

Chapter 11

PRICING ISSUES IN CHANNEL MANAGEMENT

Chapter Objectives

Pricing strategy should incorporate channel considerations before being implemented. If the channel members perceive a manufacturer's pricing strategy to be congruent with their own interests, they are likely to have a higher level of cooperation and the reverse is also true.

In developing pricing strategies, there are eight guidelines: (1) profit margins should be adequate for channel members, (2) margins offered to different classes of channel members should vary in proportion to the functions the channel members perform, (3) margins should be competitive with those of rival brands, (4) special arrangements that result in either an increase or decrease in services rendered should be reflected in the margins, (5) the manufacturer should conform to conventional norms for margins in the trade, (6) variations in margins on different models should be logical, (7) if price points exist at the wholesale/retail levels they should be recognized and prices set to meet these price points, and (8) variations in prices by a manufacturer for different products in its line should be associated with visible or identifiable differences in its line.

There are five major pricing issues a manufacturer is likely to face: (1) pricing control in the channel, (2) the impact of major price policy changes, (3) the passing of price increases through the channel, (4) use of price incentives, and (5) the problems created by "gray market" and "free riding".

Learning objectives

- 1) Be aware of the importance of pricing issues in marketing channel management.
- 2) Understand the "anatomy" of channel pricing structure and the pervasiveness of its influence in channel pricing strategy.
- 3) Recognize the channel manager's role in influencing the firm's pricing strategy.
- 4) Know the eight basic guidelines for developing effective channel pricing strategy.
- 5) Realize that these guidelines are not simple prescriptions for channel pricing strategies.
- 6) Be cognizant of some of the most basic and recurring issues in channel pricing policies.

Chapter Topics

- 1) Anatomy of Channel Pricing Structure
- 2) Guidelines for Developing Effective Channel Pricing Strategies
- 3) Other Issues in Channel Pricing

Chapter Outline

Anatomy of Channel Pricing Strategy

Participants at the various levels in the channel each want a part of the total price (the price paid by the final buyer) sufficient to cover their costs and provide a desired level of profit.

The “golden rule” of channel pricing when developing a pricing strategy is stated as follows:

“It is not enough to base pricing decisions solely on the market, internal cost considerations, and competitive factors. Rather, for those firms using independent channel members, explicit considerations of how pricing decisions affect channel member behavior is an important part of pricing strategy.”

Pricing decisions can have a substantial impact on channel member performance. If channel members perceive the manufacturer’s pricing strategy as congruent with their own interests, then a higher level of cooperation can be expected. And the reverse is also true.

Therefore, the major challenge facing the channel manager in the area of pricing is to help *foster* pricing strategies that promote channel member cooperation and minimize conflict.

An evaluation of how the manufacturer’s existing or proposed pricing strategies influence channel member behavior would normally be included as part of the general evaluation of channel member needs and problems identified in Chapter 9.

Whenever possible, the channel manager should attempt to have channel members’ viewpoints on pricing issues included as an integral part of the manufacturer’s price-making process.

Guidelines for Developing Effective Channel Pricing Strategies

Oxenfeldt offers a set of eight classic guidelines for developing pricing strategies that incorporate channel considerations. While not comprehensive, they do provide a basic framework and benchmark for pricing decisions that incorporate channel considerations. These are:

- 1) Each efficient reseller must obtain unit profit margins in excess of unit operating costs.
- 2) Each class of reseller margins should vary in rough proportion to the cost of the functions the reseller performs.

- 3) At all points in the vertical chain (channel levels), prices charged must be in line with those charged for comparable rival brands.
- 4) Special distribution arrangements—variations in functions performed or departures from the usual flow of merchandise—should be accompanied by corresponding variations in financial arrangements.
- 5) Margins allowed to any type of reseller must conform to the conventional percentage norms unless a very strong case can be made for departing from the norms.
- 6) Variations in margins on individual models and styles of a line are permissible and expected. They must, however, vary around the conventional margin for the trade.
- 7) A price structure should contain offerings at the chief price points, where such price points exist.
- 8) A manufacturer's price structure must reflect variations in the attractiveness of individual product offerings.

1) Profit Margins

Channel members need margins that are more than adequate to cover the costs associated with handling a particular product.

Channel members generally will not carry, let alone enthusiastically support, products whose margins are inadequate to cover their costs and provide room for profit.

Over time, those channel members who feel that the manufacturer is not allowing them sufficient margins are likely to seek out other suppliers or establish and promote their own private brands.

Thus, the channel manager should be involved in a continuous review of channel member margin structures to determine if they are adequate and pay particular attention to changes in the competitive environment that is likely to influence channel member perceptions of the existing margin structures.

2) Different Classes of Resellers

Ideally, the channel manager would like to set margins so that they would vary in direct proportion to the functions performed by different classes of channel members. In reality, however, margins at the wholesale and retail levels are typically governed by strong traditions that permeate the industry.

Nevertheless, periodic reviews of the margin structures available to different classes of channel members should be made, with a view toward making gradual changes if warranted.

Oxenfeldt suggests that the following questions be posed in this review:

- a. Do channel members hold inventories?
- b. Do they make purchases in large or small quantities?
- c. Do they provide repair services?
- d. Do they extend credit to customers?
- e. Do they deliver?
- f. Do they help train the customers' sale force?

The main point of periodically reviewing channel member services in relation to the margins granted them, is to find out whether there are any major inequities that are creating problems in the ranks of particular classes of channel members.

3) Rival Brands

Differentials in the margins available to channel members carrying competitive brands should be kept within tolerable limits.

The practical question facing the channel manager attempting to apply this guideline is: What levels of margin differentials are within tolerable limits? Unfortunately, there is no straightforward answer to this question.

Channel managers, then, should attempt to weight any margin differentials between their own and competitive brands in terms of what kind of support their firms offer and what level of support they expect from channel members. If this relationship is found to differ significantly from the competition, differentials in margins should be examined in terms of these differences.

4) Special Arrangements

If the usual allocation of distribution tasks between the manufacturer and the channel members changes, the margin structure should reflect these changes.

5) Conventional Norms in Margins

Oxenfeldt points to the almost universal tendency of channel members to expect margins to meet generally accepted norms.

This strong commitment among channel members to what they consider to be normal, fair or proper margin makes it very difficult for the manufacturer to deviate from the conventional margin structures.

Thus it is the job of the channel manager to attempt to explain to the channel members any margin changes that deviate downward from the norm. While this might not guarantee that the channel members will support this change, at least it will convey the reasons for taking this action.

6) Margin Variation on Models

Variations in margins on individual models and styles in a product line are common. Traffic builders (often referred to as promotional products) are usually the lowest priced in the line and yield relatively low margins for both the manufacturer and channel members. Fortunately, channel members are often amenable to accepting the lower margins associated with these products so long as they are convinced of the promotional value of the product in building patronage.

Margins on products in the line that are significantly below the norm and that are not intended as promotional products are much more difficult to justify in the eyes of the channel members.

The channel manager should attempt to influence product line pricing to use low-margin products for promotional purposes whenever possible.

7) Price Points

Key Term and Definition

- Price points: Specific prices, usually at the retail level, to which consumers have become accustomed.

In other words, consumers come to expect certain products to be available at customary prices. While most price points rise, sometimes price points can actually move down, as in the case for the under-\$1,000 personal computer.

8) Product Variations

When a manufacturer attaches prices to the various models within a given product line, it should be careful to associate price differences in product features. If the price differences are not *closely* associated with *visible or identified product features*, the channel members will have a more difficult selling job to the consumer.

Other Issues in Channel Pricing

The channel manager is faced with other channel pricing issues that require more specific and detailed attention. Five of the most important are discussed in this section.

1) Exercising Control in Channel Pricing

As stated earlier, the manufacturer's pricing strategies often require channel member support and cooperation if they are to be implemented effectively.

Of all of the elements of the marketing mix, channel members view pricing as the area that is *most* in their domain. As soon as the manufacturer seeks to exercise some control

over channel members' pricing strategies, channel members may feel that the manufacturer has stepped out of its proper boundary.

Yet, from the manufacturer's point of view, some of the most important pricing strategies may call for having some degree of control over the channel members' pricing policies. In attempting to influence some control, the manufacturer is faced with the difficult and delicate task of enforcing pricing policies without alienating channel members.

Although there is no surefire way to avoid the problem, several guidelines can be offered. These are:

- a. Any type of coercive approaches to controlling channel member pricing policies should be ruled out.
- b. Encroachment by the manufacturer into the domain of channel member pricing policies should be undertaken only if the manufacturer believes that it is in his or her vital long-term strategic interests to do so.
- c. If the manufacturer does feel that it is necessary to exercise some control over channel member pricing policies, an attempt should be made to do so through what might be called "friendly persuasion".

2) Changing Price Policies

Another important channel pricing issue that the manufacturer is almost sure to face at one time or another is dealing with channel member reactions to major changes in the manufacturer's pricing policies and related terms of sale.

Major changes in the manufacturer's pricing policies are bound to affect channel members. Typically, channel members become very uneasy when they hear about significant changes in manufacturer pricing policies or terms of sale. Indeed, channel members' own pricing strategies may be closely tied to the existing policies of the manufacturer.

Hence, a significant amount of communication and research into the *problems and issues* of channel members is needed to prevent channel conflicts from developing.

3) Passing Price Increases through the Channel

So long as each channel member is able to pass along manufacturer-initiated price increases to the next channel member, and ultimately to the final user, the price increase issue is not too worrisome.

But, when the increased prices cannot be totally passed through the channel, and hence channel members have to begin *absorbing* some or all of the price increases by cutting into *their* margins, price increases become a critical issue.

Added to the direct monetary difficulties arising from such nontransferable price increases is the ill will that they can create as each channel member blames the next for the price increase.

Unfortunately, such price increases are too simply passed along in rote fashion by the manufacturer (and other channel members) before other alternatives or strategies that could help mitigate the effects of the price increase are given adequate consideration.

Such alternatives and strategies include the following:

- a. More thought to the long- and short-term implications of going through with the price increase versus attempting to hold the line on prices should be considered.
- b. If passing on the price increase is unavoidable, the manufacturer should do whatever possible to mitigate the negative effects of the increase on channel members. Examples include: additional financial assistance, more liberal payment terms, special deals, or other price-related strategies.
- c. The manufacturer could change its strategies in the other areas of the marketing mix, particularly product strategy, to help offset the effects of price increases. For example, the product could be “improved” or the product could be “downgraded” to maintain a price point.

4) Using Price Incentives in the Channel

Pricing strategy is frequently used by manufacturers as a promotional tool. A wide range of pricing devices is used to carry out such pricing strategy, including special deals, seasonal discounts, rebates, price reductions, coupons, two for the price of one, and a variety of others.

Such enthusiasm for promotional pricing strategies shown by consumers is not always shared by channel members.

Part of the problem can be solved merely by making pricing promotions as simple and straightforward as possible, so that channel members can participate with a minimum of time and effort.

The more significant problem underlying some price promotions, however, stems from the *differing price elasticities of consumers versus retailers (and wholesalers)*. That is, consumers’ responses to price reductions may differ significantly from those of retailers and wholesalers. The corresponding price incentives offered to retailers for participating in the price promotion (to consumers) may not be sufficient to stimulate *their* desire to be fully involved in the deal. Many retailers as well as wholesalers will take advantage of manufacturers’ promotions by engaging in forward buying.

Key Term and Definition

- Forward buying: Channel members load up on the discounted products featured in the promotion by passing on the lower price to the consumer for just a portion of time.

The rest of the product is held in inventory by the wholesaler or retailer for sale at the regular price after the promotional period has ended.

The solution to the problem of getting better mileage out of manufacturer-initiated price promotions begins with the recognition on the part of the manufacturer of the differing price elasticities between consumers and retailers.

Price promotion strategies should be designed to be *at least as attractive to retailers as they are to consumers*.

Retailers and wholesalers often take advantage of price promotions so as to maximize *their* profit potential whether or not it helps the manufacturer or the final consumer.

5) Dealing with the Gray Market and Free Riding

Two of the most troublesome developments affecting the pricing policies and strategies of many manufacturers of branded products are the gray market and the related phenomenon of free riding.

Key Terms and Definitions

- Gray market: Refers to the sale, usually at very low prices, of brand-name products by unauthorized distributors or dealers.
- Free riding: A term used to describe the behavior of distributors and dealers who offer extremely low prices but little if any service to customers.

The discounters get a “free ride” from the services provided by the higher-priced full-service distributors and dealers when the consumer uses the full-service distributors and/or dealers for product information, and then buy from the lower-priced vendor.

Gray markets and free riding can both be of serious concern to the manufacturers of the products involved if these practices are widespread enough to disrupt the manufacturers’ ability to manage their marketing channels.

Channel design decisions that result in more closely controlled channels and selective distribution as well as changing buyer preferences may help to limit the growth of the gray market and free riding.