THE DISTRIBUTION STRATEGY ROLE AND THE PRICE POLICY ROLE IN SETTLING THE FIRM POSITION ON THE MARKET

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Abstract: In most companies, there is ongoing conflict between managers in charge of covering costs (finance and accounting) and managers in charge of satisfying customers (marketing and sales). Accounting journals warn against prices that fail to cover full costs, while marketing journals argue that customer willingness-to-pay must be the sole driver of prices. The conflict between these views wastes company resources and leads to pricing decisions that are imperfect compromises. Profitable pricing involves an integration of costs and customer value. To achieve that integration, however, both need to let go of misleading ideas and form a common vision of what drives profitability.

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Introduction

Costs should never determine price, but costs do play a critical role in formulating a pricing strategy. Pricing decisions are inexorably tied to decisions about sales levels, and sales involve costs of production, marketing, and administration. It is true that how much buyers will pay is unrelated to the seller's cost, but it is also true that a seller's decisions about which products to produce and in what quantities depend critically on their cost of production.

The mistake that cost-plus pricers make is not that they consider costs in their pricing, but that they select the quantities they will sell and the buyers they will serve before identifying the prices they can charge. They then try to impose cost-based prices that may be either more or less than what buyers will pay. In contrast, effective pricers make their decisions in exactly the opposite order. They first evaluate what buyers can be convinced to pay and only then choose quantities to produce and markets to serve.

Consequently, costs affect the prices they charge. A low-cost producer can charge lower prices and sell more because it can profitably use low prices to attract more price-sensitive buyers. A higher-cost producer, on the other hand, cannot afford to underbid low-cost producers for the patronage of more price-sensitive buyers; it must target those buyers willing to pay a premium price. Similarly, changes in costs should cause producers to change their prices, not because that changes what buyers will pay, but because it changes the quantities that the firm can profitably supply and the buyers it can profitably serve. When the cost of jet fuel rises, most airlines are not naive enough to try passing on the fuel cost through a cost-plus formula while maintaining their previous schedules. But some airlines do raise their average revenue per mile. They do so by reducing the number of flights they offer in order to fill the remaining planes with more full-fare passengers. To make room for those passengers, they eliminate or reduce some discount fares.

Thus the cost increase for jet fuel affects the mix of prices offered, increasing the average price charged. However, that is the result of a strategic decision to reduce the number of flights and change the mix of passengers served, not of an attempt to charge higher prices for the same service to the same people. Such decisions about quantities to sell and buyers to serve are an important part of pricing strategy for all firms and the most important part for many.

In this chapter, we discuss how a proper understanding of costs enables one to make those decisions correctly. First, however, a word of encouragement: Understanding costs is probably the most challenging aspect of pricing. You will probably not master these concepts on first reading this chapter. Your goal should be simply to understand the issues involved and the techniques for dealing with them. Mastery of the techniques will come with practice.

1. Determining relevant costs

One cannot price effectively without understanding costs. To understand one's costs is not simply to know their amounts. Even the least effective pricers, those who mechanically apply cost-plus formulas, know how much they spend on labor, raw materials, and overhead. Managers who really understand their costs know more than cost levels; they know how their costs will change with the changes in sales that result from pricing decisions.

Not all costs are relevant for every pricing decision. A first step in pricing is to identify the relevant costs: those that actually determine the profit impact of the pricing decision. Our purpose in this section is to set forth the guidelines for identifying the relevant costs once they are measured. In principle, identifying the relevant costs for pricing decisions is actually fairly straightforward.

They are the costs that are incremental (not average) and avoidable (not sunk).

In practice, identifying costs that meet those criteria can be difficult. Consequently, we will explain each distinction in detail and illustrate it in the context of a practical pricing problem.

2. Why Incremental Costs?

Pricing decisions affect whether a company will sell less of the product at a higher price or more of the product at a lower price. In either scenario, some costs remain the same (in total). Consequently, those costs do not affect the relative profitability of one price versus another. Only costs that rise or fall (in total) when prices change affects the relative profitability of different pricing strategies. We call these costs incremental because they represent the increment to costs (positive or negative) that results from the pricing decision.

Incremental costs are the costs associated with changes in pricing and sales. The distinction between incremental and nonincremental costs parallels closely, but not exactly, the more familiar distinction between variable and fixed costs. Variable costs, such as the costs of raw materials in a manufacturing process, are costs of doing business. Since pricing decisions affect the amount of business that a company does, variable costs are always incremental for pricing. In contrast, fixed costs, such as those for product design, advertising, and overhead, are costs of being in business. They are incremental when deciding whether a price will generate enough revenue to justify being in the business of selling a particular type of product or serving a particular type of customer. Since fixed costs are not affected by how much a company actually sells, most are not incremental when management must decide what price level to set for maximum profit. Some fixed costs, however, are incremental for pricing decisions, and they must be appropriately identified. Incremental fixed costs are those that directly result from implementing a price change or from offering a version of the product at a different price level.

For example, the fixed cost for a restaurant to print menus with new prices or for a public utility to gain regulatory approval of a rate increase would be incremental when deciding whether to make those changes. The fixed cost for an airline to advertise a new discount service or to upgrade its planes' interiors to offer a premium-priced service would be incremental when deciding whether to offer products at those price levels.

3. Why Avoidable Costs?

The hardest principle for many business decision makers to accept is that only avoidable costs are relevant for pricing. Avoidable costs are those that either have not yet been incurred or can be reversed. The costs of selling a product, delivering it to the customer, and replacing the sold item in inventory are avoidable, as is the rental cost of buildings and equipment that are not covered by a long-term lease. The opposite of avoidable costs are sunk costs—those costs that a company is irreversibly committed to bear. For example, a company's past expenditures on research and development are sunk costs since they cannot be changed regardless of any decisions made in the present. The rent on buildings and equipment within the term of a current lease is sunk, except to the extent that the firm can avoid the expense by subletting the property.

The cost of assets that a firm owns may or may not be sunk. If an asset can be sold for an amount equal to its purchase price times the percentage of its remaining useful life, then none of its cost is sunk since the cost can be entirely recovered through resale. Popular models of commercial airplanes often retain their value in this way, making avoidable the entire cost of their continued use. If an asset has no resale value, then its cost is entirely sunk even though it may have much useful life remaining. A neon sign depicting a company's corporate logo may have much useful life remaining, but its cost is entirely sunk since no other company would care to buy it. Frequently, the cost of assets is partially avoidable and partially sunk. For example, a new truck could be resold for a substantial portion of its purchase price but would lose some market value immediately after purchase. The portion of the new price that could not be recaptured is sunk and should not be considered in pricing decisions. Only depreciation of the resale value of the truck is an avoidable cost of using it.

From a practical standpoint, the easiest way to identify the avoidable cost is to recognize that it is the future cost, not the historical cost, associated with making a sale. What, for example, is the cost for an oil company to sell a gallon of gasoline at one of its company-owned stations? One might be inclined to say that it is the cost of the oil used to make the gasoline plus the cost of refining and distribution. Unfortunately, that view could lead refiners to make some costly pricing mistakes. The distinction between the historical cost of acquisition and the future cost of replacement is merely academic when supply costs are stable. It becomes very practical when costs rise or fall. When the price of crude oil rises, companies quickly raise prices, long before any gasoline made from the more expensive crude reaches the pump. Politicians and consumer advocates label this practice price gouging, since companies with large inventories of gasoline increase their reported profits by selling their gasoline at higher prices than they paid to produce it.

What happens when crude oil prices decline? If a company with large inventories held its prices high until all inventories were sold, it would be undercut by any company with smaller inventories that could profitably take advantage of the lower cost of crude oil to gain market share. The company would see its sales, profits, and cash flow decline. Again, the intelligent company bases its prices on the replacement cost, not the historical cost, of its inventory. In historical terms, it reports a loss. Unfortunately, even level-headed businesspeople often let sunk costs sneak into their decision making, resulting in pricing mistakes that squander profits.

4. Distribution strategy

In developing channel strategy, managers have two options to communicate value to their target customers:

"Push "strategies. The focus of communication is on the supplier's next immediate customer. Push strategies are aimed at propelling the supplier's offerings through the channel. For example, some manufacturers of overthe-counter (OTC) drugs and automotive paints do not promote these products directly to ultimate consumers. Instead, they focus on the retailer or auto-repair shops, expecting these channel firms to make the sale to the consumer. Channel firms that carry a variety of competing products may favor push strategies because they permit promoting products that are most profitable to the channel firm (the channel firm's customers frequently do not have strong preconceived preferences). Suppliers often find push strategies less expensive to implement.

"Pull" strategies. The focus of communication is on the end customer or a channel member closer to the end customer. Such strategies are aimed at pulling the supplier's offering through the distribution channel. For example, Intel maintains brand preference by advertising its chips to end consumers with the "Intel Inside®" campaign. The intent is to create a preference for computers with its chips-causing retailers to favor Intelbased computers. Channel members benefit from pull strategies when customers are "presold" for particular brands. Suppliers gain some control over channel firms because it is more difficult for channel firms to switch customers to competing brands.

Push strategies depend on channel intermediaries to carry the value message through the rest of the channel. Pull strategies "presell" the offering to the target customers, who then go to channel intermediaries with brand-specific demands.

Push strategies are essential when the supplier's product and its differential value are not apparent to target customers, or when its value delivery cannot be easily made salient to target customers. For example, most automobile buyers are unaware of the specific machine tools used in the manufacture of their automobile or of the specific brand of paint that covers it. For machinetool suppliers or automotive-paint manufacturers, convincing manufacturer that their products can make automobiles better or cheaper is more effective than trying to convince consumers to buy vehicles manufactured with a specific brand of machine tool or utilizing a particular paint. The main drawback to push strategies is they depend on the distribution channel to convey the value message to ultimate consumers. In some cases, push strategies may require managers to invest in developing the value-marketing skills of the entire distribution channel or risk having the channel not convey the value theme.

Pull strategies carry the value message directly to target customers. A pull strategy often gives a supplier greater control in communicating value to target customers. Further, pull strategies are often favored by channel intermediaries because they often create "presold" customers, thus reducing the marketing effort required by channel firms. More-exclusive retailers who compete with low-price outlets often prefer suppliers who invest in building brand image. Also, effective pull strategies can provide suppliers insurance against channel intermediaries who try to opportunistically sell competing offerings-customers arrive at the channel firm with strong brand preference.

Given these costs, it would seem that a pull strategy might be preferable, but there are three strong considerations recommending the push approach.

1. The costs are largeh variable-being proportionate to the amount of sales and the number of retail distribution outlets. This is a big advantage for a product that is starting out small. The cost of an effective advertising campaign could be prohibitive.

2. The retailers have pretargeted the market. In markets where demand is diffuse-few people are potential purchasers-the retailer (who may be a catalog or e-commerce company) has already identified them. Either the target consumers already know where to buy or retailers own a highly coveted customer list. For sales of scuba equipment, aids to the physically impaired and to people interested in do-it-yourself home repair, no advertising outlets exist to reach a majority of the potential buyers. All of the potential purchasers, however, will eventually need to visit a retailer or web site, or read a catalog which, given an adequate incentive, can promote the product.

3. The retailers or others in the chain "augment" the product. Few people would pay the prices for Mary Kay cosmetics if they were available on a rack in a drug store. The value is in the Mary Kay experience of being "made up" in the privacy of home. Mary Kay creates that experience with a team of independent distributors who are motivated by, among other things, high margins.

4. Pull strategies require sophisticated marketing, expertise that a firm may lack. Managers must know not only who might buy their product, but also understand why. They must connect their offerings to benefits and offerings that these target customers find salient, which may be difficult when channel firms augment the offering in a way that hides the supplier's components, and they must create messages that can be indirectly communicated convincingly in limited space or time.

Still, in most mature mass markets, pull strategies are preferred. They are cost-effective for high-volume, mass-marketed products, and they give the seller control over the message. Moreover, the mass-market channel partners like Wal-Mart, grocery chains, and drugstores prefer pull strategies despite lower margins. They make their money-moving inventory efficiently, not by selling. Moreover, a pull strategy creates a stronger brand identity that increases loyalty.

Pull strategies are an effective counter to brand competition for channel attention. When multiple brand competitors are competing for the same customers, opportunistic channel firms will play them against each other to extract higher margins and fees. Brands that are large enough to support the cost of a pull strategy can undermine the opportunist's ability to do this. Because customers are presold on the supplier's brand, an attempt to switch them to a competing product is more difficult.

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The choice between "push" and "pull" is usually difficult. Push strategies require both costly incentives for the retail channel partners and limited distribution. In introductory and growth markets, channel intermediaries must invest substantial resources in targeting potential customers and communicating value in return for uncertain sales that may occur considerably later. As a result, suppliers have to share a large portion of their sales price with channel firms as an incentive for the selling effort. In addition, when sales are uncertain or do not follow quickly, manufacturers generally must pay high fees for promotional efforts, such as cooperative advertising and in-store demonstrations.

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Conclusions

In markets where demand is diffuse-few people are potential purchasers-the retailer (who may be a catalog or e-commerce company) has already identified them. Either the target consumers already know where to buy or retailers own a highly coveted customer list. For sales of scuba equipment, aids to the physically impaired and to people interested in do-it-yourself home repair, no advertising outlets exist to reach a majority of the potential buyers. All of the potential purchasers, however, will eventually need to visit a retailer or web site, or read a catalog which, given an adequate incentive, can promote the product.

An efficient strategy regarding the competition involves offensive or defensive actions that aim to place the company into a supportable situation related to the five forces of the competition.

As an outcome, the company management must permanently appreciate the firm vulnerability degree and evaluate the resulting risk and everything related to the life expectation and the profitability expectation as these ones are defined in its objectives.

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