Pricing Fundamentals

Tudog defines price as the sum one party pays in order to acquire desired benefits from another party. This definition is surface only, as the components of the price, the elements of the benefits, and the way they are viewed by the market are all influencers that can offset the basic premise. Pricing is one aspect of the marketing equation that is giving less attention than it should, being delegated too often to the bean counters who deploy spreadsheets to set pricing levels. While these considerations absolutely need to be part of the price setting process, there are many other factors that cannot be neatly fit onto a spreadsheet that will help set price.

Price Versus Cost

There is typically some confusion over the terms price and cost. A consumer often sees what he/she paid for a product as the cost, and this is correct from his/her perspective. The price is what the product cost – to the consumer. But from the company perspective the price is what the company charges the consumer in exchange for the product benefit or service being offered. The cost, for the company, is the cumulative expenses required for the company to deliver that product or service to the consumer, including whatever costs are necessary to make the consumer aware of the product, want the product, and be able to attain the product. The difference between the cost and the price is where the company earns profits – the financial gain for engaging in the process.

In understanding price and the critical role it plays in the buy decision – and the sell decision – the different perspectives are important to explore.

- Buyer's Perspective – the buyer views the price as his/her cost, that is what has to be given up in order to receive the desired product and its associated benefits. The elements of the buy decision are those of necessity (how badly does the buyer need the product?), desire (how badly does the buyer want the product?), fairness (does the buyer view the price as fair and worthwhile?), and competition (can the need/desire be satisfied in another way?).
- Seller's Perspective – the seller views the price as the means to recoup the expenses invested into the development, production and delivery of the product and as the vehicle through which to derive profit from its operating activities. However, beyond this straight forward financial calculation, pricing is also the company's way to engage the market by establishing position with its targeted market, confronting competitors, and renewing interest with promotions.

Why Pricing is Important

Pricing is important not only because it is the vehicle through which the company is able to directly extract its profitability. As a marketing tool, price is value for a number of critical reasons. For example price is the most flexible tool of all marketing tactics because it can be lowered at intervals to promote immediate sales. The reduction of per unit profit is often offset by the increase of volume. While this cannot be sustained under long term conditions (as the lowered price becomes the new benchmark if it is kept for too long), the temporary reduction (the "sale") is a powerful driver of consumer demand. In addition, price helps build loyalty as it is the first interaction a consumer has with a product. The first impression – created through your exposure strategies – are either confirmed or negated by the price, which will drive the consumer to either try the product

or not. The loyalty is established once the consumer engages the product and concludes that the price being demanded is equal to (or less than) the benefit being delivered. While we will discuss this fulfillment of the value proposition in more detail below, the matching of promise to price is the creation of a strong value proposition and drives customer loyalty.

Perceived Value

The core function of price is to correlate the benefit offered with the price demanded so that the consumer makes the calculation that the buy is worthwhile. The Tudog model for perceived value is:

Perceived Quality + Price = Perceived Value

The value question, from the buyer's perspective is simply, is the product worth the price being charged? If the quality is sufficient and matches the needs of the consumer and the price is properly correlated to the benefit, the consumer will conclude that the product is worth purchasing.

Perceived value is also where the company has the opportunity to generate additional profitability if it opts for strategies that include a higher price point and the establishment of an exclusive or high end market position. If the company elects to overlook the downside to this position - lower volume – and go for the higher per unit profitability, it is maintained only if the company sustains its perceived value in the market.

Pricing Influencers

Pricing is influenced by internal factors within the company and external factors dictated by the market. Understanding these factors are key to arriving at the right pricing level – meaning the pricing level that allows you to maintain a perceived value while extracting the maximum level of profit.

Internal Factors

- Cash Flow – your company has certain income needs determined by the cost of doing business and the cash it needs to have on hand to maintain operations and pay its bills. The cash flow needs will place pressure on the price because it will encourage some within the organization to press for promotions and other events that can stimulate immediate cash. The problem with cash flow demands are that the setting of the price level is being guided solely by the costs of production and associated expenses, and not by the value of the product. This sometimes leads to a break even model, or at best minimal profitability.
- Return on Investment – often companies calculate the investment they have placed into a specific product and seek to set the price so that they can retrieve their investment within a specific set of time. Other companies set a percentage ROI on each product and set their price in accordance with the percentage of return being sought. The use of ROI as a pricing model is reliant on accurate sales projections and once again could serve to limit a company's potential as it is not looking at the maximum the company can demand, but rather the minimum the company seeks to gain.

- Positioning – the company may seek to set the price level in order to obtain a position within the market or against specific competitors. At times a price will be set to introduce a new product into the market or gain a new market segment. These price points are usually temporary and are increased once the position is achieved (and brought up to market accepted and not discounted prices).
- Maximizing Profits – once a company has established its market position and has acquired its loyal consumer base the price point can be adjusted to reflect the maximum price consumers are willing to pay for the product (according to the value perception assigned to the product). This maximum price will, provided production and marketing costs have stabilized, will allow for maximum profitability.

External Factors

External factors, unlike internal factors, are completely outside the control of the company. Although there are many ways a company can influence external factors they are, by definition, outside the realm of company power. A company can maintain awareness of the changes in the market through research and monitoring and make adjustment decisions based on what competitors are doing and what the market demands. Beyond that, understanding the external factors is the key to minimizing the potential dangers they may pose. The external factors are:

- Consumer Demand – it is widely accepted that there are three types of market demand models that company's need to model against. These are;

    (a) Elastic demand where a certain percentage in the change of price will result in a larger percentage change in the level of demand. In an elastic market decreasing price will in most cases increase overall revenue

    (b) Inelastic demand when a percentage change in price results in a lower percentage change in demand. In an inelastic market an increase in price will raise total revenue and an decrease in price will lower total revenue.

    (c) Unitary demand when the percentage of change in price results in an equal percentage change in demand. In a unitary market there is no change in revenue when price changes.

  Consumer demand is a primary external driver of price and the type of market within which you operate will be a significant impact on your pricing approach.
- Competitors – like everything else in marketing pricing is in some ways a function of competition. Unless you have a value proposition that enables you to significantly separate the price of your product from similar products on the market, you will have to remain within the acceptable span of price that is appropriate for your category.
- Regulations – in some instances, depending on your product, you may be under certain restrictions or other pricing regulations dictated by government or some other authorized agency.

Understanding pricing and the affects it can have on your success reinforces your market position, your competitive stance, and your relationship with your consumers. Pricing is as essential as any other marketing activity and the use of pricing to entice customers and offset competitors is more than just a strategy, it is an operational imperative.