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14

## Arriving at the Final Price

## LEARNING OBJECTIVES

After reading this chapter you should be able to:

**LO 14-  
1**

Describe how to establish the “approximate price level” using demand-oriented, cost-oriented, profit-oriented, and competition-oriented approaches.

**LO 14-  
2**

Recognize the major factors considered in deriving a final list or quoted price from the approximate price level.

**LO 14-  
3**

Identify the adjustments made to the approximate price level on the basis of discounts, allowances, and geography.

**LO 14-  
4**

Name the principal laws and regulations affecting specific pricing practices.

## **E-books and E-conomics: A Twisted Tale of Pricing for Profit**

Have you ever wondered why e-book prices are set a few dollars or cents under an even number, such as \$19.99? Or, from a business standpoint, does a publisher make less profit on an e-book than a printed book given the price difference? These questions may not keep you awake at night, but the answers may surprise you.

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## **Setting the Stage with E-readers: Amazon's Kindle**

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One of the most disruptive changes in the book publishing industry has been the transition from print to electronic books, or e-books. The change wasn't initiated by book publishers, but by Amazon in 2007 with the introduction of its Kindle e-reader. Its innovation was quickly followed by Barnes & Noble with its Nook e-reader in 2009. Apple entered the e-book market in 2010 when it introduced the iPad.

Amazon executives knew that for Kindle e-readers to be successful, printed books had to be converted to e-books quickly. This conversion would supply content for Kindle e-readers, thus increasing their value to consumers. One way to do this was to make e-books cheaper than printed books through advances in digital technology. However, the traditional approach to print book pricing stood in the way. The solution? Change the approach to book pricing, of course! This is when the twisted tale of e-book pricing for profit begins.

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## **Printed Book Pricing Practices**

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The approach for pricing printed books was steeped in tradition. Based on forecasted demand, a publisher would set a price to a distributor like Amazon (usually 50 percent of the publisher's suggested retail

price). The distributor would sell the book to consumers at whatever price the distributor chose. A publisher would then subtract its unit variable costs, such as unit manufacturing (paper and ink), freight and handling cost, and author royalties (about 15 percent of the price) to arrive at its unit contribution per printed book. At a \$20.00 suggested retail price (\$10.00 to the distributor), the publisher would typically record a \$4.40 unit contribution. This amount would be used to pay the total fixed costs assigned to the printed book and produce a profit.

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## **Enter E-books**

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The dynamics in the e-book market proved to be quite different from the printed book market. For example, traditional distributors, such as bookstores, had an incentive to set a printed book's retail price from the publisher higher. In contrast,

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e-reader suppliers, such as Amazon, wanted lower retail prices for e-books to build the e-reader business. Therefore, Amazon initially decided to set a retail price for e-books at \$9.99—a common decision based on belief that this act would stimulate e-book volume. This meant that Amazon would lose money on many e-book transactions: paying \$10.00 for an item and then selling it for \$9.99 presented a problem. At the same time, publishers believed that low e-book prices promoted by Amazon and other distributors would erode consumers' perception of the value of books, cannibalize printed book sales, and eventually result in lower prices charged to distributors. In short, neither party benefited.

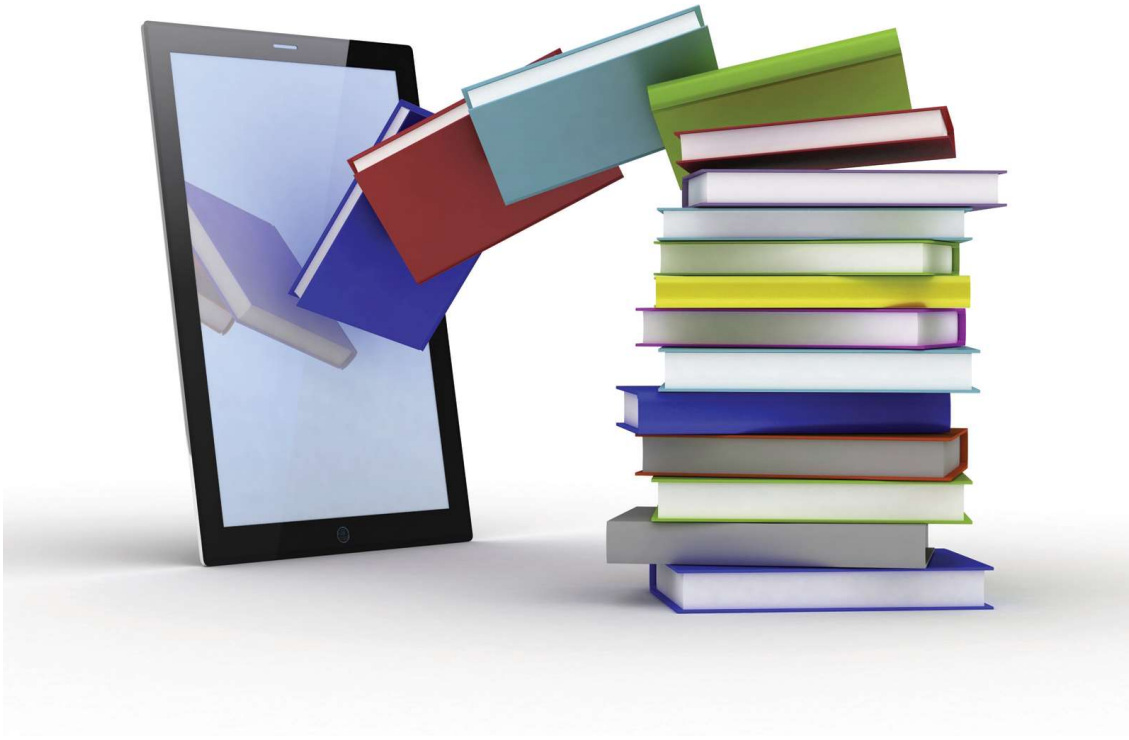
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## **Pricing E-books...Profitably**

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In 2010, book publishers changed their pricing approach. Publishers would set e-book list retail prices, and distributors, like Amazon, Barnes & Noble, or Apple, would get a commission on every e-book sold. The commission was usually 30 percent. Distributors could still set their own retail prices, but with a restriction. Distributors could set prices below a publisher's retail list price so long as they did not exceed the commission received from a publisher. Therefore, the most a publisher's retail list price of \$20.00 could be discounted was \$14.00. But consumers didn't see that retail price. Amazon and Apple usually set a price with an odd-ending number like 5, 7, or 9 as a matter of policy. The zeros in \$14.00 would be replaced by one or more of these numbers, or \$14.99.

So how do publishers and distributors make a profit using this approach to pricing? Suppose a publisher's retail list price for an e-book is \$20.00. The distributor's e-book retail price is set at \$14.99. The publisher would get 70 percent of \$14.99, or \$10.49, and the distributor would get \$4.50. The publisher has no unit manufacturing, freight, or handling cost, just an author royalty, which drops to about

\$2.62. Therefore, the publisher's unit contribution per e-book is \$7.87 ( $\$10.49 - \$2.62$ ) to pay the total fixed costs assigned to the e-book and record a profit. Remember that a publisher's unit contribution for a printed book was \$4.40. In short, both e-book distributors and publishers benefit from this pricing approach because both parties make a profit. Now you know a little bit more about e-book economics and the twisted tale of profitable pricing.<sup>1</sup>

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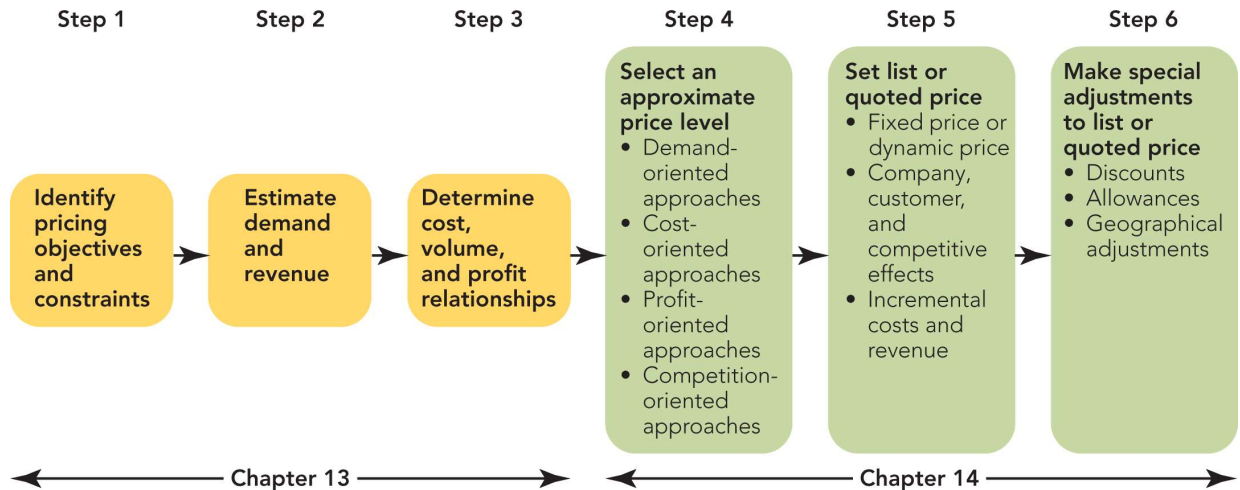
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## STEP 4: SELECT AN APPROXIMATE PRICE LEVEL

### LO 14-1

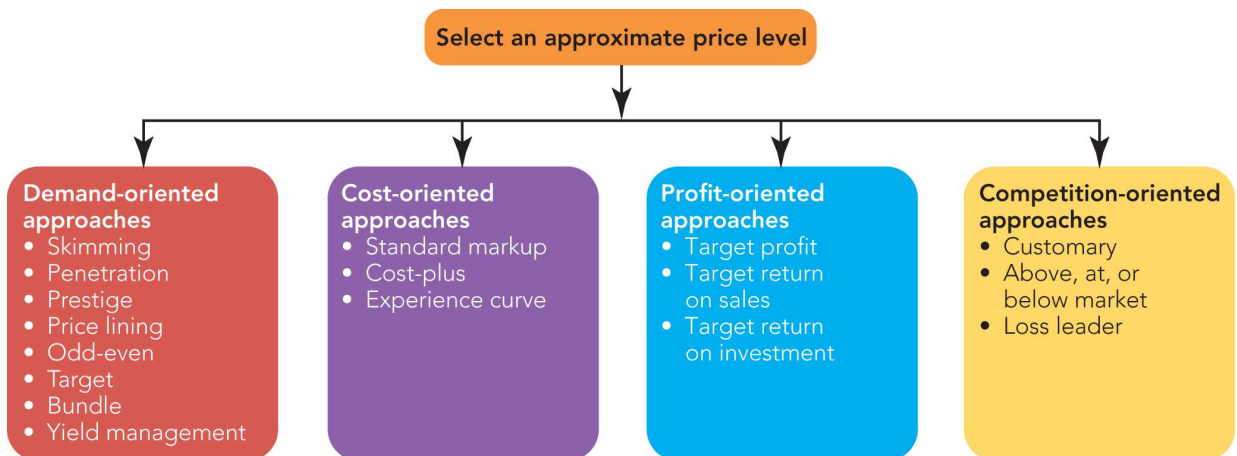
Describe how to establish the “approximate price level” using demand-oriented, cost-oriented, profit-oriented, and competition-oriented approaches.

This chapter describes how companies set an approximate price level for their offerings, highlights important considerations in setting a list or quoted price, and identifies various price adjustments that can be made to prices set by a company—the last three steps involved in setting prices (**Figure 14-1**). Legal and regulatory aspects of pricing are also described.



**Figure 14-1** The six steps in setting price. The first three steps were covered in **Chapter 13**, and the last three steps are covered in this chapter.

A key for a marketing manager setting a final price for a product is to find an approximate price level to use as a reasonable starting point. Four common approaches to helping find this approximate price level are (1) demand-oriented, (2) cost-oriented, (3) profit-oriented, and (4) competition-oriented approaches (see **Figure 14-2**). Although these approaches are discussed separately below, some of them overlap, and a seasoned marketing manager will consider several in selecting an approximate price level.



**Figure 14-2** Four approaches for selecting an approximate price level.

## Demand-Oriented Pricing Approaches

Demand-oriented approaches weigh factors underlying expected customer tastes and preferences more heavily than such factors as cost, profit, and competition when

selecting a price level.

## Skimming Pricing

A firm introducing a new or innovative product can use **skimming pricing**, setting the highest initial price that customers who really desire the product are willing to pay. These customers are not very price sensitive because they weigh the new product's price, quality, and ability to satisfy their needs against the same characteristics of substitutes. As the demand of these customers is satisfied, the firm lowers the price to attract another, more price-sensitive segment. Thus, skimming pricing gets its name from skimming successive layers of "cream," or customer segments, as prices are lowered in a series of steps.

Skimming pricing is an effective strategy when (1) enough prospective customers are willing to buy the product immediately at the high initial price to make these sales profitable, (2) the high initial price will not attract competitors, (3) lowering price has only a minor effect on increasing the sales volume and reducing the unit costs, and (4) customers interpret the high price as signifying high quality. These four conditions are most likely to exist when the new product is protected by patents or copyrights or its uniqueness is understood and valued by consumers. Gillette, for example, adopted a skimming strategy for its five-blade Fusion brand shaving system since many of these

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conditions applied. The Gillette Fusion shaving system has 70 patents that protect its product technology.

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## Penetration Pricing

Setting a low initial price on a new product to appeal immediately to the mass market is **penetration pricing**, the exact opposite of skimming pricing. Amazon consciously chose a penetration strategy when it introduced its Amazon Kindle Fire tablet computer at \$199 when competitive models were priced at \$499.<sup>2</sup>

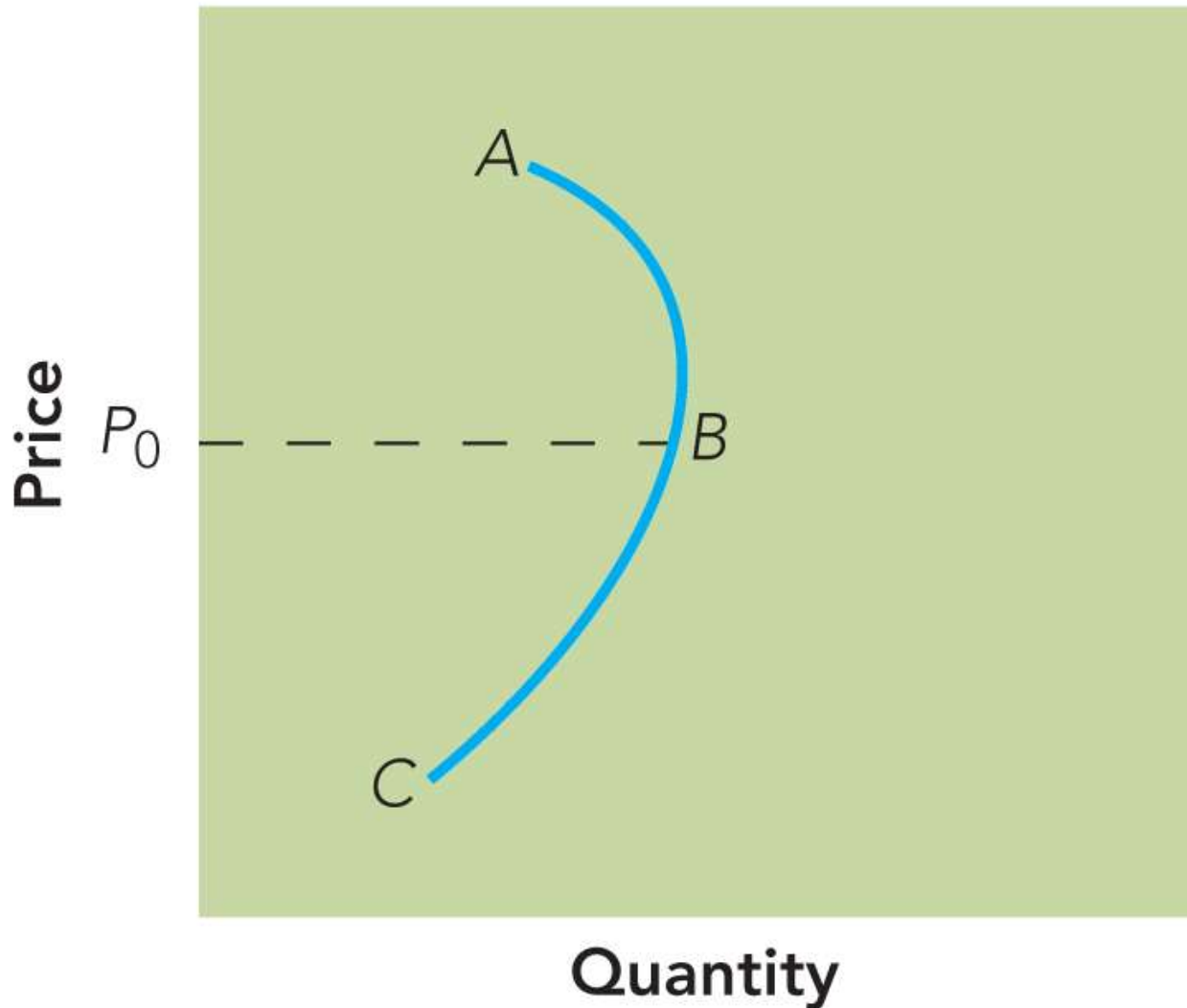
The conditions favoring penetration pricing are the reverse of those supporting skimming pricing: (1) many segments of the market are price sensitive, (2) a low initial price discourages competitors from entering the market, and (3) unit production and marketing costs fall dramatically as production volumes increase. A firm using penetration pricing may (1) maintain the initial price for a time to gain profit lost from its low introductory level or (2) lower the price further, counting on the new volume to generate the necessary profit.

In some situations, penetration pricing may follow skimming pricing. A company might initially price a product high to attract price-insensitive consumers and recoup initial research and development costs and introductory promotional expenditures. Once this is done, penetration pricing is used to appeal to a broader segment of the population and increase market share.<sup>3</sup>

## Prestige Pricing

As noted in **Chapter 13**, consumers may use price as a measure of the quality or prestige of an item so that as price is lowered beyond some point, demand for the item actually falls. **Prestige pricing** involves setting a high price so that quality- or status-conscious consumers will be attracted to the product and buy it (see **Figure 14–3**). The demand curve slopes downward and to the right between points *A* and *B* but turns back to the left between points *B* and *C* because demand is actually reduced between points *B* and *C*. From *A* to *B*, buyers see the lowering of price as a bargain and buy more; from *B* to *C*, they become dubious about the quality and prestige and buy less. A marketing manager's pricing strategy here is to stay above price  $P_0$  (the initial price).

## Prestige pricing demand curve



**Figure 14-3** For prestige pricing, the demand curve for high-quality products bought by status-conscious consumers is backward sloping.

### VIDEO 14-1

#### Rolex Ad

[kerin.tv/13e/v14-1](http://kerin.tv/13e/v14-1)

Rolls-Royce cars, Chanel perfume, Cartier jewelry, Lalique crystal, and Swiss watches, such as Rolex, have an element of prestige pricing in them and may sell worse at lower prices than at higher ones.<sup>4</sup> The recent success of Swiss watchmaker TAG Heuer is an example. The company raised the average price of its watches from \$250 to \$1,000, and its sales volume jumped sevenfold.<sup>5</sup> Recently, Energizer learned that buyers of high-performance alkaline batteries tend to link a lower price with lower quality. The Marketing Matters box on the next page describes the pricing lesson learned by Energizer.<sup>6</sup>

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## Marketing Matters

customer  
value

### **Energizer's Lesson in Price Perception—Value Lies in the Eye of the Beholder**

Battery manufacturers are as tireless as a certain drum-thumping bunny in their efforts to create products that perform better, last longer, and, not incidentally, outsell the competition. The commercialization of new alkaline battery technology at a price that creates value for consumers is not always obvious or easy. Just ask the marketing executives at Energizer about their experience with pricing Energizer Advanced Formula and Energizer e<sup>2</sup> AA alkaline batteries.



© Scott Boehm/AP Images

When Duracell launched its high-performance Ultra brand AA alkaline battery with a 25 percent price premium over standard Duracell batteries, Energizer quickly countered with its own high-performance battery—Energizer Advanced Formula. Believing that consumers would not pay the premium price, Energizer priced its Advanced Formula brand at the same price as its standard AA alkaline battery, expecting to gain market share from Duracell. It did not happen. Why? According to industry analysts, consumers associated Energizer's low price with inferior quality in the high-performance segment. Instead of gaining market share, Energizer lost market share to Duracell and Rayovac, the number three battery manufacturer.

Having learned its lesson, Energizer subsequently released its e<sup>2</sup> high-performance battery, this time priced 4 percent higher than Duracell Ultra and about 50 percent

higher than Advanced Formula. The result? Energizer recovered lost sales and market share. The lesson learned? Value lies in the eye of the beholder.

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## Price Lining

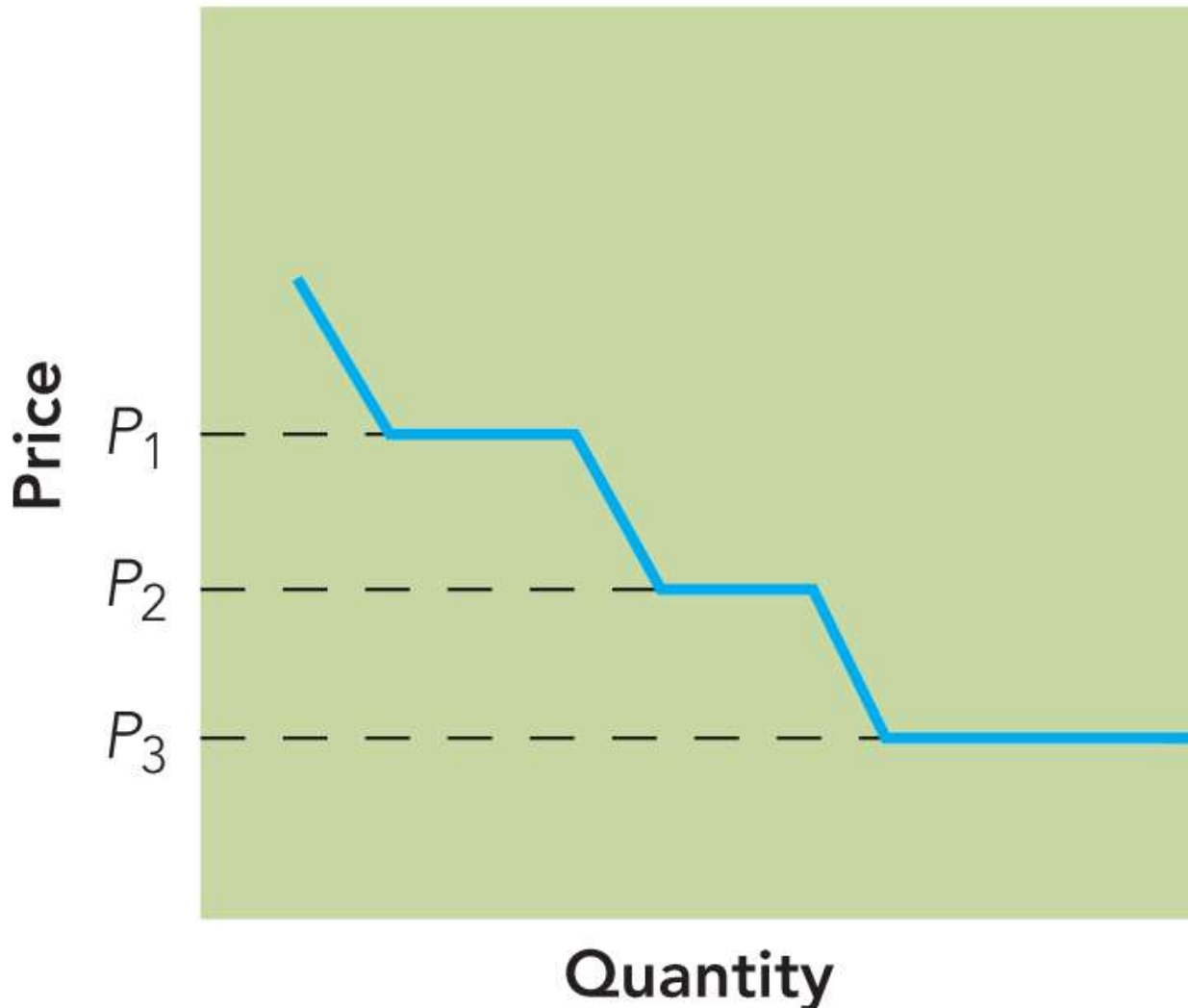
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Often a firm that is selling not just a single product but a line of products may price them at a number of different specific pricing points, which is called **price lining**. For example, a department store manager may price a line of women's casual slacks at \$59, \$79, and \$99. As shown in **Figure 14-4**, this assumes that demand is elastic at each of these price points but inelastic between these price points. In some instances, all the items might be purchased for the same cost and then marked up at different percentages to achieve these price points based on color, style, and expected demand. In other instances, manufacturers design products for different price points, and retailers apply approximately the same markup percentages to achieve the three or four different price points offered to consumers. Sellers often feel that a limited number of price points (such as 3 or 4) are preferable to 8 or 10, which may only confuse prospective buyers.<sup>7</sup>

## Price lining demand curve



**Figure 14-4** For price lining, the demand curve is elastic at each price point but inelastic between price points.

### Odd-Even Pricing

Sears offers a Craftsman radial saw for \$499.99, the suggested retail price for the Gillette Fusion shaving system is \$11.99, and Amazon sold a recent U2 CD for \$3.99. Why not simply price these items at \$500, \$12, and \$4, respectively? These firms are using **odd-even pricing**, which involves setting prices a few dollars or cents under an even number. The presumption is that consumers see the Craftsman radial saw as priced at “something over \$400” rather than “about \$500.” In theory, demand increases if the

price drops from \$500 to \$499.99. There is some evidence to suggest this does happen. However, research suggests that overuse of odd-ending prices tends to mute its effect on demand.<sup>8</sup>



Which pricing strategy is used by DIRECTV?  
Read the text to find out which one and why.

Source: DIRECTV

wholesalers to determine what price they can charge wholesalers for the product. This practice, called

## Target Pricing

Manufacturers will sometimes estimate the price that the ultimate consumer would be willing to pay for a product. They then work backward through markups taken by retailers and

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**target pricing**, results in the manufacturer deliberately adjusting the composition and features of a product to achieve the target price to consumers.

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## Bundle Pricing

A frequently used demand-oriented pricing practice is **bundle pricing**—the marketing of two or more products in a single package price. For example, Delta Air Lines offers vacation packages that include airfare, car rental, and lodging. Bundle pricing is based on the idea that consumers value the package more than the individual items. This is due to benefits received from not having to make separate purchases and enhanced satisfaction from one item given the presence of another. This is the idea behind McDonald's Extra Value Meal and DIRECTV's TV, phone, and Internet bundles. Moreover, bundle pricing often provides a lower total cost to buyers and lower marketing costs to sellers.<sup>9</sup>

## Yield Management Pricing

Have you noticed seats on airline flights are priced differently within coach class? This is **yield management pricing**—the charging of different prices to maximize revenue for a set amount of capacity at any given time. As described in **Chapter 12**, service businesses engage in capacity management, and an effective way to do this is by varying prices by time, day, week, or season. Yield management pricing is a complex approach that continually matches demand and supply to customize the price for a service. Airlines, hotels, cruise ships, and car rental companies frequently use it. American

Airlines estimates that yield management pricing produces an annual revenue that exceeds \$500 million.<sup>10</sup>

## learning review

- 14- In pricing a new product, what circumstances might support
  1. skimming or penetration pricing?
  - 14- What is odd-even pricing?
  - 2.

## Cost-Oriented Pricing Approaches

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



What are the markups for soft drinks, candy, and popcorn at your movie theater? Read the text to learn what the markup is on these items.

© andresr/E+/Getty Images

## Standard Markup Pricing

Managers of supermarkets and other retail stores have such a large number of products that estimating the demand for each product as a means of setting price is impossible. Therefore, they use **standard markup pricing**, which entails adding a fixed percentage to the cost of

all items in a specific product class. This percentage markup varies depending on the type of retail store (such as furniture, clothing, or grocery) and the product involved. High-volume products usually have smaller markups than low-volume products.

Supermarkets such as Kroger and Safeway have different markups for staple items and discretionary items. The markup on staple items such as sugar, flour, and dairy products varies from 10 percent to 23 percent. Markups on discretionary items like snack foods and candy range from 27 percent to 47 percent. These markups must cover all of the

expenses of the store, pay for overhead costs, and contribute something to profits.  
Although these

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markups may appear very large, they result in only a 1 percent profit on sales revenue, assuming the supermarket is operating efficiently. Page 376

By comparison, consider the markups on snacks and beverages purchased at your local movie theater. The markup is 87 percent on soft drinks, 65 percent on candy bars, and 90 percent on popcorn. These markups might sound high, but consider the consequences. “If we didn’t charge as much for concessions as we did, a movie ticket would cost \$20,” says the CEO of Regal Entertainment, the largest U.S. theater chain.<sup>11</sup>

## Cost-Plus Pricing

Many manufacturing, professional services, and construction firms use a variation of standard markup pricing. **Cost-plus pricing** involves summing the total unit cost of providing a product or service and adding a specific amount to the cost to arrive at a price. Cost-plus pricing generally assumes two forms. With *cost-plus percentage-of-cost pricing*, a fixed percentage is added to the total unit cost. This is often used to price one- or few-of-a-kind items, as when an architectural firm charges a percentage of the construction costs of, say, the \$92 million Rock and Roll Hall of Fame and Museum in Cleveland, Ohio.

In buying highly technical, few-of-a-kind products such as hydroelectric power plants or space satellites, governments have found that general contractors are reluctant to specify a formal, fixed price for the procurement. Therefore, they use *cost-plus fixed-fee pricing*, which means that a supplier is reimbursed for all costs, regardless of what they turn out to be, but is allowed only a fixed fee as profit that is independent of the final cost of the project. For example, suppose the National Aeronautics and Space Administration



How was the price of the Rock and Roll Hall of Fame and Museum determined? Read the text to find out.

© Stan Rohrer/Alamy

Rock and Roll Hall of Fame and Museum [www.rockhall.com](http://www.rockhall.com)

method is finding favor among business-to-business marketers in the service sector. For example, the rising cost of legal fees has prompted some law firms to adopt a cost-plus pricing approach. Rather than billing business clients on an hourly basis, lawyers and their clients agree on a fixed fee based on expected costs plus a profit for the law firm. Many advertising agencies now use this approach. Here, the client agrees to pay the agency a fee based on the cost of its work plus some agreed-on profit, which is often a percentage of total cost.

## Experience Curve Pricing

The method of **experience curve pricing** is based on the learning effect, which holds that the unit cost of many products and services declines by 10 percent to 30 percent each time a firm's experience at producing and selling them doubles. This reduction is regular or predictable enough that the average cost per unit can be mathematically estimated. For example, if the firm estimates that costs will fall by 15 percent each time volume doubles, then the cost of the 100th unit produced and sold will be about 85 percent of the cost of the 50th unit, and the 200th unit will be 85 percent of the 100th unit. Therefore, if the cost of the 50th unit is \$100, the 100th unit would cost \$85, the 200th unit would be \$72.25, and so on. Because prices often follow costs with experience curve pricing, a rapid decline in price is possible.

Japanese, Korean, and U.S. firms in the electronics industry often adopt this pricing approach. This cost-based pricing approach complements the demand-based pricing strategy of skimming followed by penetration pricing. For example,

agreed to pay Lockheed Martin \$4 billion as the cost for its Orion lunar spacecraft and agreed to a \$6.5 billion fee for providing the lunar spacecraft in 2016. Even if Lockheed Martin's cost increased to \$5 billion for the lunar spacecraft, its fee would remain at \$6.5 billion.

Cost-plus pricing is the most commonly used method to set prices for business products. Increasingly, however, this

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Sony, Samsung, LG, VIZIO, and other television manufacturers use experience Page 377  
curve pricing for HDTV sets. Consumers benefit because prices decline as cumulative sales volume grows. In fact, HDTV prices have fallen by 40 percent in the past decade.<sup>12</sup>

## Profit-Oriented Pricing Approaches

A price setter may choose to balance both revenues and costs to set price using profit-oriented approaches. These might either involve setting a target of a specific dollar volume of profit or expressing this target profit as a percentage of sales or investment.

### Target Profit Pricing

A firm that sets an annual target of a specific dollar volume of profit is using a **target profit pricing** approach. As the owner of a picture framing store, suppose you decide to use target profit pricing to establish a price for a typical framed picture. First, you need to make some assumptions, such as:

- Variable cost is a constant \$22 per unit.
- Fixed cost is a constant \$26,000.
- Demand is insensitive to price up to \$60 per unit.
- A target profit of \$7,000, at an annual volume of 1,000 units (framed pictures).

You can then calculate price as follows:

$$\begin{aligned}
 \text{Profit} &= \text{Total revenue} - \text{Total cost} \\
 \text{Profit} &= (P \times Q) - [\text{FC} + (\text{UVC} \times Q)] \\
 \$7,000 &= (P \times 1,000) - [\$26,000 + (\$22 \times 1,000)] \\
 \$7,000 &= 1,000P - (\$26,000 + \$22,000) \\
 1,000P &= \$7,000 + \$48,000 \\
 P &= \$55
 \end{aligned}$$

Note that a critical assumption is that this higher average price for a framed picture will not cause the demand to fall.

## Target Return-on-Sales Pricing

A shortcoming with target profit pricing is that although it is simple and the target involves only a specific dollar volume, there is no benchmark of sales or investment used to show how much of the firm's effort is needed to achieve the target. Firms such as supermarket chains often use **target return-on-sales pricing** to set typical prices that will give them a profit that is a specified percentage, say, 1 percent, of the sales volume. Suppose you decide to use target return-on-sales pricing in your shop. To establish a price for a typical framed picture, you begin by making the same first three assumptions shown previously. However, for the fourth assumption, your target is now a 20 percent return on sales at an annual volume of 1,250 units. This results in the following price:

$$\begin{aligned}\text{Target return on sales} &= \frac{\text{Target profit}}{\text{Total revenue}} \\ 20\% &= \frac{\text{TR}-\text{TC}}{\text{TR}} \\ 0.20 &= \frac{P \times Q - [\text{FC} + (\text{UVC} \times Q)]}{\text{TR}} \\ 0.20 &= \frac{P \times 1,250 - [\$26,000 + (\$22 \times 1,250)]}{P \times 1,250} \\ P &= \$53.50\end{aligned}$$

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So at a price of \$53.50 per unit and an annual quantity of 1,250 frames,

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$$TR = P \times Q = \$53.50 \times 1,250 = \$66,875$$

$$TC = FC + (UVC \times Q) = \$26,000 + (\$22 \times 1,250) = \$53,500$$

$$\text{Profit} = TR - TC = \$66,875 - \$53,500 = \$13,375$$

As a check,

$$\text{Target return on sales} = \frac{\text{Target profit}}{\text{Total revenue}} = \frac{\$13,375}{\$66,875} = 20\%$$

## Target Return-on-Investment Pricing

Large, publicly owned corporations and many public utilities set annual return-on-investment (ROI) targets such as an ROI of 20 percent. **Target return-on-investment pricing** is a method of setting prices to achieve this target.

As the owner of the picture frame shop, suppose you decide to set a target ROI of 10 percent, which is twice that achieved the previous year. You consider raising the average price of a framed picture to \$54 or \$58—up from last year's average of \$50. To do this, you might improve product quality by offering better frames and higher-quality matting. This is likely to increase the cost, but higher prices will probably offset the decreased revenue from the lower number of units you are likely to sell next year.

To handle this wide variety of assumptions, managers use spreadsheets to project operating statements based on a set of assumptions. **Figure 14–5** shows the results of a spreadsheet simulation, with assumptions shown at the top and the projected results at the

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bottom. A previous year's operating statement results are shown in the column headed "Last Year." The assumptions and spreadsheet results for four different sets of assumptions are shown in columns A, B, C, and D.

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SPREADSHEET SIMULATION							
Assumptions or Results	Financial Element	Last Year	A	B	C	D	
<b>ASSUMPTIONS</b>	Price per unit (P)	\$50	\$54	\$54	\$58	\$58	
	Units sold (Q)	1,000	1,200	1,100	1,100	1,000	
	Change in unit variable cost (UVC)	0%	+10%	+10%	+20%	+20%	
	Unit variable cost	\$22.00	\$24.20	\$24.20	\$26.20	\$26.40	
	Total expenses	\$8,000	Same	Same	Same	Same	
	Owner's salary	\$18,000	Same	Same	Same	Same	
	Investment	\$20,000	Same	Same	Same	Same	
	State and federal taxes	50%	Same	Same	Same	Same	
	<b>SPREADSHEET RESULTS</b>	Net sales (P × Q)	\$50,000	\$64,800	\$59,400	\$63,800	\$58,000
		Less: COGS (Q × UVC)	22,000	29,040	26,620	29,040	26,400
Gross margin		\$28,000	\$35,760	\$32,780	\$34,760	\$31,600	

Less:	\$26,000	\$26,000	\$26,000	\$26,000	\$26,000
Total expenses					
Net profit before taxes	\$2,000	\$9,760	\$6,780	\$8,760	\$5,600
Less:	1,000	4,880	3,390	4,380	2,800
Taxes					
Net profit after taxes	\$1,000	\$4,880	\$3,390	\$4,380	\$2,800
Investment	\$20,000	\$20,000	\$20,000	\$20,000	\$20,000
Return on investment	5.0%	24.4%	17.0%	21.9%	14.0%

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**Figure 14–5** Results of a spreadsheet simulation used to select a price that will achieve a target return on investment.

In choosing a price or another action using spreadsheet results, the manager must (1) study the results of the simulation projections and (2) assess the realism of the assumptions underlying each set of projections. For example, as the owner of the picture frame shop, you would look at the bottom row of **Figure 14–5** and see that all four spreadsheet simulations exceed the after-tax target ROI of 10 percent. But after more thought, you might decide that it would be more realistic to set an average price of \$58 per unit, allow the unit variable cost to increase by 20 percent to account for more expensive framing and matting, and settle for the same unit sales as the 1,000 units sold last year. Therefore, you would select simulation D in this spreadsheet approach to target ROI pricing, settling on a goal of 14 percent after-tax ROI.

## Competition-Oriented Pricing Approaches

Rather than emphasize demand, cost, or profit factors, a price setter can stress what competitors or “the market” are doing.

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Has Red Bull's price premium among energy-drink brands sold in convenience stores increased or decreased? The Applying Marketing Metrics box answers this question.

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## Customary Pricing

For some products where tradition, a standardized channel of distribution, or other competitive factors dictate the price, **customary pricing** is used. For example, tradition prevails in the pricing of Swatch watches. The \$50 customary price for the basic model has changed little in 10 years. Candy bars offered through standard vending machines have a customary price of \$1.00. A significant departure from this price may result in a loss of sales for the manufacturer. Hershey changes the amount of chocolate in its candy bars depending on the price of raw chocolate rather than varying its customary retail price so that it can continue selling through vending machines.

## Above-, At-, or Below-Market Pricing

For most products, it is difficult to identify a specific market price for a product or product class. Still, marketing managers often have a subjective feel for the competitors' price or market price. Using this benchmark, they then may deliberately choose a strategy of **above-, at-, or below-market pricing**.

Among watch manufacturers, Rolex takes pride in emphasizing that it makes one of the most expensive watches you can buy, a clear example of above-market pricing. Manufacturers of national brands of clothing such as Hart Schaffner & Marx and

Christian Dior and retailers such as Neiman Marcus deliberately set premium prices for their products.

Revlon cosmetics and Arrow brand shirts are generally priced “at market.” As such, they also provide a reference price for competitors that use above- and below-market pricing.

A number of firms use below-market pricing. Manufacturers and retailers that offer private brands of products ranging from peanut butter to shampoo deliberately set prices for these products about 8 to 10 percent below the prices of nationally branded competitive products such as Skippy peanut butter and Vidal Sassoon shampoo. Below-market pricing also exists in business-to-business marketing. Hewlett-Packard, for instance, initially priced its office personal computers below those of competitors to promote a value image among corporate buyers.<sup>13</sup>

Companies use a “price premium” to assess whether their products and brands are above, at, or below the market. An illustration of how the price premium measure is calculated, displayed, and interpreted appears in the Applying Marketing Metrics box.<sup>14</sup>

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## Applying Marketing Metrics

### Are Red Bull Prices Above, At, or Below the Market?

How would you determine whether a firm's retail prices are above, at, or below the market? You might visit retail stores and record what prices retailers are charging for products or brands. However, this laborious activity can be simplified by combining dollar market share and unit volume market share measures to create a "price premium" display on your marketing dashboard.

#### Your Challenge

Red Bull is the leading energy-drink brand in the United States in terms of dollar market share and unit market share (see the table below). Company marketing executives have research showing that Red Bull has a strong brand equity. What they want to know is whether the brand's price premium resulting from its brand equity has eroded due to heavy price discounting in the convenience store channel. This channel accounts for 60 percent of energy-drink sales.

A price premium is the percentage by which the actual price charged for a specific brand exceeds (or falls short of) a benchmark established for a similar product or basket of products. As such, a price premium shows whether a brand is priced above, at, or below the market. This premium is calculated as follows:

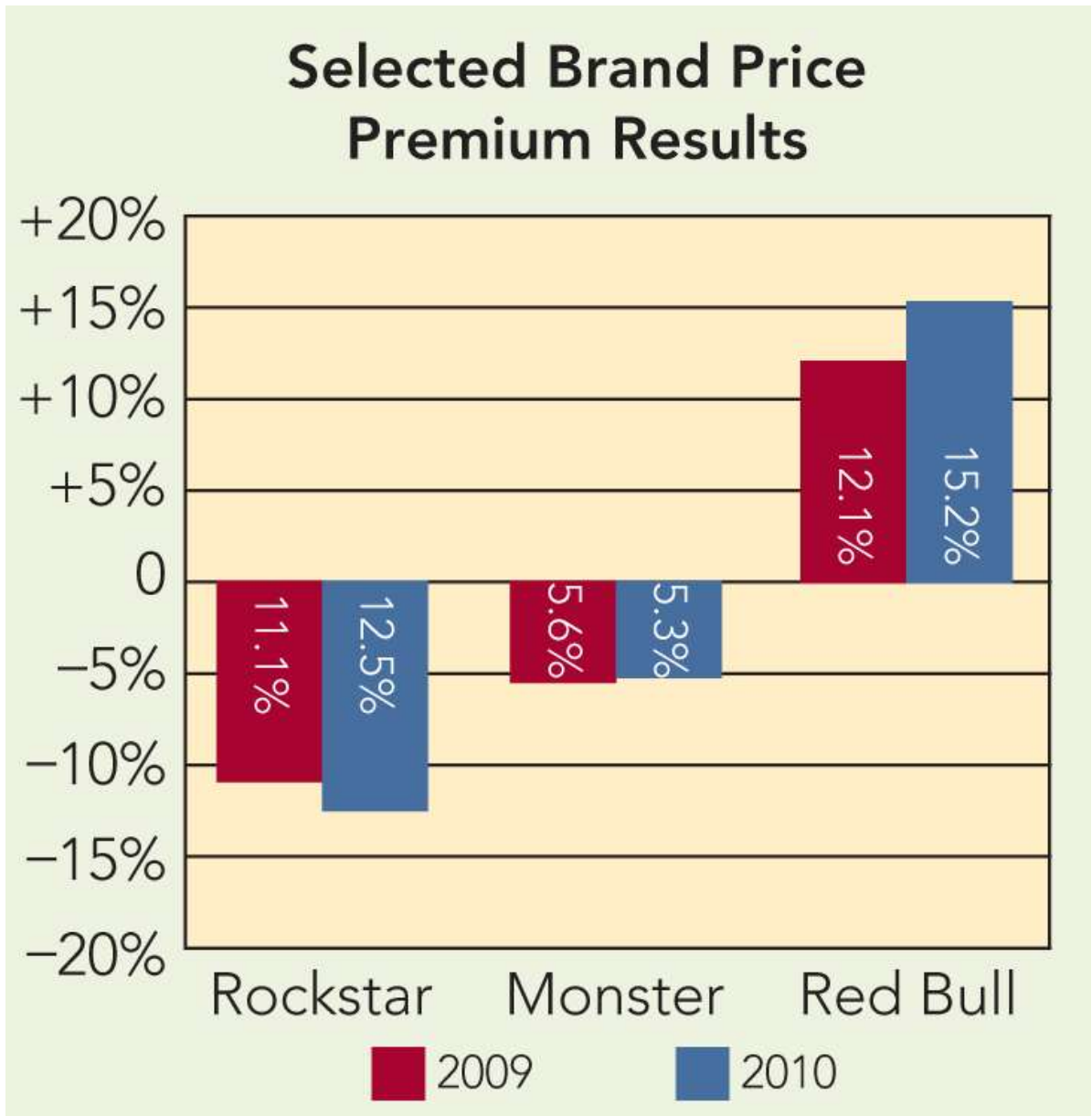
$$\text{Price premium (\%)} = \frac{\text{Dollar sales market share for a brand}}{\text{Unit volume market share for a brand}} - 1$$

### **Your Findings**

Using 2010 energy-drink brand market share data for U.S. convenience stores, the Red Bull price premium is 1.152, or 15.2 percent, calculated as follows: (38 percent ÷ 33 percent) - 1 = .152. Red Bull's average price is 15.2 percent higher than the average price for energy-drink brands sold in convenience stores. Red Bull's price premium based on 2009 brand market share data was 1.121, or 12.1 percent, calculated as follows: (37 percent ÷ 33 percent) - 1 = 12.1. Red Bull's price premium has increased relative to its competitors, notably Monster Energy and Rockstar. The price premiums for Red Bull and these two competitive brands for 2009 and 2010 are displayed in the marketing dashboard shown below.

### **Your Action**

Red Bull has increased its price premium while retaining its unit volume share, which is not only favorable news for the brand but also evidence of price discounting by other brands. Clearly, the company's brand-building effort, reflected in sponsorships and a singular focus on brand attributes valued by consumers, should be continued.



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Brand	Dollar Sales Market Share		Unit Volume Market Share	
	2010	2009	2010	2009
Red Bull	38%	37%	33%	33%
Monster	18	17	19	18
Rockstar	7	8	8	9
Other brands	<u>37</u>	<u>38</u>	<u>40</u>	<u>40</u>
	100%	100%	100%	100%

\*\*\*

## Loss-Leader Pricing

For a special promotion, retail stores deliberately sell a product below its customary price to attract attention to it. The purpose of this **loss-leader pricing** is not to increase sales but to attract customers in hopes they will buy other products as well, particularly the discretionary items with large markups. For example, supermarkets often use milk as a loss leader.

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### learning review

- 14- What is standard markup pricing?
  - 3.
- 14- What profit-based pricing approach should a manager use if he
  - 4. or she wants to reflect the percentage of the firm's resources used in obtaining the profit?
- 14- What is the purpose of loss-leader pricing when used by a retail
  - 5. firm?

## STEP 5: SET THE LIST OR QUOTED PRICE

So far, we have covered four of the six steps involved in setting a price—steps 1–3, covered in **Chapter 13**, and step 4, covered in the preceding section. The result of these four steps is an approximate price level for the product that appears reasonable. But it still remains for the manager to set a specific list or quoted price in light of all relevant factors. In deciding upon the specific price for a product, the manager must choose a price policy; consider company, customer, and competitive effects on pricing; and balance incremental costs and revenues.

**LO 14-2**

Recognize the major factors considered in deriving a final list or quoted price from the approximate price level.

**Choose a Price Policy**

Choosing a price policy is important in setting a list or quoted price. Two options are common—a fixed-price policy or a dynamic pricing policy.

**Fixed-Price Policy**

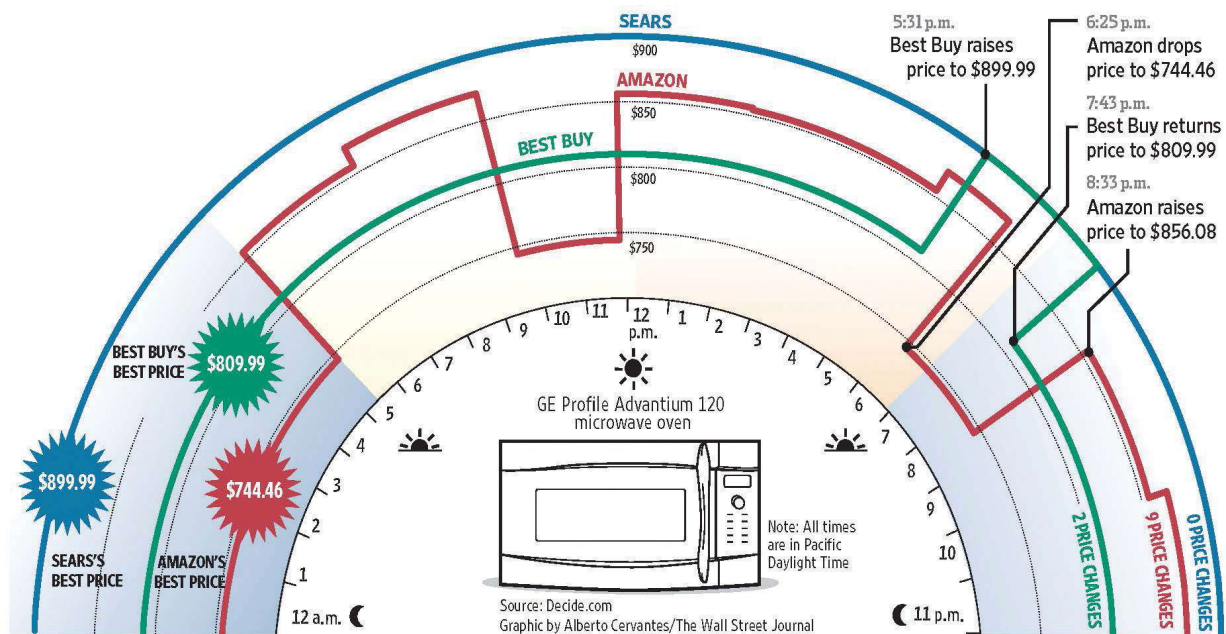
Most companies use a fixed-price policy. A **fixed-price policy**, also called a *one-price policy*, is setting one price for all buyers of a product or service. For example, when you buy a Wilson Cirrus One BLX tennis racquet from a sporting goods store, you are offered the product at a single price. You can buy it or not, but there is no variation in the price under the seller's fixed-price policy. CarMax

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uses this approach in its stores and features a “no haggle, one price” price for cars. Some retailers have married this policy with a below-market approach. Page 382

Dollar Value Stores and 99¢ Only Stores sell everything in their stores for \$1 or less.

Family Dollar Stores sell everything for \$2.



Online retailers adjust prices several times a day. This chart shows how the price for a GE microwave oven changed one day on the Amazon, Best Buy, and Sears websites.

**VIDEO 14-2****CarMax Ad**[kerin.tv/13e/v14-2](http://kerin.tv/13e/v14-2)

## Dynamic Pricing Policy

In contrast, a **dynamic pricing policy**, also called a *flexible-price policy*, involves setting different prices for products and services in real time in response to supply and demand conditions. A dynamic pricing policy gives sellers considerable discretion in setting the final price in light of demand, cost, and competitive factors. Yield management pricing is a form of dynamic pricing because prices vary by an individual buyer's purchase situation, company cost considerations, and competitive conditions. Dell Inc. uses dynamic pricing. It continually adjusts prices in response to changes in its own costs, competitive pressures, and demand from customers, from one segment of the personal computer market to another. "Our flexibility allows us to be [priced] different even within a day," says a Dell spokesperson.<sup>15</sup>

Dynamic pricing has grown in popularity because of increasingly sophisticated information technology. Today, many marketers have the ability to customize a price for an individual on the basis of his or her purchasing patterns, product preferences, and price sensitivity, all of which are stored in company data warehouses.<sup>16</sup> For example, online marketers, like Amazon, described in **Chapter 13**, routinely adjust prices in response to purchase situations and past purchase behaviors of online buyers. Some online marketers monitor an online shopper's *clickstream*—the way that person navigates through the website. If the visitor behaves like a price-sensitive shopper—perhaps by comparing many different products and prices—that person may be offered a lower price.

Dynamic pricing means that some customers pay more and others pay less for the same product or service. Dynamic pricing is not without its critics. One frequent criticism of dynamic pricing lies in the realm of "surge" pricing, which occurs when a company raises the price of its product or service if there is a spike in demand. Read the Making Responsible Decisions box to learn about the ethics and economics of surge pricing used by Uber and Lyft and decide where you stand on this practice.<sup>17</sup>

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# MAKING RESPONSIBLE Ethics

## The Ethics and Economics of Surge Pricing

Uber and Lyft have changed the way local taxi service operates. Using independent drivers and driver-owned vehicles, both companies serve as middlemen using digital technology to provide on-demand transportation services to consumers.

Nevertheless, Uber and Lyft customers often complain about the practice of “surge” or “prime-time” pricing used by these companies during periods of peak demand. From a classical economics perspective, this form of dynamic pricing makes sense based on supply and demand relationships. Fare increases in periods of high demand—a shift in the demand curve to the right—in turn increase the supply of drivers available for passengers.

From an ethical perspective, supporters of surge or prime-time pricing argue from a utilitarian view that this type of pricing increases the supply of drivers and more people get a ride. Remember from Chapter 4 that utilitarianism focuses on “the greatest good for the greatest number” by assessing the costs and benefits of the behavior, in this case, dynamic pricing.

Critics of surge or prime-time pricing argue that this practice is flagrant price gouging by Uber and Lyft. Where do you stand on the economics vs. ethics debate related to surge or prime-time pricing?



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## Consider Company, Customer, and Competitive Effects on Pricing

In determining a final list or quoted price, the manager must next assess company, customer, and competitive effects on pricing.

### Company Effects

For a firm with more than one product, a decision on the price of a single product must consider the price of other items in its product line or related product lines in its product mix. Within a product line or mix there are usually some products that are substitutes for one another and some that complement each other. Frito-Lay recognizes that its Baked Tostitos, Tostitos, and Doritos brands are partial substitutes for one another and its bean and cheese dips and salsas complement the products in its tortilla chip line.

A manager's challenge when marketing multiple products is **product-line pricing**, the setting of prices for all items in a product line. When setting prices, the manager seeks to cover the total cost and produce a profit for the complete line, not necessarily for each

item. For example, a penetration price for Sony's PlayStation 4 video game console was probably at or below its cost, but the prices of its video games (complementary products) were set high enough to cover any loss and deliver a handsome profit for the product line.

Product-line pricing involves determining (1) the lowest-priced product and price, (2) the highest-priced product and price, and (3) price differentials for all other products in the line.<sup>18</sup> The lowest- and highest-priced items in the product line play important roles. The highest-priced item is typically positioned as the premium item in quality and features. The lowest-priced item is the traffic builder designed to capture the attention

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of the hesitant or first-time buyer. Price differentials between items in the line Page 383 should make sense to customers and reflect differences in the perceived value of the products offered. Behavioral research also suggests that the price differentials should get larger as one moves up the product line.



Frito-Lay recognizes that its tortilla chip products are partial substitutes for one another. Its bean and cheese dips and salsas complement tortilla chips. This knowledge is used by Frito-Lay in its product-line pricing.

Source: Frito-Lay North America, Inc.

Frito-Lay, Inc. [www.frito-lay.com](http://www.frito-lay.com)

## Customer Effects

In setting a price, marketers pay close attention to factors that satisfy the perceptions or expectations of ultimate consumers, such as the customary prices for a variety of consumer products. For example, retailers have found that they should not price their store brands 20 to 25 percent below manufacturers' brands.<sup>19</sup> When they do, consumers often view the lower price as a signal of lower quality and don't buy.

Manufacturers and wholesalers must choose prices that result in profit for resellers in the channel to gain their cooperation and support. Toro learned this lesson the hard way when it decided to augment its traditional hardware outlet distribution by also selling its lawn mower and snow thrower product lines through mass merchandisers. To do so, it set mass merchandiser prices far below those for its traditional hardware

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outlets. Unhappy hardware stores abandoned Toro products in favor of mowers and snow throwers from competitors.

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## Competitive Effects

A manager's pricing decision is immediately apparent to most competitors, who may retaliate with price changes of their own. Therefore, a manager who sets a final list or quoted price must anticipate potential price responses from competitors. Regardless of whether a firm is a price leader or follower, it wants to avoid cutthroat price wars in which no firm in the industry makes a profit.

A **price war** involves successive price cutting by competitors to increase or maintain their unit sales or market share. Price wars erupt in a variety of industries, from consumer electronics to disposable diapers, from soft drinks to airlines, and from grocery retailing to smartphone services. Managers who engage in price wars do so expecting that a lower price will result in a larger market share, higher unit sales, and greater profit for their company. These results may occur. But, if competitors match the lower price, other things being equal, the expected market share, sales, and profit gain are lost. According to an analysis of large U.S. companies, a 1 percent price cut—assuming no change in unit volume or costs—lowers a company's net profit by an average of 8 percent.<sup>20</sup>

Marketers are advised to consider price cutting only when one or more conditions exist: (1) the company has a cost or technological advantage over its competitors, (2) primary demand for a product class will grow if prices are lowered, and (3) the price cut is

confined to specific products or customers (as with airline tickets) and is not across the board.

## Balance Incremental Costs and Revenues

When a price is changed or new advertising or personal selling programs are planned, their effect on the quantity sold must be considered. This assessment involves a continuing, concise trade-off of incremental costs incurred against incremental revenues received.

Think about these managerial questions:

- How many extra units do we have to sell to pay for that \$1,000 advertisement?
- Should we hire three more salespeople or not?

**Figure 14–6** uses an example of a picture frame store owner to illustrate the advantages and disadvantages of using incremental analysis to make marketing decisions.

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Note that the owner in this example must either conclude that a simple advertising campaign will more than pay for itself in additional sales or not undertake the campaign. The decision could also have been made to increase the average price of a framed picture to cover the cost of the campaign, but the principle still applies: Expected incremental revenues from pricing and other marketing actions must more than offset incremental costs.

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Suppose the owner of a picture framing store is considering buying a series of magazine ads to reach her upscale target market. The cost of the ads is \$1,000, the average price of a framed picture is \$50, and the unit variable cost (materials plus labor) is \$30.

This is a direct application of marginal analysis that an astute manager uses to estimate the incremental revenue or incremental number of units that must be obtained to at least cover the incremental cost. In this example, the number of extra picture frames that must be sold is obtained as follows:

$$\begin{aligned}
 \text{Incremental number of frames} &= \frac{\text{Extra fixed cost}}{\text{Price}-\text{Unit variable cost}} \\
 &= \frac{\$1,000 \text{ of advertising}}{\$50-\$30} \\
 &= 50 \text{ frames}
 \end{aligned}$$

So unless there are other benefits of the ads, such as long-term goodwill, she should buy the ads only if she expects they will increase picture frame sales by at least 50 units.

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**Figure 14-6** Expected incremental revenue from pricing and other marketing actions must more than offset incremental costs to achieve an incremental profit.

The example in **Figure 14–6** shows both the main advantage and the difficulty of incremental analysis. The advantage is its commonsense usefulness, and the difficulty is obtaining the necessary data to make decisions. The owner can measure the cost quite easily, but the incremental revenue generated by the ads is difficult to measure. To get a general idea, she might offer \$2 off the purchase price with use of a coupon printed in the ad to see which sales resulted from the ad.

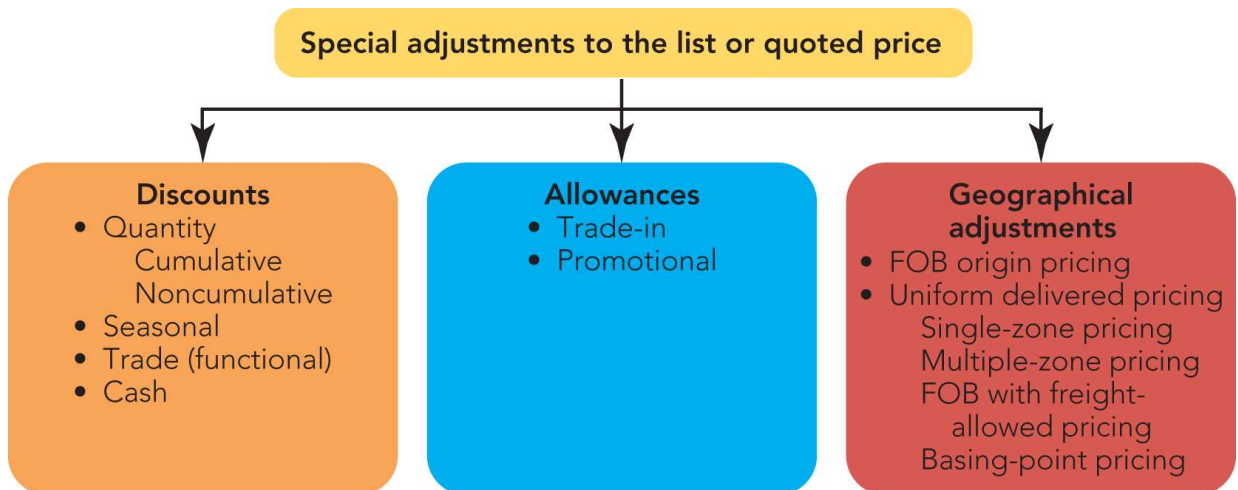
## STEP 6: MAKE SPECIAL ADJUSTMENTS TO THE LIST OR QUOTED PRICE

### LO 14-3

Identify the adjustments made to the approximate price level on the basis of discounts, allowances, and geography.

When you pay \$1.00 for a bag of M&M's in a vending machine or receive a quoted price of \$10,000 from a contractor to renovate a kitchen, the pricing sequence ends with the last step just described: setting the list or quoted price. But when you are a manufacturer of M&M's candies or Wolf gas ranges and you sell your product to dozens or hundreds of wholesalers and retailers in your marketing channel, you may need to

make special adjustments to the list or quoted price. Wholesalers adjust the list or quoted prices they set for retailers. Retailers, in turn, do the same for consumers. Three special adjustments to the list or quoted price are (1) discounts, (2) allowances, and (3) geographical adjustments (see **Figure 14–7**).



**Figure 14–7** Three special adjustments to the list or quoted price include discounts, allowances, and geographical adjustments. Each can substantially change the final price.

## Discounts

*Discounts* are reductions from the list price that a seller gives a buyer as a reward for some activity of the buyer that is favorable to the seller. Four kinds of discounts are especially important in marketing strategy: (1) quantity, (2) seasonal, (3) trade (functional), and (4) cash.<sup>21</sup>

## Quantity Discounts

To encourage customers to buy larger quantities of a product, firms at all levels in the marketing channel offer **quantity discounts**, which are reductions in unit costs for a larger order. For example, a photocopying service such as AlphaGraphics might set a price of 10 cents a copy for 1 to 25 copies, 9 cents a copy for 26 to 100, and 8 cents a copy for 101 or more. Because the photocopying service gets more of the buyer's business and has longer production runs that reduce its order-handling costs, it is willing to pass on some of the cost savings in the form of quantity discounts to the buyer.

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Quantity discounts are of two general kinds: noncumulative and cumulative. Page 386

*Noncumulative quantity discounts* are based on the size of an individual purchase order. They encourage large individual purchase orders, not a series of orders. This discount is used by FedEx to encourage companies to ship a large number of packages at one time. *Cumulative quantity discounts* apply to the accumulation of purchases of a product over a given time period, typically a year. Cumulative quantity discounts encourage repeat buying by a single customer to a far greater degree than do noncumulative quantity discounts.

## Seasonal Discounts

To encourage buyers to stock inventory earlier than their normal demand would require, manufacturers often use *seasonal discounts*. A firm such as Toro that manufactures lawn mowers and snow throwers offers seasonal discounts to encourage wholesalers and retailers to stock up on lawn mowers in January and February and on snow throwers in July and August—five or six months before the seasonal demand by ultimate consumers. This enables Toro to smooth out seasonal manufacturing peaks and troughs, thereby contributing to more efficient production. It also rewards wholesalers and retailers for the risk they accept in assuming increased inventory carrying costs and having supplies in stock at the time they are wanted by customers.

## Trade (Functional) Discounts

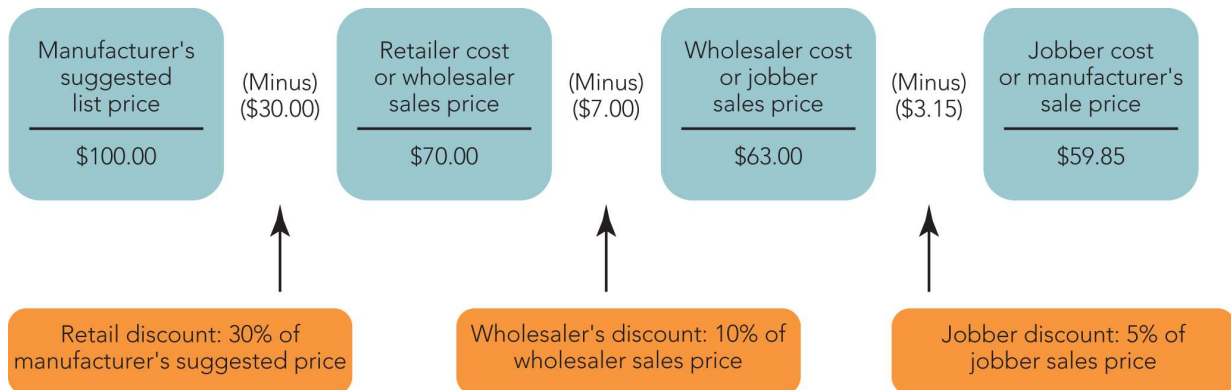
To reward wholesalers and retailers for marketing functions they will perform in the future, a manufacturer often gives *trade*, or *functional*, *discounts*. These reductions off the list or base price are offered to resellers in the marketing channel on the basis of (1)

where they are in the channel and (2) the marketing activities they are expected to perform in the future.



Discounts are a common adjustment to list prices. They are used to give a buyer a reward for some activity of the buyer that is favorable to the seller as described in the text.

Suppose a manufacturer quotes price in the following form: list price—\$100 less 30/10/5. The first number in the percentage sequence always refers to the retail end of the channel. The last number always refers to the wholesaler or jobber closest to the manufacturer in the channel. The trade discounts are simply subtracted one at a time. This price quote shows \$100 is the manufacturer's suggested retail price; 30 percent of the suggested retail price is available to the retailer to cover costs and provide a profit of \$30 ( $\$100 \times 0.3 = \$30$ ); wholesalers closest to the retailer in the channel get 10 percent of their selling price ( $\$70 \times 0.1 = \$7$ ); and the final group of wholesalers in the channel (probably jobbers) that are closest to the manufacturer get 5 percent of their selling price ( $\$63 \times 0.05 = \$3.15$ ). Thus, starting with the manufacturer's suggested retail price and subtracting the three trade discounts shows that the manufacturer's selling price to the wholesaler or jobber closest to it is \$59.85 (see [Figure 14–8](#)).



**Figure 14–8** The structure of trade discounts affects the manufacturer's selling price and the margins made by resellers in a marketing channel.

Traditional trade discounts have been established in various product lines such as hardware, food, and pharmaceutical items. Although the manufacturer may suggest the trade discounts shown in the example just cited, the sellers are free to alter the discount schedule depending on their competitive situation.

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## Cash Discounts

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To encourage retailers to pay their bills quickly, manufacturers offer them *cash discounts*. Suppose a retailer receives a bill quoted at \$1,000, 2/10 net 30. This means that the bill for the product is \$1,000, but the retailer can take a 2 percent discount ( $\$1,000 \times 0.02 = \$20$ ) if payment is made within 10 days and send a check for \$980. If the payment cannot be made within 10 days, the total amount of \$1,000 is due within 30 days. It is usually understood by the buyer that an interest charge will be added after the first 30 days of free credit.

Retailers provide cash discounts to consumers as well to eliminate the cost of credit granted to consumers. These discounts take the form of discount-for-cash policies.

## Allowances

*Allowances*, like discounts, are reductions from list or quoted prices to buyers for performing some activity. They include trade-in and promotional allowances.

## Trade-in Allowances

A new-car dealer can offer a substantial reduction in the list price of that new Toyota Camry by offering you a trade-in allowance of \$1,000 for your Honda Civic. A *trade-in allowance* is a price reduction given when a used product is accepted as part of the payment on a new product. Trade-ins are an effective way to lower the price a buyer has to pay without formally reducing the list price.

## Promotional Allowances

Sellers in the marketing channel can qualify for **promotional allowances** by undertaking certain advertising or selling activities to promote a product. Various types of allowances include an actual cash payment or an extra amount of “free goods” (as with a free case of Red Baron frozen cheese pizzas to a retailer for every dozen cases purchased). Frequently, a portion of these savings is passed on to the consumer by retailers.

Some companies, such as Procter & Gamble, have chosen to reduce promotional allowances for retailers by using everyday low pricing. **Everyday low pricing (EDLP)** is the practice of replacing promotional allowances with lower manufacturer list prices. EDLP promises to reduce the average price to consumers while minimizing promotional allowances that cost manufacturers billions of dollars every year. However, EDLP does not necessarily benefit supermarkets, as described in the Marketing Matters box.<sup>22</sup>

## Marketing Matters

customer  
value

### Everyday Low Prices at the Supermarket = Everyday Low Profits— Creating Customer Value at a Cost

Who wouldn't welcome low retail prices every day? The answer is supermarket chains—76 percent of U.S. grocery stores have not adopted this practice. Supermarkets prefer Hi-Lo pricing based on frequent specials where prices are temporarily lowered and then raised again. Hi-Lo pricing reflects allowances that manufacturers give supermarkets to push their products. Consider a supermarket that sells Bumble Bee white tuna. It regularly pays \$1.15 for a can of Bumble Bee white tuna ( $\$55.43 \div 48 = \$1.15$ ), but the allowances reduce the cost to 96 cents. A price special of 99 cents still provides a 3 cent retail markup ( $\$0.99$  retail price in ad –  $\$0.96$  cost). When the price on tuna returns to its regular level, the store's gross margin on tuna increases substantially on those cans that were bought with the allowance but not sold during the special price promotion.

Everyday low pricing (EDLP) eliminates manufacturer allowances and can reduce average retail prices by up to 10 percent. While EDLP provides lower average prices than Hi-Lo pricing, EDLP does not allow for deeply discounted price specials. EDLP can create everyday customer value and modestly increase supermarket sales—but at a cost. Already slim supermarket chain profits can slip by 18 percent with EDLP

without the benefit of allowances as described earlier. Also, some argue that EDLP without price specials is boring for many grocery shoppers who welcome price specials.



EDLP has been hailed as “value pricing” by manufacturers, but supermarkets view it differently. For them, EDLP means “Everyday Low Profits!”

### **Geographical Adjustments**

Geographical adjustments to list or quoted prices are made by manufacturers or even wholesalers to reflect the cost of transportation of the products from seller to buyer. The two general methods for quoting prices related to transportation costs are (1) FOB origin pricing and (2) uniform delivered pricing.

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## FOB Origin Pricing

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FOB means “free on board” some vehicle at some location, which means the seller pays the cost of loading the product onto the vehicle that is used (such as a barge, railroad car, or truck). **FOB origin pricing** usually involves the seller’s naming the location of this loading as the seller’s factory or warehouse (such as “FOB Detroit” or “FOB factory”). The title to the goods passes to the buyer at the point of loading, so the buyer becomes responsible for picking the specific mode of transportation, for all the transportation costs, and for subsequent handling of the product. Buyers farthest from the seller face the big disadvantage of paying higher transportation costs.

## Uniform Delivered Pricing

When a **uniform delivered pricing** method is used, the price the seller quotes includes all transportation costs. It is quoted in a contract as “FOB buyer’s location,” and the seller selects the mode of transportation, pays the freight charges, and is responsible for any damage that may occur because the seller retains title to the goods until they are delivered to the buyer. Although they go by various names, there are four kinds of delivered pricing methods: (1) single-zone pricing, (2) multiple-zone pricing, (3) FOB with freight-allowed pricing, and (4) basing-point pricing.

In *single-zone pricing*, all buyers pay the same delivered price for the products, regardless of their distance from the seller. So, although a retail store offering free delivery in a metropolitan area incurs varying transportation costs depending on a customer’s location in relation to the store, all customers pay the same delivered price.

In *multiple-zone pricing*, a firm divides its selling territory into geographic areas or zones. The delivered price to all buyers within any one zone is the same, but prices

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across zones vary depending on the transportation cost to each particular zone Page 389  
and the level of competition and demand within each zone.

With *FOB with freight-allowed pricing*, also called *freight absorption pricing*, the price is quoted by the seller as “FOB plant—freight allowed.” The buyer is allowed to deduct freight expenses from the list price of the goods, so the seller agrees to pay, or “absorb,” the transportation costs.

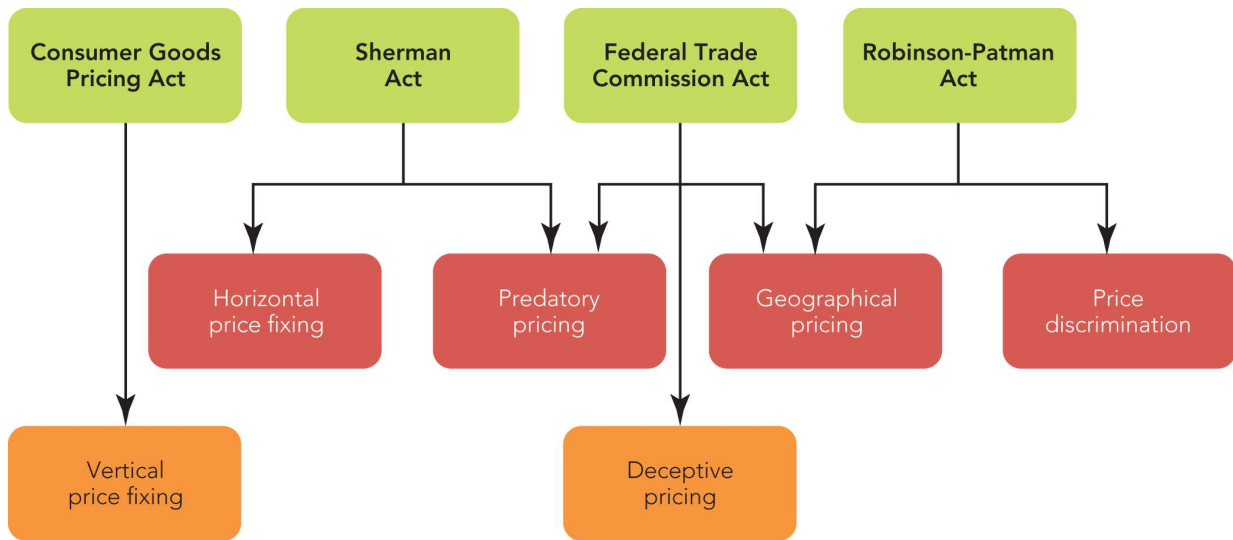
**Basing-point pricing** involves selecting one or more geographical locations (basing point) from which the list price for products plus freight expenses are charged to the buyer. For example, a company might designate St. Louis as the basing point and charge all buyers a list price of \$100 plus freight from St. Louis to their location. Basing-point pricing methods have been used in the steel, cement, and lumber industries where freight expenses are a significant part of the total cost to the buyer and products are largely undifferentiated.

## Legal and Regulatory Aspects of Pricing

Arriving at a final price is clearly a complex process. The task is further complicated by legal and regulatory restrictions. Five pricing practices have received the most scrutiny: (1) price fixing, (2) price discrimination, (3) deceptive pricing, (4) geographical pricing, and (5) predatory pricing (see **Figure 14–9**).

### LO 14-4

Name the principal laws and regulations affecting specific pricing practices.



**Figure 14–9** Several pricing practices are affected by legal and regulatory restrictions. These restrictions seek to benefit both consumers and companies.

## Price Fixing

A conspiracy among firms to set prices for a product is termed **price fixing**. Price fixing is illegal *per se* under the Sherman Act (*per se* means in and of itself). When two or more competitors explicitly or implicitly set prices, this practice is called *horizontal price fixing*. For example, in 2000, six foreign vitamin companies pled guilty to price fixing in the human and animal vitamin industry and paid the largest fine in U.S. history, a hefty \$335 million.<sup>23</sup>

*Vertical price fixing* involves controlling agreements between independent buyers and sellers (a manufacturer and a retailer) whereby sellers are required to not sell products below a minimum retail price. This practice, called *resale price maintenance*, was declared illegal *per se* in 1975 under provisions of the *Consumer Goods Pricing Act*.

Nevertheless, this practice is not uncommon. For example, shoe supplier Nine West was charged with restricting competition by coercing retailers to adhere to its resale prices. As part of its settlement, Nine West agreed to pay \$34 million.<sup>24</sup> Although this type of coercive price fixing is illegal per se, manufacturers and wholesalers can set

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the maximum retail price for their products provided the price agreement does not create an “unreasonable restraint of trade” or is anticompetitive.

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It is important to recognize that a “manufacturer’s suggested retail price,” or MSRP, is not illegal per se. The issue of legality only arises when manufacturers enforce such a practice by coercion. Furthermore, there appears to be a movement toward a “*rule of reason*” in horizontal and vertical price fixing cases.<sup>25</sup> This rule holds that circumstances surrounding a practice must be considered before making a judgment about its legality. The rule of reason perspective is the direct opposite of the per se rule.

## Price Discrimination

The Clayton Act as amended by the Robinson-Patman Act prohibits **price discrimination** —the practice of charging different prices to different buyers for goods of like grade and quality. However, not all price differences are illegal; only those that substantially lessen competition or create a monopoly are deemed unlawful. Moreover, “goods” is narrowly defined and does not include discrimination in services.

A unique feature of the Robinson-Patman Act is that it allows for price differentials to different customers under the following conditions:

1. When price differences charged to different customers do not exceed the differences in the cost of manufacture, sale, or delivery resulting from differing methods or quantities in which such goods are sold or delivered to buyers. This condition is called the *cost justification defense*.

2. When price differences result from changing market conditions, avoiding obsolescence of seasonal merchandise, including perishables, or closing out sales.
3. When price differences are quoted to selected buyers in good faith to meet competitors' prices and are not intended to injure competition. This condition is called the *meet-the-competition defense*.

The Robinson-Patman Act also covers promotional allowances. To legally offer promotional allowances to buyers, the seller must do so on a proportionally equal basis to all buyers distributing the seller's products. In general, the rule of reason applies frequently in price discrimination disputes and is often applied to cases involving firms that use dynamic pricing policies.



Buy one, get one free promotions are common. However, these promotions can be viewed as deceptive by the Federal Trade Commission. Read the text to learn when these promotions may be deceptive.

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against all of these practices. So it is essential to rely on the ethical standards of those making and publicizing pricing decisions.

## Deceptive Pricing

Price deals that mislead consumers fall into the category of *deceptive pricing*. Deceptive pricing is outlawed by the Federal Trade Commission Act. The FTC monitors such practices and has published a regulation titled “Guides against Deceptive Pricing” to help businesspeople avoid a charge of deception. The five most common deceptive pricing practices are described in **Figure 14–10**. As you read about these practices it should be clear that laws cannot be passed and enforced to protect consumers and competitors

DECEPTIVE PRICING PRACTICE	DESCRIPTION
Bait and switch	This deceptive practice exists when a firm offers a very low price on a product (the bait) to attract customers to a store. Once in the store, the customer is persuaded to purchase a higher priced item (the switch) using a variety of tricks, including (1) downgrading the promoted item, (2) not having the item in stock, or (3) refusing to take orders for the item.
Bargains conditional on other purchases	This practice may exist when a buyer is offered "1-Cent Sales," "Buy 1, Get 1 Free," and "Get 2 for the Price of 1." Such pricing is legal only if the first items are sold at the regular price, not a price inflated for the offer. Substituting lower quality items on either the first or second purchase is also considered deceptive.
Comparable value comparisons	Advertising such as "Retail Value \$100.00, Our Price \$85.00" is deceptive if a verified and substantial number of stores in the market area do not price the item at \$100.
Comparisons with suggested prices	A claim that a price is below a manufacturer's suggested or list price may be deceptive if few or no sales occur at that price in a retailer's market area.
Former price comparisons	When a seller represents a price as reduced, the item must have been offered in good faith at a higher price for a substantial previous period. Setting a high price for the purpose of establishing a reference for a price reduction is considered deceptive.

**Figure 14–10** Five most common deceptive pricing practices used by businesses. Have you ever witnessed or experienced one or more of these practices?

## Geographical Pricing

FOB origin pricing is legal, as are FOB freight-allowed pricing practices, providing no conspiracy to set prices exists. Basing-point pricing can be viewed as illegal under the Robinson-Patman Act and the Federal Trade Commission Act if there is clear-cut evidence of a conspiracy to set prices. In general, geographical pricing practices have been immune from legal and regulatory restrictions, except in those instances in which a conspiracy to lessen competition exists under the Sherman Act or price discrimination exists under the Robinson-Patman Act.

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## Predatory Pricing

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**Predatory pricing** is the practice of charging a very low price for a product with the intent of driving competitors out of business. Once competitors have been driven out, the firm raises its prices. This practice is illegal under the Sherman Act and the Federal Trade Commission Act. Proving the practice of predatory pricing is difficult and expensive, because it must be shown that the predator explicitly attempted to destroy a competitor and the predatory price was below the defendant's average cost.

### learning review

- 14-Why would a seller choose a dynamic pricing policy over a fixed-  
6. price policy?
- 14-If a firm wished to encourage repeat purchases by a buyer  
7. throughout a year, would a cumulative or a noncumulative  
quantity discount be a better strategy?
- 14-Which pricing practices are covered by the Sherman Act?  
8.

### LEARNING OBJECTIVES REVIEW

**LO 14-1** *Describe how to establish the “approximate price level” using demand-oriented, cost-oriented, profit-oriented, and competition-oriented approaches.*

Demand, cost, profit, and competition influence the initial consideration of the approximate price level for a product or service. Demand-oriented pricing approaches stress consumer demand and revenue implications of pricing and include eight types: skimming, penetration, prestige, price lining, odd-even, target, bundle, and yield management. Cost-oriented pricing approaches emphasize the cost aspects of pricing and include three types: standard markup, cost-plus, and experience curve pricing. Profit-oriented pricing approaches focus on a balance between revenues and costs to set a price and include three types: target profit, target return-on-sales, and target return-on-investment pricing. And finally, competition-oriented

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pricing approaches stress what competitors or the marketplace are doing and include three types: customary; above-, at-, or below-market; and loss-leader pricing. Although these approaches are described separately, some of them overlap, and an effective marketing manager will consider several in searching for an approximate price level. Page 392

**LO 14-2** *Recognize the major factors considered in deriving a final list or quoted price from the approximate price level.*

Given an approximate price level for a product or service, a manager sets a list or quoted price by considering three additional factors. First, a manager must decide whether to follow a fixed-price versus a dynamic pricing policy. Second, the manager should consider the effects of the proposed price on the company, customer, and competitors. Finally, consideration should be given to balancing incremental costs and revenues, particularly when price and cost changes are planned.

**LO 14-3** *Identify the adjustments made to the approximate price level on the basis of discounts, allowances, and geography.*

Numerous adjustments can be made to the approximate price level. Discounts are reductions from the list or quoted price that a seller gives a buyer as a reward for some activity of the buyer that is favorable to the seller. These include quantity, seasonal, trade (functional), and cash discounts. Allowances offered to buyers also reduce list or quoted prices. Trade-in allowances and promotional allowances are most common. Finally, geographical adjustments are made to list or quoted prices to reflect transportation costs from sellers to buyers. The two general methods for

quoting prices related to transportation costs are FOB origin pricing and uniform delivered pricing.

**LO 14-4** *Name the principal laws and regulations affecting specific pricing practices.*

There are four principal laws that affect six major pricing practices. The Sherman Act specifically prohibits horizontal price fixing and predatory pricing. The Consumer Goods Pricing Act makes it illegal for companies to engage in vertical price fixing (also called resale price maintenance agreements). The Federal Trade Commission Act outlaws deceptive pricing. Provisions in this act also address aspects of predatory pricing and geographical pricing. Finally, the Robinson-Patman Act prohibits price discrimination for goods of like grade and quality, covers the use of promotional allowances, and addresses certain aspects of geographical pricing.

## LEARNING REVIEW ANSWERS

### **14-1 In pricing a new product, what circumstances might support skimming or penetration pricing?**

Answer: Skimming pricing is an effective strategy when: (1) the firm may want to recoup the initial R&D and promotion costs in developing and promoting the product; (2) enough prospective customers are willing to buy the product immediately at the high initial price to make these sales profitable because they are not very price sensitive; (3) the high initial price will not attract competitors; (4) lowering the price has only a minor effect on increasing the sales volume and reducing the unit costs; and (5) customers interpret the high price as signifying high quality. These conditions are most likely to exist when the new product is protected by patents or copyrights or its uniqueness is understood and valued by consumers. Penetration pricing is an effective strategy when: (1) used after a skimming strategy to appeal to

a broader segment of the population and increase market share; (2) many segments of the market are price sensitive; (3) a low initial price discourages competitors from entering the market; (4) unit production and marketing costs fall dramatically as production volumes increase; (5) a firm wants to maintain the initial price for a time to gain profit lost from its low introductory level; and (6) a firm wants to lower the price further, counting on the new volume to generate the necessary profit.

**14-2 What is odd-even pricing?**

Answer: Odd-even pricing involves setting prices a few dollars or cents under an even number. Psychologically, a \$499.99 price feels lower than \$500.00, even though the difference is just 1 cent.

**14-3 What is standard markup pricing?**

Answer: Standard markup pricing entails adding a fixed percentage to the cost of all items in a specific product class. The price varies based on the type of product and the retail store within which it is sold.

**14-4 What profit-based pricing approach should a manager use if he or she wants to reflect the percentage of the firm's resources used in obtaining the profit?**

Answer: target return-on-investment pricing

**14-5 What is the purpose of loss-leader pricing when used by a retail firm?**

Answer: Loss-leader pricing involves deliberately selling a product below its customary price not to increase sales but to attract customers in hopes they will buy other products as well, such as discretionary items with large markups.

**14-6 Why would a seller choose a dynamic pricing policy**

**over a fixed-price policy?**

Answer: A dynamic pricing policy sets different prices for products and services in real time in response to supply and demand conditions. Sellers have considerable discretion in setting the final price in light of demand, cost, and competitive factors. Moreover, sellers can continually adjust prices due to the implementation of sophisticated information technology that gives them the ability to customize a price on the basis of customer purchasing patterns, product preferences, and price sensitivity. A fixed-price policy sets one price for all buyers of a product or service. Consumers can choose to buy or not buy, but there is no variation in the price from the seller.

**14-7 If a firm wished to encourage repeat purchases by a buyer throughout a year, would a cumulative or a noncumulative quantity discount be a better strategy?**

Answer: Cumulative quantity discounts apply to the accumulation of purchases of a product over a given time period (typically a year) and encourage repeat buying by a single customer to a far greater degree than do noncumulative quantity discounts.

**14-8 Which pricing practices are covered by the Sherman Act?**

Answer: The Sherman Act prohibits (1) horizontal price fixing, which is when two or more competitors explicitly or implicitly set prices and (2) predatory pricing, which is the practice of charging a very low price for a product with the intent of driving competitors out of business. Once competitors have been driven out, the firm raises its prices.

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## FOCUSING ON KEY TERMS

**above-, at-, or below-market pricing , 379**

**basing-point pricing , 389**

**bundle pricing , 375**

**cost-plus pricing , 376**

**customary pricing , 379**

**dynamic pricing policy , 382**

**everyday low pricing (EDLP) , 387**

**experience curve pricing , 376**

**fixed-price policy , 381**

**FOB origin pricing , 388**

**loss-leader pricing , 380**

**odd-even pricing , 374**

**penetration pricing , 373**

**predatory pricing , 391**

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**price discrimination , 390**

**price fixing , 389**  
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**product-line pricing , 382**  
**promotional allowances , 387**  
**quantity discounts , 385**  
**skimming pricing , 372**  
**standard markup pricing , 375**  
**target pricing , 375**  
**target profit pricing , 377**  
**target return-on-investment pricing , 378**  
**target return-on-sales pricing , 377**  
**uniform delivered pricing , 388**  
**yield management pricing , 375**

## APPLYING MARKETING KNOWLEDGE

1. Under what conditions would a digital camera manufacturer adopt a skimming price approach for a new product? A penetration approach?
2. What are some similarities and differences between skimming pricing, prestige pricing, and above-market pricing?
3. A producer of microwave ovens has adopted an experience curve pricing approach for its new model. The firm believes it can reduce the cost of producing the model by 20 percent each time volume doubles. The cost to produce the first unit was \$1,000. What would be the approximate cost of the 4,096th unit?
4. The Hesper Corporation is a leading manufacturer of high-quality upholstered sofas. Current plans call for an increase of \$600,000 in

the advertising budget. If the firm sells its sofas for an average price of \$850 and the unit variable costs are \$550, then what dollar sales increase will be necessary to cover the additional advertising?

5. Suppose executives estimate that the unit variable cost for their DVD recorder is \$100, the fixed cost related to the product is \$10 million annually, and the target volume for next year is 100,000 recorders. What sales price will be necessary to achieve a target profit of \$1 million?
6. A manufacturer of motor oil has a trade discount policy whereby the manufacturer's suggested retail price is \$30 per case with the terms of 40/20/10. The manufacturer sells its products through jobbers, who sell to wholesalers, who sell to gasoline stations. What will the manufacturer's sale price be?
7. Suppose a manufacturer of exercise equipment sets a suggested price to the consumer of \$395 for a particular piece of equipment to be competitive with similar equipment. The manufacturer sells its equipment to a sporting goods wholesaler who receives 25 percent of the selling price and a retailer who receives 50 percent of the selling price. What demand-oriented pricing approach is being used, and at what price will the manufacturer sell the equipment to the wholesaler?
8. Is there any truth in the statement, "Geographical pricing schemes will always be unfair to some buyers"? Why or why not?

## BUILDING YOUR MARKETING PLAN

To arrive at the final price(s) for your offering(s):

1. In **Chapter 13**, you considered your customers and competitors and set three possible prices. Now, modify those three prices in light of (a) pricing considerations for demand-, cost-, profit-, and competition-

oriented approaches described in this chapter and (b) possibilities for discounts, allowances, and geographic adjustments.

2. Do a break-even analysis for each of these three new prices.
3. Choose the final price(s).

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## Video Case 14 Video Case 14: Carmex (B): Setting the Price of the Number One Lip Balm

### VIDEO 14-3

#### Carmex (B) Video Case

[kerin.tv/13e/v14-3](http://kerin.tv/13e/v14-3)

“Carmex is dedicated to providing consumers with superior lip balm formulas —that heal, sooth and protect—while ensuring lips remain healthy and hydrated” exclaims Paul Woelbing, president of Carma Laboratories, Inc.

It’s an ambitious mission, but the company has been extraordinarily successful with its 75-year-old-product. Woelbing and his management team at Carma Laboratories can attribute their success to a strong brand, a loyal customer base, a growing product line, financial strength, and an exceptional talent for setting prices that achieve company objectives and still provide value to customers. Even during the recession and periods of slow growth the company has been successful. “In a rough economy,

shopping habits change,” Woelbing says. “People buy smaller quantities more frequently, but they still need personal care products.”



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Dierker, photographer

## THE COMPANY

Carmex was created by Paul’s grandfather, Alfred Woelbing, in his kitchen in Wauwatosa, Wisconsin, in 1937. Alfred had an entrepreneurial spirit and experimented with ingredients such as camphor, menthol, phenol, lanolin, salicylic acid, and cocoa seed butter to make the new product. The name didn’t have any meaning other than Alfred liked the sound of “Carma” and “ex” was a popular suffix for many brands at the time. He packaged the balm in small glass jars and sold the product for 25 cents from the trunk of his car by making personal sales calls to pharmacies in Wisconsin, Illinois, and Indiana. From the beginning, price and value were important to the product’s success. If pharmacies weren’t initially interested in Carmex, Alfred would leave a dozen jars for free. The samples would sell quickly and soon the pharmacies would place orders for more!

As the company grew, Alfred’s son, Don, joined the business and helped add new products to the company’s offerings. For example, in the 1980s Carmex made its first significant packaging change by also offering the balm in squeezable tubes. In the 1990s Carmex became available in stick form, which had been used by two of Carma’s major competitors—ChapStick and Blistex. In the 2000s Carmex became available in mint, cherry, and strawberry flavors (see **Chapter 8** for a description of the research techniques used to identify new flavors). The company also expanded into larger manufacturing facilities, added a new distribution center, and hired its first marketing experts.

Today, the company is led by Alfred's grandsons, Paul and Eric Woelbing, who continue to manage the company to new levels of success. They appeared on *The Oprah Winfrey Show* to announce the sale of their billionth jar of Carmex. The governor of Wisconsin declared a Carmex commemoration day to celebrate its 75th anniversary. NBA all-star LeBron James became a promotional partner. In addition, *Pharmacy Times* magazine recently named Carmex the number one pharmacist-recommended brand of lip balm for the 15th consecutive year. "We are honored to receive this unprecedented acknowledgement," said Woelbing.

Industry observers estimate that Carma Labs holds approximately 10 percent of the lip balm market. The company distributes its products through major drug, food, and mass merchant retailers, convenience stores, and online in more than 25 countries around the world. The company's most recent products—Carmex Healing Cream and Carmex Hydrating Lotion—represent a significant step from lip care to skin care. The expanded product line, multichannel distribution, growing volume, international trade, and direct competition make pricing decisions even more important today than when Alfred started the business many years ago.

## SETTING PRICES OF CARMEX PRODUCTS

"There are many factors that go into what results in the retail price in the store," explains Kirk Hodgdon of Bolin Marketing. As one of the marketing experts who helps Carma Labs with advertising, marketing research, and pricing decisions, Hodgdon uses information about consumer demand, production and material costs, profit goals, and competition to help Woelbing and Carmex retailers arrive at specific prices. The many factors often overlap and lead to different prices for different products, channels, and

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target markets. "It's a challenge!" says Hodgdon.

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Consumers' tastes and preferences, for example, influence the price of Carmex products. Bolin director of marketing, Alisa Allen, explains: "Consumers will tell you that they love Carmex because it's a great value. That doesn't necessarily mean that it's the absolute lowest price. It means that it does so much; they pay a dollar and they get all kinds of benefits from the product above and beyond what they would expect." A single jar of original formula Carmex may sell for \$0.99 at mass retailers such as Walmart and Target, and between \$1.59 and \$1.79 in drug and food retailers such as Walgreens and Kroger. These prices are a good indication of how important it is to understand consumers when setting prices. "There are magic price points for consumers," says Allen, "Any time you can drop a penny off, the consumer responds to that price."



Source: Carma Labs Inc.

Carmex has also introduced a premium lip balm product, Carmex Moisture Plus, at a retail price between \$2.49 and \$2.99. Moisture Plus is a lip balm that is packaged in a sleek silver tube, offers a slant tip like lipstick, and is targeted toward women. The formula offers women a satin gloss shine and includes vitamin E and aloe for richer moisturization. The upscale package and additional product benefits help Carmex Moisture Plus command a higher price than the traditional Carmex jar and tube.

The cost of the ingredients that make up the Carmex lip balm formulas, the packaging, the manufacturing equipment, and the staffing are also factored into the price of the products. Volumes are a key driver of the cost of packaging and ingredients. For example, Carmex purchases up to 12 million yellow tubes each year for the traditional product, and 2 million sticks each year for the newer Moisture Plus product. The difference in quantities leads to a lower price for the traditional yellow tubes. Similarly, ingredient suppliers, label suppliers, and box suppliers all provide discounts for larger quantities. It is also more efficient for Carmex's manufacturing facility to make a large batch of traditional formula than it is to make a small batch of Moisture Plus. Carmex has also reduced its costs with efforts such as its new

environmentally friendly Carmex jar which holds the same amount of lip balm but uses 20 percent less plastic, eliminating 35 tons of raw material costs and the related shipping costs!

Carmex also considers retailer margins when it sets its prices. According to Allen, “We typically sell our product to two types of retailers.” There are everyday low pricing (EDLP) retailers such as Walmart, and high-low retailers such as Walgreens. EDLP retailers offer consumers the lowest price every day without discounting through promotions. High-low retailers charge consumers a higher price, but they occasionally discount the product through special promotions which Carmex often supports with “marketing discretionary funds.” Carmex typically offers its products at different prices to EDLP and high-low retailers to allow each retailer to achieve its profit margin goals and to account for Carmex’s promotion expenditures. When the additional expenditures are considered, however, the cost to both types of retailer is similar.

Finally, Carmex considers competitors’ prices when setting its prices. Burt’s Bees, ChapStick, Blistex, and many other brands offer lip balm products and consumers often compare their prices to the price of Carmex. “We have found through research that it is extremely important that the price gap is not too great,” explains Allen. “If that gap becomes too wide consumers will leave the Carmex brand and purchase a competitor’s product.” When Carmex was preparing to launch its premium Moisture Plus product it conducted a thorough analysis of similar products to ensure that Moisture Plus was in an acceptable price range.

## CARMEX IN THE FUTURE

The original, and now legendary, Carmex formula and packaging will continue into the future with occasional changes to its pricing practices. New products, however, are on the horizon and likely to challenge the perceptions of the traditional products and prices in the Carmex line. Carmex Moisture Plus products, for example, will be offered in limited edition designs that ask consumers “Which personality are you?” Paul Woelbing explains the new approach:

Lip care is an important component of a daily beauty regimen and consumers need a product they can rely on that protects and serves as an important foundation. The goal of the new Carmex Moisture Plus line is to offer our consumers a hard-working lip balm line that represent and reflects their unique style.

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Some of the new styles include: *Chic* in houndstooth, *Fab* in a groovy retro look, *Adventurous* in a leopard print, *Whimsical* in an art deco design. Page 396

“We are so excited about the future of Carmex,” says Hodgdon. “We are planning new products, we have new plans for retailers, and the future is nothing but bright!”<sup>26</sup>

## Questions

1. Which of the four approaches to setting a price does Carmex use for its products? Should one approach be used exclusively?
2. Why do many Carmex product prices end in 9? What type of pricing is this called? What should happen to demand when this approach is used?
3. Should cost be a factor in Carmex’s prices? What do you think is a reasonable markup for Carmex and for its retailers?
4. What is the difference between an EDLP retailer and a high-low retailer? Why does Carmex charge them different prices?
5. Conduct an online search of lip balm products and compare the price of a Carmex product with three similar products from competitors. How do you think the competitors are setting their prices?

## Chapter Notes

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**26.** Carmex (B): This case was written by Steven Hartley and Alisa Allen. Sources: Kristen Scheuing, "The Man Behind Carmex," *Wisconsin Trails*, March/April 2011; "Carmex and Carma Laboratories: *Pharmacy Times* Names Carmex Number One Recommended Lip Balm," *IndiaPharma News*, June 21, 2013; "New Lip Balm Offers Sun Protection While Drenching Lips in Moisture," *Postmedia Breaking News*, May 21, 2013; Carma Laboratories website, [www.mycarmex.com](http://www.mycarmex.com), accessed September 2, 2013; and interviews with Bolin Media personnel.