UNIT-8

Product Pricing Strategies

Learning Outcomes

By the end of this unit the learner will be able to:

- ✓ Understand the objectives of pricing
- ✓ Describe the factors that affect price determination
- ✓ Explore various pricing strategies

Unit 8

Product Pricing Strategies

Upon finalizing product planning, pricing policies and strategies need to be finalized next. Pricing is of the utmost importance, as it directly impacts sales and company profits. Deciding the price demands extra care and caution. The first step towards pricing is the determination of the product's base price and making a decision on the objectives of pricing.

This unit deals with the various key aspects of pricing. The meanings and significance of pricing will be discussed, along with factors impacting pricing decisions, objectives and the fundamental methods of determining price.

The Function and Value of Price

Daily, we all make purchases from various markets. In exchange for the product, we make a payment. The amount paid in lieu of the product is known as its price. Therefore, the price is the value of the product articulated in a monetary unit, such as the pound, euro, or dollar. All goods with a commercial value have a price. Normally, we only think of physical products as having a price. However, even services have a price value. For example, all transport services provided either by bus, taxi, airways or railways come with a fare which is their price, while the 'premium' is the price of the risk involved in travelling by one of these modes and covered under insurance.

'Interest' is the price of a bank loan, a 'tuition fee' is the price of acquiring education and 'rent' is the price of using someone's property. Adam Smith has defined the notion of price fittingly as "the price of everything, what everything really costs, is the toil and trouble of acquiring it." Price is a valuable pillar of marketing. Upon completion of the development of products, the company must fix its price. Incorrectly determined price will always impact product sales adversely and eat away at the company's profits.

Whether or not a buyer decides to purchase a product is, to a large extent, determined by its price. Product price can be used by the company in efforts to raise or reduce product demand and the degree of competition. Improper pricing policies can bring about legal difficulties and give rise to resentment among buyers. The issue of what price is reasonable to charge from a buyer is a difficult and confusing issue for the marketing manager. While some individuals feel that it should be as high as the customer is able to pay, others believe it has to be sufficiently low so that the maximum number of people can afford to purchase it.

Price is not only a crucial factor for business entities, but also numerous other organisations that provide an array of services - insurance, banking, advertising, transport, entertainment, electricity, etc. Furthermore, institutions whose main purpose is *not* to earn a profit also benefit from pricing principals. For example, a university has to grasp what the proper or fair tuition fee would be to charge its students. Likewise, a doctor will need to know the principles of pricing to be able to set the price of consultations providesd for patients. Most often, price is the main factor that forms the basis of competition in the market. It is one of the main features that competitors keep a keen eye on. The price of merchandise will affect sales noticeably, just as it will affect the firm's total returns and final profits. Other than the firm, price plays a significance role in determining whether or not buyers and society at large are willing to purchase the goods. Price represents the value of what the market is offering the buyers. The demand for goods is greatly determined by its price. Price can also often be an indicator of the product's quality. The law of demand states that a lower price will lead to higher demand of the product. In some cases however, a rise in price may be received by buyers favourably, who may take it as a result of quality improvement. Prices of goods have a direct bearing on wages, interest, rent and profit, since these are prices payable to factors of production labour, capital, land and entrepreneurship, accordingly. Hence, price becomes the economy regulator, because it influences the allotment of production factors.

Pricing Objective

The main objectives of pricing should be similar to those of the firm itself. Before finalising the product price, the organisation has to figure out its own pricing objectives. An organization can follow multiple objectives at once. While aiming for maximum profits in the short and long-run, the organisation can also aim to uphold superior customer and worker relations, and adhere to legal restrictions outlined by the government in regards to pricing. The company can look towards increasing sales but at the same time remain considerate. If an organisation wishes to chase all these aims concurrently, it must attain equilibrium between all of the objectives. The pricing objectives need to correspond to the organisation's general objectives.

Pricing objectives may be grouped into three main types:

1) Profitability objectives;
2) Sale/volume objectives;
3) Other objectives

Let's explore each objective individually.

Profit- Oriented Objectives

When making pricing decisions, making a profit is the main objective. Profit maximisation is the customary objective of business concerns.

Profit-geared objectives can take one of the given two forms: a) maximisation of profits b) reaching the desired rate of return on an investment.

i) Maximisation of Profits: Maximizing profits is the most common objective in business. Any firm with this aim will impose a heavy margin of profit and thus maintain high prices. A firm with the main aim of maximizing profits will approximate costs and demands at different prices and choose the price that will yield the maximum profit.

ii) To be able to gain maximum profits in the long-term, they will at times have to face short-run losses. A company stepping into a new segment of the market or introducing a new item will usually set a low price to attract new customers.

Achieving the Desired Investment Returns: A company can establish the price of its goods at a level that will help it to get the predetermined return on its investment or sales. Many companies start by figuring out their costs (inclusive of manufacturing and distributing), and then move to add a profit that will give it the needed return on investment. The aimed-at rate of return can be used as a guideline for improvements, particularly when a new product line comes out. The real rate of return varies from industry to industry and from firm to firm. A number of retailers and wholesalers make use of target returns on net sales as pricing aims for short runs. This strategy (achieving target returns) is normally employed by manufacturers who lead in their respective industries, because they can afford to pick their pricing goals without fear of competition.

Sales Volume-Oriented Objectives

The financial aims of some companies' sees products priced accordingly to enhance sales volumes, maintain sales volumes, or to increase the company's market share.

i. Maximization of sales volume: a lot of firms choose to maximize sales volumes, regardless of the profits earned. In this case, the firm will establish the minimum or least acceptable profit level and then work to maximize sales. The idea being that enhanced sales hold more value in the long-term, as opposed to immediately increased profits. The increase in sales volume method may not adhere to contemporary marketing concepts, as they advocate profitable sales volumes. To increase sales volumes, management can opt to cut prices or offer heavy discounts, leading to heavy losses for the firm. Increased sales do not necessarily lead to greater profits. Quite often, products acheiving good sales do not earn sufficient profits for the firm.

Maximizing Market Share: Market shares may offer a better indication of what a company's strength is than the targeted returns on investment - particularly when the overall market is growing. As sales volumes increase, the firm's competitors also increase at growing speeds a false sense of security can set in. To counter this threat, establishments must keep a keen eye on market shares.

Other Objectives

At times, pricing objectives have no relation to either profit maximization or sales volume maximization, but may be dependent upon other important issues.

These include the following:

- price stabilisation;
- survival in the market;
- to prevent a competitor's entry in the market;
- to enhance or hold onto a firm's image as a provider of quality goods.

Let's take a closer look at these factors:

Price Stabilisation: Some firms prefer to maintain stable prices and avoid price wars. This method is observed when an establishment faces very heavy competition from a rival which behaves as a price leader - especially in cases where the product is standardised. To keep competition at a minimum, the firm will follow the leader's prices.

Survival: When an establishment must face tough competition, overcapacity, or loss of demand for its goods, its objective shifts to one of survival in the field. In this situation, the firm will set the price for its goods very low, just to cover variable costs and partial fixed costs, and aim to stay in business for the longest duration possible.

i) **Preventing Competitors' Entry:** Preventing a competitor from entering the market is more important than earning profit in the short-run. To counteract competitor entry, fixing the price at the lowest possible level is a good strategy as it takes the attraction of entering the market away for the competitor. With this plan in place, the company can infiltrate the market totally and gain control over it. Another name for this strategy is a 'market penetration objective' as it deals with maintaining the lowest possible prices and making it unappealing for potential competitors to even try entering.

ii) **Improvement of Company Image:** Becoming known as a quality goods supplier that always supplies superior goods, the company may have to face heavy expenses for producing top-quality merchandise. Due to the heavier expenses incurred, the prices will also have to be higher.

In closing, it can be summarized that for a firm with a single objective in pricing policy, targeting long-term profits should be the goal, as there are far more cases of sellers maximizing short-run profits. The latest studies show that themost common objectives of pricing are market share maximization and maximization of profits. The remaining objectives are more appropriately described as pricing methods, instead of objectives. One issue making it hard to come up with general principles and policies of pricing is that of how firms operate in varying conditions. Generally, policies and principles of pricing differ from one industry to next, one company to next and one period in time to the next.

Factors Affecting Price Determination

The main aspects that affect a product's price or service are as below:

1) The product's value to the buyer;
2) Cost of product;
3) Competition;
4) Legal considerations;
5) Other marketing elements

Let's consider the details of each of these:

The Product's Value to the Buyer:

Consumers buy goods only when they are of value to them (i.e.,they would buy food whenever their food supply gets low). Considering that purchasing power is restricted whereas a person's wants are not, people only buy goods that provide the most satisfaction for the price paid. Subjectively speaking, each consumer maintains a priority list of goods or services that they can purchase with their income. This list is made unconsciously and subjectively. Due to the subjectivity involved, it is nearly impossible to measure the value/usefulness delivered by a given product. When buyers and price are taken into consideration, it normally means how the price has a bearing on their demand for a certain product.

As you may know, in accordance with the law of demand, more goods may be commanded at a lower price instead of a higher one. This holds true for most goods. To a marketing professional, demand translates into the wish for a product to be backed with the ability to buy it. In reality, a marketer has to fix the price that will appeal to sufficient numbers of customers to reach the desired sales volume. The marketer has to determine how price-conscious the customers are to any price changes. This sensitivity can be gauged by price elasticity of demand (stated as the flexibility of demand). Price elasticity can be described as the relative difference in the quality required, caused by a comparable change in price. It can be calculated by dividing the change in percentage in the demanded quality by the change in percentage of the charged price.

Product Costs

It is more reasonable to begin the price fixing process with costs incurred. When fixing the price of a product, certain questions should be considered, such as what the product costs. What kinds of profits should be earned? These usually turn out to be simpler to answer than the question of what customers can afford to pay. Still, this is the question that holds the most importance of *all* questions that have to be considered. However, many marketers give more value to total costs (cost of manufacturing + distributing costs + administrative costs) with a reasonable profit added on, as the correct way of fixing the product price.

Types of Costs

Costs are classified in two groups for price fixing objectives:

1) fixed costs,
2) variable costs

Fixed costs are those that do not change significantly with production volumes or sales. Regardless of whether the producer makes 2,000 units or 100, or even stops production totally, they will still have to bear some expenses - rent (property tax) for the building, interest on any borrowed funds, lighting charges etc. Such costs are also called ‘overhead costs’.

Variable costs change with the level of production. Things like raw materials, labour, power etc. are all directly linked to the quantity of units manufactured, which is why they are known as ‘variable’ costs. They are kept under control by altering the volume of production. The sum of fixed and variable costs is known as total costs. The average total cost can be calculated by dividing costs by the number of units manufactured.

Competition

The higher and lower limits of a product’s price are set by considering the value of the product to the customer and its cost to the manufacturer. The final price that is determined is influence a great deal by the level of competition in the given market. When competition in the market is negligible or non-existent, the price will generally be on the high side. Healthy competition, on the other hand, may lead to a decrease in price. The features and price the competition offers will have a major influence on the price charged by a company. Even the prices of substitute products have to be considered, when fixing a product’s price. Before setting the final price, the company has to consider the prices of all competing products and how the competitors in the industry are behaving. The possibility of new competitors entering the market also has to be taken into account, when price is being fixed.

Legal Considerations

Pricing is highly-sensitive and plays a very important role in reaching marketing decisions. A price rise frequently invites public outcry and can lead to legal restraints. Take the example of an essential commodity like a medicine that costs £10 per unit. In case of an emergency, the buyer may be ready to pay any amount. Without competition, a seller can be tempted to charge an excessively high price, such as, £100 for each unit. In this situation, the seller can be restrained by law from doing this by declaring the medicine an ‘essential commodity’ under the Essential Commodities Act. The manufacturer can no longer exercise freedom of charging the high price, they have to observe the price fixed by the government and sell it in accordance with the guidelines laid out by lawmakers.

Other Elements of Marketing

A company's marketing factors (its marketing methods) have a considerable effect on the pricing of a product. The distributing means, amount and quality of advertising, sales personnel efficiency, packaging, product differentiation, credit use facility, after sales service etc., all affect the final price of the product. Companies holding strong positions in all these factors are able to charge higher prices. For companies that are deficient or lacking these factors, it may be necessary to charge lower prices. For instance, if one company is offering home delivery, 'money-back' guarantees or offering its product via high class outlets (such as air-conditioned showrooms), the product can be sold at a higher price. The company has to use consistency when adopting marketing and pricing policies. Only when a product is appreciably different from a competitor's products can the company have more freedom fixing the price of its product.

The Basic Methods of Price Determination

On the basis of sound business principles, product prices should be fixed after taking into account the costs, competition, demand, elements of the marketing mix, and legal ramifications. But in reality, marketers just depend on one of the three main determinants of prices: demand, costs and competition. Based on the comparative importance attributed to these factors, there are three sensible approaches to establishing the price of a product or service:

1) Cost-oriented pricing;
2) Demand-oriented pricing;
3) Competition-oriented pricing

Examine Figure 8.1 carefully for the varying classification methods of pricing. Let's take a closer look at the methods.

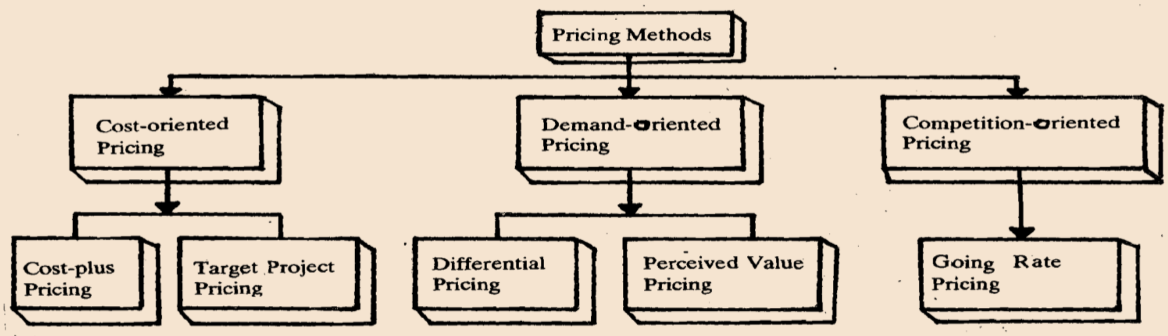

Figure 8.1 Methods of Price Determination

Cost-oriented Pricing

The cost-oriented pricing approach, which is also called cost-based pricing, is when the sale price is determined on the basis of the product's total cost with a specified margin attached.

Two methods of setting the price arise from the cost-oriented pricing:

1) Cost-plus pricing
2) Target-pricing or break-even analysis.

Let's take a more detailed look at each of these -

1) Cost-Plus Pricing

Many companies fix the sale price of their product by combining all costs incurred in manufacturing the product (inclusive of manufacturing, marketing, and distribution costs) along with a prearranged profit margin. This is explained in the illustration below:

	£ Per Unit
Total manufacturing cost	30.00
Selling and promotional costs	4.00
Distribution and administration costs	6.00

Total costs	40.00
Margin of profit	10.00
Selling price	50.00

According to this method, the final cost of the product includes both variable and fixed overhead costs. This can easily be stated as: Selling Price = Variable Costs + Overhead Costs (Fixed Costs) + Profit Margin. In order to make this method more realistic, the firm has to keep in mind the variations that will occur in these costs due to production volume changes. This pricing strategy will allow the firm to cover all costs and additionally earn the projected margin of profit. So this technique is very valid on the basis of being fair to sellers and buyers. The technique is easily understood and simple to implement. There is normally less doubt about the cost than product demand. The profit margin that is to be added is at the discretion of the company. It varies according to the industry and the given situation.

Break-Even Analysis and Target-Profit Pricing

This technique of pricing is a bit different from the cost-plus pricing method. Here, the company wants to calculate a price that will allow it to earn a specific profit. The company starts with analysis of the break-even point and then determines the specific break-even point. This break-even analysis associates total cost to total revenue. A break-even point is the point of production where the Total Sales Revenue (TR) is equal to the Total Cost (TC). Put differently, it is the point where the level of production or supply is such that the company neither earns a profit nor incurs a loss. It is shown by an intersection of TC and TR. Different selling prices come with different break-even points. Any amount that goes above the break-even point is the company's profit. Any amount below the break-even point indicates a loss for the company.

The break-even point can be determined as follows:

Breakeven Point (in Units) = Total fixed costs

$$\text{Per unit contribution to fixed cost} = \text{Total fixed costs (F)} \div \text{Selling costs (P)} - \text{ Average variable costs per unit (V)}$$

Or $\text{B.E.P} = f/p\text{-}v$

Demand-Oriented Pricing

Demand-oriented Pricing is calculated based on the volume of sales that expected at the different price levels that different types of buyers can pay. Rather than fixing the price based on costs or competitor prices, some companies fix the sale price of their product based on demand. So, regardless of cost of the product or what the competitors are charging, a greater price is fixed for a product with a greater demand or service, while a lower price is fixed when demand is lower - irrespective of the fact that both costs are the same.

The two techniques of pricing with this technique are:

1) Differential Pricing
2) Perceived-Value Pricing

Differential Pricing

Usually, varying groups of purchasers have different wants and needs. As a result, their desire for a product also varies. In these conditions, manufacturers are always tempted to charge a greater price when there is lower elastic demand and a lower price for products with greater elastic demand, for the same product.

Four main factors are employed when it comes to differential pricing; the buyer, the place (customer location), the time of sale, and the product version. Varying prices can be fixed for varying types of customers, groups or persons. This can be possible because of the difference in the customer bargaining abilities, paying capacities, knowledge about features or the very availability of the product. For instance, in a concert hall, seats in different locations within the hall come with different prices, even when everyone is watching the same band or event. If an identical or simailr product is sold for different prices at different locations, it is known as place differential

In terms of time, product demand changes by day, season, or even the hour of the day. Prices can be fixed to gain benefit of the demand strength during a given season or time. Take the case of telephone rates - they are sometimes different on working days than on holidays. They are also different for day and night calls ,or evening or morning calls. Likewise, hotels frequently have different rates for the same room during different times of the year, determined by demand for the room. In product-based differential pricing, the manufacturer charges greatly different rates for products that vary in version only slightly. Hence, the price difference is not proportional to the cost of the different versions of the product.

Competition-Oriented Pricing

Price determination based on reference to the price of a similar product being charged by a competitor - not based on the cost of the product or the different perceptions of different buyers for the same product - is called competition-oriented pricing.

Going-Rate Pricing

This technique is an important factor in competition-oriented pricing. In this approach, the firm does not keep detailed records of the different product costs. The company does not even have to determine demand intensity or value perceptions in the minds of the buyers. Instead, the firm decides to fix the price of its goods based on the 'Going-Rate' – as in current prices on the market.

The price does not need to be the same as that of the industry leader's similar product, or the same as that of a competitor; it can be higher or lower. Each time the industry's leader raises or decreases prices, the competing company follows suit. This practice of going-rate fixing price is very popular with traders, in particular with retailers. Those manufacturers who adopt this technique of pricing claim that the existing rates are representative of the industry's collective wisdom. Additionally, it is usually hard to determine the customer's reaction to differences in price and their understanding of the variations in product features. Also, this method is easy enough to adopt as the firm does not have to estimate price elasticity or the different product costs. Lastly, adopting the going- rate price method helps avoid price wars between competitors. This technique is usually practiced in situations of homogeneous products under conditions of pure competition. The company, selling undifferentiated goods in a purely competitive market, does not have much choice/flexibility in setting its own prices.

Further Reading:

- ✓ Retail Pricing Strategies and Market Power, (2002), By Gordon Mills
- ✓ Principles of Marketing',(2008), By Young, Et Al
- ✓ Price & Profit : the Essential Guide to Product & Service Pricing and , (2004), By William R. Berends