8 PRICING POLICIES AND STRATEGIES
OBJECTIVES

Upon completion of this section, you will be able to:

- describe the various types of pricing policy strategies that can be used by an organisation.
- illustrate the role it plays in an organisation.
- understand the influencing factors in pricing.
- analyse the various types of pricing strategy.
8.0 INTRODUCTION

Price is also the marketing variable that can be changed most quickly, perhaps in response to a competitor price change. *Put simply, price is the amount of money or goods for which a thing is bought or sold.*

The price of a product may be seen as a financial expression of the value of that product. For a consumer, price is the monetary expression of the value to be enjoyed/benefits of purchasing a product, as compared with other available items.

The concept of value can therefore be expressed as:

\[
(\text{Perceived}) \ \text{VALUE} = (\text{perceived}) \ \text{BENEFITS} - (\text{perceived}) \ \text{COSTS}
\]

A customer’s motivation to purchase a product comes firstly from a need and a want example;

- Need: “I need to eat.”
- want: “I would like to go out for a meal tonight.”

The second motivation comes from a perception of the value of a product in satisfying that need/want (e.g. “I really fancy a McDonalds”).
Activity

How do you cost “perceived” value into your product? Discuss.
The perception of the value of a product varies from customer to customer, because perceptions of benefits and costs vary. Perceived benefits are often largely dependent on personal taste (e.g. spicy versus sweet, or green versus blue). In order to obtain the maximum possible value from the available market, businesses try to ‘segment’ the market - that is to divide up the market into groups of consumers whose preferences are broadly similar - and to adapt their products to attract these customers.

In general, a product’s perceived value may be increased in one of two ways - either by:
   1) increasing the benefits that the product will deliver; or
   2) reducing the cost.

For consumers, the PRICE of a product is the most obvious indicator of cost - hence the need to get product pricing right.
8.1 PRICING OBJECTIVES

Price is the amount of money that is charged for “something” of value. Fees, tuition, rent, and interest are all examples of price. Almost every business transaction today involves the exchange of money for something. Price is one of the main variables in the marketing mix. Companies are particularly concerned with price because it directly affects their sales and earnings. Price can include delivery of a product, insurance, warranties, and tax. It can be related to a physical product - such as a house - or to a service, such as an estate agent’s commission. The list price is the price that final consumers are charged for the product. The list price might include any or all of the following:

- physical good or service.
- assurance of quality.
- repair facilities.
- packaging.
- credit.
- warranty.
- delivery.
Activity

What is your organisation’s pricing objectives? What was the basis for these objectives?
Customers may pay a lower price if certain elements of the list price – such as warranties - are not provided. The list price does not include discounts, allowances, rebates, or coupons. However, it does include any applicable taxes. From the perspective of channel members, the list price should include a branded, guaranteed product with warranties and service. In addition, the price should include place availability, a fair profit margin, and promotion to attract customers. Taxes and tariffs are included, but discounts and allowances are not.

Pricing objectives should fit in with a company’s overall marketing strategy. Therefore, if a company is profit-oriented, its pricing objective should be to maximise profits. Types of pricing objectives include:

- profit-oriented.
- sales-oriented.
- status quo-oriented.

Profit-oriented objectives use a target return objective to set a specific level of profit. A target return objective might be stated as a percentage of sales or return on investment. Target return objectives tend to work well in big companies because performance can be compared against the target. Products or divisions that fail to yield the target return might be eliminated or sold. Some companies only want “satisfactory” profits that ensure a company’s survival and meet stockholder expectations. Some small family-run businesses want a return that will provide a comfortable lifestyle.

Many nonprofits organisations set a price that just recovers costs. Some industry leaders pursue satisfactory long-run targets because their trading activities are in public view. Too large a return might invite government action. Firms that provide public services face government review of their prices. A profit maximisation objective seeks to make as much profit as possible.
Activity

What are the types of pricing objectives and what role do they play in your organisation?
Pricing to achieve maximum profit does not always lead to high prices. Low prices can expand the size of the market and provide greater sales and profits. Moreover, a high profit industry will attract competitors which lead to lower prices? Sales-oriented objectives aim to get some level of unit sales, dollar sales, or market share - without referring to profit.

Nonprofits companies are likely to use a sales-oriented objective. Many companies try to get a specified share of a market. It is usually easier to measure market share than to determine if a firm’s profits are being maximised. In addition, if a company has a large share, it may have better economies of scale. Sales growth does not necessarily lead to increased profits. If costs grow faster than sales, a large market share may lead to decreased profits.

Status quo objectives aim to maintain stable prices and to meet or avoid competition. This objective is used when companies are satisfied with current market share or profits and do not want to rock the boat. Status quo pricing objectives may still be part of an aggressive marketing strategy. For example, McDonald’s and Burger King stabilised their prices while experiencing growth and using a very aggressive marketing strategy.

Administered prices help companies to reach their objectives. Companies administer prices rather than let market forces set them. A firm that does not sell directly to final customers usually tries to administer both the price it receives from middlemen and the price final customers pay. It can be difficult to administer prices throughout the channel because middlemen often have their own pricing objectives to meet.
Activity

What pricing objective does your organisation adopt? Do you find it viable?
A pricing policy would not reach its objective if marketers do not administer prices efficiently. For example, a company that offers a 30% discount in the hope of stimulating sales should make sure that the discount reaches the final consumer and is not just absorbed by the wholesaler. Marketing managers have to administer prices carefully because customers must be willing to pay the price for the marketing mix to succeed.

Setting the right price is an important part of effective marketing. It is the only part of the marketing mix that generates revenue (product, promotion and place are all about marketing costs).

**8.1.1 Factors Affecting Demand**

Consider the factors affecting the demand for a product that are:

1) within the control of a business; and

2) outside the control of a business.

Factors within a businesses’ control include:

- price (assuming an imperfect market - i.e. not perfect competition).
- product research and development.
- advertising & sales promotion.
- training and organisation of the sales force.
- effectiveness of distribution (e.g. access to retail outlets; trained distributor agents).
- quality of after-sales service (e.g. which affects demand from repeat-business).

Factors outside the control of business include:

- the price of substitute goods and services.
- the price of complementary goods and services.
- consumers’ disposable income.
- consumer tastes and fashions.
Activity

What are the external factors that affect your organisation’s product demand?
Price is, therefore, a critically important element of the choices available to businesses in trying to attract demand for their products.
8.2 INFLUENCES ON PRICING POLICY

The factors that businesses must consider in determining pricing policy can be summarised in four categories:

1) Costs
In order to make a profit, a business should ensure that its products are priced above their total average cost. In the short-term, it may be acceptable to price below total cost if this price exceeds the marginal cost of production - so that the sale still produces a positive contribution to fixed costs.

2) Competitors
If the business is a monopoly, it can set any price. At the other extreme, if a firm operates under conditions of perfect competition, it has no choice but to accept the market price. The reality is usually somewhere in between. In such cases, the chosen price needs to be very carefully considered relative to those of close competitors.

3) Customers
The consideration of customer expectations about price must be addressed. Ideally, a business should attempt to quantify its demand curve to estimate what volume of sales will be achieved at given prices.

4) Business Objectives
Possible pricing objectives include:

- to maximise profits.
- to achieve a target return on investment.
- to achieve a target sales figure.
- to achieve a target market share.
- to match the competition, rather than lead the market.
Activity

List and discuss the factors that influence your organisation’s pricing decisions?
8.2.1 Link Between Price And Business Objectives

The pricing objectives of businesses are generally related to satisfying one of five common strategic objectives:

Objective 1: To Maximise Profits

Although the ‘maximisation of profits’ can have negative connotations for ‘the public’, in economic theory, one function of ‘profit’ is to attract new entrants to the market and the additional suppliers keep prices at a reasonable level. By seeking to differentiate their product from those of other suppliers, new entrants also expand the choice to consumers, and may vary prices as niche markets develop.

Objective 2: To Meet a Specific Target Return on Investment (or on net sales)

Assuming a standard volume operation (i.e. production and sales) target pricing is concerned with determining the necessary mark-up (on cost) per unit sold, to achieve the overall target profit goal. Target return pricing is effective as an overall performance measure of the entire product line, but for individual items within the line, certain strategic pricing considerations may require the raising or lowering of the standard price.

Objective 3: To Achieve a Target Sales Level

Many businesses measure their success in terms of overall revenues. This is often a proxy for market share. Pricing strategies with this objective in mind usually focus on setting price that maximises the volumes sold.

Objective 4: To Maintain or Enhance Market Share

As an organisational goal, the achievement of a desired share of the market is generally linked to increased profitability. An offensive market share strategy involves attaining increased market share, by lowering prices in the short term. This can lead to increased sales, which in the longer term can lead to lower costs (through benefits of scale and experience) and ultimately to higher prices due to increased volume/market share.
Objective 5: To Meet or Prevent Competition

Prices are set at a level that reflects the average industry price, with small adjustments made for unique features of the company’s specific product(s). Firms that adopt this objective must work ‘backwards’ from price and tailor costs to enable the desired margin to be delivered.
Activity

Discuss the link between the pricing and business objectives in your organisation.
8.3 COMMON PRICING POLICIES

One of the first decisions that a marketing manager must make is to select a pricing policy. A one-price policy offers the same price to all customers who purchase products under the same conditions and in the same quantities. Most companies use a one-price policy because it makes pricing easier and customers like it. However, companies that hold to a rigid one-price policy risk being undercut by competitors.

A flexible-price policy offers the same product and quantities to different customers at different prices. For example, grocery stores might give frequent-shoppers discount prices. Flexible pricing has become easier because companies now have access to databases that keep track of different price scales. The Internet has also made flexible pricing easier. Administering prices is still important with a flexible price policy. For example, marketers who use flexible pricing often specify a range in which a price must fall.

Flexible pricing is typically used in channel sales, in direct sales of business products, for luxury retail items, and for homogenous shopping products. An advantage of flexible pricing is that the salesperson can make on-the-spot adjustments depending on his or her relationship with the customer and the strength of competition. A disadvantage of flexible pricing is that it can reduce profits if taken to an extreme. The time spent by each company in negotiations with customers can also increase selling costs. Customers who spend time haggling can be disgruntled when others get the same deal for less.
Activity

What are the common pricing policies that can be adopted by your organisation? Give reasons.
8.4 PRICING STRATEGIES

8.4.1 Full cost plus pricing

Full cost plus pricing seeks to set a price that takes into account all relevant costs of production. This could be calculated as follows:

\[
\text{Total budgeted factory cost} + \text{selling / distribution costs} + \text{other overheads} + \text{MARK UP ON COST}
\]

\[\text{Budgeted sales volumes}\]

An illustration of applying this method is set out below. Consider a business with the following costs and volumes for a single product:

<table>
<thead>
<tr>
<th>Fixed costs</th>
<th>£750,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Factory production costs</td>
<td>£750,000</td>
</tr>
<tr>
<td>Research and development</td>
<td>£250,000</td>
</tr>
<tr>
<td>Fixed selling costs</td>
<td>£550,000</td>
</tr>
<tr>
<td>Administration and other overheads</td>
<td>£325,000</td>
</tr>
<tr>
<td>Total fixed costs</td>
<td>£1,625,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Variable costs</th>
<th>£8.00</th>
</tr>
</thead>
<tbody>
<tr>
<td>Variable cost per unit</td>
<td>£8.00</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Mark-Up</th>
<th>35%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mark-up % required</td>
<td>35%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Budgeted sale volumes (units)</th>
<th>500,000</th>
</tr>
</thead>
</table>

Source: http://www.tutor2u.net
Activity

What should the selling price be on a full cost plus basis?

The total costs of production can be calculated as follows:

- Total fixed costs: £1,625,000
- Total variable costs (£8.00 x 500,000 units): £4,000,000
- Total costs: £5,625,000
- Mark up required on cost (£5,625,000 x 35%): £1,968,750
- Total costs (including mark up): £7,593,750
- Divided by budgeted production (500,000 units)
- = Selling price per unit: £15.19

Source: [http://www.tutor2u.net](http://www.tutor2u.net)
The advantages of using cost plus pricing are:

- easy calculation.
- price increases can be justified when costs rise.
- price stability may arise if competitors take the same approach (and if they have similar costs).
- pricing decisions can be made at a relatively junior level in a business based on formulae.

The main disadvantages of cost plus pricing are often considered to be:

- this method ignores the concept of price elasticity of demand - it may be possible for the business to charge a higher (or lower) price to maximise profits depending on the responsiveness of customers to a change in price.
- the business has less incentive to cut or control costs - if costs increase, then selling prices increase. However, this might be making an “inefficient” business uncompetitive relative to competitor pricing.
- it requires an estimate and apportionment of business overheads. For example, total factory overheads need to be calculated and then allocated in some way against individual products. This allocation is always arbitrary.
- if applied strictly, a full cost plus pricing method may leave a business in a vicious circle. For example, if budgeted costs are over-estimated, selling prices may be set too high. This in turn may lead to lower demand (if the price is set above the level that customers will accept), higher costs (e.g. surplus stock) and lower profits. When the pricing decision is made for the next year, the problem may be exacerbated and repeated.
Activity

What are the advantages of using full cost plus pricing? Discuss in relation to your organisation’s products/services.
Amongst the factors that influence the choice of the mark-up percentage are as follows:

- **Nature of the market** - a mark-up should reflect the degree of competition in the market (what do the close competitors do?)
- **Bulk discounts** - should volume orders attract a lower mark-up than a single order?
- **Pricing strategy** - e.g. skimming, penetration (see more on pricing strategies further below).
- **Stage of the product in its life cycle** - products at the earlier stages of the life cycle may need a lower mark-up percentage to help establish demand.

### 8.4.2 Return On Investment Method

The “return on investment” pricing method determines the price of a product based on the target return on the **amount invested** in a product. The calculation is as follows:

\[
\text{Unit Price} = \frac{\text{Total costs (fixed and variable) } + (\% \text{ return} \times \text{Investment})}{\text{Budgeted sales volume}}
\]

This calculation can be illustrated using the following example.

Willowbrook Limited has developed a new product called the “Eternal Flame” - a methane-powered heater for use in industrial buildings. Willowbrook requires a return on invested capital of 25% per annum. The sales price for the Eternal Flame should be set using a target return on investment method. The following additional information has been provided:

<table>
<thead>
<tr>
<th>Budgeted sales volume</th>
<th>25,000 units</th>
</tr>
</thead>
<tbody>
<tr>
<td>Variable production cost per unit</td>
<td>£45</td>
</tr>
<tr>
<td>Fixed production cost per unit</td>
<td>£25</td>
</tr>
<tr>
<td>Other annual fixed costs (overheads etc.)</td>
<td>£550,000</td>
</tr>
<tr>
<td>Investment in new machinery to produce the Eternal Flame</td>
<td>£350,000</td>
</tr>
<tr>
<td>Description</td>
<td>Value</td>
</tr>
<tr>
<td>-----------------------------------------------------------------------------</td>
<td>-------------</td>
</tr>
<tr>
<td>Period over which investment in new machinery to be written off</td>
<td>4 years</td>
</tr>
<tr>
<td>Research and development costs for the Eternal Flame</td>
<td>£225,000</td>
</tr>
<tr>
<td>The total investment in the Eternal Flame is</td>
<td></td>
</tr>
<tr>
<td>(New machinery + R&amp;D costs)</td>
<td>£575,000</td>
</tr>
<tr>
<td>The required annual profit =</td>
<td>£143,750</td>
</tr>
<tr>
<td>£575,000 x 25%</td>
<td></td>
</tr>
<tr>
<td>Total annual costs can be calculated as follows:</td>
<td></td>
</tr>
<tr>
<td>Production costs per unit</td>
<td></td>
</tr>
<tr>
<td>(£45 + £25) x 25,000 units</td>
<td>£1,750,000</td>
</tr>
<tr>
<td>Annual depreciation on new machinery (£350,000 / 4)</td>
<td>£87,500</td>
</tr>
<tr>
<td>Other annual fixed costs</td>
<td>£550,000</td>
</tr>
<tr>
<td>Total annual costs</td>
<td>£2,387,500</td>
</tr>
<tr>
<td>Total required annual revenue = total annual costs + required annual profit</td>
<td>£2,531,250</td>
</tr>
<tr>
<td>Unit price (total required revenue / budgeted sales volume)</td>
<td>£101.25</td>
</tr>
</tbody>
</table>

Source: [http://www.tutor2u.net](http://www.tutor2u.net)
Activity

What are the advantages of ROI pricing in relation to your organisation’s products / services?
The use of a targeted return on investment to determine price has the following advantages:

- consistent with other performance measures - e.g. Return on Investment.
- suitable methods for market leaders who are able to set a price which competitors follow.
- a relevant pricing method for new products - particularly those that have a substantial investment.

The method does, however, have some disadvantages:

- with new products, there is an inherent uncertainty about what the achieved sales volume will be - which in turn will be influenced by the price chosen.
- some investment may be common to several products or product groups (e.g. an extension to a factory; investment in new development facilities). This raises the question of how to apportion investment amongst products.
8.4.3 Expansionistic Pricing

Expansionistic pricing is a more exaggerated form of penetration pricing and involves setting very low prices aimed at establishing mass markets, possibly at the expense of other suppliers. Under this strategy, the product enjoys a high price elasticity of demand so that the adoption of a low price leads to significant increases in sales volumes.

Expansionistic pricing strategies may be used by companies when attempting to enter new or international markets for their products. Lower-cost version of a product may be offered at a very low price to gain recognition and acceptance by consumers. Once acceptance has been achieved more expensive versions or models of the offering can be made available at higher prices.
Activity

What are the advantages and disadvantages of expansionistic pricing? At which stage of your organisation’s product life cycle would this pricing strategy be used?
The extreme case of expansionistic pricing, where offerings are made available to the (overseas) market at a price that is actually less than the cost of production is known as dumping. This practice is closely scrutinised by governments since it can force domestic producers out of business and many countries have enacted anti-dumping legislation.

Markets that might benefit from expansionistic pricing strategies include those of magazine and newspaper publishers. Where low prices (annual subscription rates) attract a large number of subscribers, publishers can benefit from the higher rates that they are able to charge advertisers for their advertising ‘space’. Book and CD ‘clubs’ also use expansionistic to attract new members.

8.4.4 Penetration Pricing

Penetration pricing involves the setting of lower, rather than higher prices in order to achieve a large, if not dominant market share. This strategy is most often used businesses wishing to enter a new market or build on a relatively small market share.

This will only be possible where demand for the product is believed to be highly elastic, i.e. demand is price-sensitive and new buyers will be attracted, or existing buyers will buy more of the product because of a low price.

A successful penetration pricing strategy may lead to large sales volumes/market shares and therefore lower costs per unit. The effects of economies of both scale and experience lead to lower production costs, which justify the use of penetration pricing strategies to gain market share. Penetration strategies are often used by businesses that needs to use up spare resources (e.g. factory capacity).
Activity

What are the advantages and disadvantages of penetration pricing?
A penetration pricing strategy may also promote complimentary and captive products. The main product may be priced with a low mark-up to attract sales (it may even be a loss-leader). Customers are then sold accessories (which often only fit the manufacturer’s main product), which are sold at higher mark-ups.

Before implementing a penetration pricing strategy, a supplier must be certain that it has the production and distribution capabilities to meet the anticipated increase in demand.

The most obvious potential disadvantage of implementing a penetration pricing strategy is the likelihood of competing suppliers following suit by reducing their prices also, thus nullifying any advantage of the reduced price (if prices are sufficiently differentiated the impact of this disadvantage may be diminished).

A second potential disadvantage is the impact of the reduced price on the image of the offering, particularly where buyers associate price with quality.

8.4.5 Skimming

The practice of ‘price skimming’ involves charging a relatively high price for a short time where a new, innovative, or much improved product is launched onto a market.

The objective of skimming is to “skim” off customers who are willing to pay more to have the product sooner; prices are lowered later when demand from the “early adopters” falls.

The success of a price-skimming strategy is largely dependent on the inelasticity of demand for the product either by the market as a whole, or by certain market segments.

High prices can be enjoyed in the short term where demand is relatively inelastic. In the short term the supplier benefits from ‘monopoly profits’, but as profitability increases, competing suppliers are likely to be attracted to the market (depending on
the barriers to entry in the market) and the price will fall as competition increases.

The main objective of employing a price-skimming strategy is, therefore, to benefit from high short-term profits (due to the newness of the product) and from effective market segmentation.
Activity

What are the advantages and disadvantages of price skimming and its role in your organisation’s pricing policy?
There are several advantages of price skimming:

- where a highly innovative product is launched, research and development costs are likely to be high, as are the costs of introducing the product to the market via promotion, advertising etc. In such cases, the practice of price skimming allows for some return on the set-up costs.

- by charging high prices initially, a company can build a high-quality image for its product. Charging initial high prices allows the firm the luxury of reducing them when the threat of competition arrives. By contrast, a lower initial price would be difficult to increase without risking the loss of sales volume.

- skimming can be an effective strategy in segmenting the market. A firm can divide the market into a number of segments and reduce the price at different stages in each, thus acquiring maximum profit from each segment.

- where a product is distributed via dealers, the practice of price skimming is very popular, since high prices for the supplier are translated into high mark-ups for the dealer.

- for ‘conspicuous’ or ‘prestige goods’, the practice of price skimming can be particularly successful, since the buyer tends to be more ‘prestige’ conscious than price conscious. Similarly, where the quality differences between competing brands is perceived to be large, or for offerings where such differences are not easily judged, the skimming strategy can work well. An example of the latter would be for the manufacturers of ‘designer-label’ clothing.
8.4.6 Variable Or Marginal Cost Pricing

With variable (or marginal cost) pricing, a price is set in relation to the variable costs of production (i.e. ignoring fixed costs and overheads). The objective is to achieve a desired “contribution” towards fixed costs and profit.

Contribution per unit can be defined as: ‘SELLING PRICE less VARIABLE COSTS’.

Total contribution can be calculated as follows:

\[
\text{Contribution per unit} \times \text{Sales Volume}
\]

The resulting profit in a business is, therefore:

\[
\text{Total Contribution} \text{ less Total Fixed Costs}
\]

The breakeven level of sales can be calculated using this information as follows:

\[
\text{Break even volume} = \frac{\text{Total Fixed Costs}}{\text{Contribution per Unit}}
\]

Consider a business with the following costs and volumes for a single product.

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<tr>
<th><strong>Fixed costs</strong></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Mark-up % required</td>
<td>35%</td>
</tr>
</tbody>
</table>

| Budgeted sale volumes (units)        | 500,000             |

Source: [http://www.tutor2u.net](http://www.tutor2u.net)
Prices are set using variable costing by determining a target contribution per unit. This reflects:

- variable costs per unit.
- total fixed costs.
- the desired level of target profit (i.e. contribution less fixed costs).

The variable/marginal costing method can be illustrated using the same data used further above:

- assume that the selling price per unit is £12.
- variable costs per unit are £8.
- the contribution per unit is, therefore, £4 (£12 less £8).

What is the break-even volume for the business?

- total fixed costs are £1,625,000.
- to achieve break-even, therefore, the business needs to sell at least 406,250 units (each of which produces a contribution of £4).

Looked at another way, what would be the required sales volume to generate a profit of £250,000?

- total contribution required = total fixed costs + required profit.
- total contribution = £1,625,000 + £250,000 = £1,875,000.
- contribution per unit = £4.
- sales volume required therefore = 468,750 (£1,875,000 / £4).
Activity

What are the disadvantages of variable/marginal costing pricing?
The advantages of using a variable/marginal costing method for pricing include the following:

- good for short-term decision-making.
- avoids having to make an arbitrary allocation of fixed costs and overheads.
- focuses the business on what is required to achieve break-even.

However, there are some potential disadvantages of using this method:

- there is a risk that the price set will not recover total fixed costs in the long term. Ultimately businesses must price their products that reflect the total costs of the business.
- it may be difficult to raise prices if the contribution per unit is set too low.

### 8.4.7 Other Pricing Strategies

**Prestige pricing**

Prestige pricing refers to the practice of setting a high price for an product, throughout its entire life cycle - as opposed to the short term ‘opportunistic’, high price of price ‘skimming’. This is done in order to evoke perceptions of quality and prestige with the product or service.

For products for which prestige pricing may apply, the high price is itself an important motivation for consumers. As incomes rise and consumers become less price sensitive, the concepts of ‘quality’ and ‘prestige’ can often assume greater importance as purchasing motivators. Thus advertisements and promotional strategies focus attention on these aspects of a product, and, not only can a ‘prestige’ price be sustained, it also becomes self-sustaining.

**Pre-emptive pricing**

Pre-emptive pricing is a strategy which involves setting low prices in order to discourage or deter potential new entrants to the
suppliers market, and is especially suited to markets in which the
supplier does not hold a patent, or other market privilege and
entry to the market is relatively straightforward.

By deterring other entrants to the market, a supplier has time to:
• refine/develop the product.
• gain market share.
• reduce costs of production (through sales/ experience
effects).
• acquire name/brand recognition, as the ‘original’
supplier.
Activity

What is price elasticity? Use examples from your organisation.
Extinction pricing

Extinction pricing has the overall objective of eliminating competition, and involves setting very low prices in the short term in order to ‘under-cut’ competition, or alternatively repel potential new entrants.

The extinction price may, in the short term, be set at a level lower even than the suppliers own cost of production, but once competition has been extinguished, prices are raised to profitable levels.

Only firms dominant in the market, and in a strong financial position will be able survive the short-term losses associated with extinction pricing strategies, and benefit in the longer term.

The strategy of extinction pricing can be used selectively by firms who can apply it either to limited geographical markets (making up any losses by increasing prices in other geographical markets), or to certain product ‘lines’. In the latter case, the low price of a product at one end of the product range might attract new purchasers to the product line, and sales of different, more profitable items might increase.
Activity

Give examples of extinction pricing.
Manufacturers may set different pricing policies for different levels of the channel system. For example, a company that produces quality crystal might sell wine glasses to retailers at a low price in order to convince the retailer to carry the product. However, they might suggest that the wine glasses are sold by the retailer at a high price to maintain the brand’s image. Money itself has a price level, measured by what it is worth in another currency. For example, $1 might be worth £0.60 in one month and several months later are worth £0.40. Marketers should keep an eye on currency fluctuations because they affect all companies - even small businesses operating locally. When the dollar is weak, companies are threatened by increased foreign competition. When the dollar is strong, companies can compete more effectively with foreign imports.
8.5 DISCOUNT PRICING POLICIES

A discount is a reduction from the list price given by the seller to the buyer. Buyers who use discounts usually give up some part of the marketing mix included in the list price - such as service. Quantity discounts are discounts that encourage customers to buy in large amounts.

Cumulative quantity discounts give a reduction in price for large purchases over a given period, such as a year. Cumulative quantity discounts are used to encourage repeat buying. Companies may use them to try to develop closer, ongoing relationships with customers.

Non-cumulative quantity discounts give a reduction in price when a customer buys a larger quantity on an individual order. For example, a store might give a free bottle of shampoo with every two bottles purchased.

Discounts that encourage buyers to buy earlier than present demand requires are known as seasonal discounts. For example, many beach resorts offer summer holiday discounts and many ski resorts offer winter holiday discounts. Phone calls made at off-peak times are also seasonal discounts.

Most business sales are made on credit. The seller sends an invoice to the buyer’s accounting department, which processes it for payment. Usually, the invoice states when payment is due. *Net* means that the payment for the face value of the invoice is due immediately - *net 30* means that payment is due in 30 days.
Activity

Why does your organisation need to give discounts?
A cash discount gives a reduction in price if the bill is paid quickly. For example, if a buyer pays within 10 days, he or she may receive a 5% discount. Sellers like to use cash discounts because they provide a quick turnover and improve cash flow. Sellers sometimes prefer cash discounts to credit card services, which can take up to 7% of the revenue for each sale and are sometimes slow to process payments.

A trade discount is a traditional list price discount given to channel members for the job they do. For example, a clothes manufacturer might give retailers a regular discount of 10% to cover their retailing costs.

A sale price is a temporary discount from the list price. Marketing managers might use sale prices to respond to changes in the market. For example, a retailer might use a sale to meet a competing store’s price. Sale prices can also be used to reduce inventory and encourage middlemen to carry a product. Constantly changing prices can confuse customers and weaken brand loyalty. Some companies avoid high list prices and discounts altogether. Instead, they use everyday low pricing that sets a low list price, which the customers can rely on.

Allowances are reductions in price given to final consumers or channel members for doing something or accepting less of something. Advertising allowances are price reductions given to channel members who advertise or promote the product in return. For example, a toy company might give its retailer a 2% advertising allowance. The retailers can buy the toys for 2% less than the list price as long as they use the 2% saving on local advertising.

A stocking allowance is a price reduction given to middlemen in return for more - or better - shelf space. Stocking allowances are used to get supermarket chains to handle new products. Push money (or prize money) allowances are cash payments given by manufacturers or wholesalers to retail salespeople who aggressively sell certain items. Push money is generally used to encourage sales of new, slow-moving, or high-margin products, such as furniture, consumer electronics, clothing, and cosmetics.

A trade-in allowance is a price reduction given for used products when similar new products are bought. Trade-ins are an easy
way for marketing managers to lower the final price without reducing the list price. Many producers offer discounts to consumers through coupons. Consumers who present coupons to retailers get a reduction of the list price. Coupons are usually used to sell consumer packaged goods. Retailers honour coupons because they increase sales and they are usually paid for the trouble of handling the coupon.
Activity

At what stage of a product life cycle is a discount necessary? At what stage of the product life cycle is the discounted product of your organisation?
A rebate is a refund paid to consumers after a purchase. Rebates can be used on both high and low-priced items. Rebates are a way of ensuring that final customers - not the middlemen - get the price reduction. Also, consumers often buy products that offer a rebate but forget to claim it.

**PRICING STRATEGY FAQ’S**

Source: Strategic Pricing Group, Inc.

**Question:**
Isn’t a customer’s willingness to pay a good proxy for the value they receive?

**Answer:**
Not Really. There are many reasons why willingness-to-pay may be less than value delivered. Among the most common are:

- the customer does not know enough about what the product can do, or the value of the benefits that it yields, to justify paying a value-based price. This calls for the seller to document and communicate the value, not to cut the price.

- the customer does not believe that he or she needs to pay for the value since they have been rewarded in the past with lower prices for refusing to pay. This calls for creating a pricing strategy with price integrity, but with enough flexibility in the offer to enable price differences across customers where the value is really different.

- the price metrics do not track value. The price metrics are the units to which price is attached. Changing metrics to ones that are more value-based enables a company to capture more value from some customers, while still maintaining a perception of fairness. For example, the traditional price metric for pricing ads in newspapers is the column inch. But isn’t the value of a classified ad for a $500K housing no more than for a $75K condominium? A more value-based approach
might be a percent of the asking price, which is the metric that real estate agents use (charging 5-6% of the sales price). That could make billing too complicated however. Thus a compromise alternative might be three sections: the regular real estate section, a section for “Affordable homes”, and a section for “Homes of Distinction” all at different prices.

Question:
We drive a lot of pricing decisions based on market share objectives…Is this appropriate?

Answer:
Successful pricing decisions are those that increase, or prevent the loss of, long-term profitability. Pricing for volume can sometimes be a brilliant decision, if appropriately supported by a strategy for operating at lower cost (Southwest Air, Wal-Mart). Many companies, however, forgo long-term profitability because of an obsession within increasing or maintaining market share. The market share that maximises profitability, however, is the share that you can serve with some competitive advantage. A company that sells a product or service that is more highly valued by 40% of the market, for example, can enjoy a price premium if it is willing to accept only a 40% share. If it insists on a 50% share, it will have to have to undercut its price to do so. Dramatic increases in profitability and cash flow are achievable when a company makes its sales goals consistent with its value delivery.

Question:
Is it okay to use price to help drive sales or prevent sales losses?

Answer:
Not always. Price often does have a powerful effect on sales. But there are two important reasons not to make hasty decisions.

- Not all pricing problems are problems with price. You can face a pricing problem because you are not appropriately communicating value, because your
distribution channel is failing to deliver on the complementary service necessary to realise your value or because a competitor has entered with a cheaper product that appears to be a good substitute.

- Sometimes, the best solution to a pricing problem is to walk away. This is especially true when the problem is localised. For example, as trade barriers declined in the European Economic Union and competition increased, many companies learned that they were better off avoiding low priced markets than letting those markets undermine higher prices elsewhere in the EC.

**Question:**
How can we deal with a company that allows users of our product to select us based on the value we bring to them, but then expects us to negotiate a price with a purchasing department that treats us like we are supplying a commodity?

**Answer:**
The answer is, in principle, quite simple and similar to the question above about dealing with “reverse auctions”: un-bundle the elements of value. When you tell the purchasing agent that you are willing to meet or come closer to the competitive price but only by taking away the things that differentiate your offering, the purchasing agent is forced to reintroduce the users to evaluate the trade-offs. If you cannot unbundle, then you have to be prepared to walk away. Do not do so without, however, reinforcing your value to and desire to work with the users. It is their job to fight the battle with purchasing. It is your job to empower them with a compelling value story for buying your product.

It is also important to understand the deceptive techniques that purchasing agents have learned to undermine a compelling value story, and how to respond to them.

**Question:**
What can we do to reverse the price erosion that we have experienced in our industry?
Answer:
The answer to this question turns on the cause of the erosion; different causes require different responses. Your first challenge is to accurately identify the cause.

- In the worst case scenario, you may simply have lost what was a differentiation in your product or service that justified a premium price. In all likelihood, this resulted from competitors getting better at offering more for less. The simplistic answer that many pop marketing theorists offer is to innovate faster. Clayton Christensen, in The Innovator’s Dilemma, makes a good case that such a strategy often fails since, once products reach a certain level of performance, the incremental cost of each additional innovation becomes small while the incremental cost to create it keeps increasing. At some point, people are happy with the commodity. The key to profitability in those cases is not to fight the trend, but to change your business model to exploit it. [See Chapter 7, page 189 of Nagle, The Strategy and Tactics of Pricing, 3rd edition for a discussion of how to manage for profitability in a mature market.]

- You may have created conditions for price erosion by empowering your buyers to negotiate away the value of your differentiation. In this case, the problem is totally reversible, although the process takes time. It first requires changing the mindset of your own organisation to think in terms of maximising the value of your brand franchise, not just the value of your top line sales. Then it requires re-educating customers that there is a relationship between the prices they and other customers pay and the value they receive.

- You may have a competitor who is deliberately diving down prices to gain a share. The question you must answer is whether that competitor has some competitive advantage enabling it to engage in that strategy profitably. If so, find a niche that that competitor cannot serve before you become toast! No one ever wins by trying to fight Wal-Mart or a Dell head-on without a comparable cost advantage.
In many cases, however, competitors engage in aggressive price competition without such an advantage. In that case, there are numerous ways to contain them. The key is to do so without undermining your own profitability in the process.

**STRATEGIC FOCUS - HOW TO FIGHT A PRICE WAR: ANALYSING THE BATTLEGROUND**

by Akshay R. Rao, Mark E. Bergen, and Scott Davis

“Price wars,” write Akshay R. Rao, Mark E. Bergen and Scott Davis, “are a fact of life—whether we’re talking about the fast-paced world of ‘knowledge products,’ the marketing of Internet appliances, or the staid, traditional business of aluminium sidings. If you’re not in a battle currently, you probably will be fairly soon.”

In “How to Fight a Price War,” they caution that price wars are not simply a matter of responding to a competitor’s aggressive price move with one of your own. Instead companies should consider all of their options, including defusing the conflict, retreating or, if a battle is unavoidable, fighting it with an arsenal of weapons beyond just price cuts themselves.

In this excerpt, Rao, Bergen and Davis suggest careful analysis of four crucial areas as the key to knowing which path to take.

Refer to Appendix 4 of this chapter for the full insight.
8.6 TRANSFER PRICING

For every item sold, and every service provided, a price is charged by the seller and paid by the buyer. And it is the sum total of prices charged and paid that determines the commercial profits (or losses) of any business. In the most straightforward cases things are offered for sale at a fixed price: the buyer has the choice of buying at the advertised price or not buying at all. But for transactions that are more complex, prices are negotiated between buyers and sellers.

Where goods are sold on the open market, it is fairly easy to fix on a price that buyers are prepared to pay (although the prices set will determine the volume of sales made). The size and nature of the market, the quality of the goods, the extent of the competition, cost and desired profit margin are all factors which bear on the selling price.

But where the parties to the transaction are connected, the conditions of their commercial relations will not be determined solely by market forces. The price will not necessarily correspond to what would have been charged if they had not been connected. And where both the seller and the purchaser are companies owned by the same person the price charged will not of itself make their common owner any richer or poorer; it will merely serve to determine the extent to which the common owner’s funds/profits/financial resources are transferred/shifted from one company to the other.

So a transfer price is the price charged in a transaction. And where connected parties transact with each other there is not always the need or the incentive to charge prices that precisely replicate what would have happened had they been dealing at arm’s length. As a result the level of their commercial profits may differ - sometimes by accident and, on occasions, by design - from what would have arisen if they had done the same transactions with unconnected parties.

The transfer pricing issue mainly arises in cross border transactions between two companies who are part of the same group. However, transfer pricing problems are not limited to
company to company transactions; for example a transaction between an individual and an overseas company he controls can be manipulated through the transfer price.

Large multinational enterprises and their advisors are well aware of the opportunities to manipulate transfer prices. From the point of view of a large multinational group, it is better to structure the business so that profits are earned in a territory that taxes them at 10%, rather than a territory that taxes them at 35%. Tax planning to help bring about such a result is now very sophisticated.

Tax authorities around the world are increasingly aware that the transfer pricing of transactions between connected parties can affect their tax yield. Moreover, this is particularly so where the parties to a transaction are subject to different tax rules and rates.

**8.6.1 How Do Companies Set Their Transfer Pricing Policy?**

There are a host of factors that potentially have a bearing on the way transfer prices are set within a multinational group. Some groups plan their transfer pricing with great care in order to shift profit to where it should properly fall - or to where they want it. Others tend to give their transfer pricing relatively little thought. In itself, it would be unlikely to constitute a significant profit generating activity unless it succeeded in lowering a group’s global tax bill. Inevitably, motives will vary and there may well be cases where transfer prices are manipulated other than for tax reasons.

Here are some of the factors that could influence the way in which transfer prices are set:

- groups want to know, for their own management purposes, where value is being added, and that imply having appropriate transfer pricing policies. However, groups tend to be more interested in knowing how value is added between functions than between countries. A distinction between countries can sometimes be relevant only for tax purposes.
- a group’s transfer pricing policy will not necessarily be influenced by purely fiscal considerations. Group
members may trade in countries which have unstable politics, high rates of inflation, rigid exchange controls or high rates of taxation. Those countries may impose high tariff barriers or otherwise restrict free movement of goods in or out of their territory. Transfer prices may be set in such a way as to extract profit from the country without falling foul of the tax rates or controls.

- circumstances vary from group to group. Some may be very tightly controlled from the centre so that their overseas subsidiaries are permitted to take no decisions of substance without reference to the parent company. In that situation, the parent’s control of transfer prices and trading arrangements might enable it to determine which of its subsidiaries makes commercial profits and how much profit individual subsidiaries are allowed to make. At this point tax is clearly an important consideration and the tendency will be to channel profits into the countries which charge nil or low rates or which, although nominally normal rate territories, offer specific exemptions or reliefs.

- not all companies, however, exercise that degree of control over their overseas operations. Wars, historical accidents, protective regimes and highly regulated industries have made it politically expedient for the subsidiaries of multinational companies to assume a distinct local identity. In some countries substantial local minority (or even majority) participation is required, thus weakening the degree of control which the overseas parent can exercise.

- groups may prefer for nationalistic reasons to pay tax in their home country, even though there may be no saving on their tax bill. There will be cultural considerations to bear in mind.

- sheer distance sometimes makes it physically impossible for the parent company to do more than exercise general oversight. It is also increasingly common to find that local subsidiaries are expected to operate as cost and profit centres, exercising genuine control over costs and endeavouring to make their operations as profitable as they should be. Directors
and employees might be able to earn bonuses and other incentives linked to profits. Price setting may be subject to negotiation but these negotiations are unlikely to replicate what would happen between independent parties.

- some territories have domestic transfer pricing rules that do not conform to the methods that are generally accepted at an international level for dealing with the transfer pricing problem.

8.6.2 How Does The Arm’s Length Principle Solve The Transfer Pricing Problem?

There is a general international consensus that, to achieve a fair division of taxing profits and to address international double taxation, transactions between connected parties should be treated for tax purposes by reference to the amount of profit that would have arisen if the same transactions had been executed by unconnected parties. This is the arm’s length principle.

For a variety of reasons, the trading arrangements and pricing policies under which multinational groups operate can result in prices and terms considerably different from those which would have been seen between independents engaged in the same or similar transactions. The pricing terms which would be expected to be seen between independents is referred to as ‘arm’s length’.

The arm’s length principle is applied to a controlled transaction by; replacing (hypothetically):
- the actual terms (price, etc.) under which a transaction was done with;
- arm’s length terms; and (for tax purposes)
- recalculating the profits accordingly.

In the United Kingdom for example, the arm’s length principle is endorsed by the OECD and enshrined in the Associated Enterprises Article of the OECD Model Tax Convention on Income and on Capital (usually referred to as the OECD Model Treaty). It enjoys general international consensus.
But the complexities of applying the arms’ length principle in practice should not be underestimated. Due to the closeness of the relationship between the parties there can be genuine difficulties in determining what arm’s length terms would have been - especially where it is not possible to find wholly comparable transactions between unconnected parties. There are many factors to take into account. Consequently, the exercise can be as much an art as a science.
Activity

If your organisation is subject to transfer pricing, discuss the issues and implication on your organisation’s pricing policy. Compare this in relation to prices in neighbouring countries.
CASE STUDY: PRICING IN THE PACKAGE HOLIDAY MARKET

Introduction

UK holidaymakers take some 36 million overseas holidays each year. Of these, almost half are “packaged holidays” - where the consumer buys a complete package of accommodation, flight and other extras - all bundled into one price. This is a highly competitive market with a small number of large tour operators (including Thomson Holidays, Air tours, First Choice, JMC) battling hard for market share.

Package holidays were devised partly as a way of achieving high sales volumes and reducing unit costs by allowing tour operators to purchase the different elements (flight, catering, accommodation, etc.) in bulk, passing some of the savings on to consumers.

Low margins require high asset utilisation

Estimates of tour operating margins vary, but fairly low average figures - of the order of 5% (or around £22 on the typical holiday price of around £450) are widely assumed in the mainstream segment of the market. It should however be noted that vertically integrated holiday operators (where the tour operator also owns an airline and a travel agency) will normally also generate profit from consumers. Accordingly, the gross margins on the total operations of the integrated operators may be larger than those on their tour operation activities alone.

Tour operators need to operate at high levels of capacity utilisation (figures of the order of 95% or more in terms of holidays sold) in order to maintain profitability. Matching capacity and demand is therefore critical to profitability, especially since package holidays are perishable goods - a given package loses all its value unless it is sold before its departure date.

Perishable goods markets require highly flexible production and distribution systems so that supply and demand can be closely matched and ‘waste’ production minimised. But
suppliers of package holidays are severely hampered in precisely aligning capacity and demand. They need to ‘produce’ (i.e. contract for the necessary flights, accommodation, etc.) virtually the whole of what they expect to sell a long time before it is ‘consumed’ (i.e. when the consumer departs for the holiday destination, or at the earliest, when the consumer pays the bulk of the price - usually around 8 weeks before departure).

**Long-term management of capacity**

Tour operators’ capacity plans, and the associated contracts with hoteliers and airlines, are typically fixed 12-18 months ahead of the holiday season. Some adjustments are possible after this date. However, within about 12 months of departure date, once the booking season has begun (i.e. from about the summer of 2002 for departures in summer 2003) the scope for changes is severely limited. This is due to the inflexibility of many commitments with suppliers and the problems associated with changing dates, flights, hotels, etc., of customers who have already booked.

Only by contracting for their expected needs well ahead of time, enabling suppliers to plan ahead, can tour operators obtain a sufficiently low price to attract an adequate volume of profitable sales. Tour operators therefore need to encourage early bookings. These improve cash flow - a substantial deposit (usually around £100 per person, equivalent to around 25% of a typical short-haul holiday price) is paid by consumers on booking; the balance is payable two months in advance of departure (except, naturally, for ‘late’ bookings).

Tour operators also reduce the risk of unsold holidays, and the consequent need for discounting, later on. Adding capacity is easier than reducing it during a season, although in some instances, e.g. where a particular resort is proving especially popular, all suitable accommodation (and/or flights to the relevant airport) will already have been reserved, at least for the peak period. But it is generally difficult for tour operators to ‘unwind’ their contracts, especially those for air transport, without substantial penalties. The tour operator, accordingly, bears almost all of the risk of any contracted capacity remaining unsold.
The price mechanism

Faced with this limited ability to reduce output in the short-term (i.e. once the brochures are published and the selling season has started), tour operators can, for the most part, only try to match supply and demand via the price mechanism - in other words, by discounting once it becomes clear that sales of their holidays appear unlikely to match the supply that they have contracted.

The fixed costs of tour operation (mainly, the cost of the airline seat and most of the accommodation and catering costs) make up a high proportion of total costs, so that relatively high levels of discount can be applied if necessary to clear unsold stock. Reductions of up to 25% off the initial brochure price are available on some ‘late’ sales - although consumers will often in such cases be required to accept the operator’s choice of hotel, or even the resort, according to availability.

Discounting of holidays during this ‘late’ part of the selling season is a similar phenomenon to that of ‘end of season stock clearance’ sales in other retail sectors (e.g. clothing). However, the impact of discounting on ‘late’ in a normal season should be seen in the context of the operator’s turnover for the season; it is effectively reduced by only about 5% (25% off 25% of holidays sold). Discounts (or equivalent incentives such as ‘free child’ places or ‘free insurance’) for early purchase are also offered, but they are much less significant both as to the amount of the reduction (5-10% appears typical) and its impact on costs and turnover. About three-quarters of all package holidays typically are sold at or close to the brochure price.

The fundamental rigidities in the market have important consequences for competition. They make suppliers closely dependent on each other from a strategic, as well as a short-term, viewpoint. In particular, any decision by a tour operator to try to increase market share by increasing capacity (i.e. offering more holidays for sale) will lead to a fall in prices unless competitors reduce their share by an equivalent amount by cutting capacity.
Question

Discuss how prices are set in the package holiday market and how price discrimination is used as part of the pricing strategies used.

8.7 SUMMARY

Price is the amount of money that is charged for “something” of value. The list price is the price that final consumers are charged for a product. Pricing objectives should fit in with a company’s overall marketing strategy.

Profit-oriented objectives use a target return objective to set a specific level of profit. A profit maximisation objective seeks to make as much profit as possible. Sales-oriented objectives aim to get some level of unit sales, dollar sales, or market share without referring to profits. Status quo objectives aim to maintain stable prices and to meet or avoid competition.
Test Questions

1) What is the role of pricing in strategic marketing planning from the perspectives of buyers, sellers, and competitors?

2) What are the elements of a pricing strategy?

3) When and why do conflicts arise over pricing decisions?

4) How are pricing strategies adapted to stages of a product or brand in its lifecycle?
5) What is psychological pricing, and what types of adjustments need to be made because of their psychological effects?

6) What types of strategic pricing models are available for use by marketers?

7) How can break-even analysis be applied to strategic pricing decisions?

8) What are the key issues, problems, and legal concerns that are involved in pricing strategy decisions?