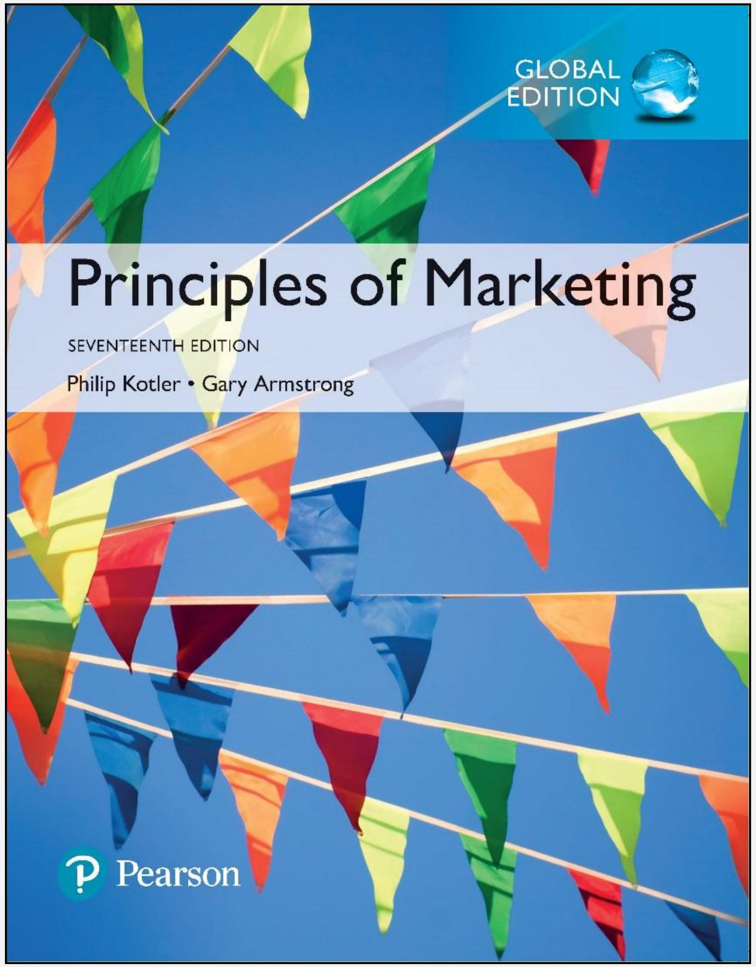
Principles of Marketing
Seventeenth Edition



Chapter 10

Pricing: Understanding and Capturing Customer Value

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Learning Objectives

10-1 Answer the question "What is a price?" and discuss the importance of pricing in today's fast-changing environment.

10-2 Identify the three major pricing strategies and discuss the importance of understanding customer-value perceptions, company costs, and competitor strategies when setting prices.

10-3 Identify and define the other important external and internal factors affecting a firm's pricing decisions.

Learning Objective 1

Answer the question “What is a price?” and discuss the importance of pricing in today’s fast-changing environment.

What Is a Price?

Price is the amount of money charged for a product or service, or the sum of all the values that customers exchange for the benefits of having or using the product or service.

Learning Objective 2

Identify the three major pricing strategies and discuss the importance of understanding customer-value perceptions, company costs, and competitor strategies when setting prices.

Major Pricing Strategies

- Figure 10.1 suggests three major pricing strategies: customer value-based pricing, cost-based pricing, and competition-based pricing.

The price the company charges will fall somewhere between one that is too low to produce a profit and one that is too high to produce any demand.

Figure 10.1 summarizes the major considerations in setting price. Customer perceptions of the product's value set the ceiling for prices. Likewise, product costs set the floor for a product's price.

In setting its price between these two extremes, the company must consider several external and internal factors, including competitors' strategies and prices, the overall marketing strategy and mix, and the nature of the market and demand.

Major Pricing Strategies

FIGURE | 10.1
Considerations in Setting Price

If customers perceive that a product's price is greater than its value, they won't buy it. If the company prices the product below its costs, profits will suffer. Between the two extremes, the "right" pricing strategy is one that delivers both value to the customer and profits to the company.

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Major Pricing Strategies

Customer Value-Based Pricing

Value-based pricing uses the buyers' perceptions of value rather than the seller's cost.

- Value-based pricing is customer driven.
- Cost-based pricing is product driven.
- Price is set to match perceived value.

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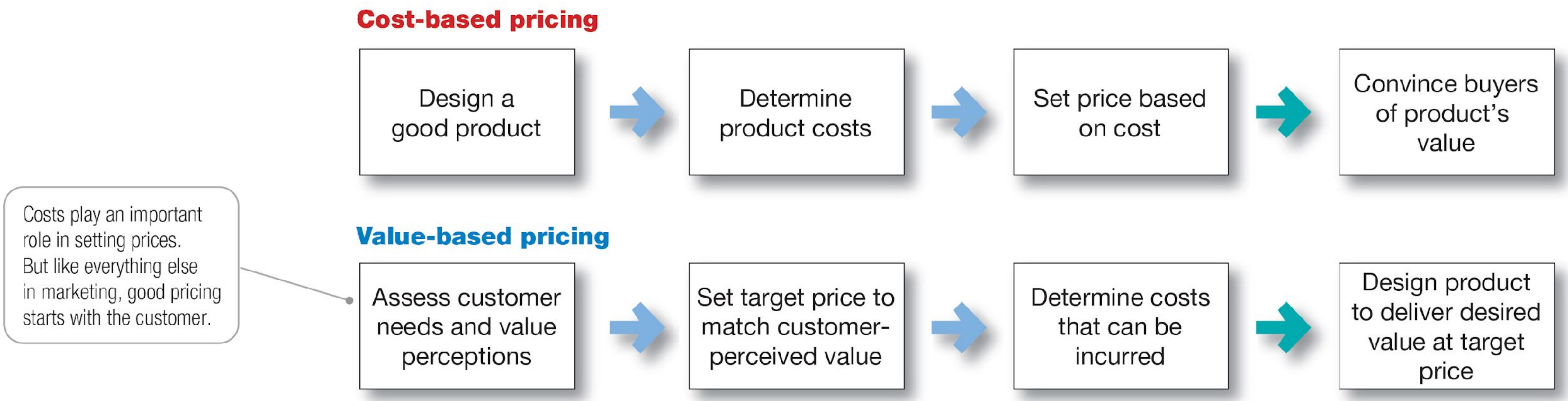
Major Pricing Strategies

FIGURE | 10.2
Value-Based Pricing versus Cost-Based Pricing



Major Pricing Strategies

Customer Value-Based Pricing

There are two types of Value-Based Pricing: Good-value pricing and added-value pricing

Good-value pricing is offering just the right combination of quality and good service at a fair price.

In many cases, this has involved introducing less-expensive versions of established brand name products or new lower-price lines.

In other cases, good-value pricing has involved redesigning existing brands to offer more quality for a given price or the same quality for less. Some companies even succeed by offering less value but at very low prices.
An important type of **Good-value pricing at the retail level is called** *everyday low pricing*
ALDI practices *everyday low pricing* (*EDLP*). The king of EDLP is Walmart, which practically defined the concept. **In contrast to** *High-low pricing.*

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Major Pricing Strategies

Customer Value-Based Pricing

Good-value pricing

Everyday low pricing (EDLP) involves charging a constant everyday low price with few or no temporary price discounts.

Good-value pricing: ALDI keeps costs low so that it can offer customers “impressively high quality at impossibly low prices” every day.

Major Pricing Strategies

Customer Value-Based Pricing

Good-value pricing

High-low pricing involves charging higher prices on an everyday basis but running frequent promotions to lower prices temporarily on selected items.

Department stores such as Sears and Macy's practice high-low pricing by having frequent sale days, early-bird savings, and bonus earnings for store credit-card holders.

Major Pricing Strategies

Customer Value-Based Pricing

Value-based pricing doesn’t mean simply charging what customers want to pay or setting low prices to meet competition. Instead, many companies adopt **value-added pricing** strategies. Rather than cutting prices to match competitors, they add quality, services, and value-added features to differentiate their offers and thus support their higher prices.

Major Pricing Strategies

Cost-Based Pricing

Cost-based pricing sets prices based on the costs for producing, distributing, and selling the product plus a fair rate of return for effort and risk.

Whereas customer-value perceptions set the price ceiling, costs set the floor for the price that the company can charge.

Some companies, such as Walmart or Southwest Airlines, work to become the low-cost producers in their industries. Companies with lower costs can set lower prices that result in smaller margins but greater sales and profits.

Major Pricing Strategies

Cost-Based Pricing
Types of costs

Fixed costs (also known as **overhead**) are costs that do not vary with production or sales level.

- Rent
- Heat
- Interest
- Executive salaries

Major Pricing Strategies

Cost-Based Pricing

Variable costs vary directly with the level of production.

- Raw materials
- Packaging

Variable costs vary directly with the level of production. Each PC produced by HP involves a cost of computer chips, wires, plastic, packaging, and other inputs. Although these costs tend to be the same for each unit produced, they are called variable costs because the total varies directly with the number of units produced.

Major Pricing Strategies

Cost-Based Pricing

Total costs are the sum of the fixed and variable costs for any given level of production.

Management wants to charge a price that will at least cover the total production costs at a given level of production.

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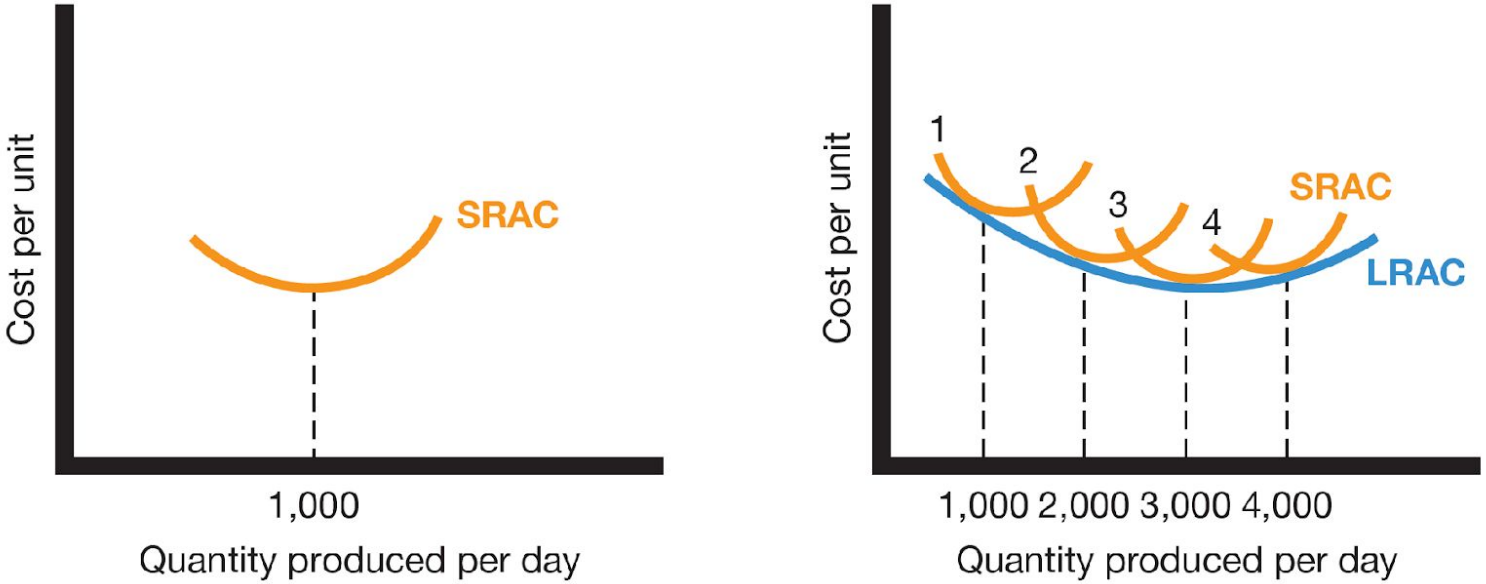
Major Pricing Strategies

FIGURE | 10.3
Cost per Unit at Different Levels of Production per Period

What's the point of all the cost curves in this and the next few figures? Costs are an important factor in setting price, and companies must understand them well!



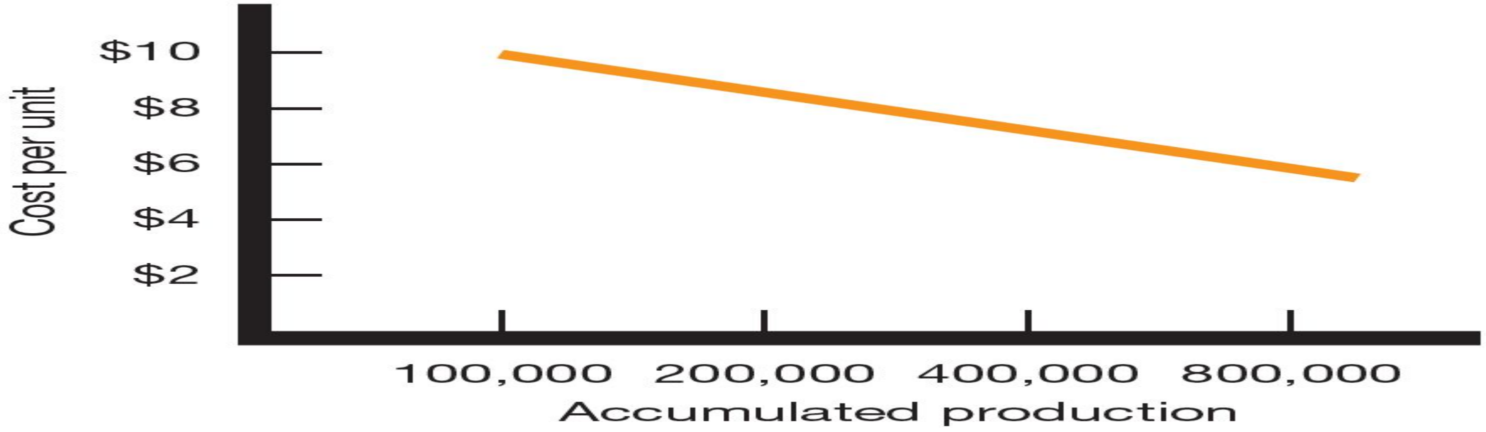
A. Cost behavior in a fixed-size plant

B. Cost behavior over different-size plants

Major Pricing Strategies

FIGURE | 10.4

Cost per Unit as a Function of Accumulated Production: The Experience Curve



Suppose TI runs a plant that produces 3,000 calculators per day. As TI gains experience in producing calculators, it learns how to do it better. This drop in the average cost with accumulated production experience is called the **experience curve** (or the **learning curve**).

Major Pricing Strategies

Cost-Based Pricing

Cost-plus pricing adds a standard markup to the cost of the product.

- Benefits
  - Sellers are certain about costs.
  - Price competition is minimized.
  - Buyers feel it is fair.
- Disadvantages
  - Ignores demand and competitor prices

Cost-Based Pricing

To illustrate markup pricing, **suppose a manufacturer of toasters has a cost of $16/unit**. If the manufacturer wants to earn a 20 percent markup on sales, the price is calculated by the following:

markup price = unit cost/(1 - desired return on sales) =$16/(1 - .2) = $20

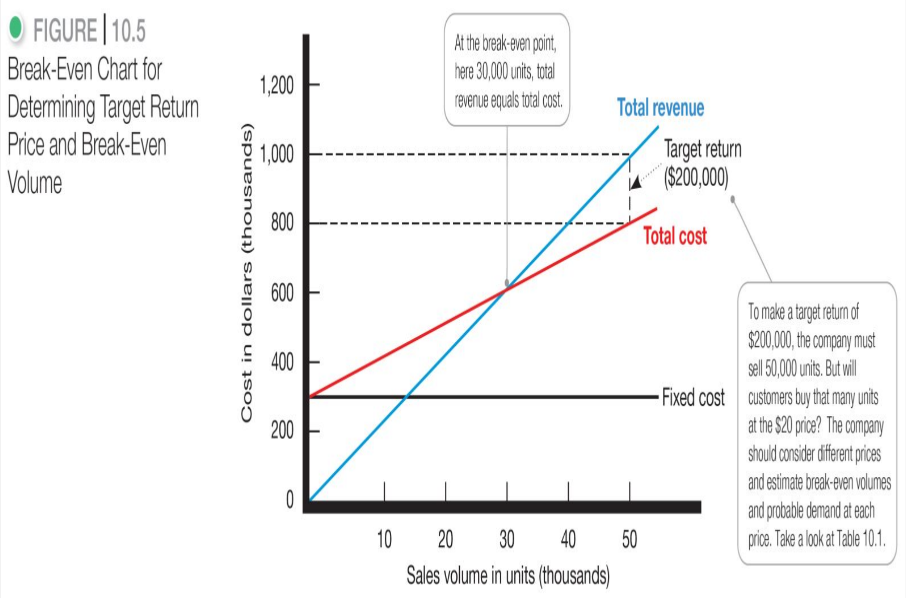
The manufacturer would charge dealers $20 per unit and make a profit of $4 per unit. The dealers, in turn, will mark up the toaster

Major Pricing Strategies

Cost-Based Pricing

Break-even pricing (target return pricing) is setting price to break even on costs or to make a target return.

Figure 10.5 Break-Even Chart for Determining Target Return Price and Break-Even Volume.



$$BEP_{Quantity} = \frac{\text{Fixed Cost}}{\text{Unit Price} - \text{Unit Variable Cost}} = \frac{FC}{P - UVC}$$

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Major Pricing Strategies

Table 10.1 | Break-Even Volume and Profits at Different Prices

Price	Unit Demand Needed to Break Even	Expected Unit Demand at Given Price	Total Revenue (1) × (3)	Total Costs*	Profit (4) − (5)
$14	75,000	71,000	$994,000	$1,010,000	−$16,000
16	50,000	67,000	1,072,000	970,000	102,000
18	37,500	60,000	1,080,000	900,000	180,000
20	30,000	42,000	840,000	720,000	120,000
22	25,000	23,000	506,000	530,000	−24,000

*Assumes fixed costs of $300,000 and constant unit variable costs of $10.

Major Pricing Strategies

Competition-Based Pricing

Competition-based pricing is setting prices based on competitors' strategies, costs, prices, and market offerings.

Consumers will base their judgments of a product's value on the prices that competitors charge for similar products.

Pricing versus competitors: Caterpillar dominates the heavy equipment industry despite charging premium prices. Customers believe that Caterpillar gives them a lot more value for the price over the lifetime of its machines.

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Learning Objective 3

Identify and define the other important external and internal factors affecting a firm's pricing decisions.

Other Considerations Affecting Price Decisions

Overall Marketing Strategy, Objectives, and Mix

Target costing starts with an ideal selling price based on consumer value considerations and then targets costs that will ensure that the price is met.

Other Considerations Affecting Price Decisions

Organizational Considerations

- Who should set prices?
- Who can influence prices?

Top management sets the pricing objectives and policies, and it often approves the prices proposed by lower-level management or salespeople.

In industries in which pricing is a key factor (airlines, aerospace, steel, railroads, oil companies), companies often have pricing departments to set the best prices or help others set them. These departments report to the marketing department or top management.

Others who have an influence on pricing include sales managers, production managers, finance managers, and accountants.

Other Considerations Affecting Price Decisions

The Market and Demand

Before setting prices, the marketer must understand the relationship between price and demand for its products.

Other Considerations Affecting Price Decisions

The Market and Demand: Pricing In Different Types of Markets

- Pure competition
- Monopolistic competition
- Oligopolistic competition
- Pure monopoly

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Other Considerations Affecting Price Decisions

The Market and Demand

Analyzing the Price–Demand Relationship

The **demand curve** shows the number of units the market will buy in a given period at different prices

- Demand and price are inversely related.
- Higher price = lower demand

Other Considerations Affecting Price Decisions

The Market and Demand

Price Elasticity of Demand

Price elasticity is a measure of the sensitivity of demand to changes in price.

Inelastic demand is when demand hardly changes with a small change in price.

Elastic demand is when demand changes greatly with a small change in price.

$$\textbf{Price elasticity of demand} = \frac{\%\ \text{change in quantity demand}}{\%\ \text{change in price}}$$

If demand is elastic rather than inelastic, sellers will consider lowering their prices. A lower price will produce more total revenue.

Other Considerations Affecting Price Decisions

The Economy and Other External Factors

. Economic factors such as a boom or recession, inflation, and interest rates affect pricing decisions because they affect consumer spending, consumer perceptions of the product's price and value, and the company's costs of producing and selling a product.

The company must consider several other factors in its external environment when setting prices.

- The company should set prices that give resellers a fair profit, encourage their support, and help them to sell the product effectively.
- The government is another important external influence on pricing decisions.
- Social concerns may need to be taken into account. In setting prices, a company's short-term sales, market share, and profit goals may need to be tempered by broader societal considerations.

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