

# 7

## Pricing strategies

### Objectives

After reading this chapter you should be able to:

- explain the advantages and disadvantages of different pricing methods;
- calculate prices using different approaches;
- choose the correct pricing strategy to fit a firm's overall objectives;
- explain some of the economic theories underlying the marketer's view of price and value.

## INTRODUCTION

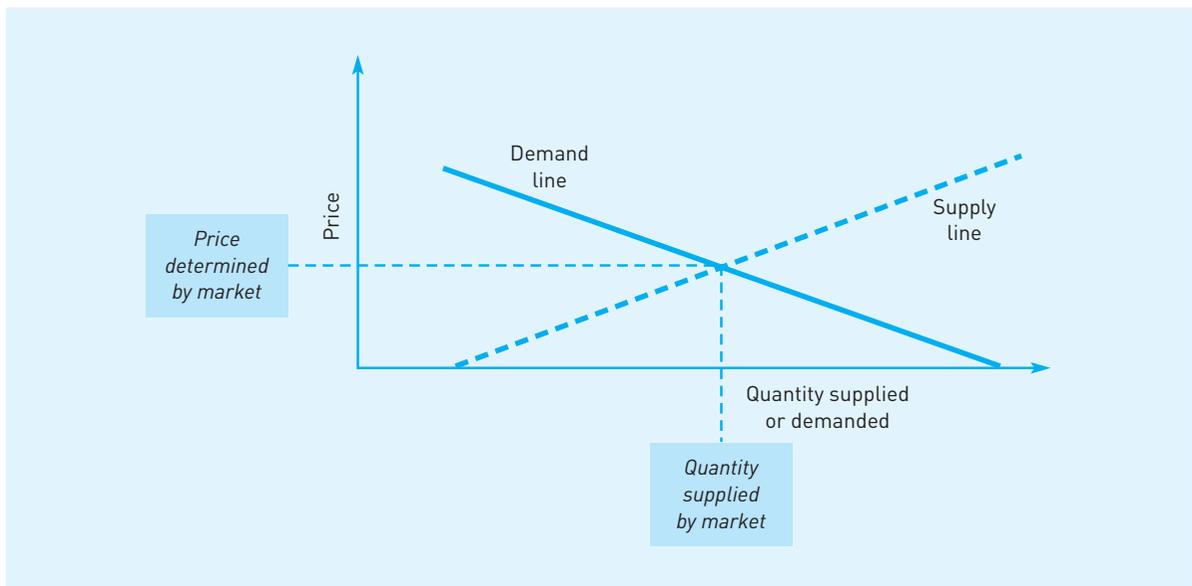
Pricing may not be exciting, but it is one of the most important issues for marketers; it is crucial not only to the profit that is to be made, but also to the quantity of the products that will be sold. This chapter examines the different ways of pricing that are used, and offers some ideas on how to choose a pricing strategy.

## ECONOMIC THEORIES OF PRICING AND VALUE

Classical economists assumed that prices would automatically be set by the laws of *supply and demand*. Figure 7.1 shows how this works.

As prices rise, more suppliers find it profitable to enter the market, but the demand for the product falls because fewer customers think the product is worth the money. Conversely, as prices fall there is more demand, but fewer suppliers feel it is worthwhile supplying the product so less is produced. Eventually a state of equilibrium is reached where the quantity produced is equal to the quantity consumed, and at that point the price will be fixed.

Unfortunately this neat model has a number of drawbacks.



**FIGURE 7.1** Supply and demand

- The model assumes that customers know where they can buy the cheapest products (i.e. it assumes perfect knowledge of the market).
- Secondly, it assumes that all the suppliers are producing identical products, which is rarely the case.
- Thirdly, it assumes that price is the only issue that affects customer behaviour, which is clearly not true.
- Fourthly, it assumes that customers always behave completely rationally, which again is substantially not the case.
- Fifthly, there is an assumption that people will always buy more of a product if it is cheaper. This is not true of such products as wedding rings or artificial limbs.
- Finally, the model assumes that the suppliers are in perfect competition – that none of them has the power to ‘rig’ the market and set the prices (see Chapter 2).

The model does, at least, take account of customers, and it was the pioneer economist Adam Smith who first said that ‘the customer is king’.<sup>1</sup> Unfortunately the shortcomings of the model mean that it has little practical use, no matter how helpful it is in understanding a principle. Economists have therefore added considerably to the theory.

## Elasticity of demand

This concept states that different product categories will show different degrees of sensitivity to price change.

Figure 7.2(a) shows a product where the quantity sold is affected only slightly by price fluctuations, i.e. the demand is **inelastic**. An example of this is salt. Figure 7.2(b) shows a product where even a small difference in price leads to a very substantial shift in the quantity demanded, i.e. the demand is **elastic**. An example of this is borrowed money, e.g. mortgages, where even a small rise in interest rates appears to affect the propensity to borrow. Although these examples relate to consumers, the same is true for suppliers: in some cases suppliers can react very quickly to changes in the quantities demanded (for example, banking), whereas in other cases the suppliers need long lead times to change the production levels (for instance, farming).

The **price elasticity of demand** concept implies that there is no basis for defining products as necessities or luxuries. If a necessity is defined as something without which life cannot be sustained, then its demand curve would be entirely inelastic: whatever the price was, people would have to pay it. In practice, no such product exists.

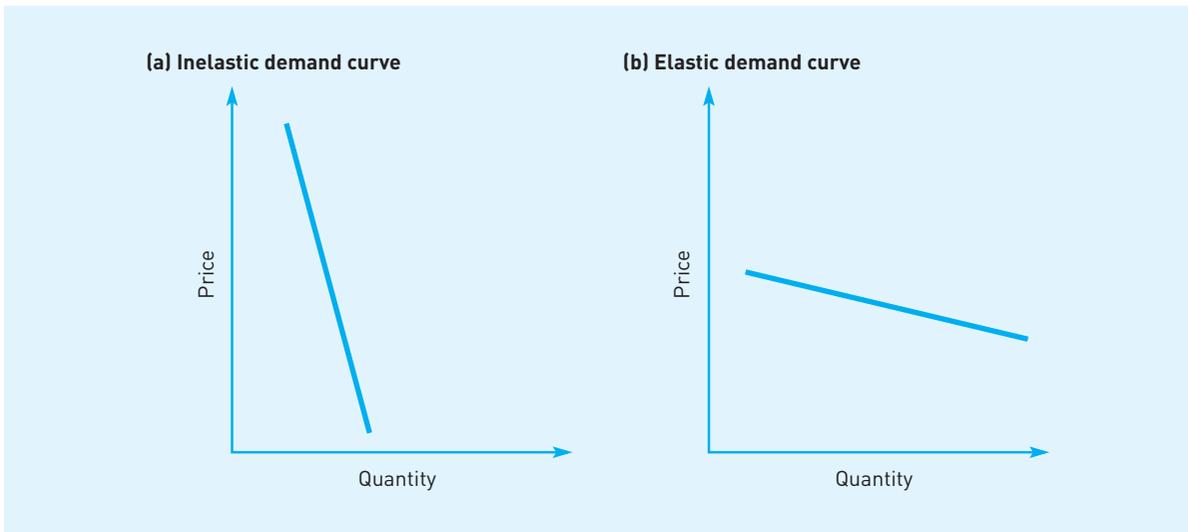


FIGURE 7.2 Price elasticity of demand

## Economic choice

Economists have demonstrated that there can never be enough resources in the world to satisfy everybody's wants, and therefore resources have to be allocated in some way (which will probably mean an equality of dissatisfaction). Resources used for one purpose cannot, of course, be used for another: this is the concept of the **economic choice**.

For example, a clothing manufacturer has only a certain number of machinists who work a certain number of hours. This means that it may be possible to produce either 8000 shirts with the available resources, or 4000 pairs of trousers. If the manufacturer has two orders, one for each type of product, he or she will have to choose which order to supply, and disappoint the other customer.

From the customer's viewpoint, the economic choice means having to choose between going to the cinema or going to the pub; there may not be the time or the money to do both. Because of this, customers may also take into account the price of activities other than those the prospective supplier is providing; the pub, for example, may not be aware that the cinema is competition, and that a fall in the price of going to the cinema may affect the takings over the bar.

Although the economists' view of pricing offers some interesting insights, there is little practical value in the theories offered because they take little account of the consumer decision-making process (see Chapter 3). Consumers are not always rational; marketers need to take account of this.

## PRICING AND MARKET ORIENTATION

As in any other question of marketing, pricing is dependent on how the customer will react to the prices set. Customers do not usually buy the cheapest products; they buy those that represent good value for money. If this were not so, the most popular cars in Britain would be Ladas and Yugos, rather than Vauxhalls and Fords. Typically, customers will assess the promises the supplier has made about what the product is and will do, and will measure this against the price being asked.<sup>2</sup>

This leaves the marketer with a problem. Marketers need to decide what price will be regarded by customers as good value for money, while still allowing the company to make a profit.

The main methods of pricing used by firms are cost-based, customer-based and competition-based.

### Cost-based pricing

Cost-based methods are the least customer-orientated; two still used are **cost-plus pricing** and **mark-up pricing**.

#### Cost-plus pricing

*Cost-plus pricing* is commonly advocated by accountants and engineers, since it is simple to use and appears to guarantee that the company meets a pre-determined profit target. The method works by calculating the cost of manufacturing the product, including distributed overhead costs and research and development costs, then adding on a fixed percentage profit to this figure in order to arrive at the price. Such a calculation might look like Table 7.1.

**TABLE 7.1** Cost-plus pricing

Item	Cost per unit
Labour costs	£2.52
Raw materials	£4.32
Electricity	£0.27
Tooling costs (assuming production run of 20 000 units)	£1.78
Overheads	<u>£3.43</u>
Total production cost per unit	£12.32
Plus profit of 20%	<u>£2.46</u>
Net price	<b>£14.78</b>

On the face of it, this type of pricing seems logical and straightforward; unfortunately, it does not take account of how the customers will react to the prices quoted. If the customers take the view that the price does not represent value for money, they will not buy the product, and the result will be that the company will have made 20 000 units of a product for which there will be no sales. Conversely, if the customers take the view that the price is incredibly good value for money, the company may not have enough stocks on hand to meet demand, and competitors will be able to enter the market easily.

Some government contracts are awarded on a cost-plus basis, but experience in the United States has shown that allowing cost-plus contracts to be granted will often result in the supplier inflating the costs to make an extra profit.

### Mark-up pricing

*Mark-up pricing* is similar to cost-plus pricing, and is the method used by most retailers. Typically, a retailer will buy in stock and add on a fixed percentage to the bought-in price (a mark-up) in order to arrive at the **shelf price**. The level will vary from retailer to retailer, depending on the type of product; in some cases the mark-up will be 100% or more, in others it will be near zero (if the retailer feels that stocking the product will stimulate other sales). Usually there is a standard mark-up for each product category.

Here the difference needs to be shown between a **mark-up** and a **margin**. Mark-up is calculated on the price the retailer pays for the product; margin is calculated on the price the retailer sells for. This means that a 100% mark-up equals a 50% margin; a 25% mark-up equals a 20% margin (Table 7.2).

Retailers use this method because of the number of lines the shop may be carrying. For a hypermarket, this could be up to 20 000 separate lines, and it would clearly be impossible to carry out market research with the customers for every line. The buyers therefore use their training and knowledge of their customer base to determine which lines to stock, and (to some extent) rely on the manufacturers to carry out the formal market research and determine the recommended retail prices.

This method is identical to the cost-plus method except for two factors: firstly, the retailer is usually in close contact with the customers, and can therefore

**TABLE 7.2** Mark-up v margin

Bought-in price	£4.00
<i>Mark-up</i> at 25% of £4.00	£1.00
Price on the shelf	£5.00
<i>Margin</i> of 20% of £5.00	£1.00
Bought-in price	£4.00

develop a good 'feel' for what customers will be prepared to pay; and, secondly, retailers have ways of disposing of unsold stock. In some cases, this will mean discounting the stock back to cost and selling it in the January sales; in other cases, the retailer will have a sale-or-return agreement with the manufacturer, so that unsold stock can be returned for credit. This is becoming increasingly common with major retailers such as Toys 'R' Us who have sufficient 'clout' in the market to enforce such agreements. In a sense, therefore, the retailer is carrying out market research by test-marketing the product; if the customers do not accept the product at the price offered, the retailer can drop the price to a point that will represent value for money, or can return it to the manufacturer for credit.

## Customer-based pricing methods

The various approaches to *customer-based pricing* do not necessarily mean offering products at the lowest possible price, but they do take account of customer needs and wants.

### Customary pricing

**Customary pricing** is customer-orientated in that it provides the customer with the product for the same price at which it has always been offered. An example is the price of a call from a coin-operated telephone box. Telephone companies need only reduce the time allowed for the call as costs rise. For some countries (e.g. Australia) this is problematical since local calls are allowed unlimited time, but for most European countries this is not the case.

The reason for using customary pricing is to avoid having to reset the call-boxes too often. Similar methods exist for taxis, some children's sweets, and gas or electricity pre-payment meters. If this method were to be used for most products there would be a steady reduction in the firm's profits as the costs caught up with the selling price, so the method is not practical for every firm.

### Demand pricing

**Demand pricing** is the most market-orientated method of pricing. Here, the marketer begins by assessing what the demand will be for the product at different price levels. This is usually done by asking the customers what they might expect to pay for the product, and seeing how many choose each price level. This will lead to the development of the kind of chart shown in Table 7.3.

As the price rises, fewer customers are prepared to buy the product, as fewer will still see the product as good value for money. In the example given in Table 7.3, the fall-off is not linear, i.e. the number of units sold falls dramatically once the price goes above £5. This kind of calculation could be used to determine the stages of a skimming policy (see below), or it could be used to calculate the appropriate launch price of a product.

**TABLE 7.3** Demand pricing

Price per unit	Number of customers who said they would buy at this price
£3 to £4	30 000
£4 to £5	25 000
£5 to £6	15 000
£6 to £7	5 000

For demand pricing, the next stage is to calculate the costs of producing the product in the above quantities. Usually the cost of producing each item falls as more are made (i.e. if we make 50 000 units, each unit costs less than would be the case if we made only 1000 units). Given the costs of production it is possible to select the price that will lead to a maximisation of profits. This is because there is a trade-off between quantity produced and quantity sold: as the firm lowers the selling price, the amount sold increases but the income generated decreases.

The calculations can become complex, but the end result is that the product is sold at a price that customers will accept, and that will meet the company's profit targets. Table 7.4 shows an example of costings to match up with the above figures. The tooling-up cost is the amount it will cost the company to prepare for producing the item. This will be the same whether 1000 or 30 000 units are made.

Table 7.5 shows how much profit could be made at each price level. The price at which the product is sold will depend on the firm's overall objectives; these may not necessarily be to maximise profit on this one product, since the firm may have other products in the range or other long-term objectives that preclude maximising profits at present.

**TABLE 7.4** Costings for demand pricing

Number of units	Unit cost (labour and materials)	Tooling-up and fixed costs	Net cost per unit
30 000	£1.20	£4000	£1.33
25 000	£1.32	£4000	£1.48
15 000	£1.54	£4000	£1.81
5 000	£1.97	£4000	£2.77

**TABLE 7.5** Profitability at different price bands

Number of units sold	Net profit per unit	Total profit for production run	Percentage profit per unit
30 000	£2.17	£65 100	62
25 000	£3.02	£75 500	67
15 000	£3.61	£54 150	66
5 000	£3.73	£18 650	57

Based on these figures, *the most profitable* price will be £4.50. Other ways of calculating the price could easily lead to making a lower profit from this product. For instance, the price that would generate *the highest profit per unit* would be £6.50, but at this price they would sell only 5000 units and make £18 650. The price that would generate *the highest sales* would be £3.50, but this would (in effect) lose the firm almost £10 000 in terms of forgone profit.

A further useful concept is that of *contribution*. Contribution is calculated as the difference between the cost of manufacture and the price for which the product is sold – in other words it does not take account of overheads. Sometimes a product is worth producing because it makes a significant extra contribution to the firm's profits, without actually adding to the overheads. It is not difficult to imagine a situation where a product carries a low profit margin, and is therefore unable to support a share of the overheads. A calculation which included an overall share of the overheads might not give a fair picture, since the contribution would be additional to existing turnover.

Demand pricing works by knowing what the customers are prepared to pay, and what they will see as value for money.

### Product-line pricing

**Product-line pricing** means setting prices within linked product groups. Often sales of one product will be directly linked to the sales of another, so that it is possible to sell one item at a low price in order to make a greater profit on the other one. Gillette sells its Mach III system razors at a very low price, with the aim of making up the profit on sales of the blades. In the long run, this is a good strategy because it overcomes the initial resistance of consumers towards buying something untried, but allows the firm to show high profits for years to come (incidentally, this approach was first used by King C. Gillette, the inventor of the disposable safety razor blade).

Polaroid chose to sell its instant cameras very cheaply (almost for cost price) for the US market and to take their profit from selling the films for a much higher price. For Europe, the firm chose to sell both films and cameras for a medium

level price and profit from sales of both. Eventually this led Kodak to enter the market with its own instant camera, but this was withdrawn from sale in the face of lawsuits from Polaroid for patent infringement.

## Skimming

**Skimming** is the practice of starting out with a high price for a product, then reducing it progressively as sales level off. It relies on two main factors: firstly that not all customers have the same perception of value for money, and secondly that the company has a technological lead over the opposition which can be maintained for long enough to satisfy the market.

Skimming is usually carried out by firms who have developed a technically advanced product. Initially the firm will charge a high price for the product, and at this point only those who are prepared to pay a premium price for it will buy. Profit may not be high, because the number of units sold will be low and therefore the cost of production per unit will be high. Once the most innovative customers have bought, and the competition is beginning to enter the market, the firm can drop the price and 'skim' the next layer of the market, at which point profits will begin to rise. Eventually the product will be sold at a price that allows the firm only a minimum profit, at which point only replacement sales or sales to late adopters will be made.

The advantage of this method is that the cost of developing the product is returned fairly quickly, so that the product can later be sold near the marginal cost of production. This means that the competitors have difficulty entering the market at all, since their own development costs will have to be recovered in some other way.

Skimming is commonly used in consumer electronics markets. This is because firms frequently establish a technological lead over the competitors, and can sometimes even protect their products by taking out patents, which take some time for competitors to overcome. An example of this was the Sony Walkman, which cost over £70 when it was first introduced in the early 1980s. Allowing for inflation, the price is now around one-tenth of what it was then. Recent research shows that customers are aware of skimming in the electronics markets, and are delaying purchases of new electronic devices until the prices drop. This may affect the way firms view skimming in the future.

Skimming requires careful judgement of what is happening in the marketplace, in terms both of observing customer behaviour, and of observing competitive response. Market research is therefore basic to the success of a skimming policy, and very careful monitoring of sales is needed to know when to cut the price again.

## Psychological pricing

**Psychological pricing** relies on emotional responses from the consumer. Higher prices are often used as an indicator of quality,<sup>3</sup> so some firms will use

**prestige pricing.** This applies in many service industries, because consumers are often buying a promise; a service that does not have a high enough quality cannot be exchanged afterwards. Consumers' expectations of high-priced restaurants and hairdressers are clearly higher in terms of the quality of service provision; cutting prices in those industries does not necessarily lead to an increase in business. **Odd-even pricing** is the practice of ending prices with an odd number, for example £3.99 or \$5.95 rather than £4 or \$6. It appears that consumers tend to categorise these prices as '£3 and a bit' or '\$5 and change' and thus perceive the price as being lower. The effect may also be due to an association with discounted or sale prices; researchers report that '99' endings on prices increase sales by around 8%.<sup>4</sup>

Recent research has shown that odd-even pricing does not necessarily work in all cultures.<sup>5</sup> In Poland, for example, the effects are negligible. Odd-even pricing also has effects on perceptions of discounts during sales. Rounding the price to (say) £5 from £4.99 leads people to overvalue the size of the discount, which increases the perception of value for money.<sup>6</sup> Thus the positive effect on sales of using a 99-ending can be negated by the effect when the product is on offer in a sale.

## Second-market discounting

**Second-market discounting** is common in some service industries and in international markets. The brand is sold at one price in one market, and in a lower price in another: for example, museums offer discounts to students, some restaurants offer discounts to elderly people on week-nights, and so forth. Often these discounts are offered to even out the **loading** on the firm; week-night discounts fill the restaurant on what would otherwise be a quiet night, so making more efficient use of the premises and staff.

In international markets products might be discounted to meet local competition. For example, Honda motorcycles are up against strong local competition in India from Royal Enfield, so the price of their basic 100 cc motorcycle is around Rs39 000 (about £600). A similar Honda motorcycle in the UK costs around £2000. The specifications of the motorcycles do differ somewhat – but it is difficult to see any difference that would account for a £1400 price differential.

## Competitor-based pricing

**Competitor-based pricing** recognises the influence of competition in the marketplace. Strategically, the marketer must decide how close the competition is in providing for the consumers' needs; if the products are close, then prices will need to be similar to those of the competition. A **meet-the-competition strategy** has the advantage of avoiding price wars and stimulating competition in other areas of marketing, thus maintaining profitability. An **undercut-the-competition strategy** is often the main plank in the firm's marketing strategy; it is particularly common among retailers, who have relatively little control over product features

and benefits and often have little control over the promotion of the products they stock. Some multinational firms (particularly in electronics) have the capacity to undercut rivals since they are able to manufacture in low-wage areas of the world, or are large enough to use widespread automation. There is a danger of starting price wars when using an undercutting policy (see penetration pricing below). Undercutting (and consequent price wars) may be becoming more common.<sup>7</sup>

Firms with large market shares often have enough control over their distribution systems and production capacity within their industries to become **price leaders**. Typically, such firms can make price adjustments without starting price wars, and can raise prices without losing substantial market share (see Chapter 2 for monopolistic competition).<sup>8</sup> Sometimes these price leaders become sensitive to the price and profit needs of their competitors, in effect supporting them, because they do not wish to attract the attention of monopoly regulators by destroying the competition.<sup>9</sup> Deliberate price fixing (managers colluding to set industry prices) is illegal in most countries.

### Penetration pricing

**Penetration pricing** is used when the firm wants to capture a large part of the market quickly. It relies on the assumption that a lower price will be perceived as offering better value for money (which is, of course, often the case).

For penetration pricing to work, the company must have carried out thorough research to find out what the competitors are charging for the nearest similar product. The new product is then sold at a substantially lower price, even if this cuts profits below an acceptable level; the intention is to capture the market quickly before the competitors can react with even lower prices. The danger with this pricing method is that competitors may be able to sustain a price war for a long period and will eventually bankrupt the incoming firm. It is usually safer to compete on some other aspect of the offering, such as quality or delivery.

### Predatory pricing

In some cases, prices are pitched below the cost of production. The purpose of this is to bankrupt the competition so that the new entrant can take over entirely; this practice is called **predatory pricing**, and (at least in international markets) is illegal. Predatory pricing was successfully used by Japanese car manufacturers when entering the European markets in the 1970s, and is commonly used by large firms who are entering new markets. For the strategy to be successful, it is necessary for the market to be dominated by firms that cannot sustain a long price war. It is worth doing if the company has no other competitive edge, but does have sufficient financial reserves to hold out for a long time. Naturally, this method is customer-orientated since it can work only by providing the customers with very much better value for money than they have been used to. The company will

eventually raise prices again in order to recoup the lost profits once the market presence has been established, however.

The ultimate in predatory pricing is dumping. This is the practice of selling goods at prices below the cost of manufacture, and was at one time commonly practised by Communist countries desperate for hard currency. Dumping is illegal under international trade rules, but is difficult to prove, and by the time the victim countries have been able to prove their case and have the practice stopped, it is usually too late.

Competitor-based pricing is still customer-orientated to an extent, since it takes as its starting-point the prices that customers are currently prepared to pay.

## SETTING PRICES

Price setting follows eight stages, as shown in Table 7.6.

Price setting can be complex if it is difficult to identify the closest competitors, but it should be borne in mind that no product is entirely without competition; there is almost always another way in which customers can meet the need supplied by the product. Also, different customers have different needs and therefore will have dif-

**TABLE 7.6** Eight stages of price setting

Stage	Explanation
Development of pricing objectives	The pricing objectives derive from the organisation's overall objectives; does the firm seek to maximise market share, or maximise profits?
Assessment of the target market's ability to purchase and evaluation of price	Buyers tend to be more sensitive to food prices in supermarkets than to drinks prices in clubs. Also, a buyer's income and availability of credit directly affect the ability to buy the product at all.
Determination of demand	For most products demand falls as price rises. This is not necessarily a straight-line relationship, nor is the line necessarily at forty-five degrees; for some products even a small price rise results in a sharp fall in demand (e.g. petrol) whereas for other products (e.g. salt) even a large price rise hardly affects demand at all.
Analysis of demand, cost and profit relationships	The firm needs to analyse the costs of producing the item against the price that the market will bear, taking into account the profit needed. The cost calculation will include both the fixed costs and the unit costs for making a given quantity of the product; this quantity will be determined by the market, and will relate to the selling price.

Evaluation of competitors' prices	This will involve a survey of the prices currently being charged, but will also have to consider the possible entry of new competitors. Prices may be pitched higher than the competitors in order to give an impression of exclusivity or higher quality; this is common in the perfume market, and in services such as restaurants and hairdressing.
Selection of a pricing policy	The pricing policy needs to be chosen from the list given in the early part of the chapter.
Development of a pricing method	Here the producer develops a simple mechanism for determining prices in the future. The simplest method is to use cost-plus or mark-up pricing; these do not take account of customers, however, so something a little more sophisticated should be used if possible.
Determining a specific price	If the previous steps have been carried out in a thorough manner, determining the actual price should be a simple matter.

(Source: Adapted from Dibb *et al.*<sup>10</sup>)

fering views on what constitutes value for money – this is why markets need to be segmented carefully to ensure that the right price is being charged in each segment. As in any question of marketing, it is wise to begin with the customer.

## CASE STUDY 7: LOW-COST AIRLINES

Prior to 1987, air travel within Europe was heavily regulated and was largely the province of the rich. National airlines of European Union member states had developed a highly complex set of agreements about who could fly where, how many seats were allowed on each aircraft, and what fares could be charged. All these decisions were made by the national airlines in negotiation with each other – so that, for example, Alitalia might not allow British Airways to fly from London to Milan unless Alitalia could be given a route from Rome to Manchester.

In essence, the national airlines regarded the skies of Europe as their personal property: the only exception was private charter flying, which of course they were powerless to prevent, and which gave rise to the cheap package holiday. Prior to 1987, it was often cheaper for a business traveller to buy a package holiday to (say) Rome and then stay in another hotel rather than buy a scheduled flight with BA or Alitalia.

All this changed in 1987 when the European Union agreed that the skies should be liberalised for any carriers. Over the protests of the national airlines, licences were granted for operators to fly scheduled routes from anywhere to anywhere,

subject of course to air traffic control regulations and agreement with the airports concerned. Thus the possibility for cheap, no-frills airlines was opened up.

One of the earliest to enter the market (and still the best-known) was EasyJet.

This airline operates a very effective website, which has served as the pattern for other cheap airlines. Seat prices are not fixed, but are controlled by demand using sophisticated computer software: as demand rises, so does the price of the seat, which means that early booking makes economic sense. Sometimes seats are sold well below cost – seats for £1 (plus airport taxes) are not unusual, and it is certainly common for an air fare from London to (say) Venice to be cheaper than the rail fare from London to Manchester.

Other airlines quickly followed, often as subsidiaries of major carriers. KLM set up their own Buzz no-frills carrier, British Midland set up BMI Baby, and MyTravel (the tour operator) set up MyTravelite. Other European countries quickly followed suit – Germany (Germanwings and HLX), Italy (Volareweb), Ireland (Ryanair) and Holland (Basiq Air). No doubt more will follow.

The basis of a low-cost airline is that the company reduces its costs to an absolute minimum, and does not provide the level of service that a full-fare carrier would provide. For example, there are no in-flight meals (although most no-frills airlines will happily sell you a sandwich), there are no tickets (everything is done over the Internet, so passengers use their own paper and ink to print tickets), and in some cases there are no boarding cards, merely plastic tokens. Check-in procedures often do not include reserving seats: passengers find a seat once on board, which sometimes results in an unseemly rush to board the aircraft in order to grab the best seats.

Turnround times on the ground are also usually very fast. The aircraft is tidied up quickly, the pilots talk to the ground engineers via radio so that they do not need to leave the cockpit, and the plane is often ready to go again with the same crew on board within 20 minutes. Some of the no-frills airlines have even reduced the number of toilets on board the aircraft in order to fit in extra seats. The aircraft will not wait for late passengers, even if they have already checked in – turnround times are too tight. Even the cabin-crew uniforms are basic – jeans and a T-shirt is typical.

From the passengers' viewpoint all this is fine. The standard of service is low, but so is the fare – no one expects great service if they are paying less for the flight than they paid for the taxi to the airport. On a short flight, the lack of enough toilets or an in-flight meal is hardly a problem, and no one really expects a fashion parade from the cabin crew. Where the major carriers have been able to compete is on the actual destinations: because low-cost carriers typically use the cheaper regional airports, passengers are often faced with lengthy journeys to get to their final destinations. Major airlines also do well from business flyers, because the price is not an issue when the company is paying. Low-cost airlines have also (so far) had very little impact on long-haul flying: a ten-hour flight without a meal and with few toilets is not as appealing as a one-hour flight in the same conditions.

Ultimately, low-cost airlines are unlikely to take the whole market. They offer the opportunity for people to travel by air where previously they might have travelled by road, rail or bus, or (more likely) stayed at home. There are threats on the horizon, too – the surface transport lobby objects to the fact that aircraft fuel is tax-free whereas road fuel is heavily taxed, and the European Union has recently clamped down on airports offering special deals to low-cost carriers in order to encourage more passengers, and thus increase business through airport shops, restaurants and bars. Also, the massive increase in air traffic in Europe has stretched air traffic control systems to breaking point, especially in the peak summer season. Meanwhile, passengers continue to enjoy low prices, hotels are enjoying unprecedented levels of tourism, and airports are burgeoning as a result of the spending power of passengers coming through the gates.

### Questions

- 1 Why would anybody fly with a major carrier, if the low-cost carriers are so much cheaper?
- 2 What type of pricing do low-cost carriers use?
- 3 Why would an airport charge a low-cost airline less than they would a major carrier?
- 4 How might a major carrier compete against a low-cost airline flying the same route?
- 5 How does value for money fit into the air travel industry?

## SUMMARY

Value for money is a subjective concept; each person has a differing view of what represents value for money, and this means that different market segments will have differing views on whether a given price is appropriate. Marketing is about encouraging trade so that customers and manufacturers can maximise the satisfaction gained from their activities; to this end, marketers always try to make exchanges easier and pleasanter for customers.

Here are the key points from this chapter:

- Prices, ultimately, are fixed by market forces, not by suppliers alone. Therefore suppliers would be ill-advised to ignore the customer.

- There is no objective difference between necessities and luxuries; the distinction lies only in the mind of the customer.
- Customers cannot spend the same money twice, so they are forced to make economic choices. A decision to do one thing implies a decision not to do another.
- Customers have a broad and sometimes surprising range of choices when seeking to maximise utility.
- Pricing can be cost-based, competition-based or customer-based; ultimately, though, consumers have the last word because they can simply spend their money elsewhere.

## CHAPTER QUESTIONS

- 1 What is the difference between margin and mark-up?
- 2 When should a skimming policy be used?
- 3 How can penetration pricing be used in international markets?
- 4 Why should a firm be wary of cost-plus pricing?
- 5 How does customary pricing benefit the supplier?

## MULTI-CHOICE QUESTIONS

- 1 Pricing which is based on how much it costs to produce a product is called:
  - (A) Cost-plus pricing.
  - (B) Demand pricing.
  - (C) Customary pricing.
- 2 What is the difference between mark-up and margin?
  - (A) Mark-up is based on customers' perceptions, margin is based on producers' perceptions.
  - (B) Mark-up is based on bought-in price, margin is based on selling price.
  - (C) Mark-up is based on a fixed percentage, margin is variable.

- 3 Setting a high price which gradually reduces as competitors enter the market is called:
- (A) Penetration pricing.
  - (B) Competitive pricing.
  - (C) Skimming.
- 4 Selling a product at one price in one market and a lower price in another is called:
- (A) Second-market discounting.
  - (B) Penetration pricing.
  - (C) Competitive pricing.
- 5 Predatory pricing is:
- (A) Setting a price below the costs of production so as to bankrupt competitors.
  - (B) Setting a price low to capture a large share of a new market.
  - (C) Setting prices high to give an impression of high quality.
- 6 Which of the following is *not* an assumption underpinning the economist's model of price setting by supply and demand?
- (A) That price is the only issue that concerns consumers.
  - (B) That supply will always rise as demand falls.
  - (C) That consumers have perfect knowledge of the marketplace.
- 7 Having to choose between alternatives when one has limited resources is called:
- (A) The economic choice.
  - (B) The decision-making unit.
  - (C) The value chain.
- 8 Demand pricing is used because:
- (A) It is easiest to apply.
  - (B) It is consumer-orientated.
  - (C) It gives the most profit per unit of production.
- 9 Ending a price with 99¢ is an example of:
- (A) Psychological pricing.
  - (B) Demand pricing.
  - (C) Customary pricing.
- 10 A reverse auction is one in which:
- (A) Buyers compete against each other to buy an item.
  - (B) The price gets higher as more people enter the market.
  - (C) Buyers combine to force prices down.



## FURTHER READING

For a fairly readable text on the economic aspects of pricing, Richard Lipsey's *Introduction to Positive Economics*, 6th edn (London, Weidenfeld and Nicholson, 1983) is worth looking at.

Len Rogers' *Pricing for Profit* (Oxford, Basil Blackwell, 1990) is a practitioner-style book which contains a very comprehensive 'how-to' guide to pricing.

Hermann Simon's *Price Management* (Amsterdam, Elsevier Science Publishers BV, 1989) gives an in-depth analysis of pricing strategy, with plenty of supporting mathematics.



## GLOSSARY

**Competitor-based pricing** Using competitors' prices as a starting-point for price-setting.

**Cost-plus pricing** Basing the price calculation on the firm's production costs, plus a predetermined allowance for profit.

**Customary pricing** A price applied to a product or for a minimum amount of a product and fixed for a number of years.

**Demand pricing** Prices based on the customers' demand for the product.

**Economic choice** The decisions forced on customers and producers by the scarcity of resources.

**Elastic demand** A state of affairs where the amount of the product that will be purchased is strongly affected by its price.

**Inelastic demand** A state of affairs where the amount of the product that will be purchased is relatively unaffected by its price.

**Loading** The level of demand for a service at different times of the day, year, week or month.

**Margin** The amount of profit calculated as a percentage of the selling price.

**Mark-up** The amount of profit calculated as a proportion of the bought-in price.

**Mark-up pricing** Adding a fixed percentage to the bought-in price of a product.

**Meet-the-competition strategy** Setting prices close to those of the nearest competitors.

**Odd-even pricing** The practice of ending prices with an odd number of cents, pence, etc., in order to give the impression of a lower price.

**Penetration pricing** Pricing a new product low in order to maximise market penetration before competitors can enter the market.

**Predatory pricing** Pricing products so far below those of competitors that the competitors will be bankrupted.

**Prestige pricing** Applying a high price to a product to indicate its high quality.

**Price elasticity of demand** The extent to which the demand for a product is affected by its price.

**Price leaders** Firms whose market share and share of the capacity in the industry are great enough for them to be able to set the prices in the market.

**Product-line pricing** Applying differential pricing policies to products that are co-dependent in terms of demand.

**Psychological pricing** Applying prices that appeal to the customer's emotions and subconscious thought processes.

**Second-market discounting** Offering products at a lower price in a second market than is charged in the main market.

**Shelf price** The retail selling price.

**Skimming** Applying high prices on the launch of a novel product and steadily reducing them as the product penetrates the market.

**Undercut-the-competition strategy** Setting prices consistently below those of the nearest competitors.



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