Chapter 7

PRICE STRATEGIES

-- SOLVED QUESTIONS --

1. Conditioning factors in price.

- Legal framework.
- Market and competition.
- Company objectives.
- Interested parties.
- Cross elasticities.
- Interaction of marketing tools.
- Response to demand.
- Costs and product experience curve.
- Product lifecycle.

2. Pricing methods based on cost.

They are the simplest methods and those with greater cultural and social tradition. From a marketing point of view, they are not always the most effective to attain the company objectives.

These methods consist in adding a profit margin to the product cost. We can classify two basic types: the cost-based pricing and the break-even pricing, with which one can determine a price that will allow for the attaining of the sales and profitability objectives.

a) Cost-based pricing. It adds a profit margin to the cost of the product. The total cost per unit is calculated by adding to the variable cost the total of the fixed cost divided by the number of manufactured units.

b) Break-even pricing. This method attempts to set the price that allows for a profit. The breakeven point analysis is used, which consists in calculating the amount of product one must sell at a certain price to cover the full amount of the fixed and variable costs of manufacturing and sales of the product.

3. Method of pricing based on competition.

In these methods, competition behaviour is the reference for pricing, although costs set the lowest price at which the product can be sold.

Prices are set depending on the leadership position of the company. Generally, large companies are usually leaders and set prices, and the others, the smaller ones, follow them.

In general, enterprises set a price similar to the one established in the sector, unless they have an advantage or disadvantage in quality, availability, distribution or complementary services, in which case, prices are set higher or lower respectively.

Price differentiation, compared to quality or services provided gives rise to nine different price strategies.

4. Fixed or variable price strategies.

The fixed price strategy is usual in low involvement products or of a low-medium price. The consumer is not segmented. For example: the price of a newspaper.

The variable price strategy implies a greater flexibility in price and conditions. Price is subject to negotiation in each transaction. The process is usual in high involvement products for the consumer and high prices. For example: the purchase of a home.

5. Secondary market discounts.

Secondary market discounts are price reductions that do not affect the whole of the consumers, as do offers or sales, only those who meet certain requirements. It is what is called the secondary market and pricing is lower

than that of the main market. Secondary market prices may even be below total cost and only cover all of the variable costs and part of the fixed ones.

The secondary market may be limited by demographical features, for example, age or family size, and it is usual in transportation services. Geographic location, for example, consists in selling to another country at a lower price due to the economic situation of the said country. If this is done with the aim of controlling a market or eliminating competitors it constitutes what is known as dumping. Consumer discrimination also takes place for socioeconomic reasons, for example, when students receive special treatment in stores or financial entities. Lastly, they may be determined by the channel or point of sales; or example, Internet sales are frequently the most economical.

New customer loyalising technologies (CRM) allows us to personalize relationships with them. This is the case of Iberia Plus, one of the pioneer loyalty programs in Spain which offers very interesting advantages for its members in flights, hotels, etc.

6. Competitive strategies.

Pricing is done taking advantage of the possible competitive strategies with the same, higher or lower prices to those in the sector, regarding technological, cost production or distribution advantages.

In strong competition and similar product environments, the usual strategy is to set a similar price to those of the competition. However, if the enterprise offers products of a higher quality or provides complementary services, it can set higher prices and practice a premium price strategy.

A low price strategy or discount prices may imply a lower quality product or fewer complementary services.

An extreme case of low prices is the sale at a loss, which is selling at below production or purchase cost. It may be done with promotional aims, in clearance sales or in the winding up of interests. If they are used to harm or eliminate the competition it is a practice that is banned by the Unfair Competition Law.

7. Psychological price strategies.

They are based on the way the market perceives the amount of the price and the association the consumer makes of price associated to the features or attributes of the product.

A high price is usually associated to a quality service or product. This prestige price strategy is effective when a consumer perceives the product as superior. A low price, on the other hand, tends to be associated to a low quality.

A rounded-off price, usually upwards, gives the impression of a product or service of superior quality or prestige. On the other hand an odd price, such as 19.99 euros, is associated to a lower price. This strategy may be adequate for a lower category of goods or services or in promotional actions.

If the consumer's psychology is to be considered, price may be established regarding the value perceived, that is, by the satisfaction provided by a good or service. The perceived price includes the *buying price* or expected benefit, and the *transaction value,* or merits perceived from the offer and quality of the service received. For example a restaurant with a trendy design usually raises its prices due to the "ambience" of the place.

Finally, there is the reference price, a standard price against which the consumers compare the real prices of the products. For example, in the pharmaceutical industry it is usual for the laboratories to set a reference price.

8. Product line pricing.

When designing the price strategy for a line of products, one must take into account the global benefit of the line and not only of each one of the products which make it up. The price set for a product frequently affects not only its demand but also the demand for others of the line.

There are cross elasticities, it may be effective to use a loss leader strategy, which implies having one or two products of the line at a low price, that do not generate profits or even generate losses, as long as these products are a hook to bring in other customers and act as an "locomotive" to push the sales of other products which have a higher price and are more profitable for the company. This strategy is very common in hypermarkets.

When it is time for pricing products of a line that are complementary, such as accessories, one may set a bundle pricing which can be lower than the total sum of the individual prices of the items. In hotels, for example, it is usually

more economical to reserve full board than to have just the breakfast service and then pay for lunch and dinner.

In some instances the complementary products are an absolute must to use the main product. Nespresso, for example, makes its profit on the sale of coffee capsules. This strategy is called captive product price. In the case of services, this strategy is called two-part price: one part is flat, for example the cost of service membership, and another is variable, dependent upon the use of the service. This is the system used to set the fees for services such as water, phone, etc.

Lastly, another possible strategy is the single price for all of the products sold. In a buffet restaurant, for example, there is one price for all, independently of customer consumption.

9. Skimming strategy.

The skimming strategy fixes a high price at first, along with a high communication investment, to lure the "cream" of the market and lower prices slowly to bring in the market segments that are more prices sensitive. Technological products are the ones which usually use this strategy, for example the iPhone.

This strategy is recommendable when one or more of the following circumstances exist:

a) *It is an innovative product* which is a novelty for the consumer. If the product can be protected by patents, this strategy is especially recommendable.

b) *Demand is inelastic to price*. That is, demand would not grow with lower prices and there is a market segment willing to pay high prices. These segments are innovators and, to a lesser degree, the first to adapt.

c) *The market is segmented.* There are various segments with different needs and features and which have different price sensitivity.

d) *Demand is sensitive to promotion.* The process for the diffusion of new products, in the initial stages of its market presence, must be more heavily supported by promotion.

10. Penetration strategy.

The penetration strategy, on the other hand**,** sets lower prices from the start of the product launch in order to obtain the maximum penetration in the quickest way possible. It is recommendable when the following circumstances concur:

a) *The product is not a novelty* on the market and may be quickly copied by the competition.

b) *Demand is highly sensitive to price.* If it is considered that a price reduction will significantly increase the demand because the product is easy to adopt.

c) *Potential for the entry of other competitors* who will be attracted by price and high profits. A low starting price may present an important sector entry barrier.

d) *Scale economies.* If costs are significantly lowered as production volumes rise, lower starting prices may generate a higher demand which will allow for the production of large series at lower costs.

e) *Rapid investment recovery.* If one does not count on enough resources for a long term recovery of the investment, or doing so implies high risk, low starting prices must be set to stimulate demand quickly.