LECTURE NOTES

CHAPTER OPENING EXAMPLE

NANO, THE CAR PRICED AT ONE LAKH

When Ratan Tata, chairman of Tata Motors, announced his dream of selling a car at one lakh (100,000 rupees or approximately US$2,500), many scoffed. Leaders in the automobile industry around the world questioned the logic of such a proposition.

Tata's car is expected to change the face of the automobile industry, both in India and around the world. It is the first time a two-cylinder gasoline engine is used in a car with a single balancer shaft.

Many are concerned that a car so cheap may not be safe. The company has assured consumers that the car has passed all safety tests, including a full-frontal crash test.

The Nano is half the price of current low-priced cars—China's Chevy and India's Maruti 800. The Maruti engine is considered old while the Nano's twin-cylinder engine is seen as considerably more advanced.

Although the car is fuel efficient, environmentalists are concerned that increased numbers of cars made more available to consumers will only result in more pollution.

I. STEP 4: SELECT AN APPROXIMATE PRICE LEVEL [LO1]

A key to a marketer's setting a final price for a product is to find an approximate price level to use as a reasonable starting point. There are four common approaches to helping find this approximate price level.

A. Demand-Oriented Pricing Approaches

Demand-oriented approaches weigh factors underlying expected customer tastes and preferences more heavily than such factors as cost, profit, and competition when selecting a price level.

1. Skimming Pricing.

a. A firm introducing a new or innovative product can use **skimming pricing**, setting the highest initial price that customers really desiring the product are willing to pay.

- These customers are not very price sensitive. They weigh the new product's price, and quality against the same characteristics of substitutes.

- As consumer demand is satisfied, the firm lowers the price to attract another, more price-sensitive segment.
- Skimming pricing gets its name from skimming successive layers of "cream," or customer segments, as prices are lowered in a series of steps.

b. Skimming pricing is an effective strategy when:

- Enough customers are willing to buy the product at the high initial price to make these sales profitable.
- The high initial price will not attract competitors.
- Lowering price has only a minor effect on increasing the sales volume and reducing the unit costs.
- Customers interpret the high price as high quality.
- These four conditions are most likely to exist when patents or copyrights protect the new product or its uniqueness is understood and valued by consumers.

2. Penetration Pricing.

a. Setting a low initial price on a new product to appeal immediately to the mass market is **penetration pricing**, the exact opposite of skimming pricing.

b. The conditions favoring penetration pricing are:

- Many segments of the market are price sensitive.
- A low initial price discourages competitors from entering the market.
- Unit production and marketing costs fall dramatically as production volumes increase.

c. A firm using penetration pricing may:

- Maintain the initial price for a time to gain profit lost from its low introductory level.
- Lower the price further, counting on the new volume to generate the necessary profit.

d. Penetration pricing may follow skimming pricing:

- A firm might initially price a product high to attract price-insensitive consumers as well as recoup initial R&D costs and introductory promotional expenses.
- Then, penetration pricing is used to appeal to a broader segment of the population and increase market share.

3. **Prestige Pricing**.

   a. **Prestige pricing** involves setting a high price so that quality- or status-conscious consumers will be attracted to the product and buy it.

   b. In Figure 14-3A:

      - The demand curve slopes downward and to the right between points A and B but turns back to the left between points B and C because demand is actually reduced between points B and C.
      - From A to B buyers see the lowering of price as a bargain and buy more; from B to C they become dubious about the quality and prestige and buy less.
      - A marketing manager's pricing strategy here is to stay above price P_o (the initial price).

   c. Products with an element of prestige pricing in them may sell worse at lower prices than at higher ones because buyers tend to associate a lower price with lower quality.

MARKETING MATTERS

Energizer's Lesson in Price Perception— Value Lies in the Eye of the Beholder

The commercialization of new alkaline battery technology at a price that creates value for consumers is not always obvious or easy. Just ask the marketing executives at Energizer about their experience with pricing Energizer Advanced Formula and Energizer e^2AA alkaline batteries.

When Duracell launched its high-performance Ultra brand with a 25 percent price premium over standard Duracell batteries, Energizer quickly countered with its own high-performance battery—Energizer Advanced Formula. Energizer priced its Advanced Formula brand at the same price point as its standard AA alkaline battery, expecting to gain market share from Duracell. This did not happen because consumers associated Energizer's low price with inferior quality in the high-performance segment. Energizer lost market share to Duracell and Rayovac, the #3 battery marketer.

Energizer subsequently released its e^2 high-performance battery, this time priced 4 percent higher than Duracell Ultra and about 50 percent higher than its Advanced Formula. Energizer recovered lost sales and market share. Value is in the eye of the beholder.

4. **Price Lining**.

   a. **Price lining** is setting the price of a line of products at a number of different specific pricing points.

b. In Figure 14-3B:

- Price lining assumes that demand is elastic at each of these price points (e.g. $59, $79, and $99) but inelastic between them.
- In some instances, all the items might be purchased for the same cost and then marked up at different percentages to achieve these price points based on color, style, and expected demand.
- In other instances, manufacturers design products for different price points, and retailers apply the same markup percentages to achieve the different price points.
- Sellers often feel that a limited number (3 or 4) of price points are preferable to 8 or 10 different ones, which may only confuse prospective buyers.

5. Odd-even pricing.

a. Odd-even pricing involves prices a few dollars or cents under an even number ($499.99 vs. $500.00).

b. There is some evidence to suggest that demand increases if the price drops from $500 to $499.99.

c. The overuse of odd-ending prices tends to reduce its effect on demand.

6. Target pricing. Consists of:

a. Estimating the price that ultimate consumers would be willing to pay for a product;

b. Working backward through markups taken by retailers and wholesalers to determine what price to charge wholesalers, and then; and then

c. Deliberately adjusting the composition and features of the product to achieve the target price to consumers.

7. Bundle Pricing.

a. Bundle pricing is the marketing of two or more products in a single package price.

b. Bundle pricing is based on the idea that consumers value the package more than the individual items.

c. Bundle pricing provides buyers with a lower total cost, not having to make separate purchases, and having multiples items together while sellers receive lower marketing costs.

8. Yield Management Pricing.

a. **Yield management pricing** is the charging of different prices to maximize revenue for a set amount of capacity at any given time.

b. Used by services firms such as airlines, hotels, and car rental firms that are engaged in capacity management by varying prices based on time, day, week, or season to match demand and supply.

LEARNING REVIEW

1. **What are the circumstances in pricing a new product that might support skimming or penetration pricing?**

   Answer: A firm introducing a new product can use either skimming pricing to set the highest initial price that customers desiring the product are willing to pay or penetration pricing to set a low initial price to appeal immediately to the mass market.

2. **What is odd-even pricing?**

   Answer: Odd-even pricing involves setting prices a few dollars or cents under an even number. Psychologically, a $499.99 price feels lower than $500.00, even though the difference is 1¢.

B. Cost-Oriented Pricing Approaches

With cost-oriented approaches, price is set by looking at the production and marketing costs (the supply side of the pricing problem) and then adding enough to cover direct expenses, overhead, and profit.

1. **Standard markup pricing** entails adding a fixed percentage to the cost of all items in a specific product class.

   a. This percentage markup varies depending on the type of retail store and on the product involved.

   b. High volume products usually have smaller markups than do low-volume ones.

   c. These markups must cover all expenses of the store, pay for overhead costs, and contribute something to profits.

2. **Cost-plus pricing** involves summing the total unit cost of providing a product or service and adding a specific amount to the cost to arrive at a price.

   a. *Cost-plus percentage-of-cost pricing* involves a fixed percentage is added to the total unit cost to price one or few-of-a-kind items.

b. *Cost-plus fixed-fee pricing* means that a supplier is reimbursed for all costs, regardless of what they turn out to be, but is allowed only a fixed fee as profit that is independent of the final cost of the project.

c. Cost-plus pricing is the most commonly used method to set prices for business products or business-to-business marketers in the service sector.

3. **Experience curve pricing** is based on the learning effect, which holds that the unit cost of many products and services declines by 10 percent to 30 percent each time a firm's experience at producing and selling them doubles, resulting in possible rapid price reductions.

a. This reduction is regular or predictable enough that the average cost per unit can be mathematically estimated.

b. Because prices often follow costs with experience curve pricing, a rapid decline in price is possible. Consumers will benefit because prices will decline as cumulative sales volume grows.

c. This approach complements the demand-based pricing strategy of skimming followed by penetration pricing.

[*SLN 14-1: Riding Down the Experience Curve*]

C. Profit-Oriented Pricing Approaches

A marketer may choose to balance both revenues and costs to set price by either setting a target of a specific dollar volume of profit or expressing this target profit as a percentage of sales or investment.

1. **Target Profit Pricing**.

a. **Target profit pricing** involves an annual target of a specific dollar volume of profit.

b. To calculate a target profit price for a picture frame store: UVC = $22; FC = $26,000; P = $60; Target Profit = $7,000; Q = 1,000.

$$\text{Profit} = \text{Total Revenue} - \text{Total Cost}$$
$$= (P \times Q) - [FC + (UVC \times Q)]$$
$$\$7{,}000 = (P \times 1{,}000) - [\$26{,}000 + (\$22 \times 1{,}000)]$$
$$\$7{,}000 = 1{,}000P - \$48{,}000$$
$$1{,}000P = \$55{,}000$$
$$P = \$55$$

2. **Target Return-on-Sales Pricing**.

a. **Target return-on-sales pricing** involves setting a price to achieve a profit that is a specified percentage of the sales volume.

b. Supermarkets often use this method due to the difficulty in establishing a benchmark of sales or investment to show how much of a firm's effort is needed to achieve the target.

c. To calculate a target profit price for a picture frame store: Target Return on Sales = 20%; UVC = $22; FC = $26,000; P = $60; Q = 1,250.

$$\text{Target Return on Sales} = \frac{\text{Target Profit}}{\text{Total Revenue}}$$

$$20\% = \frac{TR - TC}{TR}$$

$$0.20 = \frac{(P \times Q) - [FC + (UVC \times Q)]}{\text{Total Revenue}}$$

$$0.20 = \frac{(P \times 1{,}250) - [\$26{,}000 + (\$22 \times 1{,}250)]}{P \times 1{,}250}$$

$$P = \$53.50$$

So, at a price of $53.50 per unit and an annual quantity of 1,250 frames:

$$TR = P \times Q = \$53.50 \times 1{,}250 = \$66{,}875$$

$$TC = FC + (UVC \times Q) = \$26{,}000 + (\$22 \times 1{,}250) = \$53{,}500$$

$$\text{Profit} = TR - TC = \$66{,}875 - \$53{,}500 = \$13{,}375$$

As a check:

$$\text{Target Return on Sales} = \frac{\text{Target Profit}}{\text{Total Revenue}} = \frac{\$13{,}375}{\$66{,}875} = 20\%$$

3. **Target Return-on-Investment Pricing**.

   a. **Target return-on-investment pricing** involves setting a price to achieve an annual target return-on-investment (ROI).

   b. Some firms and public utilities use this method.

   c. To handle this wide variety of assumptions for this method, marketers use computerized spreadsheets such as Microsoft Excel to project operating statements based on a diverse set of assumptions.

   d. In choosing a price or another action using spreadsheet results, the manager must:

      - Study the results of the computer simulation projections.
      - Assess the realism of the assumptions underlying each set of projections.

D. Competition-Oriented Pricing Approaches

Rather than emphasize demand, cost, or profit factors, a price setter can stress what competitors or “the market” is doing.

1. **Customary pricing** involves setting a price that is dictated by tradition, a standardized channel of distribution, or other competitive factors. A significant departure from this price may result in a loss of sales for the manufacturer.

2. **Above-, at-, or below-market pricing** involves setting a market price for a product or product class based on a subjective feel for the competitors' price or market price as the benchmark.

   a. Above-market pricing sets a premium price for a product.

   b. At-market pricing establishes the going market price in the minds of their competitors and provides a reference price for competitors that use above- and below-market pricing.

   c. Below-market pricing sets a market price below the prices of nationally branded competitive products to promote a value image among buyers.

USING MARKETING DASHBOARDS

Are Cracker Jack Prices Above, At, or Below the Market?

<u>Price Premium (%)</u>

How would you determine whether a firm's retail prices are above, at, or below the market? Combine two consumer market share measures to create a "price premium" display on a marketing dashboard.

Your Challenge.

Frito-Lay is considering whether to buy the Cracker Jack brand of caramel popcorn from Borden, Inc. Frito-Lay research shows that Cracker Jack has a strong brand equity but its dollar sales market share and pound volume market share declined recently and trailed the Crunch 'n Munch brand.

Borden's management used an above-market, premium pricing strategy for Cracker Jack designed to yield an average price premium per pound of 28 percent, which is to be compared to that of Crunch 'n Munch. A price premium is the percentage by which the actual price charged for a specific brand exceeds (or falls short of) a benchmark established for a similar product or basket of products. The dollar sales and pound volume shares for Cracker Jack and others are shown in the accompanying table. The price premium for Cracker Jack and these other brands is calculated and displayed on the marketing dashboard based on these data, as shown below:

$$\text{Price Premiun (\%)} = \frac{\text{Dollar Sales Market Share for a Brand}}{\text{Unit Volume Market Share for a Brand}} - 1$$

Your Findings.

Using caramel popcorn brand market share data, the Cracker Jack price premium is 1.368, or 36.8% [(26% ÷ 19%) – 1] = 0.368. By comparison, Crunch 'n Munch enjoys no price premium. Its dollar sales and unit (pound) market shares are equal: [(32% ÷ 32%) – 1] = 0.

Your Actions.

Cracker Jack's price premium clearly exceeds the 28% Borden benchmark relative to Crunch 'n Munch. Cracker Jack's price premium may have overreached its brand equity. Cracker Jack's price premium relative to its market position should be assessed if Frito-Lay purchases the brand

3. **Loss-leader pricing** involves deliberately selling a product below its customary price, not to increase sales, but to attract customers' attention in hopes that they will buy other products as well, such as discretionary items with large markups.

LEARNING REVIEW

3. **What is standard markup pricing?**

   Answer: Standard markup pricing entails adding a fixed percentage to the cost of all items in a specific product class.

4. **What profit-based pricing approach should a manager use if he or she wants to reflect the percentage of the firm's resources used in obtaining the profit?**

   Answer: target return-on-investment pricing

5. **What is the purpose of loss-leader pricing when used by a retail firm?**

   Answer: Loss-leader pricing involves deliberately selling a product below its customary price, not to increase sales but to attract customers in hopes they will buy other products as well.

II. STEP 5: SET THE LIST OR QUOTED PRICE [LO2]

Other factors influence the setting of a specific list or quoted price.

A. Choosing a Price Policy

Choosing a price policy is important insetting a list or quoted price.

1. **One-Price Policy**.

   a. A **one-price policy**, also called *fixed pricing*, is setting one price for all buyers of a product or service.

   b. Some firms, such as car dealers, feature a “no haggle, one price” approach in its stores.

   c. Some retailers have married this policy with a below-market approach and sell everything in their stores for $1 or less.

2. **Flexible-Price Policy**.

   a. A **flexible-price policy**, also called *dynamic pricing,* involves setting different prices for products and services depending on individual buyers and purchase situations.

   b. A flexible-price policy gives sellers considerable discretion in setting the final price in light of demand, cost, and competitive factors.

   c. Yield management pricing is a form of flexible pricing because prices vary by a buyer’s purchase situation, company cost considerations, and competitive conditions.

   d. Most companies use a one-price policy. However, flexible pricing has grown in popularity because of increasingly sophisticated information technology.

   e. Marketers customize prices based on customer purchasing patterns, product preferences, and price-sensitivity, which are stored in a firm’s data warehouse.

   f. Price customization is common for online purchases.

      - Online marketers have the ability to adjust prices in response to purchase situations and past purchase behaviors of online buyers.
      - Some online marketers monitor an online shopper’s “*clickstream*”—the way that person navigates through the website. If the visitor behaves like a price-sensitive shopper, that person may be offered a lower price.

g. There are also legal issues associated with flexible pricing as a flexible-price policy may lead to price discrimination, which may violate business laws in some Asian countries.

B. Company, Customer, and Competitive Effects on Pricing

Three other factors affect the final list or quoted price.

1. Company Effects.

a. For a firm with multiple products, the price decision for a single product must consider the price of other items in its product line or lines in its product mix because there are usually some products that are substitutes for one another and some that complement each other.

b. A marketer's challenge when marketing multiple products is **product-line pricing**, setting of prices for all items in a product line to cover the total cost and produce a profit for the complete line, not necessarily for each item.

c. Product-line pricing involves determining:

- The lowest-priced product and its price.
- The highest-priced product and its price.
- Calculating the price differentials for all other products in the line.
- The lowest-priced item is the traffic builder designed to capture the attention of the hesitant or first-time buyer.
- The highest-priced item is typically positioned as the premium item in quality and features.
- Price differentials between items in a product line should make sense to customers, reflect differences in their perceived value of the products offered, and get larger as one moves up the product line.

2. Customer Effects.

a. In setting price, retailers weigh factors heavily that satisfy the perceptions or expectations of ultimate consumers, such as customary prices for a variety of consumer products.

b. Retailers have found that they should not price their store brands 20 to 25 percent below manufacturers' brands because consumers are likely to view the lower price as signaling lower quality and don't buy.

c. Manufacturers and wholesalers must choose prices that result in profit for resellers in the channel to gain their cooperation and support.

3. **Competitive Effects**.

   a. Marketers must anticipate potential price responses from competitors.

   b. A **price war** involves successive price cutting by competitors to increase or maintain their unit sales or market share.

   - Regardless of whether a firm is a price leader or follower, it usually wants to avoid cutthroat price wars in which no firm in the industry makes a satisfactory profit.
   - Sometimes, marketers will initiate a price war, expecting that a lower price will result in a larger market share, higher unit sales, and greater profit for their firm.
   - However, if competitors match the lower price, other things being equal, the expected market share, sales, and intended profit gain are lost.

   c. A recent analysis found that a 1 percent price cut—assuming no change in unit volume or costs—lowers a company's net profit by an average of 8 percent.

   d. Marketers are advised to consider price cutting only when one or more conditions exist:

   - The company has a cost or technological advantage over its competitors.
   - Primary demand for a product class will grow if prices are lowered.
   - The price cut is confined to specific products or customers, and not across-the-board.

C. Balancing Incremental Costs and Revenues

- When price is changed or new advertising or selling programs are planned, their effect on the quantity sold must be considered. This assessment, called *marginal analysis* or *incremental analysis*, involves a continuing, concise trade-off of incremental costs against incremental revenues.

- Marketers use marginal analysis to assess advertising, equipment purchase, and human resource (i.e. salespeople) decisions. The advantage is its commonsense usefulness, and the difficulty is obtaining the necessary data to make decisions.

- Expected incremental revenues from pricing and other marketing actions must more than offset incremental costs.

- The advantage of marginal analysis is its commonsense usefulness; its disadvantage is the difficulty in obtaining the necessary data to make decisions.
- Expected incremental revenues from pricing and other marketing actions must more than offset incremental costs.

III. STEP 6: MAKE SPECIAL ADJUSTMENTS TO THE LIST OR QUOTED PRICE [LO3]

Marketers make three special adjustments to the list or quoted price for both wholesalers and retailers in the channel of distribution.

A. Discounts

Discounts are reductions from the list price that a seller gives a buyer as a reward for some activity of the buyer that is favorable to the seller. Four kinds of discounts (quantity, seasonal, trade/functional, and cash) are important in marketing strategy:

1. **Quantity Discounts**.

   a. To encourage customers to buy larger quantities of a product, firms in the distribution channel are offered **quantity discounts**, which are reductions in unit costs for a larger order.

   b. Since larger purchases may make more efficient of production equipment and/or reduce order-handling costs, firms may be willing to pass on some of the cost savings in the form of quantity discounts.

   c. Quantity discounts are of two general kinds:

   - *Noncumulative quantity discounts* encourage large individual purchase orders, not a series of orders.
   - *Cumulative quantity discounts* apply to the accumulation of purchases of a product over a given time period, typically a year. Cumulative quantity discounts encourage repeat buying by a single customer.

2. **Seasonal Discounts**.

   a. Marketers use *seasonal discounts* to encourage buyers to stock inventory earlier than their normal demand would require.

   b. This allows marketers to smooth out seasonal manufacturing peaks and troughs for more efficient production.

c. It also rewards wholesalers and retailers for the risk of assuming increased inventory carrying costs and having supplies in stock when customers want.

3. Trade (Functional) Discounts.

a. To reward wholesalers and retailers for marketing functions they will perform in the future, a manufacturer often gives *trade,* or *functional, discounts*.

b. *Trade, or functional, discounts* are reductions off the list or base price offered to wholesalers and retailers on the basis of (1) where they are in the channel and (2) the marketing activities they are expected to perform in the future.

c. Suppose a manufacturer quotes a price in the following form: List price = $100 less 30/10/5.

- This price quote shows $100 is the manufacturer's suggested retail price (MSRP).
- The first number always refers to the retailer, which receives 30 percent of the MSRP to cover costs and provide a profit of $30 ($100 × 0.3 = $30).
- The middle number refers to the wholesaler closest to the retailer in the channel, which gets 10 percent of its selling price ($70 × 0.1 = $7).
- The last number always refers to the wholesaler or jobber closest to the manufacturer in the channel, which gets 5 percent of its selling price ($63 × 0.05 = $3.15).
- Thus, starting with the MSRP and subtracting the three trade discounts shows that the manufacturer's selling price to the wholesaler or jobber closest to it is $59.85.
- Although the manufacturer may suggest the trade discounts, sellers are free to alter the discount schedule depending on their competitive situation.

4. Cash Discounts.

a. Manufacturers offer retailers *cash discounts* to encourage them to pay their bills quickly.

b. A retailer receives a bill quoted at $1,000, 2/10 net 30.

- The bill for the product is $1,000.
- The retailer can take a 2 percent discount ($1,000 × 0.02 = $20) if payment is made within 10 days and sends a check for $980.

- If the payment is not made within 10 days, the total amount of $1,000 is due within 30 days. Interest will be added after the "net 30" day period.

c. The 2 percent discount offered is substantial.

- The retailer pays 2 percent on the total bill to use that amount an extra 20 days—from day 11 to day 30.
- In a 360-day business year, this is an effective annual interest rate of 36 percent [(2% × (360 ÷ 20)) = 36%)].
- Because the effective interest rate is so high, firms that cannot take advantage a cash discount try to borrow money from their local banks at rates far lower than the 36 percent to take advantage of the cash discount.
- Retailers provide cash discounts to consumers, in some cases to eliminate the cost of credit—a discount for cash payment policy.

B. Allowances

Allowances, like discounts, are reductions from list or quoted prices to buyers for performing some activity.

1. Trade-in Allowances.

a. A *trade-in allowance* is a price reduction given when a used product is part of the payment on a new product.

b. Trade-ins are an effective way to lower the price a buyer has to pay without formally reducing the list price.

2. Promotional Allowances.

a. **Promotional allowances** are cash payments or extra amount of "free goods" awarded sellers in the channel of distribution for undertaking certain advertising or selling activities to promote a product. Retailers frequently pass on a portion of these savings to the consumer.

b. **Everyday low pricing** (EDLP) is the practice of replacing promotional allowances with lower manufacturer list prices.

- EDLP reduces the average price to consumers while minimizing promotional allowances that cost marketers billions of dollars every year.
- EDLP does not necessarily benefit some firms.

MARKETING MATTERS

Everyday Low Prices at the Supermarket = Everyday Low Profits—
Creating Customer Value at a Cost

One explanation for why 76 percent of U.S. grocery stores haven't adopted everyday low pricing (EDLP) is simple: grocery store profit suffers. Grocery stores still prefer using Hi-Lo pricing based on frequent specials where prices are temporarily lowered, then raised again.
Hi-Lo pricing reflects allowances that manufacturers give supermarkets to push their products.

EDLP eliminates manufacturer allowances and can reduce average retail prices by up to 10 percent. While EDLP provides lower average prices than Hi-Lo pricing, EDLP does not allow for deeply discounted price specials. EDLP can create everyday customer value and modestly increase supermarket sales—but at a cost. Already slim supermarket chain profits can slip by 18 percent with EDLP without the benefit of allowances as described earlier.

Also, some argue that EDLP is boring for many grocery shoppers who welcome price specials. While EDLP has been hailed as "value pricing" by manufacturers, supermarkets view EDLP as "Everyday Low Profits!"

C. Geographical Adjustments

Geographical adjustments are made by manufacturers or even wholesalers to list or quoted prices to reflect the cost of transportation of the products from seller to buyer.

1. **FOB Origin Pricing**.

   a. FOB means "free on board" some vehicle (a barge, railroad car, or truck) at some location, which means the seller pays the cost of loading the product onto the vehicle that is used.

   b. **FOB origin pricing** is the price the seller quotes that includes the cost of loading the product onto the vehicle.

   - The seller names the location (warehouse or factory) where the loading is to occur.
   - The buyer is responsible for picking the mode of transportation and paying for all transportation and handling costs.

   c. The title to the goods passes to the buyer at the point of loading, so the buyer becomes responsible for picking the specific mode of transportation, for all the transportation costs, and for subsequent handling of the product.

d. Buyers farthest from the seller face the big disadvantage of paying the higher transportation costs.

2. Uniform Delivered Pricing.

a. Uniform delivered pricing is the price that the seller quotes includes all transportation costs.

b. It is quoted as "FOB buyer's location." The seller selects the mode of transportation, pays the freight charges, and is responsible for any damage that may occur because the seller retains title to the goods until delivered to the buyer.

c. There are four kinds of delivered pricing methods:

- In *single-zone pricing*, all buyers pay the same delivered price for the products, regardless of their distance from the seller.
- In *multiple-zone pricing*, a firm divides its selling territory into geographic areas or zones. The delivered price to all buyers within any one zone is the same, but prices across zones vary depending on the transportation cost to the zone and the level of competition and demand within the zone.
- With *FOB with freight-allowed pricing*, also called *freight absorption pricing*, the price is quoted by the seller as "FOB plant—freight allowed." The buyer is allowed to deduct freight expenses from the list price of the goods, so the seller agrees to pay, or "absorb," the transportation costs.
- **Basing-point pricing** involves selecting one or more geographical locations (basing point) from which the list price for products plus freight expenses are charged to the buyer.

D. Legal and Regulatory Aspects of Pricing [LO4]

The task of arriving at a final price is further complicated by five legal and regulatory restrictions.

1. Price Fixing.

a. Price fixing is a conspiracy among firms to set prices for a product and is illegal in many Asian countries.

b. *Horizontal price fixing* is when two or more competitors explicitly or implicitly set prices.

c. *Vertical price fixing* involves controlling agreements between independent buyers and sellers (a manufacturer and a retailer) whereby sellers are required to not sell products below a minimum retail price. This practice, called *resale price maintenance,* may be illegal under anti-competition wars in many Asian countries.

d. A "manufacturer's suggested retail price," or MSRP, is not illegal per se. The issue of legality only arises when manufacturers enforce such a practice by coercion.

e. There is a movement toward a "*rule of reason*" in pricing cases, which holds that circumstances surrounding a practice must be considered before judging its legality.

2. Price Discrimination.

a. Price regulation in the USA and many Asian countries prohibits **price discrimination**—the practice of charging different prices to different buyers for goods of like grade and quality.

- Only those price differences that substantially lessen competition or create a monopoly are deemed unlawful.
- Moreover, "goods" is narrowly defined and does not include discrimination in services.

b. Price differentials to different customers may be allowed in the USA and many Asian countries under the following conditions:

- *Cost justification defense*. When price differences charged to different customers do not exceed the differences in the cost of manufacture, sale, or delivery resulting from differing methods or quantities in which such goods are sold or delivered to buyers.
- When price differences result from meeting changing market conditions, avoiding obsolescence of seasonal merchandise, including perishables, or closing out sale.
- *Meet-the-competition defense*. When price differences are quoted to selected buyers in good faith to meet competitors' prices and are not intended to injure competition.
- To legally offer promotional allowances to buyers, the seller must do so on a proportionally equal basis to all buyers distributing the seller's product.

3. Deceptive Pricing.

a. *Deceptive pricing* involves price deals that mislead consumers and is outlawed by the *Federal Trade Commission Act.*

b. The FTC monitors such practices and has published a regulation titled "Guides against Deceptive Pricing" designed to help businesspeople avoid a charge of deception.

c. A frequently used pricing practice is to offer products and services for free—a great price! But this can be deceptive.

Web Link

And You Thought That "Free" Is Simply Defined

The offer of "free" merchandise or services is a promotional device often used to attract customers. The FTC acknowledges that such offers are a useful marketing practice. However, the FTC also recognizes that such offers must be made with care so as to avoid any possibility that consumers will be misled or deceived.

The FTC has issued its "Guide Concerning Use of the Word 'Free' and Similar Representations" at www.ftc.gov/bcp/guides/free. This guide illustrates that the term free has multiple dimensions. If a marketer substitutes similar words for *free*, such as *gift*, *given without charge*, or *bonus*, what is the FTC's position on this practice?

4. Geographical Pricing.

a. FOB origin and FOB freight-allowed pricing practices are legal, providing no conspiracy to set prices exists.

b. Basing-point pricing may be viewed as illegal under anti-competitive regulations if there is clear-cut evidence of a conspiracy to set prices.

c. In general, geographical pricing practices have been immune from legal and regulatory restrictions, unless there is a conspiracy to lessen competition exists.

5. Predatory Pricing.

a. **Predatory pricing** is the practice of charging a very low price for a product with the intent of driving competitors out of business.

b. This practice is illegal under anti-competition law if it is shown that the predator explicitly attempted to destroy a competitor and the predatory price was below the defendant's average cost.

LEARNING REVIEW

6. **Why would a seller choose a flexible-price policy over a one-price policy?**

   Answer: A flexible-price policy involves setting different prices for products and services depending on individual buyers and purchasing situations in light of demand, cost, and competitive factors instead of setting one price for all buyers.

7. **If a firm wished to encourage repeat purchases by a buyer throughout a year, would a cumulative or noncumulative quantity discount be a better strategy?**

   Answer: cumulative quantity discount

8. **Which pricing practices are covered by the anti-competition and consumer protection regulations?**

   Answer: horizontal price-fixing and predatory pricing

APPLYING MARKETING KNOWLEDGE

1. **Under what conditions would a digital camera manufacturer adopt a skimming price approach for a new product? A penetration approach?**

   Answers:

   a. **Skimming pricing approach**. A digital camera manufacturer might adopt a skimming price approach if the new product is unique and already has a significant prospective customer base. Some type of protection from competitive products such as a patent would also enhance the effectiveness of a skimming strategy.

   b. **Penetration pricing approach**. A penetration price approach might be adopted if the new product's unit production and marketing costs fall dramatically as production volume increases and if many of its market segments are price sensitive. Such a product would most likely appeal to a broad segment of the population and be positioned as a "me-too" product.

2. **What are some similarities and differences between skimming pricing, prestige pricing, and above-market pricing?**

   Answers:

   a. **Similarities**. Skimming, prestige, and above-market pricing all involve setting a premium price for a product, hoping consumers will associate high quality with high price. Generally, these three pricing strategies are most effective when product demand is inelastic.

b. **Differences**. Frequently, a skimming price approach is used when there are no competitively positioned products, and therefore prices, to use as a benchmark. An above-market price strategy requires a competitive reference point or price. Prestige pricing typically requires a greater subjective component than the other two methods.

3. **A producer of microwave ovens has adopted an experience curve pricing approach for its new model. The firm believes it can reduce the cost of producing the model by 20 percent each time volume doubles. The cost to produce the first unit was $1,000. What would be the approximate cost of the 4,096th unit?**

Answer: Based on the calculations identified in the table below, the approximate cost of the 4,096th unit produced is $69.

Nth Unit Produced	Cost of Previous Nth Unit	Price Reduction (100%-20%) = 80%	Cost of Nth Unit
1			$1,000
2	$1,000	80%	$800
4	$800	80%	$640
8	$640	80%	$512
16	$512	80%	$410
32	$410	80%	$328
64	$328	80%	$262

Nth Unit Produced	Cost of Previous Nth Unit	Price Reduction (100%-20%) = 80%	Cost of Nth Unit
128	$262	80%	$210
256	$210	80%	$168
512	$168	80%	$134
1,024	$134	80%	$107
2,048	$107	80%	$86
4,096	$86	80%	$69

4. **The Fanshi Zangxing Antique Furniture of China is a leading manufacturer of high-quality cabinets. Current plans call for an increase of $600,000 in the advertising budget. If the firm sells its cabinets for an average price of $850 and the unit variable costs are $550, then what dollar sales increase will be necessary to cover the additional advertising?**

Answer: To calculate the incremental sales increase needed to cover the additional advertising expense of $600,000 (the incremental increase in fixed cost), one must first calculate the number of incremental units that need to be sold, which is then multiplied by the average price of $850.

$$\text{BEP} = \frac{\text{Incremental Fixed Cost}}{\text{Unit Price} - \text{Unit Variable Cost}}$$

$$BEP = \frac{\$600{,}000}{\$850 - \$550}$$

BEP = 2,000 units

The incremental sales needed to cover the additional advertising expense of $600,000 is:

2,000 units × $850 = **$1,700,000**.

5. **Suppose executives of Su Han Electronics estimate that the unit variable cost for their VCR is $100, the fixed cost related to the product is $10 million annually, and the target volume for next year is 100,000 recorders. What sales price will be necessary to achieve a target profit of $1 million?**

   Answer: The sales price under a target profit pricing strategy is calculated as follows:

   a. **Profit equation assumptions**. Recall the profit equation from Chapter 13.

      Profit Equation = Total Revenue (TR) – Total Cost (TC)
      TR = Price (P) × Quantity (Q)
      TC = Fixed Cost (FC) + Variable Costs (VC)
      VC = Unit Variable Cost (UVC) × (Q)
      Profit = (P × Q) – [FC + (UVC × Q)]

   b. **Sales price calculation**.

$$\begin{aligned} \text{Profit} &= (P \times Q) - [FC = (UVC \times Q)] \\ \$1{,}000{,}000 &= (P \times 100{,}000) - [\$10{,}000{,}000 + (\$100 \times 100{,}000)] \\ \$1{,}000{,}000 &= 100{,}000P - \$20{,}000{,}000 \\ \$21{,}000{,}000 &= 100{,}000P \\ P &= \$210 \end{aligned}$$

      The sales price needed to achieve a target profit of $1 million is **$210**.

6. **A manufacturer of motor oil has a trade discount policy whereby the manufacturer's suggested retail price is $30 per case with the terms of 40/20/10. The manufacturer sells its products through jobbers, who sell to wholesalers, who sell to gasoline stations. What will the manufacturer's sales price be?**

Answer:

a. **Trade discount assumptions**. The motor oil manufacturer's trade discount policy of 40/20/10 means that 40% of the manufacturer's suggested retail price (MSRP) of $30 goes to the retailer, 20% goes to wholesalers, and 10% goes to jobbers.
b. **Manufacturer's sales price calculation**. Using Figure 14-7, the structure of the trade discounts for each channel member is calculated as follows:

Channel Member	Beginning Price or Cost to Channel Member	Trade Discount Percent	Discount Amount Received	Net Price or Cost to Channel Member
Retailer	$30.00	40%	$12.00	$18.00
Wholesaler	$18.00	20%	$3.60	$14.40
Jobber	$14.40	10%	$1.44	$12.96
Manufacturer	$12.96			

The manufacturer's realized sales price is **$12.96**.

7. Suppose a manufacturer of exercise equipment sets a suggested price to the consumer of $395 for a particular piece of equipment to be competitive with similar equipment. The manufacturer sells its equipment to a sporting goods wholesaler who receives 25 percent and a retailer who receives 50 percent of the selling price. What demand-based pricing method is being used, and at what price will the manufacturer sell the equipment to the wholesaler?

Answers:

a. **Demand-oriented pricing approach used**. The manufacturer is using a target pricing strategy.

b. **Sales price calculation**.

Channel Member	Beginning Price or Cost to Channel Member	Trade Discount Percent	Discount Amount Received	Net Price or Cost to Channel Member
Retailer	$395.00	50%	$197.50	$197.50
Wholesaler	$197.50	25%	$49.38	$148.13
Manufacturer	$148.13			

The sales price the manufacturer will sell the equipment to the wholesaler is **$148.13**.

8. **Is there any truth in the statement, "Geographical pricing schemes will always be unfair to some buyers?" Why or why not?**

   Answer: Unless a geographical pricing scheme individually figures transportation charges for each wholesaler and retailer in the distribution channel, some buyers will be priced "unfairly" owing to uniform pricing schemes.

BUILDING YOUR MARKETING PLAN

To arrive at the final price(s) for your offering(s):

1. **Modify the three prices from your Chapter 13 analysis in light of (*a*) pricing considerations for demand-, cost-, profit-, and competition-oriented Chapter 14 approaches and (*b*) possibilities for discounts, allowances, and geographic adjustments.**

2. **Do a break-even analysis for each of these three new prices.**

3. **Choose the final price(s).**

   Have students list their assumptions for the factors mentioned in Question #1 in their marketing plan. Then have students do break-even analyses for the three new, modified prices. By modifying some of their assumptions, they can do additional break-even analyses until they choose the final price(s). These analyses may be shown in an appendix to their marketing plan.

Helping with Common Student Problems

Students need to be encouraged to alter whatever assumptions are appropriate to calculate their final break-even point and related potential profit.

SLN 14-1: SUPPLEMENTAL LECTURE NOTE

Riding Down the Experience Curve

An important concept applicable to pricing strategy is the experience curve phenomenon, or experience effect. The experience curve is a representation of total cost reduction as volume produced increases. Specifically, the experience curve plots the constant percentage decline in total cost per unit each time the cumulative volume of a specific item doubles. The percentage decline in total cost per unit is reflected in the curve. Hence, if total cost per unit drops by 15 percent each time cumulative volume of production doubles, an 85 percent curve is indicated.

The experience curve is a managed process and results from a variety of factors. These are productivity improvements owing to technological change, economies of scale and labor specialization, product modifications designed to produce lower costs, and displacement of less-efficient production methods (e.g., labor-intensive versus capital-intensive production method).

Experience curve pricing has been successfully employed in the pricing of integrated circuits, personal computers, video cassette recorders, cellular phones, DVDs, electronic watches, and most recently flash drives and HDTVs.

Product	**Price Curve Slope**
Integrated circuits	72%
Electronic watches	74%
Handheld calculators	74%
Disk memory drives	76%
DVDs	73%

Sources: Roger A. Kerin, Vijay Mahajan, and P. Rajan Varadarajan, *Contemporary Perspectives on Strategic Market Planning* (Boston: Allyn & Bacon, 1990), pp. 114-139 and "Prices" (Arlington, VA: Consumer Electronics Association, 2004).