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Cost and Price Management 2024/2025

Introduction/Overview

Cost and price are important aspects for firms in order to stay relevant and competitive in the market place. Cost represents the resources that are spent in order to produce goods or services. Cost management is one of the ways in which firms can competitively out maneuver rivals through efficient utilization of resources required to produce value outputs. Costs form an important element to pricing since they are key in determining the prices and other management decision making. Price on the other hand is an element of the marketing mix which generates revenue for the firm. Price is the amount of money charged for the goods or services of the firm. This is the value that is captured from customers that results from them owning or benefitting from a given product or service.

In Uganda, the landscape for firms on how they manage costs and charge prices has changed significantly to cover more innovative ways in which customers can attain value from market offerings. Today, information and technology has enabled customers access more information that they use in their purchase decision making. Customers have become more frugal and averse to costly products that don't offer substantial value. This frugality could be attributed to the prevailing economic situation or just a shift in consumer perceptions and overall behavior. Some firms use supply and demand forces to setting prices, such firms have little or no influence over the final prices of products or services. These are known as **price takers**. In contrast, firms that selling products or services that are highly customised or differentiated from one another through some form of special features have some discretion in setting prices. These are also sometimes known as **price setters**.

Price is the only element in the marketing mix that produces revenue; all other elements represent costs. Price is also one of the most flexible elements of the marketing mix. Unlike product features and channel commitments, price can be changed quickly. At the same time, pricing and price competition is the number-one problem facing many marketing executives. Yet, many companies do not handle pricing well. The most common mistakes are pricing that is too **cost oriented** rather than **customer-value oriented**; prices that are not revised often enough to reflect market

changes; pricing that does not take the rest of the marketing mix into account; and prices that are not varied enough for different products, market segments, and purchase occasions.

All organizations, whether profit or not profit must set prices on their products and services. All profit organizations and many nonprofit organizations must set prices on their products or services. On the other they also have costs, these are resources that are spent to produce the value goods or services. It is inherent that organizations have structured and innovative mechanisms to manage costs and price in order to remain competitive and sustainable in the long run

Price goes by many names (rent, tuition, fee, fare, rate, interest, toll, premium, et cetera). Price is all around us. You pay rent for your apartment, tuition for your education, and a fee to your physician or dentist. The airline, boda-boda, taxi, and bus companies charge you a fare; the local utilities call their price a rate; and the local bank charges you interest for the money you borrow.

Historically, price has been the major factor affecting buyer choice. Recently, however, non-price factors have become increasingly important in buyer-choice behavior. Throughout history, prices were set by negotiation between buyers and sellers.

Definition of Cost

Cost refers to the monetary value of resources sacrificed or foregone to produce a good, deliver a service, or achieve a specific objective. Costs encompass all expenses incurred in the production, acquisition, or delivery of goods and services, including direct and indirect costs. It is a fundamental concept in price management and decision making.

Cost is defined as “a resource sacrificed or foregone to achieve a specific objective, measured in monetary terms.” (Drury, C. (2018). Management and Cost Accounting. Cengage Learning.)

Types of costs

Cost type	Description
Direct costs	Costs that can be directly traced to a specific product or service (e.g., raw materials, labor).

Indirect costs	Costs that are not directly traceable to a single product or service (e.g., rent, utilities).
Fixed costs	Costs that do not change with the level of production (e.g., salaries, rent).
Variable costs	Costs that vary directly with the level of production (e.g., raw materials).
Opportunity cost	The value of the next best alternative foregone
Product cost	Costs attributed to a specific product

Definition of Price

Price is the amount of money charged for a product or service or the sum of the values that consumers exchange for the benefits of having or using the product or service.

The price is the number of monetary units which a buyer must handover for one unit of a product.

Prices come in several forms which are much more complex. These price systems comprise a number of parameters. Here is a selection of complex price parameters and structures:

- Base price
- Discounts, bonuses, rebates, conditions, and special offers
- Differentiated prices by package size or product variant
- Differentiated prices based on customer segment, time of the day, location or phase of the product life cycle.
- Prices for complimentary or substitute products
- Prices for special or additional services
- Prices with two or more dimensions (e.g., upfront charge and a usage fee)
- Bundles and prices for individual components
- Prices based on personal negotiations
- Manufacturer and end consumer prices

This list is not exhaustive but rather illustrates prices are often complex constructs and not only one-dimensional.

Fixed price policies--setting one price for all buyers--is a relatively modern idea that arose with the development of large-scale retailing at the end of the nineteenth century. Today, we may be returning to **dynamic pricing**--charging different prices depending on the individual customers and situations. The Internet is helping to tailor products and prices.

It should be remembered that price is the only element in the marketing mix that produces revenue; all other elements represent costs.

Price is also one of the most flexible of elements of the marketing mix.

It has been stated that pricing and price competition is the number-one problem facing many marketing executives.

Many companies do not handle pricing well. Common mistakes that they make are:

1. Pricing is too cost-oriented.
2. Prices are not revised often enough to reflect market changes.
3. Prices do not take into account the other elements of the marketing mix.
4. Prices are not varied for different products, market segments, and purchase occasions.

New technologies allow sellers to collect detailed data about customers' buying habits, preferences—even spending limits—so they can tailor their products and prices.

Cost and Price Management

CIMA defines cost management as the control of current and future costs to ensure business sustainability and competitive advantage. On the other hand, price management involves determining, implementing and adjusting the pricing of products or services to align with business objectives, markets dynamics, and customers' expectations (Kotler & Keller 2016).

Therefore, ***cost and price management is an integrated process of planning, controlling and monitoring costs while determining, implementing and adjusting pricing strategies to align with business objectives, market dynamics and customer expectations.*** This duality approach to pricing ensure that resources are utilized efficiently and effectively so that profitability is maximized while products or services remain competitive in the market place.

Functions of cost and price management

Function	Explanation
Profitability analysis	Evaluating the relationship between costs, pricing, and profit margins.
Value delivery	Balancing cost management and pricing to deliver value to customers while ensuring profitability
Risk mitigation	Managing financial risks by ensuring prices cover costs and remain competitive in volatile markets.
Pricing strategy development	Designing pricing strategies (e.g., cost-plus, value-based, penetration pricing) that align with business objectives
Market research and analysis	Understanding customer preferences, competitor pricing, and market trends to make informed pricing decisions.
Dynamic pricing	Continuously adjusting prices based on demand, competition, and supply chain factors.
Revenue optimization	Ensuring that pricing maximizes revenue while maintaining customer satisfaction and loyalty.
Customer segmentation and targeting	Customizing pricing for different customer segments to maximize appeal and profitability.

FACTORS TO CONSIDER WHEN SETTING PRICES

A company's pricing decisions are affected by both internal company factors and external environmental factors

Internal factors affecting pricing decision

Internal factors affecting pricing include the company's marketing objectives, marketing mix strategy, costs, and organizational considerations.

I. Marketing Objectives

Before setting price, the company must decide on its strategy for the product. If the company has selected its target market and positioning carefully, then its marketing mix strategy, including price, will be fairly straightforward. **Pricing strategy is largely determined by decisions on market positioning.** At the same time, the company may seek additional objectives. The clearer a firm is about its objectives, the easier it is to set price. **Examples of common objectives are survival, current profit maximization, market share leadership, and product quality leadership.**

Companies set **survival** as their major objective if they are troubled by too much capacity, heavy competition, or changing customers' wants. To keep a plant going, a company may set a low price, hoping to increase demand. In this case, profits are less important than survival. As long as their prices cover variable costs and some fixed costs, they can stay in business. However, survival is only a short-term objective. In the long run, the firm must learn how to add value that consumers will pay for or face extinction.

Many companies use current **profit maximization** as their pricing goal. They estimate what demand and costs will be at different prices and choose the price that will produce the maximum current profit, cash flow, or return on investment. In all cases, the company wants current financial results rather than long-run performance.

Other companies want to obtain **market share leadership**. They believe that the company with the largest market share will enjoy the lowest costs and highest long-run profit. To become the market share leader, these firms set prices as low as possible.

A company might decide that it wants to achieve **product quality leadership**. This normally calls for charging a high price to cover higher performance quality and the high cost of R&D.

A company might also use price to attain other, more specific objectives.

- It can set prices low to prevent competition from entering the market or set prices at competitors' levels to stabilize the market.
- Prices can be set to keep the loyalty and support of resellers.
- To avoid government intervention.
- Prices can be reduced temporarily to create excitement for a product or to draw more customers into a retail store.
- One product may be priced to help the sales of other company's line.

Thus, pricing may play an important role in helping to accomplish the company's objectives at many levels.

Nonprofit and public organizations may adopt a number of other pricing objectives. A university aims for partial cost recovery, knowing that it must rely on private gifts and public grants to cover the remaining costs. A nonprofit hospital may aim for full cost recovery in its pricing.

II. Marketing Mix Strategy

Price is only one of the marketing mix tools that a company uses to achieve its marketing objectives. Price decisions must be coordinated with product design, distribution, and promotion decisions to form a consistent and effective marketing program. Decisions made for other marketing mix variables may affect pricing decisions. For example, producers using many resellers who are expected to support and promote their products may have to build larger reseller margins into their prices. The decision to position the product on high-performance quality will mean that the seller must charge a higher price to cover higher costs. Companies often position their products on price and then base other marketing mix decisions on the prices they want to charge. Here, price is a crucial product-positioning factor that defines the product's market, competition, and design. Many firms support such price-positioning strategies with a technique called **target costing**, a potent strategic weapon. Target costing reverses the usual process of first designing a new product, determining its cost, and then asking, "Can we sell it for that?" Instead, it starts with an ideal selling price based on customer considerations, and

then targets costs that will ensure that the price is met. Other companies emphasize price and use other marketing mix tools to create non-price positions. Often, the best strategy is not to charge the lowest price, but rather to differentiate the marketing offer to make it worth a higher price. Thus, the marketer must consider the total marketing mix when setting prices. If the product is positioned on non-price factors, then decisions about quality, promotion, and distribution will strongly affect price. If price is a crucial positioning factor, then price will strongly affect decisions made about the other marketing mix elements. However, even when featuring price, marketers need to remember that customers rarely buy on price alone. Instead, they seek products that give them the best value in terms of benefits received for the price paid. Thus, in most cases, the company will consider price along with all the other marketing-mix elements when developing the marketing program.

III. Costs

Costs set the floor for the price that the company can charge for its product. The company wants to charge a price that both covers all its costs for producing, distributing, and selling the product and delivers a fair rate of return for its effort and risk. A company's costs may be an important element in its pricing strategy.

Companies with lower costs can set lower prices that result in greater sales and profits.

Types of Costs

A company's costs take two forms, fixed and variable.

- **Fixed costs** (also known as overhead) are costs that do not vary with production or sales level. For example, a company must pay each month's bills for rent, heat, interest, and executive salaries, whatever the company's output.
- **Variable costs** vary directly with the level of production. Each personal computer produced involves a cost of computer chips, wires, plastic, packaging, and other inputs. These costs tend to be the same for each unit produced. They are called variable because their total varies with the number of units produced.
- **Total costs** is the sum of all costs that are incurred to produce a good or service. Total costs = variable costs + fixed costs. Total costs are the sum of the fixed and variable costs

for any given level of production. Management wants to charge a price that will at least cover the total production costs at a given level of production. The company must watch its costs carefully. If it costs the company more than competitors to produce and sell its product, the company will have to charge a higher price or make less profit, putting it at a competitive disadvantage.

Costs at Different Levels of Production

To price wisely, management needs to know how its costs vary with different levels of production. This is because fixed costs are spread over more units, with each one bearing a smaller share of the fixed cost.

IV. Organizational Considerations

Management must decide who within the organization should set prices. Companies handle pricing in a variety of ways. In small companies, prices are often set by top management rather than by the marketing or sales departments. In large companies, pricing is typically handled by divisional or product line managers. In industrial markets, salespeople may be allowed to negotiate with customers within certain price ranges. Even so, top management sets the pricing objectives and policies, and it often approves the prices proposed by lower-level management or salespeople. In industries in which pricing is a key factor (aerospace, railroads, oil companies), companies often have a pricing department to set the best prices or help others in setting them. This department reports to the marketing department or top management. Others who have an influence on pricing include sales managers, production managers, finance managers, and accountants.

V. Company Objectives

Pricing decisions depend on the company's goals, such as profit maximization, market share growth, or brand positioning. E.g., A company focused on market penetration may set lower prices to attract customers.

VI. Product Life Cycle

Prices often change depending on the stage of the product life cycle (introduction, growth, maturity, decline). E.g., A product may be priced high during the introduction stage (price skimming) and reduced later to attract more buyers.

EXTERNAL FACTORS AFFECTING PRICING DECISIONS

External factors that affect pricing decisions include the nature of the market and demand, competition, and other environmental elements.

I. The Market and Demand

Whereas costs set the lower limit of prices, the market and demand set the upper limit. Both consumer and industrial buyers balance the price of a product or service against the benefits of owning it. Thus, before setting prices, the marketer must understand the relationship between price and demand for its product. In this section, we explain how the price–demand relationship varies for different types of markets and how buyer perceptions of price affect the pricing decision. We then discuss methods for measuring the price–demand relationship.

Pricing in Different Types of Markets

The seller's pricing freedom varies with different types of markets. Economists recognize four types of markets, each presenting a different pricing challenge. Under **pure competition**, the market consists of many buyers and sellers trading in a uniform commodity such as wheat, copper. No single buyer or seller has much effect on the going market price. A seller cannot charge more than the going price because buyers can obtain as much as they need at the going price. Nor would sellers charge less than the market price because they can sell all they want at this price. If price and profits rise, new sellers can easily enter the market. In a purely competitive market, marketing research, product development, pricing, advertising, and sales promotion play little or no role. Thus, sellers in these markets do not spend much time on marketing strategy. Under **monopolistic competition**, the market consists of many buyers and sellers who trade over a range of prices rather than a single market price. A range of prices occurs because sellers can differentiate their offers to buyers. Either the physical product can be varied in quality, features, or style or the accompanying services can be varied. Buyers see differences in sellers'

products and will pay different prices for them. Sellers try to develop differentiated offers for different customer segments and, in addition to price, freely use branding, advertising, and personal selling to set their offers apart. Because there are many competitors in such markets, each firm is less affected by competitors' marketing strategies than in oligopolistic markets. Under **oligopolistic competition**, the market consists of a few sellers who are highly sensitive to each other's pricing and marketing strategies. The product can be uniform (steel, aluminum) or differentiated (cars, computers). There are few sellers because it is difficult for new sellers to enter the market. Each seller is alert to competitors' strategies and moves. If a steel company slashes its price by 10 percent, buyers will quickly switch to this supplier. The other steelmakers must respond by lowering their prices or increasing their services. An oligopolist is never sure that it will gain anything permanent through a price cut. In contrast, if an oligopolist raises its price, its competitors might not follow this lead. The oligopolist then would have to retract its price increase or risk losing customers to competitors. In a **pure monopoly**, the market consists of one seller. Pricing is handled differently in each case. A government monopoly can pursue a variety of pricing objectives. It might set a price below cost because the product is important to buyers who cannot afford to pay full cost. Or the price might be set either to cover costs or to produce good revenue. It can even be set quite high to slow down consumption. In a regulated monopoly, the government permits the company to set rates that will yield a "fair return," one that will let the company maintain and expand its operations as needed. Unregulated monopolies are free to price at what the market will bear. However, they do not always charge the full price for a number of reasons: a desire to not attract competition, a desire to penetrate the market faster with a low price, or a fear of government regulation.

Consumer Perceptions of Price and Value

In the end, the consumer will decide whether a product's price is right. Pricing decisions, like other marketing mix decisions, must be buyer oriented. When consumers buy a product, they exchange something of value (the price) to get something of value (the benefits of having or using the product). Effective, buyer-oriented pricing involves understanding how much value consumers place on the benefits they receive from the product and setting a price that fits this value. A company often finds it hard to measure the values customers will attach to its product. For example, calculating the cost of ingredients in a meal at a fancy restaurant is relatively easy. But assigning a value to other satisfactions such as taste, environment, relaxation, conversation, and status is very hard. These values will vary both for different consumers and different situations.

Still, consumers will use these values to evaluate a product's price. If customers perceive that the price is greater than the product's value, they will not buy the product. If consumers perceive that the price is below the product's value, they will buy it, but the seller loses profit opportunities.

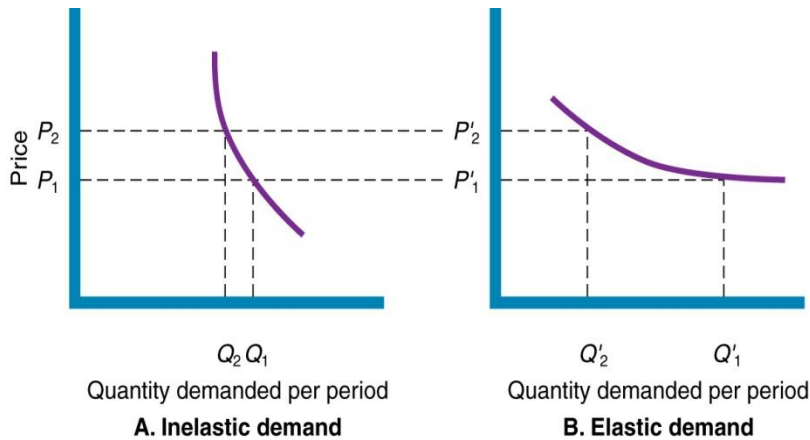
Analyzing the Price–Demand Relationship

Each price the company might charge will lead to a different level of demand. The relationship between the price charged and the resulting demand level is shown in the demand curve in Figure below.

The demand curve shows the number of units the market will buy in a given time period at different prices that might be charged. In the normal case, demand and price are inversely related; that is, the higher the price, the lower the demand. Thus, the company would sell less if it raised its price from P_1 to P_2 . In short, consumers with limited budgets probably will buy less of something if its price is too high. In the case of prestige goods, the demand curve sometimes slopes upward. Consumers think that higher prices mean more quality. Most companies try to measure their demand curves by estimating demand at different prices. The type of market makes a difference. In a monopoly, the demand curve shows the total market demand resulting from different prices. If the company faces competition, its demand at different prices will depend on whether competitors' prices stay constant or change with the company's own prices. In measuring the price–demand relationship, the market researcher must not allow other factors affecting demand to vary. For example, if any company increases its advertising at the same time that it lowers its product prices, we would not know how much of the increased demand was due to the lower prices and how much was due to the increased advertising. Economists show the impact of non-price factors on demand through shifts in the demand curve rather than movements along it.

Price Elasticity of Demand

A Marketer also needs to know price elasticity—how responsive demand will be to a change in price. Consider the two demand curves in Figure.



In Figure A, a price increase from P_1 to P_2 leads to a relatively small drop in demand from Q_1 to Q_2 . In Figure B, however, the same price increase leads to a large drop in demand from Q'_1 to Q'_2 . If demand hardly changes with a small change in price, we say the demand is inelastic. If demand changes greatly, we say the demand is elastic.

The price elasticity of demand is given by the following formula:

Price Elasticity of Demand = %change in Quantity demanded / % change in Price

Suppose demand falls by 10 percent when a seller raises its price by 2 percent. Price elasticity of demand is therefore -5 (the minus sign confirms the inverse relation between price and demand) and demand is elastic. If demand falls by 2 percent with a 2 percent increase in price, then elasticity is -1 . In this case, the seller's total revenue stays the same: The seller sells fewer items but at a higher price that preserves the same total revenue. If demand falls by 1 percent when price is increased by 2 percent, then elasticity is $-\frac{1}{2}$ and demand is inelastic. The less elastic the demand, the more it pays for the seller to raise the price.

What determines the price elasticity of demand?

- Buyers are less price sensitive when the product they are buying is unique or when it is high in quality, prestige, or exclusiveness.
- They are also less price sensitive when substitute products are hard to find or when they cannot easily compare the quality of substitutes.
- Finally, buyers are less price sensitive when the total expenditure for a product is low relative to their income or when the cost is shared by another party.

If demand is elastic rather than inelastic, sellers will consider lowering their price. A lower price will produce more total revenue. This practice makes sense as long as the extra costs of producing and selling more do not exceed the extra revenue. At the same time, most firms want to avoid pricing that turns their products into commodities. In recent years, forces such as deregulation and the instant price comparisons afforded by the Internet and other technologies have increased consumer price sensitivity, turning products ranging from telephones and computers to new automobiles into commodities in consumers' eyes. Marketers need to work harder than ever to differentiate their offerings when a dozen competitors are selling virtually the same product at a comparable or lower price. More than ever, companies need to understand the price sensitivity of their customers and prospects and the trade-offs people are willing to make between price and product characteristics.

II. Competitors' Costs, Prices, and Offers

Another external factor affecting the company's pricing decisions is competitors' costs and prices and possible competitor reactions to the company's own pricing moves.

III. Other environmental elements

When setting prices, the company also must consider other factors in its external environment.

- **Economic conditions** can have a strong impact on the firm's pricing strategies. Economic factors such as boom or recession, inflation, and interest rates affect pricing decisions because they affect both the costs of producing a product and consumer perceptions of the product's price and value.
- The company must also consider what impact its prices will have on other parties in its environment. How will resellers react to various prices? The company should set prices that give resellers a fair profit, encourage their support, and help them to sell the product effectively.
- The **government** is another important external influence on pricing decisions.
- Finally, **cultural and social concerns** may have to be considered. In setting prices, a company's short-term sales, market share, and profit goals may have to be tempered by broader societal considerations.
- Channel members
- Consumer perceptions

SETTING PRICING POLICY

Pricing policy setting starts with setting the pricing objective that can be: Profit Oriented (concerned with increase in profit), Sales Oriented (basically concerned with increase in sales) and Status Quo Oriented. Whereas costs set the lower limit of prices, the market and demand set the upper limit. Both consumer and industrial buyers balance the price of a product or service against the benefits of owning it. Thus, before setting prices, the marketer must understand the relationship between price and demand for its product. Costs set the floor for the price that the company can charge for its product. The company wants to charge a price that both covers all its costs for producing, distributing, and selling the product and delivers a fair rate of return for its effort and risk. A company's costs may be an important element in its pricing strategy. Companies with lower costs can set lower prices that result in greater sales and profits. Company's pricing decisions are also affected by competitors' costs and prices and possible competitor reactions to the company's own pricing moves therefore while setting the prices these facts should also kept in mind. Final step is setting the final price by using different methods.

GENERAL PRICING APPROACHES

The price the company charges will be somewhere between one that is too low to produce a profit and one that is too high to produce any demand.

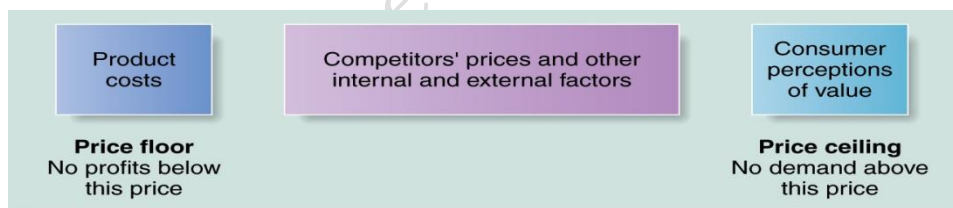


Figure summarizes the major considerations in setting price. Product costs set a floor to the price; consumer perceptions of the product's value set the ceiling. The company must consider competitors' prices and other external and internal factors to find the best price between these two extremes. Companies set prices by selecting a general pricing approach that includes one or more of three sets of factors. We examine these approaches: the cost-based approach (cost-plus pricing, break-even analysis, and target profit pricing); the buyer based approach (value-based

pricing); and the competition-based approach (going-rate and sealed-bid pricing).

A) COST-BASED PRICING

I. Cost-Plus Pricing

The simplest pricing method is cost-plus pricing—adding a standard markup to the cost of the product. Construction companies, for example, submit job bids by estimating the total project cost and adding a standard markup for profit. Lawyers, accountants, and other professionals typically price by adding a standard markup to their costs. Some sellers tell their customers they will charge cost plus a specified markup; for example, aerospace companies price this way to the government.

To illustrate markup pricing, suppose any manufacturer had the following costs and expected sales: Then the manufacturer's cost per toaster is given by:

Unit Cost = variable Cost + Fixed Cost

Price - Variable Cost

The manufacturer's markup price is given by:

Markup Price = Unit Cost

(1-desired return on sale)

Do using standard markups to set prices make sense? Generally, no. Any pricing method that ignores demand and competitor prices is not likely to lead to the best price. Markup pricing works only if that price actually brings in the expected level of sales. Still, markup pricing remains popular for many reasons. First, sellers are more certain about costs than about demand. By tying the price to cost, sellers simplify pricing—they do not have to make frequent adjustments as demand changes. Second, when all firms in the industry use this pricing method, prices tend to be similar and price competition is thus minimized. Third, many people feel that cost-plus pricing is fairer to both buyers and sellers. Sellers earn a fair return on their investment but do not take advantage of buyers when buyers' demand becomes great.

II. Break-even Analysis and Target Profit Pricing

Another cost-oriented pricing approach is break-even pricing (or a variation called target profit pricing). The firm tries to determine the price at which it will break even or make the target profit it is seeking. This pricing method is also used by public utilities, which are constrained to make a fair return on their investment. Target pricing uses the concept of a *break-even chart*, which shows the total cost and total revenue expected at different sales volume levels.

Fixed costs are same regardless of sales volume. Variable costs are added to fixed costs to form total costs, which rise with volume. The total revenue curve starts at zero and rises with each unit sold.

Break-even Volume = Fixed Cost

$$\frac{\text{-----}}{\text{Price - Variable Cost}}$$

The manufacturer should consider different prices and estimate break-even volumes, probable demand, and profits for each.

B) Value-Based Pricing

An increasing number of companies are basing their prices on the product's perceived value. Value-based pricing uses buyers' perceptions of value, not the seller's cost, as the key to pricing. Value-based pricing means that the marketer cannot design a product and marketing program and then set the price. Price is considered along with the other marketing mix variables before the marketing program is set.

Cost-based versus value-based pricing

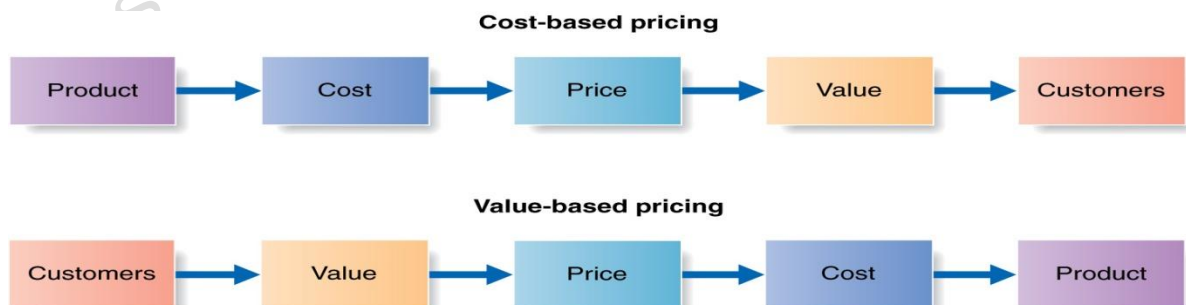


Figure compares cost-based pricing with value-based pricing. Cost-based pricing is product driven. The company designs what it considers to be a good product, totals the costs of making the product, and sets a price that covers costs plus a target profit. Marketing must then convince buyers that the product's value at that price justifies its purchase. If the price turns out to be too high, the company must settle for lower markups or lower sales, both resulting in disappointing profits.

Value-based pricing reverses this process. The company sets its target price based on customer perceptions of the product value. The targeted value and price then drive decisions about product design and what costs can be incurred. As a result, pricing begins with analyzing consumer needs and value perceptions, and price is set to match consumers' perceived value. A company using value-based pricing must find out what value buyers assign to different competitive offers. However, measuring perceived value could be difficult. Sometimes, consumers are asked how much they would pay for a basic product and for each benefit added to the offer. Or a company might conduct experiments to test the perceived value of different product offers. If the seller charges more than the buyers' perceived value, the company's sales will suffer. Many companies overprice their products, and their products sell poorly. Other companies under price; under priced products sell very well, but they produce less revenue than they would have if price were raised to the perceived-value level. During the past decade, marketers have noted a fundamental shift in consumer attitudes toward price and quality. Many companies have changed their pricing approaches to bring them into line with changing economic conditions and consumer price perceptions. The best way to hold your customers is to constantly figure out how to give them more for less." Thus, more and more, marketers have adopted value pricing strategies—offering just the right combination of quality and good service at a fair price. In many cases, this has involved the introduction of less expensive versions of established, brand-name products. In many business-to-business marketing situations, the pricing challenge is to find ways to maintain the company's *pricing power*—its power to maintain or even raise prices without losing market share. To retain pricing power—to escape price competition and to justify higher prices and margins—a firm must retain or build the value of its marketing offer. This is especially true for suppliers of commodity products, which are characterized by little differentiation and intense price competition. In such cases, many companies adopt *value-added* strategies. Rather than cutting prices to match competitors, they attach value-added services to differentiate their offers and thus support higher margins.

C) Competition-Based Pricing

Consumers will base their judgments of a product's value on the prices that competitors charge for similar products. One form of competition-based pricing is **going-rate pricing**, in which a firm bases its price largely on competitors' prices, with less attention paid to its own costs or to demand. The firm might charge the same, more, or less than its major competitors. In oligopolistic industries that sell a commodity such as steel, paper, or fertilizer, firms normally charge the same price. The smaller firms follow the leader: They change their prices when the market leader's prices change, rather than when their own demand or costs change. Some firms may charge a bit more or less, but they hold the amount of difference constant. Thus, minor gasoline retailers usually charge a few cents less than the major oil companies, without letting the difference increase or decrease. Going-rate pricing is quite popular. When demand elasticity is hard to measure, firms feel that the going price represents the collective wisdom of the industry concerning the price that will yield a fair return. They also feel that holding to the going price will prevent harmful price wars. Competition-based pricing is also used when firms *bid* for jobs. Using **sealed-bid pricing**, a firm bases its price on how it thinks competitors will price rather than on its own costs or on the demand.

The firm wants to win a contract, and winning the contract requires pricing less than other firms. Yet the firm cannot set its price below a certain level. It cannot price below cost without harming its position. In contrast, the higher the company sets its price above its costs, the lower its chance of getting the contract. Pricing decisions are subject to an incredibly complex array of environmental and competitive forces. A company sets not a single price, but rather a *pricing structure* that covers different items in its line. This pricing structure changes over time as products move through their life cycles. The company adjusts product prices to reflect changes in costs and demand and to account for variations in buyers and situations. As the competitive environment changes, the company considers when to initiate price changes and when to respond to them.

NEW-PRODUCT PRICING STRATEGIES

Pricing strategies usually change as the product passes through its life cycle. The introductory stage is especially challenging. Companies bringing out a new product face the challenge of

setting prices for the first time. They can choose between two broad strategies: market-skimming pricing and market penetration pricing.

a) Market-Skimming Pricing

Many companies that invent new products initially set high prices to "skim" revenues layer by layer from the market. Market skimming makes sense only under certain conditions.

- First, the product's quality and image must support its higher price, and enough buyers must want the product at that price.
- Second, the costs of producing a smaller volume cannot be so high that they cancel the advantage of charging more.
- Finally, competitors should not be able to enter the market easily and undercut the high price.

b) Market-Penetration Pricing

Rather than setting a high initial price to *skim* off small but profitable market segments, some companies use market-penetration pricing. They set a low initial price in order to *penetrate* the market quickly and deeply—to attract a large number of buyers quickly and win a large market share. The high sales volume results in falling costs, allowing the company to cut its price even further. Several conditions must be met for this low-price strategy to work.

- First, the market must be highly price sensitive so that a low price produces more market growth.
- Second, production and distribution costs must fall as sales volume increases.
- Finally, the low price must help keep out the competition, and the penetration pricer must maintain its low-price position—otherwise, the price advantage may be only temporary.

PRODUCT MIX PRICING STRATEGIES

The strategy for setting a product's price often has to be changed when the product is part of a product mix. In this case, the firm looks for a set of prices that maximizes the profits on the total product mix. Pricing is difficult because the various products have related demand and costs and face different degrees of competition. We now take a closer look at the five product mix pricing situations.

a) Product Line Pricing

Companies usually develop product lines rather than single products. In product line pricing, management must decide on the price steps to set between the various products in a line. The price steps should take into account cost differences between the products in the line, customer evaluations of their different features, and competitors' prices. In many industries, sellers use well-established *price points* for the products in their line. The seller's task is to establish perceived quality differences that support the price differences.

b) Optional-Product Pricing

Many companies use optional-product pricing—offering to sell optional or accessory products along with their main product. For example, a car buyer may choose to order power windows, cruise control, and a CD changer. Pricing these options is a sticky problem. Automobile companies have to decide which items to include in the base price and which to offer as options. Until recent years, the economy model was stripped of so many comforts and conveniences that most buyers rejected it.

c) Captive-Product Pricing

Companies that make products that must be used along with a main product are using captive product pricing. Examples of captive products are razor blades, camera film, video games, and computer software. Producers of the main products (razors, cameras, video game consoles, and computers) often price them low and set high markups on the supplies. Thus, camera manufacturers price their cameras low because they make their money on the film they sell. In the case of services, this strategy is called *two-part pricing*. The price of the service is broken into a *fixed fee* plus a *variable usage rate*. Thus, a telephone company charges a monthly rate—the fixed fee—plus charges for calls beyond some minimum number—the variable usage rate. Amusement parks charge admission plus fees for food, midway attractions, and rides over a minimum. The service firm must decide how much to charge for the basic service and how much for the variable usage. The fixed amount should be low enough to induce usage of the service; profit can be made on the variable fees.

d) By-Product Pricing

In producing processed meats, petroleum products, chemicals, and other products, there are often by-products. If the by-products have no value and if getting rid of them is costly, this will affect the pricing of the main product. Using by-product pricing, the manufacturer will seek a market for these by-products and should accept any price that covers more than the cost of storing and delivering them. This practice allows the seller to reduce the main product's price to make it more competitive. By-products can even turn out to be profitable. For example, many lumber mills have begun to sell bark chips and sawdust profitably as decorative mulch for home and commercial landscaping. Sometimes, companies don't realize how valuable their by-products are.

e) Product Bundle Pricing

Using product bundle pricing, sellers often combine several of their products and offer the bundle at a reduced price. Thus, theaters and sports teams sell season tickets at less than the cost of single tickets; hotels sell specially priced packages that include room, meals, and entertainment; computer makers include attractive software packages with their personal computers. Price bundling can promote the sales of products consumers might not otherwise buy, but the combined price must be low enough to get them to buy the bundle.

PRICE-ADJUSTMENT STRATEGIES

Companies usually adjust their basic prices to account for various customer differences and changing situations. The six price-adjustment strategies include: discount and allowance pricing, segmented pricing, psychological pricing, promotional pricing, geographical pricing, and international pricing.

a. Discount and Allowance Pricing

Most companies adjust their basic price to reward customers for certain responses, such as early payment of bills, volume purchases, and off-season buying. These price adjustments—called discounts and allowances—can take many forms. I.e. cash discount, quantity discount, functional discount and seasonal discount.

b. Segmented Pricing

Companies will often adjust their basic prices to allow for differences in customers, products, and locations. In segmented pricing, the company sells a product or service at two or more prices, even though the difference in prices is not based on differences in costs. Segmented pricing takes several forms. Under customer-segment pricing, different customers pay different prices for the same product or service. Museums, for example, will charge a lower admission for students and senior citizens. Under product-form pricing, different versions of the product are priced differently but not according to differences in their costs. Using location pricing, a company charges different prices for different locations, even though the cost of offering at each location is the same. For instance, theaters vary their seat prices because of audience preferences for certain locations. Finally, using time pricing, a firm varies its price by the season, the month, the day, and even the hour. Public utilities vary their prices to commercial users by time of day and weekend versus weekday. The telephone company offers lower off-peak charges, and resorts give seasonal discounts.

For segmented pricing to be an effective strategy, certain conditions must exist.

- The market must be segmentable, and the segments must show different degrees of demand.
- Members of the segment paying the lower price should not be able to turn around and resell the product to the segment paying the higher price.
- Competitors should not be able to undersell the firm in the segment being charged the higher price. Nor should the costs of segmenting and watching the market exceed the extra revenue obtained from the price difference.
- Of course, the segmented pricing must also be legal.
- Most importantly, segmented prices should reflect real differences in customers' perceived value. Otherwise, in the long run, the practice will lead to customer resentment and ill will.

c. Psychological Pricing

Price says something about the product. For example, many consumers use price to judge quality. An shs1000 bottle of perfume may contain only shs300 worth of scent, but some people are willing

to pay the \$1000 because this price indicates something special. In using psychological pricing, sellers consider the psychology of prices and not simply the economics. For example, one study of the relationship between price and quality perceptions of cars found that consumers perceive higher-priced cars as having higher quality. By the same token, higher-quality cars are perceived to be even higher priced than they actually are. When consumers can judge the quality of a product by examining it or by calling on past experience with it, they use price to judge quality. When consumers cannot judge quality because they lack the information or skill, price becomes an important quality signal. Another aspect of psychological pricing is reference pricing—prices that buyers carry in their minds and refer to when looking at a given product. The reference price might be formed by noting current prices, remembering past prices, or assessing the buying situation. Sellers can influence or use these consumers' reference prices when setting price. For example, a company could display its product next to more expensive ones in order to imply that it belongs in the same class. Department stores often sell women's clothing in separate departments differentiated by price: Clothing found in the more expensive department is assumed to be of better quality. Companies can also influence consumers' reference prices by stating high manufacturer's suggested prices, by indicating that the product was originally priced much higher, or by pointing to a competitor's higher price.

d. Promotional pricing,

Companies will temporarily price their products below list price and sometimes even below cost. Promotional pricing takes several forms. Supermarkets and department stores will price a few products as loss leaders to attract customers to the store in the hope that they will buy other items at normal markups. Sellers will also use special-event pricing in certain seasons to draw more customers. Manufacturers will sometimes offer cash rebates to consumers who buy the product from dealers within a specified time; the manufacturer sends the rebate directly to the customer. Rebates have been popular with automakers and producers of durable goods and small appliances, but they are also used with consumer-packaged goods. Some manufacturers offer low-interest financing, longer warranties, or free maintenance to reduce the consumer's "price." This practice has recently become a favorite of the auto industry. Or, the seller may simply offer discounts from normal prices to increase sales and reduce inventories. Promotional pricing, however, can have adverse effects. Used too frequently and copied by competitors, price promotions can create "deal-prone" customers who wait until brands go on sale before buying them. Or, constantly reduced prices can erode a brand's value in the eyes of

customers. Marketers sometimes use price promotions as a quick fix instead of sweating through the difficult process of developing effective longer-term strategies for building their brands. In fact, one observer notes that price promotions can be downright addicting to both the company and the customer. The point is that promotional pricing can be an effective means of generating sales in certain circumstances but can be damaging if taken as a steady diet.

e. Geographical Pricing

A company also must decide how to price its products for customers located in different parts of the country or world. Should the company take risk of losing the business of more distant customers by charging them higher prices to cover the higher shipping costs? Or should the company charge all customers the same prices regardless of location? Because each customer picks up its own cost, supporters of FOB pricing feel that this is the fairest way to assess freight charges.

The disadvantage, however, is that Peerless will be a high-cost firm to distant customers? Uniform-delivered pricing is the opposite of FOB pricing. Here, the company charges the same price plus freight to all customers, regardless of their location. The freight charge is set at the average freight cost. Other advantages of uniform-delivered pricing are that it is fairly easy to administer and it lets the firm advertise its price nationally.

Zone pricing falls between FOB-origin pricing and uniform-delivered pricing. The company sets up two or more zones. All customers within a given zone pay a single total price; the more distant the zone, the higher the price. Using base point pricing, the seller selects a given city as a "basing point" and charges all customers the freight cost from that city to the customer location, regardless of the city from which the goods are actually shipped. If all sellers used the same basing-point city, delivered prices would be the same for all customers and price competition would be eliminated.

Industries such as sugar, cement, steel, and automobiles used basing-point pricing for years, but this method has become less popular today. Some companies set up multiple basing points to create more flexibility: They quote freight charges from the basing-point city nearest to the customer.

Finally, the seller who is anxious to do business with a certain customer or geographical area might use freight-absorption pricing. Using this strategy, the seller absorbs all or part of the actual freight charges in order to get the desired business. The seller might reason that if it can get more business, its average costs will fall and more than compensate for its extra freight cost. Freight

absorption pricing is used for market penetration and to hold on to increasingly competitive markets.

f. International Pricing

Companies that market their products internationally must decide what prices to charge in the different countries in which they operate. In some cases, a company can set a uniform worldwide price. The price that a company should charge in a specific country depends on many factors, including economic conditions, competitive situations, laws and regulations, and development of the wholesaling and retailing system. Consumer perceptions and preferences also may vary from country to country, calling for different prices. Or the company may have different marketing objectives in various world markets, which require changes in pricing strategy. Costs play an important role in setting international prices. Travelers abroad are often surprised to find that goods that are relatively inexpensive at home may carry outrageously higher price tags in other countries. In some cases, such price escalation may result from differences in selling strategies or market conditions. In most instances, however, it is simply a result of the higher costs of selling in foreign markets—the additional costs of modifying the product, higher shipping and insurance costs, import tariffs and taxes, costs associated with exchange-rate fluctuations, and higher channel and physical distribution costs.