Setting the Right Price

How to Set a Price on a Product or Service

Setting the right price on a product is a four-step process:

1. Establish pricing objectives.
2. Estimate demand, costs and profits.
3. Choose a pricing strategy to help determine a base price.
4. Fine-tune the base price with pricing tactics.

Establish Pricing Goals

The first step in setting the right price is to set pricing goals. Pricing objectives fall into three categories: profit-oriented, sales-oriented and status quos. These goals are derived from the company's overall objectives. If, for example, a company's purpose is to be a dominant leader in an industry's sales, then it will seek a sales-oriented pricing goal. A conservative organization that tries to reduce risks by being a follower, rather than seeking to be a market leader, can set a goal for the status quo. This company only seeks to preserve its position in the market. Finally, a company committed to maximizing shareholder value will set aggressive profit-oriented pricing goals.

An adequate understanding of the market and the consumer can sometimes tell a manager very quickly whether a goal is feasible. For example, if the company's goal:

A) Is a target return on investment (ROI) of 20% and its product development and implementation costs are $5 million, the market must be fairly broad or it must support the price required to earn an ROI of 20%.

B) Sets out the pricing target that all new products must reach at least 15% market share in the first three years from their introduction. A detailed study of the environment can convince the marketing manager that the competition is too intense and that the goal of market share cannot be achieved.

All pricing objectives have concessions that managers must weigh. A profit maximization goal may require a larger initial investment than the company can afford or wants to commit to.

Achieving desired market share often means sacrificing short-term profit, because without careful management, long-term utility goals may not be met. Matching the competition is the easiest pricing goal to implement. But can managers actually ignore demand and costs, the lifecycle stage, and other considerations? When listing pricing objectives, managers should take these reflections into account from the target customer's perspective, the environment and the overall objectives of the company.

Estimate Demand, Costs and Profits

Total income is a function of price and the amount demanded and that depends on elasticity. Some key questions a manager might consider when doing a market research on demand and elasticity are:

- What price is so low that you would doubt its quality?
- What is the highest price at which the product would still be a bargain?
- What is the price at which the product is starting to be expensive?
- What is the price at which the product becomes too expensive to consider your purchase?

After setting pricing goals, managers should estimate the total income of a price diversity. They must then determine the corresponding costs for each price. They are then ready to calculate how much utility, if any, and how much market share can be obtained with each possible price. This data becomes the heart of the pricing policy. Managers can study options based on income, costs and profits. In turn, this information can help determine which price can best achieve the company's pricing goals.

Choose a Price Strategy

The long-term basic pricing reference framework for a good or service should be a logical extension of pricing objectives. The pricing strategy chosen by the marketing manager defines the initial price and provides a direction for price movements over the product lifecycle.

The pricing strategy sets a competitive price on a specific market segment, based on a well-defined positioning strategy. Modifying a price level from premium to super premium may require a change in the product itself, target customers served, promotional strategy or distribution channels. Therefore, varying a pricing strategy may require surprising alterations in the marketing

mix. An automaker cannot successfully compete in the super premium category if the vehicle looks and drives like an inexpensive car.

A company's freedom to price a new product and devise a pricing strategy depends on market conditions and the other elements of the marketing mix. If a company launches a new product that resembles others that already exist on the market, its pricing freedom will be restricted. To be successful, the company may have to set a price close to the market average. By contrast, a company that presents a completely novelty product without immediate substitutes will enjoy considerable pricing freedom.

REFERENCE:

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