



Business  
LINK

## Price your product or service

The price you charge for your product or service is one of the most important business decisions you make. Setting a price that is too high or too low will - at best - limit your business growth. At worst, it could cause serious problems for your sales and cashflow.

If you're starting a business, carefully consider your pricing strategy before you start. Established businesses can improve their profitability through regular pricing reviews.

When setting your prices you must make sure that the price and sales levels you set will allow your business to be profitable. You must also take note of where your product or service stands when compared with your competition.

This guide shows you how to build a pricing strategy and how to work out your costs and pricing to make sure your business is profitable. It also looks at different pricing tactics and changing your prices.

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### Developing a pricing strategy

When developing an overall pricing strategy, you will need to:

- Understand what your goods or services cost you to provide, and what they are worth to your customers. For more details see the page in this guide on the difference between cost and value.
- Work out your fixed and variable costs, and what you will need to charge to break even if you take both in to account. See the page in this guide on covering fixed and variable costs.
- Decide whether to use cost-plus or value-based pricing. See the page in this guide on cost-plus versus value-based pricing.

There are also other considerations when you are deciding what to charge for your products. It's important to find out what your competitors offer and what they charge. If you phone your rivals and ask them for a quote, you can use this information as a framework.

It's probably unwise to set your prices too much higher or lower than your competitors without a good reason. If you price too low, you will just be throwing away profit. If you price too high, you will lose customers, unless you can offer them added value. Always consider how your prices compare to the overall market, and think about what you would look for as a customer.

How customers see your product or service is also important. In many markets, a high price means that customers will see your product as being of premium value. This might encourage customers to buy from you but it might also stop price-conscious customers from doing so. Researching your market and gathering feedback from customers may help you understand how your products are perceived.

Finally, you should consider how your pricing balances out across your entire range of products and services. For example, a loss-leader (which makes a small profit or even none at all) can be offset by other, more profitable products. See the page in this guide on different pricing tactics.

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## The difference between cost and value

Knowing the difference between cost and value can increase profitability:

- the **cost** of your product or service is the amount you spend to produce it
- the **price** is your financial reward for providing the product or service
- the **value** is what your customer believes the product or service is worth to them

For example, the cost for a plumber to fix a burst pipe at a customer's home may be £5 for travel, materials costing £2.50 and an hour's labour at £10. However, the value of the service to the customer - who may have water leaking all over their house - is far greater than the £17.50 cost, so the plumber may decide to charge a total of £50.

Pricing should be in line with the value of the benefits that your business provides for its customers, while also bearing in mind the prices your competitors charge.

To maximise your profitability, find out:

- what **benefits** your customers gain from using your product or service
- the **criteria** your customers use for buying decisions - for example, speed of delivery, convenience or reliability
- what **value** your customers place on receiving the benefits you provide

Wherever possible, set prices that reflect the value you provide - not just the cost.

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## Covering fixed and variable costs

Every business needs to cover its costs in order to make a profit. Working out your costs accurately is an essential part of pricing.

Divide your costs under two headings:

- **fixed costs** that are always there, regardless of how much or how little you sell, for example rent, salaries and business rates
- **variable costs** that rise as your sales increase, such as additional raw materials, extra labour and transport

When you set a price, it must be higher than the variable cost of producing your product or service. Each sale will then make a contribution towards covering your fixed costs - and making profits.

For example, a car dealership has variable costs of £9,000 per car sold and total fixed costs of £200,000 a year that must be covered. If the company sells 80 cars each year, it needs a contribution towards the fixed costs of at least £2,500 per car (£200,000 divided by 80) to avoid making a loss.

Using this structure, you can assess the consequences of setting different price levels:

- if the car dealership sells cars at less than £9,000 (the variable cost per car), it makes a loss on each car it sells and does not cover any of its fixed costs
  - selling 80 cars at £9,000 means a loss of £200,000 per year as none of the fixed costs are covered
  - selling cars at £11,500 results in breaking even, assuming the target 80 cars are sold (80 contributions of £2,500 per car = £200,000, ie the fixed costs)
  - selling cars at £12,000 results in a profit, assuming 80 cars are sold (80 contributions of £3,000 = £240,000, ie £40,000 over the fixed costs)
  - if more or fewer than 80 cars are sold, profits are correspondingly higher or lower
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## **Cost-plus versus value-based pricing**

There are two basic methods of pricing your products and services: cost-plus and value-based pricing. The best choice depends on your type of business, what influences your customers to buy and the nature of your competition.

### **Cost-plus pricing**

This takes the cost of producing your product or service and adds an amount that you need to make a profit. This is usually expressed as a percentage of the cost.

It is generally more suited to businesses that deal with large volumes or which operate in markets dominated by competition on price.

But cost-plus pricing ignores your image and market positioning. And hidden costs are easily forgotten, so your true profit per sale is often lower than you realise.

### **Value-based pricing**

This focuses on the price you believe customers are willing to pay, based on the benefits your business offers them.

Value-based pricing depends on the strength of the benefits you can prove you offer to customers. See our guide on preparing to sell.

If you have clearly-defined benefits that give you an advantage over your competitors, you can charge according to the value you offer customers. While this approach can prove very profitable, it can alienate potential customers who are driven only by price and can also draw in new competitors.

### **Pricing services**

When you put a value on your services, rather than working from a unit price, you will need to think carefully about the value of your expertise and other desirable aspects of your service, such as a fast response time or out-of-hours service.

For example, an IT technician who is able to resolve a problem in two hours will be worth more to the customer than one who takes two days. They would be able to charge more for their service, despite it taking fewer man hours.

Market research and looking at your competitors will help you to understand the

level of service customers expect at your price point.

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## Different pricing tactics

Different tactics can help you attract more customers and maximise profits.

### Discounting

Offering specially-reduced prices can be a powerful tool. This could be a clearance discount to sell old stock, a discount for making multiple purchases of the same or similar products, or you could offer bulk discounts to encourage larger orders. You should be able to make these more profitable through lower costs.

But be careful. If you discount too much, customers may question your full-rate pricing or see you as a cheap option, making it difficult to charge full-rate prices in the future.

### Odd value pricing

Using the retailer's tactic of selling products for £9.99 instead of £10 can be useful if price is an essential part of customers' buying decisions. Some customers perceive odd value prices like this as being more attractive.

### Loss leader

This involves selling a product at a low or even loss-making price. Although you may not make a profit selling this product, you could attract customers who will also buy other, more profitable products.

### Skimming

If you have a unique product or service, you can sell it at a high price. This is known as skimming - but you need to be sure that what you are selling is unique. Otherwise you may just price yourself out of the market if there is credible competition.

### Penetration

This is the opposite of skimming - starting at a low price and gaining market share before competitors catch up with you. Once you have a loyal customer base, you should be able to find ways to raise prices later. See the page in this guide on raising or lowering prices.

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## Raising or lowering prices

There will be times when you need to change your prices. But before you do, you should analyse the impact on your profitability of any proposed price change.

There are two key questions you will need to answer:

- What effect will the price change have on the **volume** of sales?
- What will the effect be on the **profit** per sale?

### Increasing prices

Increasing prices can improve your profitability even though your sales volume may drop.

If you are increasing your prices, always explain to your customers why you are doing it. You can use the price change as an opportunity to re-emphasise the benefits you offer. For more information, see our guide on preparing to sell. A good explanation can also strengthen your relationship with a customer.

There are also ways that you can hide price increases. For example, you might:

- introduce new, higher-priced products or services and make older, cheaper ones obsolete
- lower the specification - and your costs - while maintaining the same price

But be aware that hiding price increases can risk adverse reactions from customers if they realise what you are doing.

### **Reducing prices**

You should never take the decision to lower prices lightly. Low prices often go hand-in-hand with poor-quality service - is this the image you want to create for your business?

Concentrate on building profits rather than cutting prices to build up sales. In most circumstances, your customers decide to buy from you because of the benefits you offer, along with your price. It is rare for the decision to be made based solely on the price.

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Preparing to sell

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**Pricing for product managers course details on the Chartered Institute of Marketing website**

<http://www.cim.co.uk/tandq/training/courses/0423.aspx>

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