The Buyer's Sensitivity to Price

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Introduction

Pricing is an important decision. For example, a 1% price improvement can yield much larger gains in operating profit such as 8-11% (Eugster, Kakkar and Roeegner, 2001; Marn and Rosiello, 1992). Pricing must be reasonable in order to maintain a sales level against competitors and yet yield a satisfactory profit as well.

The firm's understanding of both its external and internal environment influences pricing and market strategies. A firm needs to provide an appropriate fit between external and internal factors and pricing strategy. This can lead to development of strategic intent, mission and actions in pursuit of strategic competitiveness (Hitt, Ireland and Hoskisson, 2001). Pricing decision thus is a complex decision.

A two-level view extends this "environmental matching" approach advocating price setting at external level based on customer price sensitivity, competitive price level and government regulation; and also at internal level based on cost reduction, ROI, sales volume or production volume (Lancioni, 1998).

Furthermore, pricing is the financial basis of exchange. Therefore, pricing can seldom be made without reference to other parties in the exchange. These other parties are found in the market: prospective buyers and competitors. There is also an increasing intervention from a third source – the Government acting on behalf of what it sees to be in the public interest, leading to price controls and other anticompetitive laws related to pricing. In Horngren's words (1977), cost accountants and businessmen give excessive emphasis to costs as a guide to pricing. That is, they say and perhaps think that costs influence pricing decisions, but their actions show that customer demand and competitor behaviour greatly overshadow costs as price influencing factors.

How competitors, customers and government affect elasticity of demand?

As highlighted by Marn and Rosielo (1992), there are three distinct and closely related levels into which price management issues, opportunities and threats fall. One of them is industry supply and demand. At this highest level of price management, the basic laws of economics come into play. Changes in supply (plant closing, new competitors), demand (demographic shifts, emerging substitutes products, buyer behaviour), and costs (new technologies) have very real effects on industry price levels.

Competitors:

Market share tends to have an important influence on the pricing strategy. In a growing market, a firm with highly competitive strength may choose to price at or below (penetration) the market price in order to increase market share. While in a slow growth/no growth market, the same firm may decide to maintain or increase price (skimming) to increase the share of profits because it cannot increase the market share anymore. Going a step further, a firm in a dying market may opt for premium pricing to gain short-term profit since the product is in the decline stage of PLC. Another

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example of different pricing strategies for different competitive environments is predatory pricing. Predatory pricing occurs when companies set low prices with the intention of driving out competition and with the intention of raising rices later. This is a situation when due to high competition in the market the only way to gain share is to drive the existing competition out of market.

Besides the product market position, the pricing decision needs to be made in the context of likely competitive environment. It would be short sighted of managements contemplating price action not to consider the outcome of at least one stage of competitor reaction. However, there is a possibility that these reactions will not be very evident due to the different cost-volume-profit situation faced by firms (Simmonds, 1992). Economists concerned with price behaviour under oligopoly as well as monopolistic or imperfect competition have emphasized this element of competitive strategy in pricing for nearly a century. For example, in 1988 IBM or DEC were considered price leaders in international markets, setting prices taken by the market under oligopolistic conditions (Lancioni, 1998).

As Irving Fisher pointed out in 1898, no business man assumes either that his rivals' output or price will remain constant, any more than a chess player assumes that his opponent will not interfere with his effort to capture a knight. On the contrary, his whole thought is to forecast what move the rival will make in response to his own.

Other examples of influence of competition on price decisions include the pricing methods designed to suit different competitive situations in the market. Once such method is transfer pricing which is used as a strategic device in divisionalised firms facing duopolistic price competition. When transfer prices are observable, firms' headquarters will charge a transfer price above the marginal cost of the intermediate product to induce their marketing managers to behave as softer competitors on the final product market (Gox, 2000).

Customers

The pricing executives must be alert to general market conditions and to differences among customers in their willingness to pay higher prices (Shillinglaw, 1977). It is not surprising then that the main determinant of price from this perspective is what the customer is prepared to pay. This is related to: inherent or generated demand, benefits, value and distribution. For example, Inherent or generated demand has an influence particularly where supply is limited, such as in the housing market or the holiday market where increase in demand will push up the price.

In terms of benefits, an acceptable price will be determined to a considerable extent by the match between benefits that the product offers and benefits that the customer seeks. In particular, a premium price may be set if additional benefits are perceived. Brand loyalty (probably associated with quality) allows the setting of a premium price. Thus, software suppliers for, say library management systems (who are known to provide an effective support service and to offer effective upgrades and maintenance of software) are likely to be in a stronger position to charge a premium price than those who do not (Rowley, 1997).

Benefits can be conceptualised as the value that the customer sees in the product and in theory there should be a balance between this and the price demanded. Boulding (1968) and Eaton and Bawden (1991) have debated the issue of the value of information. Nevertheless, it remains true that value can vary between segments, depending to some extent on the way in which the information is used to generate wealth, and this accounts for the differential pricing of information to business and educational establishments. Buyers may have a range of acceptable prices, otherwise known as the reference price, for a specific product type, such as the time exchange that they are prepared to offer to locate a specific item of information or the price they are prepared to pay for an on-line search (Rowley, 1997).

Due to the increase in consumer awareness and easy access to information on prices of products and services through Internet, firms need to be careful about the price they are charging for their products. This implies that companies cannot avoid this cost transparency and will need to take different steps and approaches to deal with it. Companies can pursue the pricing strategies that go beyond just cutting their prices. One strategy involves price lining which is also called tiered pricing or versioning. Price lining is a well-known practice of offering different products or services at various price points to meet different customer's needs (Sinha, 2000). For example, America Online offers many plans at different prices for its customers worldwide based on the level of subscriber usage. Companies may also implement dynamic or smart pricing in which the prices they charge very firm one market to another, depending on market conditions, difference in the cost of serving individual buyers, and variations in the way consumers value the offering (Sinha, 2000). For example, Airlines, hotels have been practising this strategy for numerous years.

Government:

The government have had major influence on price variation in the form of laws and regulations of any country (Theodosiou and Katsikeas, 2000). One good example of this is resale price maintenance in Australia, which is enforced to protect customers from firms charging unnecessarily high price and also giving a fair chance to retailers to charge prices, as they feel appropriate. Local manufacturers are protected from unfair international competition through price controls and anti-dumping laws.

Furthermore, varying regulations and standards by regulatory authorities necessitate product modifications and process implementation to achieve certain standards of quality and safety thereby increasing costs and influencing price variations.

Numerous firms engage into differential pricing to get the maximum value for a given product from a particular customer. But due to the regulations of ACCC in Australia, firms must ensure they do not engage into price discrimination, which is illegal per se.

Case Examples:

Telecom (Kollmann, 2000) - The following example of Telecom industry clearly highlights how the customer demand, supply by firms, price, competition and government regulations are interlinked:

The de-regulation in the European telecommunication markets since the beginning of the 1990s has brought about significant changes in the communications industry. After the demise of the former state monopolies there is now increased competition in the market. New suppliers want to gain customers with new pricing structures. Finland, Sweden, the UK, Denmark and The Netherlands have opened up the market for free competition at an early stage. Other European states have dropped the monopoly system at the latest on 1st January 1998. Owing to the resulting price competition and newly created services the telecommunication industry has become the second largest industry. Growth rates of +25 per cent per year can be observed (EITO, 1998, p. 36ff.). The sector is further stimulated by the liberalisation of telecommunication deals across state boundaries. In a resolution of the 68 countries of the world trade organisation (WTO) on 15 February 1997, it was decided to prepare the ground for global competition gradually. This means that US providers can be equally as active in the European market as European providers in the USA. The provider scenario and charging structures have developed strikingly fast in Europe, so that they are not very different now from the competitive situation in the USA, where deregulation started as long as 14 years ago. We are not far away from a trans-national telecommunication market with global players, leading to numerous selection decisions on the subscriber side.

Deregulation and liberalisation of the telecommunication markets led to tough international competition, which is very sensitive to decisions in pricing policy for innovations in this area. The experience in Europe and the USA has demonstrated that it is possible to gain many private customers on the basis of lower charges and cheaper sets. In spite of continuing drops in prices it is nevertheless still possible to obtain high returns, owing to the rising number of subscribers. For example, through marginally cheaper prices it was possible for the small, private German provider TelDaFax to achieve a growth of 24 per cent of new customers in the German market in January 1999. This provider handles a throughput of 15million call minutes a day, representing no less than approximately US$32 million of turnover per month. The development towards a price dominated mass market leads to customers having more choice and the opportunity to compare the pricing structures of different providers.

International Pricing

While making pricing decisions for the international market, MNC's are generally faced with the question of whether to adopt the standardized pricing or customized pricing strategy. It is essential to take the following factors into consideration in order to determine the appropriate degree of standardization:

1. Macroenvironmental factors such as economic, legal, cultural, physical, and demographic (Douglas and Wind 1987; Jain 1989).
   On of the major obstacles to adopting the standardization approach is the difference in government laws and regulations across markets (Baalbaki and Malhotra 1995; Cavusgil, Zou, and Naidu 1993). Governments often impose price controls on certain products to protect local producers from international competition if it is deemed unfair. Pricing is also influenced by laws and regulations that necessitate product modifications in compliance with different technical specifications; health and safety standards; environmental protection acts; electric, weight, and measurement systems; and the like that may prevail in foreign markets (Buzzell 1968; Cavusgil, Zou, and Naidu 1993; Douglas and Wind 1987). Firms incur extra costs in order to make these modifications, which in turn force them, either to charge higher prices or to compress their profit margins.

2. Microenvironmental factors, such as customer characteristics, attitudes, and behaviour (Jain 1989); the structure and nature of competition (Cavusgil, Zou, and Naidu 1993; Ozsomer, Bodur, and Cavusgil 1991); and the availability, cost, and competencies of marketing intermediaries (Harvey 1993; Wind and Douglas 1986)
   The greater the similarity in customer characteristics and purchasing behaviour between an MNC's home and host countries, the higher is the degree of pricing standardization.

Conclusion

In conclusion, it is not an exaggeration to say that besides financial information, price decisions needs to be supplemented with market-based information viz. customers, competitors, government when market driven pricing is used. Environmental fit, important for firm survival, demands consideration of internal and external environments supplemented by both financial and non-financial information. Firms that understand the complexity of the pricing decision and act accordingly by paying due diligence to the elasticity of demand and role played by the customers, competition and government are likely to be rewarded with higher returns.

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