Pricing Considerations and Approaches

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Price

• The amount of money charged for a product or service, or the sum of the values that consumers exchange for the benefits of having or using the product or service.

What is Price?

• Price and the Marketing Mix:
  – Only element to produce revenues
  – Most flexible element
  – Can be changed quickly
• Price Competition
• Common Pricing Mistakes

Factors Affecting Price Decisions

Internal factors
Marketing objectives
Marketing mix strategy
Costs
Organizational considerations

External factors
Nature of the market and demand
Competition
Other environmental factors (economy, resellers, government)
Factors to Consider When Setting Price

Internal Factors
• Marketing objectives
• Marketing mix strategies
• Costs
• Organizational considerations

• Market positioning influences strategy
• Other pricing objectives:
  – Survival
  – Current profit maximization
  – Market share leadership
  – Product quality leadership
• Not-for-profit objectives:
  – Partial or full cost recovery
  – Social pricing

Product quality leadership: Four Seasons starts with very high quality service, then charges a price to match.

Internal Factors
• Marketing objectives
• Marketing mix strategies
• Costs
• Organizational considerations

• Pricing must be carefully coordinated with the other marketing mix elements
• Target costing is often used to support product positioning strategies based on price
• Nonprice positioning can also be used

Swatch used target costing to manage costs carefully and create a watch offering the right blend of fashion and functions at a price consumers would pay.
Factors to Consider When Setting Price

**Internal Factors**
- Marketing objectives
- Marketing mix strategies
- Costs
- Organizational considerations

- Types of costs:
  - Variable
  - Fixed
  - Total costs
- How costs vary at different production levels will influence price-setting
- Experience (learning) curve effects on price

**Variable versus Fixed Costs**
- Variable costs are costs that vary with sales volume
  - Sales commissions, material, labor, packaging etc.
- Fixed costs
  - Advertising, sales salaries, general and administrative overhead
  - Some of these can be changed by management, they do not vary automatically as sales change.
- COGS includes fixed + variable costs.

Cost-Volume-Profit Relationships

- Economies of scale
  - When a large increase in volume leads to a significant reduction in the average cost of a product.
  - Fixed costs are often extremely high, consider the issue of economies of scale
  - Advantage of economies of scale: price competitiveness
- Experience-curve effect
  - Variable costs may decline as volume increases.
  - What are the reasons of cost reductions in experienced firms?
    - More efficient production equipment or process
    - Ability improvement to obtain discounts or to control inventories
    - Production workers may become more efficient

**Cost Per Unit As a Function of Accumulated Production**

- Graph showing decreasing cost per unit as accumulated production increases.
Factors to Consider When Setting Price

**Internal Factors**
- Marketing objectives
- Marketing mix strategies
- Costs
- Organizational considerations

- Who sets the price?
  - Small companies: CEO or top management
  - Large companies: Divisional or product line managers
- Price negotiation is common in industrial settings
- Some industries have pricing departments

**External Factors**
- Nature of market and demand
- Competitors' costs, prices, and offers
- Other environmental elements

**Factors to Consider When Setting Price**

**External factors must also be considered when planning pricing strategy.**

**Pure Competition**
- The market consists of many buyers and sellers trading a uniform commodity such as wheat, copper, or financial securities.
- If price and profits rise, new sellers can easily enter the market.
- Sellers in these markets do not spend much time on marketing strategy.
Monopolistic Competition

• The market consists of many buyers and sellers who trade over a range of price rather than a single market price.
• A range of price → sellers can differentiate their offers to buyers

Oligopolistic Competition

• The market consists of a few sellers who are highly sensitive to each other’s pricing and marketing strategies.
• The product can be uniform or nonuniform
• Difficult to enter the market

Pure Monopoly

• The market consists of one seller.
• The seller may be government monopoly → U.S. Postal Service, private regulated monopoly, or private nonregulated monopoly → Microsoft.
• Nonregulated monopolies are free to price but they do not always charge full price. Because;
  – A desire to not attract competition
  – A desire to penetrate market faster
  – A fear of government regulation

Discussion Question

How would you characterize the type of market – in terms of level of competition – for the following:
• Electricity and gas utilities
• Cable TV, Internet services
Demand Curves

A curve that shows the number of units the market will buy in a given time period at different prices that might be charged.

Price Elasticity of Demand = \[ \frac{\% \text{ Change in Quantity Demanded}}{\% \text{ Change in Price}} \]

Demand curves sometimes slope upward—Gibson learned that its high-quality guitars didn’t sell as well at lower prices.

Factors to Consider When Setting Price

**External Factors**
- Nature of market and demand
- Competitors’ costs, prices, and offers
- Other environmental elements

Consider competitors’ costs, prices, and possible reactions when developing a pricing strategy.

- Pricing strategy influences the nature of competition
  - Low-price low-margin strategies inhibit competition
  - High-price high-margin strategies attract competition

Benchmarking costs against the competition is recommended.

PC marketing has become extremely price competitive. Knowledge of competitive prices, offers, and costs is key to pricing strategy.
Factors to Consider When Setting Price

**External Factors**
- Nature of market and demand
- Competitors’ costs, prices, and offers
- Other environmental elements

**Internal Considerations**
- Economic conditions
  - Affect production costs
  - Affect buyer perceptions of price and value
- Reseller reactions to prices must be considered
- Government may limit or restrict pricing options
- Social considerations may be taken into account

External Factors

Major Considerations in Setting Price

- Cost-Based Pricing: Cost-Plus Pricing
  - Adding a standard markup to cost
  - Ignores demand and competition
  - Popular pricing technique because:
    - It simplifies the pricing process
    - Price competition may be minimized
    - It is perceived as fairer to both buyers and sellers

Cost-Based Pricing Example

- Variable costs: $20
- Fixed costs: $500,000
- Expected sales: 100,000 units
- Desired Sales Markup: 20%

Cost-Based Pricing Example

- Variable Cost + Fixed Costs/Unit Sales = Unit Cost
  
  \[
  \text{Unit Cost} = \frac{\text{Variable Cost} + \text{Fixed Costs}}{\text{Unit Sales}}
  \]

Cost-Based Pricing Example

- Unit Cost = $20 + $500,000/100,000 = $25 per unit

Cost-Based Pricing Example

- **Unit Cost/(1 - Desired Return on Sales) = Markup Price**
  
  \[
  \text{Markup Price} = \frac{\text{Unit Cost}}{1 - \text{Desired Return on Sales}}
  \]

Cost-Based Pricing Example

- **Unit Cost/(1 - .20) = $31.25**
General Pricing Approaches

- **Cost-Based Pricing: Break-Even Analysis and Target Profit Pricing**
  - Break-even charts show total cost and total revenues at different levels of unit volume.
  - The intersection of the total revenue and total cost curves is the break-even point.
  - Companies wishing to make a profit must exceed the break-even unit volume.

Break-Even Chart for Determining Target Price

**Discussion Question**

Assume the following costs:
- Fixed costs (FC): $500,000
- Variable cost/unit (VC): $10.00

Recalling that \( BE = \frac{FC}{P - VC} \), calculate the break-even unit volume at selling prices of $15.00 and $20.00 per unit.

How many units would need to be sold if a profit of $250,000 was desired?

Cost-Based Versus Value-Based Pricing
• **Value-Based Pricing:**
  - Uses buyers’ perceptions of value rather than seller’s costs to set price.
  - Measuring perceived value can be difficult.
  - Consumer attitudes toward price and quality have shifted during the last decade.
    • Introduction of less expensive versions of established brands has become common.

**General Pricing Approaches**

• **Value-Based Pricing:**
  - Business-to-business firms seek to retain pricing power
    • Value-added strategies can help
  - Value pricing at the retail level
    • Everyday low pricing (EDLP) vs. high-low pricing

**General Pricing Approaches**

• **Competition-Based Pricing:**
  - Also called going-rate pricing
  - May price at the same level, above, or below the competition
  - Bidding for jobs is another variation of competition-based pricing
    • Sealed bid pricing