

28.24.1: Reading- Introduction to Product Pricing

Price, the Only Revenue Generator

Price is the only marketing mix variable or part of the offering that generates revenue. Buyers relate the price to value. They must feel they are getting value for the price paid. Pricing decisions are extremely important. So how do organizations decide how to price their goods and services?

New Product Pricing

With a totally new product, competition does not exist or is minimal. Two general strategies are most common for setting prices: penetration pricing and skimming

Penetration Pricing

In the introductory stage of a new product's life cycle means accepting a lower profit margin and to price relatively low. Such a strategy should generate greater sales and establish the new product in the market more quickly. Penetration pricing is the pricing technique of setting a relatively low initial entry price, often lower than the eventual market price, to attract new customers. The strategy works on the expectation that customers will switch to the new brand because of the lower price. Penetration pricing is most commonly associated with a marketing objective of increasing market share or sales volume, rather than to make profit in the short term.

The advantages of penetration pricing to the firm are the following:

- It can result in fast diffusion and adoption. This can achieve high market penetration rates quickly. This can take the competitors by surprise, not giving them time to react.
- It can create goodwill among the early adopters segment. This can create more trade through word of mouth.
- It creates cost control and cost reduction pressures from the start, leading to greater efficiency.
- It discourages the entry of competitors. Low prices act as a barrier to entry.
- It can create high stock turnover throughout the distribution channel. This can create critically important enthusiasm and support in the channel.
- It can be based on marginal cost pricing, which is economically efficient.
- A penetration strategy would generally be supported by the following conditions: price-sensitive consumers, opportunity to keep costs low, the anticipation of quick market entry by competitors, a high likelihood for rapid acceptance by potential buyers, and an adequate resource base for the firm to meet the new demand and sales.

Skimming

Skimming involves goods being sold at higher prices so that fewer sales are needed to break even. Selling a product at a high price and sacrificing high sales to gain a high profit is therefore “skimming” the market. Skimming is usually employed to reimburse the cost of investment of the original research into the product. It is commonly used in electronic markets when a new range, such as DVD players, are firstly dispatched into the market at a high price. This strategy is often used to target “early adopters” of a product or service. Early adopters generally have a relatively lower price sensitivity and this can be attributed to their need for the product outweighing their need to economize, a greater understanding of the product's value, or simply having a higher disposable income.

This strategy is employed only for a limited duration to recover most of the investment made to build the product. To gain further market share, a seller must use other pricing tactics such as economy or penetration. This method can have some setbacks as it could leave the product at a high price against the competition. A skimming strategy would generally be supported by the following conditions:

- Having a premium product. In this case, “premium” does not just denote high cost of production and materials—it also suggests that the product may be rare or that the demand is unusually high. An example would be a USD 500 ticket for the World Series or an USD 80,000 price tag for a limited-production sports car.
- Having legal protection via a patent or copyright may also allow for an excessively high price. Intel and their Pentium chip possessed this advantage for a long time. In most cases, the initial high price is gradually reduced to match new competition and allow new customers access to the product.

Psychological Pricing

Psychological pricing is a marketing practice based on the theory that certain prices have meaning to many buyers.

As with other elements in the marketing mix, price conveys meanings beyond the dollar amount it denotes. One such meaning is referred to as the psychological aspect of pricing. Associating quality with price is a common example of this psychological dimension. For instance, a buyer may assume that a suit priced at \$500 is of higher quality than one priced at \$300.

Products and services frequently have customary prices in the minds of consumers. A customary price is one that customers identify with particular items. For example, for many decades a five-stick package of chewing gum cost five cents, and a six-ounce bottle of Coca-Cola also cost five cents. Candy bars now cost 60 cents or more, which is the customary price for a standard-sized bar. Manufacturers tend to adjust their wholesale prices to permit retailers to use customary pricing.

Odd Pricing

Another manifestation of the psychological aspects of pricing is the use of odd prices. We call prices that end in digits like 5, 7, 8, and 9 “odd prices.” Examples of odd prices include: \$2.95, \$15.98, or \$299.99. Odd prices are intended to drive demand higher than would be expected if consumers were perfectly rational.

Psychological pricing is one cause of price points. For a long time, marketers have attempted to explain why odd prices are used. It seemed to make little difference whether one paid \$29.95 or \$30.00 for an item. Perhaps one of the most often heard explanations concerns the psychological impact of odd prices on customers. The explanation is that customers perceive even prices such as \$5.00 or \$10.00 as regular prices. Odd prices, on the other hand, appear to represent bargains or savings and therefore encourage buying. There seems to be some movement toward even pricing; however, odd pricing is still very common. A somewhat related pricing strategy is combination pricing, such as two-for-one or buy-one-get-one-free. Consumers tend to react very positively to these pricing techniques.

The psychological pricing theory is based on one or more of the following hypotheses:

- Consumers ignore the least significant digits rather than do the proper rounding. Even though the cents are seen and not totally ignored, they may subconsciously be partially ignored.
- Fractional prices suggest to consumers that goods are marked at the lowest possible price.
- When items are listed in a way that is segregated into price bands (such as an online real estate search), the price ending is used to keep an item in a lower band, to be seen by more potential purchasers.

Everyday Low Pricing

Everyday low price (EDLP) is a pricing strategy promising consumers a low price without the need to wait for sale-price events or comparison shopping.

EDLP saves retail stores the effort and expense needed to mark down prices in the store during sale events, as well as to market these events. EDLP is believed to generate shopper loyalty. It was noted in 1994 that the Wal-Mart retail chain in America, which follows an EDLP strategy, would buy “feature advertisements” in newspapers on a monthly basis, while its competitors would advertise 52 weeks per year.

Procter & Gamble, Wal-Mart, Food Lion, Gordmans, and Winn-Dixie are firms that have implemented or championed EDLP. One 1992 study stated that 26% of American supermarket retailers pursued some form of EDLP, meaning the other 74% were Hi-Lo promotion-oriented operators.

One 1994 study of an 86-store supermarket grocery chain in the United States concluded that a 10% EDLP price decrease in a category increased sales volume by 3%, while a 10% Hi-Low price increase led to a 3% sales decrease; but that because consumer demand at the supermarket did not respond much to changes in everyday price, an EDLP policy reduced profits by 18%, while Hi-Lo pricing increased profits by 15%.

An example of a successful brand (other than the infamous Wal-Mart) that uses the EDLP strategy is Trader Joe's. Trader Joe's is a private-brand label that conducts a Niche marketing strategy describing itself as the “neighborhood store.” The firm has been growing at a steady pace, offering a wide variety of organic and natural food items that are hard to find, enabling the business to enjoy a distinctive competitive advantage.



Everyday Low Pricing at Trader Joe's

Trader Joe's is not an ordinary store. It's unique because of its commitment to quality and lower prices, which it makes available to everyone—no membership required. The company states that “every penny we save is every penny our customer saves” (Trader Joe's 2010). Trader Joe's has worked hard to manage this economic image of value for its products, which competitors, even giant retail stores, are unable to meet.

High/Low Pricing

High-low pricing is a method of pricing for an organization where the goods or services offered by the organization are regularly priced higher than competitors. However, through promotions, advertisements, and or coupons, lower prices are offered on other key items consumers would want to purchase. The lower promotional prices are designed to bring customers to the organization where the customer is offered the promotional product as well as the regular higher priced products.

High-low pricing is a type of pricing strategy adopted by companies, usually small and medium sized retail firms. The basic type of customers for the firms adopting high-low price will not have a clear idea about what a product's price would typically be or have a strong belief that “discount sales = low price.” Customers for firms adopting this type of strategy also have strong preference in purchasing the products sold in this type or by this certain firm. They are loyal to a specific brand.

Many big firms use this type of pricing strategy (e.g., Reebok, Nike, Adidas). The way competition prevails in the shoe industry is through high-low price. High-low pricing is also used extensively in the fashion industry by department stores (ex: Macy's and Nordstrom) This pricing strategy is not only in the shoe and fashion industry but also in many other industries. However, in these industries one or two firms will not provide discounts and works on fixed rate of earnings. Those firms will follow everyday low price strategy in order to compete in the market.

One pricing strategy does not fit all, thus adapting various pricing strategies to new scenarios is necessary for a firm to stay viable.

Other Pricing Strategies

Pricing strategies for products or services encompass three main ways to improve profits. The business owner can cut costs, sell more, or find more profit with a better pricing strategy. When costs are already at their lowest and sales are hard to find, adopting a better pricing strategy is a key option to stay viable. There are many different pricing strategies that can be utilized for different selling scenarios:

Cost-Plus Pricing

Cost-plus pricing is the simplest pricing method. The firm calculates the cost of producing the product and adds on a percentage (profit) to that price to give the selling price. This method although simple has two flaws: it takes no account of demand, and there is no way of determining if potential customers will purchase the product at the calculated price.

Limit Pricing

A limit price is the price set by a monopolist to discourage economic entry into a market, and is illegal in many countries. The limit price is the price that the entrant would face upon entering as long as the incumbent firm did not decrease output. The limit price is often lower than the average cost of production or just low enough to make entering not profitable. The quantity produced by the incumbent firm to act as a deterrent to entry is usually larger than would be optimal for a monopolist, but might still produce higher economic profits than would be earned under perfect competition.

Dynamic Pricing

A flexible pricing mechanism made possible by advances in information technology, and employed mostly by Internet based companies. By responding to market fluctuations or large amounts of data gathered from customers – ranging from where they live to what they buy to how much they have spent on past purchases – dynamic pricing allows online companies to adjust the prices of

identical goods to correspond to a customer's willingness to pay. The airline industry is often cited as a success story. In fact, it employs the technique so artfully that most of the passengers on any given airplane have paid different ticket prices for the same flight.

Non-Price Competition

Non-price competition means that organizations use strategies other than price to attract customers. Advertising, credit, delivery, displays, private brands, and convenience are all examples of tools used in non-price competition. Business people prefer to use non-price competition rather than price competition, because it is more difficult to match non-price characteristics.

Pricing Above Competitors

Pricing above competitors can be rewarding to organizations, provided that the objectives of the policy are clearly understood and that the marketing mix is used to develop a strategy to enable management to implement the policy successfully. Pricing above competition generally requires a clear advantage on some non-price element of the marketing mix. In some cases, it is possible due to a high price-quality association on the part of potential buyers. Such an assumption is increasingly dangerous in today's information-rich environment. Consumer Reports and other similar publications make objective product comparisons much simpler for the consumer. There are also hundreds of dot.com companies that provide objective price comparisons. The key is to prove to customers that your product justifies a premium price.

Pricing Below Competitors

While some firms are positioned to price above competition, others wish to carve out a market niche by pricing below competitors. The goal of such a policy is to realize a large sales volume through a lower price and profit margins. By controlling costs and reducing services, these firms are able to earn an acceptable profit, even though profit per unit is usually less. Such a strategy can be effective if a significant segment of the market is price-sensitive and/or the organization's cost structure is lower than competitors. Costs can be reduced by increased efficiency, economies of scale, or by reducing or eliminating such things as credit, delivery, and advertising. For example, if a firm could replace its field sales force with telemarketing or online access, this function might be performed at lower cost. Such reductions often involve some loss in effectiveness, so the trade off must be considered carefully.

In summary, the price that we pay for any given product, good or service is the result of a series of thoughtful, well planned out strategies by the business.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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