An ESRC Research Centre

CCP CENTRE FOR COMPETITION POLICY

Price low and then price high or price high and then price low?

July 2010

Price low and then price high

CCP Executive Summary

BACKGROUND

- There are reasons why it can be considered a good strategy for a company to choose a low introductory price for a new product followed by a higher price. For example, if at least some consumers face switching costs, a low introductory price may be used to 'lock in' consumers and the price may be raised afterwards; the strategy may be used to signal low cost; or it may be used to facilitate buyer experimentation where there is uncertainty about the product's quality.
- However, it has been observed that Apple adopted the opposite strategy for the IPhone: it was originally priced at $600 and, when the price moved down to $200, everyone thought it was a bargain to buy.

METHODOLOGY

- This paper presents an experiment to test the intuition that it may be profitable for companies first to price high and then to price low.
- The aim of the experiment is to show that a 'high price – low price' strategy may be profitable for companies because of 'shaping effects'. These are changes in demand due to consumers having unclear preferences and, as a result, their preferences being shaped by the decision environment.
- The authors do not use durable goods but lotteries of different degrees of complexity as the products that consumers can buy. There are no monetary switching costs.
- The experiment consisted of repeated opportunities for subjects to decide whether and how much they wanted to buy of a lottery on sale at a randomly chosen price. Subjects received no feedback on lottery outcomes during the experiment. To incentivise subjects, the lotteries were played out at the end of the experiment based on a single random draw applicable for all units of the lottery bought during the experiment and a payment was made based on points earned.

KEY FINDINGS

- The authors' key finding is that shaping effects do matter, and that a 'high price – low price' strategy would indeed be profitable for firms under different assumptions about cost and volume of demand. This is found to be the case regardless of the type of product employed.
- The authors draw on their findings to suggest that when subjects do not have clear preferences about the value of a product, they rely on past prices to provide an indication of value. Firms may then exploit consumers' bounded rationality to gain more profits than they would otherwise.

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THE CCP

The ESRC Centre for Competition Policy (CCP), at the University of East Anglia, undertakes competition policy research, incorporating economic, legal, management and political science perspectives, that has real-world policy relevance without compromising academic rigour.

FOR MORE INFORMATION

The full working paper (10-8) and more information about CCP and its research is available from our website: www.uea.ac.uk/ccp

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