STRATEGIC PRICING ROLE IN SETTLING THE FIRM POSITION ON THE MARKET

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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 businesses to create the conditions that foster more profitable pricing.

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Introduction

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 of ten 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. Katfrer tftan attempiing to "cover costs,"fimance 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 profit ably.
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. Let's look at these flawed paradigms and destroy them once and for all.

1. The Cost-Plus Delusion

Cost-plus pricing is, historically, the most common pricing procedure because it carries an aura of financial prudence. Financial prudence, according to this view, is achieved by pricing every product or service to yield a fair return over all costs, fully and fairly allocated. In theory, it is a simple guide to profitability; in practice, it is a blueprint for mediocre financial performance.
The problem with cost-driven pricing is fundamental: In most industries it is impossible to determine a product's unit cost before determining its price. Why? Because unit costs change with volume. This cost change occurs because a significant portion of costs are "fixed" and must somehow be "allocated" to determine the full unit cost. Unfortunately, since these allocations depend on volume, which changes with changes in price, unit cost is a moving target.
To "solve" the problem of determining unit cost, cost-based pricers are forced to make the absurd assumption that they can set price without affecting volume. The failure to account for the effects of price on volume, and of vol-ume on costs, leads managers directly into pricing decisions that undermine profits. One particularly tragic example, for the company and its customers, was Wang Laboratory's experience in pricing the world's first word processor. Introduced in 1976, the product was an instant success, enabling Wang to grow rapidly and dominate the market. By the mid 1980s, however, personal computers with word-processing software were becoming credible competitors. As competition increased and growth slowed, the company's cost-driven pricing philosophy began

killing its market advantage. Unit costs were repeatedly recalculated and prices raised to reflect the rising overhead allocation. As a result, sales declined even further. Before long, even Wang's most loyal customers began making the switch to cheaper alternatives.

A price increase to "cover" higher fixed costs reduces sales further and causes unit cost to rise even higher. The result is often that price increases actually reduce profits. On the other hand, if a price cut causes sales to increase, fixed costs are spread over more units, making unit costs decline. The result is trften increased profit. Instead of pricing reactively to cover costs and profit objctives, managers need to price proactively. They need to acknowledge that pricing affects sales volume, and that volume affects costs.

The dangers of cost-based pricing are not limited to products facing increasing competition and declining volume. In fact, cost-based pricing is even more insidious when applied to strong products since there are no signals (such as declining market share) to warn of the potenţial damage. For example, an internaţional telecommunications company with many leading technologies uses cost-based pricing only as a "starting point" for pricing. Product and sales managers review the cost-based "target prices" for consistency with market conditions and then argue for adjustments to reflect market conditions. Everyone in the organization finds this system fair and reasonable.

But does the system foster profitability? During the three years this system has been in place, marketing has frequently requested and received permission to charge prices less than the cost-based "target" in order to reflect market conditions. Now, how many times during those three years do you think marketing argued that a target price should be raised to reflect market conditions? Never, despite the fact that the company often has large backlogs of orders on some of its most popular products. At this company, as at many others, cost-based target prices have become cost-based "caps" on profitability for the most valuable products.

Cost-plus pricing leads to overpricing in weak markets and underpricing in strong ones—exactly the opposite direction of a prudent strategy.The financial questions that should drive proactive pricing are "How much more sales volume must we achieve to earn additional profit from a lower price?" and "How much sales volume can we lose and still earn additional profit from a higher price?" The answers to these questions depend on how the cost of the product changes with volume. They do not depend on whether the current price of a product, at current volume, covers the cost and profit objectives.

How, then, should managers deal with the problem of pricing to cover costs and achieve profit objectives? They shouldn't. The question itself reflects an erroneous perception of the role of pricing, a perception based on the belief that one can first determine sales levels, then calculate unit cost and profit objectives, and then set a price. Once managers realize that sales volume (the beginning assumption) depends on the price (the end of the process), the flawed circularity of cost-based pricing is obvious. The only way to ensure profitable pricing is to let anticipated pricing determine the costs incurred rather than the other way around. Value-based pricing must begin before investments are made.

If cost-based prices prove unjustifiable, managers may try to fix the process by allowing "flexibility" in the markups. Although this tactic may minimize the damage, it is not fundamentally a solution since the financial return on the product remains inadequate. Finance blames marketing for cutting the price, and marketing blames finance for excessive costs. The problem keeps reoccurring as the features and costs of new products continue to mismatch the needs and values of customers. Moreover, when customers are rewarded with discounts for their price resistance, this resistance becomes more frequent even when the product has value to them. Solving the problems of cost-based pricing requires more than a quick fix. It requires completely reversing the process—starting with customers. The target price is based on estimates of value and the portion that the firm can expect to capture given the competitive alternaţives. The job of financial management is not to insist that prices recover costs. It is to insist that costs are incurred only to make products that can be priced profitably given their value to customers.

Designing products that can be sold profitably at a target price has gone in the past two decades from being unusual to being the goal at most successful companies.[2] From Marriott to Boeing, from medical technology to automobiles, profit-leading companies now think about what market segment they want a new product to serve, determine the benefits those potenţial customers seek, and establish a price those customers can be convinced to pay.Then companies challenge their engineers to develop products and services that can be produced at a cost low enough to make serving that market segment profitable. It wasn't always so. The first companies to adopt such a strategy in their industries gained huge strategic advantage. The laggards now have to learn value-based pricing for new products just to survive.

2. 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 often 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 underprice truly innovative products because they ask potențial 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. For example, most customers initially perceived that photocopiers, mainframe computers, and food processors lacked adequate value to justify their prices. Only after extensive marketing to communicate and guarantee value did these products achieve market acceptance. Forget what customers who have never used your product are initially willing to pay! Instead, understand the value of the product to satisfied customers and communicate that value to others. Low pricing is never a substitute for an adequate marketing and sales effort.

3. 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." Actually, it is more analogous to "letting the tail wag the dog." 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. Godiva chocolates, BMW cars, Peterbilt trucks, and Snapon tools would no doubt all gain substanțial market share if priced closer to the competition. It is doubtful, however, that the added share would be worth forgoing their profitable and successful positioning as high-priced brands.

Although the fallacy of competition-driven pricing is most obvious for high-priced products, the principie 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.

4. Asking the Right Questions

Strategic pricing involves recognizing that not all pricing problems involve changing price as the best solution. The reason why pricing is ineffective is frequently not that the pricers have done a poor job. It is that decisions were made about costs, customers, and competitive strategy without correctly thinking through their broader financial implications. Since the fallacy in those decisions is frequently not revealed until the product is launched and the pricing proves unprofitable, it is the pricer's job to work back from the price to understand the problem. Is the price unprofitable because there is a better price to charge, or because the value has been ineffectively communicated? Is the market share goal too high, or is the market inadequately segmented? Is the product and service offering overbuilt (and therefore too expensive) for the value it delivers, or has the seller simply enabled customers to avoid

paying for the value they get? The pricer's job is often less to set prices than to structure a pricing process that gets everyone to think about how best to address pricing problems. Recall the tactical questions about costs, customers, and competition that we argued often lead to poor pricing decisions. Whenever they come up, it is the pricer's job to reframe the discussions to consider over all financial profitability.

Conclusions

Progressive companies have begun doing more than just worrying about pricing. To increase profitability, many are abandoning tradiţional reactive pricing procedures in favor of proactive strategies. More than ever before, successful companies are building products and marketing strategies to support pricing objectives, rather than the other way around. In the past decade, tradiţional industry leaders in marketing and sales, such as Procter and Gamble and General Electric, made explicit corporate decisions to change their focus from growth in top-line sales to growth in profitability. In many industries, the current profit leader is a company with a very explicit pricing strategy supported by its product and promotional strategies. Southwest in airlines, Intel in semiconductors, Dell in computers, Wal-Mart in retailing, Quad in printing, Sony in consumer clectronics, and the *New York Times* in publishing have all adopted pricing models that drive which customers they will serve and how they will serve them.

It is not surprising that pricing has taken its place as a major element in marketing strategy in the last decade. After all, marketing itself has been in the midst of a revolution. The meaning of marketing has been transformed from „selling what the company produces” to „producing what the customer wants to buy”. Marketing has become the means by which firms identify unmet needs in the marketplace, develop products to satisfy those needs, promote them honestly, and follow with postpurchase support to ensure customer satisfaction. As selfess as all this may sound, though, the ultimate goal of marketing is not to convert the firm into a charitable organization for the sole benefit of consumers. The ultimate goal is profits for the stockholders, jobs for the employees, and growth for the organization

Perhaps it is reasonable that marketers have only recently begun to focus seriously on effective pricing. Only after managers have mastered the techniques of creating value do the techniques of capturing value become important. When companies were totally financially driven and internally focused, it was marketing's sole job to become an advocate for the customer's perspective. Today, however, marketers have won the power to make business decisions, not just advocate perspectives. With that responsibility, they must understand not only customer needs but also how and when to profitably satisfy those needs.The true test of a successful marketing strategy is its ability to create value profitably. As one marketing expert aptly stated, "For marketing strategists, [pricing] is the moment of truth—all of marketing comes to focus in the pricing decision."[5]The purpose of this book is to make sure that when you reach that moment, you know what to do.

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