
Seller Pricing Strategies: A Buyer's Perspective

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Understanding pricing strategies used by sellers is extremely important to a successful buyer. Several key variables can be identified and evaluated in determining the seller's pricing strategy and the conditions under which it was developed. Knowing how to recognize these variables and integrate them into the buying process is a challenging and demanding effort. The motivated buyer constantly hones his or her skills in this area, attempting to obtain the most advantageous business arrangement for the organization.

This article identifies various seller pricing strategies and the principal variables involved in their analysis. The strategies and variables examined should significantly assist buyers in preparing for the buying task.

In the institutional, industrial, and governmental buying process, successful contract negotiation requires knowledge and understanding of several key elements. The seller's pricing strategy is one of these. A perceptive buyer continually explores the factors that contribute to the development of a seller's pricing strategy, in an effort to determine what he or she might do differently by understanding the strategy.

In preparing for contract negotiations, many buyers typically devote only modest attention to this area because it is one of the most difficult in which to obtain valid data. It involves confidential and proprietary management information. Regardless of the difficulty, effective buyers must be aware of the types of pricing strategies sellers are likely to employ, the conditions under which these strategies generally surface, and the significance of this knowledge in the buying process. This article identifies some of the more common pricing strategies and the principal variables that contribute to the development of the strategy. It concludes with an analysis of the usefulness of this information to the buyer.

PRICING STRATEGIES

Pricing strategies exist because, for many hidden as well as obvious reasons, a seller's quoted prices are often very dif-

ferent from the prices it actually gets. The following approaches are commonly used in determining price:

- Cost-Plus (Penetration) Pricing
- Demand (Skimming) Pricing
- Rule-of-Thumb (Myopic) Pricing
- Buy-in (Foot-in-the-Door) Pricing

Cost-Plus pricing has appeal because it is a logical way to determine a minimum acceptable price. Although cost is not always a good direct determinant of price, firms must price their products at a level that at least recovers operating costs over time.⁷ This takes on special significance in new product pricing where a variation known as “penetration pricing strategy” is used. Greer defines penetration pricing as a method to diffuse the appeal of the product rapidly through low initial pricing; then, once the market is “penetrated” to take advantage of cost reductions and/or price increases to generate profits.² This strategy is also aimed at discouraging would-be competitors from entering the market due to apparently low profit margins. The buyer’s problem becomes one of determining what *cost* the seller is using to price the product.

Demand pricing can be viewed as “charging as much as the market will bear.” It is based on economic theory which focuses on the concept of the industry and the firm’s demand curves. A variation of this strategy, applicable to the introduction of new technology or innovation in the marketplace, is known as “skimming the cream.”³ The “skimming” strategy involves high initial pricing in an attempt to achieve an almost instantaneous return on investment.⁴ The obvious risks are that the seller invites competition, that it may not be able to sell as much as it would like at a high price, and that it may alienate potential buyers by the apparent profiteering.

Rule-of-Thumb pricing is a middle of the road pricing strategy. Two general approaches to this strategy include: (1) a leader-follower concept, allowing competitors to set prices and then following suit, and (2) a more traditional pricing formula such as direct material and labor costs plus 40 percent. It is generally considered conservative and safe by those who use it, often because it has worked in the past. The Rule-of-Thumb approach greatly simplifies the pricing problem. It is a way of coping with (by essentially ignoring) uncertainties in the estimation of demand function shapes and elasticities.⁵ For the buyer, it may be much easier to understand and to apply.

The “*Buy-In*” strategy is a short-term approach based on other than normal cost recovery or profit motives. It involves pricing to recover variable costs and perhaps some fixed costs to the extent that a low enough price is offered to beat the competition. In a different form, this strategy meets the conditions of a depressed market. One analyst states that “companies neither record nor generally talk about all the ‘under the table’ prices and other valuable concessions they make when the market is sluggish.”⁶ Normal business practice finds

a seller cuffing a deal with a buyer at a “certain” price because of “certain” conditions. If it became public, other buyers would want deals similar to this most favored customer regardless of the economic or financial health of the seller. The relationship between cost data and pricing decisions on a pragmatic level has received very little attention as far as empirical research is concerned. This is not surprising in that it concerns very sensitive questions that firms are generally unwilling to answer.⁷

PRICING VARIABLES

Sellers consider many factors in determining a pricing strategy. One useful approach categorizes these as intrinsic and extrinsic factors.⁸ Intrinsic factors are the baseline needs, such as costs, product characteristics, and soon, and the regulatory system which places limitations on how those needs can be met.⁹ Extrinsic factors are related to the economic and operating environment of a procurement, including product differentiation, demand, and the number of firms involved.¹⁰

The following discussion explores what are considered to be the most identifiable and significant variables that contribute to a seller’s pricing strategy in terms of both external and internal variables.

External Variables

Variables in this category can be grouped as: (1) the nature of the product, (2) market characteristics, and (3) the buyer’s control variables.

Nature of the product. The most significant aspects of this element of pricing strategy are the maturity, or stage of the product in its life cycle, and the degree of differentiation inherent in the product. Pioneering products offer a much greater flexibility in pricing strategy than do products in their prime or beyond. The implications are that a buyer can expect a higher probability of the existence of a demand (skimming) pricing strategy because of the lack of competition, the lack of product cost history, and other similar factors that accompany new product introduction.

The degree of innovativeness or differentiation can be very significant, assuming that a seller in fact is distinguished from competitors and that this differentiation is aligned with a buyer’s desires. Technological innovation may lead to significant cost advantages and the opportunity for a penetration strategy in cases where a seller capitalizes on the opportunity to deter the entry of competitors. On the other hand, a buyer might anticipate a skimming strategy if a particular product attribute is able to command a premium price well above the marginal cost of providing it. Other controlling elements are differential advantages in (1) quality and superiority—the degree to which a seller markets products that meet customer needs better than competing products; (2) customer impact and features—products that have a major impact on buyer

behavior, allow buyer cost reductions, and offer unique features; and (3) product fit and focus—the degree to which a seller’s products are similar to existing products in use, have similar end uses, fit in an existing product line, and are closely related to each other.

The scarcity of a needed product or material may also influence pricing strategy significantly. For example, a buyer might require a product using a scarce material that is subject to fluctuations in price and availability. The buyer should be very cautious if he or she detects a selling strategy that doesn’t reflect how that scarcity will affect delivery and performance. The degree to which technology and R&D are invested in a particular product will often influence the pricing decision. This is distinct from the innovativeness described above. A seller in an industry on the leading edge of technology, characterized by rapid product obsolescence, will tend to employ a strategy designed to recover investments as quickly as possible. Depending on the actual volatility of product life, this may or may not be appropriate from the buyer’s point of view.

Seller’s market characteristics. Many consider these the dominant variables in the pricing strategy process.¹¹ Seller market structure involves the application of microeconomic theory, with the primary emphasis on the nature and degree of competition. Most economists describe market structure and seller behavior in terms of four types of competition— perfect competition, monopolistic competition, oligopoly, and monopoly. The important distinctions among them are the relationship of the seller’s price and long run average cost, and the degree of choice the seller has in establishing price. Typically, a seller in a perfectly competitive market is a price taker (one extreme), while the firm in a monopolistic position is a price setter (the other extreme). The key implications for a buyer are that sellers operating in the first two types of competitive situations will tend to employ penetration pricing strategies, whereas oligopolistic or monopolistic sellers have a greater potential to utilize a skimming strategy.

Closely related to market structure is the nature of product demand and elasticity. Some theoreticians believe that the most influential concept in seller pricing behavior is that of demand elasticity relative to price.¹² That is, the degree to which buyers’ aggregate demand for a given product will change as the price is set at higher or lower levels. A product is said to have an elastic demand if aggregate demand drops off as the price increases. Practically speaking, the relevant feature of demand elasticity for a buyer is that selling firms frequently believe the demand for their product is much more elastic than is truly the case.¹³

Other seller market characteristics include things such as competitive loyalty, market newness, and market segmentation. Competitive loyalty focuses primarily on establishing and maintaining a long-term relationship between buyer and seller. The pricing approach utilized typically is consistent with this objective and involves some form of cost plus a

“fair” profit return determination. Market newness exploits the differences between fresh and existing markets, frequently creating distinctly different pricing strategies. The effect of market segmentation is the ability to sell to buyers in different markets at different prices, with no significant repercussions. What really determines segmentation sensitivity is not the number and similarity of available substitutes but individual buyer’s perceptions about these things.¹⁴ If a selling firm believes that a buyer may not be aware of competing products or substitutes, it may be inclined to increase the profit margin.

The state of the national economy and the extent of industry capacity utilization at a given time are also influential factors in price determination. Overcapacity frequently leads to dramatic price reductions, particularly in capital-intensive industries experiencing keen competition.¹⁵ In such cases, a buyer should expect to see more cost-plus pricing and should be alert for “buy-in” strategies.

Buyer’s control variables. These factors are unique in the government-commercial procurement relationship. Most government procurement is conducted with the buyer functioning in the role of a monopsony. There are several differences between private and government procurement that may affect the seller’s pricing strategy. The most significant of these are the status of parties, accountability, and process complexity.¹⁶ The effect of these differences is difficult to quantify; however, experience indicates that the number of hurdles a seller must clear in government procurement may force that seller’s pricing strategy away from the penetration approach. The unsteady influence of the political process on government programs impacts the seller’s assessment of risk and long-term relationships. In such a situation, a buyer might expect either skimming or buy-in pricing.

The type of contract utilized in government procurement will have a significant impact on a seller’s pricing strategy. Cost reimbursement contracts encourage the overoptimistic estimation of costs and a resultant buy-in strategy (particularly in research and development efforts), while fixed-price contracts tend to promote the rule-of-thumb or skimming strategy. The implication for a government buyer is that under a fixed-price contract, the seller attempting to use a buy-in strategy may be in a difficult position should performance problems develop. Government buyers may encounter greater usage of the skimming strategy in the fixed-price contract situation as the seller evaluates the degree of risk it must assume.

Internal Variables

Variables in this category can be grouped as (1) seller’s internal characteristics, (2) management orientation, and (3) accounting and costing methods.

Seller’s internal characteristics. A seller’s current capacity utilization factor is one of the most significant elements affecting its pricing strategy. At times, this situation may be tied closely to the industry and national economic conditions

on the external side. If a seller is operating at or near 100 percent capacity, it may be able to extract a substantial profit to displace existing business. Conversely, in periods of underutilized capacity, a seller's emphasis shifts from a profit motive to the recovery of fixed costs and the continued employment of resources. Hence, a buyer can expect an increased occurrence of buy-in and penetration strategies when a seller has excess capacity, and a skimming strategy in periods of full capacity utilization.

A selling firm's general financial health is another factor that can influence its pricing strategy. A financially sound seller may use a buy-in strategy less often than a firm that is financially less stable. Some observers have noted that turnover and liquidity seem to be the most important dimensions of financial condition from the standpoint of bankruptcy. In such cases, profitability clearly is the factor of least immediate importance.¹⁷

The degree to which a firm can control its costs dictates the range of pricing strategies available. Efficient operation allows a seller to profitably use a penetration strategy under many circumstances. Efficiencies often result from economies of scale and from prior job experience. Economies of scale often are available more frequently to the larger more oligopolistic selling organizations. In these types of organizations, economies of scale sometimes are used to create a barrier to market entry. As such, they may permit the seller to exercise a wider range of pricing strategies than would otherwise be possible.

Economies stemming from prior job experience frequently are visible in the form of a learning or improvement curve. Greer has identified a relationship between the slope of a firm's learning curve and the particular pricing strategy employed for major airframe manufacturers.¹⁸ He has correlated a steeper sloped curve with a skimming strategy and a flatter curve with the penetration strategy. In such procurement situations, it appears the buyer may have a fairly definitive indicator of the seller's pricing strategy.

The nature of a seller's costs and the type of business also influence its pricing strategy. A firm with heavy capital investment often can produce at relatively low variable costs per unit. An understanding of a seller's capital structure can provide valuable insights into the particular pricing strategy the seller is employing. For a firm with a high cost of capital, the type of contract contemplated can combine to significantly influence the strategy pursued. Likewise, a firm that basically is an assembler rather than a manufacturer may not be able to predict its costs accurately due to increased reliance on subcontractors. Clearly, this situation will influence the pricing process.

Management orientation. Management objectives, such as sales targets, target levels of employment, designated rate of return, and the preference for risk avoidance, all affect pricing strategies.

The initial influence of a seller's management orientation is revealed in the firm's interest in obtaining contract work. Some sellers are willing to accept new business only if the rate of return is substantial enough to compensate them for any added risks and requirements. Others emphasize repeat business. The importance of repeat business is directly related to perceived market stability. If top management feels that a certain type of business activity as a regular percentage of the contract base is necessary, the pricing strategy will be adjusted to ensure a higher probability of success in obtaining such contracts. The pricing strategy will reflect management's estimated probability of winning the award, the value it places on the work, and the cost of not getting the contract in terms of employment, contribution margin, competitors' advantage, and total sales volume. Inherent in this element is management's stated objectives of cost recovery, profit, and capital employment.

Accounting and costing methods. The more a buyer knows about a seller's internal accounting system, the greater will be his or her ability to diagnose the seller's pricing strategy. For example, the depreciation of tangible assets by a seller can have significant impact on the firm's stated operating costs. An accelerated method of depreciation will produce higher costs early in a product's life cycle. Similarly, the use of LIFO (last in, first out) inventory accounting in a period of rising costs will result in the earlier recognition of costs. The use of full absorption costing obscures what it actually costs a firm to produce on the margin. At the same time, however, the true nature of a seller's costs may be hidden from its competitors.

The significance of these considerations to a buyer is that the accounting method used in reporting cost data may not be the accounting method the pricing strategy is based on. Closely related to the seller's accounting for costs is the method the seller uses to estimate future costs. The validity of a seller's cost estimating relationships will affect the perception of expected costs and therefore influence the strategy to price for cost recovery.

CHALLENGES FOR THE BUYER

Four common pricing strategies and the key variables to be considered in evaluating these strategies have been identified. The understanding that comes from the process of trying to determine a seller's pricing strategy will significantly assist a buyer in his or her effort to obtain fair and reasonable prices. An analysis of the factors and the conditions involved in a particular buy will contribute to the preparation so necessary to successful contract negotiation.

In examining the potential pricing methods a seller might use, buyers must place themselves in the "seller's shoes" and attempt to evaluate the relative significance of both external and internal variables. They should ask themselves,

What pricing approach is most likely to fulfill the objectives and the needs of the seller, given the economic structure and the extent of competition found in its industry?" This requires the buyer to make an assessment of the seller's objectives and needs to sufficiently understand the motivations and incentives involved. For example, at the present time a seller may not be motivated by profit maximization on a given contract, but rather may be seeking an expansion of its sales volume and is employing a pricing strategy that recognizes this need.

Of the four pricing strategies, penetration (cost-plus) pricing and rule-of-thumb pricing are perhaps the easiest for a buyer to understand and to deal with. They are also the strategies in which sellers are willing to divulge how costs were estimated and to provide data supporting these estimates. Skimming and buy-in pricing are difficult to detect and even more difficult to counter. Sellers typically are unwilling to admit such strategies have been used because the buyer might feel that excessive profits are generated in the former case and that extreme caution during contract performance is necessary in the latter case.

Matching the external and internal variables to these strategies becomes the important step in determining buyer negotiation leverage and flexibility. It is also important to understand that a change in one variable is generally not an isolated event, but that it can modify the parameters of most other variables leading to significant shifts in the pricing approach. Certainly the buyer must have fairly good knowledge of the seller's costs, the earnings needed, and the competitive nature of the company's markets.

The buyer should aggressively and continually pursue data helpful to assessing the external variables affecting pricing strategy. Information concerning new versus mature products, product differentiation, product life cycle, the competitive environment, product demand, and industry capacity can all be obtained through careful attention to various industry, trade association, financial, and government publications. Factoring each of these external variables into the process which favors one pricing approach over the others allows the buyer to draw conclusions regarding the seller's proposed price.

Data on internal variables are more difficult to obtain and to assess. Data may be nonexistent or expensive to acquire. Several of these variables require the buyer to pay close attention to "signals" provided by the seller during periods of buyer-seller interaction. Such things as capacity levels, financial health, cost control, capital structure, expected rates of return, internal accounting methods, and estimating methods are all areas in which the seller may be unwilling overtly to supply enough information for the buyer to make legitimate assessments. The astute buyer must develop a feel for each of these areas, particularly during the fact-finding portion of negotiations and more generally during contract performance. In the case of federal government contracts, data from many

of these areas must be provided as a condition of contract award. Regardless of the difficulty involved, these variables are key to understanding seller pricing behavior.

CONCLUSION

If the capability of a buyer is even slightly enhanced by an improved ability to forecast a seller's objectives, through an evaluation of seller pricing strategy, then it seems clear that the use of this tool is warranted. Many factors enter into the pricing decision, and there are no simple formulas that can solve the pricing problem. A buyer may not be able to investigate and examine each of these factors. Nevertheless, a general awareness of their existence and their impact will contribute significantly to preparation for contract negotiations.

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