

**Profitable
Pricing
Strategies**

**STEPHEN L.
MONTGOMERY**

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To Carolyn

For her inspiration and support

Preface

Profitable Pricing Strategies is designed to help managers learn and make profitable use of the critical skills of planning and managing pricing activities. An accompanying software package, PricePlan, will help users of this book choose from among several alternative strategies as well as explore the economic implications of any given price strategy.

In this book, I try to give the reader a timely introduction to the management of price strategy, based on well-accepted theories, and a strong focus on actual applications. Concepts are drawn from marketing, economics, finance, and accounting, and are developed in a strategic management framework.

The reader is introduced in Chapter 1 to the strategic management process. Overall organizational strategic management is presented, and then the management of marketing, operations, finance, and other functional strategies are discussed, with emphasis placed on marketing. The components of the entire process are displayed graphically and related to each other.

Chapter 2 relates pricing strategy to the overall strategy of an organization and its functional support groups. Pricing strategy is discussed in some detail, down to the process of actually selecting a price strategy.

Later chapters cover special topics under pricing strategy. New product and service pricing, an important subject for almost any organization, is discussed in Chapter 3.

Chapter 4 explores the pricing process for groups of related products or services, usually referred to as the product line. Economics of the interrelationships among products is presented, and cost considerations in pricing are discussed.

The subject of planning and managing under conditions of uncertainty affects almost all organizations which must price their offerings to the marketplace. The factors involved in determining the actual market demand for products and services are examined, along with some methods for analyzing these factors.

This leads naturally into Chapter 6, which covers price forecasting. Price forecasting is often difficult to do. Chapter 6 provides an overview of the forecasting process in general, from the level of the overall economy down to the level of individual products and services. Many of the most widely used forecasting methods are presented here.

Service organizations are very often ignored in discussions of business planning and management, so Chapter 7 discusses services in relation to physical products or goods. Practical service pricing considerations (which often apply to physical products) are discussed in some detail.

A solid economic foundation is required for effective pricing. Chapter 8 presents cost-volume-profit analysis and some analytical methods often used to set and manage prices.

Today more than ever pricing and strategic management need to be considered in a world view. Chapter 9 discusses international pricing and the complex factors involved in selling products and services worldwide.

Chapter 10 covers the economics of price and costs, in more general terms than does Chapter 8. Special topics of pricing are covered in Chapter 11: pricing and profit maximization, pricing and promotion, pricing and marketing channels (often called distribution channels), price discrimination, and transfer pricing. Chapter 12 wraps up discussions of price strategy by giving the reader ideas on how to implement strategic plans.

I hope that the readers of this book can share my enthusiasm for the power that careful strategic planning and management can give managers in all types of business organizations. I firmly believe that readers of this book can become better pricing managers simply by getting down to basics and working smarter, not harder. It is hoped that this book and other books and software products I am developing to deal with strategic management issues will give readers numerous profitable ideas, and that the readers will be stimulated to do further reading, research, and effective business practice.

Stephen L. Montgomery

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This book was inspired by my work with business and nonprofit organizations, my teaching experiences, and my work at Planning Professionals, Inc., of Milwaukee, Wisconsin.

I owe a lot to a good friend of mine, Frank Koch, who helped me to develop the PricePlan software package. Frank and his wife Pat helped me with many administrative tasks during the book's development, and helped me coordinate numerous consulting and teaching tasks.

My parents have been a great help to me for innumerable reasons. My wife Carolyn missed much of the early work on this book but has been a tremendous inspiration and an avid supporter since I first met her.

Stephen L. Montgomery

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1

Pricing and Organizational Planning

Pricing cannot be viewed in isolation, but rather must be viewed in the context of a much larger framework. It is only one aspect of marketing, albeit a very important one, and is part of the overall planning for any organization.

Pricing is an important expression of your marketing plan and is a communication to the marketplace of your philosophy. Your philosophy is transformed into your organization's strategic plan. The strategic plan then generates or changes the marketing plan. A circular planning process is created, a primary thrust of which is your organization's pricing policy.

Pricing may reflect whether your organization is targeting the retail or the business market and whether you want to be a full-product or full-service supplier to all customers or a supplier to specific target-market segments. If you want to be the dominant market-share leader in all the markets you serve, then your prices will reflect this.

Marketing is the process of integrating buyer needs and wants into your organization's market strategy and producing products and services to fulfill these needs and wants while earning a profit (if yours is a profit-oriented organization) or satisfying other organizational objectives (if yours is a nonprofit organization).

The Strategic Management Process

Strategic management consists of a set of decisions and actions which result in the formulation and implementation of strategies designed to achieve the objectives of an organization (see Fig. 1.1). The following areas must be addressed:

1. Determine the mission of your organization, including broad statements about your purpose, philosophy, and goals.
2. Develop your organization profile, reflecting its capabilities and limitations.
3. Assess your organization's external environment.
4. Analyze possible opportunities.
5. Identify desired options consistent with the organizational mission.
6. Choose a particular set of long-term objectives and grand strategies to achieve desired options.

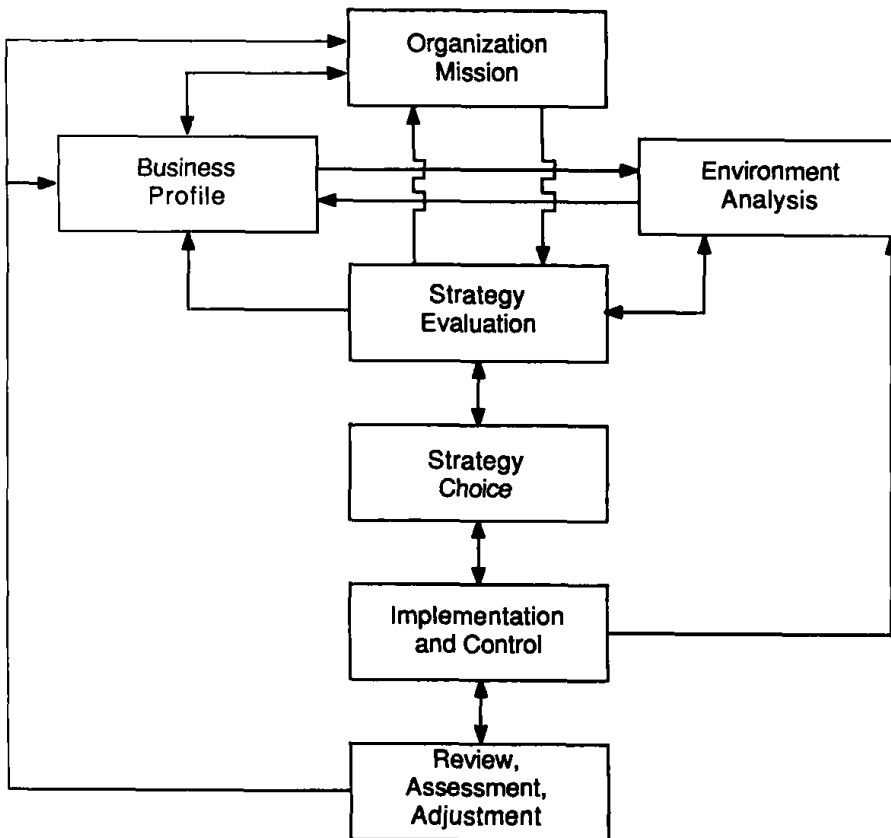


Figure 1.1. The strategic management process at the organizational level.

7. Develop annual objectives and short-term strategies compatible with long-term objectives and grand strategies.
8. Implement strategic-choice decisions based on resources.
9. Review and evaluate the success of the strategic process and input results into future decision making.

Bower (1966) suggests that the following specific management activities exist in the strategic management process:

1. Setting the organizational mission
2. Developing an organizational philosophy
3. Establishing objectives
4. Planning strategy
5. Establishing policies
6. Planning the organizational structure
7. Providing personnel
8. Establishing procedures
9. Providing facilities
10. Providing capital
11. Setting standards
12. Establishing management programs and operational plans
13. Providing control information
14. Activating people

Organizational Mission

Your first prerequisite for marketing planning is a statement of your organizational mission. This should define the kind of organization you wish to have and should identify customers and markets you want to serve. Your mission statement should tell everyone in your organization what *business* you are in. It focuses attention on the direction for the future. Your mission defines the bounds within which you look for viable marketing opportunities, and it may be assigned to divisions.

According to King and Cleland (1979), an organization mission is designed to

1. Ensure unanimity of purpose within the organization
2. Provide a basis for motivating organizational resources

3. Develop a standard for allocating resources
4. Establish a general organizational climate
5. Serve as a focal point for those who can identify with the organization's purpose and direction, and as an explication to deter those who cannot from participating further in the organization's actions
6. Facilitate translation of objectives and goals into a work breakdown structure involving assignment of tasks to responsible elements in the organization
7. Provide a specification of organizational purposes and translation of them into goals so that cost, time, and performance parameters can be assessed and controlled

Organizational Profile

Your organizational profile results from an internal analysis which determines your performance capabilities based on existing or obtainable resources. This profile describes the quality and quantity of physical, financial, and human resources available to you and assesses your organization's management and structural strengths and weaknesses. Historical successes and management views are contrasted with your current capabilities in order to identify future capabilities.

Remote and Local Environments

Your external environment consists of the total of all forces which affect your strategic options but which are beyond your ability to control. The remote environment is composed of forces which occur beyond your immediate operating environment and includes the general economic, political, social, and technological framework in which you and your competitors operate (see Fig. 1.2)

The local environment includes forces in your specific competitive operating situation which influence your strategy selections. Changes in the local environment are often the result of actions taken by you, your competitors, consumers or users, suppliers, creditors, or government bodies (see Fig. 1.3).

Analyzing Opportunities

Assessing your expected environment and your organizational profile enables you to determine the range of opportunities that you might want to

take advantage of. These opportunities represent possible directions, but the list of alternatives must be screened before a set of possible choices can be decided upon. This strategic choice process provides you with a combination of long-term objectives and grand strategy that will best position your organization in the external environment and achieve your organizational mission.

The process of choosing from among alternative strategies involves matching each of the possible and desirable opportunities with reasonable long-term objectives and targets. These are then matched with the most

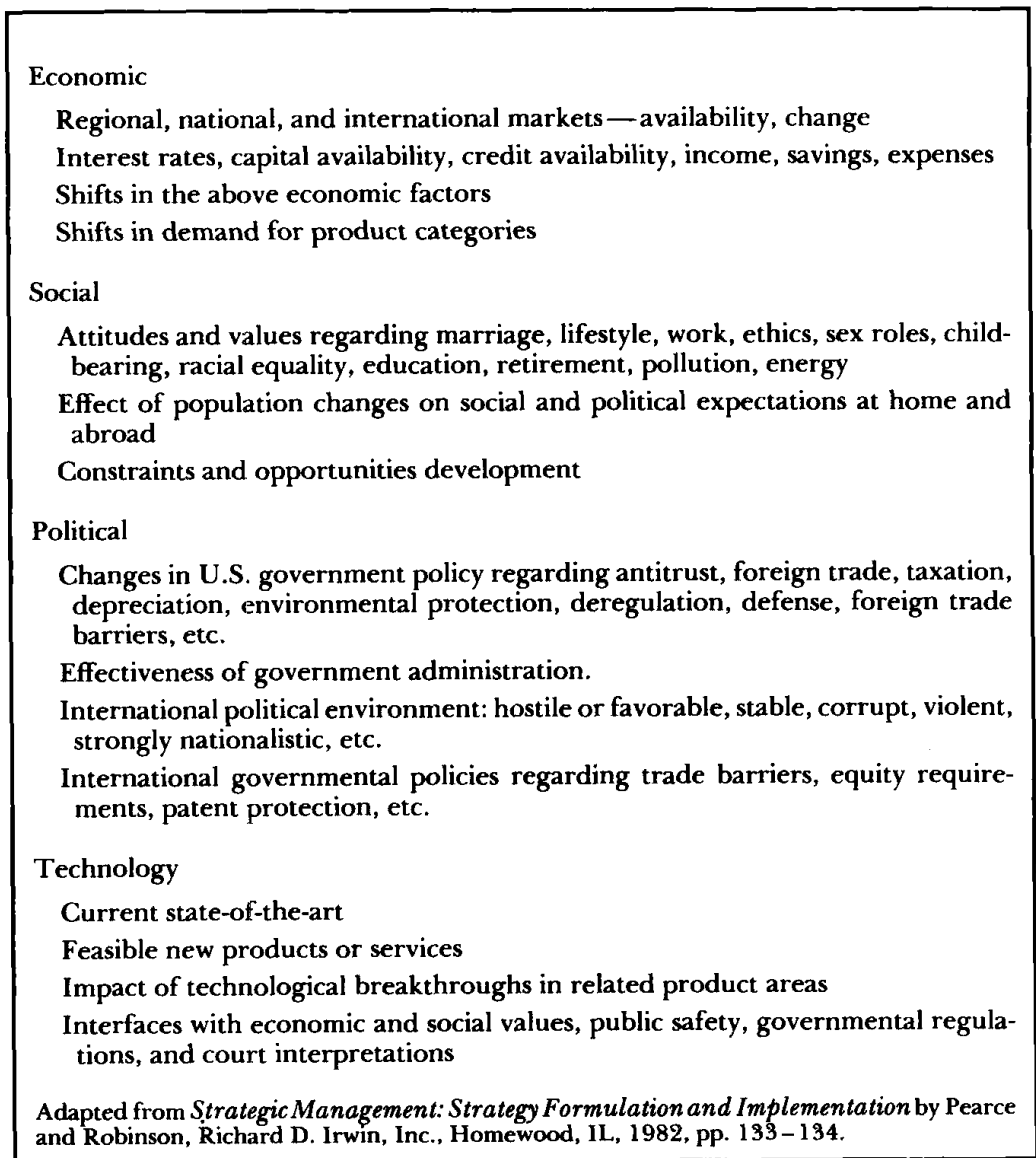


Figure 1.2. External environment considerations.

promising targets (grand strategies) for achieving the desired results. Each alternative is then evaluated to determine the one you expect to best achieve your organizational mission.

Assessing strategic alternatives requires that you develop criteria to serve as the basis for comparing one alternative with all of the others. The criteria you use might include your attitudes about risk, stability, flexibility, profitability, growth, and diversification. Also, you should consider

1. The volatility of the external environment
2. Your current organizational structure
3. Your access to resources
4. Your competitive advantages
5. Product or service life-cycle stages

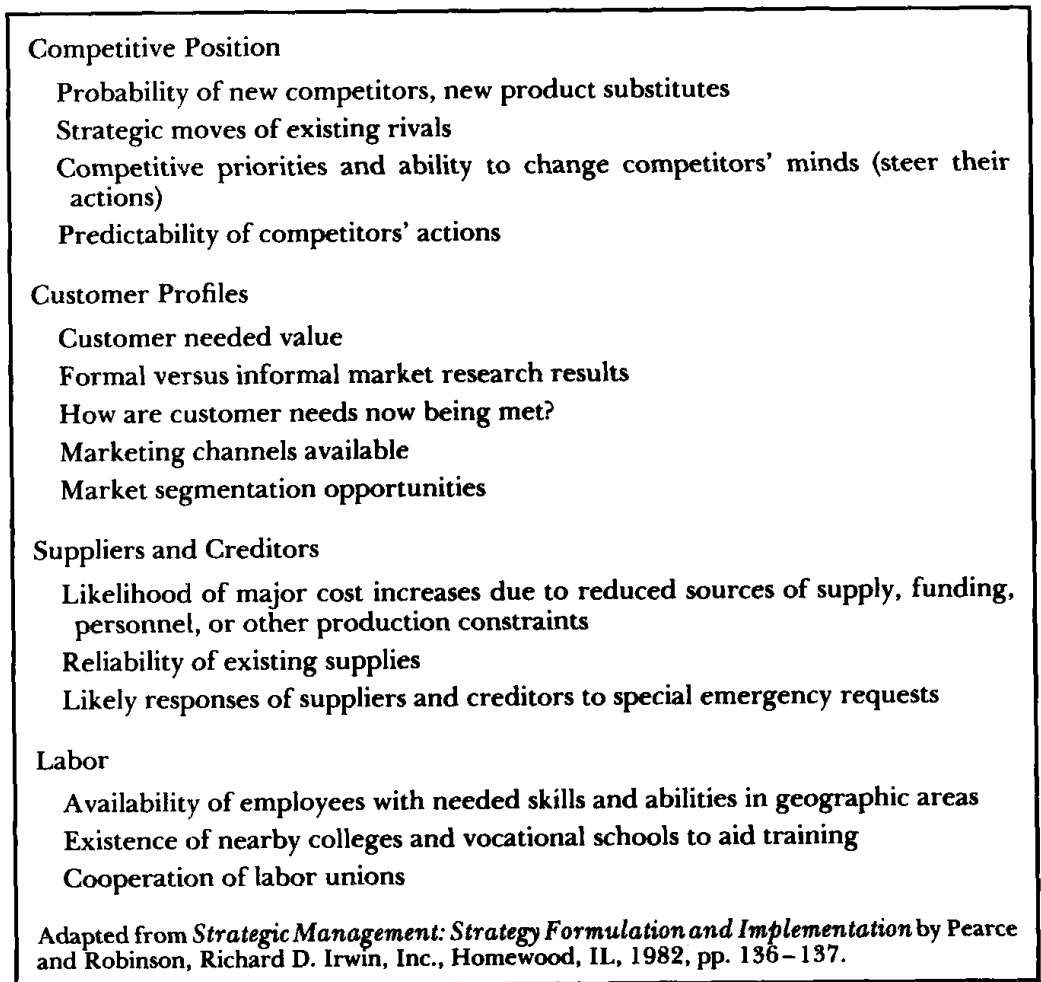


Figure 1.3. Local environment considerations.

6. The potential reaction of stockholders, creditors, employees, customers, suppliers, governments, unions, competitors, local communities, or the general public

Objectives and Strategies

After the mission statement, you must clearly define your overall objectives in order to design organizational and marketing strategies to obtain these objectives. You might set an organizational goal to attain a certain financial goal. Or you might adopt a more general objective, such as to play a certain role in your industry. You might want to gain a certain market share or achieve a certain level of innovation or technological advancement.

Top management must set the overall objectives for the organization, and the lower levels of management must set goals to support the organizational objectives. The hierarchy of objectives and goals extends down through the organization until detailed action programs can be designed and implemented at every level.

Long-term Objectives. Your long-term objectives are the results you seek to achieve over a period of, say, five years. These results are typically developed to address these and other issues:

1. Profitability
2. Competitive position
3. Productivity
4. Technological superiority
5. Employee development

For maximum effectiveness, each objective must be specific, measurable, achievable, and consistent with your other objectives.

Grand Strategy. Your grand strategy is your comprehensive, general plan of action by which you intend to achieve your long-term objectives. This statement indicates how your goals of business activity are to be achieved. The purpose of grand strategies is to guide the acquisition and allocation of resources over a specified period of time.

No single grand strategy can detail the strategic actions which you will undertake over a long period, but your commitment to a basic positioning of your organization in your marketplace provides you with a focal point for later decision making. Some examples of grand strategies include technological innovation to capture high profit margin on new products,