Chapter 14

Pricing concepts for establishing value (i)
• List the four pricing orientations.
• Explain the relationship between price and quantity sold.
• Explain price elasticity.
• Describe how to calculate a product’s break-even point.
• Indicate the four types of price competitive levels.
• Price is NOT just what you pay - it’s everything that you, as a consumer, give in exchange for the product you purchase (time, effort in finding it, effort spent researching it).
• Desperation
  – How much battery is left on a traveler’s cell phone can help to predict whether people going to accept surge pricing or not!
The 5 C’s of Pricing

- Company objectives
- Costs
- Competition
- Customers
- Channel members
• Profit oriented
  – Target profit pricing
    • Set profit goal

Example:
Companywide policy that all products must provide for at least an 18% profit margin to reach a particular profit goal for the firm.
  – Starbucks (1% price increase in 2013) --
1. Company objectives

• **Sales oriented**
  – Set prices to increase sales
  – Generally short term strategy

Example:
Set prices very low to generate new sales and take sales away from competitors, even if profits suffer
  – Launch of a new product
• **Competitor oriented**
  – Firms that measure themselves against their competitors
  – Set prices similar to competitors

Example:
  – Coke and Pepsi (generally product with little differentiation)
  – Airlines
1. Company objectives

- Customer oriented
  - Set prices to add value to product/services (set high prices to set customers perceptions, e.g., Apple, Rolex – could be a problem if quality is low!!)

Example:
Target a market segment of consumers who highly value a particular product benefit, and set prices relatively high (premium pricing).
  - Fashion industry
  - Luxury goods
1. Company objectives

What’s the goal of this ad?
What’s the goal of this ad?

- Plays with consumers expectation by comparing the purchase of a very familiar product to that of Zipcar
2. Customers

Understand customer reaction to different prices

Demand curve and pricing

Demand increases as price decreases
Demand curve and pricing

• Note: not all demand curves are downward trends!

• Prestigious product or services have upward trends
Price elasticity of demand

• How changes in price affect quantity demanded

\[
\text{Price Elasticity} = \frac{\text{Pct. Change in Quantity}}{\text{Pct. Change in Price}}
\]
2. Customers

Price elasticity of demand

• Example price elasticity

\[ p_1 = $10, \quad p_2 = $5 \]
\[ q_1 = 0.5M, \quad q_2 = 1M \]
Price elasticity of demand

- Example price elasticity

\[
\text{Pct. change } Q = \frac{(q_2 - q_1)}{q_1} = 50\%
\]
\[
\text{Pct. change } P = \frac{(p_2 - p_1)}{p_1} = -50\%
\]
\[
\text{Elasticity} = \frac{\text{Pct. change } Q}{\text{Pct. change } P} = -1
\]

- Customers

\[p_1 = \$10, \quad p_2 = \$5\]
\[q_1 = 0.5 \text{M}, \quad q_2 = 0.75 \text{M}\]
Price elasticity of demand

- **Elasticity** = Pct. change Q / Pct. change P = -1
  
  1% decrease in price generates an increase in quantity demanded of 1%

- **Elastic market** → price sensitive
  - Small change in price, large change in demand

- **Inelastic market** → price insensitive
  - Small changes in prices, small change in demand

In which markets is better to rise prices?
Customers are generally less sensitive to primary products (necessities)
Factors influencing price elasticity

- Income effect
Factors influencing price elasticity

• Income effect
Factors influencing price elasticity

• Income effect
Factors influencing price elasticity

• Substitution effect
  – The greater the availability of substitutes of a product, the higher the price elasticity
To make effective price decisions firms must take into account costs

- **Variable Costs**
  - Vary with production volume

- **Fixed Costs**
  - Unaffected by production volume

- **Total Cost**
  - Sum of variable and fixed costs
• Example: Hotel costs
  – Variable costs?
  – Fixed costs?
• **Example: Hotel costs**
  
  – **Variable costs?**
    • Food, beverages, housekeeping cleaning supplies, etc.
  
  – **Fixed costs?**
    • Land, Building Taxes to government, wages to employees, etc.
Break-even analysis

• **Break-even point:** # of units to sell in order to cover the total costs
  – At this point profit is 0!!
Break-even analysis

- Computing break even point
  
  Revenue = Total costs
Break-even analysis

- Computing break even point

Revenue = Total costs

\[ p \times q = \text{fixed costs} + \text{variable costs} \]

\[ p \times q = \text{fixed costs} + \text{variable costs per unit} \times q \]

We want to find \( q \) (break-even units):

\[ q = \frac{\text{Fixed costs}}{p - \text{variable cost per unit}} \]

Contribution per unit
3. Costs

**Break-even analysis**

- Computing break even point
  - Example hotel:
    - Fixed cost = $100,000
    - Variable cost per unit = $10
    - Price per unit \( (p) \) = $50
Break-even analysis

• Computing break-even point
  • Example hotel:
    – Fixed cost = $100,000
    – Variable cost per unit = $10
    – Price per unit (p) = $50

\[
q = \frac{\$100,000}{\$50 - \$10} = 2,500
\]

Quantity to sell to break-even
3. Costs

Break-even analysis

• Computing # of units for target profit

• Example hotel:
  – Fixed cost= $100,000
  – Variable cost per unit = $10
  – Price per unit (p) = $50
  – **Firms want a target profit of $50,000**
3. Costs

**Break-even analysis**

- Computing # of units for *target profit*

  - **Example hotel:**
    - Fixed cost = $100,000
    - Variable cost per unit = $10
    - Price per unit (p) = $50
    - **Firms want a target profit of $50,000**

\[
q = \frac{\$100,000 + \$50,000}{\$50 - \$10} = 3,750
\]
3. Costs

Break-even analysis

• Computing profit (more generally):

\[
\text{Profit} = p \times q - (\text{fixed costs} + \text{variable costs per units} \times q) \\
= \text{Contributions per unit} \times q - \text{fixed costs}
\]
Prices are affected by the presence and capabilities of competitors

- **Monopoly**
  - One firm controls the market (Microsoft)

- **Oligopoly**
  - A handful of firms control the market (airlines, mobile carriers)

- **Monopolistic (imperfect) Competition**
  - Many firms selling differentiated products at different prices (watches) → products are not perfect substitutes

- **Pure (perfect) Competition**
  - Many firms selling commodities where price is set by market (consumer goods)
<table>
<thead>
<tr>
<th>Fewer firms</th>
<th>Less price competition</th>
<th>More price competition</th>
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<tbody>
<tr>
<td></td>
<td>Monopoly</td>
<td>Oligopoly</td>
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<td>Pure competition</td>
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Walmart vs. Target
• **Manufacturers, wholesalers, retailers**
  
  – They can have different perspectives on pricing strategies

  – Example: Manufacturer and retailer
Price is affected by many factors

– The **goals** of the firm: Profit? Sales?
– Which **customers** the firm is targeting?
– Firm **costs**: variables and fixed
– **Competitions**: is there someone else selling a similar product to mine?
– Manufacturers, wholesalers, retailers