STRATEGY BULLETIN

January 2002

How low can you go?

Minimising the pain of price wars

Price wars, like other forms of aggressive pricing (such as predatory pricing and loss leading), are strategic in nature. Firms will only make drastic cuts to prices now if they believe that there may be a longer-term gain. After a price war, however, the gain materialises remarkably rarely, and persists still more infrequently. Many price wars are embarked on misguidedly or even by mistake – triggered by firms who have misinterpreted rivals' strategies, or who are too focused on short-term results. This is a particularly strong but dangerous temptation when firms are worried about an economic downturn. This bulletin explains how and why price wars occur - and what to do if you find yourself in the middle of one.

The ten-year shift from high to low inflation has seen many firms cut prices across the board. New technologies, weak commodity prices and increased competition have put downward pressure on prices. Price wars, however, are something quite different: like other forms of aggressive pricing they involve deliberate actions by firms to take prices down to unusually low (sometimes unprofitable) levels, with the aim of achieving one (or both) of the following outcomes:

- changes in market structure - the forced exit of a rival or the deterrence of entry; or
- a change in the nature of competition and/or in the nature of demand.

There are many different reasons why firms may believe that it is possible to force the exit of a rival; such strategies often fall foul of competition law, and need not be elaborated on further here. This bulletin focuses on the potential for the second type of gain, relating to changes in the nature of competition or demand.

Position yourselves, please

In all but the most commoditised markets there are several ways in which firms compete (by price, product quality, brand, etc.). Firms decide how to tailor their offers so as to maximise profitability on the basis of their competitive advantage, the nature of demand and the behaviour of their rivals. The way in which firms present this offer (their "position"), and the dynamics between them, determines the nature of competition.

The nature of demand is determined by customers' desires and their expectations of suppliers. Superficially, these desires could be summarised as "good products at low prices" but demand is rarely as simple as this. Customers are not the same; they tend to want different things and value different offers. There are many possible combinations of quality and price, and firms may be able to influence the demand for these to their advantage, especially if they present a new combination (a good example is the way in which low-cost airlines have attracted business passengers).

Competition between firms may be head-on (with all of them presenting a similar offer, or positioning themselves in the same sp
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may compete mainly on price or on non-price factors. Even if they all rely on the same factors, they may still differentiate their offers. Thus, even if competing on price, firms may use headline prices, discounts, coupons or bundling to improve the perception of their offers.

In many industries, the nature of competition between firms may be stable for long periods of time. This does not imply that competition is weak, but rather that firms are happy with their respective positions. In other industries one may see wild swings between different forms of competition, or step-changes in its nature. Within most markets, however, each firm has an expectation of how rivals would like to position themselves and this provides some stability.

Fingers on triggers

Sometimes firms may want to reposition themselves. This may be because they think that a close rival has done so (or is about to do so), or because they have changed their views on the nature of demand When one firm decides to reposition itself by lowering prices, others may follow aggressively, and this can result in a price war until new and more stable positions are established.

Other triggers for price wars include:

- a new entrant to the market who takes a different view about the nature of demand (e.g. a discounter);
- a new technology (or regulation) which changes the cost structure of at least one firm, or reduces barriers to entering the market (e.g. on-line banking);
- a reduction in product differentiation, which tends to make pricing more important (e.g. personal computers);
- a mistake.

The last of these triggers - a war that starts by mistake - requires a little more explanation.

Pricing strategies, even for the most basic of products, are a complex business. They require much thought and analysis of a firm's best strategies, and almost as much thought and analysis about its rivals' best strategies. Mistakes are easily and often made, for example:

- "accidental" repositioning, when a price cut intended to be temporary (for example, in order to absorb unused capacity in times of demand weakness) is perceived by rivals to be permanent;
- insufficient forethought, when a potential repositioner underestimates the likely response from rivals;

- a misunderstanding of the nature of demand by some of the players, or an excessive focus by one firm on short-term results, which leads it to compete more on price.

Box 1 - Looking for commitment

1. Focus. How focused is the firm in question on the battle? Is it cutting the price(s) of its most important product or merely of part of its portfolio? Firms will be much more focused on the battle for market share for their core products (and you can expect at least some senior directors to be placing their jobs on the line).

2. Burning bridges. What strategies been put in place to signal commitment to the war? Has the company in question done anything to demonstrate that it can't turn back?

3. Reputation. Has the firm in question undertaken the same strategy before? What happened then?

4. Deep pockets. Large firms with deep pockets are able to hold out longer than small firms with cash-flow problems. The ability to finance a long-term price war does not tell you everything about a firm's commitment, but financial weaknesses may tell you commitment is a luxury it cannot afford.

If such mistakes result in rivals feeling the need to respond aggressively in kind, a price war occurs. This can be extremely expensive. It will end only if the repositioning firm changes its strategy, or rivals decide it is better to maintain a differentiated position, and so pull back.

Shared pain

Price wars are rarely profitable. The usual outcome is a reduction in the value-added of the whole industry concerned. There are two main reasons for this.

First, the cost of price wars tends to feed straight to the bottom line. The short-term costs can be extremely high and only very large increases in market share, or in post-war prices, will result in the recovery of these losses.

Second, price wars also bring other, longer-term, problems. In particular, they may focus the consumer's attention more closely on prices, so that future price increases are more difficult to achieve and long-term value is destroyed. If the aim of the aggressor is to change the nature of demand, this may be intentional, but for others it may be disastrous.

Read my lips

Firms which calculate that they can "win" a price war must therefore believe either that they will change the strategy of other players, or that they will gain – and, most importantly, retain - significant market share. To believe this, a firm must be confident that others cannot profitably match its offer.

To win the war, an aggressor has to convince its rivals that it is utterly committed to the fight; otherwise, they will match the aggressor's price cuts and wait for it to withdraw. There are four good ways of demonstrating (or judging) commitment (shown in Box 1).

Commitment is necessary but not sufficient to make a price war profitable. Winning the war may be hard enough; emerging from it in a better position than you would have been if you had not provoked a fight is harder still. The combatant must also be able to hold on to gains after the price war has finished. The first requirement is that a strategy of cutting prices should deliver more market share than would be lost through raising prices thereafter. How exactly the gains are retained will depend on the reactions of rivals and customers. Brand loyalty and the behaviour of non-committed rivals can work in the aggressor's favour (the way in which Philip Morris retained market share after starting a price war on "Marlboro Friday" is a good example).

Such successes are however rare. So while firms may consider the advantages of slashing prices almost daily, they embark on a deliberate price war only rarely. This leads to an important conclusion - that most of the price wars we see around us may be "mistakes", in the sense that firms misinterpret rivals' strategies and/or the nature of demand, and trigger outright price war by inappropriate responses. If this is true, it is important to know how to avoid price wars.

Carefully does it

To avoid mistakes and accidental warfare, try following the five steps presented in Box 2.

The first three steps will help to avoid or defuse price wars. Avoidance is generally the best strategy. However, if something does trigger a war, and you have no choice, the third and fourth steps should help to ensure that you suffer minimum pain. The general rule is: always try to think what your competitor will do. Put yourself in his shoes, and work out his optimum strategy. Then think about how you can change that strategy to your best advantage. As ever, good thinking, detailed modelling and cool heads are crucial.

Box 2 - Minimising the risk of price wars

1. Don't be the cause. In a stable competitive environment, take care with your use of price as a competitive weapon. Unless you really intend to reposition yourself, avoid direct or overly aggressive forms of price-cutting. Go for coupons, loyalty points, two-for-the-price-of-one schemes and temporary promotions. Make sure that rivals can see the temporary nature of your strategy.

2. Limit your vulnerability. Try to reduce the price elasticity of demand for your product by introducing product differentiation, increasing advertising and other promotional techniques such as loyalty cards. This will reduce the gains others can make from you by price-cutting.

2. Watch out for repositioning but don't jump to conclusions. Keep a close eye on competitors' prices and look for potential repositioners. However, do not treat every price cut by others as aggressive behaviour. It may be temporary, or there may be mitigating factors (such as a reduction in quality or quantity). Do not act on anecdotal evidence or limited information. Make sure that you understand *exactly* what your rival is doing and try to work out his strategy. A hasty response could throw the whole market into an unnecessary price war.

3. If a response is necessary, make it quick and effective. If there is no other choice but to respond to rivals in order to discourage them from aggressive tactics, make your response quick and effective. First, responses should be simple (so that everyone can see them) and large (so as to make the point that aggression by others will not be tolerated). Second, make responses credible. Prices must come down and stay down until the aggressor is discouraged. An effective response now might deter future aggressors.

5. If there is a way out, try it. Once in a price war (whether you started it or not), look for escape routes. For example, if one firm edges prices up, it may be better to follow rather than treat this change as an advantage that you can exploit. If you feel that you could lead prices back up, try to do so. And think about non-price responses – these might help to defuse the situation.

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