

**Part 1: Defining Marketing and the Marketing Process (Chapters 1–2)**

**Part 2: Understanding the Marketplace and Consumers (Chapters 3–6)**

**Part 3: Designing a Customer-Driven Strategy and Mix (Chapters 7–17)**

**Part 4: Extending Marketing (Chapters 18–20)**

# 10 Pricing

## Understanding and Capturing Customer Value

### Chapter Preview

We now look at the second major marketing mix tool—pricing. If effective product development, promotion, and distribution sow the seeds of business success, effective pricing is the harvest. Firms successful at creating customer value with the other marketing mix activities must still capture some of this value in the prices they earn. In this chapter, we discuss the importance of pricing, dig into three major pricing strategies, and look at internal and external considerations

that affect pricing decisions. In the next chapter, we examine some additional pricing considerations and approaches.

For openers, let's examine the importance of pricing for mobile network providers. Entering a competitive market can be difficult, but, against all odds, that is something that Etisalat in Egypt has managed to do. And how did they accomplish this? By providing lower prices than their competitors. The challenge now is customer retention and product innovation in a bid to stay one step ahead of the competition.

### Etisalat Egypt: Changing the Rules of the Game

**E**tisalat Egypt is a subsidiary of Etisalat U.A.E., the largest telecommunications company in the United Arab Emirates (UAE) and one of the largest in the world. Etisalat operates in 18 countries across Asia, the Middle East, and Africa and serves over 100 million customers. Until 2007, only two other mobile network providers had been operating in Egypt—Mobinil and Vodafone—and they too are relative newcomers. Orascom and Vodafone, the parent companies of Mobinil and Vodafone Egypt, are successful international companies. But in May 2007, Etisalat Egypt entered the market by offering customers competitive tariffs. Etisalat Egypt introduced significantly lower prices and penetrated the market with its slogan emphasizing the cheapest rate per minute in Egypt, and the company is still living up to that promise. This has helped drive price reductions throughout the country, seen in special offers, discounts, services, rates, and scratch cards that include the tax within the cost for the first time in the Egyptian market.

As a result, the Egyptian telecommunications market has changed, with a huge number of new services and lower prices being offered, driven by fierce competition from which the customer has greatly benefited. The rules of the game changed when Mobinil and Vodafone, forced to adapt to the dynamic market changes, reduced their prices to what can be described as rock bottom to retain their current customers and entice them not to switch to Etisalat Egypt. They also came up with creative packages and removed administrative fees. Still, Etisalat Egypt acquired 900,000 subscribers: 300,000 from its pre-launch “Reserve Your Number” program and another 600,000 within the first week following its product launch.

Why was Estisalat Egypt so successful? It built a new network that was different to other networks, providing mobile 3.5G technology. It was the first to introduce 3.5G and has the widest and strongest coverage of 3.5G across Egypt. Moreover, it provides HSPA+ applications, which offer high Internet speeds for downloading and transferring data. To attract customers to its network, Etisalat Egypt offered new services that were different from what was already available in the market, including video calls and mobile TV. It succeeded in this effort and consequently achieved the highest growth rates in the history of the mobile market in Egypt.

Etisalat Egypt presented new subscription schemes and call prices, and it aligned Internet offerings with its customers' needs for innovative services and lower prices. In Egypt, mobile phones are considered necessities. In fact, it is easier to access a mobile phone than it is to subscribe to landline phone service, one reason being the poor infrastructure in rural areas. Etisalat Egypt offered the lowest price per minute for calls, including 1 cent per minute for local calls. It was the first service provider to offer international roaming rates: 1 LE pound for incoming calls, and a flat rate for international calls of LE 1.99 per minute. This, and the many other offers and services provided, allowed Etisalat Egypt to distinguish itself from its competitors. Today Etisalat Egypt is considered not only a strong competitor but also a proactive company in terms of launching services and making offers to individual and business customers.

Etisalat Egypt thought that first-time Egyptian subscribers were waiting for a third operator to launch with better, more affordable packages. It was different from any other provider in

Egypt because its prices included tax, a surprise that it announced only on the first day of its operations. In effect, Etisalat was also able to offer prices 15 percent cheaper than its competitors because its prices were inclusive of tax. A scratch card for LE 10 or LE 15 would actually allow users to make calls worth that entire amount. The company also offers 5 free minutes of calls each month, valid for life, as well as the first 3 minutes of a video call for free. In response to the market changes due to Etisalat Egypt's success, Mobinil and Vodafone introduced highly competitive packages and substantial changes to validity periods to attract new subscribers.

By 2004 Vodafone and Mobinil were starting to catch up and had brought their tariffs down. Vodafone was now more accessible and gave more value to its customers by giving them lower prices. Currently, the vast majority of subscribers on all three networks are now prepaid, which has translated into a significant drop in the average revenue per user (ARPU), the key industry metric. In fact, postpaid customers account for only 6 to 7 percent of Vodafone's subscriber base. For Mobinil, with 9 million-plus prepaid subscribers among a total of 20 million subscribers, ARPU dropped by 18 percent. The high-class segment is estimated to be only 5 percent of the population, so new subscribers are expected to be of the lower classes, which choose to use prepaid cards; thus, margins are expected to be lower for new customers. Increasing ARPU for the prepaid growth segment of the market will come through nontraditional, nonvoice services, including ringback tones, which have been successful offerings for Vodafone and Mobinil.

To be more competitive, Mobinil introduced a regional tariff with lower rates if you call within your province, excluding Cairo and Alexandria. Cairo, the capital, and Alexandria, are the most urbanized cities in Egypt. It also offered discounted youth rates after midnight and on SMSs. For the business community, it offered a friends-and-family tariff that allows users to have either access to four or five individuals at much discounted rates or unlimited usage on those numbers for a monthly fee.

Mobinil and Vodafone also offer lifetime validity, which makes it simpler for prepaid customers to keep a line active. Customers need only to make a call or send an SMS once every quarter to keep the line running, regardless of the balance on the scratch card. There is no expiration date. Both competitors now offer applications, services, and prices that are very competitive.

Egypt has some of the lowest per-minute calling rates in the world. The population of about 80 million or above, means there is room to expand. As more customers join, the costs are spread over more and more people, which is why the prices can be brought down as the market gets bigger. Although price per minute is already among the lowest in the world at 39 piasters (about 7 cents) for prepaid and 30 piasters (about 5 cents) for postpaid, it is dropping to 19 piasters (about 4 cents). Competition has been fierce, and the market has faced dramatic changes in a very short time.

One concern is that the value of the market will be destroyed; lower prices may not necessarily be the best thing for the customer because operators have to have money to invest in

**Etisalat, a newcomer to the telecommunications market in Egypt, is in competition with two giants—Vodafone Egypt and Mobinil. Etisalat is holding its own with low prices. However, although price can be a potent strategic weapon, it can also be a double-edged sword.**



providing a good service. If a price war continues, the customer is going to lose in the end as the quality of service will be compromised. Moreover, newcomers to competitive markets, such as Etisalat Egypt, sometimes give away free lines, but one company that recently adopted this strategy in Algeria went bankrupt. It's very dangerous to engage in a price war. Companies in the industry are concerned about their profits, and they know that what goes down doesn't always go back up.

In addition, each company has a different perspective and vision. Etisalat Egypt thinks there is still room for price reductions, especially for business packages. Vodafone sees that the quality offered is the most important component of success, but it must be offered with competitive prices. If the network is too crowded, then the quality of service will go down, resulting in unsatisfied customers. Operators will have to be more innovative and customer focused as customer retention becomes an increasingly important factor in the competition.<sup>1</sup>

**Etisalat Egypt, is now considered a strong competitor to more established network providers as well as a proactive company in terms of offering services and deals.**

# Objective OUTLINE

## Objective 1

Answer the question “What is a price?” and discuss the importance of pricing in today’s fast-changing environment.

### What Is a Price? (314)

## Objective 2

Identify the three major pricing strategies and discuss the importance of understanding customer-value perceptions, company costs, and competitor strategies when setting prices.

### Major Pricing Strategies (315–324)

## Objective 3

Identify and define the other important external and internal factors affecting a firm’s pricing decisions.

### Other Internal and External Considerations Affecting Price Decisions (324–330)



## Companies today

face a fierce and fast-changing pricing environment. Value-seeking customers have put increased pricing pressure on many companies. Thanks to recent economic woes, the pricing power of the Internet, and value-driven companies such as Etisalat, today’s more frugal consumers are pursuing spend-less strategies. In response, it seems that almost every company is looking for ways to cut prices.

Yet, cutting prices is often not the best answer. Reducing prices unnecessarily can lead to lost profits and damaging price wars. It can cheapen a brand by signaling to customers that price is more important than the customer value a brand delivers. ● Instead, no matter what the state of the economy, companies should sell value, not price. In some cases, that means selling lesser products at rock-bottom prices. But in most cases, it means persuading customers that paying a higher price for the company’s brand is justified by the greater value they gain.<sup>2</sup>

## What Is a Price? (p 314)

In the narrowest sense, **price** is the amount of money charged for a product or a service. More broadly, price is the sum of all the values that customers give up to gain the benefits of having or using a product or service. Historically, price has been the major factor affecting buyer choice. In recent decades, nonprice factors have gained increasing importance. However, price still remains one of the most important elements that determines a firm’s market share and profitability.

Price is the only element in the marketing mix that produces revenue; all other elements represent costs. Price is also one of the most flexible marketing mix elements. Unlike product features and channel commitments, prices can be changed quickly. At the same time, pricing is the number-one problem facing many marketing executives, and many companies do not handle pricing well. Some managers view pricing as a big headache, preferring instead to focus on other marketing mix elements. However, smart managers treat pricing as a key strategic tool for creating and capturing customer value. Prices have a direct impact on a firm’s bottom line. A small percentage improvement in price can generate a large percentage increase in profitability. More importantly, as part of a company’s overall value proposition, price plays a key role in creating customer value and building customer relationships. “Instead of running away from pricing,” says an expert, “savvy marketers are embracing it.”<sup>3</sup>

● **Pricing:** No matter what the state of the economy, companies should sell value, not price.

## Price

The amount of money charged for a product or service; the sum of the values that customers exchange for the benefits of having or using the product or service.

**Author Comment** Setting the right price is one of the marketer's most difficult tasks. A host of factors come into play. But finding and implementing the right price strategy is critical to success.

## Major Pricing Strategies (pp 315–324)

The price the company charges will fall somewhere between one that is too high to produce any demand and one that is too low to produce a profit. **Figure 10.1** summarizes the major considerations in setting price. Customer perceptions of the product's value set the ceiling for prices. If customers perceive that the product's price is greater than its value, they will not buy the product. Product costs set the floor for prices. If the company prices the product below its costs, the company's profits will suffer. In setting its price between these two extremes, the company must consider several internal and external factors, including competitors' strategies and prices, the overall marketing strategy and mix, and the nature of the market and demand.

Figure 10.1 suggests three major pricing strategies: customer value-based pricing, cost-based pricing, and competition-based pricing.

**Author Comment** Like everything else in marketing, good pricing starts with *customers* and their perceptions of value.

### Customer Value-Based Pricing

In the end, the customer will decide whether a product's price is right. Pricing decisions, like other marketing mix decisions, must start with customer value. When customers buy a product, they exchange something of value (the price) to get something of value (the benefits of having or using the product). Effective, customer-oriented pricing involves understanding how much value consumers place on the benefits they receive from the product and setting a price that captures this value.

**Customer value-based pricing** uses buyers' perceptions of value, not the seller's cost, as the key to pricing. Value-based pricing means that the marketer cannot design a product and marketing program and then set the price. Price is considered along with all other marketing mix variables *before* the marketing program is set.

**Figure 10.2** compares value-based pricing with cost-based pricing. Although costs are an important consideration in setting prices, cost-based pricing is often product driven. The company designs what it considers to be a good product, adds up the costs of making the product, and sets a price that covers costs plus a target profit. Marketing must then convince buyers that the product's value at that price justifies its purchase. If the price turns out to be too high, the company must settle for lower markups or lower sales, both resulting in disappointing profits.

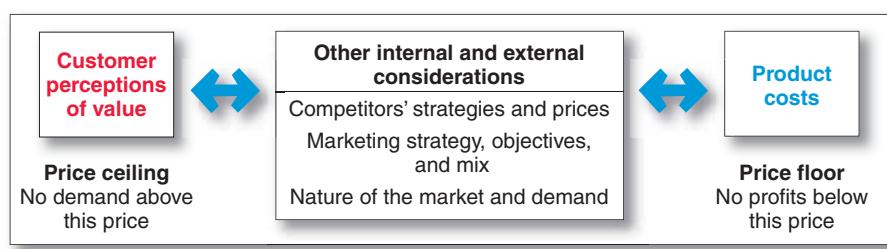
Value-based pricing reverses this process. The company first assesses customer needs and value perceptions. It then sets its target price based on customer perceptions of value. The targeted value and price drive decisions about what costs can be incurred and the resulting product design. As a result, pricing begins with analyzing consumer needs and value perceptions, and the price is set to match perceived value.

It's important to remember that "good value" is not the same as "low price." For example, a Steinway piano—any Steinway piano—costs a lot. But to those who own one, a Steinway is a great value:<sup>4</sup>

A Steinway grand piano typically runs anywhere from \$40,000 to \$165,000. The most popular model sells for around \$72,000. But ask anyone who owns a Steinway grand piano, and they'll tell you that, when it comes to Steinway, price is nothing; the Steinway experience is everything. Steinway makes very high quality pianos; handcrafting

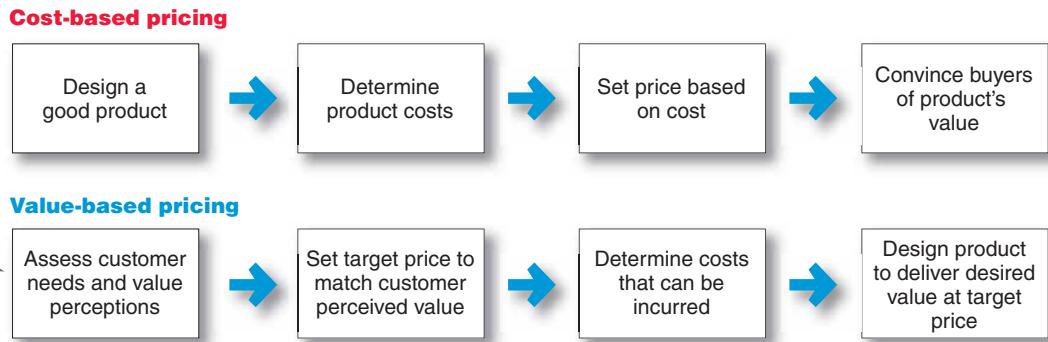
**FIGURE | 10.1**  
Considerations in Setting Price

If customers perceive that a product's price is greater than its value, they won't buy it. If the company prices a product below its costs, profits will suffer. Between the two extremes, the "right" pricing strategy is one that delivers both value to the customer and profits to the company.



**FIGURE | 10.2**

Value-Based Pricing Versus Cost-Based Pricing



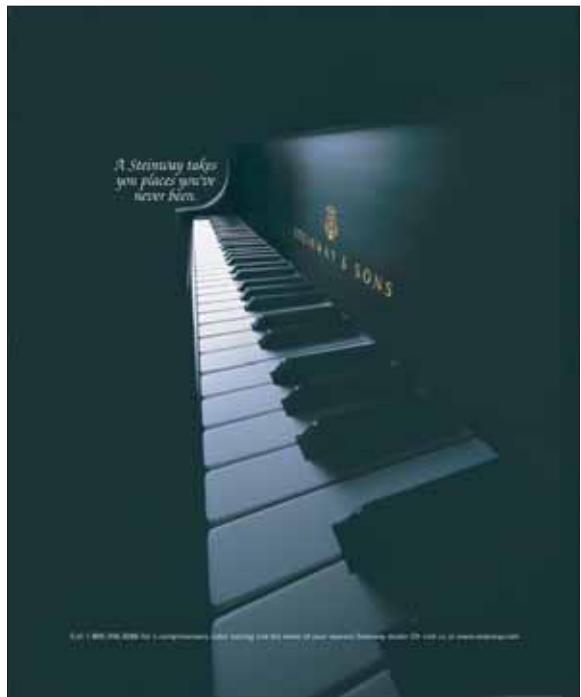
each Steinway requires up to one full year. But, more importantly, owners get the Steinway mystique. The Steinway name evokes images of classical concert stages and the celebrities and performers who've owned and played Steinway pianos across more than 155 years.

But Steinways aren't just for world-class pianists and the wealthy. Ninety-nine percent of all Steinway buyers are amateurs who perform only in their dens. ● To such customers, whatever a Steinway costs, it's a small price to pay for the value of owning one. "A Steinway takes you places you've never been," says an ad. As one Steinway owner puts it, "My friendship with the Steinway piano is one of the most important and beautiful things in my life." Who can put a price on such feelings?

Companies often find it hard to measure the value customers will attach to its product. For example, calculating the cost of ingredients in a meal at a fancy restaurant is relatively easy. But assigning value to other satisfactions such as taste, environment, relaxation, conversation, and status is very hard. Such value is subjective; it varies both for different consumers and different situations.

Still, consumers will use these perceived values to evaluate a product's price, so the company must work to measure them. Sometimes, companies ask consumers how much they would pay for a basic product and for each benefit added to the offer. Or a company might conduct experiments to test the perceived value of different product offers. According to an old Russian proverb, there are two fools in every market—one who asks too much and one who asks too little. If the seller charges more than the buyers' perceived value, the company's sales will suffer. If the seller charges less, its products sell very well, but they produce less revenue than they would if they were priced at the level of perceived value.

We now examine two types of value-based pricing: *good-value pricing* and *value-added pricing*.



● Perceived value: A Steinway piano—any Steinway piano—costs a lot. But to those who own one, a Steinway is a great value. "A Steinway takes you places you've never been."

## Good-Value Pricing

Recent economic events have caused a fundamental shift in consumer attitudes toward price and quality. In response, many companies have changed their pricing approaches to bring them in line with changing economic conditions and consumer price perceptions. More and more, marketers have adopted **good-value pricing** strategies—offering the right combination of quality and good service at a fair price.

In many cases, this has involved introducing less-expensive versions of established, brand-name products. To meet tougher economic times and more frugal consumer spending habits, fast-food restaurants such as Taco Bell and McDonald's offer value meals and dollar menu items. Armani offers the less-expensive, more-casual Armani Exchange fashion line. Alberto-Culver's TRESemme hair care line promises "A salon look and feel at a frac-

### Good-value pricing

Offering the right combination of quality and good service at a fair price.

The screenshot shows the Ryanair.com homepage. At the top, there's a search bar for 'Departing from', 'Going to', 'Depart Date', and 'Return Date'. Below that, it says 'Number of Passengers' (1 Adult, 0 Children, 0 Under 10 years). On the right, there are 'Hotels Deals' (Nabors Hotel Only £17/£25), 'Cheap Car Hire' (Low Cost Car Hire Now £220,317.26), and 'Flight Deal Alert' (£220,317.26). The main banner says 'LAST CHANCE TO BOOK FOR JULY AND AUGUST!' and 'SALE 2 MILLION SEATS TRAVEL IN JULY & AUGUST'. Below the banner, there's a section for 'Ryanair's Lowest Fare Guarantee - Book Now' and 'Travel Insurance Single Trip Cover from £3.00'. There are also sections for 'Ryanair's Lowest Fare Guarantee - Book Now' and 'Travel Insurance Single Trip Cover from £3.00'. The page lists various flight options from cities like Alghero, Biarritz, Bremen, La Rochelle, Huelva, Palma Mallorca, Paris (Orly)(Paris), Salzburg, and Turin to destinations like Berlin, Derry, Dublin, Liverpool, Madrid, Milan (Fiumicino), Paris (Charles de Gaulle), Skopje, and Warsaw. Each listing includes a price and a note that 'Fares include taxes, fees & charges'.

- Good-value pricing: Ryanair appears to have found a radical new pricing solution, one that customers are sure to love: Make flying free!

tion of the price.” And every car company now offers small, inexpensive models better suited to the strapped consumer’s budget.

In other cases, good-value pricing has involved redesigning existing brands to offer more quality for a given price or the same quality for less. Some companies even succeed by offering less value but at rock-bottom prices. ● For example, passengers flying the low-cost European airline Ryanair won’t get much in the way of free amenities, but they’ll like the airline’s unbelievably low prices.<sup>5</sup>

Ireland’s Ryanair, Europe’s most profitable airline over the past decade, appears to have found a radical pricing solution: Make flying *free!* Before long, Ryanair promises, more than half of its passengers will pay nothing for their tickets. Remarkably, the airline already offers virtually free fares to one-fourth of its customers. What’s its secret? Ryanair’s frugal cost structure makes even the most cost-conscious competitor look like a reckless spender. In addition, however, Ryanair charges for virtually everything except the seat itself, from baggage check-in to seat-back advertising space. Once in the air, flight attendants hawk everything from scratch-card games to perfume and digital cameras to their captive audience. After arriving at some out-of-the-way airport, Ryanair will sell you a bus or train ticket into town. The airline even gets commissions from sales of Hertz rental cars, hotel rooms, ski packages, and travel insurance. Despite Ryanair’s sometimes pushy efforts to extract more revenue from

each traveler, customers aren’t complaining. Most of the additional purchases are discretionary, and you just can’t beat those outrageously low prices.

An important type of good-value pricing at the retail level is *everyday low pricing (EDLP)*. EDLP involves charging a constant, everyday low price with few or no temporary price discounts. Retailers such as Costco and the furniture seller Room & Board practice EDLP. The king of EDLP is Walmart, which practically defined the concept. Except for a few sale items every month, Walmart promises everyday low prices on everything it sells. In contrast, *high-low pricing* involves charging higher prices on an everyday basis but running frequent promotions to lower prices temporarily on selected items. Department stores such as Kohl’s and Macy’s practice high-low pricing by having frequent sales days, early-bird savings, and bonus earnings for store credit-card holders.

### Value-added pricing

Attaching value-added features and services to differentiate a company’s offers and charging higher prices.



- Value-added pricing: Rather than dropping prices for its venerable Stag umbrella brand to match cheaper imports, Currim's successfully launched umbrellas with funky designs, cool colors, and value-added features and sold them at even higher prices.

### Value-Added Pricing

Value-based pricing doesn’t mean simply charging what customers want to pay or setting low prices to meet competition. Instead, many companies adopt **value-added pricing** strategies. Rather than cutting prices to match competitors, they attach value-added features and services to differentiate their offers and thus support higher prices. For example, when rebranding their hotels, Southern Sun realized they could give their customers a positive experience not by lowering prices but by adding value to the services they provide (see Real Marketing 10.1). ● Also consider this example:

The monsoon season in Mumbai, India, is three months of near-nonstop rain. For 147 years, most Mumbaikars protected themselves with a Stag umbrella from venerable Ebrahim Currim & Sons. Like Ford’s Model T, the basic Stag was sturdy, affordable, and of any color, as long as it was black. By the end of the twentieth century,

# Real Marketing 10.1

## Southern Sun: Adding Value and Style

Johannesburg-based Southern Sun Hotels was established in 1969. It now has a broad portfolio of 90 hotels throughout Africa, the Middle East, and the Seychelles. It has always prided itself on the strength of its brands and its determination to tailor each stay specifically for each guest. It offers all types of accommodation, from budget to five star.

Southern Sun has an international, multi-brand strategy, using brand names such as Holiday Inn and Crowne Plaza to give a truly international flavor to its hotels. One problem in doing this has been that the original Southern Sun brand became submerged. The business decided to reintroduce Southern Sun as the key brand driver and to apply it to its entire portfolio of hotels. For example, the Garden Court brand was brought back under the Southern Sun banner to create a clear South African brand using the slogan "A great stay and a great day."

Southern Sun wanted to focus on offering world-class accommodations across a variety of markets, offering added value designs to meet the needs of all guests, regardless of their budget. The principal brand, Southern Sun, was shown to have greater emotional appeal than other brands in the existing portfolio.

In the first phase, the company's portfolio was redeveloped to bring the hotel brands back under the Southern Sun umbrella. In the premier sector, the company found that its hotels did not offer anything distinctive compared to its competitors. To add value, the company developed a more stylish, personalized, and pampered approach, focusing on each guest as an individual. In addition, each hotel developed its own distinctive personality so that each property within the chain was unique.

The three-star economy sector also needed an element of added value. Research had shown the company that many of its competing hotels were seen as uninspiring and dull. To add value, the company moved away from a basic hotel model and introduced a noticeably South African style of hospitality, focusing on a customer experience that would be productive, comfortable, and refreshing.

At the budget end of the portfolio, Southern Sun developed StayEasy. These budget hotels were targeted mostly at frequent business travelers. A number of these hotels had been set up across South Africa, incorporating conference facilities and promising a good night's rest and a broad range of catering for business and leisure customers.

Southern Sun's market research also identified a new type of customer, dubbed the "balanced styler." This was a traveler who wanted an affordable hotel that did not compromise on style. The Italian-styled SunSquare brand was launched in early 2007 at the Montecasino on Piazza Square, Fourways, Johannesburg. The added value and pricing elements of this new brand incorporated fashion, modern accommodation, and authentic urban living. The other key elements were that it was unique to the area and competitively priced. The SunSquare concept has resulted in about an 80 percent occupancy rate as of February 2010. With its less formal, less corporate, and less structured approach,

a stylish and somewhat unconventional accommodation and dining experience has been created. To match the expectations of more modern travelers, the desk-based reception area was replaced by high-tech check-in kiosks. The lobby disappeared and was replaced by a stylish cocktail bar, which overlooked an open plan restaurant where the kitchen and activities of the chefs were transformed into a floor show. To manage costs and maintain competitive pricing, separate bathrooms were dispensed with and replaced within each bedroom with a high-pressure shower and a toilet and sink hidden behind a frosted glass enclosure.

Another key added value is the location of SunSquare, in the center of an entertainment complex. This placement was also a conscious decision, as many of the competitor hotels in the same market could only offer remote, out-of-city locations.

Clearly defined brands within the Southern Sun family, each with its own specific pricing and added value elements, are all designed to cater to specific sets of customer needs. By building in these ways on the Southern Sun brand—which the company refers to as Southern Warmth (South African hospitality)—the unique nature of the chain is clearly designed to differentiate it from its competitors.



**Great Stay Great Day:** Table Mountain forms the perfect backdrop for Southern Sun's newly branded South African hotels, which offer world-class accommodation regardless of budget.

The approach clearly worked. In April 2010, after being open for barely a year, the Southern Sun Ikoyi Hotel in Lagos, Nigeria, won the award for Nigeria's most outstanding hotel facility at the inaugural Nigerian Hospitality Excellence Awards. Later in the year the same hotel won three more awards at the Accra West Africa Tourism and Hospitality Awards. The managing director for Southern Sun Offshore was delighted that the added value offered to customers in terms of service and product had been recognized in such a highly competitive international market.

In October 2010 the Southern Sun Al Manzil Hotel in Dubai won Hotel Team of the

Year at the Hotelier Middle East Awards. The Al Manzil is one of two hotels in the heart of Dubai, the other being the Qamardeen.

The consolidation of the Southern Sun brand has also enabled other added value initiatives to be introduced, including the Frequent Guest Program. Sun Rands (loyalty points) can be collected for free holidays across the whole chain. The program also gives regular customers access to discounts and rewards.

By building added value based on the brand image, the chain has been able to focus on quality and style. These elements are translated across the brand, aiming to ensure excellent value and high levels of customer service and attention to detail. Competitive pricing and added value, which exceed the expectations of most customers, have enabled the group to continue to expand and develop.

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**Sources:** Based on information from [www.southernsun.com](http://www.southernsun.com), accessed October 25, 2010; [www.southernsunme.com](http://www.southernsunme.com), accessed October 25, 2010.

however, the Stag was threatened by cheaper imports from China. Stag responded by dropping prices and scrimping on quality. It was a bad move: For the first time since the 1940s, the brand began losing money.

Finally, however, Stag came to its senses. It abandoned the price war and started innovating. It launched designer umbrellas in funky designs and cool colors. Teenagers and young adults lapped them up. It then launched umbrellas with a built-in high-power flashlight for those who walk unlit roads at night and models with prerecorded tunes for music lovers. For women who walk secluded streets after dark, there's Stag's Bodyguard model, armed with glare lights, emergency blinkers, and an alarm. Customers willingly pay up to a 100 percent premium for the new products. Under the new value-added strategy, the Stag brand has now returned to profitability. Come the monsoon season in June, the grand old black Stags still reappear on the streets of Mumbai—but now priced 15 percent higher than the imports.<sup>6</sup>

The Stag example illustrates once again that customers are motivated not by price but by what they get for what they pay. "If consumers thought the best deal was simply a question of money saved, we'd all be shopping in one big discount store," says one pricing expert. "Customers want value and are willing to pay for it. Savvy marketers price their products accordingly."<sup>7</sup>

### Cost-based pricing

Setting prices based on the costs for producing, distributing, and selling the product plus a fair rate of return for effort and risk.

**Author** | Costs set the floor for **Comment** price, but the goal isn't always to *minimize* costs. In fact, many firms invest in higher costs so that they can claim higher prices and margins (think about Steinway pianos). The key is to manage the *spread* between costs and prices—how much the company makes for the customer value it delivers.

## Cost-Based Pricing

Whereas customer-value perceptions set the price ceiling, costs set the floor for the price that the company can charge. **Cost-based pricing** involves setting prices based on the costs for producing, distributing, and selling the product plus a fair rate of return for its effort and risk. A company's costs may be an important element in its pricing strategy.

Some companies, such as Ryanair and Walmart, work to become the "low-cost producers" in their industries. Companies with lower costs can set lower prices that result in smaller margins but greater sales and profits. However, other companies—such as Apple, BMW, and Steinway—intentionally pay higher costs so that they can claim higher prices and margins. For example, it costs more to make a "handcrafted" Steinway piano than a Yamaha production model. But the higher costs result in higher quality, justifying that eye-popping \$72,000 price. The key is to manage the spread between costs and prices—how much the company makes for the customer value it delivers.

## Types of Costs

### Fixed costs (overhead)

Costs that do not vary with production or sales level.

### Variable costs

Costs that vary directly with the level of production.

### Total costs

The sum of the fixed and variable costs for any given level of production.

A company's costs take two forms: fixed and variable. **Fixed costs** (also known as **overhead**) are costs that do not vary with production or sales level. For example, a company must pay each month's bills for rent, heat, interest, and executive salaries—whatever the company's output. **Variable costs** vary directly with the level of production. Each PC produced by HP involves a cost of computer chips, wires, plastic, packaging, and other inputs. Although these costs tend to be the same for each unit produced, they are called variable costs because the total varies with the number of units produced. **Total costs** are the sum of the fixed and variable costs for any given level of production. Management wants to charge a price that will at least cover the total production costs at a given level of production.

The company must watch its costs carefully. If it costs the company more than its competitors to produce and sell a similar product, the company will need to charge a higher price or make less profit, putting it at a competitive disadvantage.

## Costs at Different Levels of Production

To price wisely, management needs to know how its costs vary with different levels of production. For example, suppose Texas Instruments (TI) built a plant to produce 1,000 calculators per day. **Figure 10.3A** shows the typical short-run average cost curve (SRAC). It shows that the cost per calculator is high if TI's factory produces only a few per day. But as production moves up to 1,000 calculators per day, the average cost per unit decreases. This is because fixed costs are spread over more units, with each one bearing a smaller share of the fixed cost. TI can try to produce more than 1,000 calculators per day, but average costs will increase because the plant becomes inefficient. Workers have to wait for machines, the machines break down more often, and workers get in each other's way.

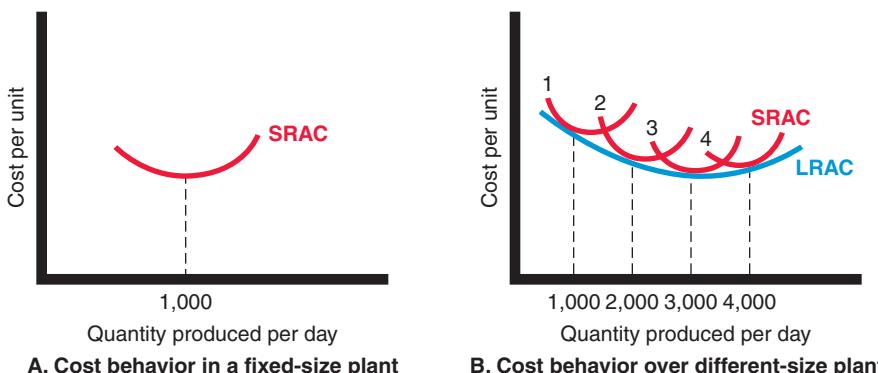
If TI believed it could sell 2,000 calculators a day, it should consider building a larger plant. The plant would use more efficient machinery and work arrangements. Also, the unit cost of producing 2,000 calculators per day would be lower than the unit cost of producing 1,000 units per day, as shown in the long-run average cost (LRAC) curve (Figure 10.3B). In fact, a 3,000-capacity plant would be even more efficient, according to Figure 10.3B. But a 4,000-daily production plant would be less efficient because of increasing diseconomies of scale—too many workers to manage, paperwork slowing things down, and so on. Figure 10.3B shows that a 3,000-daily production plant is the best size to build if demand is strong enough to support this level of production.

## Costs as a Function of Production Experience

Suppose TI runs a plant that produces 3,000 calculators per day. As TI gains experience in producing calculators, it learns how to do it better. Workers learn shortcuts and become more familiar with their equipment. With practice, the work becomes better organized, and TI finds better equipment and production processes. With higher volume, TI becomes more efficient and gains economies of scale. As a result, the average cost tends to decrease with accumulated production experience. This is shown in **Figure 10.4**.<sup>8</sup> Thus, the average cost of producing the first 100,000 calculators is \$10 per calculator. When the company has produced the first 200,000 calculators, the average cost has fallen to \$8.50. After its accumu-

**FIGURE | 10.3**

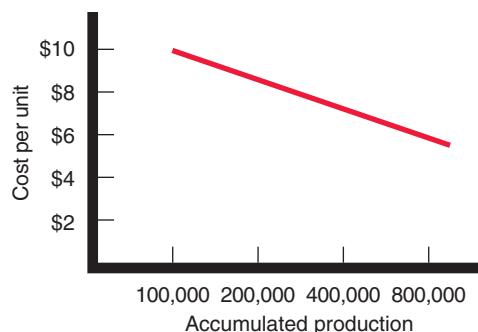
Cost per Unit at Different Levels of Production per Period



What's the point of all the cost curves in this and the next few figures? Costs are an important factor in setting price, and companies must understand them well!

### FIGURE | 10.4

Cost per Unit as a Function of Accumulated Production:  
The Experience Curve



#### Experience curve (learning curve)

The drop in the average per-unit production cost that comes with accumulated production experience.

lated production experience doubles again to 400,000, the average cost is \$7. This drop in the average cost with accumulated production experience is called the **experience curve** (or the **learning curve**).

If a downward-sloping experience curve exists, this is highly significant for the company. Not only will the company's unit production cost fall, but it will fall faster if the company makes and sells more during a given time period. But the market has to stand ready to buy the higher output. And to take advantage of the experience curve, TI must get a large market share early in the product's life cycle. This suggests the following pricing strategy: TI should price its calculators low; its sales will then increase, and its costs will decrease through gaining more experience, and then it can lower its prices further.

Some companies have built successful strategies around the experience curve. However, a single-minded focus on reducing costs and exploiting the experience curve will not always work. Experience-curve pricing carries some major risks. The aggressive pricing might give the product a cheap image. The strategy also assumes that competitors are weak and not willing to fight it out by meeting the company's price cuts. Finally, while the company is building volume under one technology, a competitor may find a lower-cost technology that lets it start at prices lower than those of the market leader, who still operates on the old experience curve.

### Cost-Plus Pricing

#### Cost-plus pricing (markup pricing)

Adding a standard markup to the cost of the product.

The simplest pricing method is **cost-plus pricing** (or **markup pricing**)—adding a standard markup to the cost of the product. Construction companies, for example, submit job bids by estimating the total project cost and adding a standard markup for profit. Lawyers, accountants, and other professionals typically price by adding a standard markup to their costs. Some sellers tell their customers they will charge cost plus a specified markup; for example, aerospace companies often price this way to the government.

To illustrate markup pricing, suppose a toaster manufacturer had the following costs and expected sales:

Variable cost	\$10
Fixed costs	\$300,000
Expected unit sales	50,000

Then the manufacturer's cost per toaster is given by the following:

$$\text{unit cost} = \frac{\text{variable cost} + \text{fixed costs}}{\text{unit sales}} = \$10 + \frac{\$300,000}{50,000} = \$16$$

Now suppose the manufacturer wants to earn a 20 percent markup on sales. The manufacturer's markup price is given by the following:<sup>9</sup>

$$\text{markup price} = \frac{\text{unit cost}}{(1 - \text{desired return on sales})} = \frac{\$16}{1 - .2} = \$20$$

The manufacturer would charge dealers \$20 per toaster and make a profit of \$4 per unit. The dealers, in turn, will mark up the toaster. If dealers want to earn 50 percent on the sales price, they will mark up the toaster to \$40 ( $\$20 + 50\% \text{ of } \$40$ ). This number is equivalent to a *markup on cost* of 100 percent ( $\$20/\$20$ ).

Does using standard markups to set prices make sense? Generally, no. Any pricing method that ignores demand and competitor prices is not likely to lead to the best price. Still, markup pricing remains popular for many reasons. First, sellers are more certain about costs than about demand. By tying the price to cost, sellers simplify pricing; they do not need to make frequent adjustments as demand changes. Second, when all firms in the industry use this pricing method, prices tend to be similar, so price competition is minimized. Third, many people feel that cost-plus pricing is fairer to both buyers and sellers. Sellers earn a fair return on their investment but do not take advantage of buyers when buyers' demand becomes great.

## Break-Even Analysis and Target Profit Pricing

### Break-even pricing (target return pricing)

Setting price to break even on the costs of making and marketing a product or setting price to make a target return.

Another cost-oriented pricing approach is **break-even pricing** (or a variation called **target return pricing**). The firm tries to determine the price at which it will break even or make the target return it is seeking.

Target return pricing uses the concept of a *break-even chart*, which shows the total cost and total revenue expected at different sales volume levels. ● **Figure 10.5** shows a break-even chart for the toaster manufacturer discussed here. Fixed costs are \$300,000 regardless of sales volume. Variable costs are added to fixed costs to form total costs, which rise with volume. The total revenue curve starts at zero and rises with each unit sold. The slope of the total revenue curve reflects the price of \$20 per unit.

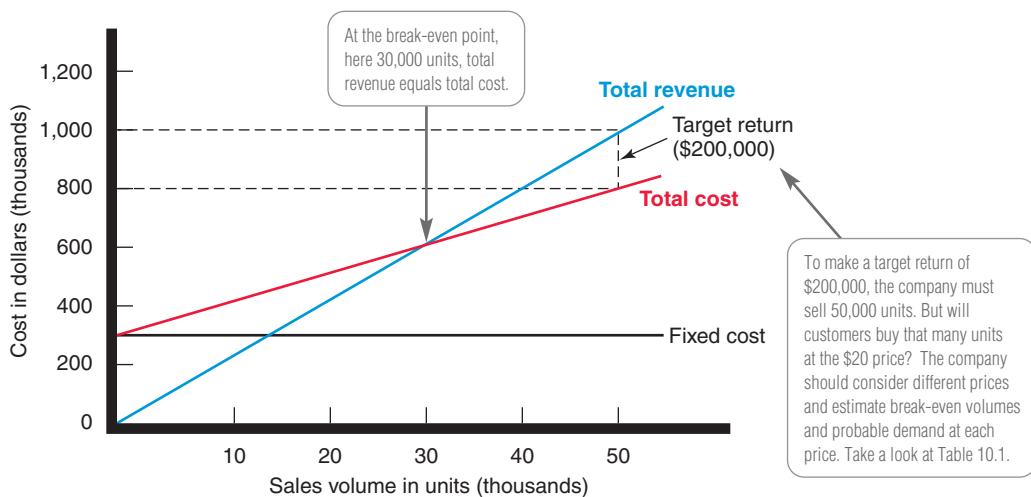
The total revenue and total cost curves cross at 30,000 units. This is the *break-even volume*. At \$20, the company must sell at least 30,000 units to break even, that is, for total revenue to cover total cost. Break-even volume can be calculated using the following formula:

$$\text{break-even volume} = \frac{\text{fixed cost}}{\text{price} - \text{variable cost}} = \frac{\$300,000}{\$20 - \$10} = 30,000$$

If the company wants to make a profit, it must sell more than 30,000 units at \$20 each. Suppose the toaster manufacturer has invested \$1,000,000 in the business and wants to set a price to earn a 20 percent return, or \$200,000. In that case, it must sell at least 50,000 units at \$20 each. If the company charges a higher price, it will not need to sell as many toasters to achieve its target return. But the market may not buy even this lower volume at the higher price. Much depends on price elasticity and competitors' prices.

The manufacturer should consider different prices and estimate break-even volumes, probable demand, and profits for each. This is done in ● **Table 10.1**. The table shows that as price increases, the break-even volume drops (column 2). But as price increases, the demand for toasters also decreases (column 3). At the \$14 price, because the manufacturer clears only \$4 per toaster (\$14 less \$10 in variable costs), it must sell a very high volume to break even. Even though the low price attracts many buyers, demand still falls below the high break-even point, and the manufacturer loses money. At the other extreme, with a \$22 price, the manufacturer clears \$12 per toaster and must sell only 25,000 units to break

● **FIGURE | 10.5**  
Break-Even Chart for Determining Target-Return Price and Break-Even Volume



● TABLE | 10.1 Break-Even Volume and Profits at Different Prices

Price	Unit Demand Needed to Break Even	Expected Unit Demand at Given Price	Total Revenue (1) × (3)	Total Costs*	Profit (4) – (5)
\$14	75,000	71,000	\$994,000	\$1,010,000	-\$16,000
16	50,000	67,000	1,072,000	970,000	102,000
18	37,500	60,000	1,080,000	900,000	180,000
20	30,000	42,000	840,000	720,000	120,000
22	25,000	23,000	506,000	530,000	-\$24,000

\*Assumes fixed costs of \$300,000 and constant unit variable costs of \$10.

even. But at this high price, consumers buy too few toasters, and profits are negative. The table shows that a price of \$18 yields the highest profits. Note that none of the prices produce the manufacturer's target return of \$200,000. To achieve this return, the manufacturer will have to search for ways to lower the fixed or variable costs, thus lowering the break-even volume.

**Author Comment** In setting prices, the company must also consider competitors' prices. No matter what price it charges—high, low, or in-between—the company must be certain to give customers superior value for that price.

### Competition-based pricing

Setting prices based on competitors' strategies, prices, costs, and market offerings.

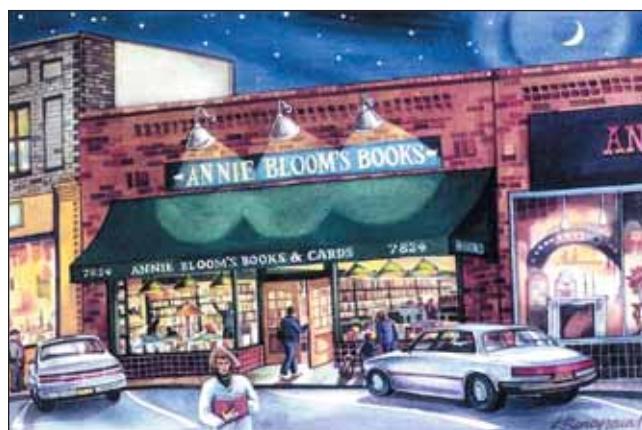
## Competition-Based Pricing

**Competition-based pricing** involves setting prices based on competitors' strategies, costs, prices, and market offerings. Consumers will base their judgments of a product's value on the prices that competitors charge for similar products.

In assessing competitors' pricing strategies, the company should ask several questions. First, how does the company's market offering compare with competitors' offerings in terms of customer value? If consumers perceive that the company's product or service provides greater value, the company can charge a higher price. If consumers perceive less value relative to competing products, the company must either charge a lower price or change customer perceptions to justify a higher price.

Next, how strong are current competitors, and what are their current pricing strategies? If the company faces a host of smaller competitors charging high prices relative to the value they deliver, it might charge lower prices to drive weaker competitors from the market. If the market is dominated by larger, low-price competitors, the company may decide to target unserved market niches with value-added products at higher prices.

For example, ● Annie Bloom's Books, an independent bookseller in Portland, Oregon, isn't likely to win a price war against Amazon.com or Barnes & Noble—it doesn't even try.



● **Pricing against larger, low-price competitors:** Independent bookstore Annie Bloom's Books isn't likely to win a price war against Amazon.com or Barnes & Noble. Instead, it relies on outstanding customer service and a cozy atmosphere to turn booklovers into loyal customers.

Instead, the shop relies on its personal approach, cozy atmosphere, and friendly and knowledgeable staff to turn local book lovers into loyal patrons, even if they have to pay a little more. Customers writing on a consumer review Web site recently gave Annie Bloom's five-star ratings, supported by the kinds of comments you likely wouldn't see for Barnes & Noble.<sup>10</sup>

Annie Bloom's is not the biggest bookstore, nor the most convenient to park at, nor are the prices incredibly discounted, nor is the bathroom easy to find . . . however, [i]t is one of the friendliest bookstores in town. It is just big enough for a solid hour of browsing. And it has a talented, smart, and long-term staff with incredible taste. . . . You'll find common best sellers here, but you'll also find all those cool books you heard about on NPR or in Vanity Fair that you never see featured at Barnes & Noble. [It's a] bookstore for the book crowd. . . . Good customer service here! Also, be nice to the cat. PS: [It] has a kid's play area in the back.

What principle should guide decisions about what price to charge relative to those of competitors? The answer is simple in

concept but often difficult in practice: No matter what price you charge—high, low, or in-between—be certain to give customers superior value for that price.

**Author Comment** Now that we've looked at the three general pricing approaches—value-, cost-, and competitor-based pricing—let's dig into some of the many other factors that affect pricing decisions.

## Other Internal and External Considerations Affecting Price Decisions (pp 324–330)

Beyond customer value perceptions, costs, and competitor strategies, the company must consider several additional internal and external factors. Internal factors affecting pricing include the company's overall marketing strategy, objectives, and marketing mix, as well as other organizational considerations. External factors include the nature of the market and demand and other environmental factors.

### Overall Marketing Strategy, Objectives, and Mix

Price is only one element of the company's broader marketing strategy. Thus, before setting price, the company must decide on its overall marketing strategy for the product or service. If the company has selected its target market and positioning carefully, then its marketing mix strategy, including price, will be fairly straightforward. For example, when Honda developed its Acura brand to compete with European luxury-performance cars in the higher-income segment, this required charging a high price. In contrast, when it introduced the Honda Fit model—billed as “a pint-sized fuel miser with feisty giddy up”—this positioning required charging a low price. Thus, pricing strategy is largely determined by decisions on market positioning.

Pricing may play an important role in helping to accomplish company objectives at many levels. A firm can set prices to attract new customers or profitably retain existing ones. It can set prices low to prevent competition from entering the market or set prices at competitors' levels to stabilize the market. It can price to keep the loyalty and support of resellers or avoid government intervention. Prices can be reduced temporarily to create excitement for a brand. Or one product may be priced to help the sales of other products in the company's line.

Price is only one of the marketing mix tools that a company uses to achieve its marketing objectives. Price decisions must be coordinated with product design, distribution, and promotion decisions to form a consistent and effective integrated marketing program. Decisions made for other marketing mix variables may affect pricing decisions. For example, a decision to position the product on high-performance quality will mean that the seller must charge a higher price to cover higher costs. And producers whose resellers are expected to support and promote their products may have to build larger reseller margins into their prices.

Companies often position their products on price and then tailor other marketing mix decisions to the prices they want to charge. Here, price is a crucial product-positioning factor that defines the product's market, competition, and design. Many firms support such price-positioning strategies with a technique called **target costing**. Target costing reverses the usual process of first designing a new product, determining its cost, and then asking, “Can we sell it for that?” Instead, it starts with an ideal selling price based on customer-value considerations and then targets costs that will ensure that the price is met. For example, when Honda set out to design the Fit, it began with a \$13,950 starting price point and an operating efficiency of 33 miles per gallon firmly in mind. It then designed a stylish, peppy little car with costs that allowed it to give target customers those values.

Other companies deemphasize price and use other marketing mix tools to create *nonprice* positions. Often, the best strategy is not to charge the lowest price but rather differentiate the marketing offer to make it worth a higher price. For example, Bang & Olufsen (B&O)—known for its cutting-edge consumer electronics—builds more value into its products and charges sky-high prices. A B&O 50-inch BeoVision 4 HDTV will cost you \$7,500; a 65-inch model runs \$13,500, and a 103-inch model goes for \$93,050. A complete B&O entertainment system? Well, you don't really want to know the price. But target customers recognize B&O's very high quality and are willing to pay more to get it.

#### Target costing

Pricing that starts with an ideal selling price and then targets costs that will ensure that the price is met.



Positioning on high price: Titus features its lofty prices in its advertising—"suggested retail price: \$7,750.00."

Some marketers even position their products on *high* prices, featuring high prices as part of their product's allure. For example, Grand Marnier offers a \$225 bottle of Cuvée du Cent Cinquante-naire that's marketed with the tagline "Hard to find, impossible to pronounce, and prohibitively expensive." And Titus Cycles, a premium bicycle manufacturer, features its high prices in its advertising. One ad humorously shows a man giving his girlfriend a "cubic zirconia" engagement ring so that he can purchase a Titus Vuelo for himself. "Suggested retail price: \$7,750.00."

Thus, marketers must consider the total marketing strategy and mix when setting prices. But again, even when featuring price, marketers need to remember that customers rarely buy on price alone. Instead, they seek products that give them the best value in terms of benefits received for the prices paid.

## Organizational Considerations

Management must decide who within the organization should set prices. Companies handle pricing in a variety of ways. In small companies, prices are often set by top management rather than by the marketing or sales departments. In large companies, pricing is typically handled by divisional or product line managers. In industrial markets, salespeople may be allowed to negotiate with customers within certain price ranges. Even so, top management sets the pricing objectives and policies, and it often approves the prices proposed by lower-level management or salespeople.

In industries in which pricing is a key factor (airlines, aerospace, steel, railroads, oil companies), companies often have pricing departments to set the best prices or help others in setting them. These departments report to the marketing department or top management. Others who have an influence on pricing include sales managers, production managers, finance managers, and accountants.

## The Market and Demand

As noted earlier, good pricing starts with an understanding of how customers' perceptions of value affect the prices they are willing to pay. Both consumer and industrial buyers balance the price of a product or service against the benefits of owning it. Thus, before setting prices, the marketer must understand the relationship between price and demand for the company's product. In this section, we take a deeper look at the price-demand relationship and how it varies for different types of markets. We then discuss methods for analyzing the price-demand relationship.

### Pricing in Different Types of Markets

The seller's pricing freedom varies with different types of markets. Economists recognize four types of markets, each presenting a different pricing challenge.

Under *pure competition*, the market consists of many buyers and sellers trading in a uniform commodity, such as wheat, copper, or financial securities. No single buyer or seller has much effect on the going market price. In a purely competitive market, marketing research, product development, pricing, advertising, and sales promotion play little or no role. Thus, sellers in these markets do not spend much time on marketing strategy.

Under *monopolistic competition*, the market consists of many buyers and sellers who trade over a range of prices rather than a single market price. A range of prices occurs because sellers can differentiate their offers to buyers. Sellers try to develop differentiated

offers for different customer segments and, in addition to price, freely use branding, advertising, and personal selling to set their offers apart. Thus, Toyota sets its Prius brand apart through strong branding and advertising, reducing the impact of price. It advertises that the third generation Prius takes you from “zero to sixty in 70% fewer emissions.” Because there are many competitors in such markets, each firm is less affected by competitors’ pricing strategies than in oligopolistic markets.

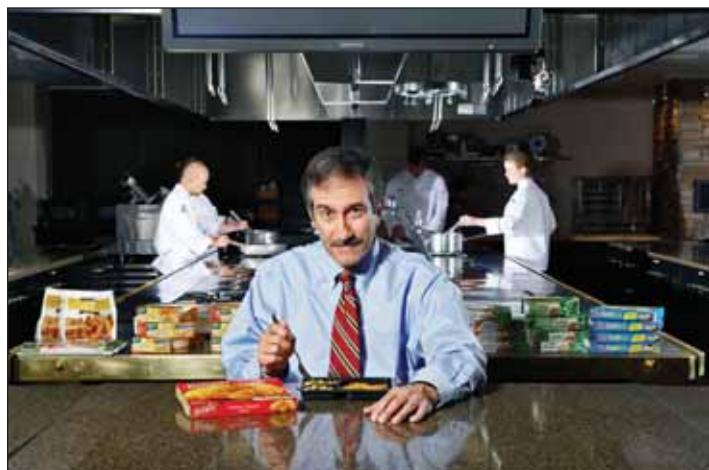
Under *oligopolistic competition*, the market consists of a few sellers who are highly sensitive to each other’s pricing and marketing strategies. Because there are few sellers, each seller is alert and responsive to competitors’ pricing strategies and moves.

In a *pure monopoly*, the market consists of one seller. The seller may be a government monopoly (the U.S. Postal Service), a private regulated monopoly (a power company), or a private nonregulated monopoly (DuPont when it introduced nylon). Pricing is handled differently in each case.

## Analyzing the Price-Demand Relationship

Each price the company might charge will lead to a different level of demand. The relationship between the price charged and the resulting demand level is shown in the **demand curve** in **Figure 10.6**. The demand curve shows the number of units the market will buy in a given time period at different prices that might be charged. In the normal case, demand and price are inversely related—that is, the higher the price, the lower the demand. Thus, the company would sell less if it raised its price from  $P_1$  to  $P_2$ . In short, consumers with limited budgets probably will buy less of something if its price is too high.

Understanding a brand’s price-demand curve is crucial to good pricing decisions. ConAgra Foods learned this lesson when pricing its Banquet frozen dinners.<sup>11</sup>



**● The price-demand curve:** When ConAgra raised prices on its Banquet frozen dinners, sales fell sharply. “The key component . . . is you’ve got to be at \$1,” says CEO Gary Rodkin, pictured above. “Everything else pales in comparison to that.”

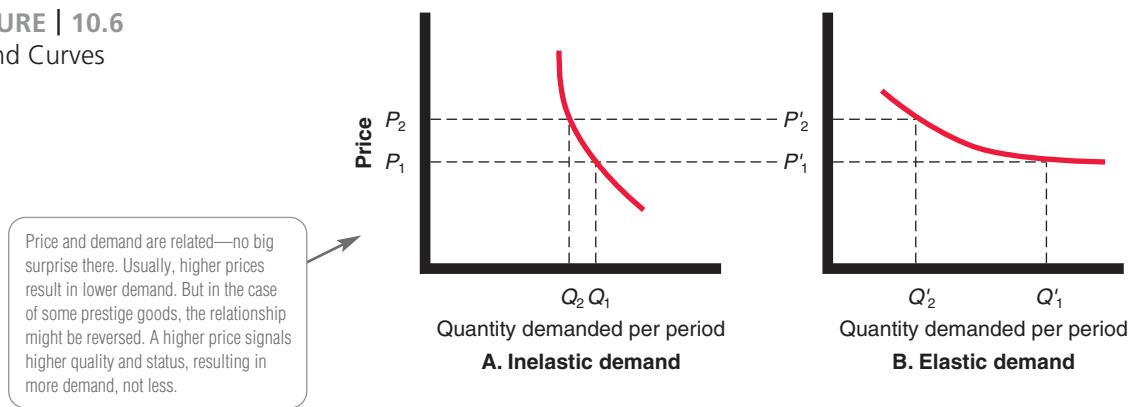
ConAgra found out the hard way about the perils of pushing up the price of a Banquet frozen dinner. When it tried to recoup high commodity costs by hiking the list price last year, many retailers began charging up to \$1.25 a meal. The response from shoppers used to paying \$1? The cold shoulder. The resulting sales drop forced ConAgra to peddle excess dinners to discounters and contributed to a 40 percent drop in the company’s stock price for the year. **●** It turns out that “the key component for Banquet dinners—the key attribute—is you’ve got to be at \$1,” says ConAgra’s CEO Gary Rodkin. “Everything else pales in comparison to that.” The price is now back to a buck a dinner. To make money at that price, ConAgra is doing a better job of managing costs. It tossed out pricey items such as barbecued chicken and country-fried pork in favor of grilled meat patties and rice and beans. It also shrank portion sizes while swapping in cheaper ingredients, such as mashed potatoes for brownies. Consumers are responding well to the brand’s efforts to keep prices down. Where else can you find dinner for \$1?

Most companies try to measure their demand curves by estimating demand at different prices. The type of market makes a difference. In a monopoly, the demand curve shows the total market demand resulting from different prices. If the company faces competition, its demand at different prices will depend on whether competitors’ prices stay constant or change with the company’s own prices.

## Price Elasticity of Demand

Consider the two demand curves in Figure 10.6. In Figure 10.6A, a price increase from  $P_1$  to  $P_2$  leads to a relatively small drop in demand from  $Q_1$  to  $Q_2$ . In Figure 10.6B, however, the same price increase leads to a large drop in demand from  $Q'_1$  to  $Q'_2$ . If demand hardly

**FIGURE | 10.6**  
Demand Curves



### Price elasticity

A measure of the sensitivity of demand to changes in price.

changes with a small change in price, we say the demand is *inelastic*. If demand changes greatly, we say the demand is *elastic*. The **price elasticity** of demand is given by the following formula:

$$\text{price elasticity of demand} = \frac{\% \text{ change in quantity demanded}}{\% \text{ change in price}}$$

Suppose demand falls by 10 percent when a seller raises its price by 2 percent. The price elasticity of demand is therefore  $-5$  (the minus sign confirms the inverse relation between price and demand), and demand is elastic. If demand falls by 2 percent with a 2 percent increase in price, then elasticity is  $-1$ . In this case, the seller's total revenue stays the same: The seller sells fewer items but at a higher price that preserves the same total revenue. If demand falls by 1 percent when price is increased by 2 percent, then elasticity is  $-\frac{1}{2}$ , and demand is inelastic. The less elastic the demand, the more it pays for the seller to raise the price.

What determines the price elasticity of demand? Buyers are less price sensitive when the product they are buying is unique or when it is high in quality, prestige, or exclusiveness; substitute products are hard to find or when they cannot easily compare the quality of substitutes; and the total expenditure for a product is low relative to their income or when the cost is shared by another party.<sup>12</sup>

If demand is elastic rather than inelastic, sellers will consider lowering their prices. A lower price will produce more total revenue. This practice makes sense as long as the extra costs of producing and selling more do not exceed the extra revenue. At the same time, most firms want to avoid pricing that turns their products into commodities. In recent years, forces such as dips in the economy, deregulation, and the instant price comparisons afforded by the Internet and other technologies have increased consumer price sensitivity, turning products ranging from telephones and computers to new automobiles into commodities in some consumers' eyes.

Marketers need to work harder than ever to differentiate their offerings when a dozen competitors are selling virtually the same product at a comparable or lower price. More than ever, companies need to understand the price sensitivity of their customers and the trade-offs people are willing to make between price and product characteristics.

## The Economy

Economic conditions can have a strong impact on the firm's pricing strategies. Economic factors such as a boom or recession, inflation, and interest rates affect pricing decisions because they affect consumer spending, consumer perceptions of the product's price and value, and the company's costs of producing and selling a product.

In the aftermath of the recent Great Recession, consumers have rethought the price-value equation. Many consumers have tightened their belts and become more value conscious. In the new, more-frugal economy, bemoans one marketer, "The frill is gone." Even more, consumers will likely continue their thrifty ways well beyond any economic recovery. As a result, many marketers have increased their emphasis on value-for-the-money pricing

strategies. “Value is the magic word,” says a P&G marketer. “In these economic times, people are . . . being much more thoughtful before making purchases. . . . Now, we’re going to be even more focused on helping consumers see value.”<sup>13</sup>

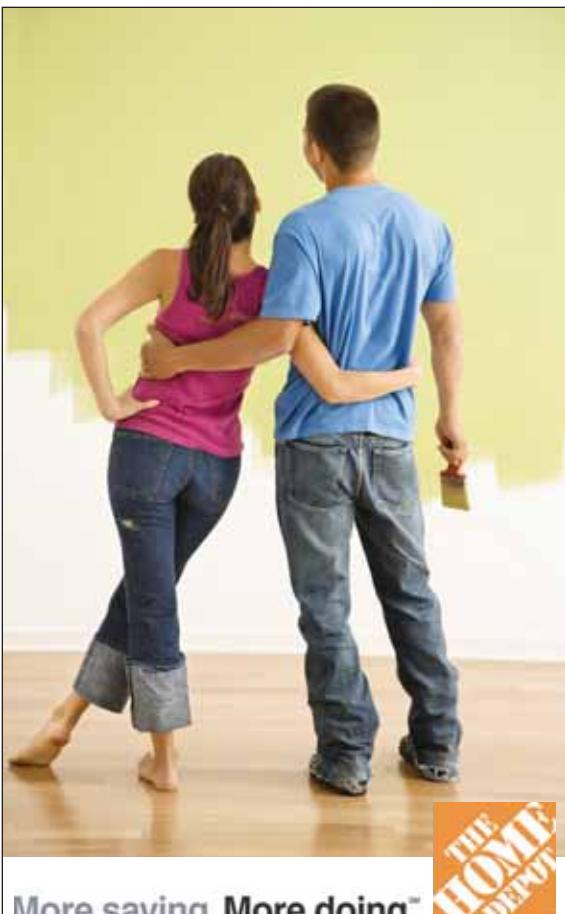
The most obvious response to the new economic realities is to cut prices and offer deep discounts. And thousands of companies have done just that. Lower prices make products more affordable and help spur short-term sales. However, such price cuts can have undesirable long-term consequences. Lower prices mean lower margins. Deep discounts may cheapen a brand in consumers’ eyes. And once a company cuts prices, it’s difficult to raise them again when the economy recovers. Consider companies such as Starbucks, Tiffany’s, or Waitrose, which have spent years successfully positioning themselves on premium products at premium prices. In adapting to the new pricing environment, such firms face the difficult task of realigning their value propositions while staying true to their longer-term “more-for-more” positioning (see Real Marketing 10.2).

Rather than cutting prices, many companies are instead shifting their marketing focus to more affordable items in their product mixes. ● For example, whereas its previous promotions emphasized high-end products and pricey concepts such as creating dream kitchens, Home Depot’s more recent advertising pushes items like potting soil and hand tools under the tagline: “More saving. More doing. That’s the power of Home Depot.” Other companies are holding prices but redefining the “value” in their value propositions. For instance, Unilever has repositioned its higher-end Bertolli frozen meals as an eat-at-home brand that’s more affordable than eating out. And Kraft’s Velveeta cheese ads tell shoppers to “forget the cheddar, Velveeta is better,” claiming that a package of Velveeta is “twice the size of cheddar, for the same price.”<sup>14</sup>

Remember, even in tough economic times, consumers do not buy based on prices alone. They balance the price they pay against the value they receive. For example, according to a recent survey, despite selling its shoes for as much as \$150 a pair, Nike commands the highest consumer loyalty of any brand in the footwear segment.<sup>15</sup> Customers perceive the value of Nike’s products and the Nike ownership experience to be well worth the price. Thus, no matter what price they charge—low or high—companies need to offer great *value for the money*.

## Other External Factors

Beyond the market and the economy, the company must consider several other factors in its external environment when setting prices. It must know what impact its prices will have on other parties in its environment. How will *resellers* react to various prices? The company should set prices that give resellers a fair profit, encourage their support, and help them to sell the product effectively. The *government* is another important external influence on pricing decisions. Finally, *social concerns* may need to be taken into account. In setting prices, a company’s short-term sales, market share, and profit goals may need to be tempered by broader societal considerations. We will examine public policy issues in pricing at the end of Chapter 11.



**More saving. More doing.**

● **Pricing and the economy:** Rather than just cutting prices, Home Depot shifted its marketing focus to more affordable items and projects under the tagline: “More saving. More doing.”

# Real Marketing 10.2

## Waitrose: Introducing the “Essentials” Range

Waitrose is a UK supermarket group and part of the John Lewis chain. Waitrose generated profits of \$417 million on a turnover of \$7 billion in 2009–2010. Waitrose’s reputation has been built on quality and freshness. Coupled with this is the company’s Price Commitment policy, which means Waitrose checks the prices of selected everyday items against the prices of other supermarkets. For some time, Waitrose has been running “Outstanding Offers” where its prices are better than the competition.

Kantar World Panel, the international market research organization, estimated that Waitrose had a 4.2 percent market share of the grocery market in the United Kingdom in June 2010. This placed Waitrose well behind market leader Tesco (30.8 percent), Asda (16.7 percent), Sainsbury’s (16.2 percent), and fourth-place William Morrison (11.9 percent). Discount supermarkets such as Lidl had a steady market share of 2.3 percent. Kantar also noted that with the UK recession in retreat, consumers were actually trading up and looking at premium products once again.

Waitrose is considered by consumers to be at the premium end of the food retail market. Until March 2009, it had its own line of private label products, but it decided that it would launch a brand new range of 1,400 products under the name “Essential Waitrose” to include meat, eggs, fruit juices, milk, and pasta. This was an attempt to reclaim customers that had been lost to cheaper supermarkets such as Asda, Lidl, and Aldi as a result of the downturn in the UK economy.

The danger for Waitrose was that introducing a budget range could affect its public image and brand position as a premium supermarket. Rupert Thomas, Waitrose’s marketing director, masterminded the strategy. He had to come up with a solution that avoided the tried and tested budget-brand phrases, such as “value” or “basics.” It was important to get across to consumers that although the Essential range would be cheaper, quality was not being compromised. On average, prices were reduced by 10 percent. Thomas also knew that to cover the price reductions, sales figures would have to increase by 5 percent. By

June 2010, Waitrose prices had in fact gone up 17 percent.

Managing Director Mark Price fully supported the move by increasing the marketing budget by 20 percent. Overall, Waitrose sales increased by 11 percent in 2009–2010 compared to the previous year, with the Essential range accounting for 16 percent of all sales. In June 2010, the marketing initiative was recognized by the Marketing Society when Waitrose was awarded the Grand Prix at the annual event.

Some of the most compelling data underlining the success of the new brand was released by Waitrose in March 2010. This was the first anniversary of the launch of the Essential range and showed that it had already achieved \$780 million in sales and was on course to break the \$1 billion barrier in the second year. According to Waitrose, 75 percent of its customers were buying products belonging to the new brand.

The initiative proved undoubtedly that even premium product shoppers like a bargain. Waitrose had proven that it could offer cheaper product lines without compromising either the Waitrose brand itself or cannibalizing sales of premium products.

By October 2010, Waitrose had made the decision to price match the UK supermarket leaders on 1,000 branded products, such as Heinz baked beans. This was a new strategy for Waitrose as it had never adopted price matching before. This was also the time when basic commodity prices for foodstuffs such as wheat had risen (up 60 percent on July 2010) and supermarkets were absorbing the price increases and actually cutting prices on products such as loaves of bread.

In November 2010, Waitrose was awarded the Excellence in Marketing Award at the National Business Awards Gala Dinner held in London. Alex Evans, head of the judging panel, cited the fact that the Essential range and marketing campaign that supported it were stunning successes. It proved that even when consumers were more cost-conscious than ever, the Waitrose premium brand had effectively taken on the big four supermarkets.

The agency handling the campaign for Waitrose was London-based MCBD. The campaign included television, print, outdoor, and



Waitrose is considered by most as a premium food retailer, but their cleverly marketed “Essential Waitrose” range shows that the company can offer value for money without compromising on the quality they are known for.

digital advertising, and marketing. MCBD was also behind the new advertising campaign launched in 2010 by Waitrose, which for the first time used celebrity chefs to boost sales. The campaign, believed to be worth \$15.5 million, featured Delia Smith (who had previously worked with Waitrose as a consultant) and Heston Blumenthal (Michelin 3-Star Chef).

It was a wise move for Waitrose, as the so-called "Delia Effect" has had massive impacts on sales of grocery products in the past. Recipes featured on her television shows in the UK have boosted sales of products from sea salt to

cranberries. The new campaign, which is set to run for three years, incorporates television, print, and outdoor advertising. Richard Hodgson, Waitrose's commercial director, announced that a new television advertisement would be broadcast each week and would run for the duration of the advertising break. Each would demonstrate a new recipe; in effect, they would be miniature Delia Smith cooking shows.

Waitrose aims to retain its premium brand status with celebrity tie-ins, while trying to cater to a broader consumer market with the Essential range. While taking on market leaders with a price match promise, Waitrose is trying to reposition itself as a credible competitor at a time when supermarkets are struggling to retain their market share as consumers look for the ideal combination of price and quality.

**Sources:** Based on information from [www.kantar.com](http://www.kantar.com), accessed November 29, 2010; [www.marketing-society.org.uk](http://www.marketing-society.org.uk), accessed November 29, 2010; [www.waitrose.com](http://www.waitrose.com), accessed November 29, 2010.

## REVIEWING Objectives AND KEY Terms

Companies today face a fierce and fast-changing pricing environment. Firms successful at creating customer value with the other marketing mix activities must still capture some of this value in the prices they earn. This chapter examined the importance of pricing, general pricing strategies, and the internal and external considerations that affect pricing decisions.

**Objective 1** Answer the question "What is a price?" and discuss the importance of pricing in today's fast-changing environment. (p 314)

Price can be defined narrowly as the amount of money charged for a product or service. Or it can be defined more broadly as the sum of the values that consumers exchange for the benefits of having and using the product or service. The pricing challenge is to find the price that will let the company make a fair profit by getting paid for the customer value it creates.

Despite the increased role of nonprice factors in the modern marketing process, price remains an important element in the

marketing mix. It is the only marketing mix element that produces revenue; all other elements represent costs. More importantly, as a part of a company's overall value proposition, price plays a key role in creating customer value and building customer relationships. Smart managers treat pricing as a key strategic tool for creating and capturing customer value.

**Objective 2** Identify the three major pricing strategies and discuss the importance of understanding customer-value perceptions, company costs, and competitor strategies when setting prices. (pp 315–324)

Companies can choose from three major pricing strategies: customer value-based pricing, cost-based pricing, and competition-based pricing. *Customer value-based pricing* uses buyers' perceptions of value as the basis for setting price. Good pricing begins with a complete understanding of the value that a product or service creates for customers and setting a price that captures that

value. Customer perceptions of the product's value set the ceiling for prices. If customers perceive that a product's price is greater than its value, they will not buy the product.

Companies can pursue either of two types of value-based pricing. *Good-value pricing* involves offering just the right combination of quality and good service at a fair price. EDLP is an example of this strategy. *Value-added pricing* involves attaching value-added features and services to differentiate the company's offers and support charging higher prices.

*Cost-based pricing* involves setting prices based on the costs for producing, distributing, and selling products plus a fair rate of return for effort and risk. Company and product costs are an important consideration in setting prices. Whereas customer value perceptions set the price ceiling, costs set the floor for pricing. However, cost-based pricing is product driven rather than customer driven. The company designs what it considers to be a good product and sets a price that covers costs plus a target profit. If the price turns out to be too high, the company must settle for lower markups or lower sales, both resulting in disappointing profits. If the company prices the product below its costs, its profits will also suffer. Cost-based pricing approaches include *cost-plus pricing* and *break-even pricing* (or target profit pricing).

*Competition-based pricing* involves setting prices based on competitors' strategies, costs, prices, and market offerings. Consumers base their judgments of a product's value on the prices that competitors charge for similar products. If consumers perceive that the company's product or service provides greater value, the company can charge a higher price. If consumers perceive less value relative to competing products, the company must either charge a lower price or change customer perceptions to justify a higher price.

**Objective 3** **Identify and define the other important internal and external factors affecting a firm's pricing decisions. (pp 324–330)**

Other *internal* factors that influence pricing decisions include the company's overall marketing strategy, objectives, and marketing mix, as well as organizational considerations. Price is only one element of the company's broader marketing strategy. If the company has selected its target market and positioning carefully, then its marketing mix strategy, including price, will be fairly straightforward. Some companies position their products on price and then tailor other marketing mix decisions to the prices they want to charge. Other companies deemphasize price and use other marketing mix tools to create *nonprice* positions.

Other *external* pricing considerations include the nature of the market and demand and environmental factors such as the economy, reseller needs, and government actions. The seller's pricing freedom varies with different types of markets. Ultimately, the customer decides whether the company has set the right price. The customer weighs price against the perceived values of using the product: If the price exceeds the sum of the values, consumers will not buy. So the company must understand concepts such as demand curves (the price-demand relationship) and price elasticity (consumer sensitivity to prices).

Economic conditions can also have a major impact on pricing decisions. The Great Recession caused consumers to rethink the price-value equation. Marketers have responded by increasing their emphasis on value-for-the-money pricing strategies. Even in tough economic times, however, consumers do not buy based on prices alone. Thus, no matter what price they charge—low or high—companies need to offer superior value for the money.

## KEY Terms

**OBJECTIVE 1**

Price (p 314)

**OBJECTIVE 2**

Customer value-based pricing (p 315)

Good-value pricing (p 316)

Value-added pricing (p 317)

**OBJECTIVE 3**

Cost-based pricing (p 319)

Fixed costs (overhead) (p 320)

Variable costs (p 320)

Total costs (p 320)

Experience curve (learning curve) (p 321)

Cost-plus pricing (markup pricing) (p 321)

Break-even pricing (target return pricing) (p 322)

Competition-based pricing (p 323)

Target costing (p 324)

Demand curve (p 326)

Price elasticity (p 327)



- Check your understanding of the concepts and key terms using the study plan for this chapter.
- Apply the concepts in a business context using the simulation entitled **Pricing**.

# DISCUSSING & APPLYING THE Concepts

## Discussing the Concepts

1. What factors must marketers consider when setting prices? (AACSB: Communication).
2. Name and describe the two types of value-based pricing methods. (AACSB: Communication)
3. Describe the types of cost-based pricing and the methods of implementing each. (AACSB: Communication)
4. What is *target costing* and how is it different from the usual process of setting prices? (AACSB: Communication)
5. Discuss the impact of the economy on a company's pricing strategies. (AACSB: Communication)
6. Name and describe the four types of markets recognized by economists and discuss the pricing challenges posed by each. (AACSB: Communication)

## Applying the Concepts

1. In a small group, discuss your perceptions of value and how much you are willing to pay for the following products:

automobiles, frozen dinners, jeans, and athletic shoes. Are there differences among members of your group? Explain why those differences exist. Discuss some examples of brands of these products that are positioned to deliver different value to consumers. (AACSB: Communication; Reflective Thinking)

2. Find estimates of price elasticity for a variety of consumer goods and services. Explain what price elasticities of 0.5 and 2.4 mean. (Note: These are absolute values, as price elasticity is usually negative.) (AACSB: Communication; Reflective Thinking)
3. In a small group, determine the costs associated with offering an online MBA degree in addition to a traditional MBA degree at a university. Which costs are fixed and which are variable? Determine the tuition (that is, price) to charge for a three-credit course in this degree program. Which pricing method is your group using to determine the price? (AACSB: Communication; Reflective Thinking)

# FOCUS ON Technology

Would you shop around for the best price on a medical procedure? Most patients do not know the price of a medical procedure, and many might not care because they think insurance will cover it. But that is not always the case. Many patients are paying out of their own pockets for their health care. However, health-care costs and doctors' prices are now more transparent thanks to the Internet. Several Web sites arm patients with cost information, and others allow them to make price comparisons in their areas. They might even get a coupon for a price reduction from a participating provider.

1. Go to [www.outofpocket.com/OOP/Default.aspx](http://www.outofpocket.com/OOP/Default.aspx) to determine the average cost for a colonoscopy. Using a source such as

[www.newchoicehealth.com](http://www.newchoicehealth.com), determine the cost for a colonoscopy in your city and in a nearby city. What is the most and least expensive in each city? Are prices comparable to the national average? Why are there differences or similarities in the range of prices for the two cities? (AACSB: Communication; Use of IT; Reflective Thinking)

2. Health-care providers offer price deals through these types of Web sites. Debate the likelihood of consumers taking advantage of Internet price discounts for medical care. (AACSB: Communication; Reflective Thinking)

# FOCUS ON Ethics

In airline pricing, \$5 here and \$10 there; it all starts to add up. Airlines are nickel-and-diming flyers right and left, except that there are more zeros after the fives and tens! Add-on fees contributed more than \$5 billion in airline revenue in 2009. Change your flight—that will cost upward of \$150. Check a bag—add another \$10 to \$25 and perhaps \$50 for a second bag if traveling overseas. Spirit Airlines even charges for carry-on bags! Taking a pet along? That's another \$50 to \$100. Hungry? \$10 or more, please. For \$10 to \$30, you can jump to the front of the check-in and se-

curity lines and board before other passengers. These fees are in addition to all the other taxes and fees imposed on flyers. A recent Government Accountability Office report, however, raises concerns over the disclosure of fees. Airlines are required to disclose only check-bag fees, making it harder for consumers to compare total costs when booking flights.

1. Go to [www.delta.com](http://www.delta.com) and determine what it would cost to fly Delta Airlines from Atlanta to Denver for a one-week

roundtrip next month. What additional fees would you have to pay to change your flight, check one bag, bring your dog with you, and eat lunch while flying? (AACSB: Communication; Reflective Thinking)

- 2.** How easy was it to determine the total cost of your flight? Should airlines be required to disclose all fees through an easier method? (AACSB: Communication; Ethical Reasoning)

## MARKETING & THE Economy

### Colgate-Palmolive

As the uncertain economy has made people more aware of their spending, many companies have slashed prices on their products and services. Still other companies successfully held prices steady, selling as much or more than they did before the economic bottom fell out. But Colgate-Palmolive is one of the fortunate few that has actually been able to *increase* prices during this more frugal era and reap benefits from doing so. Think about it—how grim would your budget have to get before you'd stop brushing your teeth or taking a shower? Economic conditions have relatively little impact on people's basic personal care habits, and brand preferences are deeply ingrained for these necessities. Based on an

accurate evaluation of customer buying habits, Colgate-Palmolive raised prices by an average of 7.5 percent without experiencing any dip in sales. Higher prices and stable volumes equal—cha-ching—higher profits. Indeed, Colgate-Palmolive saw its profits rise by 20 percent in 2008 and 17 percent in 2009, during the heart of the recent recession. It seems as though looking and smelling clean might just be recession-proof concepts.

- 1.** Does the success of Colgate-Palmolive's price increases have anything to do with the economy?
- 2.** In the longer term, as the economy recovers, what should Colgate-Palmolive anticipate in the wake of its price increases?

## MARKETING BY THE Numbers

One external factor that manufacturers must consider when setting prices is reseller margins. Manufacturers do not have the final say concerning the price to consumers; retailers do. So manufacturers must start with their suggested retail prices and work back, subtracting out the markups required by resellers that sell the product to consumers. Once that is considered, manufacturers know at what price to sell their products to resellers, and they can determine what volume they must sell to break even at that price and cost combination. To answer the following questions, refer to Appendix 2.

- 1.** A consumer purchases a computer for \$800 from a retailer. If the retailer's markup is 30 percent and the wholesaler's

markup is 10 percent, both based on their respective selling prices, at what price does the manufacturer sell the product to the wholesaler? (AACSB: Communication; Analytical Reasoning)

- 2.** If the unit variable cost for each computer is \$350 and the manufacturer has fixed costs totaling \$2 million, how many computers must this manufacturer sell to break even? How many must it sell to realize a profit of \$50 million? (AACSB: Communication; Analytical Reasoning)

## VIDEO Case

### IKEA

Lots of companies have idealistic missions. But IKEA's vision, "To create a better everyday life for the many people," seems somewhat implausible. How can a company that makes furniture improve everyday life for the masses? Interestingly, the most important part of that strategy is price. For every product that it designs, from leather sofas to plastic mugs, IKEA starts with a target price. The target price is one that's deemed affordable, making the product accessible to the masses.

Only then does IKEA begin the grueling process of creating a high-quality, stylish, and innovative product that can be delivered to the customer for that target price. As IKEA points out, anyone can make high-quality goods for a high price or poor-quality goods for a low price. The real challenge is making high-quality

products at a low price. To do so requires a relentless focus on costs combined with a thirst for innovation. That has been IKEA's quest for more than 65 years.

After viewing the video featuring IKEA, answer the following questions about the company's pricing strategy:

- 1.** What is IKEA's promise of value?
- 2.** Referring to the Klippan sofa, illustrate how IKEA delivers its promise of value to consumers.
- 3.** Based on the concepts from the text, does IKEA employ a value-based pricing approach or a cost-based pricing approach? Support your answer.

## COMPANY Case

### Cebu Pacific Air: Now, Everybody Can Fly

Cebu Pacific Air is the largest domestic airline company providing the most domestic flights in the Philippines. It was first established in August 1988 and began operations in March 1996. At present, Cebu Pacific reaches a total of 32 domestic destinations and serves 12 countries with 16 destinations.

Its parent company is JG Summit Holding, owned and controlled by the Gokongwei family of the Philippines. The company is headed by Lance Gokongwei, President and CEO. International operations were established in 2000 when the company was granted rights to operate international flights to Asia-Pacific in Singapore, Malaysia, Indonesia, Thailand, South Korea, Hong Kong, and Guam. A twice-daily service to Hong Kong was launched in November 2001, followed in March 2002 by another to Seoul (South Korea) with thrice-weekly flights and in November 2002 to Singapore. Based on the statistics from the Philippines' Civil Aeronautics Board and Civil Aviation Authority (CAAP), Cebu Pacific was the biggest domestic carrier with more than 45 percent market share, and it ranked fifth in Asia in terms of an increase in total passengers carried for the year 2008. As of November 2010, Cebu Pacific has added new international destinations to Brunei, Japan, Macau, China, Taipei, and Vietnam.

In terms of recognition, Cebu Pacific garnered an award from the Singapore Tourism Board in 2009 for the highest number of passengers carried for Singapore, with a total of 375,000 passengers. According to Gokongwei, Cebu Pacific carried a total of 5.38 million domestic passengers in 2008, a 20.7 percent increase over 2007, while international passengers rose to 1.4 million from the 1 million recorded in 2007, for growth of 33 percent. Candice Iyog, Cebu Pacific Vice President for Marketing and Distribution, projected that with the introduction of six brand-new aircraft in 2009, the company expected to transport more than 9 million passengers while making air travel cheaper for domestic passengers and those from other Asian countries too.

Due to the increasing cost of air travel, Cebu Pacific's slogan—"Now, everybody can fly"—may no longer be true. However, many passengers tend to book their flight 6 to 11 months in advance as part of a "promo fare" offer. A promo fare booked early, is cheaper than the regular fare booked two weeks to one month in advance, so customers make reservations early and pay in advance, thus saving 40 to 50 percent. The promo fare seems like a good bargain at a discounted price.

Philippine Airlines, or PAL, is the national airline of the Philippines, serving 19 domestic routes and 24 international destinations in southeast Asia, east Asia, Australia, the Middle East, and North America. PAL was established in 1941 and is considered to be the oldest airline in Asia. It is a direct competitor of Cebu Pacific for the Philippine domestic routes.

PAL was greatly affected by the Asian financial crisis in 1997, which caused financial difficulties for the company and consequently resulted in downsizing international operations. PAL reduced its flight operations in Europe and southwest Asia, and a number of domestic flight services were also terminated. In order to survive during the crisis, PAL implemented a retrenchment program among its thousands of employees. As of August 2010, PAL had 35 percent market share of the domestic capacity and 30 percent share in the international capacity.

### THE PHILIPPINE AIRLINE INDUSTRY

In 1994, before the implementation of the airline liberalization program (which included privatizing state owned airline carriers to encourage new airline companies to enter the market), PAL commanded a 96 percent market share in the Philippine airline industry and virtually monopolized the industry because of the government's one-airline policy. After the liberalization program was implemented in 1995, the airline industry changed dramatically. Barriers to entry were lifted, allowing new players to serve domestic routes and eliminating restriction on airfares and flight frequency. Benefits gained from the liberalization program include a reduction of air fare, better customer service, and more passenger traffic. The domestic route from Manila to Cebu, for example, a prime local destination formerly served by PAL alone, had a total of 927,105 passengers in 1994. In 2003, with three airlines flying the same route, PAL carried a total of 1,315,406 passengers, representing growth of 42 percent. The new entrants that were operating nationally in the industry were Grand Air, Asian Spirit, Cebu Pacific Air, South East Asian Air, and Air Philippines.

In 2005, Cebu Pacific launched its low fares on a year-round basis, which made air travel more affordable to Filipino passengers. Cebu Pacific also expanded its domestic network, acquired new aircrafts, and implemented a competitive pricing strategy. Competitors soon followed by lowering their prices and heightened the price competition among the new players in the industry. In 2007, the Philippine air travel industry carried a total of 10.4 million passengers and grew by 23 percent compared to the 8.5 million passengers recorded in 2006.

In terms of pricing, PAL has now adopted a market penetration strategy in both domestic and international airfares by lowering its prices against Cebu Pacific. For example, a booking for the period November 26 to 30, 2010, revealed the following: For PAL, regular fare for a round-trip ticket from Manila to Cebu, the prime domestic travel destination, is \$104 excluding taxes while Cebu Pacific costs \$125, a saving of 17 percent. In the past, PAL's prices were higher by 30 to 35 percent compared to Cebu Pacific. For international destinations, such as the Manila to Singapore route, which flew the most passengers in 2009, regular airfare on PAL is \$242, while Cebu Pacific charges \$367, resulting in a big saving of 34 percent for PAL passengers. The strategy of PAL is to recover its lost market share by offering a much lower price than Cebu Pacific to these two destinations. However, PAL should have implemented this strategy earlier in 2005, when Cebu Pacific launched its low-budget fare promotion. It is only now, when confronted with problems and loss of its strong position in the air travel market, that Cebu Pacific has implemented a counteroffensive.

### CUSTOMER PERCEIVED VALUE

Passengers of Cebu Pacific took advantage of the promo fare and got more value for their money. Cebu Pacific is not selling price as its main attraction; rather, it is selling customer value. Customers consider the value that they will receive for the price that they are willing to pay. In other words, customers measure the value or benefit they will receive against the price they will pay for the product or service; this is sometimes called customer perceived value (CPV). CPV is the difference between the benefit that customers will get and the price that the customer is willing to pay.

The attractiveness of Cebu Pacific does not depend only on its low fares. Cebu Pacific's customer value program includes hassle-free online reservations, a courteous check-in counter, on-time

departures and arrivals, and comfortable leather seats. Party games during the flight, such as "Bring Me," add further value; flight attendants announce the contest and ask passengers to bring them an object, such as a \$1 coin or a hairclip, and the passenger who brings the object to them first receives a token gift. These are all part of Cebu Pacific's customer value program. As one passenger has said, Cebu Pacific offers a truly Filipino culture of hospitality by ensuring its passengers enjoy their flight.

In terms of safety, the Cebu Pacific air fleet is 21.6 months old as of August 2010, according to Gokongwei. This is also part of customer value pricing. You can't expect a meal during the flight, but Cebu Pacific flight attendants provide snacks to their passengers at an affordable price.

Marketing principles state that a low-price strategy should not be used alone. It should be part of a total marketing program. Customers will try the low-price product but will be turned off if the product does not deliver its promise of customer satisfaction. No matter how low the price is, no amount of advertising will change the customer's perception of a product after a bad experience.

Because of its ability to satisfy its customers, Cebu Pacific Air was ranked the third-largest low-cost airline in Asia, with revenue growth of 21 percent in June 2009. In May 2008, the airline made news when it was named the "World's Number One Airline" in terms of growth by *Airline Business News*, an e-newsletter. Also, Cebu Pacific Air was ranked fifth in Asia for budget airline passengers by *Smart Travel Asia*, an online travel magazine. The recorded growth was a whopping 57.4 percent in 2007 compared to 2006, or a total of 5.5 million passengers carried. The award showcased Cebu Pacific Air as the pearl of the Philippines in the airline industry.

## WHY IS CEBU PACIFIC SO SUCCESSFUL?

The success of Cebu Pacific cannot be attributed just to its low-pricing strategy. It must be viewed in light of the entire marketing mix. Cebu Pacific understands its customers' needs and adds more customer value. *Value* can be defined as the benefits the customers get minus the price they pay. Customers of Cebu Pacific get their value through online reservations, which are very convenient to make, on-time departures and arrivals, and, of course, low promo fares. In terms of on-time performance (OTP), Cebu Pacific improved its performance posted in January 2010 from 91.6 percent, which is an industry standard, to a record high of 92.5 percent OTP in February 2010. OTP is defined as when an aircraft leaves the bay within 15 minutes of the scheduled departure.

In terms of promotions, Cebu Pacific also has made use of the new social media platforms, such as Twitter, and is the first airline in

the Philippines to have used this technology. Adding to the excitement in promotions, Cebu Pacific made news on September 30, 2010, when YouTube showed a video of flight attendants making a flight safety demonstration while dancing to the tune of Lady Gaga's "Just Dance." A total of 1.5 million viewers saw the video in just 36 hours, according to Britain's *Daily Mail*. When interviewed by GMA News in the Philippines, Marketing and Distribution Vice President Candice Iyog mentioned that it has always been the company's practice to become more innovative in its operations, and the company was thinking of the enjoyment that it could give to its passengers during the flight. She added that the special dance number was presented to the passengers after the standard safety flight instructions had been performed before takeoff.

Another factor that makes Cebu Pacific successful is the commitment of its staff. From the CEO to the ground crew, all are committed to deliver the highest customer value through sustained customer service attuned to the low-pricing scheme.

## Questions for Discussion

1. Cebu Pacific's success can be attributed to a low-price strategy and loyal customers. Why do you think value pricing is not just about lowering prices of your product?
2. Describe how Cebu Pacific utilizes its marketing mix to achieve successful operations.
3. You are the marketing manager of Cebu Pacific. You notice that your direct competitors are following your low-price strategy. Discuss your counterstrategies.
4. You are the CEO of Cebu Pacific. What marketing strategies are you going to implement to sustain the increasing popularity of your company in the airline industry?

**Sources:** "Cebu's Flight-safety Dance a Hit," *My Paper*, October 6, 2010, p. A15; Cebu Pacific Web site, [www.cebupacificair.com/aboutus/press/2007/05032007.html](http://www.cebupacificair.com/aboutus/press/2007/05032007.html), accessed October 2, 2010; "Asia's Top 10 Budget Airlines," [thelowcostflights.com/asia-top-10-budget-airlines](http://thelowcostflights.com/asia-top-10-budget-airlines), accessed November 24, 2010; [www.abs-cbnnews.com/video/business/08/16/10/lance-gokongwei-talks-anc-about-airline-industry-open-skies](http://www.abs-cbnnews.com/video/business/08/16/10/lance-gokongwei-talks-anc-about-airline-industry-open-skies), accessed November 25, 2010; [www.budgetairlineguide.com/com/cebu-pacific](http://www.budgetairlineguide.com/com/cebu-pacific), Accessed October 30, 2010; [www.cebupacific.com](http://www.cebupacific.com), accessed November 26, 2010; [www.dailymail.co.uk/home/search.html](http://www.dailymail.co.uk/home/search.html), accessed October 30, 2010; [www.dancewithshadows.com/flights/philippines-flights.asp](http://www.dancewithshadows.com/flights/philippines-flights.asp), accessed November 25, 2010; [www.philippineairlines.com/home/home.jsp](http://www.philippineairlines.com/home/home.jsp), accessed November 26, 2010; [www.philstar.com/Article.aspx?articleid=463995](http://www.philstar.com/Article.aspx?articleid=463995), accessed November 24, 2010; [www.philippineairlines.com/about\\_pal/about\\_pal.jsp](http://www.philippineairlines.com/about_pal/about_pal.jsp), accessed November 25, 2010.