UNIT-8

Product Pricing Strategies

Learning Outcomes

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

- ✓ Explain the objectives of pricing
- ✓ Describe the factors which effect price determination
- ✓ Explore various pricing strategies.

Unit 8

Product Pricing Strategies

Upon finalisingproduct planning, pricing policies, and strategies need to be concluded next. Pricing is of the utmost importance, as it directly impacts sales and company profits. Deciding the price requires extra care and caution. The first step towards pricing is the determination of the product’s base price and a decision on the objectives of pricing. This unit deals with the various aspects of pricing. Meanings and significance of pricing will be discussed along with factors impacting pricing decisions, objectives, and the fundamental methods of determining the price.

The Function and Value of Price

Daily, we make purchases from various markets. In exchange for the product, we make a payment. The amount paid for, 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, a 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 modesand covered under insurance.

‘Interest’ is the price of a bank loan, ‘tuition fee’ is the price of acquiring an 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 with 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,inspiredby its price. Product price can be used by the company in efforts to raise or reduce the product demand and the degree of competition. Improper pricing policies can bring about legal difficulties and give rise to resentment in the buyers. The issue of what price is reasonable to charge from a buyer is a baffling 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 numbers of people can afford to purchase.

Price is not only a crucial factor for business entities, but numerous other organisations that provide an array of services, such as, insurance, banking, advertising, transport, entertainment, and 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, that he provides his patients. Most usually price is the main factor forming the basis of competition in the market. It is one of the main features which competitors keep a keen eye on. The price of merchandise will affect its sales noticeably, as it will affect the firm’s total returns and final profits. Other

than the firm, price plays a significance role in whether or not, buyers and the society at large, are willing to purchase the goods. Price represents the value of what market is offering the buyers. The demand for goods is greatly determined by its price. Price can many times also 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

Main objectives of pricing should be similar to those of the firm itself. Before finalising the product price, the organisation has to figure it own pricing objectives. An organization can follow multiple objectives at once. While aiming for maximum profits in short and long run, the organisation can also aim to uphold superior customer and worker relations, and adhere to the legal restrictions outlined by the government in regards to pricing. The company can look towards increasing sales but at the same time preserve benevolence. 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; and
3) Other objectives

Let us explore each objective individually.

Profit- Oriented Objectives

When making pricing decisions, making profits 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 and b) reach the wished for rate of return on an investment.

i) Maximisation of Profits: Maximizing profits is the most usual objective of business concerns. Any firm with this aim will charge a heavy margin of profit and thus maintain high prices. A firm with 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 duration, they will at times have to face short run losses. A company stepping into a new portion of the market or introducing a new item will usually set a low price to magnetize 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 preordained 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 coveted return on investment. The aimed at rate of return can be used as a guideline for improvements, particularly when the 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 aims without fear of competitors.

Sales Volume- Oriented Objectives

The financial aims of some companies' prices on products are 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 wish 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, with the idea that enhanced sales hold more value in the long term compared to the immediate 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. Many times products showing 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 occur. 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 valuable issues.

These include the following:

- price stabilisation;
- survival in the market;
- prevent a competitor's entry in the market; and
- to enhance or hold on to a firm's image a provider of quality goods. Let us take a closer look at these factors.

i) **Price Stabilisation**: some firms prefer to maintain stable prices and evade price war. This method is observed when an establishment faces a very big competitor, which behaves as a price leader andespecially in cases where the product is standardised. To keep competition at its 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 for the variable costs and partial fixed costs, and aim to stay in the business for longest duration possible.

ii) **Preventing Competitors' Entry:**Preventinga competitor from entering the market is more important that earning profit in a 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 a 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 'market penetration objective' as it deals with maintaining lowest possible prices and making it unappealing for potential competitors to even try entering.

iii) **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 best 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 numerous cases of sellers maximizing short run profits. Latest studies show that most common objectives of pricing are market share maximization and maximization of profits. 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 firms operate in varying conditions. Generally, policies and principles of pricing differ from one industry to next, one company to next and one time to 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; and
5) Other marketing elements

Let us 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 be food whenever their food supply gets low). . Considering that purchasing power is restricted whereas one's wants are not, people only buy goods that provide the most satisfaction compared to the price paid. Subjectively speaking, each consumer maintains a priority list of goods or services that he can purchase with his income. This list is made unconsciously and subjectively. Due to the subjectivity involved, it is nearly impossible to measure the utility 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 commandedat alower price instead of the higher one. This holds true for most of the 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 a 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 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 is the product cost? What kinds of profits should be earned? These appear to be simpler to answer than the question what customers can afford to pay? Still, this is the one that holds the most importance of all questions that have to consider. However, many of the marketers give more value to total costs (cost of manufacturing + distributing costs + administrative costs) with a reasonable profit tagged on, as the correct way of fixing the product price.

Types of Costs

Costs are classified in two groups for price fixingobjectives:

1) fixed costs,
2) variable costs

Fixed costs are the ones which do not change significantly with the production volume or sale. Regardless of whether the producer makes 2,000 units or 100 or even, stops production totally, he will still have to bear some expenses, like 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 material, 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 alter 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 to 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 real price that is fixed is swayed a great deal by the amount of competition in the given market. When competition in the market is negligible or nonexistent, 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 charge 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 part in 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 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 described by the law.

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 said product. Companies holding strong positions in all these factors are able to charge higher prices. For companies' deficient or lacking these factors may have to charge lower prices. For instance is one company is offering home delivery or even 'money back' guarantee or offering its product through high class outlets (such as air-conditioned showroom), the product can be sold at a higher price. The company has to use consistency when following marketing and pricing policies. Only when a product is appreciably different form a competitor's products can the company have a more free hand at 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 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 us take a closer look at the methods.

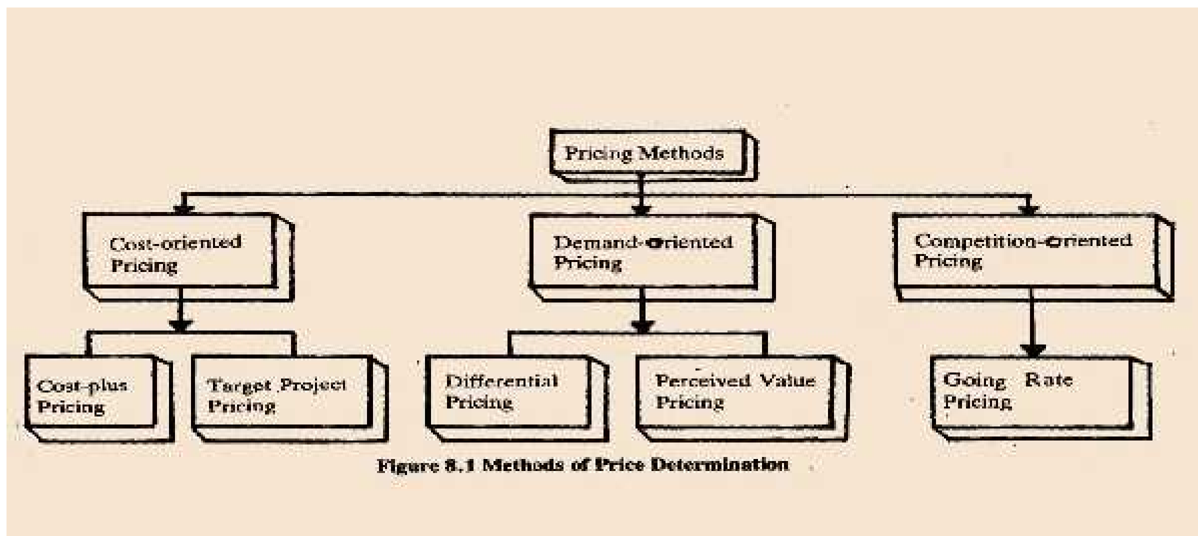

Figure 8.1 Methods of Price Determination

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 total product's cost with a specified margin attached.

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

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

Let us take a more detailed look at each of these -

1) Cost-plus Pricing

A number of firms fix 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 costs 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 effortless to implement. There is normally less doubt about the cost than the product demand. The profit margin that is to be added is at the discretion of the company. It varies according to 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 want to calculate a price that will allow it to net a desired profit. The company starts with an analysis of the break-even point and then determines the break-even point. The break-even analysis associates total cost to total revenue. A break-even point is the point of production wherethe Total Sales Revenue (TR) is equal to the Total Cost (TC). Stated differently, it is the point where the level of production or supply is

such that the company neither earns a profit nor suffers 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 that much loss for the company.

The break-even point can be determined as follows:

Breakeven Point (in Units) = Total fixed costs

( ) ( ) ( )

Or -

Demand-oriented Pricing

Demand-oriented Pricing is calculated based on the volume of sales that is expected at the different prices which 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 and a lower price is fixed when demand is less, 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 desires. As a result, their desire for a product also varies. In these conditions, manufacturers are 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, place (customer location), time of sale, and product version. Varying prices can be fixed for the 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 availability of the product. For instance, in a cinema hall, seats in different location within the hall come with different prices, even when everyone is watching the same movie. If same or closely resembling product is sold for different prices at different locations, it is known as place differential

In terms of time, the product demand changes by day, season, or even, 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 different on working days compared to 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 from buyers of 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, and are not based on the cost of the product, or even, different perceptions by different buyers for same product, is called Competition - oriented Pricing.

The 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 bother to determine demand intensity or value perceptions in the minds of the buyers. The firm decides to fix the price of its goods based on the 'Going-Rate' 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 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 the price elasticity or the different product costs. Lastly, adopting the Going- Rate Price method averts 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 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