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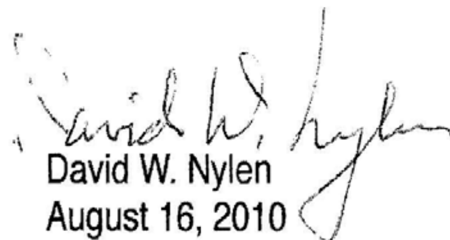

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August 16, 2010

C.32 Response to Competitive Price Changes

THE NATURE OF COMPETITIVE PRICE CHANGES

Price policies provide marketers with guidelines for making decisions in recurring pricing situations and avoid the need for complete reanalysis each time the problem arises. One recurring problem for which a price policy is frequently needed is deciding on a response to competitive price changes.

The Need for a Price Response Policy. Making a policy means that a decision or, at least the basis for making a decision, is established before the problem occurs. In the case of a competitive price response policy, advanced planning is needed. When a competitor makes a pricing change, it is frequently necessary to respond quickly, before there is a damaging loss in market share, a decline in customer good will, or competitor aggres-

siveness is encouraged. A preplanned price response policy makes prompt response possible.

A price response policy also leads to more consistent responses to competitive price moves. As will be discussed further below, if pricing responses are firm and consistent, competitors will know better what to expect and will be less likely to make destabilizing price changes.

The Need for Planning Competitive Price Responses. The problem of responding to competitive price changes is one that comes about in oligopolies, the dominant market structure in the U.S. economy. In pure competition, no producer is large enough to affect the market price that each accepts as the best price possible. In monopolistic competition, products are differentiated and prices can be set at higher levels, but no competitor is large enough for its pricing behavior to influence the others. And in monopoly, of course, there are no competitors to respond to.

But in oligopoly, there are so few competitors that the price behavior of one competitor affects the price and the market of the other competitors. In oligopoly, the price response problem is usually explained in terms of the brand demand curve being "kinked," with the market price at the kink, as shown in Figure C.32–1. Demand is elastic above the kink and inelastic below. If one oligopolist raises price, others may elect not to follow the price rise, thereby winning market share from the higher priced product. If one oligopolist cuts price, others are likely to match the cut so that they do not lose market. In fact, price cuts may draw retaliation in the form of even deeper price reductions that can begin a price war of successively deeper cuts. (See GLOSSARY entry A.1 on **competitive market structure.**)

In oligopolies, there is a tendency to seek price stability, but this requires individual competitors to forego narrow self-interest that may lead to retaliation in favor of cooperative behavior that will preserve stability.[1]

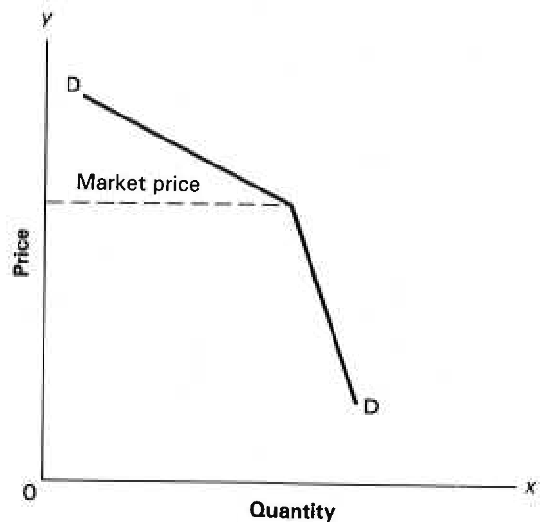

FIGURE C.32–1

The Kinked Demand Curve of an Oligopolist

This is not meant to suggest collusion in setting prices which is, of course, illegal (see GLOSSARY entry D.2). In some markets, stability is maintained by the emergence of price leaders who, by their behavior, attempt to establish changes in the market price. Firms interested in maintaining stability follow the price changes of the leader without retaliatory moves. Another approach to maintaining price stability is to leave price at a uniform level and compete with other elements of the **marketing mix** such as promotion and product design.

Oligopoly markets vary in their stability according to the competitiveness of those markets. Markets are more competitive and more likely to be unstable when (1) there are more competitors, (2) competitors are more equal in power, (3) products are standardized, (4) fixed costs are high and there is excess capacity, and (5) industry growth is slow.[2] There is evidence that markets are becoming less stable as marketers adopt more aggressive and more destabilizing price policies in an attempt to gain market share.[3]

[1]Michael E. Porter, *Competitive Strategy* (New York: Free Press, 1980), pp. 88–89.

[2]Ibid., p. 90.

[3]See discussion and references on this point in GLOSSARY entry C.13.

Stabilization of markets through price leadership is becoming less common and aggressive price cutting strategies aimed at gaining market share are becoming more prevalent.

Porter suggests that in planning price responses in this potentially volatile area, the response policy must demonstrate commitment.[4] Marketers need to define a policy that will encourage market stability and enhance the company's competitive position. Once this policy is established, the firm needs to commit to it in such a way that it is clear to competitors that the firm will stick to the policy and commit the necessary resources to carry it out. When competitors become convinced of this commitment, they may forego aggressive and destabilizing moves because they know that counteraction is inevitable.

DEFINING A COMPETITIVE PRICE RESPONSE POLICY

A competitive price response policy defines how the firm should respond to competitive price changes. The policy may vary by product, but if the products and their markets are similar, a uniform policy may be possible and will result in less confusion.

Alternative Price Response Policies. Deciding on a response to a competitive price change is complex. The marketer must decide not only whether to respond, but must also decide the form that the response should take. How to respond will depend on whether the competitive price increased or decreased, the nature of the market in which the product competes, and the characteristics of the product itself. Because of the complexity of the decision and the need for a rapid response, some marketers have suggested use of a mathematical model to assist in making the decision.[5]

Alternative responses to competitive price changes can be grouped in four classes, although there can be variety within each class.

- *No Change.* One alternative is to take no action in response to a change in competitive price. If the competitive action was a price rise, failure to follow the increase will exert pressure on the competitor to rescind the increase and revert to the former level. Not following a competitive price decrease is an attempt to maintain price stability at the prior price. It runs the risk of market share loss unless the firm's product has strong competitive advantage.
- *Match Competitive Price Change.* If the competitor initiating a price change is a recognized price leader, matching the price change serves to confirm the change as establishing a new, stable price level. If the competitor price move is an aggressive price cut, made with the intent of increasing market share, matching the competitor is used to forestall loss of share and to discourage further price cutting.
- *Retaliatory Price Response.* If an aggressive competitor cuts price, a retaliatory price response would be to cut price to a still lower level. Retaliatory price response is designed to punish price cutters and discourage future destabilization of the market. However, it can also lead to further destabilization in the form of a price war. Retaliation as a response is usually limited to market leaders with strong resources.
- *Non-price Response.* Possible responses to a competitive price change include a change in a nonprice element of the marketing mix. This response is usually designed to blunt a competitive price cut while at the same time attempting to restore price stability to the market. Use of sales promotion, which can include a temporary, sometimes disguised, price reduction, is a frequently used response. An advantage of this response is that it can be initiated rapidly (see GLOSSARY entry C.36). Other nonprice responses are to increase advertising expenditures, introduce product improvements, or introduce fighting brands. A **fighting brand** is a product of comparable quality, perhaps a simplified version with a different brand name. It is introduced at a lower price

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[4]This paragraph based on Porter, *Competitive Strategy,* pp. 100–105.

[5]See Kent B. Monroe and Albert J. Della Bitta. "Models for Pricing Decisions," *Journal of Marketing Research* 15 (August 1978), pp. 413–28, and William M. Morgenroth, "A Method for Understanding Price Determinants," *Journal of Marketing Research* 1 (August 1964), pp. 17–26.

to attract price sensitive consumers and to retaliate against price cutters while protecting the reputation and price of the main brand.

Criteria for Designing a Competitive Price Response Policy. Deciding on a policy for responding to competitive price changes requires consideration of a variety of internal and market-related factors. The important considerations are described below. Although the response chosen for a competitive price increase will differ from that for a price cut, the same criteria can be used in setting the policy.

- *Is the Industry Unstable?* In an unstable market, there is danger that retaliatory responses will further destabilize the market. The most appropriate response in unstable markets is one that encourages a return to stability. A temporary response through sales promotion, for example, may offset a competitive price cut and, at the same time, invite a return to prior price levels.
- *What Is the Product Life-Cycle Stage?* During the growth stage of the **product life cycle,** prices and products tend to be differentiated, although downward pressure on price is brought about by the entrance of competition attempting to gain market share. The price response policy in the growth stage should focus on keeping the brand price competitive. Maturity is the squeeze-out stage where large competitors drive out smaller competitors and strive to gain market share, often through aggressive pricing. It is during this stage that price wars are most likely to occur and must be guarded against in designing a price response policy. Price policy during maturity should be concerned with preserving price stability. (See GLOSSARY entry A.15 on the **product life cycle.**)
- *What Are Competitor Motives?* In changing price, a competitor may be acting as a price leader or as an aggressor. **Price leaders** change price, usually in a public way, in an attempt to get competitors to follow the price change and establish a new and stable price level. Other competitors should follow the price change of a price leader if it will result in better financial returns for them. **Price aggressors** change price, usually downward and often surreptitiously, with the hope that competitors will not follow the price cut and the aggressor will gain market share. Aggressor price cuts must usually be countered in some manner, both to retain market share and to discourage further aggressive price moves.
- *What Is Industry Demand Elasticity?* If industry demand is inelastic, an increase in market price will usually result in revenue improvement for all competitors. In this case, upward price moves by price leaders should be supported. If industry demand is elastic, a decrease in market price will usually result in revenue improvement for all competitors. Such downward price moves by price leaders should be supported.
- *How Have Other Competitors Reacted?* If other competitors follow a price leader's price move, the new price will be confirmed and should be met. If other competitors fail to match a price leader's price change, the price change should not be followed, in which case the price leader will normally revert back to the prior price. If other competitors match a price cut by a price aggressor, the price cut must usually be followed or serious market share losses will occur.
- *What Are the Characteristics of the Brand?* The ability of a brand to withstand a competitive price cut without losing market share depends on the competitive advantages of the brand. If a brand is highly differentiated, its demand curve will be inelastic and consumers will be willing to pay a premium price for the product. Nonprice responses work best for differentiated products. Standardized or commodity-like brands, by contrast, have elastic demand curves. They must match price cuts by competitors or risk serious loss of market share. Brands with strong margins can better sustain price cuts as can brands that have realized cost reductions through strong experience curve effects. (See GLOSSARY entry A.14 on **price elasticity.**)
- *What Is the Pricing Objective?* The pricing objective can give guidance to the price response policy (see GLOSSARY entry C.23). A market stability objective would be supported by a no-response or nonprice response policy toward aggressive price cuts and by following price leader moves. A pricing objective to gain market share would be supported by a policy of matching competitive price cuts but not following upward price moves.
- *What Is Product's Portfolio Role?* A company's **strategic market planning process** assigns roles to individual brands in a business's port-

folio of products (see GLOSSARY entry A.20). Brands that are designated as growth opportunities must resist competitive price moves that could slow growth in market share. Brands assigned the role of providing cash flow for other products must resist destabilizing competitive price moves that could result in lower cash flow.

- *What Resources Are Available?* Matching competitive price reductions or, even more so, retaliatory price reductions can result in a prolonged reduction in profit margins and, often, losses. Firms must have adequate financial resources before establishing such a price response policy.

SUGGESTIONS FOR FURTHER READING

MONROE, KENT B., and ALBERT J. DELLA BITTA. "Models for Pricing Decisions." *Journal of Marketing Research* 15 (August 1978), pp. 413–28.

MORGENROTH, WILLIAM M. "A Method for Understanding Price Determinants." *Journal of Marketing Research* 1 (August 1964), pp. 17–26.

PORTER, MICHAEL E. *Competitive Strategy.* New York: Free Press, 1980, chap. 5.