Pricing Strategies

Every market can be described as being 'onion shaped'. Each market has a high price sector at the top, a competitive middle, and a low-price sector. The degree to which the top range of prices differs from the bottom range is largely dependant upon the degree of product differentiation, which exists in the market. Narrow, undifferentiated products, e.g. materials supply, will have a very narrow band of distinction between the high-price and the low price suppliers. It is these markets, which are most sensitive to modest changes in price.

Companies operating in differentiated product fields have more freedom on price. Indeed executives in these companies often believe that their markets are more price-sensitive than is the case. This is because the nature of the selling/buying situation is such that even where the buyer is motivated by non-price factors, he will still attempt to negotiate the price from the platform at which the supplier sets it. Even when a purchasing officer has taken a buying decision, he will still attempt to get the price down, so the debate with the salesman turns on the issue of price. That factor deceives many companies into believing that price is more important than it really is.

Having a high price lends credibility to a selling story about high quality. From a high-price platform, if an excuse to offer a small reduction can be found, the buyer may feel satisfied at his 'bargain'. In contrast, the prices of the cut-price operator are never low enough for the buyer, and the company must fight for its arguments about product quality against a general background of suspicion.

Options

A rich variety of pricing strategies are practiced.

Cost-plus

Using this method, the figure for direct costs of materials and labour are added to an allocation of fixed costs and profits through a mark-up system. Dan Nimer, has found that 80 per cent of companies use cost-plus. Nimer describes this as an archaic practice for four reasons. First, it stresses the cost of production, which is irrelevant to the purchaser, and which can set only the minimum price that is acceptable to the company. Secondly, it leads to incorrect profit projections. Price has an effect on demand; in turn this reacts upon sales turnover and profit. Also as marketing costs become ever higher as a proportion of the total product cost, then the cost-plus system moves further away from 'cost' and ever deeper into 'plus'. The cost is usually quantifiable: the plus is an estimate. Thirdly, it seldom indicates what the buyer is willing to pay: nor does it reflect market segmentation - particularly price segmentation. Fourthly, it handicaps new product ventures when used by companies who insist on the recovery of the research and development costs within the product price.

However, in material intensive industries, particularly those having a multi-product range, say, in wholesaling and retailing, it is difficult to suggest another reasonable form of pricing technique.

Target pricing

This technique is used in corporate planning to establish pricing policies, particularly for capital-intensive companies. A required rate of return on the investment is specified, and converted into a trading profit objective. The likely sales volume is estimated, and standard costs based on this estimate are calculated. The profit objective, when added to the standard costs, yields the 'target' price per unit. The flaw is that price is a factor which influences sales volume, and this system ignores it. However, in product differentiated markets and capital-intensive companies, the technique when applied as a long-term policy has its merits.

Penetration pricing

This is the technique of moving into markets at very low prices in order to buy market share and a large volume of turnover. To succeed, the company must take sales away from competitors or must significantly increase the total size of the market by its move. The dangers involved in not achieving the required volume are obvious. The alternative strategy of moving prices up is seldom available to the cut-price operator because psychological pressures relating to the suspicion about the supplier's quality standards exert themselves on buyers.

The technique can be successful given three provisos. First, the market must be demonstrably price-sensitive. Secondly, the price advantage against competitors must be significant - usually 10 per cent or more. Thirdly, it is critical that the supplier has some technical or material advantage, which allows him a gross profit margin equal to or greater than the rest of the industry despite his lower price. If the supplier is price cutting simply because his competition is 'soft' on price, or collusive, then they will copy him immediately and his advantage will be lost. In penetration pricing it is important that competitors find it difficult to copy the reduction.

Skimming price

This is the reverse technique to penetration pricing, where the top price bracket of the market is skimmed off. This is a favourable strategic platform from which to trade. Companies using it recognize that they will not capture the bulk of the market. However, their arguments about high product quality are respected, and they find it easier to counter competitors' price moves. Their high gross margins give them profit protection and a hedge against material cost increases. To sustain their high price, they require a distinctive product or service advantage over the competition.

Plateau pricing

In price sensitive markets where costs and prices fluctuate wildly, sometimes prices can be set to stabilize the market. With this technique the rises and falls in the market are borne from net profit returns, rather than flowing through to price changes. This is one of the systems used to stop a price war; perhaps the most difficult exercise in the external marketing operation. To be successful the company needs a large market share; for a small company this technique is not available, however desirable. Its lack of market power leaves it unable to influence industry prices as a whole.

Diversionary pricing

This is where the prices are presented in such a way that the true nature of the price to the customer is disguised. For example, ice cream companies supply refrigerators to retail shops at a peppercorn rent. This is sufficient only to ensure that a legal contract exists. In return the retailers agree to stock the cabinet only with the company brand. The higher gross margins earned on the branded ice cream are sufficient to pay for the refrigerator. The same type of deal operates in the supply of rostatic copying. The supply companies agree to provide copying machines at a very low rate against a guaranteed order for copy paper. In selling new cars, most of the prices are standard from all dealers; each dealer will be very stable in pricing terms, but the offers in practice vary considerably from one dealer to another and are disguised with the trade-in and financing terms.

Competitive pricing

In this situation, a price leader exists in the market, and most competitors set their prices in relation to his - either above, below, or at the same level. In markets characterized by little product differentiation and those that are highly fragmented, this tends to be the popular technique. In such markets the profit performance is usually a function of the production efficiency of the firm.

Prestige pricing

Companies sometimes seek to carve out an exclusive corner of the market and demonstrate their specialization through very high pricing technique. This is a useful technique in markets affected by fashion or taste considerations. It has been found that the normal price demand curve can actually be reversed in some product fields; that is; sales of some products have been found actually to increase when prices are raised. The importance of the brand, the perceived quality differences, and the fear of making a wrong choice, all affect positively the buyer's willingness to pay more. In the consumer product field surveyed, portable stereos and tape recorders headed the list of products with reverse demand curves.

Promotional pricing

As a modified form of penetration pricing this is frequently used when the product sales fall off and the management judgment is that price is the inhibiting factor. The price is set at a standard that does not fully recover all the overheads at the original turnover level. This is done in the hope that extra sales volume will be gained and that this will fully recover costs and produce profits. It is, as is clear, a pricing policy with dangers attached. It may be useful to price some items this way. These products then act as 'loss leaders' to the rest of the range, gaining entry to buyers and trailing higher price products in their wake.

Discover promotion pricing

This technique is used where discounts play an important part in buying decisions. The technique is to set the list prices just above the market level, but provide higher discounts for buyers who then have the personal satisfaction of obtaining apparently high discounts. The technique has an additional advantage in that discounts need not be published in advance, but can be negotiated from buyer to buyer. Some buyers will not negotiate the full discount available to them, and the company thereby achieves a higher than average net price on those sales.

Bid pricing

This is familiar in jobbing firms and in those supplying plant or materials. Bid pricing techniques are all competition orientated and judged against the firm's capacity and need for the order. This is the prime example of setting prices based upon the expectation of competitors' prices, rather than having a rigid relationship with the company's own costs and demand.

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