Responding to Competitor Pricing

While it is generally acknowledged that it is best to stay out of a price-cutting war, sometimes competitor actions will force you into one.

*In this activity, your firm is **Restaurant C** and one of your competitors has recently cut their prices. The question is – how you will respond?*

Three Blue Mountains Restaurants

Let’s assume that there are three restaurants/cafes located together in a purely in a tourist area, such as the Blue Mountains. These restaurants/cafés are located near to each other and all rely on NEW customers/tourists each weekend.

For the sake of simplicity in this case study, let’s assume that there are only 3,000 tourists each week, across the three restaurants/cafes. These restaurants are similar in size, location, presentation, and menu choice.

As the tourists know nothing about these restaurants before they arrive, they tend to be heavily influenced by price (which is the only real distinguishing factor).

Ongoing Profits were Good for All Restaurants

For two years, all three restaurants maintained the same pricing, which meant they shared the customers equally, as shown in the following table:

Key Profit Metrics	**Restaurant A**	**Restaurant B**	**Restaurant C**
No. of meals sold	1,000	1,000	1,000
Average Price	**$10**	**$10**	**$10**
Total Income	$10,000	$10,000	$10,000
Variable Cost of Meals	$2	$2	$2
Total Food cost	$2,000	$2,000	$2,000
Rent/staff	$5,000	$5,000	$5,000
Total Costs	$7,000	$7,000	$7,000
Profit (per week)	**$3,000**	**$3,000**	**$3,000**

The Other Two Restaurants Change Their Prices (Up and Down)

However, Restaurant A recently changed ownership and the new managers reduced their prices to generate more customers. At the same time, your other competitor (Restaurant B) decided to increase its prices in an attempt to appeal to the more quality conscious consumers.

The impact on the financials of these changes was:

Key Profit Metrics	Restaurant A	Restaurant B	Restaurant C
No. of meals sold	1,200	800	1,000
Average Price	**$9**	**$11**	**$10**
Total Income	$10,800	$8,800	$10,000
Variable Cost of Meals	$2	$2	$2
Total Food cost	$2,400	$1,600	$2,000
Rent/staff	$5,000	$5,000	$5,000
Total Costs	$7,400	$6,600	$7,000
Profit (per week)	**$3,400**	**$2,200**	**$3,000**

Even More Pricing Changes

The end result was that Restaurant A picked up more customers (all switching from Restaurant B). Restaurant A was so happy that they increased profits by more than 10% decided to reduce prices even further. Restaurant B whose profits reduced, decided to return to the $10 level.

The impact on the financials of these changes was:

Key Profit Metrics	Restaurant A	Restaurant B	Restaurant C
No. of meals sold	1,400	800	800
Average Price	**$8**	**$10**	**$10**
Total Income	$11,200	$8,000	$8,000
Variable Cost of Meals	$2	$2	$2
Total Food cost	$2,800	$1,600	$1,600
Rent/staff	$5,000	$5,000	$5,000
Total Costs	$7,800	$6,600	$6,600
Profit (per week)	**$3,400**	**$1,400**	**$1,400**

Again, Restaurant A won more customers (this time both from the other competitor and, this time, from your restaurant!) The impact on your profits was disastrous. They have been more than halved.

You know that if you don't react on price, your profits will remain at this new low level. But you also know that if you do react the price-war continues, and all three restaurants will be worst off.

While you don't think that Restaurant A will proactively change their prices again, you're pretty sure that Restaurant B is looking to cut prices – and where will that leave you?

Student Discussion Questions

1. What price should you now set (for your restaurant C)?
2. How might your competitors react to your new price?
3. Look long term – which restaurant will win this price war (if any)?
4. Considering your response in Q3, what is the best solution for all concerned?