CHAPTER 1

Introduction: Pricing as an Element of the Marketing Mix

Anytime anything is sold, there must be a **price** involved. The focus of this book is to present concepts, principles, and techniques that provide guidance to help a seller set the best price.

Our study of how to set the best prices will take the marketing approach. In this chapter, we will describe the business context for pricing and provide an overview of how the basic principles of marketing can guide effective **price setting**.

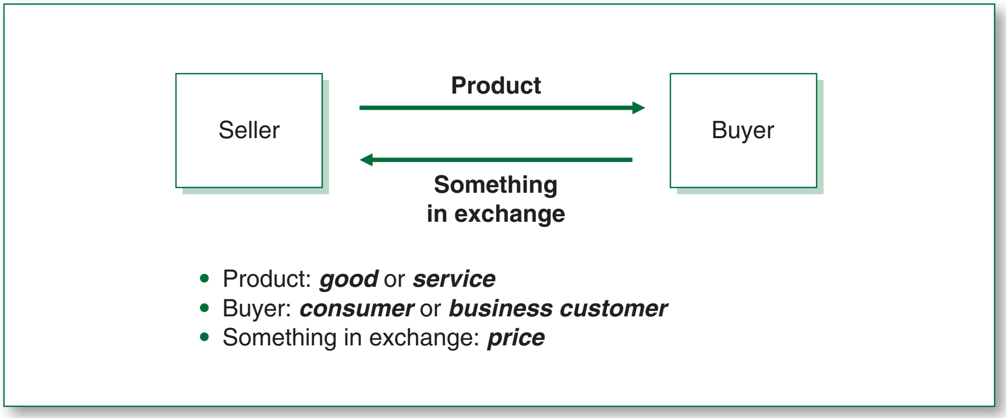
THE COMMERCIAL EXCHANGE

Although people often think of marketing as synonymous with advertising or salesmanship, it is actually much broader. Marketing consists of the full range of activities involved in facilitating commercial exchanges and having all of these activities be guided by a concern for customer needs.

The central idea here is that of the **commercial exchange** (see Figure 1.1). This is where a seller provides a **product** to a buyer in return for something in exchange (usually an amount of money). The product could be something tangible, which is referred to as a **good**, or the product could be the result of human or mechanical effort, which is referred to as a **service**. The buyer could be a **consumer**—an individual who purchases a product for his or her own use—or the buyer could be a **business customer**—an individual or group who purchases the product in order to resell it or for other business purposes.

One aspect that makes the commercial exchange a very important idea is that it describes an interaction that is voluntary. Both the buyer and seller participate in the exchange voluntarily because the exchange will lead them *both* to be better off. For example, consider the vending machine in the office lounge. You put in your dollar and get a large package of M&M's. You do that voluntarily because you would rather have the bag of candy than that dollar. On the other hand, the Mars company, which produces M&M's, also

Figure 1.1 The Commercial Exchange



- Product: ***good*** or ***service***
- Buyer: ***consumer*** or ***business customer***
- Something in exchange: ***price***

Source: Adapted from W. M. Pride and O. C. Ferrell, *Marketing: Concepts and Strategies* (Boston: Houghton Mifflin Co).

engages in this transaction voluntarily. As we know, the company would rather have your dollar than that extra package of candy.

Although we tend to take commercial exchanges for granted, we shouldn't forget that there is something very important and wonderful involved here. Because both parties to the exchange are better off after the exchange than before, one could say that the exchange makes the world a just a little bit better place. There is a little more happiness after the exchange than before it. Although there may be only a tiny bit of increased happiness from any one commercial exchange, these little pleasures can quickly mount up. In a society where the distribution of most goods and services is governed by a **free-market economy**, every person engages in numerous commercial exchanges every day. Each little increase in pleasure that a commercial exchange brings is then multiplied many times, and the societal benefits can become considerable.

In all of this, it must be recognized that there are degrees of voluntariness, and that choices may be so limited for some buyers that they may not *feel* much better off after an exchange. Also, it is possible that a product purchased voluntarily could fail to perform as expected or that a third party (other than the buyer and seller) may be harmed by an exchange. These illustrate the need for some governmental regulation—a free-market economy cannot be entirely free. Nevertheless, in modern free-market societies, people experience the pleasures of choice and are energized by entrepreneurial possibilities. The commercial exchange is at the heart of the free-market economic system, which, as we have seen in recent years, has become more and more widely adopted among the various nations of the world.

WHAT IS A PRICE?

From this understanding of the commercial exchange, we are now able to give a formal definition of a price: that which is given in return for a product in a commercial exchange.

This essential role of price in commerce is sometimes disguised by the use of traditional terms. If the product in the commercial exchange is a good, then the product's price will most likely be called "price." However, if the product is a service, then the product's price may well go by one of a variety of other possible names (see Figure 1.2).

Figure 1.2 Some Terms Used to Mean "Price"

Alternative Terms	What Is Purchased
Price	*most goods*
Tuition	*college courses, education*
Rent	*use of a place to live or use of equipment for a period of time*
Interest	*use of money*
Fee	*professional services: for lawyers, doctors, consultants*
Premium	*insurance*
Fare	*transportation: air, taxi, bus*
Toll	*use of a road or bridge, or long-distance phone rate*
Salary	*work of managers*
Wages	*work of hourly workers*
Commission	*sales effort*

Source: Adapted from Thomas C. Kinnear and Kenneth L. Bernhardt, *Principles of Marketing,* 2nd ed. (Glenview, IL: Scott, Foresman and Company, 1986), 546.

"Price" Versus "Cost"

Although a price may go by many names, one name it should not go by is **cost**. This is because, in this book, we will usually be taking the viewpoint of the seller.

If we were taking the viewpoint of the buyer, this would not be an issue. Buyers, particularly consumers, will typically use the terms *price* and *cost* synonymously. For example, a woman could tell her friend, "The price of this sweater was only $30." Or she could just as easily say, "This sweater cost me only $30."

However, from the viewpoint of the seller, the difference between prices and costs is quite important. A price is what a business charges, and a cost is what a business pays. Thus, a grocery manager may set a price of $3.79 for a 17-ounce box of Honey Nut Cheerios, may price large navel oranges at 3 for $1.99, or may sell ground chuck at the price of $3.49 per pound. But the manager must also attend to his costs. These costs include, for example, what he pays the wholesaler per case of Cheerios, what he pays employees to stock it on the shelves, what he pays for the building, for heat and lights, for advertising, and so on.

PRICING AS A MARKETING ACTIVITY

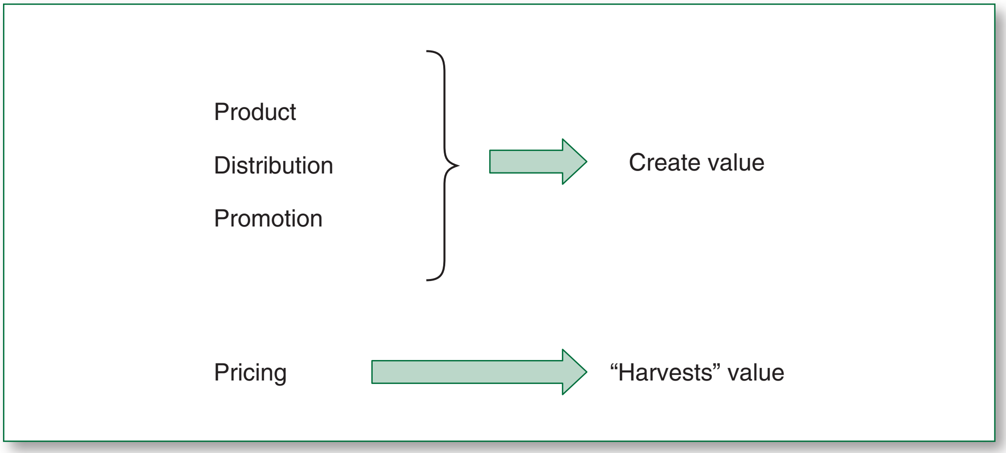
Marketing activities are those actions an organization can take for the purpose of facilitating commercial exchanges. There are four categories of marketing activities that are particularly important, which are traditionally known as the four elements of the **marketing mix**:

- *Product*—designing, naming, and packaging goods and/or services that satisfy customer needs
- *Distribution*—efforts to make the product available at the times and places that customers want
- *Promotion*—communicating about the product and/or the organization that produces it
- *Pricing*—determining what must be provided by a customer in return for the product

If you use the term *place* for the activities of distribution, the four elements of the marketing mix can be referred to as "the four Ps," a mnemonic that has proved useful to generations of marketing students.

Note that there is an important way in which pricing differs from the other three elements of the marketing mix. This is illustrated in Figure 1.3. Product, distribution, and promotion are all part of the process of providing something satisfying to the customer. Product activities concern the design and packaging of the good or service itself, distribution involves getting the product to the customer, and promotion involves communicating the product's existence and benefits to customers and potential customers. All three of these types of marketing activities contribute to the product being of value to customers. In this book, the term **value** will refer to the benefits, or the satisfactions of needs and wants, that a product provides to customers.

Figure 1.3 Pricing Harvests the Value Created by the Other Three Marketing Mix Elements



Source: Based on Nagle (1987).

Pricing, on the other hand, is not primarily concerned with creating value. Rather, it could be said to be the marketing activity involved with capturing, or "harvesting," the value created by the other types of marketing activities.[1] In the words of Philip Kotler, "Price is the marketing-mix element that produces revenue; the others produce costs."[2] Because it is a marketing activity fundamentally different than the others, it is important that the implications of pricing's uniqueness be fully understood. This is one of the reasons that a course in pricing is an important part of a business education.

The Marketing Concept

The marketing approach to business involves not only engaging in a variety of marketing activities but also having these marketing activities be guided by the marketing concept. The **marketing concept** can be expressed as follows: The key to business success is to focus on satisfying customer needs.

What this means is that an organization that works toward satisfying customer needs in every feasible way when carrying out marketing activities is likely to see more long-run success than a company that does not have such a customer focus. Sellers who rely only on their own opinions and ignore those of their customers or sellers who view their customers as "marks" to be tricked or manipulated may do well at a particular time but are unlikely to be able to sustain whatever short-term success they may have. The marketing concept is a modern form of the philosophical viewpoint known as "enlightened self-interest": One's self-interest is best served by focusing one's attention on the needs of others.

Pricing and the Marketing Concept

It is clear how product, distribution, and promotional activities can be guided by the marketing concept. Through marketing research (which, by the way, is a fifth important category of marketing activities), a personal computer manufacturer can learn, for example, the features and styling consumers want and then build machines to satisfy consumer preferences. A bank could determine the hours consumers would prefer walk-in service and could arrange to have those services available during those hours. A cell phone service provider may find out that many consumers are unaware of all of the convenient features of their service and may design a promotional program to communicate this information.

However, it is less clear how pricing activities can be guided by the marketing concept. Certainly, customers would prefer paying less. In fact, paying nothing at all might well be their first choice! But it is simply not feasible to "give away the store." An organization that gives away the value it creates will soon cease to exist, and thus the value it creates will disappear. This does not serve customers well. Rather, it is in the customer's interest for an organization that creates customer value to set prices that maximize the organization's profitability, since that would give the organization the greatest possible chance of continuing to create that value.

Lest this endorsement of profit maximization sound somewhat extreme, rest assured that in a free-market system, competition will tend to keep maximum profits modest. Nothing attracts competitors more quickly than a highly profitable product. Further, the marketing concept points the price setter to consider not only the customer value that can be harvested but also the customer's feelings about the price that is being charged. Examples of such price feelings that need to be considered include the following:

- The feeling of a price being substantially higher than the customer's expectations (sometimes referred to as "sticker shock")
- The feeling that a price is unfair or is higher than can be justified
- Customers perceiving they are receiving a discount, or a price lower than their expectations

It is important to note that both identifying the value that the product represents to the customer and considering customers' price expectations and feelings depend on understanding and attending to customer needs. Both of these aspects of the marketing approach to pricing will be discussed in detail in later chapters.

EARLY PRICING PRACTICES

As you might imagine, the practice of pricing has a very long history. Consider the following:

> The oldest records of prices ever found are clay tablets with pictographic symbols found in a town known as Uruk, in what was ancient Sumer and what is now southern Iraq. These price records are from 3300 BC—they've survived 5,300 years. The documents—records of payment for barley and wheat, for sheep, and for beer—are really receipts. "Uruk was a

> large city, at a minimum 40,000 people," says UCLA professor Robert Englund, one of the few experts on the Uruk documents. "So some of the quantities are very high—hundreds of thousands of pounds of barley, for instance."
>
> But here's the really remarkable thing. The earliest Uruk tablets aren't just the oldest pricing records ever found. They are the oldest examples of human *writing* yet discovered. In other words, when humans first took stylus to wet clay, the first things that they were compelled to record were . . . prices.[3]

In the earliest commercial exchanges, goods or services were exchanged for other goods or services. For example, the price that a farmer might pay for a bolt of cloth could be a bushel of corn. This practice, termed **barter**, still goes on today, especially in less developed countries. Barter occurred in recent years when Shell Oil purchased sugar from a Caribbean country by giving in return one million pest control devices.[4] Although barter is still used, it can make exchange difficult. For example, what if the seller of the bolt of cloth had no need for the farmer's bushel of corn? Because of such inefficiencies of barter, almost all modern commercial transactions use a **medium of exchange**—something that is widely accepted in exchange for goods and services in a market.[5]

A medium of exchange could be anything that the buyers and sellers in a society agree upon. In the past, items such as cattle, seashells, dried cod, and tobacco have been used as a medium of exchange. However, many of these presented certain difficulties. In his book *The Wealth of Nations,* Adam Smith gives an example of this:

> The man who wanted to buy salt, for example, and had nothing but cattle to give in exchange for it, must have been obliged to buy salt to the value of a whole ox, or a whole sheep, at a time. He could seldom buy less than this, because what he was to give for it could seldom be divided without loss. . . .[6]

Over time, it became clear that the best medium of exchange is one that is finely divisible, such as the metals of various weights used in coins. This use of coins and notes to represent them led to national systems of money, such as dollars, yen, or euros. It is prices expressed in such monetary terms that will be considered in this book.

THREE CATEGORIES OF PRICING ISSUES

As the use of prices in monetary terms proliferated among human societies, various questions that required pricing decisions began to arise. Most of these issues fall into one of the following three categories: (1) buyer–seller interactivity, (2) **price structure**, and (3) **price format**.

Buyer–Seller Interactivity in Determining Prices

Throughout most of history, prices were not the fixed amounts displayed in stores and advertising that are so familiar today. Rather, prices were negotiated during an interaction between the buyer and the seller. The basic elements of price negotiation can be illustrated by imagining how, for many centuries, the price determination process typically occurred:

> A customer arrives at the seller's stall in the local marketplace and examines the merchandise. When he finds something he wants, the customer asks the seller, "How much?" The seller then states an **asking price**, which is higher than his **reservation price**, the lowest price at which he would sell the item: "23 ducats." The customer then states his **initial offer**. This, of course, is lower than the *customer's* reservation price (the highest price that the customer would pay for the item): "I can't pay more than 14."
>
> The seller and the customer would then try to arrive at an amount they can both agree on by **haggling**, a process involving some number of prices and offers and statements supporting the validity of each. "This item is really of the very highest quality," the seller might argue, "but since I'm in a good mood today, I'll let you have it for 21." The customer might respond, "I've seen items at least as good as this in other shops, but since I'm here, I'll give you 16."

If there is overlap between the reservation price of the seller and that of the customer, then they could be successful in arriving at a negotiated price—that is, one that is agreeable to both. In that case, the object's price would have been the number that resulted from an interaction between the buyer and seller. A price arrived at by the buyer–seller interactions of negotiation or the interactions of auction bidding would be referred to as an **interactive price**.

If you find yourself a little uncomfortable with the deception involved in the process of price negotiation, you are not alone. Religious leaders were among the earliest critics of this type of business practice. In fact, it was George Fox, the founder of the Society of Friends (often called the Quakers), who first suggested that an alternative was possible. He led his followers to carry over to their businesses the principle of total honesty that they adhered to in their personal lives. As a result, Quaker merchants adopted the practice of stating to the customer the price that they actually expected to receive and sticking to it. Such a price is referred to as a **fixed price**.

It is interesting that, rather than hurting their competitive position, the use of fixed prices actually tended to help the Quakers in their businesses. Customers appreciated the quicker and less stressful buying process associated with fixed prices and often tended to feel more trusting of Quaker merchants. The use of fixed prices spread steadily and was strongly stimulated by the development, in the middle of the nineteenth century, of new types of retailing designed to serve mass markets. In particular, fixed prices helped make possible the large department store (pioneered by entrepreneurs such as F. W. Woolworth, John Wanamaker, and J. L. Hudson), which depended on a large number of quick transactions and staffing by low-paid, relatively unskilled clerks. In an 1859 advertisement for his growing New York department store, Rowland Macy claimed, "Best products, and same prices for all customers!" Also, the use of fixed prices enabled the growth of mail-order sales and the development of large catalog companies such as Sears Roebuck.[7]

During the twentieth century, the use of fixed prices became predominant in retail pricing throughout the developed world. Although we take fixed prices for granted when we shop, for example, in department stores, grocery stores, drugstores, hardware stores, or bookstores, the purchase of expensive items such as automobiles or real estate still usually involves price negotiation. Also, in contrast to most **retailers** (companies that sell directly to consumers), companies that sell to business customers are likely to make heavy use of price negotiation. The issues involved in buyer–seller interactivity in pricing will be discussed in more detail in a later chapter.

Price Structure

Although there are benefits to moving from negotiated prices to fixed prices, there are also disadvantages. One strength of interactive pricing is that it makes it easy for the seller to charge different prices to different buyers. For example, when prices are negotiated individually, a customer willing to pay a particularly high price could be charged, say, $200 for an item without interfering with the seller's ability to charge more typical customers a lower price, say, $125 for the same item. The practice of charging different customers different prices for the same item is known as **price segmentation**.

In order to accomplish price segmentation with fixed prices, it is necessary to have more than one price for a single product. For example, a product may have one price when purchased alone and another price when purchased in large quantity or when purchased along with other items. The product may have one price when purchased during the week and another when purchased on a weekend. It may have one price when purchased in the city and another when purchased in a rural area. These numerous prices for an item are part of the pattern of the seller's prices. In general, the pattern of an organization's prices is known as its price structure.

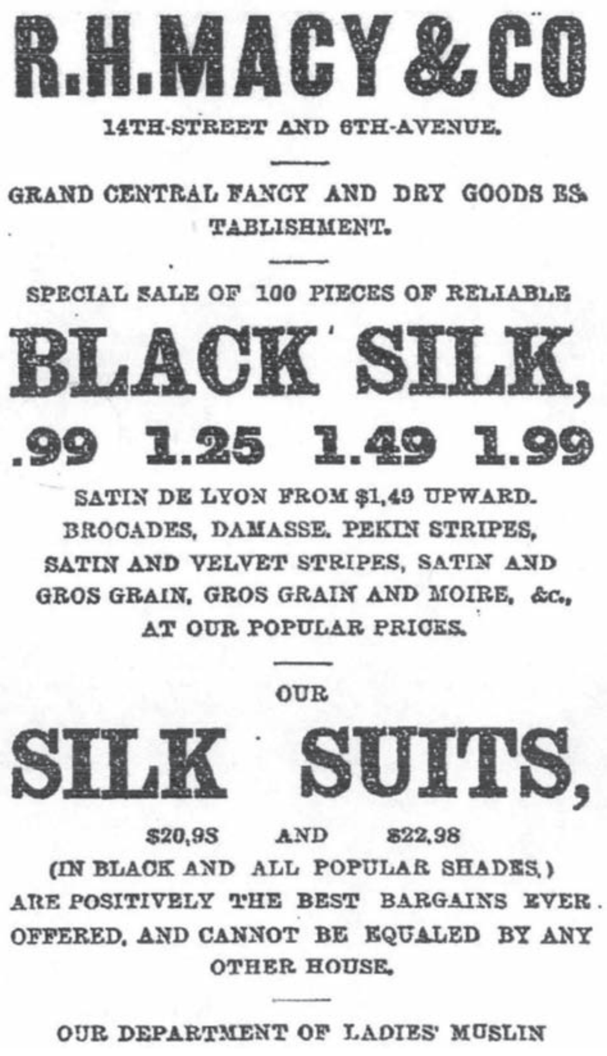
The price structure of a seller involves more than the array of prices that can be charged for the same item. Most organizations sell more than one product, and the pattern of prices across these different products is another component of the organization's price structure. Often the various products are interrelated such that the price charged for one item should take into account the prices charged for other items sold by the organization.

Price Format

The third category of pricing issues involves how a price is expressed when it is communicated to potential customers. For example, early fixed prices tended to be round numbers, such as $1.00, $5.00, or $2.50. However, by 1880 retail advertisements began to appear showing items priced at a penny or two below the round number (see Figure 1.4). The practice of pricing an item just below a round number does not substantially affect the level of a price, but it does affect how that price level is expressed. The form of expression of a price is known as the price format.

Expressing a price in a "just-below" format often has the effect of lowering the price's leftmost digit. This may make the price level appear lower than it actually is and have a positive effect on sales. It is sometimes suggested that early retailers used this technique as a means of reducing dishonesty among clerks. For example, a price such as $1.99 would oblige employees to use the cash register to make change and thus reduce their opportunity to

Figure 1.4 Macy's Ad From 1880, Showing 9-Ending Prices



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14TH-STREET AND 6TH-AVENUE.

GRAND CENTRAL FANCY AND DRY GOODS ES-
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SPECIAL SALE OF 100 PIECES OF RELIABLE

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BROCADES, DAMASSE. PEKIN STRIPES,
SATIN AND VELVET STRIPES, SATIN AND
GROS GRAIN, GROS GRAIN AND MOIRE, &c.,
AT OUR POPULAR PRICES.

OUR

SILK SUITS,

$20,98 AND $22,98
(IN BLACK AND ALL POPULAR SHADES.)
ARE POSITIVELY THE BEST BARGAINS EVER
OFFERED, AND CANNOT BE EQUALED BY ANY
OTHER HOUSE.

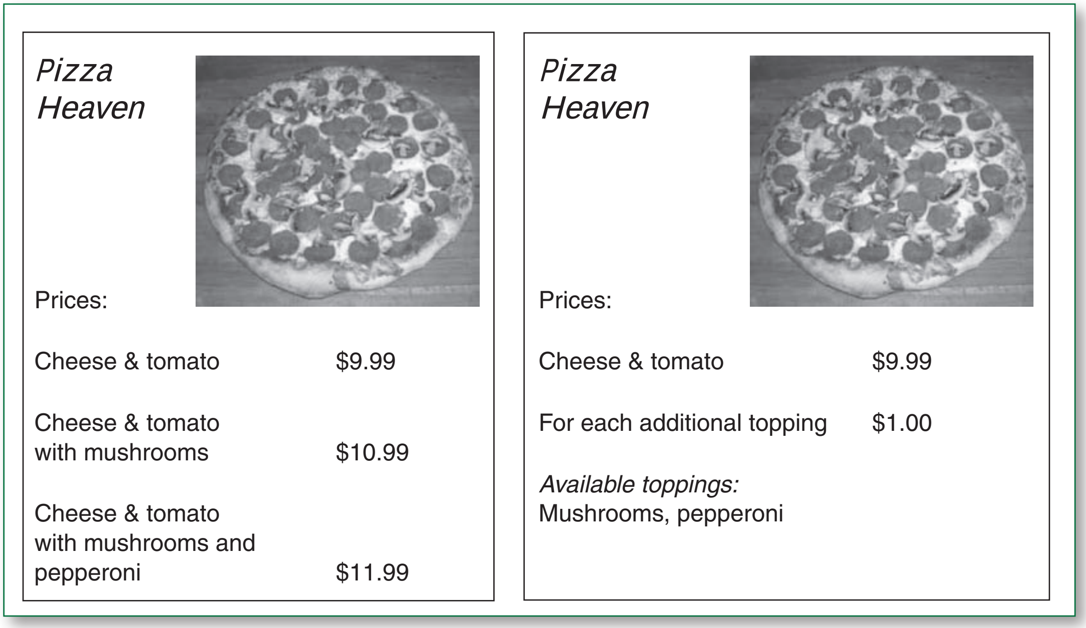
OUR DEPARTMENT OF LADIES' MUSLIN

Source: New York Times, 1880.

pocket the payment. However, research on early price advertising has indicated that just-below prices were more likely to be used when the advertised item was claimed to be a discount or an otherwise low price. This suggests that the use of the just-below price format was, from the start, motivated by managerial intuitions about its effects on the perceptions of the consumer.

Price format also involves the question of how many numbers are required to express an item's price. For example, a price advertisement could directly show the price of a mushroom and pepperoni pizza, or it could express that price as a base price plus an additional amount for the two toppings (see Figure 1.5). The price of a lamp in a home furnishings catalog might be expressed as a price for the lamp that includes shipping or as a price for the lamp alone along with a separate price for the shipping of the lamp to the purchaser. The question of whether a price should be expressed as a single number or as the sum of more than one number is the issue of **price partitioning**.

Figure 1.5 Alternative Price Formats for a Mushroom and Pepperoni Pizza



Pizza Heaven

Prices:

Cheese & tomato	$9.99
Cheese & tomato with mushrooms	$10.99
Cheese & tomato with mushrooms and pepperoni	$11.99

Pizza Heaven

Prices:

Cheese & tomato	$9.99
For each additional topping	$1.00

Available toppings:
Mushrooms, pepperoni

THE PRICING ACTIVITY

The marketing activity of capturing the value created by the other marketing activities is obviously of essential importance to a business organization. One could imagine an organization failing to carry out distribution or promotion activities and still be in business. But if there is no attention to pricing, a business organization cannot be viable.

The activity of making decisions about prices consists of two general components. One component is price setting, which consists of decisions about individual prices. These decisions concern the price of a specific item to a specific customer or market in the current marketing environment or situation at hand. The other component of the pricing activity is establishing **pricing policy**, which involves decisions that guide and regulate the setting of individual prices. This guidance could be general, such as a "fixed-price policy," which would require the organization to maintain fixed prices. It could also be more specific, such as indicating the situations when it would be permissible for the organization to offer volume discounts. Broadly, pricing policies are the organization's rules that govern particular price-setting decisions.

Participants in the Pricing Activity

In a small business organization, the owner/manager will be heavily involved in, and most responsible for, pricing activities. In a large business organization, it is likely that many people within the organization will play a role in pricing activities.

Some of the individuals in a large organization who play a role in pricing will have very direct pricing involvement and responsibility. Here are some examples of such direct roles:

- In a department store, it is usually the merchandise buyer who will do most of the price setting for the items he or she buys to be sold in the store.
- In many large consumer products organizations, a brand's product manager will have much of the responsibility for setting the prices of a brand.
- In companies that sell to business customers, salespeople and their managers play a crucial role in the negotiation processes by which prices are determined.
- In service industries, such as airlines and hotels, there will often be pricing departments with specialists trained in **revenue management**, a set of complex price-setting techniques that are frequently used in these industries.[8]

There are also likely to be many people in a large organization who participate in pricing activities but who do so in a way that is less direct. For example, employees in the accounting department often provide information about the costs of products and of the operations involved in getting products to the customer; accurate cost information is essential for effective price setting. Lawyers and others in the legal department could establish legal and ethical guidelines for pricing and could adjust proposed prices to comply with relevant laws and contracts. Analysts in the finance department may be involved in assessing the degree to which pricing schedules developed by product or sales managers are consistent with the profit goals of the organization. In many large business organizations, higher-level managers are involved in approving, and perhaps revising, proposed price schedules.

Organization of Pricing Activities

Particularly because of the likely involvement in pricing activities of many people within different parts of a large business organization, it is somewhat surprising that many companies do not have a means to effectively coordinate pricing-related decisions across departments in the company.[9] For pricing decisions to be made effectively in a large organization, it is important that these decisions either involve high-level management in the organization or use some other means to centrally coordinate and constrain the many pricing-related decisions that are likely to be made by many different people throughout the organization.[10] There are at least three reasons why such organization of pricing activities is important.

First, it is possible for a large company to experience problems in the effective implementation of pricing decisions. For example, the product manager of a manufacturing company that sells to distributors and retailers may set an item's **invoice price**—the price of the item that will appear on the customer's bill. However, a large or longtime customer may be able to convince his or her sales representative into offering a small off-invoice discount—say, an annual volume rebate. Further, the customer may contact the company's advertising department and arrange a small discount for, say, displaying the product in the customer's flyers. The accounts receivable department may be convinced to give this good customer more favorable payment terms, the transportation department might give this customer a break on shipping costs, and the account services department could allow this customer a more generous return policy. Employees in each part of the company might be assuming that it makes sense to give a break to such a good customer. However, together, all of these actions may substantially reduce the item's **pocket price**—the amount that's actually left in the company's pocket after the transaction. Without central pricing coordination, such revenue "leaks" could be as high as 20 percent of invoice prices.[11]

Second, a business organization should take steps to help insure that everyday pricing decisions fit with the organization's strategies and long-term interests. As will be seen in later chapters, pricing decisions made for immediate purposes can have consequences that are far-reaching. For example, price cutting done in response to competition can lead to price warfare and serious erosion of profits. Recent financial difficulties among companies in the U.S. airline industry may be, at least partly, a consequence of such price warfare. On the other hand, small price increases, it they continue to occur, could eventually have the effect of leading customers to find alternative types of products to serve their needs. Kellogg's, General Mills, and other breakfast cereal manufacturers made continual small price increases for many years until, eventually, sales in the entire cold cereal category began to decline as more consumers switched to bagels, muffins, and other breakfast alternatives. It is important that a person or a group with a broad view of the selling organization consider the possibility of such long-term effects of pricing decisions.

Third, for a business organization to follow the marketing concept and effectively focus on satisfying customer needs, marketing activities need to be well-coordinated with each other and with the other functions of the organization. Having pricing activities managed by a central authority can help accomplish this coordination. For example, if a price decrease is expected to lead to a sales increase, then it is useful to make sure that production, procurement, customer service, and other functions of the organization are prepared to handle this price decrease. Or if new cost economies are achieved by some aspect of the company's operations, rapid knowledge of this could contribute to more efficient pricing decisions. In addition, new possibilities, such as lowering costs by purchasing a component in an Asian country, could be more effectively evaluated with the combined input of marketing research and centrally coordinated pricing decision makers.

Relevance of Studying Pricing

It is hoped that the previous discussion helps make clear that pricing is a relevant topic to study even if you do not expect to be directly involved in the pricing activities of an organization. Pricing is so critical to a business organization that it affects, and is affected by, virtually every function of the organization. Thus, for example, if you are interested in advertising, keep in mind that the pricing of a product affects how it should be promoted—a product's pricing influences what is said about the product and to whom. Correspondingly, what is effectively communicated about the product can strongly affect the price that can be charged.

In addition, price setting is relevant to our personal lives. Even if we do not sell things at garage sales or on eBay, we are almost all marketers of our professional services. Our compensation—salary, bonuses, and benefits—constitutes the price we charge employers for our services. As managers of what is most likely, over the course of our careers, a multimillion-dollar product, it makes good sense for us to be familiar with the principles of effective pricing.

PLAN OF THE BOOK

We will begin our study of pricing with the situation where an organization is offering a product, or form of a product, that it has not sold before. What should its price be? Focusing on this relatively well-defined situation will enable us to introduce some basic pricing principles and procedures.

Of course, setting an initial price is not the most commonly occurring situation. More often than not, the manager is faced with an existing product that already has a price. The question then would be, is this existing price the *best* price? If it were higher, or lower, would more profits be likely to result? We will introduce a breakeven formula that can be of considerable help in decisions about modifying existing prices.

However, this breakeven formula alone does not make effective pricing decisions possible. What is needed also is some ability to predict (and perhaps even influence) how the customers in the market will respond to the product's price change. In order to gain this predictive ability, we will focus on understanding four types of factors that determine the market's price-change response: (1) economic, (2) competitive, (3) cognitive, and (4) emotional. The latter two types of factors will also shed light on issues of price format. Following discussion of these four types of price-response factors, we will discuss market-research procedures for directly measuring the market's price-change response.

At this point, we will have a basic ability to set a price: We will be able to set the price of a newly offered product, and we will be able to effectively modify the price of a product that is currently being offered. We then expand our focus to the design of an organization's price structure. We first discuss the use of price structure to accomplish price segmentation. We then discuss how a product's price may need to be adjusted because of interrelations with the other products that are being sold by the organization.

The last section of the book addresses several other pricing issues of importance. We will discuss some of the special challenges involved in managing interactive prices, such as prices arrived at through negotiation and auctions. Auction pricing has taken on a renewed importance with the rise of the Internet. We will become familiar with some of the basic ideas involved in considering the social and societal consequences of pricing decisions. Better understanding of these issues can not only help price setters avoid legal pitfalls but can also help us all better exercise our civic responsibilities to help make pricing policies maximally beneficial to society. Finally, we will return to the importance of a business organization having an integrated, centrally managed pricing policy and will discuss how the many pricing considerations covered in the book can be put together in constructing an overall pricing strategy.

SUMMARY

A price is what is given in a commercial exchange in return for a good or service. A price can have many names, such as “fee” or “rent” but should be not be confused with a company’s “costs.” Pricing is one of the four activities of the marketing mix; it is the marketing activity involved in capturing the value created by the other three marketing activities. Early commercial transactions involved barter, but the advantages of using a medium of exchange soon became evident and modern prices are typically expressed in terms of money.

Issues that arise in the setting of prices can be divided into three categories: (1) the question of interactive versus fixed prices, (2) the pattern of an organization’s prices, and (3) how a price can be expressed when communicated to potential buyers.

The pricing activity consists of setting specific prices and developing the rules that govern price-setting decisions. In large organizations, many people play a role in the organization’s pricing activities and central coordination of these price activities is important. Given that all businesses are involved in pricing and that pricing is part of managing one’s career, the study of pricing is an important part of one’s business education.

The book begins with the setting of an item’s initial price and continues with the modifying of existing prices to increase profits. Key in effectively modifying a price is understanding the factors that determine the market’s price-change response. The focus of the book is then expanded to the pattern of prices set by a selling organization and to considering interactive prices, societal consequences of pricing, and the integrated management of pricing activities.

KEY TERMS

price
price setting
commercial exchange
product
good
service
consumer
business customer
free-market economy
cost
marketing activities
marketing mix
value
marketing concept
barter
medium of exchange
price structure
price format
asking price
reservation price
initial offer
haggling
interactive price
fixed price
retailers
price segmentation
price partitioning
pricing policy
revenue management
invoice price
pocket price

REVIEW AND DISCUSSION QUESTIONS

1. Describe the two parties in a commercial exchange and what is given and received by each party.
2. How is the voluntary nature of the commercial exchange related to its potential for creating benefits for society?
3. Give some terms other than “price” that are commonly used to refer to prices.
4. In a business organization, describe how what a manager is referring to when speaking of “prices” differs from what a manager is referring to when speaking of “costs.”
5. What are the four categories of marketing activities, usually referred to as the marketing mix? In what important way does pricing differ from the other three categories?
6. What is the marketing concept? How can pricing activities be guided by the marketing concept?
7. What is barter? Give an example of barter, either from your reading or from your own experience.
8. What is a medium of exchange? What is most commonly used in our society as a medium of exchange?
9. Describe the basic elements of price negotiation. Why is a price arrived at through negotiation referred to as an “interactive price”?
10. What are fixed prices? What do customers like about fixed prices? What do retailers like about fixed prices?
11. What is price segmentation? Why might a seller want to engage in price segmentation?
12. Give an example of how different numbers could be used to express what would be substantially the same price.
13. What is the difference between price setting and pricing policy?
14. Give some examples of job titles of those in a large organization who are likely to have direct responsibility for making pricing decisions.
15. What are some of reasons that a item’s pocket price may not be the same as the item’s invoice price? What could be done about this?
16. Give an example of a way that everyday pricing decisions could work against a company’s long-term interests.
17. Describe some benefits of coordinating pricing activities with the other functions of a business organization.
18. Why might the study of pricing be relevant to a student who does not plan to ever set prices within a business organization?

EXERCISES

1. The CEO of a large company selling seeds and garden supplies to consumers and businesses through catalogs and the Internet is unhappy with its overall profitability. He feels that part of the solution is to be more professional in price setting, and he asks the director of marketing to hire an experienced person for a new position of pricing manager. While interviewing one candidate, the marketing director explains that the company has been advised to listen more to customers and respond to their needs and asks the candidate how he would implement this advice in the area of pricing. The candidate responds as follows:

   > "It's great to listen to the customer when you are designing your product, but it's just not practical in pricing. All the customers have to say is that they want lower prices. If you want me to increase profits, I can't very well listen to that!"

   a. What should the marketing director make of this response?

   b. If you were the candidate, how would you have responded to this question?

2. An entrepreneur is starting a business selling decorative items, such as vases, wall hangings, and prints (framed or unframed) over the Internet. She is aware that she needs to make a number of pricing decisions.

   a. Describe a decision that the entrepreneur must make that would be an example of price setting. Describe a decision that she would have to make that would be an example of pricing policy.

   b. Describe a decision that she would need to make regarding price format, and describe one regarding price structure.

3. As the marketer of your own professional services, you are responsible for price setting. Thus, it is necessary that you think about your pricing policy.

   a. Describe how a business professional might implement the following pricing policies in the pricing of his or her services: negotiated price policy and fixed price policy.

   b. Give and justify your views as to which of these pricing policies would be more appropriate in an individual's professional services pricing.

4. Identify someone you know who works in a business organization. Talk with that person to learn about the individuals in the organization who are involved in the setting of prices.

   a. Describe the job of a person within the organization who plays a direct role in price setting.

   b. Describe the job of a person within the organization who plays an indirect role in price setting. What is the information or expertise provided by that person? When during the price-setting process does that person interact with an individual who has a more direct role in price setting?

5. The marketing manager of a large truck manufacturer was surprised to learn that the price lists generated by his department had little relation to the prices that were actually charged to customers. The company's finance department often changed the prices to conform to profit goals before the prices reached the company's sales force. The salespeople often gave customers discounts to increase their sales volume. The operations manager made price adjustments to accommodate delays in promised shipping times.
   a. Why is this situation undesirable for the company?
   b. What can be done about this situation?

NOTES

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