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4.5 The seven Ps of the marketing mix

Price: Pricing methods

Setting the right price for a product is difficult. If the price is set too high, customers may not be willing to pay it. The business will lose sales. If the price is set too low, the revenues may not be high enough to cover costs of production. A business needs to carry out good market research to find the right price for its products. This section outlines some common pricing methods or strategies.

Figure 1. Price is one of the elements of the marketing mix.

Credit: Dimitri Otis, Getty Images

Concept

Economic sustainability

As has been mentioned, economic sustainability – which implies the idea of profit – is a central element of business activity. Price is a key element of this concept, since it is the only element of the seven Ps that brings money to the business. With that, the business will be able to support the well-being of some stakeholders (such as the community) and pay taxes to support public services.

Cost-plus (markup) pricing

Cost-plus (markup) pricing is a method of pricing a product or service whereby all total direct costs and some allocation of indirect costs are added together, along with some mark-up – either a fixed or percentage amount – to determine the sales price to the customers.

Sole traders who work in construction (builders or painters and decorators, for example) may adopt this simple pricing strategy. When calculating the price that they quote for a job, they may estimate all their costs, then add on a percentage to cover their profit margin. For example, suppose a builder estimates that it will cost 5000 GBP to build an extension on a client’s home. Using cost-plus pricing, the builder may decide to add 20% to cover their profit. Therefore, the price they charge to the customer will be 6000 GBP.

The advantage of this pricing method is that it is very straightforward. It is also likely, if the customer accepts the price, that the profit will be achieved. However the strategy is considered very inward facing. It takes no account of competition or the customer’s ability to pay, meaning that potential customers may be put off by prices that are too high.

Penetration pricing

Penetration pricing is a pricing method that businesses use to attract customers to a new product or service. When introducing a new product or service, the business often sets a low price initially to encourage consumers to try out the new product. Penetration pricing is a short-term strategy. Once loyalty has been established, prices will be increased so that normal profit margins can be achieved.

Penetration pricing is appropriate for products that will be purchased repeatedly. Diverse products such as shampoos, cereals or magazines might use penetration pricing. This group of products is sometimes referred to as ‘fast-moving consumer goods’.

One of the main advantages of penetration pricing is that the business may secure a large market share early on. Customer loyalty may be established quickly if the low prices encourage purchases. A disadvantage is that there may be low profit margins. If prices are increased later, consumers may be unhappy.

Examples of penetration price are streaming businesses, which offer a trial period of time in order to increase the number of people taking out subscriptions.

Figure 2. Businesses should be creative in choosing the best pricing methods.

Credit: krisanapong detraphiphat, Getty Images

Loss leader pricing

The objective of the loss leader strategy is to price a product lower than its production cost, in order to attract customers who can then be sold other, more expensive products. For instance, a popular or commonly bought 'seasonal feast' item could be sold at a loss by a grocery store, in the knowledge that the customers will also buy other items, which can be sold at a higher price.

This strategy can usually be implemented only by large businesses that can afford to set a price on a product that results in a loss for that product. Large businesses will have other products they can sell at higher prices to make up for the loss. So this strategy may not be appropriate for smaller businesses. Additionally, there is always a risk that the strategy will not work as the business planned and they may just experience losses.

The most important advantage of loss leader pricing is that businesses can increase their sales revenue. However this method only works when businesses are selling a large variety of products.

Predatory pricing

Predatory pricing describes a situation where a company sells a product or service at such a low price that other businesses cannot compete and – as a result – are forced to exit the market. Once rivals have left the market, the remaining company can enjoy a monopoly position and can raise prices accordingly. When this happens, consumers are left with less choice and are forced to pay higher prices. This method is seen as anti-competitive and is considered illegal in many countries.

The main advantage for the business using predatory pricing is that it is able to take up a dominant position in the market. It also limits the possibility of new businesses entering the market, which is a disadvantage to competitors. However, this pricing method is impossible to maintain over a longer period and, as mentioned, is considered illegal in many places. Only very large businesses – often multinational corporations – are able use predatory pricing. These companies have so many revenue streams in so many markets that they can sustain losses on some products or in some markets in order to drive out competition.

Making connections

Students learn about monopolies in the IBDP Economics course. A monopoly is where one company has a dominant position in a market. The use of predatory pricing can result in a monopoly, since the method eliminates competitors by reducing the price of the goods and services so low that competitors cannot survive in the market.

Premium pricing

Premium pricing is a pricing strategy that involves keeping the price of one of the products or services high in order to create a positive perception among customers. Because the prices are high, customers may believe that these products or services have a higher value than competing products. The advantage of this strategy is that the business may be able to earn higher profits, as long as the costs of the higher quality products are kept under control. The disadvantage of this strategy is that some consumers will not be willing to pay the higher prices. Some sales will be lost.

You may remember learning about premium pricing in Section 1.3.7 (/study/app/y12-business-management-a-hl-may-2024/sid-351-cid-174702/book/terminology-exercise-id-36522). Businesses that use the circular business model of product life extension can use premium pricing because their products last longer. You can see this with some clothing producers who specialise in high-quality, long-lasting products and/or have a ‘free repair’ policy. Consumers are often willing to pay more for a product that they will not have to replace soon.

Table 1 summarises the benefits and limitations of the different pricing methods studied in this section.

Table 1. Benefits and limitations of different pricing methods.

Pricing method	Benefits	Limitations
Cost-plus pricing	Simple and easy to ensure all costs are covered.	Inward facing and takes no account of the market.
Penetration pricing	Market share and customer loyalty may be established quickly.	Low profit margins are likely during the initial low price. Customers may not accept the price rise.
Loss leader pricing	Can lead to a large boost in sales revenue.	Is only possible for multi-product retailers.
Predatory pricing	Once competition is eliminated, higher prices and higher market share can lead to increased profits.	Is illegal in many countries.
Premium pricing	Can lead to higher profit margins and improved public perceptions of a company.	Can only be applied to a target market, which limits the possibilities to sell the products to a mass market.