Considerations in Setting Retail Prices

Price Experiment

An approach used to measure the price sensitivity of customers

Number of movie tickets sold at different prices

Results of Price Experiments

<table>
<thead>
<tr>
<th>Thea</th>
<th>Price</th>
<th>Quantity Sold</th>
<th>Column (B) x Quantity (C)</th>
<th>Column (D) + Fixed Cost</th>
<th>Fixed Cost</th>
<th>Column (E) - Column (D) - Fixed Cost</th>
<th>Column (F) - Column (E) - Fixed Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>9.00</td>
<td>6,180</td>
<td>$52,910</td>
<td>$51,500</td>
<td>51,500</td>
<td>1,410</td>
<td>1,410</td>
</tr>
<tr>
<td>2</td>
<td>9.25</td>
<td>5,620</td>
<td>$52,250</td>
<td>$51,500</td>
<td>51,500</td>
<td>750</td>
<td>750</td>
</tr>
<tr>
<td>3</td>
<td>9.50</td>
<td>5,250</td>
<td>$51,430</td>
<td>$51,500</td>
<td>51,500</td>
<td>970</td>
<td>970</td>
</tr>
<tr>
<td>4</td>
<td>9.75</td>
<td>4,800</td>
<td>$50,775</td>
<td>$51,500</td>
<td>51,500</td>
<td>725</td>
<td>725</td>
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<tr>
<td>5</td>
<td>8.00</td>
<td>2,373</td>
<td>$22,904</td>
<td>$21,380</td>
<td>21,380</td>
<td>824</td>
<td>824</td>
</tr>
<tr>
<td>6</td>
<td>8.50</td>
<td>2,150</td>
<td>$17,475</td>
<td>$16,860</td>
<td>16,860</td>
<td>610</td>
<td>610</td>
</tr>
</tbody>
</table>
Price sensitivity of customers (demand curve)

Quantity Sold at Different Prices

If customers are very price sensitive, sales decrease significantly with price increase.

Profit at Different Prices

Legal and Ethical Pricing Issues

- Price Discrimination
- Predatory Pricing
- Vertical market restraints
  - Resale Price Maintenance
  - Exclusivity
- Bait and Switch tactics
- Scanned vs. Posted Prices
- Sale Pricing
How Do Retailers Set Retail Prices?

Theoretically, retailers maximize their profits by setting prices based on the price sensitivity of customers and the cost of merchandise and considering the prices being charged by competitors.

In reality, Retailers need to set price for over 50,000 SKUs many times during year
- Set prices based on pre-determined markup and merchandise cost
- Make adjustments to markup price based on customer price sensitivity and competition

Retail Price and Markup (MU)

Retail Price = Cost of merchandise + Markup

Retail Price = Cost of merchandise + Retail price x Markup %

Retail price = \( \frac{\text{Cost of merchandise}}{1 - \text{Markup} \% \text{ (as a fraction)}} \)
**Markups**

*Initial markup* – retail selling price initially set for the merchandise minus the cost of the merchandise.

*Maintained markup* – the actual sales realized for the merchandise minus its costs.

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**Initial and Maintained Markup**

- **Initial Retail Price**: $1.00
- **Cost of Merchandise**: $0.60
- **Maintained Markup**: $0.30
- **Maintained Markup as a Percent of Actual Sales**: 33% = $0.30/$.90
- **Reductions**: $0.10

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**Initial markup**

- **Initial markup %** = 100% + **Reductions %** (as a percent of planned actual sales)
- **Maintained markup %** (as a percent of planned actual sales)
**Initial Markup and Initial Retail Price**

Merchandise costs $0.60. If the buyer planned on reductions of 10% of sales and wanted a maintained markup of 33% for the merchandise,

\[
\text{Initial markup} \% = \frac{33\% + \left(0.10/0.90 = 11.11\%\right)}{100\% + 11.11\%} = 40\%
\]

\[
\text{Initial retail price} = \text{Cost} \div (1 - \text{Initial markup} \%) = \frac{0.60}{1 - 0.40} = 1.00
\]

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**Maximize Profits through Price Discrimination**

Want Charge Every Customer the Maximum They Are Willing to Pay

Problem

- Don’t know willingness to pay
- With list prices, can’t prevent high willingness to pay customers from buying at low price

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**Price Discrimination**

- **Individualized Variable Pricing** (First Degree of Price Discrimination) – Set unique price for each customer equal to customer’s willingness to pay
  - Auctions, Personalized Internet Prices

- **Self-Selected Variable Pricing** (Second Degree of Price Discrimination) – Offer the same price schedule to all customers
  - Quantity discounts, Early Bird Special, Over Weekend Travel Discount, sales – markdowns, EDLP vs. Hi-Lo pricing

- **Pricing for Different Segment (Third Degree)**
  - Student discount. Ladies night, zone pricing
Pricing Strategies

EDLP
- Assures customers low prices
- Reduces advertising and operating expenses
- Better supply chain management
  - Fewer stockouts
  - Higher inventory turns

Hi-Lo
- Higher profits through price discrimination
- More excitement
- Build short-term sales and generates traffic

Pricing Services

Challenges due to
- The need to match supply and demand
- The difficulties customers have in determining service quality

Matching Supply and Demand for Services

“Services are intangible and thus cannot be stocked”
Airline tickets Theater tickets, Concert tickets

“Services have capacity constraints”
Restaurants, Hotels, Flights, Concerts

Seats for some Hannah Montana concerts go for $237 on StubHub, when the face value for the ticket is $63

Yield Management:
The practice of adjusting prices up or down in response to demand to control the sales generated
Pricing Techniques for Increasing Sales

- Leader Pricing
- Price Lining
- Odd Pricing

**Leader Pricing**

- Certain items are priced lower than normal to increase customers traffic flow and/or boost sales of complementary products
- Best items: purchased frequently, primarily by price-sensitive shoppers
- Examples: bread, eggs, milk, disposable diapers
- Might attract cherry pickers

**Price Lining**

- A limited number of predetermined price points.
- Ex: $59.99 (good), $89.99 (better), and 129.99 (best)
- Benefits:
  - Eliminates confusion of many prices
  - Merchandising task is simplified
  - Gives buyers flexibility
  - Can get customers to "trade up"
Odd Pricing

- A price that ends in an odd number (.9)
- $2.99
  - Assumption:
    - Consumers perceive as $2 without noticing the digits
    - 9 endings signal low prices
    - Retailers believe the practice increases sales, but probably doesn’t
- Does delineate:
  - Type of store (downscale store might use it.)
  - Sale

Guidelines for Price-ending Decisions

- When the price sensitivity of the market is high, it is advantageous to raise or lower prices so they end in high numbers like 9.
- When the price sensitivity of the market is NOT high, the risk to one’s image of using 9 is likely to outweigh the benefits. Even dollar prices and round numbers are appropriate.
- Upscale retailers appeal to price-sensitive segments of the market through periodic discounting. Combination strategy works best: break from standard of using round number endings to use 9 endings when communicating discounts and special offers.

How Can Retailers Reduce Price Competition?

- Develop lines of private label merchandise
- Negotiate with national brands manufacturers for exclusive distribution rights
- Have vendors make unique products for the retailer
Illustration of Breakeven Analysis:
Break-even volume of a new private-label product

Break-even quantity = \frac{Fixed cost}{Actual unit sales price – Unit variable cost}

= \frac{$700,000}{$12 – $5}

= 114,286 bags

Now assume that PETsMART wants to make $100,000 profit from it

= \frac{$700,000 + $100,000}{$12 – $5}

= 114,286 bags

Illustration of Breakeven Analysis:
Break-even Sales of a new private-label product

Now PETsMART is considering lowering the price to $10 with the same profit goal. How many units does PETsMART need sell then to make the same profit from the price cut?

Break-even quantity = \frac{Fixed cost}{Actual unit sales price – Unit variable cost}

= \frac{$700,000 + $100,000}{$10 – $5}

= 160,000 bags

Unit sales must increase by 40%