

## 10.5: Pricing Strategies for New Products

### Learning Objectives

By the end of this section, you will be able to

- List the pricing strategies for new products.
- Explain each pricing strategy for new products.

### Price Skimming

When introducing a new product to the market, marketers often use one of three pricing strategies. Remember that when a company introduces a new product to the market, a lot of financial resources have already been used even before the first unit is sold. Therefore, marketers should choose an appropriate price that both appeals to buyers and helps to recuperate the costs of research and development so that the company can begin to maximize profits more quickly.

Price skimming is a new-product strategy in which marketers choose to initially set a high price for a product or service and lower it over time. The goal of price skimming is to attract the segment of the market that is willing to pay the highest possible price for the product. Once achieved, the price is lowered to attract another segment of the market and so on. The term *skimming* comes from the skimming the cream, layer by layer, from raw milk—or in this case, each segment of customers.

Innovative technology often uses price skimming. For example, when Sony launched the PlayStation 3, it was set at a fairly high price of \$599. With little competition and a well-established brand, it was successful. Each year thereafter, it lowered the price—and gained new customers—until it eventually reached a price of \$299 (Sivakumar, 2021).

### Market Penetration Pricing

The opposite of price skimming is penetration pricing. The penetration pricing strategy is one in which the new product or service is set at the lowest price possible. This strategy's objective is to penetrate the market, or gain as many customers in all segments as possible from the beginning of the product life cycle.

In the late 1990s, Netflix introduced its movie rental service. For a monthly subscription fee, users could rent four movies at a time with no return date. The low initial price targeted the most segments of the market and allowed customers to try the new service with little effort or financial impact.

### Break-Even Pricing

Break-even pricing is a pricing strategy in which marketers choose a price that will cover all of the costs of manufacturing. The break-even point is when the number of units produced equals the revenue for the product. The break-even point will produce zero profit but will cover all associated costs.

The break-even formula is calculated by dividing the total fixed costs by the production unit price minus variable unit costs. The break-even point in units will tell a marketer exactly how many units must be sold in order to start making a profit.

$$\text{Break Even} = \frac{\text{Fixed Costs}}{(\text{Unit Price} - \text{Variable Unit Costs})}$$

Let's look at an example. Assume you are opening a new gourmet cookie shop and you have estimated your projected costs. You'd like to know how many units you must sell in order to break even and then start making a profit. Let's assume your fixed costs are \$20,000. This includes rent, deliveries, ingredients, and new signage. You have estimated your variable costs to be \$1.50 per unit, or cookie. You plan to charge \$2.00 per cookie. How many units must you sell to break even? Using the formula above, you find that you must sell 40,000 cookies in order to break even.

$$\begin{aligned}\text{Break Even} &= \frac{\$20,000}{(\$2.00 - \$1.50)} \\ \text{Break Even} &= \frac{\$20,000}{(\$0.50)} \\ &= 40,000\end{aligned}$$

### Knowledge Check

It's time to check your knowledge on the concepts presented in this section. Refer to the Answer Key at the end of the book for feedback.

1.

Luis is planning to introduce a new product to the market. Their aim is to gain as much of the market share as possible in the early introduction stage, so they are thinking of setting an initially low price. Which pricing strategy is Luis using?

- a. Break-even analysis
- b. Price skimming
- c. Penetration pricing
- d. Psychological pricing

2.

Alexandra is working on the pricing strategy for her new food truck items. She is interested in knowing how many hamburgers she will need to sell in order to break even. Which formula should she use?

- a. Fixed Costs + Variable Costs  
That's not correct. It is not the break-even formula.
- b. Fixed Costs – Variable Costs  
That's not correct. It is not the break-even formula.
- c. Fixed Costs / (Unit Price + Variable Unit Cost)  
That's not correct. It is not the break-even formula.
- d. Fixed Costs / (Unit Price – Variable Unit Cost)  
The break-even unit formula is Fixed Costs / (Unit Price + Variable Unit Cost)

3.

Tomas is selling his bottled sodas for \$2.00 each at the vendor fair. His fixed costs are \$100. He estimates that his variable costs are \$0.25 per bottle. How many bottles of soda must Tomas sell to break even?

- a. 57
- b. 2
- c. Less than 1
- d. 25

4.

Which of the following is true of price skimming?

- a. It captures the most market share in the introduction stage of a product.
- b. It is setting an initially high price of a product.
- c. It is setting an initially low price of a product.
- d. It determines break-even units.

5.

David hopes to capture as much of the market as possible with the company's new product. Which pricing strategy should David use?

- a. Price skimming
- b. Cost-based pricing
- c. Psychological pricing
- d. Penetration pricing

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