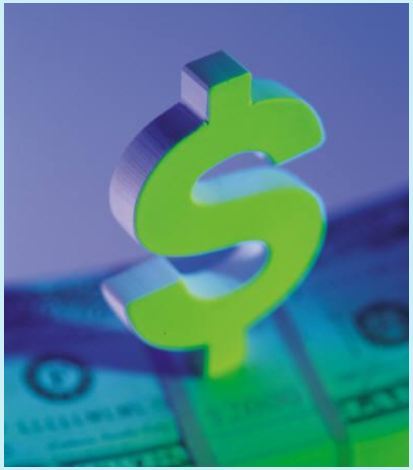
21

Pricing Concepts

Agenda

- The Nature of Price
- Price and Nonprice Competition
- Analysis of Demand
- Demand, Cost, and Profit Relationships
- Factors Affecting Pricing Decisions

The Nature of Price



- Price
  - The value exchanged for products in a marketing exchange
- Barter
  - The trading of products; the oldest form of exchange
- Terms Used to Describe Price
  - Tuition, premium, fine, fee, fare, toll, rent, commission, dues, deposit, tips, interest, taxes

The Nature of Price (cont’d)

- The Importance of Price to Marketers
  - The most readily changeable characteristic (under favorable circumstances) of a product.
  - It relates directly to generation of revenues and quantities sold.
  - A key component of the profit equation, having strong effect on the firm’s profitability.
  - Has symbolic value to customers—prestige pricing.

Profit = Total Revenue - Total Costs

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Profit = (Pric x Quantity Sold) - Total Cost

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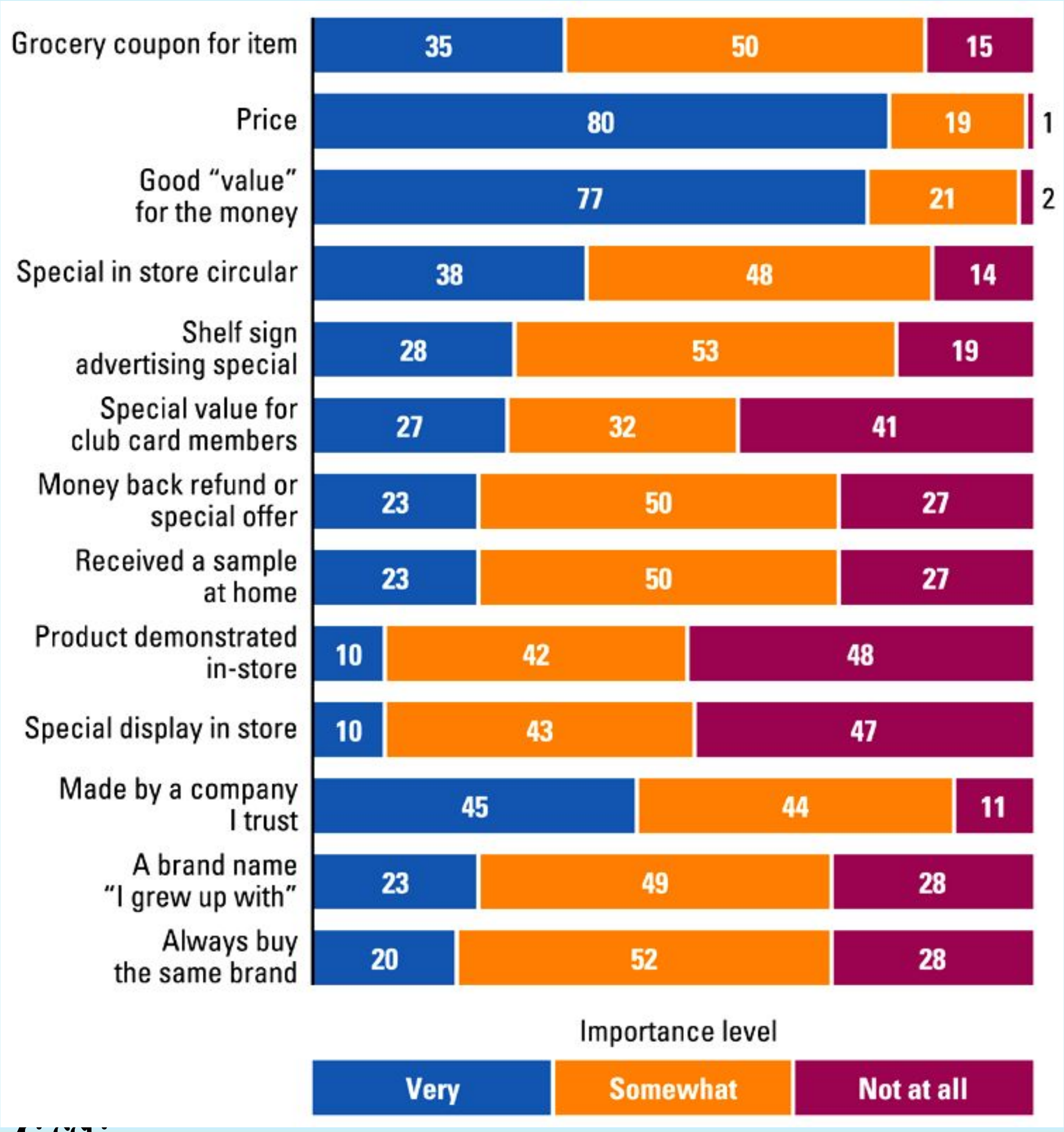
The Importance of Price-Related Factors on Consumer Brand Choice for Grocery, Health, and Beauty Products



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Price and Nonprice Competition

- Price Competition
  - Emphasizing price and matching or beating competitors' prices
  - An effective strategy in markets with standardized products
  - Lowest-cost competitor (seller) will be most profitable.
  - Allows marketers to respond quickly to competitors
  - Price wars can weaken competing organizations.

Price and Nonprice Competition (cont'd)

- Nonprice Competition
  - Emphasizing factors other than price to distinguish a product from competing brands
    - Distinctive product features
    - Service
    - Product quality
    - Promotion
    - Packaging

Price and Nonprice Competition (cont'd)

- Nonprice Competition (cont'd)
  - Advantage is in increasing brand's unit sales without changing price.
  - Is effective when a product or service's features are difficult to imitate by competitors and customers perceive their value
  - Builds customer loyalty by focusing on nonprice features

Orbitz Allows People to Save Up to 75% on Hotels

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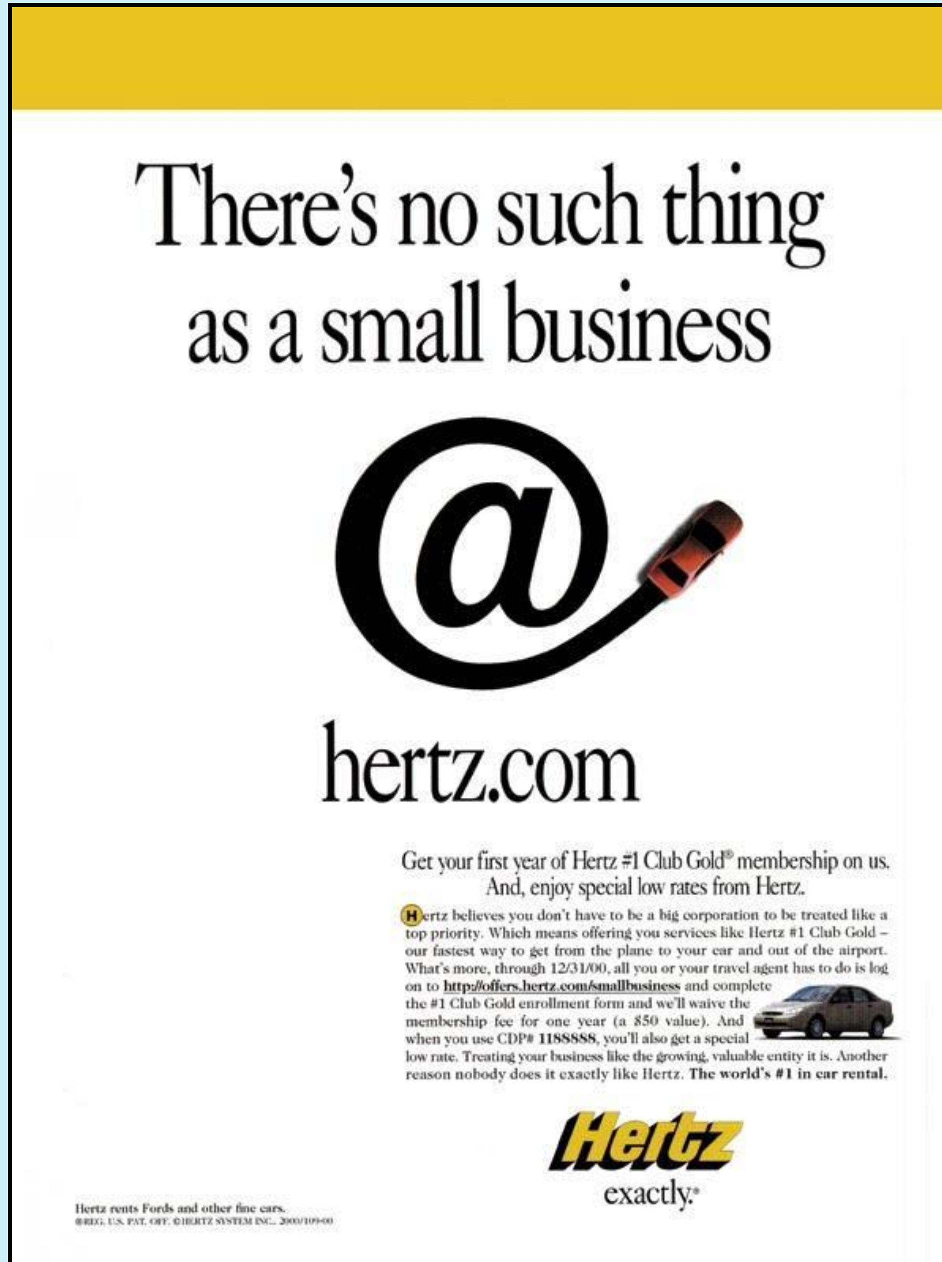
Hertz Emphasizes Its Benefits to Small Businesses



Exercise: Price Vs. Nonprice Competition

For each of the following products, indicate whether it is sold using price competition or nonprice competition and defend your selection.

____________ 1. Toyota Hybrid Prius
____________ 2. Hyundai Sonata
____________ 3. Porsche Cayenne SUV
____________ 4. Estee Lauder Electric Intense LipCreme
____________ 5. Avon Brilliant Moisture Lip Color
____________ 6. Louis Vuitton’s Murakami handbags
____________ 7. Olay Complete Moisturizing Lotion
____________ 8. Toshiba widescreen televisions

Debate Issue

Is price competition more effective than nonprice competition?

Analysis of Demand

- The Demand Curve
  - A graph of the quantity of products expected to be sold at various prices
  - Decreases in price create increases in quantities demanded.
  - Increased demand means larger quantities sold at the same price.
  - Prestige items sell best in higher price ranges.

Demand Curve Illustrating the Price / Quantity Relationship and Increase in Demand

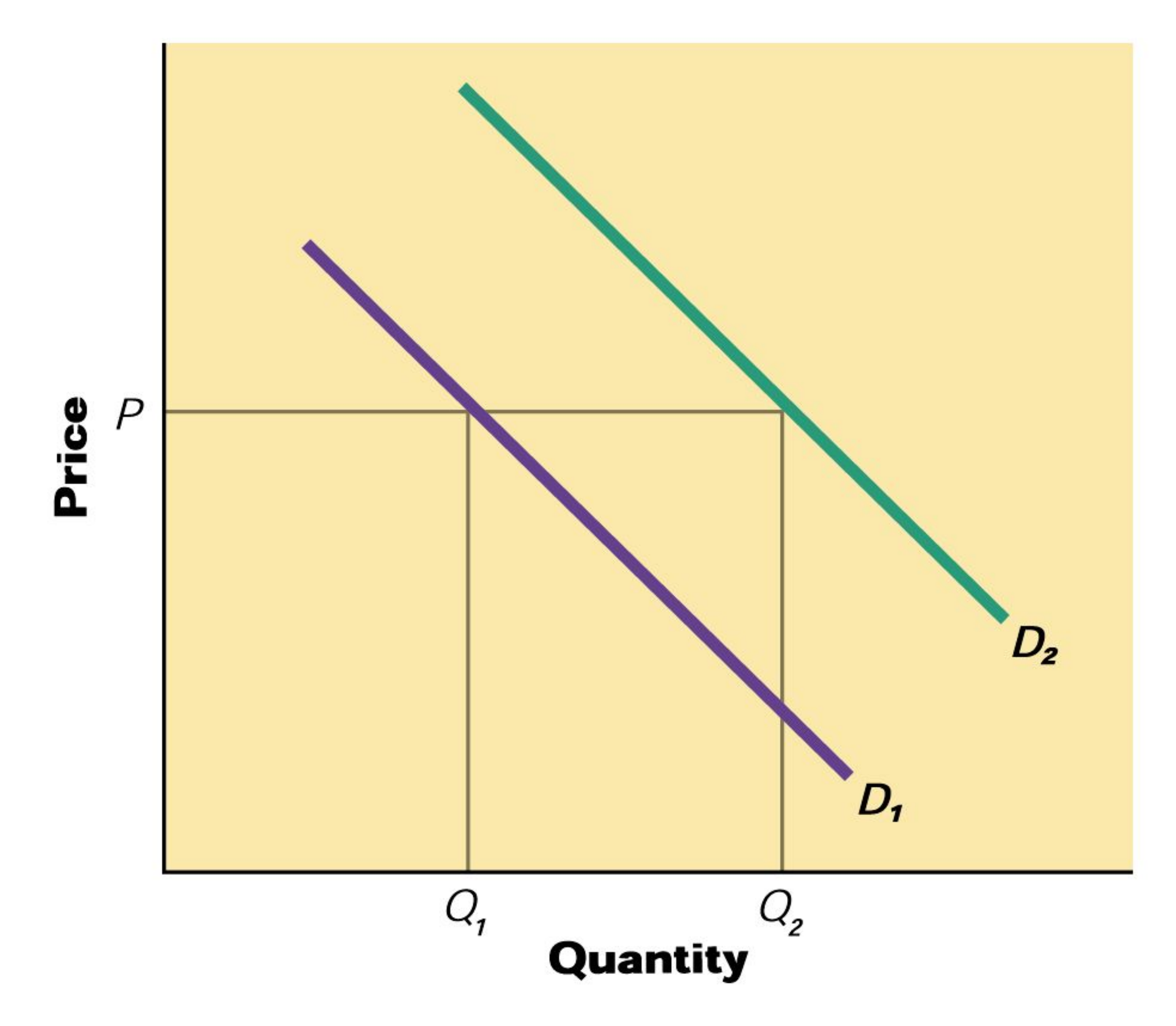


FIGURE 21.1

Demand Curve Illustrating the Relationship Between Price and Quantity for *Prestige* Products

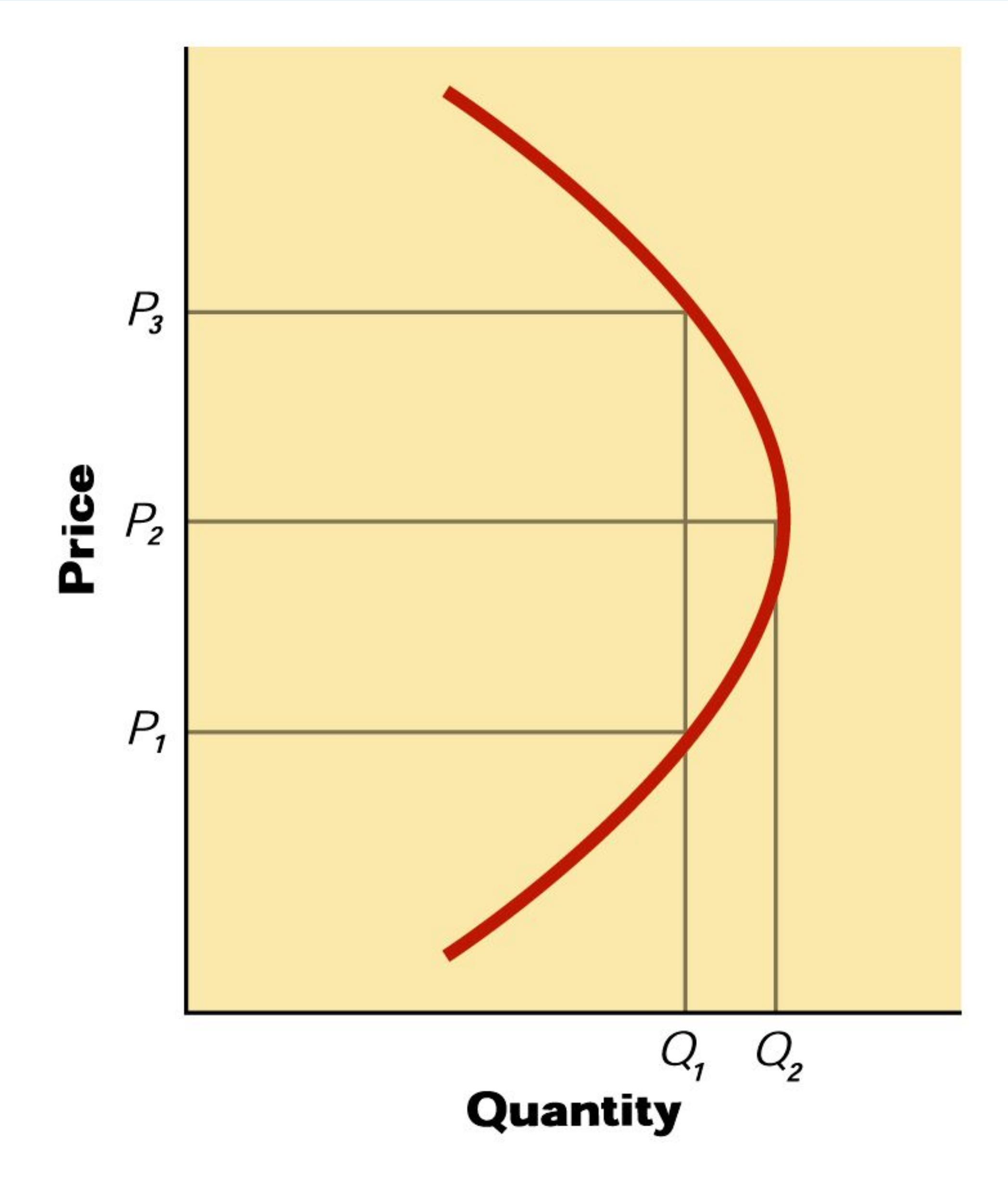


FIGURE 21.2

Analysis of Demand (cont'd)

- Demand Fluctuations
  - Changes in buyers' needs
  - Variations in the effectiveness of the marketing mix
  - The presence of substitutes
  - Dynamic environmental factors

Analysis of Demand (cont'd)

- Assessing Price Elasticity of Demand
  - Price elasticity
    - A measure of the sensitivity of demand to changes in price—the greater the change in demand for a specific change in price, the more elastic demand is

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

Elasticity of Demand

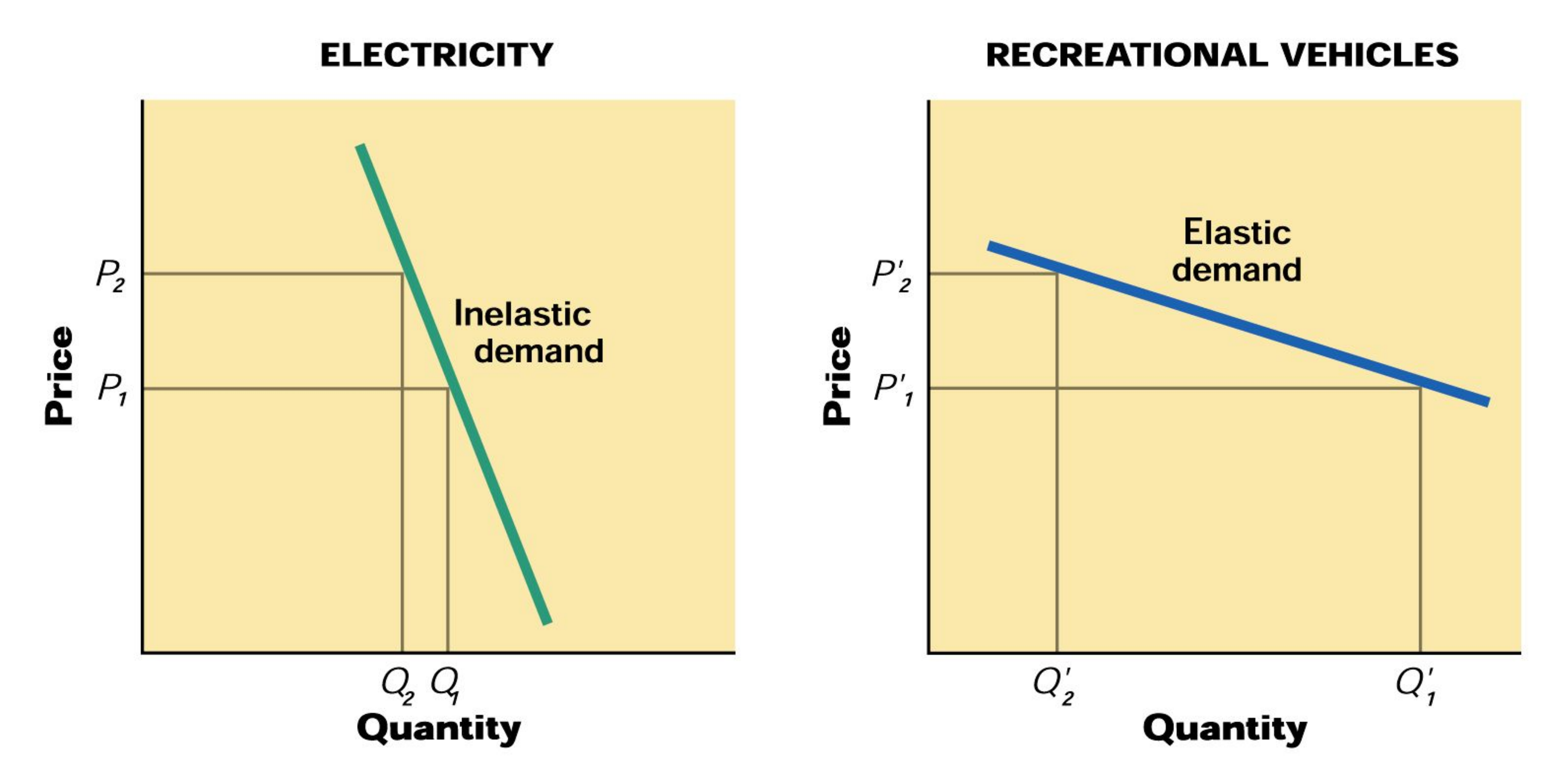


FIGURE 21.3

Demand, Cost, and Profit Relationships

- Marginal Analysis
  - Examines what happens to a firm's costs and revenues when production changes by one unit
  - Marginal Revenue
    - The change in total revenue resulting from the sale of an additional unit of product
  - Marginal Cost
    - The extra cost a firm incurs by producing one additional unit of product
- Profit is maximized where marginal costs (MC) are equal to marginal revenue (MR).

Types of Costs

Cost	
Fixed costs	Costs that do not vary with changes in the units produced or sold
Average fixed cost	The fixed cost per unit produced
Variable costs	Costs that vary directly with changes in the number of units produced or sold
Average variable cost	The variable cost per unit produced
Total cost	The sum of average fixed and average variable costs times the quantity produced
Average total cost	The sum of the average fixed cost and the average variable cost
Marginal cost (MC)	The extra cost a firm incurs by producing one more unit of a product

Table 20.1 **Costs and Their Relationships**

1	2	3	4	5	6	
Quantity	Fixed Cost	Average Fixed Cost (2) ÷ (1)	Average Variable Cost	Average Total Cost (3) + (4)	Total Cost (5) × (1)	Marginal Cost
1	$40	$40.00	$20.00	$60.00	$ 60	
						$10
2	40	20.00	15.00	35.00	70	
						5
3	40	13.33	11.67	25.00	75	
						15
4	40	10.00	12.50	22.50	90	
						20
5	40	8.00	14.00	22.00	110	
						30
6	40	6.67	16.67	23.33	140	
						40
7	40	5.71	20.00	25.71	180	

Breakeven Analysis

- Breakeven Point
  - The point at which the costs of producing a product equal the revenue made from selling the product
  - The point after which profitability begins

$$\text{Breakeven Point} = \frac{\text{Fixed Costs}}{\text{Per-Unit Contribution to Fixed Costs}}$$

$$\text{Breakeven Point} = \frac{\text{Total Fixed Costs}}{\text{Unit Price} - \text{Unit Variable Costs}}$$

Determining the Breakeven Point

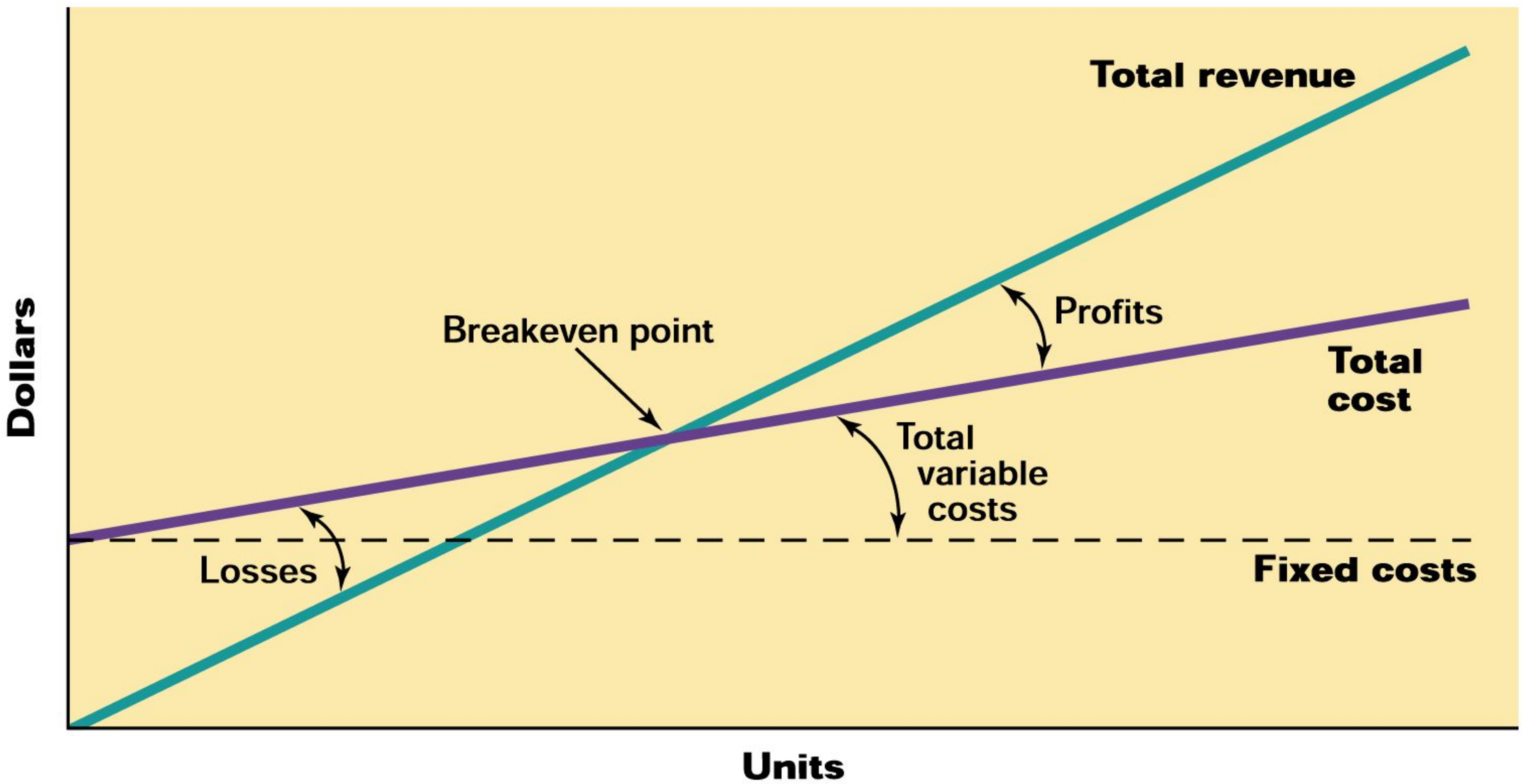


FIGURE 21.7

Exercise

Breakeven Analysis

Assume you are selling pizzas at $8. Your fixed costs (rent, salaries, utilities) are $4800/month. The food costs and other variable costs are 50 percent of the selling price. What is your break-even point?

Factors That Affect Pricing Decisions

FIGURE 21.8

Factors Affecting Pricing Decisions

- Organizational and Marketing Objectives
  - Prices should be set that are consistent with the organization’s goals and mission.
  - Prices must be compatible with marketing objectives (e.g., setting premium prices to enhance a product’s quality image).
- Types of Pricing Objectives
  - Setting prices low to increase market share
  - Using temporary price reductions to gain market share
  - Lowering prices to raise cash quickly

Factors Affecting Pricing Decisions (cont'd)

- Costs
  - Set a floor price—products must be sold above their costs if the firm is to remain in business.
  - Reducing costs increases productivity and profitability.
    - Using labor-saving technologies
    - Focusing on quality
    - Establishing efficient manufacturing processes
- Other Marketing Mix Variables
  - Price/quality image of the product or brand
  - Selective or intensive product distribution
  - Product pricing used as a promotional tool

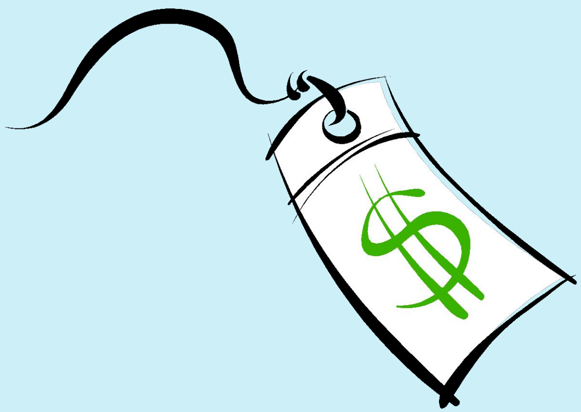
Factors Affecting Pricing Decisions (cont'd)

- Channel Member Expectations
  - To make a profit at least equivalent to the potential profit from handling a competitor's brand
  - To earn a profit in line with the effort and resources the channel member expends on the product
  - To receive discounts for volume purchases and prompt payment
  - To be supported by the producer with training, advertising, sales promotion, and return policies

Factors Affecting Pricing Decisions (cont'd)

- Customers' Interpretation and Response
  - What meaning does the product's price have to the customer?
  - Does the customer respond to the price by moving closer to or farther away from making a purchase?
  - Internal reference price
    - A price developed in the buyer's mind through experience with the product
  - External reference price
    - A comparison price provided by others

Factors Affecting Pricing Decisions (cont'd)



- Buyers' responses to price
  - Value consciousness
    - Concern about price and quality
  - Price consciousness
    - Striving to pay low prices
  - Prestige sensitivity
    - Being drawn to products that signify prominence and status
  - "Trading up"
    - Being drawn to some prestige/status products while remaining price-conscious for low-status products

Factors Affecting Pricing Decisions (cont'd)

- Competition
  - Pricing to match competitors' prices
  - Judging competitors' responses to adjusting prices
  - Changes in an industry's market structure cause and create pricing opportunities.
- Legal and Regulatory Issues
  - Price controls intended to curb inflation
  - Controls that set/regulate prices for specific products
  - Regulations and laws to prohibit price fixing, and deceptive and discriminatory pricing

Selection of a Basis for Pricing

(pp. 591-594)

- Cost-based pricing
  - Cost-plus pricing
    - Price = Costs + X
  - Markup pricing
    - As Percentage of Cost = Markup/Cost
    - As Percentage of Selling Price = Markup/Selling Price
  - Buy shirt at $10, mark it up $5 (shirt sells for $15)
    - Markup as percentage of cost = 5/10 = 50%
    - Markup as percentage of selling price = 5/15 = 33.33%
- Demand-based pricing
- Competition-based pricing

Exercise

Prices of personal computers continue to drop because of (a) increased competition among PC makers, which operate on narrow margins; (b) increased consumer knowledge and sophistication, which encourages more consumers to use mail-order discount pc marketers; and (c) decreased differences in quality and performance among competitors. Although IBM prices are still above some of the competitors, all PC manufacturers have been cutting prices to maintain market share.

Exercise (cont'd)

1. Do you think IBM should compete through price or nonprice competition? What are the advantages and disadvantages of each approach?
2. If IBM were to continue competing on price, how might other marketing mix variables be affected?
3. If IBM drops its prices in the near future, what can you expect other PC makers to do? What kind of competitive situation is the PC industry (oligopoly, monopolistic, pure competition)? What does this imply for price setting?