UNIT 14 PRICING POLICIES AND PRACTICES

Objectives

After going through this Unit, you should be able to:

- appreciate the factors affecting the pricing decision
- understand the importance and role of cost in pricing
- identify the different methods used in pricing
- understand how pricing can be used to achieve the objectives at each stage of the product life-cycle
- understand the difference in pricing of consumer and industrial products
- understand how pricing can help position a product in relation to other competing products.

Structure

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14.1 INTRODUCTION

Price is an important element of the marketing mix. It can be used as a strategic marketing variable to meet competition. It is also a direct source of revenue for the firm. It must not only cover the costs but leave some margin to generate profit for the firm. However, price should not be so high as to frighten the customers. Price is also an element which is highly perceptible to customers and significantly affects their decisions to buy a product. In general, price directly determines the quantity to be sold. That is why electric fans are sold at lower prices and hotels reduce their tariffs during off season periods to attract customers.

14.2 DETERMINANTS OF PRICING

Pricing decisions are usually determined by cost, demand and competition. We shall discuss each of,these factors separately. We take demand first.

Demand

The popular 'Law of Demand' states that "higher the price, lower the demand, and vice versa, other things remaining the same". In season, due to plentiful supplies of certain, agricultural products, the prices are low and because of low prices, the demand for them increases substantially. You can test the validity of this law yourself in your daily life. There is an inverse relationship between price and quantity demanded. If price rises, demand falls and if the price falls, the demand goes up. Of course, the law of demand assumes that there should be no change in the other factors influencing demand except price. If any one or more of the other factors, for instance, income, the price of the substitutes, tastes and perferences of the consumers, advertising, expenditures, etc. vary, the demand may rise in spite of a rise in price, or alternatively,

the demand may fall in spite of a fall in price. However, there are important exceptions to the law of demand.

There are some goods which are purchased mainly for their 'snob appeal'. When prices of such goods rise, their snob appeal increases and they are purchased in larger quantities. On the other hand, as the price of such goods falls, their snob appeal and, therefore, their demand falls. Diamonds provide a good example.

In the speculative market, a rise in prices is frequently followed by larger purchases and a fall in prices by smaller purchases. This is specially applicable to purchases of industrial raw materials.

More important than the law of demand is the **elasticity of demand.** While the law of demand tells us the **direction of change** in demand, elasticity of demand tells us the **extent of change** in demand. Elasticity of demand refers to the response of demand to a change in price.

It is necessary for the marketer to know what would be the reaction of the consumers to the change he wishes to make in the price. Let us take some examples. Smokers are usually so addicted to smoking that they will not give up smoking even if prices of cigarettes increase. So also the demand for salt or for that matter of wheat is not likely to go down even if the prices increase. Another example of inelastic demand is the demand for technical journals, which are sold mainly to libraries. On the other hand, a reduction in the price of television will bring in more than proportionate increase in demand. Some of the factors determining the price—elasticity of demand are the nature of the commodity, whether it is a necessity or luxury, extent of use, range of substitutes, urgency of demand and frequency of purchase of the product.

The concept of elasticity of demand becomes crucial when a marketer is thinking of lowering his price to increase the demand for his product and to get a larger market share. If the increase in sales is more than proportionate to the decline in price, his total sale proceeds and his profits might be higher. If the increase in sales is less than proportionate, his total sales proceeds will decline and his profits will definitely be less. Thus a knowledge of the elasticity of demand for his products will help a marketer to determine whether and to what extent he can cut the prices or pass on the increase in costs to the consumer.

It may also be noted that the price elasticity of demand for a certain commodity and the price elasticity of demand for a certain brand of that commodity may be radically different. For example, while the demand for cigarettes as such, may be highly inelastic, the price elasticity of demand for 'Capstan' or 'Charms' may be highly elastic. The reasons for this are weak brand loyalty and the availability of subsitutes.

Exercise 1

The total annual demand for fans in a country in 1987 was estimated to be 500,000 units. A company manufacturing table fans had 10% market share. The average price of its fans was Rs. 500 per unit. The gross margin per unit was Rs. 50. The capacity of the company is 100,000 fans. The impact on sales as prices were changed was estimated as follows:

	Price	Estimated Sales
A)	Rs. 550	46,000
B)	Rs. 520	44,000
C)	Rs. 480	56,000
D)	Rs. 450	100,000

Would you recommend a price change? If yes, what price will you recommend?

HINT: Calculate the sales revenue and gross margin for each of the price levels.

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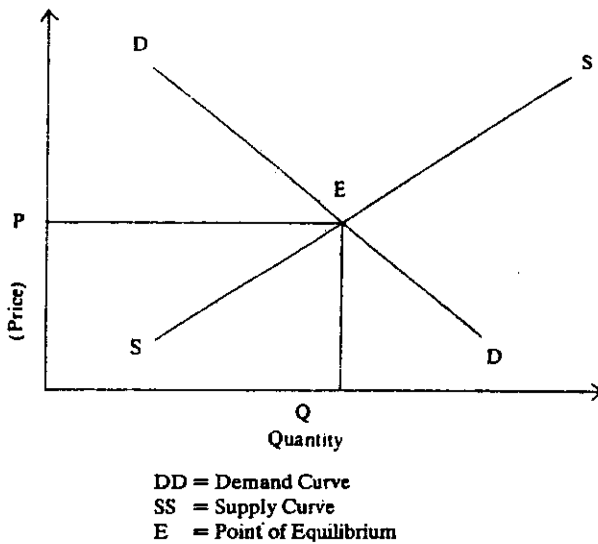
Competition

The degree of control over prices which the sellers may exercise varies widely with the competitive situation in which they operate. Sellers operating under conditions of pure competition do not have any control over the prices they receive. A monopolist, on the other hand, may fix prices according to his discretion. Sellers operating under imperfect competition may have some pricing discretion. The marketer; therefore, needs to know the degree of pricing discretion enjoyed by him. Let us take up each of these cases individually.

Perfect competition is said to exist when (i) there are a large number of buyers and sellers, (ii) each purchasing and selling such a small quantity that their withdrawal from the market will not affect the total demand and supply, (iii) the products sold by sellers are homogeneous in nature.

Prices under perfect competition are determined by the forces of supply and demand. Prices will be fixed at a point where supply and demand are at an equilibrium. This is illustrated in the following figure:

Figure 1: Pricing under perfect competition



DD = Demand Curve
SS = Supply Curve
E = Point of Equilibrium

In pure competition, all that the individual seller can do is to accept the price prevailing in the market, i.e. he is in the position of a **Price Taker.** If he wants to charge a higher price, buyers will purchase from other sellers. And he need not charge less since he can sell his small supply at the going market price.

Under **monopoly,** a single producer has complete control of the entire supply of a certain product. Railways and telephones are examples of monopoly. The main features of monopoly are (i) there is only one seller of a particular good or service and (ii) rivalry from the producers of substitutes is so remote that it is almost insignificant. As a result, the monopolist is in a position to set the price himself. Thus, he is in the position of a **Price Setter.**

However, even in the case of monopoly, there are limits to the extent to which he can increase his prices. Much depends on the elasticity of demand for the product. This, in turn, depends on the extent of availability of substitutes for the product. And in most cases, there is rather an infinite series of closely competing substitutes. Even railways and telephones organisations must take into account potential competition by alternative services—railways may be substituted by motor transport and telephone calls by telegrams. The closer the substitute and greater the elasticity of the demand for a monopolist's product, the less he can raise his price without frightening away his customers. High price of oil has led to development of alternative sources of energy.

Monopolies are constantly tending the break down due to the following reasons: (i) shifts in consumer demand, (ii) continuous process of innovations and technological developments leading to development of substitutes, (iii) lack of stimulus to efficiency provided by competition, (iv) entry of new competitors, and (v) intervention by governments.

Oligopoly is a market situation characterised by a few sellers, each having an appreciable share in the total output of the commodity. Examples of oligopoly are provided by the automobiles, cement, tyre, infant food, dry batteries, tractor, cigarettes, aluminium and razor blades industries. In each of these industries, each seller knows his competitors individually in each market.

Each oligopolist realises that any change in his price and advertising policy may lead rivals to change their policies. Hence, an individual firm must consider the possible reactions of the other firms to its own policies. The smaller the number of firms, the more interdependent are their policies. In such cases, there is a strong tendency towards close collaboration in policy determination both in regard to production and prices. Thus, oligopolists follow the philosophy of 'live and let live'. Two examples of this may be mentioned here. In response to tenders invited by the Director General of Civil Supplies and Disposals, the three principal manufacturers of storage batteries, viz. Chloride India, Standard Batteries and AMCO Batteries, quoted almost identical prices.

Oligopolistic industries are usually characterised by what is known as price leadership—a situation where firms fix their prices in a manner dependent upon the price charged by one of the firms in the industry, called the **price leader**. The price leader has lower costs and adequate financial resources, a substantial share of the market and a reputation for sound pricing decisions. Price leaders with the strongest position in the market may often increase their prices with the hope that competitors will follow suit. Price followers may delay raising their prices in the hope of snatching a part of the market share away from the leader.

Monopolistic competition is a market situation, in which there are many sellers of a particular product, but the product of each sellers is in some way differentiated in the minds of consumers from the product of every other seller. None of the sellers is in a position to control a major part of the total supply of the commodity but every seller so differentiates his portion of the supply from the portions sold by others, that buyers hesitate to shift their purchases from his product to that of another in response to price differences. At times, one manufacturer may differentiate his own products.

For example, a blade manufacturer in India manufactures more than 25 brands of blades. This differentiation of product by each manufacturer by giving it a brand name gives him some amount of monopoly if he is able to create a goodwill for his product and he may be able to charge higher prices thereof to some extent. Still, his product will have to compete with similar products of other manufacturers which puts a limit on his pricing discretion. If he charges too high a price, consumers may shift their loyalty to other competing suppliers. You can find it out yourself by going to the market, as a large number of consumer goods like toothpastes, soaps, cigarettes, radios, etc. are subject to a large degree of product differentiation as a means of attracting customer.

As long as a consumer has an impression that a particular product brand is different and superior to others, he will be willing to pay more for that brand than for any other brand of the same commodity. The differences real or illusory, may be built up in his mind by (a) recommendations by friends, (b) advertising, and (c) his own experience and observation. The producer gains and retains his customers by (a) competitive advertising and sales promotion, (b) the use of brand names quite as much as by (c) price competition.

Product differentiation is more typical of the present day economic system, than either pure competition or monopoly. And, in most cases, an individual firm has to face monopolistic competition. It tries to maintain its position and promote its sales by either (i) changing its price and indulging in price competition, or (ii) intensifying the differentiation of its product, and/or (iii) increasing its advertisement and sales promotion efforts.

14.3 ROLE OF COSTS IN PRICING

There is a popular belief that costs determine price. It is because the cost data constitute the fundamental element in the price setting process. However, their relevance to the pricing decision must neither be underestimated nor exaggerated. For setting prices, apart from costs, a number of other factors have to be taken into consideration. Demand is of equal, and, in some cases, of greater importance than costs. An increase in cost may appear to justify an increase in prices yet the demand situation may not permit such an increase. On the other hand, an increase in demand may make increase in prices possible, even without any increase in costs.

Very often, price determines the cost that may be incurred. The product is tailored to the requirements of the potential consumers and their capacity to pay for it. The radio manufacturers in India realised that if they have to capture the mass market prevailing in India, they have to price it at low level which could be done only by reducing costs—reducing the number of wave-bands in the radio. And now a single wave radio is available at around Rs. 100. Given the price, we arrive at the cost working backwards from the price consumers can afford to pay. Over a period, cost and quality are adjusted to the given price.

If costs were to determine prices, why do so many companies report losses? There are marked differences in costs as between one producer and another. Yet the facts remains that the prices are quite close for a somewhat similar product. This is, if anything, is best evidence of that costs are not the determining factor in pricing.

Price decisions cannot be based merely on cost. It is very difficult to measure costs accurately. Costs are affected by volume, and volume is affected by price. The management has to assume some desire price and volume relationship for determining costs. That is why costs play even a less important role in case of new products as compared to existing products. It is not possible to determine costs without having an idea of what volumes or numbers can be sold. But, since there is no experience of volumes, costs and prices, one starts with the going market price for similar products.

All this discussion does not purport to show that costs should be ignored altogether while setting prices. Costs have to be taken into consideration. In fact, in the long-run, if costs are not covered, manufacturers will withdraw from the market and supply will be reduced which, in turn, may lead to higher prices. The point that needs emphasis is that cost is not the only factor in setting prices. Cost must be regarded only as an indicator of the price which ought to be set after taking into consideration the demand, the competitive situation, and other factors.

Costs determine the profit consequences of the various pricing alternatives. Cost calculations may also help in determining whether the product whose price is determined by its demand is to be included in the product line or not.

Exercise 2

In the example stated in Exercise 1, the cost behaviour changes for various levels of production as follows:

No. of units manufactured	Cost Price per unit (Rs.)
50,000	450
45,000	470
55,000	440
60,000	430
70,000	420
100,000	400

Considering the price levels and expected sales mentioned earlier in Exercise 1, what would be the optimal price under above cost behaviour situation?

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14.4 PRICING METHODS

After discussing the various considerations affecting pricing policies, it would be useful to discuss the alternative pricing methods most commonly used. These methods are:

Cost-plus or Full-cost pricing
Pricing for a rate of return, also called target pricing
Marginal cost pricing
Going rate pricing, and
Customary prices.

The first three methods are cost-oriented as the prices are determined on the basis of costs. The last two methods are competition-oriented as the prices here are set on the basis of what competitors are charging.

Cost-plus or Full-cost Pricing

This is most common method used in pricing. Under this method, the price is set to cover costs (materials, labour and overhead) and a predetermined percentage for profit. The percentage differs strikingly among industries, among members—firms and even among products of the same firm. This may reflect differences in competitive intensity, differences in cost base and differences in the rate of turnover and risk. In fact, it denotes some vague notion of a **just profit.**

What determines the normal profit? Ordinarily margins charged are highly sensitive to the market situation. They may, however, tend to be inflexible in the following cases: (i) they may become merely a matter of common practice, (ii) mark-ups may be determined by trade associations either by means of advisory price lists or by actual lists of mark-ups distributed to members, (iii) profits sanctioned under price control as the maximum profit margins remain the same even after the price control is discontinued. These margins are considered ethical as well as reasonable. Its inadequacies are:

1 It ignores demand—there is no necessary relationship between cost and what people will pay for a product.
2 It fails to reflect the forces of competition adequately. Regardless of the margin of profit added, no profit is made unless what is produced is actually sold.
3 Any method of allocating overheads is arbitrary and may be unrealistic. Insofar as different prices would give rise to different sales volumes, unit costs are a function of price, and therefore, cannot provide a suitable basis for fixing prices. The situation becomes more difficult in multi-product firms.
4 It may be based on a concept of cost which may not be relevant for the pricing decision.

Explanation for the Widespread use of Full-cost Pricing
A clear explanation cannot be given for the widespread use of full-cost pricing, as firms vary greatly in size, product characteristics and product range, and face varying degrees of competition in markets for their products. However, the following points may explain its popularity:

1 Prices based on full-cost look factual and precise and may be more defensible on moral grounds than prices established by other means.

2 Firms preferring stability, use full-cost as a guide to pricing in an uncertain market where knowledge is incomplete. In cases where costs of getting information are high and the process of trial and error is costly, they use it to reduce the cost of decision-making.

3 In practice, firms are uncertain about the shape of their demand curve and about the probable response to any price change. This makes it too risky to move away from full-cost pricing.

4 Fixed costs must be covered in the long-run and firms feel insecure that if they are not covered in the long-run either.

5 A major uncertainty in setting a price is the unknown reaction of rivals to that price. When products and production processes are similar, cost-plus pricing may offer a source of competitive stability by setting a price that is more likely to yield

acceptable profit to most other members of the industry also.

6 Management tends to know more about products costs than other factors which are relevant to pricing.

7 Cost-plus pricing is specially useful in the following cases:

a) Public utilities such as electricity supply, transport, where the objective is to provide basic amenities to society at a price which even the poorest can afford.

b) Product tailoring, i.e. determining the product design when the selling price is predetermined. The selling price may be determined by government, as in case of certain drugs, cement, fertilisers. By working back from this price, the product design and the permissible cost is decided upon. This approach takes into account the market realities by looking from the viewpoint of the buyer in terms of what he wants and what he will pay.

c) Pricing products that are designed to the specification of a single buyer as applicable in case of a turn key project. The basis of pricing is estimated cost plus gross margin that the firm could have got by using facilities otherwise.

d) Monopsony buying—where the buyers know a great deal about suppliers' costs as in case of an automobile buying, components from its ancillary units. They may make the products themselves if they do not like the price. The more relevant cost is the cost that the buying company, say, the automobile manufacturer, would incur if it made the product itself.

In India, cost-plus method is widely used. There are two special reasons which could explain its wide use in India.

1 The prevalence of sellers' market in India makes it possible for the manufacturers to pass on the increases in costs to the consumers.
2 Costs plus a reasonable margin of profit are taken into consideration for the purposes of price fixation in the price-controlled industries in India. Thus, this method has the tacit approval of the Government.
3 To conclude, cost-plus is a pricing convention relying on arbitrary costs and arbitrary mark-ups. It is adopted because it is simpler to apply.

Pricing for a Rate of Return

An important problem that a firm might have to face is one of adjusting the prices to changes in costs. For this purpose the popular policies that are often followed are as under:

1 Revise prices to maintain a constant percentage mark-up over costs.
2 Revise prices to maintain profits as a constant percentage of total sales
3 Revise prices to maintain a constant return on invested capital.

The use of above policies is illustrated below:

Illustration
A firm sells 1,00,000 units per year at a factory price of Rs. 12 per unit. The various costs are given below:

Variable Costs	Materials	Rs. 3,60,000
	Labour	Rs. 4,20,000
Fixed Costs	Overhead	Rs. 1,20,000
	Selling & Administrative	Rs. 1,80,000
Total investment in cash, inventory and equipment		Rs. 8,00,000

Suppose the labour and materials cost increases by 10 per cent. The question is how to revise price according to the three policies discussed above.

The above data reveal that costs are Rs. 10,80,000. The profits as percentage of costs, sales and capital employed (according to the three policies are):

1 Percentage over costs $\frac{1,20,000}{10,80,000} = 11.1$

2 Percentage on sales $\frac{1,20,000}{12,00,000} = 10$

3 Percentage on capital employed $\frac{1,20,000}{8,00,000} = 15$

The revised costs are Rs. 11,58,000
(Rs. 10,80,000+36,000+42,000)

According to the first formula, we have to earn a profit of 11.1 per cent on costs. Our revised profits should be Rs. 1,28,667 and sales volume on this basis would be Rs. 12,86,667. The selling price would, therefore, be Rs. 12.87 per unit.

Under the second formula, the profit should be 10 per cent on sales. If sales are S, the profit would be S/10 and cost would be 9S/10. The cost is known to us and we have to find out the sales.
If 9S/10= Rs. 11,58,000 than S= Rs. 12,86,667
Therefore, the price per unit is Rs. 12.87.

Under the third formula, we assume that the capital investment is the same. Therefore, the required profit is Rs. 1,20,000 (15 per cent on Rs. 8,00,000). The sales value would then be Rs. 12,78,000 and the selling price per unit would be Rs. 12.78.

Rate of return pricing is a refined variant of full-cost pricing. Naturally, it has the same inadequacies, viz., it tends to ignore demand and fails to reflect competition adequately. It is based upon a concept of cost which may not be relevant to the pricing decision at hand and overplays the precision of allocated fixed costs and capital employed.

Marginal Cost Pricing

Both under full-cost pricing and the rate-of-return pricing, prices are based on total costs comprising fixed and variable costs. Under marginal cost pricing, fixed costs are ignored and **prices are determined on the basis of marginal cost.** The firm uses only those costs that are directly attributable to the output of a specific product.

With marginal cost pricing, the firm seeks to fix its prices so as to maximise its total contribution to fixed costs and profit. Unless the manufacturer's products are in direct competition with each other, this objective is achieved by considering each product in isolation and fixing its price at a level which is calculated to maximise its total contribution.

Advantages

1 With marginal cost pricing, prices are never rendered uncompetitive merely because of a higher fixed over-head structure. The firm's prices will only be rendered uncompetitive by higher variable costs, and these are controllable in the short-run while certain fixed costs are not.

2 Marginal cost pricing permits a manufacturer to develop a far more aggressive pricing policy than does full-cost pricing. An aggressive pricing policy should lead to higher sales and possibly reduced marginal costs through increased marginal physical productivity and lower input factor prices.

3 Marginal cost pricing is more useful for pricing over the life-cycle of a product, which requires short-run marginal cost and separable fixed cost data relevant to each particular state of the cycle, not long-run full-cost data.

Marginal cost pricing is more effective than full-cost pricing because of two characteristics of modern business:

a) The prevalence of multi-product, multi-process and multi-market concerns makes the absorption of fixed costs into product costs absurd. The total costs of separate products can never be estimated satisfactorily, and the optimal relationships

between costs and prices will vary substantially both among different products and between different markets.

b) In many businesses, the dominant force is innovation combined with constant scientific and technological development, and the long-run situation is often highly unpredictable. There is a series of short-runs of production and one must aim at maximising contribution in each short-run. When rapid developments are taking place, fixed costs and demand conditions may change from one short-run to another, and only by maximising contribution in each short-run will profit be maximised in the long-run.

Limitations

1 The encouragement to take on business which makes only a small contribution may be so strong that when an opportunity for higher contribution business arises, such business may have to be foregone because of inadequate free capacity, unless there is an expansion in organisation and facilities with the attendant increase in fixed costs.

2 In a period of business recession, firms using marginal cost pricing may lower prices in order to maintain business and this may lead other firms to reduce their prices leading to cut-throat competition. With the existence of idle capacity and the pressure of fixed costs, firms may successively cut down prices to a point at which no one is earning sufficient total contribution to cover its fixed costs and earn a fair return on capital employed.

In spite of its advantage, due to its inherent weakness of not ensuring the coverage of fixed costs, marginal cost pricing has usually been confined to pricing decision relating to special orders.

Going-rate Pricing

Instead of the cost, the emphasis here is **on the market.** The firm adjusts it own price policy to the general pricing structure in the industry. Where costs are particularly difficult to measure, this may seem to be the logical first step in a rational pricing policy. Many cases of this type are situations of price leadership. Where price leadership is well established, charging according to what competitors are charging may be the only safe policy.

It must be noted that 'going-rate pricing' is not quite the same as accepting a price impersonally set by a near perfect market. Rather it would seem that the **firm has some power** to set its own price and could be a price maker if it chooses to face all the consequences. It prefers, however, to take the safe course and conform to the policy of others.

Customary Pricing

Prices of certain goods become more or less fixed, not by deliberate action on the sellers' part but as a result of their having prevailed for a considerable period of time. For such goods, changes in costs are usually reflected in changes in quality or quantity. Only when the costs change significantly the customary prices of these goods are changed.

Customary prices may be maintained even when products are changed. For example, the new model of an electric fan may be priced at the same level as the discontinued model. This is usually so even in the face of lower costs. A lower price may cause an adverse reaction on the competitors leading to a price war so also on the consumers who may think that the quality of the new model is inferior. Perhaps, going along with the old price is the easiest thing to do. Whatever be the reasons, the maintenance of existing prices as long as possible is a factor in the pricing of many products.

If a change in customary prices is intended, the pricing executive must study the pricing policies and practices of competing firms and the behaviour and emotional make-up of his opposite number in those firms. Another possible way out, specially when an upward move is sought, is to test the new prices in a limited market to determine the consumer reaction.

Exercise 3

Consider the following data for a door handle:

Direct labour per unit	Rs. 7.50
Raw Materials per unit	Rs. 2.00
Advertising and Sales Force costs	Rs. 400,000
Other relevant fixed costs	Rs. 100,000
Current going-rate (Market) Price/Unit	Rs. 22.00

Question 1

a) Find out the contribution/unit.

b) No. of units to be sold for breaking even (Break-even point is the point where no loss or profit is made).

Question 2

a) If profit target is Rs. 60,000, how many units should be sold?

b) If currently 50,000 units are being sold, what is the profit?

Question 3

a) If owner's investment in the plant is Rs. 1,000,000 and they desire 20% rate of return before tax after covering all expenses, how many units should be sold?

Question 4

a) Let us assume that consumer behaviour in terms of units bought of this manufacturer is as follows:

Price	No. of units sold
22	50,000
21	60,000
20	70,000
23	40,000
24	30,000
25	20,000

What is the price at which manufacturer should sell the product?

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Answers	1(a)—Rs. 12.50	1(b)—40,000 units	2(a)—44,800 units
	2(b)—Rs. 125,000	3(b)—Rs. 56,000	4(a)—Rs. 20

14.5 OBJECTIVES OF PRICING POLICY

Before a marketer fixes a price, he should keep in mind certain basic considerations. The price policy he adopts is closely related to his other policies, like production programme, advertising policy and selling methods. For example, it may be necessary to reduce the price to offset the probable loss of sales from a lower advertising budget or to enable fuller utilisation of plant capacity more quickly. Aggressive sales campaign may be necessary to meet the advent of a new competitor. Your price should not be so high that it attracts others to compete with you. A low price policy may result in such a high volume of sales and low unit costs that profits are maximised even at low prices.

"My policy is to reduce the price, extend the operations and improve the article. You will note that the reduction of price comes first. I have never considered any costs as fixed. Therefore, I first reduce the price to a point where I believe more sales will result. The new price forces the costs down. . (by forcing) everybody in the plant to the highest point of efficiency," Henry Ford quoted in Phillip and Duncan, Marketing, 3rd Edition, 1956, p. 696.

If a marketing manager is to make effective pricing decisions, he should be clear about the firm's long-term marketing objectives for the entire range of products and services. If the firm is interested in increased market share, it would have to resort to penetration pricing. If it is interested in short-term profitability, it may have a higher price even at the expense of sales volume and market share. The following table gives a summary view of some marketing objectives and their pricing implications:

Marketing Area	Marketing Objective	Pricing Implication
Product	Improved Quality Acceptance	Higher cost=Price increase or lower profit.
Advertising and Promotion	Stronger Support	Increased Advertising and publicity budget = Price increase or lower profit.
Distribution	Additional Selling Points	Possibly higher distribution costs (margin increase)
Consumers/ Users	Greater Acceptance	Increased Advertising and publicity effort, possibly higher distribution cost = higher price or less profit.

Source: 2. J.J. Ward (Editor), The Export Marketing Management, International Trade Centre, Geneva 1985, P-284.

14.6 CONSUMER PSYCHOLOGY AND PRICING

Sensitivity to price change will vary from consumer to consumer. In a particular situation, the behaviour of one individual may not be the same as that of the other. Some important characteristics of consumer behaviour as revealed by research and experience are detailed below:

1 From the point of view of the consumer, prices are quantitative and precise whereas product quality, product image, customer service, promotion and similar factors are qualitative and ambiguous. It is easier to speculate about what consumers would do if prices rose by 5 per cent than if the quality improved by 5 per cent.

2 Price constitutes a barrier to demand when it is too low just as much as when it is too high. Above a particular price, the article is regarded as too expensive and, below another price, as constituting a risk of not giving adequate value. If the price is too low, consumers will tend to think that a product is of inferior quality.

   Balsara, manufacturers of **'Odonil'** and **'Promise'** realised that pricing a product too low could adversely affect its sales by creating a credibility problem. Consequently, they began to price their products with higher unit margins, to make higher advertising outlays to emphasise product attributes rather than the price and provide more attractive margins to dealers to push up their products. (Business India, April 28-May 11, 1980, P-35).

3 Price inevitably enters into the consumer's assessment of quality. There are two reasons for this:

   a) It needs expert knowledge and appropriate equipment to test the quality or durability of some particular products (to say nothing of the time and cost involved in carrying out a proper test), and

   b) Customers tend to look upon price itself as a reasonably reliable indicator of quality. What is costly is thought to be of a high quality. A higher price is ordinarily taken to be a symbol of extra quality, or extra value of extra prestige. It is very difficult to convince people that something cheap is of good quality and that something expensive is of poor quality. It may be easier to prove that

an expensive product is of superior quality than to prove that a cheap product is of good quality.

This is specially true of durable consumer goods which are very often differentiated, at least psychologically, through branding, packaging and advertising. In such cases, the sale of certain goods could be stimulated more effectively through higher rather than lower prices for two reasons: (i) the higher price increases the snob appeal of the goods and, (ii) the higher price creates confidence in the customer that he is getting good quality.

To conclude, in many cases, price is used by the prospective customer as a clue for sizing up the quality of the product. This price quality association is well established.

4 With an improvement in incomes, the average consumer becomes, quality-conscious. **An improvement may, therefore, lead to an increase in demand.** If this is so, a time may come when a rise in price results in an increase in demand. This extreme situation may arise if price in increasingly affluent societies comes to serve merely as an indicator of quality.

5 Consumers may be persuaded to pay more for heavily advertised goods. A firm's size, its financial success, and even its age are often perceived by consumers as measures of quality. Well known firms very often assert that by virtue of their reputation they are able to charge 5 to 10 per cent higher than other firms but definitely not much more.

6 In a comprehensive survey of consumer consciousness, it was revealed that the basic postulate of the demand theory, i.e., the consumer has an appropriate knowledge of market prices, was not fundamentally wrong.

The following types of consumers are most likely to perceive price as an indicator of quality:

i) persons trying to achieve status,
ii) occasional consumer who is not knowledgeable in a product area, e.g., purchase of a camera, and
iii) the buyer who is impressed by the importance of quality, but has difficulty in identifying it.

An experimental study in India showed that more than 60 per cent of the respondents revised their ratings of readymade shirts after knowing their prices indicating thereby that price information does have a significant effect on quality perception.

To conclude, higher prices that increase consumer readiness to buy may sound uneconomic, but may not be unrealistic The price-quality concept has equal relevance to new product pricing. The lesson from this discussion is that **the producer has considerable flexibility in pricing his products, provided he can create a psychological image of quality.**

14.7 PRICING OF INDUSTRIAL GOODS

For many consumer products, buyers are not usually aware of the prevailing prices. Products falling in the category of luxury goods and items not frequently purchased would constitute such goods, consumers, of course are usually aware of the regularly purchased items like groceries. On the other hand, buyers of industrial goods tend to be price conscious. They are more keen to check what they get for the price they pay. They also tend to act more rationally than an average buyer of consumer goods. Their knowledge of markets is more intensive and exact, if not perfect. Very often the buyer of an industrial product knows or at least can make a guess of the costs of manufacture.

Product differentiation is easier in industrial goods than in consumer goods by (i) providing better service in connection with delivery, use or installation, and (ii) building a reputation for reliability or quality of workmenship. Moreover, product differentiation results much more from product differences that generate provable claims. Branding, therefore, plays a much less important role in the marketing of industrial goods than in the case of consumer goods.

Price leadership is a very common phenomenon in the industrial goods market.

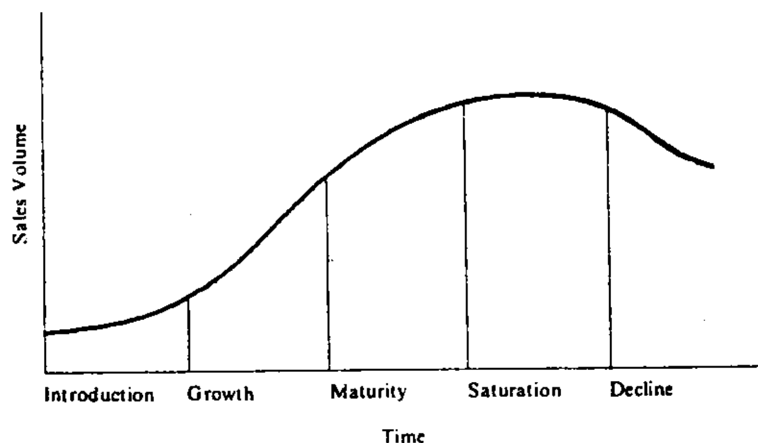
The price elasticity of the demand for an industrial product would depend to some extent on how important its price is in the general cost structure of the using firm. If it represents a significant element, a reduction in price may lead to a substantial increase in demand. If it is not, a change in price may not lead to a change in demand. The demand for equipment, however, is much less price elastic because the price of the equipment is a part of the over-head cost which cannot be readily identified.

14.8 PRICING OVER THE LIFE-CYCLE OF A PRODUCT

Many products generally have a characteristic known as 'perishable distinctiveness'. This means that a product which is distinct when new, degenerates over the years into a common commodity. The process by which the distinctiveness gradually disappears as the product merges with other competitive products has been rightly termed by Joel Dean as "the cycle of competitive degeneration". The cycle begins with the invention of a new product, and is often followed by patent protection, and further development to make it saleable. This is usually followed by a rapid expansion in its sales as the product gains market acceptance. Then competitors enter the field with imitation and rival products and the distinctiveness of the new product starts diminishing. The speed of degeneration differs from product to product. The innovation of a new product and its degeneration into a common product is termed as the life-cycle of a product.

There are five distinct stages in the life-cycle of a product as shown in Figure II.

Figure II: Life-cycle of a Product



1 Introduction: Research or engineering skill leads to product development. The product is put on the market; awareness and acceptance are minimal. There are high promotional costs. Volume of sales is low and there may be heavy losses.

2 Growth: The product begins to make rapid sales gains because of the cumulative effects of introductory promotion, distribution, and word-of-mouth influence. High and sharply rising profits may be witnessed. But, to sustain growth, consumer satisfaction must be ensured at this stage.

3 Maturity: Sales growth continues, but at a diminishing rate, because of the declining number of potential customers who remain unaware of the product or who have taken no action. There is no improvement in the product but changes in selling effort are common. Profit margins slip despite rising sales.

4 Saturation: Sales reach and remain on a plateau marked by the level of replacement demand. There is little additional demand to be stimulated.

5 Decline: Sales begin to diminish absolutely as the customers begin to tire of the product and the product is gradually edged out by better products or substitutes.

It may be noted that **products may begin in new-cycle or revert to an early stage** as a result of

a) the discovery of new uses,
b) the appearance of new users, and

c) introduction of new features.

As the distinctiveness of the products fades, the pricing discretion enjoyed by their producers gradually declines. This is what happened in the case of many products like ball point pens, transistors, radios, etc. Throughout the cycle, changes take place in price and promotional elasticity of demand as also in the production and distribution costs of the product. Pricing policy, therefore, must be adjusted over the various phases of the cycle. Let us know the pricing policy in the pioneering stage and the maturity stage of a product.

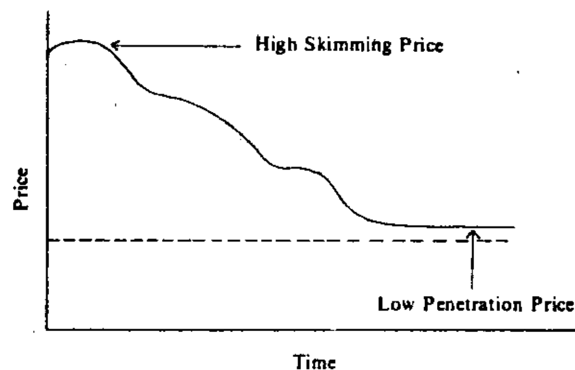
Pricing a new product

The basic question is whether to charge a **high skimming (initial) price** or a **low penetration price.**

If a skimming price is adopted, the initial price is very high. The policy may be held for varying periods of time, indefinitely if the product enjoys valid and defensible patent protection. But usually, it is not longer than the time necessary for competitors to study the product's usefulness, to decide what to do about it, and to prepare for making it, a period ranging from a few weeks to as much as two years. After this period, the price is apt to drop precipitately and over a period of a few years to approach the usual or customary margin above cost that is common in the industry.

In case of penetration pricing, the initial price of the new product is apt to be somewhere near what may be expected to be the usual or customary level once competitors enter the field, generally only slightly above the level. If the initial price is properly fixed, only minor adjustment would have to be made if and when competition develops. Figures III shows the behaviour of these two types of prices graphically:

Figure III: Skimming and Penetration Prices



A) **A high initial price** (skimming price), together with heavy promotional expenditure, may be used to launch a new product if conditions are appropriate.

For example:

a) Demand is likely to be less price elastic in the early stages than later, since high prices are unlikely to deter pioneering consumers. A new product being a novelty commands a better price. Again, at least in the early stages, the product has so few close rivals that cross elasticity of demand is low.

b) If the life of product promises to be a short one, a high initial price helps in getting as much of it and as fast as possible.

c) Such a policy can provide the basis for dividing the market into segments of differing elasticities. Hard bound edition of a book is usually followed by a paperback.

d) A high initial price may be useful if a high degree of production skill is needed to make the product so that it is difficult and time-consuming for competitors to enter on an economical basis.

e) It is a safe policy where elasticity is not known and the product not yet accepted. High initial price may finance the heavy costs of introducing a new product when uncertainties block the usual sources of capital. The benefits of reduction in product costs due to larger volume and technological developments, can be passed on to

consumers by a gradual reduction in prices. Penicillin and streptomycin were introduced at a high initial price but are now very reasonably priced. Internationally, the first ball point pen produced in 1945 at a cost of 80 cents, sold at $ 12.50. Now they are available at less than 50 cents. So is the case with most electronic components.

B) A low penetration price: In certain conditions, it can be successful in expanding the market rapidly thereby obtaining larger sales volume and lower unit costs. It is appropriate where:

a) Sales respond quickly and strongly to low prices;
b) There are substantial cost savings from volume production;
c) The product is acceptable to the mass of consumers;
d) There is no strong patent protection; and
e) There is a threat of potential competition so that a big share of the market must be captured quickly.

The objective of low penetration price is to raise barriers against the entry of prospective competitors.

Change in Price

A) Reduction in prices: A reduction price may be made to achieve the following objectives:

1 Prices may be reduced to offset a possible loss of sales resulting from a lower advertising budget.
2 When a firm is expanding its capacity, temporary price cut may help the new plant to reach capacity operation more quickly.
3 Lower prices may help the firm to broaden the market for its products.
4 Prices may have to be reduced to meet competitive pressures from domestic or foreign companies producing the same product or substitute products.
5 Prices may be reduced drastically to prevent the entry of potential competitors.
6 Technological developments may lead to reduce costs and manufacturers may wish to pass on the benefit to the consumers.

Shriram Chemicals have often reduced their prices as a result of advanced promotion techniques and better utilisation of installed capacity. DCM Data Products dramatically reduced the prices of their calculators in September, 1976 because of economies of scale.

Price reduction in individual drugs have always been a normal feature of the operations of the drugs industry both in India and abroad. Competition among drug manufacturers is becoming an increasingly important factor leading to voluntary price reductions wherever cost reduction of greater efficiency has made them possible.

Whether a reduction in price would help a firm to increase sales depends upon how the consumers react to the reduction. As has been pointed out earlier, consumers rely on prices as an indicator of quality. Reduction in price may give rise to an apprehension that quality has gone down. And a reduction in price may decrease sales unless special steps are taken to prove that the quality is maintained.

B) Increase in prices: Very often a company might face a situation where costs may have increased, and it might wonder whether to increase prices or not. The decision would depend on how demand would be affected by such an increase in prices. In fact, prices are usually increased where the market demand is strong and the business is having a boom. Prices are normally never increased during periods of depression and falling incomes. Thus while it may be true that costs may be rising at the time prices are increased, it is the rising demand that makes it possible to pass on the increase in costs to customers without any adverse effect on sales.

14.9 NATURE AND USE OF PRICE DISCOUNTS

There are two popular types of discounts (i) Quantity discounts and (ii) Cash Discounts.

Quantity Discounts: Quantity discounts are price reductions related to the quantities purchased. Quantity discounts may be related to the size of the order being measured in terms of physical units of a particular commodity. This is practicable where the commodities are homogeneous or identical in nature, or where they may be measured in terms of truck-loads. However, this method is not possible in case of heterogeneous commodities which are hard to add in terms of physical units or truck-loads. Drug industry and textile industy offer examples of this types. Here, quantity discounts are based upon the rupee value of the quantity ordered. Rupee becomes a common denominator of value.

Quantity discounts based on physical units become important where the cost of packing is a significant factor and orders of less than standard qualities, say, less than a case of 6 pressure cookers, may involve higher packing charges per cooker since the space remains unutilised. Thus quantity discounts may be employed to induce full carton purchasing.

In some cases, quantity discounts may be based on the cumulative purchases made during a particular period, usually a year or a season, e.g., Diwali discounts may be given on the basis of cumulative purchases made during the Diwali season spread over September to November.

One important **objective of quantity discounts** is to reduce the number of small orders and thereby avoid the high cost of servicing them. Quantity discounts can facilitate economic size order in three ways:

1 A given set of customers is encouraged to buy the same quantity but in bigger lots.
2 The customers may be induced to give the seller a larger share of their total requirements by giving preference over competitors.
3 Small size purchasers may be discouraged and bigger size customers may be attracted.

In many cases, discounts become a matter of trade customers.

Quantity discounts are most useful in the marketing of materials and supplies but are rarely used for marketing equipment and components.

Cash Discounts: Cash discounts are price reductions based on promptness of payment. An example of discount can be "2 per cent off if paid in ten days, full invoice price in 30 days". In practice, the size of cash discount may vary widely.

Cash discount is a convenient device to identify and overcome bad credit risks. In certain trades where credit risk is high, cash discount would be high. If a buyer decides to purchase goods on credit, this reflects his weak bargaining position, and he has to pay a higher price by foregoing the cash discount.

By prompt collections, manufacturers reduce their working capital requirements and thus save their interest costs. However, allowing discounts may involve paying 36.5 per cent in order to save 18 per cent. On the basis of "2 per cent off if paid in 10 days, full invoice price in 30 days", the seller's cost comes to 36.5 per cent (for getting the money 20 days before he has to lose 2 per cent which amounts to 36.5 per cent per year). He could get accommodation from any bank at about 18 per cent. Thus it is the reduction in collection expenses and in risks rather than savings on interest which should be the guiding consideration for cash discounts.

14.10 PRODUCT POSITIONING AND PRICE

By 'positioning' we mean the way a product is viewed by the customers in comparison with similar products. All aspects of the marketing mix must be co-ordinated to place the product in the right position in the market segment aimed at.

Price is just one element of the marketing mix and it must reflect the product's position

in the market. A toilet soap meant to be a novelty to attract the elite must be sold at higher price. This is the basic idea behind product differentiation, i.e. to avoid a situation where the product has to compete only on the basis of price alone.

14.11 NON-PRICE COMPETITION

The basic aim of non-price competition is to alter those characteristics of the product other than price which influence the decision of the buyers. The various forms of non-price competition are: (a) Advertising and creating brand loyalties, (b) changes in the quality of goods and services, (c) prompt deliveries, (d) free gifts and contests and, (e) better after-sales service. The more complex the product the greater are the characteristics which could be modified in response to customer tastes or as a result of changes in technology. Among the major factors responsible for the growth of non-price competition are (a) the tendency towards price uniformity, (b) desire to hold customers on the basis of attributes other than price, as for example, convenience and early deliveries or longer period of guarantee, (c) adoption of measures necessary even to make price competition effective. From the point of view of consumers non-price competition is a boom as they may get better quality goods and services.

14.12 SUMMARY

Pricing is an important element of the marketing mix. Pricing is affected not only by the cost of manufacturing the product, but also by (i) the company's objectives in relation to market share and sales; (ii) the nature and intensity of competition; (iii) stage of the product life-cycle at which the product is currently positioned; (iv) nature of product whether as consumer or industrial product and if the former whether it is a luxury or necessity. Before making any pricing decision it is important to understand all these factors.

There are various methods of pricing. The four most commonly used methods are full cost pricing, pricing for a rate of return going rate pricing and customary pricing. While the first two methods are based on the costs incurred, the latter methods are based on the competition's pricing. While from the company's point of view, price represents a king of 'maximum' that it can charge given its own costs and nature of competition, from the customer's viewpoint it is a representation of quality of the product. Thus, in many cases high price is associated with good quality and vice-versa.

Before designing the pricing strategy in which the choice is between penetrative and skimming pricing. The marketer must fully understand the connotation of price to a customer. In some a reduction in price may lead to an increase in sales, while in other cases it may not. This is especially true in case of industrial products, where the buyer may be more concerned with quality, reliability, delivery schedules, and after-sales services of the product rather than merely the price. Rather than a reduced price, what may be more relevant is price discounts in the form of quantity or cash discounts.

14.13 SELF-ASSESSMENT EXERCISES

1 What are the most important group of individual factors which influence the price of the product?

2 What type of competitive market structure does your company belong? How much discretion do you have in pricing your products?

3 Examine the competitive situation prevailing today in the Indian market for the following goods and indicate briefly the possible price strategies you would recommend for the maximisation of profits: (a) Fountain pens, (b) Cotton textiles, (c) Scooters and bicycles.

4 What would be your pricing strategy if you are (i) faced with an increased excise

duty on your product? (ii) if you are able to reach economies of scale; and (iii) there is a fall in the prices of your major raw materials.

5 How do the stage of product life-cycle and product positioning affect the pricing decisions regarding the product of your company?

6 Can you list out some premium priced products? Why are these products able to command high prices? What are their producers able to charge higher prices?

7 Can you find out some cases where factors other than cost have to be considered for fixing prices?

8 What are the cases where marginal costing could usually be employed? What are its limitations?

9 Can you list some companies who have been able to capture a good market share on the basis of a low price?

10 Will a lower price always induce people to buy more of your product? Will the consumers not think that the quality and price are lower? How will your competitors bear?

11 You are manufacturing washing soap on a small scale. Your capacity is 10,000 cakes per month. Your fixed expenses amount to Rs. 2,000 per year. Variable expenses amount to 40 paise per cake. At what price you would sell your soap, keeping in view the following points:

a) You face competition not only from other small units but also from large-scale units.
b) Other similar soaps sell at 50 to 55 paise per cake.
c) You consider your product to be superior to the existing products in the field.
d) You cannot afford to have your own distribution organisation.

What other points would you bear in mind while making your decision? Give reasons for your decision.

14.14 FURTHER READINGS

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