



## Pricing

- I. Many Approaches
  - a. Won't even cover microeconomic approaches
    - i. Perfect Competition (good for agriculture), price is already set
    - ii. Monopoly: Set price based on MC curve
  - b. Will take a more practical approach (less theoretical)
  - c. How much of "value added" do we want to give away, and how much to retain?
  - d. Price = Rent, Tuition, Fee, Interest Charge, "Naming Gift Opportunities," et cetera
  - e. Depending on goals, may set price differently (maximize revenue, market share, ...)
- II. Common Mistakes
  - a. Too cost-oriented ("cost obsessed") – cost is something different
  - b. Not revised frequently to exploit market changes
    - i. New products, macroeconomic shocks, et cetera – all affect demand
    - ii. Can (*should*) alter prices in response to those changes
  - c. Set independent of the rest of the marketing mix. Should be an intrinsic part of positioning strategy.
- III. Flawed Approaches
  - a. Markup Pricing
    - i. Have desired markup over cost; just set the price!
    - ii. Example
      1. VC = \$10, FC = \$300,000
      2. Forecasted Sales: 50,000 units (but shouldn't the forecast include *price*?)
      3. Unit Cost:  $300,000 / 50,000 + \$10 = \$16$
      4. Want 20% markup, so from \$16 get \$20
      5. Done! But wait; if we only sell 30,000 we make no profit.
      6. To get 20% we'd have to raise the price, but demand seems soft already.
      7. If sales are at 70,000 we'd have to lower the price! Also counterintuitive
  - b. ROI Pricing
    - i. Another cost-based approach
    - ii. Same Example
      1. Invested \$1,000,000. Want 20% ROI.
      2.  $200,000 = (50,000)p - (50,000)(\$16)$
      3. Again based on forecasted demand
  - c. Could get a ballpark sense of where the price should be by estimating a range of demand levels, but doesn't remove the fundamental conceptual flaw with cost-based pricing.
- IV. Reduction Planning
  - a. Initially everything is "full price"
  - b. As the season progresses, markdown based on observed demand
  - c. Discounts – to Boy Scouts or whatever
  - d. Stock Reductions – a.k.a. theft (about 50% of after tax net profits at department stores)
  - e. Markup on Retail =  $(R - C) / R = (\text{Operating Expenses} + \text{Profit}) / \text{Net Sales}$
  - f. So plan markup based on desired profit
    - i. Calculate markup, then raise it by amount of reductions
    - ii.  $(\text{Operating Expenses} + \text{Profit} + \text{Reductions}) / (\text{Net Sales} + \text{Reductions})$
- V. Marketing Approach
  - a. How can marketing give a better pricing answer?
  - b. Thoughts / Goals
    - i. Recognize different segments, different elasticity
    - ii. Design pricing to discriminate across segments
  - c. Tactics
    - i. Segment by Buyer Identification
      1. When we give student ID to get a discount, we're identified as price sensitive (if you're not price sensitive you don't flash the ID)
      2. Other customers identified by process of elimination

3. Car salesman asks questions to identify segments: "What do you do for a living? How long have you lived in the area?" (If you haven't lived in the area you may not know as much about the competition) "What cars have you purchased before?"
- ii. Segment by Purchase Location. Set lower prices where there's competition.
- iii. Segment by the Time of Purchase
  1. Resorts with peak / off-peak season
  2. Movie theatres with matinees
  3. Many restaurants have dinner and lunch pricing
- iv. Segment by Purchase Quantity
  1. By volume: Big buyers are price sensitive
  2. Two-Part Pricing
    - a. Amusement park charges \$20 to get in, \$1 per ride.
    - b. Health club charges for membership plus an hourly rate
    - c. Heavy users pay less per unit than lighter users
  3. Bundling – See the whole section on bundling below

## VI. Bundling

### a. Example

- i. Have two theater owners
  1. A wants Film 1 for 12k, B wants Film 1 for 18k
  2. A wants Film 2 for 25k, B wants Film 2 for 10k
- ii. With perfect price discrimination could get 37k from A and 28k from B. Total: 65k
- iii. Would never work – communication across buyers makes this impossible
- iv. Pure Component Pricing
  1. Charge \$12k for Film 1 since both theaters buy it.
  2. Charge \$25k for Film 2 – better than selling to both for 10k.
  3. Total: \$37k
  4. Legal, common pricing strategy
- v. Bundling
  1. Offer both films as a bundle
  2. A would pay \$37k for both
  3. B would pay \$28k
  4. Charge \$28k for the bundle
  5. Total: \$56k
  6. Much higher! Not as good as perfect discrimination, but cannot implement perfect discrimination. This is actually implementable

### b. Applications

- i. Season tickets
- ii. Complete dinner as opposed to à la carte
- iii. Software that comes with a computer

### c. Why?

- i. Cost savings (in production, information management)
- ii. Economies of scope.
- iii. Complementarity – Items naturally belong together
- iv. Customers have different reservation prices

### d. Types

- i. Pure bundling (available only as a bundle)
- ii. Mixed bundling (offer separately or as a bundle)
- iii. Pure components (no bundling at all)

- e. With mixed bundling there's no (known) way to tell what mix will work best without just going through the motions of calculating the profit that would result