19 Price - influencing the market

Influences on pricing

The pricing strategies used by a business may be influenced by a number of factors.

Objectives The pricing strategy chosen by a business is likely to reflect the extent to which it wants to maximise profits or sales. A business seeking to maximise short-term profits may use more aggressive and perhaps risky pricing strategies.

The marketing mix The price chosen by a business must complement the marketing mix. This means that the price must fit in with the nature of the product itself and the way in which it is being promoted and distributed to consumers. For example, a low quality product being sold in retail outlets at the bottom end of the market is likely to be sold at a fairly low price.

Costs A business which cannot generate enough revenue over time to cover its costs will not survive. In the long run, a business must charge a price which earns enough revenue to cover its total cost of production at any level of output. This means that businesses must take account of all of their costs when setting price. In the short run a business may not expect to cover the fixed costs of its factory or machinery. Providing its price is high enough to generate revenue that covers its variable costs, the firm will stay in business. Revenue below this will cause the business to cease production. As a result businesses may have greater flexibility in the short term when making pricing decisions.

Competition Competition can affect pricing decisions For a market trader, the price of her goods is largely determined by prices on nearby stalls selling similar goods. Such a trader will have little room for manoeuvre compared to a business which faces less competition. A monopolist that dominates the market may be able to charge higher prices.

Demand The higher the price set the lower the quantity sold. The effect that a higher prices has on sales is dealt with in the unit titled 'Elasticity of demand'.

Consumer perceptions Businesses must pay attention to what consumers think a product is worth. A product priced above what consumers consider its value to be may generate low sales because of doubts about its value for money. A product priced too low may also generate low sales. This is because consumers often suspect that such products have something wrong with them or that they are of inferior quality. In some cases businesses actually encourage consumers to think of their products as expensive to encourage high income earners to buy them.

Market segment Businesses that produce a range of products are likely to have some aimed at particular market segments. This is true, for example, of all major car manufacturers. They are, therefore, likely to charge different prices for each segment. However, the price which they charge to one segment of the market will affect the prices charged to other segments. A product competing in the top end of the market will need to have a different price from one aimed at the middle or bottom end of the market.

Laws and regulations The price of a number of products is affected by government. Taxes can raise the price above the level that might have been set by manufacturers. Products affected greatly by taxation include cigarettes, alcoholic drinks and petrol. There is also a number of products which are offered to consumers below the price that producers would normally charge. Such products are subsidised by the government. Maximum prices can also be set. For example, the price of products such as water and gas in the UK are determined by regulatory bodies.

Question 1.

The price of each product in a market will be influenced by a variety of factors. For some products, the ability of a business to set its price is limited. For others, there will be more scope for a business to set the price it wants to charge.

(a) What factors may have influenced the prices of the products in the photographs?

Pricing strategies

A strategy is a set of plans designed to meet objectives. PRICING STRATEGY is part of the marketing strategy of the business. Other strategies such as product and distribution strategy also make up a marketing strategy. Marketing strategy is then part of the corporate strategy of the business. Other strategies include production and financial strategy.

Pricing strategy is therefore a set of plans about pricing which help a business to achieve its marketing and corporate objectives. For example, a corporate objective might be to double in size over the next five years. A marketing objective to achieve this might be to take the products of the business 'up-market'. The pricing strategy developed from this could be to increase the average price of the products made by the business.

- Some pricing strategies can be used for **new products**, such as market skimming or penetration pricing.
- Some strategies may be more suitable for **existing products**.

Cost based pricing

All businesses are influenced by their costs when determining prices with costs acting as a 'bottom line' when choosing a price. But some use COST BASED PRICING as their strategy for price setting. Businesses using cost-based pricing are those where the influence of cost is more important than other factors such as market conditions or competitors' pricing. The local garage repair business or domestic repair services like electricians and plumbers are likely to take a cost-based approach.

There is a number of methods that businesses use to set their prices which are based upon particular costs.

Cost plus pricing This involves setting a price by calculating the average cost of producing goods and adding a MARK-UP for profit. If a business produces 10,000 goods costing £50,000, the average cost would be £5.00. A mark up of 20 per cent would mean goods would cost an extra £1.00 and the price would be £6.00 per product. Retailers often use this method of pricing. Say that a department store buys a colour TV from wholesalers for £200 and its mark-up to allow for a profit is 100 per cent. The retail price to consumers will be £400.

Figure 1: Cost plus pricing

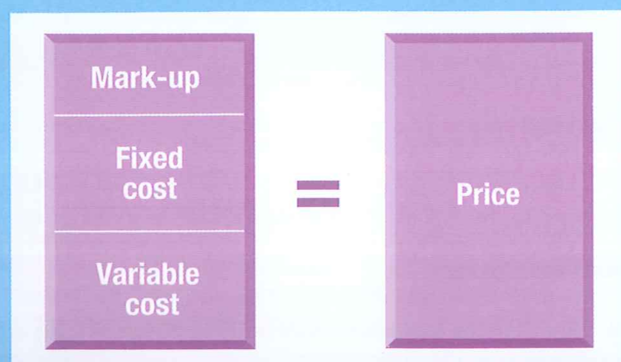
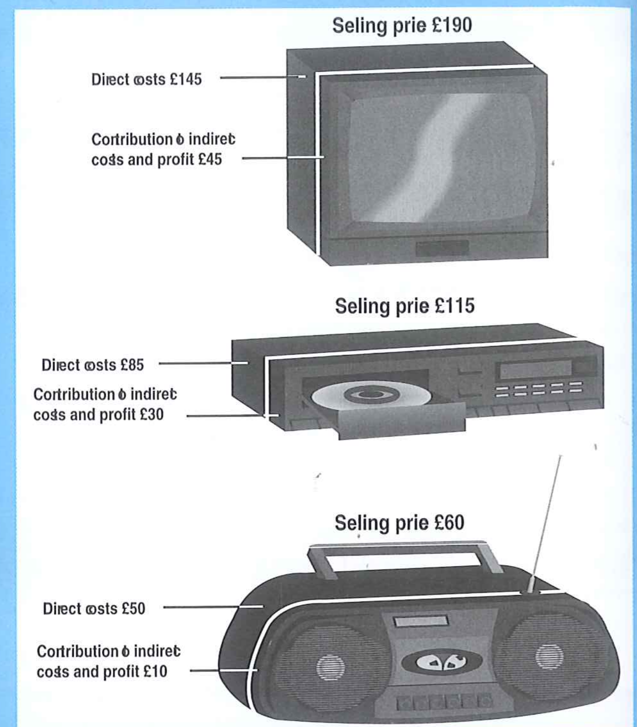


Figure 2: Contribution pricing



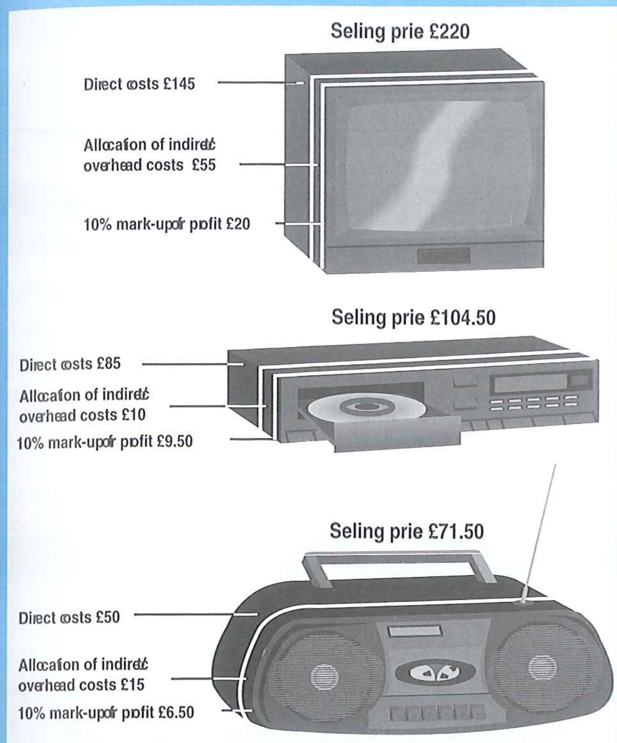
The attractiveness of cost plus pricing is that it is a quick and simple way of setting a selling price. It also ensures that sales revenue will cover total costs and generate profit. A criticism, however, is that a fixed mark-up does not allow a business to take market needs into account when setting prices. In addition, no attempt is made to allocate indirect costs to particular products. This means they do not reflect the resources being allocated by the business to that particular product or product range.

Contribution pricing This method takes into account that different products within a company might need to be priced using different criteria. For each product, a price is set in relation to the **direct costs** of producing that product and any **contribution** that the business wants that product to make towards covering its **indirect cost** and towards profit. Thus for a manufacturer of electrical goods, some prices might be as set out as in Figure 2.

No one product will be **expected** to account for all the indirect costs of the business. Each product's selling price would make some contribution to meeting indirect costs. If the producer expected to sell 100 items of each product and had to cover indirect costs of £6,500 and generate profit of £2,000 (£8,500) then:

Product A	£45 x 100 =	£4,500	contribution
Product B	£30 x 100 =	£3,000	contribution
Product C	£10 x 100 =	£1,000	contribution
		£8,500	

Figure 3: Absorption/full cost pricing



This allows businesses more flexibility than the cost plus approach. Successful products can be priced to make a large contribution. Less successful products or new products can be priced more competitively, as they need only to make a lower contribution to overheads and profits. Indeed, new products might even be making a negative contribution, ie their price does not even cover the **marginal cost** of production. Demand factors as well as cost factors are now being taken into account.

Absorption cost/full cost pricing A business may attempt to take into account the indirect costs that can be attributable to a particular product in deciding on a price. This is known as absorption or full cost pricing. In its simplest form an arbitrary method is used to allocate indirect costs to each product, for example, a percentage of total sales or total direct costs. The electrical goods manufacturer might charge the prices in Figure 3. A mark-up is then added for profit.

A more sophisticated method of allocation can also be used. Using this method to allocate indirect costs, each element of the cost will be treated separately. This means the selling price of a product will absorb elements of each overhead cost.

As we can see from Figures 3 and 4 the price of the TV is different according to the method used. A different costing formula will lead to a different final price. Under the arbitrary method a larger allocation of indirect/overhead costs was made to the television's final price.

Target pricing This is sometimes known as **target profit pricing**. It involves businesses setting prices that will earn them

Figure 4: Target pricing

a particular level of profit, which has been clearly targeted. When setting a target price (or profit) businesses make use of break-even analysis. Figure 5 shows the break-even chart for a small business producing leather briefcases. It is based upon a selling price of £90, fixed costs of £30,000 and variable costs of £30 per briefcase. In order to break-even the business must produce and sell 500 briefcases. If, however, it wishes to target a profit of £30,000 then it must produce and sell 1,000 briefcases. Using break- even analysis in this way businesses can target a particular level of profit for their product.

The price which is charged for a product affects the demand for a product. The precise relationship between demand and price is measured by price elasticity of demand. Thus the briefcase manufacturer may wish to estimate the demand for its briefcases at various price levels. It can then choose a price and associated sales which will enable it to make the profit that it wants. This is shown in Table 1. Table 1 shows that the business would not benefit at present from either lowering or raising its price from £90.

Problems of cost based pricing

Cost based pricing does have a number of problems. It is a

Figure 5: A break-even chart for a briefcase manufacturer

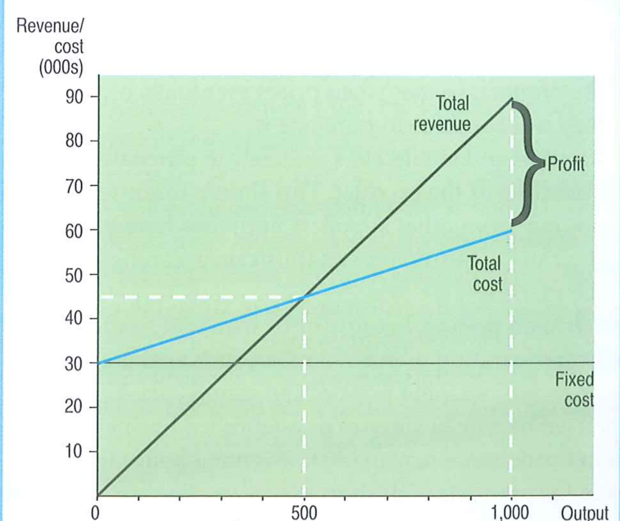


Table 1: Profits and break-even at different price levels for a briefcase manufacturer

Price	Estimated demand at given price	Total revenue	Total costs (Fixed costs = £30,000 variable costs = £30)	Break-even point	Profit
(£)		(£)	(£)		(£)
80	1,100	88,000	63,000	600	25,000
90	1,000	90,000	60,000	500	30,000
100	800	80,000	54,000	429	26,000

product and cost orientated approach which does not refer to consumers' wishes or flexibility. Contribution pricing does, however, allow more flexibility than cost plus pricing for a particular marketing strategy. Full or absorption cost pricing may result in prices being set too high or too low in relation to consumers' wishes or competitors' prices. They are also inflexible in response to market changes, as these would not necessarily be reflected in the costs of a company. The more sophisticated the costing method used when pricing, the more accurate is the allocation of costs to a product, but the further the price might be from what the market will bear.

Market orientated pricing

MARKET ORIENTATED PRICING methods are those which are based upon an analysis of the conditions in the market at which a product is aimed. As such, they are much better suited to market orientated businesses.

Penetration pricing This is used by businesses seeking to gain a foothold in a market, either with new products or with established products being placed in new markets. It involves pricing a product at a low level so that retailers and consumers are encouraged to purchase the product in large quantities.

There are two main reasons why businesses use penetration pricing.

- Consumers are encouraged to develop the habit of buying the product, so that when prices eventually begin to rise they will continue to purchase it.
- Retailers and wholesalers are likely to purchase large quantities of the product. This should mean that they will not buy from other suppliers until they have sold most of their stock. Businesses can thus gain a significant slice of the market.

Penetration pricing, because of its high cost, is often used by large firms operating in mass markets, such as those selling biscuits, sweets, washing powder and canned drinks. It is also a policy used by new businesses or established businesses in other areas to break into a new market. It is not a policy that is suitable for products with short life cycles. There is usually not enough time to recover the cost of lost revenue from the initially low price. One exception to this is new CD singles. They are sometimes launched at a lower price in the first few weeks of release before being raised to their full price.

Market skimming Market skimming involves charging a high price for a new product for a limited period. The aim is to gain as much profit as possible for a new product while it remains unique in the market. It usually means selling a product to the

Question 2.

Patel and Co has been manufacturing aluminium ladders since the business was set up in 2000. Its sales up to now have been based upon two products, a 10 metre and a 15 metre folding ladder. The business has adopted a cost plus method of pricing for each ladder, as illustrated in Table 2.

Table 2

10 metre ladder	Average cos per unit £92	20% mark-up to cover profit £18.40	Selling price to trade £110.40
15 metre ladder	Average cost per unit £125	20% mark-up to cover profit £25.00	Selling price to trade £150.00

Because of the success of these two products and pressure from competition, the company has developed a new product, a ladder which would allow people to gain constant access to their lofts, but which will be permanently attached to the loft entrance. With a third product, the company's accountant felt that a contribution pricing approach should now be used to price each of their products. He set out some initial calculations of their likely prices, as in Table 3.

Table 3

	Direct costs per unit	Contribution to indirect cost and profit	Price
10 metre ladder	£80	£35	£115
15 metre ladder	£105	£40	£145
Loft ladder	£185	£5	£190

The pricing for the loft ladder was set at a level which was in line with the price of competitors, which was £190.00.

(a) Identify the benefits to the company of using a contribution pricing approach compared to a cost plus approach for their ladders.

(b) Is the loft ladder a viable product for the company to produce given the figures produced by the accountant? Explain your answer.

most profitable segment of the market before it is sold to a wider market at a lower price.

There are two reasons why businesses adopt market skimming. They may try to maximise revenue before competitors come into the market with a similar product. Often new techniques or designs mean that entirely new products, or new versions of a product can be offered. Examples include new fashions in clothes, new childrens' toys and new inventions. When first launched, a basic digital watch could cost as much as £50 or £60. Now they often sell for as little as a few pounds. Market skimming can also be used to generate revenue in a short period of time so that further investment in the product can be made. Companies in the electronics and pharmaceutical industries often use skimming for this reason.

Customer value pricing This involves charging the price that consumers are prepared to pay. Products which have prestige names attached to them, such as Rolex, may be able to command a higher price because of the status of these names. Products for one-off events, such as music festivals or sports finals, may be given a high price because they are unique.

Loss leaders LOSS LEADERS are products priced at very low levels in order to attract customers. The price of a loss leader is set lower than the average total cost of producing the product. The company selling the product makes a 'loss' on each product sold. Businesses use this pricing technique because they expect the losses made on the loss leader to be more than compensated for by extra profits on other products. It is often used by larger supermarkets which sell everyday products such as baked-beans, bananas and corn flakes for very low prices. They aim to attract more customers into their stores, drawn in by the low prices. The 'captive' customers will then buy more highly priced and profitable items.

Psychological pricing Many businesses seek to take account of the psychological effect of their prices upon consumers. This is known as psychological pricing. A common example is the use of prices just a little lower than a round figure, such as £199.99 rather than £200, or £29.99 rather than £30. Businesses using these slightly lower prices believe that they will influence the consumers' decision as to whether or not to purchase. Such slightly lower prices also suggest that consumers will be looking for value for money. For this reason, the producers of high status products such as prestige cars or designer clothing tend to avoid such prices. Instead, they often choose prices which psychologically match their consumers expectations of higher quality. So, for example, a price of £100 may be charged for a designer shirt rather than £99.99.

Price discrimination Price discrimination occurs when a firm offers the same product at different prices when consumers can be kept separate. An example is BT's policy of charging different prices to business and residential users at different times of the day and the weekend. This allows BT to take into account the differences in cost which exists at peak and off peak times. So, for example, calls may be charged at a higher rate on Monday to Friday, 8am-6pm, than at weekends.

This price discrimination is **time based**. The price you pay for a phone call is based upon the time of day or the day of the week when you use the service. Other businesses which use this policy are rail companies (cheaper off peak travel), and holiday firms which charge higher prices for their product during school holidays.

Price discrimination can also be **market based**. This involves offering different market segments the same product at different prices. An example of this is students being given discounts on coach and bus travel.

Discounts and sales These tend to support the pricing strategies used by businesses. They often mean a reduction in the standard price for particular groups of consumers. A very common form of discount is the seasonal 'sales' of retailers. The aim is to encourage purchasers at times when sales might otherwise be low and to clear out of date and out of fashion stock. Discounts may also be given to those customers who buy in bulk or in large quantities.

Competition based pricing

With COMPETITION BASED PRICING it is the prices charged by competitors which are the major influence on a producer's price. It is used mostly by businesses which face fierce and direct competition. As a rule, the more competitive the market and the more homogeneous the products competing in that market, the greater the pressure for competition based pricing. Markets similar to the model of oligopoly will often use this form of pricing. For example, soap powder producers tend to be influenced by the price of competitors' products.

Going rate pricing This occurs in markets where businesses are reluctant to set off a price war by lowering their prices and are concerned about a fall off in revenue if prices are raised. They examine competitors' prices and choose a price broadly in line with them. It also occurs when one dominant business establishes a position of **price leadership** within a market. Other firms will follow suit when the price leader changes its prices. This type of policy can be seen when a petrol company changes the price of a gallon of petrol or when banks and building societies change interest rates.

Companies which operate in markets where going rate pricing occurs will often be frustrated by their inability to control their prices more closely. A strategy often used in such circumstances is to establish a strong **brand** identity for your product and to differentiate it from others on the market. This would be through unique design features or quality of service. An oil company's decision to upgrade all of its service stations is an example of an attempt to achieve this. A strong brand identity and unique product features allow firms much greater scope for choosing their own price levels.

Destroyer pricing The aim of destroyer pricing is to eliminate opposition. It involves cutting prices, sometimes greatly, for a period of time long enough for your rivals to go out of business. It could be argued that the offering of low price airline tickets by Ryanair and EasyJet in the 1990s was designed to drive out competition from the national European airline carriers and force some of them out of business. Some, like BA and KLM, responded by setting up their own low-price carriers and cutting prices. Others, like Sabena and SwissAir, did go out of business.

Closed bid pricing This method of pricing occurs when firms have to TENDER a bid for work which they are going to carry out. This is common practice for firms dealing with the government or local authorities. For example, if a new road is to be built firms will be invited to put in a bid to win a contract for the work. Firms will clearly need to pay very close attention to the price at which they expect their competitors to bid. Sometimes, when a number of firms bid for a contract, those with the highest prices are likely to be rejected. Another example of this type of pricing are the bids that the government organises for the National Lottery. In 2004 Camelot had won both the rounds of bidding against rival companies, including Richard Branson's Virgin group.

KNOWLEDGE

1. State 5 pricing strategies a business might use.
2. Identify 4 different pricing tactics that a business might use.
3. What are the main factors affecting a firm's pricing decisions?
4. Explain the difference between cost plus pricing and contribution pricing.
5. State one advantage and one disadvantage of cost plus and contribution pricing for a firm.
6. What is meant by absorption cost pricing?
7. Why might a firm use penetration pricing?
8. What is market skimming?
9. What types of firm might use market skimming as a pricing strategy?
10. Why might a business sell a product as a loss leader?
11. What is meant by psychological pricing?
12. What is meant by price discrimination?
13. Under what circumstances might a firm use competition based pricing?
14. Explain the terms:
    (a) going rate pricing;
    (b) destroyer pricing;
    (c) closed bid pricing.
15. Give 2 examples of tendering.

Pricing tactics

Once a business has decided upon its overall pricing strategy, it can also use price as a tactical promotional tool. This will usually involve temporary, short-term changes in prices to attract customers to specific products for a period. These PRICING TACTICS may include the following.

- Special promotional offers, such as buy one, get one free (BOGOF). Bookshops offer three books for the price of two and supermarkets offer two packets of meat for the price of one for example.
- Deliberately setting the price of a product at a low level in order to attract customers into a store to buy the product and hopefully others as well. These products are often referred to as loss leaders.
- Offering discounts on normal prices. This might be for a period of time, such as just after Christmas, for regular customers, such as offers on loyalty cards, for buying larger quantities, such as schools getting discounts for stationery, or for cost-effective purchasing, such as buying over the Internet.
- Making introductory offers. This is where the price a customer pays for the first purchase is lower than subsequent purchases. Examples include lower prices for monthly Broadband payments for the first few months or a lower price for the first issue of a magazine.

KEYTERMS

Competition based pricing – methods of pricing based upon the prices charged by competitors.
Cost based pricing – methods of pricing products which are based upon costs.
Loss leaders – products with prices set deliberately below average total cost to attract customers who will then buy other, more profitable, products.
Market orientated pricing – methods of pricing based upon the pricing conditions in the market at which a product is aimed.
Mark-up – that part of a price which seeks to provide a business with profit as opposed to covering its costs. It is used in cost plus pricing.
Pricing strategies – the pricing policies or methods of pricing adopted by businesses.
Tender – a bid to secure a contract for work.
Pricing tactics – ways of using price as a promotional tool usually over a short period of time.