

## **Chapter Eight – How is the pricing decision made?**

The price variable in the marketing mix is a critical element. Price can, by itself, communicate much about a product or service. For example, what would you think of buying an engagement ring at Bob's Really Good, But Cheap, Jewelry Store, or for that matter, at a yard sale. Most consumers link price with quality and there are many organizations that carefully reinforce the quality of their product, using price as a surrogate cue (or substitute indicator) for quality. For example, check out the websites of marketers of prestige items and observe how the price variable is used to indicate quality. Check out BMW's website and watch on of the movies there. (<http://www.bmw.com/bmwe/index.shtml>).

When the pricing decision is made, the organization must consider several factors. These factors are as follows:

- a. Supply (or cost)
- b. Demand (or revenue)
- c. Perceptions in the marketplace
- d. Competition and Competitors' pricing strategies
- e. Government Regulation
- f. Company's desired pricing position

### **Supply (or cost)**

If there is an abundant supply of a product or service, it may not be a candidate for being approached as a product or service for sale. For example, we don't consider air to breathe as being a commodity we must buy. Of course, that is only because there is a plentiful supply. Of course, in Colorado, many people find that the air supplied by the great outdoors is not sufficient in oxygen, thus, they must buy air that is rich in oxygen by renting oxygen tanks to enhance their respiratory systems. Native Americans had to locate close to a water supply, but didn't worry about having to purify the water. Hence, time can change most everything, particularly how we perceive certain goods and services as candidates for commercial products. Just a few years ago, people consumed very little bottled water throughout most of the United States. Today, demand for bottled water is growing rapidly. So, think about the things you consume that you presently don't pay for, and consider that commodity is a candidate for a product in the future (fresh air and open space, for example).

### **Demand (or revenue)**

To justify commanding a positive price in the marketplace, there must be some demand for a product or service. We have seen above where many products traditionally considered as free, have given way to other identical or similar products for which there is now a strong consumer demand, and a price to pay. Thus, the nature of demand changes constantly for goods and services.

Consider the amount of demand today for 'ice boxes' (products for keeping perishable food cool). These products were heavily demanded before the advent of the electric refrigerator. Thus, we often see that demand for a product can decrease or even disappear if substitute products are introduced that are perceived as being superior in their ability to provide the benefits being sought. For example, eight track audiotapes were popular for a few years in the late 1960's and early 1970's until a newer technology in the form of cassette tapes was introduced and vinyl records of recorded music have largely given way to the Compact Disk (CD) as the preferred medium. Will the internet and MP3 technology eclipse CD technology eventually?

### **Perceptions in the marketplace**

Perceptions in the marketplace can set both a **positive price** and a **normative price** in the marketplace. A positive price simply describes how much something costs whereas a normative price describes what something 'should cost' based on an individual's or a group's opinion. For example, the positive price was so high for selected drugs used to treat AIDS that some groups protested that the normative price was simply too high gaining societal support and eventual price decreases from the manufacturers of these pharmaceuticals. Also, consider the recent higher prices for gasoline and the various protests put forth by individuals and groups that the gasoline prices were "too high" and "not right." These protest essentially were observing that gasoline had reach a price that was above the normative price for most people.

In the U.S., a branch of government often sets normative prices, particularly in the case where there is only one supplier (a monopoly). For example, most states have a public utilities commission or board that is responsible for overseeing the pricing practices of firms that provide the populace with utility service for natural gas, water, and electricity. However, there are notable exceptions to this rule. Normative prices do not have to be specific. Usually there are consumer expectations that help guide the normative price. For example, how many times have you heard that, 'my water bill is too high!' This interaction between positive price and normative price is an ongoing phenomenon and of particular interest to marketers who attempt to create and sustain customer satisfaction.

While the marketer does not usually have control over the normative price, s/he can usually control the positive price. Setting price can be a time-consuming process and we will discuss setting price later in this chapter. However, this discussion should have already made the reader aware of the importance of understanding whether by custom of the marketplace, there is already a normative price for a product or service above which a price may be considering 'unfair' or 'price-gouging.'

## **Competition and Competitors' pricing strategies**

In the U.S., competition can have several impacts on the pricing decision.

First, if the firm is the only seller of a product considered essential to public welfare, the firm may have to function in a heavily regulated environment. This type of environment is called a monopoly (one seller).

Second, a firm may function in an industry in which there is an established price leader that perennially sets a price that other firms follow, although this may not always be the case. This type of competitive structure is called an oligopoly (few sellers).

Third, if the firm functions in a market where there are many competitors offering similar products, the firm may not have a choice about what level price to seek. (pure competition).

Fourth, the firm may compete in an industry or market in which although products are physically similar, sellers are able to draw differences in perception of such things as quality and prestige among products. This competitive model is called 'monopolistic competition' and is applicable for most everyday consumer purchases as well as business-to-business purchases in the U.S.

## **Government Regulation**

Most firms in the U.S. function in an environment that is highly regulated. For example, before starting a business, one must obtain various licenses directed at everything from local government taxation and zoning laws, to state government consumer protection laws, and finally, the grand-daddy of them all in regulation, the Federal Government which regulates all interstate commerce based on constitutional power and has major regulatory responsibility for the health and welfare of employees. However, the capitalistic system is unable in its present form to halt abuses to the environment by organizations and thus, most of this regulation, while onerous, is needed. This body of law still allows various environmental abuses such as the Summitville Mind disaster in the state of Colorado. In fact, if we explore the primary legislation that impacts pricing, we find that most of that regulation was brought about by pressure on congress exerted by businesses that were competing with other businesses. Only a small portion of these laws were passed to address the protection of consumers. So, the next time you hear businesses cry 'Get the government off our backs' realize the businesses are really saying 'get the government off my back' but 'make sure the government protects me from unfair practices by my competition.'

## **Company's desired pricing position**

Based on a company's business and marketing strategy, it should determine its pricing position. As we reviewed earlier in this chapter, some companies have a high price/exclusive/prestige position (check out the website for Rolls-Royce automobiles (<http://www.rollsroyce.co.uk/rolls-royce/index.html>) or Rolex Wristwatches, while others have a low price position (Wal-Mart, for example).

A company should choose its own price position, whether high/prestige or low/value and attempt to guide its constituencies (customers, suppliers, employees, general public, and others) to the conclusion the company desires. For example, a local store that sells 'everything for a dollar' (for example, see (<http://www.dollargeneral.com/>)) will want to position itself quite differently than a marketer of exclusive products similar to Rolex watches (see <http://www.rolex.com/>).

### **The Pricing Decision**

As pointed out above, the pricing decision is impacted by many different factors. Thus, the initial pricing decision can be time-consuming although there are exceptions. In pricing livestock, for example, the pricing decision can be quite simple. A cattle rancher may take his or her cattle to the local auction house once a year to 'thin his/her herd of older cows and young calves.' In this case, the rancher will be forced to accept whatever price his/her cattle bring at the auction. In this case, the pricing decision is reduced to answering the question: "Can I accept the price being offered at the local auction?" If the answer to this question is 'no,' the rancher then has to decide whether to seek another auction or liquidate his/her herd. However, usually the pricing decision is much more complicated and should involve a careful consideration of all five factors listed above.

### **Cost and Demand Oriented Pricing Models**

We may use cost or demand as a basis for setting pricing. Traditionally, this orientation is applied in microeconomic theory by creating demand curves based on a summation of individual utility functions for buyers in the marketplace. Thus, we first assess buyers' perception of how much they would expect to pay for a product or service based on the utility (or usefulness) they would expect to derive from product or service and combine these individual utility functions to create a demand curve for the product in question. While, this approach is straightforward theoretically, it often defies practical application. However, the general lesson we learn from the approach is an important one. That is, the price based on a demand-oriented model, can be based on the expected utility (benefits) that customers in the marketplace expect to receive from acquiring our product as compared to other available products.

## **Pricing models based on cost**

Probably the oldest model used, this approach uses cost to the seller to determine a selling price. For example, for years a **'keystone' or 'key-stoning'** pricing policy has been used by many retailers to set price. This approach simply doubles the cost and arrives at the selling price. Many other models used cost as a pricing basis, for example, internal rate of return pricing usually begins with cost determination and then computes different projected levels of return on investment for future time periods. This pricing method was adopted by General Motors early in the company's history and was applied for decades with their products. Why not just use cost-pricing always? While the approach is simple and has the advantage of 'guaranteeing' some profit margin, the approach ignores the most important factor in pricing; demand. Thus, by using solely a cost-based approach the seller may miss opportunities for additional profit or set a price too high to realize adequate sales to even cover cost.

## **Pricing models based on demand**

Witness salaries paid to professional athletes. How are these 'prices' for athletic talent determined? Usually, based on demand and what others with similar skills can expect to receive in a free market. Prices can also be set using demand for the product or service as a guide. For example, if an analysis of demand indicates that buyers, based on the benefits they would derive from it, would expect to pay \$30,000 dollars for a new kind of testing device, this at least gives the seller some guidance in setting price. This approach is known as 'the expected price approach' and, theoretically, is the basis for setting price based on demand in Microeconomics. Of course, this approach requires a time consuming analysis and it is not as simple as just setting the price based on cost. However, if a seller focuses only on cost to set a price, s/he might be either setting price so high there will be no demand, or foregoing considerable profits.

For example, if demand is very high there are times when we can virtually ignore cost structures. For example, if a professional athlete has a remarkable season of performance, s/he can sometimes demand an incredibly high salary based on his/her performance the previous season.

In some cases, there may be 'an expected price.' The expected price is a price that consumers would anticipate being reasonable for the benefits derived from using the product. There may also be a 'customary price' for a product or service. The customary price is a price level that consumers are used to paying based on history or normal expectations. For example, if consumer testers try out a new, revolutionary vacuum cleaner, when asked they indicate that they would normally anticipate paying \$500 or less for the product, although the seller cost structure would mean losing money at a price of less than \$500.

Prestige pricing is often applied by organizations that attempt to create a sense of exclusivity for their product or service. This pricing approach assumes that the product or service faces a market structure characterized by 'monopolistic competition.' Thus, prospective buyers perceive a difference in products based on the distinction or reputation of particular brands. Many product categories use this factor to set price. For example, wristwatches, liquor, and automobiles all have a 'prestige' segment created through the perception of exclusivity and distinction. Of course, in order to create and sustain such a market position, the organization must commit to a long-term strategy

## Understanding Price Elasticity of Demand

**Price elasticity of demand** is a method used in microeconomics to understand how quantity demanded moves in conjunction with price changes. That is, if prices are raised, what happens to quantity demanded? We would usually argue that quantity demanded goes down. However, can you think of a situation in which raising prices will result in more of the product or service being demanded?

It is imperative that the marketer have a clear understanding of how quantity will respond to price changes. Thus, a basic understanding of price elasticity of demand is called for. Price elasticity of demand can be computed by applying a simple formula for "e" the elasticity of demand as shown below:

Price elasticity formula in words:

Price elasticity of demand is equal to the percentage change in quantity demanded divided by the percentage change in price.

Price elasticity formula in symbols:

$$e = \% \Delta q / \% \Delta p$$

Where:        e = elasticity of demand  
                  q = quantity demanded  
                  p = price

The elasticity coefficient of elasticity, 'e,' has a domain from greater than a positive one, to less than a negative one. When 'e' is greater than one, elasticity is termed '**elastic demand**.' When 'e' is less than one, we characterize demand as '**inelastic demand**.' When we have an elasticity coefficient equal to one, demand is said to be **unitary demand**.

We will present examples at the conclusion of this chapter.

## Setting Price

The firm must arrive at a price that will provide it with sufficient profitability while being palatable to the marketplace. Of course, the ultimate price is related to all five factors that we discussed above. A very simple way to look at setting price is to consider the 'markup.' Markup can be computed on **cost** or **selling price**.

We would use the same simple formula for each approach to computing selling price: **Selling price equals Cost plus Markup or  $SP = C + M$** , where, SP = selling price, C = cost, and MU = percentage markup.

### Using Markup on cost to determine selling price

In this approach to setting price, we first determine the markup and then add it to the cost to find the selling price. That is, we simply multiply the cost by the percentage of markup.

For example, let us assume that the owner of a small gift shop desires to gain an average forty percent markup based on a percentage of cost on a of the products she sells in her shop. She will use the formula,  $SP = C + .4$  (or forty percent of cost) to determine the selling price of items in her gift shop (for example, if a children's book costs the owner \$14, her selling price will be  $SP = \$14 + .4(\$14)$  or  $\$14 + \$5.60 = \$19.60$ ).

### Using Markup on selling price to determine selling price

Some students ask "How can I determine markup based on selling price if I don't know the selling price!" Good question! We simply define the markup on the selling price in algebraic terms, initially. This approach is not as intuitive and applies simple algebra to first define and then determine the selling price. Please note, that this approach may not make as much sense to you initially if you are not comfortable with basic algebra. But please don't despair; once you understand this approach you will be able to remember it.

Selling price can also be determined as a markup based on a percentage of selling price as described in our discussion of 'key stoning' above. In this case, we apply the same simple formula. However, now we must draw on simple algebra and define the selling price as the unknown and the markup as a function of the selling price. That is, while our formula is identical to the computation using cost as a basis for markup ( $SP = C + MU$ ), now markup itself becomes an unknown, as well. That is, if we use the same gift shop and price structure as our example above, the cost is \$14, and the markup is .4 of the selling price rather than the price, or .4SP. Therefore, the solution to our problem would be  $SP = C + MU$ , or  $SP = C + .4SP$ . That is, now the markup is determined as a percentage of selling price rather than a percentage of cost. Solving for the selling price under this approach, we would find the following.

Substituting in the formula:  $SP = C + MU$ , we find that,  $SP = \$14 + .4SP$  or the selling price is equal to \$14 plus .4 times the selling price. Now, grouping the terms with 'SP' together to solve the equation, we subtract .4 from both sides. On the right side of the equation,  $\$14 + .4SP$  minus  $.4SP$  equals \$14. On the left side of the equation,  $SP$  minus  $.4SP$  equals  $.6SP$  (Remembering that "SP is understood to be '1SP.', that is,  $1SP$  minus  $.4SP = .6SP$ . Now our equation reads ' $.6SP = \$14$ .')

Recalling that we can simplify the equation ' $.6SP = \$14$ ' further, remove the '.6' by dividing both sides by '.6'. On the left side of the equation,  $.6SP$  divided by  $.6SP$  is equal to simply  $SP$ ). So the equation now reads ' $SP = 14$  divided by  $.6$ .' Thus selling price is equal to \$14 divided by  $.6$  or \$23.33. Now, substitute the selling price of \$23.33 into our formula to check your answer.

This simple approach to using selling price as a basis for markup is used by many retailers and if one ever wants to market a product to retailers (or wholesalers, for that matter) one should understand this approach to arriving at selling price.

### Chapter Eight Exercises

1. Check out BMW's website described in above in Chapter Eight (and watch one of the movies there ('ambush' or 'the hire'). Why would BMW go to such expense to produce these movies? What is the price the viewer of the movie pays? Remember, price does not have to be economic in nature. Explain your answer in a one-paragraph summary.
2. Explore the website of Cartier, Inc. (*Cartie – ā*) (<http://www.cartier.com>), and describe how this company attempts to create a high price, high quality (prestige) position in the marketplace.
3. Explore the website of Timex, Inc. (<http://www.timex.com/>) and write a paragraph observing differences between the Cartier and the Timex sites. Be sure to describe the positioning of each company's products after viewing their respective websites.
4. Explore the website of the Shane Company and describe this company's orientation to pricing and prestige ([http://www.shanecompany.com/weddings/wedding\\_planner.asp](http://www.shanecompany.com/weddings/wedding_planner.asp).)
5. Explore the website for Walmart and comment on Wal-Mart's approach to price (<http://www.walmart.com/>).
6. Why do different companies have different approaches to pricing? Use the websites above to support your answer.
7. Create a product positioning map (four cell matrix) for wristwatches. Use the dimensions of price and prestige. Summarize your product positioning map and what you learned by doing this positioning map in a two-page report.

8. Go to a local supermarket and a local department store and write a half-page report that observes differences in how prices are displayed at each store.
9. "College tuition is a price just like any other." Agree or disagree with this statement and explain your answer.

## Chapter Eight Glossary

**Positive price** – the present cost or marked price of a product

**Normative price** – a price that is considered 'fair' by an individual or group

**Company's desired pricing position** – an organization should reach its own conclusion based environmental factors, where it should set price and communicate that position to its constituencies.

**Cost-oriented pricing** – procedures used to arrive at a product's or a service's price using the organization's cost of producing the product or service.

**Demand-oriented pricing** - procedures used to arrive at a product's or a service's price using the demand structure in the marketplace.

**Price elasticity of demand** – the relative change in demand that occurs in response to a relative change in price

**Prestige pricing** – the process of setting a price based on the perceived exclusivity or reputation of the company name or brand name of the product or service