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C.23 Pricing Objectives

CHARACTERISTICS OF THE PRICING PROGRAM

Pricing is a far more complex variable than it may appear on the surface. Setting a price for a product requires making a series of interrelated decisions that, taken together, form a pricing program. This section provides perspective on the elements that make up the pricing program and the process for developing it.

Pricing as an Element in the Marketing Mix. Pricing is one of the major variables in the **marketing mix.** Determining product price and making other related pricing decisions are part of the **marketing planning process** and are recorded within the marketing plan in the pricing program section of the marketing mix. (See Chapter 4 on the **marketing planning process.**)

Like the other elements of the marketing mix, pricing decisions take central direction from the product's **positioning** (see GLOSSARY entry B.1). The positioning decision defines how the product is to relate to consumers and to competitive products. Price is one of the ways in which the desired relationship to competitive products and the desired consumer perception is established. The price selected must be supportive of the desired positioning of the product.

Price decisions also interrelate with other elements of the marketing mix.

- *Price and Product.* If the product is differentiated and has a competitive advantage, it will have a less elastic demand curve and a favorable price differential over competition can be sustained. (See GLOSSARY entry A.14 on **price elasticity.**) Products that are unique, especially if they are protected, such as by patents, also command higher prices. Higher prices are also consistent in consumers' eyes with higher quality products. Higher product quality and product differentiation may also lead to higher product costs that will create pressure for higher prices. (See GLOSSARY entry C.25 on **product design.**)
- *Price and Promotion.* High levels of promotion are often found with higher prices, although which is cause and which is effect is not clear. If promotion effectively establishes a product's advantages with the target market, higher prices can be sustained. At the same time, higher prices are necessary in order to generate margins capable of supporting higher promotional budgets. (See GLOSSARY entry C.1 on **advertising budget formulation.**)
- *Price and Distribution.* Pricing decisions must be responsive to the needs of channel members. Products that are not competitively priced or that do not offer advantageous discounts may not receive channel member cooperation (see GLOSSARY entry C.6). Control over prices to end users is affected by the choice of distribution channel. Direct distribution and distribution through vertical marketing systems increase manufacturer control over pricing. However, higher prices may be necessary to offset economic disadvantages of these distribution approaches. (See GLOSSARY entry C.10 on **direct versus indirect distribution** and GLOSSARY entry C.7 on **channel organization.**)

Decision Elements in the Price Setting Process. Developing the pricing program requires that a series of related pricing decisions be made. The process for making these decisions and the relationships among them is depicted in Figure C.23–1. Developing the pricing program occurs as part of the marketing mix, after the situation analysis has been completed and the positioning determined. Before pricing decisions are made, pricing objectives are set and the determinants of price analyzed. These two elements provide the data and direction for the pricing decisions that follow.

The components that make up the pricing process are described briefly below. Each

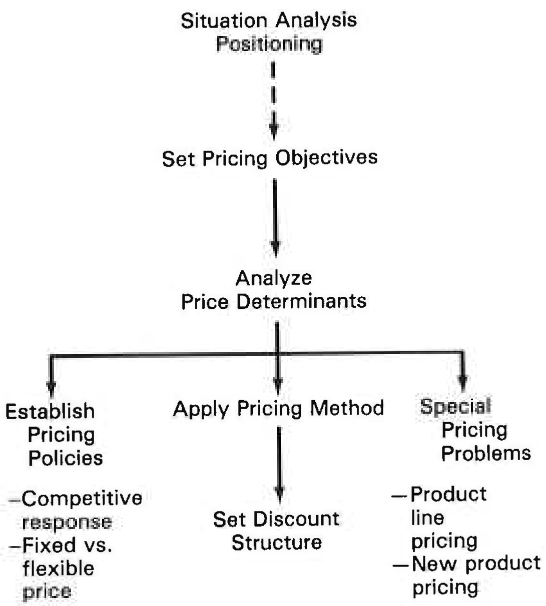

FIGURE C.23-1

Decision Elements in the Price Setting Process

one is further described as a separate GLOSSARY entry.

- *Pricing Objectives.* Pricing objectives define what the marketer hopes to accomplish with the price that is set for a product. The objectives provide direction to the detailed pricing decisions that follow. Pricing objectives are mainly concerned with the relationship of the product and its price to competitors. Alternative pricing objectives and criteria for their selection are considered in the next section of this GLOSSARY entry.
- *Price Determinants.* In the highly abstract world of economic price theory, price is determined by two variables, cost and demand. In practice, however, many more factors must be considered in setting price. Information on these price determinants must be gathered and analyzed before product prices can be set. This subject is considered in GLOSSARY entry C.21 on **price determinants.**
- *Pricing Method.* Pricing objectives are used together with information on the pricing determinants to determine the price for the product or service. A pricing method must be selected that incorporates the objectives and the major determinants, and that method is then applied to determine the price. GLOSSARY entry C.22 presents pricing **methods.**
- *Discount Structure.* The product price that is set may be the selling price to the next channel member, although it is more likely the desired retail price or price to the end user. This is termed **list price.** In either case, if the product is sold through intermediaries, the discounts and allowances from list price to be provided as incentives to the intermediaries must be determined. This decision is considered in GLOSSARY entry C.11 on **discount structure determination.**
- *Pricing Policies.* Pricing policies need to be established so that recurring pricing problems can be dealt with quickly by subordinates and representatives in the field. Two areas in which price policies need to be established are whether the firm will adhere to a fixed price schedule or a flexible one. This policy is considered in GLOSSARY entry C.13 on **fixed versus flexible pricing.** A price policy is also needed in determining how the firm will respond to competitive price changes. This policy is considered in GLOSSARY entry C.32, **response to competitive price changes.**
- *Special Pricing Problems.* Some products represent special pricing problems, calling for somewhat different methods of pricing. One of these special problems, pricing products that are part of a product line, is considered in GLOSSARY entry C.28. Another special problem is the pricing of new products, considered in GLOSSARY entry C.19.

DETERMINING PRICING OBJECTIVES

The first step in setting product price is to establish pricing objectives for that product. Alternative pricing objectives and criteria for selection of a pricing objective are considered below.

Alternative Pricing Objectives. Pricing objectives define what the firm hopes to accomplish through price in its marketing strategy. Pricing objectives should flow from the problems and opportunities defined in the situation analysis and from the positioning of the product.

Although each firm and each product will have unique requirements, researchers and writers have presented various lists of pricing objectives that are widely used. These examples may clarify the nature of pricing objectives.[1]

- *Skimming Objective.* the objective can be to set price at a level above the going market price. This is sometimes termed **skimming the market** and is usually used by new or unique products. It serves to maximize short-run profits by selling to those customers with highly inelastic demand for the product. After this group has purchased, price may be lowered to capture the next level of demand. (See GLOSSARY entry C.19 on **new product pricing.**)

  A policy of permanently pricing above the market may also be effective for products with distinctive and high quality characteristics positioned at the quality end of the market or that offer specialty features tailored to a segment of the market.
- *Penetration Objective.* When price is set below the competitive market level with the objective of gaining market share, it is termed **penetration pricing.** If the lower price does not result in competitive retaliation and if demand is elastic, the result should be growth in market share. Many marketers believe that long-term profits will be higher if dominant market share can be achieved. PIMS research supports the idea that high market share results in greater long-term profit (see GLOSSARY entry A.19).

  Pricing below the market may also be used when the objective is to discourage new entrants into the market by making it appear unattractive. Pricing below the market may also serve to drive out marginal producers whose cost structure will not permit the lower prices.
- *Stability Objective.* Price is set at the going market price when the objective is to preserve price stability in the market. Especially in oligopoly markets, pricing below the market is likely to draw retaliation from competitors and can result in price wars. To avoid this, products are priced at the market and competitive activity is focused on product improvement, distribution efforts, and promotional programs.

  Oligopoly markets give rise to price leaders and price followers. A **price leader** attempts to establish changes in the going market price. Changes are confirmed if the followers match the price changes of price leaders. Pricing objectives can be set in terms of being a price leader or a price follower.
- *Experience Curve Objective.* A special case of penetration pricing is to price in anticipation of gaining cost economies through the experience curve. The **experience curve** concept suggests that for some products, costs decline as output increases (see GLOSSARY entry A.19). If a product is thought to have strong experience curve benefits, prices can be cut to gain volume, costs will then drop, making the lower prices affordable and preempting competition from the market.
- *Target Profit Objective.* In his research, Lanzillotti found the most widely used pricing objective to be a target return on investment.[2] Setting a target profit or a target return on investment as a pricing objective leads to cost-oriented pricing. Volume must be projected and costs at that volume determined. A "satisfactory" return is added to expected costs to determine the price. Such an objective can only be realized in markets that are relatively protected from competitive disruption and by firms that have strong market leadership.
- *Market Share Objective.* Some firms set a pricing objective in terms of share of market desired. If the objective is to increase market share, this objective is the same as the penetration objective. However, for some products, such as those designated as "cash cows" by the market strategy for the business, the objective may be to stabilize share and price for maximum cash flow (see GLOSSARY A.19, 20). In the past, some companies that were dominant in a market set staying below market share maximums as a pricing objective, perhaps because of fear of government intervention. Such situations are rare today.
- *Low Price Positioning Objective.* Some products are positioned as offering the competitive ad-

[1]Three sources from which these examples of pricing objectives were drawn are Robert F. Lanzillotti, "Pricing Objectives in Large Companies," *American Economic Review* 48 (December 1958), pp. 921–40; Alfred R. Oxenfeldt, "A Decision-Making Structure for Price Decisions," *Journal of Marketing* 37 (January 1973), pp. 48–53; and Gerald Albaum, "Objective and Strategy in Price Formulation," In *Modern Marketing Thought,* 3d ed., ed. J. Howard Westing and Gerald Albaum (New York: Macmillan Publishing Co., 1975), pp. 378–81.

[2]Lanzillotti, "Pricing Objectives in Large Companies."

vantage of lower price. In such cases, the pricing objective must clearly be to sell at less than the going market rate. This objective differs from penetration pricing in that it is designed as a permanent means of competing, not as a temporary approach to gain market share. Positioning based on price is most likely to occur in mature markets where products have become homogeneous.

Criteria for Determining a Pricing Objective. Many factors must be considered in setting a pricing objective. Information on most of the determinants discussed below should be available as a result of the **marketing planning process.**

- *Target Market and Positioning.* The pricing objective should be consistent with the needs of the target market and with the positioning of the product. If the target market need is specialized and the product is tailored to it, an objective to price above the market would be consistent. The opposite would be true if the target market were motivated by economy needs (see GLOSSARY entry B.4).

  The **positioning** often gives direct pricing guidance. An above-the-market pricing objective would be consistent with a product positioned as offering superior quality. A product positioned as having the competitive advantage of lower price would obviously call for a below-the-market pricing objective (See GLOSSARY entry B.1).
- *Competitive Market Structure.* Products competing in markets that approach pure competition need no pricing objective because they have no choice but to accept the market price. When products become differentiated, as in monopolistic competition, then a price policy becomes necessary. The latitude in that policy depends upon the degree of differentiation in the product. In oligopolistic markets, the dominant market structure, the pricing objective must recognize the danger and the likelihood of competitive retaliation toward prices that deviate from market rates. Thus price stability objectives becomes more widely used. In monopoly, the pricing objective may recognize the need to limit market share in order to reduce or forestall regulation (see GLOSSARY entry A.1).
- *Market Position.* A product's market position or share of market should be considered in setting the pricing objective. Only a market leader can consistently exercise price leadership. Low market share firms are more likely to be price followers. In an oligopoly, small firms can sometimes deviate from market prices without attracting retaliation because they have little impact on the market.

  Experience curve pricing requires large, well financed firms that can risk investing in large, efficient facilities in anticipation of demand. Target-profit pricing objectives, likewise, are most feasible for firms with large and stable market shares.
- *Product Line.* The pricing objective set for a product needs to be consistent with those set for other products sold by the same firm. This is particularly important if the products share a common brand name and if the target markets are the same. Product line pricing is further considered in GLOSSARY entry C.28.
- *Demand Elasticity and Product Differentiation.* An objective of pricing above the market is feasible only when a product is differentiated and its demand curve exhibits some inelasticity. If product differentiation is protected by patents, process secrets, or in other ways, a skimming or a permanently above-the-market pricing objective is more likely to be met. When products become homogeneous and demand curves more elastic, a below-the-market pricing strategy is more likely to be successful.
- *Market Strategy of the Business.* The strategic market plan of the business defines the roles that individual products are to play in the portfolio of products. The pricing objective must be consistent with the strategic role assigned to the product (see GLOSSARY entry A.20). For example, for a product classified as a "star" and expected to generate sales growth for the business, a penetration pricing objective might be appropriate. For a product classified as a "cash cow" and expected to generate cash flow, a pricing objective to maintain or even sacrifice share to maximize return would be indicated.
- *Cost Structure.* The level of cost, the division of cost between fixed and variable, and expected experience curve effects should all be considered in selecting a pricing objective. All below-the-market pricing objectives are dependent on the ability to lower costs so that lower prices are affordable. If fixed product costs are high, growth-oriented pricing objectives are appropriate. The leverage created by high fixed costs will result in high profits if sales can be increased. The presence of experience

curve cost reductions also suggests objectives focused on sales and share growth. Positioning as the low-priced market entry and a permanent under-the-market pricing objective depend, of course, on a better cost structure than that of competitive products.

SUGGESTIONS FOR FURTHER READING

ALBAUM, GERALD. "Objective and Strategy in Price Formulation." In *Modern Marketing Thought,* 3d ed., ed. J. Howard Westing and Gerald Albaum. New York: Macmillan Publishing Co., 1975, pp. 378–81.

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