Section 3.4
Product Pricing

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Section Summary

- Define price and its importance in the marketing mix
- Show steps in developing successful pricing program
- Discuss pricing policies & other pricing methods
Price

- Must complement your product, distribution channels (place) and promotion strategies

- Relates to your costs, competition and customers

- Impacts revenue and profitability

- Acts as a substitute for value (customer perception)
Developing A Successful Pricing Program

1. Set pricing objective
2. Study demand
3. Determine costs
4. Analyze competition
5. Select pricing strategy
6. Determine final price

1. Set Pricing Objectives

- Maximize sales growth
- Maximize revenue
- Maximize profit
- Maximize price (market skimming)
- Provide quality/value leadership

Pricing Objectives

• Target the product you have positioned, or develop a broader strategy for a line of products and services
  ▶ Maximize profit margin on steaks and other high-end cuts
  ▶ Maximize quantity sold of ground beef

• Outline financial goals for your pricing strategy
  ▶ $1400 per head return
  ▶ Cover costs and earn 10% profit
Pricing Objectives

Address both cost and value issues

- How do you relate price strategy to product’s perceived added value?
- How do you cover costs? Is your strategy a response to cost structure?
2. Study Demand

- Demand shifts caused by changes in:
  - Income
  - Population
  - Product’s substitutes & complements
  - Consumer tastes and preferences

- Be familiar with your target market

- Price responsiveness (measured by elasticity) is important in developing market strategy & effective pricing
Elasticity Of Demand

• The absolute value of a % change in quantity divided by a % change in price

• Elasticity greater than 1 is elastic
  ▶ Increasing price, raises revenue

• Elasticity less than 1 is inelastic
  ▶ Increasing price, lowers revenue

• If elasticity higher than desired, how can other marketing strategies (promotion or distribution changes) “pivot” demand?
An Elasticity Example…

- Hamburger at $2.50/lb; considering an increase to $3.25/lb
- Current sales at 200 lbs/wk would drop to 160 lbs/wk
- Resulting elasticity: -0.85 (see the following slide for the elasticity calculations)
- Resulting revenue:
  - $2.50*200=$500 < $3.25*160=$520
Elasticity Example Calculations

\[
\%	ext{ change in quantity}\left\{ \frac{(160 - 200)}{(160 + 200)} \right\} \frac{2}{2} = \frac{-0.22}{0.26} = -0.85
\]

\[
\%	ext{ change in price}\left\{ \frac{(3.25 - 2.50)}{(3.25 + 2.50)} \right\} \frac{2}{2}
\]
3. Determine Costs

- Consider **all** costs (management expertise and labor, land, capital equipment, depreciation on machinery, animals, and buildings)

- Separate costs into fixed & variable:
  - Fixed costs incurred whether product is produced or not (building, machinery, land)
  - Variable costs incurred only when product is produced (feed, processing, packaging)

Know All Costs

- Add fixed & variable costs to calculate total cost
- Calculate per unit or break even cost: divide total cost by total quantity produced
- Important for determining price
- To stay in business, price your product above the production costs
Estimating Costs

• In planning a start-up business, research the costs of inputs, labor and equipment

• Project how much you plan to produce

• If production varies throughout the year, project output on a monthly basis

• Use cost and output estimates to project per unit costs
4. Analyze The Competition

• How many competitors operate in my market?
• Are my competitors large or small? Near or far?
• Is it difficult for new competitors to enter the industry?
• What types and numbers of products do they sell?
• What pricing methods do my competitors use?

5. Select A Pricing Strategy

- Cost-based
- Competition-based
- Customer-based

Cost-Based Pricing

• Use per unit or break-even costs to determine price

• Set interactive price and volume sales goals with a desired profit level

• Add the desired profit level to the break-even price
Disadvantages Of Cost-Based Pricing

• Does not consider how consumer demand affects price

• Does not account for market seasonality or varying input prices

• Actions of your competitors are not included in price; competition should affect how you price your product
Competition-Based Pricing

• Pricing to gain market share & attract and hold as many customers as possible

• Base prices on competition, if product is comparable to competitor’s product
  ▶ Larger firms price product the same, smaller firms follow the lead of large firms

• Penetration pricing: price set lower than competition to lure customers away
Disadvantages Of Competition-Based Pricing

• Less attention to product cost or demand; risk ignoring own production costs if you focus too closely on the prices set by competitors

• Must constantly update market research; greater time commitment

• Easy for competition to mimic your pricing strategies
Customer-Based Pricing

• Price relates to the benefits buyers perceive they will gain while using product (nutrition, convenience, etc.)

• Increase price by increasing perceived value through product differentiation

• Price to support product image, higher price often perceived as higher quality

• Offer promotion price to gain consumer attention: coupons, special offers, holiday discounts
Customer-Based Pricing

• Set price to increase sales volume by giving discounts for bulk purchases

• Package pricing: bundle several products together to boost sales volume & encourage variety purchased

• Bottom line: price according to benefits buyers think they will get from purchasing the product
Disadvantages Of Customer-Based Pricing

• Potential to ignore production costs; still need to account for any costs incurred during value-added production

• Need to monitor your competition’s pricing strategies
6. Determine Final Price

Consider these factors when establishing price:

- Market conditions within your industry
- Seasonality of your product
- Number of substitute or complement goods
- Brand loyalty by consumer
- Percent of consumer’s budget spent on product
Psychology of Pricing

• Buyers perceive price changes in proportional terms, rather than absolute terms

• Series of small price increases below some upper threshold is more successful than one large increase

• Buyers respond more to one large price decrease than a series of small, successive discounts
People formulate a price reference to make purchase decisions

- Current price influences judged by comparing one price to another.
- Instead of using current prices for comparisons, consumers use past prices.
Evidence Of Reference Prices

- Consumers feel that middle prices are a good compromise.

- Consumers need endpoints to serve as boundaries for decisions.
  - Given a new end point, some consumers don’t want to purchase the cheapest brand; now have an alternative.
Evidence Of Reference Prices

Studies conducted where prices are shown in descending order (high to low prices) & another group is shown the same products in ascending order (low to high prices)

- Those shown the higher price first are willing to pay more
- Those shown the lower price first want to pay less
Determinants Of Price Sensitivity

• **Perceived substitute effect**: How many substitutes exist for your product?

• **Unique value effect**: Can you increase market share through differentiation?

• **Switching cost effect**: Changing from one product to another - people are reluctant to change and learn something new
Determinants Of Price Sensitivity

- Difficult comparison effect: Hard to compare products/services
- Price-quality effect: Often associate a higher price with higher quality
- Expenditure effect: Consumers more sensitive to price changes on large, expensive products than small, inexpensive ones (such as price changes on meat compared to salt)
Determinants Of Price Sensitivity

- **Fairness effect**: People impacted by what they consider fair - grass-fed vs. conventional (sense of value-added)

- **Inventory effect**: Seasonality affects price sensitivity - in summer higher demand for steak due to outside grilling

- **End-benefit effect**: People willing to pay more for product that protects the environment or the family farm
Other Pricing Policies

• Price skimming (pricing slightly higher than competition) works for loyal and convenience customers

• Penetration pricing (pricing slightly lower than competition) works for price-oriented consumers

• Combine above policies to gain:
  ▶ large customer base (penetration) to cover fixed costs
  ▶ smaller consumer segment (skimming) for increased revenue
Other Pricing Methods

- Offer introductory price cuts for new goods or customers

- Use price points (prices pleasing to the eye)
  - $2.99 is more pleasing than $2.98 because it is an odd number
  - May use even prices, such as $3.00, for niche products because it tends to convey that the product is “not cheap”
Discounts

• **Quantity discount**: Helps achieve sales goals; recognizes a fixed cost per transaction

• **Seasonal discount**: Helps solve storage or capacity problems

• **Trade discount**: Improves economies of scale, brings faster payment from buyers

• **Cash-based discounts**: Encourages faster payment
Allowances & Credits

- **Advertising allowance**: Member of distribution channel gets a discount on your product for advertising it for you

- **Trade credit**: Improves customer loyalty but more risk for the seller
Pricing Your Product

• Set your product price to fit in the marketing mix

• Tailor your pricing strategy to your:
  ▶ customer segment
  ▶ distribution strategy
  ▶ product location in its life cycle