

# THE STRATEGY AND TACTICS OF PRICING

*A Guide to Profitable  
Decision Making*

THIRD EDITION

THOMAS T. NAGLE  
REED K. HOLDEN

PRENTICE HALL MARKETING SERIES

THIRD EDITION

# *The Strategy and Tactics of Pricing*

A Guide to Profitable  
Decision Making

THOMAS T. NAGLE

*Strategic Pricing Group, Inc.*

REED K. HOLDEN

*Strategic Pricing Group, Inc.*



Upper Saddle River, NJ 07458

**Library of Congress Cataloging-in-Publication Data**

Nagle, Thomas T., 1951–

The strategy and tactics of pricing: a guide to profitable decision making / Thomas T. Nagle, Reed K. Holden.  
p. cm.

Includes bibliographical references and index.

ISBN 0-13-026248-X

1. Pricing. 2. Marketing—Decision making. I. Holden, Reed K. II. Title.

HF5416.5 .N34 2002

658.8'16—dc21

2001036857

**Acquisitions Editor:** Whitney Blake

**Editor-in-Chief:** Jeff Shelstad

**Assistant Editor:** Anthony Palmiotto

**Editorial Assistant:** Melissa Pellerano

**Media Project Manager:** Michele Faranda

**Marketing Assistant:** Christine Genneken

**Managing Editor (Production):** John Roberts

**Production Editor:** Renata Butera

**Production Assistant:** Diane Falcone

**Permissions Coordinator:** Suzanne Grappi

**Associate Director, Manufacturing:** Vinnie Scelta

**Production Manager:** Arnold Vila

**Manufacturing Buyer:** Diane M. Peirano

**Art Director:** Jayne Conte

**Cover Design:** Bruce Kenselaar

**Manager, Print Production:** Christy Mahon

**Composition:** Carlisle Communications, Ltd.

**Full-Service Project Management:** Carlisle Communications, Ltd.

**Printer/Binder:** Phoenix Color Corp.

Credits and acknowledgments borrowed from other sources and reproduced, with permission, in this textbook appear on appropriate page within the text.

**Copyright © 2002, 1995, 1987 by Pearson Education, Inc., Upper Saddle River, New Jersey, 07458.**

All rights reserved. Printed in the United States of America. This publication is protected by Copyright and permission should be obtained from the publisher prior to any prohibited reproduction, storage in a retrieval system, or transmission in any form or by any means, electronic, mechanical, photocopying, recording, or likewise. For information regarding permission(s), write to : Rights and Permissions Department.



10 9 8 7 6 5 4 3 2 1

ISBN 0-13-026248-X

## **The Prentice Hall International Series in Marketing**

Philip Kotler, Series Editor

Anderson/Narus	<i>Business Market Management</i>
Armstrong/Kotler	<i>Marketing: An Introduction</i> , Fifth Edition
Ballou	<i>Business Logistics Management</i> , Fourth Edition
Batra/Myers/Aaker	<i>Advertising Management</i> , Fifth Edition
Berman/Evans	<i>Retail Management</i> , Eighth Edition
Best	<i>Market-Based Management</i> , Second Edition
Burns/Bush	<i>Marketing Research</i> , Third Edition
Coughlan/Anderson/	<i>Marketing Channels</i> , Sixth Edition
Stern/El-Ansary	
Cutlip/Center/Broom	<i>Effective Public Relations</i> , Eighth Edition
Hair/Anderson/Tatham/	<i>Multivariate Data Analysis</i> , Fifth Edition
Black	
Johnson/Wood/Wardlow/	<i>Contemporary Logistics</i> , Seventh Edition
Murphy	
Keegan	<i>Global Marketing Management</i> , Seventh Edition
Keller	<i>Strategic Brand Management</i>
Kerin/Peterson	<i>Strategic Marketing Problems</i> , Ninth Edition
Kotler	<i>Marketing Management</i> , Tenth Edition
Kotler/Andreasen	<i>Strategic Marketing for Nonprofit</i>
	<i>Organizations</i> , Fifth Edition
Kotler/Armstrong	<i>Principles of Marketing</i> , Ninth Edition
Lovelock	<i>Services Marketing</i> , Fourth Edition
Malhotra	<i>Marketing Research</i> , Third Edition
Manning/Reece	<i>Selling Today</i> , Eighth Edition
Nagle/Holden	<i>The Strategy and Tactics of Pricing</i> , Third Edition
Russell/Lane	<i>Kleppner's Advertising Procedure</i> , Fifteenth
	Edition
Sawhney	<i>PhotoWars: A Strategy Simulation CD</i>
Schiffman/Kanuk	<i>Consumer Behavior</i> , Seventh Edition
Solomon	<i>Consumer Behavior</i> , Fifth Edition
Strauss/Frost	<i>E-Marketing</i> , Second Edition
Urban/Hauser	<i>Design and Marketing of New Products</i> , Second
	Edition
Wells/Burnett/Moriarty	<i>Advertising</i> , Fifth Edition

*To Dan Nimer;  
Who labored alone  
with vision and persistence  
until others sought to share his wisdom*

# Preface

*“Pricing is the moment of truth—all of marketing comes to focus in the pricing decision.”*

When Raymond Corey wrote these words at the Harvard Business School in the early 1960s, marketing was just coming into its own as a strategic discipline that could drive the direction of a business. Unfortunately, few marketing practitioners actually took Corey’s words to heart. Enjoying their new prestige and power to influence corporate strategy, they were reluctant to let financial considerations constrain their “strategic” thinking.

Instead, they focused on achieving market share and customer satisfaction, believing that high profitability would somehow naturally follow. Marketing academics also slighted pricing, offering little research and few courses on the subject. Whenever the subject of pricing problems did arise, professors assured their students that all could be solved indirectly by redoubling efforts to differentiate products and services.

These attitudes toward pricing changed radically when marketers encountered the challenges of the 1980s. Companies with leading brand names saw brand loyalty and their power over distribution erode from years of price “promotion” to defend market share. Even large companies often found profits unattainable, as smaller firms targeted and lured away the most profitable customers (a practice labeled “cream skimming” by the victims). Successful corporate raiders then showed that they could increase cash flow and profits, often by raising prices, even as they lost some share. In the 1990s, a brief counterrevolution took place, as e-competitors bought market share from more efficient bricks and mortar competitors. By the end of 2000, most e-competitors went bankrupt, while the remainder looked for ways to charge prices consistent with financial viability.

Not only marketing practitioners are now under the gun to show that their efforts can ultimately pay off at the bottom line. So also are marketing theorists. Companies have become almost maniacal in their focus on increasing shareholder value. Strategies defined in terms of market share or customer satisfaction alone get short shrift. For marketers to achieve respect and influence,

the key is to show how their ideas can generate profitability. As a result, creative thinkers are integrating marketing thought with financial concepts.<sup>1</sup>

Successfully making that integration requires understanding not only what creates value for customers, but also how and when that value can be transformed into earnings per share. This does not mean that companies should regress to the days when they naively tried to increase profits by marking up costs with higher margins. It means understanding that strategic pricing is about much more than setting prices. It is about targeting markets that can be served profitably, communicating information that justifies price levels, and managing pricing processes and systems to keep prices aligned with value received.

These are not skills that have traditionally resided in finance or marketing departments. Strategic pricing is becoming a profession in its own right that bridges marketing, finance, sales, and top management. The Professional Pricing Society<sup>2</sup> reported in a survey of its members that pricing decisions were principally made by a pricing manager in 25 percent of the companies and by a cross-functional team in another 20 percent. Others cited were the marketing department (15 percent) and product manager (15 percent). Decentralized pricing by the sales organization was practiced in only 11 percent of these companies, and none had pricing principally made by finance. Although this is a biased sample, it is indicative that price in the most sophisticated companies is being proactively managed.

As in the first edition, the primary objective of this edition is to develop a practical and readable manager's guide to pricing, not a textbook. Our references are not necessarily to the seminal articles on the subject, but to those that are most managerially relevant and accessible. Professors will be happy to learn that an expanded Instructor's Manual for this edition includes new classroom exercises. We expect that the combination of clear writing and current, relevant examples will continue to make this the most popular reference on pricing for managers<sup>3</sup> as well as the most popular text in the classroom.

---

<sup>1</sup> Eugene W. Anderson, Claes Fornell, and Donald R. Lehmann, "Customer Satisfaction, Market Share, and Profitability: Findings from Sweden," *Journal of Marketing*, 58 (July 1994), pp. 53–66; Rolan Rust, Anthony J. Zatorik, and Timothy L. Keiningham, "Return on Quality: Making Service Quality Financially Accountable," *Journal of Marketing* 58 (April 1995), pp. 58–70; Rajendra K. Srivastava, Tasadduq A. Shervani, and Liam Fahey, "Market-Based Assets and Shareholder Value: A Framework for Analysis," *Journal of Marketing* 62(1), (January 1998), pp. 2–18.

<sup>2</sup> Professional Pricing Society, *PPS Members 2001 Current Practices Survey* (Atlanta, GA: 2001). For additional information about PPS and the survey, go to [www.pricingsociety.com](http://www.pricingsociety.com).

<sup>3</sup> As measured by [amazon.com](http://amazon.com).

# *Acknowledgments*

**W**e cannot practically enumerate all those people to whom we owe a debt of gratitude, but collectively they have contributed substantially to the content of this work. We wish to renew our thanks to all who contributed to the first and second editions and whose specific contributions were acknowledged there. The success of those earlier works gave us access to client companies and managers from whom we have learned much more about pricing strategy and implementation than would have been possible from purely academic research. Many thanks to our students and seminar participants whose probing questions and challenging problems continue to keep our work interesting and relevant.

We gratefully acknowledge the advice of numerous experts in marketing, pricing, and business management whose published and unpublished insights we have incorporated into this text. While we could never enumerate them all, we wish to acknowledge our special debt to George Cressman, Kent Monroe, Dan Nimer, and Mike Marn. Richard Harmer has contributed immensely to our thinking about pricing over the past fifteen years. His work is defining “value segments,” and his concepts of “segmentation fences” and “price metrics” are now widely adopted by pricing practitioners. He also contributed to our thinking about the role of income and affordability in pricing. Gerald (Jerry) Smith of Boston College coauthored two chapters in the second edition that have been revised and integrated into this edition, and he also added numerous examples and scholarly references to this edition. Jerry’s exceptional intellect added much to our own insights. Barry Margeson added an insightful section to Chapter 12. Eugene Zelek, an antitrust attorney and believer in creatively managing within rather than reacting to legal constraints, wrote the section in Chapter 14 on the law.

It is easy to underestimate how much work beyond writing is involved in publishing a book. Allison Bray edited the revised chapters. Evelyn Hennessey managed manuscript preparation. Susanna Barmakian and Bonnie Walsh secured permissions. We would like to thank our colleagues at Strategic Pricing Group who were understanding and supportive of our need for “writing time” and who accepted additional management and project responsibilities to give us that time.

Finally, Tom Nagle thanks his wife Leslie for her patience and spiritual guidance.

Reed Holden thanks his fiancée Carolyn Ruech, his children, Mark and Rebecca, and his parents Carl and “Bunny” Holden for their unwavering support over the years.



# *Brief Contents*

<b>CHAPTER 1</b>	<b>Strategic Planning: The Harvest of Your Potential</b>	<b>1</b>
<b>CHAPTER 2</b>	<b>Costs: How Should They Affect Pricing Decisions?</b>	<b>15</b>
<b>CHAPTER 3</b>	<b>Financial Analysis: Pricing for Profit</b>	<b>35</b>
<b>CHAPTER 4</b>	<b>Customers: Understanding and Influencing the Purchase Decision</b>	<b>73</b>
<b>CHAPTER 5</b>	<b>Competition: Managing Conflict Thoughtfully</b>	<b>119</b>
<b>CHAPTER 6</b>	<b>Pricing Strategy: Managing Your Market Proactively</b>	<b>147</b>
<b>CHAPTER 7</b>	<b>Life Cycle Pricing: Adapting Strategy in a Changing Environment</b>	<b>177</b>
<b>CHAPTER 8</b>	<b>Value-Based Sales and Negotiation: Influencing Customer Behavior</b>	<b>200</b>
<b>CHAPTER 9</b>	<b>Segmented Pricing: Tactics for Separating Markets</b>	<b>227</b>
<b>CHAPTER 10</b>	<b>Pricing in the Marketing Mix: Developing an Integrated Strategy</b>	<b>253</b>
<b>CHAPTER 11</b>	<b>Channel Strategy: Price Management</b>	<b>278</b>
<b>CHAPTER 12</b>	<b>Competitive Advantages: Establishing Foundations for More Profitable Pricing</b>	<b>305</b>



## BRIEF CONTENTS

- CHAPTER 13 Measuring Perceived Value and Price  
Sensitivity: Research Techniques to Supplement  
Judgment 332**
- CHAPTER 14 Ethics and the Law: Understanding the Constraints  
on Pricing 369**

# Contents

Preface	xix
Acknowledgments	xxi

## CHAPTER 1 Strategic Planning 1

The Harvest of Your Profit Potential	1
Why Pricing Is Often Ineffective	2
<i>The Cost-Plus Delusion</i>	2
<i>Customer-Driven Pricing</i>	6
<i>Competition-Driven Pricing</i>	7
<i>Asking the Right Questions</i>	8
The Discipline of Strategic Pricing	10
Summary	10
Notes	14

## CHAPTER 2 Costs 15

How Should They Affect Pricing Decisions?	15
The Role of Costs in Pricing	15
Determining Relevant Costs	16
<i>Why Incremental Costs?</i>	17
<i>Why Avoidable Costs?</i>	20
Avoiding Misleading Accounting	23
Estimating Relevant Costs	25
Percent Contribution Margin and Pricing Strategy	30
Summary	32
Notes	33

## CHAPTER 3 Financial Analysis 35

Pricing for Profit	35
Breakeven Sales Analysis: The Basic Case	37
Breakeven Sales Incorporating a Change in Variable Cost	39

Breakeven Sales with Incremental Fixed Costs	41
Breakeven Sales Analysis for Reactive Pricing	44
Calculating Potential Financial Implications	45
Breakeven Sales Curves	47
<i>Watching Your Baseline</i>	51
<i>Covering Nonincremental Fixed and Sunk Costs</i>	52
Case Study: Ritter & Sons	53
Summary	60
Notes	60
Appendix 3A: Derivation of the Breakeven Formula	62
Appendix 3B: Breakeven Analysis of Price Changes	64
Developing a Breakeven Chart	64
Breakeven Analysis with More Than One Incremental Fixed Cost	67
Breakeven Graphs	68
Summary	72

## **CHAPTER 4    Customers    73**

Understanding and Influencing the Purchase Decision	73
Role of Value in Pricing	74
Economic Value Estimation™: An Illustration	76
<i>Economic Value Profile</i>	80
<i>The Use of Economic Value Estimation™</i>	81
Factors Influencing Perceptions of Value	84
<i>Reference Price Effect</i>	84
<i>Difficult Comparison Effect</i>	88
<i>Switching Cost Effect</i>	90
<i>Price-Quality Effect</i>	91
<i>Expenditure Effect</i>	93
<i>End-Benefit Effect</i>	95
<i>Shared-Cost Effect</i>	97
<i>Fairness Effect</i>	97
<i>The Framing Effect</i>	102
Management of Value Perceptions and Price Sensitivity	104
Segmenting for Value Communication and Delivery	105
Summary	108
Appendix 4A: Economics of Price Sensitivity	109
Appendix 4B: Preparing a Managerial Price Sensitivity Analysis	111
<i>The Reference Price Effect</i>	111

<i>Difficult Comparison Effect</i>	112
<i>Switching Cost Effect</i>	112
<i>Price-Quality Effect</i>	112
<i>Expenditure Effect</i>	113
<i>End-Benefit Effect</i>	113
<i>Shared-Cost Effect</i>	114
<i>Fairness Effect</i>	114
<i>The Framing Effect</i>	114

Notes	114
-------	-----

## **CHAPTER 5    Competition    119**

Managing Conflict Thoughtfully	119
Understanding the Pricing Game	121
Competitive Advantage: The Only Sustainable Source of Profitability	122
Reacting to Competition: Think Before You Act	126
<i>Is there a response that would cost less than the preventable sales loss?</i>	127
<i>If you respond, is your competitor willing and able to cut price again to reestablish the price difference?</i>	131
<i>Will the multiple responses required to match a competitor still cost less than the avoidable sales loss?</i>	131
<i>Is your position in other (geographic or product) markets threatened if a competitor is successful in gaining share? Does the value of the markets at risk justify the cost of a response?</i>	131
How Should You React?	132
Managing Competitive Information	136
<i>Collect and Evaluate Information</i>	137
<i>Selectively Communicate Information</i>	139
<i>Preannounce Price Increases</i>	140
<i>Show Willingness and Ability to Defend</i>	140
<i>Back Up Opportunism with Information</i>	142
When Should You Compete on Price?	143
Summary	144
Notes	145

## **CHAPTER 6    Pricing Strategy    147**

Managing Your Market Proactively	147
Price Setting Versus Strategic Pricing	148
Creating a Pricing Strategy	149
Proactive Pricing: Structure and Process	150
<i>The Price Structure</i>	152
<i>The Pricing Process</i>	156

Value-Based Marketing Strategy	161
<i>Creating Customer Benefits</i>	162
<i>Communicating the Value Proposition</i>	163
Profit-Driven Competitive Positioning	164
<i>Skim Pricing</i>	166
<i>Customers</i>	166
<i>Costs</i>	167
<i>Competition</i>	168
<i>Sequential Skimming</i>	168
<i>Penetration Pricing</i>	170
<i>Customers</i>	170
<i>Costs</i>	172
<i>Competition</i>	172
<i>Neutral Pricing</i>	173
Summary	174
Notes	175

## **CHAPTER 7    Life Cycle Pricing    177**

Adapting Strategy in a Changing Environment	177
Pricing the Innovation for Market Introduction	178
<i>Marketing Innovations Through Price-Induced Sampling</i>	180
<i>Marketing Innovations Through Direct Sales</i>	181
<i>Marketing Innovations Through Distribution Channels</i>	182
Pricing the New Product for Growth	182
<i>Pricing the Differentiated Product</i>	183
<i>Pricing the Low-Cost Product</i>	184
<i>Choosing a Growth Strategy</i>	185
<i>Price Reductions in Growth</i>	188
Pricing the Established Product in Maturity	189
Pricing a Product in Market Decline	192
<i>Alternative Strategies in Decline</i>	192
Brand Stage Versus Product Life Cycle	195
Summary	197
Notes	198

## **CHAPTER 8    Value-Based Sales and Negotiation    200**

Influencing Customer Behavior	200
Value: The Basis for Policy-Driven Pricing	201
<i>Undoing the Damage</i>	202
<i>Understanding Buying Centers</i>	205

Types of Buyers and Their Negotiation Strategies	208
<i>Negotiating with Price Buyers</i>	208
<i>Negotiating with Relationship Buyers</i>	211
<i>Negotiating with Value Buyers</i>	212
Managing the Sales Force Toward Value-Based Pricing	213
<i>Account Planning</i>	213
<i>Profit-Focused Sales Incentives</i>	215
<i>Measuring the “Pocket Price”</i>	217
Summary	219
Appendix 8A Preparing Competitive Bids	220
Preparing Competitive Bids	220
<i>Quantitative Analysis</i>	220
<i>Probability of Success</i>	222
<i>Average Opponent Approach</i>	222
<i>The Winner’s Curve</i>	225
Notes	226

## **CHAPTER 9    Segmented Pricing    227**

Tactics for Separating Markets	227
Segmenting by Buyer Identification	229
<i>Obtaining Information</i>	230
Segmenting by Purchase Location	232
Segmenting by Time of Purchase	234
<i>Peak-Load Pricing</i>	235
<i>Setting Peak-Load Prices</i>	236
<i>Yield Management</i>	237
Segmenting by Purchase Quantity	239
<i>Volume Discounts</i>	239
<i>Order Discounts</i>	240
<i>Step Discounts</i>	240
<i>Two-Part Pricing</i>	241
Segmenting by Product Design	243
Segmenting by Product Bundling	244
<i>Optional Bundling</i>	245
<i>Value-Added Bundling</i>	246
Segmenting by Tie-Ins and Metering	247
<i>Tie-In Sales</i>	247
<i>Metering</i>	248
Importance of Segmented Pricing	249



Summary	250
Notes	251

## **CHAPTER 10 Pricing in the Marketing Mix 253**

Developing an Integrated Strategy	253
Pricing and the Product Line	253
<i>Pricing Substitute Products</i>	254
<i>Pricing Complementary Products</i>	256
<i>Selecting Loss Leaders</i>	257
<i>Product Line Pricing and Price Perceptions</i>	259
Pricing and Promotion	260
<i>Pricing and Advertising</i>	260
<i>Pricing and Personal Selling</i>	264
<i>Setting the Promotional Budget</i>	265
Price as a Promotional Tool	266
<i>Pricing Tactics to Induce Trial</i>	267
<i>Defensive Dealing</i>	270
<i>Trade Dealing</i>	272
Pricing and Distribution	274
Summary	274
Notes	275

## **CHAPTER 11 Channel Strategy 278**

Price Management	278
Channel Definitions	281
Channel Strategy	283
Selecting an Appropriate Channel	286
Channel Strategy Implementation	289
Maintaining Minimum Resale Prices	289
Limiting Maximum Resale Prices	291
Connecting Channel Strategies to Communication Strategy	294
Managing Price Through the Distribution Channel	297
Managing Retail Pricing Strategy	299
Managing in e-Commerce Channels	300
Summary	302
Notes	303



<b>CHAPTER 12 Competitive Advantages</b>	<b>305</b>
Establishing Foundations for More Profitable Pricing	305
Competitive Cost Advantages	306
<i>Internal Cost Efficiencies</i>	306
<i>Economies of Scope</i>	306
<i>Economies of Scale</i>	307
<i>Economies of Experience</i>	312
<i>External Cost Efficiencies</i>	316
<i>Economies of Buyer Focus</i>	316
<i>Economies of Logistical Integration</i>	317
<i>Efficiency in Transfer Pricing</i>	318
<i>Temporary Cost Advantages</i>	323
Competitive Product Advantages	324
<i>Product Superiority</i>	324
<i>Product Augmentation</i>	325
<i>Sustaining Product Advantages</i>	326
<i>Known Supplier</i>	327
<i>Buyers' Investments</i>	327
<i>Channel Preemption</i>	327
<i>Scarce Resource Preemption</i>	327
<i>Niche Marketing</i>	328
<i>Image</i>	328
Summary	328
Notes	329

## **CHAPTER 13 Measuring Perceived Value and Price Sensitivity 332**

Research Techniques to Supplement Judgment	332
Types of Measurement Procedures	332
<i>Uncontrolled Studies of Actual Purchases</i>	334
<i>Historical Sales Data</i>	334
<i>Panel Data</i>	335
<i>Store Scanner Data</i>	336
<i>Analyzing Historical Data</i>	336
<i>Experimentally Controlled Studies of Actual Purchases</i>	339
<i>In-Store Purchase Experiments</i>	339
<i>Laboratory Purchase Experiments</i>	341
<i>Uncontrolled Studies of Preferences and Intentions</i>	342
<i>Direct Questioning</i>	344
<i>Buy-Response Surveys</i>	345