10. Pricing Strategy

One of the four major elements of the marketing mix is price. Pricing is an important strategic issue because it is related to product positioning. Furthermore, pricing affects other marketing mix elements such as product features, channel decisions, and promotion.

While there is no single recipe to determine pricing, the following is a general sequence of steps that might be followed for developing the pricing of a new product:

1. **Develop marketing strategy** - perform marketing analysis, segmentation, targeting, and positioning.
2. **Make marketing mix decisions** - define the product, distribution, and promotional tactics.
3. **Estimate the demand curve** - understand how quantity demanded varies with price.
4. **Calculate cost** - include fixed and variable costs associated with the product.
5. **Understand environmental factors** - evaluate likely competitor actions, understand legal constraints, etc.
6. **Set pricing objectives** - for example, profit maximization, revenue maximization, or price stabilization (status quo).
7. **Determine pricing** - using information collected in the above steps, select a pricing method, develop the pricing structure, and define discounts.

These steps are interrelated and are not necessarily performed in the above order. Nonetheless, the above list serves to present a starting framework.

Marketing Strategy and the Marketing Mix

Before the product is developed, the marketing strategy is formulated, including target market selection and product positioning. There usually is a tradeoff between product quality and price, so price is an important variable in positioning.

Because of inherent tradeoffs between marketing mix elements, pricing will depend on other product, distribution, and promotion decisions.

Estimate the Demand Curve

Because there is a relationship between price and quantity demanded, it is important to understand the impact of pricing on sales by estimating the demand curve for the product.

For existing products, experiments can be performed at prices above and below the current price in order to determine the price elasticity of demand. Inelastic demand indicates that price increases might be feasible.

Calculate Costs

If the firm has decided to launch the product, there likely is at least a basic understanding of the costs involved, otherwise, there might be no profit to be made. The unit cost of the product sets the lower limit of what the firm might charge, and determines the profit margin at higher prices.

The total unit cost of a producing a product is composed of the variable cost of producing each additional unit and fixed costs that are incurred regardless of the quantity produced. The pricing policy should consider both types of costs.

Environmental Factors

Pricing must take into account the competitive and legal environment in which the company operates. From a competitive standpoint, the firm must consider the implications of its pricing on the pricing decisions of competitors. For example, setting the price too low may risk a price war that may not be in the best interest of either side. Setting the price too high may attract a large number of competitors who want to share in the profits.

From a legal standpoint, a firm is not free to price its products at any level it chooses. For example, there may be price controls that prohibit pricing a product too high. Pricing it too low may be considered predatory pricing or "dumping" in the case of international trade. Offering a different price for different consumers may violate laws against price discrimination. Finally, collusion with competitors to fix prices at an agreed level is illegal in many countries.

Pricing Objectives

The firm's pricing objectives must be identified in order to determine the optimal pricing. Common objectives include the following:

- **Current profit maximization** - seeks to maximize current profit, taking into account revenue and costs. Current profit maximization may not be the best objective if it results in lower long-term profits.
- **Current revenue maximization** - seeks to maximize current revenue with no regard to profit margins. The underlying objective often is to maximize long-term profits by increasing market share and lowering costs.
- **Maximize quantity** - seeks to maximize the number of units sold or the number of customers served in order to decrease long-term costs as predicted by the experience curve.
- **Maximize profit margin** - attempts to maximize the unit profit margin, recognizing that quantities will be low.
- **Quality leadership** - use price to signal high quality in an attempt to position the product as the quality leader.

- **Partial cost recovery** - an organization that has other revenue sources may seek only partial cost recovery.
- **Survival** - in situations such as market decline and overcapacity, the goal may be to select a price that will cover costs and permit the firm to remain in the market. In this case, survival may take a priority over profits, so this objective is considered temporary.
- **Status quo** - the firm may seek price stabilization in order to avoid price wars and maintain a moderate but stable level of profit.

For new products, the pricing objective often is either to maximize profit margin or to maximize quantity (market share). To meet these objectives, skim pricing and penetration pricing strategies often are employed. Joel Dean discussed these pricing policies in his classic HBR article entitled, *Pricing Policies for New Products*.

Skim pricing attempts to "skim the cream" off the top of the market by setting a high price and selling to those customers who are less price sensitive. Skimming is a strategy used to pursue the objective of profit margin maximization.

Skimming is most appropriate when:

- Demand is expected to be relatively inelastic; that is, the customers are not highly price sensitive.
- Large cost savings are not expected at high volumes, or it is difficult to predict the cost savings that would be achieved at high volume.
- The company does not have the resources to finance the large capital expenditures necessary for high volume production with initially low profit margins.

Penetration pricing pursues the objective of quantity maximization by means of a low price. It is most appropriate when:

- Demand is expected to be highly elastic; that is, customers are price sensitive and the quantity demanded will increase significantly as price declines.
- Large decreases in cost are expected as cumulative volume increases.
- The product is of the nature of something that can gain mass appeal fairly quickly.
- There is a threat of impending competition.

As the product lifecycle progresses, there likely will be changes in the demand curve and costs. As such, the pricing policy should be reevaluated over time.

The pricing objective depends on many factors including production cost, existence of economies of scale, barriers to entry, product differentiation, rate of product diffusion, the firm's resources, and the product's anticipated price elasticity of demand.

Pricing Methods

To set the specific price level that achieves their pricing objectives, managers may make use of several pricing methods. These methods include:

- **Cost-plus pricing** - set the price at the production cost plus a certain profit margin.
- **Target return pricing** - set the price to achieve a target return-on-investment.
- **Value-based pricing** - base the price on the effective value to the customer relative to alternative products.
- **Psychological pricing** - base the price on factors such as signals of product quality, popular price points, and what the consumer perceives to be fair.

In addition to setting the price level, managers have the opportunity to design innovative pricing models that better meet the needs of both the firm and its customers. For example, software traditionally was purchased as a product in which customers made a one-time payment and then owned a perpetual license to the software. Many software suppliers have changed their pricing to a subscription model in which the customer subscribes for a set period of time, such as one year. Afterwards, the subscription must be renewed or the software no longer will function. This model offers stability to both the supplier and the customer since it reduces the large swings in software investment cycles.

Price Discounts

The normally quoted price to end users is known as the *list price*. This price usually is discounted for distribution channel members and some end users. There are several types of discounts, as outlined below.

- **Quantity discount** - offered to customers who purchase in large quantities.
- **Cumulative quantity discount** - a discount that increases as the cumulative quantity increases. Cumulative discounts may be offered to resellers who purchase large quantities over time but who do not wish to place large individual orders.
- **Seasonal discount** - based on the time that the purchase is made and designed to reduce seasonal variation in sales. For example, the travel industry offers much lower off-season rates. Such discounts do not have to be based on time of the year; they also can be based on day of the week or time of the day, such as pricing offered by long distance and wireless service providers.
- **Cash discount** - extended to customers who pay their bill before a specified date.
- **Trade discount** - a functional discount offered to channel members for performing their roles. For example, a trade discount may be offered to a small retailer who may not purchase in quantity but nonetheless performs the important retail function.
- **Promotional discount** - a short-term discounted price offered to stimulate sales.