

PRICING

Recent Trends and Emerging Practices in Retailer Pricing

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Changing Retail Environment

Profitability in retailer pricing has become a paramount concern. Retailers, especially, grocery retailers, are operating on razor-thin margins. On average, a supermarket's margin is about 1% of net sales. A typical supermarket today is bigger than ever before, with several thousand items—and, owing to mergers and acquisitions, it is part of an even larger retail chain. Prices are set weekly on these items, so that supermarkets are challenged to develop a coherent and profitable pricing strategy. Moreover, retailers receive trade allowances from manufacturers for promotional pricing. Pressured by competition and by consumers who have come to expect frequent price discounts, retailers have fallen into a price-promotion trap. Although only about 20% of retail sales come from promotions, supermarkets devote about 80% of their week to managing them. The same retail pricing battle is being waged across department stores, convenience stores, and stores in other traditional retailing categories.

The current focus on profitable pricing strategies is also due to a changing retail landscape. Cross-channel consumer shopping is becoming increasingly common and is altering the pricing practices of many retailers (see also chapter by Sonneck, Ott in this book). Competition across retail channels and formats such as grocery (e.g., Kroger), drug (e.g., Walgreens), mass merchandise (e.g., Wal-Mart), convenience and gas (e.g., 7 Eleven), club (e.g., Costco), and dollar (e.g., Dollar General) appears to be much more intense than ever before (for more information on between-format competition, see chapters by Grewal et al, Fox, Sethuraman in this book). Ongoing expansion by Wal-Mart's Super Centers, plus recent growth in club and dollar stores, have lowered the price floor in many markets and catego-

ries. Concurrently, the growth of dollar stores is challenging the dominance of the giant low-cost mass merchandiser Wal-Mart. This phenomenon parallels the rise of low-cost competitors in other industries. For example, competition in the airline industry has intensified with point-to-point airlines such as Southwest Airlines and Jet Blue stealing market share from the long standing hub-and-spoke airlines such as United Airlines and Delta Airlines.

The goals of this chapter are to outline the trends in retailers' macro-environment, discuss current retailer pricing, and derive implications for emerging pricing practices. The chapter is organized in the following way. First, we describe four environmental trends: retail consolidation, changing manufacturer practices, advances in technology and innovation, and the emergence and growth of e-tailing. We discuss how each of these environmental factors has influenced current retailer pricing practices. Second, with regard to current retailer pricing, we address two key questions: How prevalent are discount prices or "everyday low price" strategies? What retailer pricing strategies are successful in today's competitive markets? Our investigation of these questions yields a typology of current pricing practices. Third, we argue that our analysis of current pricing practices suggests that retailers are moving toward an approach we call "customized pricing." This approach requires each retailer to build a coherent strategy for its products, based on its strategic position in the marketplace. Last, we close by predicting the widespread adoption of customized pricing as marketplace trends make it increasingly profitable.

Retail Consolidation and Its Effects on Retailer Pricing

Consolidation and Retail Formats. Mergers and acquisitions (M&A) have resulted in the consolidation of retail chains, thereby substantially altering the retail competitive arena. The effects of consolidation on retail formats have varied substantially. In some cases, mergers involving retailers with the same format have resulted in retailers with a single dominant format and brand name. For example, the CVS drugstore chain has renamed and reformatted all the stores acquired from the Eckerd drugstore chain as CVS stores with a CVS format. In some other cases, different retail brand names and formats have been preserved. For example, Safeway has retained the Randalls retail brand name and style after acquiring all the Randalls stores. In other cases, retailers have altered their retail formats by increasing the assortment of products and services they offer after acquiring other chains, as exemplified by Albertsons following their acquisition of Jewel Osco.

Why Consolidation? The financial rationale for consolidation is that retailers can maintain or strengthen their competitive positions in the marketplace by increasing their size, thereby lowering costs (by improving their bargaining position vis-à-vis manufacturers), expanding revenues from consumers and markets, and gaining market share across channels and formats. For example, the newly merged Kmart-Sears retailer may be able to compete more effectively against the retailing behemoths.

moth Wal-Mart on costs by improving the bargaining position with manufacturers through scale economies.

Consolidation facilitates retailers' efforts to streamline their offerings and extend their reach. The replacement of the Eckerd brand by the CVS brand in drugstores enables CVS to leverage its more popular brand name and efficient store format in expanded markets, and thus to compete more aggressively against Walgreens, its leading drugstore competitor chain.

A third reason for consolidation is to become more attractive to customers by offering a wider assortment than competing retailers. For example, Albertsons' addition of Osco pharmacy has expanded its health and beauty selections and broadened its customer base.

Last, consolidation helps improve the profitability of retailers by increasing the distribution of retailers' higher margin private label offerings vis-à-vis national brands. For example, in Switzerland, five retailers account for 88% of the grocery market since consolidation. Consequently, among all developed nations, Switzerland also has the highest share of private labels (38%) in the grocery industry.

The Effect of Consolidation on Retailer Pricing Practices. How does consolidation affect retailers' pricing strategies? Retailers span more markets and channels, but their increased span of control challenges them to manage multiple formats or integrate (or even eliminate) multiple systems. As a result, consolidated retailers' decision making is more centralized, whereby strategic distribution, pricing, and merchandising decisions are set at corporate headquarters and handed down to each division.

At the same time, however, consolidation is forcing retailers to address the unique challenges of market-specific competition and clientele for each retail division or format in their pricing strategy. Retail divisions and formats must concurrently manage their business within corporate guidelines and remain competitive in their respective markets. Within each division and format, individual stores are faced with the challenge of simultaneously complying with corporate mandates and being competitive within their trade areas. Successful retailers appear to be delicately balancing these apparently conflicting needs of local versus corporate pricing, division versus store level pricing autonomy, chain versus store level pricing and promotional tools in attempts to remain competitive.

How Changing Manufacturer Practices Influence Retailer Pricing

Manufacturers' Account Management. Since retailer consolidation, manufacturers have treated retailer pricing as a chain-wide coordinated strategic variable. By focusing on a single buyer for an entire chain, they are able to sell more efficiently with fewer account managers. The end-result is that manufacturers are directing their selling efforts at the corporate headquarters level, rather than at the market or store level.

Retailers typically appoint a specific manufacturer as “captain” for each major category. They rely on the consumer behavior analysis and pricing recommendations of the category captain. Since category captains are likely to make pricing recommendations at the corporate headquarters level, retailers frequently develop chain-wide pricing guidelines for the category. Retailers expect manufacturers’ representatives to possess the skills and resources to deliver business-building information and share category goals and objectives. However, manufacturers may not be knowledgeable about multiple retail formats, market and store differences that are relevant to the development of a coherent pricing strategy for the retailer.

Trade Promotions. The grocery industry relies heavily on manufacturers’ trade allowances or promotional funds, which account for about 54% of the marketing dollars. Trade allowances have traditionally been used to adjust pricing and support promotions at the retail level. Manufacturers provide trade funds to retailers in the form of either scan-back allowances, which means reimbursement is based on units sold by the retailer, or off-invoice allowances, meaning that reimbursement is based on units purchased by the retailer. Manufacturers typically dislike off-invoice allowances, because they may lead to forward buying or diverting, rather than supporting their brands. In fact, retailers are not required to pass along trade discounts to the consumer, and studies have shown that retailers pass on only a fraction of their trade allowances, typically discounting leading brands to draw store traffic.

Promotion inefficiencies combined with the conflicting objectives of manufacturers and retailers make it likely that trade allowances will be decreased, regulated, or eliminated. Wal-Mart already forgoes all allowances and negotiates a lower total price or “dead net cost”. However, its aggressive tactics have been difficult for other retailers to imitate, fueling their disenchantment with trade allowances. For example, Safeway attempted to use dead net cost with a few manufacturers, but encountered a high level of resistance from them.

Supermarkets’ heavy reliance on trade allowances has also made it difficult for them to calculate their true SKU costs, making price wars an unattractive option in the current environment. Hence, the use of promotional dollars can be disadvantageous for grocery retailers wishing to compete on price. However, promotions do allow retailers to highlight their strengths vis-à-vis their competitors.

Given the conflicting objectives of manufacturers and retailers and the differences in trade allowances across retailers, the development of an effective pricing strategy has eluded retailers in many categories and with different formats. Consider the situation in toy retailing. Toy retailers include specialty retailers, who carry a variety of toys, and discounters, who carry a smaller assortment at very low prices. Toys ‘R’ Us is the leading toy specialty retailer, and Wal-Mart is the leading toy discounter (as well as the leading toy seller). In 2004, two major specialty retailers, FAO Schwartz, a small chain selling premium toys, and KB Toys, a national chain with over 750 stores, declared bankruptcy. More recently, the profitability of Toys ‘R’ Us has faltered. Thus, specialty toy retailers have not been able to compete effectively on price with mass merchandisers or discounters.

How Advances in Technology and Innovation Influence Retail Pricing

Adoption of Price Optimization Software. Information management and supply chain management helped by technological advances have driven retailers' costs down. In the 1990s, supply chain tools helped improve efficiencies in the flow of goods, but did not always ensure that retailers had the right merchandise in the right stores at the right price and at the right time. Retailers traditionally relied on rules-based pricing decisions, such as a percentage markup or seasonal pricing (see also chapter by Simon, Gathen, Daus in this book). More recently, retailers have embraced optimization methods, such as retail merchandise optimization, price optimization, retail revenue management. Price optimization software predicts demand for individual products based on historical price and sales data, competitive pricing, local demographics, inventory, and promotional data .

Today, retailers are challenging traditional "rules" of pricing with prices generated from statistical modeling and data mining. The use of price optimization software has increased gross margin dollars on markdown items for many retailers. Price-optimization software can also help retailers manage nonnegotiated prices on seasonal items, recommending when prices should be reduced and when products should be sold at full price.

Pricing Implications for Different Retail Formats and Stores. The shift toward data- and technology-driven pricing approaches, as opposed to approaches based on "experience" or "hunches" has been a cultural change for many retailers. Retailers may feel they are losing control when prices are set by computer software. Some retailers are still relying on a blended centralized, rules-based pricing strategy. One argument against price optimization is the potential negative effect on market share. Many retailers fear that the differences in prices across items within a product line (i.e., flavors) may confuse the consumers and possibly drive down sales.

How the Emergence of E-Tailers Is Influencing Retailer Pricing

The explosive growth in Internet usage has led to the rapid emergence of e-tailing. In addition to many "pure" e-tailers, many traditional or bricks-and-mortar retailers now use the Internet as an important additional channel (for more discussion of electronic retailing, see Weitz chapter in this book). Multichannel shopping is also emerging as a key phenomenon in consumer shopping behavior. These trends have spawned a stream of research on relative prices of the online and offline channels and on online price dispersion, defined as the distribution of prices (such as range and standard deviation) of an item with the same measured characteristics across sellers of the item at a given point in time (See Pan, Ratchford, and Shankar

2004 for a review). Higher price dispersion within and across retail channels, including the Internet, reflects market inefficiency and greater perception of differences among retailers by consumers.

Many studies show that online price dispersion is at least as high as offline price dispersion (e.g., Ancarani and Shankar 2004). Numerous factors contribute to online price dispersion, including variability in e-tailer service attributes (e.g., shopping convenience, product information, shipping and handling), e-tailer visibility and reputation, market characteristics (e.g., number of competitors, time of online market entry), and category characteristics. Interestingly, e-tailer service quality attributes explain only a portion of online price dispersion and market characteristics are important drivers of price dispersion (Pan Shankar and Ratchford 2003). Price dispersion has remained persistent online, narrowing over time (Pan, Shankar, and Ratchford 2003; Ratchford, Pan and Shankar 2003). Despite the introduction and growth in use of online shopbots, prices have not converged and online markets remain inefficient.

Multichannel shoppers are an important segment of shoppers for retailers. They tend to buy more often, buy more items, and spend more than shoppers using only one channel. They are also typically younger, more highly educated, and more affluent. There is mixed evidence on the relative prices of the same item at pure e-tailers, traditional stores, and multi-channel retailers. Ancarani and Shankar (2004) found that although listed prices online were lower, when adjusted for shipping costs online prices were higher. Multichannel retailers have higher average prices

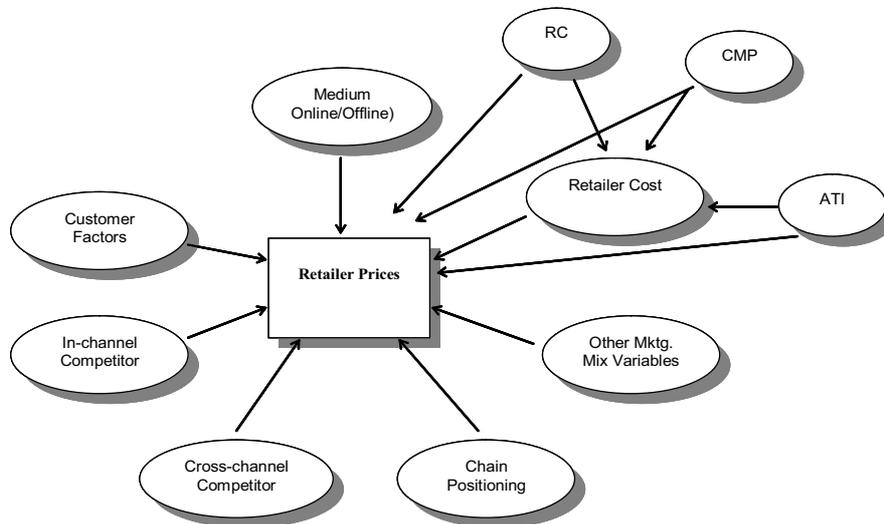


Figure 1. A Framework of Retailer Pricing

RC = Retail Consolidation; CMP = Changing Manufacturer Practices; ATI = Advances in Technology and Innovation

than pure play e-tailers, regardless of whether the price compared is the posted price or the full price including shipping costs. Overall, it appears that there are sufficient differences across channels and by price type (list or full price) for retailers to be able to differentiate themselves price effectively across channels.

The different influences on retailer pricing can be captured by a framework shown in Figure 1. As discussed above, retail consolidation, changing manufacture practices, and advances in technology directly affect both retailer cost and prices. In addition to the medium or channel (Internet vs offline), other marketing mix variables, such as advertising and promotion, customer factors, positioning of the retailer, and competition within and across channels or store formats, influence retailer prices.

Current Pricing Practices

The preceding discussion of the changes in the retailing landscape leads to two key questions about current pricing practices:

1. How prevalent are discount pricing or “everyday low price” strategies?
2. What retailer pricing strategies are successful in today’s competitive markets?

Conventional wisdom says that most retailers use one of two store-wide pricing strategies: “EDLP or “HiLo”. An EDLP policy involves offering consistently low prices on many brands and categories and is often perceived to be practiced by some supermarket chains (e.g., Food Lion and Lucky) as well as by Wal-Mart (Shankar and Krishnamurthi 1996). A HiLo policy is characterized by steep temporary price discounts with higher “regular” prices for many brands and categories, and is typically perceived to be practiced by supermarkets such as Kroger and Safeway. However, retailers are being forced to reexamine their traditional pricing strategies to allow them to survive in the new retail landscape. Innovations in information technology and supply chain management and centralized buying have significantly reduced retailer costs, and lower costs enable retailers to offer consistently lower prices than before. These trends suggest a movement toward an EDLP policy. However, many retailers seem to be following a Hi-Lo pricing policy, offering price discounts in response to competitive price pressure—even when lower prices do not reflect lower costs.

It is also widely believed that retailers’ pricing decisions are primarily driven by the principles of category management. Category management, identified as one of the four strategies of the efficient consumer response (ECR) initiative in the early 1990s, has evolved over time in different retail chains. Under category management, a retailer first identifies the roles of the different categories, such as destination, support, and ideal roles. For each category, the retailer decides its pricing policy based on its role. Further, the retailer decides prices and promotions for the

brands in the category to maximize the profits for the category, given the pricing policy for the category. While category management principles are still in vogue, retailer pricing has become more complex and increasingly customized. Surprisingly, successful retailers use an arsenal of different strategies, such as exclusive pricing, moderately promotional pricing, and aggressive pricing strategies, which are customized to fit brand, category, and market conditions, according to a large-scale empirical study of US supermarkets (Bolton and Shankar 2003; Shankar and Bolton 2004).

Conventional wisdom also suggests that retailers should customize their pricing to the store clientele's price sensitivity, and researchers have studied the determinants of consumer price sensitivity (Bolton 1989a, b; Shankar and Krishnamurthi 1996). However, research by Bolton and Shankar (2003) and by Shankar and Bolton (2004) also reveals that successful retailers customize prices with reference to many other factors, including competitor prices and deals, brand strength, and category storability. The remainder of this section summarizes the findings from their two studies (hereafter called "S&B"). The trends in the retailing environment have accelerated this movement toward customized pricing.

Five Retailer Pricing Strategies. S&B analyzed data from over 200 grocery stores in 17 chains, including Lucky, Dominicks, Jewel Osco, Safeway, and Food Lion, in five markets in the United States of America (USA), and also interviewed product managers and store managers. Data were collected from three large cities (New York City, Los Angeles, Chicago) because they represent a diverse sample of chains and stores (both large and small) and from two medium-sized cities (Pittsfield, Massachusetts and Marion, Indiana) because they are demographically representative of the population of the USA. The product categories studied—spaghetti sauce, bathroom tissue, liquid bleach, ketchup, mouthwash, and frozen waffles—represent a diverse range of product categories. Altogether, 1364 brand–store combinations from six categories of consumer packaged goods in five U.S. markets were studied over a 2-year time period.

Unlike prior research, S&B developed measures of retailers' pricing strategies specific to the brand–store combination rather than chain-wide or store-wide measures. They also measured retailer pricing decisions for given brand and store combinations using continuous measures rather than viewing pricing policy as a dichotomous decision (EDLP or HiLo). Moreover, they considered promotion or deal intensity (i.e., frequency of displays or newspaper features) and the coordination of promotions with price to be important aspects of retailer pricing decisions. Thus, S&B characterized store-level pricing decisions for brands along four independent dimensions: price consistency, promotion or deal intensity, price–promotion coordination or support, and relative brand price within category.

Retailer pricing strategies can be characterized as combinations of the four independent pricing dimensions, where each dimension is a separate continuum. They discovered that, although chains and stores may use EDLP and HiLo as positioning or signaling strategies, retailers actually practice five different pricing

Table 1. Pricing Strategies and Mean Scores on Dimensions (Clustering by Brand–Store)

Pricing dimensions Pricing strategy (% prevalent)	<i>Relative price</i>	<i>Price variation</i>	<i>Deal intensity</i>	<i>Deal support</i>
Exclusive pricing (8%)	High	Medium	Low	Low
Moderately promotional pricing (14%)	Average	Medium	Medium	Medium
HiLo pricing (11%)	Average	High	High	High
EDLP (45%)	Average	Low	Medium	Medium
Aggressive pricing (22%)	Low	High	Low	Medium

(Source: Bolton and Shankar 2003, “An Empirically Derived Taxonomy of Retailer Pricing Strategy,” *Journal of Retailing*)

strategies at the brand-store level: exclusive, moderately Promotional, HiLo, EDLP, and aggressive pricing strategies. Table 1, which is adapted from Bolton and Shankar (2003), shows a description of each strategy as a combination of the four underlying pricing dimensions. It also shows the distribution of brand–store combinations across the five clusters on each of the pricing dimensions. Each of the brand–store combinations was classified as high, medium (average), or low on each of the four pricing dimensions, according to their median scores.

HiLo and EDLP Strategies are Practiced at Brand–Store Level, and Not at Chain Level. Pricing strategies that are roughly equivalent to HiLo pricing and EDLP pricing are used by about half (56%) the brand–store combinations in our database. A HiLo pricing strategy (11%) is characterized by average relative price, high price variation, high deal intensity, and high deal support. This strategy is comparable to a storewide HiLo pricing strategy, albeit at the brand–store level, with a combination of dimensions and levels that seems intended to make a retailer competitive with its rivals through promotions. An EDLP pricing strategy (45%) consists of average relative price, low price variation, moderate deal intensity, and moderate deal support. This strategy is comparable to a storewide EDLP strategy, albeit at brand–store level. This combination of dimensions seems to be intended to offer value to customers.

An Aggressive Pricing Strategy is Commonly Adopted. Aggressive pricing is not reported in the business press, but it is utilized by nearly one fourth (22%) of all brand–store combinations. It entails offering low prices and medium deal support, accompanied by high price variation and low-medium deal intensity. In other words, price, rather than deals (i.e., features or displays), is the key weapon used for competing. This previously unknown strategy can explain apparently “incon-

sistent” behavior observed in the market place, such as when a chain that claims to practice an EDLP strategy offers less stable prices (for some categories) than a chain that is considered to practice a HiLo strategy for brands in the same category. Chains that are positioned as EDLP chains may appear (superficially) inconsistent for some brands and categories, but the retailers have simply tailored their overall strategy to recognize differences in consumer demand and competition within and across categories.

EDLP pricing and aggressive pricing are the most commonly adopted pricing strategies at a brand–store level. This finding reflects the competitive nature of the retailing landscape.

Moderately Promotional and Exclusive Pricing Strategies are Practiced. Moderately promotional pricing—corresponding to an undifferentiated strategy—is also fairly common (14%). In contrast, exclusive pricing is the strategy least often adopted (8%). Since it is characterized by low deal intensity, low deal support, and a high brand premium, this strategy can only be profitable for a small number of brands. It may be appropriate only for brands with high brand equity and manufacturer advertising.

How Retailers Should Approach Pricing

Retailers require new pricing practices to create and sustain a competitive advantage in the marketplace. Having studied successful retailers’ pricing practices, Bolton, Shankar, and Montoya (2005) claim that a new approach has emerged, which they call “customized pricing.” This approach requires retailers to build a coherent strategy for its products based on its strategic position in the marketplace, just as a house is built by following an architectural plan that has been customized to a particular geographic site (see Figure 2 from Bolton, Shankar, and Montoya, 2005). The rest of this section is a reproduction and adaptation of their work.

Successful retailers have developed many different pricing practices that are neither chain nor store wide, such as EDLP and HiLo (See Table 2). Instead, their strategies are customized to take account of additional factors, such as competitive activity, brand strength, and category storability. The implementation of customized pricing is based on the following steps: (1) Understanding key drivers of store pricing; (2) Segmenting market by store format and channel; (3) Neutralizing price as a competitive weapon; (4) Managing promotion intensity to avoid head-to-head competition; (5) Creating distinctive categories; and (6) Tailoring prices by market, category, customer, competitor, and brand.

Understanding the Key Drivers of Retail Pricing. The first step is to identify the key determinants of pricing relevant to a particular retailer. These determinants can be classified under several broad classes of factors: market, chain, store, category, manufacturer/brand, customer, and competitive retailer. Under each factor, a number of variables could potentially influence retailer pricing. For example, among chain

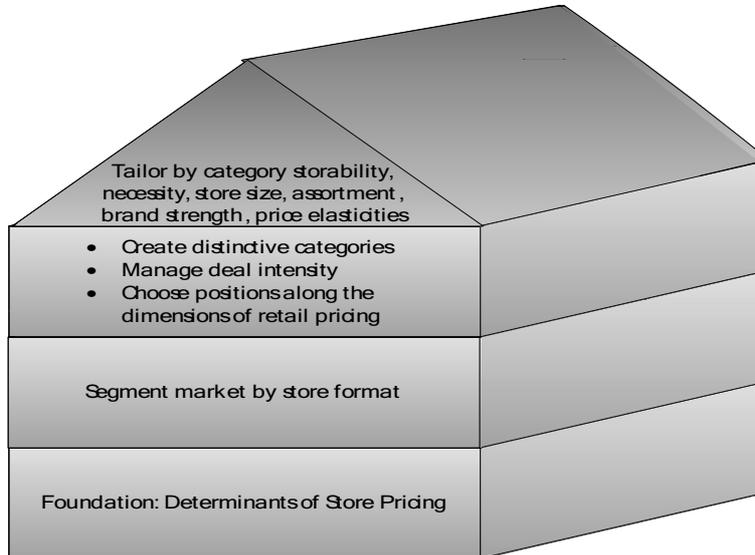


Figure 2. The Architecture of Retail Pricing

(Bolton, Shankar, and Montoya "Building a Profitable Retailer Pricing Strategy – From the Ground-Up," Working Paper, 2005)

Table 2. Customized vs. Conventional Retailer Pricing

	Conventional Retailer Pricing	Customized Retailer Pricing
Types	•EDLP, and HiLo pricing	•Includes Exclusive, Moderately promotional, Aggressive pricing in addition to EDLP and HiLo
Key Determinants	•Market price sensitivity •Costs	•Competitor prices, deals •Brand strength •Category storability •Customer price sensitivity •Store size and assortment.....
Key Steps	•Determine category role •Price destination categories low •Decide on discounts for each category, brand	•Identify key determinants of pricing in the market •Segment market by store format •Choose strategies along four key dimensions •Manage deal intensity •Create distinctive categories •Tailor by brand.....
Advantages/Limitations	•Spend most time in deciding and executing promotions •Unprofitable when competitors discount	•Based on a balanced set of factors •Not overly dependent on discounts
Focus	•Discounts, promotions and final prices on myriads of brands every week	•Overall store profitability •A coherent pricing policy •Non-price attributes
Time Horizon	•Short and Medium-term •Tactical orientation	•Long-term •Strategic orientation

(Source: Bolton, Shankar, and Montoya, 2005, "Building a Profitable Retailer Pricing Strategy – From the Ground-Up," Working Paper)

factors, chain positioning and chain size could be important determinants for a retailer. Similarly, among competitor factors, the deal frequency and price level of competitive retailers in the same channel, those of retailers from other channels in the geographic neighborhood could be driving retailer prices for a retailer. A retailer could use point-of-sale store level scanner data over the past several weeks to determine the key factors that drive prices at its store and other stores.

Segmenting by Store Format and Store Cluster. After competitor factors, category and chain factors are the factors that most influence retailer pricing strategy. A retailer tends to coordinate price and promotion when the store is located in metropolitan cities (as opposed to smaller cities), and when it is part of a large chain or a chain that is positioned as having a HiLo strategy. Price promotion coordination is greater for brands in large stores and with large category assortments. Price promotion coordination is likely to yield greater benefits in such situations due to the large scale of retail operations. These observations suggest that a successful retailer segments its stores by format (e.g., Kroger, Dillon, Fry's and Ralph's are four store formats operated by the same retailer) and by store cluster (e.g., upscale, ethnic). Variable pricing can then be applied to each format and cluster by varying markups on items and/or categories to attract targeted customers to their stores. At the same time, retailers should take into account chain size and store size. Larger chains and stores have scale economies and cost efficiencies that enable them to price and promote more aggressively.

Positioning along Key Pricing Dimensions and Neutralizing Price as a Competitive Issue. Retail competition comes from multiple channels (supermarkets, mass-market stores, club stores, convenience stores, online stores, etc.), and it has a pervasive influence on retailers' pricing decisions. However, although competition has a dominant influence, retailer pricing decisions are also influenced by category characteristics (e.g., storability and necessity), chain positioning and size, store size and assortment, brand preference and advertising, and customer factors (e.g., price sensitivity). When these factors come into play, retailers have some pricing latitude—and they should exploit them by positioning along these factors! The key to neutralizing price is to set competitive price points on “known value items” (that have high household penetration, large annual purchases, and high purchase frequency) and feature or display them. On other items, it may be possible to obtain a small (say, 5–9%) percent premium over mass-market prices and still maintain share.

Managing the Intensity of Promotions to Avoid Head-to-head Competition. The intensity of retailer promotions and the extent of price–promotion coordination depends on market type, chain size, chain positioning, store size, category assortment, storability, necessity, brand preference, relative brand advertising own deal elasticity, cross-price elasticity, and cross-deal elasticity. Retailer pricing and promotion strategies were found to be less closely coordinated for storable categories and more so for necessity categories. In contrast, price promotion coordination is also higher when consumers are less own-price and own-deal inelastic yet still willing to switch.

Retailers need not match competitors' price and deal decisions if a product is not a known-value item. Instead, they should look for categories and brands that present opportunities to build store traffic and loyalty, etc. For example, retailers seem to use higher price-promotion intensity and coordination for necessity categories, for brands with high preferences, and in markets where consumers are not price sensitive, but can still be enticed to switch. Trade promotion management software may help monitor promotion effectiveness (Kontzer 2004).

Creating Distinctive Categories. Retailers must differentiate their categories from those of competing retailers through distinctive product assortments. A large category assortment is associated with price inconsistency and less intensive promotion, but high levels of coordination of price with promotions and low relative prices. Retailers targeting price sensitive shoppers typically carry a greater assortment of brands in a given category and promotional elasticities are lower for categories with more brands, so that a retailer with a large assortment can more effectively utilize its resources by reducing promotions while, however, closely coordinating price and promotion activities. Highly storable and necessary categories such as bathroom tissue have high price-promotion intensity. Thus, they can serve as a "traffic builders," which tend to be promoted more intensely. In contrast, perishable categories such as ketchup and spaghetti sauce may require a more consistent pricing strategy to ensure steady rotation of the inventory. Household necessities have lower price consistency and higher price-promotion intensity than do nonessential categories.

Tailoring Prices to Customers, Brands, and Stores. Retailers charge lower prices when consumers are more own-price elastic and less own-deal elastic. This observation may explain why pricing decisions differ across stores in the same chain—individual outlets may have different clienteles. Which brands should be promoted together (see chapter by Gedenk, Neslin, Ailawadi I this book for more information on this issue)? Which brands does your clientele respond to? Prices are typically lower when brand preference and relative brand advertising are lower, and when chains position themselves as EDLP rather than HiLo stores. At the same time, retailers seem to be flexible. For example, they may choose to be less price consistent for brands in discretionary (nonstorable, nonessential) categories, where it is possible for price changes to stimulate increases in primary demand (rather than simply stockpiling).

Pricing Strategies in the Future

In the preceding section, we described how current pricing practices seem to reflect a fundamental change in retailers' approach to pricing, namely the emergence of customized pricing. We believe that customized pricing will be increasingly adopted by retailers in the coming years. However, we also predict that customized pricing will become increasingly profitable, owing to the following four trends.

Evolution Away From Traditional Trade Allowances. Both manufacturers and retailers realize the undesirability of current trade allowance practices. Retailers are interested in shifting away from trade deals and toward dead net costs, so that they can assess the effectiveness of price and promotions. However, this shift will not lead to wide-scale adoption of EDLP pricing practices. Instead, pricing strategies that reflect different competitive positions—accompanied by unique differential advantages—are likely to emerge in the marketplace. Retailers will develop a better understanding of their unique features (scale, product assortment, service, and so forth) for which customers are willing to pay and will alter their pricing practices accordingly. The conversion to dead net cost, which is required to implement more sophisticated pricing practices, may not be easy for traditional retailers. However, software systems offered by outside suppliers may be particularly useful during the transition period.

Increased Adoption of Pricing Customized to Local Market Conditions. Retailer pricing software tends to ignore the pricing activities of competing retailers and clientele characteristics. We predict that retailers will eventually adopt customized or variable pricing—albeit relying on sophisticated pricing software, rather than intuition and pricing heuristics—to respond to market conditions. We predict that future pricing practices will reflect a better balance between the cost efficiencies obtained over the past decade and the revenue benefits that can be derived from increased flexibility to respond to local market conditions.

Greater Pricing Flexibility. In the future, retailers will be less price consistent for brands in discretionary (nonstorable, nonessential) categories in which it is possible for price changes to stimulate increases in primary demand (rather than simply encourage stockpiling). We expect that, as pricing software allows more sophisticated strategies, retailers will exhibit increasing flexibility across brands, categories and stores, as well as over time. The use of electronic shelf labels (ESL) is sometimes offered as an example of how retailers are trying to improve customer service. However, they also enable retailers to change prices on any item at anytime based on the time of day, week, season, competition, or even current weather conditions. Although the implementation of ESL has been slow, based on costs, electronic labels may be a glimpse into the future of the execution of in-store pricing.

More Multichannel Price Consistency. Retailers are interested in optimizing prices on each item across channels: Internet, bricks-and-mortar stores, and catalogs (or direct mail). A few studies have examined retailer pricing practices across multiple channels (e.g., Ancarani and Shankar 2004; Pan, Ratchford, and Shankar 2005). They indicate that there are ample opportunities for retailers to differentiate themselves from one another and compete on nonprice attributes. Hence, despite price dispersion across retailers within a channel and across channels, we believe that the same retailer will price consistently across its different channels.

Summary

The retail landscape is being significantly altered by retail consolidations, changes in manufacturers' practices, advances in technology, and the emergence of e-tailing. In this new retailing environment, there is a renewed emphasis on profitable pricing strategies. We have described the effects of these trends on retailer pricing and analyzed successful pricing strategies, which point to the increasing use of customized pricing practice. A customized retailer pricing strategy based on a six-step pricing architecture might be useful for retailers. In the future, we anticipate a movement away from heavy trade allowances, increased customization to local conditions, greater pricing flexibility, and more multi-channel consistency of retailer pricing.

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