Rewarding Learning

A2 LEVEL Section C

FACT FILES

Technology & Design

For first teaching from September 2011
For first award in Summer 2013

Selling the Product Part 2 (Price)

FACT FILE

technology and design

FACT FILE

3.17 Selling the Product Part 2 (Price)

Learning Outcomes

Price to include;

- determining the price and the elasticity of demand;
- pricing methods to include cost-plus, contribution pricing and perceived value;
- the pricing strategy for each of the stages of the life cycle of the product;

Course Content

Price

Price is the amount of money that a consumer must pay to a business or organization for a product or service.

Price is one of the most important aspects of marketing for a business for several reasons. A products price:

1. Can affect whether profits are made.
2. Can determine the volume of products manufactured.
3. Can affect the size of the market the business will have.
4. Can affect the image of the product.

The key to successful pricing is the ability to offer the product to the customer at an attractive price. The concept of price, value and quality are hard to separate. How much a consumer is willing to pay depends on how much they value the product. Below is a list of reasons why a higher price could be justified:

1. Extra features or characteristics
2. Apparent quality of the product
3. Reputation of the product brought about by promotion
4. Possibility of paying by credit
5. Guarantees – e.g. Delivery, Performance etc.

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Every business is constrained by consumer's willingness to pay for their products. A very high sales price which deters consumers would be a bad pricing strategy, especially if a business is trading within a competitive market where there is little differentiation between products.

If a business however is operating in a market with little competition and a clear demand for the product, a high sales price would be a good pricing strategy. The potential for profits will be high with a high sales price due to the lack of competitors.

Price Elasticity of Demand

Price elasticity of demand is the measurement of changes in demand for a product or service in response to changes in its price.

The higher the price elasticity of demand the more sensitive consumers are to changes in the price of a product.

Consumers will not purchase the product if the price is too high, these products are either not essential to consumers or a lot of alternative products may exist in the market place. The elasticity of demand can be determined by the availability of substitute products.

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A very low elasticity of demand means that consumers are less sensitive to changes in the price of the product.

When a product or service has low elasticity of demand it has an inelastic demand, examples of products that would have low price elasticity or an inelastic demand are oil and coffee. As oil prices rise, petrol pump prices rise, consumers need oil and petrol for heat and transport. Consumers cannot do without this product and there are few alternatives or substitutes available; therefore any change to the price will have less of an impact on the quantity demanded and consumers will pay the price charged.

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The following formula is used to measure this elasticity of demand for products:

Price Elasticity of Demand = percentage change in quantity demanded / percentage change in price

The formulae for finding the % change in quantity demand and % change in price are:

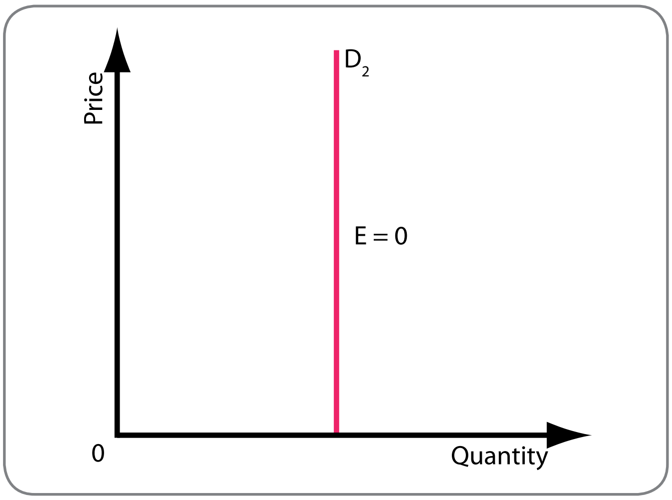
[Quantity Demand New – Quantity Demand Old] / Quantity Demand Old

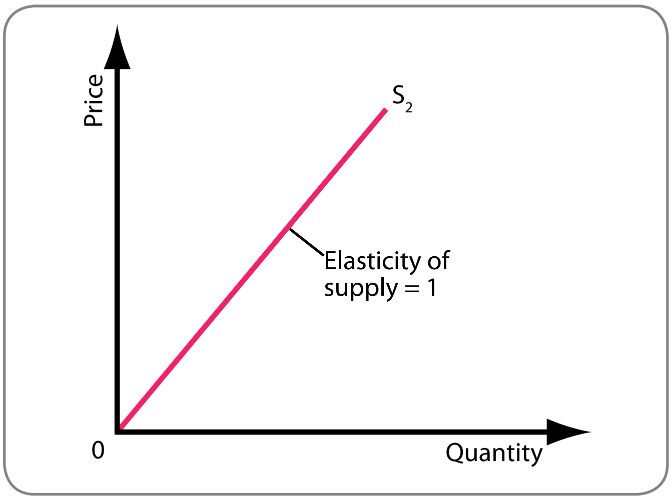
[Price New – Price Old] / Price Old

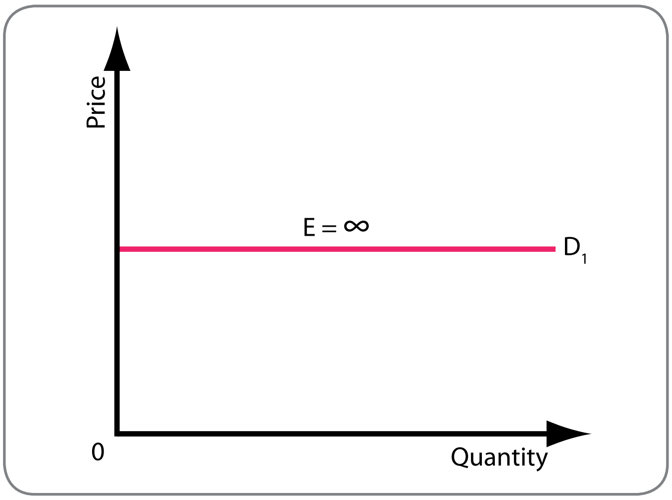
It is important to note the following:

- If the price elasticity of demand is more than 1 it is price elastic (Sensitive to changes);
- If the price elasticity of demand is equal to 1 it is unit elastic (Not sensitive to changes);
- If the price elasticity of demand is less than 1 it is price inelastic (Less sensitive to changes).

Price elasticity of demand is illustrated through the use of graphs. The graphs below illustrate what an elastic, inelastic and unit elastic graph looks like.







Pricing Methods

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A company's competitive advantage over its competitor's products is often achieved by adjusting the relationship between the product and its price in the market, this is referred to as pricing.

There are a range of pricing methods a business can use to achieve strong sales but the pricing method they choose to use will normally depend on:

- The product;
- Stage in the products life-cycle;
- Competition;
- The price people will pay; and
- The costs of production.

The types of pricing methods which could be used are:

- Price Skimming;
- Penetration;
- Competitive;
- Cost Plus;
- Perceived Value; and
- Contribution.

Price Skimming

Price skimming is used when the high price of a product will not deter consumers from purchasing a product. It is often used by businesses in markets where there is little or no competition for a product. This type of pricing is only successful if the product has an inelastic demand curve.

With price skimming a business will set a very high price at first for the product and then lower this price over the period of the products life-cycle. This is because the high product prices and profit attract competitors to the market and in order to maintain sales the price of the product has to be lowered.

Price skimming is used predominantly at the introduction stage of a products life-cycle. Companies with high-end products such as the Nintendo Wii normally use this pricing system.

Hemera/Thinkstock

Penetration Pricing

Penetration pricing is the method of setting an artificially low price at the start of a products life-cycle in an attempt to attract new consumers. This price is often lower than the eventual market price of the product. This type of product pricing is normally used in markets where there is a lot of competition.

A business will set a low price to initially attract new customers away from their competitors and then once the customers are hooked the business will raise the prices of the product.

Stockbyte/Thinkstock

Penetration pricing is often used by British Telecom, Sky TV, Gillette razors and blades and other similar companies.

Competitive Pricing

Competitive pricing is used by businesses when they are operating in a market where there is lots of competition, this type of pricing may be used during the growth and maturity stages of a products life-cycle when competition for market share is high.

In competitive pricing a business will charge a similar or lower price than their competitor's making their product more attractive to consumers and increasing their market share.

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An example of this type of pricing can be seen when you compare the price of products sold in Boots in comparison to those sold in Semi-Chem or Savers.

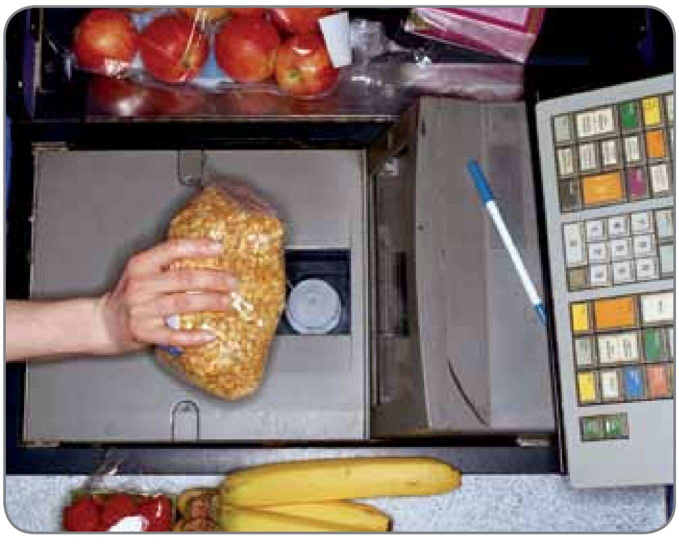
What is Cost Based/Plus Pricing

Cost based or cost plus pricing is the simplest form of pricing, a business calculates the price of producing their product and adds a percentage profit to this cost. The calculation to work out the cost plus pricing method is as follows:

Cost-based price = Total costs/Total sales + Profit

This method of pricing however has two problems:

- It does not take the demand of the product into account.
- The business has no way of knowing if the potential customers will pay the calculated price.



Digital Vision/Thinkstock

This pricing system is normally used by businesses that sell large quantities of products and operate in competitive markets that are led by price. As a result it is important that a business is always aware of the competitor's prices to ensure that this pricing system works.

What is Percieved Value Pricing?

Percieved value pricing also referred to as market led pricing is a market based approach to pricing that businesses use to determine the price of their products. It involves finding out from potential customers what they would be willing to pay for a product. With this system businesses set the price of a product on what they think the maximum price is, that a consumer is willing to pay.

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Perceived value pricing is often used by the home rental market, car rental companies and hotels. When the demand is low for the product for example during off-peak holiday seasons the price is low, but when the demand is higher the price will increase. The price set on these products is based on the highest perceived price that the business feels the consumer will pay.

This pricing system can be used during all of the stages of a products life-cycle and normally operates in competitive environment.

What is Contribution pricing?

By taking away the direct costs of producing the product from the sales price of the product a business can discover what contribution the product will make to its overheads (fixed costs) e.g.: rent, electricity etc . This is known as contribution pricing. Over a period of time this contribution to fixed costs diminishes and the remaining differences between the sales price and variable costs becomes profit.

This pricing system is often used by large manufacturing companies and exists throughout the life-cycle of a product. This pricing method would only be used for products that have long product life-cycles.

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Contribution pricing can be calculated by the following:

Sales Price – Variable Costs = Contribution

Product life cycle/pricing relationship

Entry or Introduction Stage. At this stage there are five potential pricing options:

- Penetration;
- Skimming;
- Cost-plus;
- Contribution based; and
- Perceived value.

Growth Stage

At this stage there are four potential pricing options:

- Competitive pricing;
- Cost-plus pricing;
- Contribution pricing; and
- Perceived value.

Mature Stage

At this stage there are four potential pricing options:

- Competitive;
- Cost-plus;
- Contribution; and
- Perceived value.

Declining Stage

At this stage there are three potential pricing options:

- Cost – plus;
- Contribution; and
- Perceived value.

Revision questions

1. Why is price such an important aspect of the Marketing Mix?

2. Some products in today's market are sold at a higher price than other competitors. Give **four** reasons why this might be.

3. Show with the aid of a diagram, the Pricing Strategy Matrix and discuss **two** of the pricing methods involved.

4. A pricing strategy used a lot in today's market place.
   - Explain what contribution pricing is?
   - Explain when and why a company might use it.

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