nature gives rise to special marketing practices, whereas their commodity character results in relatively little advertising and promotional activity, with some exceptions. At times, commodity groups will launch campaigns to promote their product—potatoes, cheese, and beef. Some producers brand their products—Dole salads, Mott's apples, and Chiquita bananas.

Natural products are limited in supply. They usually have great bulk and low unit value and must be moved from producer to user. Fewer and larger producers often market them directly to industrial users. Because users depend on these materials, long-term supply contracts are common. The homogeneity of natural materials limits the amount of demand-creation activity. Price and delivery reliability are the major factors influencing the selection of suppliers.

Manufactured materials and parts fall into two categories: component materials (iron, yarn, cement, wires) and component parts (small motors, tires, castings). *Component materials* are usually fabricated further—pig iron is made into steel, and yarn is woven into cloth. The standardized nature of component materials usually makes price and supplier reliability key purchase factors. *Component parts* enter the finished product with no further change in form, as when small motors are put into vacuum cleaners, and tires are put on automobiles. Most manufactured materials and parts are sold directly to industrial users. Price and service are major marketing considerations, with branding and advertising less important.

Capital items are long-lasting goods that facilitate developing or managing the finished product. They include two groups: installations and equipment. *Installations* consist of buildings (factories, offices) and heavy equipment (generators, drill presses, mainframe computers, elevators). Installations are major purchases. They are usually bought directly from the producer, whose sales force includes technical personnel, and a long negotiation precedes the typical sale. Producers must be willing to design to specification and to supply postsale services. Advertising is much less important than personal selling.

Equipment includes portable factory equipment and tools (hand tools, lift trucks) and office equipment (personal computers, desks). These types of equipment don't become part of a finished product. They have a shorter life than installations but a longer life than operating supplies. Although some equipment manufacturers sell direct, more often they use intermediaries, because the market is geographically dispersed, buyers are numerous, and orders are small. Quality, features, price, and service are major considerations. The sales force tends to be more important than advertising, although advertising can be used effectively.

Supplies and business services are short-term goods and services that facilitate developing or managing the finished product. Supplies are of two kinds: *maintenance and repair items* (paint, nails, brooms) and *operating supplies* (lubricants, coal, writing paper, pencils). Together, they go under the name of MRO goods. Supplies are the equivalent of convenience goods; they are usually purchased with minimum effort on a straight-rebuy basis. They are normally marketed through intermediaries because of their low unit value and the great number and geographic dispersion of customers. Price and service are important considerations, because suppliers are standardized and brand preference is not high.

Business services include *maintenance and repair services* (window cleaning, copier repair) and *business advisory services* (legal, management consulting, advertising). Maintenance and repair services are usually supplied under contract by small producers or from the manufacturers of the original equipment. Business advisory services are usually purchased on the basis of the supplier's reputation and staff.

Product and Services Differentiation

To be branded, products must be differentiated. At one extreme are products that allow little variation: chicken, aspirin, and steel. Yet even here, some differentiation is possible: Perdue chickens, Bayer aspirin, and India's Tata Steel have carved out distinct identities in their categories. Procter & Gamble makes Tide, Cheer, and Gain laundry detergents, each with a separate brand identity. At the other extreme are products capable of high differentiation, such as automobiles, commercial buildings, and furniture. Here the seller faces an abundance of differentiation possibilities, including form, features, customization, performance quality, conformance quality, durability, reliability, repairability, and style.[6] Design has become an increasingly important means of differentiation and we will discuss it in a separate section later.

Product Differentiation

FORM Many products can be differentiated in **form**—the size, shape, or physical structure of a product. Consider the many possible forms of aspirin. Although essentially a commodity, it can be differentiated by dosage size, shape, color, coating, or action time.

FEATURES Most products can be offered with varying **features** that supplement their basic function. A company can identify and select appropriate new features by surveying recent buyers and then calculating *customer value* versus *company cost* for each potential feature. Marketers should consider how many people want each feature, how long it would take to introduce it, and whether competitors could easily copy it.[7]

To avoid "feature fatigue," the company must prioritize features and tell consumers how to use and benefit from them.[8] Companies must also think in terms of feature bundles or packages. Auto companies often manufacture cars at several "trim levels." This lowers manufacturing and inventory costs. Each company must decide whether to offer feature customization at a higher cost or a few standard packages at a lower cost.

CUSTOMIZATION Marketers can differentiate products by customizing them. As companies have grown proficient at gathering information about individual customers and business partners (suppliers, distributors, retailers), and as their factories are being designed more flexibly, they have increased their ability to individualize market offerings, messages, and media. **Mass customization** is the ability of a company to meet each customer's requirements—to prepare on a mass basis individually designed products, services, programs, and communications.[9]

Levi's and Lands' End were among the first to introduce custom jeans. Other firms have introduced mass customization into other markets. Online retailers such as Zazzle and CafePress allow users to upload images and create their own clothing and posters or buy merchandise created by other users. Customers must know how to express their personal product preferences, however, or be given assistance to best customize a product.[10]

PERFORMANCE QUALITY Most products occupy one of four performance levels: low, average, high, or superior. **Performance quality** is the level at which the product's primary characteristics operate. Quality is increasingly important for differentiation as companies adopt a value model and provide higher quality for less money. Firms should design a performance level appropriate to the target market and competition, however, not necessarily the highest level possible. They must also manage performance quality through time. Continuously improving the product can produce high returns and market share; failing to do so can have negative consequences.

When Mercedes-Benz's quality ratings took a dive, the automaker instituted a number of significant changes to bring them back up.

Mercedes-Benz

From 2003 to 2006, Mercedes-Benz endured one of its most painful stretches in its 127-year history. Its stellar quality reputation took a beating in J.D. Power and other surveys, and BMW surpassed it in global sales. To recoup, a new management team reorganized the company around functional elements—motors, chassis, and electronic systems—instead of by model lines. Engineers begin testing electronic systems a year earlier and put each new model through 10,000 tests that ran 24 hours a day for three weeks. Mercedes tripled its number of prototypes for new designs, allowing engineers to drive them 3 million miles before production. With these and other changes, the number of flaws in the cars dropped 72 percent from their 2002 peak and warranty costs decreased by 25 percent. As a side effect, Mercedes-Benz dealers have had to contend with a sizable drop in their repair and service businesses![11]

CONFORMANCE QUALITY Buyers expect a high **conformance quality**, the degree to which all produced units are identical and meet promised specifications. Suppose a Porsche 911 is designed to accelerate to 60 miles per hour within 10 seconds. If every Porsche 911 coming off the assembly line does this, the model is said to have high conformance quality. A product with low conformance quality will disappoint some buyers.

DURABILITY **Durability**, a measure of the product's expected operating life under natural or stressful conditions, is a valued attribute for vehicles, kitchen appliances, and other durable goods. The extra price for durability must not be excessive, however, and the product must not be subject to rapid technological obsolescence, as personal computers, televisions, and cell phones have sometimes been.

RELIABILITY Buyers normally will pay a premium for more reliable products. **Reliability** is a measure of the probability that a product will not malfunction or fail within a specified time period. Maytag has an outstanding reputation for creating reliable home appliances. Its long-running "Lonely Repairman" ad campaign was designed to highlight that attribute.

REPAIRABILITY **Repairability** measures the ease of fixing a product when it malfunctions or fails. Ideal repairability would exist if users could fix the product themselves with little cost in money or time. Some products include a diagnostic feature that allows service people to correct a problem over the telephone or advise the user how to correct it. Many computer hardware and software companies offer technical support over the phone, by fax or e-mail, or via real-time chat online.

STYLE **Style** describes the product's look and feel to the buyer. It creates distinctiveness that is hard to copy. Car buyers pay a premium for Jaguars because of their extraordinary looks. Aesthetics play a key role in such brands as Apple computers, Montblanc pens, Godiva chocolate, and Harley-Davidson motorcycles.[12] Strong style does not always mean high performance, however. A car may look sensational but spend a lot of time in the repair shop.

Services Differentiation

When the physical product cannot easily be differentiated, the key to competitive success may lie in adding valued services and improving their quality. Rolls-Royce PLC has ensured its aircraft engines are in high demand by continuously monitoring their health for 45 airlines through live satellite feeds. Under its TotalCare program, airlines pay Rolls a fee for every hour an engine is in flight, and Rolls assumes the risks and costs of downtime and repairs.[13]

The main service differentiators are ordering ease, delivery, installation, customer training, customer consulting, and maintenance and repair.

Cemex guarantees cement delivery as fast as placing a pizza order.

ORDERING EASE **Ordering ease** refers to how easy it is for the customer to place an order with the company. Baxter Healthcare supplies hospitals with computer terminals through which they send orders directly to the firm. Many financial service institutions offer secure online sites to help customers get information and complete transactions more efficiently.

DELIVERY **Delivery** refers to how well the product or service is brought to the customer. It includes speed, accuracy, and care throughout the process. Today's customers have grown to expect speed: pizza delivered in one-half hour, eyeglasses made in one hour, cars lubricated in 15 minutes. Many firms have computerized *quick response systems* (QRS) that link the information systems of their suppliers, manufacturing plants, distribution centers, and retailing outlets. Cemex, a giant cement company based in Mexico, has transformed its business by promising to deliver concrete faster than pizza. It equips every truck with a *global positioning system* (GPS) so dispatchers know its real-time location. If your load is more than 10 minutes late, you get up to a 20 percent discount.[14]

INSTALLATION **Installation** refers to the work done to make a product operational in its planned location. Ease of installation is a true selling point for buyers of complex products like heavy equipment and for technology novices.

CUSTOMER TRAINING **Customer training** helps the customer's employees use the vendor's equipment properly and efficiently. General Electric not only sells and installs expensive X-ray equipment in hospitals, it also gives extensive training to users. McDonald's requires its new franchisees to attend Hamburger University in Oak Brook, Illinois, for two weeks, to learn how to manage the franchise properly.

CUSTOMER CONSULTING **Customer consulting** includes data, information systems, and advice services the seller offers to buyers. Technology firms such as IBM, Oracle, and others have learned that such consulting is an increasingly essential—and profitable—part of their business.

MAINTENANCE AND REPAIR **Maintenance and repair** programs help customers keep purchased products in good working order. Firms such as Hewlett-Packard offer online technical support, or "e-support," for customers, who can search an online database for fixes or seek online help from a technician. Even retailers are getting into the act.

Best Buy

Best Buy As consolidation and competitive pricing among electronics retailers continue, companies are increasingly looking for new ways to stand out in the crowd. That's why Best Buy contracted with the Geek Squad, a small residential computer services company, to revamp the chain's in-store computer repair services. Best Buy used to send PCs to regional repair facilities, a time-consuming process that contributed to a high degree of consumer dissatisfaction. Now about half of all repairs are made in Best Buy stores. But the real differentiator is the Geek Squad's ability to make house calls (at a higher fee) using its signature fleet of VW Beetles. Geek Squad employees even dress differently for house calls—they wear a distinctive "geek" look instead of the traditional Best Buy blue they wear at the in-store service centers.[15]

RETURNS A nuisance to customers, manufacturers, retailers, and distributors alike, product returns are also an unavoidable reality of doing business, especially with online purchases. Although the average return rate for online sales is roughly 5 percent, return and exchange policies are estimated to serve as a deterrent for one-third to one-half of online buyers. The cost of processing a return can be two to three times that of sending an outbound shipment, totaling an average of $30 to $35 for items bought online.

We can think of product returns in two ways:[16]

- *Controllable returns* result from problems or errors by the seller or customer and can mostly be eliminated with improved handling or storage, better packaging, and improved transportation and forward logistics by the seller or its supply chain partners.
- *Uncontrollable returns* result from the need for customers to actually see, try, or experience products in person to determine suitability and can't be eliminated by the company in the short run through any of these means.

One basic strategy is to eliminate the root causes of controllable returns while developing processes for handling uncontrollable returns. The goal is to have fewer products returned and put a higher percentage back into the distribution pipeline to be sold again.

Road Runner Sports San Diego–based Road Runner Sports sells running shoes, clothing, and equipment through multiple channels. The firm trains its salespeople to be as knowledgeable as possible about recommending the right products. As a result, its return rate on running shoes is 12 percent, noticeably below the industry average of 15 percent to 20 percent. Road Runner also uses SmartLabels—prepaid, preaddressed, bar-coded return labels—to make returns quick and easy for those customers who need them.[17]

Road Runner Sports goes to great lengths to minimize the number of product returns from customers.

Design

As competition intensifies, design offers a potent way to differentiate and position a company's products and services.[18] **Design** is the totality of features that affect how a product looks, feels, and functions to a consumer. Design offers functional and aesthetic benefits and appeals to both our rational and emotional sides.[19]

The designer must figure out how much to invest in form, feature development, performance, conformance, durability, reliability, repairability, and style. To the company, a well-designed product is easy to manufacture and distribute. To the customer, a well-designed product is a pleasant to look at and easy to open, install, use, repair, and dispose of. The designer must take all these factors into account.[20]

As holistic marketers recognize the emotional power of design and the importance to consumers of how things look and feel as well as work, design is exerting a stronger influence in categories where it once played a smaller role. One factor fueling Hewlett-Packard's rise in the PC market is its strong emphasis on design, forcing Dell and others to become more style-conscious to compete. The rationale behind this shift is clear: in one survey consumers reported they would pay an average of $204 more for a high-end laptop that was well-designed.[21]

Certain companies and countries are winning on design.

Top Design Companies and Countries Some countries have developed strong reputations for their design skills and accomplishments, such as Italy in apparel and furniture and Scandinavia in products designed for functionality, aesthetics, and environmental consciousness. Finland's Nokia was the first to introduce user-changeable covers for cell phones, the first to have elliptical-shaped, soft, and friendly forms, and the first with big screens, all contributing to its remarkable ascent. Braun, a German division of Gillette, has elevated design to a high art in its electric shavers, coffeemakers, hair dryers, and food processors. Kohler brought art and design to luxury kitchen and bath fixtures and faucets. The International Design and Excellence Awards (IDEA) are given each year based on benefit to the user, benefit to the client/business, benefit to society, ecological responsibility, appropriate aesthetics and appeal, and usability testing. In 2009, Samsung won eight awards, Apple seven, Dell Experience Design Group six, and GE Healthcare five. One of the more successful design companies is IDEO.[22]

In an increasingly visually oriented culture, transmitting brand meaning and positioning through design is critical. "In a crowded marketplace," writes Virginia Postrel in *The Substance of Style*, "aesthetics is often the only way to make a product stand out."[23] The GM design team for the new plug-in electric 2011 Chevy Volt wanted to make sure the car looked better than other electric car models. As the Volt design director said, "Most electric cars are like automotive Brussels sprouts. They're good for you, but you don't want to eat them."

Bang & Olufsen's timeless, stylish designs command a significant price premium in the market.

Design can shift consumer perceptions to make brand experiences more rewarding. Consider the lengths Boeing went to in making its 777 airplane seem roomier and more comfortable. Raised center bins, side luggage bins, divider panels, gently arched ceilings, and raised seats made the aircraft interior seem bigger. As one design engineer noted, "If we do our jobs, people don't realize what we have done. They just say they feel more comfortable."

A bad design can also ruin a product's prospects. Sony's eVilla Internet appliance was intended to give consumers Internet access from their kitchens. But at nearly 32 pounds and 16 inches, the mammoth product was so awkward and heavy that the owner's manual recommended customers bend their legs, not their back, to pick it up. The product was withdrawn after only three months.

Design should penetrate all aspects of the marketing program so that all design aspects work together. In search of a universal identity scheme for Coca-Cola, David Butler, vice-president of global design, established four core principles. Each design, whether of packaging, point of sale, equipment, or any other consumer touch point, should reflect (1) bold simplicity, (2) real authenticity, (3) the power of red, and (4) a "familiar yet surprising" nature.[24]

Given the creative nature of design, it's no surprise that there isn't one widely adopted approach. Some firms employ formal, structured processes. *Design thinking* is a very data-driven approach with three phases: observation, ideation, and implementation. Design thinking requires intensive ethnographic studies of consumers, creative brainstorming sessions, and collaborative teamwork to decide how to bring the design idea to reality. Whirlpool used design thinking to develop the Architect Series II kitchen appliances with a more harmonized look than had existed in the category.[25]

On the other hand, the Danish firm Bang & Olufsen (B&O)—which has received many kudos for the design of its stereos, TV equipment, and telephones—trusts the instincts of a handful of designers who rarely consult with consumers. B&O does not introduce many new products in a given year, so every new product is expected to be sold for years. Its BeoLab 8000 speakers sold for $3,000 a pair when introduced in 1992 and for $4,500 more than 15 years later. Their designer, David Lewis, has seen three of his most successful B&O product creations placed in the Museum of Modern Art's permanent collection in New York.[26]

Design is often an important aspect of luxury products. "Marketing Insight: Marketing Luxury Brands" describes some of the broader marketing issues luxury brands face.

Product and Brand Relationships

Each product can be related to other products to ensure that a firm is offering and marketing the optimal set of products.

Marketing Insight

Marketing Luxury Brands

Luxury products are perhaps one of the purest examples of branding, because the brand and its image are often key competitive advantages that create enormous value and wealth for organizations. Marketers for luxury brands such as Prada, Gucci, Cartier, and Louis Vuitton manage lucrative franchises that have endured for decades in what some believe is now a $270 billion industry.

Just like marketers in less expensive and more "down-to-earth" categories, however, those guiding the fortunes of luxury brands must do so in a constantly evolving—and sometimes rapidly changing—marketing environment. Globalization, new technologies, financial crises, shifting consumer cultures, and other forces necessitate that marketers of luxury brands be skillful and adept at their brand stewardship to succeed. Table 12.1 summarizes some key guidelines in marketing luxury brands.

Significantly higher priced than typical items in a category, luxury brands for years were about social status and who a customer was—or perhaps wanted to be. Times have changed, and especially in the face of a crippling recession, luxury has for many become more about personal pleasure and self-expression.

The common denominators of luxury brands are quality and uniqueness. A luxury shopper must feel that what he or she is getting is truly special. Enduring style and authenticity are often critical to justifying a sometimes highly extravagant price. Hermès, the French luxury leather-goods maker, sells its classic designs for hundreds or even thousands of dollars, "not because they are in fashion," as one writer put it, "but [because] they never go out of fashion." Look at how luxury brands have been created across a range of other categories:

- ***Sub-Zero refrigerators.*** Sub-Zero sells refrigerators that range from $1,600 for small, under-counter types to $12,000 for its specialty Pro 48 model with a stainless steel interior. The target is home owners with high standards of performance and design who cherish their home and what they buy to furnish it. Sub-Zero extensively surveys this group as well as the kitchen designers, architects, and retailers who plan for and sell their products.
- ***Patrón tequila.*** Cofounded by Paul Mitchell hair care founder John Paul DeJoria, Patrón came about after a 1989 trip to a distillery in the small Mexican state of Jalisco. Named Patrón to convey "the boss, the cool guy," the smooth agave tequila comes in an elegant hand-blown decanter and is sold in individually numbered bottles for $45 or more.
- ***Hearts on Fire diamonds.*** De Beers brought branding to diamonds decades ago, making them a symbol of love and commitment in part through its "Diamonds Are Forever" ad campaign in 1948. The marketers of Hearts of Fire diamonds have found a market niche as the "World's Most Perfectly Cut Diamond." Although diamonds have become increasingly commoditized on the basis of the four Cs that define quality—cut, clarity, color, and carat—Hearts on Fire have a unique "hearts and arrow" design. When viewed magnified from the bottom, eight perfect hearts appear; from the top, eight perfect fire bursts are seen. Sold through independent jewelers, Hearts on Fire commands a 15 percent to 20 percent premium over a comparable diamond from Tiffany & Co.

The recent economic recession challenged many luxury brands as they tried to justify their value proposition and avoid discounting their products. Those that have successfully extended their brands vertically across a range of price points are usually the most immune to economic downturns.

The Armani brand extended from high-end Giorgio Armani and Giorgio Armani Privé to mid-range luxury with Emporio Armani, to affordable luxury with Armani Jeans and Armani Exchange. Clear differentiation exists between these brands, minimizing the potential for consumer confusion and brand cannibalization. Each also lives up to the core promise of the parent brand, reducing chances of hurting the parent's image.

Horizontal extensions into new categories can also be tricky for luxury brands. Even the most loyal consumer might question a $7,300 Ferragamo watch or an $85 bottle of Roberto Cavalli vodka. Jewelry maker Bulgari has moved into hotels, fragrances, chocolate, and skin care, prompting some branding experts to deem the brand overstretched.

In the past, iconic fashion designers Pierre Cardin and Halston licensed their names to so many ordinary products that the brands were badly tarnished. Ralph Lauren, however, has successfully marketed an aspirational luxury brand with wholesome all-American lifestyle imagery across a wide range of products. Besides clothing and fragrances, Lauren boutiques sell linens, candles, beds, couches, dishware, photo albums, and jewelry. Calvin Klein has adopted a similarly successful expansive strategy, though with different lifestyle imagery.

In an increasingly wired world, some luxury marketers have struggled to find the appropriate online selling and communication strategies for their brand. Ultimately, success depends on getting the right balance of classic and contemporary imagery and continuity and change in marketing programs and activities. Luxury is also not viewed in the same way everywhere. In post-communist Russia for a time, the bigger and gaudier the logo the better. But in the end, luxury brand marketers have to remember they are often selling a dream, anchored in product quality, status, and prestige.

Sources: Beth Snyder Bulik, "Sub-Zero Keeps Its Cool in a Value-Obsessed Economy," *Advertising Age*, May 25, 2009, p. 14; David K. Randall, "Dandy Corn," *Forbes*, March 10, 2008, p. 70; Christopher Palmeri, "The Barroom Brawl over Patron," *BusinessWeek*, September 17, 2007, p. 72; Bethany McLean, "Classic Rock," *Fortune*, November 12, 2007, pp. 35–39; Dan Heath and Chip Heath, "The Inevitability of $300 Socks," *Fast Company*, September 2007, pp. 68–70; Stellene Volande, "The Secret to Hermès's Success," *Departures*, November–December 2009, pp. 110–12; Cathy Horyn, "Why So Stodgy, Prada.com?" *New York Times*, December 30, 2009; Christina Binkley, "Like Our Sunglasses? Try Our Vodka! Brand Extensions Get Weirder, Risking Customer Confusion," *Wall Street Journal*, November 8, 2007; Special Issue on Luxury Brands, *Fortune*, September 17, 2007.

TABLE 12.1 Guidelines for Marketing Luxury Brands

1. Maintaining a premium image for luxury brands is crucial; controlling that image is thus a priority.
2. Luxury branding typically includes the creation of many intangible brand associations and an aspirational image.
3. All aspects of the marketing program for luxury brands must be aligned to ensure quality products and services and pleasurable purchase and consumption experiences.
4. Brand elements besides brand names—logos, symbols, packaging, signage—can be important drivers of brand equity for luxury brands.
5. Secondary associations from linked personalities, events, countries, and other entities can be important drivers of brand equity for luxury brands.
6. Luxury brands must carefully control distribution via a selective channel strategy.
7. Luxury brands must employ a premium pricing strategy with strong quality cues and few discounts and markdowns.
8. Brand architecture for luxury brands must be managed very carefully.
9. Competition for luxury brands must be defined broadly as it often comes from other categories.
10. Luxury brands must legally protect all trademarks and aggressively combat counterfeits.

Source: Based on Kevin Lane Keller, "Managing the Growth Tradeoff: Challenges and Opportunities in Luxury Branding," *Journal of Brand Management* 16 (March–May 2009), pp. 290–301.

Sub-Zero targets its high-end refrigerators to homeowners looking for the best.

The Product Hierarchy

The product hierarchy stretches from basic needs to particular items that satisfy those needs. We can identify six levels of the product hierarchy, using life insurance as an example:

1. ***Need family***—The core need that underlies the existence of a product family. Example: security.
2. ***Product family***—All the product classes that can satisfy a core need with reasonable effectiveness. Example: savings and income.
3. ***Product class***—A group of products within the product family recognized as having a certain functional coherence, also known as a product category. Example: financial instruments.
4. ***Product line***—A group of products within a product class that are closely related because they perform a similar function, are sold to the same customer groups, are marketed through the same outlets or channels, or fall within given price ranges. A product line may consist of different brands, or a single family brand, or individual brand that has been line extended. Example: life insurance.
5. ***Product type***—A group of items within a product line that share one of several possible forms of the product. Example: term life insurance.
6. ***Item*** (also called *stock-keeping unit* or *product variant*)—A distinct unit within a brand or product line distinguishable by size, price, appearance, or some other attribute. Example: Prudential renewable term life insurance.

Product Systems and Mixes

A **product system** is a group of diverse but related items that function in a compatible manner. For example, the extensive iPod product system includes headphones and headsets, cables and docks, armbands, cases, power and car accessories, and speakers. A **product mix** (also called a **product assortment**) is the set of all products and items a particular seller offers for sale.

A product mix consists of various product lines. NEC's (Japan) product mix consists of communication products and computer products. Michelin has three product lines: tires, maps, and restaurant-rating services. At Northwestern University, separate academic deans oversee the schools of medicine, law, business, engineering, music, speech, journalism, and liberal arts among others.

A company's product mix has a certain width, length, depth, and consistency. These concepts are illustrated in Table 12.2 for selected Procter & Gamble consumer products.

- The *width* of a product mix refers to how many different product lines the company carries. Table 12.2 shows a product mix width of five lines. (In fact, P&G produces many additional lines.)

Michelin has three distinct, but somewhat related, product lines.

TABLE 12.2 Product Mix Width and Product Line Length for Procter & Gamble Products (including dates of introduction)

	Product Mix Width				
	Detergents	Toothpaste	Bar Soap	Disposable Diapers	Paper Products
Product Line Length	Ivory Snow (1930)	Gleem (1952)	Ivory (1879)	Pampers (1961)	Charmin (1928)
	Dreft (1933)	Crest (1955)	Camay (1926)	Luvs (1976)	Puffs (1960)
	Tide (1946)		Zest (1952)		Bounty (1965)
	Cheer (1950)		Safeguard (1963)		
	Dash (1954)		Oil of Olay (1993)		
	Bold (1965)				
	Gain (1966)				
	Era (1972)				

- The *length* of a product mix refers to the total number of items in the mix. In Table 12.2, it is 20. We can also talk about the average length of a line. We obtain this by dividing the total length (here 20) by the number of lines (here 5), for an average product line length of 4.
- The *depth* of a product mix refers to how many variants are offered of each product in the line. If Tide came in two scents (Mountain Spring and Regular), two formulations (liquid and powder), and two additives (with or without bleach), it would have a depth of eight because there are eight distinct variants.[27] We can calculate the average depth of P&G's product mix by averaging the number of variants within the brand groups.
- The *consistency* of the product mix describes how closely related the various product lines are in end use, production requirements, distribution channels, or some other way. P&G's product lines are consistent in that they are consumer goods that go through the same distribution channels. The lines are less consistent in the functions they perform for buyers.

These four product mix dimensions permit the company to expand its business in four ways. It can add new product lines, thus widening its product mix. It can lengthen each product line. It can add more product variants to each product and deepen its product mix. Finally, a company can pursue more product line consistency. To make these product and brand decisions, it is useful to conduct product line analysis.

Product Line Analysis

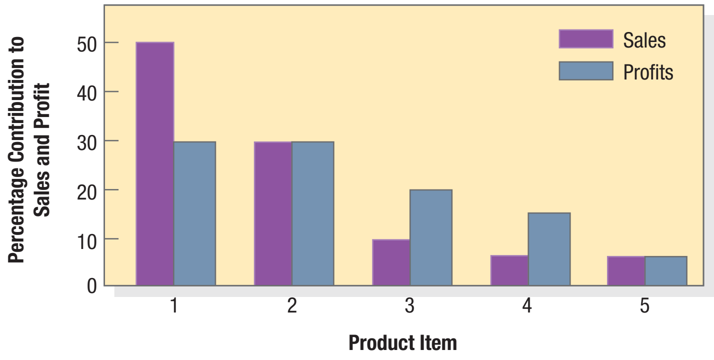
In offering a product line, companies normally develop a basic platform and modules that can be added to meet different customer requirements and lower production costs. Car manufacturers build cars around a basic platform. Homebuilders show a model home to which buyers can add additional features. Product line managers need to know the sales and profits of each item in their line to determine which items to build, maintain, harvest, or divest.[28] They also need to understand each product line's market profile.

SALES AND PROFITS Figure 12.3 shows a sales and profit report for a five-item product line. The first item accounts for 50 percent of total sales and 30 percent of total profits. The first two items account for 80 percent of total sales and 60 percent of total profits. If these two items were suddenly hurt by a competitor, the line's sales and profitability could collapse. These items must be carefully monitored and protected. At the other end, the last item delivers only 5 percent of the product line's sales and profits. The product line manager may consider dropping this item unless it has strong growth potential.

Every company's product portfolio contains products with different margins. Supermarkets make almost no margin on bread and milk, reasonable margins on canned and frozen foods, and better margins on flowers, ethnic food lines, and freshly baked goods. A telecommunication company makes different margins on its core telephone service than on added services such as call waiting, caller ID,

|Fig. 12.3|

Product-Item Contributions to a Product Line's Total Sales and Profits



and voice mail. Companies should recognize that items can differ in their potential for being priced higher or advertised more as ways to increase their sales, their margins, or both.[29]

MARKET PROFILE The product line manager must review how the line is positioned against competitors' lines. Consider paper company X with a paperboard product line.[30] Two paperboard attributes are weight and finish quality. Paper is usually offered at standard levels of 90, 120, 150, and 180 weights. Finish quality is offered at low, medium, and high levels. Figure 12.4 shows the location of the various product line items of company X and four competitors, A, B, C, and D. Competitor A sells two product items in the extra-high weight class ranging from medium to low finish quality. Competitor B sells four items that vary in weight and finish quality. Competitor C sells three items in which the greater the weight, the greater the finish quality. Competitor D sells three items, all lightweight but varying in finish quality. Company X offers three items that vary in weight and finish quality.

The **product map** shows which competitors' items are competing against company X's items. For example, company X's low-weight, medium-quality paper competes against competitor D's and B's papers, but its high-weight, medium-quality paper has no direct competitor. The map also reveals possible locations for new items. No manufacturer offers a high-weight, low-quality paper. If company X estimates a strong unmet demand and can produce and price this paper at low cost, it could consider adding this item to its line.

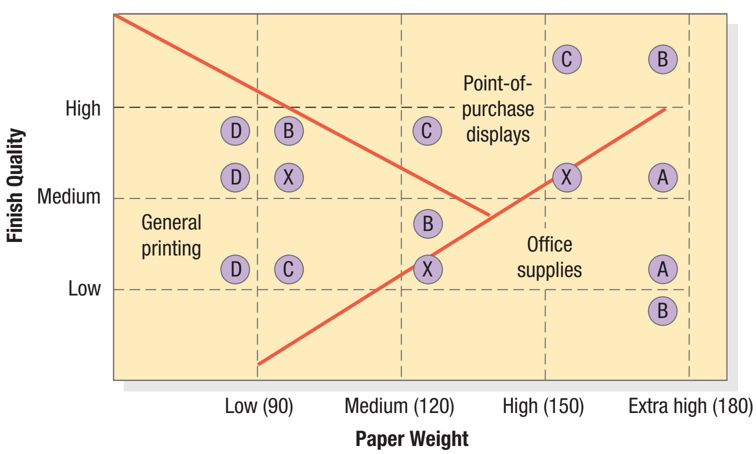
Another benefit of product mapping is that it identifies market segments. Figure 12.4 shows the types of paper, by weight and quality, preferred by the general printing industry, the point-of-purchase display industry, and the office supply industry. The map shows that company X is well positioned to serve the needs of the general printing industry but less effective in serving the other two industries.

Product line analysis provides information for two key decision areas—product line length and product mix pricing.

|Fig. 12.4|

Product Map for a Paper-Product Line

Source: Benson P. Shapiro, *Industrial Product Policy: Managing the Existing Product Line* (Cambridge, MA: Marketing Science Institute Report No. 77–110). Copyright © 2003. Reprinted by permission of Marketing Science Institute and Benson P. Shapiro.



Product Line Length

Company objectives influence product line length. One objective is to create a product line to induce up-selling: Thus BMW would like to move customers up from a 3-series vehicle to a 5-series and eventually even a 7-series vehicle. A different objective is to create a product line that facilitates cross-selling: Hewlett-Packard sells printers as well as computers. Still another objective is to create a product line that protects against economic ups and downs: Electrolux offers white goods such as refrigerators, dishwashers, and vacuum cleaners under different brand names in the discount, middle-market, and premium segments, in part in case the economy moves up or down. Companies seeking high market share and market growth will generally carry longer product lines. Companies that emphasize high profitability will carry shorter lines consisting of carefully chosen items.

Product lines tend to lengthen over time. Excess manufacturing capacity puts pressure on the product line manager to develop new items. The sales force and distributors also pressure the company for a more complete product line to satisfy customers. But as items are added, costs rise for design and engineering, inventory carrying, manufacturing changeover, order processing, transportation, and new-item promotions. Eventually, top management may stop development because of insufficient funds or manufacturing capacity. A pattern of product line growth followed by massive pruning may repeat itself many times. Increasingly, consumers are growing weary of dense product lines, overextended brands, and feature-laden products (see "Marketing Insight: When Less Is More").

A company lengthens its product line in two ways: line stretching and line filling.

LINE STRETCHING Every company's product line covers a certain part of the total possible range. For example, Mercedes automobiles are located in the upper price range of the automobile

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Marketing Insight

When Less Is More

With thousands of new products introduced each year, consumers find it ever harder to navigate store aisles. One study found the average shopper spent 40 seconds or more in the supermarket soda aisle, compared to 25 seconds six or seven years ago.

Although consumers may think greater product variety increases their likelihood of finding the right product for them, the reality is often different. One study showed that although consumers expressed greater interest in shopping with a larger assortment of 24 flavored jams than a smaller assortment of 6, they were 10 times more likely to actually make a selection with the smaller assortment.

Similarly, if the product quality in an assortment is high, consumers would actually prefer a smaller than a larger set of choices. Although consumers with well-defined preferences may benefit from more differentiated products that offer specific benefits to better suit their needs, too much product choice may be a source of frustration, confusion, and regret for other consumers. Product proliferation has another downside. Exposing the customer to constant product changes and introductions may nudge them into reconsidering their choices and perhaps switching to a competitor's product.

Smart marketers realize it's not just the product lines making consumer heads spin—many products themselves are too complicated for the average consumer. Royal Philips Electronics asked 100 of its top managers to take various Philips electronic products home one weekend and see whether they could make them work. The number of executives who returned frustrated and angry spoke volumes about the challenges the ordinary consumer faced.

Sources: Dimitri Kuksov and J. Miguel Villas-Boas, "When More Alternatives Lead to Less Choice," *Marketing Science*, 2010, in press; Kristin Diehl and Cait Poynor, "Great Expectations?! Assortment Size, Expectations, and Satisfaction," *Journal of Marketing Research* 46 (April 2009), pp. 312–22; Joseph P. Redden and Stephen J. Hoch, "The Presence of Variety Reduces Perceived Quantity," *Journal of Consumer Research* 36 (October 2009), pp. 406–17; Alexander Chernev and Ryan Hamilton, "Assortment Size and Option Attractiveness in Consumer Choice Among Retailers," *Journal of Marketing Research* 46 (June 2009), pp. 410–20; Richard A. Briesch, Pradeep K. Chintagunta, and Edward J. Fox, "How Does Assortment Affect Grocery Store Choice," *Journal of Marketing Research* 46 (April 2009), pp. 176–89; Aner Sela, Jonah Berger, and Wendy Liu, "Variety, Vice and Virtue: How Assortment Size Influences Option Choice," *Journal of Consumer Research* 35 (April 2009), pp. 941–51; Susan M. Broniarczyk, "Product Assortment," Curt P. Haugtvedt, Paul M. Herr, and Frank R. Kardes, eds., *Handbook of Consumer Psychology* (New York: Taylor & Francis, 2008), pp. 755–79; Cassie Mogilner, Tamar Rudnick, and Sheena S. Iyengar, "The Mere Categorization Effect: How the Presence of Categories Increases Choosers' Perceptions of Assortment Variety and Outcome Satisfaction," *Journal of Consumer Research* 35 (August 2008), pp. 202–15; Alexander Chernev, "The Role of Purchase Quantity in Assortment Choice: The Quantity Matching Heuristic," *Journal of Marketing Research* 45 (April 2008), pp. 171–81; John Gourville and Dilip Soman, "Overchoice and Assortment Type: When and Why Variety Backfires," *Marketing Science* 24 (Summer 2005), pp. 382–95; Barry Schwartz, *The Paradox of Choice: Why More Is Less* (New York: Harper Collins Ecco, 2004); Alexander Chernev, "When More Is Less and Less Is More: The Role of Ideal Point Availability and Assortment in Choice," *Journal of Consumer Research* 30 (September 2003), pp. 170–83; Sheena S. Iyengar and Mark R. Lepper, "When Choice Is Demotivating: Can One Desire Too Much of a Good Thing?" *Journal of Personality and Social Psychology* 79, no. 6 (December 2000), pp. 995–1006.

market. **Line stretching** occurs when a company lengthens its product line beyond its current range, whether down-market, up-market, or both ways.

Down-Market Stretch A company positioned in the middle market may want to introduce a lower-priced line for any of three reasons:

1. The company may notice strong growth opportunities as mass retailers such as Walmart, Best Buy, and others attract a growing number of shoppers who want value-priced goods.
2. The company may wish to tie up lower-end competitors who might otherwise try to move up-market. If the company has been attacked by a low-end competitor, it often decides to counterattack by entering the low end of the market.
3. The company may find that the middle market is stagnating or declining.

A company faces a number of naming choices in deciding to move a brand down-market:

1. Use the parent brand name on all its offerings. Sony has used its name on products in a variety of price tiers.
2. Introduce lower-priced offerings using a sub-brand name, such as P&G's Charmin Basics and Bounty Basics.
3. Introduce the lower-priced offerings under a different name, such as the Gap's Old Navy brand. This strategy is expensive to implement and means brand equity will have to be built from scratch, but the equity of the parent brand name is protected.

Moving down-market carries risks. Kodak introduced Kodak Funtime Film to counter lower-priced brands, but it did not price it low enough to match the lower-priced film. It also found some of its regular customers buying Funtime, so it was cannibalizing its core brand. Kodak withdrew the product and may have also lost some of its quality image in the process.

On the other hand, Mercedes successfully introduced its C-Class cars at $30,000 without injuring its ability to sell other Mercedes cars for $100,000. John Deere introduced a lower-priced line of lawn tractors called Sabre from John Deere while still selling its more expensive tractors under the John Deere name. In these cases, consumers may have been better able to compartmentalize the different brand offerings and understand functional differences between offerings in higher and lower price tiers.

Up-Market Stretch Companies may wish to enter the high end of the market to achieve more growth, realize higher margins, or simply position themselves as full-line manufacturers. Many markets have spawned surprising upscale segments: Starbucks in coffee, Häagen-Dazs in ice cream, and Evian in bottled water. The leading Japanese auto companies have each introduced an upscale automobile: Toyota's Lexus, Nissan's Infiniti, and Honda's Acura. They invented entirely new names, because consumers might not have given the brand "permission" to stretch upward when those lines were first introduced.

Other companies have included their own name in moving up-market. Gallo sells Gallo Family Vineyards (priced at $10 to $30 a bottle) with a hip, young image to compete in the premium wine segment. General Electric introduced the GE Profile brand for its large appliance offerings in the upscale market.[31] Some brands have used modifiers to signal a quality improvement, such as Ultra Dry Pampers, Extra Strength Tylenol, and Power Pro Dustbuster Plus.

Two-Way Stretch Companies serving the middle market might stretch their line in both directions. Robert Mondavi Winery, now owned by Constellation Brands, sells $35 bottles of wines as the first premium "New World wine," but it also sells $125 bottles of Mondavi Reserve at high-end wineries, restaurants, and vineyards and through direct order, as well as $11 bottles of Woodbridge created during the grape oversupply of the mid-1990s. Purina Dog Food has stretched up and down to create a product line differentiated by benefits to dogs, breadth of varieties, ingredients, and price:

- Pro Plan ($34.89/18 lb. bag)—helps dogs live long and healthy lives with high-quality ingredients (real meat, fish, and poultry)
- Purina ONE ($29.79/18 lb. bag)—meets dogs' changing and unique nutritional needs and provides superpremium nutrition for good health
- Purina Dog Chow ($18.49/20 lb. bag)—provides dogs with complete nutrition to build, replenish, and repair at each life stage
- Alpo by Purina ($10.99/17.6 lb. bag)—offers beef, liver, and cheese flavor combinations and three meaty varieties

Intercontinental Hotels Group

Intercontinental Hotels Group Intercontinental Hotels Group's Holiday Inn brand broke its domestic hotels into four separate chains to tap into different benefit segments—the upscale Crowne Plaza, the traditional Holiday Inn, the budget Holiday Inn Express, and the business-oriented Holiday Inn Select. Each chain received a different marketing program and emphasis. Holiday Inn Express launched the humorous "Stay Smart" advertising campaign, showing the brilliant feats ordinary people could attempt after staying at the chain. By developing the brands for distinct consumer targets with unique needs, Holiday Inn prevents overlap between them.[32]

LINE FILLING A firm can also lengthen its product line by adding more items within the present range. Motives for *line filling* include reaching for incremental profits satisfying dealers who complain about lost sales because of items missing from the line, utilizing excess capacity, trying to become the leading full-line company, and plugging holes to keep out competitors.

BMW AG

BMW AG In four years BMW has morphed from a one-brand, five-model carmaker into a powerhouse with 3 brands, 14 "Series," and roughly 30 distinct models. Not only has the carmaker expanded its product range downward with MINI Coopers and its compact 1-series models, but it has also built it upward with Rolls-Royce and filled the gaps in between with its X3, X5, and X6 sports activity vehicles, Z4 roadsters, and a 6-series coupe. The company has used line filling successfully to boost its appeal to the rich, the super-rich, and the wannabe-rich, all without departing from its pure premium positioning. The latest challenges? Launching the 5-series Gran Turismo, which combines the formality of a four-door sedan, the cargo capacity of a station wagon, and the high seating position and convenient hatchback of a crossover SUV. After that, BMW still has to decide what type of environmentally friendly "green" vehicles to introduce.[33]

Line filling is overdone if it results in self-cannibalization and customer confusion. The company needs to differentiate each item in the consumer's mind with a *just-noticeable difference.* According to Weber's law, customers are more attuned to relative than to absolute difference.[34] They will perceive the difference between boards 2 and 3 feet long and boards 20 and 30 feet long, but not between boards 29 and 30 feet long. The proposed item should also meet a market need and is not added simply to satisfy an internal need. The infamous Edsel automobile, on which Ford lost $350 million in the late 1950s, met Ford's internal positioning need for a car between its Ford and Lincoln lines, but not the market's needs.

LINE MODERNIZATION, FEATURING, AND PRUNING Product lines need to be modernized. The question is whether to overhaul the line piecemeal or all at once. A piecemeal approach allows the company to see how customers and dealers take to the new style. It is also less draining on the company's cash flow, but it lets competitors see changes and start redesigning their own lines.

In rapidly changing markets, modernization is continuous. Companies plan improvements to encourage customer migration to higher-valued, higher-priced items. Microprocessor companies such as Intel and AMD, and software companies such as Microsoft and Oracle continually introduce more-advanced versions of their products. It's important to time improvements so they do not appear too early (damaging sales of the current line) or too late (giving the competition time to establish a strong reputation).[35]

The product line manager typically selects one or a few items in the line to feature. Sears will announce a special low-priced washing machine to attract customers. At other times, managers will feature a high-end item to lend prestige to the product line. Sometimes a company finds one end of its line selling well and the other end selling poorly.

The company may try to boost demand for slower sellers, especially if a factory is idled by lack of demand, but it could be counterargued that the firm should promote items that sell well rather than prop up weak ones. Nike's Air Force 1 basketball shoe, introduced in the 1980s, is a billion-dollar brand that is still a consumer and retailer favorite and a moneymaker for the company due to collectable designs and tight supplies. Since their introduction, Air Force 1 shoes have been designed or inspired by many celebrities and athletes.[36]

Nike's classic Air Force 1 sneaker has been refreshed time and time again over the years, as these 25th-anniversary models show.

Using sales and cost analysis, product line managers must periodically review the line for deadwood that depresses profits.[37] One study found that for a big Dutch retailer, a major assortment reduction led to a short-term drop in category sales, caused mainly by fewer category purchases by former buyers, but it attracted new category buyers at the same time. These new buyers partially offset the sales losses among former buyers of the delisted items.[38]

In 1999, Unilever announced its "Path to Growth" program designed to get the most value from its brand portfolio by eliminating three-quarters of its 1,600 distinct brands by 2003.[39] More than 90 percent of its profits came from just 400 brands, prompting Unilever cochairman Niall FitzGerald to liken the brand reduction to weeding a garden, so "the light and air get in to the blooms which are likely to grow the best." The company retained global brands such as Lipton, as well as regional brands and "local jewels" like Persil, the leading detergent in the United Kingdom.

Multibrand companies all over the world try to optimize their brand portfolios. This often means focusing on core brand growth and concentrating resources on the biggest and most established brands. Hasbro has designated a set of core toy brands, including GI Joe, Transformers, and My Little Pony, to emphasize in its marketing. Procter & Gamble's "back to basics strategy" concentrated on brands with over $1 billion in revenue, such as Tide, Crest, Pampers, and Pringles. Every product in a product line must play a role, as must any brand in the brand portfolio.

Volkswagen

Volkswagen Volkswagen has four different core brands of particular importance in its European portfolio. Initially, Audi and Seat had a sporty image and VW and Skoda had a family-car image. Audi and VW were in a higher price-quality tier than Skoda and Seat, which had spartan interiors and utilitarian engine performance. To reduce costs, streamline part/systems designs, and eliminate redundancies, Volkswagen upgraded the Seat and Skoda brands, which captured market share with splashy interiors, a full array of safety systems, and reliable power trains. The danger, of course, is that by borrowing from its upper-echelon Audi and Volkswagen products, Volkswagen could dilute their cachet. Frugal European consumers may convince themselves that a Seat or Skoda is almost identical to its VW sister, at several thousand euros less.[40]

Product Mix Pricing

Marketers must modify their price-setting logic when the product is part of a product mix. In **product mix pricing**, the firm searches for a set of prices that maximizes profits on the total mix. Pricing is difficult because the various products have demand and cost interrelationships and are subject to different degrees of competition. We can distinguish six situations calling for product-mix pricing: product line pricing, optional-feature pricing, captive-product pricing, two-part pricing, by-product pricing, and product-bundling pricing.

PRODUCT LINE PRICING Companies normally develop product lines rather than single products and introduce price steps. A men's clothing store might carry men's suits at three price levels: $300, $600, and $900, which customers associate with low-, average-, and high-quality. The seller's task is to establish perceived quality differences that justify the price differences.[41]

OPTIONAL-FEATURE PRICING Many companies offer optional products, features, and services with their main product. A buyer of the 2010 Subaru Outback 2.5i can order four-way power passenger seats, an All-Weather package, and a power moon roof as optional features.

Pricing options is a sticky problem, because companies must decide which to include in the standard price and which to offer separately. Many restaurants price their beverages high and their food low. The food revenue covers costs, and the beverages—especially liquor—produce the profit.

My Little Pony is one of Hasbro's core toy brands that receives special attention and support.

This explains why servers often press hard to get customers to order drinks. Other restaurants price their liquor low and food high to draw in a drinking crowd.

CAPTIVE-PRODUCT PRICING Some products require the use of ancillary or **captive products**. Manufacturers of razors and cameras often price them low and set high markups on razor blades and film.[42] AT&T may give a cellular phone free if the person commits to buying two years of phone service. If the captive product is priced too high in the aftermarket, however, counterfeiting and substitutions can erode sales. Consumers now can buy cartridge refills for their printers from discount suppliers and save 20 percent to 30 percent off the manufacturer's price.

Hewlett-Packard

Hewlett-Packard In 1996, Hewlett-Packard (HP) began drastically cutting prices on its printers, by as much as 60 percent in some cases. HP could afford to make these cuts because customers typically spend twice as much on replacement ink cartridges, toner, and specialty paper as on the printer over the life of the product, and inkjet supplies typically carry 45 percent to 60 percent profit margins. As the price of printers dropped, printer sales rose, and so did aftermarket sales. HP now owns about 46 percent of the worldwide printer business, a share that accounted for 32 percent of HP's $13.4 billion profit in 2008.[43]

TWO-PART PRICING Service firms engage in **two-part pricing**, consisting of a fixed fee plus a variable usage fee. Cell phone users pay a minimum monthly fee plus charges for calls that exceed their allotted minutes. Amusement parks charge an admission fee plus fees for rides over a certain minimum. The service firm faces a problem similar to captive-product pricing—namely, how much to charge for the basic service and how much for the variable usage. The fixed fee should be low enough to induce purchase; profit can then come from the usage fees.

BY-PRODUCT PRICING The production of certain goods—meats, petroleum products, and other chemicals—often results in by-products that should be priced on their value. Any income earned on the by-products will make it easier for the company to charge a lower price on its main product if competition forces it to do so. Formed in 1855, Australia's CSR was originally named Colonial Sugar Refinery and forged its early reputation as a sugar company. The company began to sell by-products of its sugar cane: waste sugar cane fiber was used to manufacture wallboard. Today, through product development and acquisition, the renamed CSR has become one of the top 10 companies in Australia selling building and construction materials.

PRODUCT-BUNDLING PRICING Sellers often bundle products and features. **Pure bundling** occurs when a firm offers its products only as a bundle. A talent agency might insist that a "hot" actor can be signed to a film only if the film company also accepts other talents the agency represented (directors, writers). This is a form of *tied-in sales.*

In **mixed bundling**, the seller offers goods both individually and in bundles, normally charging less for the bundle than if the items were purchased separately. An auto manufacturer might offer an option package at less than the cost of buying all the options separately. A theater will price a season subscription lower than the cost of buying all the performances separately. Customers may not have planned to buy all the components, so savings on the price bundle must be enough to induce them to buy it.[44]

Some customers want less than the whole bundle in exchange for a lower price.[45] These customers ask the seller to "unbundle" or "rebundle" its offer. If a supplier saves $100 by not supplying unwanted delivery and reduces the customer's price by $80, it has kept the customer happy while increasing its profit by $20. "Marketing Memo: Product-Bundle Pricing Considerations" offers a few tips.

Co-Branding and Ingredient Branding

CO-BRANDING Marketers often combine their products with products from other companies in various ways. In **co-branding**—also called dual branding or brand bundling—two or more well-known brands are combined into a joint product or marketed together in some fashion.[46] One form of co-branding is *same-company co-branding,* as when General Mills advertises Trix cereal and Yoplait yogurt. Another form is *joint-venture co-branding,* such as General Electric and Hitachi lightbulbs in Japan, and the Citibank AAdvantage credit card. There is *multiple-sponsor co-branding,* such as Taligent, a one-time technological alliance of Apple, IBM, and Motorola.[47] Finally, there is *retail co-branding* in which two retail establishments use the same location to optimize space and profits, such as jointly owned Pizza Hut, KFC, and Taco Bell restaurants.

marketing **Memo**

Product-Bundle Pricing Considerations

As promotional activity increases on individual items in the bundle, buyers perceive less savings on the bundle and are less apt to pay for it. Research suggests the following guidelines for implementing a bundling strategy:

- Don't promote individual products in a package as frequently and cheaply as the bundle. The bundle price should be much lower than the sum of individual products or the consumer will not perceive its attractiveness.
- Limit promotions to a single item in the mix if you still want to promote individual products. Another option: alternate promotions, one after another, to avoid running conflicting promotions.
- If you offer large rebates on individual products, make them the absolute exception and do it with discretion. Otherwise, the consumer uses the price of individual products as an external reference for the bundle, which then loses value.
- Consider how experienced and knowledgeable your customer is. More knowledgeable customers may be less likely to need or want bundled offerings and prefer the freedom to choose components individually.
- Remember costs play a role. If marginal costs for the products are low—such as for proprietary software components that can be easily copied and distributed—a bundling strategy can be preferable to a pure component strategy where each component is purchased separately.
- Firms with single-products bundling products together to compete against a multiproduct firm may not be successful if a price war ensues.

Sources: Amiya Basu and Padmal Vitharana, "Impact of Customer Knowledge Heterogeneity on Bundling Strategy," *Marketing Science* 28 (July–August 2009), pp. 792–801; Bikram Ghosh and Subramanian Balachnadar, "Competitive Bundling and Counterbundling with Generalist and Specialist Firms," *Management Science* 53 (January 2007), pp. 159–68; Loren M. Hitt and Pei-yu Chen, "Bundling with Customer Self-Selection: A Simple Approach to Bundling Low-Marginal-Cost Goods," *Management Science* 51 (October 2005), pp. 1481–93; George Wuebker, "Bundles Effectiveness Often Undermined," *Marketing News,* March 18, 2002, pp. 9–12; Stefan Stremersch and Gerard J. Tellis, "Strategic Bundling of Products and Prices," *Journal of Marketing* 66 (January 2002), pp. 55–72.

The main advantage of co-branding is that a product can be convincingly positioned by virtue of the multiple brands. Co-branding can generate greater sales from the existing market and open opportunities for new consumers and channels. It can also reduce the cost of product introduction, because it combines two well-known images and speeds adoption. And co-branding may be a valuable means to learn about consumers and how other companies approach them. Companies in the automotive industry have reaped all these benefits.

The potential disadvantages of co-branding are the risks and lack of control in becoming aligned with another brand in consumers' minds. Consumer expectations of co-brands are likely to be high, so unsatisfactory performance could have negative repercussions for both brands. If the other brand enters a number of co-branding arrangements, overexposure may dilute the transfer of any association. It may also result in a lack of focus on existing brands. Consumers may feel less sure of what they know about the brand.[48]

For co-branding to succeed, the two brands must separately have brand equity—adequate brand awareness and a sufficiently positive brand image. The most important requirement is a logical fit between the two brands, to maximize the advantages of each while minimizing disadvantages. Consumers are more apt to perceive co-brands favorably if they are complementary and offer unique quality, rather than overly similar and redundant.[49]

Managers must enter co-branding ventures carefully, looking for the right fit in values, capabilities, and goals and an appropriate balance of brand equity. There must be detailed plans to legalize contracts, make financial arrangements, and coordinate marketing programs. As one executive at Nabisco put it, "Giving away your brand is a lot like giving away your child—you want to make sure everything is perfect." Financial arrangements between brands vary; one common approach is for the brand more deeply invested in the production process to pay the other a licensing fee and royalty.

Brand alliances require a number of decisions.[50] What capabilities do you *not* have? What resource constraints do you face (people, time, money)? What are your growth goals or revenue needs? Ask whether the opportunity is a profitable business venture. How does it help maintain or strengthen brand equity? Is there any risk of diluting brand equity? Does the opportunity offer extrinsic advantages such as learning opportunities?

INGREDIENT BRANDING **Ingredient branding** is a special case of co-branding.[51] It creates brand equity for materials, components, or parts that are necessarily contained within other branded products. Successful ingredient brands include Dolby noise reduction technology, GORE-TEX water-resistant fibers, and Scotchgard fabrics. Some popular ingredient-branded products are Lunchables lunch combinations with Taco Bell tacos and Lay's potato chips made with KC Masterpiece barbecue sauce.

An interesting take on ingredient branding is "self-branded ingredients" that companies advertise and even trademark. Westin Hotels advertises its own "Heavenly Bed" and "Heavenly Shower." The Heavenly Bed has been so successful that Westin now sells the bed, pillows, sheets, and blankets via an online catalog, along with other "Heavenly" gifts, bath products, and even pet items. If it can be done well, using self-branded ingredients makes sense because firms have more control over them and can develop them to suit their purposes.[52]

Ingredient brands try to create enough awareness and preference for their product so consumers will not buy a "host" product that doesn't contain it.[53] DuPont has done so successfully.

DuPont DuPont has introduced a number of innovative products, such as Corian® solid-surface material, for use in markets ranging from apparel to aerospace. Many, such as Tyvek® house wrap, Teflon® non-stick coating, and Kevlar® fiber, became household names as ingredient brands in consumer products manufactured by other companies. Since 2004, DuPont has introduced more than 5,000 new products and received over 2,400 new patents. One of its recent award winners, Sorona® is a renewably sourced or bio-based polymer for use in carpet and apparel markets.[54]

DuPont's Stainmaster carpets have become a household name.

Many manufacturers make components or materials that enter final branded products but lose their individual identity. One of the few companies that avoided this fate is Intel. Intel's consumer-directed brand campaign convinced many personal computer buyers to buy only brands with "Intel Inside." As a result, major PC manufacturers—IBM, Dell, Compaq—purchase their chips from Intel at a premium price rather than buy equivalent chips from an unknown supplier.

What are the requirements for successful ingredient branding?[55]

1. Consumers must believe the ingredient matters to the performance and success of the end product. Ideally, this intrinsic value is easily seen or experienced.
2. Consumers must be convinced that not all ingredient brands are the same and that the ingredient is superior.
3. A distinctive symbol or logo must clearly signal that the host product contains the ingredient. Ideally, this symbol or logo functions like a "seal" and is simple and versatile, credibly communicating quality and confidence.
4. A coordinated "pull" and "push" program must help consumers understand the advantages of the branded ingredient. Channel members must offer full support such as consumer advertising and promotions and—sometimes in collaboration with manufacturers—retail merchandising and promotion programs.

Packaging, Labeling, Warranties, and Guarantees

Some product packages—such as the Coke bottle and Red Bull can—are world famous. Many marketers have called packaging a fifth P, along with price, product, place, and promotion. Most, however, treat packaging and labeling as an element of product strategy. Warranties and guarantees can also be an important part of the product strategy and often appear on the package.

Packaging

Packaging includes all the activities of designing and producing the container for a product. Packages might have up to three layers. Cool Water cologne comes in a bottle (*primary package*) in a cardboard box (*secondary package*) in a corrugated box (*shipping package*) containing six dozen bottles in cardboard boxes.

The package is the buyer's first encounter with the product. A good package draws the consumer in and encourages product choice. In effect, they can act as "five-second commercials" for the product. Packaging also affects consumers' later product experiences when they go to open the package and use the product at home. Some packages can even be attractively displayed at home. Distinctive packaging like that for Kiwi shoe polish, Altoids mints, and Absolut vodka is an important part of a brand's equity.[56]

Various factors contribute to the growing use of packaging as a marketing tool:

- ***Self-service.*** An increasing number of products are sold on a self-serve basis. In an average supermarket, which may stock 15,000 items, the typical shopper passes some 300 products per minute. Given that 50 percent to 70 percent of all purchases are made in the store, the effective package must perform many sales tasks: attract attention, describe the product's features, create consumer confidence, and make a favorable overall impression.
- ***Consumer affluence.*** Rising affluence means consumers are willing to pay a little more for the convenience, appearance, dependability, and prestige of better packages.
- ***Company and brand image.*** Packages contribute to instant recognition of the company or brand. In the store, they can create a billboard effect, such as Garnier Fructis with its bright green packaging in the hair care aisle.
- ***Innovation opportunity.*** Unique or innovative packaging such as resealable spouts can bring big benefits to consumers and profits to producers.

Packaging must achieve a number of objectives:[57]

1. Identify the brand.
2. Convey descriptive and persuasive information.
3. Facilitate product transportation and protection.
4. Assist at-home storage.
5. Aid product consumption.

To achieve these objectives and satisfy consumers' desires, marketers must choose the aesthetic and functional components of packaging correctly. Aesthetic considerations relate to a package's size and shape, material, color, text, and graphics. There are a number of factors and criteria in each area.

Color is a particularly important aspect of packaging and carries different meanings in different cultures and market segments. Table 12.3 summarizes the beliefs of some visual marketing experts about its role.

Kiwi's distinctive packaging, name, and logo are all brand assets.

TABLE 12.3 The Color Wheel of Branding and Packaging
Red is a powerful color, symbolizing energy, passion or even danger. Red works best for action-oriented products or brands, products associated with speed or power, or dominant or iconic brands.
Orange often connotes adventure and fun. Like red, it's an attention-grabber and is thought to stimulate appetites, but it's less aggressive than red can be. Orange has been used to convey value and discounts, and recently has earned young, stylish associations thanks to the fashion industry.
Yellow is equated with sunny warmth and cheeriness. Its more vibrant shades elicit feelings of well-being and are said to stimulate mental activity, so yellow is often associated with wisdom and intellect. Yellow works well for products or brands tied to sports or social activities, or for products or content looking to garner attention.
Green connotes cleanliness, freshness and renewal—and, of course, environmental friendliness—but experts warn that green now is overused in the marketplace. It is one of the most predominant, naturally occurring colors, so it often is associated with wholesome attributes. It works well for organic or recycled products, or for brands associated with health and wellness.
Blue, another naturally predominant color, is regularly associated with security, efficiency, productivity and a clearness of mind. It has become a popular color in the corporate world and particularly in the high-tech industry. Blue also symbolizes cleanliness, openness and relaxation, and works well for everything from cleaning and personal care products to spas and vacation destinations.
Purple, for centuries, has symbolized nobility and wealth, and those associations hold true today. Purple is a powerful color for luxury brands and products, or for companies that want to lend an air of mystery or uniqueness to their wares. Purple is particularly popular with females of all ages.
Pink is a stereotypically girly color associated with frilliness and warmth, and is considered to have soft, peaceful, comforting qualities. Pink works well for personal care products and baby-related brands. Pink also is associated with sweetness and works well for food marketers touting sugary treats.
Brown is a strong, earthy color that connotes honesty and dependability. Brown often is cited as a favorite color among men. Its darker shades are rich and solid, while other shades work well as a foundational color. Brown often works best in conjunction with other colors
Black is classic and strong, and is a regular fixture in marketers' color schemes as either a primary component or an accent color for font or graphics. Black can convey power, luxury, sophistication and authority, and can be used to market everything from cars and electronics to high-end hotels and financial services.
White, the color of puffy clouds and fresh snow, logically connotes purity and cleanliness. It often is used as a background or accent color to brighten a color scheme, but also it can be used liberally to create clean associations for organic foods or personal care products. White also can symbolize innovation and modernity.

Source: Elisabeth Sullivan, "Color Me Profitable," *Marketing News*, October 15, 2008, p. 8. Reprinted with permission from *Marketing News*, published by the American Marketing Association.

Functionally, structural design is crucial. The packaging elements must harmonize with each other and with pricing, advertising, and other parts of the marketing program.

Packaging updates or redesigns can occur frequently to make the brand more contemporary, relevant, or practical. Although these can have immediate impact on sales, they also can have a downside, as PepsiCo learned for its Tropicana brand.

Tropicana

Tropicana PepsiCo experienced great success with its Tropicana brand, acquired in 1998. Then in 2009, the company launched a redesigned package to "refresh and modernize" the brand. The goal was to create an "emotional attachment by 'heroing' the juice and trumpeting the natural fruit goodness." Arnell Group led the extreme makeover that led to an entirely new look, downplaying the brand name, raising the prominence of the phrase "100 percent orange pure & natural," and replacing the "straw in an orange" graphic on the front of the package with a close-up of a glass of orange juice. Consumer response was swift and negative. The package looked "ugly" or "stupid," and some even confused it with a store brand. Sales dropped 20 percent. After only two months, PepsiCo management announced it would revert to the old packaging.[58]

After the company designs its packaging, it must test it. *Engineering tests* ensure that the package stands up under normal conditions; *visual tests,* that the script is legible and the colors harmonious; *dealer tests,* that dealers find the packages attractive and easy to handle; and *consumer tests,* that buyers will respond favorably. Eye tracking by hidden cameras can assess how much consumers notice and examine packages. For Comtrex cold medicine, tracking research was able to confirm that only 50 percent of consumers considered the old package on the shelf, versus 62 percent for a newly redesigned package.[59]

Although developing effective packaging may require several months and several hundred thousand dollars, companies must consider growing environmental and safety concerns about reducing packaging. Fortunately, many companies have gone "green" and are finding creative new ways to develop packaging. Frito-Lay's Sun Chips multigrain snacks, containing 30 percent less fat than potato chips, are positioned as a healthier, "good for you" snack option. Part of the firm's effort to also support a "healthier planet" was to unveil a fully compostable bag made from plant-based materials (although later withdrawn for some flavors when consumers complained of the noise the bags made) and to run its factory in Modesto on solar power.

Labeling

The label can be a simple attached tag or an elaborately designed graphic that is part of the package. It might carry a great deal of information, or only the brand name. Even if the seller prefers a simple label, the law may require more.

A label performs several functions. First, it *identifies* the product or brand—for instance, the name Sunkist stamped on oranges. It might also *grade* the product; canned peaches are grade-labeled A, B, and C. The label might *describe* the product: who made it, where and when, what it contains, how it is to be used, and how to use it safely. Finally, the label might *promote* the product through attractive graphics. Advanced technology allows 360-degree shrink-wrapped labels to surround containers with bright graphics and accommodate more product information, replacing glued-on paper labels.[60]

Labels eventually need freshening up. The label on Ivory soap has been redone at least 18 times since the 1890s, with gradual changes in the size and design of the letters. As Tropicana found out, companies with labels that have become icons need to tread very carefully when initiating a redesign to preserve key branding elements.

A long history of legal concerns surrounds labels, as well as packaging. In 1914, the Federal Trade Commission Act held that false, misleading, or deceptive labels or packages constitute unfair

Marketers must balance competing demands in their packaging; Sun Chips' environmentally friendly packaging was cut back shortly after its launch because many consumers complained about how noisy the bags were.

competition. The Fair Packaging and Labeling Act, passed by Congress in 1967, set mandatory labeling requirements, encouraged voluntary industry packaging standards, and allowed federal agencies to set packaging regulations in specific industries.

The Food and Drug Administration (FDA) has required processed-food producers to include nutritional labeling that clearly states the amounts of protein, fat, carbohydrates, and calories contained in products, as well as vitamin and mineral content as a percentage of the recommended daily allowance.[61] The FDA has also taken action against potentially misleading uses of such descriptions as "light," "high fiber," and "low fat."

Warranties and Guarantees

All sellers are legally responsible for fulfilling a buyer's normal or reasonable expectations. **Warranties** are formal statements of expected product performance by the manufacturer. Products under warranty can be returned to the manufacturer or designated repair center for repair, replacement, or refund. Whether expressed or implied, warranties are legally enforceable.

Extended warranties and service contracts can be extremely lucrative for manufacturers and retailers. Analysts estimate that warranty sales have accounted for a large percentage of Best Buy's operating profits.[62] Despite evidence that extended warranties do not pay off, some consumers value the peace of mind.[63] These warranties still generate multibillion dollars in revenue for electronic goods in the United States, though the total has declined as consumers have become more comfortable seeking solutions to technical problems online or from friends.[64]

Many sellers offer either general or specific guarantees.[65] A company such as Procter & Gamble promises general or complete satisfaction without being more specific—"If you are not satisfied for any reason, return for replacement, exchange, or refund." A. T. Cross guarantees its Cross pens and pencils for life. The customer mails the pen to A. T. Cross (mailers are provided at stores), and the pen is repaired or replaced at no charge.

Guarantees reduce the buyer's perceived risk. They suggest that the product is of high quality and the company and its service performance are dependable. They can be especially helpful when the company or product is not well known or when the product's quality is superior to that of competitors. Hyundai's and Kia's highly successful 10-year or 100,000 mile power train warranty programs were designed in part to assure potential buyers of the quality of the products and the companies' stability.

Summary

1. Product is the first and most important element of the marketing mix. Product strategy calls for making coordinated decisions on product mixes, product lines, brands, and packaging and labeling.
2. In planning its market offering, the marketer needs to think through the five levels of the product: the core benefit, the basic product, the expected product, the augmented product, and the potential product, which encompasses all the augmentations and transformations the product might ultimately undergo.
3. Products can be nondurable goods, durable goods, or services. In the consumer-goods category are convenience goods (staples, impulse goods, emergency goods), shopping goods (homogeneous and heterogeneous), specialty goods, and unsought goods. The industrial-goods category has three subcategories: materials and parts (raw materials and manufactured materials and parts), capital items (installations and equipment), and supplies and business services (operating supplies, maintenance and repair items, maintenance and repair services, and business advisory services).
4. Brands can be differentiated on the basis of product form, features, performance, conformance, durability, reliability, repairability, style, and design, as well as such service dimensions as ordering ease, delivery, installation, customer training, customer consulting, and maintenance and repair.
5. Design is the totality of features that affect how a product looks, feels, and functions. A well-designed product offers

functional and aesthetic benefits to consumers and can be an important source of differentiation.

6. Most companies sell more than one product. A product mix can be classified according to width, length, depth, and consistency. These four dimensions are the tools for developing the company's marketing strategy and deciding which product lines to grow, maintain, harvest, and divest. To analyze a product line and decide how many resources to invest in it, product line managers need to look at sales and profits and market profile.
7. A company can change the product component of its marketing mix by lengthening its product via line stretching (down-market, up-market, or both) or line filling, by modernizing its products, by featuring certain products, and by pruning its products to eliminate the least profitable.
8. Brands are often sold or marketed jointly with other brands. Ingredient brands and co-brands can add value, assuming they have equity and are perceived as fitting appropriately.
9. Physical products must be packaged and labeled. Well-designed packages can create convenience value for customers and promotional value for producers. Warranties and guarantees can offer further assurance to consumers.

Applications

Marketing Debate

With Products, Is It Form or Function?

The "form versus function" debate applies in many arenas, including marketing. Some marketers believe product performance is the be-all and end-all. Other marketers maintain that the look, feel, and other design elements of products are what really make the difference.

Take a position: Product functionality is the key to brand success *versus* Product design is the key to brand success.

Marketing Discussion

Product & Service Differentiation

Consider the different means of differentiating products and services. Which ones have the most impact on your choices? Why? Can you think of certain brands that excel on a number of these different means of differentiation?

Marketing Excellence

>>Caterpillar

Caterpillar was founded in 1925 when two California-based tractor companies merged. The name "Caterpillar," however, dates back to the early 1900s when Benjamin Holt, one of the company's founders, designed a tractor crawler with wide, thick tracks instead of wheels. These tracks prevented the machine from sinking into California's deep, rich soil, which was impassable when wet. The new farm tractor crept along the farmland in such a way that one observer said it "crawled like a caterpillar."

Holt sold the tractor under the Caterpillar brand, and once the merger occurred, the newly formed company became Caterpillar Tractor Company. Since then, Caterpillar Inc., or CAT, has grown into the largest manufacturer of earth-moving equipment and engines in the world. With over 300 different machines for sale, Caterpillar offers product solutions for eight industries: residential, nonresidential, industrial, infrastructure, mining and quarrying, energy, waste, and forestry. Its distinctive yellow machines are found all over the globe and have helped make the brand a U.S. icon.

So how did a small tractor company grow to become one of the biggest companies in the world? The company grew steadily at first, hitting a few critical milestones including the use of Caterpillar's trademark farm treads on Army tanks in WWI and WWII. Huge postwar construction and strong overseas demand kept sales strong through the mid-21st century, as did innovations like the diesel tractor and rubber-tired tractors.

Things changed, however, when the recession of the early 1980s hit Caterpillar hard and international competitors gained market share, including Japan's Komatsu. Caterpillar's high prices and inflexible bureaucracy nearly sent the company into bankruptcy. In 1982 alone, the firm lost $6.5 billion, laid off thousands of employees, closed several factories, and suffered a long United Auto Workers strike.

In the 1990s, Caterpillar recognized that it desperately needed to change, and under new leadership it successfully pulled off one of the biggest turnarounds in corporate history. Several factors played a role.

- Caterpillar boldly fought the United Auto Workers and outlasted two strikes and seven years of disagreements.
- It decentralized and restructured into several business units, each responsible for its own P&L.
- It invested a significant amount of money (ultimately $1.8 billion) in a factory-modernizing program that automated and streamlined its manufacturing process with a combination of just-in-time inventory and flexible manufacturing. By automating its manufacturing system, the company became more efficient and competitive, although it also was forced to lay off more of its workforce.
- It made research and development one of its biggest priorities, investing hundreds of millions of dollars in new technologies, products, and machines. As a result, CAT construction trucks became more high-tech, competitive, and environmentally friendly.

Today, Caterpillar ranks number one or number two in every industry it serves. Its products are unmatched in quality and reliability and the company has maintained its strong focus on innovation. With a $2 billion annual research and development budget, new products are launched every year. Recent innovations include hybrid diesel-electric tractors—the first of their kind—and lower-emission engines with ACERT technology, a clean-diesel technology that also improves fuel efficiency.

Caterpillar's product range is immense. From a small 47 horsepower skid steer to an 850 horsepower tractor to a massive 3,370 horsepower mining truck, the firm develops products that serve each market and region's specific needs. In China, for example, a critical market to the future of Caterpillar, the company has divided its product strategy into three segments: World Class, Mid-Tier, and Low-End. Caterpillar is focused on innovating high-tech machinery for the growing World Class segment and leaving the Low-End segment to local competitors that will eventually be consolidated.

Another reason for Caterpillar's dominance in the market is its business model. Caterpillar sells it all: machines, services, and support for a wide range of industries. Fifty-three percent of its sales come from products and the rest from integrated services. Caterpillar accomplishes this feat through its extensive Global Dealer Network—specially trained independent CAT dealers who can provide services on a local basis, giving the global company a personal feel.

Feeling local is important considering that 56 percent of Caterpillar's business comes from overseas, making it one of the United States' biggest exporters. Caterpillar has been a leader in building roads, bridges, highways, and airports all over the world. In developing cities like Antamin, Peru, for example, which is abundant in copper, large mining companies spend hundreds of millions of dollars on CAT machinery and services each year. Up to 50 different kinds of CAT bulldozers, front loaders, excavators, and special mining trucks help clear roads, clean up spills, and dig for copper. These massive trucks are all manufactured in Decatur, Illinois, shipped in pieces, and assembled at the job site.

Caterpillar's sales hit $51 billion in 2008 and dropped to $32 billion in 2009 due to the recession. Japan's Komatsu remains a distant number two, with less than half the sales of Caterpillar. Caterpillar maintains 50 production facilities in the United States and 60 overseas, selling products in over 200 countries.

What's next for Caterpillar? As the company moves forward, it remains focused on reducing greenhouse gas emissions in its machinery, innovating more green technologies, maintaining its strong brand, and investing in the future of emerging countries like India and China. The company believes that in order to grow, it must be successful in emerging markets.

Questions

1. What were some of the key steps that led to Caterpillar's becoming the industry leader in earth-moving machinery?
2. Discuss Caterpillar's future. What should it do next with its product line? Where is the future growth for this company?

Sources: Green Rankings, The 2009 List," *Newsweek,* http://greenrankings.newsweek.com; Tim McKeough, "The Caterpillar Self-Driving Dump Truck," *Fast Company,* December 1, 2008; Alex Taylor III, "Caterpillar: Big Trucks, Big Sales, Big Attitude," *Fortune,* August 13, 2007; Tudor Van Hampton, "A New Heavyweight Among Hybrids," *New York Times,* January 21, 2010; Steven Pearlstein, "After Caterpillar's Turnaround, A Chance to Reinvent Globalization," *Washington Post,* April 19, 2006; Dale Buss, "CAT Is Back: An Icon That Once Seemed Headed for the Dustbin, Caterpillar Has Made an Impressive Turnaround. Here's How," *Chief Executive,* July 2005; Jessie Scanlon, "Caterpillar Rolls Out Its Hybrid D7E Tractor," *BusinessWeek,* July 20, 2009; Caterpillar, Inc. supporting materials at CLSA Asia USA Forum; www.cat.com.

Marketing Excellence

>>Toyota

In 1936, Toyota admitted following Chrysler's landmark Airflow and patterning its engine after a 1933 Chevrolet engine. But by 2000, when it introduced the first hybrid electric-gasoline car, the Prius, Toyota was the leader. In 2002, when the second-generation Prius hit showrooms, dealers received 10,000 orders before the car was even available. GM followed with an announcement that it would enter the hybrid market with models of its own.

Toyota offers a full line of cars for the U.S. market, from family sedans and sport utility vehicles to trucks and minivans. It has products for different price points, from lower-cost Scions to mid-priced Camrys to the luxury Lexus. Designing these different products means listening to different customers, building the cars they want, and then crafting marketing to reinforce each make's image.

After four years of carefully listening to teens, for instance, Toyota learned that the Scion's target age group of 16- to 21-year-olds wanted personalization. So it builds the car "mono-spec" at the factory, with just one well-equipped trim level, and lets customers choose from over 40 customization elements at dealerships, from stereo components to wheels and even floor mats. Toyota markets the Scion at music events and has showrooms where "young people feel comfortable hanging out and not a place where they just go stare at a car," said Scion Vice President Jim Letz.

In contrast, the tagline for the Lexus global strategy is "Passionate Pursuit of Perfection." Dealerships offer white-glove treatment, though Toyota understands that each country defines perfection differently. In the United States, perfection and luxury mean comfort, size, and dependability. In Europe, luxury means attention to detail and brand heritage. Thus, although Toyota maintains a consistent Lexus visual vocabulary, logo, font, and overall communication, the advertising varies by country.

Another big reason behind Toyota's success is its manufacturing. The firm is the master of lean manufacturing and continuous improvement. Its plants can make as many as eight different models at the same time, bringing huge increases in productivity and market responsiveness. And Toyota relentlessly innovates. A typical Toyota assembly line makes thousands of operational changes in the course of a single year. Toyota employees see their purpose as threefold: making cars, making cars better, and teaching everyone how to make cars better. The company encourages problem solving, always looking to improve the process by which it improves all other processes.

Toyota is integrating its assembly plants around the world into a single giant network. The plants will customize cars for local markets and shift production quickly to satisfy any surges in demand from markets worldwide. With a manufacturing network, Toyota can build a wide variety of models much more inexpensively. That means it will be able to fill market niches as they emerge without building whole new assembly operations. "If there's a market or market segment where they aren't present, they go there," said Tatsuo Yoshida, auto analyst at Deutsche Securities Ltd. And with consumers increasingly fickle about what they want in a car, such market agility gives Toyota a huge competitive edge.

In 2006, Toyota earned over $11 billion—more than all other major automakers *combined*. In 2007, it edged past General Motors to become the world's largest carmaker. And, in 2008, it manufactured 9.2 million vehicles, 1 million more than GM and almost 3 million more than Volkswagen.

Over the years, Toyota's automobiles have consistently ranked high in quality and reliability. That all changed in 2009 and 2010, however, when Toyota experienced a massive recall of over 8 million of its vehicles. A variety of problems ranging from sticking accelerator pedals to sudden acceleration to software glitches in the braking system affected many Toyota brands, including Lexus, Prius, Camry, Corolla, and Tundra.

Not only had these mechanical defects caused numerous crashes, they were linked to the deaths of over 50 people. Toyota's President Akio Toyoda testified before Congress and offered an explanation of what went wrong: "We pursued growth over the speed at which we were able to develop our people and our organization. I regret that this has resulted in the safety issues described in the recalls we face today, and I am deeply sorry for any accidents that Toyota drivers have experienced."

Analysts estimated the worldwide recall will cost Toyota $2 billion to $6 billion including repair costs, legal settlements, and lost sales. Market share dropped 4 percent in the first three months of the recall and was expected to drop even further as problems continued to unfold. Hoping to bring consumers back to the Toyota brand, the company offered incentives such as two years of free maintenance and zero-percent financing.

While Toyota rides the recall storm of 2010 and faces some challenging times, it can be comforted by the fact that it continues to lead the industry in a wide range of areas including lean manufacturing and environmentally friendly technologies.

Questions

1. Toyota has built a huge manufacturing company that can produce millions of cars each year for a wide variety of consumers. Why was it able to grow so much bigger than any other auto manufacturer?
2. Has Toyota done the right thing by manufacturing a car brand for everyone? Why or why not?
3. Did Toyota grow too quickly as Toyoda suggested? What should the company do over the next year, 5 years, and 10 years? How can growing companies avoid quality problems in the future?

Sources: Martin Zimmerman, "Toyota's First Quarter Global Sales Beat GM's Preliminary Numbers," *Los Angeles Times*, April 24, 2007; Charles Fishman, "No Satisfaction at Toyota," *Fast Company,* December 2006–January 2007, pp. 82–90; Stuart F. Brown, "Toyota's Global Body Shop," *Fortune*, February 9, 2004, p. 120; James B. Treece, "Ford Down; Toyota Aims for No. 1," *Automotive News*, February 2, 2004, p. 1; Brian Bemner and Chester Dawson, "Can Anything Stop Toyota?" *BusinessWeek*, November 17, 2003, pp. 114–22; Tomoko A. Hosaka, "Toyota Counts Rising Costs of Recall Woes," *Associated Press,* March 16, 2010; "World Motor Vehicle Production by Manufacturer," *OICA,* July 2009; Chris Isidore, "Toyota Recall Costs: $2 billion," http://money.cnn.com, February 4, 2010; www.toyota.com.

In This Chapter, We Will Address the Following Questions

1. How do we define and classify services, and how do they differ from goods?
2. What are the new services realities?
3. How can we achieve excellence in services marketing?
4. How can we improve service quality?
5. How can goods marketers improve customer-support services?

The unconventional Cirque du Soleil organization creates memorable experiences for its audiences through its creative redefinition of the circus concept.

Designing and Managing Services

As product companies find it harder and harder to differentiate their physical products, they turn to service differentiation. Many in fact find significant profitability in delivering superior service, whether that means on-time delivery, better and faster answering of inquiries, or quicker resolution of complaints. Top service providers know these advantages well and also how to create memorable customer experiences.[1]

In its 25-year history, Cirque du Soleil (French for "circus of the sun") has continually broken loose from circus convention. It takes traditional ingredients such as trapeze artists, clowns, muscle men, and contortionists and places them in a nontraditional setting with lavish costumes, new age music, and spectacular stage designs. And it eliminates other commonly observed circus elements—there are no animals. Each production is loosely tied together with a theme such as "a tribute to the nomadic soul" (Varekai) or "a phantasmagoria of urban life" (Saltimbanco). The group has grown from its Quebec street-performance roots to become a half-billion-dollar global enterprise, with 3,000 employees on four continents entertaining audiences of millions annually.

Part of its success comes from a company culture that encourages artistic creativity and innovation and carefully safeguards the brand. One new production is created each year—always in-house—and is unique: There are no duplicate touring companies. In addition to Cirque's mix of media and local promotion, an extensive interactive e-mail program to its million-plus-member Cirque Club creates an online community of fans—20 percent to 30 percent of all ticket sales come from club members. Generating $800 million in revenue annually, the Cirque du Soleil brand has expanded to encompass a record label, a retail operation, and resident productions in Las Vegas (five in all), Orlando, Tokyo, and other cities.[2]

Because it is critical to understand the special nature of services and what that means to marketers, in this chapter we systematically analyze services and how to market them most effectively.

The Nature of Services

The Bureau of Labor Statistics reports that the service-producing sector will continue to be the dominant employment generator in the economy, adding about 14.6 million jobs through 2018, or 96 percent of the expected increase in total employment. By 2018, the goods-producing sector is expected to account for 12.9 percent of total jobs, down from 17.3 percent in 1998 and 14.2 percent in 2008. Manufacturing lost 4.1 million jobs from 1998 through 2008 and is expected to lose another 1.2 million jobs between 2008 and 2018.[3] These numbers and others have led to a growing interest in the special problems of marketing services.[4]

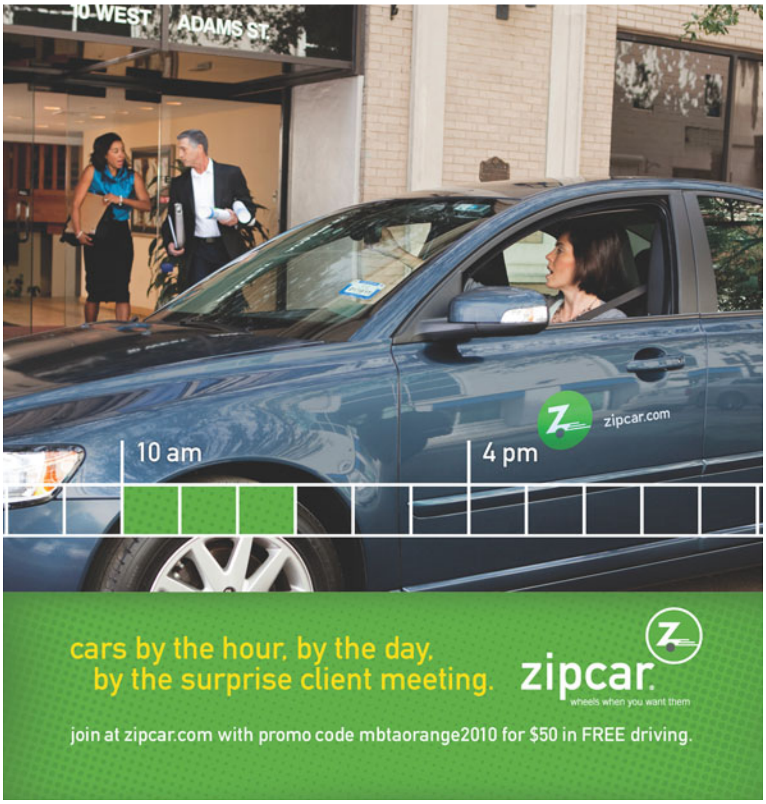
Service Industries Are Everywhere

The *government sector,* with its courts, employment services, hospitals, loan agencies, military services, police and fire departments, postal service, regulatory agencies, and schools, is in the service business. The *private nonprofit sector*—museums, charities, churches, colleges, foundations, and hospitals—is in the service business. A good part of the *business sector,* with its airlines, banks, hotels, insurance companies, law firms, management consulting firms, medical practices, motion picture companies, plumbing repair companies, and real estate firms, is in the service business. Many workers in the *manufacturing sector,* such as computer operators, accountants, and legal staff, are really service providers. In fact, they make up a "service factory" providing services to the "goods factory." And those in the *retail sector,* such as cashiers, clerks, salespeople, and customer service representatives, are also providing a service.

A **service** is any act or performance one party can offer to another that is essentially intangible and does not result in the ownership of anything. Its production may or may not be tied to a physical product. Increasingly, manufacturers, distributors, and retailers are providing value-added services, or simply excellent customer service, to differentiate themselves. Many pure service firms are now using the Internet to reach customers; some are purely online. Monster.com's Webby-award-winning site offers online career advice and employment recruiting. Done right, improvements or innovations in customer service can have a big payoff, as Zipcar found.

Zipcar Car sharing started in Europe as a means to extend public transportation. In the United States the appeal of Zipcar, the market leader and pioneer, is both environmental and economic. With a $50 membership fee and rates that total less than $100 a day—which includes gas, insurance, and parking—a typical family could save $3,000 to $4,000 a year by substituting Zipcar use for car ownership. Zipcar's fleet includes all types of popular models—BMWs, Volvos, pickup trucks, and even MINI Coopers and the Toyota Prius hybrid—and the firm estimates that every car it adds keeps up to 20 private cars off the road. Consumers—and an increasing number of universities and businesses—book online and use a sophisticated reservation system to reserve a specific car in their neighborhood. There are a number of rules for car care (such as no smoking) and logistics (such as calling to extend a reservation if running late). As CEO Scott Griffith states, "Our business model depends on the kindness of others." To help increase awareness, Zipcar slaps its logo on the side of all but the high-end luxury models. Unusual marketing stunts such as a contest to guess how many Swedish meatballs had been stuffed into a MINI Cooper parked in an IKEA parking lot also help to spread the word. Targeting major cities and college towns, the company is growing about 30 percent a year.[5]

Zipcar offers its fast-growing customer base a practical, environmentally friendly alternative to car ownership.



Categories of Service Mix

The service component can be a minor or a major part of the total offering. We distinguish five categories of offerings:

1. ***Pure tangible good***—a tangible good such as soap, toothpaste, or salt with no accompanying services.
2. ***Tangible good with accompanying services***—a tangible good, like a car, computer, or cell phone, accompanied by one or more services. Typically, the more technologically advanced the product, the greater the need for high-quality supporting services.
3. ***Hybrid***—an offering, like a restaurant meal, of equal parts goods and services. People patronize restaurants for both the food and its preparation.

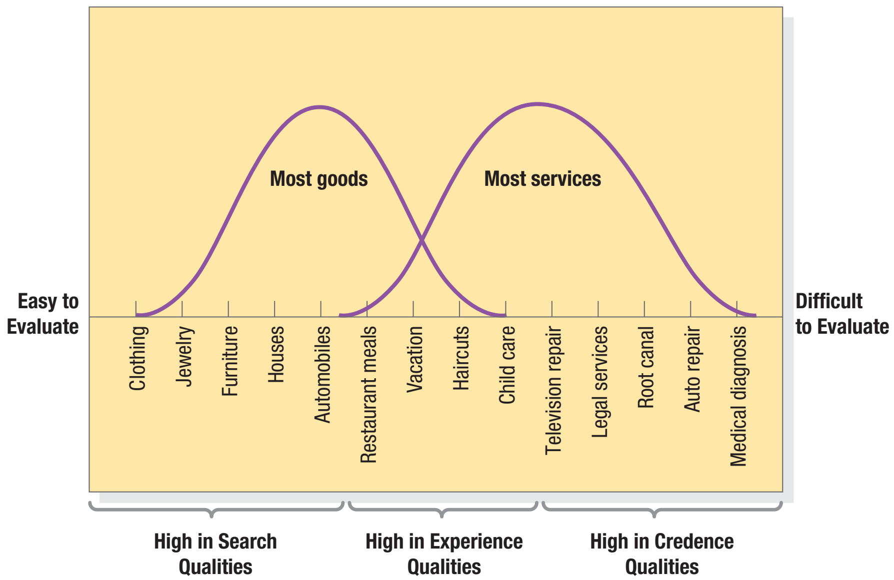
4. ***Major service with accompanying minor goods and services***—a major service, like air travel, with additional services or supporting goods such as snacks and drinks. This offering requires a capital-intensive good—an airplane—for its realization, but the primary item is a service.
5. ***Pure service***—primarily an intangible service, such as babysitting, psychotherapy, or massage.

The range of service offerings makes it difficult to generalize without a few further distinctions.

- Services vary as to whether they are *equipment based* (automated car washes, vending machines) or *people based* (window washing, accounting services). People-based services vary by whether unskilled, skilled, or professional workers provide them.
- Service companies can choose among different *processes* to deliver their service. Restaurants offer cafeteria-style, fast-food, buffet, and candlelight service formats.
- Some services need the *client's presence*. Brain surgery requires the client's presence, a car repair does not. If the client must be present, the service provider must be considerate of his or her needs. Thus beauty salon operators will invest in décor, play background music, and engage in light conversation with the client.
- Services may meet a *personal need* (personal services) or a *business need* (business services). Service providers typically develop different marketing programs for these markets.
- Service providers differ in their *objectives* (profit or nonprofit) and *ownership* (private or public). These two characteristics, when crossed, produce four quite different types of organizations. The marketing programs of a private investor hospital will differ from those of a private charity hospital or a Veterans Administration hospital.[6]

Customers typically cannot judge the technical quality of some services even after they have received them. Figure 13.1 shows various products and services according to difficulty of evaluation.[7] At the left are goods high in *search qualities*—that is, characteristics the buyer can evaluate before purchase. In the middle are goods and services high in *experience qualities*—characteristics the buyer can evaluate after purchase. At the right are goods and services high in *credence qualities*—characteristics the buyer normally finds hard to evaluate even after consumption.[8]

Because services are generally high in experience and credence qualities, there is more risk in their purchase, with several consequences. First, service consumers generally rely on word of mouth rather than advertising. Second, they rely heavily on price, provider, and physical cues to judge quality. Third, they are highly loyal to service providers who satisfy them. Fourth, because switching costs are high, consumer inertia can make it challenging to entice business away from a competitor.



|Fig. 13.1|

Continuum of Evaluation for Different Types of Products

Source: Valarie A. Zeithaml, "How Consumer Evaluation Processes Differ between Goods and Services," James H. Donnelly and William R. George, eds., *Marketing of Services* (Chicago: American Marketing Association, 1981). Reprinted with permission of the American Marketing Association.

Distinctive Characteristics of Services

Four distinctive service characteristics greatly affect the design of marketing programs: *intangibility, inseparability, variability,* and *perishability*.[9]

INTANGIBILITY Unlike physical products, services cannot be seen, tasted, felt, heard, or smelled before they are bought. A person getting cosmetic surgery cannot see the results before the purchase, and the patient in the psychiatrist's office cannot know the exact outcome of treatment. To reduce uncertainty, buyers will look for evidence of quality by drawing inferences from the place, people, equipment, communication material, symbols, and price. Therefore, the service provider's task is to "manage the evidence," to "tangibilize the intangible."[10]

Service companies can try to demonstrate their service quality through *physical evidence* and *presentation.*[11] Suppose a bank wants to position itself as the "fast" bank. It could make this positioning strategy tangible through any number of marketing tools:

1. ***Place***—The exterior and interior should have clean lines. The layout of the desks and the traffic flow should be planned carefully. Waiting lines should not get overly long.
2. ***People***—Employees should be busy, but there should be a sufficient number to manage the workload.
3. ***Equipment***—Computers, copy machines, desks, and ATMs should look like, and be, state of the art.
4. ***Communication material***—Printed materials—text and photos—should suggest efficiency and speed.
5. ***Symbols***—The bank's name and symbol could suggest fast service.
6. ***Price***—The bank could advertise that it will deposit $5 in the account of any customer who waits in line more than five minutes.

Service marketers must be able to transform intangible services into concrete benefits and a well-defined experience.[12] Disney is a master at "tangibilizing the intangible" and creating magical fantasies in its theme parks; so are companies such as Jamba Juice and Barnes & Noble in their respective retail stores.[13] Table 13.1 measures brand experiences in general along sensory, affective, behavioral, and intellectual dimensions. Applications to services are clear.

TABLE 13.1 Dimensions of Brand Experience

Sensory	
•	This brand makes a strong impression on my visual sense or other senses.
•	I find this brand interesting in a sensory way.
•	This brand does not appeal to my senses.
Affective	
•	This brand induces feelings and sentiments.
•	I do not have strong emotions for this brand.
•	This brand is an emotional brand.
Behavioral	
•	I engage in physical actions and behaviors when I use this brand.
•	This brand results in bodily experiences.
•	This brand is not action-oriented.
Intellectual	
•	I engage in a lot of thinking when I encounter this brand.
•	This brand does not make me think.
•	This brand stimulates my curiosity and problem solving.

Source: Joško Brakus, Bernd H. Schmitt, and Lia Zarantonello, "Brand Experience: What Is It? How Is It Measured? Does It Affect Loyalty?" *Journal of Marketing* 73 (May 2009), pp. 52–68. Reprinted with permission from *Journal of Marketing*, published by the American Marketing Association.

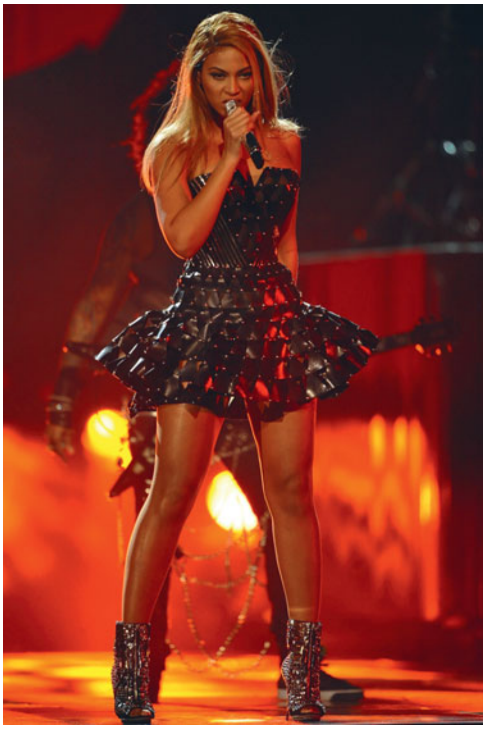
Because there is no physical product, the service provider's facilities—its primary and secondary signage, environmental design and reception area, employee apparel, collateral material, and so on—are especially important. All aspects of the service delivery process can be branded, which is why Allied Van Lines is concerned about the appearance of its drivers and laborers, why UPS has developed such strong equity with its brown trucks, and why Hilton's Doubletree Hotels offers fresh-baked chocolate chip cookies to symbolize care and friendliness.[14]

Service providers often choose brand elements—logos, symbols, characters, and slogans—to make the service and its key benefits more tangible—for example, the "friendly skies" of United, the "good hands" of Allstate, and the "bullish" nature of Merrill Lynch.

INSEPARABILITY Whereas physical goods are manufactured, then inventoried, then distributed, and later consumed, services are typically produced and consumed simultaneously.[15] A haircut can't be stored—or produced without the barber. The provider is part of the service. Because the client is also often present, provider–client interaction is a special feature of services marketing. Buyers of entertainment and professional services are very interested in the specific provider. It's not the same concert if Taylor Swift is indisposed and replaced by Beyoncé, or if a corporate legal defense is supplied by an intern because antitrust expert David Boies is unavailable. When clients have strong provider preferences, the provider can raise its price to ration its limited time.

Several strategies exist for getting around the limitations of inseparability. The service provider can work with larger groups. Some psychotherapists have moved from one-on-one therapy to small-group therapy to groups of over 300 people in a large hotel ballroom. The service provider can work faster—the psychotherapist can spend 30 more efficient minutes with each patient instead of 50 less-structured minutes and thus see more patients. The service organization can train more service providers and build up client confidence, as H&R Block has done with its national network of trained tax consultants.

VARIABILITY Because the quality of services depends on who provides them, when and where, and to whom, services are highly variable. Some doctors have an excellent bedside manner; others are less empathic.

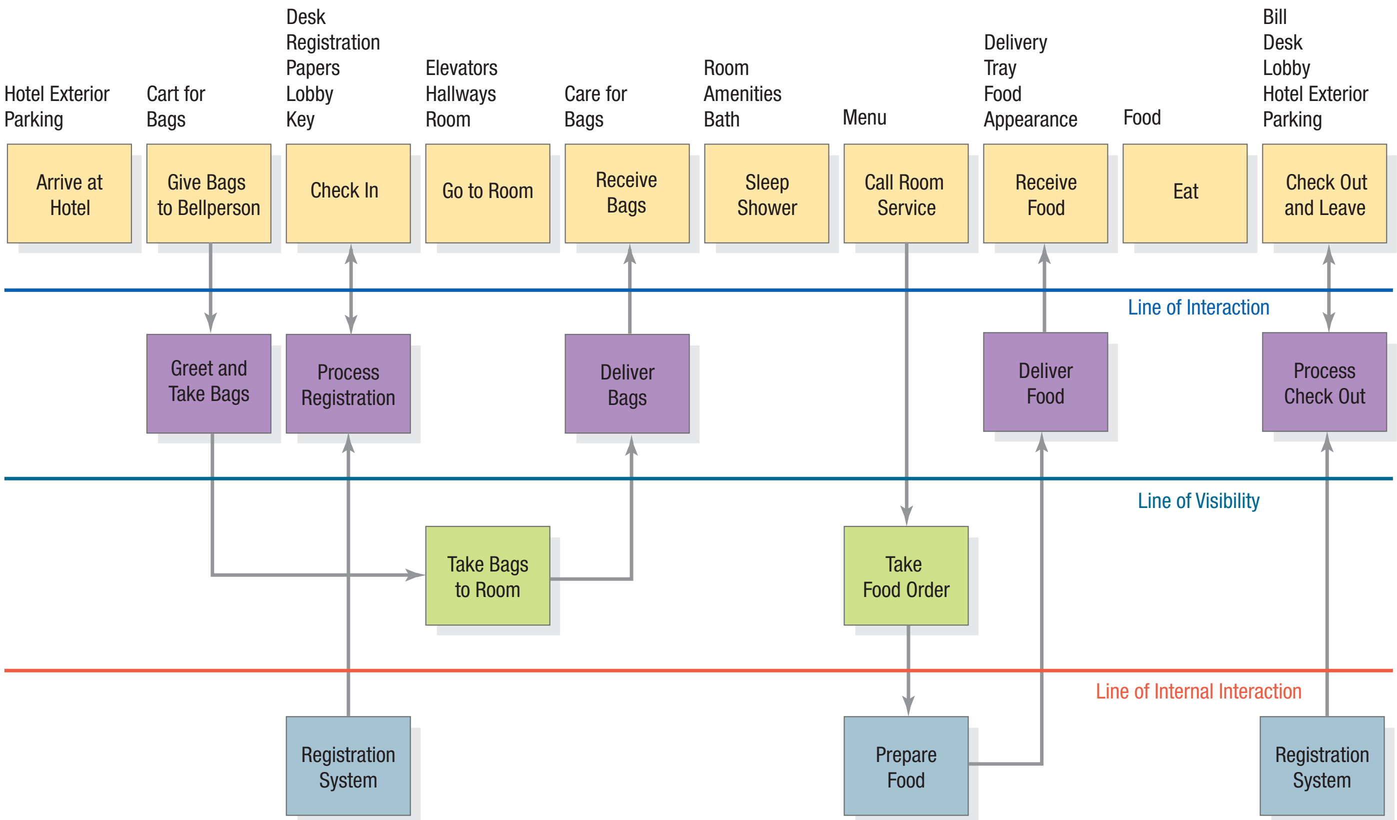


A different entertainer creates a different concert experience—a Beyoncé concert is not the same as a Taylor Swift concert.

Service buyers are aware of this variability and often talk to others before selecting a service provider. To reassure customers, some firms offer *service guarantees* that may reduce consumer perceptions of risk.[16] Here are three steps service firms can take to increase quality control.

1. ***Invest in good hiring and training procedures.*** Recruiting the right employees and providing them with excellent training is crucial, regardless of whether employees are highly skilled professionals or low-skilled workers. Better-trained personnel exhibit six characteristics: Competence, courtesy, credibility, reliability, responsiveness, and communication.[17] Given the diverse nature of its customer base in California, banking and mortgage giant Wells Fargo actively seeks and trains a diverse workforce. The average Wells Fargo customer uses 5.2 different bank products, roughly twice the industry average, thanks in part to the teamwork of its highly motivated staff.[18]
2. ***Standardize the service-performance process throughout the organization.*** A *service blueprint* can map out the service process, the points of customer contact, and the evidence of service from the customer's point of view.[19] Figure 13.2 shows a service blueprint for a guest spending a night at a hotel.[20] Behind the scenes, the hotel must skillfully help the guest move from one step to the next. Service blueprints can be helpful in developing new service, supporting a zero-defects culture, and devising service recovery strategies.
3. ***Monitor customer satisfaction.*** Employ suggestion and complaint systems, customer surveys, and comparison shopping. Customer needs may vary in different areas, allowing firms to develop region-specific customer satisfaction programs.[21] Firms can also develop customer information databases and systems for more personalized service, especially online.[22]

Because services are a subjective experience, service firms can also design marketing communication and information programs so consumers learn more about the brand than what they get from service encounters alone.



|Fig. 13.2|

Blueprint for Overnight Hotel Stay

Source: Valarie Zeithaml, Mary Jo Bitner, and Dwayne D. Gremler, *Services Marketing: Integrating Customer Focus across the Firm*, 4th ed. (New York: McGraw-Hill, 2006).

PERISHABILITY Services cannot be stored, so their perishability can be a problem when demand fluctuates. Public transportation companies must own much more equipment because of rush-hour demand than if demand were even throughout the day. Some doctors charge patients for missed appointments because the service value (the doctor's availability) exists only at the time of the appointment.

Demand or yield management is critical—the right services must be available to the right customers at the right places at the right times and right prices to maximize profitability. Several strategies can produce a better match between service demand and supply.[23] On the demand side:

- ***Differential pricing*** will shift some demand from peak to off-peak periods. Examples include low matinee movie prices and weekend discounts for car rentals.[24]
- ***Nonpeak demand*** can be cultivated. McDonald's pushes breakfast service, and hotels promote minivacation weekends.
- ***Complementary services*** can provide alternatives to waiting customers, such as cocktail lounges in restaurants and automated teller machines in banks.
- ***Reservation systems*** are a way to manage the demand level. Airlines, hotels, and physicians employ them extensively.

Disney's innovative FASTPASS system helps to match supply and demand for its Disney World theme park rides.

On the supply side:

- ***Part-time employees*** can serve peak demand. Colleges add part-time teachers when enrollment goes up; stores hire extra clerks during holiday periods.
- ***Peak-time efficiency*** routines can allow employees to perform only essential tasks during peak periods. Paramedics assist physicians during busy periods.
- ***Increased consumer participation*** frees service providers' time. Consumers fill out their own medical records or bag their own groceries.
- ***Shared services*** can improve offerings. Several hospitals can share medical-equipment purchases.
- ***Facilities for future expansion*** can be a good investment. An amusement park buys surrounding land for later development.

Many airlines, hotels, and resorts e-mail short-term discounts and special promotions to self-selected customers. After 40 years of making people stand in line at its theme parks, Disney instituted FASTPASS, which allows visitors to reserve a spot in line and eliminate the wait. Polls revealed 95 percent like the change. Disney's vice president, Dale Stafford, told a reporter, "We have been teaching people how to stand in line since 1955, and now we are telling them they don't have to. Of all the things we can do and all the marvels we can create with the attractions, this is something that will have a profound effect on the entire industry."[25]

The New Services Realities

Service firms once lagged behind manufacturers in their use of marketing because they were small, or they were professional businesses that did not use marketing, or they faced large demand or little competition. This has certainly changed. Some of the most skilled marketers now are service firms. One that wins praise for its marketing success is Singapore Airlines.

Singapore Airlines (SIA) Singapore Airlines is consistently recognized as the world's "best" airline—it wins so many awards, it has to update its Web site monthly to keep up to date—in large part due to its stellar holistic marketing. Famous for pampering passengers, SIA continually strives to create a "wow effect" and surpass customers' expectations. It was the first to launch individual video screens at airplane seats. Thanks to the first-of-its-kind $1 million simulator SIA built to mimic the air pressure and humidity inside a plane, the carrier found that taste buds change in the air and that, among other things, it needed to cut back on spices in its food. SIA places a high value on training; its "Transforming Customer Service (TCS)" program includes staff in five key operational areas: cabin crew, engineering, ground services, flight operations, and sales support. The TCS culture is also embedded in all management training, company-wide. It

Singapore Airlines goes to extraordinary lengths to ensure that every aspect of the passenger experience exceeds expectations.

applies a 40-30-30 rule in its holistic approach to people, processes, and products: 40 percent of resources go to training and invigorating staff, 30 percent to reviewing process and procedures, and 30 percent to creating new product and service ideas. With its innovatively designed Boeing 777-300 ERS and Airbus A380 planes, SIA set new standards of comforts in all classes of service, from eight private minirooms in first class to wider seats, AC power supplies, and USB ports in coach.[26]

A Shifting Customer Relationship

Not all companies, however, have invested in providing superior service, at least not to all customers. In many service industries, such as airlines, banks, stores, and hotels, customer satisfaction in the United States has not significantly improved—or in some cases actually dropped—in recent years.[27] Customers complain about inaccurate information; unresponsive, rude, or poorly trained workers; and long wait times. Even worse, many find their complaints never actually reach a live human being because of slow or faulty phone or online reporting systems.

It doesn't have to be that way. Fifty-five operators handle 100,000 calls a year on Butterball Turkeys' 800 number—10,000 on Thanksgiving Day alone—about how to prepare, cook, and serve turkeys. Trained at Butterball University, the operators have all cooked turkeys dozens of different ways and can handle the myriad queries that come their way, including why customers shouldn't stash turkeys in snow banks or thaw them in bathtubs.[28]

Savvy services marketers are recognizing the new services realities, such as the importance of the newly empowered customer, customer coproduction, and the need to engage employees as well as customers.

CUSTOMER EMPOWERMENT Customers are becoming more sophisticated about buying product-support services and are pressing for " unbundled services." They may desire separate prices for each service element and the right to select the elements they want. Customers also increasingly dislike having to deal with a multitude of service providers handling different types of equipment. Some third-party service organizations now service a greater range of equipment.

Customer service dissatisfaction increasingly goes viral—Canadian singer Dave Carroll's musical frustration with United Airlines was downloaded by millions.

Most importantly, the Internet has empowered customers by letting them vent their rage about bad service—or reward good service—and send their comments around the world with a mouse click. Although a person who has a good customer experience is more likely to talk about it, someone who has a bad experience will talk to more people.[29] Ninety percent of angry customers reported sharing their story with a friend. Now, they can share their stories with strangers too. At PlanetFeedback.com, shoppers can send a complaint, compliment, suggestion, or question directly to a company, with the option to post comments publicly on the site as well.

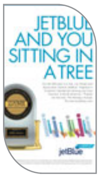
United Breaks Guitars When Canadian singer Dave Carroll faced $1,200 in damages to his $3,000 Gibson guitar after a United flight, he put his creative energy to good use. He created a humorous video, *United Breaks Guitars*, and launched it on YouTube with this catchy refrain:

> "United, you broke my Taylor guitar. United, some big help you are. You broke it, you should fix it. You're liable, just admit it. I should have flown with someone else or gone by car 'cuz United breaks guitars."

Viewed over 5 million times, his follow-up video focused on his frustrating efforts to get United to pay for the damage. United got the message. It donated a check for $1,200 to a charity Carroll designated and now uses the incident in training baggage handlers and customer-service representatives.[30]

Most companies respond quickly. Comcast allows contact 24/7 by phone and e-chat but also reaches out to customers and monitors blogs, Web sites, and social media. If employees see a customer report a problem on a blog, they get in touch and offer help. E-mail responses to customers must be implemented properly to be effective. One expert believes companies should (1) send an automated reply to tell customers when a more complete answer will arrive (ideally within 24 hours), (2) ensure the subject line always contains the company name, (3) make the message easy to scan for relevant information, and (4) give customers an easy way to respond with follow-up questions.[31]

More important than simply responding to a disgruntled customer, however, is preventing dissatisfaction from occurring in the future. That may mean simply taking the time to nurture customer relationships and give customers attention from a real person. Columbia Records spent $10 million to improve its call center, and customers who phone the company can now opt out to reach an operator at any point in their call. JetBlue took a service disaster and used it to improve its customer service approach.



JetBlue CEO David Neeleman set the bar high for responding to enraged customers after the company's drastic Valentine's Day failure of 2007. During storms in New York City, JetBlue left hundreds of passengers stranded aboard grounded aircraft—some for longer than 9 hours without amenities—and cancelled more than 1,000 flights. JetBlue had built its reputation on being a more responsive, humane airline in an era of minimal services and maximal delays. Neeleman knew he had to act fast to stem another kind of storm: a whirlwind of customer defections. Within 24 hours, he had placed full-page ads in newspapers nationwide in which he personally responded to JetBlue's debacle. "We are sorry and embarrassed," the ads declared, "But most of all we are deeply sorry." JetBlue gave concrete reparations to passengers. Neeleman announced a new "customer bill of rights" that promised passengers travel credits for excessive waits. For instance, passengers who are unable to disembark from an arriving flight for 3 hours or more would receive vouchers worth the full value of their round-trip ticket. JetBlue will also hand out vouchers for the full amount of passengers' round trips if a flight is cancelled within 12 hours of a scheduled departure. The apology, backed by concrete benefits for the angry and inconvenienced passengers, netted kudos for the company from both the business press and JetBlue's own true blue customers. Neeleman eventually stepped down as new management was brought in to address some of the growth challenges the airline faced.[32]

JetBlue weathered a customer service disaster and continues to receive kudos from its passengers.

CUSTOMER COPRODUCTION The reality is that customers do not merely purchase and use a service; they play an active role in its delivery.[33] Their words and actions affect the quality of their service experiences and those of others, and the productivity of frontline employees.

Customers often feel they derive more value, and feel a stronger connection to the service provider, if they are actively involved in the service process. This coproduction can put stress on employees, however, and reduce their satisfaction, especially if they differ culturally or in other ways from customers.[34] Moreover, one study estimated that one-third of all service problems are caused by the customer.[35] The growing shift to self-service technologies will likely increase this percentage.

Preventing service failures is crucial, since recovery is always challenging. One of the biggest problems is attribution—customers often feel the firm is at fault or, even if not, that it is still responsible for righting any wrongs. Unfortunately, although many firms have well-designed and executed procedures to deal with their own failures, they find managing *customer* failures—when a service problem arises from a customer's lack of understanding or ineptitude—much more difficult. △ Figure 13.3 displays the four broad causes of customer failures. Solutions come in all forms, as these examples show:[36]

1. ***Redesign processes and redefine customer roles to simplify service encounters.*** One of the keys to Netflix's success is that it charges a flat fee and allows customers to return DVDs by mail at their leisure, giving customers greater control and flexibility.
2. ***Incorporate the right technology to aid employees and customers.*** Comcast, the largest cable operator by subscribers in the United States, introduced software to identify network glitches before they affected service and to better inform call-center operators about customer problems. Repeat service calls dropped 30 percent as a result.
3. ***Create high-performance customers by enhancing their role clarity, motivation, and ability.*** USAA reminds enlisted policyholders to suspend their car insurance when they are stationed overseas.
4. ***Encourage "customer citizenship" so customers help customers.*** At golf courses, players can not only follow the rules by playing and behaving appropriately, they can encourage others to do so.

SATISFYING EMPLOYEES AS WELL AS CUSTOMERS Excellent service companies know that positive employee attitudes will promote stronger customer loyalty.[37] Instilling a strong customer orientation in employees can also increase their job satisfaction and commitment, especially if they have high customer contact. Employees thrive in customer-contact positions when they have an internal drive to (1) pamper customers, (2) accurately read customer needs, (3) develop a personal relationship with customers, and (4) deliver quality service to solve customers' problems.[38]

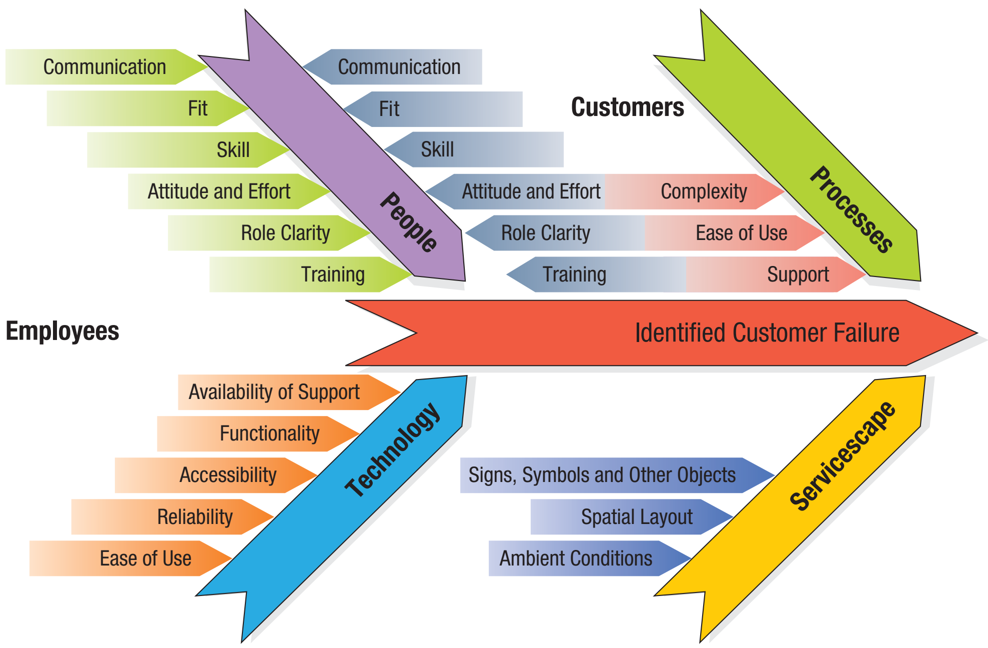
Consistent with this reasoning, Sears found a high correlation between customer satisfaction, employee satisfaction, and store profitability. In companies such as Hallmark, John Deere, and Four Seasons Hotels, employees exhibit real company pride. The downside of not treating employees right is significant. A survey of 10,000 employees from the largest 1,000 companies found that 40 percent of workers cited "lack of recognition" as a key reason for leaving a job.[39]

Given the importance of positive employee attitudes to customer satisfaction, service companies must attract the best employees they can find. They need to market a career rather than just a job. They must design a sound training program and provide support and rewards for good performance. They can use the intranet, internal newsletters, daily reminders, and employee roundtables to reinforce customer-centered attitudes. Finally, they must audit employee job satisfaction regularly.

|Fig. 13.3| △

Root Causes of Customer Failure

Source: Stephen Tax, Mark Colgate, and David Bowen, *MIT Sloan Management Review* (Spring 2006): pp. 30–38.



The Panda Express restaurant chain has management turnover that's half the industry average, due in part to a combination of ample bonuses and health benefits with a strong emphasis on worker self-improvement through meditation, education, and hobbies. Special wellness seminars and get-to-know-you events outside work help to create a caring, nurturing atmosphere.[40]

Achieving Excellence in Services Marketing

The increased importance of the service industry has sharpened the focus on what it takes to excel in the marketing of services.[41] Here are some guidelines.

Marketing Excellence

Marketing excellence with services requires excellence in three broad areas: external, internal, and interactive marketing (see Figure 13.4).[42]

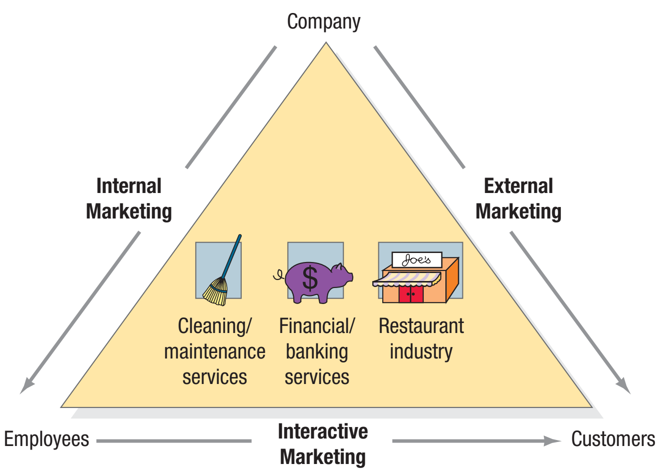
- ***External marketing*** describes the normal work of preparing, pricing, distributing, and promoting the service to customers.
- ***Internal marketing*** describes training and motivating employees to serve customers well. The most important contribution the marketing department can make is arguably to be "exceptionally clever in getting everyone else in the organization to practice marketing."[43]
- ***Interactive marketing*** describes the employees' skill in serving the client. Clients judge service not only by its *technical quality* (Was the surgery successful?), but also by its *functional quality* (Did the surgeon show concern and inspire confidence?).[44]

A good example of a service company achieving marketing excellence is Charles Schwab.

Charles Schwab

Charles Schwab

Charles Schwab, one of the nation's largest discount brokerage houses, uses the telephone, Internet, and wireless devices to create an innovative combination of high-tech and high-touch services. One of the first major brokerage houses to provide online trading, Schwab today services more than 8 million individual and institutional accounts. It offers account information and proprietary research from retail brokers, real-time quotes, an after-hours trading program, the Schwab learning center, live events, online chats with customer service representatives, a global investing service, and market updates delivered by e-mail. Besides the discount brokerage, the firm offers mutual funds, annuities, bond trading, and now mortgages through its Charles Schwab Bank. Schwab's success has been driven by its efforts to lead in three areas: superior service (online, via phone, and in local branch offices), innovative products, and low prices. Daily customer feedback reports are reviewed and acted on the next day. If customers have trouble filling out a form or experience an unexpected delay, a Schwab representative calls to ask about the source of the problem and how it can be solved.[45]



|Fig. 13.4|

Three Types of Marketing in Service Industries

In interactive marketing, teamwork is often key, and delegating authority to frontline employees can allow for greater service flexibility and adaptability through better problem solving, closer employee cooperation, and more efficient knowledge transfer.[46]

Technology also has great power to make service workers more productive. When US Airways deployed handheld scanners to better track baggage in 2008, mishandled baggage decreased almost 50 percent from the year before. The new technology paid for itself in the first year and helped contribute to a 35 percent drop in complaints.[47]

Sometimes new technology has unanticipated benefits. When BMW introduced Wi-Fi to its dealerships to help customers pass the time more productively while their cars were being serviced, more customers chose to stay rather than use loaner cars, an expensive item for dealers to maintain.[48]

Companies must avoid pushing productivity so hard, however, that they reduce perceived quality. Some methods lead to too much standardization. Service providers must deliver "high touch" as well as "high tech." Amazon.com has some of the most amazing technological innovations in online retailing, but it also keeps customers extremely satisfied when a problem arises even if they don't actually talk to an Amazon.com employee.[49]

The Internet lets firms improve their service offerings and strengthen their relationships with customers by allowing for true interactivity, customer-specific and situational personalization, and real-time adjustments of the firm's offerings.[50] But as companies collect, store, and use more information about customers, they have also raised concerns about security and privacy.[51] Companies must incorporate the proper safeguards and reassure customers about their efforts.

Best Practices of Top Service Companies

In achieving marketing excellence with their customers, well-managed service companies share a strategic concept, a history of top-management commitment to quality, high standards, profit tiers, and systems for monitoring service performance and customer complaints.

STRATEGIC CONCEPT Top service companies are "customer obsessed." They have a clear sense of their target customers and their needs and have developed a distinctive strategy for satisfying these needs. At the Four Seasons luxury hotel chain, employees must pass four interviews before being hired. Each hotel also employs a "guest historian" to track guest preferences. With more branch offices in the United States than Starbucks has, Edward Jones brokerage stays close to customers by assigning a single financial advisor and one administrator to each office. Although costly, maintaining such small teams fosters personal relationships.[52]

TOP-MANAGEMENT COMMITMENT Companies such as Marriott, Disney, and USAA have a thorough commitment to service quality. Their managements look monthly not only at financial performance, but also at service performance. Ray Kroc of McDonald's insisted on continually measuring each McDonald's outlet on its conformance to QSCV: quality, service, cleanliness, and value. Some companies insert a reminder along with employees' paychecks: "Brought to you by the customer." Sam Walton of Walmart required the following employee pledge: "I solemnly swear and declare that every customer that comes within 10 feet of me, I will smile, look them in the eye, and greet them, so help me Sam."

HIGH STANDARDS The best service providers set high quality standards. Citibank aims to answer phone calls within 10 seconds and customer letters within 2 days. The standards must be set *appropriately* high. A 98 percent accuracy standard may sound good, but it would result in 64,000 lost FedEx packages a day; 6 misspelled words on each page of a book; 400,000 incorrectly filled prescriptions daily; 3 million lost USPS mail pieces each day; no phone/Internet/electricity 8 days per year or 29 minutes per day; 1,000 mislabeled or (mispriced) products at a supermarket; and 6 million people unaccounted for in a U.S. census.

PROFIT TIERS Firms have decided to raise fees and lower services to those customers who barely pay their way, and to coddle big spenders to retain their patronage as long as possible. Customers in high-profit tiers get special discounts, promotional offers, and lots of special service; customers in lower-profit tiers may get more fees, stripped-down service, and voice messages to process their inquiries.

When the recent recession hit, Zappos decided to stop offering complimentary overnight shipping to first-time buyers and offer it to repeat buyers only. The money saved was invested in a new VIP service for the company's most loyal customers.[53] Companies that provide differentiated levels of service must be careful about claiming superior service, however—customers who receive lesser treatment will bad-mouth the company and injure its reputation. Delivering services that maximize both customer satisfaction and company profitability can be challenging.

MONITORING SYSTEMS Top firms audit service performance, both their own and competitors', on a regular basis. They collect *voice of the customer (VOC) measurements* to probe customer satisfiers and dissatisfiers. They use comparison shopping, mystery or ghost shopping, customer surveys, suggestion and complaint forms, service-audit teams, and customers' letters to the president.

We can judge services on *customer importance* and *company performance*. *Importance-performance analysis* rates the various elements of the service bundle and identifies required actions. Table 13.2 shows how customers rated 14 service elements or attributes of an automobile dealer's service department on importance and performance. For example, "Job done right the first time" (attribute 1) received a mean importance rating of 3.83 and a mean performance rating of 2.63, indicating that customers felt it was highly important but not performed well. The ratings of the 14 elements are divided into four sections in Figure 13.5.

- Quadrant A in the figure shows important service elements that are not being performed at the desired levels; they include elements 1, 2, and 9. The dealer should concentrate on improving the service department's performance on these elements.

TABLE 13.2 Customer Importance and Performance Ratings for an Auto Dealership

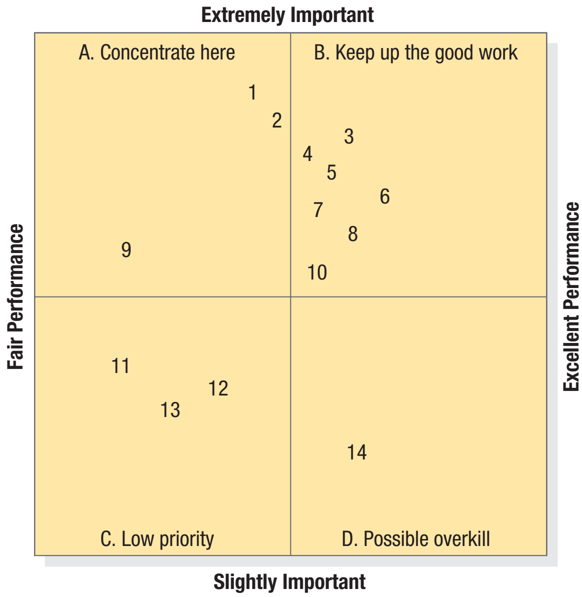
Number Attribute	Attribute Description	Mean Importance Rating[a]	Mean Performance Rating[b]
1	Job done right the first time	3.83	2.63
2	Fast action on complaints	3.63	2.73
3	Prompt warranty work	3.60	3.15
4	Able to do any job needed	3.56	3.00
5	Service available when needed	3.41	3.05
6	Courteous and friendly service	3.41	3.29
7	Car ready when promised	3.38	3.03
8	Perform only necessary work	3.37	3.11
9	Low prices on service	3.29	2.00
10	Clean up after service work	3.27	3.02
11	Convenient to home	2.52	2.25
12	Convenient to work	2.43	2.49
13	Courtesy buses and cars	2.37	2.35
14	Send out maintenance notices	2.05	3.33

[a] Ratings obtained from a four-point scale of "extremely important" (4), "important" (3), "slightly important" (2), and "not important" (1).

[b] Ratings obtained from a four-point scale of "excellent" (4), "good" (3), "fair" (2), and "poor" (1). A "no basis for judgment" category was also provided.

|Fig. 13.5|

Importance-Performance Analysis



- Quadrant B shows important service elements that are being performed well; the company needs to maintain the high performance.
- Quadrant C shows minor service elements that are being delivered in a mediocre way but do not need any attention.
- Quadrant D shows that a minor service element, "Send out maintenance notices," is being performed in an excellent manner.

Perhaps the company should spend less on sending out maintenance notices and use the savings to improve performance on important elements. Management can enhance its analysis by checking on the competitors' performance levels on each element.[54]

SATISFYING CUSTOMER COMPLAINTS On average, 40 percent of customers who suffer through a bad service experience stop doing business with the company.[55] But if those customers are willing to complain first, they actually offer the company a gift if the complaint is handled well.

Companies that encourage disappointed customers to complain—and also empower employees to remedy the situation on the spot—have been shown to achieve higher revenues and greater profits than companies without a systematic approach for addressing service failures.[56] Pizza Hut prints its toll-free number on all pizza boxes. When a customer complains, Pizza Hut sends a voice mail to the store manager, who must call the customer within 48 hours and resolve the complaint.

Getting frontline employees to adopt *extra-role behaviors,* and to advocate the interests and image of the firm to consumers, as well as take initiative and engage in conscientious behavior in dealing with customers, can be a critical asset in handling complaints.[57] Customers evaluate complaint incidents in terms of the outcomes they receive, the procedures used to arrive at those outcomes, and the nature of interpersonal treatment during the process.[58]

Companies also are increasing the quality of their *call centers* and their *customer service representatives* (CSRs). "Marketing Insight: Improving Company Call Centers" illustrates what top companies are doing.

Differentiating Services

Finally, customers who view a service as fairly homogeneous care less about the provider than about the price. Marketing excellence requires service marketers to continually differentiate their brands so they are not seen as a commodity.

PRIMARY AND SECONDARY SERVICE OPTIONS Marketers can differentiate their service offerings in many ways, through people and processes that add value. What the customer

Marketing Insight

Improving Company Call Centers

Many firms have learned the hard way that demanding, empowered customers will no longer put up with poor service when contacting companies.

After Sprint and Nextel merged, they set out to run their call centers as cost centers, rather than a means to enhance customer loyalty. Employee rewards were based on keeping customer calls short, and when management started to monitor even bathroom trips, morale sank. With customer churn spinning out of control, Sprint Nextel began a service improvement plan at the end of 2007 to put more emphasis on service over efficiency. Among other changes that accompanied the appointment of the firm's first chief service officer, call center operators were rewarded for solving problems on a customer's first call, rather than for keeping their calls short. The average customer contacted customer service four times in 2008, a drop from eight times in 2007.

Some firms are getting smarter about the type of calls they send overseas to off-shore call centers. They are investing more in training as well as returning more complex calls to highly trained domestic customer service reps. *Homeshoring* occurs when a customer service rep works from home with a broadband line and computer. These at-home reps often provide higher-quality service at less cost and with lower turnover.

Firms have to manage their number of customer service reps carefully. One study showed that cutting just four reps at a call center of three dozen sent the number of customers put on hold for four minutes or more from zero to eighty. Firms can also try to reasonably get more from each rep. USAA cross-trains its call center reps so that agents who answer investment queries can also respond to insurance-related calls, reducing the number of transfers between agents and increasing productivity as a result. USAA and other firms such as KeyBank and Ace Hardware have also consolidated call center operations into fewer locations, allowing them to maintain their number of reps in the process.

Finally, keeping call center reps happy and motivated is obviously also a key to their ability to offer excellent customer service. American Express lets call center reps choose their own hours and swap shifts without a supervisor's approval.

Sources: Michael Sanserino and Cari Tuna, "Companies Strive Harder to Please Customers," *Wall Street Journal*, July 27, 2009, p. B4; Spencer E. Ante, "Sprint's Wake-Up Call," *BusinessWeek*, March 3, 2008, pp. 54–57; Jena McGregor, "Customer Service Champs," *BusinessWeek*, March 5, 2007; Jena McGregor, "When Service Means Survival," *BusinessWeek*, March 2, 2009, pp. 26–30.

expects is called the *primary service package.* Vanguard, the second-largest no-load mutual fund company, has a unique client ownership structure that lowers costs and permits better fund returns. Strongly differentiated from many competitors, the brand grew through word of mouth, PR, and viral marketing.[59]

The provider can add *secondary service features* to the package. In the hotel industry, various chains have introduced such secondary service features as merchandise for sale, free breakfast buffets, and loyalty programs.

The major challenge is that most service offerings and innovations are easily copied. Still, the company that regularly introduces innovations will gain a succession of temporary advantages over competitors. Schneider National keeps a step ahead of its competitors by never standing still.

Schneider National Schneider National is the world's largest long-haul truckload freight carrier, with $3.7 billion in revenues and more than 54,000 bright orange tractors and trailers on the roads. Although its core benefit is to move freight from one location to another, Schneider sees itself in the *customer solutions* business. Its service guarantees are backed by monetary incentives for drivers who meet tight schedules; driver-training programs improve performance. Schneider was the first to introduce in-cab satellite technology and mobile technology to every driver. In 2009, it had its biggest award-winning year, garnering 43 awards for strong customer service, solutions, and commitment to the environment from shippers, government organizations, and industry media. To actively recruit the best drivers, Schneider advertises on television shows such as

Long-haul truckload freight carrier Schneider National goes to great lengths to satisfy its customers and build its brand.

Retail health clinics are reinventing patient care for minor illnesses and injuries.

Trick My Truck, on satellite radio, in newspapers, and online; employs Webinars and PR; and partners with AARP, local organizations, and veterans' groups. Even painting the trucks Omaha orange was part of a branding strategy to improve safety and create awareness.[60]

INNOVATION WITH SERVICES Innovation is as vital in services as in any industry. After years of losing customers to its Hilton and Marriott hotel competitors, Starwood decided to invest $1.7 billion in its Sheraton chain of 400 properties worldwide to give them fresher décor and brighter colors, as well as more enticing lobbies, restaurants, and cafés. In explaining the need for the makeover, one hospitality industry expert noted, "There was a time when Sheraton was one of the leading brands. But it lagged in introducing new design and service concepts and developed a level of inconsistency."[61]

On the other hand, consider how these relatively new service categories emerged and how, in some cases, organizations created creative solutions in existing categories.[62]

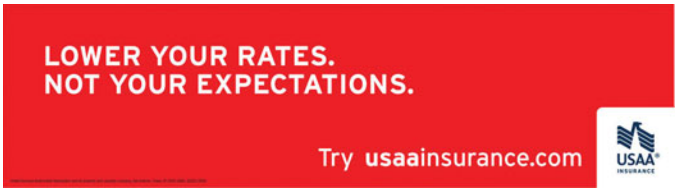
- ***Online Travel.*** Online travel agents such as Expedia and Travelocity offer customers the opportunity to conveniently book travel at discount prices. However, they make money only when visitors go to their Web sites and book travel. Kayak is a newer online travel agency that applies the Google business model of collecting money on a per-click basis. Kayak's marketing emphasis is on building a better search engine by offering more alternatives, flexibility, and airlines.
- ***Retail Health Clinics.*** One of the hardest areas in which to innovate is health care. But whereas the current health care system is designed to treat a small number of complex cases, retail health clinics address a large number of simple cases. Retail health clinics such as Quick Care, RediClinic, and MinuteClinic are often found in drugstores and other retail chain stores such as Target and Walmart. They typically use nurse practitioners to handle minor illnesses and injuries such as colds, flu, and ear infections, offer various health and wellness services such as physicals and exams for high school sports, and perform vaccinations. They seek to offer convenient, predictable service and transparent pricing, without an appointment, seven days a week. Most visits take no more than 15 minutes, and costs vary from $25 to $100.
- ***Private Aviation.*** Initially, private aviation was restricted to owning or chartering a private plane. Fractional ownership pioneered by NetJets allowed customers to pay a percentage of the cost of a private plane plus maintenance and a direct hourly cost. Marquis Jets further innovated with a simple idea of combining prepaid time on the world's largest, best-maintained fleet, offering the consistency and benefits of fractional ownership without the long-term commitment.

Many companies are using the Web to offer primary or secondary service features that were never possible before. Salesforce.com uses cloud computing—centralized computing services delivered over the Internet—to run customer-management databases for companies. Häagen-Dazs estimated it would have had to spend $65,000 for a custom-designed database to stay in contact with the company's retail franchises across the country. Instead, it spent only $20,000 to set up an account with Salesforce.com and pays $125 per month for 20 users to remotely monitor franchises via the Web.[63]

Managing Service Quality

The service quality of a firm is tested at each service encounter. If employees are bored, cannot answer simple questions, or are visiting each other while customers are waiting, customers will think twice about doing business there again. One business that understands how to treat customers right is USAA.

USAA From its beginnings, USAA focused on selling auto insurance, and later other insurance products, to those with military service. It increased its share of each customer's business by launching a consumer bank, issuing credit cards, opening a discount brokerage, and offering a selection of no-load mutual funds. Though it now conducts transactions for more than 150 products and services on the phone or online, USAA boasts one of the highest customer satisfaction ratings of any company in the United States. It was the first bank to allow iPhone deposits for its military customers, to routinely text balances to soldiers in the field, and to heavily discount customers' car insurance when they are deployed overseas. A leader in virtually every customer service award or survey, the company inspired one industry expert to comment: "There is nobody on this earth who understands their customer better than USAA."[64]



By relentlessly focusing on its military customers, USAA has created extraordinary levels of customer satisfaction.

Service outcome and customer loyalty are influenced by a host of variables. One study identified more than 800 critical behaviors that cause customers to switch services.[65] These behaviors fall into eight categories (see Table 13.3).

A more recent study honed in on the service dimensions customers would most like companies to measure. As Table 13.4 shows, knowledgeable frontline workers and the ability to achieve one-call-and-done rose to the top.[66]

Flawless service delivery is the ideal state for any service organization. "Marketing Memo: Recommendations for Improving Service Quality" offers a comprehensive set of guidelines to

TABLE 13.3 Factors Leading to Customer Switching Behavior

Pricing
- High price
- Price increases
- Unfair pricing
- Deceptive pricing

Inconvenience
- Location/hours
- Wait for appointment
- Wait for service

Core Service Failure
- Service mistakes
- Billing errors
- Service catastrophe

Service Encounter Failures
- Uncaring
- Impolite
- Unresponsive
- Unknowledgeable

Response to Service Failure
- Negative response
- No response
- Reluctant response

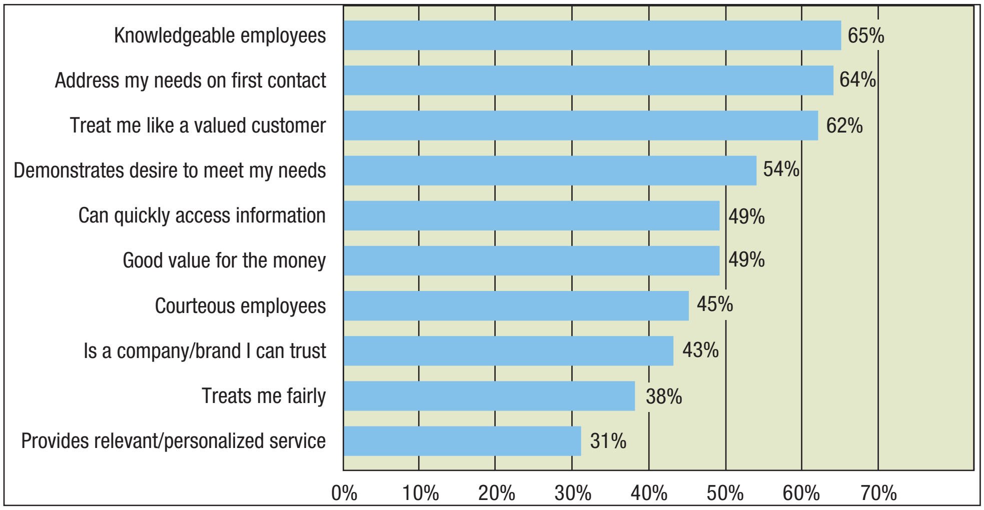
Competition
- Found better service

Ethical Problems
- Cheat
- Hard sell
- Unsafe
- Conflict of interest

Involuntary Switching
- Customer moved
- Provider closed

Source: Susan M. Keaveney, "Customer Switching Behavior in Service Industries: An Exploratory Study," *Journal of Marketing* (April 1995), pp. 71–82. Reprinted with permission from *Journal of Marketing*, published by the American Marketing Association.

TABLE 13.4 Dimensions of Service Customers Want Companies to Deliver



Source: Convergys 2008 U.S. Customer Scorecard

marketing **Memo**

Recommendations for Improving Service Quality

Pioneers in conducting academic service research, Berry, Parasuraman, and Zeithaml offer 10 lessons they maintain are essential for improving service quality across service industries.

1. *Listening*—Service providers should understand what customers really want through continuous learning about the expectations and perceptions of customers and noncustomers (for instance, by means of a service-quality information system).
2. *Reliability*—Reliability is the single most important dimension of service quality and must be a service priority.
3. *Basic service*—Service companies must deliver the basics and do what they are supposed to do—keep promises, use common sense, listen to customers, keep customers informed, and be determined to deliver value to customers.
4. *Service design*—Service providers should take a holistic view of the service while managing its many details.
5. *Recovery*—To satisfy customers who encounter a service problem, service companies should encourage customers to complain (and make it easy for them to do so), respond quickly and personally, and develop a problem-resolution system.
6. *Surprising customers*—Although reliability is the most important dimension in *meeting* customers' service expectations, process dimensions such as assurance, responsiveness, and empathy are most important in *exceeding* customer expectations, for example, by surprising them with uncommon swiftness, grace, courtesy, competence, commitment, and understanding.
7. *Fair play*—Service companies must make special efforts to *be* fair, and to *demonstrate* fairness, to customers and employees.
8. *Teamwork*—Teamwork is what enables large organizations to deliver service with care and attentiveness by improving employee motivation and capabilities.
9. *Employee research*—Marketers should conduct research with employees to reveal why service problems occur and what companies must do to solve problems.
10. *Servant leadership*—Quality service comes from inspired leadership throughout the organization; from excellent service-system design; from the effective use of information and technology; and from a slow-to-change, invisible, all-powerful, internal force called corporate culture.

Sources: Leonard L. Berry, A. Parasuraman, and Valarie A. Zeithaml, "Ten Lessons for Improving Service Quality," *MSI Reports Working Paper Series, No.03-001* (Cambridge, MA: Marketing Science Institute, 2003), pp. 61–82. See also, Leonard L. Berry's books, *On Great Service: A Framework for Action* (New York: Free Press, 2006) and *Discovering the Soul of Service* (New York: Free Press, 1999), as well as his articles; Leonard L. Berry, Venkatesh Shankar, Janet Parish, Susan Cadwallader, and Thomas Dotzel, "Creating New Markets through Service Innovation," *Sloan Management Review* (Winter 2006): 56–63; Leonard L. Berry, Stephan H. Haeckel, and Lewis P. Carbone, "How to Lead the Customer Experience," *Marketing Management* (January–February 2003), pp. 18–23; and Leonard L. Berry, Kathleen Seiders, and Dhruv Grewal, "Understanding Service Convenience," *Journal of Marketing* (July 2002), pp. 1–17.

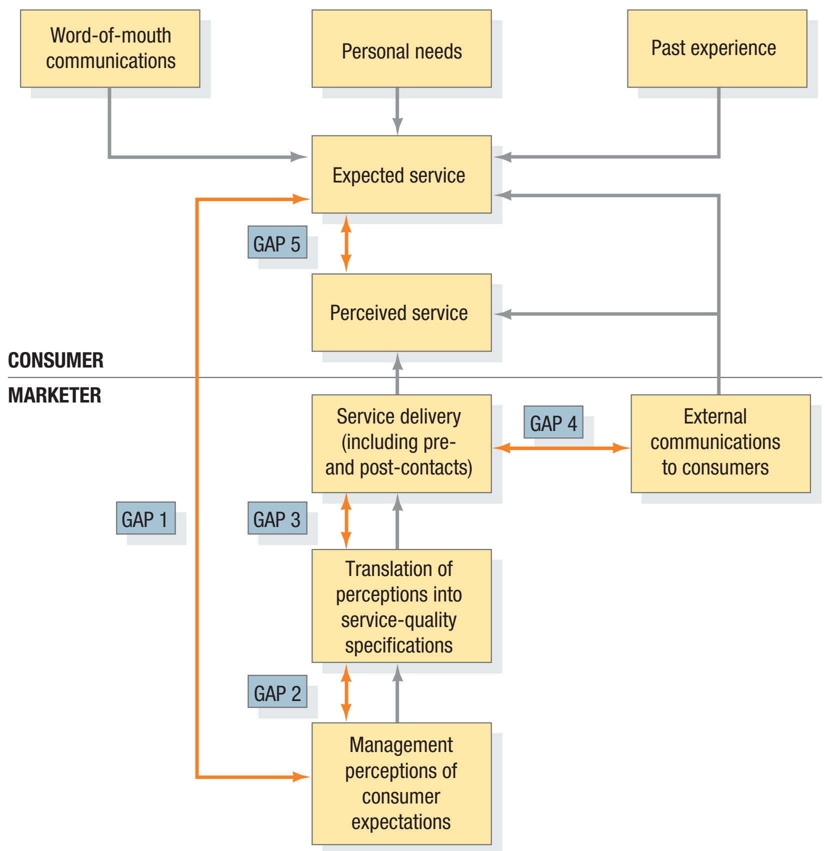
which top service marketing organizations can adhere. Two important considerations in service delivery are managing customer expectations and incorporating self-service technologies.

Managing Customer Expectations

Customers form service expectations from many sources, such as past experiences, word of mouth, and advertising. In general, customers compare the *perceived service* with the *expected service*.[67] If the perceived service falls below the expected service, customers are disappointed. Successful companies add benefits to their offering that not only *satisfy* customers but surprise and *delight* them. Delighting customers is a matter of exceeding expectations.[68]

The service-quality model in △ Figure 13.6 highlights the main requirements for delivering high service quality.[69] It identifies five gaps that cause unsuccessful delivery:

1. ***Gap between consumer expectation and management perception***—Management does not always correctly perceive what customers want. Hospital administrators may think patients want better food, but patients may be more concerned with nurse responsiveness.
2. ***Gap between management perception and service-quality specification***—Management might correctly perceive customers' wants but not set a performance standard. Hospital administrators may tell the nurses to give "fast" service without specifying it in minutes.
3. ***Gap between service-quality specifications and service delivery***—Employees might be poorly trained, or incapable of or unwilling to meet the standard; they may be held to conflicting standards, such as taking time to listen to customers and serving them fast.
4. ***Gap between service delivery and external communications***—Consumer expectations are affected by statements made by company representatives and ads. If a hospital brochure shows a beautiful room but the patient finds it to be cheap and tacky looking, external communications have distorted the customer's expectations.



|Fig. 13.6| △

Service-Quality Model

Sources: A. Parasuraman, Valarie A. Zeithaml, and Leonard L. Berry, "A Conceptual Model of Service Quality and Its Implications for Future Research," *Journal of Marketing* (Fall 1985), p. 44. Reprinted with permission of the American Marketing Association. The model is more fully discussed or elaborated in Valarie Zeithaml, Mary Jo Bitner, and Dwayne D. Gremler, *Services Marketing: Integrating Customer Focus across the Firm*, 4th ed. (New York: McGraw-Hill, 2006).

5. ***Gap between perceived service and expected service***—This gap occurs when the consumer misperceives the service quality. The physician may keep visiting the patient to show care, but the patient may interpret this as an indication that something really is wrong.

Based on this service-quality model, researchers identified five determinants of service quality, in this order of importance:[70]

1. ***Reliability***—The ability to perform the promised service dependably and accurately.
2. ***Responsiveness***—Willingness to help customers and provide prompt service.
3. ***Assurance***—The knowledge and courtesy of employees and their ability to convey trust and confidence.
4. ***Empathy***—The provision of caring, individualized attention to customers.
5. ***Tangibles***—The appearance of physical facilities, equipment, personnel, and communication materials.

Based on these five factors, the researchers developed the 21-item SERVQUAL scale (see Table 13.5).[71] They also note there is a *zone of tolerance*, or a range where a service dimension would be deemed satisfactory, anchored by the minimum level consumers are willing to accept and the level they believe can and should be delivered.

The service-quality model in Figure 13.6 highlights some of the gaps that cause unsuccessful service delivery. Subsequent research has extended the model. One *dynamic process model* of service quality was based on the premise that customer perceptions and expectations of service quality change over time, but at any one point they are a function of prior expectations about what *will* and what *should* happen during the service encounter, as well as the *actual* service delivered during the last contact.[72] Tests of the dynamic process model reveal that the two different types of expectations have opposite effects on perceptions of service quality.

1. *Increasing* customer expectations of what the firm *will* deliver can lead to improved perceptions of overall service quality.
2. *Decreasing* customer expectations of what the firm *should* deliver can also lead to improved perceptions of overall service quality.

TABLE 13.5 SERVQUAL Attributes

Reliability	**Empathy**
• Providing service as promised	• Giving customers individual attention
• Dependability in handling customers' service problems	• Employees who deal with customers in a caring fashion
• Performing services right the first time	• Having the customer's best interests at heart
• Providing services at the promised time	• Employees who understand the needs of their customers
• Maintaining error-free records	• Convenient business hours
• Employees who have the knowledge to answer customer questions	
Responsiveness	**Tangibles**
• Keeping customer informed as to when services will be performed	• Modern equipment
• Prompt service to customers	• Visually appealing facilities
• Willingness to help customers	• Employees who have a neat, professional appearance
• Readiness to respond to customers' requests	• Visually appealing materials associated with the service
Assurance	
• Employees who instill confidence in customers	
• Making customers feel safe in their transactions	
• Employees who are consistently courteous	

Source: A. Parasuraman, Valarie A. Zeithaml, and Leonard L. Berry, "A Conceptual Model of Service Quality and Its Implications for Future Research," *Journal of Marketing* (Fall 1985), pp. 41–50. Reprinted by permission of the American Marketing Association.

Much work has validated the role of expectations in consumers' interpretations and evaluations of the service encounter and the relationship they adopt with a firm over time.[73] Consumers are often forward-looking with respect to their decision to keep or switch from a service relationship. Any marketing activity that affects current or expected future usage can help to solidify a service relationship.

With continuously provided services, such as public utilities, health care, financial and computing services, insurance, and other professional, membership, or subscription services, customers have been observed to mentally calculate their *payment equity*—the perceived economic benefits in relationship to the economic costs. In other words, customers ask themselves, "Am I using this service enough, given what I pay for it?"

Long-term service relationships can have a dark side. An ad agency client may feel that over time the agency is losing objectivity, becoming stale in its thinking, or beginning to take advantage of the relationship.[74]

Incorporating Self-Service Technologies (SSTs)

Consumers value convenience in services.[75] Many person-to-person service interactions are being replaced by self-service technologies (SSTs). To the traditional vending machines we can add automated teller machines (ATMs), self-pumping at gas stations, self-checkout at hotels, and a variety of activities on the Internet, such as ticket purchasing, investment trading, and customization of products.

Not all SSTs improve service quality, but they can make service transactions more accurate, convenient, and faster. Obviously, they can also reduce costs. One technology firm, Comverse, estimates the cost to answer a query through a call center at $7, but only 10 cents online. One of its clients was able to direct 200,000 calls a week through online self-service support, saving $52 million a year.[76] Every company needs to think about improving its service using SSTs.

Marketing academics and consultants Jeffrey Rayport and Bernie Jaworski define a *customer-service interface* as any place at which a company seeks to manage a relationship with a customer, whether through people, technology, or some combination of the two.[77] They feel that although many companies serve customers through a broad array of interfaces, from retail sales clerks to Web sites to voice-response telephone systems, the whole often does not add up to the sum of its parts, increasing complexity, costs, and customer dissatisfaction as a result. Successfully integrating technology into the workforce thus requires a comprehensive reengineering of the front office to identify what people do best, what machines do best, and how to deploy them separately and together.

Some companies have found that the biggest obstacle is not the technology itself, but convincing customers to use it, especially for the first time. Customers must have a clear sense of their roles in the SST process, must see a clear benefit, and must feel they can actually use it.[78] SST is not for everyone. Although some automated voices are actually popular with customers—the unfailingly polite and chipper voice of Amtrak's "Julie" consistently wins kudos from callers—many can incite frustration and even rage.

Managing Product-Support Services

No less important than service industries are product-based industries that must provide a service bundle. Manufacturers of equipment—small appliances, office machines, tractors, mainframes, airplanes—all must provide *product-support services.* Product-support service is becoming a major battleground for competitive advantage.

Chapter 12 described how products could be augmented with key service differentiators—ordering ease, delivery, installation, customer training, customer consulting, maintenance, and repair. Some equipment companies, such as Caterpillar Tractor and John Deere, make a significant percentage of their profits from these services.[79] In the global marketplace, companies that make a good product but provide poor local service support are seriously disadvantaged.

Many product companies have a stronger Web presence than they had before. They must ensure that they offer adequate—if not superior—service online as well. "Marketing Memo: Assessing E-Service Quality" reviews two models of online service quality.

Identifying and Satisfying Customer Needs

Traditionally, customers have had three specific worries about product service:[80]

- They worry about reliability and *failure frequency.* A farmer may tolerate a combine that will break down once a year, but not two or three times a year.
- They worry about *downtime.* The longer the downtime, the higher the cost. The customer counts on the seller's *service dependability*—the seller's ability to fix the machine quickly or at least provide a loaner.[81]
- They worry about *out-of-pocket costs.* How much does the customer have to spend on regular maintenance and repair costs?

A buyer takes all these factors into consideration and tries to estimate the **life-cycle cost**, which is the product's purchase cost plus the discounted cost of maintenance and repair less the discounted salvage value. A one-computer office will need higher product reliability and faster repair service than an office where other computers are available if one breaks down. An airline needs 100 percent reliability in the air. Where reliability is important, manufacturers or service providers can offer guarantees to promote sales.

marketing **Memo**

Assessing E-Service Quality

Academic researchers Zeithaml, Parasuraman, and Malhotra define online service quality as the extent to which a Web site facilitates efficient and effective shopping, purchasing, and delivery. They identified 11 dimensions of perceived e-service quality: access, ease of navigation, efficiency, flexibility, reliability, personalization, security/privacy, responsiveness, assurance/trust, site aesthetics, and price knowledge. Some of these service-quality dimensions were the same online as offline, but some specific underlying attributes were different. Different dimensions emerged with e-service quality too. Empathy didn't seem to be as important online, unless there were service problems. Core dimensions of regular service quality were efficiency, fulfillment, reliability, and privacy; core dimensions of service recovery were responsiveness, compensation, and real-time access to help.

Another set of academic researchers, Wolfinbarger and Gilly, developed a reduced scale of online service quality with four key dimensions: reliability/fulfillment, Web site design, security/privacy, and customer service. The researchers interpret their study findings to suggest that the most basic building blocks of a "compelling online experience" are reliability and functionality to provide time savings, easy transactions, good selection, in-depth information, and the "right" level of personalization. Their 14-item scale looks like this:

Reliability/Fulfillment

The product that came was represented accurately by the Web site.

You get what you ordered from this Web site.

The product is delivered by the time promised by the company.

Web Site Design

This Web site provides in-depth information.

The site doesn't waste my time.

It is quick and easy to complete a transaction at this Web site.

The level of personalization at this site is about right, not too much or too little.

This Web site has good selection.

Security/Privacy

I feel that my privacy is protected at this site.

I feel safe in my transactions with this Web site.

This Web site has adequate security transactions.

Customer Service

The company is willing and ready to respond to customer needs.

When you have a problem, the Web site shows a sincere interest in solving it.

Inquiries are answered promptly.

Sources: Mary Wolfinbarger and Mary C. Gilly, "E-TailQ: Dimensionalizing, Measuring, and Predicting E-Tail Quality," *Journal of Retailing* 79 (Fall 2003), pp. 183–98; Valarie A. Zeithaml, A. Parasuraman, and Arvind Malhotra, "A Conceptual Framework for Understanding E-Service Quality: Implications for Future Research and Managerial Practice," *Marketing Science Institute Working Paper,* Report No. 00-115, 2000.

To provide the best support, a manufacturer must identify the services customers value most and their relative importance. For expensive equipment, manufacturers offer *facilitating services* such as installation, staff training, maintenance and repair services, and financing. They may also add *value-augmenting services* that extend beyond the functioning and performance of the product itself. Johnson Controls reached beyond its climate control equipment and components business to manage integrated facilities by offering products and services that optimize energy use and improve comfort and security.

A manufacturer can offer, and charge for, product-support services in different ways. One specialty organic-chemical company provides a standard offering plus a basic level of services. If the customer wants additional services, it can pay extra or increase its annual purchases to a higher level, in which case additional services are included. Many companies offer *service contracts* (also called *extended warranties*), in which sellers agree to provide free maintenance and repair services for a specified period of time at a specified contract price.

Product companies must understand their strategic intent and competitive advantage in developing services. Are service units supposed to support or protect existing product businesses or to grow as an independent platform? Are the sources of competitive advantage based on economies of scale or economies of skill?[82] See Figure 13.7 strategies of different service companies.

Postsale Service Strategy

The quality of customer service departments varies greatly. At one extreme are departments that simply transfer customer calls to the appropriate person or department for action with little follow-up. At the other extreme are departments eager to receive customer requests, suggestions, and even complaints and handle them expeditiously. Some firms even proactively contact customers to provide service after the sale is complete.[83]

CUSTOMER-SERVICE EVOLUTION Manufacturers usually start by running their own parts-and-service departments. They want to stay close to the equipment and know its problems. They also find it expensive and time consuming to train others and discover they can make good money from parts and service if they are the only supplier and can charge a premium price. In fact, many equipment manufacturers price their equipment low and compensate by charging high prices for parts and service.

|Fig. 13.7|

Service Strategies for Product Companies

Source of Competitive Advantage	Strategic Intent: Protect or Enhance Product	Strategic Intent: Expand Independent Service
Economies of scale	• Apple's iPod music download and transaction management service (iTunes) • Otis Elevator's remote monitoring and diagnostics services • General Motors' OnStar auto remote diagnostics service • Symantec's virus protection and data security services	• Cardinal Healthcare's hospital inventory-management services • Cincinnati Bell's billing services (now part of Convergys) • IBM's data-center-outsourcing services • Johnson Controls' integrated facilities-management services
Economies of skill	• Cisco's network integration and maintenance services • EMC's storage-management and maintenance services • SAP Systems' integration services • UTC's utilities field support services	• Cincinnati Bell's call-center-management services (now part of Convergys) • General Electric's aircraft-engine-maintenance services • GE Healthcare's hospital equipment—support and diagnostics services for hospital equipment • IBM's systems integration services

Source: Byron G. Auguste, Eric P. Harmon, and Vivek Pandit, "The Right Service Strategies for Product Companies," The McKinsey Quarterly, no. 1 (2006), pp. 41–51. All rights reserved. Reprinted by permission of McKinsey & Company.

Over time, manufacturers switch more maintenance and repair service to authorized distributors and dealers. These intermediaries are closer to customers, operate in more locations, and can offer quicker service. Still later, independent service firms emerge and offer a lower price or faster service. A significant percentage of auto-service work is now done outside franchised automobile dealerships by independent garages and chains such as Midas Muffler, and Sears. Independent service organizations handle mainframes, telecommunications equipment, and a variety of other equipment lines.

THE CUSTOMER-SERVICE IMPERATIVE Customer-service choices are increasing rapidly, however, and equipment manufacturers increasingly must figure out how to make money on their equipment, independent of service contracts. Some new-car warranties now cover 100,000 miles before servicing. The increase in disposable or never-fail equipment makes customers less inclined to pay 2 percent to 10 percent of the purchase price every year for a service. A company with several hundred laptops, printers, and related equipment might find it cheaper to have its own service people on-site.

Summary

1. A service is any act or performance that one party can offer to another that is essentially intangible and does not result in the ownership of anything. It may or may not be tied to a physical product.
2. Services are intangible, inseparable, variable, and perishable. Each characteristic poses challenges and requires certain strategies. Marketers must find ways to give tangibility to intangibles, to increase the productivity of service providers, to increase and standardize the quality of the service provided, and to match the supply of services with market demand.
3. Marketing of services faces new realities in the 21st century due to customer empowerment, customer coproduction, and the need to satisfy employees as well as customers.
4. In the past, service industries lagged behind manufacturing firms in adopting and using marketing concepts and tools, but this situation has changed. Achieving excellence in service marketing calls not only for external marketing but also for internal marketing to motivate employees, as well as interactive marketing to emphasize the importance of both "high tech" and "high touch."
5. Top service companies excel at the following practices: a strategic concept, a history of top-management commitment to quality, high standards, profit tiers, and systems for monitoring service performance and customer complaints. They also differentiate their brands through primary and secondary service features and continual innovation.
6. Superior service delivery requires managing customer expectations and incorporating self-service technologies. Customers' expectations play a critical role in their service experiences and evaluations. Companies must manage service quality by understanding the effects of each service encounter.
7. Even product-based companies must provide postpurchase service. To offer the best support, a manufacturer must identify the services customers value most and their relative importance. The service mix includes both presale services (facilitating and value-augmenting services) and postsale services (customer service departments, repair and maintenance services).

Applications

Marketing Debate

Is Service Marketing Different from Product Marketing?

Some service marketers maintain that service marketing is fundamentally different from product marketing and relies on different skills. Some traditional product marketers disagree, saying "good marketing is good marketing."

Take a position: **Product and service marketing are fundamentally different *versus* Product and service marketing are highly related.**

Marketing Discussion

Educational Institutions

Colleges, universities, and other educational institutions can be classified as service organizations. How can you apply the marketing principles developed in this chapter to your school? Do you have any advice as to how it could become a better service marketer?

Marketing Excellence

>>The Ritz-Carlton

Few brands attain such a high standard of customer service as the luxury hotel, The Ritz-Carlton. The Ritz-Carlton dates back to the early 20th century and the original Ritz-Carlton Boston, which revolutionized the way U.S. travelers viewed and experienced customer service and luxury in a hotel. The Ritz-Carlton Boston was the first of its kind to provide guests with a private bath in each guest room, fresh flowers throughout the hotel, and an entire staff dressed in formal white tie, black tie, or morning coat attire.

In 1983, hotelier Horst Schulze and a four-person development team acquired the rights to the Ritz-Carlton name and created the Ritz-Carlton concept as it is known today: a company-wide concentration on both the personal and the functional side of service. The five-star hotel provides impeccable facilities but also takes customer service extremely seriously. Its credo is, "We are Ladies and Gentlemen serving Ladies and Gentlemen." According to the company's Web site, The Ritz-Carlton "pledge(s) to provide the finest personal service and facilities for our guests who will always enjoy a warm, relaxed, yet refined ambience."

The Ritz-Carlton fulfills this promise by providing impeccable training for its employees and executing its Three Steps of Service and 12 Service Values. The Three Steps of Service state that employees must use a warm and sincere greeting always using the guest's name, anticipate and fulfill each guest's needs, and give a warm good-bye again using the guest's name. Every manager carries a laminated card with the 12 Service Values, which include bullets such as number 3: "I am empowered to create unique, memorable and personal experiences for our guests," and number 10: "I am proud of my professional appearance, language and behavior." Simon Cooper, the company president and chief operating officer, explained, "It's all about people. Nobody has an emotional experience with a thing. We're appealing to emotions." The Ritz-Carlton's 38,000 employees at 70 hotels in 24 countries go out of their way to create unique and memorable experiences for their guests.

While The Ritz-Carlton is known for training its employees on exceptional customer service, the hotel also reinforces its mission and values to its employees on a daily basis. Each day, managers gather their employees for a 15-minute "line up." During this time, managers touch base with their employees, resolve any impending problems, and spend the remaining time reading and discussing what The Ritz-Carlton calls "wow stories."

The same "wow story" of the day is read to every single employee around the world. These true stories recognize an individual employee for his or her outstanding customer service and also highlight one of the 12 Service Values. For example, one family staying at the Ritz-Carlton, Bali, needed a particular type of egg and milk for their son who suffered from food allergies. Employees could not find the appropriate items in town, but the executive chef at the hotel remembered a store in Singapore that sold them. He contacted his mother-in-law, who purchased the items and personally flew them over 1,000 miles to Bali for the family. This example showcased Service Value 6: "I own and immediately resolve guests' problems."

In another instance, a waiter overheard a man telling his wife, who used a wheelchair, that it was too bad he couldn't get her down to the beach. The waiter told the maintenance crew, and by the next day they had constructed a wooden walkway down to the beach and pitched a tent at the far end where the couple had dinner. According to Cooper, the daily wow story is "the best way to communicate what we expect from our ladies and gentlemen around the world. Every story reinforces the actions we are looking for and demonstrates how each and every person in our organization contributes to our service values." As part of company policy, each employee is entitled to spend up to $2,000 on a guest to help deliver an anticipated need or desire.

The hotel measures the success of its customer service efforts through Gallup phone interviews, which ask both functional and emotional questions. Functional questions ask "How was the meal? Was your bedroom clean?" while emotional questions uncover a sense of the customer's well-being. The Ritz-Carlton uses these findings as well as day-to-day experiences to continually enhance and improve the experience for its guests.

In less than three decades, The Ritz-Carlton has grown from 4 locations to over 70 and earned two Malcolm Baldrige Quality Awards—the only company ever to win the prestigious award twice.

Questions

1. How does The Ritz-Carlton match up to competitive hotels? What are the key differences?
2. Discuss the importance of the "wow stories" in customer service for a luxury hotel like The Ritz-Carlton.

Sources: Robert Reiss, "How Ritz-Carlton Stays at Top," *Forbes,* October 30, 2009; Carmine Gallo, "Employee Motivation the Ritz-Carlton Way," *BusinessWeek,* February 29, 2008; Carmine Gallo, "How Ritz-Carlton Maintains Its Mystique," *BusinessWeek,* February 13, 2007; Jennifer Robison, "How The Ritz-Carlton Manages the Mystique," *Gallup Management Journal,* December 11, 2008; *The Ritz Carlton*, www.RitzCarlton.com.

Marketing Excellence

>>Mayo Clinic

Mayo Clinic is the first and largest integrated not-for-profit medical group practice in the world. William and Charles Mayo founded the clinic over 100 years ago as a small outpatient facility and pioneered the concept of a medical group practice—a model that is widely used today.

Mayo Clinic provides exceptional medical care and leads the nation in many specialties such as cancer, heart disease, respiratory disorders, and urology. It consistently ranks at the top of *U.S. News & World Report's* Best Hospitals list and enjoys 85 percent brand recognition among U.S. adults. It has reached this level of success by taking a different approach from most clinics and hospitals and putting a relentless focus on the patient's experience. The clinic's two interrelated core values trace back to its founders and are at the heart of all the organization does: placing the patient's interests above all others and practicing teamwork.

Every aspect of the patient's experience is considered at Mayo Clinic's three campuses in Rochester (MN), Scottsdale (AZ), and Jacksonville (FL). The moment a patient walks into one of Mayo Clinic's facilities, he or she feels the difference. New patients are welcomed by professional greeters who walk them through the administrative processes. Returning patients are greeted by name and with a warm smile. The buildings have been designed so that, in the words of the architect of one, "patients feel a little better before they see their doctors." The 21-story Gonda Building in Rochester has spectacular wide-open spaces with the capability of adding 10 more floors. Fine art hangs on the walls, and doctor's offices are designed to feel cozy and comforting rather than sterile and impersonal.

The lobby of the Mayo Clinic hospital in Scottsdale has an indoor waterfall and a wall of windows overlooking mountains. In pediatric exam rooms, resuscitation equipment is hidden behind a large cheery picture. Hospital rooms feature microwave ovens and chairs that really do convert to beds because, as one staff member explained, "People don't come to the hospital alone." The newest emergency medical helicopter was customized to incorporate high-tech medical equipment and is one of the most advanced aircraft in the world.

The other significant difference in serving patients is Mayo Clinic's concept of teamwork. A patient can come to Mayo Clinic with or without a physician's referral. At that time, the patient's team is assembled, which can include the primary physician, surgeons, radiation oncologists, radiologists, nurses, residents, or other specialists with the appropriate skill, experience, and knowledge.

Teams of medical professionals work together to diagnose patients' medical problems, including debating test results for hours to determine the most accurate diagnosis and best treatments. Once a team consensus has been reached, the leader meets with the patient and discusses his or her options. Throughout the process, patients are encouraged to take part in the discussion. If surgery is necessary, the procedure is often scheduled to take place within 24 hours, a dramatic difference from the long wait patients experience at many hospitals. Mayo Clinic's doctors understand that those who seek their care want action as soon as possible.

Mayo's doctors are put on salary instead of being paid by the number of patients seen or tests ordered. As a result, patients receive more individualized attention and care, and physicians work together instead of against each other. As one pediatrician at Mayo explained, "We're very comfortable with calling colleagues for what I call 'curbside consulting.' I don't have to make a decision about splitting a fee or owing someone something. It's never a case of quid pro quo."

Mayo Clinic is a not-for-profit, so all its operating income is invested back into the clinic's research and education programs. Breakthrough research is quickly implemented into the quality care of the patients. Mayo Clinic offers educational programs through its five schools, and many of its physicians come up through these programs with Mayo's philosophies engrained in their heads, including Mayo's motto: "The best interest of the patient is the only interest to be considered."

President Obama often cites Mayo Clinic as a key example in health care reform. Mayo Clinic has been recognized by third parties for decades for its independent thinking, outstanding service and performance, and core focus on patient care and satisfaction.

Questions

1. Explain why Mayo Clinic is so good at customer service. Why has it been so successful practicing medicine differently from other hospitals?
2. Do conflicts of interest exist between wanting to make your patient happy and providing the best medical care possible? Why or why not?

Sources: Avery Comarow, "America's Best Hospitals," *U.S. News & World Report*, July 15, 2009; Chen May Yee, "Mayo Clinic Reports 2007 Revenue Grew 10%," *Star Tribune,* March 17, 2008; Leonard L. Berry and Kent D. Seltman, *Management Lessons from Mayo Clinic* (New York: McGraw-Hill, 2008); Leonard L. Berry, "Leadership Lessons from Mayo Clinic," *Organizational Dynamics* 33 (August 2004), pp. 228–42; Leonard L. Berry and Neeli Bendapudi, "Clueing in Customers," *Harvard Business Review,* February 2003, pp. 100–106; John La Forgia, Kent Seltman, and Scott Swanson, "Mayo Clinic: Sustaining a Legacy Brand and Leveraging Its Equity in the 21st-Century Market," Presentation at the Marketing Science Institute's Conference on Brand Orchestration, Orlando, FL, December 4–5, 2003; Paul Roberts, "The Agenda—Total Teamwork," *Fast Company,* March 31, 1999.

Chapter 14

In This Chapter, We Will Address the Following Questions

1. How do consumers process and evaluate prices?
2. How should a company set prices initially for products or services?
3. How should a company adapt prices to meet varying circumstances and opportunities?
4. When should a company initiate a price change?
5. How should a company respond to a competitor's price change?

As a high-end luxury goods provider, Tiffany & Co. knows the importance of preserving the integrity of its prices.

Developing Pricing Strategies and Programs

Price is the one element of the marketing mix that produces revenue; the other elements produce costs. Prices are perhaps the easiest element of the marketing program to adjust; product features, channels, and even communications take more time. Price also communicates to the market the company's intended value positioning of its product or brand. A well-designed and marketed product can command a price premium and reap big profits. But new economic realities have caused many consumers to pinch pennies, and many companies have had to carefully review their pricing strategies as a result.

For its entire century-and-a-half history, Tiffany's name has connoted diamonds and luxury. Tiffany designed a pitcher for Abraham Lincoln's inaugural, made swords for the Civil War, introduced sterling silver to the United States, and designed the "E Pluribus Unum" insignia that adorns $1 bills as well as the Super Bowl and NASCAR trophies. A cultural icon—its Tiffany Blue color is even trademarked—Tiffany has survived the economy's numerous ups and downs through the years. With the emergence in the late 1990s of the notion of "affordable luxuries," Tiffany seized the moment by creating a line of cheaper silver jewelry. Its "Return to Tiffany" silver bracelet became a must-have item for teens of a certain set. Earnings skyrocketed for the next five years, but the affordable jewelry brought both an image and a pricing crisis for the company: What if all those teens who bought Tiffany charm bracelets grew up to think of Tiffany only as a place where they got the jewelry of their girlhood? Starting in 2002, the company began hiking prices again. At the same time, it launched higher-end collections, renovated stores to feature expensive items appealing to mature buyers, and expanded aggressively into new cities and shopping malls. When the recession began in 2008, the firm knew it had to be careful not to dilute its high-end appeal. Tiffany offset softer sales largely with cost-cutting and inventory management, and—very quietly—it lowered prices on its best-selling engagement rings only, by roughly 10 percent.[1]

Pricing decisions are clearly complex and difficult, and many marketers neglect their pricing strategies.[2] Holistic marketers must take into account many factors in making pricing decisions—the company, the customers, the competition, and the marketing environment. Pricing decisions must be consistent with the firm's marketing strategy and its target markets and brand positionings.

In this chapter, we provide concepts and tools to facilitate the setting of initial prices and adjusting prices over time and markets.

Understanding Pricing

Price is not just a number on a tag. It comes in many forms and performs many functions. Rent, tuition, fares, fees, rates, tolls, retainers, wages, and commissions are all the price you pay for some good or service. Price also has many components. If you buy a new car, the sticker price may be adjusted by rebates and dealer incentives. Some firms allow for payment through multiple forms, such as $150 plus 25,000 frequent flier miles for a flight.[3]

Throughout most of history, prices were set by negotiation between buyers and sellers. Bargaining is still a sport in some areas. Setting one price for all buyers is a relatively modern idea that arose with the development of large-scale retailing at the end of the nineteenth century. F. W. Woolworth, Tiffany & Co., John Wanamaker, and others advertised a "strictly one-price policy," because they carried so many items and supervised so many employees.

Traditionally, price has operated as a major determinant of buyer choice. Consumers and purchasing agents who have access to price information and price discounters put pressure on retailers to lower their prices. Retailers in turn put pressure on manufacturers to lower their prices. The result can be a marketplace characterized by heavy discounting and sales promotion.

A Changing Pricing Environment

Pricing practices have changed significantly. At the turn of the 21st century, consumers had easy access to credit, so by combining unique product formulations with enticing marketing campaigns, many firms successfully traded consumers up to more expensive products and services. The onset of the Great Recession—a recession more severe than previous recessions, which resulted in many jobs lost and many businesses and consumers unable to receive loans due to their poorly leveraged situations—changed things though.

A combination of environmentalism, renewed frugality, and concern about jobs and home values forced many U.S. consumers to rethink how they spent their money. They replaced luxury purchases with basics. They bought fewer accessories like jewelry, watches, and bags. They ate at home more often and purchased espresso machines to make lattes in their kitchens instead of buying them at expensive cafés. If they bought a new car at all, they downsized to smaller, more fuel-efficient models. They even cut back spending on hobbies and sports activities.[4]

Downward price pressure from a changing economic environment coincided with some longer-term trends in the technological environment. For some years now, the Internet has been changing how buyers and sellers interact. Here is a short list of how the Internet allows sellers to discriminate between buyers, and buyers to discriminate between sellers.[5]

Buyers can:

- ***Get instant price comparisons from thousands of vendors.*** Customers can compare the prices offered by multiple bookstores by just clicking mySimon.com. PriceSCAN.com lures thousands of visitors a day, most of them corporate buyers. Intelligent shopping agents ("bots") take price comparison a step further and seek out products, prices, and reviews from hundreds if not thousands of merchants.
- ***Name their price and have it met.*** On Priceline.com, the customer states the price he or she wants to pay for an airline ticket, hotel, or rental car, and Priceline looks for any seller willing to meet that price.[6] Volume-aggregating sites combine the orders of many customers and press the supplier for a deeper discount.
- ***Get products free.*** Open Source, the free software movement that started with Linux, will erode margins for just about any company creating software. The biggest challenge confronting Microsoft, Oracle, IBM, and virtually every other major software producer is: How do you compete with programs that can be had for free? "Marketing Insight: Giving It All Away" describes how different firms have been successful with essentially free offerings.

Marketing Insight

Giving It All Away

Giving away products for free via sampling has been a successful marketing tactic for years. Estée Lauder gave free samples of cosmetics to celebrities, and organizers at awards shows lavish winners with plentiful free items or gifts known as "swag." Other manufacturers, such as Gillette and HP, have built their business model around selling the host product essentially at cost and making money on the sale of necessary supplies, such as razor blades and printer ink.

With the advent of the Internet, software companies began to adopt similar practices. Adobe gave away its PDF Reader for free in 1994, as did Macromedia with its Shockwave player in 1995. Their software became the industry standard, but the firms really made their money selling their authoring software. More recently, Internet start-ups such as Blogger Weblog publishing tool, MySpace online community, and Skype Internet phone calls have all achieved some success with a "freemium" strategy—free online services with a premium component.

Chris Anderson, editor-in-chief of *Wired*, strongly believes that in a digital marketplace, companies can make money with "free" products. As evidence, he offers revenue models involving cross-subsidies (giving away a DVR to sell cable service) and freemiums (offering the Flickr online photo management and sharing application for free to everyone while selling the superior FlickrPro to more highly involved users).

Some online firms have successfully moved "from free to fee" and begun charging for services. Under a new participative pricing mechanism that lets consumers decide the price they feel is warranted, buyers often choose to pay more than zero and even enough that the seller's revenues increase over what a fixed price would have yielded.

Offline, profits for discount air carrier Ryanair have been sky-high thanks to its revolutionary business model. The secret? Founder Michael O'Leary thinks like a retailer, charging for almost everything but the seat itself:

1. A quarter of Ryanair's seats are free. O'Leary wants to double that within five years, with the ultimate goal of making all seats free. Passengers currently pay only taxes and fees of about $10 to $24, with an average one-way fare of roughly $52.
2. Passengers pay extra for everything else: for checked luggage ($9.50 per bag), snacks ($5.50 for a hot dog, $4.50 for chicken soup, $3.50 for water), and bus or train transportation into town from the far-flung airports Ryanair uses ($24).
3. Flight attendants sell a variety of merchandise, including digital cameras ($137.50) and iPocket MP3 players ($165). Onboard gambling and cell phone service are projected new revenue sources.

Other strategies cut costs or generate outside revenue:

4. Seats don't recline, window shades and seat-back pockets have been removed, and there is no entertainment. Seat-back trays now carry ads, and the exteriors of the planes are giant revenue-producing billboards for Vodafone Group, Jaguar, Hertz, and others.
5. More than 99 percent of tickets are sold online. The Web site also offers travel insurance, hotels, ski packages, and car rentals.
6. Only Boeing 737–800 jets are flown to reduce maintenance, and flight crews buy their own uniforms.

The formula works for Ryanair's customers; the airline flies 58 million of them to over 150 airports each year. All the extras add up to 20 percent of revenue. Ryanair enjoys net margins of 25 percent, more than three times Southwest's 7 percent. Some industry pundits even refer to Ryanair as "Walmart with wings!" European discount carrier easyJet has adopted many of the same practices.

Sources: Chris Anderson, *Free: The Future of a Radical Price* (New York: Hyperion, 2009); Peter J. Howe, "The Next Pinch: Fees to Check Bags," *Boston Globe,* March 8, 2007; Katherine Heires, "Why It Pays to Give Away the Store," *Business 2.0* (October 2006): 36–37; Kerry Capel, "'Wal-Mart with Wings,'" *BusinessWeek,* November 27, 2006, pp. 44–45; Matthew Maier, "A Radical Fix for Airlines: Make Flying Free," *Business 2.0* (April 2006): 32–34; Ju-Young Kim, Martin Natter, and Martin Spann, "Pay What You Want: A New Participative Pricing Mechanism," *Journal of Marketing* 73 (January 2009), pp. 44–58; Koen Pauwels and Allen Weiss, "Moving from Free to Fee: How Online Firms Market to Change Their Business Model Successfully," *Journal of Marketing* 72 (May 2008), pp. 14–31; Bruce Myerson, "Skype Takes Its Show on the Road," *BusinessWeek*, October 29, 2007, p. 38.

Sellers can:

- ***Monitor customer behavior and tailor offers to individuals.*** GE Lighting, which gets 55,000 pricing requests a year, has Web programs that evaluate 300 factors that go into a pricing quote, such as past sales data and discounts, so it can reduce processing time from up to 30 days to 6 hours.

Discount airline Ryanair's revolutionary business model is to charge next to nothing for a seat on a flight, but something for virtually everything else.

- ***Give certain customers access to special prices.*** Ruelala is a members-only Web site that sells upscale women's fashion, accessories, and footwear through limited-time sales, usually two-day events. Other business marketers are already using extranets to get a precise handle on inventory, costs, and demand at any given moment in order to adjust prices instantly.

Both buyers and sellers can:

- ***Negotiate prices in online auctions and exchanges or even in person.*** Want to sell hundreds of excess and slightly worn widgets? Post a sale on eBay. Want to purchase vintage baseball cards at a bargain price? Go to www.baseballplanet.com. With the advent of the recession, many consumers began to take the practice of haggling over price honed at car dealers and flea markets into other realms like real estate, jewelry, or virtually any retail durable purchase. Almost three-quarters of U.S. consumers reported negotiating for lower prices in recent years, up a third from the five years before the recession hit.[7]

How Companies Price

Companies do their pricing in a variety of ways. In small companies, the boss often sets prices. In large companies, division and product line managers do. Even here, top management sets general pricing objectives and policies and often approves lower management's proposals.

Where pricing is a key factor (aerospace, railroads, oil companies), companies often establish a pricing department to set or assist others in setting appropriate prices. This department reports to the marketing department, finance department, or top management. Others who influence pricing include sales managers, production managers, finance managers, and accountants.

Executives complain that pricing is a big headache—and getting worse by the day. Many companies do not handle pricing well and fall back on "strategies" such as: "We determine our costs and take our industry's traditional margins." Other common mistakes are not revising price often enough to capitalize on market changes; setting price independently of the rest of the marketing program rather than as an intrinsic element of market-positioning strategy; and not varying price enough for different product items, market segments, distribution channels, and purchase occasions.

For any organization, effectively designing and implementing pricing strategies requires a thorough understanding of consumer pricing psychology and a systematic approach to setting, adapting, and changing prices.

Consumer Psychology and Pricing

Many economists traditionally assumed that consumers were "price takers" and accepted prices at "face value" or as given. Marketers, however, recognize that consumers often actively process price information, interpreting it from the context of prior purchasing experience, formal communications (advertising, sales calls, and brochures), informal communications (friends, colleagues, or family members), point-of-purchase or online resources, and other factors.[8]

Purchase decisions are based on how consumers perceive prices and what they consider the current actual price to be—*not* on the marketer's stated price. Customers may have a lower price threshold below which prices signal inferior or unacceptable quality, as well as an upper price threshold above which prices are prohibitive and the product appears not worth the money. The following example helps illustrate the large part consumer psychology plays in determining three different prices for essentially the same item: a black T-shirt.

A Black T-Shirt

The black T-shirt for women looks pretty ordinary. In fact, it's not that different from the black T-shirt sold by Gap and by Swedish discount clothing chain H&M. Yet, the Armani T-shirt costs $275.00, whereas the Gap item costs $14.90 and the H&M one $7.90. Customers who purchase the Armani T-shirt are paying for a T-shirt made of 70 percent nylon, 25 percent polyester, and 5 percent elastane, whereas the Gap and H&M shirts are made mainly of cotton. True, the Armani T is a bit more stylishly cut than the other two and sports a "Made in Italy" label, but how does it command a $275.00 price tag? A luxury brand, Armani is primarily known for suits, handbags, and evening gowns that sell for thousands of dollars. In that context, it can sell its T-shirts for more. But because there aren't many takers for $275.00 T-shirts, Armani doesn't make many, thus further enhancing the appeal for status seekers who like the idea of having a "limited edition" T-shirt. "Value is not only quality, function, utility, channel of distribution," says Arnold Aronson, managing director of retail strategies for Kurt Salmon Associates and former CEO of Saks Fifth Avenue; it's also a customer's perception of a brand's luxury connotations.[9]

The perceived value of a product as simple as a black T-shirt depends in part on where it is sold.

Consumer attitudes about pricing took a dramatic shift in the recent economic downturn as many found themselves unable to sustain their lifestyles.[10] Consumers began to buy more for need than desire and to trade down more frequently in price. They shunned conspicuous consumption, and sales of luxury goods suffered. Even purchases that had never been challenged before were scrutinized. Almost 1 million U.S. patients became "medical tourists" in 2010 and traveled overseas for medical procedures at lower costs, sometimes at the urging of U.S. health insurance companies.[11]

Even in a recession, however, some companies can command a price premium if their offerings are unique and relevant enough to a large enough market segment. Pangea Organics expanded distribution of its pricey $8 soaps and $50 oils, thanks to environmentally friendly organic formulations and clever, seed-infused packaging.[12]

Understanding how consumers arrive at their perceptions of prices is an important marketing priority. Here we consider three key topics—reference prices, price–quality inferences, and price endings.

REFERENCE PRICES Although consumers may have fairly good knowledge of price ranges, surprisingly few can accurately recall specific prices.[13] When examining products, however, they often employ **reference prices**, comparing an observed price to an internal reference price they remember or an external frame of reference such as a posted "regular retail price."[14]

All types of reference prices are possible (see Table 14.1), and sellers often attempt to manipulate them. For example, a seller can situate its product among expensive competitors to imply that it belongs in the same class. Department stores will display women's apparel in separate departments differentiated by price; dresses in the more expensive department are assumed to be of better quality.[15] Marketers also encourage reference-price thinking by stating a high manufacturer's suggested price, indicating that the price was much higher originally, or pointing to a competitor's high price.[16]

When consumers evoke one or more of these frames of reference, their perceived price can vary from the stated price.[17] Research has found that unpleasant surprises—when perceived price is lower than the stated price—can have a greater impact on purchase likelihood than pleasant surprises.[18] Consumer expectations can also play a key role in price response. On Internet auction sites such as eBay, when consumers know similar goods will be available in future auctions, they will bid less in the current auction.[19]

TABLE 14.1 Possible Consumer Reference Prices
• "Fair Price" (what consumers feel the product should cost)
• Typical Price
• Last Price Paid
• Upper-Bound Price (reservation price or the maximum most consumers would pay)
• Lower-Bound Price (lower threshold price or the minimum most consumers would pay)
• Historical Competitor Prices
• Expected Future Price
• Usual Discounted Price

Source: Adapted from Russell S. Winer, *Pricing*, MSI Relevant Knowledge Series (Cambridge, MA: Marketing Science Institute, 2006).

Clever marketers try to frame the price to signal the best value possible. For example, a relatively expensive item can look less expensive if the price is broken into smaller units, such as a $500 annual membership for "under $50 a month," even if the totals are the same.[20]

PRICE-QUALITY INFERENCES Many consumers use price as an indicator of quality. Image pricing is especially effective with ego-sensitive products such as perfumes, expensive cars, and designer clothing. A $100 bottle of perfume might contain $10 worth of scent, but gift givers pay $100 to communicate their high regard for the receiver.

Price and quality perceptions of cars interact.[21] Higher-priced cars are perceived to possess high quality. Higher-quality cars are likewise perceived to be higher priced than they actually are. When information about true quality is available, price becomes a less significant indicator of quality. When this information is not available, price acts as a signal of quality.

Some brands adopt exclusivity and scarcity to signify uniqueness and justify premium pricing. Luxury-goods makers of watches, jewelry, perfume, and other products often emphasize exclusivity in their communication messages and channel strategies. For luxury-goods customers who desire uniqueness, demand may actually increase price, because they then believe fewer other customers can afford the product.[22]

PRICE ENDINGS Many sellers believe prices should end in an odd number. Customers see an item priced at $299 as being in the $200 rather than the $300 range; they tend to process prices "left-to-right" rather than by rounding.[23] Price encoding in this fashion is important if there is a mental price break at the higher, rounded price.

Another explanation for the popularity of "9" endings is that they suggest a discount or bargain, so if a company wants a high-price image, it should probably avoid the odd-ending tactic.[24] One study showed that demand actually increased one-third when the price of a dress *rose* from $34 to $39 but was unchanged when it rose from $34 to $44.[25]

Prices that end with 0 and 5 are also popular and are thought to be easier for consumers to process and retrieve from memory.[26] "Sale" signs next to prices spur demand, but only if not overused: Total category sales are highest when some, but not all, items in a category have sale signs; past a certain point, sale signs may cause total category sales to fall.[27]

Pricing cues such as sale signs and prices that end in 9 are more influential when consumers' price knowledge is poor, when they purchase the item infrequently or are new to the category, and when product designs vary over time, prices vary seasonally, or quality or sizes vary across stores.[28] They are less effective the more they are used. Limited availability (for example, "three days only") also can spur sales among consumers actively shopping for a product.[29]

A product priced at $2.99 can be perceived as distinctly less expensive than one priced at $3.00.

Setting the Price

A firm must set a price for the first time when it develops a new product, when it introduces its regular product into a new distribution channel or geographical area, and when it enters bids on new contract work. The firm must decide where to position its product on quality and price.

Most markets have three to five price points or tiers. Marriott Hotels is good at developing different brands or variations of brands for different price points: Marriott Vacation Club—Vacation Villas (highest price), Marriott Marquis (high price), Marriott (high-medium price), Renaissance (medium-high price), Courtyard (medium price), TownePlace Suites (medium-low price), and Fairfield Inn (low price). Firms devise their branding strategies to help convey the price-quality tiers of their products or services to consumers.[30]

The firm must consider many factors in setting its pricing policy.[31] Table 14.2 summarizes the six steps in the process.

Marriott's hotel brands differ in price points and the levels of service they offer.

Step 1: Selecting the Pricing Objective

The company first decides where it wants to position its market offering. The clearer a firm's objectives, the easier it is to set price. Five major objectives are: survival, maximum current profit, maximum market share, maximum market skimming, and product-quality leadership.

SURVIVAL Companies pursue *survival* as their major objective if they are plagued with overcapacity, intense competition, or changing consumer wants. As long as prices cover variable costs and some fixed costs, the company stays in business. Survival is a short-run objective; in the long run, the firm must learn how to add value or face extinction.

MAXIMUM CURRENT PROFIT Many companies try to set a price that will *maximize current profits.* They estimate the demand and costs associated with alternative prices and choose the price that produces maximum current profit, cash flow, or rate of return on investment. This strategy assumes the firm knows its demand and cost functions; in reality, these are difficult to estimate. In emphasizing current performance, the company may sacrifice long-run performance by ignoring the effects of other marketing variables, competitors' reactions, and legal restraints on price.

MAXIMUM MARKET SHARE Some companies want to *maximize their market share.* They believe a higher sales volume will lead to lower unit costs and higher long-run profit. They set the lowest price, assuming the market is price sensitive. Texas Instruments (TI) famously practiced this **market-penetration pricing** for years. TI would build a large plant, set its price as low as possible, win a large market share, experience falling costs, and cut its price further as costs fell.

The following conditions favor adopting a market-penetration pricing strategy: (1) The market is highly price sensitive and a low price stimulates market growth; (2) production and distribution

TABLE 14.2	Steps in Setting a Pricing Policy
1.	Selecting the Pricing Objective
2.	Determining Demand
3.	Estimating Costs
4.	Analyzing Competitors' Costs, Prices, and Offers
5.	Selecting a Pricing Method
6.	Selecting the Final Price

Apple created an uproar among its early-adopter customers when it significantly lowered the price of its iPhone after only two months.

costs fall with accumulated production experience; and (3) a low price discourages actual and potential competition.

MAXIMUM MARKET SKIMMING Companies unveiling a new technology favor setting high prices to *maximize market skimming.* Sony is a frequent practitioner of **market-skimming pricing**, in which prices start high and slowly drop over time. When Sony introduced the world's first high-definition television (HDTV) to the Japanese market in 1990, it was priced at $43,000. So that Sony could "skim" the maximum amount of revenue from the various segments of the market, the price dropped steadily through the years—a 28-inch Sony HDTV cost just over $6,000 in 1993, but a 40-inch Sony HDTV cost only $600 in 2010.

This strategy can be fatal, however, if a worthy competitor decides to price low. When Philips, the Dutch electronics manufacturer, priced its videodisc players to make a profit on each, Japanese competitors priced low and rapidly built their market share, which in turn pushed down their costs substantially.

Moreover, consumers who buy early at the highest prices may be dissatisfied if they compare themselves to those who buy later at a lower price. When Apple dropped the iPhone's price from $600 to $400 only two months after its introduction, public outcry caused the firm to give initial buyers a $100 credit toward future Apple purchases.[32]

Market skimming makes sense under the following conditions: (1) A sufficient number of buyers have a high current demand; (2) the unit costs of producing a small volume are high enough to cancel the advantage of charging what the traffic will bear; (3) the high initial price does not attract more competitors to the market; (4) the high price communicates the image of a superior product.

PRODUCT-QUALITY LEADERSHIP A company might aim to be the *product-quality leader* in the market. Many brands strive to be "affordable luxuries"—products or services characterized by high levels of perceived quality, taste, and status with a price just high enough not to be out of consumers' reach. Brands such as Starbucks, Aveda, Victoria's Secret, BMW, and Viking have positioned themselves as quality leaders in their categories, combining quality, luxury, and premium prices with an intensely loyal customer base.[33] Grey Goose and Absolut carved out a superpremium niche in the essentially odorless, colorless, and tasteless vodka category through clever on-premise and off-premise marketing that made the brands seem hip and exclusive.[34]

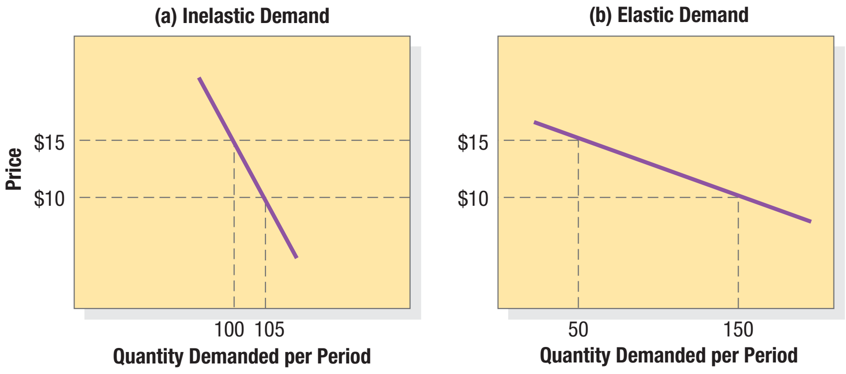
OTHER OBJECTIVES Nonprofit and public organizations may have other pricing objectives. A university aims for *partial cost recovery,* knowing that it must rely on private gifts and public grants to cover its remaining costs. A nonprofit hospital may aim for full cost recovery in its pricing. A nonprofit theater company may price its productions to fill the maximum number of seats. A social service agency may set a service price geared to client income.

Whatever the specific objective, businesses that use price as a strategic tool will profit more than those that simply let costs or the market determine their pricing. For art museums, which earn an average of only 5 percent of their revenues from admission charges, pricing can send a message that affects their public image and the amount of donations and sponsorships they receive.

Step 2: Determining Demand

Each price will lead to a different level of demand and have a different impact on a company's marketing objectives. The normally inverse relationship between price and demand is captured in a demand curve (see △ Figure 14.1): The higher the price, the lower the demand. For prestige goods, the demand curve sometimes slopes upward. One perfume company raised its price and sold more rather than less! Some consumers take the higher price to signify a better product. However, if the price is too high, demand may fall.

PRICE SENSITIVITY The demand curve shows the market's probable purchase quantity at alternative prices. It sums the reactions of many individuals with different price sensitivities. The first step in estimating demand is to understand what affects price sensitivity. Generally speaking, customers are less price sensitive to low-cost items or items they buy infrequently. They are also less price sensitive when (1) there are few or no substitutes or competitors; (2) they do not readily



|Fig. 14.1|

Inelastic and Elastic Demand

notice the higher price; (3) they are slow to change their buying habits; (4) they think the higher prices are justified; and (5) price is only a small part of the total cost of obtaining, operating, and servicing the product over its lifetime.

A seller can successfully charge a higher price than competitors if it can convince customers that it offers the lowest *total cost of ownership* (TCO). Marketers often treat the service elements in a product offering as sales incentives rather than as value-enhancing augmentations for which they can charge. In fact, pricing expert Tom Nagle believes the most common mistake manufacturers have made in recent years is to offer all sorts of services to differentiate their products without charging for them.[35]

Of course, companies prefer customers who are less price-sensitive. Table 14.3 lists some characteristics associated with decreased price sensitivity. On the other hand, the Internet has the potential to *increase* price sensitivity. In some established, fairly big-ticket categories, such as auto retailing and term insurance, consumers pay lower prices as a result of the Internet. Car buyers use the Internet to gather information and borrow the negotiating clout of an online buying service.[36] But customers may have to visit multiple sites to realize these savings, and they don't always do so. Targeting only price-sensitive consumers may in fact be "leaving money on the table."

ESTIMATING DEMAND CURVES Most companies attempt to measure their demand curves using several different methods.

- ***Surveys*** can explore how many units consumers would buy at different proposed prices. Although consumers might understate their purchase intentions at higher prices to discourage the company from pricing high, they also tend to actually exaggerate their willingness to pay for new products or services.[37]

TABLE 14.3 Factors Leading to Less Price Sensitivity
• The product is more distinctive.
• Buyers are less aware of substitutes.
• Buyers cannot easily compare the quality of substitutes.
• The expenditure is a smaller part of the buyer's total income.
• The expenditure is small compared to the total cost of the end product.
• Part of the cost is borne by another party.
• The product is used in conjunction with assets previously bought.
• The product is assumed to have more quality, prestige, or exclusiveness.
• Buyers cannot store the product.

Source: Based on information from Thomas T. Nagle, John E. Hogan, and Joseph Zale, *The Strategy and Tactics of Pricing,* 5th ed. (Upper Saddle River, NJ: Prentice Hall, 2011). Printed and electronically reproduced by permission of Pearson Education, Inc., Upper Saddle River, New Jersey.

- ***Price experiments*** can vary the prices of different products in a store or charge different prices for the same product in similar territories to see how the change affects sales. Another approach is to use the Internet. An e-business could test the impact of a 5 percent price increase by quoting a higher price to every 40th visitor, to compare the purchase response. However, it must do this carefully and not alienate customers or be seen as reducing competition in any way (and thus violate the Sherman Antitrust Act).[38]
- ***Statistical analysis*** of past prices, quantities sold, and other factors can reveal their relationships. The data can be longitudinal (over time) or cross-sectional (from different locations at the same time). Building the appropriate model and fitting the data with the proper statistical techniques calls for considerable skill, but sophisticated price optimization software and advances in database management have improved marketers' abilities to optimize pricing.

One large retail chain was selling a line of "good-better-best" power drills at \$90, \$120, and \$130, respectively. Sales of the least and most expensive drills were fine, but sales of the midpriced drill lagged. Based on a price optimization analysis, the retailer dropped the price of the midpriced drill to \$110. Sales of the low-priced drill dropped 4 percent because it seemed less of a bargain, but the sales of the midpriced drill increased by 11 percent. Profits rose as a result.[39]

In measuring the price-demand relationship, the market researcher must control for various factors that will influence demand.[40] The competitor's response will make a difference. Also, if the company changes other aspects of the marketing program besides price, the effect of the price change itself will be hard to isolate.

PRICE ELASTICITY OF DEMAND Marketers need to know how responsive, or elastic, demand is to a change in price. Consider the two demand curves in Figure 14.1. In demand curve (a), a price increase from \$10 to \$15 leads to a relatively small decline in demand from 105 to 100. In demand curve (b), the same price increase leads to a substantial drop in demand from 150 to 50. If demand hardly changes with a small change in price, we say the demand is *inelastic.* If demand changes considerably, demand is *elastic.*

The higher the elasticity, the greater the volume growth resulting from a 1 percent price reduction. If demand is elastic, sellers will consider lowering the price. A lower price will produce more total revenue. This makes sense as long as the costs of producing and selling more units do not increase disproportionately.[41]

Price elasticity depends on the magnitude and direction of the contemplated price change. It may be negligible with a small price change and substantial with a large price change. It may differ for a price cut versus a price increase, and there may be a *price indifference band* within which price changes have little or no effect.

Finally, long-run price elasticity may differ from short-run elasticity. Buyers may continue to buy from a current supplier after a price increase but eventually switch suppliers. Here demand is more elastic in the long run than in the short run, or the reverse may happen: Buyers may drop a supplier after a price increase but return later. The distinction between short-run and long-run elasticity means that sellers will not know the total effect of a price change until time passes.

One comprehensive study reviewing a 40-year period of academic research that investigated price elasticity yielded interesting findings:[42]

- The average price elasticity across all products, markets, and time periods studied was –2.62. In other words, a 1 percent decrease in prices led to a 2.62 percent increase in sales.
- Price elasticity magnitudes were higher for durable goods than for other goods, and higher for products in the introduction/growth stages of the product life cycle than in the mature/decline stages.
- Inflation led to substantially higher price elasticities, especially in the short run.
- Promotional price elasticities were higher than actual price elasticities in the short run (although the reverse was true in the long run).
- Price elasticities were higher at the individual item or SKU level than at the overall brand level.

Step 3: Estimating Costs

Demand sets a ceiling on the price the company can charge for its product. Costs set the floor. The company wants to charge a price that covers its cost of producing, distributing, and selling the product, including a fair return for its effort and risk. Yet when companies price products to cover their full costs, profitability isn't always the net result.

TYPES OF COSTS AND LEVELS OF PRODUCTION A company's costs take two forms, fixed and variable. **Fixed costs**, also known as **overhead**, are costs that do not vary with production level or sales revenue. A company must pay bills each month for rent, heat, interest, salaries, and so on regardless of output.

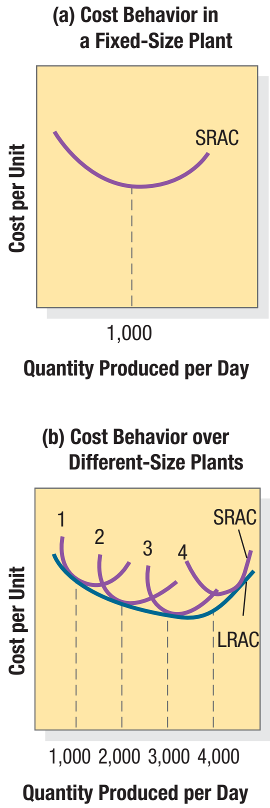
Variable costs vary directly with the level of production. For example, each hand calculator produced by Texas Instruments incurs the cost of plastic, microprocessor chips, and packaging. These costs tend to be constant per unit produced, but they're called *variable* because their total varies with the number of units produced.

Total costs consist of the sum of the fixed and variable costs for any given level of production. **Average cost** is the cost per unit at that level of production; it equals total costs divided by production. Management wants to charge a price that will at least cover the total production costs at a given level of production.

To price intelligently, management needs to know how its costs vary with different levels of production. Take the case in which a company such as TI has built a fixed-size plant to produce 1,000 hand calculators a day. The cost per unit is high if few units are produced per day. As production approaches 1,000 units per day, the average cost falls because the fixed costs are spread over more units. Short-run average cost *increases* after 1,000 units, however, because the plant becomes inefficient: Workers must line up for machines, getting in each other's way, and machines break down more often (see △ Figure 14.2(a)).

If TI believes it can sell 2,000 units per day, it should consider building a larger plant. The plant will use more efficient machinery and work arrangements, and the unit cost of producing 2,000 calculators per day will be lower than the unit cost of producing 1,000 per day. This is shown in the long-run average cost curve (LRAC) in Figure 14.2(b). In fact, a 3,000-capacity plant would be even more efficient according to Figure 14.2(b), but a 4,000-daily production plant would be less so because of increasing diseconomies of scale: There are too many workers to manage, and paperwork slows things down. Figure 14.2(b) indicates that a 3,000-daily production plant is the optimal size if demand is strong enough to support this level of production.

There are more costs than those associated with manufacturing. To estimate the real profitability of selling to different types of retailers or customers, the manufacturer needs to use activity-based cost (ABC) accounting instead of standard cost accounting, as described in Chapter 5.

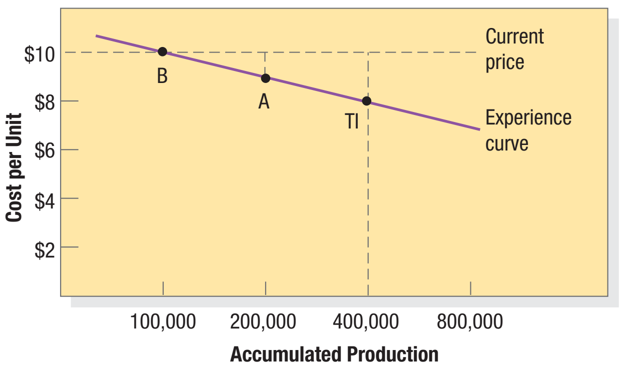


|Fig. 14.2| △

Cost per Unit at Different Levels of Production per Period

ACCUMULATED PRODUCTION Suppose TI runs a plant that produces 3,000 hand calculators per day. As TI gains experience producing hand calculators, its methods improve. Workers learn shortcuts, materials flow more smoothly, and procurement costs fall. The result, as △ Figure 14.3 shows, is that average cost falls with accumulated production experience. Thus the average cost of producing the first 100,000 hand calculators is $10 per calculator. When the company has produced the first 200,000 calculators, the average cost has fallen to $9. After its accumulated production experience doubles again to 400,000, the average cost is $8. This decline in the average cost with accumulated production experience is called the **experience curve** or **learning curve**.

Now suppose three firms compete in this industry, TI, A, and B. TI is the lowest-cost producer at $8, having produced 400,000 units in the past. If all three firms sell the calculator for $10, TI



|Fig. 14.3| △

Cost per Unit as a Function of Accumulated Production: The Experience Curve makes $2 profit per unit, A makes $1 per unit, and B breaks even. The smart move for TI would be to lower its price to $9. This will drive B out of the market, and even A may consider leaving. TI will pick up the business that would have gone to B (and possibly A). Furthermore, price-sensitive customers will enter the market at the lower price. As production increases beyond 400,000 units, TI's costs will drop still further and faster and will more than restore its profits, even at a price of $9. TI has used this aggressive pricing strategy repeatedly to gain market share and drive others out of the industry.

Experience-curve pricing nevertheless carries major risks. Aggressive pricing might give the product a cheap image. It also assumes competitors are weak followers. The strategy leads the company to build more plants to meet demand, but a competitor may choose to innovate with a lower-cost technology. The market leader is now stuck with the old technology.

Most experience-curve pricing has focused on manufacturing costs, but all costs can be improved on, including marketing costs. If three firms are each investing a large sum of money in marketing, the firm that has used it longest might achieve the lowest costs. This firm can charge a little less for its product and still earn the same return, all other costs being equal.[43]

TARGET COSTING Costs change with production scale and experience. They can also change as a result of a concentrated effort by designers, engineers, and purchasing agents to reduce them through **target costing**.[44] Market research establishes a new product's desired functions and the price at which it will sell, given its appeal and competitors' prices. This price less desired profit margin leaves the target cost the marketer must achieve.

The firm must examine each cost element—design, engineering, manufacturing, sales—and bring down costs so the final cost projections are in the target range. When ConAgra Foods decided to increase the list prices of its Banquet frozen dinners to cover higher commodity costs, the average retail price of the meals increased from $1 to $1.25. When sales dropped significantly, management vowed to return to a $1 price, which necessitated cutting $250 million in other costs through a variety of methods, such as centralized purchasing and shipping, less expensive ingredients, and smaller portions.[45]

Companies can cut costs in many ways.[46] With General Mills, it was as simple as reducing the number of varieties of Hamburger Helper from 75 to 45 and the number of pasta shapes from 30 to 10. Dropping multicolored Yoplait lids saved $2 million a year. Some companies are applying what they learned from making affordable products with scarce resources in developing countries such as India to cutting costs in developed markets. Cisco blends teams of U.S. software engineers with Indian supervisors. Other companies such as Aldi take advantage of the global scope.

ConAgra learned the importance to its customers of keeping its Banquet frozen dinners priced at $1.

Aldi

Aldi Germany's Aldi follows a simple formula globally. It stocks only about 1,000 of the most popular everyday grocery and household items, compared with more than 20,000 at a traditional grocer such as Royal Ahold's Albert Heijn. Almost all the products carry Aldi's own exclusive label. Because it sells so few items, Aldi can exert strong control over quality and price and simplify shipping and handling, leading to high margins. With more than 8,200 stores worldwide currently, Aldi brings in almost $60 billion in annual sales.[47]

Step 4: Analyzing Competitors' Costs, Prices, and Offers

Within the range of possible prices determined by market demand and company costs, the firm must take competitors' costs, prices, and possible price reactions into account. If the firm's offer contains features not offered by the nearest competitor, it should evaluate their worth to the customer and add that value to the competitor's price. If the competitor's offer contains some features not offered by the firm, the firm should subtract their value from its own price. Now the firm can decide whether it can charge more, the same, or less than the competitor.

The introduction or change of any price can provoke a response from customers, competitors, distributors, suppliers, and even government. Competitors are most likely to react when the number of firms is few, the product is homogeneous, and buyers are highly informed. Competitor reactions can be a special problem when these firms have a strong value proposition, as Green Works did.

Green Works

Green Works Although the natural cleaner market was pioneered by Seventh Generation and method cleaning products, Clorox Green Works now commands 42 percent market share. The Green Works product line consists of 10 natural cleaners using biodegradable ingredients, packaged in recyclable materials, and not tested on animals. The first major new Clorox brand in more than 20 years, it doubled the size of the natural cleaning category with its strategy of "delivering a line of affordable products that are good for consumers, good for retailers, and good for the environment." The company charges only a 10 percent to 20 percent premium over conventional cleaners, versus the premium of 40 percent or more charged by other natural cleaners. Launch marketing efforts included the use of viral marketing and social media, prominent TV coverage in shows like *Ellen* and *Oprah*, collaborations with retail customers such as Safeway and Walmart in product development and in-store promotion, and an endorsement from and cause marketing program with the Sierra Club (resulting in a donation of $645,000 to the organization in 2009).[48]

How can a firm anticipate a competitor's reactions? One way is to assume the competitor reacts in the standard way to a price being set or changed. Another is to assume the competitor treats each price difference or change as a fresh challenge and reacts according to self-interest at the time. Now the company will need to research the competitor's current financial situation, recent sales, customer loyalty, and corporate objectives. If the competitor has a market share objective, it is likely to match price differences or changes.[49] If it has a profit-maximization objective, it may react by increasing its advertising budget or improving product quality.

The problem is complicated because the competitor can put different interpretations on lowered prices or a price cut: that the company is trying to steal the market, that it is doing poorly and trying to boost its sales, or that it wants the whole industry to reduce prices to stimulate total demand.

|Fig. 14.4|

The Three Cs Model for Price Setting

Step 5: Selecting a Pricing Method

Given the customers' demand schedule, the cost function, and competitors' prices, the company is now ready to select a price. Figure 14.4 summarizes the three major considerations in price setting: Costs set a floor to the price. Competitors' prices and the price of substitutes provide an orienting point. Customers' assessment of unique features establishes the price ceiling.

Companies select a pricing method that includes one or more of these three considerations. We will examine six price-setting methods: markup pricing, target-return pricing, perceived-value pricing, value pricing, going-rate pricing, and auction-type pricing.

MARKUP PRICING The most elementary pricing method is to add a standard **markup** to the product's cost. Construction companies submit job bids by estimating the total project cost and adding a standard markup for profit. Lawyers and accountants typically price by adding a standard markup on their time and costs.

Variable cost per unit	$10
Fixed costs	$300,000
Expected unit sales	50,000

Suppose a toaster manufacturer has the following costs and sales expectations:
The manufacturer's unit cost is given by:

$$\text{Unit cost} = \text{variable cost} + \frac{\text{fixed cost}}{\text{unit sales}} = \$10 + \frac{\$300{,}00}{50{,}000} = \$16$$

Now assume the manufacturer wants to earn a 20 percent markup on sales. The manufacturer's markup price is given by:

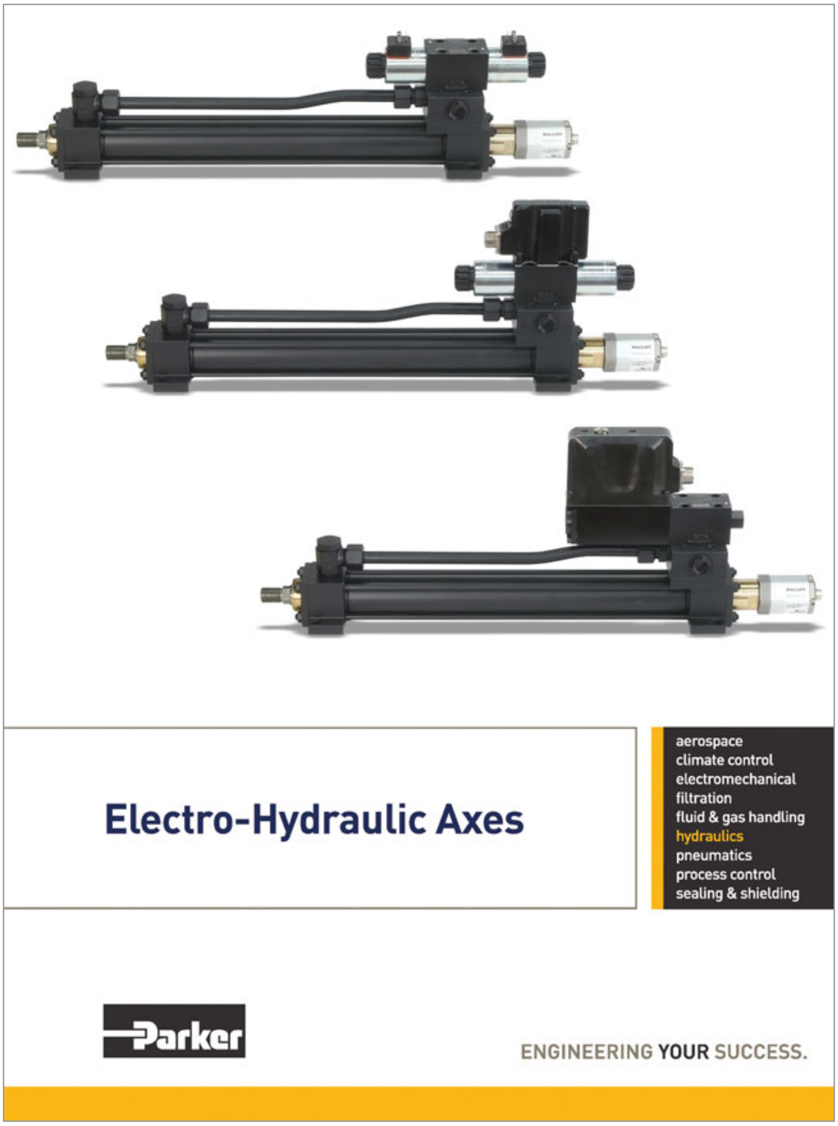
$$\text{Markup price} = \frac{\text{unit cost}}{(1 - \text{desired return on sales})} = \frac{\$16}{1 - 0.2} = \$20$$

The manufacturer will charge dealers $20 per toaster and make a profit of $4 per unit. If dealers want to earn 50 percent on their selling price, they will mark up the toaster 100 percent to $40. Markups are generally higher on seasonal items (to cover the risk of not selling), specialty items, slower-moving items, items with high storage and handling costs, and demand-inelastic items, such as prescription drugs.

Does the use of standard markups make logical sense? Generally, no. Any pricing method that ignores current demand, perceived value, and competition is not likely to lead to the optimal price. Markup pricing works only if the marked-up price actually brings in the expected level of sales. Consider what happened at Parker Hannifin.

Parker Hannifin When Donald Washkewicz took over as CEO of Parker Hannifin, maker of 800,000 industrial parts for the aerospace, transportation, and manufacturing industries, pricing was done one way: Calculate how much it costs to make and deliver a product and then add a flat percentage (usually 35 percent). Even though this method was historically well received, Washkewicz set out to get the company to think more like a retailer and charge what customers were willing to pay. Encountering initial resistance from some of the company's 115 different divisions, Washkewicz assembled a list of the 50 most commonly given reasons why the new pricing scheme would fail and announced he would listen only to arguments that were not on the list. The new pricing scheme put Parker Hannifin's products into one of four categories depending on how much competition existed. About one-third fell into niches where Parker offered unique value, there was little competition, and higher prices were appropriate. Each division now has a pricing guru or specialist who assists in strategic pricing. The division making industrial fittings reviewed 2,000 different items and concluded that 28 percent were priced too low, raising prices anywhere from 3 percent to 60 percent.[50]

Still, markup pricing remains popular. First, sellers can determine costs much more easily than they can estimate demand. By tying the price to cost, sellers simplify the pricing task. Second, where



With a stronger focus on customer value and competitive pressures, Parker Hannifin was able to simplify its approach to the pricing of its thousands of products.

all firms in the industry use this pricing method, prices tend to be similar and price competition is minimized. Third, many people feel that cost-plus pricing is fairer to both buyers and sellers. Sellers do not take advantage of buyers when the latter's demand becomes acute, and sellers earn a fair return on investment.

TARGET-RETURN PRICING In **target-return pricing**, the firm determines the price that yields its target rate of return on investment. Public utilities, which need to make a fair return on investment, often use this method.

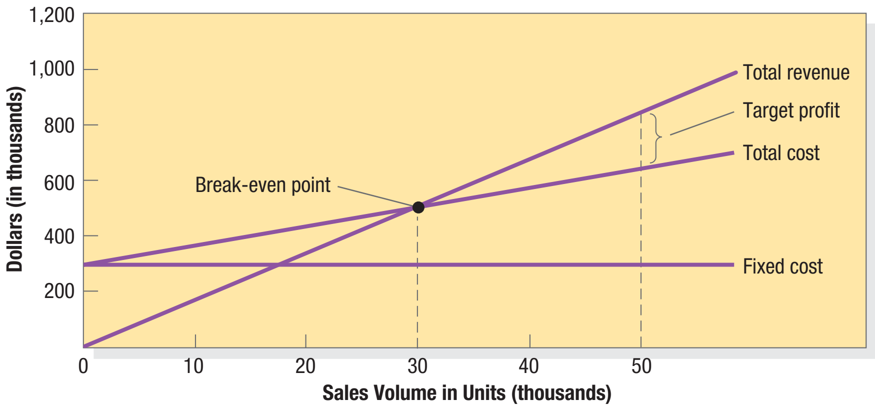
Suppose the toaster manufacturer has invested \$1 million in the business and wants to set a price to earn a 20 percent ROI, specifically \$200,000. The target-return price is given by the following formula:

$$\text{Target-return price} = \text{unit cost} + \frac{\text{desired return} \times \text{invested capital}}{\text{unit sales}}$$

$$= \$16 + \frac{.20 \times \$1{,}000{,}000}{50{,}000} = \$20$$

|Fig. 14.5|

Break-Even Chart for Determining Target-Return Price and Break-Even Volume



The manufacturer will realize this 20 percent ROI provided its costs and estimated sales turn out to be accurate. But what if sales don't reach 50,000 units? The manufacturer can prepare a break-even chart to learn what would happen at other sales levels (see Figure 14.5). Fixed costs are \$300,000 regardless of sales volume. Variable costs, not shown in the figure, rise with volume. Total costs equal the sum of fixed and variable costs. The total revenue curve starts at zero and rises with each unit sold.

The total revenue and total cost curves cross at 30,000 units. This is the break-even volume. We can verify it by the following formula:

$$\text{Break-even volume} = \frac{\text{fixed cost}}{(\text{price} - \text{variable cost})} = \frac{\$300{,}000}{\$20 - \$10} = 30{,}000$$

The manufacturer, of course, is hoping the market will buy 50,000 units at \$20, in which case it earns \$200,000 on its \$1 million investment, but much depends on price elasticity and competitors' prices. Unfortunately, target-return pricing tends to ignore these considerations. The manufacturer needs to consider different prices and estimate their probable impacts on sales volume and profits.

The manufacturer should also search for ways to lower its fixed or variable costs, because lower costs will decrease its required break-even volume. Acer has been gaining share in the netbook market through rock-bottom prices made possible because of its bare-bones cost strategy. Acer sells only via retailers and other outlets and outsources all manufacturing and assembly, reducing its overhead to 8 percent of sales versus 14 percent at Dell and 15 percent at HP.[51]

PERCEIVED-VALUE PRICING An increasing number of companies now base their price on the customer's **perceived value**. Perceived value is made up of a host of inputs, such as the buyer's image of the product performance, the channel deliverables, the warranty quality, customer support, and softer attributes such as the supplier's reputation, trustworthiness, and esteem. Companies must deliver the value promised by their value proposition, and the customer must perceive this value. Firms use the other marketing program elements, such as advertising, sales force, and the Internet, to communicate and enhance perceived value in buyers' minds.[52]

Caterpillar uses perceived value to set prices on its construction equipment. It might price its tractor at \$100,000, although a similar competitor's tractor might be priced at \$90,000. When a prospective customer asks a Caterpillar dealer why he should pay \$10,000 more for the Caterpillar tractor, the dealer answers:

\$90,000	is the tractor's price if it is only equivalent to the competitor's tractor
\$7,000	is the price premium for Caterpillar's superior durability
\$6,000	is the price premium for Caterpillar's superior reliability
\$5,000	is the price premium for Caterpillar's superior service

$2,000	is the price premium for Caterpillar's longer warranty on parts
$110,000	is the normal price to cover Caterpillar's superior value
– $10,000	discount
$100,000	final price

The Caterpillar dealer is able to show that although the customer is asked to pay a $10,000 premium, he is actually getting $20,000 extra value! The customer chooses the Caterpillar tractor because he is convinced its lifetime operating costs will be lower.

Ensuring that customers appreciate the total value of a product or service offering is crucial. Consider the experience of PACCAR.

PACCAR PACCAR Inc., maker of Kenworth and Peterbilt trucks, is able to command a 10 percent premium through its relentless focus on all aspects of the customer experience to maximize total value. Contract Freighters trucking company, a loyal PACCAR customer for 20 years, justified ordering another 700 new trucks, despite their higher price, because of their higher perceived quality—greater reliability, higher trade-in value, even the superior plush interiors that might attract better drivers. PACCAR bucks the commoditization trend by custom-building its trucks to individual specifications. The company invests heavily in technology and can prototype new parts in hours versus days and weeks, allowing more frequent upgrades. PACCAR was the first to roll out hybrid vehicles in the fuel-intensive commercial trucking industry (and sell at a premium). The company generated $1 billion of profit on $15 billion of revenue in 2008—its 70th consecutive year of profitability—bolstered by record European sales and $2.3 billion in sales of aftermarket parts.[53]

Because of its high standards for quality and continual innovation, PACCAR can charge a premium for its trucks.

Even when a company claims its offering delivers more total value, not all customers will respond positively. Some care only about price. But there is also typically a segment that cares about quality. The makers of Stag umbrellas in India—umbrellas are essential in the three months of near-nonstop monsoon rain in cities such as Mumbai—found themselves in a bitter price war with cheaper Chinese competitors. After realizing they were sacrificing quality too much, Stag's managers decided to increase quality with new colors, designs, and features such as built-in high-power flashlights and prerecorded music. Despite higher prices, sales of the improved Stag umbrellas actually increased.[54]

The key to perceived-value pricing is to deliver more unique value than the competitor and to demonstrate this to prospective buyers. Thus a company needs to fully understand the customer's decision-making process. For example, Goodyear found it hard to command a price premium for its more expensive new tires despite innovative new features to extend tread life. Because consumers had no reference price to compare tires, they tended to gravitate toward the lowest-priced offerings. Goodyear's solution was to price its models on expected miles of wear rather than their technical product features, making product comparisons easier.[55]

The company can try to determine the value of its offering in several ways: managerial judgments within the company, value of similar products, focus groups, surveys, experimentation, analysis of historical data, and conjoint analysis.[56] Table 14.4 contains six key considerations in developing value-based pricing.

VALUE PRICING In recent years, several companies have adopted **value pricing**: They win loyal customers by charging a fairly low price for a high-quality offering. Value pricing is thus not a

TABLE 14.4 A Framework of Questions for Practicing Value-Based Pricing

1.	What is the market strategy for the segment? (What does the supplier want to accomplish? What would the supplier like to have happen?)
2.	What is the differential value that is *transparent* to target customers? (*Transparent* means that target customers easily understand how the supplier calculates the differential value between its offering and the next best alternative, and that the differential value can be verified with the customer's own data.)
3.	What is the price of the next best alternative offering?
4.	What is the cost of the supplier's market offering?
5.	What pricing tactics will be used initially or eventually? ("Pricing tactics" are changes from a price that a supplier has set for its marketing offering—such as discounts—that motivate customers to take actions that benefit the supplier.)
6.	What is the customer's expectation of a "fair" price?

Source: James C. Anderson, Marc Wouters, and Wouter Van Rossum, "Why the Highest Price Isn't the Best Price," *MIT Sloan Management Review* (Winter 2010), pp. 69–76.

matter of simply setting lower prices; it is a matter of reengineering the company's operations to become a low-cost producer without sacrificing quality, to attract a large number of value-conscious customers.

Among the best practitioners of value pricing are IKEA, Target, and Southwest Airlines. In the early 1990s, Procter & Gamble created quite a stir when it reduced prices on supermarket staples such as Pampers and Luvs diapers, liquid Tide detergent, and Folgers coffee to value price them. To do so, P&G redesigned the way it developed, manufactured, distributed, priced, marketed, and sold products to deliver better value at every point in the supply chain.[57] Its acquisition of Gillette in 2005 for $57 billion (a record five times its sales) brought another brand into its fold that has also traditionally adopted a value pricing strategy.

Gillette

Gillette In 2006, Gillette launched the "best shave on the planet" with the six-bladed Fusion—five blades in the front for regular shaving and one in the back for trimming—in both power and nonpower versions. Gillette conducts exhaustive consumer research in designing its new products and markets aggressively to spread the word. The company spent over $1.2 billion on research and development after the Fusion's predecessor, the Mach3, was introduced. About 9,000 men tested potential new products and preferred the new Fusion over the Mach3 by a two-to-one margin. To back the introduction, Procter & Gamble spent $200 million in the United States and over $1 billion worldwide. The payoff? Gillette enjoys enormous market leadership in the razor and blade categories, with 70 percent of the global market, and sizable price premiums. Refills for the Fusion Power cost $14 for a four-pack, compared to $5.29 for a five-pack of Sensor Excel. All this adds up to significant, sustained profitability for corporate owner P&G.[58]

Value pricing can change the manner by which a company sets prices too. One company that sold and maintained switch boxes in a variety of sizes for telephone lines found that the probability of failure—and thus maintenance costs—was proportional to the number of switches customers had in their boxes rather than to the dollar value of the installed boxes. The number of switches could vary in a box, though. Therefore, rather than charging customers based on the total spent on their installation, the company began charging based on the total number of switches needing servicing.[59]

An important type of value pricing is **everyday low pricing (EDLP)**. A retailer that holds to an EDLP pricing policy charges a constant low price with little or no price promotions and special sales. Constant prices eliminate week-to-week price uncertainty and the "high-low" pricing of promotion-oriented competitors. In **high-low pricing**, the retailer charges higher prices on an everyday basis but runs frequent promotions with prices temporarily lower than the EDLP level.[60] These two strategies have been shown to affect consumer price judgments—deep discounts (EDLP) can lead customers to perceive lower prices over time than frequent, shallow discounts (high-low), even if the actual averages are the same.[61]

In recent years, high-low pricing has given way to EDLP at such widely different venues as Toyota Scion car dealers and upscale department stores such as Nordstrom, but the king of EDLP is surely Walmart, which practically defined the term. Except for a few sale items every month, Walmart promises everyday low prices on major brands.

EDLP provides customer benefits of time and money. Toyota believes its Gen Y target dislikes haggling because it takes too long. These buyers collect a lot of information online anyway, so Toyota cut the time to sell Scions from the industry average of 4.5 hours to 45 minutes requiring fewer managers to approve negotiated prices and less advertising of sales.[62] Some retailers base their entire marketing strategy around *extreme* everyday low pricing.

Dollar Stores Once-unfashionable "dollar stores" such as Dollar General, Family Dollar, Big Lots, and Dollar Tree are gaining popularity, partly fueled by an economic downturn. In 2008, these four biggest players in the category generated $26 billion in sales with 20,000 stores and gross margins of 35 percent to 40 percent. These ultradiscounters are not dollar stores in a strict sense of the word—they sell many items over $1, although most are under $10. They have, however, developed a simple, successful formula for drawing shoppers from Target and even Walmart: Build small, easy-to-navigate stores in expensive real estate locations with parking handy; keep overhead low by limiting inventory to mostly inexpensive overstocks, odd lots, and buyouts; and spend sparingly on store décor and get free word-of-mouth publicity. Because most customers pay in person and in cash, dollar stores can avoid the expense of processing a lot of credit card purchases and elaborate Internet marketing or supporting a significant e-commerce presence online.[63]

Even though not everything it sells costs less than a dollar, Family Dollar has become one of the hottest retailers in recent years.

The most important reason retailers adopt EDLP is that constant sales and promotions are costly and have eroded consumer confidence in everyday shelf prices. Consumers also have less time and patience for past traditions like watching for supermarket specials and clipping coupons. Yet, promotions do create excitement and draw shoppers, so EDLP does not guarantee success. As supermarkets face heightened competition from their counterparts and alternative channels, many find the key is a combination of high-low and everyday low pricing strategies, with increased advertising and promotions.

GOING-RATE PRICING In **going-rate pricing**, the firm bases its price largely on competitors' prices. In oligopolistic industries that sell a commodity such as steel, paper, or fertilizer, all firms normally charge the same price. Smaller firms "follow the leader," changing their prices when the market leader's prices change rather than when their own demand or costs change. Some may charge a small premium or discount, but they preserve the difference. Thus minor gasoline retailers usually charge a few cents less per gallon than the major oil companies, without letting the difference increase or decrease.

Going-rate pricing is quite popular. Where costs are difficult to measure or competitive response is uncertain, firms feel the going price is a good solution because it is thought to reflect the industry's collective wisdom.

AUCTION-TYPE PRICING Auction-type pricing is growing more popular, especially with scores of electronic marketplaces selling everything from pigs to used cars as firms dispose of excess inventories or used goods. These are the three major types of auctions and their separate pricing procedures:

- ***English auctions (ascending bids)*** have one seller and many buyers. On sites such as eBay and Amazon.com, the seller puts up an item and bidders raise the offer price until the top price is reached. The highest bidder gets the item. English auctions are used today for selling antiques, cattle, real estate, and used equipment and vehicles. After watching eBay and other ticket brokers, scalpers, and middlemen reap millions by charging what the market would bear, Ticketmaster has overhauled the way it sells tickets to try to gain more of the multi-billion-dollar ticket resale industry. It now runs auctions for 30 percent of major music tours including popular artists such as Christina Aguilera and Madonna and allows some customers to resell their seats on its Web site.[64]
- ***Dutch auctions (descending bids)*** feature one seller and many buyers, or one buyer and many sellers. In the first kind, an auctioneer announces a high price for a product and then slowly decreases the price until a bidder accepts. In the other, the buyer announces something he or she wants to buy, and potential sellers compete to offer the lowest price. FreeMarkets.com—later acquired by Ariba—helped Royal Mail Group plc, the United Kingdom's public mail service company, save approximately £2.5 million (almost $4 million), in part via an auction where 25 airlines bid for its international freight business.[65]
- ***Sealed-bid auctions*** let would-be suppliers submit only one bid; they cannot know the other bids. The U.S. government often uses this method to procure supplies. A supplier will not bid below its cost but cannot bid too high for fear of losing the job. The net effect of these two pulls is the bid's *expected profit*.[66]

To buy equipment for its drug researchers, Pfizer uses reverse auctions in which suppliers submit online the lowest price they are willing to be paid. If the increased savings a firm obtains in an online auction translates into decreased margins for an incumbent supplier, however, the supplier may feel the firm is opportunistically squeezing out price concessions.[67] Online auctions with a large number of bidders, greater economic stakes, and less visibility in pricing result in greater overall satisfaction, more positive future expectations, and fewer perceptions of opportunism.

Step 6: Selecting the Final Price

Pricing methods narrow the range from which the company must select its final price. In selecting that price, the company must consider additional factors, including the impact of other marketing activities, company pricing policies, gain-and-risk-sharing pricing, and the impact of price on other parties.

IMPACT OF OTHER MARKETING ACTIVITIES The final price must take into account the brand's quality and advertising relative to the competition. In a classic study, Paul Farris and David Reibstein examined the relationships among relative price, relative quality, and relative advertising for 227 consumer businesses and found the following:[68]

- Brands with average relative quality but high relative advertising budgets could charge premium prices. Consumers were willing to pay higher prices for known rather than for unknown products.
- Brands with high relative quality and high relative advertising obtained the highest prices. Conversely, brands with low quality and low advertising charged the lowest prices.
- For market leaders, the positive relationship between high prices and high advertising held most strongly in the later stages of the product life cycle.

These findings suggest that price is not necessarily as important as quality and other benefits.

COMPANY PRICING POLICIES The price must be consistent with company pricing policies. Yet companies are not averse to establishing pricing penalties under certain circumstances.[69]

Airlines charge $150 to those who change their reservations on discount tickets. Banks charge fees for too many withdrawals in a month or early withdrawal of a certificate of deposit. Dentists, hotels, car rental companies, and other service providers charge penalties for no-shows who miss appointments or reservations. Although these policies are often justifiable, marketers must use them judiciously and not unnecessarily alienate customers. (See "Marketing Insight: Stealth Price Increases.")

Many companies set up a pricing department to develop policies and establish or approve decisions. The aim is to ensure that salespeople quote prices that are reasonable to customers and profitable to the company.

Marketing Insight

Stealth Price Increases

With consumers resisting higher prices, companies are trying to figure out how to increase revenue without really raising prices. They often resort to adding fees for once-free features. Although some consumers abhor "nickel-and-dime" pricing strategies, small additional charges can add up to a substantial source of revenue.

The numbers can be staggering. The telecommunications industry has been aggressive at adding fees for setup, change-of-service, service termination, directory assistance, regulatory assessment, number portability, and cable hookup and equipment, costing consumers billions of dollars. Fees for consumers who pay bills online, bounce checks, or use automated teller machines bring banks billions of dollars annually.

When credit card companies were faced with a set of reforms in 2009 to some of their most reviled practices—including abrupt interest rate changes and late payment fees—they responded with new ways to raise revenue, such as rate floors for variable rate cards, higher penalty fees for overdue payments at lower balance thresholds, and inactivity fees for not using cards.

This explosion of fees has a number of implications. Given that list prices stay fixed, they may understate inflation. They also make it harder for consumers to compare competitive offerings. Although various citizens' groups have tried to pressure companies to roll back some of these fees, they don't always get a sympathetic ear from state and local governments, which have been guilty of using their own array of fees, fines, and penalties to raise necessary revenue.

Companies justify the extra fees as the only fair and viable way to cover expenses without losing customers. Many argue that it makes sense to charge a premium for added services that cost more to provide, rather than charging all customers the same amount whether or not they use the extra service. Breaking out charges and fees according to the related services is a way to keep basic costs low. Companies also use fees as a means to weed out unprofitable customers or get them to change their behavior.

Ultimately, the viability of extra fees will be decided in the marketplace, and by the willingness of consumers to vote with their wallets and pay the fees, or vote with their feet and move on.

Sources: Alexis Leondis and Jeff Plungis, "The Latest Credit Card Tricks," *Bloomberg BusinessWeek*, December 28, 2009 & January 4, 2010, p. 95; Brian Burnsed, "A New Front in the Credit Card Wars," *BusinessWeek*, November 9, 2009, p. 60; Kathy Chu, "Credit Card Fees Can Suck You In," *USA Today,* December 15, 2006; Michael Arndt, "Fees! Fees! Fees!" *BusinessWeek,* September 29, 2003, pp. 99–104; "The Price Is Wrong," *Economist,* May 25, 2002, pp. 59–60.

GAIN-AND-RISK-SHARING PRICING Buyers may resist accepting a seller's proposal because of a high perceived level of risk. The seller has the option of offering to absorb part or all the risk if it does not deliver the full promised value. Some recent risk-sharing applications include big computer hardware purchases and health plans for big unions.

Baxter Healthcare, a leading medical products firm, was able to secure a contract for an information management system from Columbia/HCA, a leading health care provider, by guaranteeing the firm several million dollars in savings over an eight-year period. An increasing number of companies, especially business marketers who promise great savings with their equipment, may have to stand ready to guarantee the promised savings but also participate in the upside if the gains are much greater than expected.

IMPACT OF PRICE ON OTHER PARTIES How will distributors and dealers feel about the contemplated price?[70] If they don't make enough profit, they may choose not to bring the product to market. Will the sales force be willing to sell at that price? How will competitors react? Will suppliers raise their prices when they see the company's price? Will the government intervene and prevent this price from being charged?

U.S. legislation states that sellers must set prices without talking to competitors: Price-fixing is illegal. Many federal and state statutes protect consumers against deceptive pricing practices. For example, it is illegal for a company to set artificially high "regular" prices, then announce a "sale" at prices close to previous everyday prices.

Adapting the Price

Companies usually do not set a single price but rather develop a pricing structure that reflects variations in geographical demand and costs, market-segment requirements, purchase timing, order levels, delivery frequency, guarantees, service contracts, and other factors. As a result of discounts, allowances, and promotional support, a company rarely realizes the same profit from each unit of a product that it sells. Here we will examine several price-adaptation strategies: geographical pricing, price discounts and allowances, promotional pricing, and differentiated pricing.

Geographical Pricing (Cash, Countertrade, Barter)

In geographical pricing, the company decides how to price its products to different customers in different locations and countries. Should the company charge higher prices to distant customers to cover the higher shipping costs, or a lower price to win additional business? How should it account for exchange rates and the strength of different currencies?

Another question is how to get paid. This issue is critical when buyers lack sufficient hard currency to pay for their purchases. Many buyers want to offer other items in payment, a practice known as **countertrade**. U.S. companies are often forced to engage in countertrade if they want the business. Countertrade may account for 15 percent to 20 percent of world trade and takes several forms:[71]

- ***Barter.*** The buyer and seller directly exchange goods, with no money and no third party involved.
- ***Compensation deal.*** The seller receives some percentage of the payment in cash and the rest in products. A British aircraft manufacturer sold planes to Brazil for 70 percent cash and the rest in coffee.
- ***Buyback arrangement.*** The seller sells a plant, equipment, or technology to another country and agrees to accept as partial payment products manufactured with the supplied equipment. A U.S. chemical company built a plant for an Indian company and accepted partial payment in cash and the remainder in chemicals manufactured at the plant.
- ***Offset.*** The seller receives full payment in cash but agrees to spend a substantial amount of the money in that country within a stated time period. PepsiCo sold its cola syrup to Russia for rubles and agreed to buy Russian vodka at a certain rate for sale in the United States.

Price Discounts and Allowances

Most companies will adjust their list price and give discounts and allowances for early payment, volume purchases, and off-season buying (see Table 14.5).[72] Companies must do this carefully or find that their profits are much lower than planned.[73]

TABLE 14.5	Price Discounts and Allowances
Discount:	A price reduction to buyers who pay bills promptly. A typical example is “2/10, net 30,” which means that payment is due within 30 days and that the buyer can deduct 2 percent by paying the bill within 10 days.
Quantity Discount:	A price reduction to those who buy large volumes. A typical example is “$10 per unit for fewer than 100 units; $9 per unit for 100 or more units.” Quantity discounts must be offered equally to all customers and must not exceed the cost savings to the seller. They can be offered on each order placed or on the number of units ordered over a given period.
Functional Discount:	Discount (also called *trade discount*) offered by a manufacturer to trade-channel members if they will perform certain functions, such as selling, storing, and record keeping. Manufacturers must offer the same functional discounts within each channel.
Seasonal Discount:	A price reduction to those who buy merchandise or services out of season. Hotels, motels, and airlines offer seasonal discounts in slow selling periods.
Allowance:	An extra payment designed to gain reseller participation in special programs. *Trade-in allowances* are granted for turning in an old item when buying a new one. *Promotional allowances* reward dealers for participating in advertising and sales support programs.

Discount pricing has become the modus operandi of a surprising number of companies offering both products and services. Salespeople, in particular, are quick to give discounts in order to close a sale. But word can get around fast that the company's list price is "soft," and discounting becomes the norm, undermining the value perceptions of the offerings. Some product categories self-destruct by always being on sale.

Some companies with overcapacity are tempted to give discounts or even begin to supply a retailer with a store-brand version of their product at a deep discount. Because the store brand is priced lower, however, it may start making inroads on the manufacturer's brand. Manufacturers should consider the implications of supplying retailers at a discount, because they may end up losing long-run profits in an effort to meet short-run volume goals.

Only people with higher incomes and higher product involvement willingly pay more for features, customer service, quality, added convenience, and the brand name. So it can be a mistake for a strong, distinctive brand to plunge into price discounting to respond to low-price attacks. At the same time, discounting can be a useful tool if a company can gain concessions in return, such as the customer agreeing to sign a longer contract, order electronically, or buy in truckload quantities.

Sales management needs to monitor the proportion of customers receiving discounts, the average discount, and any salespeople over-relying on discounting. Higher levels of management should conduct a **net price analysis** to arrive at the "real price" of the offering. The real price is affected not only by discounts, but by other expenses that reduce the realized price (see "Promotional Pricing"). Suppose the company's list price is $3,000. The average discount is $300. The company's promotional spending averages $450 (15 percent of the list price). Retailers are given co-op advertising money of $150 to back the product. The company's net price is $2,100, not $3,000.

Promotional Pricing

Companies can use several pricing techniques to stimulate early purchase:

- ***Loss-leader pricing.*** Supermarkets and department stores often drop the price on well-known brands to stimulate additional store traffic. This pays if the revenue on the additional sales compensates for the lower margins on the loss-leader items. Manufacturers of loss-leader brands typically object because this practice can dilute the brand image and bring complaints from retailers who charge the list price. Manufacturers have tried to keep intermediaries from using loss-leader pricing through lobbying for retail-price-maintenance laws, but these laws have been revoked.
- ***Special event pricing.*** Sellers will establish special prices in certain seasons to draw in more customers. Every August, there are back-to-school sales.
- ***Special customer pricing.*** Sellers will offer special prices exclusively to certain customers. Road Runner Sports offers members of its Run America Club "exclusive" online offers with price discounts twice those for regular customers.[74]
- ***Cash rebates.*** Auto companies and other consumer-goods companies offer cash rebates to encourage purchase of the manufacturers' products within a specified time period. Rebates can help clear inventories without cutting the stated list price.
- ***Low-interest financing.*** Instead of cutting its price, the company can offer customers low-interest financing. Automakers have used no-interest financing to try to attract more customers.
- ***Longer payment terms.*** Sellers, especially mortgage banks and auto companies, stretch loans over longer periods and thus lower the monthly payments. Consumers often worry less about the cost (the interest rate) of a loan, and more about whether they can afford the monthly payment.
- ***Warranties and service contracts.*** Companies can promote sales by adding a free or low-cost warranty or service contract.
- ***Psychological discounting.*** This strategy sets an artificially high price and then offers the product at substantial savings; for example, "Was $359, now $299." Discounts from normal prices are a legitimate form of promotional pricing; the Federal Trade Commission and Better Business Bureaus fight illegal discount tactics.

Promotional-pricing strategies are often a zero-sum game. If they work, competitors copy them and they lose their effectiveness. If they don't work, they waste money that could have been put into other marketing tools, such as building up product quality and service or strengthening product image through advertising.

Differentiated Pricing

Companies often adjust their basic price to accommodate differences in customers, products, locations, and so on. Lands' End creates men's shirts in many different styles, weights, and levels of quality. As of January 2010, a men's white button-down shirt could cost as little as $14.99 or as much as $79.50.[75]

Price discrimination occurs when a company sells a product or service at two or more prices that do not reflect a proportional difference in costs. In first-degree price discrimination, the seller charges a separate price to each customer depending on the intensity of his or her demand.

In second-degree price discrimination, the seller charges less to buyers of larger volumes. With certain services such as cell phone service, however, tiered pricing results in consumers paying *more* with higher levels of usage. With the iPhone, 3 percent of users accounted for 40 percent of the traffic on AT&T's network, resulting in costly network upgrades.[76]

In third-degree price discrimination, the seller charges different amounts to different classes of buyers, as in the following cases:

- ***Customer-segment pricing.*** Different customer groups pay different prices for the same product or service. For example, museums often charge a lower admission fee to students and senior citizens.
- ***Product-form pricing.*** Different versions of the product are priced differently, but not proportionately to their costs. Evian prices a 48-ounce bottle of its mineral water at $2.00 and 1.7 ounces of the same water in a moisturizer spray at $6.00.
- ***Image pricing.*** Some companies price the same product at two different levels based on image differences. A perfume manufacturer can put the perfume in one bottle, give it a name and image, and price it at $10 an ounce. The same perfume in another bottle with a different name and image and price can sell for $30 an ounce.
- ***Channel pricing.*** Coca-Cola carries a different price depending on whether the consumer purchases it in a fine restaurant, a fast-food restaurant, or a vending machine.
- ***Location pricing.*** The same product is priced differently at different locations even though the cost of offering it at each location is the same. A theater varies its seat prices according to audience preferences for different locations.
- ***Time pricing.*** Prices are varied by season, day, or hour. Public utilities vary energy rates to commercial users by time of day and weekend versus weekday. Restaurants charge less to "early bird" customers, and some hotels charge less on weekends.

The airline and hospitality industries use yield management systems and **yield pricing**, by which they offer discounted but limited early purchases, higher-priced late purchases, and the lowest rates on unsold inventory just before it expires.[77] Airlines charge different fares to passengers on the same flight, depending on the seating class; the time of day (morning or night coach); the day of the week (workday or weekend); the season; the person's employer, past business, or status (youth, military, senior citizen); and so on.

That's why on a flight from New York City to Miami you might pay $200 and sit across from someone who paid $1,290. Continental Airlines launches 2,000 flights a day and each has between 10 and 20 prices. The carrier starts booking flights 330 days in advance, and every flying day is different from every other flying day. At any given moment the market has more than 7 million prices. And in a system that tracks the difference in prices and the price of competitors' offerings, airlines collectively charge 75,000 different prices a day! It's a system designed to punish procrastinators by charging them the highest possible prices.

The phenomenon of offering different pricing schedules to different consumers and dynamically adjusting prices is exploding.[78] Many companies are using software packages that provide real-time controlled tests of actual consumer response to different pricing schedules. Constant price variation can be tricky, however, where consumer relationships are concerned. Research shows it's most effective when there's no bond between the buyer and the seller. One way to make it work is to offer customers a unique bundle of products and services to meet their needs precisely, making it harder to make price comparisons.

The tactic most companies favor, however, is to use variable prices as a reward rather than a penalty. For instance, shipping company APL rewards customers who can better predict how much cargo space they'll need with cheaper rates for booking early. Customers are also getting savvier about how to avoid buyer's remorse from overpaying. They are changing their buying behavior to

The likelihood is extremely high that every passenger shown in this airport lobby is paying a different price, even if they are all on the same flight.

accommodate the new realities of dynamic pricing—where prices vary frequently by channels, products, customers, and time.

Most consumers are probably not even aware of the degree to which they are the targets of discriminatory pricing. For instance, catalog retailers such as Victoria's Secret routinely send out catalogs that sell identical goods at different prices. Consumers who live in a more free-spending zip code may see only the higher prices. Office product superstore Staples also sends out office supply catalogs with different prices.

Although some forms of price discrimination (in which sellers offer different price terms to different people within the same trade group) are illegal, price discrimination is legal if the seller can prove its costs are different when selling different volumes or different qualities of the same product to different retailers. Predatory pricing—selling below cost with the intention of destroying competition—is unlawful, though.[79]

For price discrimination to work, certain conditions must exist. First, the market must be segmentable and the segments must show different intensities of demand. Second, members in the lower-price segment must not be able to resell the product to the higher-price segment. Third, competitors must not be able to undersell the firm in the higher-price segment. Fourth, the cost of segmenting and policing the market must not exceed the extra revenue derived from price discrimination. Fifth, the practice must not breed customer resentment and ill will. Sixth, of course, the particular form of price discrimination must not be illegal.[80]

Initiating and Responding to Price Changes

Companies often need to cut or raise prices.

Initiating Price Cuts

Several circumstances might lead a firm to cut prices. One is *excess plant capacity*: The firm needs additional business and cannot generate it through increased sales effort, product improvement, or other measures. Companies sometimes initiate price cuts in a *drive to dominate the market through lower costs.* Either the company starts with lower costs than its competitors, or it initiates price cuts in the hope of gaining market share and lower costs.

Cutting prices to keep customers or beat competitors often encourages customers to demand price concessions, however, and trains salespeople to offer them.[81] A price-cutting strategy can lead to other possible traps:

- ***Low-quality trap.*** Consumers assume quality is low.
- ***Fragile-market-share trap.*** A low price buys market share but not market loyalty. The same customers will shift to any lower-priced firm that comes along.
- ***Shallow-pockets trap.*** Higher-priced competitors match the lower prices but have longer staying power because of deeper cash reserves.
- ***Price-war trap.*** Competitors respond by lowering their prices even more, triggering a price war.[82]

Customers often question the motivation behind price changes.[83] They may assume the item is about to be replaced by a new model; the item is faulty and is not selling well; the firm is in financial trouble; the price will come down even further; or the quality has been reduced. The firm must monitor these attributions carefully.

Initiating Price Increases

A successful price increase can raise profits considerably. If the company's profit margin is 3 percent of sales, a 1 percent price increase will increase profits by 33 percent if sales volume is unaffected. This situation is illustrated in Table 14.6. The assumption is that a company charged $10 and sold 100 units and had costs of $970, leaving a profit of $30, or 3 percent on sales. By raising its price by 10 cents (a 1 percent price increase), it boosted its profits by 33 percent, assuming the same sales volume.

A major circumstance provoking price increases is *cost inflation.* Rising costs unmatched by productivity gains squeeze profit margins and lead companies to regular rounds of price increases. Companies often raise their prices by more than the cost increase, in anticipation of further inflation or government price controls, in a practice called *anticipatory pricing.*

Another factor leading to price increases is *overdemand.* When a company cannot supply all its customers, it can raise its prices, ration supplies, or both. It can increase price in the following ways, each of which has a different impact on buyers.

- ***Delayed quotation pricing.*** The company does not set a final price until the product is finished or delivered. This pricing is prevalent in industries with long production lead times, such as industrial construction and heavy equipment.
- ***Escalator clauses.*** The company requires the customer to pay today's price and all or part of any inflation increase that takes place before delivery. An escalator clause bases price increases on some specified price index. Escalator clauses are found in contracts for major industrial projects, such as aircraft construction and bridge building.
- ***Unbundling.*** The company maintains its price but removes or prices separately one or more elements that were part of the former offer, such as free delivery or installation. Car companies sometimes add higher-end audio entertainment systems or GPS navigation systems as extras to their vehicles.
- ***Reduction of discounts.*** The company instructs its sales force not to offer its normal cash and quantity discounts.

TABLE 14.6 Profits Before and After a Price Increase

	Before	After	
Price	$10	$10.10	(a 1% price increase)
Units sold	100	100	
Revenue	$1,000	$1,010	
Costs	–970	–970	
Profit	$30	$40	(a 33 1/3% profit increase)

Although there is always a chance a price increase can carry some positive meanings to customers—for example, that the item is "hot" and represents an unusually good value—consumers generally dislike higher prices. In passing price increases on to customers, the company must avoid looking like a price gouger.[84] Coca-Cola's proposed smart vending machines that would raise prices as temperatures rose and Amazon.com's dynamic pricing experiment that varied prices by purchase occasion both became front-page news. The more similar the products or offerings from a company, the more likely consumers are to interpret any pricing differences as unfair. Product customization and differentiation and communications that clarify differences are thus critical.[85]

Generally, consumers prefer small price increases on a regular basis to sudden, sharp increases. Their memories are long, and they can turn against companies they perceive as price gougers. Price hikes without corresponding investments in the value of the brand increase vulnerability to lower-priced competition. Consumers may be willing to "trade down" because they can no longer convince themselves the higher-priced brand is worth it.

Several techniques help consumers avoid sticker shock and a hostile reaction when prices rise: One is maintaining a sense of fairness around any price increase, such as by giving customers advance notice so they can do forward buying or shop around. Sharp price increases need to be explained in understandable terms. Making low-visibility price moves first is also a good technique: Eliminating discounts, increasing minimum order sizes, and curtailing production of low-margin products are examples, and contracts or bids for long-term projects should contain escalator clauses based on such factors as increases in recognized national price indexes.[86]

Given strong consumer resistance, marketers go to great lengths to find alternate approaches that avoid increasing prices when they otherwise would have done so. Here are a few popular ones.

- Shrinking the amount of product instead of raising the price. (Hershey Foods maintained its candy bar price but trimmed its size. Nestlé maintained its size but raised the price.)
- Substituting less-expensive materials or ingredients. (Many candy bar companies substituted synthetic chocolate for real chocolate to fight cocoa price increases.)
- Reducing or removing product features. (Sears engineered down a number of its appliances so they could be priced competitively with those sold in discount stores.)
- Removing or reducing product services, such as installation or free delivery.
- Using less-expensive packaging material or larger package sizes.
- Reducing the number of sizes and models offered.
- Creating new economy brands. (Jewel food stores introduced 170 generic items selling at 10 percent to 30 percent less than national brands.)

Responding to Competitors' Price Changes

How should a firm respond to a competitor's price cut? In general, the best response varies with the situation. The company must consider the product's stage in the life cycle, its importance in the company's portfolio, the competitor's intentions and resources, the market's price and quality sensitivity, the behavior of costs with volume, and the company's alternative opportunities.

In markets characterized by high product homogeneity, the firm can search for ways to enhance its augmented product. If it cannot find any, it may need to meet the price reduction. If the competitor raises its price in a homogeneous product market, other firms might not match it if the increase will not benefit the industry as a whole. Then the leader will need to roll back the increase.

In nonhomogeneous product markets, a firm has more latitude. It needs to consider the following issues: (1) Why did the competitor change the price? To steal the market, to utilize excess capacity, to meet changing cost conditions, or to lead an industry-wide price change? (2) Does the competitor plan to make the price change temporary or permanent? (3) What will happen to the company's market share and profits if it does not respond? Are other companies going to respond? (4) What are the competitors' and other firms' responses likely to be to each possible reaction?

Market leaders often face aggressive price cutting by smaller firms trying to build market share. Using price, Fuji has attacked Kodak, Schick has attacked Gillette, and AMD has attacked Intel.

Brand leaders also face lower-priced store brands. Three possible responses to low-cost competitors are: (1) further differentiate the product or service, (2) introduce a low-cost venture, or (3) reinvent as a low-cost player.[87] The right strategy depends on the ability of the firm to generate more demand or cut costs.

An extended analysis of alternatives may not always be feasible when the attack occurs. The company may have to react decisively within hours or days, especially where prices change with some frequency and it is important to react quickly, such as the meatpacking, lumber, or oil industries. It would make better sense to anticipate possible competitors' price changes and prepare contingent responses.

Summary

1. Despite the increased role of nonprice factors in modern marketing, price remains a critical element of marketing. Price is the only element that produces revenue; the others produce costs. Pricing decisions have become more challenging, however, in a changing economic and technological environment.
2. In setting pricing policy, a company follows a six-step procedure. It selects its pricing objective. It estimates the demand curve, the probable quantities it will sell at each possible price. It estimates how its costs vary at different levels of output, at different levels of accumulated production experience, and for differentiated marketing offers. It examines competitors' costs, prices, and offers. It selects a pricing method, and it selects the final price.
3. Companies usually set not a single price, but rather a pricing structure that reflects variations in geographical demand and costs, market-segment requirements, purchase timing, order levels, and other factors. Several price-adaptation strategies are available: (1) geographical pricing, (2) price discounts and allowances, (3) promotional pricing, and (4) discriminatory pricing.
4. Firms often need to change their prices. A price decrease might be brought about by excess plant capacity, declining market share, a desire to dominate the market through lower costs, or economic recession. A price increase might be brought about by cost inflation or overdemand. Companies must carefully manage customer perceptions when raising prices.
5. Companies must anticipate competitor price changes and prepare contingent responses. A number of responses are possible in terms of maintaining or changing price or quality.
6. The firm facing a competitor's price change must try to understand the competitor's intent and the likely duration of the change. Strategy often depends on whether a firm is producing homogeneous or nonhomogeneous products. A market leader attacked by lower-priced competitors can seek to better differentiate itself, introduce its own low-cost competitor, or transform itself more completely.

Applications

Marketing Debate

Is the Right Price a Fair Price?

Prices are often set to satisfy demand or to reflect the premium that consumers are willing to pay for a product or service. Some critics shudder, however, at the thought of $2 bottles of water, $150 running shoes, and $500 concert tickets.

Take a position: Prices should reflect the value consumers are willing to pay *versus* Prices should reflect only the cost of making a product or delivering a service.

Marketing Discussion

Pricing Methods

Think about the pricing methods described in this chapter—markup pricing, target-return pricing, perceived-value pricing, value pricing, going-rate pricing, and auction-type pricing. As a consumer, which do you prefer to deal with? Why? If the average price were to stay the same, which would you prefer a firm to do: (1) set one price and not deviate or (2) employ slightly higher prices most of the year but offer slightly discounted prices or specials for certain occasions?

Marketing Excellence

>>eBay

In 1995, Pierre Omidayar, a French-Iranian immigrant, wrote the code for an auction Web site where everyone would have equal access to a single global marketplace. Omidayar couldn't believe it when a collector bought the first item, a broken laser pointer, for $14.83.* Soon the site grew into a broader auction site where consumers could auction collectibles such as baseball cards and Barbie dolls. The momentum continued when individuals and small businesses discovered that eBay was an efficient way to reach new consumers and other businesses. Large companies began using eBay as a means of selling their bulk lots of unsold inventory. Today, people can buy and sell virtually any product or service, on the world's largest online marketplace. From appliances and computers to cars and real estate, sellers can list anything as long as it is not illegal or violates eBay's rules and policies.

eBay's success truly created a pricing revolution by allowing buyers to determine what they would pay for an item; the result pleases both sides because customers gain control and receive the best possible price while sellers make good margins due to the site's efficiency and wide reach. For years, buyers and sellers used eBay as an informal guide to market value. Even a company with a new-product design that wanted to know the going price for anything from a copier to a new DVD player checked on eBay.

eBay has evolved to also offer a fixed-price "buy it now" option to those who don't want to wait for an auction and are willing to pay the seller's price. Sellers can also use the fixed price format with a "best offer" option that allows the seller to counteroffer, reject, or accept an offer.

The impact of eBay's global reach is significant. In 2009, over $60 billion worth of goods was sold on eBay—that's almost $2,000 worth every second. The site has 405 million registered and 90 million active users and receives 81 million unique visitors a month. More than 1 million members make their living from the site. Yet eBay itself doesn't buy any inventory or own the products on its site. It earns its money by collecting fees: an insertion fee for each listing plus a final-value fee based on the auction or fixed price. For example, if an item sells for $60.00, the seller pays 8.75 percent on the first $25.00 ($2.19) plus 3.5 percent on the remaining $35.00 ($1.23). Therefore, the final-value fee for the sale is $3.42. This pricing structure was developed to attract high-volume sellers and deter those who list only a few low-priced items. With eBay's expansion into a wide range of other categories—from boats and cars and travel and tickets to health and beauty and home and garden—collectibles now make up only a small percentage of eBay sales.

eBay's business model is based on connecting individuals who otherwise would not be connected. It was the first example of online social networking, years before Twitter and Facebook existed, and consumer trust is a key element of its success. While skeptics initially questioned whether consumers would buy products from strangers, Omidayar believed people are innately good, and eBay's originators did two things well: they worked hard to make their Web site a community, and they developed tools to help reinforce trust between strangers. The company tracks and publishes the reputations of both buyers and sellers on the basis of feedback from each transaction. eBay extended its feedback service in 2007 by adding four different seller categories: items as described, communication, shipping time, and shipping and handling rate. The ratings are anonymous but visible to other buyers. Sellers with the highest rankings appear at the top of search results.

eBay's millions of passionate users also have a voice in all major decisions the company makes through its Voice of the Customer program. Every few months, eBay brings in as many as a dozen sellers and buyers and asks them questions about how they work and what else eBay needs to do. At least twice a week the company holds hour-long teleconferences to poll users on almost every new feature or policy. The result is that users (eBay's customers) feel like owners, and they have taken the initiative to expand the company into ever-new territory.

eBay continues to expand its capabilities to build its community and connect people around the world by adding services, partnerships, and investments. The company acquired PayPal, an online payment service, in 2002 after eBay members made it clear that PayPal was the preferred method of payment. The acquisition lowered currency and language barriers and allowed merchants to easily sell products around the world. eBay also acquired Skype Internet voice and video

*Some falsely believe that eBay was created to help Omidayar's girlfriend find and collect Pez candy dispensers. That story, however, was created by an employee to help generate initial interest in the company.

communication service in 2005, which allowed buyers and sellers to communicate over voice or video free and generated additional ad revenue for eBay. However, in 2009 eBay sold a majority stake in Skype to focus more on its e-commerce and payments businesses, leading the company to acquire Shopping.com, StubHub, Bill Me Later, and others. eBay now has a presence in 39 markets around the world.

Although eBay was a darling in the dot-com boom and has achieved tremendous success since then, it is not without challenges. These include a worldwide recession, increased competition from Google, and difficulties as it expands globally into tough markets such as China. Its CEO, Meg Whitman, retired in 2008 after leading the company for 10 years and was replaced by John Donahue. Under its new leadership, the company continues to focus on one of its founding beliefs: a strong commitment to and investment in technologies that help people connect. Recent efforts to adopt mobile applications, integrate with iPhones, and become more green have helped take the company to the top of such lists such as *Newsweek*'s Greenest Companies in America and *Fortune*s 100 Best Companies to Work For in back-to-back years.

Questions

1. Why has eBay succeeded as an online auction marketplace while so many others have failed?
2. Evaluate eBay's fee structure. Is it optimal or could it be improved? Why? How?
3. What's next for eBay? How does it continue to grow when it needs both buyers and sellers? Where will this growth come from?

Sources: Douglas MacMillan, "Can eBay Get Its Tech Savvy Back?" *BusinessWeek*, June 22, 2009, pp. 48–49; Cattherine Holahan, "eBay's New Tough Love CEO," *BusinessWeek*, February 4, 2008, pp. 58–59; Adam Lashinsky, "Building eBay 2.0," *Fortune,* October 16, 2006, pp. 161–64; Matthew Creamer, "A Million Marketers," *Advertising Age,* June 26, 2006, pp. 1, 71; Clive Thompson, "eBay Heads East," *Fast Company* (July–August 2006): 87–89; Glen L. Urban, "The Emerging Era of Customer Advocacy," *MIT Sloan Management Review* (Winter 2004): 77–82; www.ebay.com.

Marketing Excellence

>>Southwest Airlines

Southwest Airlines entered the airline industry in 1971 with little money but lots of personality. Marketing itself as the LUV airline, the company featured a bright red heart as its first logo and relied on outrageous antics to generate word of mouth and new business. Flight attendants in red-orange hot pants served Love Bites (peanuts) and Love Potions (drinks).

As Southwest grew, its advertising showcased its focus on low fares, frequent flights, on-time arrivals, top safety record, and how bags fly free. Throughout all its communication efforts, Southwest uses humor to poke fun at itself and convey its warm, friendly personality. One TV spot showed a small bag of peanuts with the words, "This is what our meals look like at Southwest Airlines. . . . It's also what our fares look like." Its ongoing "Wanna Get Away?" campaign uses embarrassing situations to hit a funny bone with consumers. And its tagline: "Ding! You are now free to move around the country" is a self-parody of its in-flight announcements. This lighthearted attitude carries over to the entertaining on-board announcements, crews that burst into song in the terminal, and several personalized aircrafts, including three painted as flying killer whales, "Lone Star One" painted like the Texas flag, and "Slam Dunk One," symbolizing the airline's partnership with the NBA.

Southwest's business model is based on streamlining its operations, which results in low fares and satisfied consumers. The airline takes several steps to save money and passes the savings to customers through low fares. It flies over 3,100 short, "point-to-point" trips in a day—shuttling more passengers per plane than any other airline. Each aircraft makes an average of 6.25 flights a day, or almost 12 hours each day. Southwest can accomplish such a feat because it avoids the traditional hub-and-spoke system and has extremely fast turnaround service. In its early years, it turned planes around in less than 10 minutes. Today, its turnaround averages 20 to 30 minutes—still the best in the industry and half the industry average. Southwest's unique boarding process helps. Instead of assigned seating, passengers are assigned to one of three groups (A, B, C) and a number when they check in. The number refers to where they stand in line at the gate. Group A boards first, and once on board, passengers may sit anywhere they like.

Southwest grows by entering new markets other airlines overprice and underserve. The company believes it can bring fares down by one-third to one-half whenever it enters a new market, and it expands every market it serves by making flying affordable to people who could not afford it before. Southwest currently serves 68 cities in 35 states, usually secondary cities with smaller airports that have lower gate fees and less congestion—another factor that leads to faster turnaround and lower fares.

Another unique cost savings strategy is Southwest's decision to operate Boeing 737s for all its flights. This simplifies the training process for pilots, flight attendants, and mechanics, and management can substitute aircraft, reschedule flight crews, or transfer mechanics quickly.

Jet fuel is an airline's biggest expense. According to the industry's trade group, Air Transport Association, jet fuel now accounts for 40 percent of an airplane ticket versus 15 percent just eight years ago. Southwest's biggest cost savings technique and competitive advantage has long been its program to hedge fuel prices by purchasing options years in advance. Many of its long-term contracts allow the airline to purchase fuel at $51 per barrel, a significant savings especially during the oil shocks of the 2000s that drove oil past $100 per barrel. Analysts estimate that Southwest has saved more than $2 billion with fuel hedging.

Because lighter planes use less fuel, Southwest makes its planes lighter by, for instance, power-washing their jet engines to remove dirt each night. It carries less water for bathrooms and has replaced its seats with lighter models. Southwest consumes approximately 1.5 billion gallons of jet fuel each year so every minor change adds up. The airline estimates that these changes saved $1.6 million in fuel costs over just three months.

Southwest has pioneered services and programs such as same-day freight service, senior discounts, Fun Fares, and Ticketless Travel. It was the first airline with a Web site, the first to deliver live updates on ticket deals, and the first to post a blog. Despite its reputation for low fares and no-frills service, Southwest wins the hearts of customers. It consistently ranks at the top of lists of customer service for airlines and receives the lowest ratio of complaints per passenger.

Southwest has been ranked by *Fortune* magazine as the United States' most admired airline since 1997, the fifth-most admired corporation in 2007, and one of the top five best places to work. Its financial results also shine: the company has been profitable for 37 straight years. It has been the only airline to report profits every quarter since September 11, 2001, and one of the few with no layoffs amid a travel slump created by the slow economy and the threat of terrorism.

Although the hot pants are long gone, the LUVing spirit remains at the heart of Southwest. The company's stock symbol on the NYSE is LUV, and red hearts can be found across the company. These symbols embody the Southwest spirit of employees "caring about themselves, each other, and Southwest's customers." "Our fares can be matched; our airplanes and routes can be copied. But we pride ourselves on our customer service," said Sherry Phelps, director of corporate employment. That's why Southwest looks for and hires people who generate enthusiasm. In fact, having a sense of humor is a selection criterion it uses for hiring. As one employee explained, "We can train you to do any job, but we can't give you the right spirit." And the feeling is reciprocated. When Southwest needed to close reservation centers in three cities in 2004, it didn't fire a single employee but rather paid for relocation and commuting expenses.

Questions

1. Southwest has mastered the low-price model and has the financial results to prove it. Why don't the other airlines copy Southwest's model?
2. What risks does Southwest face? Can it continue to thrive as a low-cost airline when tough economic times hit?

Sources: Barney Gimbel, "Southwest's New Flight Plan," *Fortune*, May 16, 2005, pp. 93–98; Melanie Trottman, "Destination: Philadelphia," *Wall Street Journal*, May 4, 2004; Andy Serwer, "Southwest Airlines: The Hottest Thing in the Sky," *Fortune*, March 8, 2004; Colleen Barrett, "Fasten Your Seat Belts," *Adweek*, January 26, 2004, p. 17; Jeff Bailey, "Southwest Airlines Gains Advantage by Hedging on Long-Term Oil Contracts." *New York Times,* November 28, 2007; Michelle Maynard, "To Save Fuel, Airlines Find No Speck Too Small," *New York Times,* June 11, 2008; Daniel B. Honigan, "Fred Taylor Leads Southwest Airlines' Customers to New Heights of Customer Satisfaction," *Marketing News*, May 1, 2008, pp. 24–26; Matthew Malone, "In for a Landing," *Condé Nast Portfolio*, August 2008, pp. 91–93; www.southwest.com.

Chapter 15

With a novel pricing and distribution scheme for DVD rentals, Netflix founder Reid Hastings has found heaps of success.

In This Chapter, We Will Address the Following Questions

1. What is a marketing channel system and value network?
2. What work do marketing channels perform?
3. How should channels be designed?
4. What decisions do companies face in managing their channels?
5. How should companies integrate channels and manage channel conflict?
6. What are the key issues with e-commerce and m-commerce?

Designing and Managing Integrated Marketing Channels

Successful value creation needs successful value delivery. Holistic marketers are increasingly taking a value network view of their businesses. Instead of limiting their focus to their immediate suppliers, distributors, and customers, they are examining the whole supply chain that links raw materials, components, and manufactured goods and shows how they move toward the final consumers. Companies are looking at their suppliers' suppliers upstream and at their distributors' customers downstream. They are looking at customer segments and considering a wide range of new and different means to sell, distribute, and service their offerings.

Convinced that DVDs were the home video medium of the future, Netflix founder Reed Hastings came up with a form of DVD rental distribution in 1997 different from the brick-and-mortar stores used by market leader Blockbuster. Netflix's strong customer loyalty and positive word of mouth is a result of the service's distinctive capabilities: modest subscription fees (as low as $9 a month), no late fees, (mostly) overnight mail delivery, a deep catalog of over 100,000 movie titles, and a growing library of over 12,000 movies and television episodes. The service also has proprietary software that allows customers to easily search for obscure films and discover new ones. To improve the quality of its searches, Netflix sponsored a million-dollar contest that drew thousands of entrants. The winning team consisted of seven members with diverse backgrounds and skills whose solution was estimated to make Netflix's recommendations twice as effective. With new competition from Redbox's thousands of DVD-rental kiosks in McDonald's and other locations, Netflix is putting more emphasis on streaming videos and instantaneous delivery mechanisms. But it still sees growth in DVD rentals from its over 11 million subscriber base. Netflix's success has also captured Hollywood's attention. Its online communities of customers who provide and read reviews and feedback can be an important source of fans for films.[1]

Companies today must build and manage a continuously evolving and increasingly complex channel system and value network. In this chapter, we consider strategic and tactical issues with integrating marketing channels and developing value networks. We will examine marketing channel issues from the perspective of retailers, wholesalers, and physical distribution agencies in Chapter 16.

Marketing Channels and Value Networks

Most producers do not sell their goods directly to the final users; between them stands a set of intermediaries performing a variety of functions. These intermediaries constitute a marketing channel (also called a trade channel or distribution channel). Formally, **marketing channels** are sets of interdependent organizations participating in the process of making a product or service available for use or consumption. They are the set of pathways a product or service follows after production, culminating in purchase and consumption by the final end user.[2]

Some intermediaries—such as wholesalers and retailers—buy, take title to, and resell the merchandise; they are called *merchants*. Others—brokers, manufacturers' representatives, sales agents—search for customers and may negotiate on the producer's behalf but do not take title to the goods; they are called *agents*. Still others—transportation companies, independent warehouses, banks, advertising agencies—assist in the distribution process but neither take title to goods nor negotiate purchases or sales; they are called *facilitators*.

Channels of all types play an important role in the success of a company and affect all other marketing decisions. Marketers should judge them in the context of the entire process by which their products are made, distributed, sold, and serviced. We consider all these issues in the following sections.

The Importance of Channels

A **marketing channel system** is the particular set of marketing channels a firm employs, and decisions about it are among the most critical ones management faces. In the United States, channel members collectively have earned margins that account for 30 percent to 50 percent of the ultimate selling price. In contrast, advertising typically has accounted for less than 5 percent to 7 percent of the final price.[3] Marketing channels also represent a substantial opportunity cost. One of their chief roles is to convert potential buyers into profitable customers. Marketing channels must not just *serve* markets, they must also *make* markets.[4]

The channels chosen affect all other marketing decisions. The company's pricing depends on whether it uses online discounters or high-quality boutiques. Its sales force and advertising decisions depend on how much training and motivation dealers need. In addition, channel decisions include relatively long-term commitments with other firms as well as a set of policies and procedures. When an automaker signs up independent dealers to sell its automobiles, it cannot buy them out the next day and replace them with company-owned outlets. But at the same time, channel choices themselves depend on the company's marketing strategy with respect to segmentation, targeting, and positioning. Holistic marketers ensure that marketing decisions in all these different areas are made to collectively maximize value.

In managing its intermediaries, the firm must decide how much effort to devote to push versus pull marketing. A **push strategy** uses the manufacturer's sales force, trade promotion money, or other means to induce intermediaries to carry, promote, and sell the product to end users. A push strategy is particularly appropriate when there is low brand loyalty in a category, brand choice is made in the store, the product is an impulse item, and product benefits are well understood. In a **pull strategy** the manufacturer uses advertising, promotion, and other forms of communication to persuade consumers to demand the product from intermediaries, thus inducing the intermediaries to order it. Pull strategy is particularly appropriate when there is high brand loyalty and high involvement in the category, when consumers are able to perceive differences between brands, and when they choose the brand before they go to the store.

Top marketing companies such as Coca-Cola, Intel, and Nike skillfully employ both push and pull strategies. A push strategy is more effective when accompanied by a well-designed and well-executed pull strategy that activates consumer demand. On the other hand, without at least some consumer interest, it can be very difficult to gain much channel acceptance and support, and vice versa for that matter.

Hybrid Channels and Multichannel Marketing

Today's successful companies typically employ hybrid channels and multichannel marketing, multiplying the number of "go-to-market" channels in any one market area. **Hybrid channels** or **multichannel marketing** occurs when a single firm uses two or more marketing channels to reach customer segments. HP has used its sales force to sell to large accounts, outbound telemarketing to sell to medium-sized accounts, direct mail with an inbound number to sell to small accounts, retailers to sell to still smaller accounts, and the Internet to sell specialty items. Philips also is a multichannel marketer.

Philips

Philips Royal Philips Electronics of the Netherlands is one of the world's biggest electronics companies and Europe's largest, with sales of over $66 billion in 2009. Philips's electronics products are channeled toward the consumer primarily through local and international retailers. The company offers a broad range of products from high to low price/value quartiles, relying on a diverse distribution model that includes mass merchants, retail chains, independents, and small specialty stores. To work most effectively with these retail channels, Philips has created an organization designed around its retail customers, with dedicated global key account managers serving leading retailers such as Best Buy, Carrefour, Costco, Dixons, and Tesco. Like many modern firms, Philips also sells via the Web through its own online store as well as through a number of other online retailers.[5]

In multichannel marketing, each channel targets a different segment of buyers, or different need states for one buyer, and delivers the right products in the right places in the right way at the least cost. When this doesn't happen, there can be channel conflict, excessive cost, or insufficient demand. Launched in 1976, Dial-a-Mattress successfully grew for three decades by selling mattresses directly over the phone and, later, the Internet. A major expansion into 50 brick-and-mortar stores in major metro areas was a failure, however. Secondary locations, chosen because management considered prime locations too expensive, could not generate enough customer traffic. The company eventually declared bankruptcy.[6]

On the other hand, when a major catalog and Internet retailer invested significantly in brick-and-mortar stores, different results emerged. Customers near the store purchased through the catalog less frequently, but their Internet purchases were unchanged. As it turned out, customers who liked to spend time browsing were happy to either use a catalog or visit the store; those channels were interchangeable. Customers who used the Internet, on the other hand, were more transaction focused and interested in efficiency, so they were less affected by the introduction of stores. Returns and exchanges at the stores were found to increase because of ease and accessibility, but extra purchases made by customers returning or exchanging at the store offset any revenue deficit.

Companies that manage hybrid channels clearly must make sure their channels work well together and match each target customer's preferred ways of doing business. Customers expect *channel integration*, which allows them to:

- Order a product online and pick it up at a convenient retail location
- Return an online-ordered product to a nearby store of the retailer
- Receive discounts and promotional offers based on total online and offline purchases

Here's a company that has carefully managed its multiple channels. We discuss the topic of optimal channel integration in greater detail later.

REI Outdoor supplier REI has been lauded by industry analysts for the seamless integration of its retail store, Web site, Internet kiosks, mail-order catalogs, value-priced outlets, and toll-free order number. If an item is out of stock in the store, all customers need to do is tap into the store's Internet kiosk to order it from REI's Web site. Less Internet-savvy customers can get clerks to place the order for them at the checkout counters. And REI not only generates store-to-Internet traffic, it also sends Internet shoppers into its stores. If a customer browses REI's site and stops to read an REI "Learn and Share" article on backpacking, the site might highlight an in-store promotion on hiking boots. Like many retailers, REI has found that dual-channel shoppers spend significantly more than single-channel shoppers, and tri-channel shoppers spend even more.[7]

REI's in-store Internet kiosk gives customers a convenient way to order out-of-stock items.

Value Networks

A supply chain view of a firm sees markets as destination points and amounts to a linear view of the flow of ingredients and components through the production process to their ultimate sale to customers. The company should first think of the target market, however, and then design the supply chain backward from that point. This strategy has been called **demand chain planning**.[8]

A broader view sees a company at the center of a **value network**—a system of partnerships and alliances that a firm creates to source, augment, and deliver its offerings. A value network includes a firm's suppliers and its suppliers' suppliers, and its immediate customers and their end customers. The value network includes valued relationships with others such as university researchers and government approval agencies.

A company needs to orchestrate these parties in order to deliver superior value to the target market. Oracle relies on 5.2 million developers and 400,000 discussion forum threads to advance its products.[9] Apple's Developer Connection—where folks create iPhone apps and the like—has 50,000 members at different levels of membership.[10] Developers keep 70 percent of any revenue their products generate, and Apple gets 30 percent.

Demand chain planning yields several insights.[11] First, the company can estimate whether more money is made upstream or downstream, in case it can integrate backward or forward. Second, the company is more aware of disturbances anywhere in the supply chain that might change costs, prices, or supplies. Third, companies can go online with their business partners to speed communications, transactions, and payments; reduce costs; and increase accuracy. Ford not only manages numerous supply chains but also sponsors or operates on many B2B Web sites and exchanges.

Managing a value network means making increasing investments in information technology (IT) and software. Firms have introduced supply chain management (SCM) software and invited such software firms as SAP and Oracle to design comprehensive *enterprise resource planning* (ERP) systems to manage cash flow, manufacturing, human resources, purchasing, and other major functions within a unified framework. They hope to break up departmental silos—where each department only acts in its own self interest—and carry out core business processes more seamlessly. Most, however, are still a long way from truly comprehensive ERP systems.

Marketers, for their part, have traditionally focused on the side of the value network that looks toward the customer, adopting customer relationship management (CRM) software and practices. In the future, they will increasingly participate in and influence their companies' upstream activities and become network managers, not just product and customer managers.

The Role of Marketing Channels

Why would a producer delegate some of the selling job to intermediaries, relinquishing control over how and to whom products are sold? Through their contacts, experience, specialization, and scale of operation, intermediaries make goods widely available and accessible to target markets, usually offering the firm more effectiveness and efficiency than it can achieve on its own.[12]

Many producers lack the financial resources and expertise to sell directly on their own. The William Wrigley Jr. Company would not find it practical to establish small retail gum shops throughout the world or to sell gum by mail order. It is easier to work through the extensive network of privately owned distribution organizations. Even Ford would be hard-pressed to replace all the tasks done by its almost 12,000 dealer outlets worldwide.

Channel Functions and Flows

A marketing channel performs the work of moving goods from producers to consumers. It overcomes the time, place, and possession gaps that separate goods and services from those who need or want them. Members of the marketing channel perform a number of key functions (see Table 15.1).

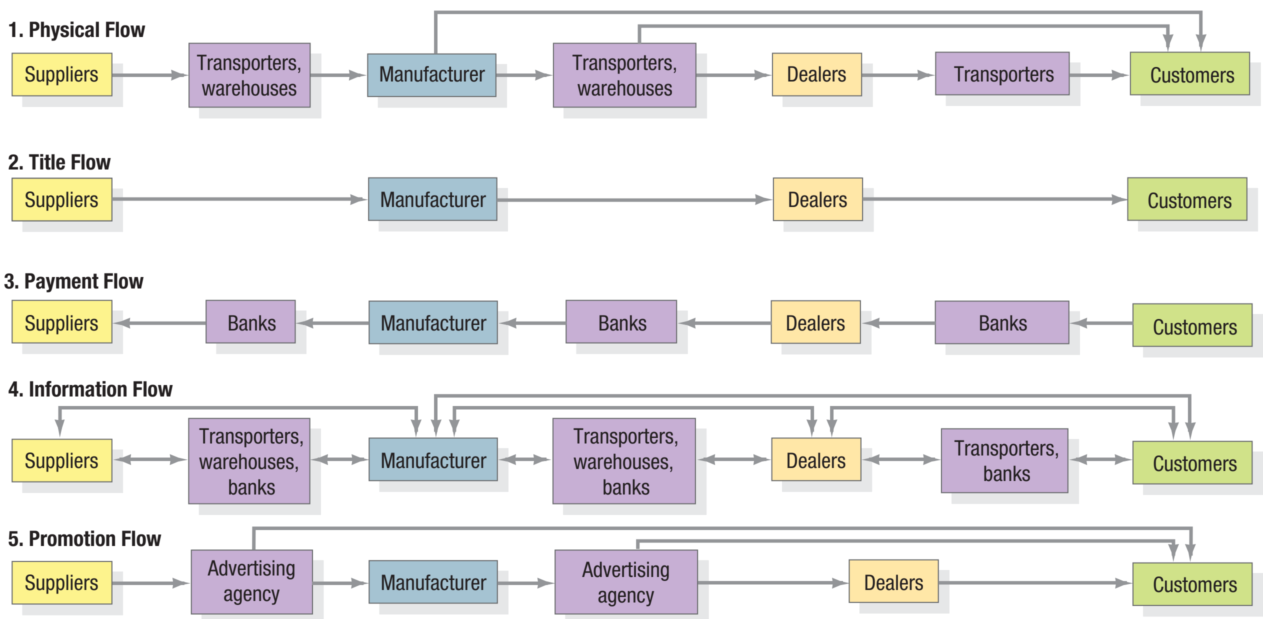
Some of these functions (storage and movement, title, and communications) constitute a *forward flow* of activity from the company to the customer; other functions (ordering and payment) constitute a *backward flow* from customers to the company. Still others (information, negotiation, finance, and risk taking) occur in both directions. Five flows are illustrated in Figure 15.1 for the marketing of forklift trucks. If these flows were superimposed in one diagram, we would see the tremendous complexity of even simple marketing channels.

A manufacturer selling a physical product and services might require three channels: a *sales channel*, a *delivery channel*, and a *service channel*. To sell its Bowflex fitness equipment, the Nautilus Group historically has emphasized direct marketing via television infomercials and ads, inbound/outbound call centers, response mailings, and the Internet as sales channels; UPS ground service as the delivery channel; and local repair people as the service channel. Reflecting shifting consumer buying habits, Nautilus now also sells Bowflex through commercial, retail, and specialty retail channels.

TABLE 15.1 Channel Member Functions

• Gather information about potential and current customers, competitors, and other actors and forces in the marketing environment.
• Develop and disseminate persuasive communications to stimulate purchasing.
• Negotiate and reach agreements on price and other terms so that transfer of ownership or possession can be affected.
• Place orders with manufacturers.
• Acquire the funds to finance inventories at different levels in the marketing channel.
• Assume risks connected with carrying out channel work.
• Provide for the successive storage and movement of physical products.
• Provide for buyers' payment of their bills through banks and other financial institutions.
• Oversee actual transfer of ownership from one organization or person to another.

The question for marketers is not *whether* various channel functions need to be performed—they must be—but rather, *who* is to perform them. All channel functions have three things in common: They use up scarce resources; they can often be performed better through specialization; and they can be shifted among channel members. Shifting some functions to intermediaries lowers the producer's costs and prices, but the intermediary must add a charge to cover its work. If the intermediaries are more efficient than the manufacturer, prices to consumers should be lower. If consumers perform some functions themselves, they should enjoy even lower prices. Changes in channel institutions thus largely reflect the discovery of more efficient ways to combine or separate the economic functions that provide assortments of goods to target customers.



|Fig. 15.1|

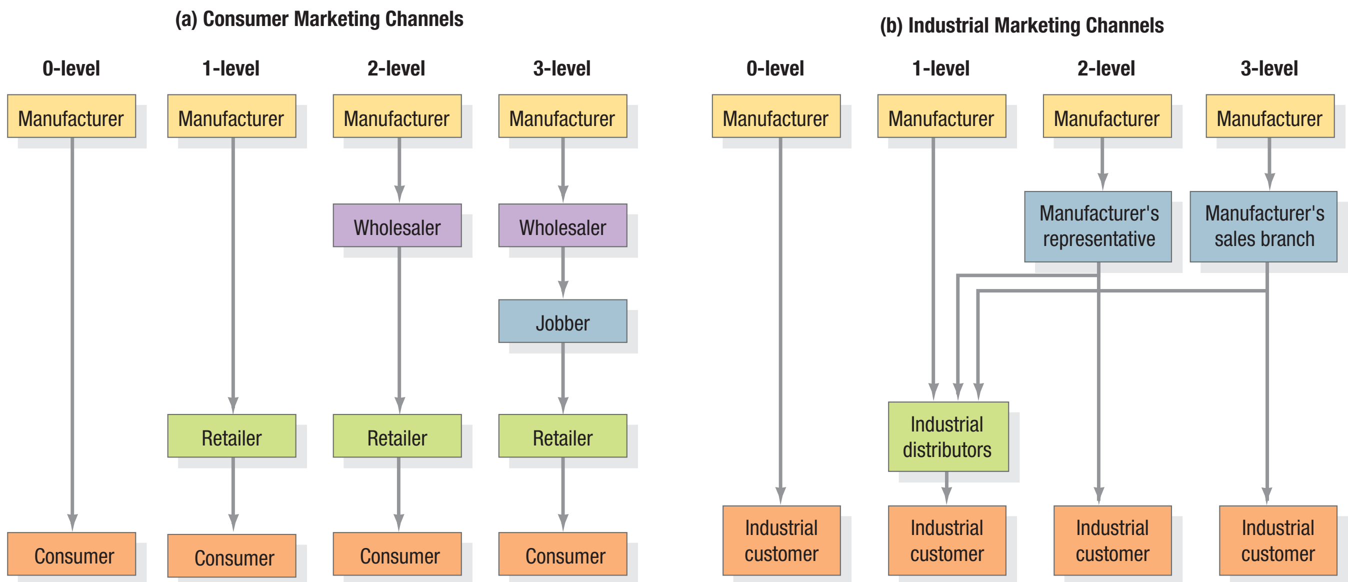
Five Marketing Flows in the Marketing Channel for Forklift Trucks

Bowflex fitness equipment is sold through a variety of channels.

Channel Levels

The producer and the final customer are part of every channel. We will use the number of intermediary levels to designate the length of a channel. △ Figure 15.2(a) illustrates several consumer-goods marketing channels of different lengths.

A **zero-level channel**, also called a **direct marketing channel**, consists of a manufacturer selling directly to the final customer. The major examples are door-to-door sales, home parties, mail order, telemarketing, TV selling, Internet selling, and manufacturer-owned stores. Traditionally, Avon sales representatives sell cosmetics door-to-door; Franklin Mint sells collectibles through mail order; Verizon uses the telephone to prospect for new customers or to sell enhanced services to existing customers; Time-Life sells music and video collections through TV commercials or



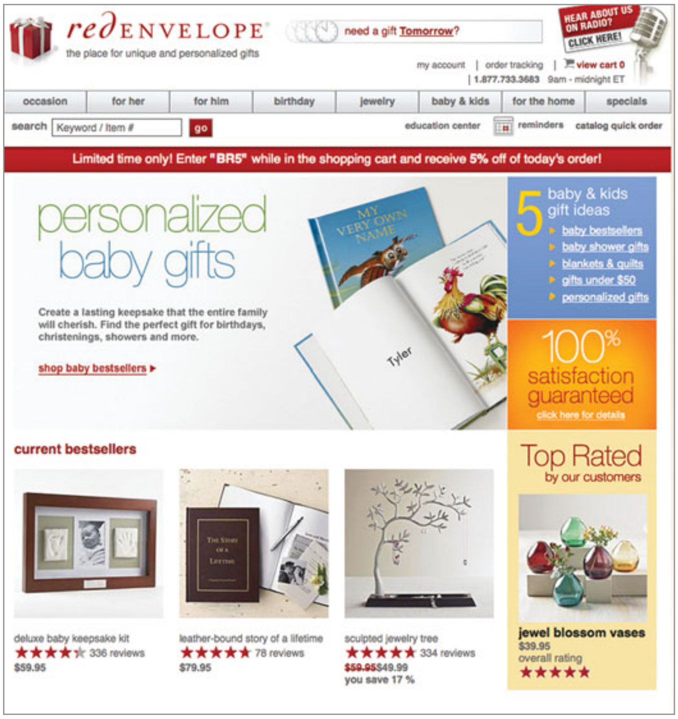
|Fig. 15.2| △

Consumer and Industrial Marketing Channels longer "infomercials"; Red Envelope sells gifts online; and Apple sells computers and other consumer electronics through its own stores. Many of these firms now sell directly to customers in more ways than one, via online, catalogs, etc.

A *one-level channel* contains one selling intermediary, such as a retailer. A *two-level channel* contains two intermediaries. In consumer markets, these are typically a wholesaler and a retailer. A *three-level channel* contains three intermediaries. In the meatpacking industry, wholesalers sell to **jobbers**, essentially small-scale wholesalers, who sell to small retailers. In Japan, food distribution may include as many as six levels. Obtaining information about end users and exercising control becomes more difficult for the producer as the number of channel levels increases.

Figure 15.2(b) shows channels commonly used in B2B marketing. An industrial-goods manufacturer can use its sales force to sell directly to industrial customers; or it can sell to industrial distributors who sell to industrial customers; or it can sell through manufacturer's representatives or its own sales branches directly to industrial customers, or indirectly to industrial customers through industrial distributors. Zero-, one-, and two-level marketing channels are quite common.

Channels normally describe a forward movement of products from source to user, but *reverse-flow channels* are also important (1) to reuse products or containers (such as refillable chemical-carrying drums), (2) to refurbish products for resale (such as circuit boards or computers), (3) to recycle products (such as paper), and (4) to dispose of products and packaging. Reverse-flow intermediaries include manufacturers' redemption centers, community groups, trash-collection specialists, recycling centers, trash-recycling brokers, and central processing warehousing.[13] Many creative solutions have emerged in this area in recent years, such as Greenopolis.



RedEnvelope has built an online gift powerhouse.

Greenopolis Launched by Waste Management Corporation after it acquired the Code Blue Recycling company, Greenopolis is a new company with an entirely different recycling system that allows consumers and a consortium of consumer packaged goods (CPG) companies to "close the loop" in the recovery and reuse of postconsumer material. With its mantra, "Rethink. Recycle. Reward," Greenopolis consists of (1) an extensive set of interactive, on-street recycling kiosks in various retail settings, (2) a number of material reprocessing facilities, (3) a menu of consumer recycling rewards, and (4) a significant online community and social media network. Participating CPG companies use the Greenopolis symbol on their product packaging. The kiosk system is designed to collect those products, track and reward consumers who bring them, and put packaging into reuse or reprocessing. An important feature is that Greenopolis is fully accountable. Innovative kiosk technology allows consumers to follow their recycling contribution, as well as the rewards they earn from the partnering companies. CPG companies, in turn, are able to measure their share of recovery. By achieving sufficient scale and accessibility in the marketplace and making recycling fun, easy, and personally rewarding to consumers, Greenopolis aims to improve recycling rates and make an important environmental difference.[14]

Greenopolis is a novel recycling system that offers financial and environmental benefits to consumers and companies.

Service Sector Channels

As Internet and other technologies advance, service industries such as banking, insurance, travel, and stock buying and selling are operating through new channels. Kodak offers its customers four ways to print their digital photos—minilabs in retail outlets, home printers, online services at its Ofoto Web site, and self-service kiosks. The world leader with 80,000 kiosks, Kodak makes money both by selling the units and by supplying the chemical and paper they use to make the prints.[15]

Marketing channels also keep changing in "person marketing." Besides live and programmed entertainment, entertainers, musicians, and other artists can reach prospective and existing fans online in many ways—their own Web sites, social community sites such as Facebook and Twitter, and third-party Web sites. Politicians also must choose a mix of channels—mass media, rallies, coffee hours, spot TV ads, direct mail, billboards, faxes, e-mail, blogs, podcasts, Web sites, and social networking sites—for delivering their messages to voters.

Nonprofit service organizations such as schools develop "educational-dissemination systems" and hospitals develop "health-delivery systems." These institutions must figure out agencies and locations for reaching a far-flung population.

Cleveland Clinic One of the largest and most respected hospitals in the country, Cleveland Clinic, provides medical care in a variety of ways and settings. The main campus in Cleveland, whose 50 buildings occupy 166 acres, is the hub for patient care, research, and education. Cleveland Clinic also operates 15 family primary-care centers in the suburbs. Eight hospitals extend the clinic's reach in Northeast Ohio. Community outreach programs in all these areas provide education and free health screenings. Cleveland Clinic also offers major medical care in Florida, Toronto, and, as of 2012, Abu Dhabi. It has a suite of secure online health services for both patients and physicians and is developing partnerships with Google and Microsoft to further its Internet capabilities.[16]

Cleveland Clinic provides health care services in a variety of different locations and settings.

Channel-Design Decisions

To design a marketing channel system, marketers analyze customer needs and wants, establish channel objectives and constraints, and identify and evaluate major channel alternatives.

Analyzing Customer Needs and Wants

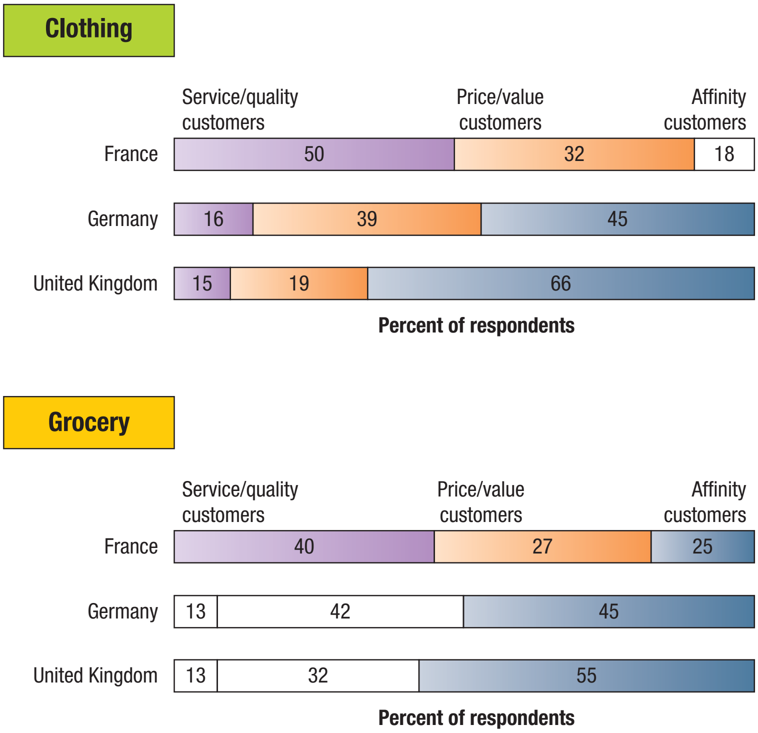
Consumers may choose the channels they prefer based on price, product assortment, and convenience, as well as their own shopping goals (economic, social, or experiential).[17] As with products, segmentation exists, and marketers must be aware that different consumers have different needs during the purchase process.

One study of 40 grocery and clothing retailers in France, Germany, and the United Kingdom found that they served three types of shoppers: (1) *service/quality customers* who cared most about the variety and performance of products and service, (2) *price/value customers* who were most concerned about spending wisely, and (3) *affinity customers* who primarily sought stores that suited people like themselves or groups they aspired to join. As Figure 15.3 shows, customer profiles differed across the three markets: In France, shoppers stressed service and quality, in the United Kingdom, affinity, and in Germany, price and value.[18]

Even the same consumer, though, may choose different channels for different functions in a purchase, browsing a catalog before visiting a store or test driving a car at a dealer before ordering online. Some consumers are willing to "trade up" to retailers offering higher-end goods such as TAG Heuer watches or Callaway golf clubs and "trade down" to discount retailers for private-label paper towels, detergent, or vitamins.[19]

Channels produce five service outputs:

1. ***Lot size***—The number of units the channel permits a typical customer to purchase on one occasion. In buying cars for its fleet, Hertz prefers a channel from which it can buy a large lot size; a household wants a channel that permits a lot size of one.
2. ***Waiting and delivery time***—The average time customers wait for receipt of goods. Customers increasingly prefer faster delivery channels.
3. ***Spatial convenience***—The degree to which the marketing channel makes it easy for customers to purchase the product. Toyota offers greater spatial convenience than Lexus because there are



|Fig. 15.3|

What Do European Consumers Value

Source: Peter N. Child, Suzanne Heywood, and Michael Kliger, "Do Retail Brands Travel?" *The McKinsley Quarterly*, 2002, Number 1, pp. 11–13. All rights reserved. Reprinted by permission of McKinsey & Company.

more Toyota dealers, helping customers save on transportation and search costs in buying and repairing an automobile.

4. ***Product variety***—The assortment provided by the marketing channel. Normally, customers prefer a greater assortment because more choices increase the chance of finding what they need, although too many choices can sometimes create a negative effect.[20]
5. ***Service backup***—Add-on services (credit, delivery, installation, repairs) provided by the channel. The greater the service backup, the greater the work provided by the channel.[21]

Providing greater service outputs also means increasing channel costs and raising prices. The success of discount stores such as Walmart and Target and extreme examples like Dollar General and Family Dollar indicates that many consumers are willing to accept smaller service outputs if they can save money.

Establishing Objectives and Constraints

Marketers should state their channel objectives in terms of service output levels and associated cost and support levels. Under competitive conditions, channel members should arrange their functional tasks to minimize costs and still provide desired levels of service.[22] Usually, planners can identify several market segments based on desired service and choose the best channels for each.

Channel objectives vary with product characteristics. Bulky products, such as building materials, require channels that minimize the shipping distance and the amount of handling. Nonstandard products such as custom-built machinery are sold directly by sales representatives. Products requiring installation or maintenance services, such as heating and cooling systems, are usually sold and maintained by the company or by franchised dealers. High-unit-value products such as generators and turbines are often sold through a company sales force rather than intermediaries.

Marketers must adapt their channel objectives to the larger environment. When economic conditions are depressed, producers want to move goods to market using shorter channels and without services that add to the final price. Legal regulations and restrictions also affect channel design. U.S. law looks unfavorably on channel arrangements that substantially lessen competition or create a monopoly.

In entering new markets, firms often closely observe what other firms are doing. France's Auchan considered the presence of its French rivals Leclerc and Casino in Poland as key to its decision to also enter that market.[23] Apple's channel objectives of creating a dynamic retail experience for consumers was not being met by existing channels, so it chose to open it own stores.[24]

Apple Stores When Apple stores were launched in 2001, many questioned their prospects and *BusinessWeek* published an article titled, "Sorry Steve, Here's Why Apple Stores Won't Work." Fast-forward five years, and Apple was celebrating the launch of its spectacular new Manhattan showcase store. With almost 275 locations by the end of 2009, net revenue from stores totaled $6.6 billion and represented roughly 20 percent of total corporate revenue. Annual sales per square foot of an Apple store have been estimated at $4,700—the Fifth Avenue location is reported to do a staggering $35,000 of business per square foot–compared to Tiffany's $2,666, Best Buy's $930, and Saks's $362. Any way you look at it, Apple stores have been an unqualified success. Designed to fuel excitement for the brand, they let people see and touch Apple products—and experience what Apple can do for them—making it more likely they'll become Apple customers. They target tech-savvy customers with in-store product presentations and workshops; a full line of Apple products, software, and accessories; and a "Genius Bar" staffed by Apple specialists who provide technical support, often free of charge. Although the stores upset existing retailers, Apple has worked hard to smooth relationships, in part justifying the decision as a natural evolution of its existing online sales channel.

Apple stores offer a unique brand experience to Apple enthusiasts and prospects.

Identifying Major Channel Alternatives

Each channel—from sales forces to agents, distributors, dealers, direct mail, telemarketing, and the Internet—has unique strengths and weaknesses. Sales forces can handle complex products and transactions, but they are expensive. The Internet is inexpensive but may not be as effective with complex products. Distributors can create sales, but the company loses direct contact with customers. Several clients can share the cost of manufacturers' reps, but the selling effort is less intense than company reps provide.

Channel alternatives differ in three ways: the types of intermediaries, the number needed, and the terms and responsibilities of each. Let's look at these factors.

TYPES OF INTERMEDIARIES Consider the channel alternatives identified by a consumer electronics company that produces satellite radios. It could sell its players directly to automobile manufacturers to be installed as original equipment, auto dealers, rental car companies, or satellite radio specialist dealers through a direct sales force or through distributors. It could also sell its players through company stores, online retailers, mail-order catalogs, or mass merchandisers such as Best Buy.

As Netflix did, companies should search for innovative marketing channels. Columbia House has successfully merchandised music albums through the mail and Internet. Harry and David and Calyx & Corolla have creatively sold fruit and flowers, respectively, through direct delivery.

Sometimes a company chooses a new or unconventional channel because of the difficulty, cost, or ineffectiveness of working with the dominant channel. One advantage is often reduced competition, at least at first. Years ago, after trying to sell its inexpensive Timex watches through jewelry stores, the U.S. Time Company placed them instead in fast-growing mass-merchandise outlets. Frustrated with a printed catalog it saw as out-of-date and unprofessional, commercial lighting company Display Supply & Lighting developed an interactive online catalog that drove down costs, speeded the sales process, and increased revenue.[25]

NUMBER OF INTERMEDIARIES Three strategies based on the number of intermediaries are exclusive distribution, selective distribution, and intensive distribution.

Exclusive distribution means severely limiting the number of intermediaries. It's appropriate when the producer wants to maintain control over the service level and outputs offered by the resellers, and it often includes *exclusive dealing* arrangements. By granting exclusive distribution, the producer hopes to obtain more dedicated and knowledgeable selling. It requires a closer partnership between seller and reseller and is used in the distribution of new automobiles, some major appliances, and some women's apparel brands.

Exclusive deals are becoming a mainstay for specialists looking for an edge in markets increasingly driven by price.[26] When the legendary Italian designer label Gucci found its image severely tarnished by overexposure from licensing and discount stores, it decided to end contracts with third-party suppliers, control its distribution, and open its own stores to bring back some of the luster.[27]

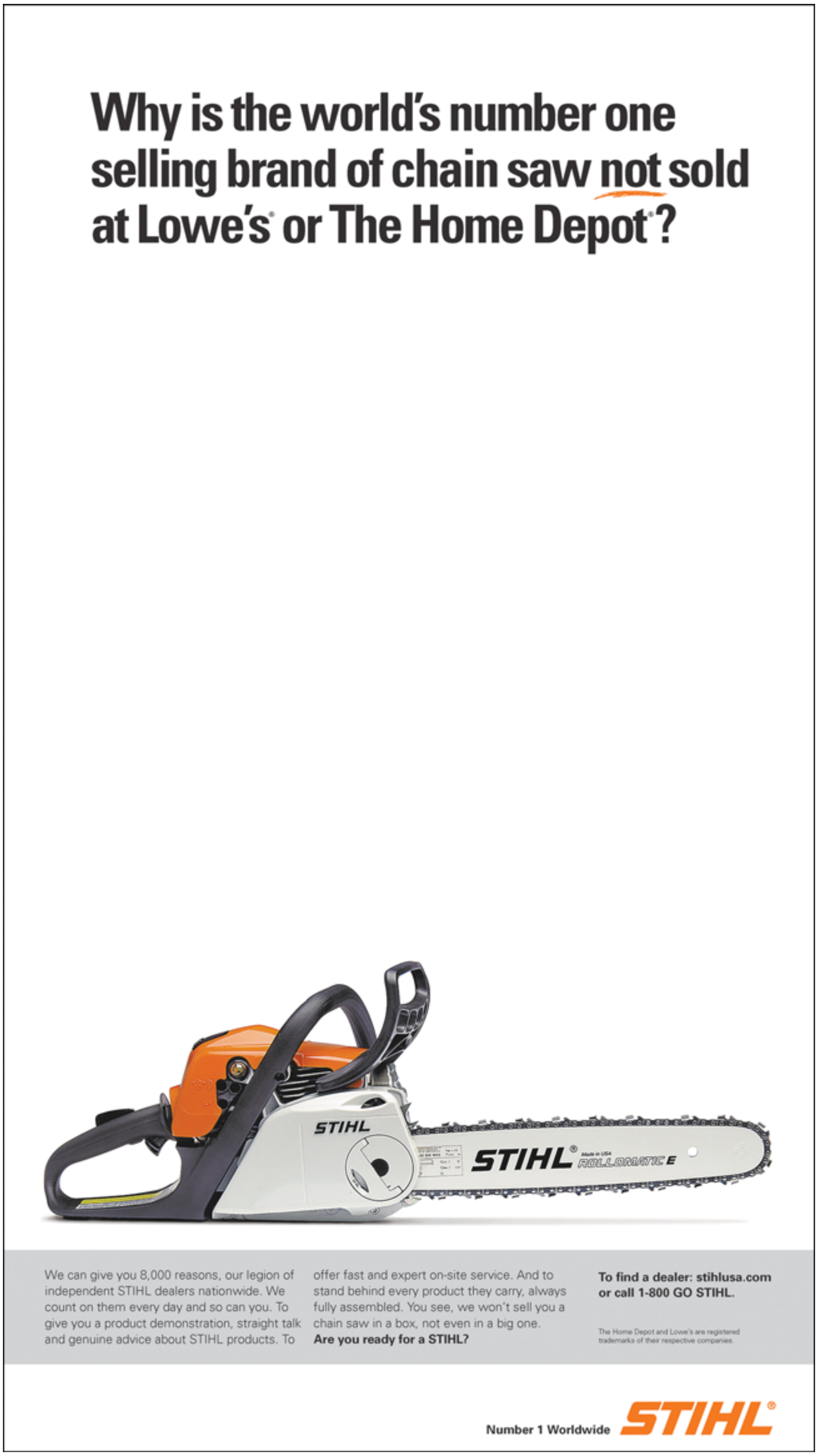
Selective distribution relies on only some of the intermediaries willing to carry a particular product. Whether established or new, the company does not need to worry about having too many outlets; it can gain adequate market coverage with more control and less cost than intensive distribution. STIHL is a good example of selective distribution.

STIHL STIHL manufactures handheld outdoor power equipment. All its products are branded under one name and it does not make private labels for other companies. Best known for chain saws, it has expanded into string trimmers, blowers, hedge trimmers, and cut-off machines. It sells exclusively to six independent U.S. distributors and six STIHL-owned marketing and distribution centers, which sell to a nationwide network of more than 8,000 servicing retail dealers. The company is also a worldwide exporter of U.S. manufactured STIHL products to 80 countries. STIHL is one of the few outdoor-power-equipment companies that do not sell through mass merchants, catalogs, or the Internet.[28]

Intensive distribution places the goods or services in as many outlets as possible. This strategy serves well for snack foods, soft drinks, newspapers, candies, and gum—products consumers buy frequently or in a variety of locations. Convenience stores such as 7-Eleven, Circle K, and gas-station-linked stores such as ExxonMobil's On the Run have survived by selling items that provide just that—location and time convenience.

Manufacturers are constantly tempted to move from exclusive or selective distribution to more intensive distribution to increase coverage and sales. This strategy may help in the short term, but if not done properly, it can hurt long-term performance by encouraging retailers to compete aggressively. Price wars can then erode profitability, dampening retailer interest and harming brand equity. Some firms do not want to be sold everywhere. After Sears acquired discount chain Kmart, Nike pulled all its products from Sears to make sure Kmart could not carry the brand.[29]

STIHL's selective distribution strategy includes 8,000 independent dealers but does *not* include other, broader forms of distribution.



TERMS AND RESPONSIBILITIES OF CHANNEL MEMBERS Each channel member must be treated respectfully and given the opportunity to be profitable. The main elements in the "trade-relations mix" are price policies, conditions of sale, territorial rights, and specific services to be performed by each party.

- ***Price policy*** calls for the producer to establish a price list and schedule of discounts and allowances that intermediaries see as equitable and sufficient.
- ***Conditions of sale*** refers to payment terms and producer guarantees. Most producers grant cash discounts to distributors for early payment. They might also offer a guarantee against defective merchandise or price declines, creating an incentive to buy larger quantities.
- ***Distributors' territorial rights*** define the distributors' territories and the terms under which the producer will enfranchise other distributors. Distributors normally expect to receive full credit for all sales in their territory, whether or not they did the selling.
- ***Mutual services and responsibilities*** must be carefully spelled out, especially in franchised and exclusive-agency channels. McDonald's provides franchisees with a building, promotional support, a record-keeping system, training, and general administrative and technical assistance. In turn, franchisees are expected to satisfy company standards for the physical facilities, cooperate with new promotional programs, furnish requested information, and buy supplies from specified vendors.

Evaluating Major Channel Alternatives

Each channel alternative needs to be evaluated against economic, control, and adaptive criteria.

ECONOMIC CRITERIA Each channel alternative will produce a different level of sales and costs. Figure 15.4 shows how six different sales channels stack up in terms of the value added per sale and the cost per transaction. For example, in the sale of industrial products costing between $2,000 and $5,000, the cost per transaction has been estimated at $500 (field sales), $200 (distributors), $50 (telesales), and $10 (Internet). A Booz Allen Hamilton study showed that the average transaction at a full-service branch costs the bank $4.07, a phone transaction costs $.54, and an ATM transaction costs $.27, but a typical Web-based transaction costs only $.01.[30]

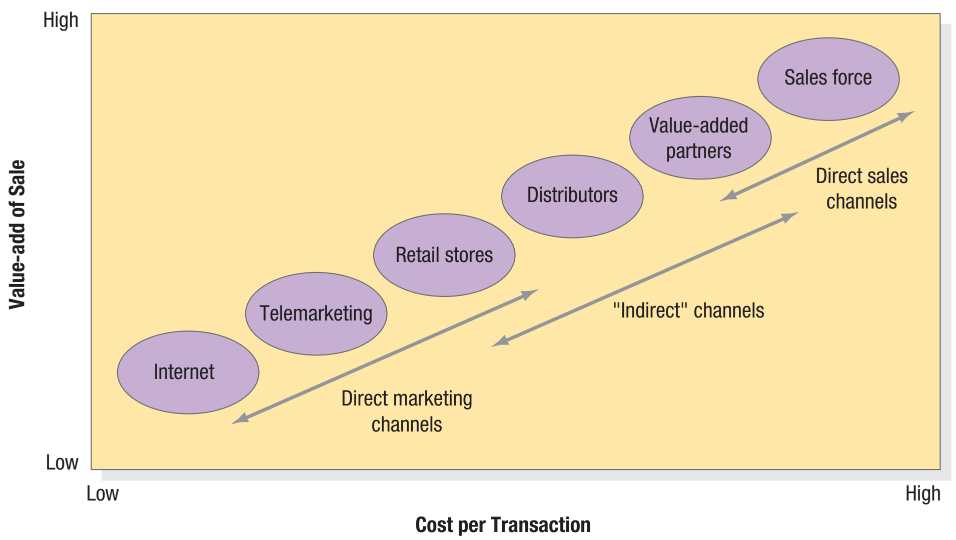
Firms will try to align customers and channels to maximize demand at the lowest overall cost. Clearly, sellers try to replace high-cost channels with low-cost channels as long as the value added per sale is sufficient. Consider the following situation:

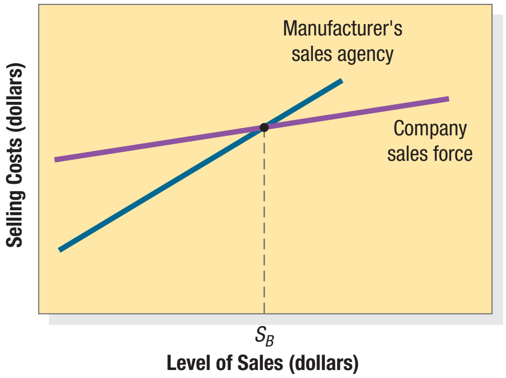
> A North Carolina furniture manufacturer wants to sell its line to retailers on the West Coast. One alternative is to hire 10 new sales representatives to operate out of a sales office in San Francisco and receive a base salary plus commissions. The other alternative is to use a San Francisco manufacturer's sales agency that has extensive contacts with retailers. Its 30 sales representatives would receive a commission based on their sales.

|Fig. 15.4|

The Value-Adds versus Costs of Different Channels

Source: Oxford Associates, adapted from Dr. Rowland T. Moriarty. Cubex Corp.





|Fig. 15.5|

Break-Even Cost Chart for the Choice between a Company Sales Force and a Manufacturer's Sales Agency

The first step is to estimate how many sales each alternative will likely generate. A company sales force will concentrate on the company's products, be better trained to sell them, be more aggressive because each rep's future depends on the company's success, and be more successful because many customers prefer to deal directly with the company. The sales agency however has 30 representatives, not just 10; it may be just as aggressive, depending on the commission level; customers may appreciate its independence; and it may have extensive contacts and market knowledge. The marketer needs to evaluate all these factors in formulating a demand function for the two different channels.

The next step is to estimate the costs of selling different volumes through each channel. The cost schedules are shown in Figure 15.5. Engaging a sales agency is less expensive than establishing a new company sales office, but costs rise faster through an agency because sales agents get larger commissions.

The final step is comparing sales and costs. As Figure 15.5 shows, there is one sales level (S_B) at which selling costs are the same for the two channels. The sales agency is thus the better channel for any sales volume below S_B, and the company sales branch is better at any volume above S_B. Given this information, it is not surprising that sales agents tend to be used by smaller firms, or by large firms in smaller territories where the volume is low.

CONTROL AND ADAPTIVE CRITERIA Using a sales agency can pose a control problem. Agents may concentrate on the customers who buy the most, not necessarily those who buy the manufacturer's goods. They might not master the technical details of the company's product or handle its promotion materials effectively.

To develop a channel, members must commit to each other for a specified period of time. Yet these commitments invariably reduce the producer's ability to respond to change and uncertainty. The producer needs channel structures and policies that provide high adaptability.

Channel-Management Decisions

After a company has chosen a channel system, it must select, train, motivate, and evaluate individual intermediaries for each channel. It must also modify channel design and arrangements over time. As the company grows, it can also consider channel expansion into international markets.

Selecting Channel Members

To customers, the channels are the company. Consider the negative impression customers would get of McDonald's, Shell Oil, or Mercedes-Benz if one or more of their outlets or dealers consistently appeared dirty, inefficient, or unpleasant.

To facilitate channel member selection, producers should determine what characteristics distinguish the better intermediaries—number of years in business, other lines carried, growth and profit record, financial strength, cooperativeness, and service reputation. If the intermediaries are sales agents, producers should evaluate the number and character of other lines carried and the size and quality of the sales force. If the intermediaries are department stores that want exclusive distribution, their locations, future growth potential, and type of clientele will matter.