# CHAPTER 24

# Pricing and Sales Promotion

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## 1. INTRODUCTION TO PRICING MANAGEMENT

A husband and wife were interested in purchasing a new full-sized automobile. They found just what they were looking for, but its price was more than they could afford—$28,000. They then found a smaller model for $5,000 less that seemed to offer the features they wanted. However, they decided to look at some used cars and found a one-year-old full-size model with only 5,000 miles on it. The used car included almost a full warranty and was priced at $20,000. They could not overlook the $8,000 difference between their first choice and the similar one-year-old car and decided to purchase the used car.

This simple example illustrates an important aspect of pricing that often is not recognized: buyers respond to price differences rather than to specific prices. While this basic point about how prices influence buyers' decisions may seem complex and not intuitive, it is this very point that drives how businesses are learning to set prices. You may reply that this couple was simply responding to the lower price of the used car. And you would be correct—up to a point. These buyers were responding to a *relatively* lower price, and it was the *difference* of $8,000 that eventually led them to buy a used car.

Now consider the automobile maker who has to set the price of new cars. This decision maker needs to consider how the price will compare (1) to prices for similar cars by other car makers; (2) with other models in the seller's line of cars; and (3) with used car prices. The car maker also must consider whether the car dealers will be able to make a sufficient profit from selling the car to be motivated to promote the car in the local markets. Finally, if the number of new cars sold at the price set is insufficient to reach the profitability goals of the maker, price reductions in the form of cash rebates or special financing arrangements for buyers might have to be used. Besides these pricing decisions, the car maker must decide on the discount in the price to give to fleet buyers like car rental companies. Within one year, these new rental cars will be sold at special sales to dealers and to individuals like the buyer above.

Pricing a product or service is one of the most important decisions made by management. Pricing is the only marketing strategy variable that directly generates income. All other variables in the marketing mix—advertising and promotion, product development, selling effort, distribution—involve expenditures. The purpose of this chapter is to introduce this strategically important marketing decision variable, define it, and discuss some of the important ways that buyers may respond to prices. We will also discuss the major factors that must be considered when setting prices, as well as problems managers face when setting and managing prices.

### 1.1. The Definition of Price

It is usual to think of price as the amount of money we must give up to acquire something we desire. That is, we consider price as a formal ratio indicating the quantities of money (or goods and services) needed to acquire a given quantity of goods or services. However, it is useful to think of price as a ratio of what buyers receive in the way of goods and services relative to what they give up in the way of money or goods and services. In other words, price is the ratio of what is *received* relative to what is *given up*.

Thus, when the price of a pair of shoes is quoted as $85, the interpretation is that the seller receives $85 from the buyer and the buyer receives one pair of shoes. Similarly, the quotation of two shirts for $55 indicates the seller receives $55 and the buyer receives two shirts. Over time, a lengthy list of terms that are used instead of the term *price* has evolved. For example, we pay a postage *rate* to the Postal Service. *Fees* are paid to doctors and dentists. We pay *premiums* for insurance coverage, *rent* for apartments, *tuition* for education, and *fares* for taxis, buses, and airlines. Also, we pay *tolls* to cross a bridge, *admission* to go to a sporting event, concert, movie, or museum. Banks may have *user fees* for credit charges, *minimum required balances* for a checking account service, *rents* for safety deposit boxes, and fees or *interest charges* for automatic teller machine (ATM) use or cash advances. Moreover, in international marketing, *tariffs* and *duties* are paid to import goods into another country.

The problem that this variety of terms creates is that we often fail to recognize that the setting of a rent, interest rate, premium, fee, admission charge, or toll is a pricing decision exactly like that for the price of a product purchased in a store. Moreover, most organizations that must set these fees, rates, and so on must also make similar pricing decisions to that made by the car maker discussed above.

### 1.2. Proactive Pricing

The need for correct pricing decisions has become even more important as global competition has become more intense. Technological progress has widened the alternative uses of buyers' money and time and has led to more substitute products and services. Organizations that have been successful in making profitable pricing decisions have been able to raise prices successfully or reduce prices without competitive retaliation. Through careful analysis of pertinent information and deliberate acquisition of relevant information, they have become successful pricing strategists and tacticians (Cressman 1997).

There are two essential prerequisites to becoming a successful proactive pricer. First, it is necessary to understand how pricing works. Because of the complexities of pricing in terms of its impact on suppliers, salespeople, distributors, competitors, and customers, companies that focus primarily on their internal costs often make serious pricing errors.

Second, it is essential for any pricer to understand the pricing environment. It is important to know how customers perceive prices and price changes. Most buyers do not have complete information about alternative choices and most buyers are not capable of perfectly processing the available information to arrive at the "optimum" choice. Often, price is used as an indicator not only of how much money the buyer must give up, but also of product or service quality. Moreover, differences between the prices of alternative choices also affect buyers' perceptions. Thus, the price setter must know who makes the purchase decision for the products being priced and how these buyers perceive price information.

### 1.3. Factors to Consider When Setting Price

There are five essential factors to consider when setting price. *Demand* considerations provide a ceiling or maximum price that may be charged. This maximum price depends on the customers' perceptions of value in the seller's product or service offering. On the other hand, *costs* provide a floor or minimum possible price. For existing products or services, the relevant costs are those costs that are directly associated with the production, marketing, and distribution of these products or services. For a new product or service, the relevant costs are the *future costs* over that offering's life. The difference between the maximum price that some buyers are willing to pay (value) and the minimum cost-based price represents an initial pricing discretion. However, this range of pricing discretion is narrowed by *competition, corporate profit and market objectives,* and *regulatory constraints*.

## 2. PRICING OBJECTIVES

### 2.1. Profit Objectives

Pricing objectives need to be measured precisely. Performance can then be compared with objectives to assess results. In practice, the objective of profit maximization may be realized in multiple ways. In some markets, relatively low prices result in greater sales and higher profits. But in other markets, relatively high prices result in slightly decreased unit sales and also higher profits. Thus, the profits of some firms may be based on low prices and high sales volume, while for other firms high prices and low sales volume may be more profitable. Another common pricing objective is some form of target return on investment, that is, regaining a specified percentage of investment as income. Return on investment (ROI) is expressed as the ratio of profits to investments. For manufacturers, investments include capital, machinery, buildings, and land, as well as inventory. For wholesalers and retailers, inventory and buildings constitute the bulk of investments.

### 2.2. Volume-Based Objectives

Some organizations set pricing objectives in terms of sales volume. A common goal is sales growth, in which case the firm sets prices to increase demand. Other firms may seek sales maintenance, knowing that growth does not ensure higher profits and that they may not have the resources needed to pursue sales growth.

If capturing a high market share is a marketing objective, pricing objectives should reflect this goal. In general, a high market share is achieved by setting prices relatively low to increase sales. From a profitability perspective, the organization must be willing to accept lower initial profits in exchange for the profits that may be produced over time by increased volume and high market share. However, other companies achieve a strong position in selected markets by setting high prices and offering high-quality products and service.

### 2.3. Competitive Objectives

At times, firms base their pricing objectives on competitive strategies. Sometimes, the goal is to achieve price stability and engage in nonprice competition, while at other times, they price aggressively. When marketing a mature product and when the firm is the market leader, it may seek to stabilize prices. Price stability often leads to nonprice competition in which a firm's strategy is advanced by other components of the marketing mix: the product itself, the distribution system, or the promotional efforts.

In some markets, a firm may choose to price aggressively, that is, price below competition, to take advantage of market changes, for example, when products are in early stages of the life cycle, when markets are still growing, and when there are opportunities to establish or gain a large market share. As with a market share or volume objective, this aggressiveness must be considered within the context of a longer term perspective.

## 3. DEMAND CONSIDERATIONS

One of the most important cornerstones of price determination is demand. In particular, the volume of a product that buyers are willing to buy at a specific price is that product's demand. In this section we will review some important analytical concepts for practical pricing decisions.

### 3.1. Influence of Price on Buyer Behavior

In economic theory, price influences buyer choice because price serves as an indicator of product or service cost. Assuming the buyer has perfect information concerning prices and wants satisfaction of comparable product alternatives, he or she can determine a product/service mix that maximizes satisfaction within a given budget constraint. However, lacking complete and accurate information about the satisfaction associated with the alternative choices, the buyer assesses them on the basis of known information. Generally, one piece of information available to the buyer is a product's price. Other pieces of information about anticipated purchases are not always known, and buyers cannot be sure how reliable and complete this other information is. And because this other information is not always available, buyers may be uncertain about their ability to predict how much they will be satisfied if they purchase the product. For example, if you buy a new car, you do not know what the relative incidence of car repairs will be for the new car until after some months or years of use. *As a result of this imperfect information, buyers may use price both as an indicator of product cost as well as an indicator of quality* (*want satisfaction attributes*).

### 3.2. Useful Economic Concepts

This brief outline of how price influences demand does not tell us about the extent to which price and demand are related for each product/service choice, nor does it help us to compare, for example, engineering services per dollar to accounting services per dollar. The concept of elasticity provides a quantitative way of making comparisons across product and service choices.

#### *3.2.1. Demand Elasticity*

Price elasticity of demand measures how the quantity demanded for a product or service changes due to a change in the price of that product or service. Specifically, price elasticity of demand is defined as the percentage change in quantity demanded relative to the percentage change in price. Normally, it is assumed that quantity demanded falls as price increases; hence, price elasticity of demand is a negative value ranging between 0 and $-\infty$.

Because demand elasticity is relative, various goods and services show a range of price sensitivity. Elastic demand exists when a given percentage change in price results in a greater percentage change in the quantity demanded. That is, price elasticity ranges between $-1.0$ and $-\infty$. When demand is inelastic, a given percentage change in price results in a smaller percentage change in the quantity demanded. In markets characterized by inelastic demand, price elasticity ranges between 0 and $-1$. Another important point about price elasticity: it does change and is different over time for different types of products and differs whether price is increasing or decreasing.

A second measure of demand sensitivity is cross price elasticity of demand, which measures the responsiveness of demand for a product or service relative to a change in price of another product or service. Cross price elasticity of demand is the degree to which the quantity of one product demanded will increase or decrease in response to changes in the price of another product. If this relation is negative, then, in general, the two products are complementary; if the relation is positive, then, in general, the two products are substitutes.

Products that can be readily substituted for each other are said to have high cross price elasticity of demand. This point applies not only to brands within one product class but also to different product classes. For example, as the price of ice cream goes up, consumers may switch to cakes for dessert, thereby increasing the sales of cake mixes.

#### *3.2.2. Revenue Concepts*

There is a relationship between sellers' revenues and the elasticity of demand for their products and services. To establish this relationship we need to define the concepts of total revenue, average revenue, and marginal revenue. Total revenue is the total amount spent by buyers for the product ($TR = P \times Q$). Average revenue is the total outlay by buyers divided by the number of units sold, or the price of the product ($AR = TR/Q$). Marginal revenue refers to the change in total revenue resulting from a change in sales volume.

The normal, downward-sloping demand curve reveals that to sell an additional unit of output, price must fall. The change in total revenue (marginal revenue) is the result of two forces: (1) the revenue derived from the additional unit sold, which is equal to the new price; and (2) the loss in revenue which results from marking down all prior saleable units to the new price. If force (1) is greater than force (2), total revenue will increase, and total revenue will increase only if marginal revenue is positive. Marginal revenue is positive if demand is price elastic *and* price is decreased, or if demand is price inelastic *and* price is increased.

#### *3.2.3. Consumers' Surplus*

At any particular price, there are usually some consumers willing to pay more than that price in order to acquire the product. Essentially, this willingness to pay more means that the price charged for the product may be lower than some buyers' perceived value for the product. The difference between the maximum amount consumers are willing to pay for a product or service and the lessor amount they actually pay is called consumers' surplus. In essence, it is the money value of the willingness of consumers to pay in excess of what the price requires them to pay. This difference represents what the consumers gain from the exchange and is the money amounts of value-in-use (what is gained) minus value-in-exchange (what is given up). Value-in-use always exceeds value-in-exchange simply because the most anyone would pay must be greater than what they actually pay, otherwise they would not enter into the trade.

### 3.3. Understanding How Buyers Respond to Prices

As suggested above, a successful pricer sets price consistent with customers' perceived value (Leszinski and Marn 1997). To understand how customers form value perceptions, it is important to recognize the relative role of price in this process. Because of the difficulty of evaluating the quality of products before and even after the product has been acquired, how customers form their perceptions of the product becomes an important consideration when setting prices. During this perceptual process, buyers make heavy use of information cues, or clues. Some of these cues are price cues and influence buyers' judgments of whether the price differences are significant. For example, buyers may use the prices of products or services as indicators of actual product quality.

#### *3.3.1. Price, Perceived Quality, and Perceived Value*

Would you buy a package of 25 aspirin that costs only 50 cents? Would you be happy to find this bargain, or would you be suspicious that this product is inferior to other brands priced at 12 for \$1.29? In fact, many consumers would be cautious about paying such a low relative price. Thus, the manufacturers of Bayer and Excedrin know that some people tend to use price as an indicator of quality to help them assess the relative value of products and services.

Since buyers generally are not able to assess product quality perfectly (i.e., the ability of the product to satisfy them), it is their *perceived quality* that becomes important. Under certain conditions, the perceived quality in a product is positively related to price. Perceptions of value are directly related to buyers' preferences or choices; that is, the larger a buyer's perception of value, the more likely would the buyer express a willingness to buy or preference for the product. Perceived value represents a trade off between buyers' perceptions of quality and sacrifice and is positive when perceptions of quality are greater than the perceptions of sacrifice. Figure 1 illustrates this role of price on buyers' perceptions of product quality, sacrifice, and value. Buyers may also use other cues, such as brand name, and store name as indicators of product quality.

#### *3.3.2. Price Thresholds*

Those of us who have taken hearing tests are aware that some sounds are either too low or too high for us to hear. The low and high sounds that we can just barely hear are called our lower and upper absolute hearing thresholds. From psychology, we learn that small, equally perceptible changes in a response correspond to proportional changes in the stimulus. For example, if a product's price being raised from \$10 to \$12 is sufficient to deter you from buying the product, then another product originally priced at \$20 would have to be repriced at \$24 before you would become similarly disinterested.

Our aspirin example above implies that consumers have lower and upper price thresholds; that is, buyers have a range of acceptable prices for products or services. Furthermore, the existence of

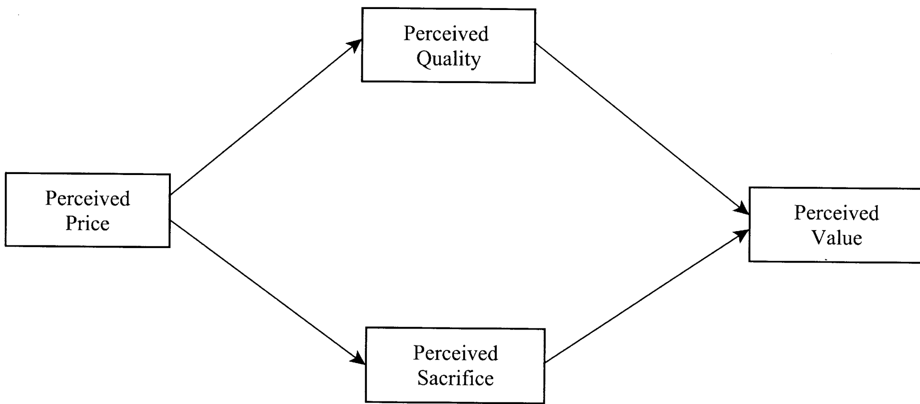


**Figure 1** Perceived Price–Perceived Value Relationship

a lower price threshold implies that there are prices greater than $0 that are unacceptable because they are considered to be too low, perhaps because buyers are suspicious of the product's quality. Practically, this concept means that rather than a single price for a product being acceptable to pay, buyers have some range of acceptable prices. Thus, people may refrain from purchasing a product not only when the price is considered to be too high, but also when the price is considered to be too low. The important lesson to learn is that there are limits or absolute thresholds to the relationship between price and perceived quality and perceived value (Monroe 1993).

When buyers perceive that prices are lower than they expect, they may become suspicious of quality. At such low prices, this low perceived quality may be perceived to be less than the perceived sacrifice of the low price. Hence, the mental comparison or trade-off between perceived quality and perceived sacrifice may lead to an unacceptable perceived value. Thus, a low price may actually reduce buyers' perceptions of value. At the other extreme, a perceived high price may lead to a perception of sacrifice that is greater than the perceived quality, also leading to a reduction in buyers' perceptions of value. Thus, not only is it important for price setters to consider the relationship among price, perceived quality, and perceived value, but to recognize that there are limits to these relationships.

Usually a buyer has alternative choices available for a purchase. However, even if the numerical prices for these alternatives are different, it cannot be assumed that the prices are perceived to be different. Hence, the price setter must determine the effect of perceived price differences on buyers' choices. As suggested above, the perception of a price change depends on the magnitude of the change.

Generally, it is the perceived relative differences between prices that influence buyers' use of price as an indicator of quality. In a similar way, relative price differences between competing brands, different offerings in a product line, or price levels at different points in time affect buyers' purchase decisions. A recent experience of a major snack food producer illustrates this point. At one time, the price of a specific size of this brand's potato chips was $1.39 while a comparable size of the local brand was $1.09, a difference of 30 cents. Over a period of time, the price of the national brand increased several times until it was being retailed at $1.69. In like manner, the local brand's price also increased to $1.39. However, while the local brand was maintaining a 30-cent price differential, the national brand obtained a significant gain in market share. The problem was buyers perceived a 30-cent price difference relative to $1.69 as less than a 30-cent price difference relative to $1.39. This example illustrates the notion of differential price thresholds, or the degree that buyers are sensitive to relative price differences.

From behavioral price research, a number of important points about price elasticity have emerged:

1. Buyers, in general, are more sensitive to perceived price increases than to perceived price decreases. In practical terms, this difference in relative price elasticity between price increases vs. price decreases means it is easier to lose sales by increasing price than it is to gain sales by reducing price.
2. Sometimes a product may provide a unique benefit or have a unique attribute that buyers value. These unique benefits or attributes serve to make the product less price sensitive.

3. The frequency of past price changes can influence buyers' sensitivity to price changes. If prices have been changing relatively frequently, buyers may not have adjusted to the previous price change when a new change occurs. If buyers have not adjusted to the last price increase, then another price increase will be perceived as a larger increase than it actually is, making them more sensitive to the increase. The issue this point raises is the concept of reference prices and is discussed next.

#### *3.3.3. Effects of Reference Prices on Perceived Value*

In the past few years, evidence has emerged confirming the existence of a reference price serving as an anchor for price judgments. One of the most important points stemming from the concept of reference prices is that buyers do judge or evaluate prices comparatively. That is, for a price to be judged acceptable, too high, or too low, it has to be compared to another price. This other comparative price is the buyer's reference price for that particular judgment. The reference price serves as an anchor for buyers' price judgments. Buyers may use as a reference point the range of prices last paid, the current market price or perceived average market price, a belief of a fair price to pay, or an expected price to pay to judge actual prices.

Price perceptions are relative. That is, a specific price is compared to another price or a reference price. The illustration for relating this important point to pricing strategy and tactics comes from a firm introducing a new product with an introductory low price. Initially, the product was targeted to sell at a price of $17.50. However, the firm used the tactic of introducing the product at a low price of $14.95. Later, when it was time to remove the introduction price because of increased costs, the regular price was set at $20.00. The product failed to sustain sufficient sales volume to warrant its continued existence. The error in this situation was that the pricing tactic of a low introductory price established a baseline or reference price of $14.95 rather than $17.50. Hence, the $20.00 price, when compared to $14.95, was perceived to be too expensive and buyers stopped buying.

Recent behavioral research has provided additional explanations of how people form value judgments and make decisions when they do not have perfect information about alternatives. Moreover, these explanations further our understanding of why buyers are more sensitive to price increases than to price decreases and how they respond to comparative price advertisements, coupons, rebates, and other special price promotions. The common element in these explanations is that buyers judge prices comparatively, that is, a reference price serves to anchor their judgments (Monroe 1993).

### 3.4. The Effect of E-commerce on Pricing

There is a clear emerging trend toward electronic commerce becoming a significant aspect of the economy. Estimates of online sales indicate that the $7.8 billion in sales in the United States recorded in 1998 grew to approximately $15 billion in 1999 and is expected to grow to $23–28 billion in 2000 (Schmeltzer 2000; Sparks 2000). Accompanying this rapid growth of electronic sales is an emphasis on exchanges occurring at lower prices than in conventional exchanges. Several questions naturally arise with this knowledge of increasing electronic sales at relatively lower prices:

1. How does information play a role in this phenomenon?
2. What forces exist to pressure or enable online sellers to sell at lower prices?
3. Can these relatively lower prices (and accompanying lower profit margins) be sustained?

#### *3.4.1. The Role of Information*

In Section 3.1, we pointed out that traditional economic theory assumes that buyers and sellers have perfect information about prices, their own tastes and preferences, and their budget or income available for purchasing goods and services. However, when buyers are faced with imperfect information and the inability to assess quality, and therefore the ability to determine their degree of satisfaction prior to purchase, they may use price to infer quality and their expected degree of satisfaction. However, the quality of the attributes of some goods can be assessed prior to purchase. We call these goods search products. Examples of search products would include books, videotapes and music CDs, brand-name hard goods, airline tickets, toys, pet supplies, and standard industrial supplies. Indeed, a recent survey indicated that online shoppers purchased more books and videotapes online than in stores (*Chicago Tribune* 2000). Further, the CPI inflation rate for November 1999 for recreational products was 0.7% compared to the overall CPI inflation rate of 2.2% (Cooper and Madigan 1999). Products in the recreational category include toys, music, books, and pet supplies. Buyers perceive less risk in buying products that they believe vary little in quality across alternative sellers. Thus, searching online for the lowest prices for these types of products is convenient, quick, and virtually costless. For example, CompareNet offers detailed information on more than 100,000 products. Other sites provide software agents to find products (Green 1998). Moreover, the online shopper

can search in a wider geographical area than in the local community. Finally, consumers and corporate buyers can pool their purchasing power and get volume discounts. General Electric Co. was able to reduce its purchase cost by 20% on more than $1 billion in purchases of operating materials by pooling orders from divisions on a worldwide basis (Hof 1999).

### *3.4.2. Pressures on E-commerce Prices*

As indicated above, the online buyer may be able to reduce search costs while not incurring any significant increase in risk. At the same time, the direct supplier–buyer relationship in e-commerce transactions reduces or eliminates the various intermediaries in traditional distribution systems. Further, the information intermediary may take a smaller percentage of the final selling price for the information service provided (perhaps 10% as opposed to 40–50% traditional intermediary margins) (Hof 1999). Also, a large and growing number of information intermediaries, manufacturers, distributors, and retailers are providing buyers access to buying on the internet. This increasing competitive pressure will keep prices relatively low, as expected from traditional economic theory. But the question is, how long will we see both this intensive competition and these relatively very low prices?

### *3.4.3. The Feasibility of Sustainable Low Internet Prices*

Currently almost all online sellers are losing money because they do not have sufficient sales at the relatively low profit margins to recover their fixed costs (Sparks 1999). Further, to get the sales growth necessary to become profitable will require increasing amounts of investment in marketing, that is, increasing fixed costs. Without infusion of large amounts of venture capital, many of these enterprises will not succeed and will either fail outright or will be acquired by more successful online sellers or manufacturers and retailers with the financial and marketing capital to generate the necessary sales growth.

Further, as more manufacturers, distributors, and retailers enter electronic selling, it is likely that their online sales will be at lower unit profit margins, given the current pressure on prices. Initially, their online sales will be at the expense of their higher-margin conventional sales, reducing their overall profit margins. Overcoming this negative effect on profitability will require new sales growth from new buyers who may shift from other electronic sellers. At some point there will be a shakeout between the e-commerce sellers and prices will likely stabilize at relatively higher levels than we encounter in this early stage of electronic commerce. This expectation is not different from the various revolutions in selling that have occurred over the years. The real problem will be predicting when the shakeout will occur leading to prices stabilizing profits at sustainable levels from electronic sellers. And if there is little perceived quality variation across sellers, then buyers are more likely to minimize the price paid for these items.

However, searching for the lowest price from alternative sellers can be time consuming in traditional shopping. Most busy people have neither the time nor the willingness to visit multiple outlets seeking the lowest price for a purchase they are considering.

## 4. THE ROLE OF COSTS IN PRICING

As indicated earlier, demand provides an upper limit on the pricing discretion the firm has. This limit is the willingness of buyers to purchase at a stated price. On the other hand, the other variable directly affecting profits—costs—sets a floor to a firm's pricing discretion. If prices are too low in comparison with costs, volume may be high but profitless. By determining the difference between costs and the price under consideration and then balancing that margin against the estimated sales volume, the seller can determine whether the product or service will contribute sufficient money to enable the firm to recover its initial investment. In considering the cost aspect of a pricing decision, a crucial question is what costs are relevant to the decision.

It is important for the seller to know the causes and behavior of product costs in order to know when to accelerate cost recovery, how to evaluate a change in selling price, how to profitably segment a market, and when to add or eliminate products. Even so, costs play a limited role in pricing. They indicate whether the product or service can be provided and sold profitably at any price, but they do not indicate the actual prices that buyers will accept. Proper costs serve to guide management in the selection of a profitable product mix and determine how much cost can be incurred without sacrificing profits.

### 4.1. Cost Concepts

To determine profit at any volume, price level, product mix, or time, proper cost classification is required. Some costs vary directly with the rate of activity, while others do not. If the cost data are classified into their fixed and variable components and properly attributed to the activity causing the cost, the effect of volume becomes apparent and sources of profit are revealed.

In addition to classifying costs according to ability to attribute a cost to a product or service, it is also important to classify costs according to variation with the rate of activity (Ness and Cucuzza

1995). Some costs vary directly with the activity level, while other costs, although fixed, are directly attributable to the activity level. Hence, it is important to clarify specifically what is meant by the terms *direct* and *indirect*. The directly traceable or attributable costs are those costs that we can readily determine as contributing to the product or service's cost. However, whether a direct cost is variable, fixed, or semivariable depends on properly determining the cause of that cost. Perhaps more than anything else, managers need to exert the will to understand how costs are incurred and how they behave as activity levels change in their organizations.

### 4.2. Profitability Analysis

Virtually every planned action or decision in an organization affects costs and therefore profits. Profit analysis attempts to determine the effect of costs, prices, and volume on profits. The goal of this analysis is to provide accurate information about the profit contributions made by each product, thereby giving management a sound basis for managing its product lines.

One of the most important pieces of data resulting from a profit analysis is the contribution ratio, which is usually referred to as the profit-volume ratio (PV). The PV ratio is the proportion of sales dollars available to cover fixed costs and profits after deducting variable costs:

$$\text{PV} = \frac{\text{unit price} - \text{unit variable cost}}{\text{unit price}}$$

This PV ratio is an important piece of information for analyzing the profit impact of changes in sales volume, changes in the cost structure of the firm (i.e., the relative amount of fixed costs to total costs), as well as changes in price.

For a single product situation, the elements of profitability that the firm must consider are price per unit, sales volume per period, variable costs per unit, and the direct and objectively assignable fixed costs per period. However, typically firms sell multiple products or offer multiple services, and the cost-classification requirements noted above become more difficult. Further, many companies now recognize that it is important to avoid arbitrary formulas for allocating overhead (common costs) so that each product carries its fair share of the burden. In part, these companies understand that the concept of variable costs extends beyond the production part of the business. That is why we have stressed the notion of activity levels when defining variable costs. These companies have found out that using the old formula approach to cost allocation has meant that some products that were believed to be losing money were actually profitable and that other so-called profitable products were actually losing money.

A key lesson from the above discussion and the experiences of companies that use this approach to developing the relevant costs for pricing is that profits must be expressed in monetary units, not units of volume or percentages of market share. Profitability is affected by monetary price, unit volume, and monetary costs.

### 4.3. Profit Analysis for Multiple Products

In multiproduct firms, it is important to place emphasis on achieving the maximum amount of contribution revenue for each product instead of attempting to maximize sales revenues. Each product offering faces different competition, has a different demand elasticity, and perhaps depends for its sales, at least in part, on the sales of the other products in the line.

Within a multiproduct firm, each offering generates a different amount of volume, a different cost structure, including variable and fixed costs, different unit prices, and, of course, different revenues. Not only are these important factors different, but they are changing. The PV ratio can be used to analyze the relative profit contributions of each product in the line. Each product has a different PV value and different expected dollar sales volume as a percentage of the line's total dollar volume. In multiple-product situations, the PV is determined by weighting the PV of each product by the percentage of the total dollar volume for all products in the line.

This issue of managing the prices and profitability of the firm's product line is extremely important. For example, consider the prices of a major hotel chain. For the same room in a given hotel, there will be multiple rates: the regular rate (commonly referred to as the rack rate), a corporate rate that represents a discount for business travelers, a senior citizen rate, a weekend rate, single vs. double rates, group rate, and conference rate, to name just a few. Over time, the hotel's occupancy rate expressed as a percentage of rooms sold per night had increased from about 68% to 75%. Yet despite increasing prices that more than covered increases in costs, and increasing sales volume, profitability was declining.

After a careful examination of this problem, it was discovered that they were selling fewer and fewer rooms at the full rack rate while increasing sales, and therefore occupancy, of rooms at discounted rates that were as much as 50% off the full rack rate. As a result, the composite weighted PV ratio had significantly declined, indicating this demise in relative profitability. Further, to illustrate the importance of considering buyers' perceptions of prices, the price increases had primarily been

at the full rack rate, creating a greater and more perceptible difference between, for example, the full rate and the corporate rate. More and more guests were noticing this widening price difference and were requesting and receiving the lower rates.

When there are differences in the PVs among products in a line, a revision in the product selling mix may be more effective than an increase in prices. That is, a firm, by shifting emphasis to those products with relatively higher PVs, has a good opportunity to recover some or all of its profit position. Hence, profit at any sales level is a function of prices, volume, costs and the product dollar sales mix (Monroe and Mentzer 1994).

## 5. TYPES OF PRICING DECISIONS

As shown in Table 1, there are many kinds of pricing decisions that a firm must make. There is the decision on the specific price to set for each product and service marketed. But this specific price depends on the type of customer to whom the product is sold. For example, if different customers purchase in varying quantities, should the seller offer volume discounts?

The firm must also decide whether to offer discounts for early payment and, if so, when a customer is eligible for a cash discount and how much to allow for early payment. Should the firm attempt to suggest retail or resale prices, or should it only set prices for its immediate customers? When a firm uses other business firms as intermediaries between itself and its customers, it does not have direct contact with its ultimate customers. Yet the way customers respond to prices depends on how they perceive the prices and the relationships between prices. Hence, the manufacturer is very interested in having the prices that the final customer responds to correspond to its strategic objectives.

Normally, the firm sells multiple products and these questions must be answered for each product or service offered. Additionally, the need to determine the number of price offerings per type of product and the price relationships between the products offered make the pricing problem more complex. Further, different types of market segments respond differently to prices, price differences, and price changes.

The firm must also decide on whether it will charge customers for the transportation costs incurred when shipping the products to them. Customers located at different distances from the manufacturer will pay a different total price if they are charged for the transportation costs. Yet if the seller quotes a uniform price that includes the transportation costs regardless of distance from the manufacturer, some buyers may receive the products at a total price that is less than the costs incurred to the manufacturer while other customers will pay a price that exceeds the total costs incurred by the manufacturer. Such differences in prices to similar types of customers may lead to some concerns about the legality of the pricing policy.

### 5.1. Pricing New Products

One of the most interesting and challenging decision problems is that of determining the price of a new product or service. Such pricing decisions are usually made with very little information on demand, costs, competition, and other variables that may affect the chances of success. Many new products fail because they do not provide the benefits desired by buyers, or because they are not available at the right time and place. Others fail because they have been incorrectly priced, and the error can as easily be in pricing too low as in pricing too high. Pricing decisions usually have to be made with little knowledge and with wide margins of error in the forecasts of demand, cost, and competitors' capabilities.

The core of new product pricing takes into account the price sensitivity of demand and the incremental promotional and production costs of the seller. What the product is worth to the buyer, not what it costs the seller, is the controlling consideration. What is important when developing a

**TABLE 1 Basic Pricing Decisions**

1. What to charge for the different products and services marketed by the firm
2. What to charge different types of customers
3. Whether to charge different types of distributors the same price
4. Whether to give discounts for cash and how quickly payment should be required to earn them
5. Whether to suggest resale prices or only set prices charged one's own customers
6. Whether to price all items in the product line as if they were separate or to price them as a "team"
7. How many different price offerings to have of one item
8. Whether to base prices on the geographical location of buyers (i.e., whether to charge for transportation)

*Source:* Monroe 1990, p. 278.

new product's price is the relationship between the buyers' perceived benefits in the new product relative to the total acquisition cost (i.e., financial value), and relative to alternative offerings available to buyers.

It has been generally presumed that there are two alternatives in pricing a new product: *skimming* pricing, calling for a relatively high price, and *penetration* pricing, calling for a relatively low price. There are intermediate positions, but the issues are made clearer by comparing the two extremes.

#### *5.1.1. Skimming Pricing*

Some products represent drastic improvements upon accepted ways of performing a function or filling a demand. For these products, a strategy of high prices during market introduction (and lower prices at later stages) may be appropriate. Skimming is not always appropriate and does have drawbacks. A skimming strategy is less likely to induce buyers into the market and does not encourage rapid adoption or diffusion of the product. Moreover, if skimming results in relatively high profit margins, competitors may be attracted into the market.

#### *5.1.2. Penetration Pricing*

A penetration strategy encourages both rapid adoption and diffusion of new products. An innovative firm may thus be able to capture a large market share before its competitors can respond. One disadvantage of penetration, however, is that relatively low prices and low profit margins must be offset by high sales volumes. One important consideration in the choice between skimming and penetration pricing at the time a new product is introduced is the ease and speed with which competitors can bring out substitute offerings. If the initial price is set low enough, large competitors may not feel it worthwhile to make a big investment for small profit margins. One study has indicated that a skimming pricing strategy leads to more competitors in the market during the product's growth stage than does a penetration pricing strategy (Redmond 1989).

### 5.2. Pricing During Growth

If the new product survives the introductory period, as demand grows, usually a number of competitors are producing and selling a similar product and an average market price begins to emerge. Normally there is a relatively wide range of market prices early in the growth stage, but this market price range narrows as the product approaches maturity.

In regard to pricing products during the growth stage, three essential points should be noted: (1) the range of feasible prices has narrowed since the introductory stage; (2) unit variable costs may have decreased due to the experience factor; and (3) fixed expenses have increased because of increased capitalization and period marketing costs. The pricing decision during the growth stage is to select a price that, subject to competitive conditions, will help generate a sales dollar volume that enables the firm to realize its target profit contribution.

### 5.3. Pricing During Maturity

As a product moves into the maturity and saturation stages, it is necessary to review past pricing decisions and determine the desirability of a price change. Replacement sales now constitute the major demand, and manufacturers may also incur regional competition from local brands. Market conditions do not appear to warrant a price increase, hence the pricing decision usually is to reduce price or stand pat.

When is a price reduction profitable? We know that when demand is price elastic it is profitable to reduce prices if costs do not rise above the increase in revenues. But since it can be expected that any price decrease will be followed by competitors, it is also necessary that the market demand curve be elastic within the range of the price reduction. Moreover, the requirements for a profitable price reduction strategy include beginning with a relatively high contribution margin (i.e., relatively high PV ratio), opportunity for accelerating sales growth and a price-elastic demand (Monroe and Mentzer 1994). When a product has reached the maturity stage of its life cycle, it is most likely that these conditions will not exist.

At the maturity stage of the life cycle, the firm probably should attempt to maximize short-run direct product contribution to profits. Hence, the pricing objective is to choose the price alternative leading to maximum contribution to profits. If competition reduces prices, the firm may, however reluctantly, match the price reduction. On the other hand, it may try to reduce costs by using cheaper materials, eliminating several labor operations, or reducing period marketing costs. All or any of these actions may allow the firm to match competitively lower prices and still maintain target contributions to profit.

### 5.4. Pricing a Declining Product

During the declining phase of a product's life, direct costs are very important to the pricing decision. Normally, competition has driven the price down close to direct costs. Only those sellers who were

able to maintain or reduce direct costs during the maturity stage are likely to have remained. If the decline is not due to an overall cyclical decline in business but to shifts in buyer preferences, then the primary objective is to obtain as much contribution to profits as possible.

So long as the firm has excess capacity and revenues exceed all direct costs, the firm probably should consider remaining in the market. Generally, most firms eliminate all period marketing costs (or as many of these costs as possible) and remain in the market as long as price exceeds direct variable costs. These direct variable costs are the minimally acceptable prices to the seller. Thus, with excess capacity, any market price above direct variable costs would generate contributions to profit. Indeed, the relevant decision criterion is to maximize contributions per sales dollar generated. In fact, it might be beneficial to raise the price of a declining product to increase the contributions per sales dollar. In one case, a firm raised the price of an old product to increase contributions while phasing it out of the product line. To its surprise, sales actually grew. There was a small but profitable market segment for the product after all!

## 5.5. Price Bundling

In marketing, one widespread type of multiple products pricing is the practice of selling products or services in packages or bundles. Such bundles can be as simple as pricing a restaurant menu for either dinners or the items à la carte, or as complex as offering a ski package that includes travel, lodging, lift and ski rentals, and lessons. In either situation, there are some important principles that need to be considered when bundling products at a special price.

### *5.5.1. Rationale for Price Bundling*

Many businesses are characterized by a relatively high ratio of fixed to variable costs. Moreover, several products or services usually can be offered using the same facilities, equipment, and personnel. Thus, the direct variable cost of a particular product or service is usually quite low, meaning that the product or service has a relatively high profit–volume (PV) ratio. As a result, the incremental costs of selling additional units are generally low relative to the firm's total costs.

In addition, many of the products or services offered by most organizations are interdependent in terms of demand, either being substitutes for each other or complementing the sales of another offering. Thus, it is appropriate to think in terms of relationship pricing, or pricing in terms of the inherent demand relationships among the products or services. The objective of price bundling is to stimulate demand for the firm's product line in a way that achieves cost economies for the operations as a whole, while increasing net contributions to profits.

### *5.5.2. Principles of Price Bundling*

Underlying the notion of bundling is the recognition that different customers have different perceived values for the various products and services offered (Simon et al. 1995). In practical terms, these customers have different maximum amounts they would be willing to pay for the products. For some customers, the price of the product is less than this maximum acceptable price (upper price threshold), resulting in some consumer surplus. However, for these customers, the price of a second product or service may be greater than they are willing to pay and they do not acquire it. If the firm, by price bundling, can shift some of the consumer surplus from the highly valued product to the less valued product, then there is an opportunity to increase the total contributions these products make to the firm's profitability.

The ability to transfer consumer surplus from one product to another depends on the complementarity of demand for these products. Products or services may complement each other because purchasing them together reduces the search costs of acquiring them separately. It is economical to have both savings and checking accounts in the same bank to reduce the costs of having to go to more than one bank for such services. Products may complement each other because acquiring one may increase the satisfaction of acquiring the other. For the novice skier, ski lessons will enhance the satisfaction of skiing and increase the demand to rent skis. Finally, a full product-line seller may be perceived to be a better organization than a limited product-line seller, thereby enhancing the perceived value of all products offered.

## 5.6. Yield Management

A form of segmentation pricing that was developed by the airlines has been called yield management. Yield management operates on the principle that different segments of the market for airline travel have different degrees of price sensitivity. Therefore, seats on flights are priced differently depending on the time of day, day of the week, length of stay in the destination city before return, when the ticket is purchased, and willingness to accept certain conditions or restrictions on when to travel. Besides the airlines, hotels, telephone companies, rental car companies, and banks and savings and loans have used yield management to increase sales revenues through segmentation pricing. It seems likely that retail firms could use yield management to determine when to mark down slow-moving

merchandise and when to schedule sales, or how to set a pricing strategy for products with short selling seasons.

The unique benefits of the yield-management pricing program is it forces management to continuously monitor demand for its products. Further, changes in demand lead to pricing changes to reflect these changes. If the product is not selling fast enough, then price reductions can be initiated to stimulate sales. Because of a relatively high fixed costs to total variable costs cost structure, these focused price reductions can provide leverage for increasing operating profits, by the effect on sales volume. With relatively high contribution margins (high PV ratios), small price reductions do not require large increases in volume to be profitable.

## 6. ADMINISTERING THE PRICING FUNCTION

Perhaps the most difficult aspect of the pricing decision is to develop the procedures and policies for administering prices. Up to this point, the issue has been on the setting of base or list prices. However, the list price is rarely the actual price paid by the buyer. The decisions to discount from list price for volume purchases or early payment, to extend credit, or to charge for transportation effectively change the price actually paid. In this section, we consider the problems of administering prices.

An important issue relative to pricing is the effect that pricing decisions and their implementation have on dealer or distributor cooperation and motivation as well as on salespeople's morale and effort. While it is difficult to control prices legally through the distribution channel, nevertheless, it is possible to elicit cooperation and provide motivation to adhere to company-determined pricing policies. Also, because price directly affects revenues of the trade and commissions of salespeople, it can be used to foster desired behaviors by channel members and salespeople.

Price administration deals with price adjustments or price differentials for sales made under different conditions, such as:

1. Sales made in different quantities
2. Sales made to different types of middlemen performing different functions
3. Sales made to buyers in different geographic locations
4. Sales made with different credit and collection policies
5. Sales made at different times of the day, month, season, or year

Essentially, price structure decisions define how differential characteristics of the product and/or service will be priced. These price structure decisions are of strategic importance to manufacturers, distributors or dealers, and retailers (Marn and Rosiello 1992). In establishing a price structure, there are many possibilities for antagonizing distributors and even incurring legal liability. Thus, it is necessary to avoid these dangers while at the same time using the price structure to achieve the desired profit objectives.

We have noted that the definition of price includes both the required monetary outlay by the buyer, plus a number of complexities including terms of agreement, terms of payment, freight charges, offering a warranty, timing of delivery, or volume of the order. Moreover, offering different products or services in the line with different features or benefits at different prices permits the opportunity to develop prices for buyers who have different degrees of sensitivity to price levels and price differences. Moving from a simple one-price-for-all-buyers structure to a more complex pricing structure provides for pricing flexibility because the complexity permits price variations based on specific product and service characteristics as well as buyer or market differences. Moreover, a more complex price structure enhances the ability of firms to (Stern 1986):

1. Respond to specific competitive threats or opportunities
2. Enhance revenues while minimizing revenue loss due to price changes
3. Manage the costs of delivering the product or service
4. Develop focused price changes and promotions
5. Be more effective in gaining distributors' cooperation

To accomplish this goal of differential pricing requires identifying the key factors that differentiate price-market segments. Then the elements of the price structure may be developed that reflect these factors.

A product's list price is the product's price to final buyers. Throughout the distribution system, manufacturers grant intermediaries discounts, or deductions from the list price. These price concessions from producers may be seen as payment to intermediaries for performing the distribution function and for providing time and place utilities. The difference between the list price and the amount that the original producer receives represents the total discounts provided to channel members.

Channel members themselves employ discounts in various ways. Wholesalers pass on discounts to retailers just as manufacturers pass along discounts to wholesalers. Retailers may offer promotional discounts to consumers in the form of sweepstakes, contests, and free samples. Some stores offer quantity and cash discounts to regular customers. Even seasonal discounts may be passed along—for example, to reduce inventory of Halloween candy or Christmas cards.

## 7. PRICE AND SALES PROMOTIONS

Price promotions consist of tactics designed to achieve specific objectives in a limited time in a target market. Price promotions are directed at two primary audiences: consumers and the trade. Some commonly used promotion tactics are summarized next.

Aimed at both consumers and distributors, price-off promotions involve temporary price reductions to retailers with the intent that savings will be passed along to consumers. In an immediate price-off promotion, the marketer usually affixes a special label to the product's package to indicate the percentage or cash savings, which the retailer then honors. In a delayed price-off promotion, the consumer has to pay the normal price but can send the marketer a proof-of-purchase label to claim a cash rebate (refund).

Coupons offer buyers price reductions at the point of sale (most often at a retail checkout counter). Coupons are made available to consumers in a variety of ways. Some can be clipped from daily newspaper ads for supermarkets; some come as colorful freestanding inserts in Sunday newspapers; and some are distributed as fliers to homes within a store's immediate vicinity. Coupons are also mailed directly to consumers, often in booklets or packets assembled by distributors or companies specializing in such promotions. Finally, in-pack and on-pack coupons may be affixed to the product and allow savings on the current or a future purchase.

### 7.1. Price Promotion as Price Segmentation

As mentioned earlier, manufacturers and retailers have made increasing use of coupons, rebates and refunds, and short-term price reductions to stimulate short-term demand for their products and services. However, despite the popularity of these price deals, it is not at all clear that a majority of these deals are profitable. Simply offering a coupon, rebate, or price-off deal to current buyers in the hope of stimulating a substantial increase in unit sales likely will reduce profits unless mostly new buyers take advantage of the deal. Thus, the underlying objective of a price promotion to final customers should be to focus on a price-market segment that is more price sensitive or deal responsive than existing buyers. Essentially, then, price promotions to final customers simply becomes an aspect of segment pricing.

Not all buyers of a product on price promotion take advantage of the promotion. Redemption rates for coupons and rebates indicate that many buyers do not redeem coupons, nor do they follow through and take the rebate that is offered. One reason for this lack of redemption or follow-through is that the perceived cost of redeeming coupons or qualifying for the rebate is larger than the perceived value of the coupon or rebate. Thus, buyers who do not take advantage of the price promotion pay the regular price. Therefore, by offering a coupon or rebate, the seller has effectively segmented the market into two price segments.

For this type of segmented pricing to be profitable, some additional conditions must prevail. First, the segments must be separable to some degree. This separation must either be due to some natural separation, such as geographic region or location, time of purchase, or category of buyer, e.g., business buyer vs. consumer. Second, these segments must have different degrees of price sensitivity and/or different variable purchasing costs. Third, the variable costs of selling to these segments must not be so different that the effect of the lower price is not canceled by increased selling costs.

### 7.2. Price Promotion Decision Variables

To understand the complexity of developing a price promotion policy, it is useful to review the types of decisions that need to be made before a promotion can be implemented. The decisions outlined below indicate there is a need to plan this activity carefully.

1. Should a price promotion be offered? The first decision is simply whether the seller should offer a coupon, rebate, cents-off deal, or promotional discount.
2. To whom should the deal be offered: dealers or final customers? Offering a price promotion to dealers or distributors in anticipation that the deal will be offered to final customers is not the same as offering it directly to final customers. Dealers may choose to reduce their prices in the full amount or less, or not at all. Further, they may buy excess amounts of the deal merchandise, relative to actual demand, and sell some units at full price after the deal period is over.
3. When should the promotion be offered? This question refers not only to the specific time of the year but also to whether to offer the deal during peak or slack selling seasons. For example,

should ketchup manufacturers offer price promotions during the peak outdoor cooking season (May–September) or during the winter months?

4. How frequently should a promotion be run? If a product is offered frequently on some form of a price deal, customers may come to expect the deal and only buy on deal. The effect is that the product is rarely sold at full list price and the advantage of price segmentation is lost.
5. How long should the promotion be run? This decision is related to the issue of promotion frequency, peak vs. slack selling periods, and the length of buyers' repurchase periods. Some consumer coupons do not have an expiration date, thereby extending the promotion period indefinitely and making it difficult to measure the effectiveness of the coupon promotion.
6. How many units should be covered by the promotion? When deals are offered to the trade, there often is a restriction on the amount that a dealer can order on deal. This restriction may be related to the dealer's usual order size for the length of the promotion period.
7. What products and/or sizes should be promoted? Should a coffee producer offer a coupon on all package sizes of coffee, or only the 13 oz. size? Should a luggage manufacturer feature all of its luggage in the promotion, or only certain models?
8. How much should the price be reduced? What should be the amount of the rebate? What should be the value of the coupon? As discussed earlier, the degree of buyer sensitivity to the price reduction, or the degree that buyers perceive additional transaction value, will have an impact on the success of the promotion. The important issue here is how much of a price difference (reduction) is necessary to induce buyers to take advantage of the offer.

## 7.3. Some Perspectives on Price and Sales Promotions

Promotions comprise a significant portion of the marketing communications budget. With this increased managerial importance of price and sales promotions has come considerable research on how promotions affect sales. However, much of this new research information is still quite recent, and the evidence on how promotions affect sales is still emerging. In this section we will look at three different time frames to consider these effects (Blattberg and Neslin 1989): (1) the week or weeks in which the promotion occurs (immediate); (2) the weeks or months following the promotion (intermediate); and (3) the months or years following the implementation of several promotions (long term).

### *7.3.1. Immediate Effects of Price and Sales Promotions*

Promotions seem to have a substantial immediate impact on brand sales. For example, price cuts for bathroom tissue are accompanied by immediate increases in brand sales. When such price promotions are coordinated with special point-of-purchase displays and local feature advertising, sales might increase as much as 10 times normal sales levels. Because of such observable immediate sales impact, many brands of packaged consumer goods are frequently promoted.

A large proportion of this immediate increase in sales is due to nonloyal buyers (brand switchers). For example, one study showed that 84% of the increase in coffee brand sales generated by promotions came from brand-switching consumers (Gupta 1988). However, not all brands have the same capability of inducing consumers to switch brands with a promotional activity.

The effect of brand A's promotions on brand B's sales likely is different than the effect of brand B's promotions on brand A's sales. This asymmetry of the promotion cross-elasticities is a very important managerial finding. That is, a strong brand, say brand A, may be more successful in inducing buyers of brand B to switch to brand A with a promotion than the weaker brand B would be in using a similar promotion to induce buyers of brand A to switch to brand B. This finding implies that when there are simultaneous promotions by both brands, brand A likely will experience a more positive sales impact than will brand B.

Another important finding is that different forms of price and sales promotions have separate effects on sales. Further, when several forms are used together, the total impact may be greater than the sum of the effects due to each form.

An important reason for the immediate sales effect is purchase acceleration, which occurs because loyal consumers buy larger quantities when the brand is promoted and/or purchase the brand sooner than normal. The issue of purchase acceleration is very important when we try to determine whether a promotion has been profitable. Indeed, if buyers do not change their rate of consumption of the product, then larger purchase quantities or earlier purchases means that there will be fewer sales later at the regular price.

### *7.3.2. Intermediate Effects of Price and Sales Promotions*

Usually, promotions have been considered short-term tactics to provide for an immediate increase in sales. However, as in advertising, there are effects that occur even after a particular promotion campaign has expired. For example, if a consumer purchases brand A for the first time when A is being promoted, will that consumer buy brand A on the next purchase occasion (repeat purchase)? Or will

the consumer develop a loyalty to the deal and look for another promoted brand on the next purchase occasion? The managerial implications of a promotion extend beyond the immediate sales effect of that promotion.

While there has been considerable research on whether brand purchasing enhances repeat brand purchases, such research provides conflicting results. There is some evidence that a prior brand purchase may increase the likelihood of buying that brand again. However, given the increasing use of promotions, other research shows no evidence that promotions enhance repeat brand purchases.

A reason why promotions may not enhance repeat brand purchases involves the question of why consumers may decide to buy the brand initially. It has been suggested that people may attribute their purchase to the deal that was available and not to the brand itself being attractive (Scott and Yalch 1980). If consumers indicate a negative reason for a purchase decision, there is a smaller likelihood that the experience will be a positive learning experience relative to the brand itself. If a brand is promoted quite frequently, then the learning to buy the brand occurs because of the reward of the deal, not the positive experience of using the brand itself.

#### *7.3.3. Long-Term Effects of Price and Sales Promotions*

In the long run, the relevant issue is the ability of the brand to develop a loyal following among its customers (Jones 1990). The important objective is to develop favorable brand attitudes of the customers such that they request that the retailer carry the brand and are unwilling to buy a substitute. As we observed above, many marketing practitioners fear that too-frequent promotional activity leads to loyalty to the deal, thereby undermining the brand's franchise. And if buyers come to expect that the brand will often be on some form of a deal, they will not be willing to pay a regular price and will be less likely to buy because they do not believe that the brand provides benefits beyond a lower price.

A second problem develops if consumers begin to associate a frequently promoted brand with lower product quality. That is, if consumers believe that higher-priced products are also of higher quality, then a brand that is frequently sold at a reduced price may become associated with a lower perceived quality level. Thus, the result may be that buyers form a lower reference price for the product. Products that are perceived to be of relatively lower quality have a more difficult time trying to achieve market acceptance.

## 8. LEGAL ISSUES IN PRICING

The development of a price structure to implement a pricing strategy is not only a difficult and complex task but is fraught with the potential for violating federal and state laws. In fact, the legal aspects of pricing strategy comprise one of the most difficult parts of marketing strategy and have left many business people not only frightened of making pricing decisions but often vulnerable to legal action because of their pricing activities.

As indicated earlier, the short-term effects of reducing price on profits likely will not be positive. Yet many firms attempting to gain volume or market share often resort to price reductions. Other competing firms often feel compelled to follow these price reductions and often to undercut the original price-reducing firm. Also, there is pressure, real or perceived, to provide certain buyers a favored status by giving them additional discounts for their business. To counteract these pressures to reduce prices and stabilize profits, some businesses have attempted by either overt or covert actions to stabilize prices and market share. In other situations, a larger firm has aggressively reduced prices in one market area or to a specific set of customers in order to reduce competition or drive a competitor out of business. Moreover, we have suggested that there are typically several price-market segments distinguished by different degrees of sensitivity to prices and price differences. Thus, the opportunity exists to set different prices or to sell through different channels to enhance profits.

Each of these various possible strategies or tactics is covered by some form of legislation and regulation. In fact, there are laws concerning price fixing amongst competitors, exchanging price information or price signalling to competitors, pricing similarly to competitors (parallel pricing), predatory pricing, and price discrimination. This section briefly overviews the laws that cover these types of activities.

### 8.1. Price Fixing

The Sherman Antitrust Act (1890) specifically addresses issues related to price fixing, exchanging price information, and price signaling. It also has an effect on the issue of predatory pricing. Section 1 of the Act prohibits all agreements in restraint of trade. Generally, violations of this section are divided into per se violations and rule of reason violations. Per se violations are automatic. That is, if a defendant has been found to have agreed to fix prices, restrict output, divide markets by agreement, or otherwise act to restrict the forces of competition, he or she is automatically in violation of the law and subject to criminal and civil penalties. There is no review of the substance of the situation, that is, whether there was in fact an effect on competition. In contrast, the rule-of-reason doctrine calls for an inquiry into the circumstances, intent, and results of the defendants' actions. That is, the

courts will examine the substantive facts of the case, including the history, the reasons for the actions, and the effects on competition and the particular market. The current attitude of federal and state agencies and courts is that price fixing is a per se violation and that criminal sanctions should be applied to the guilty persons.

Section 2 of the Act prohibits the act of monopolizing, that is, the wrongful attempt to acquire monopoly power. Thus, having a monopoly is not illegal, but the deliberate attempt to become a monopoly is illegal. The issue here in recent cases has been not whether a firm had acquired a monopoly per se, but the methods of achieving such market power. Thus, the courts have been somewhat more aware of a firm's need to develop a strong competitive position in the markets it serves and that these strong competitive actions may lead to dominant market shares. However, if this dominant market share leads to above-market-average prices, some form of legal or regulatory action may take place.

### 8.2. Exchanging Price Information

Many trade associations collect and disseminate price information from and to their members. The legal issue arises when there is an apparent agreement to set prices based on the exchanged price information. Thus, if members discuss prices and production levels in meetings and prices tend to be uniform across sellers, it is likely that the exchange of information led to some form of price fixing. Again, the issue is whether the exchange of price information seems to have the effect of suppressing or limiting competition, which is a violation of section 1 of the Sherman Act. Care must be exercised about when and how price information is exchanged by competing sellers. The trend in recent years has been to make it more difficult to prove that such exchanges do not violate section 1.

### 8.3. Parallel Pricing and Price Signaling

In many industries and markets, one firm may emerge as a price leader. That is, one firm often is the first to announce price changes, and most rival sellers will soon follow the price changes made by the leader. At other times, another firm may initiate the price changes, but if the price leader does not introduce similar price changes, the other firms as well as the initial firm will adjust their prices to correspond to the price leader's prices. The legal question arises as to whether these somewhat concerted prices and price changes constitute a tacit, informal, and illegal agreement in violation of section 1.

Recently, some questions have been raised as to whether the public announcement of prices and price changes has been used by sellers to signal prices and achieve this common understanding about prices. That is, do sellers achieve this common understanding about prices through public announcements about their prices and price changes? If so, then a violation of section 1 may exist. For example, if one company announces a price increase effective 60 days later, some legal people have suggested that the announcement serves as a signal to competition. The suggestion seems to imply that if others follow with similar announcements, then the price increase will remain in effect; if others do not follow, the price increase will be rescinded. Announcing price increases ahead of the effective date provides time for customers, distributors, and the sales force to adjust their price frame of reference. However, what may be an effective managerial practice could be interpreted as a mechanism for attempting to achieve a common understanding among rival sellers. The ramifications of price signaling from a legal perspective remain to be determined by either legislative action, litigation, or further debate.

### 8.4. Predatory Pricing

Predatory pricing is the cutting of prices to unreasonably low and/or unprofitable levels so as to drive competitors from the market. If this price cutting is successful in driving out competitors, then the price cutter may have acquired a monopoly position via unfair means of competition—a violation of section 2 of the Sherman Act.

There is considerable controversy about predatory pricing, particularly how to measure the effect of a low-price strategy on the firm's profits and on competitors. Predatory pricing occurs whenever the price is so low that an equally efficient competitor with smaller resources is forced from the market or discouraged from entering it. Primarily, the effect on the smaller seller is one of a drain on cash resources, not profits per se. Much of the controversy surrounding measuring the effects of an alleged predatory price relates to the proper set of costs to be used to determine the relative profitability of the predator's actions. Recently, the courts seem to have adopted the rule that predatory pricing exists if the price does not cover the seller's average variable or marginal costs. However, the intent of the seller remains an important consideration in any case.

### 8.5. Illegal Price Discrimination

The Robinson-Patman Act was passed in 1936 to protect small independent wholesalers and retailers from being charged more for products than large retail chains were. Sellers can, however, defend

themselves against discrimination charges by showing that their costs of selling vary from customer to customer. Cost savings can then be passed along to individual buyers in the form of lower prices. The Robinson-Patman Act therefore permits price discrimination in the following cases:

1. If the firm can demonstrate that it saves money by selling large quantities to certain customers, it can offer these buyers discounts equal to the amount saved.
2. Long-term sales agreements with customers also reduce costs; again, discounts may be granted equal to the amount saved.
3. In cases where competitors' prices in a particular market must be met, it is legal to match the competitors' lower prices in such a market while charging higher prices in other markets.

## 9. FOUR BASIC RULES FOR PRICING

The four rules given below are intended to capture the essence of the analysis necessary to determine and evaluate pricing strategies. The order in which the rules are presented does not imply a hierarchy of importance; each rule is equally important.

### 9.1. Know Your Objectives

As demonstrated earlier, many firms stress the profit objective of return on investment. Other firms stress the objective of maintaining specified profit margins, while still other firms seek to achieve market-share goals. It is not necessary for each product to maintain the same profit margin in order to achieve a particular return on investment. Similarly, different margins on products may still produce an overall desired corporate profit goal. Finally, firms stressing market share may utilize the experience curve factor and build profits by reducing prices.

The important point to remember is that differences in corporate profit objectives eventually will lead to differences in prices and the role of price in influencing actual profits. Ultimately, regardless of the financial goal, the pricing objective is behavioral in nature. That is, whether buyers buy more, whether nonbuyers decide to buy now, and whether buyers decide to purchase less frequently but in greater volume per order, or to pay earlier, are influenced by the prices and price structure of the seller. Further, the degree to which distributors and dealers are cooperative and motivated to sell the firm's products depends largely on the financial incentives provided by the suppliers' prices and price structure. Also, the sales force's motivation to help the firm achieve its financial objectives depends on its understanding and acceptance of the pricing strategy being followed. Price has an important role in developing incentives for distributors, salespeople, and buyers to perform in ways that will be beneficial to the firm. Thus, it is important that the seller develop a positive attitude toward pricing, leading to a proactive pricing approach.

### 9.2. Know Your Demand

This prescription suggests that the firm understand fully the factors influencing the demand for its products and services. The key question is the role of price in the purchaser's decision process. Price and price differentials influence buyer perceptions of value. Indeed, many companies have achieved positive results from differentially pricing their products and services.

Coupled with knowing how price influences buyers' perceptions of value, it is necessary to know how buyers use the product or service. Is the product used as an input in the buyer's production process? If so, does the product represent a significant or insignificant portion of the buyer's manufacturing costs? If the product is a major cost element in the buyer's production process, then small changes in the product's price may significantly affect the buyer's costs and the resulting price of the manufactured product. If the final market is sensitive to price increases, then a small price increase to the final manufacturer may significantly reduce demand to the initial seller of the input material. Thus, knowing your buyers also means understanding how they react to price changes and price differentials as well as knowing the relative role price plays in their purchase decisions.

Further, the seller should also know the different types of distributors and their functions in the distribution channel. This prescription is particularly important when the manufacturer sells both to distributors and to the distributors' customers.

### 9.3. Know Your Competition and Your Market

In addition to the influence of buyers, a number of other significant market factors influence demand. It is important to understand the operations of both domestic and foreign competitors, their rate of capacity utilization, and their products and services. In many markets, the dynamic interaction of supply and demand influences prices. Moreover, changes in capacity availability due to capital investment programs will influence supply and prices. A second important aspect of knowing the market is the need to determine price–volume relationships.

### 9.4. Know Your Costs

It is important to determine the basic cost data necessary for the pricing decision. As stated earlier, it is necessary to know which costs vary directly with changes in levels of activity and the underlying causes of the changes in costs. It is also necessary to identify the costs that are directly related to the product or service being costed but do not vary with activity levels-direct period or fixed costs. Furthermore, marketing and distribution costs should be objectively assigned to the products and not simply lumped into a general overhead category.

Valid cost data provide an objective basis for choosing between pricing alternatives, determining discounts, and establishing differential pricing alternatives. Furthermore, objective cost studies that are completed before the pricing decisions provide the firm with a valid legal justification for its price structure.

## 10. SUMMARY

It is important to realize there is no one right way to determine price. Pricing simply cannot be reduced to a formula—there are too many interacting factors. Successful pricing requires considering all internal and external factors and adapting to changes as they occur. Successful pricing is adaptive pricing. Pricing decisions should be logically made and should involve rigorous thinking, with minimum difficulty from human and organizational factors. Further, it should be recognized that judgment and prediction are needed about the future, not the past. Finally, pricing decisions should be made within a dynamic, long-run corporate and marketing strategy.

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