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Additional resource

Pricing strategies

The following presents a summary of different types of pricing strategies. Which is appropriate depends on the nature of the market and product or service being produced.

Product-line pricing occurs when a firm sets prices that are linked to other products. This means that sales of one product will be directly linked to the sales of another, so it is possible to sell one item at a low price in order to make a greater profit on the second item. For example, computer printers are sold at a very low price, but the ink cartridges and consumables are expensive. Mobile phones are often given away free, but the profits are made on the subscription contracts and call charges. Although most small start-up firms will have only a single product/service, they will need to be aware of larger multi-product/service competitors that may be pursuing product-line pricing strategies.

Skimming is the practice of charging a high price for a new product and then reducing it progressively as sales level off. Skimming is usually used by firms that have developed a technically advanced product or discontinuous technology. The advantage of this method is that the cost of developing the product is recovered fairly quickly. This means that the competitors will also have difficulty entering the market since their own development costs will have to be recovered in some other way. This pricing strategy is commonly used in consumer electronics markets and requires careful judgement of what is happening in the competitive environment in terms of consumer behaviour and competitor response. Market research is therefore critical to success and psychological pricing or prestige pricing occur when a higher price is charged for a product or service on the basis that it is an indicator of quality – whereas a low price would indicate the opposite. This applies to upmarket retailers (e.g. jewellery and high fashion) as well as to certain service industries because consumers are buying a promise and a poor service cannot be exchanged afterwards – hence the importance of quality and a price that reflects this.

Differential pricing is common in some service industries and also international markets. The brand is sold at one price in one market and at a lower price in another. For example, a company that is selling to both individual consumers and trade buyers will sell to the latter at a lower price on the basis of economies of scale.

Competitor-based pricing acknowledges the influence of competition in the marketplace. The entrepreneur must decide how close the competition is in meeting consumers' needs. If they are close then the entrepreneur will need to set prices similar to the competition. This is known as a meet the competition strategy and it avoids damaging price wars (which a small start-up can ill-afford) thus maintaining profitability. On the other hand, an undercut the-competition strategy has become very common among retailers

with little control over product features and benefits or the promotion of products. However, there is a risk of starting a price war when using an undercutting strategy, which is not a recommended approach for a small firm with limited market share and financial resources.

Penetration pricing is used when the firm wants to capture a large part of the market quickly. It relies on the assumption that a lower price will be perceived as offering better value for money. The danger of this strategy is that larger competitors will probably be able to sustain a low price indefinitely, eventually bankrupting the incoming entrepreneurial firm. The small firm is therefore advised to try and compete on some other aspect of the offering, such as quality and delivery.

Predatory pricing occurs when prices are set below the cost of production. The purpose of this is to bankrupt the competition and is now illegal in international markets. In order for the strategy to be successful, it is necessary for the market to be dominated by firms that cannot sustain a long price war (e.g. fragmented markets). Although small firms (due to limited scale and resources) are not in a position to pursue such a strategy, they may become victims of such an approach by larger companies. An example of predatory pricing occurred in the early 1980s when the entrepreneur Sir Freddy Laker's no-frills low-cost airline, Skytrain, was forced into bankruptcy following the predatory pricing strategies of the major legacy carriers. Careful monitoring of competitive behaviour is therefore critical.