# UNIT 11 PRICE ADJUSTMENT STRATEGIES

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## 11.0 OBJECTIVES

After studying this unit, you should be able to:

- explain the reasons as to why companies change the prices of their products;

- identify different types of discounts and allowances offered to customers and distributors;
- explain various pricing methods relating to price adjustment according to geographic locations of the buyers;
- discuss various terms of delivery used in international marketing contracts and their implications on price quotations;
- describe alternative pricing strategies for new products;
- identify the advantages and disadvantages of fixed pricing vis-a-vis flexible pricing; and
- state the concept of unit pricing and its utility.

## 11.1 INTRODUCTION

The job relating to pricing does not end once the basic price of a product has been arrived at (as discussed in Unit 10 earlier). In fact the job has only begun. The company has to decide as to how it is going to recover the costs incurred in transporting the product from the production point to each one of the customers. Charging the entire transportation cost in the product price may push the price to uncompetitive levels, while not charging the transportation cost at all will definitely eat into profits or even it may incur losses. Another decision pertains to the incentives to be offered to consumers and distributors for loyalty, service, bulk purchase, cash purchase, off season purchase, etc.

While the above pose a particular set of challenges, pricing a new product poses a different type of challenge. Should the product be priced high or low? What will be the reaction of the customers and competitors to a high price and low price? How a high price or a low price impact the image of the company?

Companies in multi product business have to sort out another problem, i.e., the problem related to pricing of the product-mix. Finally, should the company provide some margin in the product price for bargaining by customers or should it stick to a fixed price?

There may be situations like change in the prices of raw-materials, government taxes, distribution costs, etc., where it may be necessary to increase or decrease price of the product. Similarly, the competitors may change the prices of their products, where you are forced to change the price of your product too. How to respond in such situations?

This unit discusses all the above aspects of pricing in marketing management.

## 11.2 WHY PRICE ADJUSTMENT?

You have studied in the previous unit various methods of fixing basic price of your products. After arriving at a basic price for the product, you have to make adjustments in that basic price. Price adjustments may be brought about as part of a deliberate marketing strategy or due to factors beyond the control of the company. For instance, increasing competition in airline and telecommunication industries has forced price reduction in the sectors. Similarly, falling demand has brought about price reduction in the tourism and hotel sectors. Marketers may be compelled to make adjustment in product prices due to increase or decrease in costs. Sometimes price reduction or increase may be pursued by marketers as a deliberate marketing strategy to reposition the product in the customers' minds or to reduce/increase profit margin.

To make your product available to the ultimate consumers, you engage several middlemen such as distribution agents, wholesalers, retailers, commission agents, etc. You have to decide how much margin you give to each of them. Therefore, you have to decide how you adjust the basic price to provide margin to each of the middlemen in the distribution channel. Marketers may have to make adjustment in prices to reward customers and distributors for their loyalty, prompt payment, bulk purchase, off season purchase, promotion of the product, product support services provided, etc. For example, you know that less price is charged in the case of cash purchases, price of a product is less in the off season, price is less when purchased in large quantities. These are all price adjustment strategies adopted by marketers. To promote the latest models of their products, a number of companies offer "trade in" facility to the customers i.e. reduction in the price of a new model in exchange for an old model. Price adjustment also becomes necessary when a company moves up from a single product producer to a multi-product producer because the objective is to maximize profits of the product-mix and not a particular product.

Thus, as a marker you have to adjust the basic price to change in the costs, provide margins to middlemen, discounts and allowances to customers and middlemen for various services they provide, geographical variations in transport and other incidental costs, etc. You will study various methods of such price adjustments in the succeeding sections in this unit.

## 11.3 DISCOUNTS AND ALLOWANCES

The price of a product is generally indicated on the package/label. Companies also prepare a list of prices which indicate the prices to be paid by the customer for the listed products. However, in practice, most companies adjust the listed prices to reward customers for certain responses such as on the spot payment, bulk purchase, off season purchase, etc.

### 11.3.1 Cash Discount

Cash discount refers to the reduction in price when bills are settled promptly, i.e., payments are made timely. It is normal practice among many retailers to charge different prices for the same product depending on whether it is purchase on credit or on down cash payment basis. Normally, price is lesser for cash payment than the credit sale. When sales are made on credit and if the buyer settles the bill sufficiently earlier than the due date, it is a general practice to allow a discount in the price. For instance, if it is indicated in the bill as "2/10 net 30" it means that although the buyer is given 30 days to settle the bill, he can deduct 2 per cent of the bill if the payment is made within 10 days. For example, Municipal Corporation of Delhi (MCD) gives in House Tax if it is paid in advance within a specified time period. Cash discount does not discriminate among buyers, and all those who meet the terms get the same benefit of the facility.

From the marketer (seller) point of view, there are certain benefits of cash discount. It improves the liquidity position of the seller and reduces the risks involved in credit sales, such as bad debts, late payments, etc. It also reduces the costs associated with keeping accounts, employing collection staff and borrowing to finance the credit. From the buyer's point of view, a cash discount means money saved and the saving will be substantial for large purchases. The rate of cash discount is normally moderate and comparable to bank interest rates, it is neither too high nor very low. A company may not be able to afford a high cash discount without cutting into its own profits. Moreover, by nature, a cash discount should not be too high since it will then lose its relevance. A very low discount, on the other hand, may not be enough to motivate the buyers to settle the bill in advance promptly. Cash discount has become customary in many industries.

### 11.3.2 Quantity Discount

Discount given on price on the basis of the number of units of the product (quantity) purchased is called quantity discount. For instance, "Rs. 10 per unit upto 100 units and Rs. 9 per unit for every unit purchased over 100" is an instance of quantity discount. In this case, a discount of Re. 1 per unit is given for the quantity purchased over and above 100 units. The logic behind offering quantity discount is that sales in huge quantities means less unit cost of sale. It is common practice among places of tourist interest such as museums, parks and zoological parks to charge less per ticket for visitors in groups. Similarly, airlines also offer, though not discount in price per ticket, some free tickets is there is bulk booking of tickets. It is a common experience where retailers offer 'Buy One Get One Free', '3 for 2', 'Buy One & Get 50% Discount on the Second', etc.

Quantity discounts are of two types: (1) non-cumulative, and (2) cumulative. **Non-cumulative discount** refers to the discount given on each purchase of a specified quantity of the product at a time from the same seller. The example in Table 11.1 is an instance of non-cumulative discount.

**Table 11.1: Non-Cumulative Discount on Shampoo**

| *No. of Shampoo Bottles (100 ml) Bought at a Time* | *Discount from List Price* |
|---|---|
| upto 5 | Nil |
| 6 - 10 | 2% |
| 11 - 15 | 3% |
| 16 - 20 | 4% |
| 21 and above | 5% |

Above is an illustration where the discount is expressed in terms of percent from list price. Alternatively, the same may be expressed in terms of reduced price per unit of purchase as the number of units bought goes up as shown in Table 11.2.

**Table 11.2: Non-Cumulative Discount on Shampoo in terms of Price per Unit**

| *No. of Shampoo Bottles (100 ml) Bought at a Time* | *Selling Price Per Shampoo Bottle (100 ml) Rs.* |
|---|---|
| Upto 5 | 50.00 |
| 6-10 | 49.00 |
| 11-15 | 48.50 |
| 15-20 | 48.00 |
| 21 and above | 47.50 |

When discount is given in the form of a reduction in the price of a product or a group of products based on the quantum of purchases made by a buyer from the same seller during a specified period, it is called "cumulative discount" or "deferred or patronage discount" signifying that discount is given as a reward for patronizing a particular seller for a reasonably long period. The more a buyer buys during a specified period, the more he will get as discount. An illustration of cumulative quantity discount is provided in Table 11.3.

**Table 11.3: Cumulative Quantity Discount**

| *Annual Purchase (No. of units of the product)* | *Discount from List Price* |
|---|---|
| Unto 10,000 | Nil |
| 10,001-20,000 | 2% |
| 20,001-30,000 | 3% |
| 30,001-40,000 | 4% |
| 40,001-50,000 | 5% |
| Above 50,000 | 6% |

Cumulative quantity discounts are given to attract and retain buyers who make repeated purchases of a product over a long period. Generally, cumulative quantity discount is aimed at buyers of industrial goods who use the goods as inputs in the production of consumer goods and distributors of consumer goods since the demand for any consumer goods from a single consumer is not expected to be of high order. This type of discount is usually given at the end of a specified period.

### 11.3.3 Functional Discount or Trade Discount

Discount offered by the seller to trade channel members (intermediaries) such as wholesalers and retailers for performing certain functions like storing, sorting, information collection, record keeping, customer servicing, etc., is called **functional discount or trade discount**. The rate of discount given depends on the type of channel member and the nature, extent and the quality of services provided. Different types of middlemen may be allowed different rates of discount depending upon the functions and services they provide in the distribution of the product. Thus, the discounts offered to wholesalers, retailers, distributors, stockists are different. However, the discount will be the same for all channel members of the same level for a particular service provided. For example, all the wholesalers may be offered the same discount and all the retailers receive the same discount.

### 11.3.4 Seasonal Discount

It is normal practice among most companies to offer discount from the list price during certain seasons. For instance, manufacturers of air-conditioners, air-coolers, refrigerators and fans offer price discount during the winter season which is the off season for these products. Similarly, woolen garment makers offer discounts during the summer season. During major festival seasons such as Diwali, Dashera, Pongal and New Year, a number of sellers offer price discounts on almost all durable consumer goods. The strategy behind seasonal discounts is that during periods when there is less demand for products (seasonal demand) or when consumers are in a mood for shopping, they may be motivated to buy your product more by offering discounts even though the product may not be put to use immediately. Such discounts help the company to reduce mismatch between production and sales from one period to another, reduce inventory costs and avoid keeping labour idle during off seasons. Hotels and airlines offer seasonal discounts to attract tourists during off-season. Seasonal discounts are also offered to wholesalers and retailers to encourage them to place orders and keep stocks during off season. At times, middlemen pass on whole or part of such discounts to customers.

### 11.3.5 Allowances

There are discounts given for other functions/reasons to dealers and customers, known as allowances. **Promotional Allowance** is a price reduction to reward

dealers for undertaking promotion of the product such as advertising, product display and demonstration, participation in trade fairs and exhibitions, word of mouth publicity, etc. A **Trade-in-Allowance** is price reduction given to the customer for trading in, that is, turning in an old item when buying a new one. Nowadays it is common for companies to trade-in durable consumer goods such as refrigerators, television sets, washing machines, mixers etc. Such an allowance is an incentive for customers to go in for the latest model of these products although they may have, with them, the earlier models. Trading-in offers to the customer the double advantage of price reduction in the latest model of the product and, at the same time, finding a way to dispose of the old model.

**Check Your Progress A**

1) Differentiate between functional discount and promotional allowance.

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2) Differentiate between cash discount and quantity discount.

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3) State whether the following statements are correct or incorrect?

   i) When a buyer settles the bill promptly, the reduction in price that is offered to him is called cash discount.

   ii) Deferred or patronage discount is given when the buyer buys the same product or group of products from the same seller during a specified period in substantial quantity.

   iii) Cumulative quantity discount is generally aimed at the consumer rather than the distributor.

   iv) Seasonal discount enables the manufacturer to meet seasonal demand.

   v) Trade-in offers practical solution to the customer's problem of disposal of the old model of the product.

## 11.4 GEOGRAPHICAL PRICING

You have studied the methods of deciding the basic price of the product. Then you have studied how to adjust the price through discounts and allowances for seasonality, intermediaries, quantum purchased, rewarding intermediaries for their additional services, etc. Another major pricing decision to be taken by the marketers relates to the policy in pricing its product to customers located in different parts of the country/ world. When the product is transported from one place to the other place, you have to incur costs like labour charges for loading and unloading, transportation, insurance, storage and warehousing, customs and excise, etc. Some of these costs increase with the increase in distance. Since the cost of carrying of the product from the factory to a distant customer will be definitely more than that of carrying it to the customer in the nearby location, the company has to devise a carefully thought out method to ensure that it does not lose business from distant customers by loading the entire transportation cost on to the price charged to them or alternatively annoy the nearby

customers by making them share a high proportion of the cost of transporting to distant customers. Therefore, you have to decide the policy whether you charge all customers uniformly irrespective of their location or charge differently as per the distance or location. Following are some of the methods available to marketers to sort out this problem.

### 11.4.1 FOB-Origin Pricing

Under the FoB (Free on Board) Origin Pricing method, the customer has to bear the entire transportation cost and other incidental costs like unloading, insurance, etc. from the first point the product is loaded on to the truck, ship/boat, airline or train. The seller bears only the cost upto loading the merchandise (goods) on the carrier, while the buyer bears all the remaining expenses. This obviously means that the return to the seller will be constant while the product price will differ from one group of customers to others depending on their location in relation to the point of production. In the case of movement of the product by rail, this method is referred to as FOR (Free on Rail) Origin pricing.

Since each customer is expected to bear the expenses involved in moving the product to the place where he wants it, it appears that FOB-Origin Pricing is a fair and equitable way to allocate freight charges as per the distance of buyers. It is also easy for the seller to comprehend and implement. The advantage of this method is that the product will be highly priced to a distant customer and quite cheap to a nearby customer. Therefore, customers may like to buy from the nearby suppliers in order to avoid high costs. In case you adopt this method of geographical pricing, the distant customers may gradually shift to competitors nearer to their locations. It means that all companies may have to contend with selling their products only to nearby customers and no company can perhaps hope to capture a distance market. This, in fact, will create geographic monopolies, each company enjoying a monopoly in the closeby markets and the consumer being denied the benefit of choice.

### 11.4.2 Uniform Delivered Pricing

Uniform Delivered Pricing refers to the practice of charging the same price to all the customers, irrespective of their location. This is done by averaging out the freight cost and distributing it equally on each unit of the product. This method of pricing is, at times, referred to as "postage stamp pricing" since postage rates are the same within a country for all destinations. The advantage of uniform delivered pricing is that it does not discriminate among customers based on distances and easy to administer. A company may advertise its price nationally and project a national image of the company. Many products of common use such as soaps and toothpastes are priced the same all over the country. However, the risk you face in following this strategy is that a competiting company which adopts the FOB-Origin Pricing technique may price out your company's product in locations close to that company, because under FOB-Origin pricing method the costs would be lesser for short distances.

### 11.4.3 Zone Pricing

Zone pricing is a compromise or a middle path between FOB-Origin Pricing and Uniform Delivered Pricing. Under this method, the entire market is divided into a number of geographical zones and each zone has a separate price fixed on the basis of the average freight cost to the zone. The product is sold at one price within the zone, irrespective of the location of the customer in that zone. For instance, India may be divided into four zones, say, North, South, East and West, and all the customers in the north zone will pay the same price for a product which will be different from the prices charged to the customers in each one of the other three zones and vice-versa. The advantage of this method of geographical pricing is that it is a fairly equitable

method of allocation of freight charges since it avoids the extremes of the earlier two methods and it is also easy to administer. However, customers living in one side of the border of two zones will find that they have to pay a higher price than those on the other side just because their place did not fall on the other side when the line dividing the market into zones was drawn. Second, it also suffers from the same disadvantage as uniform delivered pricing in that customers located in distant zones may find a competing company's price offer more attractive, since the company is located nearby and is following the FOB-Origin Pricing strategy.

### 11.4.4 Basing-Point Pricing

In this method of pricing, the company selects a particular city or town as the "basing point" and the price of the product includes the transportation costs from the selected "basing point" to the location of the customer irrespective of the place from which the product is transported. For example, a company might set New Delhi as the "basing point" and charge all customers the cost of moving the product from New Delhi to their location. In this example, if the product is manufactured at Kanpur, a Kanpur customer is charged the transportation cost from New Delhi (basing point). Though close to the actual product point, Kanpur customer has to pay a price higher than the one paid by a New Delhi customer. Thus, using a place, other than the place from which the goods are actually transported as "basing point" raises the product price to customers near the production point and lowers the price to those close to the "basing point" even if the latter are located far away from the place of production as compared to the former. One way of getting over this anomaly is to set up multiple "basing points" and charge the customer for transportation from the nearest "basing point". This is almost like zone pricing. Actually, to overcome the disadvantages of zone pricing, basing point pricing is deployed.

### 11.4.5 Freight Absorption Pricing

There may be instances like "free home delivery" where a company charges only sale price and does not charge anything additional from any customer as freight charges. The price of the product includes the freight charges and all customers are charged the same price irrespective of their locations. Since the freight expenses are mostly borne by the seller, this method is referred to as "Freight Absorption Pricing". This method of geographical pricing is suitable in the following situations:

a) when the competition in the market is very severe and the company has no choice but to keep the price of its product as low as possible, or

b) when the company wants to penetrate into a new market, or

c) when it expects large business to be generated due to its product price being low, which in turn will have the effect of lowering average costs.

### 11.4.6 Price Quotations in International Markets

Price quotations for exports depend on the terms of delivery. There are several well-accepted standardized terms in regular use in international marketing. These terms known as "INCO Terms" have been evolved by the International Chamber of Commerce, Paris. Each price quotation (term) carries with it the rights and obligations of the sellers and buyers. As a marketer involved in exports and imports, you must familiarize yourself with all such price quotations and the associated rights and obligations. Some of the popularly used international price quotations are as follows:

**EXWEX Works (.... Named Place):** Under this quotation, the seller delivers the goods at his premises (works, factory, warehouse, etc.) and the price he quotes includes all expenses upto that designated premises. It is the buyer's responsibility to

meet the costs and risks associated in moving the goods from that seller's designated premises.

**FCA–Free Carrier (.... Named Place):** This quotation means that the seller has to hand over the goods into the charge of the carrier named by the buyer at the named place. The price quoted by seller will cover the expenses upto the point when the goods are handed over to the carrier.

**FAS–Free Alongside Ship (.... Named Port of Shipment):** Here, the seller has to ensure that the goods are placed alongside the vessel on the quay or in lighters at the port of shipment and the price includes the expenses upto that point.

**FOB–Free on Board (.... Named Port of Shipment):** Price quotation under an FOB contract should include all the costs till the goods have passed over the carrier at the port of shipment named by the importer.

**C&F–Cost and Freight (.... Named Port of Destination):** Under a C&F contract, the seller has to incur all costs and freight charges necessary to bring the goods to the named port of destination. This means that the price includes the freight element but any additional costs due to events occurring after the goods have been delivered on board the vessel have to be borne by the buyer.

**CIF–Cost, Insurance and Freight (.... Named Port of Destination):** CIF contract means that the seller, in addition to meeting his obligations under a C&F contract, has also to procure marine insurance against the buyer's risk of loss or damage to goods during carriage. This implies that the seller's price should include the cost incurred by him on marine insurance premium besides the costs incurred under C&F contract.

The above are some of the widely used quotations in international business. Besides, there are other quotations such as CPT (carriage paid to), CIP (carriage and insurance paid to), DAF (delivered at frontiers), DES (delivered ex-ship), DEQ (delivered ex-quay, duty paid), DDU (delivered duty unpaid), and DDP (delivered duty paid). Each one of the above quotations has implications on product pricing and on the rights and obligations of the seller and buyer.

## 11.5 PRICE CHANGES

Once a company decides on the price for its product, it does not mean that it can hope to maintain the price at the same level indefinitely. In fact, there may be occasions where the companies are forced to increase or decrease prices due to changes in marketing environment. It is generally known that marketing is an integrated function and decision in respect of any one of the marketing mix elements influences the decisions in respect of others and, in turn, is influenced by decisions in respect of the others. However, product and price share a special relationship and often adjustments are made in the product to meet some problems cropping up in the pricing area. Following are some such product-price adjustment strategies. As far as price changes are concerned, companies often face two types of situations:

a) Initiate price change

b) Respond to price changes by competitors.

Now let us discuss these issues in detail.

### 11.5.1 Initiating Price Change

Due to changed market conditions you may decide to reduce the price or even increase the price. However, while you initiate price cut or price increase, you must keep in mind how the buyers, middlemen and competitors react to it. Now, let us briefly discuss these issues.

**Price Cuts:** For instance, a firm may reduce the price of its product when there is decline in raw material prices, since it makes sense to pass on the benefit of lower costs to the consumers. However, if the reduction in costs is likely not to last long, then it would not be advisable to reduce the product price, as you have to increase the price again consequent to increased raw material prices. This may lead to consumer resentment and resistance. Sometimes you may decide to reduce price as part of a deliberate strategy to increase sales and, thereby, market share. For instance, the reduction in airfares which have become quite frequent now in India is an example of price reduction for raising market share. Same is the case with the steep fall in cell phone tariffs. Sometimes you may reduce prices in response to price cuts by competitors to protect your market shares. This is what is happening in the airlines business and the cell phone business today and what happened in the daily newspaper business some years back.

Better utilization of the manufacturing capacity may be yet another reason for price reduction. If the company is not operating its manufacturing capacity to full extent, it may decide to reduce the price with an anticipation of increase in sale. A reduction in price may result in demand increase leading to higher capacity utilisation, lower unit cost of production, increased sales, greater market share and higher profits.

Some companies may, as a strategy, not like to adopt "follow the leader" policy in pricing. Hence, opt for price reduction rather than charge the same price as the leader though the other companies may not like to price their product lower than that charged by the leader.

In times of cost increase, if it is felt that corresponding price increase should be avoided or not possible, the product may be adjusted in terms of quality and/or quantity and the price may be left undisturbed at the earlier level. Conversely, if costs decline, rather than reducing the price, the company may offer a better quality or higher quantity of the product at the old price and may gain a better image and higher sales.

Whatever may be the reason for price reduction by a company, this strategy hides the danger of snowballing into price-wars which may not ultimately benefit any company.

**Price Increase:** Price increase may be caused by rising costs. Rising costs squeeze profit margins and companies may be forced to raise product prices in order to maintain the profit margin. Companies generally would not like to raise the prices frequently every time the costs go up but, they may increase the price more than the increase in cost thus providing a cushion for further cost increases in the near future. There have also been instances of price increase to curb excess demand when the company finds it difficult to meet the requirements of all its customers. A company may increase the price of its product just to make more profits when it finds that there is not much of competition in the market or if the company happens to be the "leader" in the market.

Price increases are generally resented by customers and even by dealers. To some extent, the adverse reactions of the customers may be softened by communicating the reasons for price increase to the customers. Instead of raising prices directly, a company may adopt indirect methods such as reducing discounts, adding higher priced units to the line, curtailing production of low margin product items, etc., are some examples. It is important that you communicate the customers reasons for increase in prices. If you increase the prices frequently, customers may perceive that you charge excessive prices. You must be careful about this factor.

Similarly, to accommodate rising costs, rather than increasing the price, the product form and/or packaging may be changed to reduce costs. For instance, introducing refill packages and offering beverages in powdered mix form rather than as liquids

(thus avoiding the cost of water and container) as earlier or in small unit packs for one serving (pan masalas) which have the effect of reducing costs/increasing price are some examples of this technique.

To accommodate rising costs, certain facilities that were hitherto part of the price charged, such as free home delivery or free after sales service may be given up or may be provided on payment only. Thus the bundle of utility, earlier provided to the customer, is unbundled. Conversely, during periods of decline in costs, rather than reducing the product price, new features can be added to the bundle without charging anything extra for the added utilities.

When rise in costs make it unavoidable to raise prices, certain additional facilities such as providing credit, arranging finance for purchase of a high unit value item and supplying products on instalment basis are offered by firms to persuade the customers and dealers to purchase the higher priced product.

**Customer Reactions to Price Changes:** Price revisions, both downwards and upwards, provoke different types of reactions from buyers, competitors, distributors and even government. An excessive price reduction might be interpreted by consumers as an attempt by the company to dispose off defective products or products of poor quality. Sometimes customers may also get the impression that the company is in financial trouble and may close down the operations soon. They may think that the company will shortly introduce newer models of the product and hence is disposing of the old models at reduced prices. Some consumers, in anticipation of further price reduction, may postpone purchases. There may also be consumers who may consider price reduction as reflective of the ethical standards of a company.

A price increase may have positive meanings for some buyers and negative meanings for some others. When a company raises the price of its product, some buyers may take the price increase as an indication of better quality of the product or it is the latest model and a "hot" item. Such customers may rush to buy it fearing further price increases in future or the "hot item" may run out of stock soon. On the other hand, some other customers may feel that the company is greedy and is trying to exploit the consumer.

**Competitors Reactions to Price Change:** Just as consumer reaction to price changes, your competitors may also react to a price change by your company. Each competitor will generally react according to his self interest. However, majority of the competitors may react in a set way. Under market conditions of pure competition, if the company initiating the price change is not a marginal player, the competitors are likely to match the price change. On the other hand, if the company initiating the price change is a marginal player and/or there is evidence available to prove that the company is performing poorly, the competitors are unlikely to match the price change. Some companies, instead of matching the price change, may compensate the consumer in other ways through sales promotion, discounts, product service, packaging, incentives, etc.

### 11.5.2 Responding to Price Changes by Competitors

We have discussed that a company must be ready with strategies to take proper care of the customers' and competitors' reactions to the price change that it may initiate. In the same way, the company also be ready to respond to price change initiated by a competitor. First of all, it should try to find out the reasons behind the competitor's price change strategy; whether it was caused by changing cost conditions or it was prompted by excess capacity or a desire to gain more market share or lead an industry wide price war? It should also try to find out the possible responses of the other competing firms to the change in price and whether the price change was going to be a long term revision or a temporary reaction to some unforeseen developments.

Internally, the company must consider its own costs, the product's stage in life-cycle, its strengths and weaknesses vis-a-vis competitors, how important is the particular product in its product mix, etc. Since a company may not always find time to undertake such a detailed analysis of the factors mentioned above, it may have to react immediately. The only way to cut down on the response time is to be ready with alternative responses to possible price changes by competitors.

## 11.6 PRICING A NEW PRODUCT

One of the greatest challenges a company may face relate to the pricing strategy it should adopt when it introduces a "new product" into the market. The "new product" need not necessarily be a real product innovation but the market should consider it "new" in the sense that the majority of customers must feel that no close substitute is available in the market at that point of time. Two approaches are available as regards pricing a new product:

a) Market-Skimming Pricing Strategy

b) Market-Penetration Pricing Strategy

Now let us discuss these two strategies in detail.

### 11.6.1 Market-Skimming Pricing

Setting high prices for the product initially is referred to as **market-skimming pricing strategy**. As the name indicates, the objective is to "skim" the market, for high revenues, as much as possible. Companies like Polaroid Corporation are known to follow skimming pricing policy. The strategy is to set a high price for the product, skim the creamy segments of the market, generate as much revenue as possible and then, as competition develops, bring out lower priced versions of the product to draw in new segments.

The advantage of this pricing strategy is that high price helps recover initial investment fast. This is particularly necessary for products which involve high research and development (R&D) expenditure and high marketing costs. The funds so realized by skimming the market can be utilized to finance entry into other segments of the market, if and when necessary. Also, it has become necessary for companies to recover as much finances as early as possible in the present days of shorter product life cycles. Skimming pricing strategy generally creates a high quality image for the product and helps build up strong brand loyalty among status conscious segment of customers. In any case, it may be easier and advisable to start at high price, and if need be, reduce the price subsequently rather than start at low price and find it difficult to raise the price subsequently, even if it is justified.

The risk associated with skimming-pricing strategy is that high price normally tends to attract competition and limits market size in due course. Besides, it projects a poor image of the company as a socially and ethically irresponsible one.

Market skimming makes sense under certain conditions. Firstly, the product must be considered "new" by the target segment and it should take time and substantial resources for competitors to develop substitutes. Secondly, the demand for the product should be inelastic. Though the size of the segment may be small in terms of the number of customers and the sales volume (in terms of units) the value of the sales should be high and profits also high. The small segment should comprise elitist buyers such as trend setters but the demand (measured in terms of value of purchase) should be sufficiently high to justify production for such a small sized segment and the costs of producing a small volume should not be high enough to cancel the advantage of producing for a limited number of buyers.

### 11.6.2 Market-Penetration Pricing

Rather than setting a high initial price and skim a small segment, *market-penetration pricing strategy* advocates setting as low an initial price as possible in order to penetrate the market as fast and as much as possible. Companies like Texas Instruments are known to be users of this strategy. Low price is expected to attract high volume of business which, in turn, will have the effect of lowering the costs further. The advantage of penetration-pricing strategy is that low price generally discourages competition and hence gives substantial market share to the company practicing this strategy.

It suffers from the disadvantage that charging low price may leave considerable consumer surplus in the sense that, if the market is prepared to pay a higher price, then the company charging a lower price stands to lost revenue. Moreover, low price may generate very high demand and, if the company if not able to match supply with demand, its reputation may be affected. Low price also tends to be associated with low quality of the product and poor service.

The conditions favouring deployment of penetration-pricing strategy are the opposite of those favouring deployment of skimming-pricing strategy i.e. the product does not involve much of investment for R&D and marketing. It should be relatively easy for competitors to come out with substitutes. The demand is elastic and the market is a mass market in terms of number of buyers, sales volume and value and the unit profit is low.

**Check Your Progress B**

1) List the different geographical pricing strategies.

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2) Why does a company initiate price changes?

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3) Differentiate between market skimming pricing strategy and penetration pricing strategy.

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4) State whether the following statements are correct or incorrect.

   i) Freight absorption pricing means that the buyer has to absorb the transportation cost.

   ii) Under an FOB contract, the buyer has to incur the freight costs.

   iii) Penetration pricing strategy is advocated for selling low unit value low technology items.

   iv) Zone pricing is of great advantage to customers living in distant zones.

v) Market skimming pricing strategy means that the company is not bothered about profits.

## 11.7 PRODUCT-MIX PRICING STRATEGIES

It is not often that a company manufactures only one product and hence has to formulate pricing strategies taking into account only one set of relevant factors. Even if a company, at the time of its establishment, may begin only with one product, over the years it may grow into a multi-product firm. The strategy for setting price to one product may not work for another product or most of the other products. In fact, at times, what works for one product, may turn out to be counter-productive for a number of other products. Hence, there may be a need for pricing strategy, when a product is part of a mix, which is different from the strategy when the company is a single product company. In a product-mix pricing strategy, the firm has to look for a set of prices that maximizes the profits on the total product mix.

### 11.7.1 Product-Line Pricing

Companies manufacturing a product-line (different versions of the same product such as different capacities of refrigerators, various models of cars, all varieties of toilet soaps, etc.) may decide on the price steps to be set between the various versions of the product by taking into account the cost differences, differences in consumer perception and competitors' prices. For instance, your company is manufacturing colour TVs of various models of 14" TV, 21" TV, 25" TV and 29" TV. Normally the price of 14" TV would be the lowest and 29" TV price would be the highest. Here you have to decide the price of each of these four models in comparison with each other taking into account cost factors, technical features, consumer segments, consumer perceptions about the models, prices of comparable models of competitors' models, etc.

### 11.7.2 Optional-Product Pricing

In this strategy, the buyer is given the option to buy accessory products alongwith the main product. For example, along with the television set you may sell other accessories like TV stand, TV cover, remote, voltage stabilizer, etc. Similarly, central locking system, car stereo, gear lock, seat covers, perfume, etc. are optional products you may or may not buy alongwith the car. There will be a base price for the main product and each of the options offered will have separate price. The company has to decide which items to build into the base price and which to offer as options. The pricing strategy should be carefully worked out in such a way that most of the options should not remain unsold. At the same time, the buyer should not feel that he is forced to pay unnecessarily for the options separately while the accessories should have come free with the main product.

### 11.7.3 Captive-Product Pricing

There are certain products, which cannot be used without certain other products. Examples of such products are safety razor with razor blades and shaving cream, toothpaste with tooth brush, cameras with films, computers with software, fountain pen with ink, etc. Manufacturers of such complementary products may use captive product pricing strategy where the main product is priced low while the supplies can be priced relatively high. Companies which are in the business of only the main product will then find themselves priced out from the market. This is also the strategy being followed by companies in the business of durable consumer goods (such as cars, television sets, refrigerators, etc.) where the spares, components and servicing

are charged relatively high while the relatively low prices of the main products make them competitive.

In the case of services, the strategy is called two-part pricing. The price of the service comprises two parts, a **fixed fee** and a **variable usage fee**. For example, telephone companies charge a fixed monthly rent plus charges for calls made during the period over and above the minimum number of free calls. The service company must make the basic service fee low enough to attract customers and profits should mainly come from the variable usage fee.

### 11.7.4 By-Product Pricing

In a number of industries, production of main products throws up by-products which also find usage. For instance, a number of by-products emerge in petroleum refining. The same is the case in many chemical industries. In the cashew industry, extraction of cashew kernel throws up cashew-nut-shell liquid, cashew apple. The famous drink "Feni" (popular in Goa) is extracted from cashew apple. Using by-product pricing, a company can keep the price of the main product competitive. At the same time, company also finds a way of disposing of the by-products.

### 11.7.5 Product-Bundle Pricing

Under this strategy, sellers can combine a number of their products and offer the bundle at attractive price. For example, it is a common experience during festive seasons, retailers offer durable goods like refrigerator, washing machine, TV as a bundle at a single price which is much lower than the total price you pay for each of them separately. Tour operators often offer package tours which include air travel, hotel and food, sight-seeing, insurance, visa fee, airport taxes, local travel etc. The price of the total package has often been found much lower than the sum total of the prices of each item separately. If the product bundle is priced attractively, it will stimulate the sales of all items in the bundle.

## 11.8 FIXED PRICE AND FLEXIBLE PRICE

It is common practice in countries like India to find some products being sold at the same price to all customers and some others being sold at different prices to different customers. In the latter case, prices may vary according to the quantity of sale (bulk purchases being offered price concession) or the loyalty of the customer to the shop (frequent buyer of the same product getting price concession) or familiarity of the customer with the seller or hard bargaining may bring in price concession. A company should take into account the nature of the product, the profile of the customer segment, the margin of profit, etc., in deciding about the pricing policy. It is common practice in India to sell products at prices less than the Maximum Retail Price (MRP) indicated on the package and high unit value durable consumer goods such as refrigerators, air-conditions and television sets being offered at different prices to different customers. In fact, one of the industries where flexible pricing policy is being followed aggressively is the travel and tourism sector, tourist operators offer same package tours to different customers at different prices depending on familiarity with the customer, customer loyalty and relative bargaining power. While flexible pricing policy offers the seller flexibility in dealing with different customers and, at the same time, leaves consumer surplus among the customers, it has the danger of some customers doubting any price quoted by the seller. Fixed pricing policy, on the other hand, builds customer confidence and the seller and the company and saves the time of both the buyer and seller, which would have been spent if they were to bargain.

## 11.9 UNIT PRICING

It is normal to find products like tooth paste, perfumes, vegetable oils, biscuits, etc., being offered in packages of different sizes such as 500 ml, 100 ml, 50 gms, 150 gms, one kilogram, five kilograms, etc. Products like toilet soaps and detergent cakes also come in different weights such as 75 gm, 100 gm, etc. These packages carry different prices and often it becomes difficult to compare prices of different brands because the quantities offered may differ from manufacturer to manufacturer and from one brand to another of the same company. In such conditions, unit pricing facilitates price comparison. Unit pricing refers to the practice of indicating price per unit of the product irrespective of the size of the package

## 11.10 LET US SUM UP

Companies often have to adjust the price of their product in response to changes in costs and demand and competitive and environmental conditions. Similarly, companies also resort to adjustment in listed prices, reward customers and distributors in the form of discounts and allowances. While discounts to customers are related to the quantum of one time purchase, quick settlement of payment and off-season purchase, distributors are rewarded for the services provided by them. In this context, the firm has to decide the adjustment in base price for cash discount, quantity discount, functional discount, seasonal discounts and various allowances.

One of the areas relating to which a company should have a clear-cut pricing strategy pertains to recovering the cost of transporting the product from the product point to the consuming point. A number of alternative strategies are available in this regard, varying from one extreme of loading the entire freight cost on to the product to the other extreme of the company completely absorbing the freight cost; in between, there are other alternatives of distributing the transportation cost uniformly on the entire sales volume, or zone-wise or basing-point wise. While quoting for exports or while importing, a company must not only use the internationally accepted quotations but also be familiar with the implications of the quotations on pricing as well as the rights and obligations of the seller and buyer under each of the quotations.

Occasions may arise when a company finds that the product price warrants revision. What is important is not that much revising the price but, more importantly, anticipating the reactions of customers, distributors and competitors to price change and taking pre-emptive action. In the same way, a company must also respond properly to the price changes initiated by competitors. Another challenging occasion in pricing will be when a new product has to be priced; a company may charge a high price or a low price to a new product; each of the strategies has its own advantages and disadvantages and the decision should be based on the supply, demand and competitive conditions.

While pricing a single product has its own challenges, pricing strategy for a mix of products poses another set of challenges. Strategies such as product-line pricing, optional-product pricing, captive-product pricing, by-product pricing and product-bundle pricing are the choices available to a firm in product-mix pricing. Finally, a seller may follow a policy of fixed price or the alternative of flexible price depending on the nature of product and market and cost considerations.

## 11.11 KEY WORDS

**Allowance:** Reward or price reduction given to distributors and/or customers for promoting a product or buying the latest version of the product in place of the old version.

**Captive Product Pricing:** A pricing strategy involving complementary products where the main product is priced low and the secondary product is priced high.

**Cash Discount:** Reduction in list price given to a buyer when a bill is settled within a specified time period.

**CIF Contract:** Contract between an exporter and importer, where the exporter has to incur all the costs, including the freight and marine insurance premium costs, upto the port of destination.

**Geographical Pricing:** Pricing strategy adopted to accommodate the freight expenses incurred in moving the product from the point of product to the consuming point.

**Market Skimming Pricing:** Setting a high price for a new product and thus skimming the cream of the market.

**Market Penetration Pricing:** Setting a low price for a new product and thus gaining a large market share.

**Quantity Discount:** Reduction in list price given on the basis of the quantity of purchase.

**Seasonal Discount:** Reduction in list price given for purchases made during certain seasons.

**Two-part Pricing:** A pricing strategy for services in which price is broken into a fixed price plus a variable usage rate.

## 11.12 ANSWERS TO CHECK YOUR PROGRESS

A. 1) Financial discount is the discount offered to the trade channel members by a company for performing certain functions such as storing, sorting, record keeping, customer servicing, etc., while promotional allowance is given by the company to the dealers in the form of payment or product price reduction for undertaking promotion of the product such as advertisement, display, demonstration, etc.

2) Rs. 20,000

3) i) Correct ii) Correct iii) Incorrect iv) Incorrect v) Correct

B. 1) FOB-Origin Pricing, Uniform-delivered pricing, Zone pricing, Basing-point pricing, Freight absorption pricing.

2) Due to change in costs, to increase sales/market share/profits, to meet competition, for better utilisation of manufacturing capacity, to follow a strategy different from that of the "market leader", to curb excess demand.

3) The product must be an innovative one, should not be easy for competitor to develop substitutes; the product demand should be price elastic, the customer segment should be elitist, the value of sales and profits should be high, cost of a small volume of production should not be high.

4) i) Incorrect ii) Correct iii) Correct iv) Incorrect v) Incorrect

## 11.13 TERMINAL QUESTIONS

1) List and explain the various geographical pricing strategies.

2) Distinguish between:

i) FOB-Origin pricing and FOB contract pricing

ii) Zone-Pricing and Basing-point pricing

iii) Cumulative discount and non-cumulative discount

iv) Fixed pricing and flexible pricing.

3) Examine the conditions under which "Market-Skimming Pricing" and "Market-Penetration Pricing" can be deployed and also analyse the advantages and disadvantages of each of the above pricing strategies.

4) Write short notes on the following:

i) FAS (Named Port of Shipment)

ii) Cash discount

iii) By-product pricing

iv) "Trade-in" allowance.

**Note:** These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University for assessment. These are for your practice only.