

Pricing Introduction

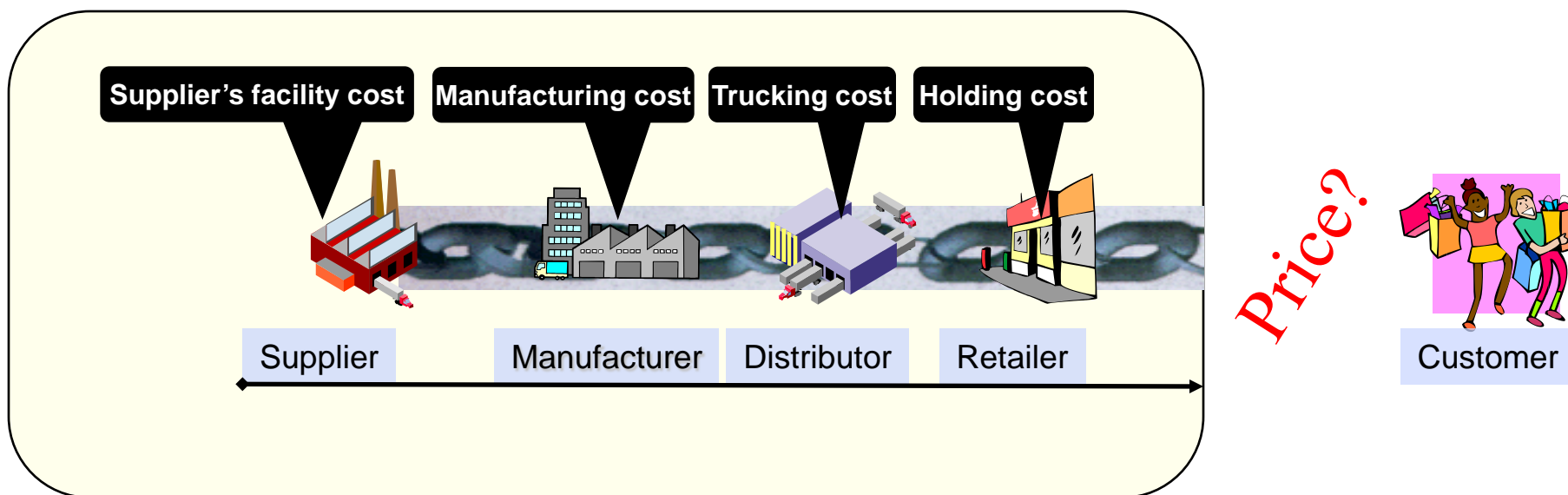
Outline

- ◆ **Types of Prices**
- ◆ **Pricing Approaches**
- ◆ **Pricing Process**

Based on Phillips (2005) Chapter 2

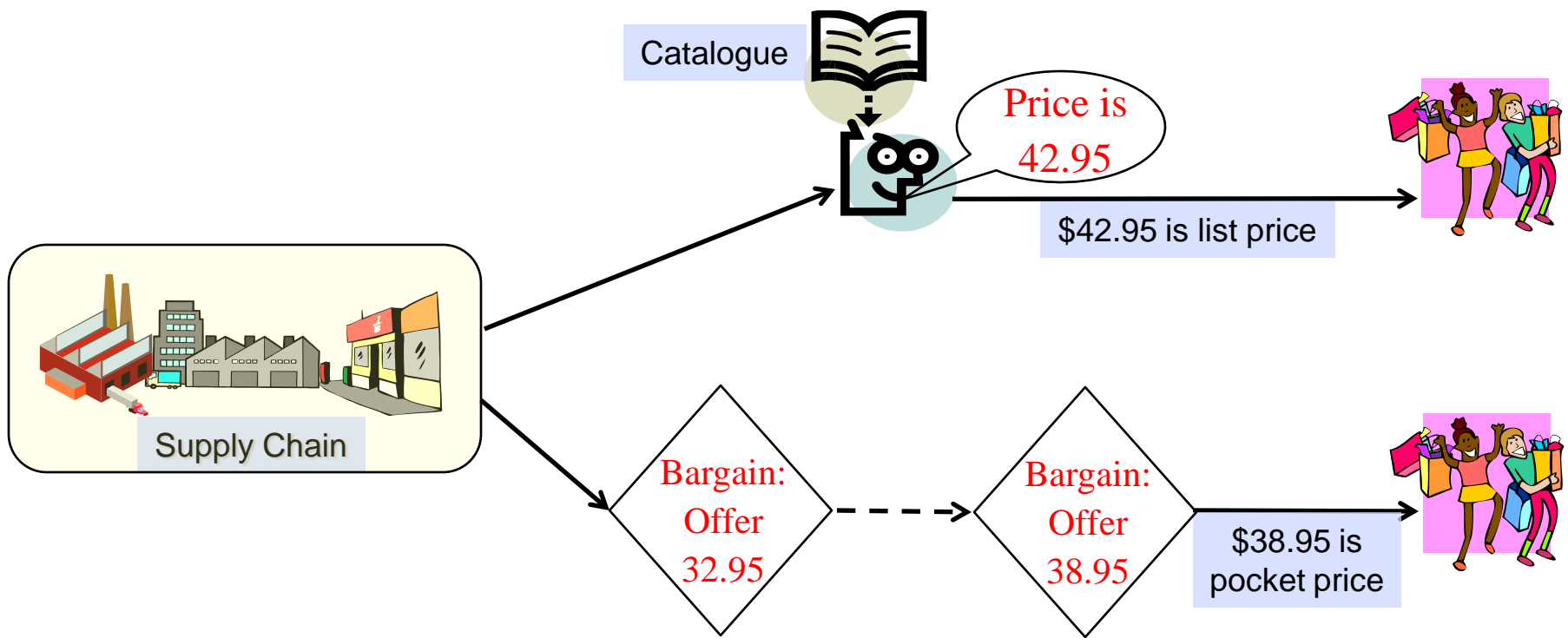
Cost vs Price

A supply chain and its costs.



Find out the costs from accounting records, decide on the price.

List (Catalogue) Price and Pocket Price



- Buyer offers a lower price than the list price and brings up the offer.
- Seller rejects offers until the price is sufficiently high.
- How much to discount?

Why **List Price** differs from **Pocket Price**?

The Case of B2B Transactions

Retailer Performance (quantity, quality, time)

- ◆ **Annual volume bonus:** An end-of-year bonus paid to a retailer who buys a certain amount.
- ◆ **Stocking allowance:** Quantity based discount often before a seasonal demand increase.
- ◆ **Performance penalties:** Penalties charged to retailer if performance targets in terms of quality or delivery times are missed.

Advertising and Promotion

- ◆ **Cooperative advertising:** An allowance paid to the retailer for locally advertising the supplier's product.
- ◆ **Market-development funds:** A discount given to retailer to promote sales in specific segments of the market. For example, after an entry to a new national market.
- ◆ **End-customer discount:** A rebate paid to a retailer for discounting a product for a strategic customer.
- ◆ **Off-invoice promotions:** A discount given to retailer during a specific promotion.

Logistics

- ◆ **Freight:** Supplier may assume transportation cost.
- ◆ **On-line order discount:** Discount for retailers ordering over the Internet.
- ◆ **Slotting allowance:** Paid to retailers to secure shelf space.

Transaction Accounting

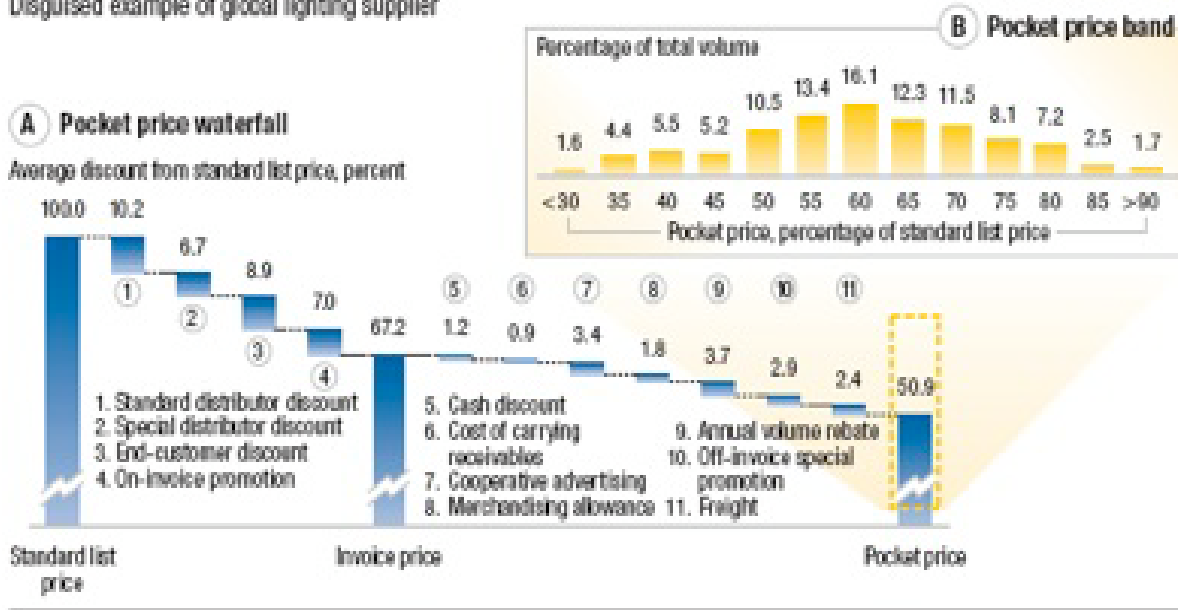
- ◆ **Consignment cost:** The cost of funds when a supplier owns retailer's inventory.
- ◆ **Receivable carrying cost:** The cost of funds to be received from invoicing until receiving.
- ◆ **Cash discount:** A deduction from the invoice price if payment is received quickly, <15 days.

Price Waterfall

takes us from List Price to Pocket Price

Money in your pocket

Disguised example of global lighting supplier



Source: The power of pricing, McKinsey Quarterly, February 2003.

- ◆ If the pocket price differs from the list price by 50%, what is the appropriate margin?
- ◆ Some argue that we should compute pocket margin instead:
 - Pocket margin = Pocket price – direct cost – indirect cost – cost to serve a specific account
- ◆ The last cost is big with customized products.
 - For example, Tempered (toughened) special cut glass for heavy trucks, farm and construction machinery.

Pocket Price Band

Pocket price band: the histogram of the pocket prices obtained, as a % of list price.

- From the last page, 2.5% of the customers pay 85% of the list price
- ◆ Pocket price band does not necessarily indicate bad pricing policy. It may indicate just the contrary.
- ◆ Sophisticated buyers ask for / bargain for various prices.
- ◆ A company, in response to a buyer's wish, should offer a responsive price.
- ◆ Customer characteristics specify the offered price
 - Customer size: Small pays big. Recall annual volume bonus.
 - Customer's disposable income: Rich pays big.
 - Willingness to buy (pay): Enthusiast pays big.
 - Future sales potential: Low potential pays big. Recall market development funds.
 - Past history: Friendship matters.
 - Access to alternatives matter: Isolated customers pay big.
 - Negotiation effort, alternative product search effort matter: Lazy pays big.
- ◆ Price Optimization on seller's part can lead to a wide pocket price band.

Why **List Price** differs from **Pocket Price**?

The Case of Carpet Sellers



Music ("Ney" instrument)
is served for the soul



Food (a wrap and tea) is
served for the body



"This is the man who gouged [overcharged] me
bad for a jewelry box that smelled like fish."
Source: flickr.com

Expensive Bargaining lesson for Istanbul: **Act like you couldn't care about the wares.** **If you're interested in something, walk past it at first. Do NOT linger.** Then pick it up like it's a dead stinky fish and you've seen a million like it and say "How much?". **Never compliment the beauty of the items,** and **frown incredulously at the price they quote you,** then walk away with a look of "What kind of fool do you take me for". **Don't buy at the first 5 places you come to.** The items are the same everywhere in the bazaar. The prices are inflated at least 200%. When you finally do buy, stop comparison shopping, because inevitably the next place you go to will be selling the same item at a third of the price you just paid. Ignorance is bliss.

Based on a flickr.com comment

What is the list price of a jewelry box? Why do you pay the list price when you shop?

Traditional Pricing Approaches

Cost Plus Pricing

- ◆ Cost Plus Pricing: Add a surcharge to the **cost** of a product to find its price.
 - Finance departments insist on margins to ensure profitability
 - » 5% for established products
 - » 50% for design/customized products
 - » In a non-profit business, mark up by once; price about the cost.
 - » In restaurant business, mark up
 - ◆ food by 3 times
 - ◆ beer 4 times
 - ◆ liquor 6 timesof the direct cost
- ◆ Cost plus pricing is an introverted process for **ignoring**
 - **Customer**
 - **Competition**
- ◆ Cost plus pricing is very common
- ◆ Fixed costs complicate the computation of cost-plus prices

Traditional Pricing Approaches

Cost Plus Pricing: Millie's Cider Shop

- ◆ Millie is an entrepreneur spirited SOM graduate. She wants to open a non-alcoholic cider shop at “Shops at Legacy”.
 - She will buy ciders at \$2 per bottle from the wholesaler.
 - Besides this wholesale cost, her major cost is the shop rental of \$1000/month.
 - She aims for 20% margin. What should the price of a cider bottle be?
- ◆ Cost plus pricing approach requires the allocation of \$1000 rental cost to the bottles sold over a month. It is important to find out average monthly sales.
- ◆ Her market analysis shows that she can sell
 - 1500 bottles if the price is less than \$3.50;
 - 1000 bottles if the price is between \$3.50-4.00;
 - 500 bottles if the price is between \$4.00-5.00.
 - 0 bottles if the price is more than \$5 per bottle.
 - We can call customers low, medium and high-end.
- ◆ Millie ignores the low-end customers and targets medium and high-end customers. Then monthly sales is 1000 and Millie should charge

$$(1+0.2)(2 + 1000/1000) = 3.6 \text{ dollars per bottle.}$$
- ◆ If Millie targets low end customers as well, she can sell 1500 per month. She then should charge

$$(1+0.2)(2 + 1000/1500) = 3.2 \text{ dollars per bottle.}$$
- ◆ Targeted market affects demand which affects fixed cost allocation.

Traditional Pricing Approaches

Market Based Pricing

- ◆ Market-based pricing takes **competition** into account but **ignores customers** and to some extent costs.
- ◆ Market-based pricing suggests adjusting prices to match market prices.
 - Matching is typically by lowering own price preferably while keeping it above the cost
 - This decreases profit margins but can increase the number of units sold (sales volume)
 - Price-matching strategies are common in marketing
- ◆ Market-based pricing is applied in new markets to capture market share
 - Alamo car rental initially priced to be less than both Hertz and Avis
 - In 1990's, Japanese car manufacturers priced their cars below American manufactured cars.
 - In 2010's, Chinese car manufacturers may underprice to capture North American market.
- ◆ Recall that Millie is charging \$3.6 per cider bottle.
 - Millie is concerned that the next door Starbucks is charging an average of \$3.5 per drink.
 - What should Millie do? Perhaps bring her price down to \$3.5. This little adjustment makes her prices competitive with those of Starbucks.

Traditional Pricing Approaches

Value Based Pricing

- ◆ Market-based pricing takes each **customer's valuation** of a product into account.
- ◆ It can be named as personalized or one-to-one pricing.
- ◆ Finding each customer's value is hard in a B2C transaction as there are many customers
 - Group customers and assign values to groups by using surveys, focus group analysis
 - » Disney prices differently for Orlando residents, AAA members, etc.
 - Use Internet to record each customer's characteristics and previous purchases
 - » Amazon is the leader; Supermarket's membership discount cards
- ◆ In a B2B transaction, there are fewer and bigger customers.
 - Caterpillar's sales people know more about their customers such as municipalities, port authorities, transportation authorities, mining companies, construction companies.
 - Siemens Infrastructure Group surveys airports for luggage handling equipment.
 - Knowing your customers goes a long way to assess their valuation of your product.
- ◆ Customers value your products not in absolute isolation but in relatively.
 - Market matters, maybe indirectly
- ◆ Recall that Millie is charging \$3.5 per bottle. Yet some can pay up to \$5.
 - What should Millie do? Create two forms of service and charge \$3 and \$5 simultaneously.
 - » In Europe, to-go (called to-take-away) drinks are cheaper than for here (to-stay) drinks.

Traditional Pricing Approaches vs. RM

Approach	Based on	Ignores	Liked by
Cost plus	Cost	Competition, Customers	Finance
Market based	Competition	Cost, Customers	Sales
Value based	Customers	Cost, Competition	Marketing
Revenue Management	Capacity	Mostly Competition	Operations

- ◆ **Combine** these pure approaches to have hybrids
- ◆ **Alternate** between pure approaches
 - ◆ Use cost plus with high margin for new products because market or competition may not exist
 - ◆ Market and value based with mature products

PRO (Price-Revenue Optimization) Scope

- ◆ Scope of pricing depends on 4 factors:
 - Product
 - Segment
 - Channel
 - Time
 - » The textbook lists the first three, but time should be added.
- ◆ Prices change over products, segments, channels, or time.
- ◆ Example different age groups of women buying apparel online

The Big Spenders

In the 12 months ending in March, women between 45 and 54 years old spent far more on clothes online than women between 25 and 34, and the fastest-growing segment was women between 55 and 64.

Online women's apparel sales by age group*		Percentage change from year earlier
13-17 years old	\$671.0 million	+10.5%
18-24	946.7	+9.7
25-34	1,450.9	-7.6
35-44	1,601.1	+7.7
45-54	1,991.5	-3.7
55-64	1,674.3	+11.1
65 and up	552.0	-2.5

*April 2008 to March 2009
Source: The NPD Group/Consumer Tracking Service

What is the Product, Segment, Channel, Time?

Rules of the Game

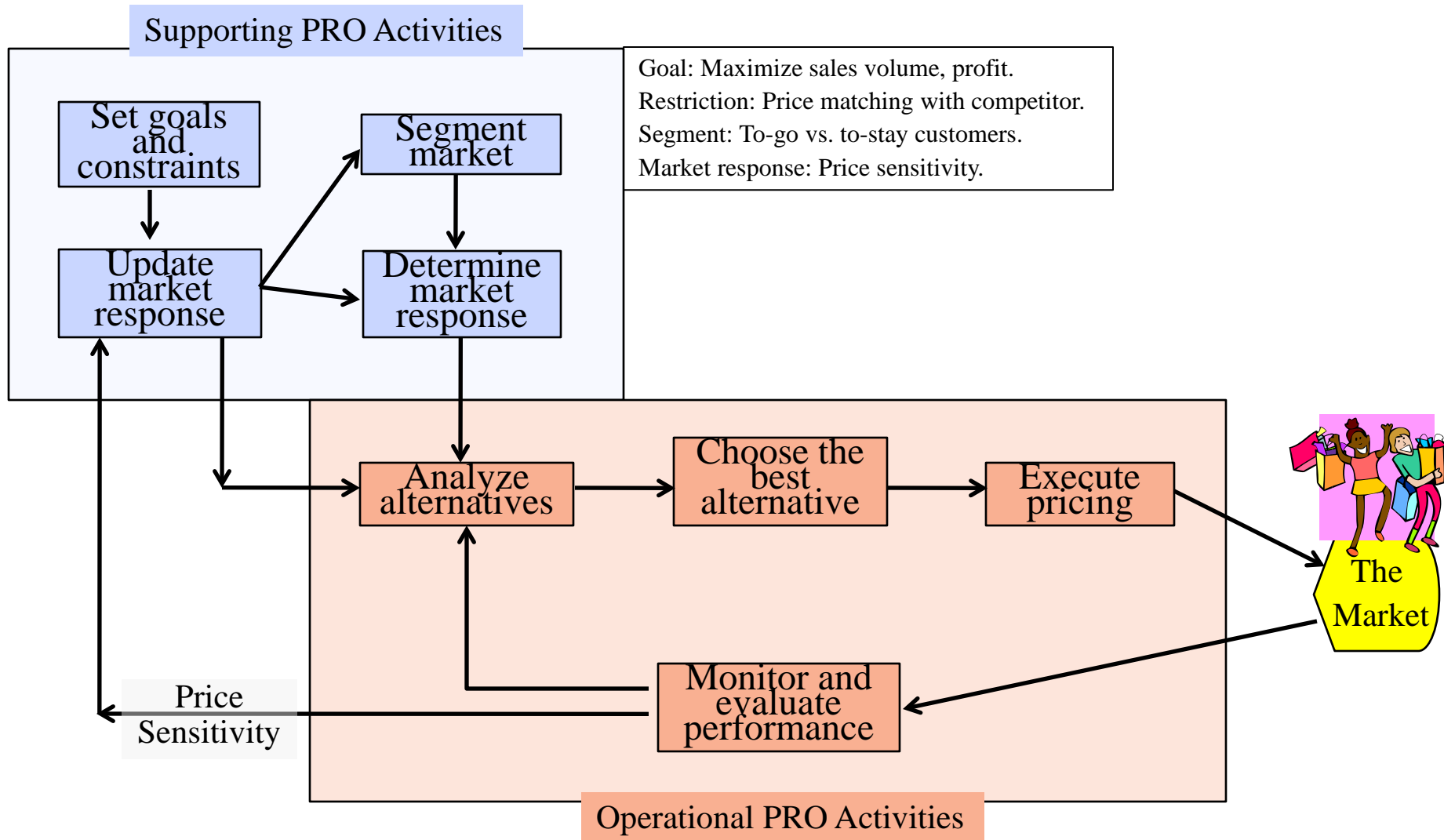
Commitments of a Seller to a Buyer

Customer commitments are the products or services provided now or in the future to a customer.

Examples:

- ◆ Trivial: Products, services, prices
- ◆ Nontrivial
 - Time period over which the commitment will be delivered
 - » Manufacturer's warranty period: 3 years for Dell keyboards; 1 year for pool motors;
 - » 4 years free service for cars; Forever for your UTD education.
 - Expiry date of an offer
 - » The introductory pricing is valid until
 - » Contractual pricing: Special price for a certain buyer for a certain time window
 - Payment terms
 - » Buy now pay in 6 months
 - » Rebate coupons
 - Return policy
 - » Returns are acceptable with a restocking fee
 - Risk sharing
 - » If a new car has flat tire, customer is responsible; if it has engine problem, manufacturer is responsible.
 - » Customer can buy flat-tire insurance from a dealer.
 - » Refundable airline tickets
 - » Nonrefundable Mavericks tickets

PRO Process



Summary

- ◆ **Types of Prices: List vs. Pocket price**
- ◆ **Traditional Pricing Approaches**
 - **Cost plus**
 - **Market based**
 - **Value based**
- ◆ **PRO Process**