EXERCISES

Clearly, pricing is a marketing 'tool' just as much as advertising, promotions and the use of the sales force. Moreover, it is generally easier and quicker to change a price than it is to alter an advertising campaign, revamp a sales promotion, or to deploy the sales force in a different manner.

Pricing decisions not only affect the revenue the company can earn, but also they influence demand, thereby making an impact on the quantities sold. Yet for all this, few companies have a pricing plan. Indeed, rather than a positive strategy, the very topic often becomes a battle-ground in a war of apparently conflicting interests between marketers and accountants.

Exercise 9.1 looks at how to set a competitive price for a product or service, taking into account a number of different factors which can have a bearing on the pricing decision.

Exercise 9.2 is concerned with selecting the price.

Exercise 9.3 provides some insights into the real impact of price discounts.

Exercise 9.4 is a self-scoring questionnaire which gives you some assessment about your readiness to get involved in aggressive pricing situations.

Exercise 9.5 poses a number of awkward questions about pricing and gives you the opportunity to test out your expertise.

Exercise 9.1 Setting a competitive price

This exercise will enable you to use pricing in a creative way, one which will support your marketing plan. It will use information from your marketing audit and a few new pieces of data to help you to arrive at a sensible pricing plan for your products or services.

It goes without saying that unless the company has an accurate costing system, one that realistically reflects its internal situation, then it will be impossible to establish anything like a sensible pricing policy. The reason for this will become self-evident as you provide the information requested below.

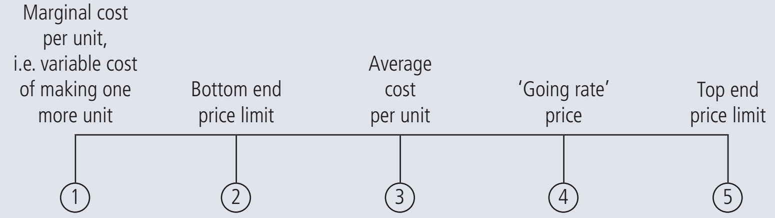

Figure 9.11: Some key positions or the costing/pricing continuum.

(Continued)

Figure 9.11 shows some key positions on the costing/pricing continuum. Taking just *one* of your company's major products or services, enter on the worksheet the actual figures that correspond to the numbers 1 to 5, in the positions marked in Figure 9.11, i.e. the actual marginal cost, bottom end price limit, etc.

When considering the average cost please remember that costing systems that allocate fixed costs to all products in the range, while being popular, can produce some very misleading results, especially if the basis of cost allocation is somewhat arbitrary. Some products can never survive the cost load they have to carry. Knowing what the customer is prepared to pay for your chosen product/service (the going rate price), consider different costing options, with the objective of getting the average cost per unit as low as possible, thereby providing you with a wider range of pricing options.

Consider other products and services and repeat this process for them. The worksheet is useful in order to establish the range of discretion open to you, but the more important task will be to identify where exactly on this scale to select your price position.

Worksheet Cost price continuum (Exercise 9.1)

PRODUCT/SERVICE	*1 Marginal cost per unit*	*2 Bottom end price limit per unit*	*3 Average cost per unit*	*4 Going rate price per unit*	*5 Top end price limit per unit*
Example	£6.50	£8.50	£10	£13	£20

Exercise 9.2: Selecting the price

It can be shown that there are a number of factors that can influence your ultimate choice of price. These will be considered in turn.

Corporate objectives

If the corporate objectives dictate that it will be important to generate short-term profits for your chosen product/service, it would be reasonable to select a high price, somewhere between 4 and 5 on the scale established in Figure 9.11. Alternatively, if the aim is to extend market share, then a position between 3 and 4 would be more suitable.

You can see from this example that whatever the nature of the corporate or marketing objectives for your chosen product or service, it is possible to select a position somewhere on the scale which appears to be most appropriate. Select a position for your chosen product and record the price on the worksheet where indicated.

Worksheet Factors affecting price (Exercise 9.2)

	Example (based on example on preceding worksheet)	*Prod. 1*	*Prod. 2*	*Prod. 3*	*Prod. 4*
1 Corporate objectives	£18.00				
2 Portfolio matrix	£16.00				
3 Life-cycle analysis	£16.00				
4 Product position	£10.00				
5 Current competition	£12.00				
6 Potential competition	£10.00				
7 Channels of distribution	Not applic.				
8 Differential benefits	£9.00				
9 Consumer attitudes	£9.00				
Total score	£100.00				
Number of factors	8				
Suggested price average	£12.50				

Portfolio matrix

It has been shown that a different marketing strategy would be required according to which quadrant 'housed' your chosen product. Generally speaking, this would mean that prices should be selected as follows:

1. '*Question mark*' – price competitively to get market share.
2. '*Star*' – price to maintain/increase market share.
3. '*Cash cow*' – stabilize or even raise price.
4. '*Dog*' – raise price.

With these guidelines in mind, select a position on the 1–5 scale for your product/service and again record the price on the worksheet.

Lifecycle

Your chosen product's position on its lifecycle will also be significant when calculating its price:

1. *Introduction stage* – either price low to capture market share or, if there is genuine novelty or innovation associated with the product, price high in recognition of its prestige value.
2. *Growth stage* – price low to get market share.

(*Continued*)

3. *Maturity* – as for growth stage.
4. *Saturation* – stabilize price, consider raising it.
5. *Decline* – raise price.

Using these suggestions, select a position for your chosen product on the 1–5 scale and, again, note the price on the worksheet.

Product position

Your price will have to take into account the marketing profile you are trying to establish for your chosen product. If yours is the biggest, the best, the most technologically advanced product, then your price ought to echo the fact. Similarly, if your target is just high-income customers, your price should reflect that exclusivity. The converse will be true for down-market economy models, where a lower price would be more consistent with the product position.

Carefully consider your product position and use your judgement to 'score' a position on the 1–5 scale. Record your choice of price on the worksheet.

Current competition

Analyse the prices charged by your competitors for their versions of your product or service. Will these influence your ultimate choice of price?

Where does this information suggest you position the price on the 1–5 scale? Enter your answer on the worksheet.

Potential competition

Another consideration you will have to take into account will be the extent to which your chosen price might either attract or repel competitors. Clearly, if you can get away with charging high prices and making correspondingly high margins, then it will not be long before others become interested in your sphere of business.

Estimate the price you can charge using the 1–5 scale as a reference. Note the selected price on the worksheet.

Channels of distribution

If your business is one where you need to use intermediaries to reach your customers, then, in return for their services, they will expect a reward in the shape of a 'mark-up' or margin on the goods. Thus the price you charge at the factory gate has to be profitable for you, yet still allow the intermediary a fair margin without leading to an excessively high price for the ultimate consumer. What will this mean for your pricing decision?

Choose a position on the 1–5 scale and enter the price on the worksheet.

Differential benefits

If your product or service provides differential customer benefits which your competitors do not provide, then you could justify a higher price and gain the reward from higher revenue. Your option for doing this might be limited by some of the other considerations above. For example, it might be better to use your product advantage to gain a larger market share. Nevertheless, if the benefit analysis you carried out in Chapter 4 suggests any room for manoeuvre on pricing, score the new choice on the 1–5 scale and enter the actual figure on the worksheet.

Consumer attitudes

Consumer attitudes to your particular product/service or to your company, because of its name and reputation, might also influence your ultimate choice of price. To what extent will this be the case? Again select a price position on the 1–5 scale that you believe can be justified as a result of consumer attitudes to your product.

Record the price on the worksheet.

You have now looked at nine different factors that are known to influence pricing. These have been considered in isolation and a notional price position for your product has been calculated against each factor.

The price positions were established by using a cost–price continuum, with key positions numbered 1–5. The actual money value of each of these positions was calculated in the worksheet of Exercise 9.1.

The worksheet in this exercise is a record of the results you have attributed to the various pricing factors. You will now use this information in the following way:

1. Find the average price position for your product by adding up the column of prices and dividing it by the number of factors you used (an example is shown on the worksheet). This average figure would seem to be the 'best fit' when taking all the factors into account, and should therefore be selected as the price for your chosen product, unless, of course, there are other factors known to you which would militate against this decision.
2. Now repeat this process for other products or services.

Critique of example provided on worksheets

This approach to pricing raises many important issues. In the example provided it is quite evident that the corporate objectives are for the product to generate revenue. The positions on the portfolio matrix and lifecycle also appear to support this strategy of pricing high.

But look at some of the other factors. The product position would not appear to justify a high price, there seem to be few differential benefits and consumer attitudes are not very positive. In addition it looks as if the company will have to price below the 'going rate' if it is going to cope with the competition.

Result – a compromise price of £12.50 per unit.

Moral – if the company wants to price high, it must upgrade the product in terms of providing more differential benefits and work to improve customer attitudes.

Alternatively, or in addition, it should carefully re-examine the actual costs and its costing system and by doing so try to improve the margin that would be achievable at £12.50. By these means, it might well obtain results similar to its original objectives of pricing high.

(*Continued*)

Exercise 9.3: The use of discounts

To give a price reduction, which is really what a discount is, appears on the surface to be a fairly straightforward and easy-to-apply mechanism for stimulating demand. However, it is not always fully appreciated how many extra products have to be sold merely to break even, i.e. to get back to the original situation.

Here is a simple example. Suppose a company had sales of 100 units of a product per week, priced at £10. Thus the total income was £1,000 and this yielded a profit of £200. The marketing director of the company decides that a 10 per cent reduction in price will stimulate a demand in sales. What new level of sales in units would have to be achieved to break even?

• • •

Write your answer here ____

• • •

Probably this was how you calculated your figure:

	Units	*Price*	*Total income*	*Profit*
Original situation	100	£10	£1,000	£200

Since 100 units yielded £200 profit, profit per unit = £2. With price reduced to £9 (10 per cent reduction) new profit per unit = £1.

Therefore new situation becomes:

	Units	*Price*	*Total income*	*Profit*
New situation	200	£9	£1,800	£200

Thus the company would have to double its sale of units to maintain its existing profit level if it sold at the new lower price. Perhaps some questions would have to be asked about the feasibility of this happening.

To avoid having to make tedious calculations each time you contemplate making a price reduction, Table 9.1 provides an easy-to-use reference.

If you cut your price	**And your present gross profit is**							
	5%	**10%**	**15%**	**20%**	**25%**	**30%**	**35%**	**40%**
	You need to sell this much more to break even							
	%	%	%	%	%	%	%	%
1%	25.0	11.1	7.1	5.3	4.2	3.4	2.9	2.6
2%	66.6	25.0	15.4	11.1	8.7	7.1	6.1	5.3
3%	150.0	42.0	25.0	17.6	13.6	11.1	9.4	8.1
4%	400.0	66.6	36.4	25.0	19.0	15.4	12.9	11.1
5%	–	100.0	50.0	33.3	25.0	20.0	16.7	14.3

6%	–	150.0	66.7	42.9	31.6	25.0	20.7	17.6
7%	–	233.3	87.5	53.8	38.9	30.4	25.0	21.2
8%	–	400.0	114.3	66.7	47.1	36.4	29.6	25.0
9%	–	1,000.0	150.0	81.8	56.3	42.9	34.6	29.0
10%	–	–	200.0	100.0	66.7	50.0	40.0	33.3
11%	–	–	275.0	122.2	78.6	57.9	45.8	37.9
12%	–	–	400.0	150.0	92.3	66.7	52.2	42.9
13%	–	–	650.0	185.7	108.3	76.5	59.1	48.1
14%	–	–	1,400.0	233.3	127.3	87.5	66.7	53.8
15%	–	–	–	300.0	150.0	100.0	76.8	60.0
16%	–	–	–	400.0	177.8	114.3	84.2	66.7
17%	–	–	–	566.7	212.5	100.8	94.4	73.9
18%	–	–	–	900.0	257.1	150.0	105.9	81.8
19%	–	–	–	1,900.0	316.7	172.7	118.8	90.5
20%	–	–	–	–	400.0	200.0	133.3	100.0
21%	–	–	–	–	525.0	233.3	150.0	110.5
22%	–	–	–	–	733.3	275.0	169.2	122.2
23%	–	–	–	–	1,115.0	328.6	191.7	135.3
24%	–	–	–	–	2,400.0	400.0	218.2	150.0
25%	–	–	–	–	–	500.0	250.0	166.7

Example: Your present gross margin is 25 per cent and you cut your selling price by 10 per cent. Locate 10 per cent in the left-hand column. Now follow across to the column headed 25 per cent. You find you will need to sell 66.7 per cent *more* units.

Table 9.1 Effects of price reductions

Exercise 9.4 Questionnaire

This exercise* is really designed for personal insight, but you won't fail to notice that you could use it equally well to analyse your marketing director or chief executive.

Consider these statements and *quickly* tick the score which most aptly represents your position.

* Exercises 9.4 and 9.5 are based on John Winkler's work on pricing and we are indebted to him for the ideas. Readers are recommended to follow this up by reading his book *Pricing for Results* (Butterworth-Heinemann, 2nd edition 1991).

(*Continued*)

	Very true of me	Usually true of me	No feeling either way	Usually untrue of me	Very untrue of me
1. If a rival company is cheaper, I want to match or beat its price.	5	4	3	2	1
2. I would like to talk to competitors about equalizing prices.	5	4	3	2	1
3. I'm prepared to start a discount battle any time; I believe the first one in wins.	5	4	3	2	1
4. Before quoting a special price I will always ask 'Why?'	1	2	3	4	5
5. I fully expect to lose some deals on price.	1	2	3	4	5
6. I always try to keep it simple if I can! '10 per cent off' is the way to do it	5	4	3	2	1
7. I try not to publish discounts. I prefer to negotiate them individually.	1	2	3	4	5
8. I am always prepared to offer bigger discounts than I allow those working for me to offer.	5	4	3	2	1
9. I believe that most people will jump at a 10 per cent discount.	5	4	3	2	1
10. I believe that people who start savage price wars often live to regret it.	1	2	3	4	5

Now add up the total score for all your ticks and write it here ______________.

Scoring and interpretation of Exercise 9.4

The questions are not very subtle and so very good scores are required from this exercise. The lowest score for each question is the best, but an extremely low score, of *12 or less*, while suggesting the right instincts, might show you to be rather inflexible. You might well be used to working in an industry where the quality content of what you offer is very high, with prices that reflect this. In these circumstances you would tend to avoid price fights as much as you can. But if in your current role your firm does not always have a strongly differentiated offer, you may need to be more discriminating.

A score of *13–16* is a good score – you will hold on and make sensible, profitable deals most of the time. Although you might lose out here and there on high volume, you would rather make the largest profits than the largest sales.

Above 25 – you are a potential warmonger, probably used to working at the bottom end of some very tough markets, with some rapacious buyers. There's one other thing, and you might not like to hear this. These buyers are probably taking you to the cleaners.

Exercise 9.5 Awkward questions on pricing[4]

Here are some hypothetical questions concerning pricing. How would you deal with these situations?

Question 1

You are the marketing director of a pharmaceuticals company in a country where there is no equivalent of a National Health Service, and patients have to pay for the drugs they use. Your company produces a life-support drug. Once patients have been treated with it, they must stay on it continuously to survive. This drug has been outdated by a machine which treats new patients and, as a result, your market is gradually eroding. Should you adopt:

(a) A system based on cost-plus?
(b) A system based on what the market will bear?
(c) A system based on some notion of morality?
(d) A system based on what the competition charges?

Question 2

You have an excess of stock of a poor line to clear. You must shift this stock in order to raise money to invest in better products. What is your view of promotional pricing? Do you:

(a) Actively encourage it all the time?
(b) Offer it only to your best customers?
(c) Refuse to use it at all?
(d) Use it sparingly, outside normal markets?
(e) Use it a little, but create an impression that you use it a lot, through advertising, etc.?

Question 3

You want to price aggressively in order to take over a major part of a total market. What level of price discount should you offer in a normal consumer product market, as a minimum, to make the market turn to you in a meaningful way?

(a) 10 per cent off competitors' prices.
(b) 15 per cent off competitors' prices.
(c) 20 per cent off competitors' prices.
(d) 30 per cent off competitors' prices.
(e) Between 40 and 50 per cent off competitors' prices.

Question 4

If you average out all the prices of consumer products in a given market, you can arrive at an average price. Yours is the biggest selling brand in this market. Together with your two nearest competitors you share 60 per cent of the market. Measured against the average market price, where would you expect your brand leader product to be positioned?

(a) 10 per cent less than the average price.
(b) On, or closely around, the average price.
(c) 20 per cent less than the average price.
(d) 7 per cent above the average price.

(*Continued*)

Answers to Exercise 9.5

Question 1

(a) Score + 1.
(b) Score – 5. They will pay anything to stay alive, but how can you live with yourself?
(c) Score + 5.
(d) Score + 1.

Question 2

(a) Score 0.
(b) Score + 1. A poor tactic because it will make your best customers look for bargains all the time. It might generate some goodwill.
(c) Score + 1. Too rigid.
(d) Score + 5. Get rid of it altogether if you can, otherwise go for (e).
(e) Score + 4. A technique used by some supermarkets. A few loss leaders in reality, but all of them promoted very heavily. But you will still be attracting price cutting in your market, and you will have to advertise your price cuts as well as give the discounts away. This can be expensive unless the volume sales justify it.

Question 3

(a) Score 0.
(b) Score +1.
(c) Score +2.
(d) Score +3.
(e) Score +4.

Question 4

(a) Score 0.
(b) Score +2.
(c) Score –2.
(d) Score +5.

Interpretation of scores

15 or more	You did very well and/or are very experienced
10–14	Think a bit harder before making decisions
Less than 10	Don't engage in pricing decision making!