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PRICING AND CUSTOMER VALUE

11.1 INTRODUCTION

Given the important role that **price** does to **influence customer value**, it is vital that marketers carefully undertake a thorough study of customer expectations as the basis for determining the price at which products and services are offered to the market.

The **process of pricing decision** is complicated because customers have varying quality requirements and hence differing views of their expected price they are willing to pay. The interaction between price and quality expectations means that the supplier faces a number of alternative choices in

using price as a mechanism through which customer satisfaction in a market can be achieved.

These **alternative market scenarios** can be illustrated by constructing a quality / price matrix of the type shown in (**Exhibit 11-1**).

Exhibit 11-1 : Quality/Price Strategy

QUALITY \ PRICE	High	Average	Low
High	Superiority Satisfaction Pricing 1	Shared benefit Satisfaction Pricing 2	Temporary Satisfaction Pricing 3
Average	Status Satisfaction Pricing 4	Standard Satisfaction Pricing 5	Bargain Satisfaction Pricing 6
Low	Dissatisfac-tion Pricing 7	Limited Satisfaction Pricing 8	Value Satisfaction Pricing 9

The explanations behind the various quality / price offerings in the diagram are as follows:

- The diagonal strategies 1,5, 9 can all coexist in the same market.
- Positioning strategies 2,3,6 can attack the diagonal positions.
- Positioning strategies 4,7,8 amount to over-pricing the product in relation to its quality.

11.2 THE SCOPE OF PRICING DECISIONS

Price is the **stimulator** that converts the procrastination of buyers into the desired choice, that suggests value, that moves someone to take certain risks, that encourages them to spend the money to incur shopping and travel costs. Pricing decisions have an impact on all phases of the supply / marketing channels. Suppliers, sales people, distributors, competitors and customers - all are affected by the pricing system.

Price also gives a **perception of quality.** For example, a hotel chain, servicing the tourist package holiday market, will offer cheap prices to its customers. The customers will have a lower expectation of service quality than those offered at full premium price package. Since any offering is merely perceived as a bundle of diverse values, the opposite course, in product choice, is to agree to sacrifice service quality in favor of a lower price.

Price, of course, is not the only **marketing tool** available to the formulation of a marketing strategy. The **price of money** is only one of many interdependent references used to make a purchase that may favor or inhibit purchase. In fact, **price often is not the decisive factor**. The inherent belief that price is the main determinant of buyer choice will lead a business to react to any sales-led crisis by discounting to distributors or final customers or both. Unless sales responds strongly, this strategy will compound disaster, in that continued low sales at the lower price, known as price war, will make an even smaller contribution to fixed overheads. But even if sales goes up, gross margins will remain squeezed and a higher total income cannot be generated. Worse, the extra sales may be the result of pipeline-filling by the distributors or by final customers stocking up ahead. Such increases may only be temporary, to be later compensated by a downward re-adjustment. Worse still, any significant increase in sales will come at the expense of other suppliers, and is likely to encourage retaliation by the most badly hit competitor. This in turn usually leads to a general price war, which quickly drives the weakest suppliers from the market and leaves even the strongest on permanently reduced margins.

In the early 1980s, **People Express** gained a significant market share in the air travel market through very much reduced prices. Other airlines, as a reaction, cut also their prices in order to maintain passenger loads. The final result was not an increased share of the market for People Express, but was adversely affected, falling into near bankruptcy. The condition deteriorated that in 1986, it was taken over by one of its competitors.

A workable marketing strategy must take full account of the following factors, in addition to price:

- Conforming quality
- Perceived quality
- Time expenditure costs
- Time and place availability costs
- Risk costs
- Learning costs
- Search effort costs
- Design compromise costs

The **market strategy** must be planned in terms of the way customers perceived value and react to differing stimuli affecting them. Customer value perception and expectations are structured in the following ways:

- There are clearly established noticeable difference thresholds.
- Customers expect price lining and price slotting.
- Customers impute both quality criteria and the appropriate pricing system.
- Customers make judgments about correct cost-price

relationships.

- When a customer decides to buy, he or she uses a fair price reference in mind, comparing with past purchases made and with other or similar situations. The customer will assess what seems to be the best price.

11.3 TRADITIONAL PRICING STRATEGIES

Many executives and economists argue that not cost but the **market fix the prices.** While true in theory, this is rarely the case in practice. Almost all companies set prices on a **cost-plus-basis**. They rely on the traditional labor-based cost accounting system to establish a cost-based price. Since product costs are calculated according to volume and product mix, prices are set to an acceptable profit margin above the product costs. Therefore, each company has its costs systematically decided in the same direction - underpricing low-volume, customized products; and overcosting high-volume, standardized products. This distortion, no doubt, influences pricing.

Traditional cost systems ignore the so-called **"below-the-line"** expenses, like sales, distribution, R&D and administration. At many companies, those costs are not assigned to different markets, customers, channels of distribution or even products. Many managers believe these costs are fixed. Therefore, these **"below- the-line"** costs are treated as though they are equally distributed across all customers. Yet, some customers are much more expensive to serve than others. Using one price to all customers may either underprice or overcost to the disadvantage of some customers.

A company cannot set up a right pricing strategy unless it **changes** from the traditional labor-based costing method to **"activity-based"** costing method. Activity-based costing splits costs into two different groups - one that is **product-driven** and another that is **customer-driven.**

Product-driven costs are the costs of designing and manufacturing products. These costs include procurement, warehousing & transport, production planning, quality control, engineering etc. **Customer-driven costs** are the costs of delivery, servicing, and supporting customers and markets. These costs include order entry, distribution sales, R&D, advertising, marketing, etc.

Activity-based costing (ABC) assigns costs to products or customer bands on the resources they consume. The system identifies the costs of activities such as order entry, shipping, billing and freight. These costs vary with the frequency of the activities and can be modified at different levels.

Another traditional method of pricing is the **demand-oriented pricing.** The classic optimization model of microeconomics theory assumes that the firm's pricing objective is to maximize short-term profits. To maximize profit, a company chooses a price at the intersection point of the marginal cost and marginal revenue curves. A major limitation of the marginal analysis is the assumption that cost data and demand schedule information are readily available. However, we can easily estimate the cost impact of a volume change on a product's production cost. Few companies know precisely what their products’ price elasticity is; that is, what the demand curves look like. The company does not know how much sales volume it will lose by increasing the product's price, or vice versa. Therefore, it is only possible to estimate the optimal price for the highest cash flow; but it is difficult to determine the profitability of a company.

Some other traditional methods of pricing are as follows:

- **Rate of return pricing**, whereby prices are set to achieve a preset rate of return on investments or assets.
- **Competitive parity pricing**, where prices are set on the basis of following those set by the market leader.
- **Loss leading pricing**, usually applied on a short-term basis, to establish a position in the market, gain market shares, or to

provide an opportunity to cross-sell other products.

- **Bundle pricing**, where a set of products or services are combined and a low, single price is charged for the whole package.
- **Cross-benefit pricing**, where price is set at or below cost for one product in a product line, but relatively high price is set for another item in the line which serves as a direct complement.
- **Stay-out pricing**, where the firms set prices lower than the demand conditions so as to discourage market entry by new competitors.

The **problems** with most of the traditional pricing methods are as follows:

- They consider only one party (the customer) in price setting. In the real world, the firm must consider all channel members such as competitors, suppliers, public policy makers, officials in non-marketing functional areas, and others.
- They put strong emphasis on price to set the marketing strategy. Actually, many other controllable and uncontrollable variables are involved. The marketing manager must consider the role of each of the other elements in the marketing mix and the relationships among them.
- Almost all pricing decisions remain largely the domain of economic theory, as in the case of cost-plus, demand-oriented or imitative pricing. However, a pricing policy or strategy may be formulated to take advantage of an impending market opportunity or in response to customer value.
- Most of the pricing decisions are based on a simple assumption - to increase the sale volume in the short-run - without considering the activity costing information and the outcome of the price changes.

- Traditionally, price setters have considered a very limited number of alternatives when faced with pricing difficulties. If their prices seemed high, they would lower it, and if it was too low, they would simply raise it. Much more complex behaviors should be considered which provide opportunities for novel approaches. For example, price setters might change the product's package, advertising, quality design, or the after-sale customer service.

11.4 IMPUTATION OF QUALITY IN PRICING

It is the perceived opinion that **value influences** purchase and repurchase. Value is formed by the **relationship between quality and price**. There are no definable lowest-price products because customers only pay close attention to the price-quality relationships in each market segment. Thus, the acceptability of price is obviously judged on the basis of associations, not solely on the basis of physical product and the monetary price alone.

Customers tend to judge the suitability of the price of one item by their judgment of the prices of other items important to them which are in the same market segment. For every customer, some of the items in the same market segment are more salient than others. They pay more attention to their cost and relative quality. The seller succeeds only when he or she tailors the merchandise and the accompanying price to the needs and expectations, tailoring a price system for the particular market segment.

Some companies can command a **premium price** because of the tendency of buyers to impute quality from price when unable to judge relative performance directly. Such as, of course, the case for a substantial proportion of all the satisfaction bundles by almost any company, and for a large proportion of the customers of almost any complex product (including computers, perfumes etc.). Therefore, it is clear that an ill-considered price

cut can sometimes curtail demand rather than, as assumed in economic theory, promote it.

The tendency to impute quality from price is an especially important consideration when introducing **well-differentiated new items** to the market. Too low an initial offering price can cause customers to perceive the offering as being of inferior quality. Of course, it is not always true that all of the potential customers are able to judge product quality from an objective stand point. Some knowledgeable and discriminating tend to be the **taste-maker** for the new products. Therefore, the quality must really be there in some sense, and must, indeed be there in all aspects of the marketing mix.

The concept **of economic utility** is a useful way to visualize the relationship between quality, value, and choice. Either quality increases, or utility decreases or vice versa. As price increases, utility decreases. Different people may have different utility perceptions, and this helps explain why different people make such different decisions. Therefore, the concept of value is a function of "utility of quality" (benefits) and "disutility of price" (sacrifices). According to this notion, customer value may be seen as:

Value = Utility of Quality - Disutility of price

or = Benefits - Sacrifices

Choice, then, is based primarily on getting the best value. Some people will be happy to pay for more quality because they will perceive the corresponding increase in price as having little disutility (sacrifices). People with higher disposable income, therefore, tend to pay for more quality. Less well-off people will refuse to pay for more quality, because the price increase has great disutility to them.

Therefore, many customers seem to approach price quotations with a **single reference price** in mind as being the correct level. Moreover, some form of social learning seems involved in determining the level of this reference point, since experience indicates that this tends to be the optimum volume-sales-

point when used. As a consequence, the actual demand / price curves encountered in practice are, seldom if ever, the smoothly sloping ones we encounter in the economic text books, but often exhibit a very sharp "kink" - a point defining the price at which sales will be greater than at any quotation either above or below it.

The relationship between the supplier and the customer also can have a profound impact on perceptions of value. Things such as trust, familiarity, devotion, and friendship may greatly affect customer value. This formulates the issue of customer relationship marketing. The following equation includes **relationship** as a significant additional component in customer value:

Value = (Utility of Quality - Disutility of Price) X Relationship

11.5 CUSTOMER-DRIVEN PRICING METHODS

A **pricing policy** or strategy should be formulated with other variables and marketing mix to deliver the customer value. To manage the pricing function, a firm must first develop a thorough understanding of what contributes to the customer's perceptions of value, customer responses to price changes of the product, and the specific responses of competitors to both price and non-price actions.

Price settlers also require an information system to monitor the effects of their pricing arrangements and thus to help make prompt and specific adaptive action in a fast changing market environment. Salesmen's reports, current sales experience, individual favorite customers, customers' attitudes toward prices and quality, number of lost customers, activity-based costing information on product and customer, competitor's prices, inventory levels and market share etc. are the primary sources of information needed to set up a pricing strategy. Information technologies have made important contributions in obtaining these information and data.

A warning system will detect pricing problems and allow manager to decide how much attention to give to each potential price problem. Some of the pricing problems are as follows:

- A decline in sales.
- Prices are too high or too low.
- The company is regarded as exploitative of customers and not to be trusted.
- The firm's price reflects negatively on itself and on its products.
- The firm's price policy attracts undesirable kinds of customers which have no loyalty.
- The firm's pricing behavior makes customer unduly price sensitive and unappreciative of quality differences.

To completely understand **how and when price works**, the company must understand how potential customers perceive, interpret, and evaluate price changes in relation to quality characteristics. These decisions vary with the individual. Therefore, a firm must also consider different market segments. A firm must not regard its actions as simply shifting prices on individual product offerings. It must combine a price change with other actions; including other elements of the marketing mix and the quality improvement programs.

In a total quality setting, cost reduction can be achieved by the systems and process improvement; which enhances the capability of a company to lower its price and maintain a sustainable profit margin. In order to gain a competitive advantage, a firm may not necessarily reduce its price, it may consider adding more value to customers by better customer services. There are several approaches to the customer-driven pricing strategies:

- Activity-based pricing

- Value-based pricing
- Relationship pricing

Activity-based pricing is based on the belief that different customers are willing to pay for different products and services. Customers will **pay according to their own needs**. In order words, a firm can associate price with activities, because customer-driven pricing looks at a customer as a set of needs, not as someone who buys its products. A customer's needs are satisfied by activities. Customers want to consume a supplier's activities in return for payments.

For example, UPS can tell you exactly how much its express delivery system is worth by how much customer are willing to pay. UPS can then compare this price to the delivery system activities that provide guaranteed two day delivery versus the standard ten days.

However, to set up an activity-based pricing strategy, it requires a firm to set up an activity-based costing system. With such a system, one can link all customer needs with a company's activities and how much each activity will cost the customer. By understanding how much a customer's warehousing, financing, and handling costs, a company can estimate how much quicker delivery would be worth to a customer. Using this information and customer value survey, the company evaluates how effectively the customers are being satisfied at every step, how much it is costing the company, what are the price for each activity, and how effective the trade-offs are between different activities.

Value-based pricing is based on the belief that customers are looking for "affordable quality" - better quality at a better price; where prices are based on the perceived value to a given customer segment. In order to deliver better customer value, a firm can reduce its price continually or improve its quality continually.

However, in some particular customer segments (such as low income customer segment), better customer value can only be achieved by reducing prices continuously. This may have a negative effect on the profit margin of a company unless it sets-up long-term systems or process improvement programs to drive the cost down continuously. It requires a company to implement TQM.

In a segment where customer have **high disposable income,** a firm can change premium price by improving the customer services or product quality. It requires a firm to do the customer value survey from time to time. As such, companies should be willing to invest capital to help meet the customer needs. Companies must commit to and expound a philosophy of customer satisfaction first.

Relationship pricing is the extension of value pricing; it follows closely the customer-driven approach of value pricing but takes the life-time value of the customer into account. In order to build long-term customer relationship, a company must develop some customer care, customer service and customer partnership programs to retain customers for life. Its aim is to develop customer loyalty. Strong customer loyalty also makes the company less vulnerable to price wars.

Relationship pricing is based on value considerations of future potential profit streams over the life-time of customer.

11.6 CASE STUDY VALUE PRICING AT P&G

Proctor & Gamble (P & G) is one of the largest consumer product manufacturers in the world, with over 100,000 employees working at more than 200 locations in over 50 countries.

Being a leading TQM-based organization, P & G goes for a customer value strategy - the ability to deliver better quality at lower prices. It builds quality into the marketing mix by using the following strategies:

1. Develop a thorough understanding of what contributes to the customer's perceptions of value.
2. Continually improve the systems - from suppliers to store shelves - to drive out non-value-added costs and improve service.
3. Take a portion of trade promotion dollars, along with savings from increasing system efficiency, to fund reduced list prices.
4. Keep track of daily transactions on activity level by information technology.
5. Set up the activity-based costing information on products, locations and customers.
6. Constantly review the cost, profit margin and selling price.
7. Savings are then reinvested into providing better quality service and better prices for the customer.

After the customer value strategy, P & G was able to reduce the price of 30% to 40% off the regular shelf price for short periods of time. Take the example of *"Dawn",* the liquid dishwashing soap, before value pricing, the price of a regular size bottle swung from US$ 0.99 to US$ 1.89. Now, under value pricing, it regularly sells for about US$ 1.32; and the brand has achieved a record year in volume and share.

11.7 TARGET PRICING STRATEGY

Target price strategy is a market-driven pricing that stimulates market demand so that volume goals can be achieved. When companies use target

price proactively to stimulate market share, they must implement a target cost strategy aimed at reducing costs through productivity and quality improvement programs or cost-reduction plans.

Target cost strategy does not mean cost-cutting. It uses the following quality programs to reduce the costs:

- Product re-design
- Reducing complexity
- Process improvement
- Reducing cycle times
- Robotics
- Re-organization
- Value engineering
- Value analysis

This **process** results in a pricing strategy that has an incremental impact upon the firm's operation. Continuous improvement in process and product reduces cost. Companies seeking to improve their competitive position through target pricing must have improved product cost information, so they can adequately address their policies. To make a target pricing program effective and to assess product costs and changes in product costs accurately, activity-based costing systems will become the foundation of target pricing program. Activity-based accounting enables the firm to keep track of the cost of any processes or activities on a cause-and-effect relationship. Non-value-added costs are identified and eliminated by the process improvement programs. The target pricing strategy is as follows:

1. Establish a selling price based upon what the market will accept to build volume.

2. Estimate the target profit margin that reflects the company's strategic plans and financial projections.

3. Estimate the target cost (difference between target sales price and target profit margin).

4. Calculate the allowable cost (difference between target sales price and the actual cost).

5. Set up process improvement programs and tackle the current technologies to diminish the gap between allowable cost and target cost.

6. Set up activity-based costing systems to make more enlightened decisions about product costs, therefore, pricing.

Target prices are estimated upon competitive factors, historical data, and forecasts of the desired market position two to three years into the future. Having achieved the requisite market share, costs are lowered because the company has set up the cost-reduction programs to drive the cost down. Revenues are higher because it has established a larger market share.