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Entrepreneurship

Pricing

IDEATION

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Ajuntament de Barcelona

Barcelona Activa

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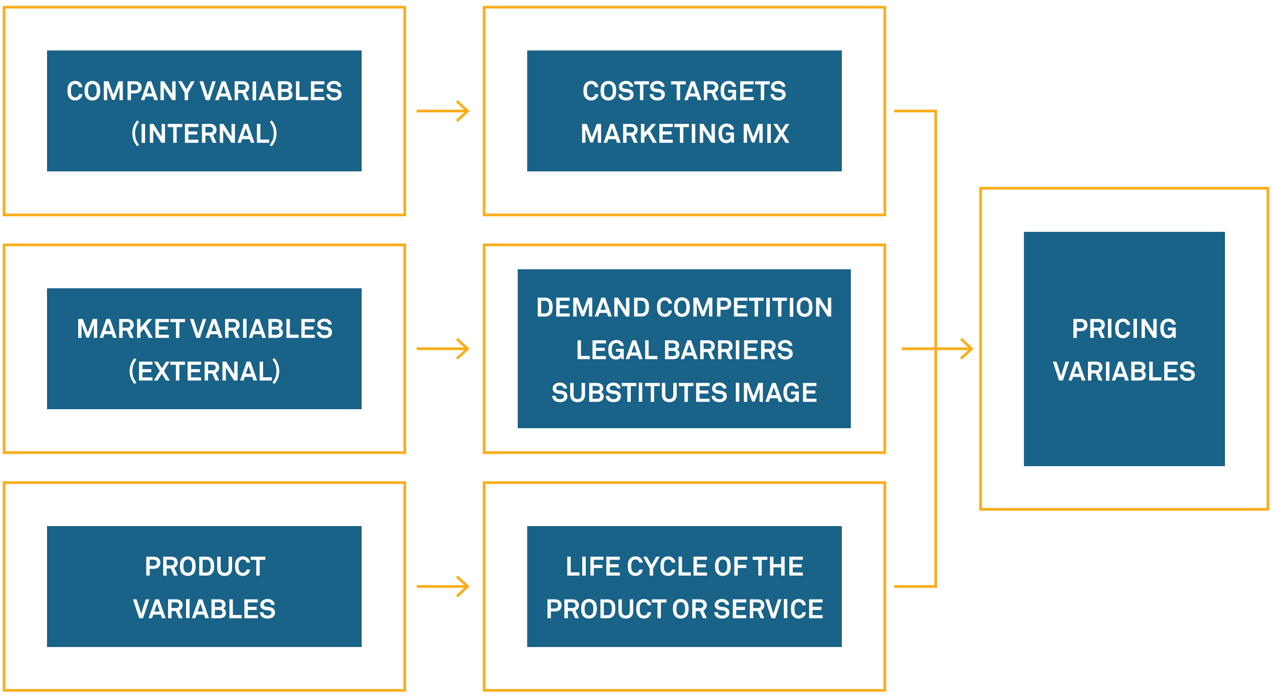
Introduction

With the exception of some basic products or strategic raw materials, goods produced or marketed under a monopoly or a government franchise, and basic services such as water, electricity, gas and telephone services, prices can be freely established for the vast majority of consumer goods and services.

However, establishments are legally required to provide full information about the prices of their products and services, so that they can be demanded by customers, because establishments are bound by their advertised prices.

Just now, pricing is one of the main factors when it comes to designing a marketing mix strategy (the combination of marketing tools: price, product, place and promotion). As discussed later in this report, a business' pricing policy encapsulates the entire strategy underlying it.

This means that a rational pricing policy must be linked to current circumstances rather than take into account only the calculation system used. As shown in the following diagram, pricing is affected by both internal (relating to the business itself) and external (relating to the competition or customer perception) factors:



02
Internal variables: costs, penetration prices, goals and marketing mix

Costs are the main factor when it comes to establishing prices. A pricing formula based on the total cost (both direct and indirect) of the product plus a mark-up is relatively simple to use. The business must calculate the costs involved in manufacturing the product, as it will need this information in order to ascertain the profitability of the product.

Business line		Product A	Product B	Product C
Direct costs	Cost of raw materials	1.000	500	800
	Cost of direct labour	1.000	200	500
Total direct costs		**2.000**	**700**	**1.300**
Indirect costs	Marketing	100	50	80
	Administration	50	25	40
	Maintenance	75	37,5	60
	Depreciation	25	12,5	20
Total indirect costs		**250**	**125**	**200**
Trading margin		**2.925**	**1.073**	**1.950**
Retail margin		**3.600**	**1.320**	**2.400**

There are three types of costs:

→ **Direct costs,** which are the costs arising directly from the production process for each product or business line; i.e. the cost of labour and of the raw materials used.

→ **Indirect costs,** which are not directly linked to the production of goods or provision of services. They can be attributed to each business line by means of various expense allocation criteria (such as turnover per business line, or the costs attributable to each product).

→ **Distribution costs,** where the margin is split between the marketing and retail processes, resulting in a cost-based sale price.

In **provisions of services,** as there is no exchange of goods, there are no raw material costs. Pricing is therefore based on the hourly rate charged for each service.

It is also worth noting that, under Article 14 of Act 7/1996, of 15 January, on retail trade, making **sales at a loss, also known as dumping**, is banned. This is when the price of a product is lower than its acquisition price according to the invoice (after deducting a proportional part for any discounts there may be) or the actual production cost in the case of items manufactured by the trader itself.

Another option is what is known as **penetration price.** This strategy involves setting prices that are low enough to push up demand from the outset. The increase in sales will reduce costs, which means that prices can remain low. A business that can carry out this strategy needs sufficient financial capacity to survive with low prices until it has secured the necessary demand to sufficiently reduce costs.

The goals set by the business to reach the market will determine the price of the product. In the long run, a business will always seek to obtain the highest possible profit from sales. However, this goal may not match its daily operations in the market. A business can set a low price to penetrate a new market in order to take on and achieve a certain share of sales. It can also change prices on a temporary basis to counter a competitor's aggressive marketing campaign or to remain in the market by bearing its costs while it waits for more profitable situations to arise and include extension pricing in order to eliminate competitors.

The price must be in line with the other tools in the **marketing mix**[1]: product, place and promotion suitable for each market. If a product has been modified and adapted to the market with a good promotional campaign, it can have a higher price than if it is not adapted to the market and does not have the attributes. You should also remember that pricing is also affected by the way you enter each market and the distribution channels within it. If you use agents or distributors, you will need a higher trade margin than if you trade, for example, through a joint venture[2] or your own sales outlets.

1- The marketing mix is a combination of the marketing tools described above: price, promotion, place and product.

2- A partnership between businesses, or an agreement between two businesses to carry out an economic activity.

03
External variables: demand, competition, legal barriers and image

The economic and socio-cultural characteristics of each country determine how products are appreciated by consumers and their benefits. It is therefore important to know how much consumers will be willing to pay; i.e. demand.

Consumers buy on the basis of price, because they only see a small difference between the most expensive product and the cheapest one. Those businesses that create and communicate more through their products' characteristics, design, features and other differentiating elements will be able to set higher prices. This entails targeting the right customer segment and understanding all their direct or ancillary needs relating to the product.

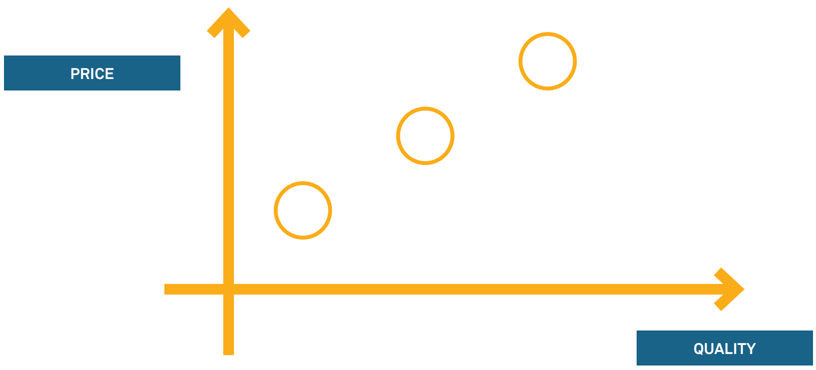
Purchasers can be split into three categories:

→ Those who are strictly price-conscious.

→ Those who are willing to pay a little more for a better quality or service but only up to a point.

→ Those who want the best quality and the best service.

Each business must therefore focus on one of these groups and create a reasonable offer. To see this in a more graphic way, you can use a **price quality** matrix to position yourself in the market.



Many small and medium-sized businesses find that the price in each market is determined by the **competition**. In any case, competitors' current and potential future prices are something that a business must be aware of and be able to predict. Price differences with respect to one's competitors must be justified to customers on the basis that your product or service provides different benefits.

Legal political factors can also restrict a business' freedom to set its prices based only on market and cost considerations. Examples include pricing in certain industries or the existence of public administration subsidies for certain products, which can also affect pricing policies for a business or industry.

A business' pricing policy must take into account the relationship between the end consumers' perception (**image**) and price. When there is a negative image and a low price, consumers perceive the product or service as being of low quality, although this will not necessarily stop them from buying it.

Image	Low price	High price
Positive	Good value for money	High quality
Negative	Low quality	Bad value for money

04
04. Product variables: the product’s life cycle

The product’s life cycle situation in each market makes it possible to apply different prices. When a product is at the introductory stage and there are few competitors, the business has more room for setting its prices. As it moves forward in the cycle, however, tighter prices will be required by the market. A product’s life cycle varies over time and in each market, making price differentiation possible.

In the case of new technologies, for example, when computers were first introduced and there was very little competition (there were only a couple of brands), they were very expensive. However, they have become more and more popular and are now a consumer good that no home can be without. Prices gradually dropped as a result of competition between brands, to a point where the industry became established as an oligopoly, and now competition is less based on price and more on the products’ features and innovation in the market (e.g. peripheral products, such as printers).

05
Prices and the Internet

The Internet has had a huge impact on prices, leading to a drop in many products' prices and profit margins. Prices are more transparent online. For example, on the US websites buy.com (http://www.buy.com) and compare.com (http://www.compare.com), you can check the prices at which a specific item is sold by a variety of retailers. Purchasers can find a wide range of prices for electronic devices, books, etc., and, if the service provided by the retailers that sell them is comparable, they will buy from the one that sells at the lowest price.

06
Prices and promotion: sales

Sales are reductions in the price of products compared to their usual price. Such price reductions should not in any case entail a reduction in the quality of the product sold.

REQUIREMENTS FOR DISCOUNTED PRODUCTS OR SERVICES:

→ Discounted products must display the old price next to the discounted price, and the same warranties as those applicable before the sales period must apply during it.

→ Damaged or low-quality products or products bought specifically for this purpose may not be sold in the sales.

→ Furthermore, products sold during sales periods must have been available for sale before the sales period.

SALES PERIOD:

There can be no more than two sales periods per year.

In Catalonia, these are:

→ Winter sales: from 7 January to 6 March.

→ Summer sales: July and August.

07 Regulations

Under the current legislation, prices are subject to the following **requirements**:

The sale price of goods and products must be displayed both in the shop window and inside the establishment, preceded by the abbreviation "PVP" (equivalent to "RRP"). The price must be inclusive of taxes and any delivery charges.

→ In the case of services, the price must be visibly displayed to the public.

→ In the case of products sold by weight or in bulk, the price must be stated per unit of measurement (e.g. per kilo, litre or metre).

→ In the case of measurable packaged products, the price per measurement unit must also be stated in addition to the product's unit price.

Under Act 1/1998 on **language policy:**

→ Businesses and establishments that sell products or provide services in Catalonia must be able to serve consumers in any of Catalonia's official languages.

→ Standard-form contracts must be immediately available to consumers in separate versions in Spanish and Catalan.

→ Establishments that are open to the public must have the following at least in Catalan:

  → signs;

  → permanent posters with general information; and

  → service offer documents.

For more information, please see the following laws and decrees: [1]

→ Decree 150/1996, of 30 April, establishing sales periods.

→ Legislative Decree 1/1993, of 9 March, on domestic trade.

→ Act 7/1996, of 15 January, on retail commerce regulations.

For more information and legislation on pricing, go to the "El Consum" ["Consumer Matters"] section of the website of the Catalan Consumer Agency, an autonomous body of the Generalitat de Catalunya (http://www.consum.cat/).

1- Available on the Generalitat de Catalunya's trade website http://www.consum.cat/temes_de_consum/preus/index.html.

08
Summary

Pricing is a very complex matter. Businesses must therefore ask themselves the following questions to help them set the right prices:

→ Does our pricing enable us to achieve the goals we have set ourselves for this year?

→ Do we need to review the discount policy before making any changes to prices?

→ How will our competitors react to our prices?

→ Will the new price be accepted by distributors?

→ Do we provide enough added value to change the price and stand out from the competition?

→ What product ranges do we have so we can set different prices for similar products?

→ Does the pricing we have set provide enough scope to make changes to our pricing policy?

Produced by the Barcelona Activa team

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