11 Pricing strategy

This chapter covers Unit 2, Module 2, Section 8.
On completion of this chapter you should be able to:

- analyse the pricing process – objectives, analysis, pricing basis, list price, price adaptation
- compare and contrast different pricing strategies and evaluate the usefulness of them in different business situations

Price is the value placed on a product by a business, expressed in terms of money, that consumers must pay in order to obtain it. Prices of similar products are compared by consumers to judge which one gives the best ‘value for money’.

Pricing process

Deciding on the price to charge for a good or service is of crucial importance in determining the market success of the product. Setting an inappropriate price can result in many serious problems such as:

- Making a loss if the price is below costs.
- Failing to meet sales targets if the price is too high, e.g. much above that of competitors selling similar products.
- Encouraging competitors to join the same market niche if the price is set at a level that gives very high profits.
- Failing to achieve a balanced and integrated marketing mix if the price is set with no attempt to link it to the other ‘Ps’ of product, place or promotion. This could lead to confusion amongst consumers regarding the quality and image of the product.

These are some of the important factors that a marketing manager should consider when undertaking the pricing process:

1 Objectives

The marketing objectives for a product will reflect the company’s overall objectives. If the firm has the aim of achieving high short-term profits, then this will be reflected in the marketing objectives set for each product. Short-term profits could be earned by setting high prices for goods that are distinctive from those of rivals. Although the high prices may lead to increased competition – attracted by the profitability of the initial product – the business will have earned high profit margins in the short term.

In contrast, if the overall corporate aim is one of long-term shareholder returns, this could be reflected in marketing objectives of increased market share, and long-term control over the markets it operates in. A low pricing strategy could encourage consumers towards the firm’s products, and discourage new rivals or force out existing competitors. Other objectives that could influence the prices charged include:

- Cash flow – recover cash as fast as possible, especially with products with short life cycles.
- Status quo – maintain market share by matching the prices, and price changes, of competitors.
- Survival – accepting short-term losses in a competitive market as this may be necessary for survival in the short term.

So, the objective of the company and its marketing department will be reflected in the pricing decision.

2 Internal and external analysis

This means identifying and analysing the key factors – within the business and external to the business – that might impact on the pricing decision.

Internal factors include: costs – fixed and variable – production capacity, objectives (see above) and the other components of the marketing mix.
External factors include: competitors' prices, price elasticity of demand (see below), consumers' incomes, consumers' perceptions of the product (high or low quality) and the state of the national economy in which the product is sold.

**Price elasticity of demand** The relationship between price changes and the size of the resulting change in demand is known as price elasticity of demand. It measures the responsiveness of demand following a change in price. This concept can be demonstrated on demand curves but it can also be measured mathematically.

The formula for price elasticity of demand (PED) is:

\[
\text{Percentage change in quantity demanded} = \frac{\text{Percentage change in price}}{\text{Unitary PED}}
\]

The value of PED is normally negative because a fall in price (→) usually results in a rise in demand (→). This is called an inverse relationship but it is normal to ignore the negative sign as it is the extent of the change that is important.

*Example.* If the price increased from $4 to $5 and demand fell from 300 units per week to 270 units, what is the PED?

**Step 1** Calculate the percentage change in price

\[
\text{Change in price} = \frac{\text{Original price}}{100} = \frac{4}{1} \times 100 = 25%.
\]

**Step 2** Calculate the percentage change in demand

\[
\text{Change in demand} = \frac{30}{300} \times 100 = 10%.
\]

**Step 3** Use the PED formula

\[
\frac{\text{% change in demand}}{\text{% change in price}} = \frac{10}{25} = 0.4.
\]

It is now important to explain this result. A PED of 0.4 (do not forget that we are overlooking the minus sign) means that demand changes by 0.4% for every 1.0% change in price. As this is less than one, it is described as being *inelastic*. Consumers do not respond greatly to a change in the price in this product so that an increase in price will raise revenue and a fall in price, because demand will change little, will reduce revenue.

Table 11.1 shows how different possible results for PED may be classified.

**Factors that determine price elasticity of demand**

There are a number of factors that will determine the PED of a product:

1. **How necessary the product is** The more necessary consumers consider a product to be the less they will react to price changes. This will make the demand price inelastic, for example as for salt.

<table>
<thead>
<tr>
<th>Value of PED</th>
<th>Classification</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Zero</td>
<td>Perfectly inelastic demand</td>
<td>The same amount is demanded, no matter what the price. In reality, there is no product that would have this PED.</td>
</tr>
<tr>
<td>Between 0 and 1</td>
<td>Inelastic demand</td>
<td>The percentage change in demand is less than the percentage change in price. If a firm faces this elasticity of demand, it can raise the price, not lose much demand and increase sales revenue. However, this cannot keep happening. As the price continues to rise, demand will become more elastic.</td>
</tr>
<tr>
<td>Unitary</td>
<td>Unit elasticity</td>
<td>The percentage change in demand is equal and opposite to the percentage change in price, so any price change will lead to an equal change in demand and the total sales revenue will remain constant. When PED = 1, sales revenue will be maximised.</td>
</tr>
<tr>
<td>Between 1 and infinity (∞)</td>
<td>Elastic demand</td>
<td>The percentage change in demand is greater than the percentage change in price. If a firm faces this elasticity of demand, then it can lower the price, pick up a lot more demand and increase sales revenue.</td>
</tr>
<tr>
<td>Infinity (∞)</td>
<td>Perfectly elastic demand</td>
<td>An infinitely large amount is demanded at one price and then demand falls to zero if the price is raised, even by the smallest amount. In reality, there is no product that would have this PED.</td>
</tr>
</tbody>
</table>

Table 11.1 The potential range of elasticity and its effects
Activity

Read the short case study below and then tackle the exercises that follow.

Case study – The Daily Times

The owner of the Daily Times newspaper is concerned about falling circulation (sales). He believes that newspaper readers are mainly influenced by price when making their decisions over which papers to buy. He therefore decided to cut the price of his paper from $1.50 to $1.20. In the following week circulation increased by 150,000 copies to 1,650,000. After four weeks, however, sales had fallen back to their original level. The owner was confused about the possible reasons for this and wondered whether he should cut the price again to $1.

(25 marks, 35 minutes)
1 Calculate the PED in the first week after the price reduction. (4)
2 Comment on your result in terms of the apparent price elasticity of this product. (2)
3 Calculate the newspaper’s daily revenue just before and just after the price cut. Comment on your results. (5)
4 Explain two possible reasons why demand fell back to the original level some weeks after the price reduction. (6)
5 What action would you advise the newspaper’s owner take now to increase sales – would a further price cut be advisable? (8)

2 How many similar competing products or brands are there. If there are many competitors then there are a large number of substitutes and consumers will quickly switch to another brand if the price of one manufacturer’s product increases, for example fruit being sold by one seller in a large street market. Any move by a business to reduce the number of competing products, such as a merger or takeover, will probably make demand for its own products less elastic.

3 The degree of consumer loyalty. If a firm has been successful, through the branding of a product, in creating a high degree of loyalty amongst consumers, then the consumers will be likely to continue to purchase the product following a price rise. An example of this is designer clothes that have a strong following amongst well-off consumers. All businesses attempt to increase brand loyalty with influential advertising and promotional campaigns and by making their products more distinct – this is called product differentiation.

4 The price of the product. A cheap product that takes up a small proportion of consumers’ incomes, such as matches, is unlikely to have highly elastic demand as consumers will not care too much about a 10% or 15% price increase.

Applications of price elasticity of demand

There are two main business uses of PED:

1 Enabling a business to make more accurate sales forecasts. If a business is considering a price increase, perhaps to cover rises in production costs, then an awareness of PED should allow forecasted demand to be calculated. For instance, if PED is believed to be –0.8 and the price is increased by 10%, what will be the new weekly sales level if it is currently 10,000 per week? Demand will fall by 8% (check this out using the PED formula) and this will give a forecasted sales level of 9,200 per week.

2 Assisting in pricing decisions. If an operator of bus services is considering changing its pricing structure then, if it is aware of the PED of different routes, it could raise prices on routes with low PED (inelastic) and lower them on routes with high PED. This kind of analysis also underpins the strategy known as price discrimination – this is covered later in this chapter.

Activity

A firm sells three products. The price elasticity of demand is estimated to be:
A –3  B –0.5  C –1
(a) Explain what these results mean. (6)
(b) Explain what the effect on sales will be for each product if all prices rise by 10%. (6)
3 Pricing basis

This means the way in which the price is going to be calculated for each customer. In many cases, there will be no variation in the prices charged. The same postage stamp can be used to send a letter anywhere in the country, whether it be addressed to the next street or 400 miles away. A can of Coca Cola will not be sold at different prices to different customers of the same shop. In many other situations marketing managers have to decide on the pricing basis that will be used by the firm. Here are some examples of different ‘pricing bases’:

**Distance** Taxi, rail and bus companies will use the distance travelled to calculate prices.

**Weight** Postal and parcel delivery businesses will not only consider distance but also the weight of the item to be transported.

**Quantity used** Gas and electric companies will often charge a lower unit cost the greater the amount of energy consumed – high energy users pay a lower tariff than low energy users.

**Age** Different tariffs are often offered to consumers depending on the age range they fall into, e.g. discounts at the cinema or on the buses for young and elderly customers.

4 List price

The list price is the standard price that the firm intends to charge to its customers. This is the price ‘listed’ in the firm’s catalogues and sales brochures. It is necessary for firms to have a list price so that customers can refer to this and make comparisons with other similar products. Once this price has been determined, the business would hope to charge it to as many customers as possible – but discounts from the list price may have to be offered to some consumers. Some of the most common reasons for selling a product below list price are:

**At sale time** when goods must be cleared to allow for new stock, any remaining products may be sold ‘under list price’ – the level of discount offered is often part of the promotion of the sale, e.g. ‘45% off our normal list price’.

To customers who order in large quantity it is common to offer a ‘bulk discount’ to encourage repeat large orders. Although the selling price will make a slightly lower gross profit per item, the total profitability of the large contract will usually more than make up for this.

**Introductory discounts** from list price are sometimes offered to new customers in an attempt to encourage them to try the product and to start building consumer loyalty.

**Other discounts** from list price are payment in cash; goods subject to seasonal demand and a consumer makes a purchase out of season; trade customers and not consumers may be offered discounts to encourage the use of this firm’s products rather than those of a rival, e.g. trade discounts on paint to a professional decorator.

5 Price adaptation

In many market situations, companies do not usually set one single list price. Instead they will have a pricing structure that reflects differences between markets, market segments and customers within market segments. In these cases it is quite common to find different customers paying different prices for the same product. This can result from different costs in selling the product in different markets, e.g. the additional transport and marketing costs of selling to export markets.

The term used to describe most of these examples of price adaptation is **price discrimination**. Price discrimination exists when a business is able to separate distinct groups of consumers for the same product or service and charge them different prices.

Price discrimination takes place in markets where it is possible to charge different groups of consumers different prices for the same product. An example of this would be airline firms, who charge many different rates for the same journey. Firms can price discriminate if there are different groups of consumers, with different elasticities of demand for the product, and where the firm is able to avoid resale between the groups. This is easier to do with services.

Pricing strategies

**Cost-plus pricing**

The basic idea is that firms will assess their costs per unit, and then add an amount on top of the calculated cost. There are a number of different methods of cost-based pricing that may be adopted:
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- **Mark-up pricing** is usually carried out by retailers, who take the price that they pay the producer or wholesaler for the product in question, and then just add a percentage mark-up. The size of the mark-up usually depends upon a combination of the strength of demand for the product, the number of other suppliers, and the age and stage of life of the product. Sometimes it also depends on traditional practice in the industry.

  For example:

  - Total cost of brought-in materials $40
  - 50% mark-up on cost $20
  - Selling price $60

- **Full cost (or absorption cost) pricing** is where the company attempts to calculate a unit cost for the product and then adds an agreed profit margin. However, it is not always easy to allocate all of the costs of a firm to a specific product, especially if the firm makes a range of products. It is especially difficult to allocate the fixed costs.

  The method differs from mark-up pricing only to the extent that a method of allocating fixed costs among the various products produced has to be found.

  *Example of full cost pricing.* A business is manufacturing industrial training DVDs. The annual overheads or fixed costs are $10,000. The variable cost of producing each DVD is $5. The business is currently producing 5,000 units per year. The total costs of this product each year are:

  \[
  \text{Total cost} = 10,000 + 5,000(\times 5) = 35,000
  \]

  The average or unit cost of making each DVD is:

  \[
  \frac{35,000}{5,000} = 7
  \]

  The business will have to charge at least $7 each in order to break even.

  If the firm now adds a 300% profit margin then the total selling price becomes $28.

  *Contribution cost (or marginal cost) pricing* does not try to allocate the fixed costs to specific products. Instead of this, the firm calculates a unit variable cost for the product in question and then adds an extra amount that is known as a contribution to fixed costs. If enough units are sold, the total contribution will be enough to cover the fixed costs and to return a profit. For example, let us suppose that a firm produces a single product that has direct costs of $2 per unit and that the total fixed costs of the firm are $40,000 per year. The firm sets a contribution of $1 per unit and so sells the product at $3. Every unit sold makes a contribution towards the fixed costs of $1. If the firm sells 40,000 units in the year, then the fixed costs will be covered. Every unit sold over 40,000 will return a profit. Thus, if the firm sells 60,000 units, then the fixed costs will be covered and there will be $20,000 profit realised.

  Obviously, it would be good for a firm if it produced a range of products that all made a positive contribution to the fixed costs. Then, each product is ‘doing its bit’. As a general rule of thumb, a product that makes a positive contribution to fixed costs should continue to be produced so long as there is spare capacity in the firm, it does not take the place of a product with a higher contribution and there is not another option that has a higher contribution. There are many firms that have excess capacity and hence use contribution cost pricing to attract extra business which will absorb the excess capacity.

  Examples are train companies, for which there is substantial excess capacity except in the morning and evening rush hours. Even then, trains tend to run almost empty in one of the two directions. Electricity and telephone companies face the same sort of situation.

  *Example of contribution cost or marginal cost pricing.* A firm produces a single product that has a variable cost per unit of $4. The annual fixed costs or overheads are $80,000. The firm decides on a contribution of $2 per unit sold. Therefore, selling price is $6. If the business sells 50,000 units in one year the total contribution to fixed costs becomes 50,000 × $2 = $100,000. This exceeds the fixed costs by $20,000 and so a profit of this amount has been made. This firm would have to sell at least 40,000 units per year in order to break even.
Cost-plus pricing – an evaluation  In today’s market place it is becoming increasingly common for businesses NOT to base prices on costs but on market factors such as the number of competitors and the prices they are charging. There is increasing ‘price resistance’ from consumers as the world is in a period of low inflation, mainly due to the process of globalisation. The prices of many products imported from China and India are actually falling, such as shoes, clothing, toys, consumer electronics and many other products. If a business JUST based its pricing decisions on its costs, then it may experience extreme consumer resistance if rivals – perhaps selling imported goods – can sell at lower prices. This ‘new world’ of marketing and pricing decisions can be summed up by these two simple distinctions:

1  Traditional view of pricing = add up costs and add on an acceptable profit margin.

2  Modern view of pricing = set a target price that consumers will pay (based on market research and competitors prices), decide on an acceptable level of profit and THEN make sure that production costs do not exceed the figure arrived at. So, much of the pressure on managers these days is to reduce costs!

Activity

*Hartwood Hats manufactures caps for sportswear companies. The caps cost $3 each for materials and labour – the only variable costs. Last year, a total of 400,000 caps were produced and sold to two big sports firms. The fixed costs of the business amounted to $200,000 per year. The marketing manager has to decide on pricing levels for the coming year and is uncertain whether to use full cost or contribution pricing. Last year a price of $6 was set. The firm was left with spare capacity of around 100,000 caps.

(15 marks, 25 minutes)

1  Calculate the profit made by Hartwood last year. (3)

2  What was the contribution per cap last year? (1)

3  What price would be charged if full cost pricing was used and 100% mark-up added to unit cost? (3)

4  Refer to your answer to 3. Advise the firm on what factors it should consider before fixing the price at this level. (4)

5  If there was a 50% increase in variable costs and the contribution was lowered to $2 what profit would be made if sales remained unchanged? (4)
We now consider other pricing strategies which DO take market factors and competitors prices into account:

**Competition pricing.**
This is a pricing strategy that a firm uses when it bases its prices on what its competitors are charging for similar products. It requires information about competitors' price levels. This information will be easy to obtain for most consumer products such as confectionery or clothing – the data required can be gained from observation in shops. For many products sold to industry such as machinery or aircraft, discovering the actual prices charged can be very difficult as the seller will not want to release this information.

Assuming that it is possible to find out what competitors' prices are, the business setting a price for its own products then has the choice of either setting prices below, above or at the same level of those of rival companies.

It may set prices **below** those of rivals because:
- It is a large business that enjoys economies of scale so its average costs might be lower.
- It wants to gain market share and is prepared to accept lower profit margins in the short term.
- It is one of the dominant firms in the industry and it wants to either squeeze out a new competitor or prevent new firms from joining the industry. This is sometimes known as ‘destroyer’ or ‘predatory’ pricing. The business has to be careful though – this strategy is illegal in many countries as it is regarded as a form of unfair competition.

It may set prices **above** those of rivals because:
- The marketing manager believes that the product offers consumers something substantially different or unique so sufficient consumers will still be prepared to pay a higher price.
- The business is trying to establish an exclusive and upmarket image for the product.
- The business is the dominant firm in the industry and is the ‘price leader’ so other firms may follow its example and raise prices too.

**Going rate pricing.**
This means setting the price at the same level as prices of similar products in the same market. It is a form of competition-based pricing. This is most common in markets where the products from competing firms are very similar to each other – even homogenous.

Examples include steel, milk and petrol. Why might a firm use this pricing strategy? For two main reasons: first, to avoid a price war that could lead to price reductions by all firms and damage profitability in the industry. Second, because the business is new to the industry and it cannot set prices lower than the going rate (as it probably has higher average costs than other firms) and it cannot charge higher prices due to consumer resistance. Why pay more for the same type of product from a new and unknown business?

**Perceived value pricing.**
This strategy can be used in markets where demand is known to be price inelastic – perhaps from previous company experience in this market. The price charged is often a high one to reflect the value placed on the product by the consumers. This ‘perceived value’ can be established by means of market research, for example by asking focus groups how much they think the price is of this product. The more prestigious the brand name, for example Rolex, the higher will be the consumers' perceived value of the product. In these cases, a high price can be charged – perhaps much higher than for apparently similar products being marketed under less prestigious brand names.

The danger of setting a **low** price in these situations is that it will not match the consumers’ perceived value of the product and they will assume that it must be of lower quality and less exclusive – they will not assume that it is better value!

**Penetration pricing and price skimming.**
Pricing strategies for new products are normally split into two different approaches. The first is **penetration pricing**: a relatively low price is set and strong promotion takes place in order to achieve a high volume of sales. Firms tend to adopt penetration pricing because they are attempting to use mass marketing and gain a large market share. If the product gains a large market share, then the price could slowly be increased. The second approach is **market skimming**, which usually occurs when a firm has a unique product that competitors will copy so it attempts to make relatively high short-term profits by charging a high price for as
long as the product can hold its strong position. An example of this is pharmaceutical firms, who are often given a legal monopoly for a certain number of years for new drugs. They are able to charge high prices in order to recoup their considerable investments in research and to make high profits. It is not uncommon for them to lower their prices in the last year of their legal monopoly in order to hold their market share when other companies enter. This is a typical example of market skimming price strategy.

![Figure 11.1 Skimming and penetration pricing strategies](image)

**Pricing strategy** | **Brief outline** | **Most likely to be used**
--- | --- | ---
Cost-plus | Mark-up – add a profit % on cost of goods bought in by retailers. Full cost – add up all costs for producing each unit and add % for profit. Contribution pricing – add up all variable costs for producing each unit and add % for contribution. | Mark-up – used by retailers to ensure cost of materials is covered plus gross profit margin. Full cost – by a single product firm or where fixed costs can be accurately allocated to product lines. Little notice taken of competition. Contribution pricing – used when fixed costs cannot be accurately allocated to different product lines or when spare capacity exists and full cost pricing would deter consumers. |
Competition pricing | Using information about competitors’ prices for similar products as a basis for pricing decisions. | In a competitive market situation with rival companies selling similar products. In certain situations prices may be set above or below competitors’ prices. |
Perceived value | Researching consumers opinions on the value they give to a product and basing price on this value. | When the psychological perception by consumers of the product’s quality and the value it offers should be reflected in the price. |
Going rate | Setting price at the same level as competitors. | When there is so little difference between the products being sold by rival firms that the business sets price at same level as them. |
Penetration pricing | Price new products lower than rivals – may raise price at a later stage. | To gain market share quickly – product life cycle may be short. |
Price skimming | Price new products higher than rivals – or the product may be unique. Price could be lowered at a later stage. | To recover R&D costs and establish a prestige image for the product. |

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**Pricing strategies – a summary**