

10.4: The Five-Step Procedure for Establishing Pricing Policy

Learning Objectives

By the end of this section, you will be able to

- List the five-step procedure for establishing pricing policy.
- Describe ways to determine the pricing objective.
- Identify ways to estimate demand.
- List ways to estimate costs.
- Explain how to analyze the external environment.
- Discuss selecting pricing strategies or tactics.

Determine Pricing Objectives

Whether a product is new to the market or established, marketers face the challenge of setting prices. Recall that the main objective for pricing is for the buyer to perceive value in the product while the company maximizes profits. Marketers often use a five-step approach for establishing pricing policies (see Figure 10.4).



Figure 10.4 The Five-Step Process for Establishing Pricing Policies (CC BY 4.0; Rice University & OpenStax)

During the first step in establishing pricing policies, the marketing team will set the pricing objectives (see Table 10.1). The most common pricing objectives are based on customer value, cost, sales orientation, market share, target return, competition, and being customer-driven. It is not uncommon for more than one objective to be set within the company. Let's take a look at each of the pricing objectives in more detail.

Pricing Objectives

Objective	Description
Customer value	Based on a product's added value
Cost	Based on the cost to produce a product
Sales orientation	Developed to boost sales volume(s) of a product
Market share	Focused on increasing market share
Target return	Focused on a specific profit at a specific time
Competition	Developed based on competitors' prices
Customer-driven	Focus on what the customer is willing to pay

Table 10.1 Pricing Objectives

Customer Value-Based Objective

As you've already learned, it's essential to have a deep understanding of the value a product will provide for customers. Before Jim Semick and his team launched GoToMeeting, a conferencing app, they developed the pricing of \$49 "all you can meet flat-rate pricing." This pricing was unique to the industry, and Semick stated that they determined this pricing structure based on dozens of interviews with potential customers. From these interviews, the GoToMeeting team discovered key areas that would provide value to customers not only through the product itself but also through the flat-rate price structure that was easy to understand (Semick, 2015). Semick utilized the customer value-based objective, one in which the company understands the value-added benefits of a product and sets its price accordingly.

Cost-Based Objective

A fairly simple way to price products and services is to use the cost-based objective. This pricing objective sets prices based on the costs of doing business, which were explained earlier in the chapter. The biggest pitfall of utilizing this pricing objective is that it might not align well with the customer's value perception. Remember, customers don't know (or care) what the cost of doing business is, so long as they receive value in their purchase. Therefore, marketers run the risk of overpricing the product. Marketers using this objective also risk pricing their products too low and failing to maximize profits.

Consider the manufacturing of a smartphone. Assume the total cost to the manufacturer to produce one smartphone is \$3,000. This cost includes all expenses to the company for producing this one smartphone (product costs, variable and fixed expenses). According to Bhasin (2021), the company chooses to set the selling price of this smartphone to include these costs plus a profit of 10 percent, which sets the final price at \$3,300 ($3,000 + 10\% \times 3,000$)

Sales-Oriented Objective

A company may wish to seek a boost in the sales volume of a product. In this case, marketers would choose the sales-oriented objective. The goal of a sales-oriented objective is to increase the volume, or units sold, of a product against the company's sales over a period of time. This objective is achieved by raising or lowering prices to increase sales. An increase in sales assumes a direct impact on profits, thus maximizing profits. Consider the smartphone manufacturer again. Executives have set a sales goal of 1,000 units within the first quarter. Marketers may choose to lower the price of the smartphone to meet the goal. So perhaps the company changes the price from \$3,300 to \$3,100 for a short period until the sales goal is reached. Note that the company is still covering the cost of manufacturing the product and still making some profit.

Market Share–Oriented Objective

A market share–oriented objective is one in which the company's pricing objective is to set prices based on those of the competition. This strategy involves comparing similar products offered in the market and pricing at, below, or above those prices depending on the products offered. The cell phone market is one example of an industry that leans on market share orientation. The biggest suppliers of cell phones—Apple, Google, and Samsung—take their pricing cues from one another and are priced very similarly (Campbell, 2020).

Target Return Objective

A target return objective is one in which marketers calculate the price so that it returns a specific profit in a given period. Suppose a company has invested \$1 million into a new product. Company executives wish to recuperate 10% of those costs in year one of sales. If it costs the company \$2 to manufacture one unit of product and marketers estimate that it will sell 50,000 products in the first year, marketers know they will need to price the product high enough to yield the desired results. The obvious drawback to this objective is that much of the decision is based on estimations of units sold in a given time frame.

Competition Objective

A competition-based objective, as its name suggests, is when a company sets its prices according to the prices of its competitors. Amazon often uses this pricing objective for some of its most popular products. Using data intelligence, the company gathers the prices of its competitors' products and sets its prices just below the price set by competitors (Prisync, 2018).

Customer-Driven Objective

Some companies choose to set prices based on customer-driven objectives—what the customer is willing to pay for a product or service. Auctions, e-trades, and bids are common examples of customer-driven objectives. eBay, for example, allows a company (or individual) to place an item for sale on its website. The interested buyer will often bid on the item, thus stating what they are willing to pay. The highest bidder is then able to buy the product.

Estimate Demand

After setting the pricing objectives, marketers will estimate the product or service demand. Demand is an economic term that refers to the buyer's desire and willingness to purchase a product or service at various prices. All other factors being consistent, a price increase will result in a decrease in demand. The demand curve is a visual representation to understand demand.

Understanding the Demand Curve

The demand curve is a graph that shows how the demand for a product or service varies with the change in price. As you can see from Figure 10.5, the price (p) is located on the vertical axis, and the quantity (q) demanded is located on the horizontal axis. As

the price of a product increases, demand for the product decreases.

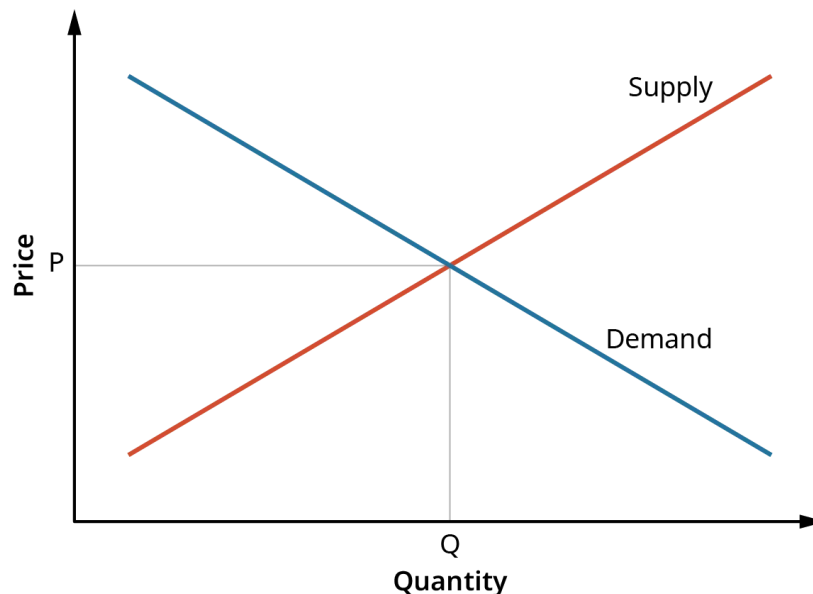


Figure 10.5 Demand Curve (CC BY 4.0; Rice University & OpenStax)

The relationship between price and demand shown in the figure above is contingent on certain conditions remaining constant. Such conditions include substitute goods, personal income, and consumer tastes, which are further discussed below. Changes in these conditions can cause a change in demand that might not follow this basic concept of the demand curve.

The Demand Curve for Prestige Products

One pricing strategy that negates the demand curve is prestige pricing. Prestige pricing is a strategy that marketers use to set high prices, knowing that demand will increase with higher prices because the higher price increases the perceived value of the product. Prestige pricing is closely tied to brand image and appeals to buyers who see value in elevated status. Consider these brands of shoes. The Adidas Yeezy Boost 750 costs around \$76 to produce but sometimes sells for over \$1,000, while the D Rose 5 Boost costs around \$43 and sells for around \$100. So why the large price difference? The Yeezy Boost 750 pricing strategy is that of prestige pricing. The allure and exclusivity of the Yeezy Boost 750 allowed the company to price the shoes much higher (Fuchs, 2021).

Link to Learning: Prestige Pricing

In this article, [HubSpot explores](#) the pros and cons of prestige pricing and things to consider when implementing this strategy. Included are several prestige pricing examples such as the Adidas Yeezy Boost and the D Rose 5 Boost, as well as diamonds, cars, AirPods, and T-shirts.

Demand Elasticity

What will the impact of demand for a product be if the price is changed? If the product is discounted, will demand increase? If the price goes up, will demand decrease? The concept of demand elasticity helps marketers answer these questions. In short, demand elasticity is a measure of the change in the quantity demanded in relation to the change in its price. Mathematically, it is derived from the percentage change in quantity demanded divided by the percentage change in price. If you have been considering buying a new home, would the prices of homes sway your decision? Perhaps so. Home prices are considered elastic because the price greatly impacts the demand for new homes. Additionally, there are many options for housing, including apartments, roommates, living with relatives, condos, etc. (Hall, 2022).

As a second example, consider gasoline. Because we need gasoline to get to work, school, the grocery store, and meetups with friends, it is considered relatively inelastic. There are very few substitutes for gasoline. Because gasoline has inelastic demand, the price may fluctuate considerably, but the demand for gasoline remains relatively the same. Consider the higher gas prices of 2022, averaging over \$5.00/gallon across the United States and even higher globally. Even though the prices have risen, the demand for gasoline has not changed because people still must travel to work and other essential places (Eitches & Crain, 2016).

In summary, if a product is determined to be inelastic, the demanded quantity does not change with a change in price. Conversely, if the product is elastic, the demanded quantity will change with a change in price. You might be asking: What makes a product elastic or inelastic? Several factors help determine how elastic a product or service will be.

Factors in Demand Elasticity

When determining the demand elasticity of products and services, there are several factors to keep in mind. These include substitutes, the effect of income, time, and cross-elasticity of demand (see Figure 10.6). Let's explore each of these in depth.

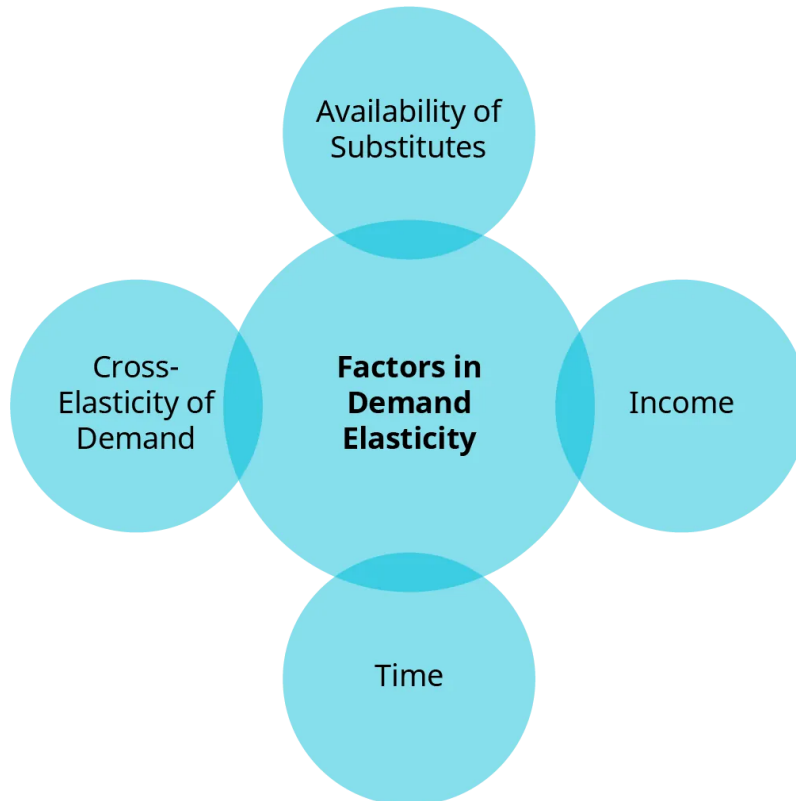


Figure 10.6 Factors in Demand Elasticity (CC BY 4.0; Rice University & OpenStax)

Availability of Substitutes

Substitutes are products and services that are similar to the one being offered. If a buyer can easily choose a different product when the prices change, the demand will be more elastic. For example, if you normally buy English muffins at the grocery store but the store is out, you can easily purchase bagels instead. Conversely, if there are relatively few alternatives, demand will be more inelastic. Consider the generic need for gasoline. It is fairly inelastic. The availability of substitutes for car travel is inconvenient. However, the demand for gasoline at specific gas stations is considered elastic because buyers can choose the gas station they prefer based on price. If two gas stations are located within a convenient geographic region for the buyer, they will choose the station with lower prices.

Income

Buyers have limited money to spend on their needs and must decide how purchasing goods and services will impact their total income. The income effect is how buyers see the change in price affecting their real income. Generally, a price increase indicates that the buyer will have less money left over to spend; therefore, they will choose to buy less of a product, decreasing demand. The opposite is also true: the lower the price, the more money buyers have to buy more of the product, thus increasing demand. Consider the 8.6% inflation the United States saw between May 2021 and May 2022. Because inflation is a general rise in prices, consumers noticed that their purchases of goods and services caused their real income to decline. In other words, consumers had less money to spend on products and ultimately chose to purchase less.

Time

When the price of a good or service is changed, it takes time for buyers to adjust to the change in price. The time factor of price elasticity indicates that the product's elasticity of demand is dependent upon the time it takes buyers to adjust to the new prices. For example, if there is a sharp decrease in the price of automobiles, buyers would not immediately go out and buy a new vehicle. Rather, it would take some time to save money for a down payment, secure a loan, and generally go through the buying process. Therefore, the demand for automobiles would increase but over time rather than immediately.

Cross-Elasticity of Demand

What happens when one of two similar products has a price increase or decrease? If the price of coffee increases, it would be expected that the demand for tea (a substitute product) would also increase. Buyers see the price increase and look for lower-priced substitutes to replace the higher-priced item. The cross-elasticity of demand measures the amount demanded for one good when the price for a similar good or service changes (Hayes, 2022).

Estimate Costs

The next step in determining a pricing policy is to estimate the total cost of producing a product or service. Recall that maximizing profits is the goal of a pricing strategy and marketers must factor the cost of doing business into pricing considerations. When estimating total costs, it is important to divide costs into fixed and variable costs.

Fixed and Variable Costs

As mentioned earlier in this chapter, costs are categorized as either fixed or variable. Fixed costs are those expenses that do not change regardless of the number of units sold. Consider the example used earlier in the chapter of manufacturing a smartphone. If the company manufactures 1,000 or 100,000 smartphones, it must pay the same amount for its lease on the property on which the plant is located. The lease payment does not change based on the number of units produced. Alternatively, variable costs do change based on the number of units produced. In this example, the amount manufacturing spends depends on the number of smartphones produced.

Analyze the External Environment

The fourth step in determining prices is to analyze the external environment. The external environment comprises factors outside of the organization that impact marketing decisions. While marketers cannot directly change these factors, they should know how they might impact pricing decisions.

One way to remember the external environment factors is through the acronym PESTLE: political, economic, social, technological, legal, and environmental (Aguilar, 1967). Questions to consider in a PESTLE analysis when analyzing the external environment as it relates to pricing are included in Table 10.2.

PESTLE Factors

Factors	Question	Example
Political	What is the current political situation as it relates to the market?	A price cap on certain pharmaceuticals would limit the price a company could charge.
Economic	What is the current economic climate?	During inflation or deflation, prices may need to increase or decrease.
Social	How is culture changing or shaping the industry?	During the latter months of the year, the Indian market purchases more vehicles than at other times of the year.
Technological	What technologies are trending?	If a product's technology is becoming obsolete, a price decrease may be necessary.
Legal	What current legislation is impacting the industry?	A new vehicle emission law may require new technology, thus increasing the price of vehicles.

Factors	Question	Example
Environmental	What are the environmental concerns of the product?	A highly toxic product or process may need a higher price to properly and safely dispose of byproducts.

Table 10.2 PESTLE Factors

Link to Learning: PESTLE Analysis

Hundreds of online resources discuss PESTLE. Here are a few to start with:

- The Corporate Finance Institute provides a [PESTLE walk-through](#).
- The Oxford College of Marketing outlines the [advantages and disadvantages of a PESTLE analysis](#).
- [Business-to-you](#) provides a video, sample analysis, and a full list of PESTLE factors.

Competitors' Costs, Prices, and Products

It probably seems obvious by now that analyzing the competition is key in setting prices. Marketers must constantly analyze current and potential market competition to understand how their products will measure up to that of the competition. If a competitor is planning to introduce a nearly identical product to one that your organization already has on the market—but at a much lower price—you will need to consider how that will affect your sales and analyze how it is offering such a lower price. Should you lower your price? Consider changing suppliers for lowered costs? Take a cut in profits to stay competitive? All of these questions, and more, will help you as a marketer determine what pricing strategy should be used.

Stage in the Product Life Cycle

How long a product—and its substitutes—have been in the market will impact the marketer's choice of pricing strategies. Recall that the product life cycle consists of four stages: introduction, growth, maturity, and decline. During the introduction stage, marketers must choose pricing strategies wisely to capture the intended market and begin recuperating research and development costs. As a product moves through the other stages of the life cycle, prices may need to be changed to stay relevant to consumers.

Status of the Economy

As you can imagine, the state of the economy at any given time will impact the buyer's ability to purchase products and their willingness to spend. Marketers should be aware of economic factors when considering demand for products, including employment, inflation, interest rates, and consumer confidence (Maverick, 2022).

One of the main factors that influences consumer demand is the employment rate. The unemployment rate is a measure of the number of people who are not employed but are actively seeking work in a given period—usually one month. When employed and receiving steady income, buyers are more likely to use discretionary income. Discretionary income is the money left over after all taxes and necessities—such as food and housing—are paid. When discretionary income decreases, demand for nonessential items also decreases.

Inflation is an economic measure of the rate of rising prices of goods and services in an economy. When inflation occurs, prices for most goods and services rise. Therefore, a buyer's discretionary income decreases, and demand for nonessential goods and services also decreases. Consider the high inflation in the United States economy from 2021 to 2022, which was 8.6% as of May 2022 (U.S. Inflation Calculator, 2022). The inflation rate is currently the highest that it has been since 1981. Because of the higher price of goods and services within the economy, consumers spend more of their earned income on necessities such as food and shelter. This, in turn, causes them to purchase fewer nonessential items such as vacations, toys, and the like. Inflation also impacts pensions and other retirement accounts. Hence, as inflation rises considerably, people are even less likely to spend their discretionary income and more likely to save anything left over after essentials for future use (Amadeo, 2021).

Even consumers who do not have a deep understanding of the economy have some degree of optimism regarding the overall state of the economy. This is known as consumer confidence—it measures how optimistic consumers are about the economy and their own finances (The Conference Board, 2022). When consumers have little optimism in the economy, they are more likely to save their discretionary income than spend it.

The overall status of the economy—current and future—is important for marketers to be aware of as it directly impacts buyers' ability and willingness to spend money. Choosing pricing strategies that are aligned with the health of the economy will have a greater chance of success.

Select Pricing Strategies or Tactics

After gathering all the data explained in the previous steps, marketers are ready to set specific pricing strategies or tactics. The strategies and tactics chosen for a product or service should align with the other marketing mix elements, create customer value, and maximize company profits. In the next section, we will discuss specific strategies and tactics and how to optimize each.

Knowledge Check

It's time to check your knowledge on the concepts presented in this section. Refer to the Answer Key at the end of the book for feedback.

1.

Sam is explaining to her friend Beth that prices for video conferencing software are increasing because more people are working from home. This relationship can be described by _____.

- a. prestige pricing
- b. customer-driven pricing
- c. the demand curve
- d. the income effect

2.

Each month, you pay your rent. It is \$800 and does not change based on the number of hours you work. This is known as a _____.

- a. variable cost
- b. fixed cost
- c. changing cost
- d. profit

3.

Decreased prices are most often associated with which stage of the product life cycle?

- a. Introduction
- b. Growth
- c. Maturity
- d. Decline

4.

Adding fixed costs to variable costs yields which of the following?

- a. Total costs
- b. Profit
- c. Value
- d. Inflation

5.

When the price of a product increases and the demand for its substitute product increases, this is explained by _____.

- a. elasticity
- b. inelasticity
- c. a change in income
- d. cross-elasticity of demand

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