Price Skimming

Price skimming involves setting a high price before other competitors come into the market.

This is often used for the launch of a new product, which faces little, or now competition – usually due to some technological features. Such products are often bought by "early adopters" who are prepared to pay a higher price to have the latest or best product in the market.

There are some other problems and challenges with this approach:

Price skimming as a strategy cannot last for long, as competitors soon launch rival products that put pressure on the price.

Distribution (place) can also be a challenge for an innovative new product. It may be necessary to give retailers higher margins to convince them to stock the product, reducing the improved margins that can be delivered by price skimming.

A final problem is that by price skimming, a firm may slow down the volume growth of demand for the product. This can give competitors more time to develop alternative products ready for the time when market demand (measured in volume) is strongest.

Penetration Pricing

You often see the tagline "special introductory offer" – the classic sign of penetration pricing. The aim of penetration pricing is usually to increase market share of a product, providing the opportunity to increase price once this objective has been achieved.

Penetration pricing is the pricing technique of setting a relatively low initial entry price, usually lower than the intended established price, to attract new customers. The strategy aims to encourage customers to switch to the new product because of the lower price.

Penetration pricing is most commonly associated with a marketing objective of increasing market share or sales volume. In the short term, penetration pricing is likely to result in lower profits than would be the case if price were set higher. However, there are some significant benefits to long-term profitability of having a higher market share, so the pricing strategy can often be justified.

Penetration pricing is often used to support the launch of a new product, and works best when a product enters a market with relatively little product differentiation and where demand is price elastic – so a lower price than rival products is a competitive weapon.

**Amongst the advantages claimed for penetration pricing include:**

- Catching the competition off-guard / by surprise

- Encouraging word-of-mouth recommendation for the product because of the attractive pricing (making promotion more effective)

- It forces the business to focus on minimising unit costs right from the start (productivity and efficiency are important)

- The low price can act as a barrier to entry to other potential competitors considering a similar strategy

- Sales volumes should be high, so distribution may be easier to obtain

**Penetration pricing strategies do have some drawbacks, however:**

- The low initial price can create an expectation of permanently low prices amongst customers who switch. It is always harder to increase prices than to lower them

- Penetration pricing may simply attract customers who are looking for a bargain, rather than customers who will become loyal to the business and its brand (repeat business)

- The strategy is likely to result in retaliation from established competitors, who will try to maintain their market share.

What is full cost-plus pricing?

Full cost plus pricing seeks to set a price that takes into account all relevant costs of production.This could be calculated as follows:

Total budgeted factory cost + selling / distribution costs + other overheads + MARK UP ON COST / budgeted sales volume

An illustration of applying this method is set out in this study note.

Consider a business with the following costs and volumes for a single product:

|  |  |
| --- | --- |
| **Fixed costs:** |  |
| Factory production costs | £750,000 |
| Research and development | £250,000 |
| Fixed selling costs | £550,000 |
| Administration and other overheads | £325,000 |
| Total fixed costs | £1,625,000 |
| **Variable costs** |  |
| Variable cost per unit | £8.00 |
| **Mark-Up** |  |
| Mark-up % required | 35% |
|  |  |
| Budgeted sale volumes (units) | 500,000 |

What should the selling price be on a full cost plus basis?

The total costs of production can be calculated as follows:

|  |  |
| --- | --- |
| Total fixed costs | £1,625,000 |
| Total variable costs (£8.00 x 500,000 units) | £4,000,000 |
| Total costs | £5,625,000 |
| Mark up required on cost (£5,625,000 x 35%) | £1,968,750 |
| Total costs (including mark up) | £7,593,750 |
| Divided by budgeted production (500,000 units) |  |
| = Selling price per unit | **£15.19** |

**The advantages of using cost plus pricing are:**

- Easy to calculate

- Price increases can be justified when costs rise

- Price stability may arise if competitors take the same approach (and if they have similar costs)

- Pricing decisions can be made at a relatively junior level in a business based on formulas

**The main disadvantages of cost plus pricing are often considered to be:**

- This method ignores the concept of price elasticity of demand - it may be possible for the business to charge a higher (or lower) price to maximise profits depending on the responsiveness of customers to a change in price

- The business has less incentive to cut or control costs - if costs increase, then selling prices increase. However, this might be making an "inefficient" business uncompetitive relative to competitor pricing;

- It requires an estimate and apportionment of business overheads. For example, total factory overheads need to be calculated and then allocated in some way against individual products. This allocation is always arbitrary.

- If applied strictly, a full cost plus pricing method may leave a business in a vicious circle. For example, if budgeted costs are over-estimated, selling prices may be set too high. This in turn may lead to lower demand (if the price is set above the level that customers will accept), higher costs (e.g. surplus stock) and lower profits. When the pricing decision is made for the next year, the problem may be exacerbated and repeated.

Amongst the factors that influence the choice of the mark-up percentage are as follows:

·**Nature of the market** - a mark-up should reflect the degree of competition in the market (what do the close competitors do?)

**- Bulk discounts** - should volume orders attract a lower mark-up than a single order?

- **Pricing strategy** - e.g. skimming, penetration (see more on pricing strategies further below)

**- Stage of the product in its life cycle**; products at the earlier stages of the life cycle may need a lower mark-up percentage to help establish demand.

Competitor-based pricing

If there is strong competition in a market, customers are faced with a wide choice of who to buy from. They may buy from the cheapest provider or perhaps from the one which offers the best customer service. But customers will certainly be mindful of what is a reasonable or normal price in the market.

Most firms in a competitive market do not have sufficient power to be able to set prices above their competitors. They tend to use **"going-rate" pricing** – i.e. **setting a price that is in line with the prices charged by direct competitors**. In effect such businesses are **"price-takers"**– they must accept the going market price as determined by the forces of demand and supply.

An advantage of using competitive pricing is that selling prices should be line with rivals, so price should not be a competitive disadvantage.

Psychological pricing

Sometimes prices are set at what seem to be unusual price points. For example, why are DVD's priced at £12.99 or £14.99? The answer is the **perceived price barriers** that customers may have. They will buy something for £9.99, but think that £10 is a little too much. So a price that is one pence lower can make the difference between closing the sale, or not!

The aim of **psychological pricing** is to make the customer believe the product is cheaper than it really is. Pricing in this way is intended to attract customers who are looking for "value".

The main problem is that the business needs some other way to attract customers. It has to use non-price methods to compete – e.g. providing distinct customer service or better availability.

Predatory pricing (note: this is illegal)

With predatory pricing, prices are deliberately set very low by a dominant competitor in the market in order to **restrict or prevent competition**. The price set might even be free, or lead to losses by the predator. Whatever the approach, predatory pricing is illegal under competition law.

Loss leaders

The use of loss leaders is a method of sales promotion. A loss leader is a product priced below cost-price in order to attract consumers into a shop or online store. The purpose of making a product a loss leader is to encourage customers to make further purchases of profitable goods while they are in the shop. But does this strategy work?

Pricing is a key competitive weapon and a very flexible part of the marketing mix.

If a business undercuts its competitors on price, new customers may be attracted and existing customers may become more loyal. So, using a loss leader can help drive customer loyalty.

One risk of using a loss leader is that customers may take the opportunity to "bulk-buy". If the price discount is sufficiently deep, then it makes sense for customers to buy as much as they can (assuming the product is not perishable).

Using a loss leader is essentially a short-term pricing tactic for any one product. Customers will soon get used to the tactic, so it makes sense to change the loss leader or its merchandising every so often.