Pricing Strategies - I

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Factors to Consider When Setting Prices

Price is the Amount of Money Charged for a Product or Service.

Internal Factors

Pricing Decisions

External Factors

Why is Price so Critical?

• Consider a company with an 8% profit margin
• Suppose the company could raise its price by 1% without it having any impact on sales?
• What will the increase in margin be?

- Sales = X Euros
- Cost = 0.92X Euros
- Margin = (X - 0.92X) = 0.08X Euros
- New sales = 1.01X Euros
- Increase in margin = \( \frac{100 \times (0.09X - 0.08X)}{0.08X} \) = 12.5%

External Factors Affecting Pricing Decisions

- Market and Demand
- Competitors’ Costs, Prices, and Offers
- Economic Conditions
- Reseller Needs
- Government Actions
- Social Concerns

Market and Demand Factors that Affect Pricing Decisions

- Pure Competition
  Many Buyers and Sellers Who Have Little Effect on the Price.
- Monopolistic Competition
  Many Buyers and Sellers Who Trade Over a Range of Prices.
- Oligopolistic Competition
  Few Sellers Who Are Sensitive to Each Other’s Pricing/Marketing Strategies
- Pure Monopoly
  Single Seller

Marketing Objectives that Affect Pricing Decisions

- Survival
  Low Prices to Cover Variable Costs and Some Fixed Costs to Stay in Business.
- Current Profit Maximization
  Choose the Price that Produces the Maximum Current Profit, Cash Flow or ROI.
- Market Share Leadership
  Low as Possible Prices to Become the Market Share Leader.
- Product Quality Leadership
  High Prices to Cover Higher Performance Quality and R & D.
Pricing Methods

- Markup Pricing
- Target Return Pricing
- Going-Rate Pricing
- Sealed-Bid Pricing
- Perceived Value Pricing
- Value Pricing

Cost Factors that Affect Pricing Decisions

Fixed Costs (Overhead)
- Costs that don’t vary with sales or production levels.
  - Executive Salaries
  - Rent

Variable Costs
- Costs that do vary directly with the level of production.
  - Raw materials

Total Costs
- Sum of the Fixed and Variable Costs for a Given Level of Production

Price Elasticity of Demand

A. Inelastic Demand - Demand Hardly Changes With a Small Change in Price.

P₂ P₁
Q₂ Q₁

B. Elastic Demand - Demand Changes Greatly With a Small Change in Price.

P'₂ P'₁
Q₂ Q₁

What is Cost-Plus Pricing and Why is it Popular?

Adding a Standard Markup to the Cost of the Product.

Sellers Are More Certain About Costs Than Demand

Minimizes Price Competition

Perceived Fairness to Both Buyers and Sellers

Breakeven Analysis or Target Profit Pricing

Tries to Determine the Price at Which a Firm Will Break Even or Make a Target Profit

Cost in Dollars (millions)

Target Profit ($2 million)

Total Cost

Fixed Cost

Sales Volume in Units (thousands)
The Three C’s Model
Value Pricing

1. True Value
2. Perceived Value
3. Price
4. Cost

Examples of Value-Based Pricing

- Glaxo pricing of Zantac in the US market in 1983
- Competition with SKB’s Tagamet (#1 drug in the world)
- Additional value offered by Zantac
  - Easier schedule of doses
  - Fewer side effects
  - Taken safely with other medication unlike Tagamet
- Based on greater perceived value, Glaxo charged a 50% premium over Tagamet instead of pricing at parity or below (as in Follower pricing)

In 4 years, Zantac was the market leader.

Determining Economic Value-In-Use

- **Economic Value = Reference Value + Differentiation Value**
  - **Reference Value**: Cost of competing product that the customer views as the best substitute for the product being evaluated
    - \( RV = \text{Price of Competing product adjusted for any difference in quantity used} \)
  - **Differentiation Value**: Value of product attributes that are different from those of the best substitute
    - \( DV = \begin{cases} 
    \text{Positive if customer likes differentiating attribute, Negative otherwise} 
    \end{cases} \)

Interpreting Economic Value

- A product’s market value is determined not only by the economic value but also by the accuracy with which buyers perceive that value
- **Weakness of EV**: Does not indicate the appropriate price to charge. Gives the maximum price consumers will be willing to pay if they were perfectly cognizant of the economic value and were motivated by economic value to make their purchase decisions
- **Strength of EV**: Enables a firm to determine whether a product is selling poorly because it is overpriced relative to its true economic value or because it is under-promoted and consequently, under-appreciated by the market
  - Ex: DuPont used this to increase sales by raising price and educating consumers

Price-Adjustment Strategies

- **Discount & Allowance**: Reducing Prices to Reward Customer Responses such as Paying Early or Promoting the Product.
- **Segmented Pricing**: Adjusting Prices to Allow for Differences in Customers, Products, and Locations.
Discount and Allowance Pricing

Adjusting Basic Price to Reward Customers For Certain Responses

Cash Discount 2/10, net 30
Seasonal Discount
Quantity Discount
Functional Discount
Trade-In Allowance
Promotional Allowance

Cash Discounts

To encourage retailers to pay their bills quickly, manufacturers offer them cash discounts.

EX: a bill quoted at $1,000 2/10 net 30:
The bill for the product is $1,000, but the retailer can take a 2 percent discount ($20) if payment is made within 10 days, and send a check for $980. If the payment cannot be made within 10 days, the total amount is due within 30 days. It is usually understood by the buyer that an interest charge will be added after the first 30 days of free credit.

- The 2 percent discount means that the buyer pays 2 percent on the total amount to be able to use that amount an extra 20 days—from day 11 to day 30. In a 360-day business year, this is an effective interest rate of 36 percent. Because the rate is so high, firms that cannot take advantage of a 2/10 net 30 cash discount often try to borrow money from their local banks at rates far lower than the 36 percent.

Segmented Pricing

Selling Products At Different Prices Even Though There Is No Difference in Cost

Customer - Segment
Location Pricing
Product - Form
Time Pricing

Price Customization Translates As ....

- Segmenting by Buyer Identification
  - Coupons; Student Discounts; Automobile prices
- Segmenting by Purchase Location
  - Hair Salons have different prices in different locations
  - Large grocery stores Vs. convenience stores
  - Freight absorption in industrial product markets
- Segmenting by Time of Purchase
  - Theaters: Matinee Vs. Evening rates
  - Restaurants: Fixed price lunches (Restaurant next door)
  - Peak-Load pricing (Airlines, Electric Utilities, Telephones)
  - Problem of Peak Reversal with long distance calling

Price Discrimination

- 1st Degree
  - Prices set for each buyer and each unit
  - Extract all Consumer Surplus ➔ Perfect Discrimination
    - Boeing with Airlines for each plane
- 3rd Degree (Direct)
  - Selection by Indicators
    - Divide buyers into groups:
      - geographical, membership discounts; age; student price;
      - Characteristics have to be observable; Most common form
- 2nd Degree (Indirect)
  - Cannot Observe the Characteristics: Self-Selection
    - Quantity discounts; Coupons;
    - Menu of Prices; Product branding; Versioning ➔ “damaged goods”;

19th-century Railroad Pricing

- “It is not because of the few thousand francs which would have to be spent to put a roof over the third-class carriage or to upholster the third-class seats that some company or other has open carriages with wooden benches...
- What the company is trying to do is prevent the passengers who can pay the second-class fare from traveling third class;
- it hits the poor, not because it wants to hurt them, but to frighten the rich...
- And it is again for the same reason that the companies, having proved almost cruel to the third class passengers and mean to the second-class ones, become lavish in dealing with first class customers. Having refused the poor what is necessary, they give the rich what is superfluous.”
  ➔ 19th-century French economist Emile Dupuit

Marketing
**Price-Adjustment Strategies**

- **Geographical Pricing**
  - Adjusting Prices to Account for the Geographical Location of Customers.
  - i.e. FOB-Origin, Uniform-Delivered, Zone Pricing, etc.

- **International Pricing**
  - Adjusting Prices for International Markets.
  - Price Depends on Costs, Consumers, Economic Conditions & Other Factors.

**The Learning Curve**

A line displaying the relationship between unit Service/Production time and the number of consecutive units produced. Wide range of Applications in the Business World.

- Pricing;
- Negotiations;
- Capital Investments ...

Based on a model of constant proportional cost reduction for each doubling of cumulative volume...

eg., Airline Industry - First Application

**The Learning Curve**

Can be applied to Individuals or Organizations

- People repeat a process and gain Skill or Efficiency from their own Experience:
  - “Practice makes Perfect”!

- Organizational Learning:
  - but also from changes in administration, equipment, product design...

Example:
- Heart Transplants:
  - Learning rates are highest for Death Rate Reduction;
  - Much Lower for Length of Stay and
  - Lowest for Average Charges.

**Learning with Improvements**

Average improvements may create a scallop effect in the curve.

**Worker Learning Curves**

Time/cycles

- A (under-qualified)
- B (average)
- C (overqualified)

One week Training time
A producer of microwave ovens has adopted an experience curve pricing approach for its new model. The firm believes it can reduce the cost of producing the model by 20 percent each time volume doubles. The cost to produce the first unit was $1,000. What would be the approximate cost of the 4,096th unit?

**Answer:**

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<th>COST</th>
<th>UNIT#</th>
<th>COST</th>
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<td>$1,000</td>
<td>128</td>
<td>(.80)x(262) = $210</td>
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<td>256</td>
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<td>64</td>
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**Developing Learning Curves**

- **Arithmetic approach**
  - Uses relationship: \( T_{2M} = L \cdot T_M \)
  - Useful only if values doubled

- **Logarithmic analysis**
  - Uses relationship: \( T_N = T_1 N^{\log L / \log 2} \)
  - \( N \) = Unit of interest; \( T_1 \) = Time for unit 1
  - Can find time for any value of \( N \)

- **Learning curve coefficients approach**
  - Uses relationship: \( T_N = T_1 C \) (from Table)