Pricing Strategies

Product and Customer Management

Professor Rui de Carvalho

JeongWon Lee

João David Carvalho

João Rodrigues

CATÓLICA LISBON
SCHOOL OF BUSINESS & ECONOMICS

Índice

Introduction 3
Differential pricing strategies 4
Second Market discounting 4
Periodic discounting 5
Random discounting 6
Competitive Pricing 7
Penetration Pricing 7
Experience Curve Pricing 9
Price Signaling 10
Geographic Pricing 11
Product line pricing strategies 13
Price Bundling 13
Premium Pricing 14
Image Pricing 15
Complementary Pricing 16
Conclusion 18

Introduction

The objective of this group-work is to study and analyse several price strategies. In order to do it in a more deep and comprehensive way, it was requested to present an example for each price strategy.

The most conceptual part of this work was based on the paper of Gerald J. Tellis, “Beyond the many faces of price: An integration of pricing strategies” and the examples for each strategy were selected by the group, based on the information available on the web for the respective product or service.

In this globalized world-wide context when we are faced everyday by so many stimuli, it is important to know why and how companies face their price strategies in order to attract and discriminate customers. The price is the visible cost to clients, but in fact, the price strategy that each company chooses is not only determined by adding a margin to a variable cost but also determined by its context, their positioning and the type of customers to whom they want to sell.

There were analyzed 11 different types of pricing strategies, according to 3 different groups:

- Differential pricing strategies
- Competitive pricing
- Product line pricing strategies

Being a price strategy a “a reasoned choice from a set of alternative prices (or price schedules) that aim a profit maximization within a planning period in response to a given scenario”, this work aims to identify and clarify the most common pricing strategies according to the referred groups.

Differential pricing strategies

The main goal of this kind of pricing strategies is to discriminate prices due to the existence of different kind of customers for the same product or service. If a company wants to maximize its profit, it must not only discriminate its price (in order to take advantage of its client's heterogeneity) but also to be perceived by different types of customer as the most valuable product.

Second Market discounting

This pricing strategy is much related to the opportunity costs that companies may face. When a company has unused capacity (when it produces less than it could), every offer of buying that outperforms the variable costs is a good one. This fact is explained by the existence of fixed costs that, as its name indicate, they are the same independently of the sales, so they must be covered. Every cent that overpays the variable costs it's a profitable one.

In general, this efficient and economic option goes along with companies that have the opportunity to sell to different markets (exportation, during production proposals, "white brands" of the same brand, special prices for a segment, etc.) and to segments that have high transactional costs.

Some economists criticise this kind of strategy considering it dumping, but in general the idea of covering the fixed costs by reducing the price even with a higher variable cost is accepted. However, explicit price discrimination is illegal in most countries.

Example:

Nestle has its well known coffee brand Nescafé Gold that, in average, sells at 6.49€. However, the same brand has created a variance of this kind of product with a different name, brand and positioning: Belmont Gold, which is sold at 3.29€.

Due to its huge capacity of production, Nestlé intended to create a new brand that could reach a different type of customers in a different and much lower price. With this strategic option, Nestle can not only cover its fixed costs as also satisfy a new segment.

Periodic discounting

In markets that have unpredictable demand, the periodic discounting (that includes price skimming) might seem like a secure way of getting its production costs covered.

This strategy consists in differentiating the price of the same product in different time spaces and for different types of costumers. In the beginning of the selling period, the company starts by putting a high price to its product or service, usually having a big margin. However, and it has not to be necessarily in a year, the price gets slowly lower and, sometimes, in the end of the product life cycle, it is being sold with a minimal margin, reaching the customer "reservation price", the value of a product to a customer.

By doing this, the company can not only stabilize demand (because it is usually applied to "one time buy" products) but also can discriminate prices for early adopters, covering its fixe cost in a faster manner (for example, at the 3rd month of sells, the company may have already 70% of the profits).

This kind of pricing strategy is very predictable and sometimes the customers themselves already know that it will happen, but because there are different kind of need (fast or more rational) for a product, it is nor a disadvantage. It is vey common to happen with airplane tickets, game consoles (like Playstation or Xbox) or even happy hour drinks in a party.

Example:

In 2007, the release price in Portugal of Playstation 3 (Ps3), Sony's game console, was on average 650€. However, periodically, Sony reduced its price, and today (5 years passed) it is nearly 350€ in its "slim" version.

Even though the same situation had happened with the release of Ps2, there were thousands of people waiting in line to be the first ones to get the new console, happily spending much more than the minimum wage for a game console.

By doing this all over the world, Sony had the capacity to gain a huge margin in its first years of sales and also nowadays can reach a more reserved and a spender segment.

Random discounting

The strategy known as random discounting has a lot to do with customer search and its search costs.This is the third type of differential pricing and its objective is to descriminate the customers buy its cost of search for a different price.

Some customers are more rational and more price sensitive, so they will perceive their benefit of finding a lower price as much superior when comparing to the time they spend looking for an alternative. They are the informed customers.

In the other hand, there are some customers that due to their price insentivity or to having less time for shopping, buy the first product that they see. These are the uninformed customers.

By doing a random discounting, for example, stablishing a lower price A and a higher price B, the company makes sure that the informed customers will buy their products because this price A will be lower than its competitors. At the same time, by having a price B, the company ensures that there will be some uninformes customers that will buy at a higher price, providing a higher margin.

Example:

A new type of business that is emerging are the “discounting websites”, where it provides some daily or weekly products at a very low price (sometimes 70% discount). These kind of websites put in their platform some products from companies that use the random discounting strategy.

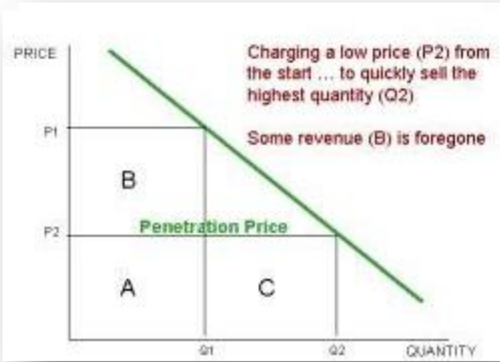
The most informed and price sensitive customers will frequently use this websites (like groupon, planeo, etc.), being a way to the companies to discriminate by segment. The uninformed custumers don’t have the time or the patience to search in this web pages, being able to pay a higher price at local stores.

Competitive Pricing

Competitive Pricing is used more often by businesses selling similar products, since services can vary from business to business while the attributes of a product remain similar.

Inside this Competitive Pricing, there are four main strategies. First, the Penetration pricing; in second place, the Experience Curve Pricing; in third place, the Price Signalling; and at last, the Geographic Pricing.

Penetration Pricing



Penetration pricing is a marketing strategy used by companies to attract customers to a new product or service. This strategy consists by offering a low price for a new product or service during its initial offering in order to leave customers away from competitors. The reason behind this marketing strategy is that customers will buy and become conscious of the new product owing to its lower price in the marketplace relative to rivals.

This strategy pricing can be a successful marketing strategy when applied correctly. It can often increase both market share and sales volume. It calls for a sacrifice of short-term profits in order to establish a certain amount of market share. One objective is to obtain a committed customer. Farther, the high sales volume can also lead to lower production costs and higher inventory turnover, both of which are positive for any company with fixed overhead.

Developing your product or service and increasing sales typically involves market penetration. Market penetration refers to the successful selling of a product or service in a specific market. Companies that establish an effective market penetration strategy can ultimately increase their customer base and the quantity of products sold. As any strategy, this one has advantages and disadvantages.

The main advantage is the gain market share, the increasing sales and volume product, the product diffusion and the formation of a hedge that discourages the entry in the market by other competitors.

The chief disadvantage, however, is that the increase in sales volume may not necessarily lead to a profit if prices are kept too low. As well, if the price is only an introductory campaign, customers may leave the brand once prices begin to rise to levels more in line with rivals.

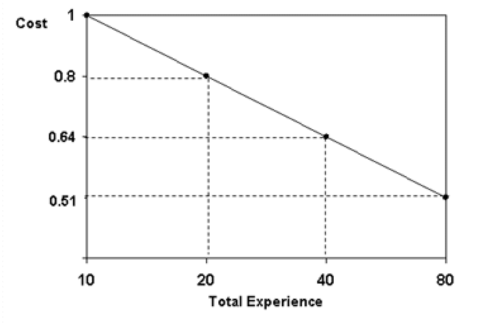
Example:

This is an example of "Penetration Price Strategy", is a Wal-Mart's Backyard Grill with a price of $18, 97. Wal-Mart use penetration pricing in two ways. First, they offer new products through their stores at prices much lower than other stores, waiting that you will buy more than that one product once you come in the store.

They are prepared to lose money on the new product as a way to get more customers through the door. They use penetration pricing in new geographic markets by underselling their more well-established competitors. When they have a loyal customer base, they normally begin to gradually increase prices.

Experience Curve Pricing

Experience Curve Pricing is a strategy where there are a competitive market, a price sensitive customers and a large experience of the industry.



A market leader will usually have greater demand for its goods and services than its competition. As a result of increased production, the Experience Curve suggests its costs will decrease over time. This will allow the company to decrease its prices to levels below what is sustainable for the competition, resulting in increased competitive advantage. As the cycle repeats itself the company should continue to strengthen its overall position.

Of course this reduction in cost as volume increases does not happen automatically. The relationship is the result of conscious actions taken by management to actively bring down costs over time, usually in the face of competitive pressures. Thus, one can think of the Experience Curve relationship as the result of a company fully realizing it's potential.

There are some advantages on this strategy. First, the competitors can't follow the company so they will quit the market. Is also important, the hypothesis of the experienced company could acquire new market. In third, the possibility of new customers enters in the market. At last, the fact of with this strategy the company will sacrifice itself, but, nevertheless, could be quickly sustainable.

Example:

Bausch & Lomb

This is an example of Experience Curve Pricing, is Bausch & Lomb (creator of the Ray-Ban glasses) that has consolidated its position in soft contact lenses by automating, using computerized lens design. Its market share climbed from 55% in 1980 to 65% in 1983 and now earns gross margins 20 to 30 percentage points higher than its competitors.

What distinguishes the winners from the losers in the experience curve game is their achievement of both the logic of the experience curve and the characteristics of the competitive arena that determine its suitability as a strategic weapon. And in this case, Bausch & Lomb known how implement the strategy, driving off some competitors off the market.

Price Signaling

Price Signaling is an explicit or implicit agreement among competitors to fix prices through coordinated action among participants, eliminating competition and raising product prices, obtaining higher profits to the detriment of consumer welfare.

This strategy generate a premium estimated at between 10% and 20% compared to the price in a competitive market, causing losses of hundreds of billions of dollars annually to consumers.

Consequently, it has born an interesting problem. In terms of economic incentives, and when combined with the partners a certain price to sell, each member has an advantage in deceiving partners, break this agreement and sell more and cheaper, stealing customers to competitors. Therefore, this normally ends with price wars. The problems of some companies that use this strategy usually result from bad behavior of its participants, which is motivated by this incentive to stick the agreement.

So, this strategy, now illegal, is considered the most serious injury to competition and harms consumers by raising prices and restricting supply, thus making goods and services more expensive or unavailable.

Example:

In Portugal, the “competition law” forbids colligations between companies that have the objective of settle prices or other elements that disturb the normal operation of the market. However, one of the most difficult to be regulated is the market of petroleum and the petrol stations.

One example of Price Signaling is the Portuguese petrol stations (Galp Energia, BP and Repsol). Although, they say the opposite is clear as water. The price of the tree gas stations change exactly at the same and exactly time, having the same price (sometimes a minimum difference).

Geographic Pricing

Geographic Pricing is a variable pricing method in which a selling price is computed according to the customer's or market's distance or transportation costs incurred.

Geographic pricing can be seen like a selling strategy that involves consideration of the average cost of goods in a given geographic area as well as the expenses incurred to transport those goods to the point of sale. Using the data related to the location and the amount of cost involved in providing goods to that area, the manufacturer or seller will determine a unit price that covers all expenses and also allows for the generation of an equitable amount of profit. As with any type of pricing, the final figure in geographic pricing will also be impacted by the demand for the goods in question and how many competitors are offering similar products in the area.

The companies have five options to settle the prices.

First, through "FOB", that's when the company decides to charge a large amount because, they claim for additional shipping fee.

Second, through uniform delivered price, when the markets share the transportation cost (the company take the same price in both zones).

Third, trough freight absorption cost, when the company take a higher price for the foreign market because the competitive price is settled lower than the company would choose to, if she added the transportation cost. This is the opposite of the first one, "FOB".

Fourth, trough basing point pricing, when certain cities are designated as basing points, and all goods shipped from a given basis point are charged the same amount. At last, trough zone pricing, when prices increase as shipping distances increase. This is sometimes done by drawing concentric circles on a map with the plant or warehouse at the center and each circle defining the boundary of a price zone.

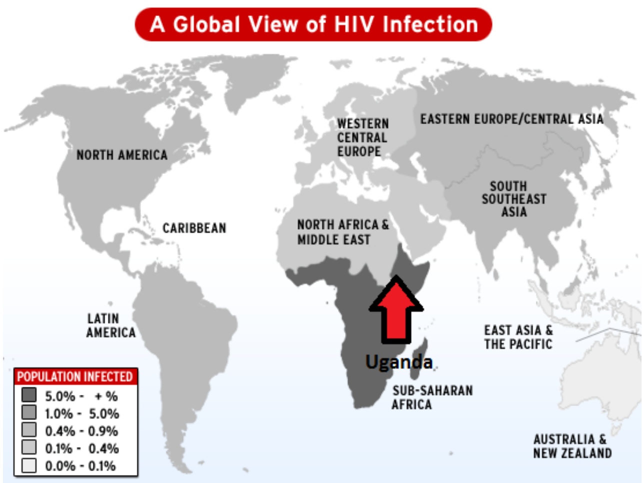
Example:

An example of price discrimination exists in the market for protease inhibitors and other AIDS drugs. Cipla (an Indian Pharmaceutical Company) is an example of Geographic Pricing.

It all started with the famous case of Uganda and the high price of AIDS drugs. The prices of AIDS drugs in Norway were lower than the prices available in Uganda. A simple reading of price discrimination theory would lead one to expect that Norway would have higher prices, because its citizens' incomes were much higher and, thus, their demand for AIDS drugs would be much more inelastic than the demand for AIDS drugs in Uganda.

The number of AIDS cases in Norway was relatively low and the causes tend to be concentrated among those with the lowest incomes, where substantial elasticity exists. In Uganda, the incidence of AIDS is much higher. Most Ugandans couldn't afford AIDS medication even at Norwegian prices. After substantial political pressure was brought to bear, prices in Africa were reduced.

Cipla, a big producer of such generic drugs, needed a new factory site in a least developed country so it could keep selling its wares. Cipla decided on a site in Kampala due to the East African nation's high prevalence of HIV and malaria and its business-friendly environment.



The plant (with that is produced the generic drugs) followed the most advanced manufacturing practices. Still, the cost of production in Uganda was much lower than in Europe, the U.S., or even India. With lower production costs and an exemption from patent regulations, the new plant could sell its drugs for as little as 5% the cost of imports.

Product line pricing strategies

In order to increase the sales, sometimes companies face themselves with the option of selling different products that can be assimilated, creating different prices for different benefits. A product with more benefits (extras) will be more expensive.

By doing this, a company can create not only the idea that sells a lot of products but also that their services are personalized.

Price Bundling

Price Bundling is a part of product line pricing strategies. This is used when a firm is in front of heterogeneity of demand for nonsubstitute, perishable products. This strategy is interested in consumers to buy at the price bundle. It is easy to be broken out with different perceived value for more than two products. For example, firm a produce product A and B. The firm selects high prices as much as they can sell, then make bundle to maximize more profit for customers who want to buy both products when perceived values by consumers were different.

Through this, all consumers and sellers can be more satisfied with the mixed bundling strategy than with the pure pricing. Profit maximizing strategy uses making package of products. The mixed bundling strategy has the added advantage of creating the reference price effect. This strategy is usually used in season tickets, buffet dinners, packages of stereo equipment, and packages of options on automobiles.

Example:

The example of price bundling is Haagen-dazs. This company is famous as ice cream which is focusing on consumers who can pay high price to high quality. It sells one scoop of ice cream as 2.75 euros and coffee as 1 euro. But if you buy two products, you can get it with 3 euros. Consumer can buy bundle with relatively cheap price, and this firm can maximize its profit.

Premium Pricing

Premium pricing is that exploits consumer heterogeneity of demand for substitute products with joint economies of scale. Being relative to its costs, the firm takes a premium on its higher priced version. But, because of exploiting joint economies of scale and the heterogeneity of demand, it can profitably produce and sell the products.

Premium pricing is used in durable goods, such as appliances, for which multiple versions differing in price and features cater to different consumer segments, exclusive perfumes, insurance policies, rear auditorium seating, deluxe and basic hotel rooms. This strategy emphasizes segment differences by pricing substitutes differently, and holds for any one time and the price variation is over related models. In retail, Premium pricing is used for enabling retailers to carry some otherwise unprofitable products desired only by select segments.

Example:

One of examples of Premium pricing is seats at football match in stadium. It has R(Royal), S(Special), A, B seats with various prices. Up to distance and condition, the prices are becoming different. For instance, in Korean football match season, R seats are higher than 100,000\ in football match, S are around 70,000\. Seats are sold at about 50,000, and B seats are lower than 30,000\. Through providing seats with different price, it makes segment differences. In addition, stadium holds for any one time and the price variation.

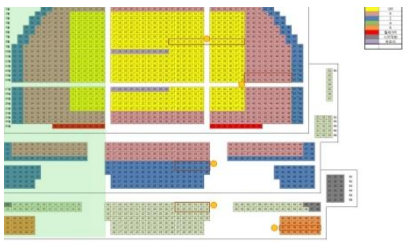
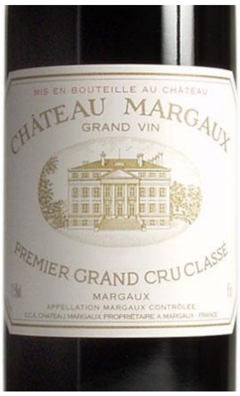


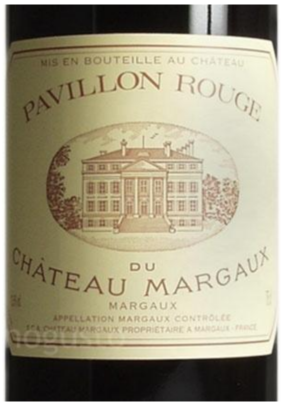
Image Pricing

A company can bring out an identical version of its current product with a different name and a higher price. The intention for using this strategy is to signal quality of products. There is this strategy between price signalling and premium pricing.

A firm needs to use the higher priced products to signal quality for consumers who don't know about products well. Also, this firm requires using the profit subsidizing the price on the products which is low price makes on the higher priced version. In this strategy, prices are different over different brands of the same firm's product line. This pricing strategy can be useful in prices of alternative brands of cosmetics, soaps, dresses.

Example:





Chateau Margaux winery which is a winery in France, produces a few kinds of wines. The famous one is 'Chateau Margaux' and another one is Pavillon Rouge Du Chateau Margaux, the second label of Chateau Margaux . Chateau Margaux was sold at 100,000￥ in 2005. However, the second label wine was bought at 30,000￥. These two wines are made by same procedure, but because of image, they have very big price gap. Through this strategy, Chateau Margaux can be recognized as a very good quality wine.

Complementary Pricing

Complementary pricing includes captive pricing, two-part pricing, and loss leadership.

Captive pricing is that a firm would have to include as costs a discount for future earnings and the risk that consumers would not purchase supplies. This strategy has limit if consumers are not source loyal and would like not to buy supplier likes from the original source even at a higher price.

Two-part pricing has fixed fee plus variable usage fees. This strategy can be used in libraries, health or entertainment clubs, amusement park, or rental agencies.

Loss leadership includes decreasing the price on a famous brand to generate store traffic. The discount price should be big gap for compensating consumers for the transaction cost such as letting extra time. For concrete a success using this pricing strategy, retailers feature several “super buys”, products of national brands sold below cost.

Example:

1. **Captive pricing**

In Korea, There is a company named Woongjin Coway renting water purifier. This company rents water purifier making contract. In this contract, consumers have to deposit some money, and should pay monthly then company rents the machine with maintaining service. After 3 years, company gives this water purifier to the consumer.

2. **Two-part pricing**

If a exchange student wants use cell phone, he or she has to pay 5 euros as a basic fixed fees, and then needs to pay more for using SMS, internet, and calling.

3. **Loss leadership**

The example of loss leadership is outlet of specific brand. One of example of this pricing strategy is PRADA, very well-known as a luxury brand. PRADA has its own outlet, the PRADA SPACE. If you go there, you can buy the products with more than 50% discounts.

PRADA

Conclusion

According to the firm's type of clients, demand and vision, a clear pricing strategy must be elaborated in order to maximize its profits under its constraints. The price, has we saw, represents much of the product or service image and positioning, being a critical factor to determine wheter a company has a successful or unsuccsseful path.

With this work we hope to have identified the most important pricing strategies in a clear manner, supported by pertinent and appliable examples.