BUS 214: PRINCIPLES OF MARKETING II

Study Session 5

1. TOPIC: PRICING STRATEGY

2. Introduction

In this study session, you will learn wide range of topical issues in strategic pricing aimed at providing sound knowledge of the concept of pricing. After producing the product it is expected that marketers will attach value (price) to their products before taking it to the market place. In this session, we shall understand how to set a price of a new product and identify some pricing constraints.

3. Learning Outcomes for Study Session 4

After studying this session, you should be able to:

(a) discuss the concept of pricing objectives and strategies
(b) understand the procedures for setting up a new price
(c) identify the pricing constraints.
(d) analyze competitors costs.

4. Procedures for Setting a Price of a New Product

The firm has to consider many factors in setting its pricing policy. This may include: selecting the pricing objective, Determining Demand, estimating costs, Analyzing competitors costs, prices and offers, as well as selecting a pricing method and selecting the final price:

Step 1: Selecting the pricing objective: the company first decides where it wants to position its market offering. The clearer the firm's objectives, the easier it is to set price. A company can pursue any of five major objectives through pricing:

Survival*:* Companies pursue survival as the major objective if they are plagued with over capacity, intense competition, or changing consumer wants. As long as prices cover variable costs and some fixed costs, the company stays in business. Survival is a short-run objective; in the long-run, the firm must learn how to add value or face extinction.

Maximum Current Profit: Many companies try to set a price that will maximize current profits. They estimate the demand and costs associated with alternative prices and choose the price that produces maximum current profit, cash flow or rate of return on investment.

Maximum Market Share*:* Some companies want to maximize their market share. They believe that a higher sales volume will lead to lower unit costs and higher long run profit. They set the lowest price, assuming that the market is price-sensitive (market penetration pricing).

Maximum Market Skimming: Market Skimming makes sense when sufficient number of buyers have a high current demand, it is also sensible when the unit costs of producing a small volume are not so high that they cancel the advantage of charging what the traffic will bear; it again makes sense if the high initial price does not attract more competitors to the market or if the price communicates the image of a superior product.

Step 2: Determining Demand: Each price will lead to a different level of demand and therefore have a different impact on a company's marketing objectives. Under normal situation, demand and price are inversely related: the higher the price, the lower the demand.

Step 3: Estimating Costs: Demand sets a ceiling on the price the company can charge for its product. Costs set the floor. The company wants to charge a price that covers its cost of producing, distributing and selling the product, including a fair return for its effort and risk. A company's costs take two forms, fixed and variable costs:

Fixed Costs*:* this is also known as overhead they are costs that do not vary with production or sales revenue. A company must pay bills each month for rent, heat, interest, salaries and so on, regardless of output.

Variable Costs: These costs vary directly with the level of production. These costs funds to be constant per unit produced. They are called variable because their total varies with the number of units produced.

Total Costs*:* this consists of the sum of the fixed and variable costs for any given level of producing.

Average Cost*:* this is the cost per unit at that level of production; it is equal to total costs divided by the production. Management want to charge a price that will at least cover the total production costs at a given level of production.

Step 4: Analyzing Competitors Costs, Prices, and offers: within the range of possible prices determined by market demand and company costs, the firm must take the competitors costs prices and possible price reactions into account. The firm should first consider the nearest competitors price. If the firms offer contains positive differentiation features not offered by the nearest competitor, their worth to the customer should be evaluated and added to the competitor's price. If the competitors offer contains some features not offered by the firm, their worth to the customer should be evaluated and subtracted from the firm's price. Now the firm can decide whether it can charge more, the same, or less than the competitor. The firm must be aware, however, that competitors can change their prices in reaction to the price set by the firm.

Step 5: Selecting a Pricing Method: given the three CS-the customers demand schedule, the cost function and competitor's prices the company is now ready to select a price. There are three major considerations in price setting; these include: Costs set a floor to the price; Competitors prices and the price of substitutes provide an orienting point. Customer's assessment of unique product features establishes the ceiling price. Companies select a pricing method that includes one or more of these three considerations. We will examine seven price-setting methods: markup pricing, target return pricing, perceived-value pricing, value pricing, going rate pricing, and auction type pricing, and group pricing:

Markup Pricing: the most elementary pricing method is to add a standard markup to the product's cost. Construction companies submit job bids by estimating the total project cost and adding a standard markup for profit. Lawyers and accountants typically price by adding a standard mark-up on their time and costs.

Target Return Pricing: In target return pricing, the firm determines the price that would yield its target rate of return on investment. Target pricing is used by General motors, which prices its automobiles to achieve a 5 to 20 percent returns on investment. This method is also used by public utilities, which need to make a fair return on their investment.

Perceived –Value Pricing: An increasing number of companies base their price on the customer's perceived value. They must deliver the value promised by their value proposition, and the customer most perceive this value. They use the marketing mix elements, such as advertising and sales force to communicate and enhance perceived value in buyer's minds. Perceived value is made up of several elements, such as the buyer's image of the product performance the channel deliverable, the warranty quality, customer support, and softer attributes such as the suppliers reputation, trust worthiness, and esteem.

Value Pricing: This involves charging fairly low price for a high quality offering. Among the best practitioners of value pricing are Mr. Biggs, hotels, boutiques etc.

Going-Rate Pricing: This is the kind of pricing that a firm bases its price largely on competitor's prices. The firm might charge the same, more, or less than major competitors**.**

Auction-Type Pricing: This type of pricing is becoming more popular especially with the growth of the internet. There are over 2,000 electronic market places selling everything from pigs to used vehicles to Cargo to chemicals. One major use of auctions is to dispose of excess inventories or used goods.

Group Pricing: The internet is facilitating a method whereby consumers and business buyers can join groups to buy at a lower price. Consumers can turn to volume buy .com to buy electronics, computers, subscriptions and other items when a consumer finds a desired product, he or she will see the current pool price, which is a function of the number of orders received so far. The web page may also indicate that if (say) three more orders were to come, the price would fall by a specified amount. Major drawback is that some buyers will not wait for the volume order to be executed.

Step 6: Selecting the Final Price: Pricing methods narrow the range from which the company must select its final price. In selecting that price, the company must consider additional factors, including Psychological Pricing, gains-and- risk-sharing pricing, and the influence of other marketing mix elements on price, company pricing policies, and the impact of price on other parties.

5. Identifying Pricing Constraints

There are many forces that place limits on the range of possible prices. Some of these (such as cost) are internal forces, whereas others (such as government laws) are external forces that affect pricing decisions.

Costs

The price a company gets for its product must cover the cost of production and marketing, plus a variety of other expenses, and still leave enough for profit. Some costs are directly related to the materials and wages involved in the production of goods, but other costs come from licensing fees, taxes, and investments in research, business services, and other areas

Government Influences

The Nigeria government plays a big role in regulating prices of commodities as do the governments of many other countries. In an effort to protect consumers and encourage fair competition, the government has enacted a variety of price-related legislation over the years, and all marketers need to be aware of legal ramifications. Unfortunately, these laws can be confusing and they are subject to changes in judicial interpretation. Marketers must navigate these legal waters carefully or risk facing lawsuits from the government, their competitors, or their customers. The softest and simplest route is to learn what pricing practices the courts have considered illegal in the past and then avoid these or similar tactics. The government monitors pricing in the areas of price fixing, price discrimination, deceptive pricing, and predatory pricing.

Price Fixing: when two or more companies supplying the same type of products agree on the prices they will charge or on the formulas they use to set prices, they are engaging in a practice known as **price fixing.** In nearly all cases, price fixing is illegal; two exceptions are when the government itself fixes prices or when regulated public utilities set prices for their services (which they can do only with government approval).

Price discrimination: One of the most important pieces of pricing – related legislation in the United States is the Robinson – Pitman Act. A key part of this legislation outlaws Price discrimination**,** the practice of unfairly offering attractive discounts to some customers but not to others.

Deceptive Pricing: This is the kind of pricing which the federal government has the authority to investigate and stop pricing schemes that it considers misleading; the term normally used in such cases is the problem in this case is not so much a pricing issue, but the way in which prices are promoted. The federal government guidelines describe five situations considered deceptive pricing:

1. Comparison with former prices

2. Comparison with prices that aren’t really being charged

3. Comparison with suggested retail prices

4. Bargains with strings attached

5. Other misrepresentations.

Other deceptive pricing schemes include

(1) "Limited-time offers" when the company has no intention of eventually raising the price and

(2) Low prices advertised for "seconds" if the products aren't clearly identified as being of lower quality.

Predatory Pricing: sometimes the government considers a price to be so low that it unfairly hurts competition. This is especially true if the seller sets prices that are below its costs, and lower than it charges in other markets. Such tactics are considered predatory pricing and are illegal if your intent is to drive competitors of business. However, if your intent is only to cause temporary pain for a competitor, rather than to run it out of business, aggressive under pricing is legal.

A special case of international pricing occurs when a firm exporting its products to the U.S is accused of both price discrimination and predatory pricing. The term dumping refers to the practice of selling imported goods at prices so low as to injure local competition; the price discrimination occurs because the supplier sells its products for different prices in various countries. Dumping has been an issue in the semiconductor industry, for instance, as Japanese firms try to build market share in the United States. Of course, dumping isn't bad news for everybody; most customers are more than happy to buy dumped goods at their attractive prices.

Channel Expectation: the expectations of all the organizations in the marketing channel also place constraints on pricing. For instances, when a product moves from the producers to a wholesalers to a retailer, costs are incurred at each stage, and the final price has to be high enough to support those costs. In addition, depending on the type of organizations in a particular marketing channel, the final price also has to cover fees, commissions, and profits for each channel member. Various industries have evolved different cost structures and expectations; when you enter these marketing channels, you need to make your prices meet the needs of all the members in the channel.

Customer Demand: Customer demand is obviously an important aspect of pricing. Marketers together with retailers priced the game at a level they felt the market would support. As customers demand grows or shrinks, prices often need to be adjusted. During the introductory stage, for instance, a price may be raised to temporarily increase profit. This is possible only if demand is significant, of course. On the other hand, if people aren't exactly lining up in anticipation of your new product, you may have to lower prices initially to encourage people to try your product.

Competition: As you might expect, competitive forces are usually a major pricing constraint, and the more emphasis customers put on price, the more powerful the competitive constraint becomes. For example, when students try to decide between two colleges, they might not put a lot of emphasis on price differences. However, when students' parents enter the discussion, chances are pretty good that competitive prices become an issue.

From the marketer's perspective, then, the presence of price competition can place firm limits on the range of possible prices. It's important to remember, however, that there is more to competition than price. **Non–price competition** refers to all elements of competition, other than price, that companies can use to differentiate their products. Some of these attributes are quality, service, warranties, performance, and image.

Ethics: finally, ethical considerations play a role in the pricing decision. Although a number of unethical pricing moves are illegal and monitored by various government agencies, gray areas exist in which the ethical choice is left up to the marketer in addition. The opportunities for illegal pricing outnumbered the government watchdogs. But even if a company doesn't think it will get caught, it should still manage its business, including pricing, by acceptable standards of conduct. Questionable pricing practices are not unheard of, however. For example, pricing in the travel industry is so complicated that even professional travel agents can't always figure out the true price customers have to pay.

Moreover, airlines have been accused at advertising attractive low fares that were nearly impossible for any passenger to take advantage of because there were so many restrictions. A more ethical approach might be to establish and advertise the prices that most people will actually end up paying.

6. Summary of Study Session, 'Pricing Strategy'

Now that you have completed this study Session 5, you have learnt Price is an amount charged for a product or service. The term price looks simple but always serves as a bottleneck to management decision. Different pricing strategies must be studied carefully by management, so that it can apply appropriately to fuse with the method or objective of pricing of the organization. Generally, Setting price for a new product always present peculiar problem to marketers the initial price quoted for an item may determine whether the product will eventually be accepted in the market place. It may also affect the amount of competition that will emerge.

7. Self-Assessment Questions (SAQs) for Study Session 5

Now that you have completed this study session, you can assess yourself with the following questions:

(a) Identify and explain the steps involved in setting a price for a new product.
(b) In recent years the majority of price changes made by marketers have been Price increases. Why?
(c) Discuss the pricing constraints and suggest how best a marketer can overcome them while setting a price.

8. Notes on SAQs for Study Session 5

9. References

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