Lesson: Pricing

Page Title: Lesson Introduction

Page Number: 1
Have you ever wondered why your favorite brand of blue jeans cost what they do? Why would one company sell their jeans for $30, but another company price their jeans at $300? Can there really be $270 worth of fabric in that second pair? The answer is "no." So how do those companies come to those decisions about pricing?

Marketers research the people they'd like to sell their products to so that they can find out what prices they will pay for the products they buy. Compiling this information is a big deal; knowing what to do with it is the difference between a product that sells and one that lingers on the shelf.

Page Title: Menu Page

Page Number: 2
This lesson presents the following topics:

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- Understanding Price
- Cost Types
- Considering the Market and Demand
- Types of Markets
- Price-Demand Relationship
- Product Mix and Price

Page Title: Understanding Price

Page Number: 3
Before a company can sell its product or service to consumers, the company must answer a very important question: What should be its **price** [The amount of money charged for a product or service, or the sum of all the values that customers give up in order to gain the benefits of having or using a product or service]?

Often, the price of a product boils down to what consumers will be willing to pay for it. Charge too much, and fewer people (or no one at all!) will buy the product. Charge too little, and you cost the company in profits.

Page Title: Factors That Affect Pricing

Page Number: 4
Marketers consider two major factors when thinking about pricing:

- How customers will perceive the value of the product
- The costs to the company to produce the item

There are a few considerations in setting price. Customer perceptions of the product’s value set the ceiling for prices. If the customers perceive that the price is greater than the product’s value, they will not buy the product. Product costs set the floor for prices.

To remain between the floor and the ceiling, the company must consider internal factors, including the overall marketing strategy and mix, the nature of the market and demand, competitor’s strategies and prices, and certain other external factors.

Page Title: How Customers Perceive Value

Page Number: 5
Companies often use **value-based pricing** [Setting price based on buyers’ perceptions of value rather than on the seller’s cost] to decide what to charge customers. This may be the real difference between the $30 jeans and the $300 jeans, not the quality of the denim. The price has little to do with how much the item cost to make!

“Good value” is not the same as “low price.” Some car buyers consider the luxurious Bentley Continental GT automobile a real value, even at an eye popping price of $150,000.

Page Title: Good-Value Pricing

Page Number: 6
Good-value pricing [Offering just the right combination of quality and good service at a fair price] is what most customers hope they are getting. Do you prefer to buy products that are of high quality but at a fair price? And do you like to buy from a store that offers sharp service? These three aspects combined add up to good-value pricing.

But not everyone prefers this. Status symbols, for example, may be priced way above what they actually cost the company to make.

Page Title: Value-Added Pricing

Page Number: 7
Value-added pricing [Attaching value-added features and services to differentiate a marketing offer and support higher prices, rather than cutting prices to match competitors] is another pricing tactic used by marketers.

Think about products you might buy, anything from a DVD player to a pair of shoes. Why might you choose one DVD player over another? Marketers who are selling products that many competitors sell may use value-added pricing in order to allow them to sell their product for a higher price than competitors do.

Think about the vast difference in pricing between automobiles, for example. The most basic way to think about a car might be as a means of transportation. If that's all it is, then how come one is $20,000 while another is $50,000? The answer is value-added pricing.

Another example: Caterpillar offers its dealers a wide range of value-added services—from guaranteed parts delivery to investment management advice and equipment training. Such added value supports a higher price.

Page Title: Types of Perception Pricing: Summary

Page Number: 8
Marketers are careful to consider how a customer will "see" a product when coming up with a price to charge for it. Marketers know that customers will be more likely to choose their product over a competitor's if the customer feels he or she is getting an appropriately priced product.

Think about your last "big" purchase, be it a car or a computer. Do you think you were influenced by pricing? Do you think the marketers set the pricing using **good-value pricing**, **value-added pricing**, or something else? And perhaps most importantly, do you think you got a fair deal?

Page Title: Check Your Understanding

Page Number: 9
For each example statement given below, select the most appropriate answer option.

Statement 1: Which of the following behaviors is likely to be considered unethical?

Answer Options:
- Good-value pricing
- Value-based pricing
- Value-added pricing

The correct answer is: **Value-based pricing**

Page Title: Check Your Understanding (Cont'd)

Page Number: 10
Statement 2: Value-menus at fast food restaurants

Answer Options:
- Good-value pricing
- Value-based pricing
- Value-added pricing

The correct answer is: **Good-value pricing**

Page Title: Check Your Understanding (Cont'd)

Page Number: 11
Statement 3: Offering free satellite radio with a new-car purchase

Answer Options:

- Good-value pricing
- Value-based pricing
- Value-added pricing

The correct answer is: **Value-added pricing**

Page Title: Pricing Based on the Cost of the Product

Page Number: 12
While value-based pricing tells marketers how "high" they can go when setting a product's price, marketers also need to figure out how low they can go and still turn a profit. This is where product cost comes in.

A company can't stay in business if it's not turning a profit, and it can't possibly turn a profit if it's selling its merchandise for less than it costs to make it. Maybe as a kid you sold lemonade in front of your house. Even if you sold only one cup to a sympathetic neighbor, you probably made a huge profit. But if you, instead of your mom, had paid for the lemonade, the cardboard sign, and the markers to write on that sign, your little company probably would have gone bankrupt that afternoon.

Businesses must consider every little cost, from electricity to running the factory to advertising, when setting the price floor for a product.

Page Title: Cost Types

Page Number: 13
There are three major categories for costs for a company:

- **Fixed costs:** Costs that do not vary with production or sales level
- **Variable costs:** Costs that vary directly with the level of production
- **Total costs:** The sum of the fixed and variable costs for any given level of production

Think about that lemonade stand for a moment with these types of costs in mind. A fixed cost might be the rent you didn't pay to set up that cardboard stand on your mom's property. No matter how much lemonade you made and sold, the rent would've been the same. But the cost of the sugar to make the lemonade would've been a variable cost, because it would've varied depending on how much lemonade you made each day. The total costs would have included both the rent and the sugar, along with every other thing you had to pay for to conduct your business.

Page Title: Cost-Plus Pricing

Page Number: 14
Many companies keep pricing fairly simple, and just add a standard percentage

markup to their products. So, if a bag of potato chips costs $1 to produce, and the company has a 10% standard markup, the price will be $1.10. If the same company also makes dip at a cost of $2 per jar, that company would still apply a 10% markup, making the price of the dip $2.20. This is called **cost-plus pricing** [Adding a standard markup to the cost of the product].

Page Title: Break-Even Pricing

Page Number: 15
Another pricing tactic is called **break-even pricing** [Setting the price to break even on the costs of making and marketing a product; or setting the price to make a target profit]. Break-even pricing is used when a company figures out how many units of a product they must sell in order to get as much money back as they put into making a product. So, if a company needs to sell 20,000 bags of chips to break even, that company would obviously strive to sell more than 20,000 bags in order to turn a profit.

The company uses variation called **target profit pricing** to determine the price at which it will break even or make the target profit it is seeking. Target pricing uses the concept of a **break-even chart** which uses the sum of fixed cost and variable cost to find the total cost. The slope of the total revenue curve reflects the price. This helps the firm to determine the target profit and the point to break even.

Page Title: Check Your Understanding

Page Number: 16
For each statement given below, select the most appropriate answer option.

Statement 1: Basing a price on cost involves figuring out how low you may price your product and still turn a profit.

Answer Options:
- True
- False

The correct answer is: **True**

Page Title: Check Your Understanding (Cont'd)

Page Number: 17
Statement 2: There are three major categories for costs for a company: Fixed costs, Variable costs and Overhead costs.

Answer Options:
- True
- False

The correct answer is: **False**

Statement 3: Fixed costs include employee salaries.

Answer Options:
- True
- False

The correct answer is: **True**

Page Title: Check Your Understanding (Cont'd)

Page Number: 18
Statement 4: Cost-plus pricing involves adding a fixed percentage to a product's cost to determine its price.

Answer Options:
- True
- False

The correct answer is: **True**

Statement 5: Break-even pricing involves selling just enough to break even without turning a profit.

Answer Options:
- True
- False

The correct answer is: **False**

Page Title: Considering the Market and Demand

Page Number: 19
Marketers must understand their customers and how they perceive products in order to set pricing appropriately. Part of this is understanding the relationship between how much the company charges and how much the customer wants the product. This is called **demand** [Human wants that are backed by buying power].

Marketers must consider the following when figuring out this relationship:

- The different types of markets
- The relationship between price and demand
- Demand's price elasticity

Example: A Steinway piano costs a lot, but buyers aren't looking for bargains. When it comes to a Steinway, price is nothing, the Steinway experience is everything.

Page Title: Types of Markets

Page Number: 20
There are four types of markets to consider before setting your price:

- **Pure competition:** Pure competition keeps sellers to the “going price.”
- **Monopolistic competition:** Monopolistic competition allows for varied pricing due to varied quality of product. For example, the company, Moen sets its products apart through strong branding and advertising, reducing the impact of price.
- **Oligopolistic competition:** Oligopolistic competition has just a few sellers, so they watch each others’ prices carefully.
- **Pure monopoly:** A pure monopoly, on the other hand, has only one seller. Prices are based mostly on whether the monopoly is regulated by the government or not.

Page Title: Check Your Understanding

Page Number: 21
For each statement given below, select the most appropriate answer option.

Statement 1: Pure competition involves uniform commodities.

Answer Options:
- True
- False

The correct answer is: **True**

Page Title: Check Your Understanding (Cont’d)

Page Number: 22
Statement 2: Oligopolistic competition is not concerned with others’ pricing.

Answer Options:
- True
- False

The correct answer is: **False**

Statement 3: Pure monopolies include the United States Post Office.

Answer Options:
- True
- False

The correct answer is: **True**

Page Title: Check Your Understanding (Cont’d)

Page Number: 23
Statement 4: Monopolistic competition has several buyers and several sellers, and prices can vary greatly.

Answer Options:
- True
- False

The correct answer is: **False**

Page Title: Price-Demand Relationship

Page Number: 24
Let's face it: price affects demand. Think about cars. Luxury automobiles that close in on a six-figure price tag are in far less demand than those priced much lower. The **demand curve** [A curve that shows the number of units the market will buy in a given time period, at different prices that might be charged] reflects the above-mentioned fact. In the usual scenario, demand and price are inversely related. Thus, the company would sell less if it raised its price.

But a high price is not necessarily a negative aspect in marketing. This demand curve also shows that in the case of prestige goods (like that luxury car), consumers will sometimes associate a high price with high quality. In cases where consumers are buying a product that should last over a long period of time, many consumers will go for the higher-priced product.

Page Title: Price Elasticity of Demand

Page Number: 25
You must also consider the **price elasticity** [A measure of the sensitivity of demand to changes in price] of a product. If you change the price you are charging for a product, will demand remain the same? If it will, we call the demand **inelastic**. An example of this might be cigarettes. Most smokers will not quit buying the product if it suddenly jumps in price by 10%. So, the demand for cigarettes is inelastic. Another example of an inelastic demand could be gasoline. When the price rises, people who need gas will still buy it, even if they complain while doing so.

But if the demand changes greatly when the price does, we call the price **elastic**. An example of this might be produce. If drought in one part of the country causes the cost of apples to rise, shoppers may choose to buy bananas instead.

Page Title: Check Your Understanding

Page Number: 26
For each term given below, select the most appropriate answer option.

Term 1: Demand curve

Answer Options:
- Gasoline
- Luxury cars selling fewer units at lower prices
- Tomatoes

The correct answer is: **Luxury cars selling fewer units at lower prices**

Page Title: Check Your Understanding (Cont'd)

Page Number: 27
Term 2: Elastic demand

Answer Options:
- Gasoline
- Luxury cars selling fewer units at lower prices
- Tomatoes

The correct answer is: **Tomatoes**

Page Title: Check Your Understanding (Cont'd)

Page Number: 28
Term 3: Inelastic demand

Answer Options:
- Gasoline
- Luxury cars selling fewer units at lower prices
- Tomatoes

The correct answer is: **Gasoline**

Page Title: Market-Skimming Pricing

Page Number: 29
Marketers consider a couple of issues when pricing a new product for the market. One strategy is called **market-skimming pricing** [Setting a high price for a new product to skim maximum revenues layer by layer from the segments willing to pay the high price; the company makes fewer but more profitable sales]. Have you noticed that when a new technology comes out, it's often very highly priced? Think about the latest video game system. Do you think this game system will still be priced as high a year from now?

Just a short while ago, Apple's iPod was an expensive item only a few people could really afford. However, the price has dropped dramatically. Now, many consumers can afford to own an iPod. The lower price attracted a new range of buyers for this product. Sony priced its early HDTV's high, and then reduced prices gradually over the years to attract new buyers.

Page Title: Market-Penetration Pricing

Page Number: 30
Another strategy is **market-penetration pricing** [Setting a low price for a new product in order to attract a large number of buyers and a large market share]. Rather than trying to reach big gains early on, marketers are trying to attract a wide number of buyers with this tactic. The hope is that these buyers will remain loyal if

prices rise because “they got it here first.”

A great example of this strategy is Wal-Mart and its brethren. Many shoppers of these discount stores are loyal ones. And while Wal-Mart continues to set most of its prices low, Wal-Mart could easily charge a higher price for a few products, and its customers would still buy from the chain.

Page Title: Check Your Understanding

Page Number: 31
For each statement given below, select the most appropriate answer option.

Statement 1: An example of market-skimming pricing is a new HDTV.

Answer Options:
- True
- False

The correct answer is: **True**

Page Title: Check Your Understanding (Cont’d)

Page Number: 32
Statement 2: An example of market-penetration pricing is Wal-Mart.

Answer Options:
- True
- False

The correct answer is: **True**

Statement 3: Market-skimming price strategies start high.

Answer Options:
- True
- False

The correct answer is: **True**

Page Title: Check Your Understanding (Cont’d)

Page Number: 33
Statement 4: Market-penetration price strategies start high.

Answer Options:
- True
- False

The correct answer is: **False**

Page Title: Product Mix and Price

Page Number: 34
Marketers also consider several types of pricing strategies based on the product mix. These situations are the following:

Product Mix Pricing Strategies

Strategy	**Description**
Product line pricing	Setting price steps between product line items
Optional-product pricing	Pricing optional or accessory products sold with the main product
Captive-product pricing	Pricing products that must be used with the main product
By-product pricing	Pricing low-value by-products to get rid of them
Product bundle pricing	Pricing bundles of products sold together

Each of these situations deals with figuring out the maximum price for the product.

Page Title: Product Mix and Price Examples

Page Number: 35
Product line pricing: Product line pricing [Setting the price steps between various products in a product line based on cost differences between the products, customer evaluations of different features, and competitors' prices] involves a company that makes many models or types of the same product. Apple makes several models of computers, for example. These models range in price. As another example, Gramophone sells a complete line of high-quality sound systems, ranging in price from $5000 to $120,000.

Optional-product pricing: Optional-product pricing occurs when a company offers additional products to go with their main product. A car company might offer a basic model, but also have optional features (such as a CD changer) that add to the price.

Captive-product pricing: Captive-product pricing are for additional products that you must buy in order to use the main product. Particular razor blades must be purchased in order to use a specific shaver. Although HP makes very low margins on its printers, it makes very high margins on printer cartridges and other printer supplies.

Page Title: Product Mix and Price Examples (Cont'd)

Page Number: 36
By-product pricing: By-product pricing involves the selling of by-products created in the manufacture of the main product. A slaughterhouse that prepares meat for human consumption may have lots of "leftovers" that are not fit for human

consumption. These leftovers might be sold to a dog food company in order to offset the price of the meat the company sells for people to eat. Woodland Park Zoo in Seattle sponsors annual Fecal Fests, selling processed manure by the trash can and truck load to lucky lottery winners. "It's not just compost, rather it's a movement."

Product bundle pricing: Product bundle pricing is the art of selling several products as a bundle, such as combining several items from a fast food menu into one "value meal." A customer who might not have purchased a beverage might do so if it seems like a better deal when bundled.

Page Title: Check Your Understanding

Page Number: 37
For each statement given below, select the most appropriate answer option.

Statement 1: By-product pricing occurs when a company offers additional products to go with their main product.

Answer Options:
- True
- False

The correct answer is: **False**

Page Title: Check Your Understanding (Cont'd)

Page Number: 38
Statement 2: Product line pricing involves a company that makes many models or types of the same product.

Answer Options:
- True
- False

The correct answer is: **True**

Statement 3: Captive-product pricing are for additional products that you must buy in order to use the main product.

Answer Options:
- True
- False

The correct answer is: **True**

Page Title: Check Your Understanding (Cont'd)

Page Number: 39
Statement 4: Optional-product pricing involves the selling of by-products created in the manufacture of the main product.

Answer Options:

- True
- False

The correct answer is: **False**

Page Title: Summary

Page Number: 40

By now, you should be pretty familiar with how you can price your products in the various markets. This lesson explained how pricing decisions can impact consumer perceptions and choices. The lesson also discussed ethics as related to pricing issues. Finally, the lesson compared the various types of pricing.

Think about these issues and how they affect you as not just a consumer but as a marketer. What's important? What's effective?