The price decision

The four Ps

*In the second of his series on the marketing mix, **Peter Stimpson** considers the importance of the pricing decision within an integrated marketing strategy*

Deciding on the price of any product is not an easy task. Marketing managers probably lose more sleep over this decision than any other. No other business decision requires such careful balancing of potentially conflicting factors — the need to be competitive but profitable too. Managers' worries are made even more intense by the importance of getting it 'right' first time.

> VW have chosen a price for the new Golf that gives it a premium, almost Mercedes-like, image in the market.
> (*Observer*, 22 February 2004)

Launching a new product at a price that consumers consider too high could lead to embarrassing price cuts early in a product's life. Could this prove to be the case with the VW Golf in the UK? Special offers were announced just 6 weeks after its launch in Germany.

Setting a price that is too low could lead to non-existent profit margins and an undesirable marketing image for the product that could be hard to correct.

> I chose 20 pence because I want to fill the cinema. (Stelios Haji-Ioannou, Chairman of the easyGroup of companies, May 2003 at the opening of the first easyCinema)

The lowest internet price for the easyCinema has already risen to £1 — five times the original launch price. But is the 'cheap and cheerful' cinema image the one that customers want? According to consultants McKinsey, 80–90% of poor price decisions are because the prices for new products are *too low*.

Not just one pricing decision — but many

Marketing managers cannot just set one price for a product and then turn their attention to other matters. Prices for existing products have to be continually monitored and compared with competitors. Prices may need to be adapted to the dif-

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Pricing in practice 1
Profiteering or successful management reaction?

In 2003, many British Airways flights were cancelled as a result of a strike by baggage handlers. Virgin Airways was quick to respond to problems faced by BA customers. Within a day or two of the strike, it had raised prices on some of its premium seats on its transatlantic routes. Virgin had decided that this is what the 'market would bear', but was it unethical profiteering from another's misfortune, or making a smart marketing move in response to a competitor's temporary problems? The decision was certainly profitable in the short term — clever pricing can obviously impact on a firm's profitability.

Pricing in practice 2
The impact of increased competition

'Australian low-cost airlines Jetstar and Virgin Blue have launched a price war. 300,000 cut-price tickets are being offered for flights between Australia's eastern cities. Jetstar, the budget airline set up by the country's dominant airline, Qantas, said it would offer 100,000 tickets at A$29 to undercut Virgin Blue. Brett Godfrey, Virgin Blue's chief executive, responded by saying "To you, Jetstar we say we will match you 100,000 and raise you 100,000". His airline is now offering twice the number of tickets as Jetstar at the same very low price.' (Adapted from the *Financial Times*, 26 February 2004)

Qantas is confident that Jetstar's costs will be lower than those of Virgin Blue. It expects to break even this year and make a profit in 2005.

- Will a price war benefit either company?
- Will consumers definitely gain from this extreme competition?

Pricing in practice 3
The impact of the internet on pricing decisions

Over 50% of UK homes now have access to the internet. Online sales have increased by 40% in the last 12 months. How does the growth of internet buying affect pricing decisions? First, the internet increases consumer information about product prices and availability. At the click of a mouse we have almost perfect 'price transparency'. We can discover the prices of books, CDs, holidays and countless other products being offered by a huge number of suppliers. We can easily buy from the cheapest business without leaving our front room. This consumer knowledge has helped to drive down prices of many products, from CDs to cameras. It has also made it much more difficult for most businesses to price discriminate — charging different prices in different markets for the same product. This is because we all now have access to the cheapest market through our computers.

On the other hand, computer-selling has actually increased the use of price discrimination by airlines and other companies that can sell to identifiable customers who cannot resell to others. Try the easyCinema website — it gives you the option to state the price you are prepared to pay for a seat, from £1 to £10. Whether you are successful in bidding for a seat to see the film you want, on the day and at the time you want, depends on the strength of consumer demand. Ticket prices therefore vary greatly, depending on the film, day and time you choose. Airlines and travel companies can now vary their prices constantly as the deadline for a flight or holiday approaches — again, depending on the strength of demand.

Buying and selling via the internet gives power not only to consumers, it also gives power to certain types of businesses to vary prices between different consumers, depending on when they want the product and how early they book. Try asking the person next to you in the easyCinema or on a Ryanair flight how much they paid — the chances are it will not be the same as you.

ferent stages of a product's life cycle — for example, selling off stocks of a product nearing withdrawal from the market is often achieved with special, low-price levels. In short, pricing is a continuous process and prices need to be 'managed', from a product's launch to its withdrawal from the market.

Why is the pricing decision so important?

The price a business charges for its products has a number of very important consequences.

- **It will impact on the revenue, and therefore the profit the product makes for the business**. Sales revenue = price × quantity sold. This simple formula helps to indicate the importance of price. Changing the price will nearly always have an impact on sales revenue. *How much* revenue changes following a price change will depend on price elasticity of demand. Generally, a lower price will increase the quantity sold of a product. But, will this *always* be the case? By how much will demand change if the price is lowered?

Marketing managers need to have a good understanding of the link between the prices of their products and the demand for them. With existing products, this can often be gained by recording what happens to demand when price changes are made. With new products, it is much more difficult to get the price decision right — managers have to depend heavily on the results of market research.

- **It will have a psychological effect on consumers**. Consumers are complex beings. We would expect lower prices to lead to higher consumer demand, and higher prices to cut demand. But prices influence consumers' perception of product quality and image. Would sales of Versace clothes benefit from price cuts? In the short term, perhaps. In the longer term, the damage to the brand image and the reduction in the 'show off' appeal of the brand is likely to hit long-term sales and profits.
- **It might encourage competitors to enter the market**. Setting a high price in a niche market might encourage other businesses to aim products towards that market. High prices could lead to high profits — and potential competitors will want a share of the action too. Look at the premium ice-cream market. Häagen-Dazs revolutionised this market sector by charging very high prices for a carefully promoted 'premium' product. Look in the ice-cream freezer cabinet of a supermarket and identify how many competing brands there are in this market segment now.

The pricing spectrum

The price for a product can be fixed anywhere between two extreme levels. Take the case of stand-alone music players, such as Apple's iPod. The maximum price that could realistically be charged would be based on the value of the product's benefits to the consumer. This would depend on technical uniqueness and brand reputation. The lowest price would be based on an accurate analysis of the costs of developing and manufacturing the product (see Figure 1 overleaf). So where on this pricing spectrum would the final price be fixed? This will depend on the results of market

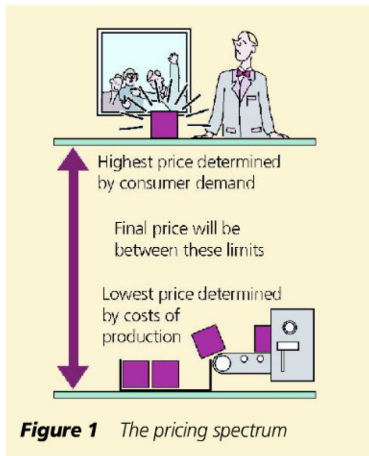

Figure 1 *The pricing spectrum*

research and the businesses strategy for the product.

Pricing strategies and pricing methods

The pricing strategy is the overall plan that the marketing department has for a product in terms of its price level. Within the chosen overall strategy, different pricing methods or tactics can be used to determine the actual price level. It often helps to consider pricing strategies for new products separately from those for existing products — Box 1 summarises the different strategies.

Once the *strategy* has been decided on, the marketing team must work out a final price *within* this strategic plan. This will involve using one of the following pricing methods.

- **Cost plus pricing** — estimate average total cost and add on a targeted profit margin. For example, a firm has fixed costs of £60,000 per month and variable costs of £1 per unit. It wants to price its product on the basis of a 25% profit margin on total cost per unit. Monthly sales are estimated at 100,000 units.

$$\begin{aligned}\text{Total costs per unit} &= \text{fixed costs per unit} + \text{variable costs per unit}\\ &= £60{,}000/100{,}000 + £1\\ &= £0.60 + £1\\ \text{Price} &= \text{total cost per unit} + 25\%\\ &= £1.60 + 25\% = £2.00\end{aligned}$$

- **Contribution pricing** — basing the price on the variable costs of production plus a contribution. This might be used when it is difficult or impossible to accurately allocate fixed costs to different products. For example, a hotel with several divisions, such as accommodation, bar, restaurant and conferences, would find it difficult to divide all fixed costs accurately between these divisions. Basing prices on variable costs plus an acceptable contribution margin would be the most likely pricing method.
- **Competitive pricing** — using existing prices for similar products as a guide to the price to be charged. For example, Esso's price watch campaign bases prices at each petrol station on an average of local competitors' prices.
- **Price discrimination** — charging different groups of consumers different prices for the same product. Clearly, the consumers buying it at a low price should not be able to sell it on to other consumers in the high-priced segment for a profit.

Box 1 *Pricing strategies*

New products

Strategy	Explanation	Likely use
Skimming price	Setting a high price at product launch which can be lowered if and when competitors enter the market.	For innovative products with little, if any, existing competition. If development costs are high, this strategy should allow them to be covered more quickly than with a lower price.
Penetration price	Setting a relatively low price to establish a significant market share.	When competitors already exist. If the product proves popular, perhaps because of successful differentiation, the price could be raised at a later stage.

Existing products

Strategy	Explanation	Likely use
Price leader	Setting a price higher than the market average.	When a business has a dominant brand or little effective competition.
Price taker	Setting a price in line with that of major competitors.	When there is significant competition or it is difficult to establish a clear brand identity for the products.
Predatory pricing	Setting a price lower than rivals, especially newly established competitors, with the intention of driving one or more of them out of the market.	When new competitors threaten to reduce market share and profitability of existing businesses. Careful — it could be illegal if proven.

Pricing as part of an overall strategy

The textbook definition of the marketing mix is: 'The marketing elements that businesses use to carry out their marketing strategy.' The key here is to understand that pricing is just one part of an overall strategy. Price decisions cannot be taken in isolation from other factors, including:

- the marketing objectives — high market share in a mass market or aiming for a niche market?
- the nature of the target market — for example, income levels and average consumer age
- the product — quality, innovativeness, design
- the promotion — the media to be used and the size of the budget
- the distribution methods used (place) — cheap mail order catalogues or exclusive department stores?

If the price decision is not supported by the other components of the marketing mix, then consumers will receive confused 'messages'. Will cheap furniture sold through Harrods appeal to shoppers there? Will consumers be convinced by exclusive and very expensive jewellery sold via eBay? A successful marketing strategy requires all parts of the mix to be interlinked and mutually supportive.

Conclusion

Pricing can never be just an afterthought or a stand-alone decision. Successful pricing decisions need to be based on substantial market research and made as part of an integrated marketing strategy.

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