



# Price

- Price means different things to different people:
  - **Buyers**
    - Price is the **opportunity cost**
  - **Sellers**
    - Price represents revenue, and so affects profits
  - **Government**
    - Changes in price affect inflation
  
- Therefore, in business studies we define price as:

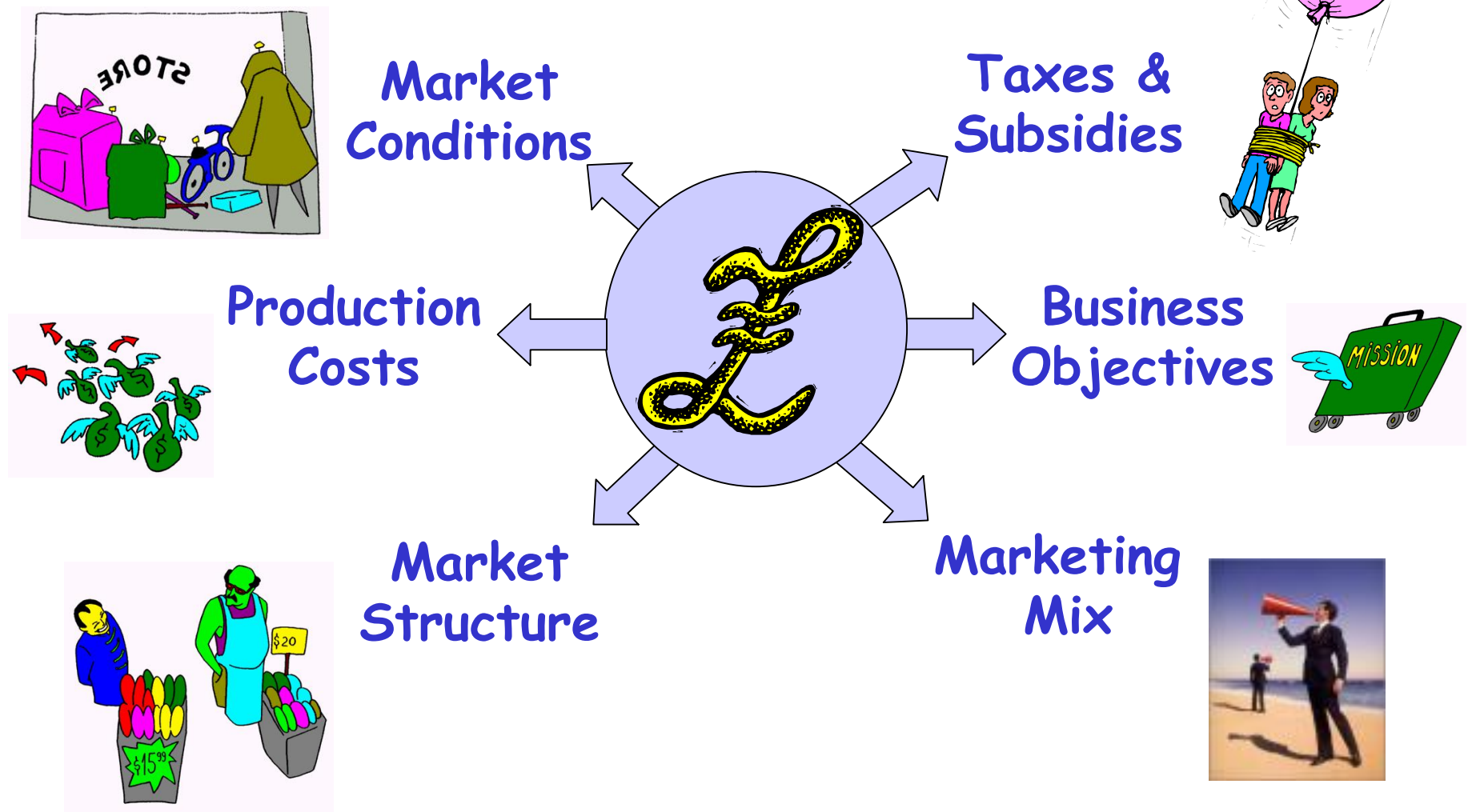
*“The amount of money for which something is exchanged  
**IRRESPECTIVE** of its value or worth”*





# Influences on Price

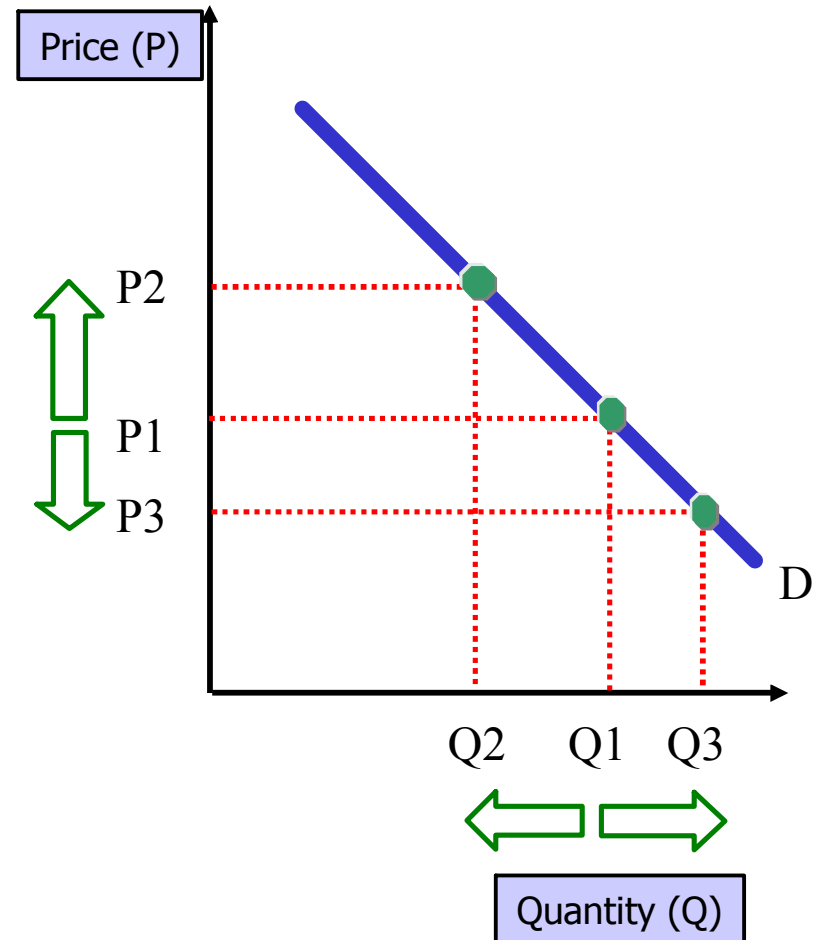
● Prices are affected by many things:





# Price & Demand

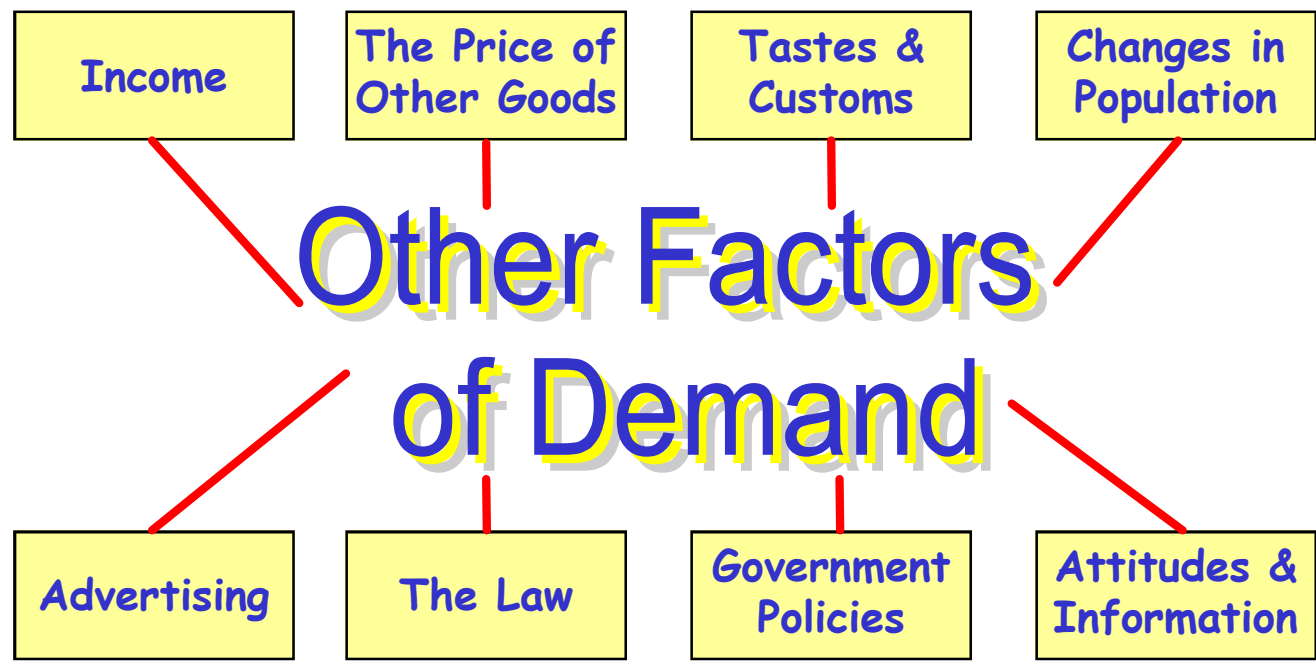
- Firms must consider the **Law of Demand** when setting prices
- This states that:
  - Any increase in the price of a product will result in a fall in the quantity that consumers are willing to buy
  - This can be shown on a **demand curve**:





# Remember the Determinants of Demand?

- Other than price the following factors will also have an effect on demand:



- If these factors change **the demand curve itself will shift**



# Price Elasticity of Demand

- This measures the responsiveness of demand to changes in price
- Firms must consider this because it will have an effect upon **total revenue**
- It is calculated using the formula:

$$PEd = \frac{\% \Delta \text{ Quantity Demanded}}{\% \Delta \text{ Price}}$$

- OR, if you don't like percentages!

$$PEd = \frac{\text{Original Price}}{\text{Original Quantity}} \times \frac{\Delta \text{ Quantity}}{\Delta \text{ Price}}$$



# Interpreting PEd

- Since there is an **inverse** relationship between price and quantity the result of any PEd calculation will be **negative**
- As such the **NEGATIVE SIGN IS IGNORED**
- Therefore there are 3 possible outcomes:
  - **Ped > 1** elastic demand (quantity changes more than price)
  - **Ped = 1** unitary-elastic demand
  - **Ped < 1** inelastic demand (quantity changes less than price)



# PEd & Total Revenue

- The effect of changes in price upon TR can be seen below:

	<b>For a Price Increase</b>	<b>For a Price Decrease</b>
<b>Demand is Elastic</b>	TR Decreases	TR Increases
<b>Demand is Unitary Elastic</b>	TR does not change	TR does not change
<b>Demand is Inelastic</b>	TR Increases	TR Decreases

- Therefore it is not always profitable to increase prices!



# Pricing Strategies

- Although there are many different pricing strategies, they can be split into 4 broad groups:
  - **Demand-based pricing**
    - Where the price is reflective of the demand for a product
  - **Cost-based pricing**
    - Where costs are used as the starting point for price
  - **Competition-based pricing**
    - Where the number of competitors in the market influences price
  - **Psychological pricing**
    - Where prices are set to influence consumer perception
  
- In addition there are a number of **short-term** pricing policies that can be pursued



# Demand-Based Pricing

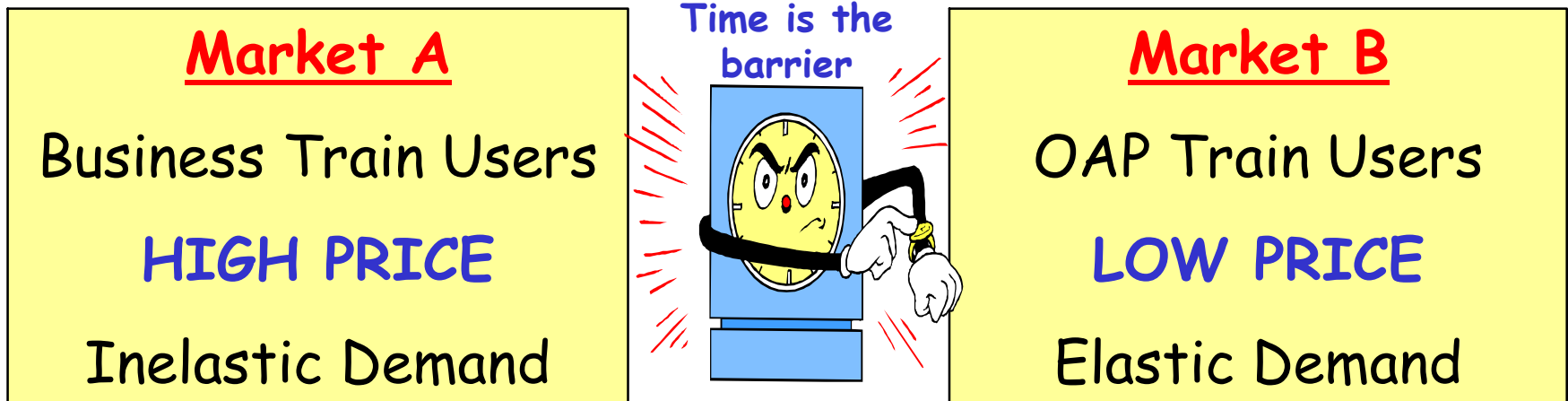
- Where this method is used, a high demand leads to a high price
- This pricing method has 2 main advantages
  - It allows **price discrimination** to be used
  - The price is determined naturally by market forces
- However, it has 1 main disadvantage
  - Unit costs will remain the same irrespective of the price, thus firms run the risk of making losses
- Demand-based pricing is therefore only used for selected products, mainly where discrimination can take place





# Price Discrimination

- This is where a firm can charge different **market segments** different prices for an **IDENTICAL** product
- Three conditions **MUST** hold if price discrimination is to be used:
  - The firm must have significant **market power**
  - The firm must have more than one market, with a **barrier** between them
  - **Elasticity** in the different markets must be different
- E.g.:





# Cost-Based Pricing

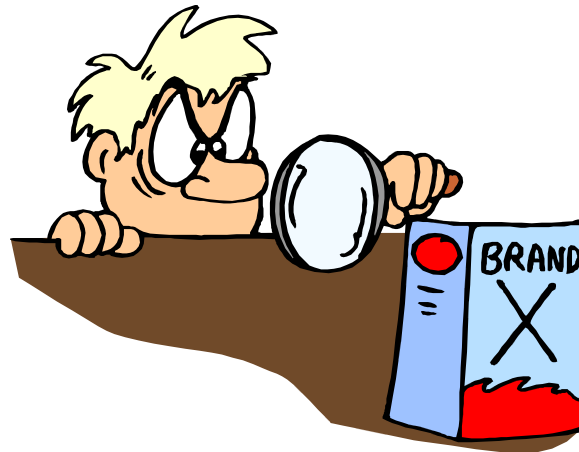
- This is where firms set prices on the basis of production costs
- There are 3 main methods:
  - **Cost-Plus Pricing (Mark-up)**
    - Here a % profit is added to the average cost per unit
    - Simple and ensures revenue is greater than costs
    - Does not account for market conditions
  - **Absorption/Full Cost Pricing**
    - Here the firm allocates indirect costs to particular products e.g. heating costs
    - Ensures that revenue is greater than costs
    - Inflexible and more complex to calculate
  - **Marginal/Contribution Pricing**
    - Here the firm allocates direct costs & required contributions
    - More flexible - less successful products can make less contribution
    - Can be very complex to calculate





# Competition-Based Pricing

- This method considers competitors prices
- Used where goods are **homogeneous** and competition is fierce (e.g. **Oligopolistic markets**)
- There are 3 main types:
  - **Going Rate Pricing**
    - Used by non-leading firms trying to avoid a price war
  - **Destroyer Pricing**
    - Used to eliminate competition by setting very low prices
  - **Close Bid Pricing**
    - Used when firms have to tender bids for a contract





# Psychological Pricing

- Where firms set prices to influence consumer thinking
  - e.g. at £99.99 firms can claim that a product is “less than £100 pounds” in their promotional literature
- Sometimes this is used to affect consumer perceptions of their products
  - e.g. many people believe that more expensive means better quality, so a high price could be charged to create a high quality image





# Short-Term Pricing Policies

- There are a number of short-term policies which are often used for promotional reasons:
  - **Penetration Pricing**
    - Charging an initially low price
    - Used to establish a new product, to encourage retailers to stock it and consumers to try it
  - **Market Skimming**
    - Charging a high price when a product is unique i.e. mobile phones
    - Maximises revenue whilst consumers have no alternative
  - **Discounts & Sales**
    - Used to sell discontinued or unfashionable products
  - **Loss Leader Pricing**
    - Used commonly by retailers to attract customers into their store in the hope they will then make further purchases
    - Also used with games consoles

