Principles of Marketing, v. 1.0

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15.2 Factors That Affect Pricing Decisions

Learning Objectives

1. Understand the factors that affect a firm's pricing decisions.
2. Understand why companies must conduct research before setting prices in international markets.
3. Learn how to calculate the breakeven point.

Having a pricing objective isn't enough. A firm also has to look at a myriad of other factors before setting its prices. Those factors include the offering's costs, the demand, the customers whose needs it is designed to meet, the external environment—such as the competition, the economy, and government regulations—and other aspects of the marketing mix, such as the nature of the offering, the current stage of its product life cycle, and its promotion and distribution. If a company plans to sell its products or services in international markets, research on the factors for each market must be analyzed before setting prices. Organizations must understand buyers, competitors, the economic conditions, and political regulations in other markets before they can compete successfully. Next we look at each of the factors and what they entail.

Customers

How will buyers respond? Three important factors are whether the buyers perceive the product offers value, how many buyers there are, and how sensitive they are to changes in price. In addition to gathering data on the size of markets, companies must try to determine how price sensitive customers are. Will customers buy the product, given its price? Or will they believe the value is not equal to the cost and choose an alternative or decide they can do without the product or service? Equally important is how much buyers are willing to pay for the offering. Figuring out how consumers will respond to prices involves judgment as well as research.

Price elasticity, or people's sensitivity to price changes, affects the demand for products. Think about a pair of sweatpants with an elastic waist. You can stretch an elastic waistband like the one in sweatpants, but it's much more difficult to stretch the waistband of a pair of dress slacks. Elasticity refers to the amount of stretch or change. For example, the waistband of sweatpants may stretch if you pull on it. Similarly, the demand for a product may change if the price changes. Imagine the price of a twelve-pack of sodas changing to $1.50 a pack. People are likely to buy a lot more soda at $1.50 per twelve-pack than they are at $4.50 per twelve-pack. Conversely, the waistband on a pair of dress slacks remains the same (doesn't change) whether you pull on it or not. Likewise, demand for some products won't change even if the price changes. The formula for calculating the price elasticity of demand is as follows.

Price elasticity = percentage change in quantity demanded ÷ percentage change in price

When consumers are very sensitive to the price change of a product—that is, they buy more of it at low prices and less of it at high prices—the demand for it is price elastic. Durable goods such as TVs, stereos, and freezers are more price elastic than necessities. People are more likely to buy them when their prices drop and less likely to buy them when their prices rise. By contrast, when the demand for a product stays relatively the same and buyers are not sensitive to changes in its price, the demand is price inelastic. Demand for essential products such as many basic food and first-aid products is not as affected by price changes as demand for many nonessential goods.

The number of competing products and substitutes available affects the elasticity of demand. Whether a person considers a product a necessity or a luxury and the percentage of a person's budget allocated to different products and services also affect price elasticity. Some products, such as cigarettes, tend to be relatively price inelastic since most smokers keep purchasing them regardless of price increases and the fact that other people see cigarettes as unnecessary. Service providers, such as utility companies in markets in which they have a monopoly (only one provider), face more inelastic demand since no substitutes are available.

Competitors

How competitors price and sell their products will have a tremendous effect on a firm's pricing decisions. If you wanted to buy a certain pair of shoes, but the price was 30 percent less at one store than another, what would you do? Because companies want to establish and maintain loyal customers, they will often match their competitors' prices. Some retailers, such as Home Depot, will give you an extra discount if you find the same product for less somewhere else. Similarly, if one company offers you free shipping, you might discover other companies will, too. With so many products sold online, consumers can compare the prices of many merchants before making a purchase decision.

The availability of substitute products affects a company's pricing decisions as well. If you can find a similar pair of shoes selling for 50 percent less at a third store, would you buy them? There's a good chance you might. Recall from the five forces model discussed in Chapter 2 "Strategic Planning" that merchants must look at substitutes and potential entrants as well as direct competitors.

The Economy and Government Laws and Regulations

The economy also has a tremendous effect on pricing decisions. In Chapter 2 "Strategic Planning" we noted that factors in the economic environment include interest rates and unemployment levels. When the economy is weak and many people are unemployed, companies often lower their prices. In international markets, currency exchange rates also affect pricing decisions.

Pricing decisions are affected by federal and state regulations. Regulations are designed to protect consumers, promote competition, and encourage ethical and fair behavior by businesses.

For example, the Robinson-Patman Act limits a seller's ability to charge different customers different prices for the same products. The intent of the act is to protect small businesses from larger businesses that try to extract special discounts and deals for themselves in order to eliminate their competitors. However, cost differences, market conditions, and competitive pricing by other suppliers can justify price differences in some situations. In other words, the practice isn't illegal under all circumstances. You have probably noticed that restaurants offer senior citizens and children discounted menus. The movies also charge different people different prices based on their ages and charge different amounts based on the time of day, with matinees usually less expensive than evening shows. These price differences are legal. We will discuss more about price differences later in the chapter.

Price fixing, which occurs when firms get together and agree to charge the same prices, is illegal. Usually, price fixing involves setting high prices so consumers must pay a high price regardless of where they purchase a good or service. Video systems, LCD (liquid crystal display) manufacturers, auction houses, and airlines are examples of offerings in which price fixing existed. When a company is charged with price fixing, it is usually ordered to take some type of action to reach a settlement with buyers.

Price fixing isn't uncommon. Nintendo and its distributors in the European Union were charged with price fixing and increasing the prices of hardware and software. Sharp, LG, and Chungwa collaborated and fixed the prices of the LCDs used in computers, cell phones, and other electronics. Virgin Atlantic Airways and British Airways were also involved in price fixing for their flights. Sotheby's and Christie's, two large auction houses, used price fixing to set their commissions.

One of the most famous price-fixing schemes involved Robert Crandall, the CEO of American Airlines in the early 1990s. Crandall called Howard Putnam, the CEO of Braniff Airlines, since the two airlines were fierce competitors in the Dallas market. Unfortunately for Crandall, Putnam taped the conversation and turned it over to the U.S. Department of Justice. Their conversation went like this:

Crandall: "I think it's dumb—to pound—each other and neither one of us making a [expletive] dime."

Putnam: "Well…"

Crandall: "I have a suggestion for you. Raise your—fares twenty percent. I'll raise mine the next morning."

Putnam: "Robert, we—

Crandall: "You'll make more money and I will too.

Putnam: "We can't talk about pricing."

Crandall: “Oh, [expletive] Howard. We can talk about any [expletive] thing we want to talk about.” [1]”

By requiring sellers to keep a minimum price level for similar products, unfair trade laws protect smaller businesses. Unfair trade laws are state laws preventing large businesses from selling products below cost (as loss leaders) to attract customers to the store. When companies act in a predatory manner by setting low prices to drive competitors out of business, it is a predatory pricing strategy.

Similarly, bait-and-switch pricing is illegal in many states. Bait and switch, or bait advertising, occurs when a business tries to “bait,” or lure in, customers with an incredibly low-priced product. Once customers take the bait, sales personnel attempt to sell them more expensive products. Sometimes the customers are told the cheaper product is no longer available.

You perhaps have seen bait-and-switch pricing tactics used to sell different electronic products or small household appliances. While bait-and-switch pricing is illegal in many states, stores can add disclaimers to their ads stating that there are no rain checks or that limited quantities are available to justify trying to get you to buy a different product. However, the advertiser must offer at least a limited quantity of the advertised product, even if it sells out quickly.

Product Costs

The costs of the product—its inputs—including the amount spent on product development, testing, and packaging required have to be taken into account when a pricing decision is made. So do the costs related to promotion and distribution. For example, when a new offering is launched, its promotion costs can be very high because people need to be made aware that it exists. Thus, the offering’s stage in the product life cycle can affect its price. Keep in mind that a product may be in a different stage of its life cycle in other markets. For example, while sales of the iPhone remain fairly constant in the United States, the Koreans felt the phone was not as good as their current phones and was somewhat obsolete. Similarly, if a company has to open brick-and-mortar storefronts to distribute and sell the offering, this too will have to be built into the price the firm must charge for it.

The point at which total costs equal total revenue is known as the breakeven point (BEP). For a company to be profitable, a company’s revenue must be greater than its total costs. If total costs exceed total revenue, the company suffers a loss.

Total costs include both fixed costs and variable costs. Fixed costs, or overhead expenses, are costs that a company must pay regardless of its level of production or level of sales. A company’s fixed costs include items such as rent, leasing fees for equipment, contracted advertising costs, and insurance. As a student, you may also incur fixed costs such as the rent you pay for an apartment. You must pay your rent whether you stay there for the weekend or not. Variable costs are costs that change with a company’s level of production and sales. Raw materials, labor, and commissions on units sold are examples of variable costs. You, too, have variable costs, such as the cost of gasoline for your car or your utility bills, which vary depending on how much you use.

Consider a small company that manufactures specialty DVDs and sells them through different retail stores. The manufacturer's selling price (MSP) is $15, which is what the retailers pay for the DVDs. The retailers then sell the DVDs to consumers for an additional charge. The manufacturer has the following charges:

Copyright and distribution charges for the titles	$150,000
Package and label designs for the DVDs	$10,000
Advertising and promotion costs	$40,000
Reproduction of DVDs	$5 per unit
Labels and packaging	$1 per unit
Royalties	$1 per unit

In order to determine the breakeven point, you must first calculate the fixed and variable costs. To make sure all costs are included, you may want to highlight the fixed costs in one color (e.g., green) and the variable costs in another color (e.g., blue). Then, using the formulas below, calculate how many units the manufacturer must sell to break even.

The formula for BEP is as follows:

BEP = total fixed costs (FC) ÷ contribution per unit (CU) contribution per unit = MSP – variable costs (VC) BEP = $200,000 ÷ ($15 – $7) = $200,000 ÷ $8 = 25,000 units to break even

To determine the breakeven point in dollars, you simply multiply the number of units to break even by the MSP. In this case, the BEP in dollars would be 25,000 units times $15, or $375,000.

Key Takeaway

In addition to setting a pricing objective, a firm has to look at a number of factors before setting its prices. These factors include the offering's costs, the customers whose needs it is designed to meet, the external environment—such as the competition, the economy, and government regulations—and other aspects of the marketing mix, such as the nature of the offering, the stage of its product life cycle, and its promotion and distribution. In international markets, firms must look at environmental factors and customers' buying behavior in each market. For a company to be profitable, revenues must exceed total costs.

Review Questions

1. What factors do organizations consider when making price decisions?
2. How do a company's competitors affect the pricing decisions the firm will make?
3. What is the difference between fixed costs and variable costs?