

# DEFINING ASPECTS OF SETTING THE PRICE ACCORDING TO THE CUSTOMER AND THE COMPETITION

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## *Abstract:*

*Few managers, even those specializing in marketing, think strategically about pricing. Consider your experiences and observations. Were the pricing decisions you encountered made in reaction to a pricing problem, or were they planned to exploit an opportunity? Did the company arrive at those decisions by analyzing only the immediate impact on profitability, or did it also consider how the reactions of customers or competitors might change the picture? Did the decisions focus purely on price, or did they involve alignment of a marketing program to support the pricing decision? Few companies proactively manage their business to create the conditions that foster more profitable pricing.*

## **Introduction**

Few managers, even those specializing in marketing, think strategically about pricing. Few companies proactively manage their business to create the conditions that foster more profitable pricing.

The difference between price setting and strategic pricing is the difference between reacting to market conditions and proactively managing them. It is the reason why companies with similar market shares and technologies often earn such different rewards for their efforts. Strategic pricing is the coordination of interrelated marketing, competitive, and financial decisions to set prices profitably. For most companies, strategic pricing requires more than a change in attitude; it requires a change in when, how, and who makes pricing decisions. For example, strategic pricing requires anticipating price levels before beginning product development.

The only way to ensure profitable pricing is to reject early those ideas for which adequate value cannot be captured to justify the cost. Strategic pricing also requires that management take responsibility for establishing a

coherent set of pricing policies and procedures, consistent with its strategic goals for the company. Abdicating responsibility for pricing to the sales force or to the distribution channel is abdicating responsibility for the strategic direction of the business.

Perhaps most important, strategic pricing requires a new relationship between marketing and finance. Strategic pricing is actually the interface between marketing and finance. It involves finding a balance between the customer's desire to obtain good value and the firm's need to cover costs and earn profits. Unfortunately, pricing at most companies is characterized more by conflict than by balance between these objectives. If pricing is to reflect value to the customer, specific prices must be set by those best able to anticipate that value—presumably marketing and sales managers. But their efforts will not generate sustainable profits unless constrained by appropriate financial objectives. Rather than attempting to "cover costs," finance must learn how costs change with changes in sales and must use that knowledge to develop appropriate

incentives and constraints for marketing and sales to achieve their objectives profitably. With their respective roles appropriately defined, marketing and finance can work together toward a common goal—to achieve profitability through strategic pricing. Before marketing and finance can attain this goal, however, they must discard the flawed thinking about pricing that leads them into conflict and that drives them to make unprofitable decisions.

### **Customer – Driven Pricing**

Most companies now recognize the fallacy of cost-based pricing and its adverse effect on profit. They realize the need for pricing to reflect market conditions. As a result, many have taken pricing authority away from financial managers and given it to sales or product managers. In theory, this trend is clearly consistent with value-based pricing, since marketing and sales are that part of the organization best positioned to understand value to the customer. In practice, however, the misuse of pricing to achieve short-term sales objectives of ten undermines perceived value and depresses profits even further.

The purpose of value-based pricing is not simply to create satisfied customers. Customer satisfaction can usually be bought by discounting sufficiently, but marketers delude themselves if they believe that the resulting sales represent marketing successes. The purpose of value-based pricing is to price more profitably by capturing more value, not necessarily by making more sales. When marketers confuse the first objective with the second, they fall into the trap of pricing at whatever buyers are willing to pay, rather than at what the product is really worth. Although that decision enables marketers to meet their sales objectives, it invariably undermines long-term profitability.

Two problems arise when prices reflect the amount buyers seem willing to

pay. First, sophisticated buyers are rarely honest about how much they are actually willing to pay for a product. Professional purchasing agents are adept at concealing the true value of a product to their organizations. Once buyers learn that sellers' prices are flexible, the former have a financial incentive to conceal information from, and even actively mislead, the latter. Obviously, this tactic undermines the salesperson's ability to establish close relationships with customers and to understand their needs.

Second, there is an even more fundamental problem with pricing to reflect customers' willingness to pay. The job of sales and marketing is not simply to process orders at whatever price customers are currently willing to pay but rather to raise customers' willingness to pay a price that better reflects the product's true value. Many companies under price truly innovative products because they ask potential customers, who are ignorant of the product's value, what they would be willing to pay. But we know from studies of innovations that the "regular" price has little impact on customers' willingness to try them.

### **Competition – Driven Pricing**

Lastly, consider the policy of letting pricing be dictated by competitive conditions. In this view, pricing is a tool to achieve sales objectives. In the minds of some managers, this method is "pricing strategically".

Why should an organization want to achieve market-share goals? Because more market share usually produces greater profit. Priorities are confused, however, when managers reduce the profitability of each sale simply to achieve the market-share goal. Prices should be lowered only when they are no longer justified by the value offered in comparison to the value offered by the competition.

Although price-cutting is probably the quickest, most effective way to achieve sales objectives, it is usually a

poor decision financially. Since a price cut can be so easily matched, it offers only a short-term competitive advantage at the expense of permanently lower margins. Consequently, unless a company has good reason to believe that its competitors cannot match a price cut, the long-term cost of using price as a competitive weapon usually exceeds any short-term benefit. Although product differentiation, advertising, and improved distribution do not increase sales as quickly as price cuts, their benefit is more sustainable and thus is usually more cost-effective.

The goal of pricing should be to find the combination of margin and market share that maximizes profitability over the long term. Often, the most profitable price is one that substantially restricts market share relative to the competition.

Although the fallacy of competition-driven pricing is most obvious for high-priced products, the principle can be applied more generally. Many companies that were recapitalized in the 1980s learned that they could substantially increase cash flow simply by scaling back their market-share objectives. One low-margin, industrial company increased price by 9 percent and suffered a 20 percent loss of market

share—proof, some might argue, that its market was price sensitive. On the other hand, this company retained four out of five sales. Apparently, most customers valued the product by at least 9 percent more than they had been paying! The company had been prevented from capturing that value by its market-share goal. Although some capacity was idled, the company's contribution to profit increased by more than 70 percent.

### **Conclusion**

Strategic pricing imposes financial discipline—an optimizing constraint—on marketing and sales decisions. It says that a firm should satisfy customers, but only up to the point where the incremental increase in value created exceeds the incremental increase in the product's cost. It dictates that a firm should satisfy customers when doing so is consistent with its competitive position and complements its core competencies. Without this discipline, top-line revenue is pursued indiscriminately, without constraints regarding which customers to serve and how to serve them. Indeed, sales and customer satisfaction achieved by giving ever more while asking ever less in return is, more often than not, a recipe for financial mediocrity.

## **REFERENCES**

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