Pricing Policy: A Tool to Implement Corporate

In many cases, in order to achieve their long tern vision, a manufacturer needs to coordinate their trade promotional policies (cost) and retail pricing policies (price) into a cohesive effort. To develop these two strategies in isolation is to not fully utilize the cost-price arsenal. An excellent example is the implementation of discounts, promotions and other pricing policies without significant research into the effectiveness, purposes or profitability of these strategies. Author Robert C. Maddux examines several of these promotions tactics and gives insight into how and why they can be counterproductive to revenue and growth goals.

Pricing is one of a company's most important and perhaps most neglected strategic resources. However, decisions on pricing need to be considered as the utilization of vital corporate assets. It is imperative that a manufacturer have an integrated, well planned pricing policy that penetrates all levels of their distribution channel. When a manufacturer does not have a clear, current, executable, and logical pricing strategy it leaves to chance and market forces the fate of its brand and its future.[1]

Pricing is often one of the most complex and contentious decisions facing a company. It often creates conflict between various divisions within a company. It is also one area of business research that is often overlooked by both managers and academicians, even though it is the only element of marketing that is directly related to revenues and profit.

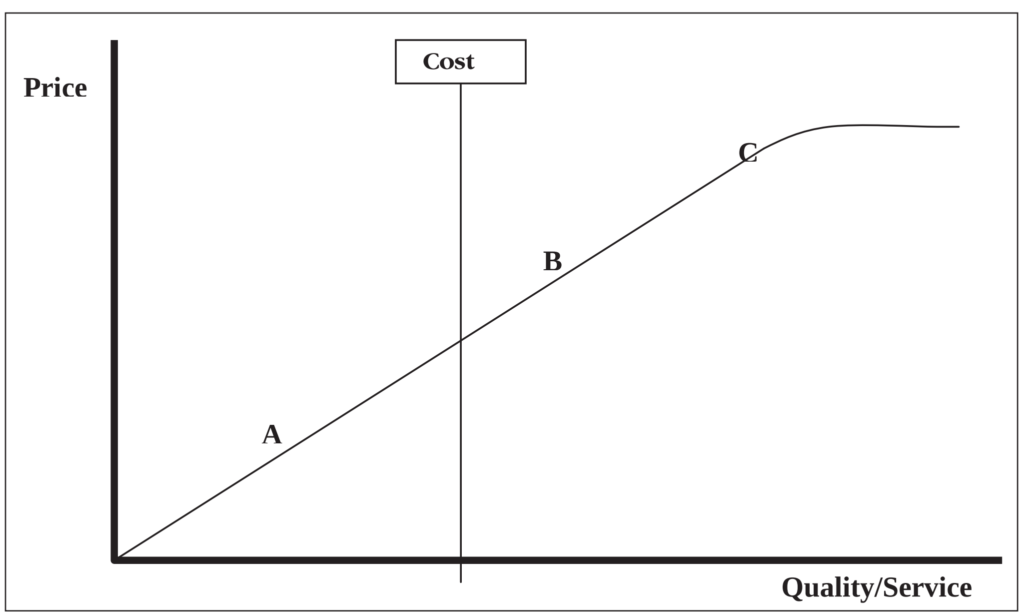
Pricing decisions in a company are often left to mathematicians who have derived complicated formulas. In many cases these mathematicians are more concentrated on producing a certain margin over what a product costs than with determining the product's actual value in the marketplace. The reason for studying and manipulating price should be to maximize value and profit.[2]

If the goal of pricing is to maximize value and profit, the cost of the product is not the starting point in a pricing strategy. The starting point is determining what a customer is willing to pay. Cost becomes a factor once market value has been determined. The goal is always to maximize profit; cost therefore is always a factor. But once market value has been determined, then cost may be affected by what the market demands.

It is possible that a manufacturer needs to raise or lower its cost based on what the customer wants. A customer may demand additional quality or service requiring a higher cost and selling price. Or, the customer may desire a lower quality or service requiring a manufacturer to cut their cost in order to reach the customer's price demands and still maximize profit.[2]

Looking at the graph below, most customers' "wants" lay somewhere on the Price/quality continuum. The higher the levels of quality and service they demand, the more they are willing to pay.

If the customers' "wants" lie at point C on the chart below, the company may need to raise their costs in order to provide that level of quality and/or service. However, if the customers' "wants" lie at point B, the company may need to reduce their costs with a resulting drop in quality and/or service in order to maximize profit. Finally, if the customers' "wants" lie at point A, the company may need to produce a new product or look at an alternative business model.



Strategy or a Reaction to Market Pressure

Pricing Promotions

Given that a manufacturer wants to maximize profit, why would they implement promotional pricing? Manufacturers use a number of pricing tools either to implement corporate strategy or react to market pressures. Among these tools are trade promotions, trade discounts, special discounts, volume discounts, suggested retail price, minimum advertised retail price, and minimum allowable retail price. In many cases, the reason why a manufacturer either did or would implement one or more of these tactics is not fully understood, long forgotten, or both, by the people in the company responsible for strategic management.

Exactly what is considered a "promotion" in today's market place often is unclear. For the purpose of this discussion, a promotion will be any additional discount off a manufacturers' "true" selling price (MTSP) to its primary retailers. Many manufacturers have numerous discount schedules and often play games with different discount structures and price lists. Manufacturers have wholesale price lists, distributor price lists, stocking dealer price lists, non stocking dealer price lists and more.

In this discussion, what we are referring to when we discuss the manufacturers' "true" selling price to its primary retailers is that price which the majority of retailers receive on a consistent basis. For example, if a manufacturer has a "wholesale price list" and 90% of the retailers in the market receive 20% off the wholesale price list as a standard procedure, then 20% off is not considered a promotion. It is considered the manufacturers' "true" selling price (MTSP) to its primary retailers. If 15% of the retailers receive 25% off for some qualifying reason, then that additional discount is considered the promotional discount. In addition, any discount or rebate that a reseller receives that is a factor of their purchases will be considered a promotion.

Discounts and Promotion:

It is important to understand why a manufacturer would want to have a promotional price. All manufacturers try to maximize net profit. It is therefore imperative to find the correct balance between price and quantity. Why would a manufacturer not just set what they believe is the optimum price and attempt to maximize profit dollars? Most of the reasons usually concern competition and market forces.

The following are two of the key reasons why manufacturers offer trade discounts and promotions:[4]

Capture maximum retailer inventory dollars: Most retailers have a certain amount of cash flow that is usually moderately fixed by their business activity. As the business grows or shrinks, this amount may vary, but for most typical retailers it is a fairly stable and constant variable. It is therefore in the manufacturer's best interest to try to capture as much of a retailer's total inventory dollars as possible. One key objective is to deny those dollars being spent with a competing manufacturer.

Capture maximum retailer inventory shelf space: As with inventory dollars, most retailers have a limited amount of space to store and display inventory. Capturing limited storage and display space can be of vital importance to a manufacturer. Consumers often purchase items they see or that are available at the moment. If a product is not on the shelf, in the line of sight or immediately available consumers are much less likely to buy it. Shelf space therefore becomes a high priority for many manufacturers, and the more visible the space the greater its importance. Therefore, manufacturers offer discounts and programs to capture a prominent place on the shelf.[3]

Types of Discounts and Promotions[1, 4]

Over the last twenty years manufacturers have created a number of types of discounts. Many of these discounts were developed in reaction to some type of market or competitive force. Regardless of the type of discount program, the two reasons stated above still appear to be the main intentions for having a discount or promotional program.

The numerous discount structures and types of promotion in use today can divided into the following nine basic types:

1. Quantity – Discount Schedules

A discount based on a quantity purchased is perhaps one of the oldest forms of promotional discounts and one of the earliest attempts of manufacturers to affect channel-coordination issues.[3] Basically these schedules reward retailers who buy greater quantities of inventory. Either through "quantity over time" or through "specific order size" a retailer is rewarded for buying specific quantities of inventory. There are also some circumstances in which a retailer can "double dip" on these promotions and purchase products with both types of discounts in effect.

It is evident that some manufacturers did not understand the long term consequences of these types of programs when they put them into effect. At first glance, it would appear logical to reward resellers with greater discounts the more inventory they purchased. This would certainly seem to be an excellent method

Many manufacturers have products that sell best during certain times of the year. A manufacturer wants to make sure that the right mix of products is on the limited shelf space at the correct selling time.

to gain retailer loyalty. However, in the absence of some type of retail price structure, which in many cases is illegal, this will also allow the strong reseller to get stronger and the weak to perish.

Furthermore, some manufacturers, when they implemented these discount programs, may not have realized that they were creating a situation that would allow for the growth of one regional retailer that was able to control the market and sometimes control the manufacturer. So how can this situation also affect consumer welfare? In a market with a large number of retailers of different sizes and strengths, a larger retailer, with multiple locations, can afford to function at a break-even or in a loss situation, in one location, for a sufficient period of time that could cause a smaller retailer to become insolvent. Once competition has been reduced or eliminated, the large firm is free to raise its price to a level higher than was currently in the market, or a level that might be controlled by a manufacturer's Retail Price Maintenance (RPM) agreement. Thus the manufacturer's discount structure, absence of RPM has allowed for the elimination of competition and the lowering of overall consumer welfare.[5, 6]

2. Time Sensitive Promotions (Push certain products at certain times)

Many manufacturers have products that sell best during certain times of the year. A manufacturer wants to make sure that the right mix of products is on the limited shelf space at the correct selling time. Therefore they often offer special promotions on the items that they want sold during these times, e.g. grass seed or deck stain at the beginning of summer.

3. New Customer/Growth Promotion

Many manufacturers offer some type of promotional buy for a retailer who is new to their line of products or to a current customer who wants to add an additional location. Most manufacturers want to grow through new outlets. In order to assist a retailer in opening an additional outlet or to entice a retailer to add their products or replace a competitor's products, an enticement in the form of a promotion is often given.

4. New Product Promotion

When a manufacturer introduces a new product it is imperative to have those products displayed and promoted. Therefore manufacturers often offer promotional buys around the introduction of a new product line. These promotions may have certain stipulations that require the reseller to participate in certain marketing activities. The level of involvement in the marketing activity by the reseller may affect the level of promotion from the manufacturer.

5. Reward for Compliance/Loyalty Discounts

A more recent phenomenon in today's business environment is the advent of manufacturer compliance programs. Today manufacturers are frequently trying to attract new customers and improve customer loyalty by offering a better buying experience. Many manufacturers sell to independently-owned retailers and often have no direct control over the way these resellers conduct business. Therefore they need to influence certain behaviors through monetary rewards. These types of programs can involve many diverse elements including store appearance and set up, personnel staffing levels and training, inventory mix and stock levels. They may also influence advertising programs and even the way the businesses operate concerning ethical practices. In addition, loyalty discounts are often included as part of a compliance program.

6. Segment Driven Promotions

Many companies face markets with a number of distinct and separate consumer segments in which willingness to pay for a product or service (price elasticity) differs greatly. In simple terms, one group of buyers is willing to pay more for a product or service than another group. In order to receive full value for their product from each segment, a company needs to find ways to segment, market, and price to these groups in diverse ways. For instance, the Wall Street Journal sells at one price to a standard household, perhaps a 70% discount to a college student, and a 100% discount to a college professor.

Segment driven promotions become more difficult when a company sells its product through resellers. Manufacturers are often faced with trying to pass a promotion to the targeted end user without passing additional discount to the reseller. When the discount is given to the reseller, it can be difficult to prevent the reseller from passing that discount to all segments instead of only to the particular segment the discount is intended to reach. These types of promotions are often referred to as price tailoring, and could perhaps be considered price discrimination.

In order to implement profitable segment driven promotions, the following three elements must exist:

- The different segments must have clear, definable boundaries.
- There must be a true willingness on the part of the segments to pay different prices.
- Finally the cost of implementing the program must be less than the sales increase received.[7]

7. Spiffs as Promotions

Manufacturers are beginning to realize that there are many factors, other than the power of their brand, that affect consumer preference. Consumers can be swayed by many factors, one of which is the recommendation of a professional. To the degree that reseller store personnel are seen as experts in a particular field they can have a strong influence on brand preference. Often brand preference can be shifted or modified by store personnel. Many manufacturers understand this "personnel modified preference" for brand selection and work hard to make sure retail store personnel are adequately trained on the merits and features of their products. However, some manufactures, under special circumstances, pay bonuses, usually referred to as "spiffs," directly to store personnel for selling their products. These spiffs have proven to be effective in influencing reseller staff to recommend one product over another

8. Year End "Make the Number" Promotions

What happens when the sales department is in charge of year end promotions? Often year end bonuses are linked to total sales for the year. When those sales are short of goals there are often last minute efforts to make these goals. Ad hoc promotions designed to make year end numbers can be the least effective and most costly promotions utilized. Usually these types of promotions do not increase yearly demand, but only move demand for one period to the next.

Experience has shown that in many cases the timing of a purchase by a retailer may be affected by a promotion, but the overall yearly purchases are not affected, creating a periodic but un-sustained peak in sales. These periodic swings in sales, production and inventory level are known as the "bullwhip effect".[1] What makes this particularly costly to manufacturers is that this peak demand often causes increased production cost on goods that are selling at a significant discount.

9. Promotions as a Tool to Reduce Manufacturing Cost

In many cases it actually costs a manufacturer more to generate products during a special promotion phase than it does to make them during normal demand times. Therefore a manufacturer's profits can be hit particularly hard during some promotional periods.[1] They take a reduction in their normal gross profit and their variable costs to produce the goods increases in order to meet increased demand. Meeting demand during promotional periods can involve overtime, increased warehousing and shipping costs, and even increases in the price of raw materials needing to be expedited. It is definitely in a manufacturer's best interest to try to schedule and plan demand periods. In an attempt to accomplish this, some manufacturers have built programs that reward "planned growth."

Measuring your efforts: Discounts, Promotions and Price Elasticity[7]

It may be surprising the number of companies that use a variety of promotions and discounts to accomplish a combination of the goals mentioned above and never stop to measure if their actions are actually effective in increasing the bottom line. When establishing pricing actions, many companies need to stop and understand the price elasticity of their products. Price elasticity is the most common gauge in use in determining responsiveness to price changes. Understanding that quantity purchased is a function of price charged is the basic tenant of price elasticity. Most business managers do not have a problem understanding price elasticity in a qualitative sense. If we drop or raise prices do we expect demand to go up, hold steady or plummet? The greatest difficulty is trying to quantify what effect our price changes or promotions will have on demand.[6]

In simple terms, price elasticity is the ratio of percentages that expresses the responsiveness of demand to a small change in price. Price elasticity can be divided into two major demand functions. These two demand functions are referred to as linear and constant. In the first case of a linear demand function, the slope is constant but the elasticity is not. Slope is the change in quantity when price changes slightly. Elasticity is the percentage change in quantity caused by a small percentage change in price. For a linear demand curve, the percentage change in quantity (elasticity) changes with price. [7]

The second case of a constant demand function describes a demand curve with a constantly changing slope. The demand conditions in this scenario are the opposite of the linear demand curve. The slope changes at every point while the elasticity remains constant. A constant elasticity demand curve assumes that a small percentage change in price will cause the same percentage change in quantity. The value of the initial price is unimportant. The rate of change in quantity versus price is equal to a constant throughout the curve. This constant which is expressed as a ratio of percentages, is the elasticity.[7]

For the purpose of quantification, price promotions can be divided into two broad categories;

- Temporary price reduction
- Permanent features of pricing structures

In order to quantify the value of temporary price promotions it is valuable to divide sales metrics into two key components: baseline and incremental. A company's baseline sales are those sales that would have been achieved in absence of any promotion or pricing action. A company's incremental sales are those additional sales caused by any such action. The incremental sales increase is also referred to as the "lift" associated with the promotion.

It is important to note that time plays a vital element in analysis of incremental sales. If a company only looks at its baseline and incremental sales in a narrow time frame there may appear to be a significant increase over baseline. However, if that same analysis is stretched over a longer period, it could show the incremental sales increase over baseline to be marginal or non-existent with the decrease in price. For a complete understanding of measuring pricing action please refer to chapters 7 and 8 of "Marketing Metrics: 50+ Metrics Every Executive Should Know" by Paul W. Farris et al.[6]

Until recently, attempts by manufacturers to implement any true Retail Price Maintenance (RPM) agreements have been met by the courts as automatic violations of current antitrust laws.

Is "every day low price" the answer?

Many manufacturers have put into effect a patchwork series of discounts and promotions that have evolved over the years in an attempt to resolve some of the dilemmas created by their poorly conceived mix of discounts and promotions. Often a new promotion solves one problem, but creates another. Over time, pricing and discount policies can become a mélange of special deals, one off programs, and specific incentives that make it difficult for business managers to understand or control their full effect. In an attempt to clean the slate, some manufacturers are investigating the merits of every day low prices (EDLP).

In fact, EDLP will level the playing field amongst retailers. As it has been mentioned, the use of various buying promotions has allowed larger retailers to become larger and stronger at the expense of smaller retailers. In addition EDLP will allow a manufacturer, to a greater degree, to establish a consistent manufacturing schedule that does not have as many peak demand periods and the associated costs of a group of promotional buys.[1]

EDLP probably will solve some of the ills that have been created by inadequately planned discounts and promotions that have been implemented over the years. However, when you remember the two key reasons why discounts and promotions were implemented in the first place, which are to gain more inventory dollars and gain more inventory shelf space, will an EDLP program create a situation in which a manufacturer is losing either of these two vital elements? Just as promotions have created many issues that were not foreseen or expected, one can predict that a fully implemented EDLP will also have some long term unforeseen and unexpected consequences.[1]

Before launching an EDLP program a strategic manager must consider the functions that current promotions are designed to perform. This analysis must consider the effect on subsequent order cycles as well competitive and channel reactions. A carefully constructed "modified" EDLP that includes discounts and promotions built around structured and planned long term goals may be the answer for some manufacturers.

The role of Retail Pricing Policies

Manufacturers have used promotional policy in an attempt to solve myriad distribution and retailer issues. They have also tried to use promotional policies in an attempt to control downstream prices that resellers charge to their consumers. However, these strategies often do not have the desired effect because the manufacturer has had little or no control over prices actually charged to the end user/purchaser by the reseller.

Manufacturers have also attempted to affect downstream prices on their products using a number of retail pricing tools. One of these tools is Minimum Advertised Price (MAP) which forbids a reseller from advertising a manufacturer's product on sale below a certain minimum price. Any MAP policy is as effective as the resolve of the manufacturer to enforce it. Some manufacturers have taken strong stands when dealing with violators of MAP policies. Others have turned a blind eye and their policy is more propaganda then regulation.

Another retail pricing tool that is often employed is manufacturer's Suggested Retail Price (SRP). Many manufacturers have published lists of prices which they use to recommend prices to resellers who are selling their products to retail customers. These prices can be an actual attempt by manufacturers to establish a value level for their products. But in reality these efforts are often ignored by the resellers who are under no obligation to utilize them and manufacturers have no power to enforce them.

A few courageous manufacturers have in fact implemented Mandatory Retail Pricing (MRP) under the Colgate Doctrine, a Supreme Court ruling that allows a manufacturer to enforce a mandatory retail pricing schedule, but only if it is an all or nothing proposition. However, it is a decision fraught with possible negative legal side effects and implementation difficulties.[5]

Until recently, attempts by manufacturers to implement any true

Retail Price Maintenance (RPM) agreements have been met by the courts as automatic violations of current antitrust laws. A RPM agreement is basically a manufacturer's requirement that downstream distribution conform to a set of minimum or maximum prices. Price maintenance agreements usually involve contracts that are enforceable through a set of consequences by the manufacturer if they are violated.

A recent United States Supreme Court ruling has cracked the door open slightly for manufacturers to consider using RPM agreements. However there is still an opportunity for legal action against manufacturers by the state courts. In the recent Supreme Court case, it was argued that RPM prices particularly affected high tech, information-intensive consumer durables. There are also ample examples to illustrate its effect on products that are considered commodities. In many product lines, however, there is a group of consumers that will benefit from higher prices on commodity type items because of the inherent needs of the customer, not the just the differentiation of the product. [5,6]

In a number of market situations, involving differentiated products, including brand names, RPM can actually serve to enhance consumer welfare. This happens when "retail service" becomes a fundamental element in the buying decision as opposed to price being the primary factor. Retail Service is broadly defined as the numerous elements that are a part of the decision and satisfaction fundamentals of a completed transaction. This may include more modern equipment, enhanced displays, product-specific information, improved store hours and locations, retailer certification, additional and superior trained customer service personnel, sufficient inventory, post sale satisfaction, and the list goes on.

The salient argument against Retail Price Maintenance is that it would be logical that retailers who provide these services would attract customers who desire them and Retail Price Maintenance would not be necessary. However this does not happen when a premium service retailer tempts an inferior service provider whose primary selling technique is price competition, to become what the court refers to as a "free rider." A "free rider" is a retailer who takes advantage of another company's assets and steals the customer on price alone. This becomes a vital factor when that customer could not have made the buying decision without the premium service provider.[5]

As discussed earlier, another way that RPM will secure long term overall consumer welfare is that it protects the small retailer from the regional or national entities that have the potential to lower their prices in one market in order to drive smaller competition out of business. A larger retailer can afford to work in a loss situation for a sufficient period of time that could cause a smaller retailer to become insolvent. Once competition has been reduced or eliminated, the large firm is free to raise its price to a level higher then was currently in the market, or a level that might be controlled by RPM. Thus the absence of RPM has allowed for the elimination of competition and the lowering of overall consumer welfare.

There is another factor at play here. It is one that allows certain manufacturers to be able to pick and choose in which markets they will compete purely on price and which markets they will compete on service. Some manufacturers that also have completely vertically integrated retail operations, who only sell through their own stores, can select which markets and customers they will sell products to based on price alone and in which markets they will choose to sell service. To the degree that customer segmentation can be fined tuned so that a manufacturer knows where their "service oriented customers" reside, it can be argued that a vertically integrated manufacturer has a marked advantage over one that relies on second step distribution.

The current question now is what does the future hold for retail price maintenance agreements? Will the Supreme Court decision produce radical change in manufacturers pricing policies? Will manufacturer begin to exercise more courage in developing pricing and promotion policies that work to achieve their long term business goals?

In many cases, in order to achieve their long tern vision, a manufacturer needs to coordinate their trade promotional policies (cost) and retail pricing policies (price) into a coordinated effort. To develop these two strategies in isolation is to not fully utilize the cost-price arsenal. Company leaders may have to review who, within their organization, makes the decisions on reseller cost and retail price issues.

In cases where these strategic decisions are made in isolation from each other it cannot possible yield an optimum solution. If the marketing department is making all decisions on the cost at which products are being sold to resellers and the sales department is making the decision on retail pricing schedules, one can not expect a coordinated perspective that will most effectively support long term corporate strategy. Recent Supreme Court rulings (Leegin Creative Leather Products, Inc. v. PSKS, Inc, dba KAY's KLOSETS...KAY'S SHOES) [8] have definitely opened the door for manufacturers to have greater flexibility in coordinating those efforts.

A fully developed Cost-Price strategy is of greater importance for a manufacturer whose strategic direction is to be a premium service provider as opposed to a low cost leader. According to Z John Zhang, a Wharton marketing professor, "Previous legal treatment of retail price maintenance meant that specialty stores had diminishing incentive to offer informational and other services, since consumers were likely to purchase goods at discounters after tapping specialty stores for data about the goods," he says. "Now, with fewer obstacles to retail price maintenance, more retailers may be encouraged to provide service." [9] It is now up to manufacturers to have the vision and courage to move in this direction if they want to establish their brands as premium, and exemplary service is a key element to that brand offering.

Note:
A special thanks to Dr. Paul Farris (Landmark Communications Professor of Business Administration, University of Virginia, Darden School) for all of his help and guidance in my academic pursuits.

References:

1. Kusum Ailawadi, Paul Farris, Ervin Shames. "Trade Promotion: Essential to Selling through Resellers." Sloan Management Review (1999).

2. Kostis Indounas. "Making Effective Pricing Decisions" Athens University of Economics and Business, Indiana University, Kelley School of Business, HBS BH 211.

3. Paul Farris & Kusum Ailawadi. "Retail Power: Monster or Mouse?" Journal of Retailing Vol 68 #4 (Winter 1992).

4. James Olver & Paul Farris. "Push and Pull; A One-Two Punch for Packaged Goods." Sloan Management Review # 53 (Fall 1989).

5. Kenneth G. Elzinga and David E. Mills "The Economic of Resale Price Maintenance." Forthcoming in Wayne D. Collins, Issues in Competition Law and Policy, American Bar Association Antitrust Section (2008).

6. Marie L. Fiala and Scott A. Westrich. "Leegin Creative Products; What does the New Rule of Reason Standard Mean for Resale Price Maintenance Claims?" The Antitrustsource (August 2007).

7. Paul W. Farris et al. "Marketing Metrics: 50+ Metrics Every Executive Should Know." Wharton School Publishing (Jan. 2007) Chapters 7 and 8.

8. Leegin Creative Leather Products, Inc. v. PSKS, Inc, dba KAY's KLOSETS...KAY'S SHOES. Supreme Court of the United States (2007)

9. "Retail Price Maintenance Policies: A bane for Retailers, but a Boon for Consumers." Knowledge at Wharton. Stephen Laboton. "Century Old Ban Lifted on Minimum Retail Pricing." The New York Times. 29 June 2007.