Chapter 5. Pricing

5.1 INTRODUCTION

As firms strive to grow their profits, they often turn their focus toward decreasing production costs or increasing product demand. In doing so, firms tend to neglect one of the most important strategic areas involved with growing profits: pricing. This chapter provides a comprehensive overview of both traditional and new economy pricing levers, and also presents two new pricing process frameworks: A framework for firms to use when selecting which pricing strategy best suits their product under the current market conditions and a framework that highlights which pricing levers are best suited to guide consumers through the four relationship stages. This chapter also focuses on how the 2Is (Individualization and Interactivity) have affected pricing strategy which has been shown in diagram 5.1.

Diagram 5.1
The Effects of the 2Is on Pricing

- **Individualization**
  - Easy to convey prices to individuals
  - Allows more targeted price promotions
  - Dynamic pricing sites can keep individuals informed

- **Interactivity**
  - Allows a larger buying & selling community
  - Facilitates dynamic pricing strategies
  - Allows prices to be changed easily
  - Allows consumers to easily check prices
  - Easier to understand and measure consumers’ reactions to price promotions
  - Easier to receive customer feedback on price, understand customers’ willingness to pay, and implement price-discrimination strategies
The individualization force of the Internet has affected pricing in the following manner:

1. **Easier to convey prices:**

   By informing companies of their pricing and product desires, consumers make it easier for firms to convey prices of products in which they have an interest.

2. **Cheaper and easy to conduct targeted price promotions:**

   Customers can register their preferences with firms, making it easier for those firms to offer targeted, individualized pricing promotions.

3. **Easy to adopt dynamic pricing:**

   Customers can more easily participate in dynamic pricing processes. Sites that practice dynamic pricing can notify customers via e-mail when their bids are no longer the highest.

The interactivity force of the Internet has affected pricing by making it:

1. **Easier to reach wider audiences:**

   New markets are created, or existing markets are made more efficient by bringing together disparate groups of buyers and sellers in a low cost manner. Sellers who offer their products over the Internet have the potential to reach buyers from around the world. By increasing the number of potential bidders, firms benefit in both the selling of product and procuring supplies.

2. **Easier and cheaper to implement dynamic pricing strategies:**

   Auctions, for instance, can be implemented in a less costly and more efficient manner. While auctioning is an effective selling process, it has often been difficult to implement auctions in a manner that encourages many buyers and sellers to participate. The Internet allows auctions to be implemented in a very cost efficient manner.
3. **Easier and Cheaper to change prices:**

   Prices can be changed instantly on websites

4. **Cheaper for consumers to investigate prices:**

   With an easy click, consumers can check prices instantly. Consumers can also register with sites to receive e-mail notification of changes in product prices.

5. **Easier to understand and measure consumers’ reactions to price promotions:**

   Tracking consumers electronically makes it easier to understand what types of customers are stimulated by price promotions, then to develop strategies to best design and implement pricing promotions.

6. **Easier to receive customer feedback on price, understand customer willingness to pay for a product, and implement price-discrimination strategies:**

   By better understanding how customers navigate a website or by requiring information such as the consumer’s zip code, firms can more easily customize prices for individuals.

### 5.2 ECONOMICS OF PRICING

The strategic pricing goes far beyond the foundation concepts, it is important to begin with a review of a basic demand curve pricing analysis. Diagram 5.2 displays a hypothetical demand curve for a firm selling online music downloads.
Table 5.1 provides an example for demand curve pricing analysis. Two key terms in demand curve pricing are marginal revenue and marginal cost.

**Table 5.1**

**Pricing Analysis**

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<th>Marginal Revenue</th>
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<td>-11</td>
</tr>
</tbody>
</table>

**Marginal Revenue:** Marginal revenue is the additional (or negative) revenue reaped from lowering or increasing the product price by increments.
In the example presented in diagram 5.2, no one purchases the product at a price of Rs. 12. At a price of Rs.11, one person purchases the product. Thus, the marginal revenue derived from decreasing the price from Rs.12 to Rs.11 is Rs.11. Likewise, a decrease in the price of the product to Rs.10 will lead to marginal revenue of Rs.9 (total revenue increases from Rs.11 to Rs.20). However, marginal revenue is not always positive. Consider what happens when the product price drops from Rs. 5 to Rs.4. At a price of Rs.5, seven units are sold, and the total revenue is Rs.35. At a price of Rs.4, eight units are sold, and the total revenue is Rs. 32. In this case, the marginal revenue is Rs.3.

**Marginal Cost:** Marginal cost is the cost associated with producing an additional good. In many cases, marginal costs vary by how many units of the goods are produced. Often, a marginal cost curve is U-shaped—as more goods are produced firms often experience increasing returns to scale. For simplicity, the example in diagram 5.2 assumes that no matter how many goods are sold, marginal cost of producing an additional good is Rs. 4.5.

To maximize profits, product price should be set at the point at which marginal revenue is equal to marginal cost. In the example set forth in diagram 5.2, this price is Rs.8. If the firm lowered the price to Rs.7, it would sell one additional unit; the additional revenue reaped (i.e., the marginal revenue) would be Rs.3. However, by lowering the price to Rs.7, the firms would incur an additional cost of Rs.4.5, which would result in a net loss of Rs.1.5. Thus, there is no economic rationale to lower the price to Rs.7.

Similarly, if the firm increased the produce price to Rs.9, it would sell one less good, but all of the good it sold would reap an additional Rs.1 for each good sold. The marginal revenue derived from increasing the price to Rs.9 is (−) Rs.5. By increasing the price to Rs.9, the firm loses Rs.5 in revenue, but does not incur Rs.4.5 in additional cost. The firm’s new loss would be Rs.0.5. Thus, increasing price to Rs.9 is not profitable either.
Key Variables that affect Demand Curve

The variables that affect the downward sloping demand curve, as well as its position, shape and slope are shown in diagram 5.3.

**Diagram 5.3**

**Key Variables that affect Demand Curve Slope and Position**

1. **Price:**

   There is an inverse relationship between price and quantity. This relationship is intuitive. As a product price decreases, more units of good will be demanded by the market. Likewise, as the product price increases, some consumers will not find it worth their while to purchase the product, so total aggregate demand will decrease.

   **Substitute Offerings Price:**

   Both the types of substitute goods and their prices affect a product’s demand curve. If there are close substitutes for a product, the product has limited maneuverability in terms of pricing. Due to the
availability of close substitutes, a product is not able to raise its prices significantly above the prices of close-substitute products.

Complementary Offerings Price

The prices of complementary goods affect a product's demand curve. If complementary product prices decrease, this will stimulate demand for a product. Likewise, if complementary product prices increase, this will negatively affect product demand.

Income

In general, income is positively correlated with demand. For most products, as income increases, so does the product demand.

2. Market Size:

Market size is also positively correlated with demand. For most products, as market size increases, so does demand for a product.

3. Taste:

Consumer taste is a very important variable, regardless of the market size, price, income and the number of substitute and complementary products. In order for a product to achieve market success, consumers must have a desire to purchase it. The latitude that a firm has to price its product is dependent on the slope of its demand curve. Diagram 5.4 demonstrates the two extremes of demand curves and degree of flexibility in pricing. The demand curve slope is often indicative of the degree of pricing flexibility of a firm. The steeper the demand curve, the more power firms have in terms of pricing.
Diagram 5.4 (a) describes a demand curve for a firm that has no pricing flexibility. Firms that produce commodity type goods—goods that are homogenous and easily purchased from other sellers, such as consumables can sell all of their products at prevailing price. As a result, such firms have no incentive to decrease price. Commodity firms are not able to increase their product price because buyers can readily purchase the same goods from rival sellers at a lower price.

Diagram 5.4 (b) describes a demand curve for a firm that has flexibility in pricing its products. While extremely rare, this type of demand curve shows a firm that can charge virtually any price for its product. There are few real world examples of such a demand curve. Many eager fans are willing to pay higher prices to obtain a new electronic music download of a popular artist on the day of its release. This strong demand implies that there is a wide range of prices that record companies could charge for the download.
5.3 DYNAMIC PRICING STRATEGIES

Dynamic pricing is one of the most significant contributions the Internet and the 2Is have made to pricing strategy. Dynamic pricing is a pricing environment in which prices are not set but are fluid. The Internet has enhanced the attractiveness of dynamic pricing in two primary ways as shown in diagram 5.5.

Diagram 5.5
Effects of the Internet on Dynamic Pricing

Decreased Menu Costs:
Menu costs are the costs associated with changing the price of a good. When a retail store changes its product prices, there is a cost associated with physically changing all of the price tags. Likewise, when a mail-order catalog changes its prices, there are considerable costs associated with reprinting the catalog with the new prices. For goods advertised on the Web, it is easy and virtually costless to change product prices. It is very attractive for firms to change their prices based on demand and supply conditions.
Interactivity:

The Internet makes it easy for sellers and buyers around the world to interact and negotiate prices. In the old economy, it was costly to create a dynamic pricing market due to the costs associated with bringing together sellers and buyers to negotiate. The fact that buyers and sellers can easily interact from their homes or workplaces via the Internet makes it easy to conduct dynamic pricing structures.

In the new economy, forecasters view auctions as a key pricing strategy. By 2002 Forrester Research estimates, 50 percent of online business transactions will be conducted through auctions.88 Diagram 5.6 indicates the wide variety of dynamic pricing and how they are being implemented on the Internet.

Diagram 5.6
Dynamic Pricing

Auctions
- English
- Reverse Price English
- Dutch
- First Price Sealed Bid

Group Buying

Exchanges

Auctions

In general the term auction refers to a selling process in which buyers successively raise their bids until only one buyer remains. However there is a

wide variety of types of auction i.e. English Auction, Reverse Price English Auction, Dutch Auction and First Price Sealed Bid.

1. **English Auctions**

   English auctions are the most common auction type. Also known as ascending or oral auctions, English auctions are open auctions in which buyers successively raise their bids until only one buyer remains. The term open auction indicates that all of the bidders know the amount of the highest bid at all times. English auctions can occur in person or via the Internet, or phone. In many instances, the product seller can maintain a reserve price; if the final bid does not equal or exceed the reserve price, the item is not sold. Depending on the auction structure, this reserve price is either known or unknown to bidders.

2. **Reverse Price English Auctions**

   Many auction sites- B2B sites, in particular-use reverse price auctions to help firms save on supply costs. On these sites, firms often submit a request for proposal (REP) or request for quotation (RFQ) to initiate a supply auction. The auction winner is the firm that provides the lowest bid to supply the requested goods or services. **Indiamart.com** has become well known in the B2B space as a site that helps firms significantly lower their supply costs by implementing reverse auctions. **Indiamart.com** is a B2B site that uses reverse price English auctions that has potential suppliers bidding to serve customers. Registered **Indiamart.com** customers can post what goods they are searching for and select which **Indiamart.com** related suppliers they would like to have bid on their requests.

3. **Dutch Auctions**

   There is a difference between how economists and **baazee.com** define a Dutch auction, which gets its name from the process by which flowers have
been sold in the Netherlands for the last century. Typically, at Dutch flower auctions, an auctioneer will start by announcing a high price for the product and then begin to slowly decrease the product price until a bidder accepts the price. This auction is the exact opposite of an English auction. Dutch auctions have two key drawbacks:

1. The process does not allow the price to be increased when buyers reveal their interest in goods. In English auctions, when a buyer reveals interest in a product by bidding, other parties may re-evaluate the worth of the good and increase their bids.

2. It is important for Dutch auctions to start at a price that is higher than the market clearing price, or else profit has been left on the table.

At baazee.com, Dutch auction refers to a special auction format in which a seller sells multiple identical items. The seller specifies the minimum price (the starting bid) and the number of items available. Buyers bid at or above that minimum price for the quantity they are interested in purchasing. At the close of auction, the highest bidders purchase the items at the price offered by the lowest winning bidder. This derivative of Dutch auctions is called a new economy Dutch auction.

Suppose a seller has two pens, and the seller is demanding a minimum bid of Rs.20 for each pen. In the simplest case, two buyers will bid Rs.20 for one pen thus each bidder will end up purchasing one pen for Rs.20. Now consider a more difficult case. Suppose buyer A bids Rs.20 for one pen, buyer B bids Rs.20 for one pen, and buyer C bids Rs.21 for one pen. At the end of the auction, buyer C will get to purchase the pen for Rs.20, buyer A will get to purchase the pen for Rs.20 (because buyer A was the first to bid Rs.20), and buyer B will not be able to purchase the pen.
4. First Price Sealed Bid Auctions

This is a very straightforward type of auction. Sellers offer a good for buyers to evaluate and consider bidding on. Before a specified time, potential buyers have the option to submit one sealed bid for the product. One implication of this auction is that since the bidding is sealed, buyers do not know the bid amount of competing bidders. After the bidding deadline, the product is sold to the highest bidder. The seller also has the right to specify a minimum reserve price. If the bidding does not reach this reserve price, the seller does not have to sell the good. Sellers have the option of making the minimum reserve price either known or unknown to potential bidders.

Onlinehotelsindia.com has created a new economy variant of the first price sealed bid auction. In onlinehotelsindia.com’s auction model, bidders submit a price (guaranteed by a credit card) for a hotel room on specified days. Once bidders submit their bids, they agree that Onlinehotelsindia.com can provide them any hotel at the mentioned location and that the tariffs are non-refundable. Once a bid has been submitted, the site automatically checks if the bid price is in line with the fares/restrictions that participating hotels have offered to Onlinehotelsindia.com for its customers. After identifying by the site, if a hotel is willing to provide a room at or below the customer’s bid price, the hotel then checks to see if it has available inventory for the specified dates. If the hotel does, it charges the bidder’s credit card and notifies him or her of the schedule.

Onlinehotelsindia.com derives revenues from this process in two primary ways:

1. Based on availability, participating hotels have agreed to provide rooms for set price. Onlinehotelsindia.com makes money on the spread—the difference between the hotel’s tariff and the bid price.

2. Onlinehotelsindia.com charges nominal service fee.
Group Buying

Group buying is a fashionable dynamic pricing strategy that several retail firms started by implementing a demand-aggregation/group-buying strategy to sell products to their community of cost-conscious buyers. Demand-aggregation sites strive to create a community of buyers who regularly visit the site to see what products are available for the community. On such sites, the more products that are sold to the group community, at lower the price. The final price is dependent on the number of people that purchase the good. All of the customers, no matter whether they were the first or last to buy, and agreed to purchase the product at a higher price, pay the final discounted price. Demand aggregation is an interesting buying strategy in the sense that it gives the customer the feeling of empowerment: if customers bind together, they receive a group discount.

The real question is whether demand aggregation sites can create a large enough community whose members are willing to check the site regularly and bid on a limited number featured products. While group buying is an intriguing way to sell products, it has been difficult to sustain a community that is ready to purchase whenever new goods are offered on the site. As far as India is concerned in the year 2000 a group-buying site i.e. buyasone.com was launched but after 2001 it was closed.

Exchanges

Electronic exchanges are marketplaces that have arisen to bring buyers and sellers together. Typically, an electronic exchange acts as the middleman for a sale, and collects a percentage of the total sale price. Exchanges serve as a meeting ground where sellers can post goods that they have for sale for a set time period. During this time period, prospective buyers can submit product bids. In a similar fashion, prospective buyers can post a request for a specific product. During a fixed time period, potential suppliers can post bids to supply the product. A key advantage for buyers using the exchange is the
exposure to a large number of sellers. The economic theory posits that the average buying price should be lower than it would be if fewer seller bid for the product. Similarly, a seller’s products are exposed to more potential buyers when a seller uses an exchange, sellers will theoretically receive higher prices for their products.

Onlineghar.com is an example of an electronic exchange designed to give its members access to a marketplace in which to more efficiently buy and sell electronic components. Onlineghar.com prequalifies all buyers and sellers to ensure integrity within its trading community, and buyers and sellers negotiate anonymously online to arrive at a mutually agreeable price. Because buyers and sellers are anonymous, Onlineghar.com acts as an intermediary.

5.4 ADVANCED PRICING STRATEGIES

1. Price Discrimination

Pricing strategists dislike using the word discrimination because of its negative connotations. When applied to pricing, the word discrimination refers to the practice of charging different prices to different people for the same product, based on their willingness to pay. Price discrimination raises interesting questions about whether such tactics are appropriate or beneficial to society. Pricing strategists often classify discriminatory pricing into three key categories: first-degree price discrimination, second degree price discrimination and third degree price discrimination as shown in diagram 5.7.
Diagram 5.7
Price Discrimination

- **First Degree**
  Charge consumers exactly what they are willing to pay for a product.

- **Second Degree**
  Charge consumers exactly what they are willing to pay for first unit of good as well as additional.

- **Third Degree**
  Divide customers into distinct segments, charging different price to different segments.

**a) First Degree Price Discrimination**

First degree price discrimination involves getting consumers to pay exactly what they are willing to pay for an item. This implies that in order to charge each consumer exactly what he or she is willing to pay for a product, the firm must know each consumer’s demand curve—which is unrealistic. In addition, while a consumer may be willing to pay a high price for a good, even if a firm tries to implement first degree price discrimination, other sellers may be offering lower prices. Consumers will flock to these other sellers to avoid being charged higher prices. What is more realistic is for the merchant to ascertain more information from consumers in an effort to gauge what they are willing to pay for a few minutes of haggling, skilled merchant can get a good idea of what a consume is willing to pay for a good. Similarly, when a site asks, about budget, it’s an attempt to understand a consumer’s willingness to pay.
b) Second Degree Price Discrimination

Second degree price discrimination is a close cousin of first degree price discrimination. When a firm implements first degree price discrimination it is striving to find the maximum price that each consumer is willing to pay for the good. In second degree price discrimination, the firm is trying to ascertain how much consumers are willing to pay not only for the first unit of good but for each additional unit.

c) Third Degree Price Discrimination

This is by far the most common type of price discrimination. It involves classifying customers by category, according to their willingness to pay. Price discrimination by age is often used in the movie theater business: Theaters charge children and senior less than they charge regular customers. Likewise, media companies such as Business Standard often offer significantly discounted prices to students under the theory that the optimal price for students is lower than that for the general public. Firms offer different prices to different customers for the same product because these different customer segments have a different willingness to pay for the good. As long as it is easy to discern the characteristics of consumers such as age or student status and it is not easy to resell goods i.e. buy the goods at a low price and resell the goods to segments that are paying a higher price for the goods, price discrimination makes good business sense. In economic terms, it is necessary for the lowest price offered in a price discrimination strategy to be greater than the variable cost of producing the good.

An often controversial discussion arises when consumers and business people describe the price discrimination strategy used by major airlines. It is not uncommon for a business person flying on a full fare ticket to end up sitting next to a vacationer who paid less than 15 percent what the business person paid for his or her round ticket. Airlines engage in price
discrimination by selling the same product at different prices to different types of consumers. Airlines hypothesize that business travelers can afford to pay more for an airline ticket than the average leisure traveler, which is generally true. In an effort to effectively segment leisure travelers, airlines set certain airfare rules. The lowest fares are only offered to customers who book well in advance and such tickets cannot be changed or refunded. The highest fares offered by airlines are for tickets that are fully refundable, completely changeable, require no advance purchase. These rules have proved a highly effective way of segmenting customers. In most instances, leisure travelers plan in advance, and have fixed travel schedule. Likewise, business travelers rarely plan in advance and want the flexibility to change their airline tickets at the last minute. There are always some business travelers who manage to book flights at leisure fares, and some leisure travelers who end up paying the business fares for a trip but on average, the current airfare pricing structure does a good job of segmenting customers.

2. Volume Discount Pricing

Theoretically, if a music company could estimate the exact individual demand for CD singles, it could design a volume pricing plan that would charge customers exactly what they are willing to pay for the first CD single and each additional one. Pricing strategies that decrease price as the quantity increases are designed to try to capture the inverse price quantity relationship that consumers have for products. **Super Cassettes Industries Limited (T series)** is notorious for offering specials such as a “**buy one, get the second on for half price**” promotion. For example assuming the production cost of a CD single is Rs. 1.50, company could offer customer the opportunity to purchase CD singles at the following price schedule:
First single @ Rs.6
- Second single @ Rs.5
- Third single @ Rs.4
- Forth single @ Rs.3
- Fifth single @ Rs.2
- Total revenue = Rs.20; Total profit=Rs.12.50

While this pricing schedule fully extracts from customer exactly what he is willing to pay for each CD single, this pricing structure is difficult to understand, and this difficulty could adversely affect sales. A more simplified schedule could be structured as follows: Buy the first three singles for Rs.4 each, and the next two singles for Rs.2 each. While this pricing structure is clearly easier to understand, the tradeoff is that this simplicity costs the music company profits. Total profit under this simplified volume discount pricing plan is Rs.8.50 (Total revenue is Rs.16).

3. Two Part Pricing

In an effort to better capture what consumers are willing to pay for an increased number of goods, firms often use two part pricing strategy. This strategy is composed of a fixed fee and an associated variable charge for each purchased item. In the CD single pricing example, the optimal two part pricing structure is for the music company to charge a flat fee of Rs.12.50 and a price per single fee of Rs.1.50. After paying a flat fee of Rs.12.50, consumers can buy as many CD singles as they want for Rs.1.50 each. From an economic standpoint, it is important that the variable price in a two part pricing strategy is equal to the variable cost of producing the good. In this case, the cost of producing a CD single is 1.50, thus the variable fee should be Rs.1.50. To maximize profits, it is necessary to structure two part pricing in a way that restricts consumers from buying a product at a variable price that is less than the cost of producing that product.
4. Bundling

There are two primary types of bundling or packaging strategies: pure bundling and mixed bundling. Pure bundling occurs when a firm offers its products only as part of a bundle. For instance, bundling can be used as a promotional vehicle for new products. To target new customers, a firm can bundle new product with established products. For example, a toothpaste company could bundle its newest complementary product, a toothbrush, with its most popular toothpaste brand. The bundle is attractive to customers because they are getting an additional product for free or at a discounted price.

Firms might bundle complementary products simply for convenience reasons. Several companies offer bundles of their products without a price discount. There is no cost advantage to buying the bundle. However, ordering a bundle is convenient, and the notion of purchasing a No.1 puts customers in the frame of mind to purchase all items in bundles. The same is true for complementary consumer products. Offering the bundle is convenient and stimulates customer demand.

Mixed bundling is a popular marketing strategy that involves selling goods both individually and in bundles. The bundle price is generally less than the sum of the individual component prices. Mixed bundling is a particularly easy and profitable pricing strategy to implement for Internet electronic service products. Consider an electronic research company that offers **Commodity market, automobile industry and advertising industry** news research products. Diagram 5.8 displays the demand and price structure for a hypothetical company, e-information. In this example:
Company A purchases the value bundle. By purchasing the bundle, Company A implicitly pays Rs.2000 for automobile industry and Rs.500 for the advertising industry.

- Company B purchases the value bundle. B implicitly pays Rs.1500 for automobile industry and Rs.1000 for advertising industry.

- Company C purchases only commodity market package.

A key benefit of using price discrimination is that the firm can sell more goods by implicitly selling the same products to different consumers at different prices. In this example, the bundle induced company A to buy the automobile industry report by implicitly charging a lower price than others paid, and induced company B to purchase the advertising industry report by implicitly charging a lower price relative to others.
5. **Price discrimination Over Time**

A common strategy to induce consumers to pay different prices for the same product is to implement price discrimination over time. Given the low menu costs associated with the Internet, this strategy can be easily implemented by Web retailers.

When a new product is released, the price can be set high and slowly lowered over time. This is often the case with new technology: Despite knowing that the price will be lowered over time, consumers who are willing to pay significantly for the product will often make the purchase immediately instead of waiting for a lower price and risking that the product will no longer be available. Similarly, consumers who are willing to pay less will often wait until the price is lowered before purchasing the product. By embarking on a strategy of price discrimination over time, consumers self select by paying different prices for the same product.

In industries such as publishing and music, price discrimination over time is often implemented in reverse order. For popular music, it is not uncommon to have fans line up at stores on the release date of much anticipated CD in order to be among the first to purchase it. If these fans reveal their diehard consumer status by going to such measures, music retailers could probably charge a higher price during the first week of sales. Instead, retailers often significantly discount new releases during the first few weeks that they are on the shelves; after this initial time period, retailers generally increase the price. This pricing is in direct contrast to the principles of the strategy of price discrimination over time. Reverse pricing strategy evolved because retailers view new CD and book releases as a promotion to bring customers into their stores. Thus, knowing that there will be strong demand for the new CD or book, retailers will heavily advertise it often with financial assistance from the music or publishing companies at a discounted
price. Music and publishing companies do not discourage this practice because sales figures from the first few weeks have become a major marketing vehicle for new releases. Being highly ranked on the basis of sales by various magazines and T.V. channels is a significant marketing vehicle and a signal to the industry and consumers.

6. **Frenzy Pricing**

Firms often implement pricing schemes that result in significant excess demand due to low prices. This can occur for a variety of reasons as shown in diagram 5.9.

![Diagram 5.9: Frenzy Pricing](image)

**a) Fairness Pricing**

A firm faced with excess demand may opt to keep prices below the market clearing price in an effort to maintain goodwill. This can create buying frenzy.

**b) Demand Uncertainty**

When a firm brings a new product to market, there may be uncertainty about whether the market will accept the product. If demand is unexpectedly high, retailers and manufacturers are often risk averse in terms of increasing prices once some products have been sold at a lower price. As during fairness pricing, consumers often accuse firms of price cutting when they
raise prices during periods in which price exceeds supply. While it may be more profitable to increase prices, the potential of adverse publicity may discourage firms from doing so.

**c) Efficient Method of selling**

Maruti udyog Ltd created buying frenzies with the launch of Zen (two doors) model by announcing that these cars would be sold in limited numbers; after that limit, the car would not be available at retail outlets. This type of strategy creates hype in the media and encourages consumers to purchase the item immediately. It also allows Maruti to concentrate its marketing in a very finite phase.

**d) Signal of quality**

If prices are set so that there is excess demand, many may view this as a signal of high quality. For consumers, there are often high search costs involved in determining product quality. Consumers often code excess demand as a signal or verification of quality.

**e) Marketing**

A key derivative of frenzy pricing is the frenzied nature of the consumers who are trying to obtain a good. This frenzy often leads hopeful consumers to sleep outside of stores, bid on auction sites or frantically drive from store to store to find the product. The consumer frenzy often creates media coverage. As Mr. Ratan Tata\(^89\) promised to launch a car, costing Rs.1 lakh, in India. But due to some conflict (in the year 2008) at the production site production was delayed and for sake of delay the cost also went up. Moreover TATA announced that company will provide only 1 lakh cars in first year. This announcement created frenzy among consumers eager to purchase the car. Now in April 2009 the booking for this car has been

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\(^{89}\) Chairman TATA Group
started, as a result of the tremendous consumer frenzy and unprecedented amount of free publicity by media consumers became aware of the product and there is a huge demand for this car.

5.5 **STRATEGIC RESPONSES TO COMPETITORS PRICE CUTS**

Competitors often attempt to decrease price in an effort to gain market share. As a general rule, decreasing prices and competing solely on price is not a wise long term strategy for any company. When a firm embarks on a major competitive price cut, stock exchanges often punishes all of the companies in the industry by lowering stock prices. Stock exchanges’ intuition is that when a firm initiates a price cut, competitive companies will be forced to match. Price wars lower profit margins. These lower prices are not generally made up for by increased sales, thus they negatively affect profits.

When a competitive firm initiates a price decrease, a firm’s first response should be to understand why its competitor is decreasing price. Understanding a competitor’s motives can help a firm to decide how to respond to the price cut. Typical motives for price cutting are shown in diagram 5.10
Diagram 5.10
Motives for Price Cutting

Financial Trouble

Decreasing prices may be a desperate attempt to raise cash, or signal to competitors an interest in being acquired.

Attempting to become an Industry leader

Decreasing prices is sometimes a show of strength. Slashing prices may indicate that a firm is doing well enough to withstand the lower costs, or is willing to endure hardship to become an industry leader. This action may intimidate competitors into allowing the firm to become an industry leader.

Signaling displeasure over a competitor’s strategy

A firm can use a price cut to punish a competitor for a change in its strategy.

As a general rule, firms should avoid competitive price cutting that could lead to a price war. Discounting price lowers margins, often damages the brand, and conditions consumers to pay less. While price wars are beneficial to consumers, they are detrimental to firms’ balance sheets. The
three general ways that firms respond to competitors’ price cuts are shown in diagram 5.11.

**Diagram 5.11**

**Responding to Competitors Price Cuts**

1. **Enhance the Value Proposition**

   One price cut reaction is to enhance the product value proposition by maintaining the price level and offering product enhancements. Typical product enhancements include additional services, extended warranties, and the inclusion of ancillary products. While arguably similar to decreasing price, by continuing to pay the same price consumers do not get conditioned to expect lower prices and the brand remain intact. Hotels often use enhanced packages to entice travelers. Weekend packages often maintain price levels but include such extras as complementary wine, free parking, late
checkout and dining discounts. These enhancements increase the attractiveness of staying at the hotel while maintaining price.

2. **Battle**

In addition to the often costly general price cutting attack, there are three other potentially less costly surgical attacks that a firm might launch.

**a. General Price Cutting Attack**

Responding to a price cut with a matching or lower price cut sends a clear signal to competitors. In the delicate chess game played in many industries, responding with a price cut indicates to competitors a willingness to fight strongly and puts the industry in a position in which all the market players will lose money. This also conveys a resistance to the initial price cutter becoming the industry leader. An aggressive response also creates a reputation that may inhibit similar future actions by current competitors and/or potential entrants. Battling may prove costly, but in the long run it may be the most profit protecting strategy to employ because it establishes an aggressive reputation.

**b. Cross Parry Attack**

In order to grow profits, an established firm might branch out into a new product line or extend its geographical presence. As a company like baazee.com tries to monetize its large customer base, it will undoubtedly enter new product markets and harm market incumbents. Instead of engaging in a price war, incumbent firm can enter into marketing agreements with baazee’s strategic competitors that would hurt baazee’s core business. As a result, baazee.com may have to pull resources firm its effort to enter the new market in order to protect its core business. Moreover, the incumbents have
sent a strong message to baazee.com and other potential entrants not to enter their market.

A similar response can be employed when a firm expands into a new geographic territory. Instead of fighting on price in the new territory, established firms may opt to fight on the new entrant’s primary turf. The effects and intent of geographic cross parry are similar to the effects of a core product cross parry. A geographic cross parry attack may force the price discount aggressor to retreat in order to concentrate on protecting its geographic territory. This action also sends a single to future potential entrants/price aggressors.

c. Targeted Price Cut

Localized response is a form of price discrimination. A competitor may heavily advertise a discounted product price in certain markets and media formats. Instead of simply lowering the product price to match the competitor’s price, a firm may opt to heavily advertise in the same markets and media. This strategy involves requiring consumers to mention a special promotion code when ordering the product. By structuring a matching price decrease in this fashion, the firm only discounts prices to consumers who may otherwise defect to the competing product simply because of a lower price.

d. Fighter Brand

One method of responding to a price decrease is to maintain product price and create a fighter brand. Fighter brand products are noticeably different from the firm’s regular product and are used to retain the firm’s price sensitive customers. The hope is that the firm’s price insensitive customers will continue to purchase the primary product and that price
sensitive customers will purchase the fighter brand. Fighter brand products are often used in the fast food industry.

3. **Justify Price Differential**

   In many industries, firms could do a better job of informing consumers of how their products are differentiated from competing products. Price wars often occur when low cost airlines enter a market currently being served by well established airlines. Incumbent airlines are often quick to match a new entrant’s price. When they may have other options; instead of matching price, incumbent airlines could inform consumers of the benefits of flying with them. These benefits may include:

   - Excellent frequent flier program
   - Spare aircraft in case one is grounded due to mechanical problems
   - Routing options (due to an established airline’s large network, it has a wide range of options for routing passengers experiencing flight problems such as cancellations and delays)
   - Better statistics in terms of customer service, on time arrivals, service personnel to passenger ratios, maintenance excellence etc.

   Instead of matching low prices by new entrants, a winning strategy for incumbent airlines may be to highlight why their services are significantly better, thereby justifying the higher price.