Unit IV Introduction to Markets & Pricing Policies

Types of competition:

Definition:

Competition is the rivalry between companies selling similar products and services with the goal of achieving revenue, profit, and market-share growth. Companies strive to increase sales volume by utilizing the 4 components of the marketing mix, also referred to as the 4P's*:* product, place, promotion, and place.

Some of the early steps in designing a successful marketing strategy include knowing and understanding your competition. Consequently, if you are not current on whom the competition is, it becomes likely that another firm can provide a competitive advantage, such as product offerings at lower prices or value added benefits. Identifying your competition and staying current with their products and services and critical to remain competitive in the market.

Types of Competitors

Direct Competitors:

A direct competitor is another company that offers the same products and services aimed at the same target market and customer base, with the same goal of profit and market-share growth. A direct competitor is what typically comes to mind when you refer to the term 'competition,' and usually the type that draws the most focus from company's when designing strategies.

Customers will shop for a variety of price points, locations, service levels, and product features when determining their purchase. In comparison, though, customers will not similarly choose the same mix of these options - and this is where competition becomes a factor. Recognizing where your competition is positioned is a key factor in understanding the potential your business solutions can fulfill.

Indirect Competitors:

Indirect competitor is another company that offers the same products and services, much like direct competitors; however, the same end goals are different. These competitors are seeking to grow revenue with a different strategy.

Nearly every company is involved with some form of indirect competition. General contractors face indirect competition from do-it-yourself promoters, such as The Home Depot. Both of these strategies are aimed at satisfying the customer's needs and desires utilizing a different marketing mix. By outlining all the potential ways, the customer's needs can be met and using the marketing mix to handle the competition you can generate an advantage for your products and services.

Replacement Competitors:

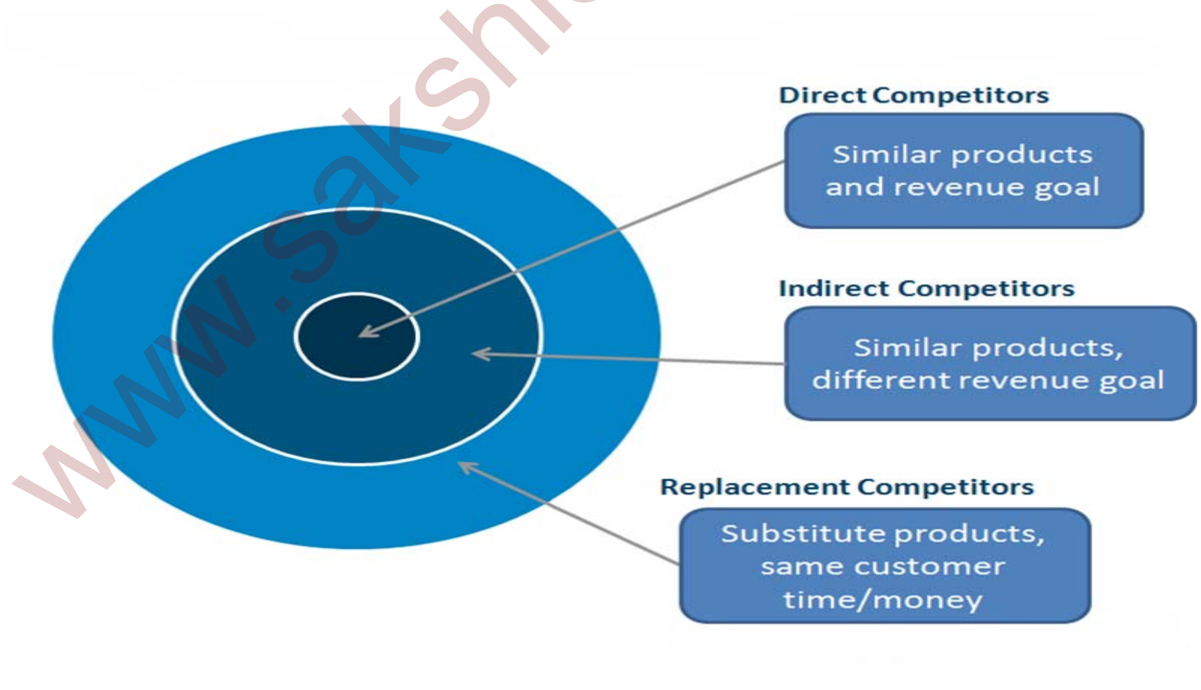
"A replacement competitor is something someone could do instead of choose your product," Paul remarked. "But they're using the same resources they could have committed to your product."

These are the most challenging competitors to identify. However, we must remember that our customers define our competition. After all, the competition is simply the other choices they may choose to make. So we must interview customers, listen to their social media conversations, and understand macro trends to gain an understanding of what choices they are really making.

Spacely Games Example*:* The Magic Tree House series of children's books is a replacement competitor for Spacely Games. Essentially, if children have a free hour in their day, they can either decide to download a game or to read a book.

Of course, I'm being a little idealistic assuming the average 8-year-old in 2012 is really considering reading a book instead of playing a mobile game, but that's my end point. You have to be a bit of an anthropologist and really study your customers to determine what they consider as replacement competition for your products and services.

So does an 8-year-old consider a book as competition for a mobile game? I'm guessing no. However, does a major influence on that purchase decision (in this case, the parent) consider a book to be a replacement competitor? Well, this parent certainly does.



Features of Perfect competition:

What is a Competitive Market?

The degree to which a market or industry can be described as competitive depends in part on how many suppliers are seeking the demand of consumers and the ease with which new businesses can enter and exit a particular market in the long run.

The spectrum of competition ranges from highly competitive markets where there are many sellers, each of whom has little or no control over the market price - to a situation of pure monopoly where a market or an industry is dominated by one single supplier who enjoys considerable discretion in setting prices, unless subject to some form of direct regulation by the government.

In many sectors of the economy markets are best described by the term oligopoly - where a few producers dominate the majority of the market and the industry is highly concentrated. In a duopoly, two firms dominate the market although there may be many smaller players in the industry.

Features of Perfect competition

1. All firms sell an identical product.
2. All firms are price takers.
3. All firms have a relatively small market share.
4. Buyers know the nature of the product being sold and the prices charged by each firm.
5. The industry is characterized by freedom of entry and exit.

Profit Maximization:

Profit is the difference between Total revenue and total cost. In order to find the firm's profit, we must know the firm's cost and revenue.

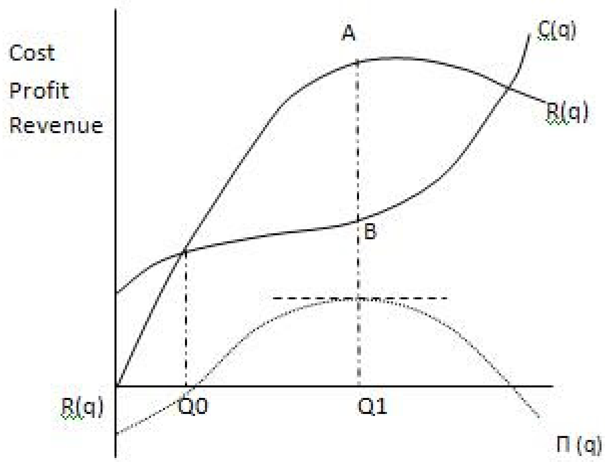
$\Pi(q) = R(q) – C(Q)$

Revenue = profit – total cost of production

Total cost of production is the sum of fixed cost and variable cost.

Revenue = Price of the product x number of units sold.

In order to maximize its profit, firms will choose the amount of output that minimizes the cost. With minimum cost and the same revenue, profit gets maximized.



We can derive the profit maximizing condition from equation 1,
Profit is maximized at a point where the slope of profit curve becomes zero. i.e. $\Delta \Pi/\Delta q = 0$
or $\Delta\Pi /\Delta q = \Delta R/\Delta q - \Delta C /\Delta q = 0$
Where $\Delta R /\Delta q$ = MR and $\Delta C /\Delta q$ = MC
Or MR – MC = 0
Or MR = MC.

Monopoly:

Monopoly is a market situation where only one producer exists in the industry with no close substitutes.
There are barriers to entry.

In reality, Monopoly rarely exists; always some form of substitute is available. Indian Railways is an example of Monopoly.

Why Monopolies Arise:

The fundamental cause of monopoly is barriers to entry and Economies of Scale. Barriers to entry have three sources:

Ownership of a key resource.

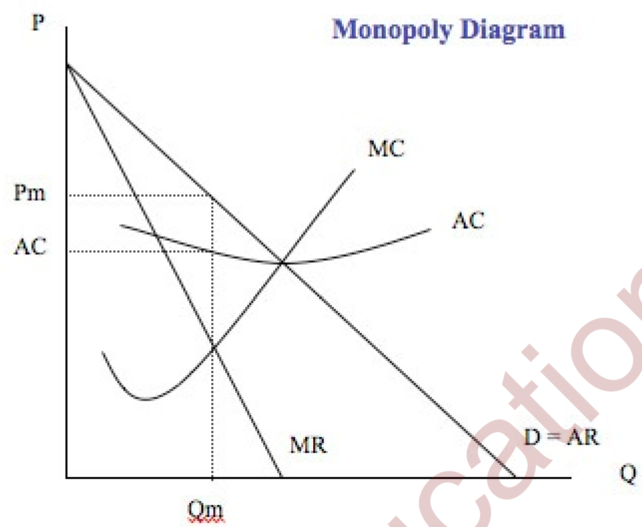
This tends to be rare. De Beers (diamonds) is an example

The government gives a single firm the exclusive right to produce some good.

Patents, Copyrights and Government Licensing.

Costs of production make a single producer more efficient than a large number of the producers.

Natural Monopolies.



A Monopolist is a price maker because he does not face any competitors. Therefore, demand is price inelastic.

A monopolist will seek to maximize profits by setting output where MR = MC

This will be at output Q m and Price Pm.

If the market was competitive the price would be lower and output higher.

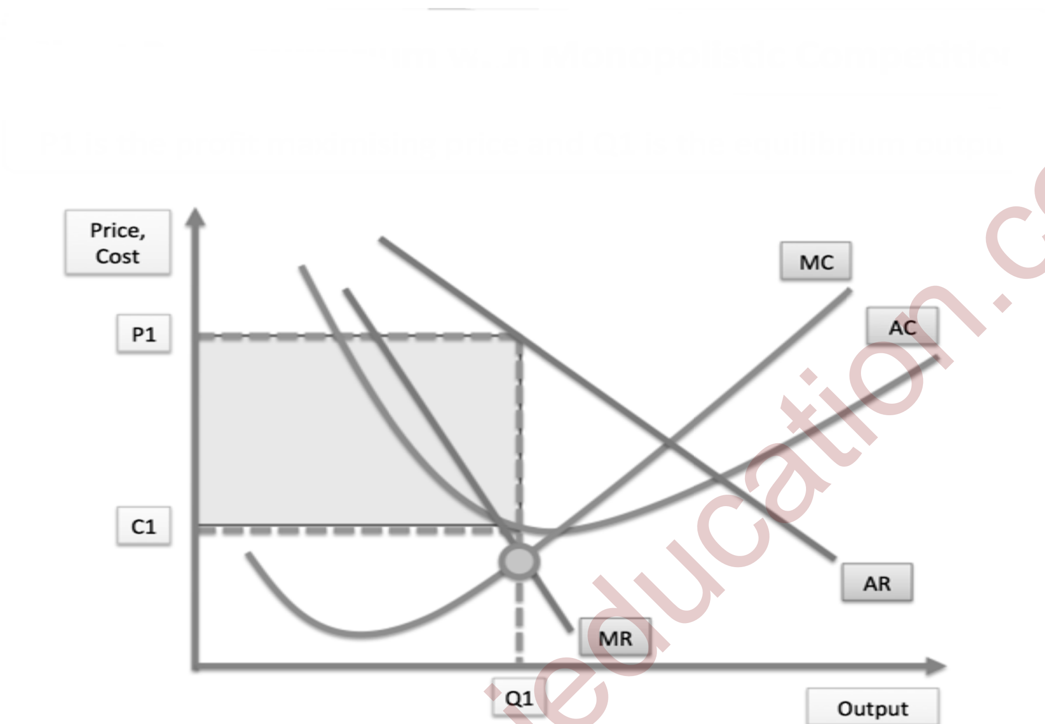
Monopolistic Competition:

Monopolistic competition is a form of imperfect competition and can be found in many real world markets ranging from clusters of sandwich bars, other fast food shops and coffee stores in a busy town centre to pizza delivery businesses in a city or hairdressers in a local area.

Small-scale nurseries and care homes for older people might also fit into the market structure known as monopolistic competition

Monopolistic competition is similar to perfect competition, some economist regard it as more realistic, because the products are differentiated.

Short run price, output and profit under monopolistic competition



The assumptions of monopolistic competition are as follows - as you check through them, look to see the differences between monopolistic competition and perfect competition.

There are many producers and many consumers - the industry concentration ratio is low.

Consumers perceive that there are non-price differences among products i.e. there is product differentiation – competition is strong, plenty of consumer switching takes place.

Producers have some control over price - they are “price makers" not “price takers" but the price elasticity of demand is higher than it would be under a situation of monopoly.

The barriers to entry and exit into and out of the market are low

In the short run the profits made by businesses competing in this type of market structure can be at any level - in our example above the business is making supernormal profits indicated by the shaded area.

Strong brand loyalty can make consumer demand less sensitive to price i.e. lowering the PED

Unlike monopoly, there are no barriers to entry. This means that the short run supernormal profit attracts new producers into the market, and so normal profits only are made in the long run equilibrium

As more firms enter the market, the demand curve facing any existing firm moves to the left (as consumers choose the products offered by new or alternative companies).

The demand curve continues to move to the left until it is tangential to the AC curve. At this point, the monopolistically competitive firm is at its profit-maximizing level of output (because MR = MC) but is making normal profit (because AR = AC)

In the long run equilibrium the representative firm in the market is making normal profits

The reality is that a stable equilibrium is never reached - new products come and go all of the time, some do better than others. Existing products within a market will typically go through a product life cycle that affects the volume and growth of sales.

Price-Output Determination in case of Perfect Competition and Monopoly:

MARKET STRUCTURE:

A market is a set of conditions in which buyers and sellers meet each other for the purpose of exchange of goods and services for money.

PERFECT COMPETITION:

The concept of perfect competition was first introduced by Adam Smith in his book "Wealth of Nations".

EQUILIBRIUM OF THE FIRM:

A firm under perfect competition faces an infinitely elastic demand curve or we can say for an individual firm, the price of the commodity is given in the market.

SHORT RUN EQUILIBRIUM OF THE PRICE TAKER FIRM:

By short run is meant a length of time which is not enough to change the level of fixed inputs or the number of firms in the industry but long enough to change the level of output by changing variable inputs.

SHORT RUN SUPPLY CURVE OF A PRICE TAKER FIRM:

In a competitive market, the supply curve of a firm is derived from its marginal cost curve. Supply curve is that portion of the marginal cost curve which lies above the average variable cost curve.

SHORT RUN SUPPLY CURVE OF THE INDUSTRY:

The short run supply curve of a competitive firm is that part of the marginal cost curve which lies above the average variable cost.

LONG RUN EQUILIBRIUM OF THE PRICE TAKER FIRM:

All the firms in a competitive industry achieve long run equilibrium when market price or marginal revenue equals marginal cost equals minimum of average total cost.

LONG RUN SUPPLY CURVE FOR THE INDUSTRY:

While explaining the short run supply curve for the firm, we stated that the supply curve in the short run is that portion of the marginal cost curve which lies above the average variable cost curve, it is because of the fact that when the variable casts of a firm are realized, the firm decides to produce the goods.

PRICE DETERMINATION UNDER PERFECT COMPETITION:

Dr. Alfred Marshall was the first economist who pointed out that the pricing problem should be studied from the view point of time.

MARKET PRICE:

In a market, there are two sets of forces tending in the opposite direction. On the one side, there are large numbers of buyers who compete with one another for the purchase of commodities at lower prices.

DETERMINATION OF SHORT RUNS NORMAL PRICE:

In the short run, the size of a firm and the number of firms comprising an industry remain the same. The time is considered to be so short that if demand for product increases, the old firm can use their existing equipments more intensively but new firms cannot enter into the industry.

LONG RUN NORMAL PRICE AND THE ADJUSTMENT OF MARKET PRICE TO THE LONG RUN NORMAL PRICE:

When we speak of a long period, we do not mean an interval of time in which we all may be dead. By long run is meant the period in which the factors of production can be adjusted to changes in demand.

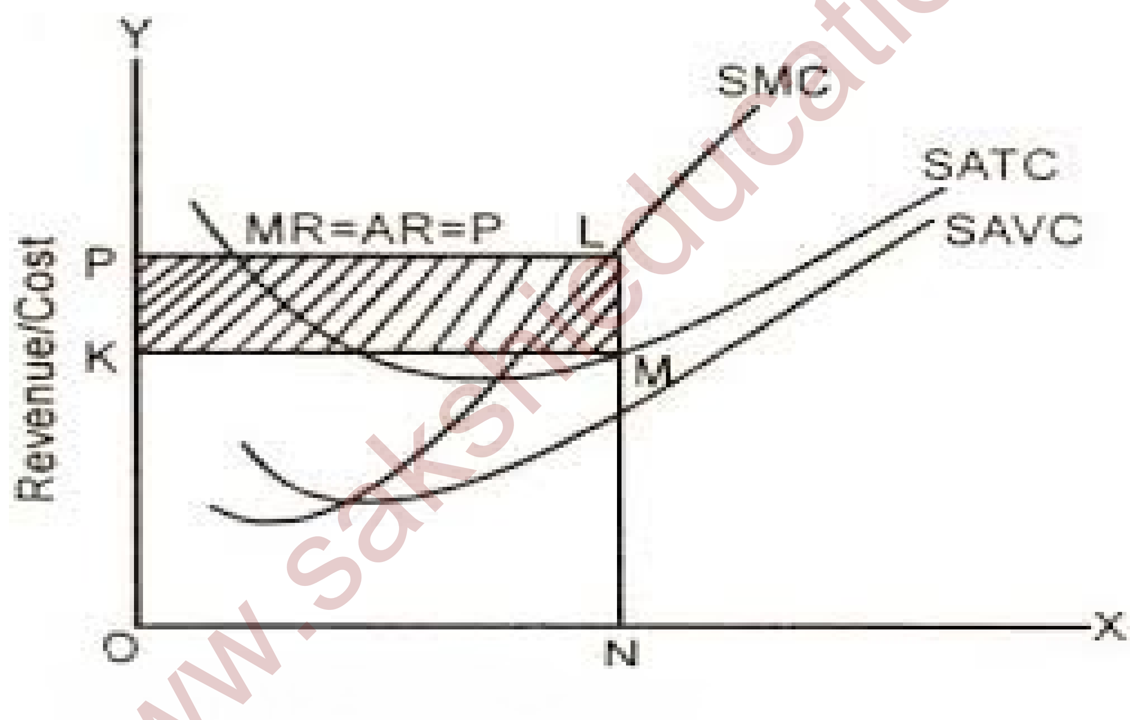
Large number of firms:

The basic condition of perfect competition is that there is a large number of firms in an industry. Each firm in the industry is so small and its output so negligible that it exercises little influence over price of the commodity in the market. A single firm cannot influence the price of the product either by reducing or increasing its output. An individual firm takes the market price as given and adjusts its output accordingly. In a competitive market, supply and demand determine market price. The firm is price taker and output adjuster.

Large number of buyers:

In a perfect competitive market, there is very large number of buyers of the product. If any consumer purchases more or purchases less, he is not in a position to affect the market price of the commodity. His purchase in the total output is just like a drop in the ocean. He, therefore, too like the firm, is a price taker.

In the figure PK is the market price determined by the market forces of demand and supply. The price taker firm has to adjust and sell its output at Price PK or OE.



The product is homogeneous:

Another provision of perfect competition is that the good produced by all the firms in the industry is identical. In the eyes, of the consumer, the product of one firm (seller) is identical to that of another seller. The buyers are indifferent as to the firms from which they purchase. In other words, the cross elasticity between the products of the firm is infinite.

No barriers to entry:

The firms in a competitive market have complete freedom of entering into the market or leaving the industry as and when they desire. There are no legal, social or technological barriers for the new firms (or new capital) to enter or leave the industry. Any new firm is free to start production if it so desires and stop production and leave the industry if it so wishes. The industry, thus, is characterized by freedom of entry and exit of firms.

Profit maximization:

For perfect competition to exist, the sole objective of the firm must be to get maximum profit.

Price and Output Determination under Monopoly:

Monopoly refers to a market structure in which there is a single producer or seller that has a control on the entire market.

This single seller deals in the products that have no close substitutes and has a direct demand, supply, and prices of a product.

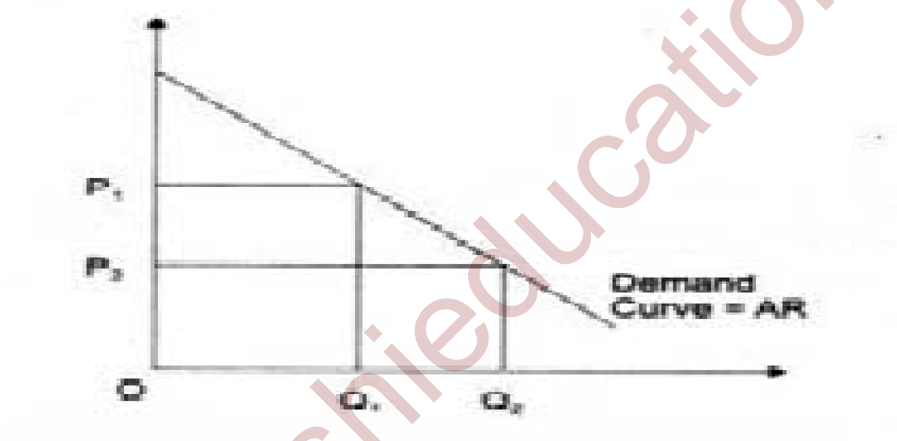
Therefore, in monopoly, there is no distinction between an one organization constitutes the whole industry.

Demand and Revenue under Monopoly:

In monopoly, there is only one producer of a product, who influences the price of the product by making Change m supply. The producer under monopoly is called monopolist. If the monopolist wants to sell more, he/she can reduce the price of a product. On the other hand, if he/she is willing to sell less, he/she can increase the price.

As we know, there is no difference between organization and industry under monopoly. Accordingly, the demand curve of the organization constitutes the demand curve of the entire industry. The demand curve of the monopolist is Average Revenue (AR), which slopes downward.

Figure shows the AR curve of the monopolist:



In Figure-9, it can be seen that more quantity (OQ_2) can only be sold at lower price (OP_2). Under monopoly, the slope of AR curve is downward, which implies that if the high prices are set by the monopolist, the demand will fall. In addition, in monopoly, AR curve and Marginal Revenue (MR) curve are different from each other. However, both of them slope downward.

The negative AR and MR curve depicts the following facts:

When MR is greater than AR, the AR rises

When MR is equal to AR, then AR remains constant

When MR is lesser than AR, then AR falls

Here, AR is the price of a product, as we know, AR falls under monopoly; thus, MR is less than AR.

Table-1 shows the numerical calculation of AR and MR under monopoly:

Table-1: AR and MR under Monopoly

No. of Units Sold (Q)	Price	TR =P *Q	MR	AR = TR /Q
1	10	10	10	10
2	9	18	8	9
3	8	24	6	8
4	7	28	4	7
5	6	30	2	6
6	5	30	0	5
7	4	28	-- 2	4

As shown in Table-1, AR is equal to price. MR is less than AR and falls twice the rate than AR. For instance, when two units of Output are sold, MR falls by Rs. 2, whereas AR falls by Re. 1.

Objectives and Policies of Pricing- Methods of Pricing:

One of the four major elements of the marketing mix is price. Pricing is an important strategic issue because it is related to product positioning. Furthermore, pricing affects other marketing mix elements such as product features, channel decisions, and promotion.

While there is no single recipe to determine pricing, the following is a general sequence of steps that might be followed for developing the pricing of a new product:

1. **Develop marketing strategy** :

   Perform marketing analysis, segmentation, targeting, and positioning.

2. **Make marketing mix decisions**:

   Define the product, distribution, and promotional tactics.

3. **Estimate the demand curve**:

   Understand how quantity demanded varies with price.

4. **Calculate cost** :

   Includes fixed and variable costs associated with the product.

5. **Understand environmental factors** :

   Evaluate likely competitor actions, understand legal constraints, etc.

6. **Set pricing objectives** :

   For example, profit maximization, revenue maximization, or price stabilization (status quo).

7. **Determine pricing** :

   Using information collected in the above steps, select a pricing method, develop the pricing structure, and define discounts.

These steps are interrelated and are not necessarily performed in the above order. Nonetheless, the above list serves to present a starting framework.

Marketing Strategy and the Marketing Mix:

Before the product is developed, the marketing strategy is formulated, including target market selection and product positioning. There usually is a tradeoff between product quality and price, so price is an important variable in positioning.

Because of inherent tradeoffs between marketing mixes elements, pricing will depend on other product, distribution, and promotion decisions.

Estimate the Demand Curve:

Because there is a relationship between price and quantity demanded, it is important to understand the impact of pricing on sales by estimating the demand curve for the product.

For existing products, experiments can be performed at prices above and below the current price in order to determine the price elasticity of demand. Inelastic demand indicates that price increases might be feasible.

Calculate Costs:

If the firm has decided to launch the product, there likely is at least a basic understanding of the costs involved; otherwise, there might be no profit to be made. The unit cost of the product sets the lower limit of what the firm might charge, and determines the profit margin at higher prices.

The total unit cost of a producing a product is composed of the variable cost of producing each additional unit and fixed costs that are incurred regardless of the quantity produced. The pricing policy should consider both types of costs.

Environmental Factors:

Pricing must take into account the competitive and legal environment in which the company operates. From a competitive standpoint, the firm must consider the implications of its pricing on the pricing decisions of competitors. For example, setting the price too low may risk a price war that may not be in the best interest of either side. Setting the price too high may attract a large number of competitors who want to share in the profits.

From a legal standpoint, a firm is not free to price its products at any level it chooses. For example, there may be price controls that prohibit pricing a product too high. Pricing it too low may be considered predatory pricing or "dumping" in the case of international trade. Offering a different price for different consumers may violate laws against price discrimination. Finally, collusion with competitors to fix prices at an agreed level is illegal in many countries.

Pricing Objectives:

The firm's pricing objectives must be identified in order to determine the optimal pricing. Common objectives include the following:

Current profit maximization:

Seeks to maximize current profit, taking into account revenue and costs. Current profit maximization may not be the best objective if it results in lower long-term profits.

Current revenue maximization:

Seeks to maximize current revenue with no regard to profit margins. The underlying objective often is to maximize long-term profits by increasing market share and lowering costs.

Maximize quantity :

Seeks to maximize the number of units sold or the number of customers served in order to decrease long-term costs as predicted by the experience curve.

Maximize profit margin:

Attempts to maximize the unit profit margin, recognizing that quantities will be low.

Quality leadership:

Use price to signal high quality in an attempt to position the product as the quality leader.

Partial cost recovery:

An organization that has other revenue sources may seek only partial cost recovery.

Survival:

In situations such as market decline and overcapacity, the goal may be to select a price that will cover costs and permit the firm to remain in the market. In this case, survival may take a priority over profits, so this objective is considered temporary.

Status quo:

The firm may seek price stabilization in order to avoid price wars and maintain a moderate but stable level of profit.

For new products, the pricing objective often is either to maximize profit margin or to maximize quantity (market share). To meet these objectives, skim pricing and penetration pricing strategies often are employed. Joel Dean discussed these pricing policies in his classic HBR article entitled, Pricing Policies for New Products.

Skim pricing:

Attempts to "skim the cream" off the top of the market by setting a high price and selling to those customers who are less price sensitive. Skimming is a strategy used to pursue the objective of profit margin maximization.

Skimming is most appropriate when:

- Demand is expected to be relatively inelastic; that is, the customers are not highly price sensitive.
- Large cost savings are not expected at high volumes, or it is difficult to predict the cost savings that would be achieved at high volume.
- The company does not have the resources to finance the large capital expenditures necessary for high volume production with initially low profit margins.

Penetration pricing:

Pursues the objective of quantity maximization by means of a low price. It is most appropriate when:

- Demand is expected to be highly elastic; that is, customers are price sensitive and the quantity demanded will increase significantly as price declines.
- Large decreases in cost are expected as cumulative volume increases.
- The product is of the nature of something that can gain mass appeal fairly quickly.
- There is a threat of impending competition.

As the product lifecycle progresses, there likely will be changes in the demand curve and costs. As such, the pricing policy should be reevaluated over time.

The pricing objective depends on many factors including production cost, existence of economies of scale, barriers to entry, product differentiation, rate of product diffusion, the firm's resources, and the product's anticipated price elasticity of demand.

Pricing Methods:

To set the specific price level that achieves their pricing objectives, managers may make use of several pricing methods. These methods include:

Cost-plus pricing:

Set the price at the production cost plus a certain profit margin.

Target return pricing:

Set the price to achieve a target return-on-investment.

Value-based pricing:

Base the price on the effective value to the customer relative to alternative products.

Psychological pricing:

Base the price on factors such as signals of product quality, popular price points, and what the consumer perceives to be fair.

In addition to setting the price level, managers have the opportunity to design innovative pricing models that better meet the needs of both the firm and its customers. For example, software traditionally was purchased as a product in which customer made a one-time payment and then owned a perpetual license to the software. Many software suppliers have changed their pricing to a subscription model in which the customer subscribes for a set period of time, such as one year. Afterwards, the subscription must be renewed or the software no longer will function. This model offers stability to both the supplier and the customer since it reduces the large swings in software investment cycles.

Price Discounts:

The normally quoted price to end users is known as the list price. This price usually is discounted for distribution channel members and some end users. There are several types of discounts, as outlined below.

Quantity discount :

Offered to customers who purchase in large quantities.

Cumulative quantity discount :

A discount that increases as the cumulative quantity increases. Cumulative discounts may be offered to resellers who purchase large quantities over time but who do not wish to place large individual orders.

Seasonal discount:

Based on the time that the purchase is made and designed to reduce seasonal variation in sales. For example, the travel industry offers much lower off-season rates. Such discounts do not have to be based on time of the year; they also can be based on day of the week or time of the day, such as pricing offered by long distance and wireless service providers.

Cash discount:

Extended to customers who pay their bill before a specified date.

Trade discount:

A functional discount offered to channel members for performing their roles. For example, a trade discount may be offered to a small retailer who may not purchase in quantity but nonetheless performs the important retail function.

Promotional discount:

A short-term discounted price offered to stimulate sales.

Marginal Cost Pricing:

Marginal cost is an important concept in business. In this lesson, you'll learn what marginal costs are and their standard formula with some illustrative examples. A short quiz follows the lesson.

Key Concepts of Marginal Costs

Marginal cost:

Is the increase or decrease in the total cost a business will incur by producing one more unit of a product or serving one more customer. If you plot marginal costs on a graph, you will usually see a U-shaped curve where costs start high but go down as production increases, but then rise again after some point. For example, in most manufacturing endeavors, the marginal costs of production decreases as the volume of output increases because of economies of scale. Costs are lower because you can take advantage of discounts for bulk purchases of raw materials, make full use of machinery, and engage specialized labor.

However, production will reach a point where diseconomies of scale will enter the picture and marginal costs will begin to rise again. Costs may rise because you have to hire more management, buy more equipment, or because you have tapped out your local source of raw materials, causing you to spend more money to obtain the resources.

You can use marginal costs for production decisions. If the price you charge for a product is greater than the marginal cost, then revenue will be greater than the added cost and it makes sense to continue production. However, if the price charged is less than the marginal cost, then you will lose money and production should not expand.

Formula for Marginal Cost

The formula for marginal costs can be expressed as follows:

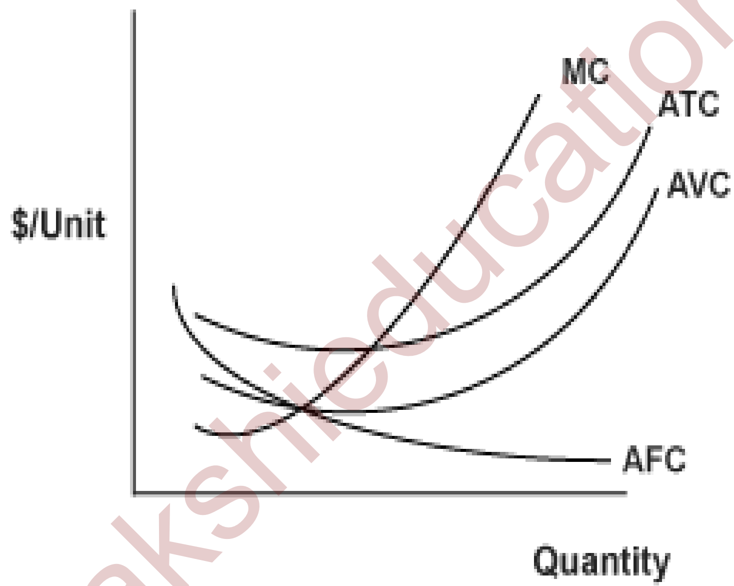
Marginal Cost = Change in costs / Change in quantity

For the more algebraically inclined, marginal cost can be also be expressed by this equation:

$$\text{Marginal Cost (MC)} = \frac{\Delta TC}{\Delta Q}$$

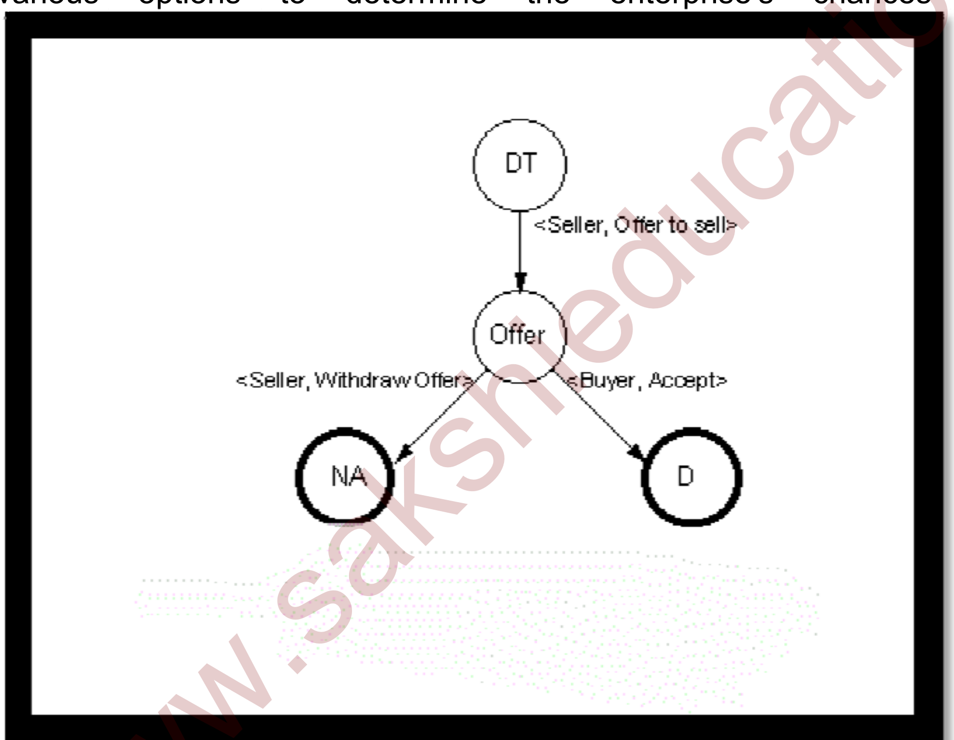
Where

$\Delta =$ Change
$TC =$ Total Cost
$Q =$ Quantity



Sealed Bid Pricing:

Sealed-bid pricing (Sealed-Bid Pricing) sealed-bid pricing refers to the case of bidding in the tender, companies know their competitors on the basis of our competitors pricing. This price is the enterprise of its competitors offer estimates based on certain, with the aim of signing the contract, its bid should be less than the competitors offer. Sealed bids are mainly used for pricing the tender transaction. Sealed-bid pricing (Sealed-Bid Pricing) [edit] Overview of sealed bids, sealed bids pricing is the pricing situation in the tender bid, the companies know their competitors on the basis of pricing. This price is the enterprise of its competitors offer estimates based on certain, with the aim of signing the contract, its bid should be less than the competitors offer. Sealed bids are mainly used for pricing the tender transaction. At home and abroad, many commodities, raw materials, equipment and construction projects trading and contracting, and the sale of small businesses, are often tender with the Employer, contractor bidding way to select the contractor to determine the final contract price. Generally, only one tender side, in a relatively monopolistic position, but there are multiple bidders, in competition status. Subject matter of the price from the various companies is involved in bidding each other down to determine the conditions of independence. The buyer of all bidders in the tender, the tender offer are usually the lowest bid, its offer is the contract price. Such competitive sealed bids, said the pricing method pricing. [Edit] Application of sealed-bid pricing method in the bidding, the winning bid price is the ability of the business critical factors. While high prices can bring higher profits, but the chances of winning contracts reduced; the other hand, low prices, low profits, although the chance of winning, but the opportunity costs are high, less profit. So, companies should determine how the bid price? First, the enterprises according to their own cost, to determine the tender price of several alternative programs and the cost of margin are calculated based on corporate earnings in all price levels may be. Secondly, the analysis of the strength and potential competitors offer various options to determine the enterprise's chances of winning cont



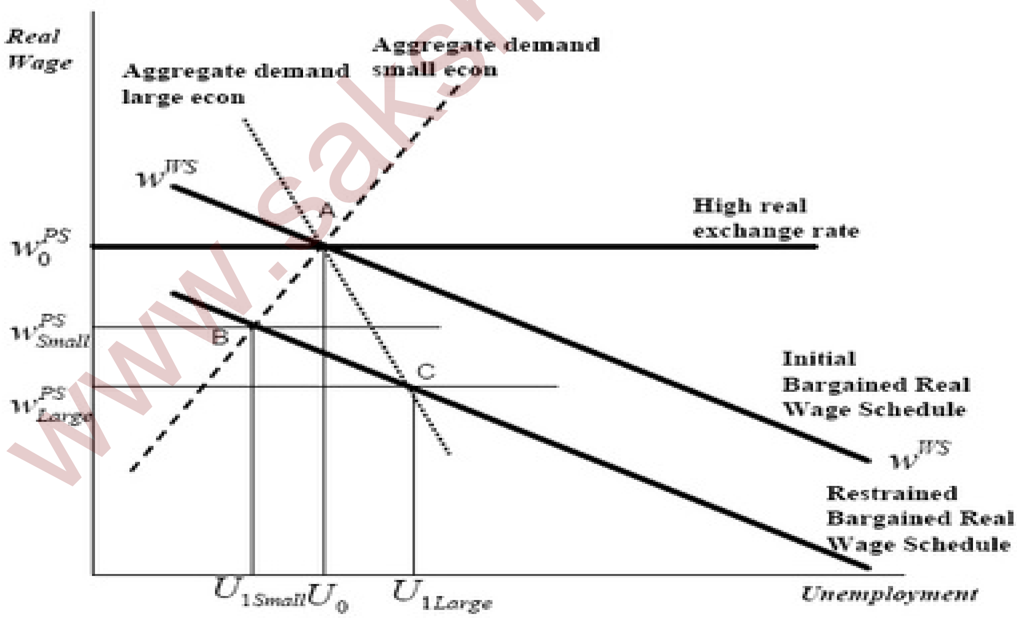
Going rate pricing:

It is a competitive pricing method under which a firm tries to keep its price at the average level charged by the industry. The use of such a practice of pricing is especially useful where it is difficult to measure costs. Adoption of going rate pricing will not only yield fair return but would be least disruptive for industry's harmony.

Going rate pricing primarily characterizes pricing practice in homogeneous product markets, The concern selling a homogeneous product in a highly competitive market has actually very little choice about the setting of its price. It is apt to be a market determined price for the product, which is not established by any single firm or clique of firms but through the collective interaction of buyers and sellers. The concern which is going to charge more than the going rate would attract virtually no customers. The concern should not charge less because it can dispose of its entire output at the going rate.

Thus, under highly competitive conditions in a homogeneous product market (such as food, raw materials and textiles) the concern really has no pricing decision to make. The major challenge before such a concern is good cost control. Since promotion and personnel selling are not in the picture, the major marketing costs arise in physical distribution.

In pure oligopoly, where a few large concerns dominate the industry, the concern also tends to charge the same price as is being charged by its competitors. Since there are only a few concerns, each firm is quite aware of others' prices, and so are the buyers. This does not mean that the going price in an oligopoly market will be in practice indefinitely. It cannot, since industry costs and demand change over time.



Limit Pricing:

Limit pricing has similarities to predatory pricing, in that a dominant firm sets prices in order to clear the field and/or create barriers to entry. Limit pricing goes further, entirely clearing the playing field and blocking all entry. This strategy is usually used by a monopolist or members of an oligopoly. Rather than controlling prices directly, limit pricing increases output to the point where prices in the market drop to levels lower than new entrants can afford to charge.

Illustration of a successful limit pricing strategy:

Two companies are competing for a market segment. Both companies have perfect information. Company A is already in the market and is making a monopolistic profit. Company B is considering entry into the market segment to take some of the profits from company A. Company A is not keen on the idea. So, to discourage company B from entering the market, company A begins to sell its products below the monopolistic price (or threatens to sell its products below the monopolistic price if company B decides to enter the market). This action would reduce or eliminate any potential future profits company B would make if it entered the market segment. Ultimately company B decides the profit margins are too low and forfeits entering the market segment. Company A continues making monopolist profits.
An unsuccessful limit pricing strategy can occur if one of the firms involved cannot make the rational link between costs and future profits.

PRINCIPLE

"For limit pricing to effectively prevent entry by rational competitors, the pre-entry price must be linked to the post-entry profits of potential entrants."

Key concepts that are related to limit pricing and link the pre-entry price to the post-entry profits:

Commitment Mechanisms

These occur when a company already in the market makes a decision about production possibilities. In a game, the incumbent company has first mover advantage. The company deciding whether or not to enter the market has to wait and see what the incumbent will do. Once the incumbent makes a decision the new entrant can decide whether to enter the market or stay out (for game theory, see links below). The commitment element of this idea exists when the incumbent company "commits" to an action, locking itself into place. The second company now can make the most profitable decision for itself.

Learning Curve Effects

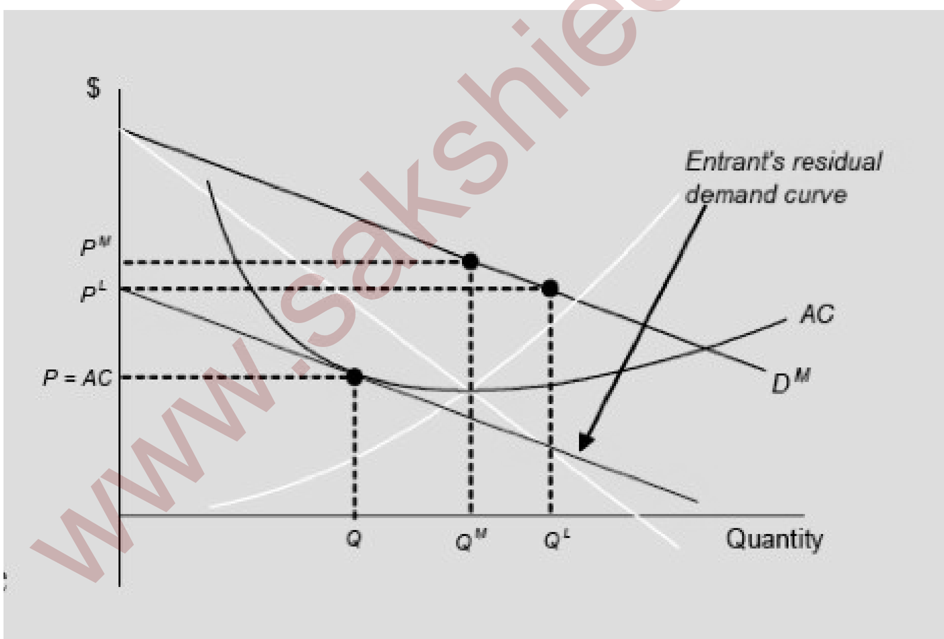
If a company wants to enter a market segment they are going to have a learning curve, as the company does not have knowledge from past experiences to help them make more profitable decisions. After the starting period such a company will have gained knowledge that will allow them to produce at a more profitable level. If the initial learning curve cost is too high it could stop a potential competitor from entering the market.

Incomplete Information

This concept considers the amount of knowledge a company has when entering the market. If members of the company are not aware of all of the competitions costs, they can face many (financial) problems.

Reputation Effects

This concept moves us back to game theory, i.e. the reputation a company has in the market segment as concerns responding to competition.



Market Skimming Pricing:

Definition of 'price skimming'

A product pricing strategy by which a firm charges the highest initial price that customers will pay. As the demand of the first customers is satisfied, the firm lowers the price to attract another, more price-sensitive segment.

Therefore, the skimming strategy gets its name from skimming successive layers of "cream," or customer segments, as prices are lowered over time.

Investopedia explains 'price skimming'
Firms often use this technique to recover the cost of development.

Skimming is a useful strategy when:
-There are enough prospective customers willing to buy the product at the high price.
-The high price does not attract competitors.
-Lowering the price would have only a minor effect on increasing sales volume and reducing unit costs.
-The high price is interpreted as a sign of high quality.

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.

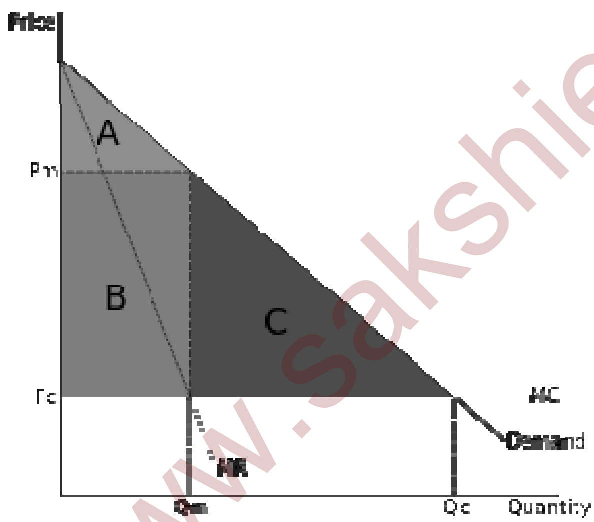
Penetration pricing is often used to support the launch of a new product, and works best when a product enters a market with relatively little product differentiation and where demand is price elastic – so a lower price than rival products is a competitive weapon.

Block Pricing:

Block pricing is a pricing strategy in which identical products are packaged together in order to increase profits by forcing customers to make an all or none decision. By packaging the product and selling it as one unit the firm earns more than if it sold all of the units at a simple per unit price. The profit maximizing price for a block pricing scheme is the total amount the consumer receives for the product. This amount also includes the consumer surplus. This pricing strategy is very similar to the two-part pricing strategy in that its purpose is to extract the maximum consumer surplus.

Source: Baye, Michael. Managerial Economics and Business Strategy. 2006. The chart below illustrates the block pricing scheme:

Block Pricing:



This chart shown above illustrates the block pricing strategy. In a block pricing scheme, the firm will charge a price equal to the sum of A,B,C and the area below the MC curve and to the left of Qc. By charging this price for a quantity of Qc, the firm will be able to extract all of the consumer surplus. Furthermore, the firm will force the consumer to make an all or nothing decision. The consumer will have to either buy an amount of Qc or buy nothing. Given the two choices the hope and the expectation is that the consumers will choose to purchase Qc units at a price of Pc. An added benefit to the block pricing scheme over the price discrimination pricing strategy is that firms can increase profits with block pricing even in situations where consumers have identical demands for a firms products.

Real World situation where block pricing is used:

Block pricing is frequently used by supermarkets to extract the most value out of the consumers. An example is a package of toilet paper. Oftentimes the supermarkets will bundle the toilet paper into units of 24 or 48 to force the consumer to buy the large pack or not to buy the pack at all. By packaging the toilet paper in this way, the supermarket can earn a larger profit.

Bundling Pricing:

It is combining several products or services into a single comprehensive package for an all-inclusive reduced price. Despite the fact that the items are sold for discounted prices, it can increase profits because it promotes the purchase of more than one item.

Deeper Insights

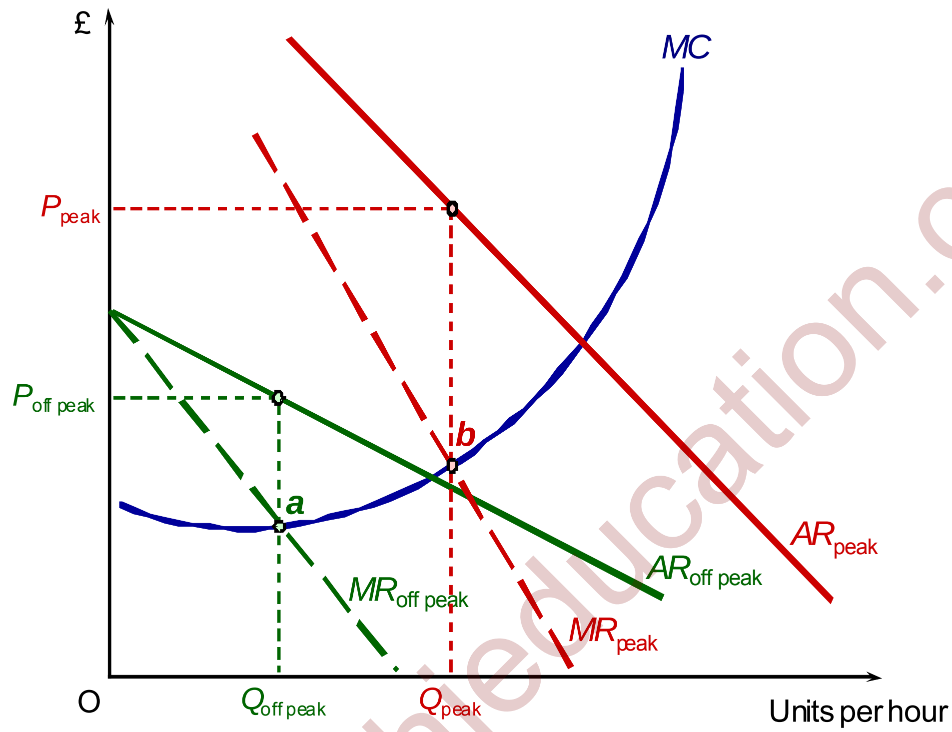
For example,

Mobile phone retailers frequently bundle the prices of several products and services together for their new customers. They offer the phone itself with a package that also includes the 2-year phone plan, internet access, and phone charger. This bundle benefits the customer because it provides them with all the tools they need for their phone all at once and it benefits the mobile phone retailer because they are selling the customer supplementary products and services other than just a phone.

Peak Load Pricing:

A common form of price discrimination[i] is *peak-load pricing*. This is where people are charged more at times of peak demand and less at off-peak times. Take the case of a holiday. If you look through the brochures, you will see that high-season prices are often considerably higher than low-season prices. Similarly, call charges for telephones are much higher during weekdays than in the evenings and weekends. Other examples of peak-load (or 'peak-period') pricing are rail and air fares, prices in cinemas and restaurants (higher in the evenings), charges made by health and sports clubs (higher at weekends and in the evenings) and electricity prices (lower prices at off-peak times to those with special meters that only operate at such times).

The reason for the higher prices charged at peak times has partly to do with elasticity of demand (and in this sense, therefore, is price discrimination: i.e. charging different prices because of different demand elasticities in different parts of the market). Demand is less elastic at peak times. For example, many commuters have little option but to pay higher rail fares at peak times.



Peak-period and off-peak-period pricing

Strictly speaking, price discrimination is where different prices are charged in different parts of the market as a result of different price elasticity's of demand: the higher price being charged in the part of the market with the lower price elasticity. Where differing prices, as in this case study, are partly also the result of differing *costs*, then this is not pure price discrimination.

Cross Subsidization:
This is a pricing strategy in which profits from the sale of one product are used to subsidize sales of a related product (Baye, 419). When a firm has related products it may chose to charge a price that is at or below cost for one product and sell the other at a price above cost. Sometimes the firm may chose to take a loss on one product and supplement the loss by charging a higher price for other products. It can also be said that a service provides a cross-subsidy to other services in the same network if the

charge for that service exceeds the standalone cost of providing the service.

Cross-subsidizing in some cases is used to make products and services more affordable to people. For example, cities may choose to use the revenue from one mode of transportation to cross-subsidize another mode. Subway revenues could be used to cross-subsidize bus transportation. Cities use this strategy to reduce the traffic congestion. So both the city and people benefit.