CHAPTER9

PRICING THE PRODUCT

LEARNING OBJECTIVES

After you have read this chapter, you should develop an understanding of the following key points related to pricing:

The meaning of pricing from the perspective of the buyer, seller, and society.

The sellers' objectives in making pricing decisions.

The alternative pricing approaches available to the manager.

THE MCDONALD'S EFFECT

McDonald's is one humongous company. With 21,000 restaurants in 101 countries, it is everywhere–which is why the glotal economy is sometimes called McWorld. But back home in America, the execs that run this vast e.mpire aren't feeling very lordly. More than ever they find they have to kowtow to the price demands of ordinary folks like Alonso Reyes, a 19-year-old Chicagoan who works at a local car dealership. Never mind that Chicago is Micky D's world headquarters–he splits his fast-food patronage between McDonald's and its arch-rival, Burger King, and counts every pennyworth of beef when deciding where to eat. So Reyes perked up when he heard that McDonald's had announced "an unprecedented value offering"–a 55-cent Big Mac that the company boasted was bad news for their competition. "Cool," said Reyes, "Coupons, specials, sales. I'll take whatever I can get."

For McDonald's top management, this pricing strategy made perfect sense. After all, declining same-store sales in the U.S. were the chain's most glaring weakness. What better way to put some sizzle in the top line than a bold pocketbook appeal?

Well, McDonald's executives should have realized that there is, in fact, a better way. But apparently they took no notice of the fallout when Phillip Morris announced deep cuts on "Marlboro Friday," or of "Grape Nuts Monday," when the Post unit of Kraft Foods kicked off a cereal price war. Predictably, "Hamburger Wednesday" sent investors on a Big Mac attack, slicing 9% off McDonald's share price in three days and dragging rival fast-food issues down with it. "It looks almost desperate," says Piper Jaffray, Inc. analyst Allan Hickok of the 55-cent come-on. Adds Damon Brundage of NatWest Securities Corp.; "They have transformed one of the great brands in American business into a commodity."

In theory, McDonald's plan will payoff, because customers only get the discount if they buy a drink and french-fries, too. Yet that gimrnick-within-a-gimmick threatens to undermine pricier "Extra Value Meals," one of the chain's most successful marketing initiatives. Consumers expecting cut-rate combos won't go back to paying full price, especially if other fast-feeders discount their package deals.

Sources: Greg BUllls, "McDonald's: Now, It's Just Another Burger Joint," *Business Week,* March 17, 1997, pp. 3-8; Bill McDowell, "McDonald's Falls Back to Price-Cutting Tactics," *Advertising Age,* February 3, 1997, pp. 5-7; Michael Hirsch, "The Price is Right," *Time,* February 10, 1997, p. 83; Louise Kramer, "More-Nimble McDonald's is Getting Back on Track," *Advertising Age,* January 18, 1999, p. 6; David Leonhardt, "Getting Off Their McButts," *Business Week,* February 22, 1999, pp. 84-85; Bruce Horovitz, "Fast-Food Facilities Face Sales Slowdown," *USA Today*, Wednesday, February 21, 2001, p. 3B.

INTRODUCTION

From a customer's point of view, value is the sole justification for price, Many times customers lack an understanding of the cost of mateliais and other costs that go into the making of a product. But those customers can understand what that product does for them in the way of providing value. It is on this basis that customers make decisions about the purchase of a product.

Effective pricing meets the needs of consumers and facilitates the exchange process. It requires that marketers understand that not all buyers want to pay the same price for products, just as they do not all want the same product, the same distribution outlets, or the same promotional messages. Therefore, in order to effectively price products, markets must distinguish among various market segments. The key to effective pricing is the same as the key to effective product, distribution, and promotion strategies. Marketers must understand buyers and price their products according to buyer needs if exchanges are to occur, However, one cannot overlook the fact that the price must be sufficient to support the plans of the organization, including satisfying stockholders. Price charged remains the primary source of revenue for most businesses,

PRICE DEFINED: THREE DIFFERENT PERSPECTIVES

Although making the pricing decision is usually a marketing decision, making it correctly requires an understanding of both the customer and society's view of price as well. In some respects, price setting is the most important decision made by a business. A price set too low may result in a deficiency in revenues and the demise of the business. A price set too high may result in poor response from customers and, unsurprisingly, the demise of the business. The consequences of a poor pricing decision, therefore, can be dire. We begin our discussion of pricing by considering the perspective of the customer.

The Customer's View of Price

As discussed in an earlier chapter, a customer can be either the ultimate user of the finished product or a business that purchases components of the finished product. It is the customer that seeks to satisfy a need or set of needs through the purchase of a particular product or set of products. Consequently, the customer uses several criteria to determine how much they are willing to expend in order to satisfy these needs. Ideally, the customer would like to pay as little as possible to satisfy these needs. This perspective is summarized in Figure 9.1.

Therefore, for the business to increase value (i.e., create the competitive advantage), it can either increase the perceived benefits or reduce the perceived costs, Both of these elements should be considered elements of price,

PRICE

VALUE = PERCEIVED BENEFITS - PERCEIVED COSTS

FIGURE 9.1 The customer's view of price

To a certain extent, perceived benefits are the mirror image of perceived costs. For example, paying a premium price-e.g., $650 for a piece of Lalique crystal-is compensated for by having this exquisite work of art displayed in one's home. Other possible perceived benefits directly related to the price- value equation are status, convenience, the deal, brand, quality, choice, and so forth. Many of these benefits tend to overlap. For instance, a Mercedes Benz E 750 is a very high-status brand name and possesses superb quality. This makes it worth the $100,000 price tag. Further, if Mark Smith can negotiate a deal reducing the price by $15,000, that would be his incentive to purchase. Likewise, someone living in an isolated mountain community is willing to pay substantially more for groceries at a local store rather than drive 78 miles to the nearest Safeway. That person is also willing to sacrifice choice for greater convenience. Increasing these perceived benefits is represented by a recently coined *term-value-added.* Thus, providing value-added elements to the product has become a popular strategic alternative. Computer manufacturers now compete on value-added components such as free delivery setup, training, a 24-hour help line, trade-in, and upgrades.

Perceived costs include the actual dollar amount printed on the product, plus a host of additional factors. As noted, these perceived costs are the mirror-opposite of the benefits. When finding a gas station that is selling its highest grade for 6¢ less per gallon, the customer must consider the 16-mile drive to get there, the long line, the fact that the middle grade is not available, and heavy traffic. Therefore, inconvenience, limited choice, and poor service are possible perceived costs. Other common perceived costs include risk of making a mistake, related costs, lost opportunity, and unexpected consequences, to name but a few. A new cruise traveler discovers she really doesn't enjoy that venue for several reasons-e.g., she is given a bill for incidentals when she leaves the ship, she has used up her vacation time and money, and she receives unwanted materials from this company for years to come.

In the end, viewing price from the customer's perspective pays off in many ways. Most notably, it helps define value-the most important basis for creating a competitive advantage.

Price from a Societal Perspective

Price, at least in dollars and cents, has been the historical view of value. Derived from a bartering system-i.e., exchanging goods of equal value-the monetary system of each society provides a more convenient way to purchase goods and accumulate wealth. Price has also become a variable society employs to control its economic health. Price can be inclusive or exclusive. In many countries, such as Russia, China, and South Africa, high prices for products such as food, health care, housing, and automobiles, means that most of the population is excluded from purchase. In contrast, countries such as Denmark, Germany, and Great Britain charge little for health care and consequently make it available to all.

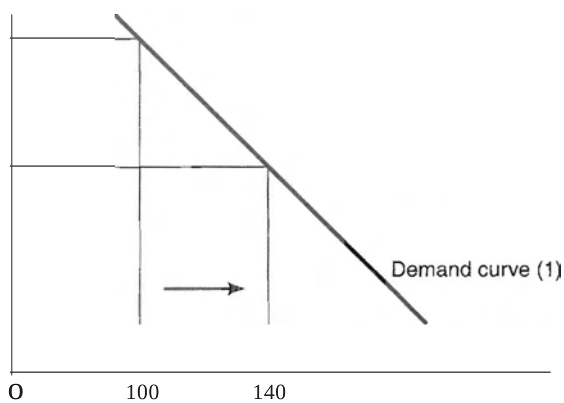
There are two different ways to look at the role price plays in a society: rational man and irrational man. The former is the primary assumption underlying economic theory, and suggests that the results of price manipulatio'1 are predictable. The latter role for price acknowledges that man's response to price is sometimes unpredictable and pretesting price manipulation is a necessary task. Let's discuss each briefly.

Rational Man Pricing: An Economic Perspective

Basically, economics assumes that the consumer is a rational decision maker and has perfect :nformation. Therefore, if a price for a particular product goes up and the customer is aware of all relevant information, demand will be reduced for that product. Should price decline, demand would increase. That is, the quantity demanded typically rises causing a downward sloping demand curve.

A *demand curve* shows the quantity demanded at various price levels (see Figure 9.2). As a seller changes the price requested to a lower level, the product or service may become an attractive use of financial resources to a larger number of buyers, thus expanding the total market for the item. This total market demand by all buyers for a product type (not just for the company's own brand name) is called *primary demand.* Additionally, a lower price may cause buyers to shift purchases from competitors, assuming that the competitors do not meet the lower price. If primary demand does not expand and competitors meet the lower price the result will be lower total revenue for all sellers.

Since, in the U.S., we operate as a free market economy, there are few instances when someone outside the organization controls a product's price. Even commodity-like products such as air travel, gasoline, and telecommunications, now determine their own prices. Because large companies have economists on staff and buy into the assumptions of economic theory as it relates to price, the classic price-demand relationship dictates the economic health of most societies. Alan Greenspan, Chairman of the U. S. Federal Reserve, determines interest rates charged by banks as well as the money supply, thereby directly affecting price (especially of stocks and bonds). He is considered by many to be the most influential person in the world.



A $3 reduction in price unit would cause a 40-unit increase in the quantity demanded assuming no other variable changes.

FIGURE 9.2 Price and der;land

Irrational Man Pricing: Freedom Rules

There are simply too many examples to the contrary to believe that the economic assulop-tions posited under the rational man model are valid. Prices go up and people buy more. Prices go down and people become suspicious and buy less. Sometimes we simply behave in an irrational manner. Clearly, as noted in our earlier discussion on consumers, there are other factors operating in the marketplace. The ability of paying a price few others can afford may be irrational, but it provides important personal status. There are even people who refuse to buy anything on sale. Or, others who buy everything on sale. Often businesses are willing to hire a $10,000 consultant, who does no more than a $5,000 consultant, simply to show the world they're successful.

In many societies, an additional irrational phenomenon may exist-support of those that cannot pay. In the U.S., there are literally thousands of not-for-profit organizations that provide goods and services to individuals for very little cost or free. There are also government agencies that do even more. Imagine what giving away surplus food to the needy does to the believers of the economic model.

Pricing planners must be aware of both the rational as well as the irrational model, since, at some level, both are likely operating in a society. Choosing one over the other is neither wise nor necessary.

The Marketer's View of Price

Price is important to marketers, because it represents marketers' assessment of the value customers see in the product or service and are willing to pay for a product or service. A number of factors have changed the way marketers undertake the pricing of their products and services.[1]

1. Foreign competition has put considerable pressure on U.S. firms' pricing strategies. Many foreign-made products are high in quality and compete in U.S. markets on the basis of lower price for good value.
2. Competitors often try to gain market share by reducing their prices. The pnce reduction is intended to increase demand from customers who are judged to be sensitive to changes in price.
3. New products are far more prevalent today than in the past. Pricing a new product can represent a challenge, as there is often no historical basis for pricing new products. If a new product is priced incorrectly, the marketplace will react unfavorably and the "wrong" price can do long-term damage to a product's chances for marketplace success.
4. Technology has led to existing products having shorter marketplace lives. New products are introduced to the market more frequently, reducing the "shelf life" of existing products. As a result, marketers face pressures to price products to recover costs more quickly. Prices must be set for early successes inCluding fast sales growth, quick market penetration, and fast recovery of research and development costs.

PRICING OBJECTIVES

Firms rely on price to cover the cost of production, to pay expenses, and to provide the profit incentive necessary to continue to operate the business. We might think of these fac-

MARKETING CAPSULE 9.

1. Price should be viewed from three perspectives:
   a. The customer
   b. The marketer
   c. Society
2. Pricing objectives:
   a. Survival
   b. Profit
   c. Sales
   d. Market share
   e. Image

tors as helping organizations to: (1) survive, (2) earn a profit, (3) generate sales, (4) secure an adequate share of the market, and (5) gain an appropriate image.

1. *Survival:* It is apparent that most managers wish to pursue strategies that enable their organizations to continue in operation for the long term. So survival is one major objective pursued by most executives. For a commercial firm, the price paid by the buyer generates the firn1's revenue. If revenue falls below cost for a long period of time, the firm cannot survive.
2. *Profit:* Survival is closely linked to profitability. Making a $500,000 profit during the next year might be a pricing objective for a firm. Anything less will ensure failure. All business enterprises must earn a long-term profit. For many businesses, long-term profitability also allows the business to satisfy their most important constituents-stockholders. Lower-than-expected or no profits will drive down stock prices and may prove disastrous for the company.
3. *Sales:* Just as survival requires a long-term profit for a business enterprise, profit requires sales. As you will recall from earlier in the text, the task of marketing management relates to managing demand. Demand must be managed in order to regulate exchanges or sales. Thus marketing management's aim is to alter sales patterns in some desirable way.
4. *Market Share:* If the sales of Safeway Supermarkets in the Dallas-Fort Worth metropolitan area account for 30% of all food sales in that area, we say that Safeway has a 30% market share. Management of all firms, large and small, are concerned with maintaining an adequate share of the market so that their sales volume will enable the firm to survive and prosper. Again, pricing strategy is one of the tools that is significant in creating and sustaining market share. Prices must be set to attract the appropriate market segment in significant numbers.
5. *Image:* Price policies play an important role in affecting a firm's position of respect and esteem in its community. Price is a highly visible communicator. It must convey the message to the community that the firm offers good value, that it is fair in its dealings with the public, that it is a reliable place to patronize, and that it stands behind its products and services.

DEVELOPING A PRICING STRATEGY

While pricing a product or service may seem to be a simple process, it is not. As an illustration of the typical pricing process, consider the following quote: "Pricing is guesswork. It is usually assumed that marketers use scientific methods to determine the price of their products. Nothing could be further from the truth. In almost every case, the process of decision is one of guesswork."2

Good pricing strategy is usually based on sound assumptions made by marketers. It is also based on an understanding of the two other perspectives discussed earlier. Clearly, sale pricing may prove unsuccessful unless the marketer adopts the consumer's perspective toward price. Similarly, a company should not charge high prices if it hurts society's health. Hertz illustrates how this can be done in the Integrated Marketing Box that follows.

A pricing decision that must be made by all organizations concems their competitive position within their industry. This concern manifests itself in either a competitive pricing strategy or a nonprice competitive strategy. Let's look at the latter first.

Nonprice Competition

Nonprice competition means that organizations use strategies other than price to attract customers. Advertising, credit, delivery, displays, private brands, and convenience are all example of tools used in nonprice competition. Businesspeople prefer to use nonprice competition

INTEGRATED MARKETING 9.1

HOW TO SELECT THE BEST PRICE

The Hertz Corporation knows when its rental cars will be gone and it knows when the lots will be full. How? By tracking demand throughout past six years. "We know, based on past performance and seasonal changes, what times of year there is a weak demand, and when there is too much demand for our supply of cars," says Wayne Meserue, director of pricing and yield management at Hertz. To help strike a balance, the company uses a pricing strategy called "yield management" that keeps supply and demand in check. The strategy looks at two aspects of Hertz's pricing: the rate that is charged and the length of the rental.

"Price is a legitimate rationing device," says Meserue. "What we're really talking about is efficient distribution, pricing, and response in the marketplace." For example, there are times when cars are in great demand. "It's always a gamble, but it's definitely a calculated gamble. With yield management, we monitor demand day by day, and adjust (prices as necessary)," Meserue says.

Hertz also uses length of rental as a yield management device. For instance, they established a three-night minimum for car rentals during President's Day weekend in Febmary. "We didn't want to be turning away business for someone who wanted the car for five nights just because we had given our cars to people who came in frrst for one night," says Meserue, who adds that it's often better for Hertz to mandate a minimum number of days for a rental, because it ensures that cars will be rented for more days.

A smart pricing strategy is essential for increasing profit margins and reducing supply. Yet at last count, only 15% of large corporations were conducting any sort of pricing research, reports Robert Dolan, professor at Harvard Business School. "People don't realize that if you can raise your prices by just one percent, that's a big increase in your profit margin," he says. For example, if a supermarket is operating with a two-percent net margin, raising the prices by one percent will increase profitability by 33%. "The key is not taking one percent across the board, but raising it 10% for 10% of your customers," says Dolan, "Find those segments of the market that are willing to take the increase." That doesn't mean that companies can automatically pass their cost increases on the customer, notes Dolan. If the costs are affecting an entire industry, then those costs can be passed through easily to the consumer, because competitors will likely follow the lead.

A fundamental point in smart pricing, according to Dolan: base prices on the value to the customer. As much as people talk about customer focus, they often price according to their own costs, Companies can profit from customizing prices to different customers. The value of a product can vary widely depending on factors such as age and location.

Source: Ginger Conlon, "Making Sure the Price is Right;' *Sales and Marketing Management*, May 1996, pp. 92–93; Thomas T. Nagle and Reed K. Holden, *The Strategy and Tactics of Pricing*, 2nd ed., Upper Saddle River, N.J.: Prentice Hall, Inc. 1995; William C. Symonds, "'Build a Better Mousetrap' is No Claptrap;' *Business Week*, February 1, 1999, p. 47; Marcia Savage, "Intel to Slash Pentium II Prices," *Company Reseller News*, February 8, 1999, pp. 1, 10.

AD 9.1 An example of nonprice competition.

rather than price competition, because it is more difficult to match nonprice characteristics. Competing on the basis of price may also have a deleterious impact on company profitability. Unfortunately, when most businesses think about price competition, they view it as matching the lower price of a competitor, rather than pricing smarter. In fact, it may be wiser not to engage in price competition for other reasons. Price may simply not offer the business a competitive advantage (employing the value equation).

Competitive Pricing

Once a business decides to use price as a primary competitive strategy, there are many weJ]-established tools and techniques that can be employed. The pricing process normally begins with a decision about the company's pricing approach to the market.

Approaches to the Market

Price is a very important decision criteria that customers use to compare alternatives. It also contributes to the company's position. In general, a business can price itself to match its competition, price higher, or price lower. Each has its pros and cons.

Pricing to Meet Competition Many organizations attempt to establish prices that, on average, are the same as those set by their more important competitors. Automobiles of the same size and having equivalent equipment tend to have similar prices. This strategy means that the organization uses price as an indicator or baseline. Quality in production, better service, creativity in advertising, or some other element of the marketing mix are used to attract customers who are interested in products in a particular price category,

The keys to implementing a strategy of meeting competitive prices are an accurate definition of competition and a knowledge of competitor's prices. A maker of hand-crafted leather shoes is not in competition with mass producers. If he/she attempts to compete with mass producers on price, higher production costs will make the business unprofitable. A more realistic definition of competition for this purpose would be other makers of hand-crafted leather shoes. Such a definition along with a knowledge of their prices would allow a manager to put the strategy into effect. Banks shop competitive banks every day to check their prices.

Pricing Above Competitors Pricing above competitors can be rewarding to organizations, provided that the objectives of the policy are clearly understood and that the marketing mix is used to develop a strategy to enable management to implement the policy successfully.

Pricing above competition generally requires a clear advantage on some nonprice element of the marketing mix. In some cases, it is possible due to a high price- quality association on the part of potential buyers. But such an assumption is increasingly dangerous in today's information-rich environment. *Consumer Reports* and other similar publications make objective product comparisons much simpler for the consumer. There are also hundreds of dot.com companies that provide objective price comparisons. The key is to prove to customers that your product justifies a premium price.

Pricing Below Competitors While some firms are positioned to price above competition, others wish to carve out a market niche by pricing below competitors. The goal of such a policy is to realize a large sales volume through a lower price anci profit margins. By controlling costs and reducing services, these firms are able to earn an acceptable profit, even though profit per unit is usually less.

Such a strategy can be effective if a significant segment of the market is price-sensitive and/or the organization's cost structure is lower than competitors. Costs can be reduced by increased efficiency, economics of scale, or by reducing or eliminating such things as credit, delivery, and advertising. For example, if a firm could replace its field sales force with telemarketing or online access, this function might be performed at lower cost. Such reductions often involve some loss in effectiveness, so the tradeoff must be considered carefully.

Historically, one of the worst outcomes that can result from pricing lower than a competitor is a "price war." Price wars usually occur when a business believes that price-cutting produces increased market share, but does not have a true cost advantage. Price wars are often caused by companies misreading or misunderstanding competitors. Typically, price wars are overreactions to threats that either aren't there at all or are not as big as they seem.

Another possible drawback when pricing below competition is the company's inability to raise price or image. A retailer such as K-mart, known as a discount chain, found it impossible to reposition itself as a provider of designer women's clothiers. Can you image Swatch selling a $3,000 watch?

How can companies cope with the pressure created by reduced prices? Some are redesigning products for ease and speed of manufacturing or reducing costly features that their customers do not value. Other companies are reducing rebates and discounts in favor of stable, everyday low prices (ELP). In all cases, these companies are seeking shelter from pricing pressures that come from the discount mania that has been common in the U.S. for the last two decades.

NEW PRODUCT PRICING

A somewhat different pricing situation relates to new product pricing. With a totally new product, competition does not exist or is minimal. What price level should be set in such cases? Two general strategies are most comn:on-penetration and skimming. *Penetration pricing* in the introductory stage of a new proQucl's lifecyc1e means accepting a lower profit Jl1argin and to price relatively low. Such a strategy should generate greater sales and establish the new product in the market more quickly. *Price skimming* involves the top part of the demand curve. Price is set relatively high to generate a high profit margin and sales are limited to those buyers willing to pay a premium to get the new product (see Figure 9.3).

NEWSLINE: THE RISK OF FREE PC'S

There's no such thing as a free PC. But judging from the current flood of offers for free or deeply discounted computers, you might think that the laws of economics and common sense have been repealed. In fact, all of those deals come with significant strings attached and reqUire close examination. Some are SImply losers. Others can provide substantial saVings, but only for the right customers.

The offers come in two categories. In one type, consumers get a free computer along with free Internet access, but have to accept a constant stream of advertising on the screen. In the other category, the customer gets a free or deeply discounted PC in exchange for a long-term contract for paid Internet services.

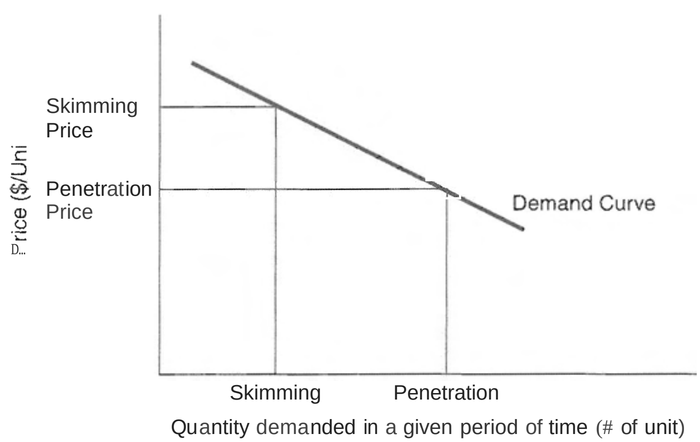
Most of these are attractive deals, but the up-front commitment to $700 or more worth of Internet service means they are not for everyone. One group that will find little value in the arrangement is college students, since nearly all schools provide free and often high-speed Net access. Others who could well end up losing from these deals are the lightest and heaviest users of the Internet. People who want Internet access only to read e-mail and do a little light Web browsing would likely do better to buy an inexpensive computer and sign up for a $10-a-month limited-access account with a service provider.

People who use the Internet a lot may also be poor candidates. That's because three years is a long commitment at a time when Internet access technology is changing rapidly. Heavy users are likely to be the earliest adopters of high-speed cable or digital subscriber line service as it becomes available in their areas.

Sources: Stephen H. Weldstrom. "The High Cost of Free PCs." *Business Week,* September 13, 1999. p. 20; Steven Bruel. "Why Talk's Cheap," *Business Week*, Septeber 13. 1999, pp. 34-36; Mercedes M. Cardona and Jack Neff, "Everything's at a Premium," *Advertising Age,* August 2. 1999, pp. 12-13.

Which strategy is best depends on a number of factors. A penetration strategy would generally be supported by the following conditions: price-sensitive consumers, opportunity to keep costs low, the anticipation of quick market entry by competitors, a high likelihood for rapid acceptance by potential buyers, and an adequate resource base for the firm to meet the new demand and sales.

A skimming strategy is most appropriate when the opposite conditions exist. A premium product generally supports a skimming strategy. In this case, "premium" doesn't just denote high cost of production and materials; it also suggests that the product may be rare or that the demand is unusually high. An example would be a $500 ticket for the World Series or an $80,000 price tag for a limited-production sports car. Having legal protection via a patent or copyright may also allow for an excessively high price. Intel and their Pentium chip possessed this advantage for a long period of time. In most cases, the initial high price is gradually reduced to match new competition and allow new customers access to the product.



Skimming generates a higher profit margin while penetration generates greater volume.

FIGURE 9.3 Penetration and skimming: pricing strategies as they relate to the demand curve

PRICE LINES

You are already familiar with price lines. Ties may be priced at $15, $17, $20, and $22.50; bluejeans may be priced at $30, $32.95, $37.95, and $45. Each price must be far enough apart so that buyers can see definite quality differences among products. Price lines tend to be associated with consumer shopping goods such as apparel, appliances, and carpeting rather than product lines such as groceries. Customers do very little comparison-shopping on the latter.

Price lining serves several purposes that benefit both buyers and sellers. Customers want and expect a wide assortment of goods, particularly shopping goods. Many small price differences for a given item can be confusing. If ties were priced at $15, $15.35, $15.75, and so on, selection would be more difficult; the customer could not judge quality differences as reflected by such small increments in price. So, having relatively few prices reduces the confusion.

From the seller's point of view, price lining holds several benefits. First, it is simpler and more efficient to use relatively fewer prices. The product/service mix can then be tailored to selected price points. *Price points* are simply the different prices that make up the line. Second, it can result in a smaller inventory than would otherwise be the case. It might increase stock turnover and make inventory control simpler. Third, as costs change, either increasing or decreasing the prices can remain the same, but the quality in the line can be changed. For example, you may have bought a $20 tie fifteen years ago. You can buy a $20 tie today, but it is unlikely that today's $20 tie is of the same fine quality as it was in the past. While customers are likely to be aware of the differences, they are nevertheless still able to purchase a $20 tie. During inflationary periods the quality/price point relationship changes. From the point of view of salespeople, offering price lines will make selling easier. Salespeople can easily learn a small number of prices. This reduces the likelihood that they will misquote prices or make other pricing errors. Their selling effort is therefore more relaxed, and this atmosphere will influence customers positively. It also gives the salesperson flexibility. If a customer can't afford a $2,800 Gateway system, the $2,200 system is suggested.

PRICE FLEXIBILITY

Another pricing decision relates to the extent of *price flexibility*. A flexible pricing policy means that the price is bid or negotiated separately for each exchange. This is a common practice when selling to organizational markets where each transaction is typically quite large. In such cases, the buyer may initiate the process by asking for bidding on a product or service that meets certain specifications. Alternatively. a buyer may select a supplier and attempt to negotiate the best possible price. Marketing effectiveness in many industrial markets requires a certain amount of price flexibility.

Discounts and Allowances

In addition to decisions related to the base price of products and services, marketing managers must also set policies related to the use of discounts and allowances. There are many different types of price reductions-each designed to accomplish a specific purpose.

Quantity discounts are reductions in base price given as the resuL of a buyer purchasing some predeterm:ned quantity of merchandise. A noncumulative quantity discount applies

AD 9.2 A rebate can be a very effective price discount.

to each purchase and is intended to encourage buyers to make larger purchases. This means that the buyer holds the excess merchandise until it is used, possibly cutting the inventory cost of the seller and preventing the buyer from switching to a competitor at least until the stock is used. A cumulative quantity discount applies to the total bought over a period of time. The buyer adds to the potential discount with each additional purchase. Such a policy helps to build repeat purchases. Building material dealers, for example, find such a policy quite useful in encouraging builders to concentrate their purchase with one dealer and to continue with the same dealer over time. It should be noted that such cumulative quantity discounts are extremely difficult to defend if attacked in the courts.

Seasonal discounts are price reductions given or out-of-season merchandise. An example would be a discount on snowmobiles during the summer. The intention of such discounts is to spread demand over the year. This can allow fuller use of production facilities and improved cash flow during the year. Electric power companies use the logic of seasonal discounts to encourage customers to shift consumption to off-peak periods. Since these companies must have production capacity to meet peak demands, the lowering of the peak can lessen the generating capacity required.

Cash discounts are reductions on base price given to customers for paying cash or within some short time period. For example, a two-percent discount on bills paid within ten days is a cash discount. The purpose is generally to accelerate the cash flow of the organization.

Trade discounts are price reductions given to middlemen (e.g., wholesalers, industrial distributors, retailers) to encourage them to stock and give preferred treatment to an organization's products. For example, a consumer goods company may give a retailer a 20% discount to place a larger order for soap. Such a discount might also be used to gain shelf space or a preferred position in the store.

Personal allowances are similar devices aimed at middlemen. Their purpose is to encourage middlemen to aggressively promote the organization's products. For example, a furniture manufacturer may offer to pay some specified amount toward a retailer's advertising expenses if the retailer agrees to include the manufacturer's brand name in the ads.

INTEGRATED MARKETING

BEAM ME UP, SCOITYI

You remember William Shatner, a.k.a. Captain James T. Kirk. As Kirk, he represented the epitome of integrity and professionalism. Death was better than compromise. Yet, here he is doing rather strange TV ads for Pliceline.com. Inc. Why? Probably because he's being paid a ton of money, and he's having fun. Working for an apparent winner is also exciting.

We say "apparent" because transferring Priceline's patented "name your own price" system of selling airline tickets, groceries, cars, gasoline, telephone minutes, and a raft of other products is proving quite difficult. Complicating matters, several airlines and hotels are studying whether to launch Web services that could cut the legs out from under Priceline's established travel businesses.

Priceline could soon face stiff competition from its own suppliers. Hyatt, Marriott, Starwood, and Cendant-most of which sell excess hotel rooms through Priceline-are having serious discussions about starting their own company to distribute over the Internet. Essentially, these chains worry that by handing sales to Priceline, they could lose control of their customers. Several airlines have the same concerns.

To stay one step ahead, Priceline has decided to introduce 18 new products. Initially, Priceline generated 90% of its revenues from airline tickets, rental cars, and hotel rooms. By 2003, Priceline estimates that only 50% of revenues wiII come from these sources.

By June 2000, users were able to name their price for long-distance phone service, gasoline, and cruises. At the end of 2000, Priceline.com started selling blocks of long-distance phone time to small companies. Later, it will offer them ad space, freight services, and office equipment. New joint ventures are in the works with companies in Hong Kong, Australia, Japan, Europe, and Latin America.

Execs at Priceline say they're on the right track and that they're building a broad-based discounting powerhouse.

Sources: Pamela L. Moore, "Name Your Price-For Everything?" *Business Week*, ApriJ 17, 2000, pp. 72-75; "Priceline.com to Let Callers Name Price," *Los Angeles Times*, Nov. 9, 1999, p. 3; "Priceline to offer auto insurance," *Wall Street Journal*, Aug. 3, 2000, p. J2; "Priceline teams up with 3 phone companies to sell long distance," *Wall Street Journal*, May 2000, p. 16.

Some manufacturers or wholesalers also give prize money called *spijfs* for retailers to pass on to the retailer's sales clerks for aggressively selling ce11ain items. This is especially common in the electronics and clothing industries, where it is used primarily with new products, slow movers, or high margin items.

Trade-in allowances alSO reduce the base price of a product or service. These are often used to allow the seller to negotiate the best price with a buyer. The trade-in may, of course, be of value if it can be resold. Accepting trade-ins is necessary in marketing many *types* of products. A construction company with a used grader worth $70,000 would not likely buy a new model from an equipment company that did not accept trade-ins, particularly when other companies do accept them.

PRICE BUNDLING

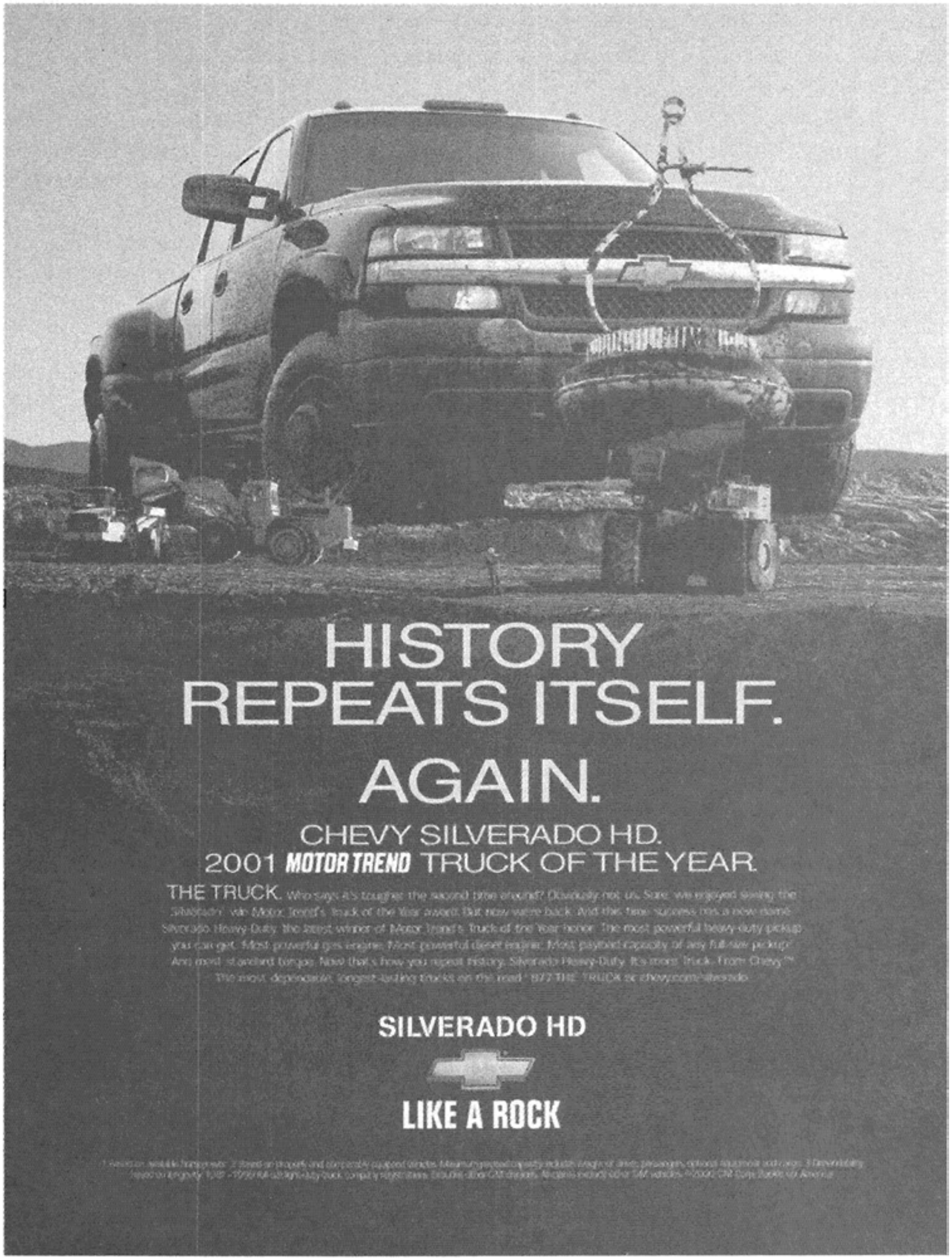
A very popular pricing strategy, *price bundling,* is to group similar or complementary products and to charge a total price that is lower if they were sold separately. Dell Computers and Gateway Computers follow this strategy by combining different components for a set price. Customers assume that these computer experts are putting together an effective product package and they are paying less. The underlying assumption of this pricing strategy is that the increased sales generated will more than compensate for a lower profit margin. It may also be a way of selling a less popular product by combining it with popular ones. Clearly, industries such as financial services and telecommunications are big users of this.

PSYCHOLOGICAL ASPECTS OF PRICING

Price, as is the case with certain other elements in the marketing mix, appears to have meaning to many buyers that goes beyond a simple utilitarian statement. Such meaning is often referred to as the *psychological aspect* of pricing. Inferring quality from price is a common example of the psychological aspect. A buyer may assume that a suit priced at $500 is of higher quality than one priced at $300. From a cost-of-production, raw material, or workmanship perspective, this mayor may not be the case. The seller may be able to secure the higher price by nonprice means such as offering alterations and credit or the benefit to the buyer may be in meeting some psychological need such as ego enhancement. In some situations, the higher price may oe paid simply due to lack of information or lack of comparative shopping skills. For some products or services, the quantity demanded may act.lally rise to some extent as price is increased. This might be the case with an item such as a fur coat. Such a pricing strategy is called *prestige pricing.*

Products and services frequemly have *customary prices* in the minds of consumers. A customary price is one that customers identify with particular items. For example, for many decades a five-stick package of chewing gum cost five cents and a six-ounce bottle of Coca-Cola cost five cents. Candy bars now cost 60 cents or more, a customary price for a standard-sized bar. Manufacturers tend to adjust their wholesale prices to permit retailers in using customary pricing. However, as we have witnessed duriDg the past decade, prices have changed so often that customary prices are weakened.

Another manifestation of the psychological aspects of pricing is the use of *odd prices.*[3] We call prices that end in such digits as 5, 7, 8, and 9 "odd prices" (e.g., $2.95, $15.98, or $299.99). Even prices are $3, $16, or $300. For a long time marketing people have attempted to explain why odd prices are used. It seems to make little difference whether one pays $29.95 or $30 for an item. Perhaps one of the most often heard explanations concerns the



AD 9.3 Winning an award is a psychological aspect of price.

psychological impact of odd prices on customers. The explanation is that customers perceive even prices such as $5 or $10 as regular prices. Odd prices, on the other hand, appear to represent bargains or savings and therefore encourage buying. There seems to be some movement toward even pricing; however, odd pricing is still very common. A somewhat related pricing strategy is *combination pricing.* Examples are two-far-one, buy-one-get-one-free. Consumers tend to react very positively to these pricing techniques.

MARKETING CAPSULE

1. Developing a pricing strategy
   a. Nonprice competition
   b. Competitive pricing
2. New product pricing
   a. Penetration
   b. Skimming
3. Price lining means a number of sequential price points are offered within a product category.
4. Price flexibility allows for different prices charged for different customers and/or under different situations.
5. Price bundling groups similar or complementary products and charges a total price that is lower than if they were sold separately.
6. Certain pricing strategies, such as prestige pricing, customary pJ1cing, or odd pricing, play on the psychological perspectives of the consumer.

ALTERNATIVE APPROACHES TO DETERMINING PRICE

Price deteonination decisions can be based on a number of factors, including cost, demand, competition, value, or some combination of factors. However, while many marketers are aware that they should consider these factors, pricing remains somewhat of an art. For purposes of discussion, we categorize the alternative approaches to detennining price as follows: (1) cost-oriented pricing; (2) demand-oriented pricing; and (3) value-based approaches.

Cost-Oriented Pricing: Cost-Plus and Mark-Ups

The *cost-plus* method, sometimes called *gross margin pricing,* is perhaps most widely used by marketers to set price. The manager selects as a goal a particular gross margin that will produce a desirable profit level. Gross margin is the difference between how much the goods cost and the actual price for which it sells. This gross margin is designated by a percent of net sales. The percent selected varies among types of merchandise. That means that one product may have a goal of 48% gross margin while another has a target of 33⅓ % or 7.%.

A primary reason that the cost-plus method is attractive to marketers is that they do not have to forecast general business conditions or customer demand. If sales volume projections are reasonably accurate, profits will be on target. Consumers may also view this method as fair, since the price they pay is related to the cost of producing the item. Likewise, the marketer is sure that costs are covered.

A major disadvantage of cost-plus pricing is its inherent inflexibility. For example, department stores have often found difficulty in meeting competition from discount stores, catalog retailers, or furniture warehouses because of their commitment to cost-pius pricing. Another disadvantage is that it does not take into account consumers' perceptions of a product's value. Finally, a company's costs may fluctuate so constant price changing is not a viable strategy.

When middlemen use the teon *mark-Up,* they are referring to the difference between the average cost and price of all merchandise in stock, for a particular department, or for an individual item. The difference may be expressed in dollars or as a percentage. For example, a man's tie costs $4.60 and is sold for $8. The dollar mark-up is $3.40. The mark-up may be designated as a percent of selling price or as a percent of cost of the merchandise. In this example, the mark-up is 74% of cost ($3.40/$4.60) or 42.5% of the retail price ($3.40/$8).

There are several reasons why expressing mark-up as a percentage of selling price is preferred to expressing it as a percentage of cost. One is that many other ratios are expressed as a percentage of sales. For instance, selling expenses are expressed as a percentage of sales. If selling costs are 8%, this means that for each $100,000 in net sales, the cost of selling the merchandise is $8,000. Advertising expenses, operating expenses, and other types of expenses are quoted in the same way. Thus, there is a consistency when making comparisons in expressing all expenses and costs, including mark-up, as a percentage of sales (selling price).

Middlemen receive merchandise daily and make sales daily. As new shipments are received, the goods are marked and put into stock. *Cumulative mark-up* is the term applied to the difference between total dollar delivered cost of all merchandise and the total dollar price of the goods put into stock for a specified period of time. The original mark-up at which individual items are put into stock is referred to as the *initial mark-up*.

Maintained mark-up is another important concept. The maintained mark-up percentage is an essential figure in estimating operating profits. It also provides an indication of efficiency. Maintained mark-up, sometimes called *gross cost of goods*, is the difference between the actual price for which all of the merchandise is sold and the total dollar delivered cost of the goods exclusive of deductions. The maintained mark-up is typically less than the initial mark-up due to mark-downs and stock shrinkages from theft, breakage, and the like. Maintained mark-up is particularly important for seasonal merchandise that will likely be marked-down substantially at the end of the season.

Although this pricing approach may seem overly simplified, it has definite merit. The problem facing managers of certain types of businesses such as retail food stores is that they must price a very large number of items and change many of those prices frequently. The standard mark-up usually reflects historically profitable margins and provides a good gui.deline for pricing.

To illustrate this cost-based process of pricing, let's look at the case of Johnnie Walker Black Label Scotch Whiskey. This product sells for about $30 in most liquor stores. How was this price derived?

$5.00 production, distillation, maturation + $2.50 advertising + $3.11 distribution + $4.39 taxes + $7.50 mark-up (retailer) + $7.50 net margin (manufacturer)

Certainly costs are an important component of pricing. No firm can make a profit until it covers its costs. However, the process of determining costs and then setting a price based on costs does not take into consideration what the customer is willing to pay at the marketplace. As a result, many companies that have set out to develop a product have fallen victim to the desire to continuously add features to the product, thus adding cost. When the product is finished, these companies add some percentage to the cost and expect customers to pay the resulting price. These companies are often disappointed, as customers are not willing to pay this cost-based price.

Break-Even Analysis

A somewhat more sophisticated approach to cost-based pricing is the *break-even analysis*. The information required for the formula for break-even analysis is available from the accounting records in most firms. The break-even price is the price that will produce enough revenue to cover all costs at a given level of production. Total cost can be divided into fixed and variable (total cost = fixed cost + variable cost). Recall that *fixed cost* does not change as the level of production goes up or down. The rent paid for the building to house the operation might be an example. No cost is fixed in the long run, but in the short run, many expenses cannot iealistically be changed. *Variable cost* does change as production is increased or decreased. For example, the cost of raw material to make the product will vary with production.

A second shortcoming of break-even analysis is it assumes that variable costs are constant. However, wages will increase with overtime and shipping discounts will be obtained. Third, break-even assumes that all costs can be neatly categorized as fixed or variable. Where advertising expenses are entered, break-even analysis will have a significant impact on the resulting break-even price and volume.

Target Rates of Return

Break-even pricing is a reasonable approach when there is a limit on the quantity which a finn can provide and particularly when a *target return* objective is sought. Assume, for example, that the firm with the costs illustrated in the previous example detennines that it can provide no more than 10,000 units of the product in the next period of operation. Furthermore, the firm has set a target for profit of 20% above total costs. Referring again to internal accounting records and the changing cost of production at near capacity levels, a new total cost curve is calculated. From the cost curve profile, management sets the desirable level of produclion at 80% of capacity or 8,000 units. From the total cost curve, it is determined that the cost for producing 8,000 units is $18,000. Twenty percent of $18,000 is $3,600. Adding this to the total cost at 8,000 units yields the point at that quantity through which the total revenue curve must pass. Finally, $21,600 divided by 8,000 units yields the price of $2.70 per unit; here the $3,600 in profit would be realized. The obvious shortcoming of the target return approach to pricing is the absence of any infOlmation concerning the demand for the product at the desired price. It is assumed that all of the units will be sold at the price which provides the desired return.

It would be necessary, therefore, to determine whether the desired price is in fact attractive to potential customers in the marketplace. If break-even pricing is to be used, it should be supplemented by additional information concerning customer perceptions of the relevant range of prices for the product. The source of this information would most commonly be survey research, as well as a thorough review of pricing practices by competitors in the industry. In spite of their shortcomings, break-even pricing and target return pricing are very common business practices.

Demand-Oriented Pricing

Demand-oriented pricing focuses on the nature of the demand curve for the product or service being priced. The nature of the demand curve is influenced largely by the structure of the industry in which a finn competes. That is, if a firm operates in an industry that is extremely competitive, price may be used to some strategic advantage in acquiring and maintaining market share. On the other hand, if the firm operates in an environment with a few dominant players, the range in which price can vary may be minimal.

Value-Based Pricing

If we consider the three approaches to setting price, cost-based is focused entirely on the perspective of the company with very little concern for the customer; demand-based is focused on the customer, but only as a predictor of sales; and value-based focuses entirely on the customer as a determinant of the total price/value package. Marketers who employ value-based pricing might use the following definition: "It is what you think your product is worth to that customer at that time." Moreover, it acknowledges several marketing/price truths:

- To the customer, price is the only unpleasant part of buying.
- Price is the easiest marketing tool to copy.
- Price represents everything about the product.

Still, value-based pricing is not altruistic. It asks and answers two questions: (1) what is the highest price I can charge and still make the sale? and (2) am I willing to sell at that price? The first question must take two primary factors into account: customers and competitors. The second question is influenced by two more: costs and constraints. Let's discuss each briefly.

Many customer-related factors are important in value-based pricing. For example, it is critical to understand the *customer buying process*. How important is price? When is it considered? How is it used? Another factor is the *cost ofswitching.* Have you ever watched the TV program "The Price is Right"? If you have, you know that most consumers have poor price knowledge. Moreover, their knowledge of comparable prices within a product category--e.g., ketchup-is typically worse. So *price knowledge* is a relevant factor. Finally, the marketer must assess the customers' *price expectations.* How much do you expect to pay for a large pizza? Color TV? DVD? Newspaper? Swimming pool? These expectations create a phenomenon called "sticker shock" as exhibited by gasoline, automobiles, and ATM fees.

A second factor influencing value-based pricing is *competitors.* As noted in earlier chapters, defining competition is not always easy. Of course there are like-category competitors such as Toyota and Nissan. We have already discussed the notion of pricing above, below, and at the same level of these direct competitors. However, there are also indirect competitors that consumers may use to base price comparisons. For instance, we may use the price of a vacation as a basis for buying vacation clothes. The cost of eating out is compared to the cost of groceries. There are also instances when a competitor, especially a market leader, dictates the price for everyone else. Weyerhauser determines the price for lumber. Kellogg establishes the price for cereal.

If you're building a picnic table, it is fairly easy to add up your receipts and calculate costs. For a global corporation, determining costs is a great deal more complex. For example, calculating *incremental* costs and identifying *avoidable* costs are valuable tasks. *Incremental* cost is the cost of producing each additional unit. If the incremental cost begins to exceed the incremental revenue, it is a clear sign to quit producing. *Avoidable* costs are those that are unnecessary or can be passed onto some other institution in the marketing channel. Adding costly features to a product that the customer cannot use is an example of the former. As to the latter, the banking industry has been passing certain costs onto customers.

Another consideration is *opportunity costs.* Because the company spent money on store remodeling, they are not able to take advantage of a discounted product purchase. Finally, costs vary from market-to-market as well as quantities sold. Research should be conducted to assess these differences.

Although it would be nice to assume that a business has the freedom to set any price it chooses, this is not always the case. There are a variety of *constraints* that prohibit such freedom. Some constraints are formal, such as government restrictions in respect to strategies like collusion and price-fixing. This occurs when two or more companies agree to charge the same or very similar prices. Other constraints tend to be informal. 5xamples include matching the price of competitors, a traditional price charged for a particular product, and charging a price that covers expected costs.

Ultimately, value-based pricing offers the following three tactical recommendations:

- Employ a segmented approach toward price, based on such criteria as customer type, location, and order size.

MARKETING CAPSULE

1. Approaches to determining price include:
   a. Cost-plus and mark-ups
   b. Demand-oriented pricing
   c. Value-based approaches to pricing

- Establish highest possible price level and justify it with comparable value.
- Use price as a basis for establishing strong customer relationships.[4]

THE FUTURE OF PRICING

For too long, pricing decisions have been dominated by economists, discounters, and financial analysts. While making a reasonable profit remains a necessity, pricing must become a more strategic element of marketing. Smarter pricing, as portrayed by the value-based strategy, appears to represent the future. A case in point is the Ford Motor Co., which managed to earn $7.2 billion in 2000, more than any automaker in history. Despite a loss of market share, the key to their success was a 420,000-unit decrease in sales of low-margin vehicles such as Escorts and Aspires, and a 600,000-unit increase in sales of high-margin vehicles such as Crown Victorias and Explorers. Ford cut prices on its most profitable vehicles enough to spur demand, but not so much that they ceased to have attractive margins.

THE WALL STREET JOURNAL.

IN PRACTICE

Customers make judgments about pricing based on perceived value, not production costs. For organizations, however, pricing determines the primary source of revenue for the business. Various market segments and their respective price sensitivities must be considered when marketers decide on a pricing strategy.

Increasingly, marketers are responsible for pricing. Marketers must understand strategies previously reserved for economlsls and financial analysts. Questions of price points, price lining, and price bundling now fall to marketers.

What do marketers need to know to price products to maximize profits and capture market share? Break-even analyses, target rates of return, and mark-ups are a few of the processes marketers must master.

To learn more about profits and pricing, click on the Interactive Journal's link to **Money & Investing** on the **Front Section.**

In this section you'll find information about interest rates, economic conditions, and venture capital. Because interest rates affect consumer spending, it is important to understand economic indicators and their impact

The **Business Focus** section of **Marketplace** is a good resource for articles that discuss various business marketing issues, including pricing.

Naming your own price is the strategy for Priceline.com. Customers name their own price for plane tickets, hotel rooms, and rental cars. Initially, the company relished great success. Powever, it has recently suffered financial losses, due in part to the "Name Your Own Price" strategy. Visit the site now at www.priceline.com.

Facilitating exchanges between customers is a successful business strategy for eBay. Calling itself "the worid's online marketplace," eBay has created a trading medium for anyone interested in buying or selling items online. Items range from one-of-a-kind collectibles to everyday items such as musical instruments and sporting goods. Check out the Web site now at www.ebay.com.

DELIVERABLE

The airline industry competes heavily on price. Select two airlines and research fares for one round trip ticket on each airline, any destination. Visit several Web sites that sell airline tickets and compare fares. Compare these prices to those offered on the airlines' Web sites. Check your local newspaper for fare prices, too. Write a one-page overview of your findings.

DISCUSSION QUESTIONS

1. How do organizations decide whether to price to meet, price above, or price below competition? How do organizations measure the success or failure of their chosen strategy?
2. Are you price sensitive to any products? Do you engage in conparative shopping, searching for the "best deal"?
3. How has the Internet affected pricing strategies? How do Internet companies compete with traditional "brick and mortar" companies **in** pricing?

SUMMARY

The chapter begins by defining price from the perspective of the consumer, society, and the business. Each contributes to our understanding of price and positions it as a competitive advantage.

The objectives of price are fivefold: (1) survival, (2) profit, (3) sales, (4) market share, and (5) image. In addition, a pricing strategy can target to: meet competition, price above competition, and price below competition.

Several pricing tactics were discussed. They include new product pricing, price lining, price flexibility, price bundling, and the psychological aspects of pricing.

The chapter concludes with a description of the three alternative approaches to pricing: cost-oriented, demand-oriented, and value-based.

MARKETER'S VOCABULARY

Demand curve Quantity demanded at various price levels.

Nonprice competition Organization uses strategies other than price to attract customers.

Price war Pricing significantly lower than competition.

Penetration pricing Accepting a lower profit margin during the introduction of a product.

Price skimming Price set relatively high to generate a high profit margin.

Price lining Selling a product with several price points.

Quantity discounts Reduction in base price given as the result of a buyer purchasing some pre-determined quantity of merchandise.

Seasonal discounts Price discount given on out-of-season merchandise.

Cash discounts Reduction on base price given to customers for paying cash or paying within a short period of time.

Trade discount Price reductions given to middlemen to encourage them to stock and give preferred treatment to an organization's product.

Spiffs Prize money given to retailers to pass on to the retailer's sales personnel for selling ce11ain items.

Price bundling Grouping similar complementary products and charging a total price that is lower than if they were sold separately.

Mark-up Difference between the average cost and price of a product.

Break-even price Price that will produce enough revenue to cover all costs at a given level of production.

Value-based pricing What that product is worth to that customer at that point in time.

DISCUSSION QUESTIONS

1. Why is price an important part of the marketing *mix?*
2. Who typically has responsibility for setting prices in most organizations? Why?
3. Discuss the objectives which pricing policies can be established to accomplish.

4. What conditions are necessary if a "pricing above the competition" strategy is to be successful?
5. Discuss the alternative strategies that can be adopted in new product pricing. Under what conditions should each be used?
6. List some advantages of psychological pricing. What are some of the risks?
7. What are some of the more common types of discounts and allowances and the purpose of each?
8. What is price lining? What benefits does price lining hold for customers?
9. What advantage might a uniform delivered price have for a seller?

PROJECT

Interview a marketing person responsible for pricing in their organization.
Assess the type of pricing strategy they use and why. Write a three- to five-page report.

CASE APPLICATION

UNITED TECHTRONICS

United Techtronics faced a major pricing decision with respect to its new video screen television. "We're really excited here at United Techtronics," exclaimed Roy Cowing, founder and president of United Techtronics. "We've made a most significant technological breakthrough in large screen, video television systems." He went on to explain that the marketing plan for this product was now his major area of concern and that what price to charge was the marketing question that was giving him the most difficulty.

Cowing founded United Techtronics (UT) in Boston in 1959. Prior to that time, Cowing had been an associate professor of electrical engineering at M.I.T. Cowing founded UT to manufacUlre and market products making use of some of the electronic inventions he had developed while at M.I.T. Sales were made mostly to the space program and the military.

For a number of years, Cowing had been trying to reduce the company's dependency on government sales. One of the diversification projects that he had committed research and development monies to was the so-called video screen project. The objective of this project was to develop a system whereby a television picture could be displayed on a screen as big as eight to ten feet diagonally. One of UT's engineers made the necessary breakthrough and developed working prototypes. Up to that point, UT had invested $600,000 in the project.

Extra-large television systems were not new. There were a number of companies who sold such systems both to the consumer and commercial (taverns, restaurants, and so on) markets. Most current systems made use of a special magnifying screen. The result of this process is that the final picture lacked much of the brightness of the original small screen. As a result, the picture had to be viewed in a darkened room. There were some other video systems that did not use the magnifying process. These systems used special tubes, but they also suffered from a lack of brightness.

UT had developed a system that was bright enough to be viewed in regular daylight on a screen up to ten feet diagonally. Cowing was unwilling to discuss how this was accomplished. He would only say that a patent protected the process and that he thought it would take at least two to three years for any competitor to duplicate the results of the system.

A number of large and small companies were active in this area. Admiral, General Electric, *RCA*, Zenith, and Sony were all thought to be working on developing large-screen systems directed at the consumer market. Sony was rumored to be ready to introduce a 6O-inch diagonal screen system that would retail for about $2,500. A number of small companies were already producing systems. Advent Corporation, a small New England company, claimed to have sold 4,000 84-inch diagonal units at prices from $1,500 to $2,500, Cowing was adamant that none of these systems gave as bright a picture as UT's, He estimated that about 10,000 large screen systems were sold in 1996.

Cowing expected about 50% of the suggested retail-selling price to go for wholesaler and retailer margins. He expected that UT's direct manufacturing costs would vary depending on the volume produced. He expected direct labor costs to fall at higher production volumes due to the increased automation of the process and improved worker skills.

Material costs were expected to fall due to less waste due to automation. The equipment costs necessary to automate the product process were $70,000 to produce in the 0-5,000 unit range; an additional $50,000 to produce in the 5,001-10,000 unit range; and an additional $40,000 to produce in the 10,001-20,000 unit range. The useful life of this equipment was put at five years. Cowing was sure that production costs were substantially below those of current competitors including Sony. Such was the magnitude of UT's technological breakthrough. Cowing was unwilling to produce over 20,000 units a year in the first few years due to the limited cash resources of the company to support inventories and so on.

Cowing wanted to establish a position in the consumer market for his product. He felt that the long-run potential was greater there than in the commercial market. With this end in mind, he hired a small economic research-consulting firm to undertake a consumer study to determine the likely reaction to alternative retail prices for the system. These consultants took extensive pricing histories of competitive products. They concluded that, "UT's video screen system would be highly price-elastic across a range of prices from $500 to $5,000 both in a primary and secondary demand sense." They went on to estimate the price elasticity of demand in this range to be between 4.0 and 6.5.

Mr. Cowing was considering a number of alternative suggested retail prices. "I can see arguments for pricing anywhere from above Advent's to substantially below Muntz's lowest price,' he said. A decision on pricing was needed soon.

Questions:

1. Should penetration pricing be used or would skimming be better?
2. What should be the base price for the new product?

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AD 9.4 A traditional retail ad.