The Pricing Paradox

The profit equation has three variables – price, volume, and cost. Of these, price is the most common candidate for manipulation since nothing else need change to produce profits for everyone, provided everyone changes prices together. That togetherness is what gives birth to dreams of “industry statesmanship”, as a way to better profits through higher prices.

In fact, both volume and cost are easier to change than industry price levels. Efforts to change industry prices can cause them to ebb and flow like the tide, with equal net effect on mean sea level. Above normal prices inevitably attract additional capacity until prices become depressed. Depressed prices inhibit capacity replacement or additions until prices rise. This is a corollary of the economic truism that competition will force prices down to approach costs or it will cause costs to rise to approach prices.

The consequences of a price advance are predictable. At best, other producers will follow the leader and there will be a substantial price rise. But this in turn sets up a ready-made umbrella for the new capacity of these other competitors who must force their way into the market to fill their added capacity.

The usual result is an artificial list price which hides real price cuts at the expense of the market leader. Because of the price leader’s price rise, his profit erosion is obscured temporarily until he decides at some later date that he must retain his share of market. In the meantime, he has subsidized the invasion of his market share by competitors and justified their investment in more capacity.

Short term, the others may not follow his price leadership. Consequently, he must not only retract the price increase, but suffer some market volume loss also.

Over the longer term, the consequences are quite different. Long term, share of the market is determined by who has the capacity in being and in a position to be used fully. Long term, the maintenance or addition of capacity is nearly always a function of profits in the past and their effect on profit expectations in the future.

Over the long term, profit and profit expectations are based upon anticipated relative costs and operating rates. As a consequence, short-term higher prices for the industry tend to encourage capacity additions and to provide the cash flow to justify that expansion.

All of this is simple classic economics, but the strategic implications are not immediately obvious:

• If you have the lowest cost at nominal capacity, then it is to your advantage to keep prices down at all times sufficiently to dissuade competitors from making additional capacity investments, unless, of course, you can raise them and still stay at nominal capacity.
• Also, it is to your advantage to invest in added capacity yourself as long as you can do so and maintain your cost advantage. This requires that the added capacity be operated at a load factor high enough to provide cost levels no higher than competitors’ average cost. In fact, in an active technology you must make capacity additions to maintain a cost advantage.
• If your fixed costs are higher but your operating costs are lower than competitors’, then you are more sensitive to changes in operating rate. It is to your advantage to accept any kind of price depression short-term which provides a high operating rate. Only under these conditions can you maintain a relative cost advantage. For the same reason, you can accept a lower price level without out-of-pocket loss than your competitors can. This situation is usually true of the new facility.

If you are the low cost producer with the newest facilities, then any price which is required to operate your facility at nominal capacity is not only
justified but a prerequisite for maintaining your relative cost advantage. Any higher price is relatively disadvantageous. Conversely, the interests of high cost producers must be to keep prices high or to obtain a higher operating rate.

Competitive strategy comes into play in the efforts to induce competitors to accept practices which shift relative costs.

The producer with the new low-cost facility must induce competitors to believe that he can and will depress prices indefinitely - until prices are below their cost, if need be - to the point that his new facilities are operating at average industry capacity. In fact, he has the power to do this. He benefits most, however, if he does not need to depress prices to fill his new capacity.

The producer with the higher cost facilities but in possession of the market must attempt to convince competitors that high prices for the industry are to everyone’s advantage. In this way, he can offset his relative cost disadvantage. He may also find it necessary to convince competitors that it will be too costly to wrest away his existing market share by price action. If he can induce competitors to use nonprice means of competing, then their added costs may defer for a long time their realization of the inherent advantage of newer and more efficient capacity.

Short term, the really critical elements of strategy are those which induce a competitor, for whatever reason, to accept a lower operating rate. This imposes a relative cost handicap which has no offsetting virtues.

Long term, the critical elements are those which determine the willingness of competitors to make further capital investment in capacity. Any uncertainty, risk, or competitive policy which can delay this kind of decision produces a higher profit level on average for those who are already in production.

Viewed in this light:

- Short-term price increases tend to depress industry profits long-term by accelerating the introduction of new capacity and depressing market demand.
- Short-term price increases favor the high cost producer relatively more than the low cost producer.
- The lower cost producer has everything to gain and little to lose by depressing prices until he is operating at nominal capacity.
- The perfect strategy for the lowest cost producer is one which persuades others to permit him to obtain maximum capacity use with minimum price depression – at the others’ expense in terms of operating rate and profit.
- The perfect strategy for the high cost producer is one which persuades others that market shares cannot be shifted except over long periods of time, and, therefore, that the highest practical industry prices are to everyone’s advantage.

Paradoxically, it is often the strongest and lowest cost producer who leads the way in establishing higher prices, even though he himself may be operating below his optimum capacity. When this happens, it must be considered a strategic victory for the higher cost producer in the market.

If all of this seems obvious, it is difficult to explain the concern of businessmen, security analysts, and others with industry price levels. It would appear that the factor of vital concern should be relative costs – or rather, relative profit margins. The concentration of attention upon short-term profits, which are often transient profits, frequently produces the very opposite long-term effect on performance from that desired.

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