UNIT – IV

4.1 Introduction

Pricing is one of the most important elements of the marketing, as it is the only factor which generates a turnover for the organization. It can be defined as "Activities aimed at finding a product’s optimum price, typically including overall marketing objectives, consumer demand, product attributes, competitors' pricing, and market and economic trends." It costs to produce and design a product; it costs to distribute a product and costs to promote it.

Price must support these elements of the mix. Pricing is difficult and must reflect supply and demand relationship. Pricing a product too high or too low could mean a loss of sales for the organization.

It is the value that is put to a product or service and is the result of a complex set of calculations, research and understanding and risk taking ability.

Meaning of Pricing

Pricing is a process of fixing the value that a manufacturer will receive in the exchange of services and goods. Pricing method is exercised to adjust the cost of the producer’s offerings suitable to both the manufacturer and the customer. The pricing depends on the company’s average prices, and the buyer’s perceived value of an item, as compared to the perceived value of competitors product.

Every businessperson starts a business with a motive and intention of earning profits. This ambition can be acquired by the pricing method of a firm. While fixing the cost of a product and services the following point should be considered:

- ✓ The identity of the goods and services
- ✓ The cost of similar goods and services in the market
- ✓ The target audience for whom the goods and services are produces

- ✓ The total cost of production (raw material, labour cost, machinery cost, transit, inventory cost etc).
- ✓ External elements like government rules and regulations, policies, economy, etc.,

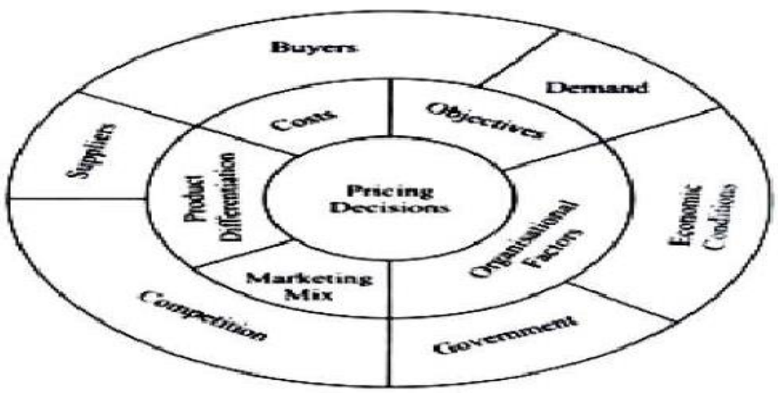
The Influencing Factors for a Pricing Decision Can Be Divided Into Two Groups

a) Internal Factors

b) External Factors

Figure 4.1

Factors Affecting Pricing Decisions



a) Internal Factors

i) Organizational Factors

Pricing decisions occur on two levels in the organisation. Over-all price strategy is dealt with by top executives. They determine the basic ranges that the product falls into in terms of market segments. The actual mechanics of pricing are dealt with at lower levels in the firm and focus on individual product strategies. Usually, some combination of production and marketing specialists are involved in choosing the price.

ii) Marketing Mix

Marketing experts view price as only one of the many important elements of the marketing mix. A shift in any one of the elements has an immediate effect on the other three—Production, Promotion and Distribution. In some industries, a firm may use price reduction as a marketing technique.

Other firms may raise prices as a deliberate strategy to build a high-prestige product line. In either case, the effort will not succeed unless the price change is combined with a total marketing strategy that supports it. A firm that raises its prices may add a more impressive looking package and may begin a new advertising campaign.

iii) Product Differentiation

The price of the product also depends upon the characteristics of the product. In order to attract the customers, different characteristics are added to the product, such as quality, size, colour, attractive package, alternative uses etc. Generally, customers pay more prices for the product which is of the new style, fashion, better package etc.

iv) Cost of the Product

Cost and price of a product are closely related. The most important factor is the cost of production. In deciding to market a product, a firm may try to decide what prices are realistic, considering current demand and competition in the market. The product ultimately goes to the public and their capacity to pay will fix the cost, otherwise product would be flapped in the market.

v) Objectives of the Firm

A firm may have various objectives and pricing contributes its share in achieving such goals. Firms may pursue a variety of value-oriented objectives, such as maximizing sales revenue, maximizing market share, maximizing customer volume, minimizing customer volume, maintaining an image, maintaining stable price etc. Pricing policy should be established only after proper considerations of the objectives of the firm.

b) External Factors

i) Demand

The market demand for a product or service obviously has a big impact on pricing. Since demand is affected by factors like, number and size of competitors, the prospective buyers, their capacity and willingness to pay, their preference etc. are taken into account while fixing the price.

A firm can determine the expected price in a few test-markets by trying different prices in different markets and comparing the results with a controlled market in which price is not altered. If the demand of the product is inelastic, high prices may be fixed. On the other hand, if demand is elastic, the firm should not fix high prices, rather it should fix lower prices than that of the competitors.

ii) Competition

Competitive conditions affect the pricing decisions. Competition is a crucial factor in price determination. A firm can fix the price equal to or lower than that of the competitors, provided the quality of product, in no case, be lower than that of the competitors.

iii) Suppliers

Suppliers of raw materials and other goods can have a significant effect on the price of a product. If the price of cotton goes up, the increase is passed on by suppliers to manufacturers. Manufacturers, in turn, pass it on to consumers.

Sometimes, however, when a manufacturer appears to be making large profits on a particular product, suppliers will attempt to make profits by charging more for their supplies. In other words, the price of a finished product is intimately linked up with the price of the raw materials. Scarcity or abundance of the raw materials also determines pricing.

iv) Economic Conditions

The inflationary or deflationary tendency affects pricing. In recession period, the prices are reduced to a sizeable extent to maintain the level of turnover. On the other hand, the prices are increased in boom period to cover the increasing cost of production and distribution. To meet the changes in demand, price etc.

Several pricing decisions are available:

- ✓ Prices can be boosted to protect profits against rising cost,
- ✓ Price protection systems can be developed to link the price on delivery to current costs,
- ✓ Emphasis can be shifted from sales volume to profit margin and cost reduction etc.

v) Buyers

The various consumers and businesses that buy a company's products or services may have an influence in the pricing decision. Their nature and behaviour for the purchase of a particular product, brand or service etc. affect pricing when their number is large.

vi) Government

Price discretion is also affected by the price-control by the government through enactment of legislation, when it is thought proper to arrest the inflationary trend in prices of certain products. The prices cannot be fixed higher, as government keeps a close watch on pricing in the private sector. The marketers obviously can exercise substantial control over the internal factors, while they have little, if any, control over the external ones.

While Setting the Price, the Firm May Aim At the Following Objectives

i) Price-Profit Satisfaction

The firms are interested in keeping their prices stable within certain period of time irrespective of changes in demand and costs, so that they may get the expected profit.

ii) Sales Maximization and Growth

A firm has to set a price which assures maximum sales of the product. Firms set a price which would enhance the sale of the entire product line. It is only then, it can achieve growth.

iii) Making Money

Some firms want to use their special position in the industry by selling product at a premium and make quick profit as much as possible.

iv) Preventing Competition

Unrestricted competition and lack of planning can result in wasteful duplication of resources. The price system in a competitive economy might not reflect society's real needs. By adopting a suitable price policy the firm can restrict the entry of rivals.

v) Market Share

The firm wants to secure a large share in the market by following a suitable price policy. It wants to acquire a dominating leadership position in the market. Many managers believe that revenue maximisation will lead to long run profit maximisation and market share growth.

vi) Survival

In these days of severe competition and business uncertainties, the firm must set a price which would safeguard the welfare of the firm. A firm is always in its survival stage. For the sake of its continued existence, it must tolerate all kinds of obstacles and challenges from the rivals.

vii) Market Penetration

Some companies want to maximise unit sales. They believe that a higher sales volume will lead to lower unit costs and higher long run profit. They set the lowest price, assuming the market is price sensitive. This is called market penetration pricing.

viii) Marketing Skimming

Many companies favour setting high prices to 'skim' the market. DuPont is a prime practitioner of market skimming pricing. With each innovation, it estimates the highest price it can charge given the comparative benefits of its new product versus the available substitutes.

ix) Early Cash Recovery

Some firms set a price which will create a mad rush for the product and recover cash early. They may also set a low price as a caution against uncertainty of the future.

x) Satisfactory Rate of Return

Many companies try to set the price that will maximise current profits. To estimate the demand and costs associated with alternative prices, they choose the price that produces maximum current profit, cash flow or rate of return on investment.

Types of Pricing

a) Cost Based Pricing Method

i) Cost plus pricing

Product unit's total cost + percentage of profit. Commonly followed in departmental stores. Does not consider the competition factor.

ii) Marginal cost pricing

Also called break-even pricing. Selling price is fixed in such a way that it covers fully the variable or marginal cost.

b) Competition-Oriented Pricing

i) Sealed bid Pricing

This method is more popular in tenders & contracts. Each contracting firm quotes its price in a sealed cover called 'tender'. All the tenders are opened on a scheduled date and the person who quotes the lowest price is awarded the contract.

ii) Going rate Pricing

Price is charged in tune with the price in the industry as a whole. When one wants to buy or sell gold, the prevailing market rate at a given point of time is taken as the basis to determine the price

c) Demand-Oriented Pricing

i) Price discrimination

Practice of charging different prices to customers for the same good. It is also called differential pricing. Prices are discriminated on the basis of customer requirements, nature of product itself, geographical areas, income group etc.

ii) Perceived value pricing

Price fixed on the basis of the perception of the buyer of the value of the product. For example: Mobile phones without touch screens these days.

d) Strategy-Based Pricing

i) Market Skimming

When the product is introduced for the first time in the market, the company follows this method. Under this method, the company fixes a very high price for the product. The idea is to charge the customer maximum possible. Mostly found in technical products.

ii) Market Penetration

Opposite to the market skimming method. Here the product is fixed so low that the company can increase its market share.

iii) Two-part pricing

A firm charges a fixed fee for the right to purchase its goods, plus a per unit charge for each unit purchased. Organizations such as country clubs, golf courses charge membership fee and offer their products & services cost- to-cost.

iv) Block Pricing

Block pricing is another way a firm with market power can enhance its profits. We see block pricing in our day-to- day life. Six lux soaps in a single pack or Maggi noodles in a single pack illustrate this pricing methods. By selling certain number of units of a product as one package, the firm earns more than by selling unit wise.

v) Commodity bundling

Commodity bundling refers to the practice of bundling two or more different products together and selling them at a single ‘bundle price’. For example: The package deals offered by the tourist companies, airlines etc.

vi) Peak load Pricing

During seasonal period when demand is likely to be higher, a firm may enhance profits by peak load pricing. The firm’s philosophy is to charge a higher price during peak times than is charged during off- peak times

vii) **Cross subsidization** In cases where demand for two products produced by a firm is interrelated through demand or costs, the firm may enhance the profitability of its operation through cross subsidization. Using the profits generated by established products, a firm may expand its activities by financing new product development and diversification into new product market. For example, A computer selling both hardware & Software.

viii) Transfer Pricing

Transfer pricing is an internal pricing technique. It refers to a price at which inputs of one department are transferred to another, in order to maximize the overall profits of the company.

ix) Price Matching

A firm promises to match a lower price offered by any competitor, while announcing its own price. It is necessary that one should be confident, before adopting this strategy.

x) Promoting Brand Loyalty

This is an advertising strategy where the customers are frequently reminded by the brand value of a given product or service. Conviction is to retain the brand loyalty, so that customers will not slip away when the competitors come up with lower prices. For example: Pepsi and Coke spend huge amounts on advertising campaigns to draw the attention of consumers.

xi) Time-to-time Pricing

This is also called randomized pricing strategy where the firm varies its price from time-to-time, say hour-to- hour or day-to-day. Customers cannot learn from experience which firm charges the lowest price in the market. For ex: Markets of bullion, currency and bank deposits.

xii) Promotional Pricing

Promoting the product by intentionally charging lower price to attract the customer

xiii) Target Pricing

This is a strategy where company fixes a price keeping in view a targeted profit in mind.

Pricing Practices and Strategy

It takes into account segments, ability to pay, market conditions, competitor actions, trade margins and input costs, amongst others. It is targeted at the defined customers and against competitors.

i) Cost-plus pricing

It Refers to the simplest method of determining the price of a product. In cost-plus pricing method, a fixed percentage, also called mark-up percentage, of the total cost (as a profit) is added to the total cost to set the price. For example, XYZ organization bears the total cost of Rs. 100 per unit for producing a product. It adds Rs. 50 per unit to the price of product as' profit. In such a case, the final price of a product of the organization would be Rs.

150. Cost-plus pricing is also known as **average cost pricing.** This is the most commonly used method in manufacturing organizations.

In economics, the general formula given for setting price in case of cost-plus pricing is as follows:

P = AVC + AVC (M)

AVC= Average Variable Cost M = Mark-up percentage

AVC (m) = Gross profit margin

Mark-up percentage (M) is fixed in which AFC and net profit margin (NPM) are covered.
AVC (m) = AFC+ NPM

a) For determining average variable cost, **the first step** is to fix prices. This is done by estimating the volume of the output for a given period of time. The planned output or normal level of production is taken into account to estimate the output.

b) **The second step** is to calculate Total Variable Cost (TVC) of the output. TVC includes direct costs, such as cost incurred in labor, electricity, and transportation. Once TVC is calculated, AVC is obtained by dividing TVC by output, Q. [AVC= TVC/Q]. The price is then fixed by adding the mark-up of some percentage of AVC to the profit [P = AVC + AVC (m)].

Advantages of cost-plus pricing method are as follows:

- ✓ Requires minimum information
- ✓ Involves simplicity of calculation
- ✓ Insures sellers against the unexpected changes in costs

Disadvantages of cost-plus pricing method are as follows**:**

- ✓ Ignores price strategies of competitors
- ✓ Ignores the role of customers

ii) Markup Pricing

It Refers to a pricing method in which the fixed amount or the percentage of cost of the product is added to product's price to get the selling price of the product. Markup pricing is more common in retailing in which a retailer sells the product to earn profit.

For example, if a retailer has taken a product from the wholesaler for Rs. 100, then he/she might add up a markup of Rs. 20 to gain profit.It is mostly expressed by the following formulae:

a. Markup as the percentage of cost= (Markup/Cost) *100
b. Markup as the percentage of selling price= (Markup/ Selling Price)*100
c. For example, the product is sold for Rs. 500 whose cost was Rs. 400. The mark up as a percentage to cost is equal to (100/400)*100 =25. The mark up as a percentage of the selling price equals (100/500)*100= 20.

iii) Demand-based Pricing

Demand-based pricing refers to a pricing method in which the price of a product is finalized according to its demand. If the demand of a product is more, an organization prefers to set high prices for products to gain profit; whereas, if the demand of a product is less, the low prices are charged to attract the customers. The success of demand-based pricing depends on the ability of marketers to analyze the demand. This type of pricing can be seen in the hospitality and travel industries

iv) Competition-based Pricing

Competition-based pricing refers to a method in which an organization considers the prices of competitors' products to set the prices of its own products. The organization may charge higher, lower, or equal prices as compared to the prices of its competitors.

The aviation industry is the best example of competition-based pricing where airlines charge the same or fewer prices for same routes as charged by their competitors. In addition, the introductory prices charged by publishing organizations for textbooks are determined according to the competitors' prices.

v) Value Pricing

Implies a method in which an organization tries to win loyal customers by charging low prices for their high- quality products. The organization aims to become a low cost producer without sacrificing the quality. It can deliver high- quality products at low prices by improving its research and development process. Value pricing is also called value-optimized pricing.

vi) Target Return Pricing

It Helps in achieving the required rate of return on investment done for a product. In other words, the price of a product is fixed on the basis of expected profit.

vii) Going Rate Pricing

It implies a method in which an organization sets the price of a product according to the prevailing price trends in the market. Thus, the pricing strategy adopted by the organization can be same or similar to other organizations. However, in this type of pricing, the prices set by the market leaders are followed by all the organizations in the industry.

viii) Transfer Pricing

It involves selling of goods and services within the departments of the organization. It is done to manage the profit and loss ratios of different departments within the organization. One department of an organization can sell its products to other departments at low prices. Sometimes, transfer pricing is used to show higher profits in the organization by showing fake sales of products within departments.

ix) Market Skimming Pricing

Skimming is adopted where a new product is launched and the seller has little information on the acceptable price in the market. The seller, therefore, starts by setting high price on the launch of the product and then, over a period of time, lowers the price to meet the varying price elastic ties of demand.

This enables gradual expansion in capacity by the seller. This practice is followed in the consumer durables market. The seller chooses to start by setting at a high price to avoid the risk of losing on customers who are willing to pay a high price.

x) Penetration Pricing

Penetration pricing is a strategy employed by businesses introducing new goods or services into the marketplace. With this policy, the initial price of the good or service is set relatively low in hopes of 'penetrating' into the marketplace quickly and securing significant market share.

- ✓ A penetration policy is even more attractive if selling larger quantities results in lower costs because of economies of scale. Penetration pricing may be wise if the firm expects strong competition very soon after introduction.
- ✓ A low penetration price may be called a 'stay out' price. It discourages competitors from entering the market. Once the product has secured a desired market share, its producers can then review business conditions and decide whether to gradually increase the price.
- ✓ Penetration pricing involves the setting of lower, rather than higher prices in order to achieve a large, if not dominant, market share.

This strategy is most often used in businesses wishing to enter a new market or build on a relatively small market share.

This will only be possible where demand for the product is believed to be highly elastic, i.e., demand is price-sensitive and either new buyers will be attracted or existing buyers will buy more of the product as a result of a low price.

xi) Bundling Pricing

It is a pricing practice when two or more products are sold as bundle. Also, the constituent products of the bundle are not sold individually.

Price bundling is a strategy whereby a seller bundles together many different goods/items being sold and offers the entire bundle at a single price.

There are two forms of price bundling—pure bundling, where the seller does not offer buyers the option of buying the items separately, and **mixed bundling**, where the seller offers the items separately at higher individual prices. Mixed bundling is usually preferable to pure bundling, both because there are fewer legal regulations forbidding it, and because the reference price effect makes it appear even more attractive to buyers.

Suppose there are two buyers, A and B, and two products, X and Y. Suppose buyer A values product X at 20 units above the cost of production, and values 7 at 15 units above the cost of production. Suppose buyer B values Y at 20 units above the cost of production, and X at 15 units above the cost of production.

The ideal thing for the seller would be to practice price discrimination: charge each buyer the maximum that buyer is willing to pay. However, this may be forbidden by law or otherwise difficult to implement.

Instead, the seller can pursue the following bundling strategy- charge slightly under 35 units above production cost for the combination of X and Y. Since both buyers value the combination at 35 units, this deal appeals to both buyers. This allows the seller to obtain the entire social surplus as producer surplus.

The seller can even make this a mixed bundling strategy – offer both X and Y individually for 20 units, and offer the combination for slightly less than 35 units.

xii) Peak Load Pricing

It is a pricing practice where price varies with time of the day. When demand for a commodity or service varies at different periods of time, it has been generally suggested that higher price of a commodity or service be charged for the peak period when demand is greater and lower price be charged for off-peak period when demand is lower. This dual pricing, that is higher price for peak period and lower price for off-peak period is known as peak-load pricing.

For example. In India charges for trunk or STD calls during day time which is the peak period is higher and charges for the off-peak period from 9 P.M. to 6 A.M. are lower. In many countries, electric companies are permitted to charge higher rates during the day time which is the peak period for the use of electricity and lower rates for the night which is off-peak period for the use of electricity. Similarly, airlines often follow peak-load pricing; in off season they often lower their rates as compared to the peak periods of travel.

xiii) Limit Pricing

Limit pricing refers to the pricing by incumbent firm(s) to deter or inhibit the entry or the expansion of fringe firms.

Limit pricing implies that firms sacrifice current profits in order to deter entry of new firms and earn future profits. It is not clear whether this strategy is always superior to one where current prices (and profits) are higher, but decline over time as an entry occurs.

Limit pricing thus involves charging prices below the monopoly price in order to make entry appear unattractive (to limit entry). A low price would discourage entry if prices had a commitment value. But they do not, because prices can be changed quickly. Hence, if a potential entrant has complete information about the incumbent, limit pricing would be useless.

It is the policy adopted by firms already in a market to reduce their prices so as to make it unprofitable for other firms to try to enter the market. The price so established is called an entry forestalling price.

xiv) Prestige Pricing

Prestige pricing is a marketing strategy where prices are set higher than normal because lower prices will hurt instead of helping sales, such as for high-end perfumes, jewelry, clothing, cars, etc. It is also called image pricing or premium pricing.

It is a price system that implies added value of a product because of its location at the higher end of the price scale. Prices within this type of financial modeling are artificially elevated for a psychological marketing advantage. This type of pricing aims to capitalize on buyers' notions that one brand's high-priced item is superior in quality to a similar item that could be purchased for significantly less.

The strategy behind prestige pricing is not tied to its quality but more to its image.

Advantages of Price Practices

i) Firms will be able to increase revenue

Price discrimination will enable some firms to stay in business who otherwise would have made a loss. For example price discrimination is important for train companies who offer different prices for peak and off-peak. Without price discrimination, they may go out of business or be unable to provide off-peak services.

ii) Increased investment

These increased revenues can be used for research and development which benefit consumers

iii) Lower prices for some

Some consumers will benefit from lower fares. For example, old people benefit from lower train companies; old people are more likely to be poor. Also, customers willing to spend time in researching ‘special offers’ and travelling at awkward times will be rewarded with lower prices.

iv) Manages demand

Airlines can use price discrimination to encourage people to travel at unpopular times (early in the morning) This helps avoid over-crowding and helps to spread out demand.

Disadvantages of Pricing Practices

i) Higher prices for some

Under price discrimination, some consumers will end up paying higher prices (e.g. people who have to travel at busy times). These higher prices are likely to be allocatively inefficient because P > MC.

ii) Decline in consumer surplus

Price discrimination enables a transfer of money from consumers to firms – contributing to increased inequality.

iii) Potentially unfair

Those who pay higher prices may not be the poorest. For example, adults paying full price could be unemployed, senior citizens can be very well off.

iv) Administration costs

There will be administration costs in separating the markets, which could lead to higher prices.

v) Predatory pricing

Profits from price discrimination could be used to finance predatory pricing.

4.2 Objectives of Pricing Policy

Pricing is not an end in itself. Pricing is a means to an end. Therefore, the firm must explicitly lay down its pricing objectives. The firm's overall objectives serve as guiding principle to pricing. Thus, firm's business objectives are normally spelled out as the objectives of its price policy. Empirical evidences reflect that theoretical goal of profit maximisation is rarely taken in practice by the business firms in their price policy.

The following are the commonly adopted major pricing objectives of a business firm:

Survival

Basically, in these days of monopolistic competition or dynamic changes and business uncertainties, a firm is always interested in its continued survival first. For the sake of assuring continued existence, generally, a firm is ready to tolerate all kinds of upheaval in product lines, organisational and even personnel changes.

Rate of Growth and Sales Maximization

A firm may be interested in setting a price policy which will permit a rapid expansion of the firm's business and its sales maximization.

i) Market Shares

By adopting a price policy the firm may wish to capture a larger share in the market and acquire a dominating leadership position. In oligopoly market, this is quite common.

ii) Target Return on Investment

The firms may have a predetermined target return of their investment, for instance say 10 per cent.

iii) Preventing Competition

In pricing its product, the firm may keep an eye on rival's entry. So, it may fix up the price such that would prevent competition.

iv) Making Money

Some firms are interested in making a fast buck taking their monopoly advantage into account and try to sell their goods at premium. Thus, pricing objective may be of making money.

v) Service Motive

A firm may set pricing policy such as to serve the community and improve its welfare.

vi) Regular Income

Some firms are interested in maintaining regular flow of income, so would set their price policy accordingly.

vii) Price Stabilization

The firms may be generally interested in keeping their prices stable within certain range over a period of time, irrespective of marginal changes in demand and costs.

However, the survival of the firm is always the underlying objective in pricing. In practice, thus, the following interrelated pricing objectives are commonly held:

- ✓ to fulfil a goal rate of return on investment;
- ✓ to seek the anticipated rate of growth;
- ✓ to improve the market share;
- ✓ to stabilize prices and profit margins for the regular flow of income.

4.3 Factors Involved In Pricing Policy

The executive's problems of private pricing policy involves many considerations and right advice from the professional business economist. The following are the important factors deserving special attention in determination of a pricing policy of any firm.

i) Costs;
ii) Demand and Consumer Psychology;
iii) Competition;
iv) Profit; and
v) Government policy.

i) Costs

Cost is an important element in price determination. Cost data serve as the base. Price has to be along cost. If price is below the cost of production it would mean losses. Thus, cost analysis is important. Along the total costs, average and marginal costs are to be determined.

- ✓ For business decisions in the short run, direct or variable costs have greater relevance. The firms seek to cover full allocated costs.
- ✓ Economy in cost is also important for setting a lower price for the product. A high cost of production obviously calls for a higher price.

ii) Demand

In pricing policy, demand can never be overlooked. Rather, demand is more important for the effective sales. Demand for a firm's product depends on consumer's preferences. So, the consumer psychology is very important. Through appropriate advertising and sales campaign consumers' psychology can be influenced and their preferences may be altered, thus, demand
can be manipulated.

A low or high price policy is to be set in view of the elasticity of demand. If demand for the product is highly inelastic, then only rising price policy would be a paying proposition to the businessman.

Further, in all cases demand is not price elastic. In some cases, especially, consumer durables, *e.g.*, TV set, car, etc., demand is income elastic. Thus, when income of the buyers rises, the firm can expect to sell more such goods even at high prices.

In case of elastic demand for the goods, a price cut would be beneficial in boosting the sale. However, consumers' psychology — their anticipation about the price change is also significant. If consumers anticipate a further price cut, then the price cut policy will result increasing the sale only marginally in the short-run. But, if they feel that the price cut is final, it will definitely improve the sale to a greater extent.

iii) Competition

The nature of pricing policy largely depends on the degree of competition prevailing in the market. Under perfect competition, there is a uniquely determined ruling price in the market, also the firm has no scope to design its own price policy. Under monopoly, oligopoly or monopolistic competition, the firm can determine its own price policy.

iv) Profits

In determining price policy, profit consideration is also significant. In practice, however, rarely is there a goal of profit maximisation. Usually, pricing policy is based on the goal of obtaining a reasonable profit. Further, most of the businessmen would prefer to hold constant price for their products rather than going for a price rise on a price cut, as far as possible. Thus, price rigidity may be the norm of the price policy. But, rigidity does not mean inflexibility. Price fluctuations do conform to cost changes.

v) Government Policy

Pricing policy of a firm is also affected by the government policy. If the government resorts to price control, the firm has to adopt the price as per the formula and ceiling prescribed by the government, then there is little scope to pursue its own pricing. For instance, in India we have drug price control, etc.

4.4 Methods of Pricing

Pricing method is a technique that a company apply to evaluate the cost of their products. This process is the most challenging challenge encountered by a company, as the price should match the current market structure and also compliment the expenses of a company and gain profits. Also, it has to take the competitor's product pricing into consideration so, choosing the correct pricing method is essential.

Types of Pricing Methods

The pricing methods are broadly classified into two categories: **Cost-Oriented Pricing Methods** and **Market-Oriented Pricing Methods.** The Cost-Oriented Pricing Methods include Cost-Plus Pricing, Markup Pricing, and Target Return Pricing. However, the Market-Oriented Pricing Methods include Perceived Value Pricing, Value Pricing, Going Rate Pricing, Differential Pricing, and Auction Type Pricing.

I. Cost-Oriented Pricing Methods

1. Cost-Plus Pricing

Cost-plus pricing is the easiest and most basic method of pricing. Under this method, the seller adds a pre-specified percentage on the cost of producing one unit. This pre-specified percentage, also known as **Markup Percentage**, is used to determine the selling price. The markup; thus, is the profit percentage implied on the cost of production. Cost-plus pricing ensures the desired rate of return. Price determination under cost-oriented pricing is calculated as follows:

Total Cost = Fixed Costs + Variable Costs

$$\text{Unit cost} = \frac{Total\ cost}{Number\ of\ units}$$

Markup Price = Unit cost x Markup Percentage Selling Price = Unit cost + Markup Price

For example, Assume that the cost of production of product A is ₹1,000 with a markup of 50% on the total cost, then the selling price will be calculated as:

Markup Price = Unit cost x Markup Percentage = ₹1,000 x 50% = ₹500 Selling Price = Unit cost + Markup Price = ₹1,000 + ₹500

Selling Price = ₹1,500

2. Markup Pricing

Markup Pricing is the method where markup is calculated on the selling price of the product. In other words, it is the method of adding a profit percentage to the selling price of the product. Prices under markup pricing are considered as:

$$\text{Marked Price} = \frac{Unit\ Cost}{1 - Desired\ return\ on\ sale}$$

For example, Assume that the cost of production of product A is ₹1,000 and the seller wants to earn a profit of 20% on sales, then the markup price will be calculated as:

$$\text{Marked-up Price} = \frac{Unit\ Cost}{1 - Desired\ Return\ on\ Sale}$$

$$= \frac{1000}{1 - 0.20}$$

Marked-up Price = ₹1,250

3. Target Return Pricing

Target Return Pricing is the method under which the firm decides to set up the prices of products according to the pre-specified required rate of Return on Investment (ROI).

$$\text{Target Return Price} = \text{Unit Cost} + \frac{\text{Desired Return} \times \text{Capital Invested}}{\text{Unit Sales}}$$

For example, Assume that the manufacturer has invested ₹10,000 in business and is expecting an ROI of 20% i.e., ₹2,000, given that the unit price is ₹50 and the target sales is 100 units, then the target return price is given by

$$\text{Target Return Price} = \text{Unit Cost} + \frac{\text{Desired Return} \times \text{Capital Invested}}{\text{Unit Sales}}$$

= 50+\frac{0.20\times{10,000}}{100}

Target Return Price = ₹70

II. Market-Oriented Pricing Methods

1. Perceived Value Pricing

Under this pricing method, the manufacturer undertakes the customers' perception of goods and services. The customer's expectation of the price of the product plays an important role in deciding the price of the product. **For Example,**

- ✓ Starbucks charges high prices for its coffee as compared to other coffee brands, relying on the perception of a unique coffee experience and ambience.
- ✓ Organic food products are often priced higher than non-organic food products, leveraging the perception of healthier and more sustainable options.

2. Value Pricing

Under this method of pricing, re-engineering is done to reduce the cost of production as well as maintain the high-end quality. The cost of product/services are thus low with better quality. **For example,**

- ✓ Walmart is known for its value pricing strategy, offering a wide range of products at lower prices than many of its competitors. This attracts budget-conscious consumers who prioritise affordability.
- ✓ McDonald's offers a value-priced menu with items prices at low prices, catering to customers looking for affordable meal options.

3. Going Rate Pricing

Under this method of pricing, the firm undertakes the prices of rival firms and sets its prices accordingly. Generally, to end the price wars among the firms, the prices of all firms in an industry remain more or less the same when they adopt the going-rate pricing method. Oligopolistic firms like steel, fertilizers, paper, etc., practice going rate pricing. **For example,**

- ✓ Telecommunication firms like Jio, Airtel, and Vodaphone charge almost the same rates under the going rate pricing method.
- ✓ Ride-sharing companies like Uber and Lyft use dynamic pricing, adjusting fares based on factors like demand and supply.

4. Differential Pricing

Differential pricing is practiced under price discrimination where the sellers charge different prices from different buyers. The prices can also vary from age, gender, location, customer standard, etc. **For example,**

- ✓ The price of Mineral Water charged is different in different places, hotels, restaurants, general stores, etc.
- ✓ Movie Theaters often use differential pricing based on factors like age, time of the day, and special occasions.

5. Auction Type Pricing

This type of pricing method came into existence with the increased usage of the internet. Websites like OLX, Quikr, eBay, etc., practice auction-type pricing. There are three types of auctions:

- ✓ **English Auctions:** English Auctions consist of one seller and multiple buyers. The sellers tend to increase the price until the product reaches the best bid.
- ✓ **Dutch Auctions:** Under Dutch auctions, there may be one seller and many buyers or many sellers and one buyer. The former type consists of setting up the best price and adjusting it according to the capacity of bidders and the latter type undertakes the bidder asking for the product and multiple sellers offering reasonable prices.
- ✓ **Sealed-Bid Auctions:** Government and industrial purchases generally follow this method of pricing. Under this, potential buyers communicate their prices with suppliers only and do not disclose them to anyone else.

4.5 Dual Pricing

Dual pricing is the practice of setting different prices in different markets for the same product or service. This tactic may be used by a business for a variety of reasons, but it is most often an aggressive move to take market share away from competitors.

Dual pricing refers to two types of prices for a commodity, viz., (i) controlled price, and (ii) market price. Controlled price of the product is directly, fixed up by the government for a certain portion of the total output. Its market price is the freely determined market price for the remaining quantity of output. Dual pricing involves the following considerations:

- ✓ Determining a certain proportion of the output of a commodity which is to be procured by the government at a fixed rate called levy rate.
- ✓ Fixing the procurement or levy price.
- ✓ Arranging for the distribution of the procured quantity of output to specified categories
- ✓ of consumers/users called beneficiaries.
- ✓ Determining the issue price, *i.e.*, the price payable by the beneficiaries.
- ✓ Permitting the rest of the stock to be sold by the producers in the open market. It is referred to as 'free sale quantity' which is sold at freely determined market price through market mechanism.

Thus, the major problems associated with dual price system are:

- ✓ Identification of the commodity to be brought under the system of dual pricing.
- ✓ Determination of a considerate levy rate or procurement price.
- ✓ Determination of a reasonable levy price or issue price for the beneficiaries.
- ✓ Organisation of efficient distribution system. The following are the main merits of dual pricing:
- ✓ It is easier and less expensive to administer.
- ✓ It legitimises the existence of two prices for the product as well as price discrimination among two groups of buyers.
- ✓ It permits restricting the benefits of price control to the deserving sections of buyers only on priority consideration.
- ✓ It reduces the pressure on the government budget to provide for subsidies and incentives for the production of a particular commodity.
- ✓ It also obviates the need for higher taxation. The major drawbacks of dual pricing are as follows:
- ✓ There is a problem of leakages in administering the system of 'dual pricing.' This problem occurs when there is a vast difference between the 'issue price' and 'open market price' of the product. The leakage means transfer of levy quantity for the sale in open market by the producers.
- ✓ It may lead to black marketing.
- ✓ It may induce/intensify corruption.
- ✓ It may involve deterioration of quality of the output released for procurement.
- ✓ It increases the financial burden for the government in organising distribution system.

- ✓ It may put the government into an embarrassing position when over a period there is a tremendous expansion of output causing a 'surplus' in the economy so that at a time free market price tends to be lower than the levy price.

4.6 Price Discrimination

A monopoly firm which adopts the policy of price discrimination is referred to as a discriminating monopoly. Price discrimination implies the act of selling the output of the same product at different prices in different markets or to different buyers. In a broad sense, price discrimination occurs in two ways: *(i)* by charging different prices for the same product, and *(ii)* by not setting prices of different varieties of products or different products in relation to their cost differences. In the theory of discriminating monopolies, however, for the sake of simplicity and convenience, the meaning of price discrimination is basically confined to the former notion, *i.e.*, charging of different prices for the same product to different buyers or in different markets. Indeed, the conclusion arrived at from this simple variation of price discrimination can be extended to a more complicated version.

Forms of Price Discrimination

Price discrimination may take many forms and guises. The common forms of price discrimination may be stated as under:

i) Personal discrimination

Generally, depending upon the economic status of buyers, different prices may be charged to different buyers in providing similar services. For example, a surgeon may charge a high operation fee to a rich patient and a lower fee to a poor one. Similarly, lawyers may charge different fees to different types of clients depending on theirincome status. A teacher also discriminates between rich and poor students as regards his private tuition fees.

ii) Age discrimination

Price discrimination may be based on the basis of age of the buyers. Usually, buyers are grouped into children and adults. Thus, for instance, a barber may charge lower rates for children's haircuts than those for adults. In railways and bus transport services, it is a commonly adopted form of price discrimination that persons below 12 years of age are charged at half the rates.

iii) Sex discrimination

In selling certain goods, producers may discriminate between male and female buyers by charging low prices to females. For instance, a tour organising firm may provide seats to ladies at concessional rates. In certain cinema houses in small towns, a *Zenana* show may be arranged at concessional rates for ladies only.

iv) Locational or territorial discrimination

When a monopolist charges different prices in different markets located at different places, it is called locational or geographical discrimination. For instance, a film producer may sell distribution rights to different film distributors in different territories at different prices. Similarly, a firm may discriminate between domestic markets and export markets for its products.

v) Size discrimination

On the basis of size or quantity of the product, different prices may be charged. For instance, an economy size toothpaste tube is relatively cheaper than a small size tube. Similarly, a product is sold in the retail market at a higher price than in the wholesale market by the producer.

vi) Quality variation discrimination

On the basis of some qualitative differences, different prices may be charged for the same product. For instance, a publisher may sell a deluxe edition of the same book at a higher price than its paperback edition. Quality variation may be in the form of material used, the nature of packing, colour, style, etc. Thus, jellies packed in tins are sold at a lower price than in bottles. A tailor charges higher stitching charges for a safari bush shirt than for an ordinary shirt. A particular print or colour saree may be priced higher than other sarees of the same cloth.

vii) Special service or comforts

Price discrimination may also be resorted to on the basis of special facilities or comforts. Railways, for instance, charge different fares for the first class and second class travel. Similarly, cinema houses keep different admission rates for stalls, upper stalls, dress circle and balcony. Likewise, restaurants charge different rates for special rooms and general tables. In a hospital also, charges for special wards and general wards are different.

viii) Use discrimination

Sometimes, depending on the kind of use of the product, different rates may be charged. For instance, an electricity distribution company may charge low rates for domestic consumption of electricity while still lower rates for industrial use as compared to the higher rates for light and fan.

ix) Time discrimination

On the basis of the time of service, different rates may be charged. For instance, cinema houses charge lower rates of admission for morning and matinee shows than for regular shows. Similarly, the telephone company charges half-rates for trunk-calls at night.

x) Nature of commodity discrimination

Sometimes, because of the nature of a commodity, price discrimination may be made, for instance, freight charges by the railways are different for coal and iron for the same distance. The Ingredients for Discriminating Monopoly: Conditions Essential for Price Discrimination

The following are the essential conditions enabling the firm to resort to price discrimination:

i) Monopoly

Monopoly is a prerequisite of price discrimination. Undoubtedly, price discrimination is incompatible with perfect competition, because, as there are many sellers selling a homogeneous product, if one seller quotes a higher price to a group of buyers, who know the ruling market price, it is quite likely that they will go to other sellers. Under a monopoly, price discrimination is possible because even though different buyers would know that they are differently charged, they have no alternative source of buying the product. Monopoly is a necessary but a sufficient condition to engage in price discrimination. Other ingredients for price discrimination are as follows:

ii) Segmentation of the market

The monopolist should be in a position to segment the market by classifying the buyers into separate groups. When total market is divided into submarkets, each submarket acquires a separate identity so that one submarket has no connection with the others. Again, consumers have no inclination to move from a high priced market to a low priced one, either due to ignorance or absence of inertia.

iii) Apparent product differentiation

Through artificial differences in the same product, such as differences in packing, brand name, etc., an apparent product differentiation may be created, so that it can be sold to the poor and the rich consumers at different prices. Price discrimination, with product differentiation, is tolerated by buyers.

iv) Buyers' illusion

When consumers have an irrational attitude that high priced goods are always highly qualitative, a monopolist can resort to price discrimination. Obviously, there is hardly difference in viewing a film from the last row of the stalls and from the front row in the upper stall seats, yet a purchaser of an upper stall seat derives greater pleasure or place utility of occupying a high priced seat.

v) Prevention of resale or re-exchange of goods

Goods of discriminating monopoly, sold in different markets, should not be re-exchangeable between buyers of a low priced market and a high priced market. Wide geographical distance, high cost of transport, national frontiers (in case of internationally traded goods) and tariffs, effectively prevent re-exchange.

vi) Non-transferability characteristics of goods

There are some goods which, by their very nature, are non-transferable between one buyer and another. In direct personal services, therefore, price discrimination is easily resorted to because of this non transferability characteristic. Obviously, a poor person cannot go on behalf of the rich to get medical treatment from a doctor. Similarly, haircuts, private tuitions, etc., are non-transferable services by their very nature.

vii) Let-go attitude of buyers

When price differences between two markets are very small, the consumers do not think it worthwhile to consider such discrimination. For instance, in the distribution of Dalda Vanaspati (cooking medium), there is a zonal price differential which is a marginal one, so that we hardly pay any attention to such differences of 5 to 10 paise per kilogram in different zones.

viii) Legal sanction

When, in some cases, price discrimination is legally sanctioned, the transfer of use of the produce is legally prohibited in order to make it effective. For instance, if electricity, for domestic purposes is used for commercial purposes, the customer is liable to penalties.

When Is Price Discrimination Profitable?

Even though circumstances may favour price discrimination, it may not be always profitable for the monopolist. Price discrimination is possible when there are different separate markets. But, the profitability aspect of price discrimination basically depends on the nature of elasticity of demand in these markets. Thus, the basic conditions of profitable price discrimination are:

1. Elasticity of demand differs in each market.

The cost-differential of supplying output in different markets should not be large in relation to the price-differential based on elasticity-differential.

Indeed, the elasticity-differential in different markets is a very vital condition. If the degrees of elasticity of demand at each price in different markets have the same numerical coefficient, price discrimination cannot be profitably adopted. Thus, markets with identical elasticities of demand will be treated as one by the monopolist from the price policy point of view. Because, in order to maximise profit, the monopolist follows the rule of equating marginal cost with marginal revenue. When the monopolist considers separate markets, he takes the combined marginal revenue (*CMR*) by aggregating the marginal revenue of different markets and distributes equilibrium total output in different markets so that marginal revenues in each market are the same.

Now, if the monopolist faces iso-elastic demand curves in two markets, he will not resort to price discrimination, because he finds that it cannot improve upon his total revenue; so it cannot add to his profits. When at a single price, elasticities of demand are equal in two markets, their average revenue are equal, so their marginal revenues too are equal. This is apparent from the formula:

MR = P (e – 1) /e

Now, when *P* and *e* are the same in two markets, it follows that *MR* in the two markets is the same. Hence, if any amount of output is transferred from one market to the other and different prices are charged, the aggregate total revenue from the two markets will remain the same as before. This means, that the gain realised in one market is lost in the other. Hence, the purpose of price discrimination, *i.e.*, to maximise profit, is not served. The monopoly profit, whether in simple monopoly or discriminating monopoly in this situation, remains the same. So, the monopolist will not resort to price discrimination and displease his buyers for no material gain.

It follows that if elasticities of demand in two markets at a single monopoly price are different, it would be profitable to adopt price discrimination. Because when elasticity differs in two markets at a given price, the marginal revenue in the two markets will not be identical. To clarify the point, let us assume two markets I and II, and the single monopoly price Rs. 10; say, elasticity of demand in market I, $e1 = 2$, while in market II, $e2 = 4$.

Thus,

In market I, $MR_1 = P = \left(\frac{e-1}{e}\right) = 10\left(\frac{2-1}{2}\right) = 5$

While, in market II, $MR_2 = 10\left(\frac{4-1}{4}\right) = 7.5$

Again, *MR* is high in market II, having a higher elasticity of demand. Hence, if output is transferred from the low elasticity market to the high elasticity one, marginal gain will be more than marginal loss. For instance, if one more unit is sold in market II, the gain will be Rs. 7.50 while the loss in market I is Rs. 5. Hence, net gain is Rs. 2.50. But on account of the downward sloping demand curve, the price will have to be lowered in market II in order to sell more.

Suppose the price is lowered to Rs. 9. Then, $MR2 = 9 \times (4 - 1)/4 = 6.75$.

Correspondingly, due to lesser output supplied in market I, the price may rise there, to say Rs. 11. Then, $MR1 = 11 \times (2-1)/2 = 5.50$. This means, by resorting to price discrimination, *MR* of inelastic demand market is also improved, and consequent rise in average and total revenue leads to a rise in total profit.

It may, therefore, be concluded that price discrimination is a profitable proposition to a monopolist only when he deals with different markets with different elasticities of demand.