

15

Pricing decisions and terms of doing business

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Learning objectives

After studying this chapter you should be able to do the following:

- Explain how internal and external variables influence international pricing decisions.
- Explain why and how prices escalate in export selling.
- Discuss the strategic options in determining the price level for a new product.
- Explain the necessary sales volume increase as a consequence of a price decrease.
- Explain what is meant by experience curve pricing.
- Explore the special roles and problems of transfer pricing in global marketing.
- Discuss how varying currency conditions challenge the international marketer.
- Identify and explain the different terms of sale (price quotations).
- Discuss the conditions that affect terms of payment.
- Discuss the role of export credit and financing for successful export marketing.

15.1 Introduction

Pricing is part of the marketing mix. Pricing decisions must therefore be integrated with the other three Ps of the marketing mix. Price is the only area of the global marketing mix where policy can be changed rapidly without large direct cost implications. This characteristic, plus the fact that overseas consumers are often sensitive to price changes, results in the danger that pricing action may be resorted to as a quick fix instead of changes being made in other areas of the firm's marketing programme. It is thus important that management realises that constant fine-tuning of prices in overseas markets should be avoided and that many problems are not best addressed by pricing action.

Generally, pricing policy is one of the most important yet often least recognized of all the elements of the marketing mix. The other elements of the marketing mix all lead to costs. The only source of profit to the firm comes from revenue, which in turn is dictated by pricing policy. In this chapter we focus on a number of pricing issues of special interest to international marketers.

15.2 International pricing strategies compared with domestic pricing strategies

For many SMEs operating in domestic markets pricing decisions are based on the relatively straightforward process of allocating the total estimated cost of producing, managing and marketing a product or service and adding an appropriate profit margin. Problems for these firms arise when costs increase and sales do not materialize or when competitors undercut them. In international markets, however, pricing decisions are much more complex, because they are affected by a number of additional external factors, such as fluctuations in exchange rates, accelerating inflation in certain countries and the use of alternative payment methods such as leasing, barter and counter-trade.

Of special concern to the global marketing manager are pricing decisions on products made or marketed locally, but with some centralized influence from outside the country in which the products are made or marketed. Broadly speaking, pricing decisions include setting the initial price as well as changing the established price of products from time to time.

15.3 Factors influencing international pricing decisions

An SME exporting for the first time, with little knowledge of the market environment that it is entering, is likely to set a price that will ensure that the sales revenue generated at least covers the costs incurred. It is important that firms recognize that the cost structures of products are very significant, but they should not be regarded as sole determinants when setting prices.

Pricing policy is an important strategic and tactical competitive weapon that, in contrast to the other elements of the global marketing mix, is highly controllable and inexpensive to change and implement. Therefore pricing strategies and action should be integrated with the other elements of the global marketing mix.

Figure 15.1 International pricing framework

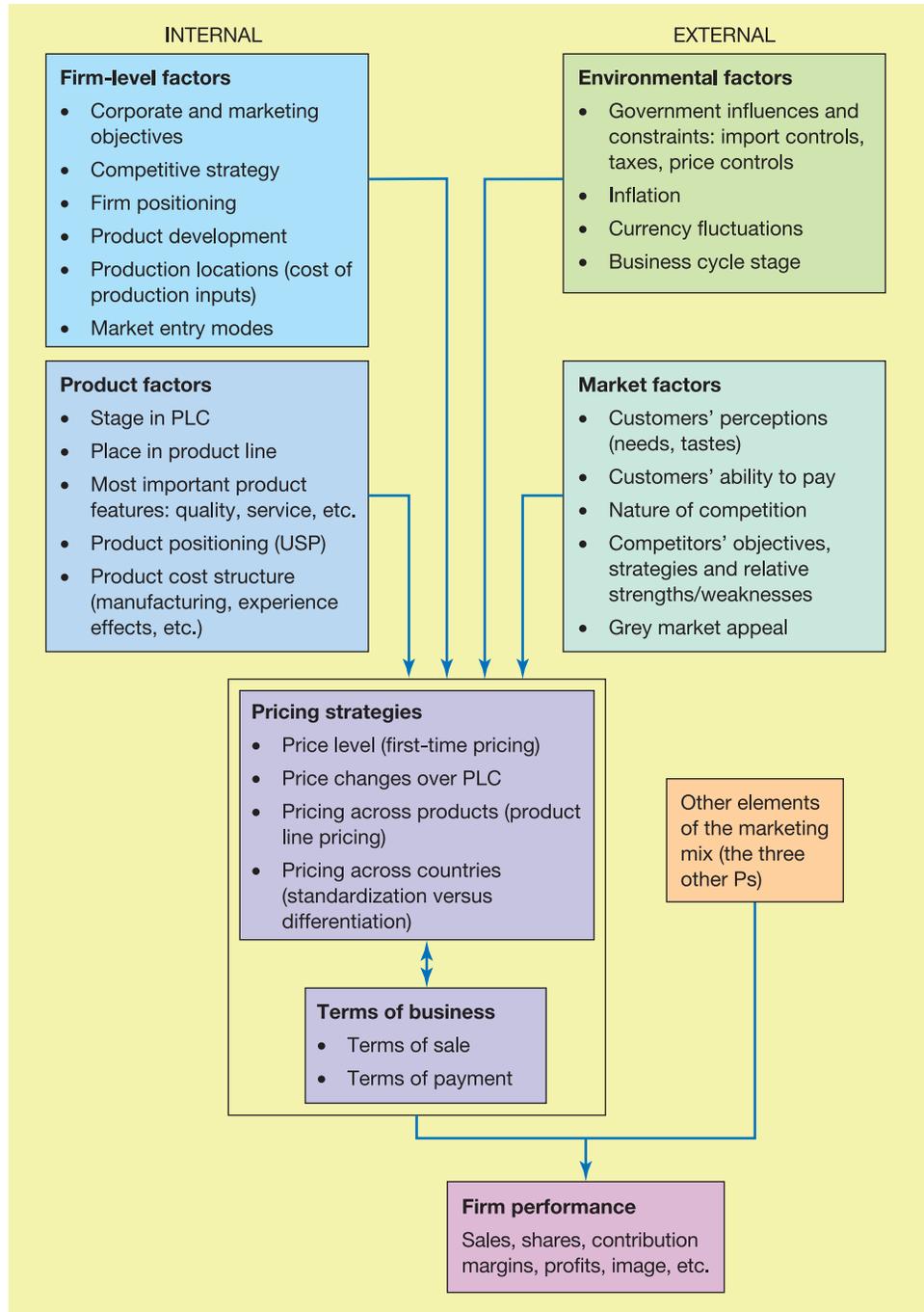


Figure 15.1 presents a general framework for international pricing decisions. According to this model, factors affecting international pricing can be broken down into two main groups (internal and external factors) and four subgroups, which we will now consider in more detail.

Firm-level factors

International pricing is influenced by past and current corporate philosophy, organization and managerial policies. The short-term tactical use of pricing in the form of

discounts, product offers and reductions is often emphasized by managers at the expense of its strategic role, and yet pricing over recent years has played a very significant part in the restructuring of many industries, resulting in the growth of some businesses and the decline of others. In particular, Japanese firms have approached new markets with the intention of building market share over a period of years by reducing price levels, establishing the brand name, and setting up effective distribution and servicing networks. The market share objectives of the Japanese firms have usually been accomplished at the expense of short-term profits, as international Japanese firms have consistently taken a long-term perspective on profit. They are usually prepared to wait much longer for returns on investments than some of their western counterparts.

The choice of foreign market entry mode also affects the pricing policy. A manufacturer with a subsidiary in a foreign country has a high level of control over the pricing policy in that country.

Product factors

Key product factors include the unique and innovative features of the product and the availability of substitutes. These factors will have a major impact on the stage of the product life cycle, which will also depend on the market environment in target markets. Whether the product is a service or a manufactured or commodity good sold into consumer or industrial markets is also significant.

The extent to which the organization has had to adapt or modify the product or service, and the level to which the market requires service around the core product, will also affect cost and thereby have some influence on pricing.

Costs are also helpful in estimating how rivals will react to the setting of a specific price, assuming that knowledge of one's own costs helps in the assessment of competitors' reactions. Added to the above is the intermediary cost, which depends on channel length, intermediary factors and logistical costs. All these factors add up and lead to **price escalation**.

The example in Table 15.1 shows that, due to additional shipping, insurance and distribution charges, the exported product costs some 21 per cent more in the export market than at home. Through the use of an additional distribution link (an importer), the product costs 39 per cent more abroad than at home.

Many exporters are not aware of rapid price escalation; they are preoccupied with the price they charge to the importer. However, the final consumer price should be of vital concern because it is on this level that the consumer can compare prices of different competitive products and it is this price that plays a major role in determining the foreign demand.

Price escalation is not a problem for exporters alone. It affects all firms involved in cross-border transactions. Companies that undertake substantial intracompany shipment of goods and materials across national borders are exposed to many of the additional charges that cause price escalation.

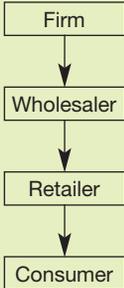
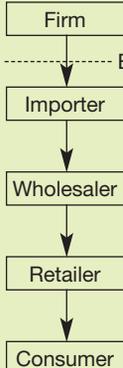
The following management options are available to counter price escalation:

- *Rationalizing the distribution process.* One option is to reduce the number of links in the distribution process, either by doing more in-house or by circumventing some channel members.
- *Lowering the export price from the factory* (firm's net price), thus reducing the multiplier effect of all the mark-ups.
- *Establishing local production of the product* within the export market to eliminate some of the cost.

Price escalation

All cost factors (e.g. firms' net ex-works price, shipping costs, tariffs, distributor mark-up) in the distribution channel add up and lead to price escalation. The longer the distribution channel, the higher the final price in the foreign market.

Table 15.1 Price escalation (examples)

	Domestic channel	Foreign marketing channel	
	(a)	(b)	(c)
			
	£	£	£
Firm's net price	100	100	100
Insurance and shipping costs	—	10	10
Landed cost	—	110	110
Tariff (10% of landed cost)	—	11	11
Importer pays (cost)	—	—	121
Importer's margin/mark-up (15% of cost)	—	—	18
Wholesaler pays (cost)	100	121	139
Wholesaler's mark-up (20% of cost)	20	24	28
Retailer pays (cost)	120	145	167
Retail margin/mark-up (40% of cost)	48	58	67
Consumer pays (price) (exclusive of VAT)	168	203	234
% price escalation over domestic channel	—	21	39

- *Pressurizing channel members to accept lower profit margins.* This may be appropriate if these intermediaries are dependent on the manufacturer for much of their turnover.

It may be dangerous to overlook traditional channel members. In Japan, for example, the complex nature of the distribution system, which often involves many different channel members, makes it tempting to consider radical change. However, existing intermediaries do not like to be overlooked, and their possible network with other channel members and the government may make it dangerous for a foreign firm to attempt to cut them out.

Environmental factors

The environmental factors are external to the firm and thus uncontrollable variables in the foreign market. The national government control of exports and imports is usually based on political and strategic considerations.

Generally speaking, import controls are designed to limit imports in order to protect domestic producers or reduce the outflow of foreign exchange. Direct restrictions commonly take the form of tariffs, quotas and various non-tariff barriers. Tariffs directly increase the price of imports unless the exporter or importer is

willing to absorb the tax and accept lower profit margins. Quotas have an indirect impact on prices. They restrict supply, thus causing the price of the import to increase.

Since tariff levels vary from country to country there is an incentive for exporters to vary the price somewhat from country to country. In some countries with high customs duties and high price elasticity the base price may have to be lower than in other countries if the product is to achieve satisfactory volume in these markets. If demand is quite inelastic the price may be set at a high level, with little loss of volume, unless competitors are selling at lower prices.

Government regulations on pricing can also affect the firm's pricing strategy. Many governments tend to have price controls on specific products related to health, education, food and other essential items. Another major environmental factor is fluctuation in the exchange rate. An increase (revaluation) or decrease (devaluation) in the relative value of a currency can affect the firm's pricing structure and profitability.

Market factors

One of the critical factors in the foreign market is the purchasing power of the customers (customers' ability to pay). The pressure of competitors may also affect international pricing. The firm has to offer a more competitive price if there are other sellers in the market. Thus the nature of competition (e.g. oligopoly or monopoly) can influence the firm's pricing strategy.

Under conditions approximating pure competition price is set in the marketplace. Price tends to be just enough above costs to keep marginal producers in business. Thus, from the point of view of the price setter, the most important factor is cost. The closer the substitutability of products, the more nearly identical the prices must be, and the greater the influence of costs in determining prices (assuming a large enough number of buyers and sellers).

Under conditions of monopolistic or imperfect competition the seller has some discretion to vary the product quality, promotional efforts and channel policies in order to adapt the price of the total product to serve preselected market segments. Nevertheless the freedom to set prices is still limited by what competitors charge, and any price differentials from competitors must be justified in the minds of customers on the basis of differential utility: that is, perceived value.

When considering how customers will respond to a given price strategy, Nagle (1987) has suggested nine factors that influence the sensitivity of customers to prices:

- 1 More distinctive product.
- 2 Greater perceived quality of products.
- 3 Consumers less aware of substitutes in the market.
- 4 Difficulty in making comparisons (e.g. in the quality of services such as consultancy or accountancy).
- 5 The price of a product represents a small proportion of total expenditure of the customer.
- 6 The perceived benefit for the customer increases.
- 7 The product is used in association with a product bought previously, so that, for example, components and replacements are usually extremely highly priced.
- 8 Costs are shared with other parties.
- 9 The product or service cannot be stored.

Price sensitivity is reduced in all these nine cases.

In the following sections we discuss the different available pricing strategies.

15.4 International pricing strategies

In determining the price level for a new product the general alternatives are as shown in Figure 15.2.

Skimming

In this strategy a high price is charged to ‘skim the cream’ from the top end of the market, with the objective of achieving the highest possible contribution in a short time. For a marketer to use this approach the product has to be unique, and some segments of the market must be willing to pay the high price. As more segments are targeted and more of the product is made available the price is gradually lowered. The success of skimming depends on the ability and speed of competitive reaction.

Products should be designed to appeal to affluent and demanding consumers, offering extra features, greater comfort, variability or ease of operation. With skimming the firm trades off a low market share against a high margin.

Problems with skimming are as follows:

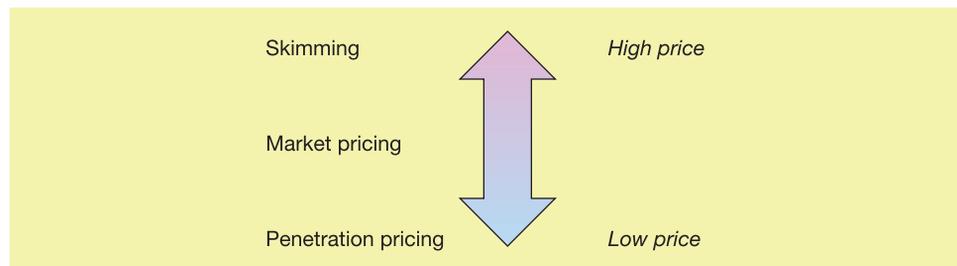
- Having a small market share makes the firm vulnerable to aggressive local competition.
- Maintenance of a high-quality product requires a lot of resources (promotion, after-sales service) and a visible local presence, which may be difficult in distant markets.
- If the product is sold more cheaply at home or in another country grey marketing (parallel importing) is likely.

Market pricing

If similar products already exist in the target market, market pricing may be used. The final customer price is based on competitive prices. This approach requires the exporter to have a thorough knowledge of product costs, as well as confidence that the product life cycle is long enough to warrant entry into the market. It is a reactive approach and may lead to problems if sales volumes never rise to sufficient levels to produce a satisfactory return. Although firms typically use pricing as a differentiation tool the global marketing manager may have no choice but to accept the prevailing world market price.

From the price that customers are willing to pay it is possible to make a so-called retrograde calculation where the firm uses a ‘reversed’ price escalation to calculate backwards (from market price) to the necessary (ex factory) net price. If this net price can create a satisfactory contribution margin then the firm can go ahead.

Figure 15.2 Strategies for pricing a new product



Penetration pricing

A penetration pricing policy is used to stimulate market growth and capture market shares by deliberately offering products at low prices. This approach requires mass markets, price-sensitive customers and reduction in unit costs through economies of scale and experience curve effects. The basic assumption that lower prices will increase sales will fail if the main competitors reduce their prices to a correspondingly low level. Another danger is that prices might be set so low that they are not credible to consumers. There exist 'confidence levels' for prices below which consumers lose faith in the product's quality.

Motives for pricing at low levels in certain foreign markets might include the following:

- Intensive local competition from rival companies.
- Lower income levels of local consumers.
- Some firms argue that, since their R&D and other overhead costs are covered by home sales, exporting represents a marginal activity intended merely to bring in as much additional revenue as possible by offering a low selling price.

Japanese companies have used penetration pricing intensively to gain market share leadership in a number of markets, such as cars, home entertainment products and electronic components.

Price changes

Price changes on existing products are called for when a new product has been launched or when changes occur in overall market conditions (such as fluctuating foreign exchange rates).

Table 15.2 shows the percentage sales volume increase or decrease required to maintain the level of profit. An example (the figure in bold type in Table 15.2) shows how the table functions. A firm has a product with a contribution margin of 20 per cent. The firm would like to know how much the sales volume should be increased as a consequence of a price reduction of 5 per cent, if it wishes to keep the same total profit contribution. The calculation is as follows:

Before price reduction

Per product	sales price	£100
	variable cost per unit	£80
	contribution margin	£20
Total contribution margin: 100 units @ £20 = £2,000		

After price reduction (5%)

Per product	sales price	£95
	variable cost per unit	£80
	contribution margin	£15
Total contribution margin: 133 units @ £15 = £1,995		

As a consequence of a price reduction of 5 per cent, a 33 per cent increase in sales is required.

If a decision is made to change prices, related changes must also be considered. For example, if an increase in price is required it may be accompanied, at least initially, by increased promotional efforts.

When reducing prices the degree of flexibility enjoyed by decision makers will tend to be less for existing products than for new products. This follows from the high probability that the existing product is now less unique, faces stronger competition and is

Table 15.2 Sales volume increase or decrease (%) required to maintain total profit contribution

Profit contribution margin (price – variable cost per unit as % of the price)									
Price reduction (%)	5	10	15	20	25	30	35	40	50
	Sales volume increase (%) required to maintain total profit contribution								
2.0	67	25	15	11	9	7	7	5	4
3.0	150	43	25	18	14	11	9	8	6
4.0	400	67	36	25	19	15	13	11	9
5.0		100	50	33	25	20	17	14	11
7.5		300	100	60	43	33	27	23	18
10.0			200	100	67	50	40	33	25
15.0				300	150	100	75	60	43

Profit contribution margin (price – variable cost per unit as % of the price)									
Price increase (%)	5	10	15	20	25	30	35	40	50
	Max. sales volume reduction (%) required to maintain total profit contribution								
2.0	29	17	12	9	7	6	5	5	4
3.0	37	23	17	13	11	9	8	7	6
4.0	44	29	21	17	14	12	10	9	7
5.0	50	33	25	20	17	14	12	11	9
7.5	60	43	33	27	23	20	18	16	13
10.0	67	50	40	33	29	25	22	20	17
15.0	75	60	50	43	37	33	30	27	23

aimed at a broader segment of the market. In this situation the decision maker will be forced to pay more attention to competitive and cost factors in the pricing process.

The timing of price changes can be nearly as important as the changes themselves. For example, a simple tactic of time lagging competitors in announcing price increases can produce the perception among customers that you are the most customer-responsive supplier. The extent of the time lag can also be important.

In one company an independent survey of customers (Garda, 1995) showed that the perception of being the most customer-responsive supplier was generated just as effectively by a six-week lag in following a competitor’s price increase as by a six-month lag. A considerable amount of money would have been lost during the unnecessary four-and-a-half-month delay in announcing a price increase.

Experience curve pricing

Combination of the experience curve (lowering costs per unit with accumulated production of the product) with typical market price development within an industry.

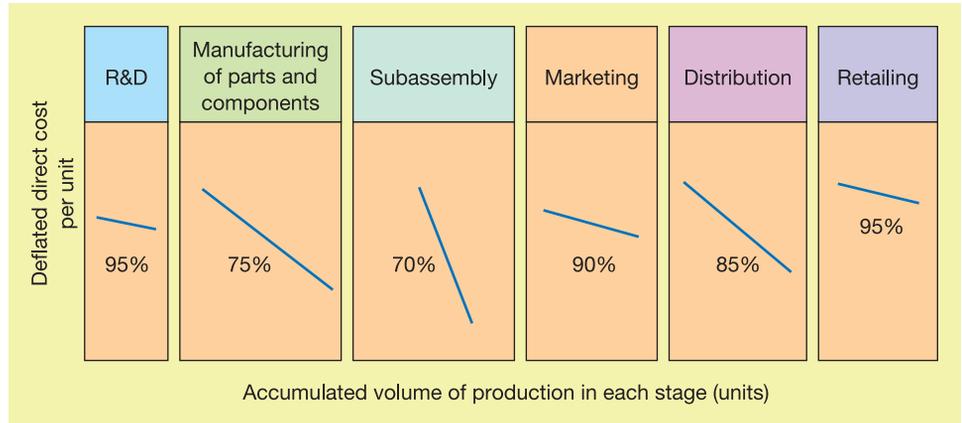
Experience curve pricing

Price changes usually follow changes in the product’s stage in the life cycle. As the product matures more pressure will be put on the price to keep the product competitive because of increased competition and less possibility of differentiation.

Let us also integrate the cost aspect into the discussion. The experience curve has its roots in a commonly observed phenomenon called the learning curve, which states that as people repeat a task they learn to do it better and faster. The learning curve applies to the labour portion of manufacturing cost. The Boston Consulting Group extended the learning effect to cover all the value-added costs related to a product – manufacturing plus marketing, sales, administration and so on.

The resulting experience curves, covering all value chain activities (see Figure 15.3), indicate that the total unit costs of a product in real terms can be reduced by a certain percentage with each doubling of cumulative production. The typical decline in cost is 30 per cent (termed a 70 per cent curve), although greater and lesser declines are observed (Czepiel, 1992, p. 149).

Figure 15.3 Experience curves of value chain activities

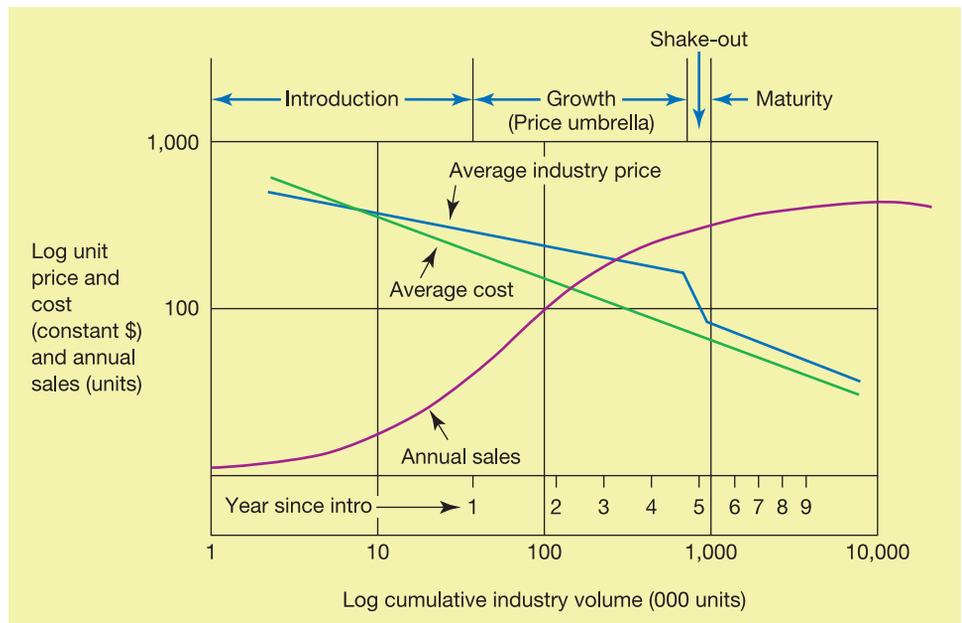


Source: Czepiel, 1992, p. 154.

If we combine the experience curve (average unit cost) with the typical market price development within an industry we will have a relationship similar to that shown in Figure 15.4.

Figure 15.4 shows that after the introduction stage (during part of which the price is below the total unit cost), profits begin to flow. Because supply is less than demand prices do not fall as quickly as costs. Consequently the gap between costs and prices widens, in effect creating a price umbrella, attracting new competitors. However, the competitive situation is not a stable one. At some point the umbrella will be folded by one or more competitors reducing the prices in an attempt to gain or retain market share. The result is that a shake-out phase will begin: inefficient producers will be shaken out by rapidly falling market prices, and only those with a competitive price/cost relationship will remain.

Figure 15.4 Product life cycle stages and the industry price experience curve



Source: Czepiel, 1992, p. 167.

Pricing across products (product line pricing)

With across-product pricing the various items in the line may be differentiated by pricing them appropriately to indicate, for example, an economy version, a standard version and a top-of-the-range version. One of the products in the line may be priced to protect against competitors or to gain market share from existing competitors.

Products with less competition may be priced higher to subsidize other parts of the product line, so as to make up for the lost contribution of such 'fighting brands'. Another strategy is price bundling (total 'package' price), where a certain price is set for customers who simultaneously buy several items within the product line (one price for a personal computer package with software and printer). In all such cases a key consideration is how much consumers in different countries want to save money, to spend time searching for the 'best buy' and so forth. Furthermore, some items in the product line may be priced very low to serve as loss leaders and induce customers to try the product. A special variant of this is the so-called buy in–follow on strategy (Weigand, 1991). A classic example of this strategy is the razor blade link where Gillette, for example, uses a penetration price on its razor (buy in) but a skimming pricing (relatively high price) on its razor blades (follow on). Thus the linked product or service – the follow on – is sold at a significant contribution margin. This inevitably attracts hitchhikers who try to sell follow-on products without incurring the cost of the buy in.

The buy in–follow on strategy is different from a low introductory price, which is based on the hope that the customer (of habit) will return again and again at higher prices. With the buy in–follow on strategy sales of two products or services are powerfully linked by factors such as legal contracts, patents, trade secrets, experience curve advantages and technological links.

Other examples of the strategy are as follows:

- The price of a Polaroid instant camera is very low, but Polaroid hopes that this will generate sales of far more profitable films for many years.
- The telephone companies sell mobile (cellular) telephones at a near giveaway price, hoping that the customer will be a 'heavy' user of the profitable mobile telephone network.

Bundle pricing

Bundling product and services together in a system-solution product. If the customer thinks that entry price is a key barrier, service contracts can be priced higher, which allows for lower entry product pricing – the practice in many software businesses.

Product-service bundle pricing

The structure and level of pricing is perhaps the most crucial design choice in embedded *services*. To get pricing right, a company needs a clear grasp of its strategic intent and its sources of competitive advantage and must often make trade-offs between product penetration and the growth and margins of its *service* business.

A company's strategic intent largely determines the appropriate extent of product-*service* bundling and the *value* attributed to *services* in such bundles. Companies that focus on enhancing or protecting core products should price their *services* to improve their product penetration. The pricing strategy to achieve such product pull-through varies according to customer purchasing decisions. Companies can raise the *value* of the product in use and increase its pull-through by bundling products and *services* into a higher-*value* solution. If the entry price is a key factor, *service* contracts can be priced higher, which allows for lower product pricing – the practice in many software businesses. In some cases, companies can raise the price of maintenance *service* contracts to accelerate the rate of product upgrades. The strategic goal of product pull-through also means that sales and field agents should have some flexibility and authority in the pricing of *services*. However, companies must still actively manage pricing discipline by ensuring that these salespeople are accountable for the total profitability of the bundles they sell.

By contrast, companies aiming to create an independent, growth-oriented *service* business should price their offerings to achieve profitable growth and set pricing targets as close to the *service's value* to customers as competitive alternatives permit. These companies should set pricing guidelines and delegate authority centrally, with relatively limited freedom for sales and field personnel and clear rules for discounting. Bundling prices for *services* and products is usually a bad idea for a growth platform in *services*, since within any given customer's organization, the person who buys the *service* might not be the one who buys the product. It is also difficult to bundle prices while holding both product and *service* business units accountable for their independent sales and margin targets.

The source of competitive advantage – scale or skill – mainly affects pricing structures. If economies of scale drive a business, its pricing should be based on standard units (such as terabytes of storage managed) and it should offer volume discounts to encourage growth in usage. Such companies ought to make the price of any customized variation from their standard *service* offerings extremely high, since these exceptions push up costs throughout the business.

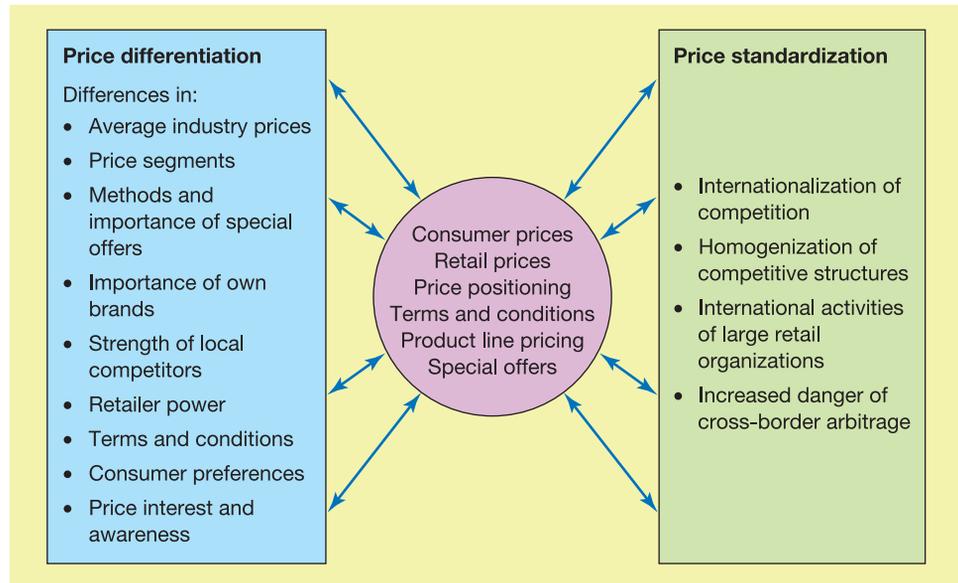
By contrast, if a *service* business relies mostly on special skills, it should base its prices on the costs its customers avoid by using its *services* or on the cost of the next-best alternative. Such *value*-based pricing requires a sophisticated analysis of a customer segment's total cost of ownership and a deep understanding of the cost structure of the *service* business. Competitive benchmarks and the cost of deploying the skills should determine the respective upper and lower bounds for these price levels. In the best case, companies can package this intelligence into pricing tools that allow sales and field agents to estimate customer *value* more accurately and thus improve field-level pricing decisions (Auguste *et al.*, 2006).

Pricing across countries (standardization versus differentiation)

A major problem for companies is how to coordinate prices between countries. There are two essential opposing forces: first, to achieve similar positioning in different markets by adopting largely standardized pricing; and second, to maximize profitability by adapting pricing to different market conditions. In determining to what extent prices should be standardized across borders two basic approaches appear:

- 1 *Price standardization*. This is based on setting a price for the product as it leaves the factory. At its simplest it involves setting a fixed world price at the headquarters of the firm. This fixed world price is then applied in all markets after taking account of factors such as foreign exchange rates and variance in the regulatory context. For the firm this is a low-risk strategy, but no attempt is made to respond to local conditions and so no effort is made to maximize profits. However, this pricing strategy might be appropriate if the firm sells to very large customers, who have companies in several countries. In such a situation the firm might be under pressure from the customer only to deliver at the same price to every country subsidiary, throughout the customer's multinational organization. In Figure 15.5 this is exemplified, for example, by the international activities of large retail organizations. Another advantage of price standardization includes the potential for rapid introduction of new products in international markets and the presentation of a consistent (price) image across markets.
- 2 *Price differentiation*. This allows each local subsidiary or partner (agent, distributor, etc.) to set a price that is considered to be the most appropriate for local conditions, and no attempt is made to coordinate prices from country to country. Cross-cultural empirical research has found significant differences in customer characteristics,

Figure 15.5 Structural factors of standardized versus differentiated pricing in European consumer goods markets



Source: Reprinted from *European Management Journal*, Vol. 12, No. 2, Diller, H. and Bukhari, I. (1994) 'Pricing conditions in the European Common Market', p. 168, Copyright 1994, with permission from Elsevier.

preference and purchasing behaviour among different countries (Theodosiou and Katsikeas, 2001). The weakness with 'price differentiation' is the lack of control that the headquarters has over the prices set by the subsidiary operations or external partner. Significantly different prices may be set in adjacent markets, and this can reflect badly on the image of multinational firms. It also encourages the creation of parallel importing/grey markets (which are dealt with in greater detail in Chapter 17), whereby products can be purchased in one market and sold in another, undercutting the established market prices in the process.

The underlying forces favouring standardization or differentiation are shown in Figure 15.5.

An international pricing taxonomy

As we discussed previously, pricing decisions in the international environment tend to be a function of the interplay between the external, market-related complexities that shape firm operations and the capabilities of the firm to respond effectively to these contingencies. Solberg's (1997) framework captures this interface in a meaningful way and leads to sufficiently important consequences for the export pricing behaviour of firms in foreign markets. Solberg suggests that firms' international strategic behaviour is shaped primarily by two dimensions: (a) the degree of globalism of the firm's industry (a measure of the market related factors) and (b) its degree of preparedness for internationalization (a measure of the firm's abilities to respond to these factors). These two dimensions are discussed in Chapter 1 (Figure 1.1) with the purpose of suggesting under which circumstances the firm should 'stay at home', 'strengthen the global position' or something in between. In Figure 15.6 an international pricing taxonomy is proposed along these two dimensions (Solberg *et al.*, 2006).

A global industry is dominated by a few, large major competitors that 'rule' their categories in world markets within their product category. Thus, the degree of globalism

Figure 15.6 A taxonomy of international pricing practices



Source: Adapted from Solberg *et al.*, 2006, p. 31. In the original article Solberg has used the concept 'Globality' instead of 'Globalism'.

along the industry globalism dimension is considered to vary between two extremes: a monopoly at one end (the right) and atomistic competition at the other (the left). The strategic implication of this perspective is that the monopolistic and oligopolistic global player would be the price setter, whereas the firm in the atomistic (multilocal) market setting would be exposed to local market forces, finding itself needing to follow market prices in every case. Although most firms fall into intermediate positions along this continuum, we believe that the leverage of the individual international firm in setting its pricing strategy will be greatly influenced by the globalism of the competitive environment in which it will operate.

On the other dimension, *preparedness for internationalization*, experienced firms find international pricing to be a more complicated matter, even though they devote additional resources to collecting and processing greater amounts of information. These firms are found to have the international preparedness that is necessary to offset the effects of reduced prices when they penetrate new markets or respond to competitive attacks, to be more self-confident in setting pricing strategies, and, in general, to enjoy higher market shares in the export market. In contrast, smaller and more inexperienced firms seem to be too weak both in relation to their local counterparts and in terms of generating local market insight to be able to determine effective price levels for their products in foreign markets. Therefore, they tend to possess smaller shares in their markets and to follow the pricing practices of their competitors or segment leaders.

Looking through the lens of this framework we assume that large, internationally experienced exporters will be likely to centralize their pricing decisions and will prefer higher degrees of control over those decisions, whereas smaller, often new-to-export, and internationally inexperienced firms will be likely to experiment with decentralized and often opportunistic modes of price-setting behaviour in their market.

The following discusses the characteristics of each of the four strategic prototypes in Figure 15.6.

Prototype 1: The local price follower firm

In this cell the firm (manufacturer) will only have limited international experience, and consequently, the firm's local export intermediate (agent or distributor) will serve as the key informant for the firm. This information asymmetry bears the danger that

the export intermediate might mislead the exporter by exercising opportunism or by pursuing goals that are in conflict with those of the exporter. That may cause further transaction costs, and lead to internalization (see section 3.3 on transaction cost analysis). Because of the limited market knowledge the exporter is prone to calculate its prices crudely and most likely on the basis of cost and the (sometimes insufficient or biased) information from its local export intermediary. In the extreme case such an exporter would respond only to unsolicited offers from abroad, and will tend following a pricing procedure based on internal cost information, thus missing potential international business opportunities.

Prototype 2: The global price follower firm

Firms that fall into the global price follower cell have limited preparedness for internationalization. In contrast, however, global price follower firms are often more motivated in expanding their international market involvement, as they are 'pushed' by the global market. Firms in this cell are expected to charge a standardized price in all countries because the interconnected international markets have more or less the same price level.

Given their marginal position in global markets, such firms have limited bargaining leverage and may be compelled to adopt the price level set by global market leaders, often very large global customers (see also the discussion about global account management (GAM) in Chapter 20). The Prototype 2 firms are typically under constant pressure from their more efficient distribution and globally branded counterparts to adjust their prices.

Prototype 3: The multilocal price setter firm

Firms in this cell are well-prepared international marketers with well-entrenched positions in local markets. Typically they are capable of assessing local market conditions through in-depth analyses and evaluation of market information, established market intelligence systems and/or deeply rooted market knowledge. They tend to have a tight control of their local market distribution networks through information and feedback systems. Prototype 3-firms adapt their prices from one market to the next in light of the differentiated requirements of each local market and manage the different market and pricing structures they cope with in their many (multidomestic) markets with relatively high sophistication.

In contrast to their local price follower counterparts (Prototype 1), however, these firms are often the pricing leaders in their local markets and base their pricing strategy primarily on local market conditions in each market. Given their multidomestic orientation, these firms tend to shift pricing decision-making authority to local subsidiary managers, even though their headquarters personnel closely monitors sales trends in each local market. Firms in this cell face challenges from grey market imports in their local markets that are motivated by the opportunity for cheaper producers to exploit price differences across markets (see also section 16.8 on grey marketing).

Prototype 4: The global price leader firm

Firms in this cell hold strong positions in key world markets. They manage smoothly functioning marketing networks, operating mainly through hierarchical entry modes or in combination with intermediate modes like joint ventures or alliances in major world markets. Prototype 4-firms compete against a limited number of competitors in each major market, similar to a global (or a regional) oligopoly. Typical of oligopoly players, they tend to be challenged by the cross-border transparency of the price

mechanism; manage global (or regional) constraints, such as demand patterns and market regulation mechanisms; and set prices pan-regionally (i.e. across the EU). Global price leaders tend to maintain relatively high price levels in their markets, though possibly not as effectively as their multilocal counterparts. Compared with the global price leader firm, the multilocal price setter more effectively erects local entry barriers, such as brand leadership, has closer relationships with its local distributors and a deeper understanding of local conditions in each local market, thus protecting itself from the downside of international price competition (Solberg *et al.*, 2006).

Establishing global-pricing contracts (GPCs)

Global pricing contracts

A customer requiring one global price (per product) from the supplier for all its foreign SBUs and subsidiaries.

As globalization increases the following sentence is heard frequently among global suppliers and global customers: ‘Give me a **global-pricing contract** (GPC) and I’ll consolidate my worldwide purchase with you.’ Increasingly, global customers are demanding such contracts from suppliers. For example, in 1998 General Motor’s Powertrain Group told suppliers of components used in GM’s engines, transmissions and subassemblies to charge GM the same for parts from one region as they did for parts from another region.

Suppliers do not need to lose out when customers globalize. The most attractive global-pricing opportunities are those that involve suppliers and customers working together to identify and eliminate inefficiencies that harm both. Sometimes, however, suppliers do not have a choice – they cannot afford to shut themselves out of business with their largest and fastest-growing customers.

Suppliers and customers have different advantages and disadvantages with global-pricing contracts and Table 15.3 illustrates some of these.

One chemicals manufacturer concentrated on relationships with a few select customers. It had decided that its strength lay in value-added services but that potential customers in emerging markets were fixated on price. The select customers, however, were interested in money-saving supply and inventory management initiatives developed jointly with the supplier.

Global customers’ demands for detailed cost information can also put suppliers at risk. Toyota, Honda, Xerox and others force suppliers to open their books for inspection. Their stated objectives: to help suppliers identify ways to improve processes and quality while reducing costs – and to build trust. But in an economic downturn the global customer might seek price reductions and supplementary services.

European pricing strategy

In 1991 price differentials for identical consumer goods across Europe were around 20 per cent on average, but much greater differences were apparent in certain products (Simon and Kucher, 1993). In another study (Diller and Bukhari, 1994) there were also considerable price differences for identical take-home ice-cream products.

The causes of price differentials are differences in regulations, competition, distribution structures and consumer behaviour, such as willingness to pay. Currency fluctuations can also influence short-term price differences. The pressures of regionalization are accelerating the move to uniform pricing, but Simon and Kucher (1993) warn that this is a potential time bomb, as the pressure is for uniform pricing to be at the lowest pricing levels.

Europe was a price differentiation paradise as long as markets were separated. But it is becoming increasingly difficult to retain the old price differentials. There are primarily two developments that may force companies to standardize prices across European countries:

Table 15.3 Global pricing contracts (GPCs): advantages and disadvantages

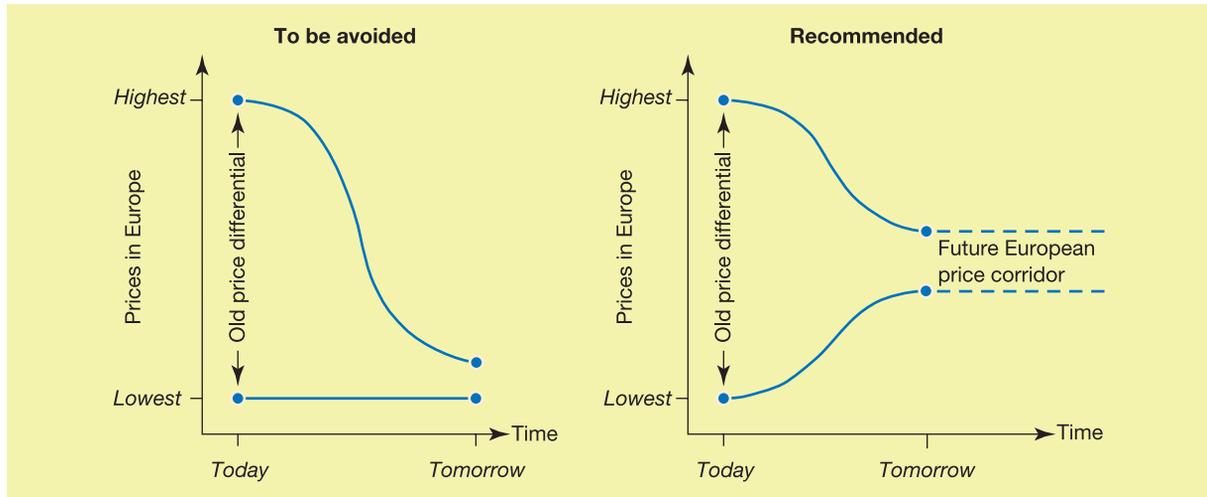
	Customers	Suppliers
<i>Advantages</i>	<p>Lower prices worldwide coupled with higher levels of service.</p> <p>Standardization of products and services offered across markets.</p> <p>Efficiencies in all processes, including new product development, manufacturing, inventory, logistics and customer service</p> <p>Faster diffusion of innovations globally.</p>	<p>Easily gain access to new markets and grow the business.</p> <p>Consolidate operations and achieve economies of scale.</p> <p>Work with industry leaders and influence market development by using them as showcase accounts.</p> <p>Collaborate with customers and develop strong relationships that are difficult for potential competitors to break into.</p> <p>Rectify price and service anomalies in a customer relationship across country markets.</p>
<i>Disadvantages</i>	<p>Customer might be less adaptable to local market variance and changes over time.</p> <p>Supplier might not have capabilities to provide consistent quality and performance across markets.</p> <p>Supplier might use customer's over-dependence to extract higher prices.</p> <p>Local managers might resist global contracts and prefer dealing with local suppliers.</p> <p>Costs of monitoring global contracts might outstrip the benefits.</p>	<p>Local managers sometimes resist change, and supplier may get caught in the crossfire between customer's HQ and country managers.</p> <p>Supplier might lose the ability to serve other attractive customers.</p> <p>Customer might not be able to deliver on promises.</p> <p>Customer might take advantage of cost information shared in the relationship.</p> <p>Supplier might become over-dependent on one customer, even when there are other more attractive customers to serve.</p> <p>Supplier might have a conflict with existing channels of distribution in the new markets.</p>

Source: adapted from Narayandas, Quelch and Swartz, 2000, pp. 61–70.

- 1 International buying power of cross-European retail groups.
- 2 Parallel imports/grey markets. Because of differentiated prices across countries, buyers in one country are able to purchase at a lower price than in another country. As a result there will be an incentive for customers in lower-price markets to sell goods to higher-price markets in order to make a profit. Grey marketing will be examined further in section 17.8.

Simon and Kucher (1993) suggest a price 'corridor' (Figure 15.7). The prices in the individual countries may only vary within that range. Figure 15.7 is also interesting in the light of the euro, which had been fully implemented by January 2002. However, price differences that can be justified by transportation costs and short-term competitive conditions, etc., may still be maintained. They recommend that business in smaller countries should be sacrificed, if necessary, in order to retain acceptable pricing levels in the big markets such as France, Germany, the United Kingdom and Italy. For example, for a pharmaceutical manufacturer it is more profitable not to sell in the Portuguese pharmaceutical market than to accept a price reduction of 10 per cent in the German market due to parallel imports from Portugal.

Figure 15.7 Development of prices in Europe



Source: Simon and Kucher, 1993, p. 26. Copyright ESOMAR.

Transfer pricing

Prices charged for intra-company movement of goods and services. While transfer prices are internal to the company, they are important externally for cross-border taxation purposes.

Transfer pricing

Transfer prices are those charged for intracompany movement of goods and services. Many purely domestic firms need to make transfer-pricing decisions when goods are *transferred* from one domestic unit to another. While these transfer prices are internal to the company they are important externally because goods being transferred from country to country must have a value for cross-border taxation purposes.

The objective of the corporation in this situation is to ensure that the transfer price paid optimizes corporate rather than divisional objectives. This can prove difficult when a company internationally is organized into profit centres. For profit centres to work effectively a price must be set for everything that is transferred, be it working materials, components, finished goods or services. A high transfer price – for example, from the manufacturing division to a foreign subsidiary – is reflected in an apparently poor performance by the foreign subsidiary (see the high mark-up policy in Table 15.4), whereas a low price would not be acceptable to the domestic division providing the goods (see the low mark-up policy in Table 15.4). This issue alone can be the cause of much mistrust between subsidiaries.

The 'best' of Table 15.4's two mark-up policies seen from the consolidated point of view is to use a high mark-up policy, since it generates a net income of \$550, as against \$475 from using a low mark-up policy. The 'best' solution depends on the tax rates in the countries of the manufacturing and distribution affiliates (subsidiaries).

There are three basic approaches to transfer pricing:

- 1 *Transfer at cost.* The transfer price is set at the level of the production cost and the international division is credited with the entire profit that the firm makes. This means that the production centre is evaluated on efficiency parameters rather than profitability. The production division normally dislikes selling at production cost because it believes it is subsidizing the selling subsidiary. When the production division is unhappy the selling subsidiary may get sluggish service, because the production division is serving more attractive opportunities first.
- 2 *Transfer at arm's length.* Here the international division is charged the same as any buyer outside the firm. Problems occur if the overseas division is allowed to buy elsewhere when the price is uncompetitive or the product quality is inferior, and further problems arise if there are no external buyers, making it difficult to establish

Table 15.4 Tax effect of low versus high transfer price on net income (\$)

	Manufacturing affiliate (division)	Distribution/selling affiliate (subsidiary)	Consolidated company total
<i>Low mark-up policy</i>			
Sales	1,400	2,000	2,000
Less cost of goods sold	1,000	1,400	1,000
Gross profit	400	600	1,000
Less operating expenses	100	100	200
Taxable income	300	500	800
Less income taxes (25%/50%)	75	250	325
Net income	225	250	475
<i>High mark-up policy</i>			
Sales	1,700	2,000	2,000
Less cost of goods sold	1,000	1,700	1,000
Gross profit	700	300	1,000
Less operating expenses	100	100	200
Taxable income	600	200	800
Less income taxes (25%/50%)	150	100	250
Net income	450	100	550

Note: Manufacturing affiliate pays income taxes at 25%. Distribution affiliate pays income taxes at 50%.

Source: adapted from Eiteman and Stonehill, 1986.

a relevant price. Nevertheless the arm's-length principle has now been accepted worldwide as the preferred (not required) standard by which transfer prices should be set (Fraedrich and Bateman, 1996).

- 3 *Transfer at cost plus*. This is the usual compromise, where profits are split between the production and international divisions. The actual formula used for assessing the transfer price can vary, but usually it is this method that has the greatest chance of minimizing executive time spent on transfer-price disagreements, optimizing corporate profits and motivating the home and international divisions. A senior executive is often appointed to rule on disputes.

A good transfer-pricing method should consider total corporate profile and encourage divisional cooperation. It should also minimize executive time spent on transfer-price disagreements and keep the accounting burden to a minimum.

Currency issues

A difficult aspect of export pricing is the decision about what currency the price should be quoted in. The exporter has the following options:

- the foreign currency of the buyer's country (local currency);
- the currency of the exporter's country (domestic currency);
- the currency of a third country (usually US dollars);
- a currency unit such as the euro.

If the exporter quotes in the domestic currency then not only is it administratively much easier, but also the risks associated with changes in the exchange rate are borne by the customer, whereas by quoting prices in the foreign currency the exporter bears the exchange rate risk. However, there are benefits to the exporter in quoting in foreign currency:

- Quoting in foreign currency could be a condition of the contract.
- It could provide access to finance abroad at lower interest rates.

- Good currency management may be a means of gaining additional profits.
- Customers normally prefer to be quoted in their own currency in order to be able to make competitive comparisons and know exactly what the eventual price will be.

Another difficult problem that exporters face is caused by fluctuating exchange rates. A company in a country with a devalued currency can (all other things being equal) strengthen its international competitive position. It can choose to reduce prices in foreign currencies or it can leave prices unchanged and instead increase profit margins.

When the Italian lira dropped by 15–20 per cent in value against the German mark it gave the Italian car producer Fiat a competitive advantage in pricing. The German car exporters, such as Volkswagen, were adversely affected and had to lower its list prices. In this respect the geographic pattern of a firm's manufacturing and sales subsidiaries compared with those of its main competitors becomes very important, since a local subsidiary can absorb most of the negative effects of a devaluation.

15.5 Implications of the Internet for pricing across borders

Europe's single currency, the euro (<http://europa.eu.int/euro/>) has finally become a reality after more than a decade of planning and preparation. In one stroke the single currency has created the largest single economy in the world, with a larger share of global trade and a greater number of consumers than in the United States.

The implication is that Europe suddenly became a single market by the end of 2000, and people can purchase from another country as easily as they can from a shop across the road. The same currency will be used; only the language issue remains. Opinion in Europe is that, as more of the population goes online, and as Europe starts using its new single currency, online shopping will experience a tremendous growth.

Most of this growth has been fuelled by aggressive price cutting from internet service providers (ISPs). A number of UK companies, for example, are now offering free internet access or pay-as-you-go models, which have encouraged new sections of the population to try the Internet for the first time.

A European single currency was a long-held ambition for members of the European Union. The idea was first considered in the 1970s, but knocked off-course by oil price rises. It re-emerged in the early 1980s and was finally agreed to in the 1992 Maastricht Treaty. There were many accounting criteria to be met by each country, such as the control of the rate of inflation and the debt/GDP ratio. Most countries have met these criteria and were permitted to join the European Monetary Union.

The euro is now (end 2006) the currency of 12 European Union member states: Belgium, Germany, Greece, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland. As from 1 January 2007, the euro is also the currency of Slovenia.

The United Kingdom being outside the euro region will be quite inconvenient for many US companies who trade heavily with UK companies or have UK subsidiaries.

The main detailed implications of the euro will be that it will:

- lower prices for consumers by making prices transparent across Europe;
- create a real single market by reducing 'friction' to trade caused by high transaction costs and fluctuating currencies;
- enhance competition by forcing companies to concentrate on price, quality and production instead of hiding behind weak currencies;

- benefit SMEs and consumers by making it easier for the former to enter 'foreign' markets and allowing the latter, increasingly via the internet, to shop in the lowest priced markets;
- establish inflation and interest rate stability via the new European Central Bank; and
- lower the costs of doing business through lower prices, lower interest rates, no transaction costs or loss through exchanging currencies, and the absence of exchange rate fluctuations.

In short, the single currency will significantly increase competition, lower transaction costs, and bring about greater certainty. These new forces will bring about structural reforms in Europe. Almost every aspect of Europe's business and political environment will be affected.

Perhaps most importantly, marketing and pricing strategies need rethinking. Because the euro will allow easy price comparison across Europe (especially via the Internet), it will reveal the differences between higher and lower priced markets.

For those selling via the Internet the euro will make it easier to do business and give encouragement to companies selling to European customers. Since Europeans will now be able to shop and compare prices at the click of a mouse they will also be more favourably inclined towards e-commerce.

In any single European country there is not usually much competition for a given product, since purchasing habits have always been local (in one's own country). Now that Europeans will be able to shop internationally via the Internet they will become aware of other choices and prices for the same product that were not previously known. Competition will heat up for the buyer's euro, and this should put a downward pressure on prices.

However, recent research has also shown that the Internet is not creating a state of perfect competition with decreasing prices as a result. In fact, in some cases, online prices are higher than those of conventional retail outlets. Research has also shown that online consumers are not as price sensitive as had previously been thought. Consumers become less price sensitive and more loyal as the level of quality information on a site increases (Kung and Monroe, 2002).

15.6 Terms of sale/delivery terms

The price quotation describes a specific product, states the price for the product as well as a specified delivery location, sets the time of shipment and specifies payment terms. The responsibilities of the buyer and the seller should be spelled out as they relate to what is and what is not included in the price quotation and when ownership of goods passes from seller to buyer. Incoterms are the internationally accepted standard definitions for terms of sale set by the International Chamber of Commerce. They have been fully revised for the new millennium in line with developments in commercial practice. Published in September 1999, *Incoterms 2000* may be used to define the responsibilities of buyer and seller in contracts effective from 1 January 2000.

The 13 terms contained in *Incoterms 2000* are the following:

EXW	<i>Ex-works</i> (. . . named place)
FCA	<i>Free carrier</i> (. . . named place)
FAS	<i>Free alongside ship</i> (. . . named port of shipment)
FOB	<i>Free on board</i> (. . . named port of shipment)
CFR	<i>Cost and freight</i> (. . . named port of destination)

CIF	<i>Cost, insurance and freight</i> (. . . named port of destination)
CPT	<i>Carriage paid to</i> (. . . named place of destination)
CIP	<i>Carriage and insurance paid to</i> (. . . named place of destination)
DAF	<i>Delivered at frontier</i> (. . . named place)
DES	<i>Delivered ex-ship</i> (. . . named port of destination)
DEQ	<i>Delivered ex-quay</i> (. . . named port of destination)
DDU	<i>Delivered duty unpaid</i> (. . . named place of destination)
DDP	<i>Delivered duty paid</i> (. . . named place of destination)

Table 15.5 describes the point of delivery and risk shift for some terms of sale.

The following is a description of some of the most popular terms of sale:

- *Ex-works (EXW)*. The term ‘Ex’ means that the price quoted by the seller applies at a specified point of origin, usually the factory, warehouse, mine or plantation, and the buyer is responsible for all charges from this point. This term represents the minimum obligation for the exporter.
- *Free alongside ship (FAS)*. Under this term the seller must provide for delivery of the goods free alongside, but not on board, the transportation carrier (usually an ocean vessel) at the point of shipment and export. This term differs from that of FOB, since the time and cost of loading are not included in the FAS term. The buyer has to pay for loading the goods onto the ship.
- *Free on board (FOB)*. The exporter’s price quote includes coverage of all charges up to the point when goods have been loaded on to the designated transport vehicle. The designated loading point may be a named inland shipping point, but is usually the port of export. The buyer assumes responsibility for the goods the moment they pass over the ship’s rail.
- *Cost and freight (CFR)*. The seller’s liability ends when the goods are loaded on board a carrier or are in the custody of the carrier at the export dock. The seller pays all the transport charges (excluding insurance, which is the customer’s obligation) required to deliver goods by sea to a named destination.
- *Cost, insurance and freight (CIF)*. This trade term is identical with CFR except that the seller must also provide the necessary insurance. The seller’s obligations still end at the same stage (i.e. when goods are loaded or aboard), but the seller’s insurance company assumes responsibility once the goods are loaded.
- *Delivered ex-quay (DEQ)*. Ex-quay means from the import dock. The term goes one step beyond CIF and requires the seller to be responsible for the cost of the goods and all other costs necessary to place the goods on the dock at the named overseas port, with the appropriate import duty paid.
- *Delivered duty paid (DDP)*. The export price quote includes the costs of delivery to the importer’s premises. The exporter is thus responsible for paying any import duties and costs of unloading and inland transport in the importing country, as well

Table 15.5 Point of delivery and where risk shifts from seller to buyer

	EXW	FAS	FOB	CFR	CIF	DEQ	DDP
Supplier’s factory/warehouse	×						
Dock at port of shipment (export dock)		×					
Port of shipment (on board vessel)			×	×	×		
Port of destination (import dock)					×	×	
Buyer’s warehouse (destination)							×
Main transit risk on	buyer	buyer	buyer	buyer	seller	seller	seller

* The seller transfers the risk to its insurance company.

Source: adapted from Onkvisit and Shaw, 1993, p. 799. Courtesy of Sak Onkvisit.

as all costs involved in insuring and shipping the goods to that country. These terms imply maximum exporter obligations. The seller also assumes all the risks involved in delivering to the buyer. DDP used to be known as 'Franco domicile' pricing.

Export price quotations are important because they spell out the legal and cost responsibilities of the buyer and seller. Sellers favour a quote that gives them the least liability and responsibility, such as ex-works, which means the exporter's liability finishes when the goods are loaded on to the buyer's carrier at the seller's factory. Buyers, on the other hand, would prefer either DDP, where responsibility is borne by the supplier all the way to the customer's warehouse, or CIF port of discharge, which means that the buyer's responsibility begins only when the goods are in its own country.

Generally, the more market-oriented pricing policies are based on CIF, which indicates a strong commitment to the market. By pricing ex-works an exporter is not taking any steps to build a relationship with the market and so may be indicating only short-term commitment.

15.7 Terms of payment

The exporter will consider the following factors in negotiating terms of payment for goods to be shipped:

- practices in the industry;
- terms offered by competitors;
- relative strength of the buyer and the seller.

If the exporter is well established in the market with a unique product and accompanying service, price and terms of trade can be set to fit the exporter's desires. If, on the other hand, the exporter is breaking into a new market or if competitive pressures call for action, pricing and selling terms should be used as major competitive tools.

The basic methods of payment for exports vary in terms of their attractiveness to the buyer and the seller, from cash in advance to open account or consignment selling. Neither of the extremes will be feasible for longer-term relationships, but they do have their uses in certain situations. The most common payment methods are presented in Figure 15.8.

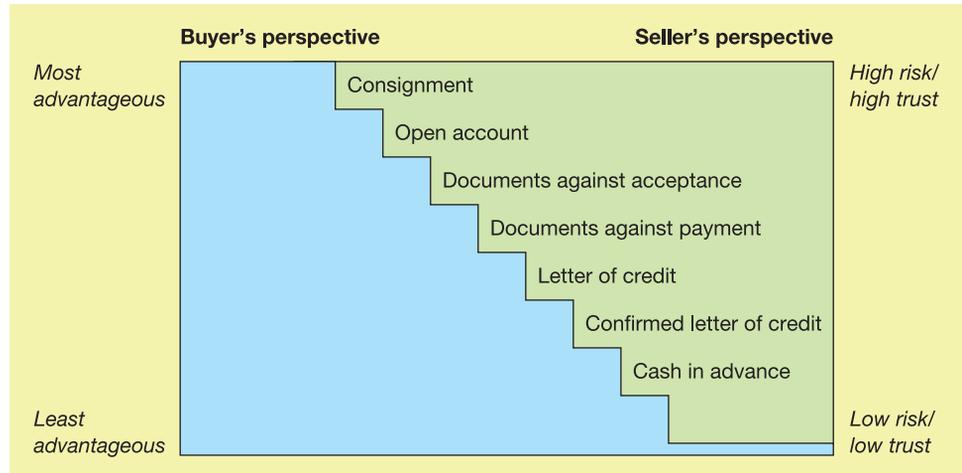
The most favourable term to the exporter is cash in advance because it relieves the exporter of all risk and allows for immediate use of the money. On the other hand, the most advantageous option seen from the buyer's perspective would be consignment or open account.

The most common arrangements, in decreasing order of attractiveness to the exporter, will now be described.

Cash in advance

The exporter receives payment before shipment of the goods. This minimizes the exporter's risk and financial costs, since there is no collection risk and no interest cost on receivables. However, importers will rarely agree to these terms, since it ties up their capital and the goods may not be received. Consequently such terms are not widely used. They are most likely either when the exporter lacks confidence in the importer's ability to pay (often the case in initial export transactions) or where economic and

Figure 15.8 Different terms of payment



Source: Chase Manhattan Bank, 1984, p. 5.

political instability in the importing country may result in foreign exchange not being made available for importers.

Letter of credit

Worldwide letters of credit are very important and very common. A letter of credit is an instrument whereby a bank agrees to pay a specified amount of money on presentation of documents stipulated in the letter of credit, usually the bill of lading, an invoice and a description of the goods. In general, letters of credit have the following characteristics:

- They are an arrangement by banks for settling international commercial transactions.
- They provide a form of security for the parties involved.
- They ensure payment, provided that the terms and conditions of the credit have been fulfilled.
- Payment by such means is based on documents only and not on the merchandise or services involved.

The process for handling letters of credit is illustrated in Figure 15.9.

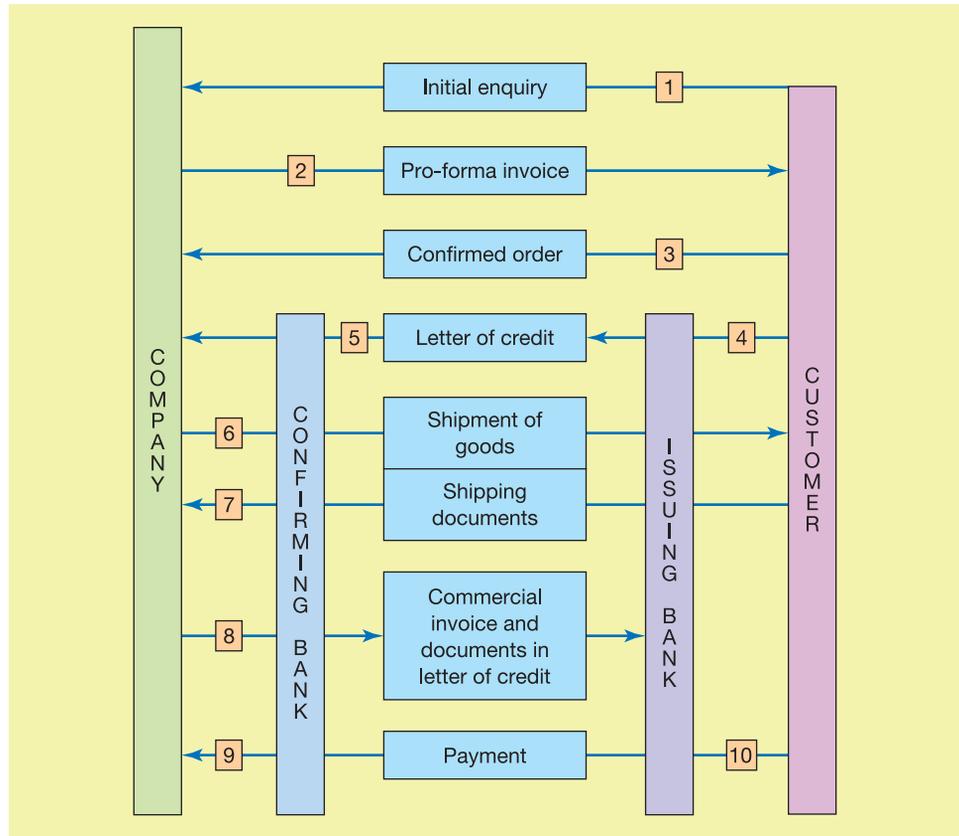
In the process the customer agrees to payment by a confirmed letter of credit. The customer begins the process by sending an enquiry for the goods (1). The price and terms are confirmed by a pro-forma invoice (2) by the supplier, so that the customer knows for what amount (3) to instruct its bank (the issuing bank) to open a letter of credit (4). The letter of credit is confirmed by a bank (5) in the supplier's country.

When the goods are shipped (6) the shipping documents are submitted by the supplier to its bank (7), so that shipment is confirmed by their presentation (8) together with the letter of credit and all other stipulated documents and certificates for payment (9). The money is automatically transmitted from the customer's account via the issuing bank. The customer may collect the goods (10) only when all the documents have been delivered to it by its bank – the issuing bank (adapted from Phillips *et al.*, 1994, p. 453).

The letter of credit (L/C) has three forms:

- 1 *Revocable L/C*. Now a rare form, this gives the buyer maximum flexibility as it can be cancelled without notice to the seller up to the moment of payment by the bank.

Figure 15.9 The process for handling letters of credit



Source: Phillips et al., 1994, p. 454, with permission from ITBP Ltd.

- Irrevocable but unconfirmed L/C.** This is as good as the credit status of the establishing bank and the willingness of the buyer's country to allow the required use of foreign exchange. An unconfirmed L/C should not necessarily be viewed with suspicion. The reason for the lack of confirmation may be that the customer has been unwilling to pay the additional fee for confirmation.
- Confirmed irrevocable L/C.** This means that a bank in the seller's country has added its own undertaking to that of the issuing bank, confirming that the necessary sum of money is available for payment, awaiting only the presentation of shipping documents. While it guarantees the seller its money it is much more costly to the buyer. Generally the buyer pays a fixed fee plus a percentage of the value, but where the letter of credit is confirmed the confirming bank will also charge a fee. On the other hand, the confirmation of an irrevocable letter of credit by a bank gives the shipper the most satisfactory assurance that payment will be made for the shipment. It also means that the exporter does not have to seek payment under any conditions from the issuing bank – invariably located in some foreign country – but has a direct claim on the confirming bank in the exporter's home country. Thus the exporter need not be concerned about the ability or willingness of the foreign bank to pay.

Documents against payment and acceptance

In the following two 'documents against' situations the seller ships the goods and the shipping documents, and the draft (bill of exchange) demanding payment is presented

to the importer through banks acting as the seller's agent. There are two principal types of bill of exchange: sight draft (documents against payment) and time draft (documents against acceptance).

- 1 *Documents against payment.* Here the buyer must make payment for the face value of the draft before receiving the documents conveying title to the merchandise. This occurs when the buyer first sees the draft (*sight draft*).
- 2 *Documents against acceptance.* When a draft is drawn 'documents against acceptance' credit is extended to the buyer on the basis of the buyer's acceptance of the draft calling for payment within a specified time and usually at a specified place. Acceptance means that the buyer formally agrees to pay the amount specified by the draft on the due date. The specified time may be expressed as certain number of days after sight (*time draft*). A time draft offers less security for the seller than a sight draft, since the sight draft demands payment prior to the release of shipping documents. The time draft, on the other hand, allows the buyer a delay of 30, 60 or 90 days in payment.

Open account

The exporter ships the goods without documents calling for payment, other than the invoice. The buyer can pick up the goods without having to make payment first. The advantage of the open account is its simplicity and the assistance it gives to the buyer, which does not have to pay credit charges to banks. The seller in return expects that the invoice will be paid at the agreed time. A major weakness of the method is that there are no safeguards for payment. Exporters should sell on open account only to importers they know very well or that have excellent credit ratings, and to markets with no foreign exchange problems. Open account sales are less complex and expensive than drafts, since there are no documentation requirements or bank charges.

Consignment

Here the exporter retains title of the goods until the importer sells them. Exporters own the goods longer in this method than any other, and so the financial burden and risks are at their greatest. The method should be offered only to very trustworthy importers with an excellent credit rating in countries where political and economic risk is very low. Consignments tend to be mainly used by companies trading with their own subsidiaries.

The credit terms given are also important in determining the final price to the buyer. When the products of international competitors are perceived to be similar the purchaser may choose the supplier that offers the best credit terms, in order to achieve a greater discount. In effect the supplier is offering a source of finance to the buyer.

15.8 Export financing

Exporters need financing support in order to obtain working capital and because importers will often demand terms that allow them to defer payment. Principal sources of export finance include commercial banks, government export financing programmes, export credit insurance, factoring houses and counter-trade.

Commercial banks

The simplest way of financing export sales is through an overdraft facility with the exporter's own bank. This is a convenient way to finance all the elements of the contract, such as purchasing, manufacturing, shipping and credit. The bank is generally more favourably disposed towards granting an overdraft if the exporter has obtained an export credit insurance policy.

Export credit insurance

Export credit insurance is available to most exporters through governmental export credit agencies or through private insurers. Such insurances usually cover the following:

- *political risks* and non-convertibility of currency;
- *commercial risks* associated with non-payment by buyers.

Exporters may be able to use credit insurance to enable them to grant more liberal credit terms or to encourage their banks to grant them financing against their export receivables. The costs of such insurance are often quite low in many markets, ranging from 1–2 per cent of the value of the transaction. Specialized insurance brokers handle such insurance.

Factoring

Factoring means selling export debts for immediate cash. In this way the exporter shifts the problems of collecting payment for completed orders over to organizations or factors that specialize in export credit management and finance.

Ideally the exporter should go to the factor before any contract is signed or shipment made, and secure its willingness to buy the receivable. The factor will check out the credit rating and so forth of the prospective buyer(s) typically by having a correspondent in the importer's country do the necessary checking. Thus the factor acts as a credit approval agency as well as a facilitator and guarantor of payment.

The factor does not usually purchase export debts on terms exceeding 120 days. The factor normally charges a service fee of between 0.75 and 2.5 per cent of the sales value, depending on the workload and the risk carried by the factor.

Forfeiting

This is a finance method developed in Switzerland in the 1950s. It is an arrangement whereby exporters of capital goods can obtain medium-term finance (between one and seven years). The system can briefly be explained as follows.

An exporter of capital goods has a buyer that wishes to have medium-term credit to finance the purchase. The buyer pays some of the cost at once and pays the balance in regular instalments for, say, the next five years. The principal benefit is that there is immediate cash for the exporter and, along with the first cash payment by the buyer, forfeiting can finance up to 100 per cent of the contract value.

Bonding

In some countries (e.g. in the Middle East) contracts are cash or short term. Whereas this is an ideal situation for suppliers, it means that the buyer loses some of its leverage over the supplier as it cannot withhold payment. In this situation a bond or

guarantee is a written instrument issued to an overseas buyer by an acceptable third party, either a bank or an insurance company. It guarantees compliance of its obligations by an exporter or contractor, or the overseas buyer will be indemnified for a stated amount against the failure of the exporter/contractor to fulfil its obligations under the contract.

Leasing

Exporters of capital equipment may use leasing in one of two ways:

- 1 to arrange cross-border leases directly from a bank or leasing company to the foreign buyer;
- 2 to obtain local leasing facilities either through overseas branches or subdivisions of international banks or through international leasing associations.

With leasing the exporter receives prompt payment for goods directly from the leasing company. A leasing facility is best set up at the earliest opportunity, preferably when the exporter receives the order.

Counter-trade

Counter-trade is a generic term used to describe a variety of trade agreements in which a seller provides a buyer with products (commodities, goods, services, technology) and agrees to a reciprocal purchasing obligation with the buyer in terms of an agreed percentage (full or partial) of the original sales value.

Barter

This is a straightforward exchange of goods for goods without any money transfer. Bilateral barter, where only two parties are involved, is relatively uncommon. The bartering process can, however, be facilitated when a third (trilateral barter) or even more countries (multilateral barter) become involved in a trading chain.

Compensation deal

This involves the export of goods in one direction. The 'payment' of the goods is split into two parts:

- 1 Part payment in cash by the importer.
- 2 For the rest of the 'payment' the original exporter makes an obligation to purchase some of the buyer's goods. These products can be used in the exporter's internal production or they may be sold on in the wider market.

Buy-back agreement

The sale of machinery, equipment or a turnkey plant to the buyer's production is financed at least in part by the exporter's purchase of some of the resultant output. Whereas barter and compensation deals are short-term arrangements, buy-back agreements are long-term agreements. The contract may last for a considerable period of time, such as 5–10 years. The two-way transactions are clearly linked, but are kept financially separate.

Counter-trade has arisen because of shortages of both foreign exchange and international lines of credit. Some have estimated that the size of counter-trade is as high as 10–15 per cent of world trade.

15.9 Summary

The major issues covered in this chapter include the determinants of price, pricing strategy, how foreign prices are related to domestic prices, price escalation, the elements of price quotation, and transfer pricing.

Several factors must be taken into consideration in setting price, including cost, competitors' prices, product image, market share/volume, stage in product life cycle and number of products involved. The optimum mix of these ingredients varies by product, market and corporate objectives. Price setting in the international context is further complicated by such factors as foreign exchange rates, different competitive situations in each export market, different labour costs and different inflation rates in various countries. Also local and regional regulations and laws in setting prices have to be considered.

The international marketer must quote a meaningful price by using proper international trade terms. When there is doubt about how to prepare a quotation freight forwarders may be consulted (see section 17.5). These specialists can provide valuable information with regard to documentation (e.g. invoice, bill of lading) and the costs relevant to the movement of goods. Financial documents, such as letters of credit, require a bank's assistance. International banks have international departments that can facilitate payment and advise clients regarding pitfalls in preparing and accepting documents.

CASE STUDY 15.1

Harley-Davidson: Does the image justify the price level?

The Harley-Davidson (HD) Corporation has been dominating the motorcycle industry for many decades. Today, it continues to have a strong presence in the world market for the heavyweight cruisers. In financial year 2005, the net revenues of HD were \$5.3 billion. In 2005 HD had 1300 dealers selling 329,000 HD motorcycles worldwide. HD employs about 9000 people worldwide. In the heavyweight section (651 + cc) HD is a clear market leader in North America with a 48% market share. Their market share in Europe is 9%. The mission statement of the company is to fulfil dreams through the experience of motorcycling, by providing to the motorcyclists and the general public an expanding line of motorcycles, and branded products and services, in selected market segments. HD offers a complete range of motorcycles, parts, accessories, apparel and general merchandise. Strategic licensing of the HD brand helps create future generations of Harley-Davidson enthusiasts.



Source: Ann Heisenfelt/AP/EMPICS.

In 2003 HD celebrated its 100-year anniversary. Over the previous century the company managed to create a strong brand image and a loyal customer base within the marketplace. Much of the value of a Harley resides in its tradition – the look, sound, and

heritage that has made it an all-American symbol. The bikes represent something very basic – a desire for freedom, adventure, and individualism.

HD maintains a close relationship with its customers through a variety of programmes (Harley Owners' Group), product offerings and events such as the Daytona bike week, motor shows and rallies, etc. However, the company is facing rigorous competition from Japanese manufacturers, specifically Honda and Yamaha. Harley-Davidson's strength is its brand image within the marketplace, but its weakness is related to production capacity and unfulfilled demand for its products. HD tries to continue to strengthen its positioning strategy by building on the 'Own an American Icon' slogan.

As its average customer's age rises, and sales go down, Harley-Davidson faces the task of attracting younger customers. Part of retooling its image includes releasing a new motorcycle, the Buell, designed for young professionals.

According to the Motorcycle Industry Council (www.mic.org), an industry trade group based in Irvine, California no one doubts that the women's market is real, although it still accounts for only 11 per cent of the total motorcycling population.

Pricing

The international price competition is getting tougher. Compared to similar models from Honda, Harley-Davidson has still has a 30 per cent price premium; even though Harley bikers still wear T-shirts saying 'I'd rather push a Harley than drive a Honda'.

Today, Harley's overseas sales of motorcycles outside the United States is around 25 per cent of its annual total. Europeans like cruiser bikes, but not so much Harley prices. In 2005, the European market share of HD in the heavyweight segment (over 650 cc) was around 9 per cent. The 2004 market leaders in Europe were Honda, Yamaha, Suzuki and BMW, each with around 15 per cent market share.

Sources: www.harley-davidson.com/; www.mic.org/; www.motorcyclenews.com/; www.neobike.net/industry.

Questions

- 1 Describe the HD's general pricing strategy. What does the company's positioning have to do with its pricing strategy?
- 2 Should Harley alter its price, given strong price pressures from rivals?
- 3 What should HD do to improve its market share in Europe?

CASE STUDY 15.2

Gillette Co.: Is price standardization possible for razor blades?

In the battle to out-blade the competition, Gillette's latest creation, a five-bladed razor called Fusion, leapfrogs the Schick Quattro by one blade and aims to provide an even closer shave to the millions of men who apparently are having trouble with only three or four blades.

Fusion (launched in September 2005) is the first entirely new men's razor system launched by Gillette since Mach 3, which was launched in 1998. Gillette's previous flagship razor, the Mach 3, has three blades while the Schick Quattro has four, but Gillette president James Kilts insists this latest 'innovation' has nothing to do with the competition: 'The Schick launch has nothing to do with this, it's like comparing a Ferrari to a Volkswagen as far as we're concerned . . . There was never a plan to go to four.'

Fusion has one more blade than the Quattro sold by rival Schick, a unit of Energizer Holdings Inc., plus a trimming blade on the back of the pivoting



Source: Gillette. The Procter & Gamble Company.

cartridge for shaping facial hair, trimming sideburns and shaving under the nose.

Question

- 1 Evaluate the price level of Gillette's Fusion.
- 2 Discuss whether it is possible for Gillette to standardize pricing across borders for its new five-blade, Fusion. Which factors would favour price standardization and which factors would favour price differentiation?

VIDEO
CASE STUDY
15.3

download from
www.pearsoned.co.uk/hollensen

Ford Motor Company

Ford Motor Company (www.ford.com) is one of the largest automotive manufacturers in the world. It manufactures and distributes cars in 200 markets across six continents. The company's automotive vehicle brands include Aston Martin, Ford, Jaguar, Land Rover, Lincoln, Mazda, Mercury and Volvo. Ford primarily operates in the US and Europe. Its headquarters are in Michigan and it employs about 300,000 people. The video shows a classic example of how developing the right pricing strategy can spell the difference between profit mediocrity and profit stardom, which occurred at Ford Motor in the 1990s.

Questions

Go to: <http://www.fordboldmoves.com/#> (a documentary about recent 'bold' decisions in the Ford:

- 1 Please suggest strategies for Ford's target customers and pricing in the US market for the following car models:
 - Ford Shelby GT (Episode no. 9)
 - Ford Edge (Episode nos 13 and 21)
 - Ford Hydrogen (Episode no. 24)
- 2 Would your suggestion for pricing strategies differ if Ford had to develop international marketing plans for the same models in Europe or Asia?

For further exercises and cases, see this book's website at www.pearsoned.co.uk/hollensen



Questions for discussion

- 1 What are the major causes of international price escalation? Suggest possible courses of action to deal with this problem.
- 2 Explain how exchange rate and inflation affect the way you price your product.
- 3 In order to protect themselves, how should marketers price their product in a country with high inflation?
- 4 International buyers and sellers of technology frequently disagree on the appropriate price for knowledge. Why?
- 5 What methods can be used to compute a transfer price (for transactions between affiliated companies)?
- 6 What relevance has the international product life cycle theory for pricing strategy in international firms?
- 7 Why is it often difficult to compute fair arm's-length transfer prices?
- 8 Explain these terms of sale: EXW, FAS, FOB, CFR, CIF, DEQ and DDP. Which factors will determine the terms of sale?
- 9 Explain these types of letter of credit: revocable/irrevocable, confirmed/unconfirmed. Under what sets of circumstances would exporters use the following methods of payment:

- (a) revocable letter of credit;
 - (b) confirmed letter of credit;
 - (c) confirmed irrevocable letter of credit;
 - (d) time draft [i.e. bill of exchange]?
- 10 Name some of the financing sources for exporters.
 - 11 How does inflation affect a country's currency value? Is it a good idea to borrow or obtain finance in a country with high inflation?
 - 12 How and why are export credit financing terms and conditions relevant to international pricing?
 - 13 What is counter-trade? Why should firms be willing to consider counter-trade arrangements in their global marketing efforts?

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