Edexcel (B) Economics A-level

Theme 2: The Wider Economic Environment

2.2 Firms, Consumers and Elasticities of Demand

2.2.2 Competing on price

Notes

Pricing strategies:

○ Cost plus (calculating mark up on unit cost)

When a retailer wants to know the gross profit margin of a sale in advance, they might use cost-plus pricing. A benefit of this is that the retailer reduces the uncertainty of profits, since they know costs will be covered if they can sell the good. However, it could lead to a fall in the quantity sold, the revenues and profits and market share of the firm since the price is uncompetitive.

○ Price skimming

This is a short term pricing strategy which is used most commonly when a new product is launched. This is when the product has little or no competition, so a high price is set temporarily before competitors enter the market. It is most common where technology has changed or a product is distinctive. It is only used in the short term, because the high profits earned in the market act as a signal to other firms to enter the market, so competition increases.

○ Penetration

This involves setting a low price initially, which is below the intentional price, in order to attract customers. It aims to encourage customers to switch to this brand since the price is low, and once consumer loyalty is gained, the price is increased again.

○ Predatory

This involves firms setting low prices to drive out firms already in the industry. In the short run, it leads to them making losses. As firms leave, the remaining firms raise their prices slowly to regain their revenue. They price their goods and services below their average costs. This reduces contestability.

○ Competitive

This is when prices are set based on the prices of competitors, and it is used when the products are similar.

- **Psychological**

This is a pricing strategy which uses the emotional and not rational reactions to the price of a good. For example, a good might be priced at 99p rather than £1, since the 99p price tag seems a lot cheaper than the £1 price tag, even though there is only a penny difference. Therefore, consumers might be more inclined to purchase the good.

Factors that determine the most appropriate pricing strategy for a particular situation:

- **Number of USPs/amount of differentiation**

If a product is unique or highly differentiated, the business is more likely to put a premium price on the product. If there are several similar goods in a market, prices are likely to be lower, since firms will only be able to differentiate on price rather than characteristics of the product.

- **Price elasticity of demand**

A good with a low price elasticity of demand (PED) is not very responsive to changes in price. This is more likely to have a high price, since the price does not affect the quantity sold significantly. A good with a high PED is more likely to have a lower price, since the quantity sold is more dependent on the price.

Goods with a strong brand image are more price inelastic, since consumers are more loyal towards the brand. Therefore, the business can charge premium prices.

- **Stage in the product life cycle**

When a product has been newly launched, a business might use penetration pricing if there is a lot of competition. This is with the aim of encouraging customers to buy their product instead of that of the competition. If the product is new and has no competition, the business might use price skimming, especially if initial demand is likely to be high. During growth and maturity, the price is more likely to be competitive. During the stages of decline, the price is more likely to be lower in order to sell off the remaining stock.