4.2: Pricing Considerations
What you’ll learn to do: explain the primary factors to consider in pricing

The Market Planning Process: a vertical Flowchart with 7 layers. The chart is organized into three subunits: the first subunit includes Layer 1 only, the second subunit includes Layer 2, Layer 3, and Layer 4, and the third subunit includes Layer 5, Layer 6, and Layer 7. From top of flow chart: Layer 1 “Corporate Mission” points to Layer 2 “Situational Analysis”. Layer 2 points to Layer 3 “Internal Factors: Strengths & Weaknesses” and “External Factors: Opportunities & Threats”. Layer 3 points to Layer 4 “Corporate Strategy: Objectives & Tactics”. Layer 4 concludes the second subunit of the flowchart and points to Layer 5, which begins the third subunit of the flowchart. Layer 5 is “Marketing Strategy: Objectives & Tactics”. Layer 5 points to Layer 6, a graphic made of five items: “Target Market” is the central item and the 4 Ps (Product, Price, Promotion, and Place) are attached to the four corners of “Target Market”. Layer 6 points to the seventh and final layer “Implementation & Evaluation”.

Now that we’ve considered the customer perspective, we need to understand how pricing fits into the company strategy. It’s important to remember that all elements of the marketing mix, including pricing, fit into a larger customer mission and strategy.

An effective pricing strategy will align with the corporate mission, account for competitive factors, and support corporate strategies and objectives.

The specific things you’ll learn in this section include:

- Explain company objectives in the pricing strategy
- Define break-even pricing
- Describe how competition affects pricing strategies
Pricing Objectives

Companies set the prices of their products in order to achieve specific objectives. Consider the following examples:

In 2014 Nike initiated a new pricing strategy. The company determined from a market analysis that its customers appreciated the value that the brand provided, which meant that it could charge a higher price for its products. Nike began to raise its prices 4–5 percent a year. Footwear News reported on the impact of their strategy:

“The ability to raise prices is a key long-term advantage in the branded apparel and footwear industry—we are particularly encouraged that Nike is able to drive pricing while most U.S. apparel names are calling for elevated promotional [and] markdown levels in the near-term,” said UBS analyst Michael Binetti. Binetti said Nike’s new strategy is an emerging competitive advantage.[1]

Nike’s understanding of customer value enabled it to raise prices and achieve company growth objectives, increasing U.S. athletic footwear sales by $168 million in one year.

In 2015 the U.S. airline industry lost $12 billion in value in one day because of concerns about potential price wars. When Southwest Airlines announced that it was increasing its capacity by 1 percent, the CEO of American Airlines—the world’s largest airline—responded that American would not lose customers to price competition and would match lower fares. Forbes magazine reported on the consequences:

This induced panic among investors, as they feared that this would trigger a price war among the airlines. The investors believe that competing on prices would undermine the airline’s ability to charge profitable fares, pull down their profits, and push them back into the shackles of heavy losses. Thus, the worried investors sold off stocks of major airlines, wiping out nearly $12 billion of market value of the airline industry in a single trading day.[2]

Common Pricing Objectives

Not surprising, product pricing has a big effect on company objectives. (You’ll recall that objectives are essentially a company’s business goals.) Pricing can be used strategically to adjust performance to meet revenue or profit objectives, as in the Nike example above. Or, as the airline-industry example shows, pricing can also have unintended or adverse effects on a company’s objectives. Product pricing will impact each of the objectives below:
• Profit objective: For example, “Increase net profit in 2016 by 5 percent”
• Competitive objective: For example, “Capture 30 percent market share in the product category”
• Customer objective: For example, “Increase customer retention”

Of course, over the long run, no company can really say, “We don’t care about profits. We are pricing to beat competitors.” Nor can the company focus only on profits and ignore how it delivers customer value. For this reason, marketers talk about a company’s “orientation” in pricing. Orientation describes the relative importance of one factor compared to the others. All companies must consider customer value in pricing, but some have an orientation toward profit. We would call this profit-oriented pricing.

**Profit-Oriented Pricing**

Profit-oriented pricing places an emphasis on the finances of the product and business. A business’s profit is the money left after all costs are covered. In other words, profit = revenue – costs. In profit-oriented pricing, the price per product is set higher than the total cost of producing and selling each product to ensure that the company makes a profit on each sale.

The benefit of profit-oriented pricing is obvious: the company is guaranteed a profit on every sale. There are real risks to this strategy, though. If a competitor has lower costs, then it can easily undercut the pricing and steal market share. Even if a competitor does not have lower costs, it might choose a more aggressive pricing strategy to gain momentum in the market.

Also, customers don’t really care about the company’s costs. Price is a component of the value equation, but if the product fails to deliver value, it will be difficult to generate sales.

Finally, profit-oriented pricing is often a difficult strategy for marketers to succeed with, because it limits flexibility. If the price is too high, then the marketer has to adjust other aspects of the marketing mix to create more value. If the marketer invests in the other three Ps—by, say, making improvements to the product, increasing promotion, or adding distribution channels—that investment will probably require additional budget, which will further raise the price.

It’s fairly standard for retailers to use some profit-oriented pricing—applying a standard mark-up over wholesale prices for products, for instance—but that’s rarely their only strategy. Successful retailers will also adjust pricing for some or all products in order to increase the value they provide to customers.

**Competitor-Oriented Pricing**

Sometimes prices are set almost completely according to competitor prices. A company simply copies the competitor’s pricing strategy or seeks to use price as one of the features that differentiates the product. That could mean either pricing the product higher than competitive products, to indicate that the firm believes it to provide greater value, or lower than competitive products in order to be a low-price solution.

This is a fairly simple way to price, especially with products whose pricing information is easily collected and compared. Like profit-oriented pricing, it carries some risks, though. Competitor-oriented pricing doesn’t fully take into account the value of the product to the customer vis-à-vis the value of competitive products. As a result, the product might be priced too low for the value it provides, or too high.
As the airline example illustrates, competitor-oriented pricing can contribute to a difficult market dynamic. If players in a market compete exclusively on price, they will erode their profits and, over time, limit their ability to add value to products.

**Customer-Oriented Pricing**

![Price-Value Equation
VALUE = PERCEIVED BENEFITS - PERCEIVED COSTS](image)

Figure 1

Customer-oriented pricing is also referred to as value-oriented pricing. Given the centrality of the customer in a marketing orientation (and this marketing course!), it will come as no surprise that customer-oriented pricing is the recommended pricing approach because its focus is on providing value to the customer. Customer-oriented pricing looks at the full price-value equation (Figure 1, above; discussed earlier in the module in “Demonstrating Customer Value”) and establishes the price that balances the value. The company seeks to charge the highest price that supports the value received by the customer.

Customer-oriented pricing requires an analysis of the customer and the market. The company must understand the buyer persona, the value that the buyer is seeking, and the degree to which the product meets the customer need. The market analysis shows competitive pricing but also pricing for substitutes.

In an attempt to bring the customer voice into pricing decisions, many companies conduct primary market research with target customers. Crafting questions to get at the value perceptions of the customer is difficult, though, so marketers often turn to something called the Van Westerndorp price-sensitivity meter. This method uses the following four questions to understand customer perceptions of pricing:

1. At what price would you consider the product to be so expensive that you would not consider buying it? (Too expensive)
2. At what price would you consider the product to be priced so low that you would feel the quality couldn’t be very good? (Too cheap)
3. At what price would you consider the product starting to get expensive, such that it’s not out of the question, but you would have to give some thought to buying it? (Expensive/High Side)
4. At what price would you consider the product to be a bargain—a great buy for the money? (Cheap/Good Value)

Each of these questions asks about the customer’s perspective on the product value, with price as one component of the value equation.

The responses of many potential buyers can be plotted on a graph (see Figure 2, below). Each line shows the different customer responses to each of the questions at different price points. For example, 100 percent of those interviewed think the product is too cheap at $0, and 40 percent think that it’s still too cheap at a price of $500. The graph shows an acceptable price range in which the customers’ responses cross one another. They become torn between whether the prices are cheap or expensive but are not clearly landing on one side or the other. The results of this graph suggest a price band between $500 and $1,200.
For the purposes of this course, we won’t be getting into a full analysis of these data or the price-sensitivity meter; the important point is that marketers need to balance the customer’s perception of the value provided with the customer’s perception of the right price (“perceived costs” in Figure 1, above) in the value equation.

![Van Westendorp Price Sensitivity Meter](image)

**Figure 2. Van Westendorp Price Sensitivity Meter**

### Break-Even Pricing

Regardless of the pricing strategy a company ultimately selects, it is important to do a break-even analysis beforehand. Marketers need to understand break-even analysis because it helps them choose the best pricing strategy and make smart decisions about the short- and long-term profitability of the product.

The break-even price is the price that will produce enough revenue to cover all costs at a given level of production. At the break-even point, there is neither profit nor loss. A company may choose to price its product below the break-even point, but we’ll discuss the different pricing strategies that might favor this option later in the module.
Understanding Breakeven

Let’s begin with a very simple calculation of breakeven and build from there.

Imagine that you decide to hold a bake sale and sell cookies in the student union as a social event for students. You don’t want to lose money on the cookies, but you are not trying to make a profit or even cover your time. You spend a very convenient $24 on groceries and bake 4 dozen cookies (48 cookies). What is your break-even price for the cookies? It’s the total cost divided by the number of cookies that you expect to sell, represented by the formula below:

Break-Even Price = Costs / Units

So, it would be $24 / 48 = $.50, or 50 cents per cookie. What if you sell only 40 cookies? The calculation would be $24 / 40 = $.60. Your break-even price goes up if you sell fewer cookies.

One challenge of calculating breakeven is that all of the variables can change, and some are unknown. For instance, it may be impossible to know exactly the quantity that you will sell. For that reason, companies often calculate the break-even quantity rather than the break-even price. Focusing on quantity enables the marketer to answer the following question: “Given this set of costs and this price, how many products must I sell to break even?” The break-even quantity is shown by the following formula:

Break-Even Quantity (in terms of units) = Costs / Price

In our cookie example, once you have spent $24 on groceries, you know your cost. What if you plan to sell the cookies for $1 apiece? According to the equation above, units = cost / price, so in our case, units = $24 / $1, or 24 cookies.

Of course this is a very simple example, but it gives you a sense of why breakeven matters, and how you would calculate it.
Including Fixed and Variable Costs

Let’s add one more complication to make our example a little more realistic and interesting. Your cookies have been such a hit that you decide to sell them more broadly. In fact, you rent a commercial kitchen space and hire an experienced baker named Helen to do the baking. Your break-even point just went up dramatically. Now you need to cover the costs of your kitchen and an employee. For the sake of this exercise, let’s assume that Helen works a set number of hours every week—20 hours—and that you pay her $20 per hour including all taxes and benefits. You rent the kitchen for $100 per week, and that price includes all the equipment and utilities. Those are costs that are not going to change no matter how many cookies you sell. If you baked nothing, you would still need to pay $100 per week in rent and $400 per week in wages. Those are your fixed costs. Fixed costs do not change as the level of production goes up or down. Your fixed costs are $500 per week.

Now you need to buy ingredients for the cookies. Once you add up the food costs of making a single large batch of cookies, you find that it’s a total of $7.20 for a batch of 12 dozen (144) cookies. If you divide that out, you can tell that each cookie costs $.05 in food costs ($7.20 / 144 cookies = $.05). In other words, every cookie you sell is going to have a variable cost of $.05. Variable costs do change as production is increased or decreased.

Adding these different types of costs makes the break-even equation more complicated, as shown below:

\[ pn = Vn + FC \]

\[ p = \text{price} \]

\[ n = \text{number of units sold} \]

\[ V = \text{variable cost per unit} \]

\[ FC = \text{fixed costs} \]

With this equation we can calculate either the break-even price or the break-even quantity.
Calculating Break-Even Price

Chances are good that you can only bake a certain number of cookies each week—let’s say it’s 2,500 cookies—so, based on that information, you can calculate the break-even price. The formula to do that is the following:

\[ p = \frac{Vn + FC}{n} \]

\[ n = 2,500 \]
\[ V = \$0.05 \]
\[ FC = \$500 \]

Therefore, \[ p = \frac{($0.05 \times 2,500) + \$500}{2,500} \]
\[ p = \frac{($125 + \$500)}{2,500} \]
\[ p = \$0.25 \]

Your break-even price for your cookies is 25 cents. That doesn’t mean it’s the right market price for the cookies; nor does it mean that you can definitely sell 2,500 cookies at whatever price you choose. It simply gives you good information about the price and quantity at which you will cover all your costs.

Calculating Break-Even Quantity

Now let’s assume that you have set your price and you need to know your break-even quantity. You are an exceptional marketing student, so you have talked to the people who are likely buyers for your cookies, and you understand what price is a bargain and what price is too expensive. You have compared the price with competitor prices. And, you have considered the price of your cookie compared to the price of doughnuts and ice cream (both are "substitutes" for your product). All of this analysis has led you to set a price of $2 per cookie, but you want to make sure that you don’t lose money on your business: You need to calculate the break-even quantity. The formula to do that is the following:

\[ n = \frac{FC}{p - V} \]

Using the same inputs for the variables, your equation looks like this: \[ n = \frac{\$500}{($2 - \$0.05)} \]
\[ n = \frac{\$500}{$1.95} \]
\[ n = 256.41 \text{ cookies} \]

So, let’s round up and just call the break-even quantity 257 cookies. Does that mean that you keep the full $2 as profit for every cookie after 257? Sadly, no. First, you have to cover the variable cost for each cookie ($0.05 per cookie), which means you make just $1.95 per cookie you sell (after you’ve surpassed the break-even point). Second, our simple break-even example did not include all of the costs. After you’ve locked down the product costs and the pricing, you will need to invest in promotion and distribution of the cookies. You’ll also probably want to cover your time (i.e., pay yourself) and add some profit into the total fixed costs. For instance, if you wanted to earn a profit of $600 each week, then you would need to add that to the $500 fixed costs of the kitchen and Helen.
Breakeven in the Marketing Strategy

Now that we have a cost example, it’s a little easier to think about the pricing objectives. If you decided to price your cookies with a profit orientation, then you would simply add a profit ($1 per cookie, say,) to the break-even price. That approach doesn’t take the customer into account at all, though, since a profit orientation is only about the business.

What if you found that your campus stores and vending machines sell a national chain of cookies for 75 cents? Using a competitor-oriented pricing approach, you might decide to match that price and compete on that basis. The drawback is that this approach does not take into account the value your customers find in a fresh, local product—i.e., your cookies—made from high-quality ingredients.

A customer-oriented pricing approach allows you to treat the break-even data as one input to your pricing, but it goes beyond that to bring your customers’ perceptions and the full value of your product into the pricing evaluation.

Competitor Impact on Pricing

It’s important to remember that pricing is just one component of the marketing mix, and even very specific pricing decisions need to take into account the other components. This is particularly true in a competitive marketplace. Actions by different competitors integrate all elements of the marketing mix and do not focus on price alone. A competitor might make a change to a product or initiate a promotion that impacts customers’ perceptions of value and, therefore, their perceptions of price.

Competitive Pricing

Once a business decides to use price as a primary competitive strategy, there are many well-established tools and techniques that can be employed. The pricing process normally begins with a decision about the company’s pricing approach to the market. Price is a very important decision criterion that customers use to compare alternatives. It also contributes to the company’s position. In general, a business can price its offering to match its competition, or it can price higher or price lower. Each has its pros and cons.
Pricing to Meet Competition

Many organizations attempt to establish prices that, on average, are the same as those set by their more important competitors. Automobiles of the same size with comparable equipment and features tend to have similar prices, for instance. This strategy means that the organization uses price as an indicator or baseline. Quality in production, better service, creativity in advertising, or some other element of the marketing mix is used to attract customers who are interested in products in a particular price category.

The key to implementing a strategy of meeting competitive prices is to have an accurate definition of competition and a knowledge of competitors’ prices. A maker of handcrafted leather shoes is not in competition with mass producers. If he/she attempts to compete with mass producers on price, higher production costs will make the business unprofitable. A more realistic definition of competition in this case would be other makers of handcrafted leather shoes. Such a definition along with an understanding of competitors’ prices would enable management to put the strategy into effect.

The banking industry often uses this strategy by using technology to actively monitor competitors’ rates, fees, and packages in order to adjust their own prices.

Pricing Above Competitors

Pricing above competitors can be rewarding to organizations, provided that the objectives of the policy are clearly understood and the marketing mix is developed in such a way that the policy can be successfully implemented by management.

Pricing above competition generally requires a clear advantage on some nonprice element of the marketing mix. In some cases, that advantage may be due to a high price-quality association on the part of potential buyers.

Betting on that advantage is increasingly dangerous in today’s information-rich environment, however. Online shoppers can get quick price comparisons and read customer or expert reviews to evaluate other elements of the value proposition. This is true for both business-to-consumer and business-to-business offerings. Many consumers also take advantage of their smartphones when they shop: it’s easy enough to stand in one store and compare price and distribution options for the same product and for competitive products. Customers’ access to information puts more pressure on marketers to understand customer value and provide an offering whose price, relative to competitors’ prices, contributes to the value.

You’ll recall our earlier example of Nike using a strategy of raising prices—while its competitors were holding pricing flat or reducing prices—because its analysis showed that it was providing sufficient value to sustain a higher price.

Pricing Below Competitors

While some firms are positioned to price above competition, others wish to carve out a market niche by pricing below competitors. The goal of such a policy is to realize a large sales volume through a lower price and lower profit margins. By controlling costs and reducing services, these firms are able to earn an acceptable profit, even though profit per unit is usually less.

Such a strategy can be effective if a significant segment of the market is price sensitive and/or the organization’s cost structure is lower than competitors’. Costs can be reduced by increased efficiency, economics of scale, or by reducing or...
eliminating such things as credit, delivery, and advertising. For example, if a firm could replace its field sales force with telemarketing or online access, this function might be performed at lower cost. Such reductions often involve some loss in effectiveness, so the trade-off must be considered carefully.

One of the worst outcomes that can result from pricing lower than a competitor is a “price war.” Price wars usually occur when a company believes that price-cutting will increase market share, but it doesn’t have a true cost advantage. Price wars are often caused by companies misreading or misunderstanding competitors. Typically, they are overreactions to threats that either are nonexistent or are not as big as they seem. You will remember our example of the airline price war, in which the stock price of airlines plummeted because stockholders reacted negatively to price reductions, fearing that a price war would eliminate profits and put the health of the industry at risk.

In the module on product marketing we described the ride-sharing service Uber. Uber has successfully undercut the taxi industry with a product that improves services while lowering prices, which has led to extremely rapid growth and success for the company. When lower prices are part of a complete, compelling value proposition, pricing can provide a powerful solution and create a challenging competitive environment for existing players.

Benefits of Value-Based Pricing

We have discussed common company objectives that affect pricing and the competitive impact on pricing. The most important perspective in the pricing process is the customer’s. Value-based pricing brings the voice of the customer into the pricing process. It bases prices primarily on the value to the customer rather than on the cost of the product or historical prices determined by competitors.

If we consider the three approaches to setting price, cost-based pricing is focused entirely on the perspective of the company, with very little concern for the customer; demand-based pricing is focused on the customer, but only as a predictor of sales; and value-based pricing focuses entirely on the customer as the determiner of the total price/value package. Marketers who employ value-based pricing might describe it this way: “Price is what you think your product is worth to that customer at that time.” This approach regards the following as marketing/price truths:
• To the customer, price is the only unpleasant part of buying.
• Price is the easiest marketing tool to copy.
• Price represents everything about the product.

Still, value-based pricing is not altruistic. It asks and answers two questions:

1. What is the highest price I can charge and still make the sale?
2. Am I willing to sell at that price?

In order to answer these questions we need to consider both customer- and competitor-related factors. In answering the second question, we would also want to use the break-even analysis that we discussed in the previous section, as well as other financial and strategic analyses.

Customer-Related Factors

Several customer-related factors are important in value-based pricing; one of them is understanding the customer buying process. For a convenience good, customers often spend little time, planning, or effort in the buying process, and purchases are more often made on impulse. With a shopping product, the consumer is more likely to compare a number of options when evaluating quality, cost, and features; as a result, he or she will require a better understanding of price in order to assess value.

Another issue is that different groups or segments of customers view price differently. Buyer personas can be instrumental to a marketer's grasp of those differences and the role price plays in the decision-making process. Some buyers will weight convenience or quality over price, for instance, while others will be highly price sensitive.

The marketer must understand what the customer values, what the customer expects, and how the customer evaluates price in the value equation.

Competitor-Related Factors
A second factor influencing value-based pricing is competitors. We asserted above that the primary driver of value-based pricing is the customer’s estimation of value—not costs or historical competitor prices. Still, competitors do influence the customer’s view of value. The marketing mix of competitive products have an impact on customer expectations because they an important part of the decision-making context. Customers are shopping across products and brands and take price differences into account when evaluating the quality and benefits of competitive products. These direct comparisons have tremendous impact on the customer’s perceptions of value.

In value-based pricing, the marketer must also consider indirect competitors that consumers may use as a basis for price comparisons. For example, one might use the price of a vacation as a basis for buying vacation clothes. The cost of eating out is frequently compared to the cost of groceries.

Ultimately, value-based pricing offers the following three tactical recommendations:

- Employ a segmented approach toward price that considers how each group of customers assesses value.
- Establish the highest possible price level and justify it with comparable value.
- Use price as one component in the marketing mix, building compelling value across all elements of the offering.


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