

Summary

Chapter Thirteen

Pricing Decisions, Policies and Practices

Introduction :

Price has direct impact on firm's profits. Fixing appropriate price is a major decision making function of any enterprise. Price decisions, therefore, are reviewed by the top management from time to time.

Determinants of price of a commodity.

1. Cost of production. Normally prices are determined to cover the costs and allow profit to the enterprise.
2. Demand for the product. Products in demand always command high prices.
3. Elasticity of demand. Products with lesser elasticity of demand are sold at higher prices and vice versa.
4. Objective or the goal of the producer. If the goal of the firm is sales maximization, or earning goodwill of consumers, lower prices are fixed.
5. Nature of competition in the market. Fierce competition forces firms to fix prices most aggressively. Under *perfect competition* price

is determined by the point of intersection of supply & demand.

Producer is a price taker and not a price maker. Under *monopoly* producer fixes price through trial and error until his $MR = MC$. At that point his profit is maximum and he is in equilibrium.

Producer practicing *price discrimination* fixes different price for each market depending on elasticity of demand for his product in each market.

Under *monopolistic competition* producers do not have a price war, instead they differentiate their products to charge competitive prices.

Under *oligopoly* producers will have a price war, or charge (normally high) prices by an agreement with each other. Prices are normally rigid in oligopoly.

6. Government policy pertaining to the product. Firms need to comply with the pricing policies of the Government.

Pricing Methods in Practice

1. Full Cost Pricing :-

Is also known as Cost Plus Pricing.

Price in this method is a sum of Average Variable Cost, Average Fixed Cost and Net Profit Margin. The method is attractive as price based on cost appears reasonable. Plus the method is simple and fair method of pricing.

However, it suffers from the following limitations:

It disregards demand.

Seller is not forced to control costs.

Method leads to over pricing in decreasing costs situation or under pricing in rising costs situation, as only historical costs considered in this method.

Method is difficult to implement if variable costs of the firm fluctuate frequently.

Forces of competition are totally ignored by the method and there is a chance that the firm may be wiped out of market.

2. Marginal Cost Pricing :-

In this method only variable costs are considered and fixed costs are ignored. The method is very useful in a short period. But in the long period, fixed costs must be considered.

The method has distinct advantages as it encourages aggressive pricing policy. The firm encouraged to keep marginal cost under control to offer low prices. Prices fixed under this method are very competitive. The method is very useful for a multi-product, multi-process or multi-market firm. Also is useful for pricing over the life cycle of a product.

However the method cannot be used over a long period as fixed costs are ignored. It is possible that it may lead to frequent changes in price, which is not appreciated by consumers. The method leads to over pricing in decreasing costs or under pricing in rising costs, as only historical costs considered.

3. Multi Product Pricing :-

Firms producing more than one product, whether variations, substitutes, complementary or of totally different nature have to resort to multi product pricing.

Availability of unutilized capacity has a major impact in pricing multi- products.

If products are totally independent, pricing is similar to single product pricing. But in case of joint products, total cost must be recovered by the pricing of both products together. In case of substitutes, the degree of elasticity of demand separates the markets. The multi product firm is more like a discriminating monopolist fixing prices of products based on elasticity of their demand.

4. Pricing of a New Product :-

If the new product has many substitutes in the market, competitive prices need to be fixed. If the product is entirely new, Skimming or Penetration pricing are alternatives available to the producer.

In Skimming Price method, the firm charges highest possible price that the consumer can bear. This is fortified with heavy sales promotion and advertising efforts. In penetration price, lowest possible price is initially charged to get into the market as early as possible. Prices are raised as the firm establishes its market share.

5. Pricing of Exports :-

Pricing of exports is complex when compared to pricing in the local market. The nature of demand in the foreign market can be very different. Degrees of competition based on quality of the product vary from country to country. Different technologies employed by competing firms in other countries have their effects on costs.

Pricing has to consider availability of substitutes in each overseas market. Government's incentives have favourable effect on prices. On the other hand, export regulations can restrict pricing decisions. Regularity of demand is another factor that has to be considered as it is quite likely that current demand could be only for a short period. Conditions for delivering goods overseas have to be studied as they add to the cost of product.

After considering above factors, firms adopt these pricing strategies. Penetration pricing of low prices is undertaken by firms to capture foreign market. Firms also resort to Skimming price for maximization of profit. It is common practice to arrange Dumping - charging lower export price, to enter exports. Competitive pricing is required when there are many players. Standard worldwide price that is based on average cost of production can be fixed if producing firms can work together. Dual pricing based on cost plus or marginal costing is another useful strategy. Some firms follow the leader in the market and fix price which equals that charged by a major market share holder. Probe pricing by firms uses trial & error method.

A variety of approaches in setting prices.

1. Intuitive Pricing : a psychological method. Price is based on the feel of the market.
2. Experimental : or trial & error pricing.
3. Initiative Pricing: Firms follow price fixing policy of the market leader.

4. Backward Cost Pricing: Price decided first, then product designed to arrive at a suitable cost that provides reasonable profit margin.

5. Odd number & Critical Number Pricing: Price is always an odd or other number fancied by consumers.

6. Double pricing: Two prices appear on the price tag. The higher one is scored out making the second price attractive to customers..

7. Prestige Pricing: Some sort of social scaling exerts a powerful influence on the pricing behaviour, as result higher prices are expected to reflect higher quality.

8. Multiple Pricing / Collective Pricing: Offering more units for a (higher) price. This replaces common method of indicating price per single unit.

9. Peak Load Pricing : Changing prices to suit Peak and off peak demand. Higher prices are charged when demand is at a peak and they are lowered once peak season is over.

Administered prices and Price control.

Administered prices

Prices were first administered by a monopolist who fixed them irrespective of costs. In India, administered prices are those prices which are fixed and enforced by the Government. Prices are fixed to prevent exploitation of consumers by firms charging high prices to maximize their profit. Providing stable and assured income to

farmers or other weaker sections of the Society is another objective of price control. It is used for discouraging or encouraging the consumption of products by increasing prices of harmful products or lowering prices of essentials.

Price Control

Price Control refers to a direct measure on the part of the Government in fixing the prices for achieving certain macro economic goals like social welfare, efficient resource allocation, prevention of exploitation of the consumers etc.

Informal price control results in producers voluntarily agreeing to maintain prices at levels suggested by the Government. Formal price control enforces prices fixed by the Government on the producers.

Total price control covers entire output of the product e.g. drug prices. It is also known as Mono Pricing. Partial price control covers a part of the output that has to be sold at regulated prices, usually through approved agencies to selected group of customers. It is also known as Dual Pricing

Price control for agricultural products, drugs, cotton and other essential products, is administered by the Government, through various Commissions, Boards, Bureaus appointed by it.