy or least price-sensitive customers will buy it.
- ▲ **Penetration pricing.** Accepting a lower profit margin and pricing relatively low in the introduction of a product. It generates higher sales and helps the product get established in the market quickly.

Sometimes marketers even want to minimize unit volume — for example, they may not have the capacity to sell the product to a mass market and so decide to skim the market. Then they lower prices later on, when they have made maximum profits from the high-end customers and have added production capacity. CD players, fax machines, and satellite dishes for receiving TV programming all entered U.S. and European markets at high prices, using the skimming strategy.

Do not use a skimming strategy unless you are sure that you are safe from aggressive competition in the short term. Also, you need a premium product, for which demand is unusually high. A \$500 ticket for the World Series or an \$80,000 price tag for a limited-production sports car are two more examples. Intel and its Pentium chip possessed the advantage of legal protection for a while, which allowed it to charge premium prices. The initial high prices from skimming are usually reduced at some point, however, to match new competition and allow new customers access.

Penetration pricing works if and when you have price-sensitive customers, the opportunity to keep costs low, the anticipation of quick market entry by competitors, a high likelihood of acceptance by prospective buyers, and the adequate resources to meet the new demand.

SELF-CHECK

- Define prestige pricing, price-lining strategy, special offers, coupon, redemption rate, and price bundling.
- Distinguish cost-based pricing from value-based pricing.
- What are three ways to estimate your redemption rate?
- Name and define two different pricing strategies when pricing a new market.

9.4 Keeping It Legal

You do not have to be a legal whiz to know when pricing is illegal. Whenever a customer or competitor can make a good case for unfair or deceptive pricing, you are as good as busted. This section explains some of the more common and serious illegal pricing practices.

9.4.1 Price Fixing and Its Variants

Do not agree to (or even talk about) prices with other companies. The exception is a company you sell to, of course — but note that you cannot force them to resell your product at a specific price.

- ▲ **Price fixing:** Business competitors agreeing informally to push the price of a product as high as possible, leading to great profits for all sellers

Shady marketers have tried, unsuccessfully, to get around price fixing laws. If your competitors want you to require the same amount of down payment, start your negotiations from the same list prices as theirs, or use a standardized contract for extending credit or form a joint venture to distribute all your products (at the same price), you better realize that these friendly suggestions are all forms of price fixing in disguise. Just say no. And in the future, refuse even to take phone calls from marketers who offer you such deals.

This includes any exchanging of price information. You cannot talk to your competitors about prices. Ever. If it ever comes to light that anyone in your company gives out information about pricing and receives some in return, you are in big trouble, even if you do not feel you acted on that information. Take this warning seriously. Also avoid signaling.

- ▲ **Price signaling:** Announcing a planned price increase

This is sometimes seen as an unfair exchange of price information, because competitors may use such announcements to signal to others that everyone should make a price increase.

Believe it or not, you shouldn't even treat other marketers unfairly. Purchasers are also under this law. If purchasers join together in order to dictate prices from their suppliers, this can very well be price fixing. Have a skilled lawyer review any such plans.

In some cases, the U.S. government can charge you with price fixing, even if you didn't talk to competitors — just because you have similar price structures. After all, the result may be the same — to boost prices unfairly.

▲ **Parallel pricing:** Mirroring competitors' prices

In other cases, the law considers similar prices as natural. Here's a good-sense rule to keep in mind: Do not mirror competitors' prices, unless everyone and her uncle can see that you selected those prices on your own — especially if your price change involves a price increase.

9.4.2 Bid Rigging

If you are bidding for a contract, the same thing applies. Do not share any information with anyone. Do not compare notes with another bidder. Do not agree to make an identical bid. Do not *split* by agreeing not to bid on one job if the competitor doesn't bid on another. Do not interfere with the bidding process in any manner, or you are guilty of **bid rigging**.

9.4.3 Offenses against Competitors

Certain illegal acts involve using prices to push a competitor out of business, or to push or keep them out of a particular market. To the average marketer, these illegal acts are effectively the same (although they are tested under different U.S. regulations).

- ▲ Price squeezes
- ▲ Predatory pricing
- ▲ Limit pricing
- ▲ Dumping

FOR EXAMPLE

Big-time Bid Rigging

Bid rigging in the insurance industry is widespread, according to the New York State attorney general, Eliot Spitzer, and it hurts consumers. Eight insurance executives were indicted in 2005 on felony charges of bid rigging that totaled millions of dollars. Seven of them were from Marsh & McLennan, the largest insurance broker in the United States. These antitrust charges are taken very seriously by the government, which wants consumers to pay competitive prices for products and services. The insurance brokers allegedly colluded with major insurance companies to arrange noncompetitive bids, which were given to corporate clients (reported by the Associated Press, September 16, 2005).

For example, the classic **price squeezing** involves setting wholesale prices too high for small-sized orders. Doing so drives the independent or small retailer out of business, giving unfair advantage to the big-chain buyers that can qualify for a volume discount.

At the retail level, **predatory pricing** involves setting prices so low that local competitors cannot keep up. Predatory pricing is also used by chains and multinationals to drive locals out of business. If you are pricing at or below cost, you are probably doing predatory pricing.

Similarly, if your prices are so aggressive that they lock other competitors out of a market (even if you price above cost), then you are probably guilty of **limit pricing**. A variant is **dumping**, in which you try to buy your way into a new market by dumping a lot of product into that market at artificially low prices.

Some people throw up their hands in despair because so many pricing techniques are illegal. They say, "What can I do?" But trying to influence prices in certain ways is legal. You can offer volume discounts to encourage larger purchases, as long as those discounts do not force anybody out of the market. And although you, as a marketer, cannot force a retailer to charge a certain price for your product, you can encourage them to by advertising the suggested retail price and by listing it as such on your product.

Also, you can always offer an effective price cut to consumers through a consumer coupon or other special offer. Retailers usually agree to honor such offers (check with an ad agency, the retailer, or a lawyer to find out how to form such contracts). However, if you offer a discount to your retailers, you cannot force them to pass that discount on to your customers. They may just put the money in the bank and continue to charge customers full price.

SELF-CHECK

- Define price fixing, price signaling, and bid rigging.
- Who is hurt by predatory pricing and dumping?

SUMMARY

Pricing right means taking into account the customer's indifference zone, your costs, and secondary influences on price. The discount structure sets how much of the price you get to keep. Understand how to avoid illegal pricing practices, and understand the risks and benefits of special promotions.

KEY TERMS

Competitive pricing	Pricing relative to an important competitor or set of competitors.
Cost-based pricing	Using your costs as the only basis for your pricing without taking other factors into consideration.
Coupon	Any certificate entitling the holder to a reduced price.
Dumping	Buying a way into a new market by dumping a lot of product into that market at artificially low prices.
Indifference zone	The difference between the customer's desired price and a noticeably higher price.
Limit pricing	Pricing so aggressively that it locks other competitors out of a market.
Parallel pricing	Mirroring competitors' prices.
Penetration pricing	Accepting a lower profit margin and pricing relatively low in the introduction of a product. It generates higher sales and helps the product get established in the market quickly.
Premium	Any product that you give away to customers or sell at a discount as a reward for doing business with you.
Prestige pricing	Using a high price to signal quality.
Price bundling	Grouping similar or complementary products and charging a total price that is lower than if they were sold separately.
Price fixing	Business competitors agreeing informally to push the price of a product as high as possible, leading to great profits for all sellers.
Price lining	Keeping pricing consistent with product positions in your product line.
Price sensitivity	The degree to which purchases are affected by price level.
Price signaling	Announcing a planned price increase.
Price squeezing	Setting wholesale prices too high for small-sized orders, which drives independent or small-size retailers out of business.

Rebates	A refund of a fixed amount of money for a certain amount of time.
Redemption rate	The percentage of people who use the coupon.
Self-liquidating premium	A premium that customers end up covering your costs for.
Skimming the market	Selling the product at such a high price that only the very wealthy or least price-sensitive customers will buy it.
Special offers	Temporary inducements to make customers buy on the basis of price or price-related factors.
Trade discounts	The amount your intermediaries receive out of the total price.
Value-based pricing	When only the customer's perception determines your price.

ASSESS YOUR UNDERSTANDING

Go to www.wiley.com/college/Hiam to evaluate your knowledge of the basic pricing concepts.

Measure your learning by comparing pre-test and post-test results.

Summary Questions

1. Which of the following is **not** affecting modern pricing?
 - (a) decreased price sensitivity
 - (b) improved technology
 - (c) foreign competition
 - (d) more new products
2. With a 30/10/5 discount structure, the wholesaler is paying \$70 for the product. True or false?
3. The bottom of your price range would be your cost plus your profit. True or false?
4. Possible pricing objectives are
 - (a) profit, sales, and sensitivity
 - (b) image, sales, and survival
 - (c) costs, sales, and profits
5. A self-liquidating premium can cut into your profit margins. True or false?
6. Promotions increase price sensitivity. True or false?
7. Price signaling is always illegal. True or false?
8. It's legal to discuss your pricing with a competitor if it doesn't affect your policies. True or false?
9. Trade discounts are a form of cost to the marketer. True or false?
10. What's the best way to price your product relative to a competitor in a competitive market?
 - (a) price lower
 - (b) price at the same level
 - (c) price according to product benefits vis a vis your competitor
 - (d) price according to your costs

Review Questions

1. In what situations would a customer want to pay *more* for your product?
2. What is the *redemption rate*? How many coupons are redeemed in North America? Less than 5 percent, about 10 percent, or 32 percent?
3. Why can't you just set your price at the top of the price range, every time? Explain.

Applying This Chapter

1. Your new line of snack foods isn't making a profit, and you think you need to raise prices to cover your costs. What other options do you have that are mentioned in this chapter?
2. If your distribution channel has a discount structure of 20/15/10, how much of the \$500 list price of the item are you keeping and how much are your intermediaries getting?
3. Name two products or services in which consumers are generally price sensitive. Then name two more that you think people do not shop for based on price.
4. If you estimate your customers' indifference zone at between \$5 and \$8 for your product, how much might you want to offer for a coupon promotion if your product is currently retailing for \$6.50? What do you need to know to figure out if your promotion will pay off?

YOU TRY IT

The Price of Music

Let's say you want to buy the latest CD of your favorite band but you do not want to pay full price. Price the CD at a local privately owned music store, a discount retailer, a Web site, and a national chain such as Best Buy. Whose price is the best and why do you think that is the case?

Finding the Zone

It costs you \$3 to manufacture your product on average, and you've determined your customers' indifference zone is between \$5 and \$10. The bottom of your price range will be where?