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**When You Finish This Chapter, You Should**

1. Understand how pricing objectives should guide strategy planning for pricing decisions.

2. Understand choices the marketing manager must make about price flexibility.

3. Know what a marketing manager should consider when setting the price level for a product in the early stages of the product life cycle.

4. Understand the many possible variations of a price structure, including discounts, allowances, and who pays transportation costs.

5. Understand the value pricing concept and its role in obtaining a competitive advantage and offering target customers superior value.

6. Understand the legality of price level and price flexibility policies.

7. Understand the important new terms (shown in red).

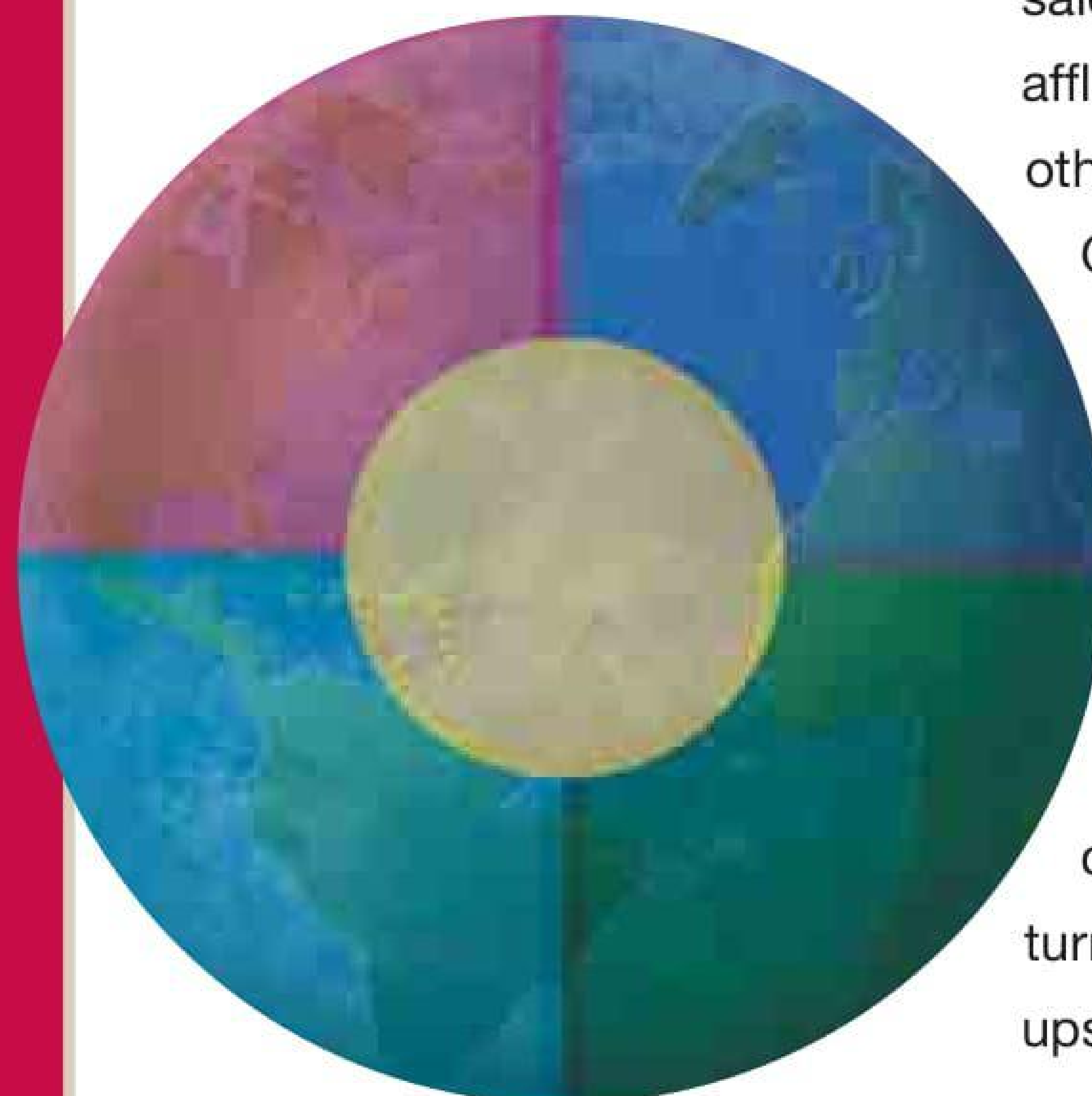
# Chapter Seventeen

# Pricing Objectives and Policies

For years, the Chevy Suburban utility vehicle was a low-price, no-frills, work truck targeted at commercial users. Then changes in the marketing environment presented a new opportunity. To turn the opportunity into profits, marketing managers planned a new strategy for the Suburban—and new price policies were a crucial aspect of the strategy.

In the early 1990s, luxury car sales to the high-income, baby-boomer crowd were growing fast. BMW, Lexus, and Mercedes sedans seemed to be the ultimate yuppie status symbol and the leaders in customer satisfaction. Yet sales of luxury sedans slowed as affluent consumers looked for other ways to meet their needs. One clear sign of this shift was the growth in demand for fancy utility vehicles like the Jeep Grand Cherokee.

As consumer preferences changed, marketing managers for the Chevy Suburban changed their strategy. They turned the Suburban into an upscale utility vehicle targeted at



price

place

promotion

produc

families for hauling special cargo—like kids, toys, and pets. And this target market wanted to do its hauling in style. So marketing managers for the Suburban added many luxury features and options—like leather interiors and power everything. They also significantly raised the suggested list price; a fully equipped Suburban cost about $40,000. In 1996, Suburbans could command that price because no other model was as big, plush, and powerful. If a consumer really wanted jumbo-sized luxury, Suburban was the only choice.

Even at its steep price, demand for the Suburban was so hot that supply couldn't keep up. Yet GM managers didn't want to build a new factory. They realized that other firms were scrambling to develop competing models that would cut into Suburban's sales and lofty prices. If a new factory turned into excess capacity and high overhead costs, it would be hard to cut Suburban prices and still make a profit. That risk didn't seem worth it when the profit on each Suburban was about $8,000—much higher than for most cars.

Dealers couldn't get all the Suburbans they could sell, so many sold the ones they could get at a premium of $1,000 or more above the suggested list price. This jacking up of prices irritated buyers—and many switched to Ford Explorers or other vehicles. Yet GM's marketing managers couldn't *make* dealers charge the suggested list price—and it's not legal to charge uncooperative dealers a higher price for the Suburbans that they buy.

In 1997, two new jumbo luxury haulers—the Lincoln Navigator and the Ford Expedition—hit the market. They were instant successes. They attracted a lot of the people who had walked away when Suburban dealers tried to

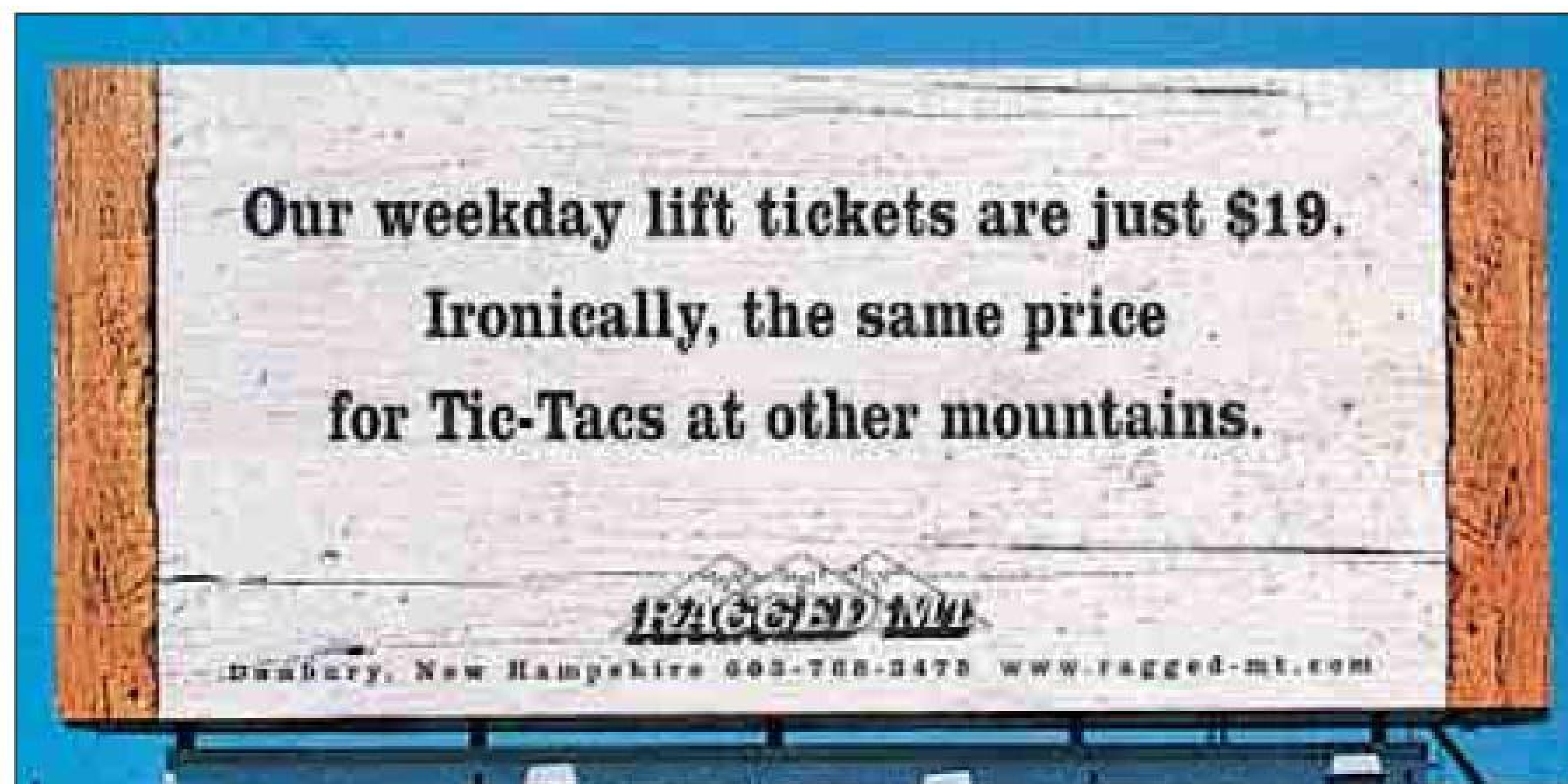
extract an unreasonable price. Other customers just liked the smoother ride. It also didn't hurt that gasoline prices were at a 25-year low. That pulled new consumers into the market who earlier had thought that the high operating cost of a gas guzzler made it a bad value, no matter how useful it might be.

By 2001, more competitors had come on the scene. Toyota redesigned its Land Cruiser for more interior space and luxury in 1998 and then hit even harder with a new Sequoia model. The exchange rate of the Japanese yen against the dollar gave Toyota a price advantage as the economy was shifting into lower gear. And Mercedes introduced its ML320 luxury sport-ute. It is smaller than the Suburban, but many consumers think that its styling, safety features, and low price make it a better value. Suburban sales were even cannibalized by other brands in the GM product line—including Cadillac's Escalade, which gave GM an offering at the next price line up from Suburban.

The economy, high gas prices, and competition cooled the demand for Suburbans. A special website (www.chevrolet.com/suburban) promotion offered Suburban buyers in the West (where the economic and competitive situation was the worst) financing at a 1.9 percent annual interest rate. However, some buyers from other regions saw the website and complained to dealers that the low financing rate wasn't available to them. In the end, to move inventory, many of these dealers just took a price cut or threw in free options.[1]

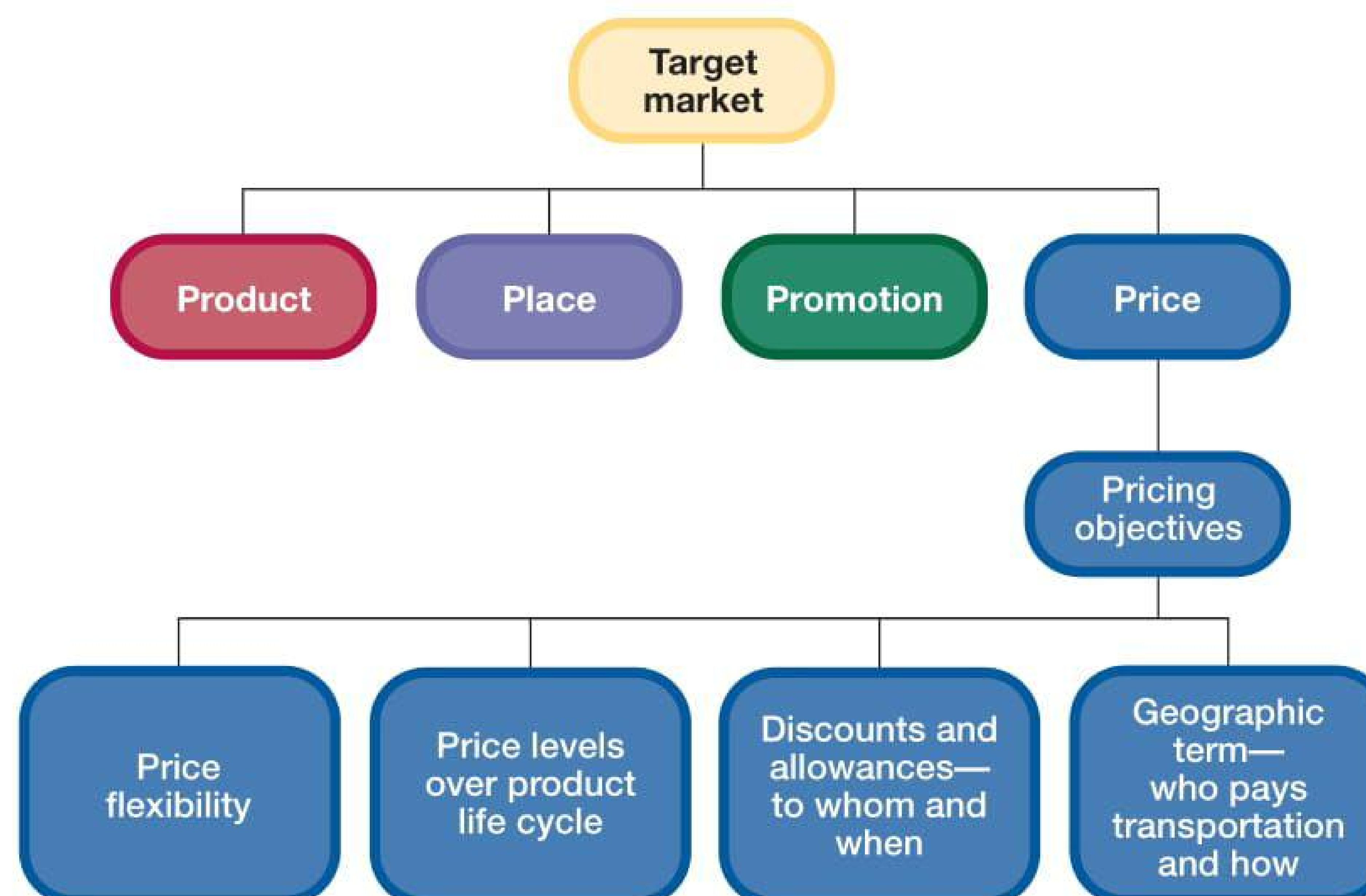
## Price Has Many Strategy Dimensions

Price is one of the four major variables a marketing manager controls. Price-level decisions are especially important because they affect both the number of sales a firm makes and how much money it earns. From a customer's perspective, Price is what must be given up to get the benefits offered by the rest of a firm's marketing mix, so it plays a direct role in shaping customer value.




Ragged Mountain wants its customers to know that its price is a good value compared to what they get at other ski resorts.

Exhibit 17-1
Strategy Planning for Price




Guided by the company's objectives, marketing managers must develop a set of pricing objectives and policies. They must spell out what price situations the firm will face and how it will handle them. These policies should explain (1) how flexible prices will be, (2) at what level they will be set over the product life cycle, (3) to whom and when discounts and allowances will be given, and (4) how transportation costs will be handled. See Exhibit 17-1. These Price-related strategy decision areas are the focus of this chapter. After we've looked at specific decision areas, we will discuss how they combine to impact customer value as well as laws that are relevant. In the next chapter, we will discuss how specific prices are set—consistent with the firm's pricing objectives and policies and its whole marketing strategy.

It's not easy to define price in real-life situations because prices reflect many dimensions. People who don't realize this can make big mistakes.

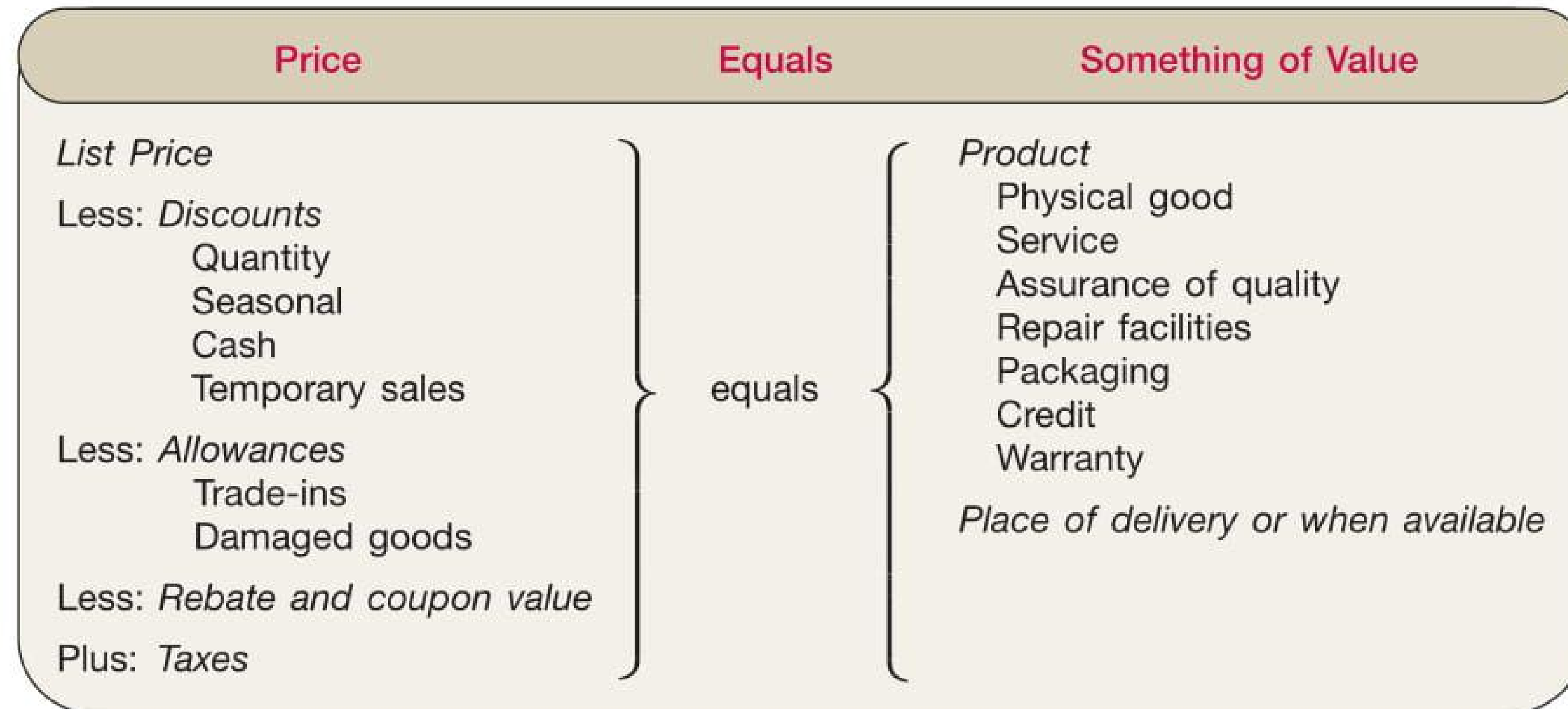
Suppose you've been saving to buy a new car and you see in an ad that the base price for the new-year model has dropped to $16,494—5 percent lower than the previous year. At first this might seem like a real bargain. However, your view of this deal might change if you found out you also had to pay a $400 transportation charge and an extra $480 for an extended service warranty. The price might look even less attractive if you discovered the options you wanted—a CD player, side airbags, and a moonroof—cost $1,200 more than the previous year. The sales tax on all of this might come as an unpleasant surprise too. Further, how would you feel if you bought the car anyway and then learned that a friend who just bought the exact same model got a much lower price from the dealer by using a broker he found on the Internet?[2]

## The price equation: price equals something of value

This example emphasizes that when a seller quotes a price, it is related to *some* assortment of goods and services. So **Price** is the amount of money that is charged for "something" of value. Of course, price may be called different things in different settings. Colleges charge tuition. Landlords collect rent. Motels post a room rate. Country clubs get dues. Banks ask for interest when they loan money. Airlines have fares. Doctors, lawyers, and Internet providers set fees. Employees want a wage. People may call it different things, but *almost every business transaction in our modern economy involves an exchange of money—the Price—for something.*

The something can be a physical product in various stages of completion, with or without supporting services, with or without quality guarantees, and so

Exhibit 17-2
Price as Seen by Consumers or Users


| Price | Equals | Something of Value |
| --- | --- | --- |
| *List Price*<br>Less: *Discounts*<br>Quantity<br>Seasonal<br>Cash<br>Temporary sales<br>Less: *Allowances*<br>Trade-ins<br>Damaged goods<br>Less: *Rebate and coupon value*<br>Plus: *Taxes* | equals | *Product*<br>Physical good<br>Service<br>Assurance of quality<br>Repair facilities<br>Packaging<br>Credit<br>Warranty<br>*Place of delivery or when available* |

on. Or it could be a pure service—dry cleaning, a lawyer's advice, or insurance on your car.

The nature and extent of this something determines the amount of money exchanged. Some customers pay list price. Others obtain large discounts or allowances because something is *not* provided. Exhibit 17-2 summarizes some possible variations for consumers or users, and Exhibit 17-3 does the same for channel members. These variations are discussed more fully below, and then we'll consider the customer value concept more fully—in terms of competitive advantage. But here it should be clear that Price has many dimensions. How each of these dimensions is handled affects customer value. If a customer sees greater value in spending money in some other way, no exchange will occur.

## Objectives Should Guide Strategy Planning for Price

Pricing objectives should flow from, and fit in with, company-level and marketing objectives. Pricing objectives should be *explicitly stated* because they have a direct effect on pricing policies as well as the methods used to set prices. Exhibit 17-4 shows the various types of pricing objectives we'll discuss.

Exhibit 17-3
Price as Seen by Channel Members

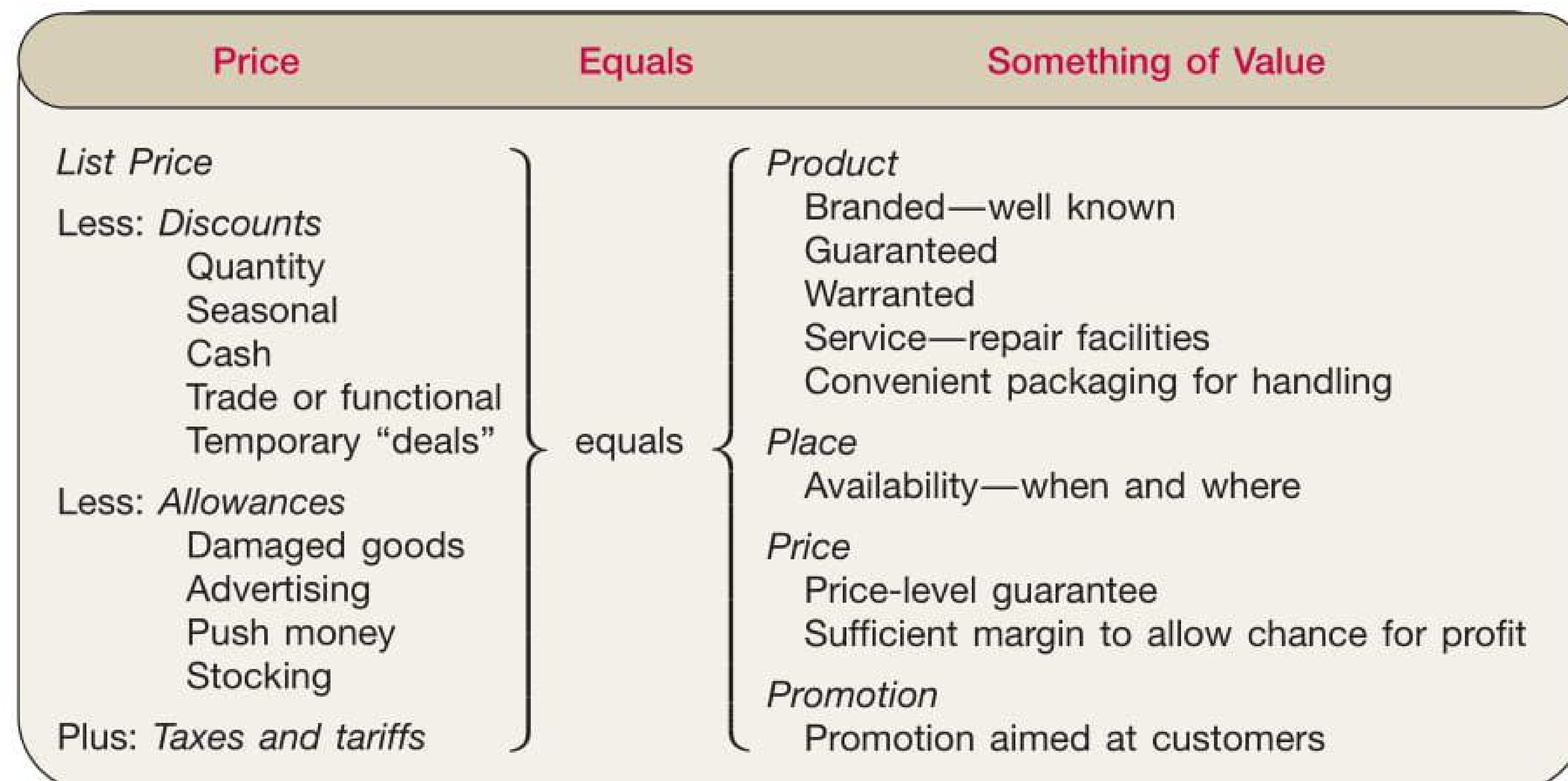
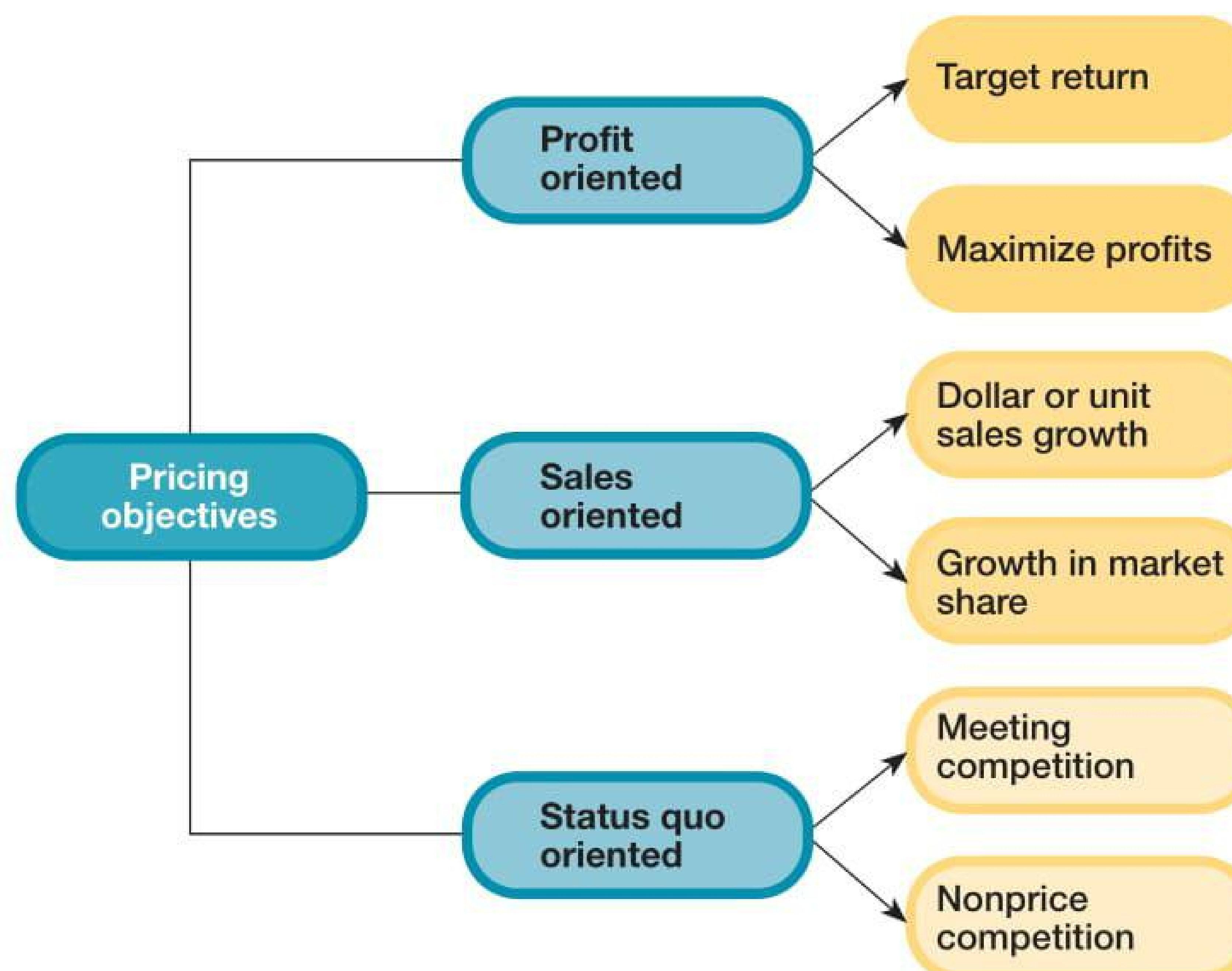

| Price | Equals | Something of Value |
| --- | --- | --- |
| *List Price*<br>Less: *Discounts*<br>Quantity<br>Seasonal<br>Cash<br>Trade or functional<br>Temporary "deals"<br>Less: *Allowances*<br>Damaged goods<br>Advertising<br>Push money<br>Stocking<br>Plus: *Taxes and tariffs* | equals | *Product*<br>Branded—well known<br>Guaranteed<br>Warranted<br>Service—repair facilities<br>Convenient packaging for handling<br>*Place*<br>Availability—when and where<br>*Price*<br>Price-level guarantee<br>Sufficient margin to allow chance for profit<br>*Promotion*<br>Promotion aimed at customers |

Exhibit 17-4
Possible Pricing Objectives




## Profit-Oriented Objectives

### Target returns provide specific guidelines

A **target return objective** sets a specific level of profit as an objective. Often this amount is stated as a percentage of sales or of capital investment. A large manufacturer like Motorola might aim for a 15 percent return on investment. The target for Safeway and other grocery chains might be a 1 percent return on sales.

A target return objective has administrative advantages in a large company. Performance can be compared against the target. Some companies eliminate divisions, or drop products, that aren't yielding the target rate of return. For example, General Electric sold its small appliance division to Black & Decker because it felt it could earn higher returns in other product-markets.

### Some just want satisfactory profits

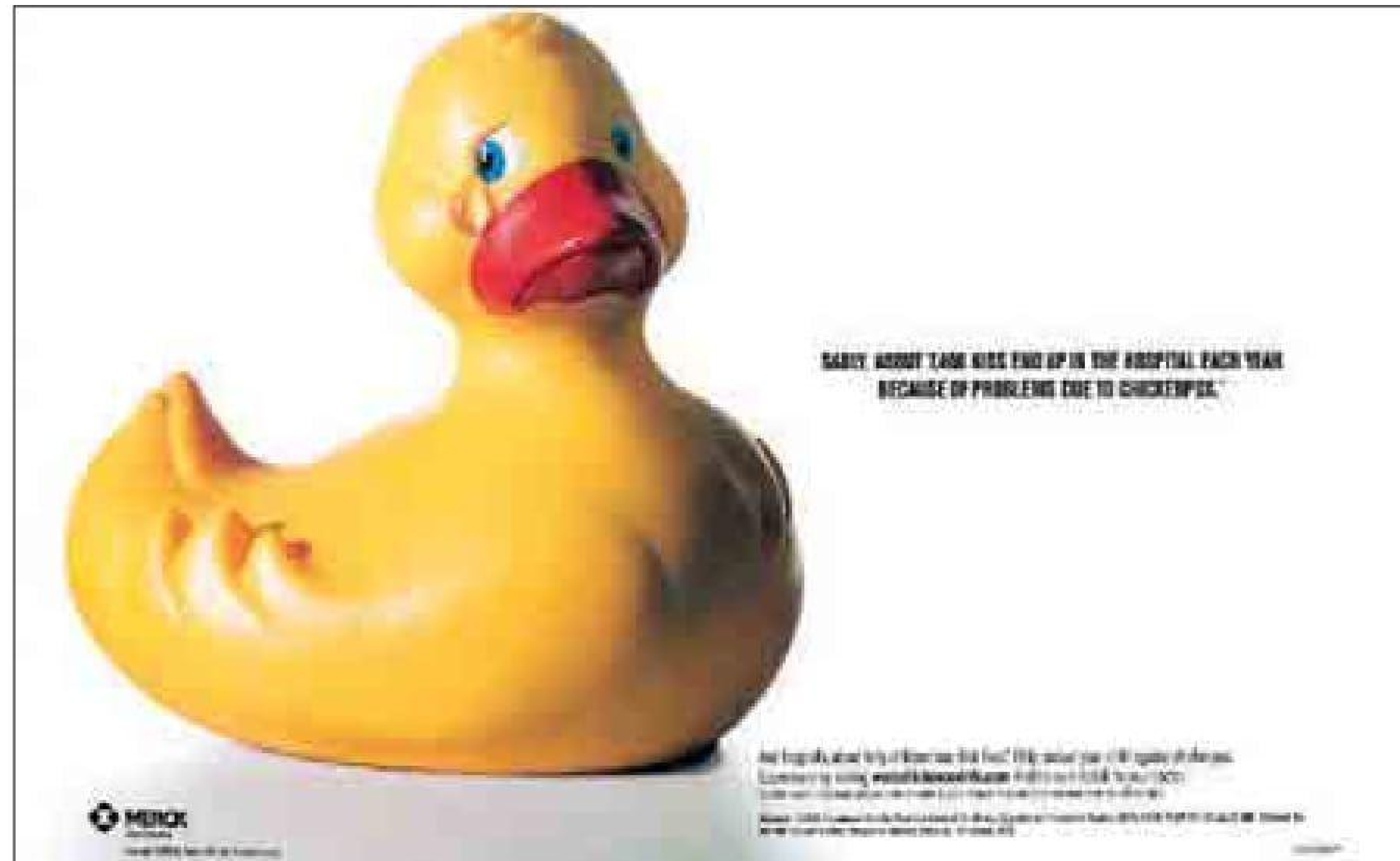
Some managers aim for only satisfactory returns. They just want returns that ensure the firm's survival and convince stockholders they're doing a good job. Similarly, some small family-run businesses aim for a profit that will provide a comfortable lifestyle.[3]

Many private and public nonprofit organizations set a price level that will just recover costs. In other words, their target return figure is zero. For example, a government agency may charge motorists a toll for using a bridge but then drop the toll when the cost of the bridge is paid.

Companies that are leaders in their industries—like Lockheed Martin (aerospace) and Blue Cross and Blue Shield (health insurance)—sometimes pursue only satisfactory long-run targets. They are well aware that their activities are in public view. The public and government officials expect them to follow policies that are in the public interest when they play the role of price leader or wage setter. Too large a return might invite government action. Similarly, firms that provide critical public services—including many utility and insurance companies, transportation firms, and defense contractors—face public or government agencies that review and approve prices.[4]

This kind of situation can lead to decisions that are not in the public interest. For example, some critics argue that some power companies that serve California were not motivated to keep costs low or expand capacity. After deregulation, there

Some politicians want to control the prices of drugs, but that may not be in the public interest if it reduces the incentive for firms to make the big investment required to develop innovative new medicines that people need. That, in turn, would reduce consumer choices.



were big shortages, and even price gouging by some firms, because it takes a long time to add new power systems.

**Profit maximization can be socially responsible**

A **profit maximization objective** seeks to get as much profit as possible. It might be stated as a desire to earn a rapid return on investment—or, more bluntly, to charge all the traffic will bear.

Some people believe that anyone seeking a profit maximization objective will charge high prices—prices that are not in the public interest. However, pricing to achieve profit maximization doesn't always lead to high prices. Low prices may expand the size of the market and result in greater sales and profits. For example, when prices of VCRs were very high, only innovators and wealthy people bought them. When producers lowered prices, nearly everyone bought one.

If a firm is earning a very large profit, other firms will try to copy or improve on what the company offers. Frequently, this leads to lower prices. IBM sold its original personal computer for about $4,500 in 1981. As Compaq, Dell, and other competitors started to copy IBM, it added more power and features and cut prices. By 2001, customers could buy a personal computer with more than 50 times the power, speed, and data storage for about $600, and prices continue to drop.[5]

We saw this process at work in Chapter 10—in the rise and fall of profits during the product life cycle. Contrary to the popular myth, a profit maximization objective is often socially desirable.

## Sales-Oriented Objectives

A **sales-oriented objective** seeks some level of unit sales, dollar sales, or share of market—*without referring to profit*.

**Sales growth doesn't necessarily mean big profits**

Some managers are more concerned about sales growth than profits. They think sales growth always leads to more profits. This kind of thinking causes problems when a firm's costs are growing faster than sales—or when managers don't keep track of their costs. Recently, many major corporations have had declining profits in spite of growth in sales. At the extreme, many dot-coms kept lowering prices to

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PeoplePC uses a young spokesman in its TV ad to explain that the PeoplePC price—at an affordable $.82 a day—includes not only a computer but also unlimited Internet access, in-home service, and shopping discounts.

increase market share but never earned any profits. Pets.com had growing sales until it burned through investors' money and went bankrupt. Generally, however, business managers now pay more attention to profits, not just sales.[6]

Managers of some nonprofit organizations set prices to increase market share—precisely because they are *not* trying to earn a profit. For example, many cities set low fares to fill up their buses. Buses cost the same to run empty or full, and there's more benefit when they're full even if the total revenue is no greater.

### Market share objectives are popular

Many firms seek to gain a specified share (percent) of a market. If a company has a large market share, it may have better economies of scale than its competitors. In addition, it's usually easier to measure a firm's market share than to determine if profits are being maximized.

A company with a longer-run view may decide that increasing market share is a sensible objective when the overall market is growing. The hope is that larger future volume will justify sacrificing some profit in the short run. In the early days of the Internet, Netscape took this approach with its browser software. And companies as diverse as 3M, Coca-Cola, and IBM look at opportunities in Eastern Europe this way.

Of course, objectives aimed at increasing market share have the same limitations as straight sales growth objectives. A larger market share, if gained at too low a price, may lead to profitless "success." As simple as this point is, it's missed by many executives. It's a too-common symptom of death-wish marketing.

## Status Quo Pricing Objectives

### Don't-rock-the-boat objectives

Managers satisfied with their current market share and profits sometimes adopt **status quo objectives**—don't-rock-the-*pricing*-boat objectives. Managers may say that they want to stabilize prices, or meet competition, or even avoid competition. This don't-rock-the-boat thinking is most common when the total market is not

Marketing managers for Hydra Pools consciously set prices so that consumers receive a good value at a price that will yield attractive profits for both the producer and the retailer.

growing. Maintaining stable prices may discourage price competition and avoid the need for hard decisions.

### Or stress nonprice competition instead

A status quo pricing objective may be part of an aggressive overall marketing strategy focusing on **nonprice competition**—aggressive action on one or more of the Ps other than Price. Fast-food chains like McDonald's, Wendy's, and Burger King experienced very profitable growth by sticking to nonprice competition for many years. However, when Taco Bell and others started to take away customers with price-cutting, the other chains also turned to price competition.[7]

## Most Firms Set Specific Pricing Policies—To Reach Objectives

### Administered prices help achieve objectives

Price policies usually lead to **administered prices**—consciously set prices. In other words, instead of letting daily market forces (or auctions) decide their prices, most firms set their own prices. They may hold prices steady for long periods of time or change them more frequently if that's what's required to meet objectives.

If a firm doesn't sell directly to final customers, it usually wants to administer both the price it receives from middlemen and the price final customers pay. After all, the price final customers pay will ultimately affect the quantity it sells.

Yet it is often difficult to administer prices throughout the channel. Other channel members may also wish to administer prices to achieve their own objectives. This is what happened to Alcoa, one of the largest aluminum producers. To reduce its excess inventory, Alcoa offered its wholesalers a 30 percent discount off its normal price. Alcoa expected the wholesalers to pass most of the discount along to their customers to stimulate sales throughout the channel. Instead, wholesalers bought *their* aluminum at the lower price but passed on only a small discount to customers. As a result, the quantity Alcoa sold didn't increase much, and it still had excess inventories, while the wholesalers made more profit on the aluminum they did sell.[8]

Some firms don't even try to administer prices. They just meet competition—or worse, mark up their costs with little thought to demand. They act as if they have no choice in selecting a price policy.

Remember that Price has many dimensions. Managers usually *do* have many choices. They *should* administer their prices. And they should do it carefully because, ultimately, customers must be willing to pay these prices before a whole marketing mix succeeds. In the rest of this chapter, we'll talk about policies a marketing manager must set to do an effective job of administering Price.[9]

## Price Flexibility Policies

One of the first decisions a marketing manager has to make is about price flexibility. Should the firm use a one-price or a flexible-price policy?

### One-price policy—the same price for everyone

A **one-price policy** means offering the same price to all customers who purchase products under essentially the same conditions and in the same quantities. The majority of U.S. firms use a one-price policy—mainly for administrative convenience and to maintain goodwill among customers.

A one-price policy makes pricing easier. But a marketing manager must be careful to avoid a rigid one-price policy. This can amount to broadcasting a price that competitors can undercut—especially if the price is somewhat high. One reason for the growth of mass-merchandisers is that conventional retailers rigidly applied traditional margins and stuck to them.

### Flexible-price policy—different prices for different customers

A **flexible-price policy** means offering the same product and quantities to different customers at different prices. When computers are used to implement flexible pricing, the decisions focus more on what type of customer will get a price break.

### Pricing databases make flexible pricing easier

Various forms of flexible pricing are more common now that most prices are maintained in a computer database. Frequent changes are easier. You see this when grocery chains give frequent-shopper club members reduced prices on weekly specials. They simply change the database in the central office. The checkout scanner reads the code on the package, then the computer looks up the club price or the regular price depending on whether a club card has been scanned.

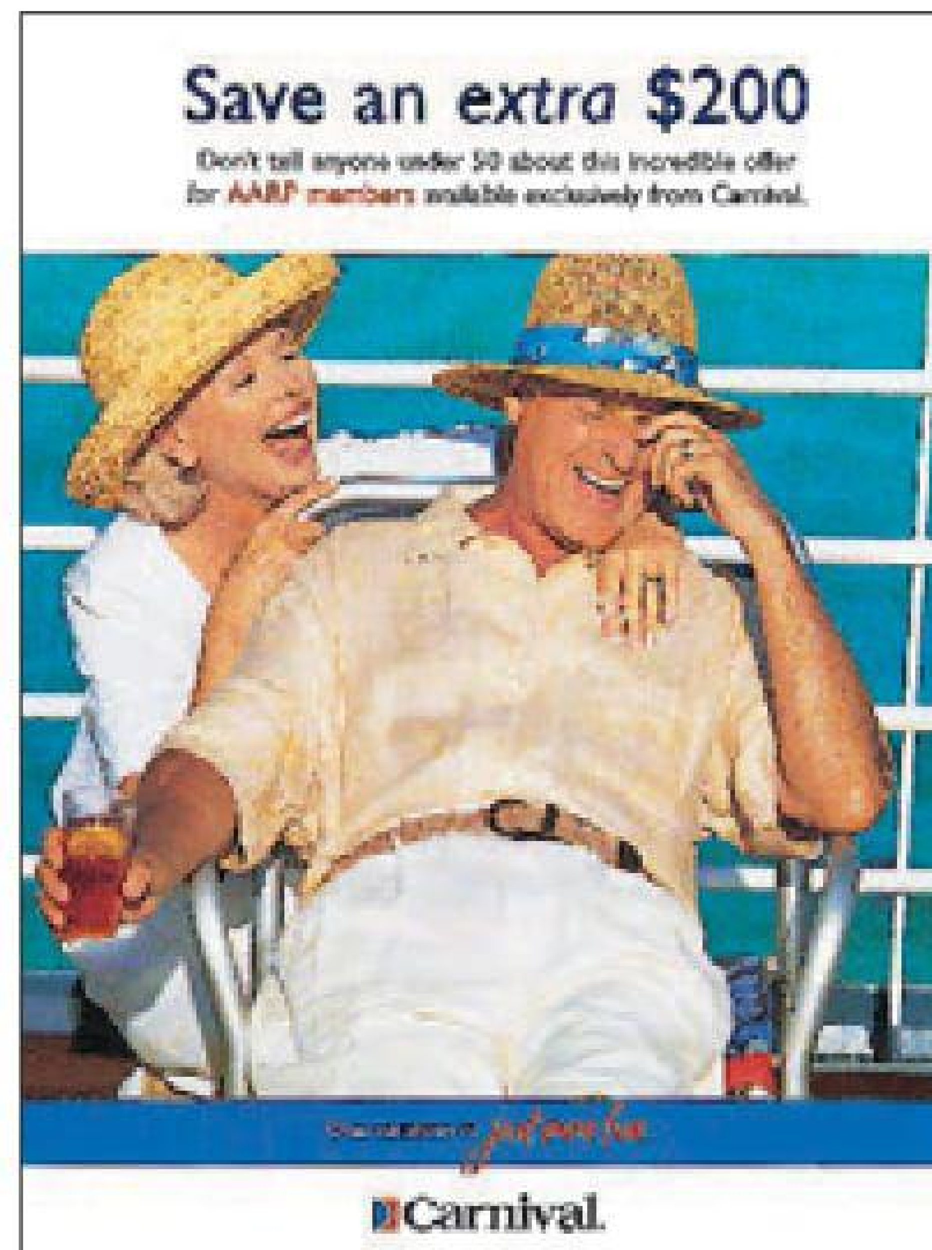
Another twist on this is more recent. Some marketing managers have set up relationships with Internet companies whose ads invite customers to "set your own price." For example, Priceline operates a website at www.priceline.com. Visitors to the website specify the desired schedule for an airline flight and what price they're willing to pay. Priceline electronically forwards the information to airlines and if one accepts the offer the consumer is notified. Priceline has a similar service for new cars and other products such as home mortgages, hotel rooms, rental cars, and long-distance rates.

It may appear that these marketing managers have given up on administering prices. Just the opposite is true. They are carefully administering a flexible price. Most airlines, for example, set a very high list price. Not many people pay it. Travelers who plan ahead or who accept nonpeak flights get a discount. Business travelers who want high-demand flights on short notice pay the higher prices. However, it doesn't make sense to stick to a high price and fly the plane half empty. So the airline continuously adjusts the price on the basis of how many seats are left to fill. If seats are still empty at the last minute, the website offers a rock-bottom fare. Other firms, especially service businesses, use this approach when they have excess capacity.[10]

### Salespeople can adjust prices to the situation

Flexible pricing is most common in the channels, in direct sales of business products, and at retail for expensive items and homogeneous shopping products. Retail shopkeepers in less-developed economies typically use flexible pricing. These

To reach its objectives, Carnival uses flexible pricing—including discounts for retired people. By contrast, *Professional Carwashing & Detailing,* a trade magazine, wants advertisers to know that it charges everyone the same price for ad space.



situations usually involve personal selling, not mass selling. The advantage of flexible pricing is that the salesperson can make price adjustments—considering prices charged by competitors, the relationship with the customer, and the customer's bargaining ability. Flexible-price policies often specify a *range* in which the actual price charged must fall.[11]

Most auto dealers use flexible pricing. The producer suggests a list price, but the dealers bargain for what they can get. Their salespeople negotiate prices every day. Inexperienced consumers, reluctant to bargain, often pay hundreds of dollars more than the dealer is willing to accept. By contrast, however, Saturn dealers have earned high customer-satisfaction ratings by offering haggle-weary consumers a one-price policy. CarMax has adopted the same approach with used vehicles.

Flexible pricing does have disadvantages. A customer who finds that others paid lower prices for the same marketing mix will be unhappy. This can cause real conflict in channels. For example, the Winn-Dixie supermarket chain stopped carrying products of some suppliers who refused to give Winn-Dixie the same prices available to chains in other regions of the country. Similarly, companies that post different prices for different segments on a website that all can see often get complaints.[12]

If buyers learn that negotiating can be in their interest, the time needed for bargaining will increase. This can increase selling costs and reduce profits.

## Too much price-cutting erodes profits

Some sales reps let price-cutting become a habit. This reduces the role of price as a competitive tool and leads to a lower price level. It can also have a major effect on profit. A small price cut may not seem like much; but keep in mind that all of the revenue that is lost would go to profit. If salespeople for a producer that usually earns profits equal to 15 percent of its sales cut prices by an average of about 5 percent, profits would drop by a third!