Introduction to Marketing Essentials
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Lecture - 25
Pricing Products and Services - I

Welcome to Introduction to Marketing Essentials. And now, it is time to start with module 25. The module 25 and 26 are dedicated to understanding Pricing of Products and Services. So, let us get started with module 25. And these are the things that will be covered in this module that we will describe the nature and importance of pricing, then we will talk about the various approaches used to select an approximate price level. And thereafter, we will explain what a demand curve is and the role of revenues in pricing decisions.

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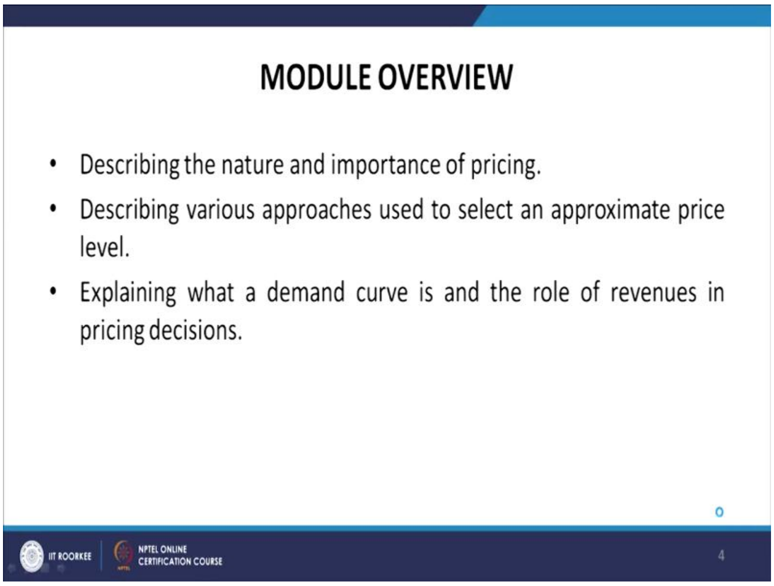

So, to introduce the price, the price paid for products and services goes by many names.

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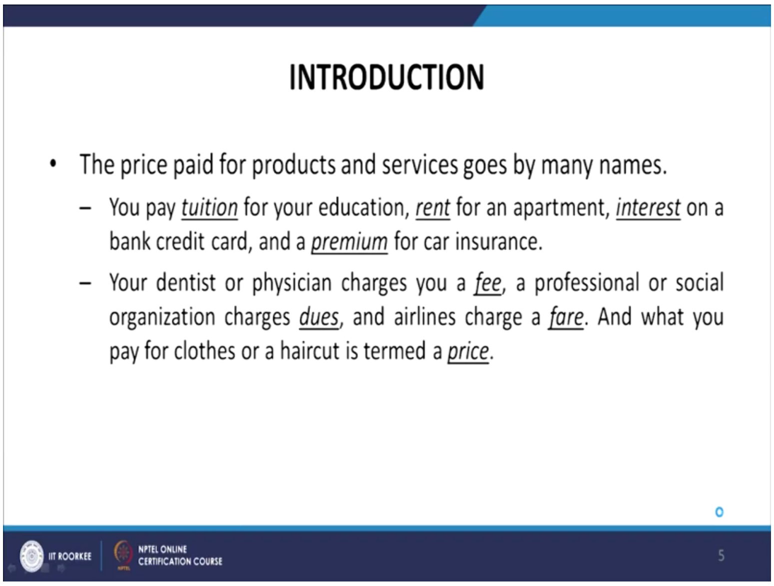

You pay tuition for your education, rent for your apartment, interest on the bank credit card, and premium for car insurance. Your dentist or physician charges you a fee, a professional or a social organization charges dues, and airline charges the fare. And what you pay for clothes or a haircut is termed as a price. So, all these terms they are used to indicate the same thing that is the price.

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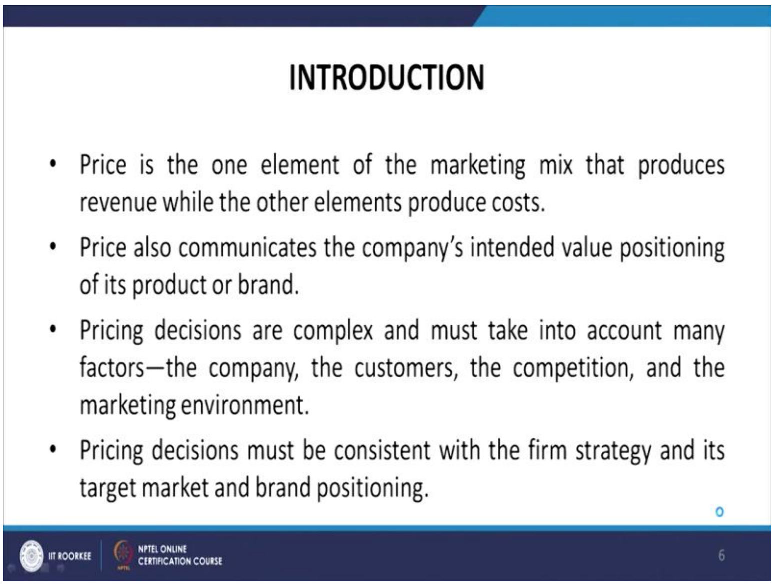

So, price is one element of marketing mix that produces revenues while the other elements produce cost. Price also communicates the company's intended value positioning of its product or brand. Pricing decisions are complex and must take into account many factors such as the company, the customer, the competition and the marketing environment. Pricing decisions must be consistent with the firm’s strategy and its target market and brand positioning.

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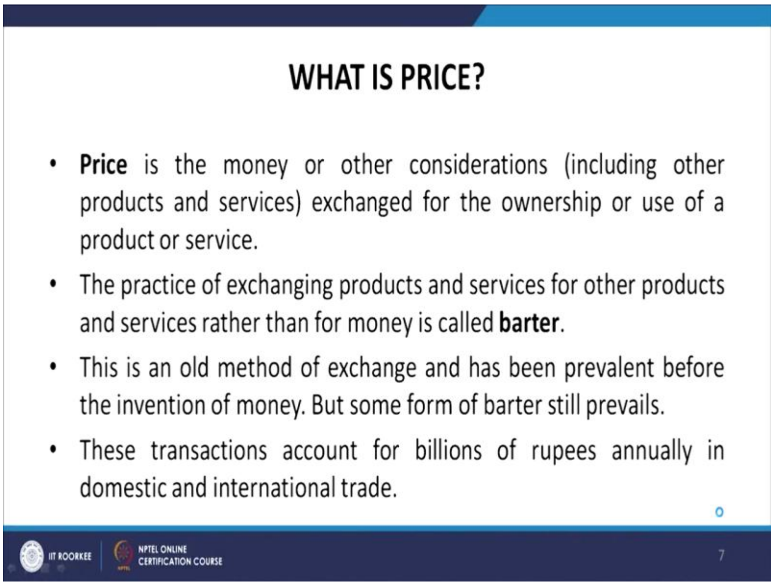

Now, let us look at what is price. So, price is the money or other considerations including other products and services exchanged for the ownership or use of a product or service. The practice of exchanging products and services for other products and services rather than for any money is called as barter. It is an old method of exchange and has been prevalent before the invention of money. But some form of barter still happens, prevails. These transactions account for millions of rupees annually in domestic and international trade.

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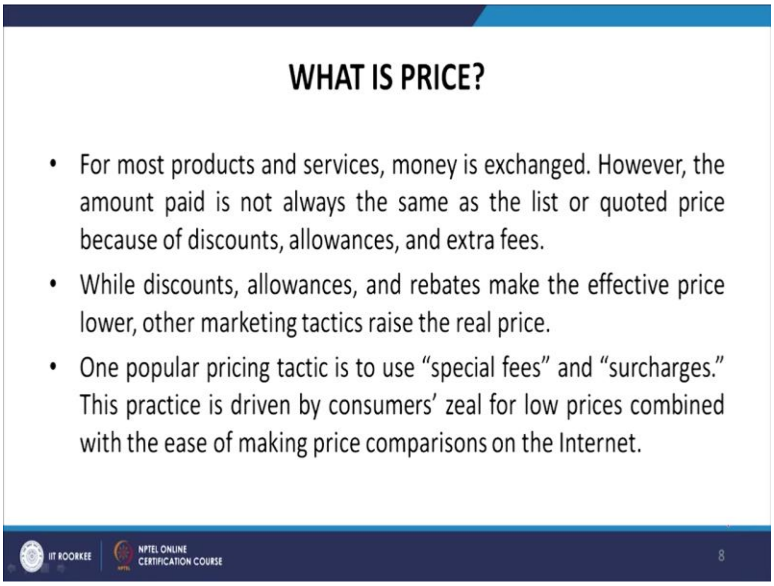

For most products and services, money is exchanged. However, the amount paid is not always the same as the list or quoted price because of discounts, allowances, and extra fees. While discounts, allowances, and rebates make the effective price lowers other marketing tactics raise the real price. One popular pricing tactics is to use "special fee" and "surcharges." This practice is driven by the consumer's zeal for low prices combined with the ease of making price comparisons on the internet.

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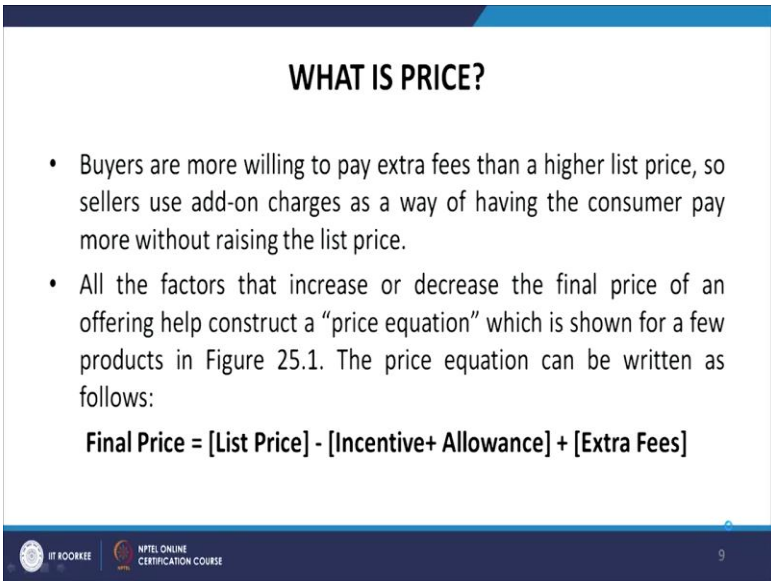

Buyers are more willing to pay extra fees than a higher list price. So, sellers use add-on charges as a way of having the consumers pay more without raising the list price. All the factors that increase or decrease the final price of an offering help construct a “price equation” which is shown for a few products in this figure that is 25.1. The price equation can be written as follows. So, that is

Final Price = [List Price] – [Incentives + Allowances] + [Extra Fees]

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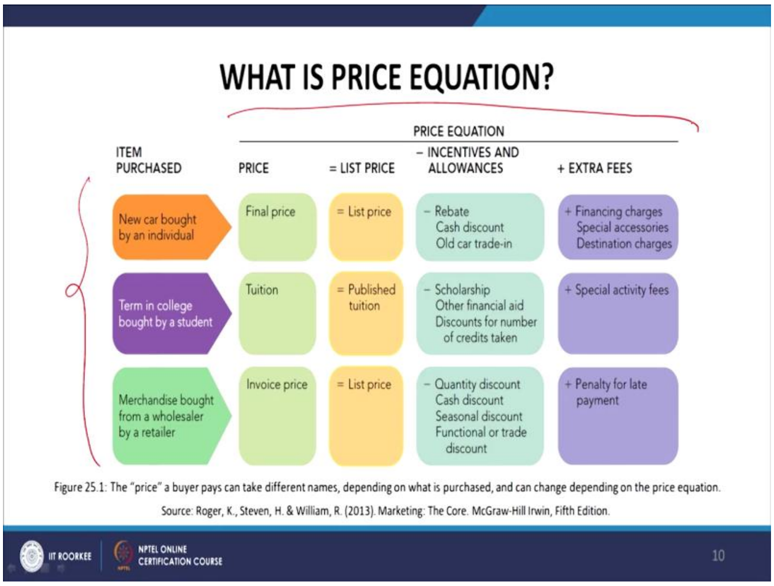

Now, let us look at this price equation. Here we have listed down some examples that is the item purchased. So, new car bought by an individual and, on the right are the various components of the price equation. So, for new car bought by an individual, the price that is the final price is equal to the list price minus incentives and allowances. Now, these incentive and allowances include the rebate, cash discounts and old car trade in plus some extra fees, for example, financing charges special accessories and destination charges.

Another example is that of paying a term fee in a college by a student. So, that is called as tuition. The list price is the published tuition fee, minus incentive and allowances. These incentive and allowances includes the scholarships, other financial aid, discounts for number of credits taken. And the extra fee includes the special activity fee.

Then the third example is merchandise bought from a wholesaler by a retailer. So, the price is the invoice price, which is equal to the list price minus quantity discounts, cash discounts, seasonal discounts, etcetera plus a penalty for late payment.

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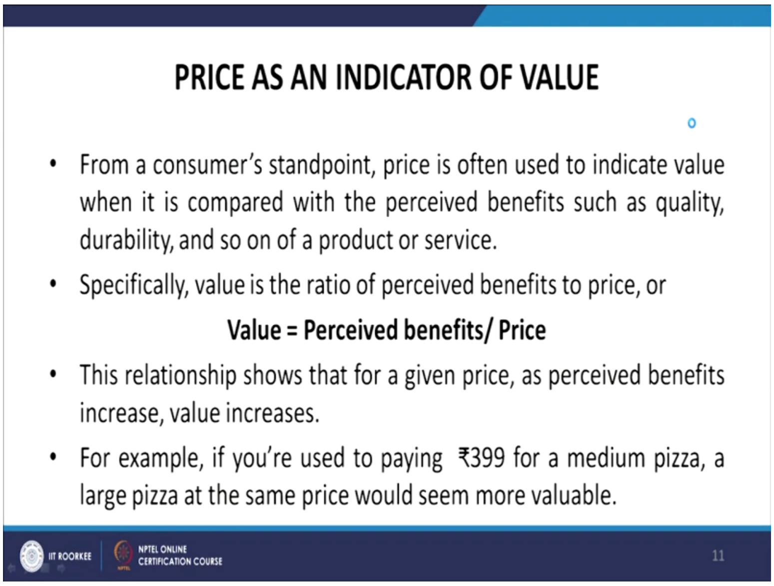

Now, let us look at price as an indicator of value. From a consumer's standpoint price is often used to indicate value when it is compared with the perceived benefits such as quality, durability, and so on of a product or service. Especially, value is the ratio of perceived benefits to price, or

$$\text{Value} = \text{Perceived benefits/ Price}$$

This relationship shows that for a given price, as perceived benefit increases value increases. For example, if you are used to paying a rupee 399 for a medium pizza, a large pizza at the same price would seem more valuable.

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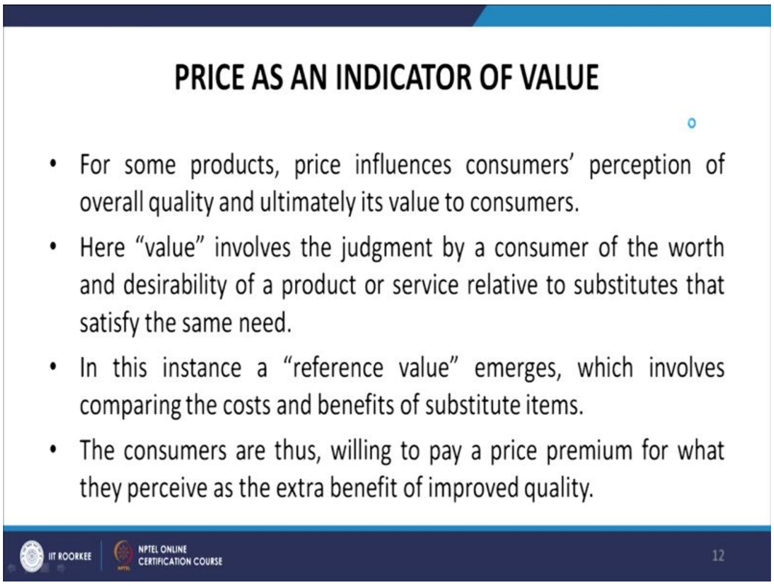

For some products, price influences consumer's perception of overall quality and ultimately its value to the consumers. Here "value" involves the judgment by the consumer of the worth and desirability of a product or service related to substitutes that satisfy the same need. In this instance a "reference value" emerges, which involves comparing the costs and benefits of substitute items. The consumers are thus, willing to pay a price premium for what they perceive as the extra benefit of improved quality.

Now, let us look at the role of price in the marketing mix.

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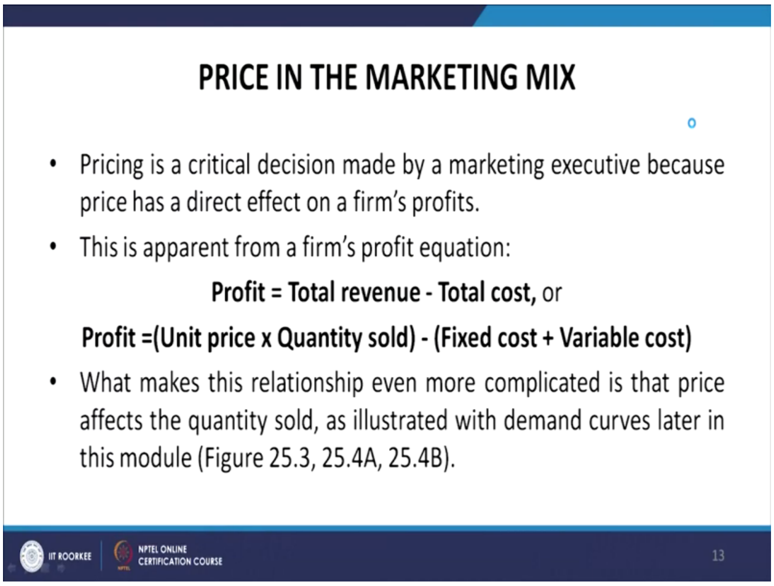

So, pricing is a critical decision made by marketing executives because price has a direct effect on the firm’s profit. So, this is apparent from the firms profit equation that is

Profit = Total Revenues - Total Cost, or

Profit = (Unit Price x Quantity sold) – (Fixed Cost + Variable Cost)

What makes this relationship even more complicated is that price affects the quantity sold, as illustrated with demand curves later in this module that is in figure 25.3, 25.4A and 25.4B.

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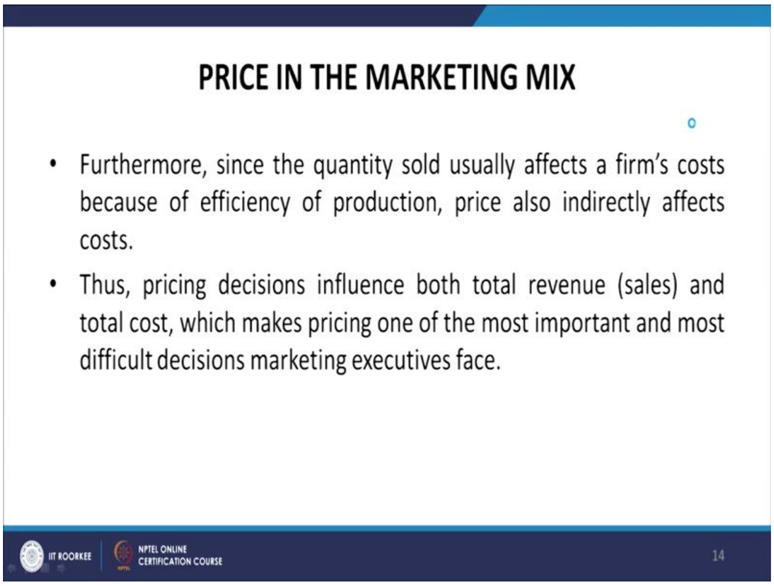

Furthermore, since the quantity sold usually affect a firm’s cost because of efficiency of production, price are indirectly affecting the cost. Thus, pricing decision influence both total revenues that is sales and total cost, which makes pricing one of the most important and most difficult decision marketing executives faces.

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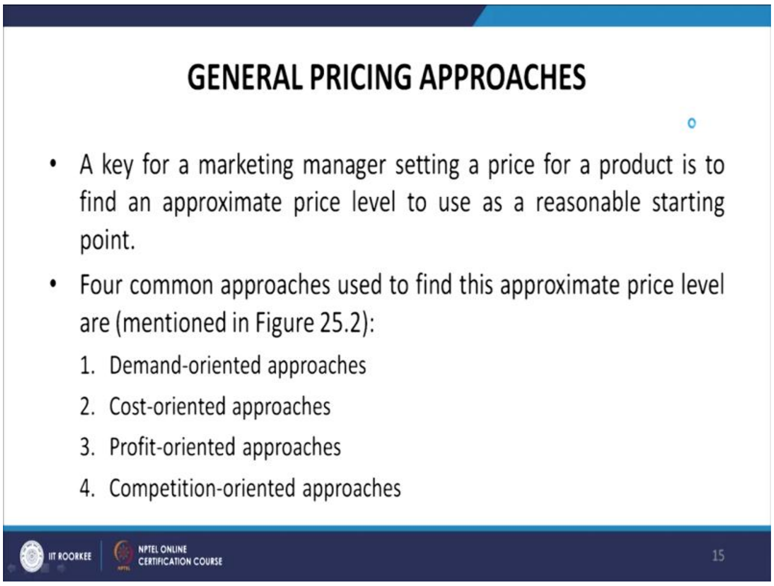

Now, there are various approaches to pricing that are called as general pricing approaches. A key for a marketing manager setting a price for a product is to find an approximate price level to use as a reasonable starting point.

Now, there are four common approaches used to find this approximate price level and they are mentioned in figure 25.2, and they include: the first is demand-oriented approaches, the second is cost-oriented approaches, the third is profit-oriented approaches and the fourth is competition-oriented approaches.

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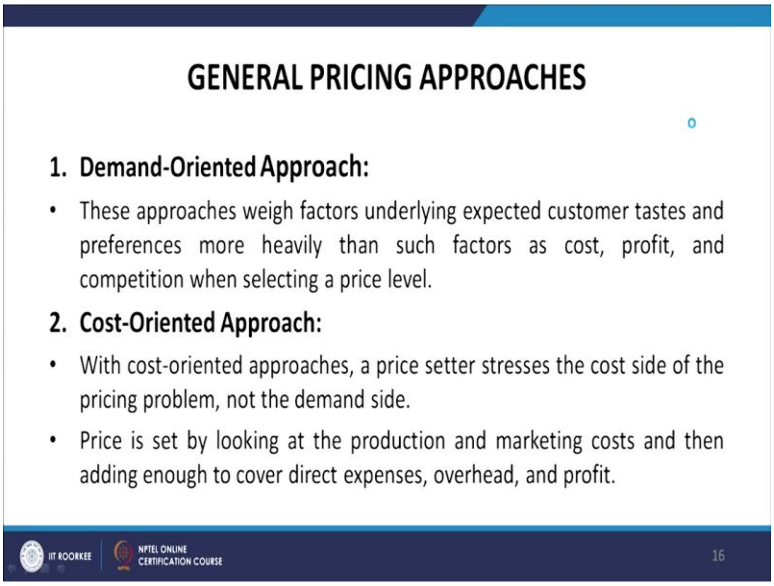

Now, let us see what is this demand-oriented approach. These approaches weigh factors underlying expected customer tastes and preferences more heavily than such factors as cost, profit, and competition when selecting a price level.

The second is the cost-oriented approach. With cost-oriented approaches, a price setter stresses the cost side of the pricing problem, not the demand side. Price is set by looking at the production and marketing cost and then adding enough to cover direct expenses, overheads, and profits.

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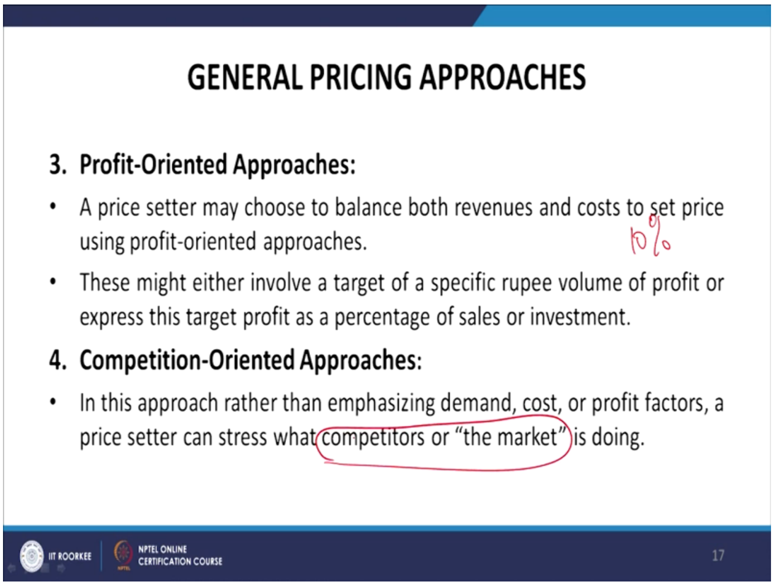

The third is profit-oriented approach. A price setter may choose to balance both revenues and cost to set price using profit-oriented approaches. These might either involve a target of a specific rupee volume of profit or express this target profit as a percentage of sales or investments. For example, 10 percent of the investments.

And then, the fourth one is competition-oriented approaches. In this approach rather than emphasizing demand, cost, or profit factors, a price setter can stress what competitors or "the market" is doing. So, what are the other competitors doing that is one way of setting the prices.

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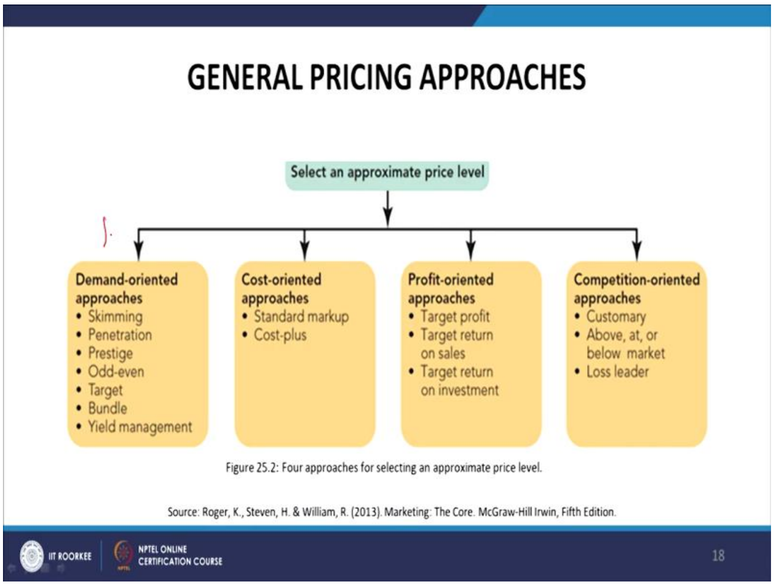

Now, these are the various approaches for that. So, let us start with the first one that is the demand-oriented approach. In this there are the following tactics the skimming, penetration, prestige, odd-even, target, bundle, yield management. Then in cost-oriented approaches, there are standard markup, cost-plus pricing.

In profit-oriented approaches, there are target profits, target return on sale and target return on investment. While in competition-oriented prices, they are customary, or above, at, or below market or the company may choose to be a loss leader.

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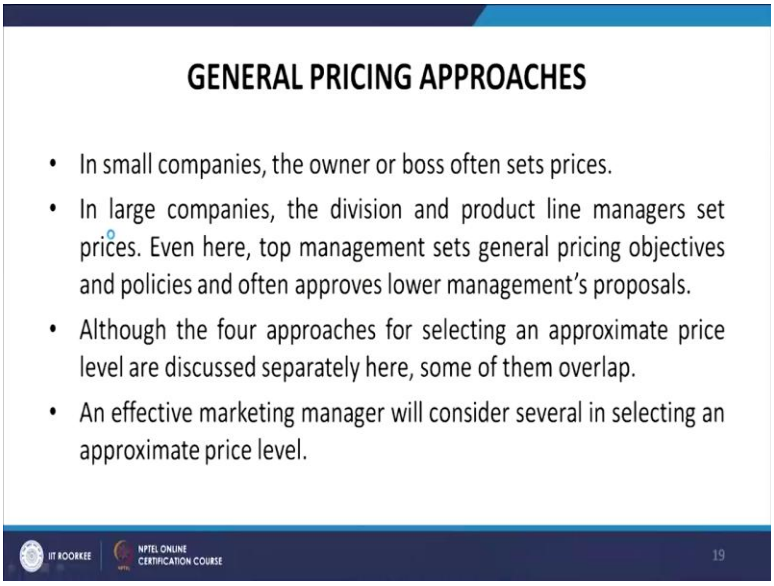

In small companies, the owner or boss often set the prices. In large companies, the division and product line managers set prices. Even here, top management sets general pricing objectives and policies and often approves lower management's proposals. Although the four approaches for selecting an approximate price level are discussed separately here, some of them overlap. An effective marketing manager will consider several in selecting an approximate price level.

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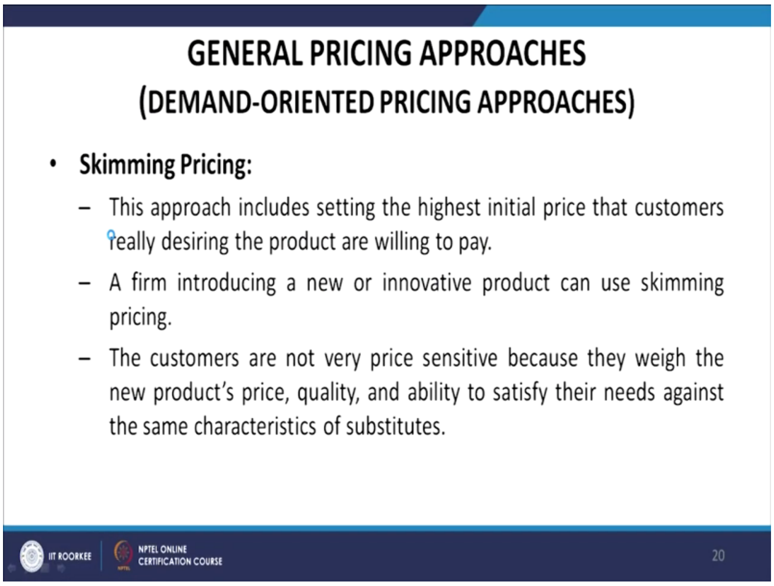

Now, let us look at each of these tactics in detail. So, when we are talking of demand-oriented pricing approach the first one was the skimming pricing. Now, this approach includes setting the highest initial price that customers really desiring the product are willing to pay.

A firm introducing a new or innovative products can use a skimming pricing. The customers are not very price sensitive because they weigh the new product's prices, quality, and ability to satisfy their needs against the same characteristics of a substitute.

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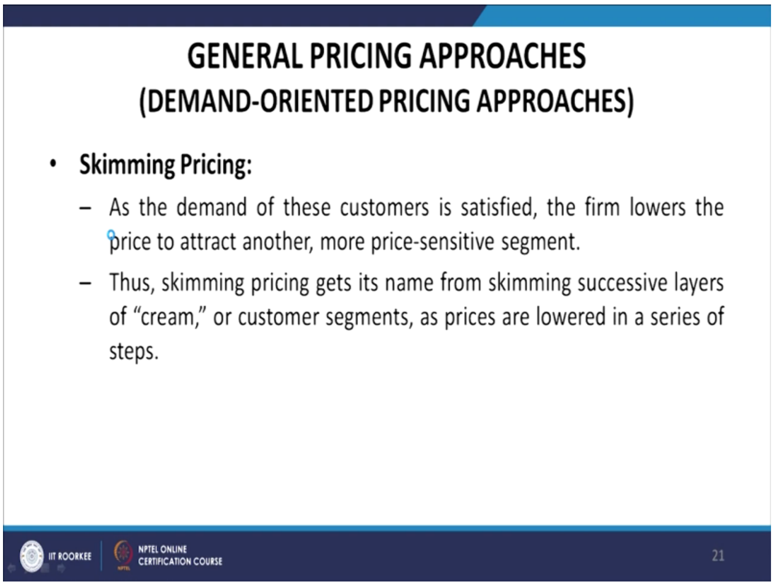

As the demand of these customers is satisfied, the firm lowers the price to attract another, more price-sensitive segments. Thus, skimming pricing gets its name from a skimming successive layer of "cream," or customer segments, as prices are lowered in a series of steps.

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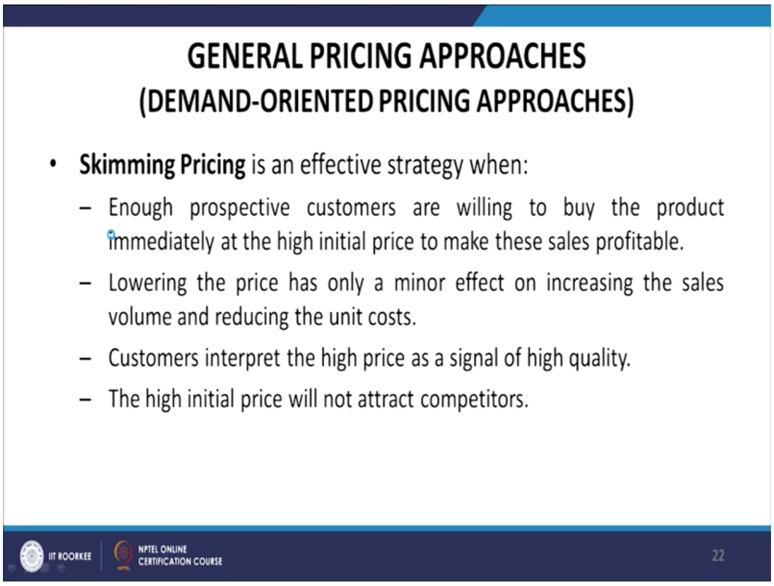

Skimming pricing is an effective strategy when enough prospective customers are willing to buy the product immediately at the high initial price to make these sales profitable. Lowering the price has only a minor effect on increasing the sales volume and reducing the unit cost. Customers interpret the high price as a signal of high quality. And the high initial price will not attract competitors.

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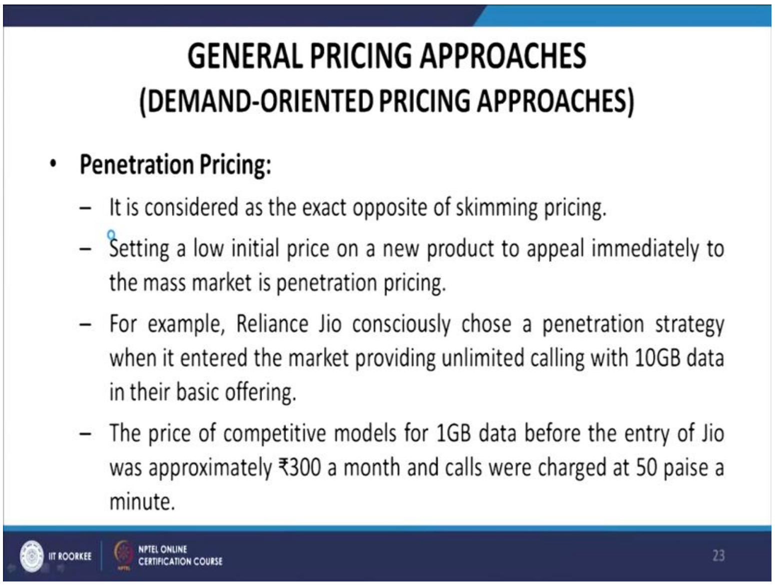

The next demand oriented pricing approach is penetration pricing. It is considered as the exact opposite of skimming pricing. Setting a low initial price on a new product to appeal immediately to the mass market is penetration pricing. For example, Reliance Jio consciously chose a penetration strategy when it entered the market providing unlimited calling with 10 GB data in their basic offerings. The price of competitive models for 1 GB data before the entry of Jio was approximately rupees 300 a month and calls were charged at 50 paisa a minute.

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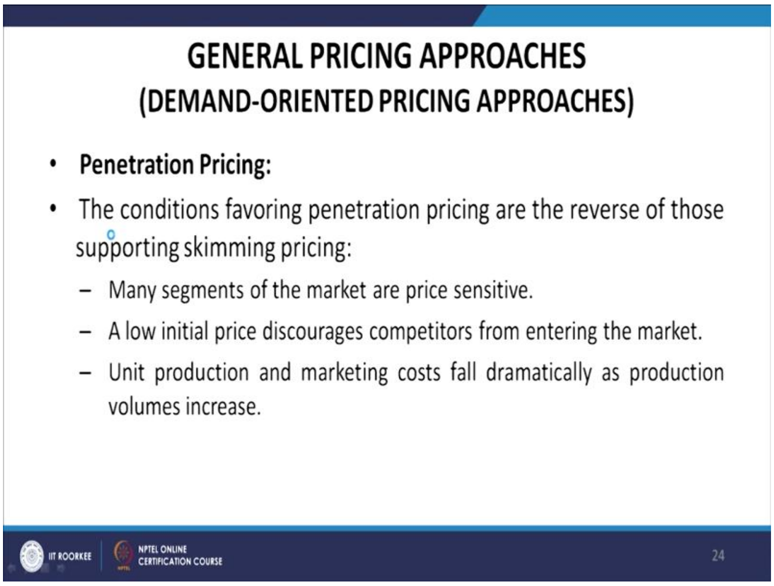

So, the conditions favoring penetration pricing are the reverse of those supporting skimming prices. Many segments of the markets are price sensitive. A lower initial price discourages competition from entering the market. And a unit production and marketing cost fall dramatically as production volume increases.

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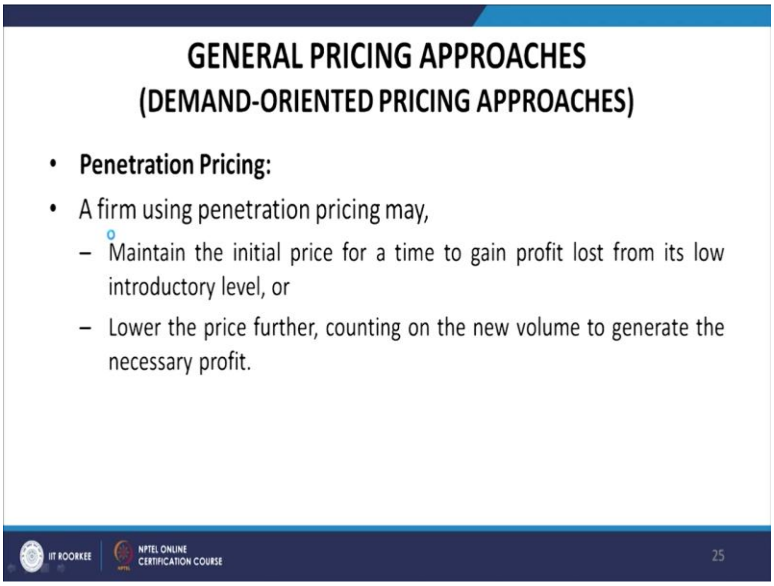

So, a firm using penetration pricing may maintain the initial price for a time to gain profits lost from its lower introductory level, or lower the price further, counting on new volumes to generate the necessary profits.

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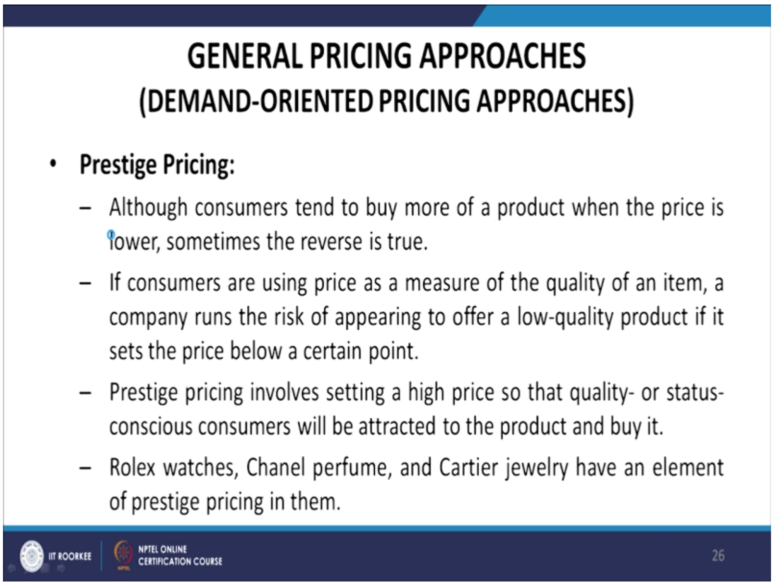

Another type of demand-oriented pricing approach is the prestige pricing. Although consumers tend to buy more of a product when the price is lower, sometimes the reverse is also true. If consumers are using price as a measure of the quality of an item, a company runs the risk of appearing to offer a low quality product if it sets the price below a certain point.

Prestige pricing involves setting a high price so that quality or status conscious customers will be attracted to the product and buy that product. Rolex watches, Chanel perfume, and Cartier jewelry have an element of prestige pricing in them.

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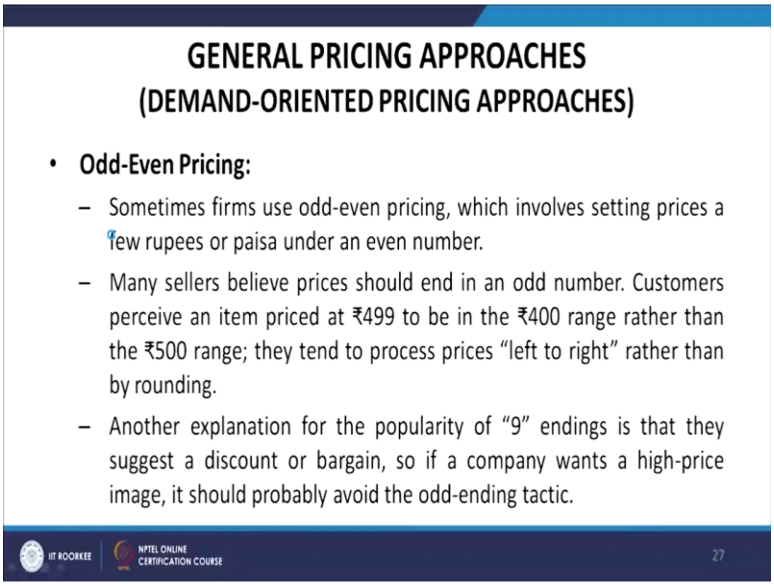

Now, let us look at what is this odd-even pricing. Sometimes firms use odd-even pricing, which involves setting prices a few rupee or paisa under an even number. Many sellers believe prices should end in an odd number. Customers perceive an item priced at rupees 499 to be in the rupees 400 range rather than the 500 range; they tend to process prices "left to right" rather than by rounding.

Another explanation for the popularity of "9" ending is that they suggest a discount or bargain, so if a company wants a high-price image, it should probably avoid the odd ending tactics.

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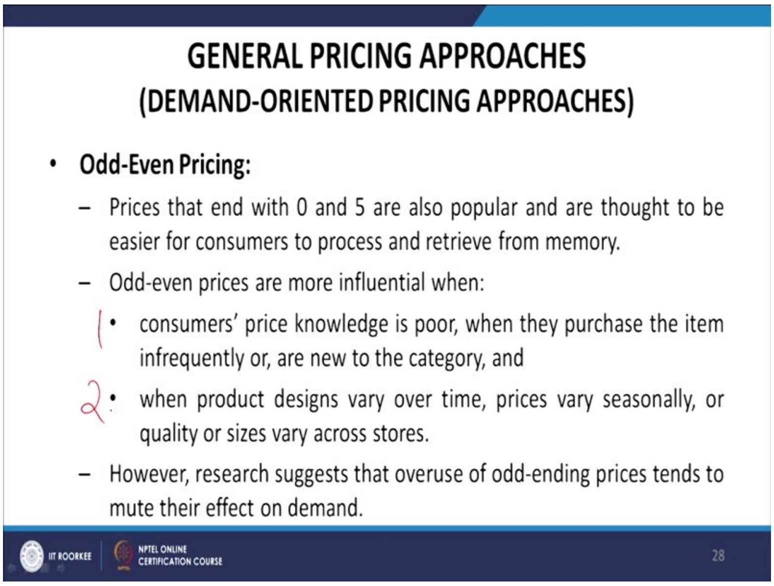

So, prices that end with 0 and 5 are also popular and are thought to be easier for consumers to process and retrieve from memory. Odd-even prices are more influential when, first consumer's price knowledge is poor, when they purchase the item infrequently or, are new to the category, and two, when product designs vary over time, prices vary seasonally, or quality or sizes vary across stores. However, research suggests that overuse of odd-ending prices tend to mute their effect on demand.

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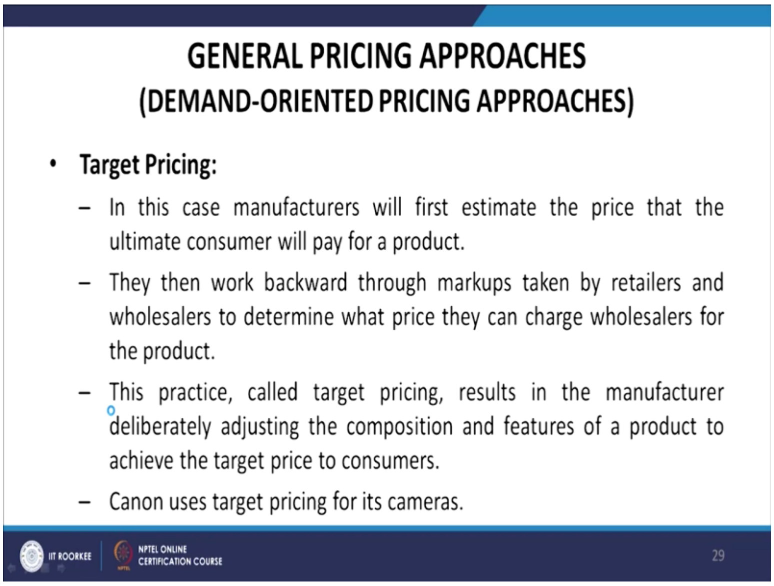

Yet another type of pricing is target pricing. In this case manufacturers will first estimate the price that the ultimate consumer will pay for a product. They then work backwards through markups taken by retailers and wholesalers to determine what price they can charge wholesalers for the product. This practice, called target pricing, results in the manufacturer deliberately adjusting the composition and feature of a product to achieve the target price to consumer. Canon uses target pricing for its cameras.

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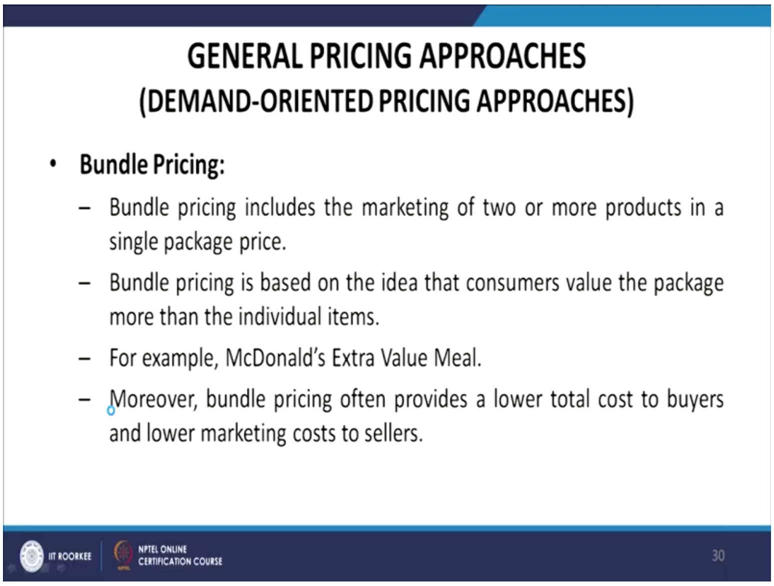

Yet another type of demand-oriented pricing approach is the bundle pricing. Bundle pricing includes the marketing of two or more product in a single package price. Bundle pricing is based on the idea that consumers value the package more than the individual item. For example, McDonald's extra value meal. Moreover, bundle pricing often provides a lower total cost to buyers and lower marketing cost to sellers.

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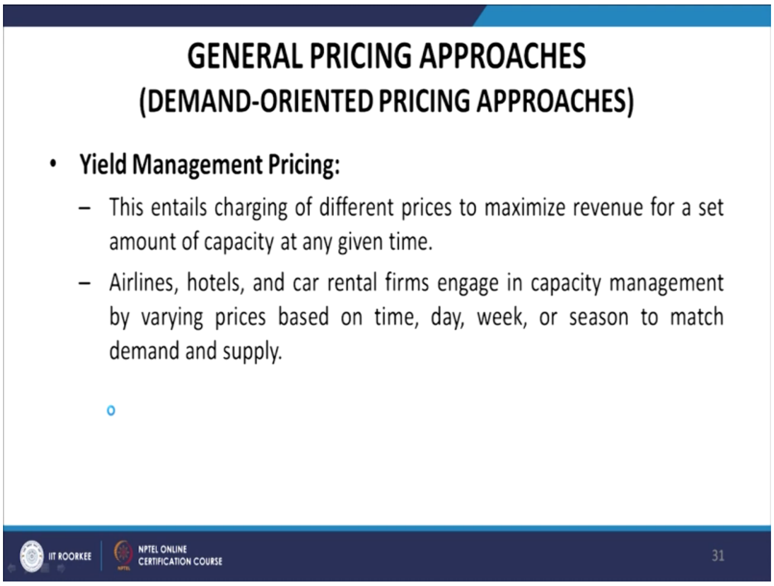

Now, let us talk of yield management pricing. This entails charging of different prices to maximize revenues for a set amount of capacity at any given time. Airlines, hotels, and car rental firms engage in capacity management by varying prices based on the time, day, week, or season to match the demand with supply.

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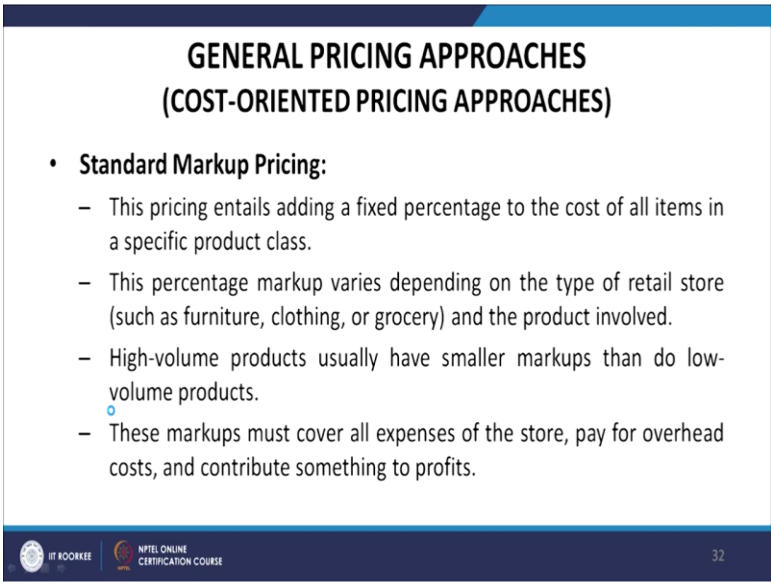

Now, we are talking about cost-oriented pricing approaches. The first of that is the standard markup pricing. Now, this pricing entails adding a fixed percentage to the cost of all items in a specific product class. This percentage markup varies depending on the type of retail store such as a furniture store, or a clothing store, or a grocery store, and the product involved.

High volume product usually have smaller markups then do low volume products. These markups must cover all expenses of the store, pay for overhead cost, and contribute something to profits.

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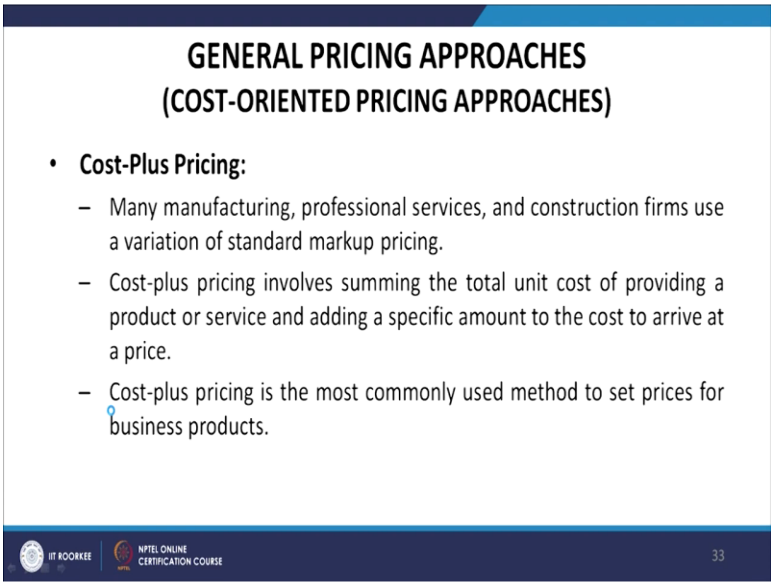

Now, let us look at the cost plus pricing. Many manufacturing, professional services, and construction firms use a variation of a standard markup pricing. Cost-plus pricing involves summing the total unit cost of providing a product or services and adding a specific amount to the cost to arrive at a price. Cost-plus pricing is the most commonly used method to set prices for business product.

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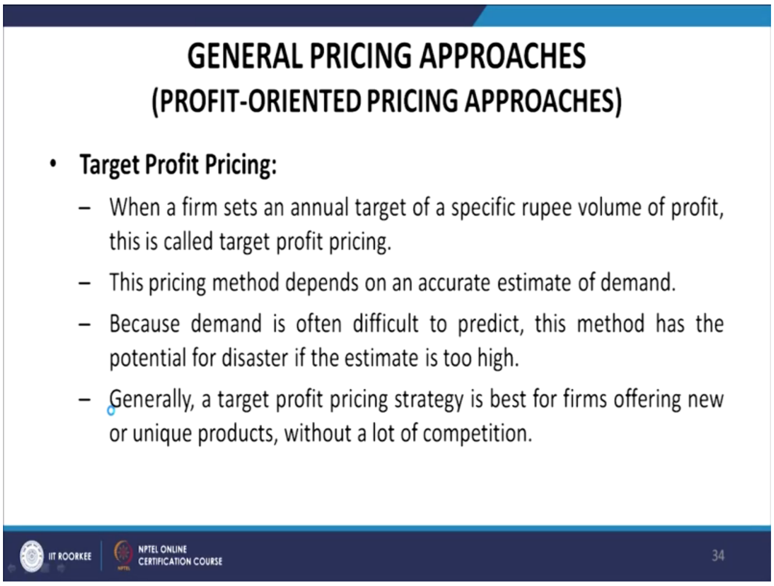

Then comes target profit pricing. When a firm sets an annual target of a specific rupee volume of profit, this is called as target profit pricing. This pricing method depends on accurate estimate of demand. Because demand is often difficult to predict, this method has the potential for disaster if the estimate is too high. Generally, a target profit pricing strategies best for firms offering new or unique products, without a lot of competition.

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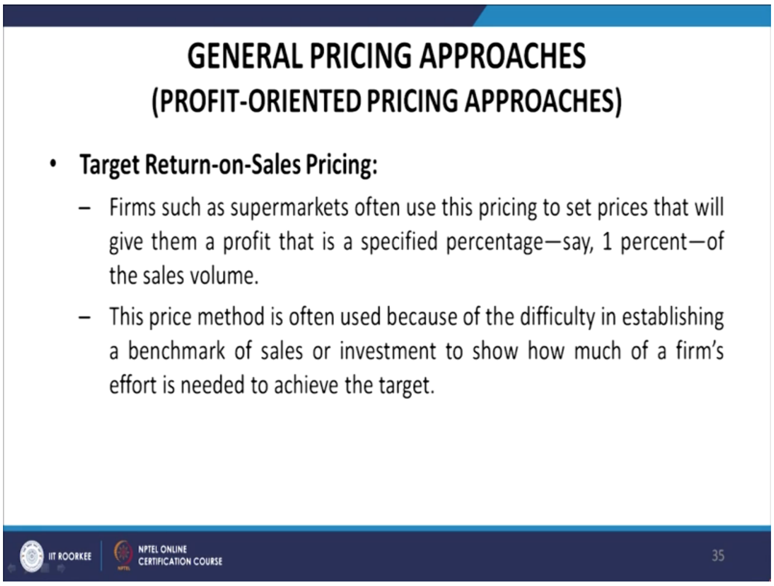

Then, comes target return on sales pricing. Firms such as supermarkets often use this pricing to set prices that will give them a profit that is a specified percentage say, 1 percent of the sales volume. This price method is often used because of the difficulty in establishing a benchmark of sales or investment to show how much of a firm's effort is needed to achieve the target.

Another profit-oriented of pricing approach is target return on investment pricing.

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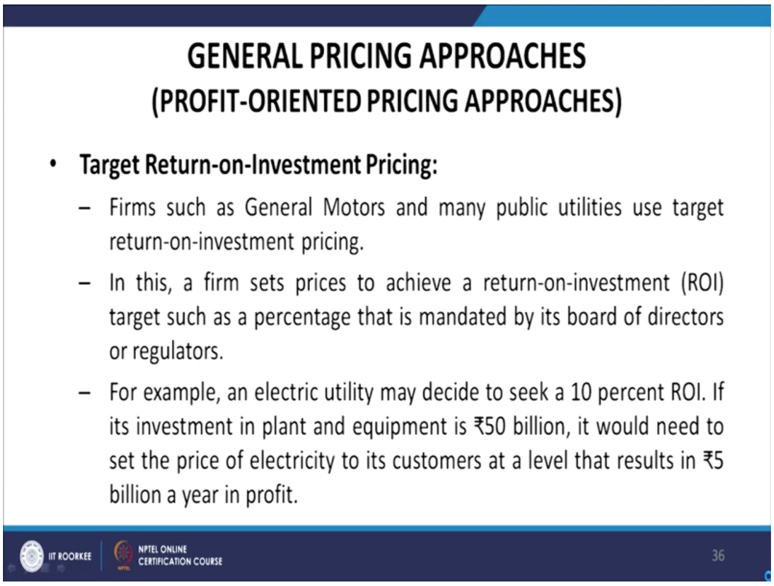

Firm such as General Motors and many public utilities use target return-on-investment pricing. In this, a firm set prices to achieve a certain return-on-investment targets such as percentage that is mandated by its board of directors or regulators. For example, an electric utility may decide to seek a 10 percent return-on-investments. If its investments in plant and equipment is rupees 50 billion, it would need to set the prices of electricity to its customer at a level that results in rupees 5 billion a year in profit.

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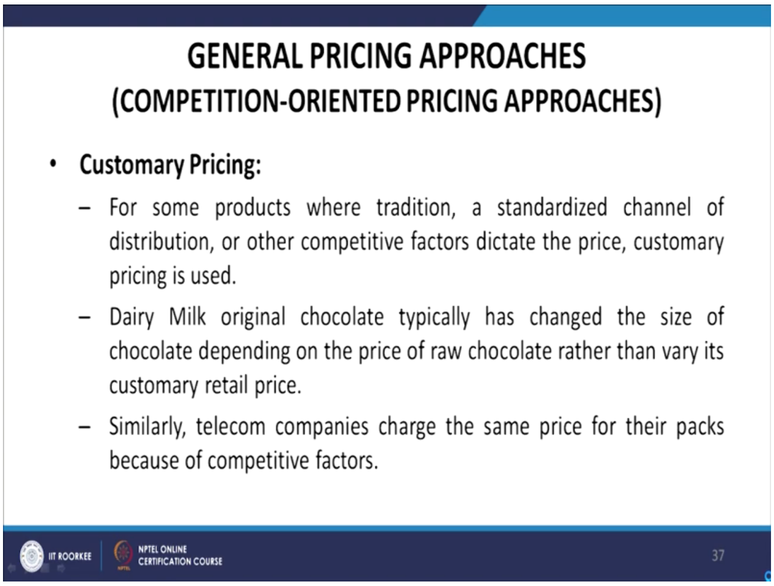

Now, we are talking of competition-oriented pricing approach, and the first of that approach is customary pricing. For some products where tradition, a standardized channel of distribution, or other competitive factors dictate the price, customary pricing is used.

Dairy Milk original chocolate typically has changed the size of chocolate depending on the price of raw chocolate rather than vary its customary retail price. Similarly, telecom companies charge the same price for their packs because of competitive factors.

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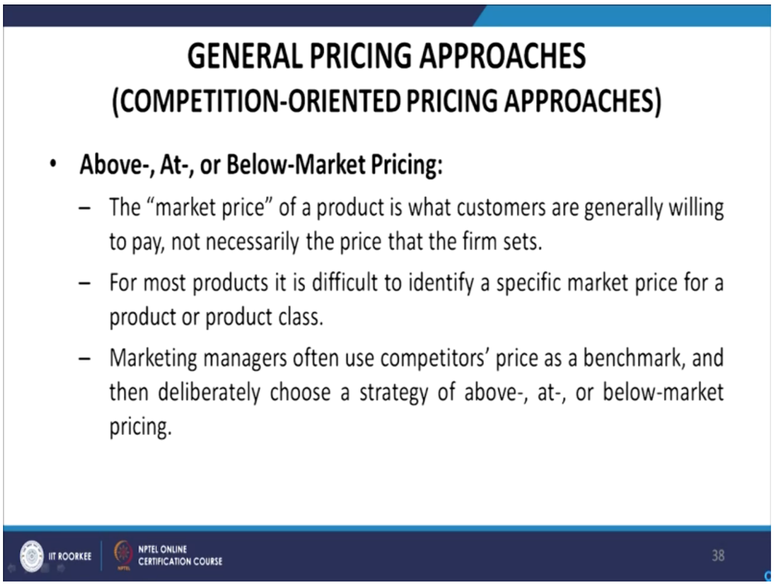

Another type of competition-oriented pricing is above, at or below market pricing. The "market price" of a product is what customers are generally willing to pay not necessarily the price that the firm sets. For most products it is difficult to identify a specific market price for a product or product class. Marketing managers often use competitor's price as a benchmark, and then deliberately choose a strategy of above, at, or below market pricing.

Another type of competition-oriented pricing approach is called as loss-leader pricing.

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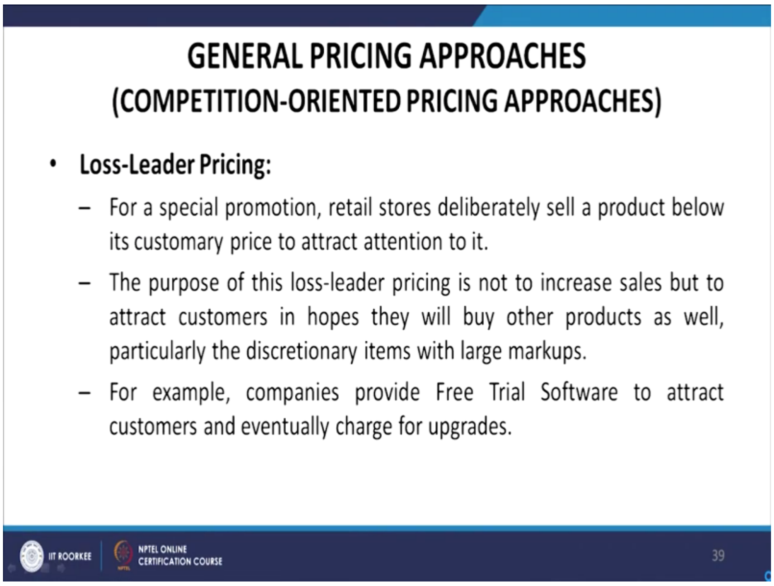

For a special promotion, retail stores deliberately sell a product below its customary price to attract attention to it. The purpose of this loss-leader pricing is not to increase sales but to attract customers in a hope that they will buy other products also, particularly the discretionary item with large markups. For example, company provide free trial software to attract customers and eventually charge for upgrades.

Now, let us look at how to go about estimating demand and revenue, and we are looking at this demand curve.

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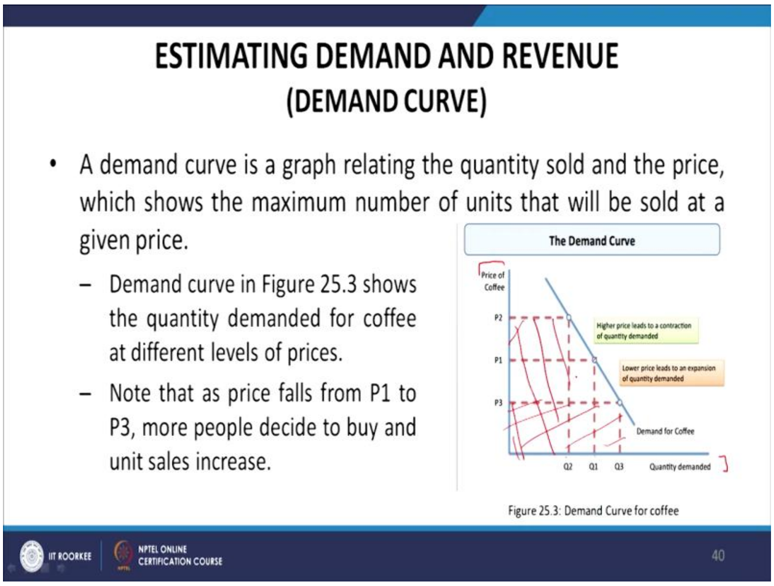

So, look at this to figure 25.3. A demand curve is a graph relating the quantity sold and the price which shows the maximum number of units that will be sold at a given price. So, the demand curve in figure 25.3 shows the quantity demanded for coffee at different levels of price. So, on this axis we have the quantity demanded and here we have the prices of coffee. So, the prices of coffee vary from P 1, and P 2, and P 3, while quantities Q 1, Q 2, and Q 3.

Now, you see that this Q 1 quantity has P 1 price, Q 2 quantity has P 2 price and Q 3 quantity has P 3 price. Now, this is the demand curve for coffee. So, the higher price lead to a contraction of quantity demanded. So, you see there are when prices are higher the quantity is less, when prices are lower the quantity is more. So, in this area, the quantity demanded is the most, while in this area the quantity demanded is the least but the price is the highest. So, note that as price falls from P 1 to P 3 more people decide to buy and unit sales increases.

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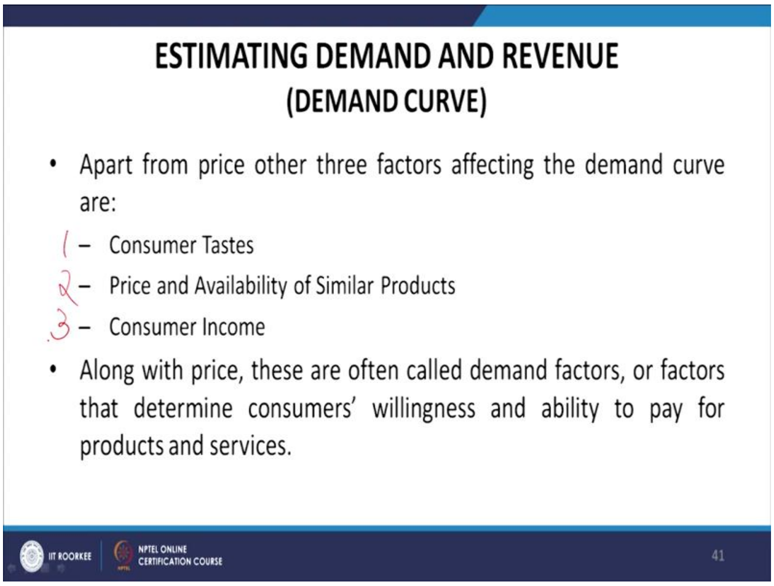

Apart from price other three factors affecting the demand curve are, first is, the customer taste. So, if the customer do not want to drink coffee then the price is not important for them. The second is price and availability of similar products. And the third is consumer income. So, these are three additional factors.

So, along with prices, these are often called as demand factors, or factors that determine consumer's willingness and ability to pay for products and services.

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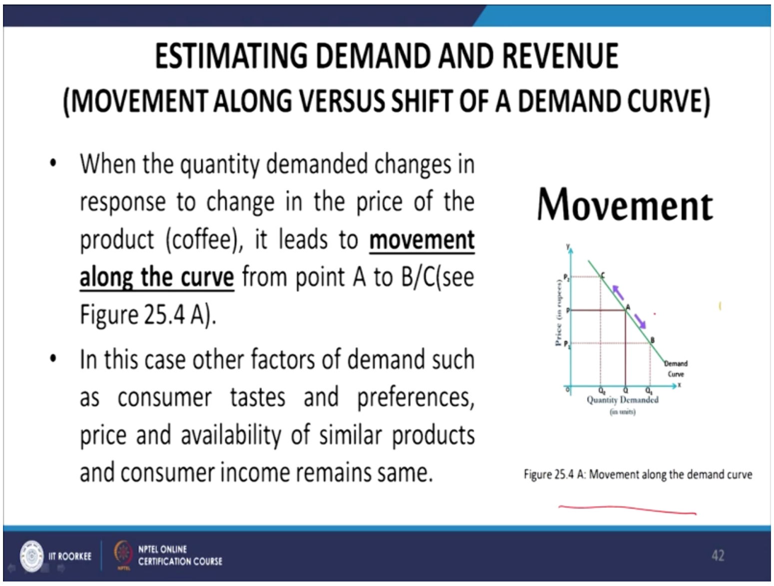

Now, let us look at the movement along versus shift of a demand curve. So, when the quantity demanded changes in response to the change in the price of the product that is coffee it leads to a movement along the curve from the point A to point B.

So, look at this. So, this is the same figure that we have looked at earlier. So, this is the demand curve Q 1. So, at the lowest price that is P 1, the quantity demanded is the highest and so on so forth. But now you see that there is movement along this curve from A to C or A to B.

In this case other factors of demand such as consumer taste and preferences, price and availability of similar products and consumer incomes remain same.

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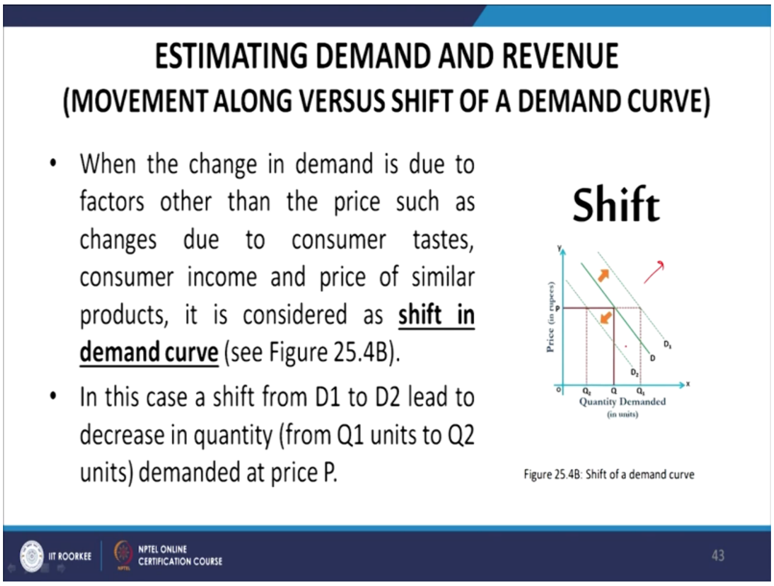

Now, you see that the demand curve is shifting. So, that is movement along versus shift of a demand curve. When the change in demand is due to factors other than the price such as changes due to the consumer taste, consumer income and price of similar products, it is considered as shift in the demand curve.

Now, you see that with the same price. Now, the quantity demanded for this price is Q 1 and the demand curve has shifted or it may have shifted here, so the quantity demanded would have been Q.

In this case a shift from D 1 to D 2 leads to decrease in quantity from Q 1 units to Q 2 units demanded at price P. So, for the same price the demand is changed.

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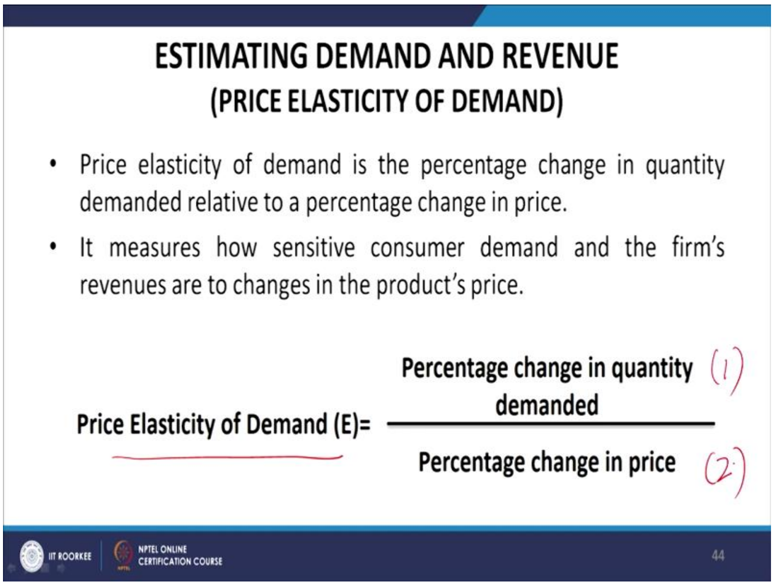

Now, let us look at what is this price elasticity of demand. Price elasticity of demand is the percentage change in quantity demanded relative to a percentage change in price. It measures how sensitive consumer demand and the firm's revenues are to change in the product prices. And this is the equation for that. So,

Price elasticity of demand (E) = Percentage change in quantity demanded/ Percentage change in price

So, product with elastic demand is one in which a slight decrease in price results in a relatively large increase in demand, or units sold.

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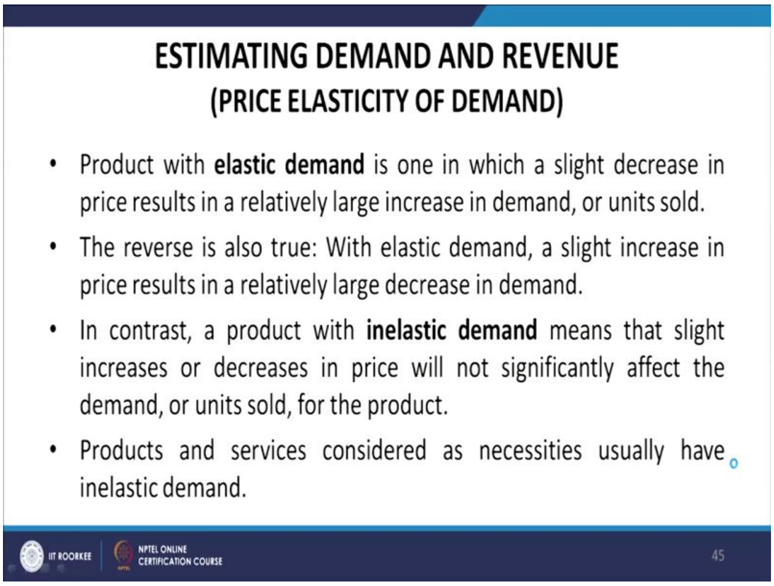

The reverse is also true: With elastic demand, a slight increase in price results in a relatively large decrease in demand. In contrast, a product with inelastic demand means that slight increase or decrease in price will not significantly affect the demand, or unit sold, for the product. Products and services considered as necessities usually have inelastic demand.

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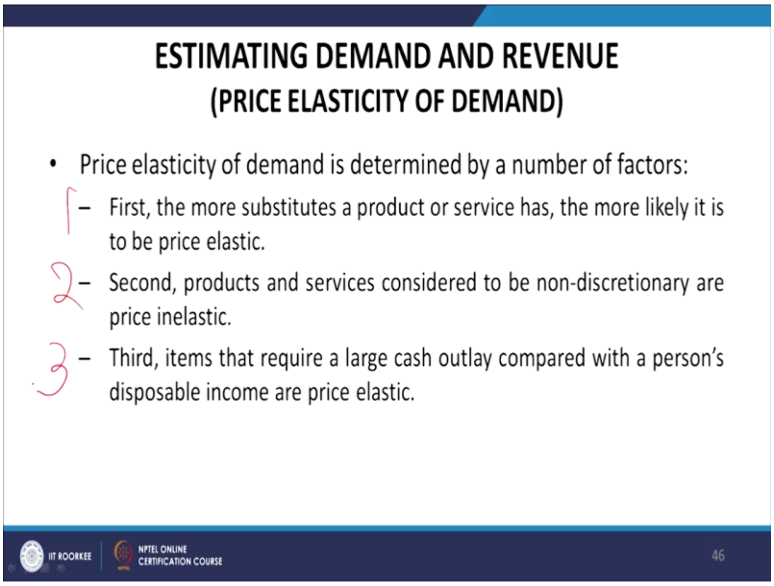

So, price elasticity of demand is determined by a number of factors. The first is the more substitute a product or services have, the more likely it is to be price elastic. So, as soon as the prices for this product goes up the customer shift to the substitute products. The second is products and services considered to be non-discretionary are price inelastic.

So, these are the products and services which consumer will buy irrespective of the price. And the third factor is, items that require large cash outlay compared to a person's disposable income are price elastic. Now, let us look at the fundamentals of estimating revenues.

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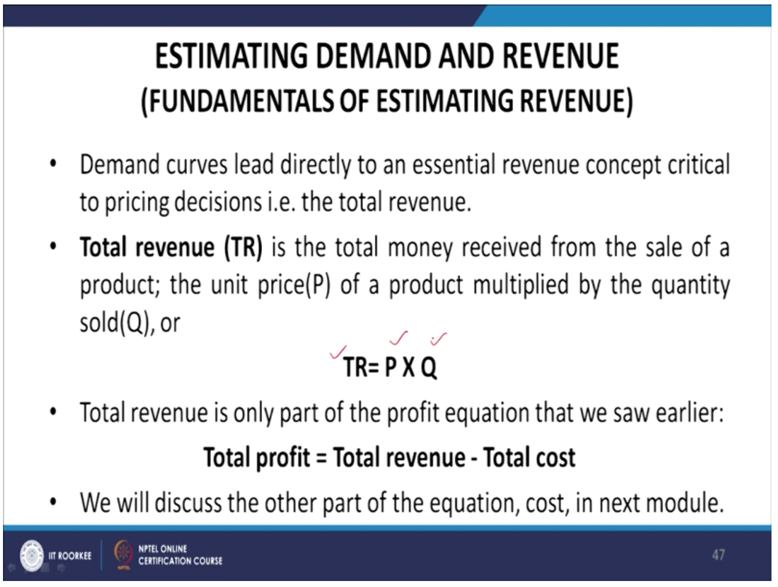

Demand curves lead directly to an essential revenue concept critical to pricing decisions that is the total revenue. Total revenue is the total money received from the sale of a product the unit price P of a product multiplied by quantity Q, or

$$TR = P \times Q$$

So, total revenue is only a part of the profit equation that we saw earlier. So, that was total profit is equal to total revenues minus total cost, and in this you see total revenues are in P into Q. We will discuss the other part of equation, that is cost, etcetera, in the next module.

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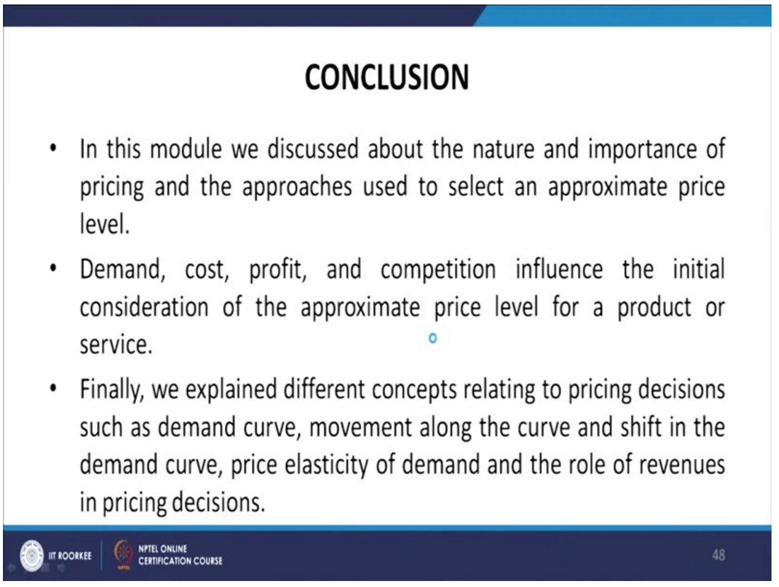

So, to conclude in this module we have discussed about the nature and importance of pricing and the approaches used to select an approximate price level. The second thing that we have talked about in this module is the demand, cost, profit, and competition influence the initial consideration of the approximate price level for a product or service.

Finally, we have then explained different concepts relating to pricing decisions such as demand curve, movement along the curve, and the shift in the demand curve, price elasticity of demand and the role of revenues in pricing decisions.

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And these are the 3 books we used for this module.

Thank you.