Chapter 2

Pricing in the Marketing Mix

In this chapter the role of pricing in the marketing mix is examined. An emphasis is placed on its importance and sample applications from the literature in which pricing strategies were developed alongside with the development of a marketing strategy are present. The main objective of this is to familiarize the reader with pricing research in the context of marketing. The importance of pricing also explains the great interest in the topic the management of the Nokia online shop in Germany has.

It will be shown that pricing has turned from cost oriented approaches to value based approaches. In value based approaches a marketer estimates the perceived values of a product and sets a price in view of these valuations. This is an important development because in order to estimate consumers' valuations for different product offerings a marketer needs reliable instruments for estimation.

Subsequent to the discussion regarding the role of pricing in the marketing-mix the next focus is on bundling strategies. Bundling is a special type of pricing strategy. Different types of bundling and underlying mechanisms will be introduced as simulations of different bundling strategies are part of the empirical investigation of this thesis, which will be presented in Chapter 8.

2.1 The Role of Pricing

Pricing is one of the most important elements of the marketing mix (Nagle and Holden (2002, p. 13), Monroe (2003, p. 8)). It is the only element that generates income. All other elements, such as advertising and promotion, product development, selling effort, distribution, packaging and so forth, involve expenditures. The price at which a product is finally offered interacts heavily with most other elements of the marketing mix. Setting the "right" price for a product or service is the number-one problem facing many marketing executives.

There exist many definitions of price in literature. Kotler and Armstrong (2001, p. 371) define price as "the amount of money charged for a product or service, or the sum of the values that consumers exchange for the benefits of having or using the product or service".

Cost-Based Pricing

Product $\longrightarrow$ Cost $\longrightarrow$ Price $\longrightarrow$ Value $\longrightarrow$ Customers

Value-Based Pricing

Customers $\longrightarrow$ Value $\longrightarrow$ Price $\longrightarrow$ Cost $\longrightarrow$ Product

Figure 2.1: Cost-Based versus Value-Based Pricing (Nagle and Holden, 2002, p. 4).

Monroe (2003, p. 5) defines price more formally as

$$P = \frac{M}{G}$$

with

P	:	Price
M	:	Quantity of money or goods and services received by the seller
G	:	Quantity of goods and services received by the buyer.

To employ a good pricing strategy for products a company needs good estimates of the amount of money customers are willing to pay for the offered products. In practice many firms still do not apply sufficient pricing strategies for their products (Monroe, 2003, p. 19). Among many possible mistakes in pricing decisions pricing is often too cost oriented, rather than being based on the values of the products as perceived by the customers. Another source of foregone profit is too little product differentiation. Product differentiation is the modification of a product to make it more attractive to a certain group of customers differentiating it from competitors' products. Differentiation aims at dividing the customers into segments and optimizing the products for the specific needs of the segments. Differentiation requires a sophisticated pricing strategy based on the perceived values of the products (Kotler and Armstrong, 2001, p. 371).

Mostly, the pricing of a product is placed inside a marketing strategy at a higher level, such as a skimming or penetration strategy. This strategy determines the surrounding factors for pricing. Within a defined strategy a firm may wish to seek short-term objectives for a single or a family of products. Among the most common objectives is profit maximization of the current product, or increase of market share. Both objectives rely on thorough knowledge of how the market will react to different pricing patterns. For such short-term objectives price is the most important element. It is the most flexible element of the marketing mix. It can be changed and adjusted quickly and short term adjustments translate directly into changes in profit and market shares.

Many companies base their prices for products on the consumers' perceived values. This approach is called *value-based pricing*. In contrast to *cost-based pricing* marketers do not design a product and marketing program and then set the price. Rather, price is considered along with the other marketing variables before the marketing program is set.