DO YOU COMPARE PRICES when you shop? You may consider some prices great. Other times you might feel the price is too high. You may have wondered how merchants determine prices. Pricing goods and services can be quite involved. Some pricing strategies are discussed in this unit.

Objective:

Describe major pricing objectives, basic pricing methods, different pricing strategies, and markups.

Key Terms:

- breakeven quantity
- cash discounts
- discount
- economy pricing
- fixed costs
- loss leaders
- markup
- multiple-unit pricing
- odd pricing
- penetration pricing
- premium pricing
- price lining
- price point
- price skimming
- pricing
- psychological pricing
- quantity discounts
- revenue
- selling price
- trade discounts
- variable costs

Pricing

Pricing is one of the four Ps of the marketing mix. Pricing is the process of applying a price to a product or a service.

MAJOR PRICING OBJECTIVES

A firm may have several objectives in mind when setting a price on a product. Before establishing prices, management must decide what it expects to accomplish through pricing. Pricing
objectives give direction to the pricing process, so a company must consider its overall financial objectives, the objectives of the product, what the customer is willing to pay, and the company’s available resources.

A well-set price will achieve profits for the company; fit within the customer’s price range; and support its position in the market in terms of quality, amount of advertising, manufacturing cost, etc. Some pricing objectives include earning the maximum profit, increasing the sales volume, building store traffic, increasing market share, enhancing or creating an image, and furthering social causes.

**Maximize Profit**

Ultimately, the goal of marketing is to make a profit by providing goods and services to others. One long-term pricing objective of almost all companies is to optimize (make the most possible) profits.

**Increase Sales Volume**

A company may lower prices to increase the quantity of sales. Such a move could hurt profit margins in the short run, but it generally enables the company to become more financially secure in the long run because more products are sold and more customers are secured. This strategy, referred to as giving a discount, is often a short-term one. A **discount** is a deduction from the regular price of an item. For example, a company may have a three-day or week-long sale and then prices return to the regular **price point**—sale point where demand is relatively high. Another way a seller may increase sales volume is by trying to clean out part of the inventory. This can be accomplished by discounting sales prices until the items are gone. Types of discounts include trade discounts, quantity discounts, and cash discounts.

**Trade discounts** (wholesale pricing) are deductions from the regular price point that are offered to marketing intermediaries. A company may offer another retailer wholesale pricing so customers can purchase the product at multiple companies. Even though the parent company does not make as much on the product when it sells at wholesale pricing, a higher volume of sales is usually achieved when multiple companies offer it for sale.

**Quantity discounts** are deductions given to customers who buy in large quantities. For example, when someone purchases many reams of paper, the price usually decreases. A company offers this kind of discount, or any type of discount, to build good relationships with customers.

**Cash discounts** are deductions offered for prompt payment. Many
times gas stations offer two prices for gas: one price for payments made with a credit card and one for payments made with cash. They do this because they do not have to wait for payment from the credit card company when they receive cash directly from the customer. In addition, they avoid paying a user fee to the credit card company.

**Build Store Traffic**

The long-term objective is to make profits by following the short-term objective of building a strong customer base. This is achieved by enticing customers into the store with great deals. Supermarkets often advertise certain products at or below cost (loss leaders) to attract people to the store. The customers purchase these loss leaders, but they typically also purchase many other products on which the supermarket makes a profit.

**Increase Market Share**

Pricing products or services lower than the competition may help the company capture a larger portion of the market. The profit per unit will be lower, but it is hoped to sell a large enough quantity to maintain a high profit level.

**Enhance or Create an Image**

By pricing a product high, the company tries to promote or increase the product's image. Sometimes high pricing is placed on all items a company offers so people view the retailer as prestigious, or a few products or certain product lines may have high prices. The hope is that people will view those products as elite. Proper promotion is a major key in the success of this pricing objective. We often see this used on certain watches, perfumes, and other socially visible products. These items are priced high to give them an image of exclusivity.

**Further Social Causes**

A company may price a product low so people with few resources can afford it, such as on “essential” household items. Basic or “generic” brands of bread, milk, and cheese are examples.

**BASIC PRICING METHODS**

Once a firm has developed its pricing objectives, it must select a pricing method to reach that goal. The pricing method provides a price for each product. For any product, the
**breakeven quantity** is the number of units that must be sold for the revenue to equal the total cost invested in producing and selling the product. **Revenue** is the total amount received from product sales.

The cost involved in operating a business can be classified in two groups: fixed-costs and variable costs. **Fixed costs** are expenses incurred no matter how many units of a product are produced or sold (e.g., rent, utilities, full-time staff salaries, and benefits). In contrast, **variable costs** are expenses that depend on the number of units produced. The more units produced, the higher the overall cost. Per piece, however, the cost usually decreases as the volume produced increases. Marketing, advertising, promotions, and discounts are all considered variable costs. There are four basic pricing methods: cost-plus pricing, demand-based pricing, competition-based pricing, and psychological pricing.

**Cost-Based Pricing**

Cost-based pricing is the simplest method of pricing. The seller first determines the total cost of producing one unit of the product (fixed cost). Based on the current or anticipated volume of sales, the variable costs per unit are determined. The seller then adds a **markup**, which is an additional percentage on top of the total cost of a product to produce a profit. The total of the cost plus the markup is the **selling price** (retail price). As long as the costs are calculated correctly and sales volumes are accurately predicted, the company will always operate on a profit. This pricing method is often used in small businesses with unique offerings.

**Demand-Based Pricing**

Demand-based pricing is based on the level of demand for the product when this method is used. It results in a high price when product demand is strong and a low price when demand is weak. Compared with cost-plus pricing, demand-based pricing places a firm in a better position to attain higher profit levels, assuming that buyers value the product at levels sufficiently above the product’s cost. Products that often use demand-based pricing are crude oil, gas, lumber, and paper. To a certain extent, cost-plus pricing is used in this method because a company must know its combined breakeven price before putting a price tag on the product (for a high or a low price).

**Competition-Based Pricing**

Competition-based pricing places costs and revenue secondary to a competitor’s price. The importance of this method increases if competing products are quite similar and the company is serving markets in which price is a crucial variable of the marketing strategy. A company that uses competition-based pricing may choose to be below the competitor’s prices, slightly above competitor’s prices, or at the same level. Competition-based pricing can help attain a pricing objective to increase sales or market share.

**Psychological Pricing**

**Psychological pricing** is a strategy that encourages purchases based on emotional response rather than on economically rational responses. This pricing is used primarily for consumer products and services rather than for industrial products.
Some examples of psychological pricing are odd pricing, multiple-unit pricing, and price lining. **Odd pricing** is the strategy of setting prices at odd amounts slightly below an even or whole-dollar amount. Many retailers believe that consumers respond more positively to odd-number prices (e.g., $4.99) than to whole-dollar prices (e.g., $5). **Multiple-unit pricing** is a strategy that sets a single price for two or more units. This is often used in infomercials. “But wait! We’ll throw in two more for the same low price!” **Price lining** is a strategy to sell goods only at a certain predetermined price that reflects definite price breaks. An example would be a store that sells everything for $1 or a boutique that sells everything for $15.

### DIFFERENT PRICING STRATEGIES

A seller may temporarily or permanently apply various pricing strategies to the basic prices of its individual products or its complete product lines. Pricing strategies are often dependent on the market situation (e.g., demand and competition trends). Four pricing strategies are economy pricing, penetration pricing, price skimming, and premium pricing.

**Economy Pricing**

**Economy pricing** offers customers a “no frills” low price. The cost of marketing and production are kept at a minimum. Generic brands of food and medicine are priced with economy pricing.

**Penetration Pricing**

**Penetration pricing** marks products and services artificially low to gain a market share. After the company reaches a certain base of customers, it raises the price to a profitable price point. This pricing strategy is used for new products.

**Price Skimming**

**Price skimming** places a high price on a product because the company has a big competitive advantage. The advantage, though, is not sustainable as other companies are able to offer a similar product. When similar products enter the market, the original product’s price falls. Price skimming often happens in the electronics industry. Examples are iPods®, iPhones®, JumpDrives®, and SD cards.

**Premium Pricing**

**Premium pricing** sets a high price to project an aura of quality and status or places a high price on unique items. Many buyers believe that a high price is equivalent to high quality for certain products. In most cases, products and services that carry premium price tags have more variable costs (e.g., advertising and promotions) than those offered at lower prices. Companies that often practice premium pricing are Rolex, Mercedes, and J.W. Marriott Hotels.
MARKUPS

To put any of the methods or strategies of pricing into practice, an understanding of basic cost-plus pricing is essential. The following formulas will help in calculating a retail price.

**Determining Breakeven Price**

\[(\text{fixed cost} + \text{variable cost})/\text{total quantity produced} = \text{breakeven price}\]

\[(\text{fixed cost}/\text{quantity produced}) + (\text{total variable costs for the business percentage of business’s variable costs item must carry}) = \text{breakeven price}\]

**Determining Markup**

At times, a retailer may want to make a certain dollar amount of profit from the sale of each item. In that case, the markup would be figured by the following formula: breakeven price + desired profit amount = retail price. (This generally works for items where there is a large difference between the breakeven price and the price customers will pay.)

Another approach may use the following formula: breakeven price additional percentage to generate profit = retail price (This would be used when a retailer determines that he or she would like to retail items for a certain percentage over cost. A number (e.g., 10 or 25 percent) is then chosen to help the company reach its financial goals.

A third approach to markup is figuring out the breakeven cost and then placing a retail price on the product that customers believe is fair or common. For instance, if the breakeven cost of a T-shirt is $8.62, a retailer may decide to retail it for $14.99 or $19.99 because those are common price points for T-shirts.

When fixed or variable costs change, a company is faced with several pricing decisions and many questions. Setting a retail price is not a hard and fast science. It is an art where retailers must combine realistic expectations and educated guesses to come to a price that will help move their products. Questions a company must consider include:

- Should the item’s price increase by the same amount that the fixed or variable price increased?
- Should the retail price decrease if the product’s costs have gone down?
- Should the retail price remain the same as before even though the item will produce less profit?
- If we keep the retail price the same as before, can some variable costs be cut to keep the profit the same?
- If the variable costs are reduced, including advertising, will the product exposure be enough to keep sales volume goals on track?

**Summary:**

Pricing is the process of applying a price to a product or a service. Some pricing objectives include maximizing profits, increasing sales volume, building store traffic,
increasing market share, enhancing or creating an image, and furthering social causes. Types of discounts are trade discounts, quantity discounts, and cash discounts.

For any product, the breakeven quantity is the number of units that must be sold for the revenue to equal the total cost invested in producing and selling the product. There are four basic pricing methods: cost-plus pricing, demand-based pricing, competition-based pricing, and psychological pricing. Some examples of psychological pricing are odd pricing, multiple-unit pricing, and price lining.

Pricing strategies are often dependent on the market situation. Four pricing strategies are economy pricing, penetration pricing, price skimming, and premium pricing.

To put any of the methods or strategies of pricing into practice, an understanding of basic cost-plus pricing is essential. These can be calculated in a number of ways.

**Checking Your Knowledge:**

1. What are some pricing objectives?
2. What are three types of discounts?
3. What are four basic pricing methods?
4. What are some examples of psychological pricing?
5. How can markup be calculated?

**Expanding Your Knowledge:**

Increase your awareness of pricing strategies. Note how retailers offer discounts and sales. Based on this reading, classify the pricing strategies used. If you work for a retailer or a family member owns a retail business, ask how prices are determined.

**Web Links:**

- **Understanding Pricing Objectives and Strategies**
  [http://pubs.cas.psu.edu/FreePubs/pdfs/ua441.pdf](http://pubs.cas.psu.edu/FreePubs/pdfs/ua441.pdf)

- **Pricing Strategy**

- **Discounts and Allowances**

- **Pricing in a Retail Store**
  [http://www.belgotec.com/small-business-marketing/marketing-m2y3.htm](http://www.belgotec.com/small-business-marketing/marketing-m2y3.htm)

- **Agricultural Career Profiles**
  [http://www.mycaert.com/career-profiles](http://www.mycaert.com/career-profiles)