

The concept of pricing



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This module introduces the concept of pricing and discusses its importance and significance to organisations. With a view to the relative significance of pricing on organisations profits and sales, appropriate pricing policies needs to be formulated strategically. The various pricing decisions that organisations need to make are price setting, adapting price and managing price change which is dealt in this module.

Pricing Strategies

Introduction

This lesson discusses pricing and its importance to organisations and the various factors to be considered while formulating pricing policies:

Define the concept of price

Explain the factors influencing pricing decisions.

Discuss the process of price setting.

Explain how organisations adapt prices.

Discuss the price change management policies adopted by organisations.

Understanding pricing

Price is the amount of money at which a product or service is offered in the market. It is the exchange rate of a product or service in terms of its monetary value.

Pricing is an important decision area for an organisation. The pricing and sales volume of the product put together determines the profit for an organisation. The sales volume itself depends on the type of pricing policy adopted by the organisation. Profits too are dependent on the pricing policies.

Hence organisations have to formulate pricing policies strategically. Pricing also determines the acceptance of the product in the market, one can say that it determines the product's future success in the market.

IKEA pricing strategy is to provide quality products at low prices to its customers.

Internet advertising through Google ads,

Pricing is an important aspect not only for the organization producing the product, but also for the consumers as well as the society. Price represents the value of the market offering to the consumers, it also indicates the quality of the product. Increase in price could be perceived favourably by the consumers by interpreting it as a consequence of improvement of quality.

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The factors affecting pricing policies of an organisation are:

Internal Factors – While making pricing policies, marketers need to take into account several factors which are the result of company decisions and actions. To a great extent these factors are controllable and alterable by the company. Internal factors are as follows:

Objectives of the organisation

Positioning sought by organisation through pricing

Nature of product

Price elasticity of the product

The stage of Product life cycle of the product

Usage and repurchase level of the product

Cost of production

Product distinctiveness and positioning

Other p's of the marketing mix and their influence on the pricing

Composition of product line of the firm

External Factors – There are a number of influencing factors which are external to the firm and cannot be controlled by the firm but will impact pricing decisions. External factors are as follows:

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Market structure

Consumer behavior

Bargaining power of consumer groups

Bargaining power of major suppliers

Competitors policies

Government controls/regulations

Other legal aspects

Social considerations

cartels

Setting the Price

The organisation has to think over several factors while setting its pricing policy. The process of setting the price is as follows:

Deciding the pricing objectives: The organisation has to first of all analyse its position of offering in the market. If the organisational objectives are clearly set, setting price becomes easier. The major objectives that organisations look to pursue through pricing policy are sustenance, profit maximization, market share maximization, market skimming and quality leadership.

Organisations would adopt sustenance policy, if there is too much competition and changing in trends due to changes in customer taste and preferences. Here the organisation would generally be looking to cover some

variable and fixed cost of production and a marginal profit. This kind of policy is useful only in the short run, in the long run firms would have to add value to its offer or face extinction.

Setting the pricing policy :

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In case the organisational objective of the firm is profit maximization, the firm will then choose that price which will give it maximum profits, cash flow or maximum rate of return on investments. For such a strategy the firm has also to take demand situation into consideration.

In case where the main objective of the organisation is market share maximisation, they would generally set a low price so that market can be penetrated easily. Low pricing or penetration pricing policy is applicable in the following situations:

Consumers are price sensitive

There is possibility of market penetration with the help of low prices

Production and distribution cost fall with higher production level and experience

Competition is discouraged due to the low prices in the market

Skimming price is adopted by firms to gain higher profits in the short run and is applicable in the following situations:

High demand exists in the market due to product being a pioneer product

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Not much competition exists in the market

Consumer perception is that, high price indicates quality

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Determining demand: The different prices set by organisations will lead to difference in demand for the product in the market. The demand curve shows the different quantities demanded by customers at varying prices. Universally, as demand and price of the products are inversely related, according to the law of demand at a higher price lesser the quantity demanded and at lower price higher the quantity demanded. Only in exceptional cases it can be seen that with increase in price of product, demand too increased, especially seen in cases of prestige goods such as perfumes, diamonds etc.

(Fig 1. 1 – Demand Curve)

(For reference)

Figure 1. 1, in the first case shows elastic demand and the second case it shows inelastic demand.

Price Sensitivity: The demand curve shows the markets sensitivity to the changes in prices of the product. It shows the response of customers to changes in prices. Generally customers are more price sensitive to products that cost much such as speciality goods and those goods which are frequently such as staple goods. They are less price sensitive to goods which

are brought infrequently or such products, the cost of which is insignificant to the customer.

Products which would have less price sensitivity are:

Distinctive products

Where there very few substitutes to the products or customers are not aware of substitute products

Quality comparison of substitute products are not easy

The price of product is insignificant to the consumers income

It is a complementary good to an earlier purchase

The product is assumed to be of higher quality, prestige.

It is not possible to store the product.

The advent of internet has led to an increased price sensitivity in the society. Internet has made it possible for people to compare prices instantly and go for the lowest prices available. Firms have to understand the price sensitivity of their target market and accordingly formulate pricing policies.

Demand estimation and forecasting is an important function to be carried out by organisations for determining the demand for their products. There are various methods that can be used to arrive at demand estimation and forecast.

Where different variables of the price are identified statistical analysis can be undertaken, data for these variables collected and then analysis is done by using various statistical methods to arrive at the demand forecast.

Experimentation method is another way in which demand can be estimated at various price levels. Here the prices of the products are charged differently in different markets or in the same market different prices are introduced at different times and then the result is analysed to arrive at the demand.

Another method is doing customer surveys and interview to gauge the customers response to varying prices.

Price elasticity of demand: Elasticity of demand is to extend the responsiveness of demand to the different prices charged. The marketer needs to have an idea of how responsive the market demands are, to various prices set by the firm. If with the change in price the demand for the product changes substantially then we can say that the demand is elastic to price. If with a change in price there is very less or no change in the demand for the product the demand would be said to be inelastic.

Demand would usually be less or inelastic in the following situations:

There is no competition or substitute products in the market

Habits

Necessity goods

Where the price of product is small or insignificant to the consumer

Price elasticity depends on the degree of change in prices. Elasticity would be less in case of low level price change and would be more if the price change is significant. For example – consumer durables like television and washing machines, with a slight increase in their prices the demand for these product would not fall significantly but with a substantial increase in their prices the demand can come down considerably.

If price elasticity differs according to the time period under consideration, in the short run the elasticity would be different than in the long run. This happens because in the short run certain determinants remain static which can be varied in the long run. For example – Habits of people can be changed in the long run, competitive scenario can change in the long run.

Cost estimation:

Pricing policies of firms significantly depends on the cost of production and other related costs incurred by the organisation for offering the product in the market. Firms generally would charge a price which covers the production cost as well as a fair profit for the firms effort and risk.

There are different types of cost related to production of a product :

Fixed cost – which are fixed in nature and do not vary with the level of production or sales. For example – rent, interest on capital invested etc.

Variable cost – vary directly with the level of production of the firm. For example – wages, power consumption etc.

Total cost – can be said as the sum total of the fixed and variable costs for the total production level.

Average Cost: can be said as the total cost divided by the total number of units produced.

The firm would want to charge at least a price which would cover the total production cost.

To develop adequate pricing policies the management needs to know how cost varies with different levels of production.

Cost of production would also change according to its production scale and experience. Over the period of time, the experience gained by organisation leads in making more effective and production scheduling policies leading to lower costs. As well as with the expansion of plant and machinery, i. e large scale production helps organisations to lessen the cost of production considerably.

Organisations now a days try to adapt their offering as per the requirements of different buyers. A manufacturer may set different terms and prices for different retail chains according to their requirements. Certain retailer may not want to stock too much inventory of a particular product, in that case the delivery that has to be made to this retailer would be much frequent. On the other hand a retailer who has the stocking facility may want deliveries less frequently, accordingly the pricing and profit levels of the manufacturer would differ too.

Some companies adopt target pricing, here first of all through market survey the firm arrives at the product features and design. The next step would be to determine at what price the product will be sold. On the basis of the price, a percentage is deducted as profits and the rest would be the cost of production. Hence the organisation has arrived at the cost at which production should happen and that is the target cost at which production should happen.

Competitors pricing policies analysis :

Competitors policies have significant effect on the firm's own policies and strategies. The firm has to have a good knowledge of the competitors policies and their possible response to the firms pricing policies. In case the firm is offering product features which are exclusive and not provided by its competitors then their price should be set accordingly. If competitor provides additional features then their worth to the customers should be evaluated and subtracted from firm's price.

Selecting a pricing method :

The various pricing methods that organisations can use as follows :

Mark up Pricing :

The most widely used pricing technique is to add a standard mark up to the products cost.

Mark up is expressed in terms of percentage. Here, either the cost price or the sale price is taken as the base for determination of the mark up.

Eg. Cost price of travel bag – Rupees 2000

Mark up Rupees 400

Therefore selling price – Rupees 2400

Mark up based on cost price = $400/2000 = 20\%$

Mark up based on Selling price = $400/2400 = 16.67\%$

Mark up pricing:

Example :

Shopkeeper buys goods for Rupees 300/- at a wholesale rate. His cost based mark-up is 25%.

Hence sale mark-up price = $300 \times 0.25 = 75$ or 0.25.

Therefore sales price = $300 + 75 = 375$

While determining any pricing policy current demand, value of product perceived by customers, competition existing in the market has to be considered. Mark up price would only be useful if it brings in expected sales.

Mark up price is quite popular due to the following reasons :

Determining cost is quite easy than estimating demand

It is a much simpler way of pricing

If all firms in industry use this pricing policy then price would be similar, leading to less intense price competition.

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It is believed that cost pricing is fair for both customers and producers, where customers are not exploited and producers get a fair enough return.

Rate on return pricing –

The price is determined on the basis of a planned rate of return on investment made by the organisation.

The total cost of one financial year's standard production is estimated and taken as the standard cost. The mark up percentage of profit is obtained by multiplying capital turnover by estimated rate of return.

Perceived value pricing : Here the valuation of the product is done on the basis of how much the customers are willing to pay, instead of considering the production and related costs.

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Value pricing : Here the firm charges a fairly lower price for high quality products thereby winning loyal customer.

Tesco, UK is one of the largest retailers in UK.

Tesco's key competence is its pricing policy. It keep its product prices low so that sales can be maximised. Lot many customers were attracted to its products due to its value added low priced products.

Tesco launched the ' unbeatable value' campaign in the 1996, it made massive reductions in its prices during this campaign. Tesco adopted a low daily low price strategy alongside its promotional programs. This stragegy

stressed on regularising low prices for its customers on a regular and daily basis.

Going rate Prices : Going rate pricing emphasises on market conditions.

The firm adjusts its own pricing policy to the price structure existing at the industry level. This kind of pricing is usually seen in oligopolistic market structure, where the prices are mutually decided by the firms. Also in cases where costs are difficult to be determined, firms tend to follow the going rate price because it reflects the entire industries price rate. Examples would be petroleum and oil.

Auction pricing or price bidding: This type of pricing methods has emerged in the recent years especially due to the growth of Internet. These kind of pricing strategy is mostly seen in electronic goods market, selling a diverse range of products and services by auctioning them through the bidding process. The important function of auction is to dispose of excess products existing with the firm. There are three major auction type pricing.

These types are:

Ascending bids, (English auctions) : One seller and many buyers. The seller puts up the product or auction and the buyers bid prices, the highest price is accepted.

Descending bids (Dutch auctions) : One seller and many buyers or one buyer and many sellers. In this kind of auction the buyer quotes a higher price and then decreases it gradually till a bidder accepts the price. In the other case

the buyers lets know his intention to buy a particular product and then the sellers bids the prices by offering lower prices.

Sealed bid auctions: Here the suppliers can submit only one bid and do not know about other bids. From the submitted bids the most feasible bid is selected

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While selecting the final price, additional factors has to be considered by the firm such as :

Psychological pricing : Psychological pricing a marketing practice which is based on the theory that certain kind of prices have psychological influence on customers minds. The prices are expressed as odd prices: e. g. Rs. 299. 00 or Rs. 499. 00.

Gain and Risk sharing pricing :

This type of pricing is used for pricing complex, high valued products or services. Many times buyers refrain from accepting sellers proposal due to the high risk if the promised value is not delivered.

In order to provide some form of risk sharing or price protection as new drugs are adopted into formularies biopharma companies and payers are entering into agreements.

Onyx/Bayers Nexavar (sorafenib) and Pfizers Sutent (sunitinib malate) both anti-cancer drugs; Novartis Aclasta (zoledronic acid), and

Sanofi-Aventis/Procter & Gambles Actonel (risedronate sodium), both osteoporosis drugs are some of the best known drugs.

In Germany, Italy and the US, manufacturers have agreed to provide drugs free of charge if no progress is seen after the first treatment, or to recompense health plans, say for instance if bone fractures occur despite the osteoporosis therapy.

While setting the final price, firm has also to consider – the brand quality, advertising, company pricing policies. Firms also need to consider the distributors and agents, sales persons, competitors, suppliers response to the prices of the product. Finally, firms also need to consider the legal implications while setting their prices.

Adapting the price :

Organisations generally set different prices according to variations in geographical demand and costs, market segment requirements, purchase time period, order levels, frequency of delivery, guarantees and various other factors.

Various price adaptation strategies are as follows:

Geographical pricing: It involves the pricing of products to different customers in different locations and countries. Taking into consideration the transportation costs example shipping / cargo costs for distant customers. Also the firm needs to lower the prices of its product/s from sales promotion point of view to retain or expand its business. Considering the export of products to countries abroad where the payment from buyer becomes

crucial, should he lack payment he may offer other items. This practice also recognised as countertrade. Countertrade accounts approximately up to 25 percent of current world trade. Usually this trading is done as Buyback agreements, Barter, offset and Compensation deals.

Countertrade deals may become complex for example an ' A ' company in Europe sells 50 yachts to Turkey and accepts in exchange 150 Turkish made cars, which it sold to Pakistan for Rice, which in turn sold to America and achieved payment in dollars . Such deals are carried by a separate department within the organisation. Other companies may depend on barter houses or countertrade specialists.

Most companies give discounts and allowances in order to receive early payments on volume purchases and off-season buying. This may lead to decreased profits, hence an assumptive price of the products needs to be worked out with planning. Marketing researchers have found that up to 35 percent of buyers in most categories are price sensitive. Higher income people are more interested in buying products with added features, customer service, quality and brand. Hence it's essential for a strong brand not to get into price discounting in order to react to low price attacks.

A company can gain some concessions, if a customer agrees to sign a contract for a bulk years example 3-5 years or if an order is placed in a larger quantity or if an order is placed online thus saving the company money.

It is necessary to maintain and monitor all records regarding discounts such as the quantity of customers receiving discount and average discount, etc. It

is essential for higher levels of management to conduct a net price analysis in order to get the real price offered. However the realised price is affected not only by discounts, also but by firm's average promotional spending's, advertising spending's to retailers to back the product, thus the listed price of the product and so for the net price of the product are two ends of the same thread with couple of other expenses in between.

However companies in an overcapacity tend to offer their branded products at a deep discounted rate. Firms should avoid offering discounts to retailers in the long term which in turn would decrease their profits in an effort to meet short term volume goals.

In order to stimulate early purchase of a product firm's can use several pricing techniques. Examples could be found where branded products are offered at a discounted price in order to stimulate extra purchases of other store products. This pays only if the revenue is generated by selling other products in proportion to the lower margins on the loss -leader product.

In certain seasons and occasions of festive periods example every June there are back -to-back school sales and during Diwali, Christmas and New Year special prices will be established on products.

In order to clear inventories without affecting the listed price, auto companies and other consumer goods companies offer cash rebates to help purchase of products during a certain period.

Some auto companies offer the product with an attractive finance scheme such as zero interest rate or in case of consumer durable goods buy now and start paying after six or nine months instead of cutting its price.

Equated monthly instalments may be stretched over a longer period in order to lower them, here the consumer focus is on affording to pay back in instalments rather the rate of interest. This can be in cases of auto companies and consumer durable goods etc.

Often auto companies offer an attractive warranty and servicing contract in order to promote their sales.

Many a times products price is listed at an artificially high price and then offered with a discount . This creates a psychological discounting in minds of consumers that they have purchased the product at a considerably lower price and have gained but in fact haven't.

Often in order to accommodate differences in customers, products, locations, etc firms adjust their basic price. Thus price differentiation arises where a product is sold at two or more prices without any proportional difference in costs. Customers are charged depending on their intensity of demand.

Buyers would be charged at a lower rate depending on the volume of buying.

In case of Museum's or places of historic importance there is lower admission fee to children, foreigners, etc.

A firm charges 30 Rs for adding 150 gms sugar in a Rasgulla tin pack sweet, however it charges 35 Rs for adding the same quantity of sugar for a Kala Jamun pack sweet.

A firm can price the same product at two different levels based on image differences. A detergent manufacturer can put detergent in one packet, name it with an image, and price it at 50 Rs. It can put the same detergent in another packet with a different name and image and price it at 75 Rs.

Soft drinks prices often differ in an A grade restaurant, vending machines or when sold in canteens or general stores.

Same product is priced differently at different locations even though the cost of offering at each location is the same. A concert audience is charged variably for seating as per their preferences for different locations.

Prices differ by season, day or hour etc.

Electricity as an important public utility source is charged differently by time of day in United Kingdom. Restaurants and Clubs in United Kingdom charge less during happy hours.

Airlines have different fares on same flight for same class for instance its economy class, which also is known as Yield Management / Revenue Management system. They have child fares, adult fares, seasonal fares etc. Extra luggage price by an airline for a single kilo differs from Dubai to London as opposed to travelling the other way back from London to Dubai.

Websites have coupled up different seller's product together such as Car Insurance, Consumer durable goods, home insurance, medical insurance etc, which allows buyers to discriminate between sellers by comparing their prices.

Responding to price changes :

Many time organisations have to go for price cuts and increase as per the situation.

Price Cuts : It is a possibility that organisation may go for price cuts due to existence of price cuts, also where even with added effort the sales have not increased or due to declining market share. Price cuts can lead to price wars in the market. Lower price can be used by firms so as to dominate market. Organisations may also have to cut down the prices in case of recession.

Price Increase : Price increases are undertaken by organisations when there is cost inflation. With rise in cost of production the organisations profits lessens, hence they need to go for price increase to earn normal profits. Many times organisations increase their prices more than the increase in cost due to anticipation of further cost increase.

Price increase can also happen when there is too much demand for the product and the supply is less.

Price increase can be done in the following ways :

Final price is not set, until the product is delivered to the customer. Generally seen in construction and heavy equipment industries.

Here firm wants customers to pay current price and all or part of any cost inflation that can happen before the delivery of the product.

Here the price is kept same but some elements are separated from the product and priced individually. Example in case of automobiles, accessories, other additional features come with extra cost.

Discount if any, could be reduced to maintain profits.

Organisation also can tackle high cost and over demand without raising prices as follows :

Reducing the amount offered without increasing the prices

By substituting raw materials with less expensive materials wherever possible

Lessening the product features to lessen its cost

Lessening product services

Usage of less cost packaging

Creating economy brands

Reacting to changes in prices :

Price changes can have a reaction from customers, competitors, distributors, suppliers and governments.

Customers may perceive and respond to price cuts in different ways. Price cuts may be interpreted as lower quality product or faulty products. Price rise would generally carry some positive indications to customers. The

product is considered to be of high quality and having added value when prices increased.

Competitors may also respond in various ways to price changes. To contemplate competitors reaction organisations have to assess their financial situation, sales scenario, market share and their objectives. In case the competitors objective is to increase market share then they will change their price in response of firm's price changes. If its objective is profit motivation then it will increase its promotional activities to maintain its sales.

Responding to competitors price changes :

It is an important decision on how firm should react to price changes by competitors, the products could go for product augmentation having homogenous characteristics. If product augmentation is not possible then they would have to go for price cuts to counter the competitors price cuts. If price is increased by the competitor in the homogenous market, then other firms may not increase their prices until it is unavoidable.

If price change happens in a heterogeneous market then the various aspects needs to be considered before responding to the price change :

What is the reason for competitors price cuts – is it due to over capacity of production, rise in costs of production or the intention is to increase market share.

Is the price change temporary or permanent

What will be the scenario if the firm does not respond to competitors price change

Are other competitors going to respond to the price change and if yes how?

Market leaders many a times have to face price changes from new entrants in the market or smaller competitors. There are many ways in which a market leader can respond to competitors price changes:

Maintain price – Market leader may decide to maintain its current price and profit due to the belief that :

Too much profits will be lost if prices are decreased

It would not lose too much market share

It is possible to regain market share when required

Maintain price and add value to its offering

The product could be augmented, its services and communication improved.

Reduce price : Leader may go for price cuts to match the competitors price cuts due to following reasons :

As the market is price sensitive it would lose market share

It would be difficult to build market share once lost

Its costs reduces with higher volume in production

Increase price and increase quality: The leader may decide to initiate price increase and also increase quality of product and also introduce new brands or innovative products.

Introduce low priced product line : It could contemplate adding a low priced product line to