

Value-added Marketing

F A R M B U S I N E S S . P S U . E D U

Product Pricing: What Do I Charge?

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Product pricing is a critical activity for a business owner. For most consumers, price can be a determining factor for whether or not they purchase a product. This is particularly true for products that can be classified as wants rather than needs.

Product pricing, particularly for small businesses, is extremely important. Consumers are likely to be comparing the price of your product to that of similar products available from big box and warehouse type businesses able to take advantage of economies of size or scale. The person pricing your product(s) must consider many factors such as cost of production, financial goals, and consumer demographics.

It is important that you perform market research prior to determining the prices you will assign to your products or services. Your business and marketing goals and knowledge of the industry, your competition, and the market are essential.

This publication will describe the many pricing methods that business owners may utilize. Advantages and disadvantages of these methods are also discussed here. Additionally, price discounts are discussed. Discounts are a tool business owners can utilize to lure new customers and retain current ones.

Cost of Production and Competitors' Prices

Before you can price your product or service it is essential that you calculate the cost of producing the product or providing that service by completing an enterprise budget. Make sure you have accounted for all fixed and variable costs. The cost of production for a product will provide you with a base, or a break-even, price. The break-even price is calculated by simply dividing total costs (variable and fixed) by quantity produced.

You should also run sensitivity analyses on your cost of production. This will show you what your break-even price would need to be if there are changes either in the price of your inputs or to the amount you are able to produce. If research indicates that your cost of production is greater than what you can reasonably charge, you will need to revisit your production system to determine whether there are inefficiencies. If efficiency isn't an issue, you need to reconsider whether your product/service is viable for business.

For more on determining cost of production, see the Ag Alternatives publication on Enterprise Budget

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Analysis (<http://agalternatives.psu.edu>).

In addition to knowing the cost of production for your product or service, it is essential that you know the attributes and prices of your competitors' products. This will aid you in determining whether the price that you would like to place on your product is reasonable. For instance, if the price of your product is 50 percent higher than that of your competition and there are no discernable differences in attributes or quality, you will want to reconsider the price you came up with. Other times you may decide to price your product based on the competitors' prices. This is acceptable assuming that the price covers your cost of production. Keep competitor prices in mind when utilizing any of the pricing methods discussed here.

Pricing Methods

Once you have determined your cost of production you can turn to the actual pricing process. There are several methods available to assist with this. The method that you choose will need to correspond with your business's mission and objectives.

Cost-plus pricing – Cost-plus pricing is a method whereby the price for a product is determined by first determining the cost to produce the product and then adding on a standard markup. Let's say that you produce apple butter and the cost to produce it is \$1.75 per jar. Assuming that you apply a standard mark-up of 60 percent to all of your products, the price for a jar of your apple butter would be \$1.75 plus

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\$1.05 (1.75 * 0.6) for a price of \$2.80 per jar.

Target return pricing – This pricing method sets prices in such a way as to generate a target return-on-investment. As an example, assume that you have invested \$100,000 into the production and marketing for your new maple syrup product and you have forecast that you will be able to sell 50,000 units. Cost of production for each unit of the product is calculated to be \$2.25 for a total production cost of \$112,500. If your target return on investment is 30 percent, or \$30,000, then gross revenue must be \$142,500 resulting in a sale price of \$2.85 per unit (\$142,500 / 50,000 units).

Value-based pricing – A value-based pricing method determines product prices based on the value that consumers place on, and their willingness to pay for, the product in question as compared to other alternative products available to them. Utilizing this pricing method can be difficult since it is necessary to assess the value that your customers place on the product. However, let's assume that you produce a fine sheep's milk cheese and comments made by a test group of customers leads you to believe that they think your cheese is of higher quality and better taste than comparable cheeses available at area specialty stores. Using this information you would price your cheese higher than these other cheeses, being sure to cover your costs of production.

Psychological pricing – This pricing method takes advantage of consumers' perceptions when they see product prices. For instance, pricing a product at 97 cents rather than at an even dollar amount takes advantage of the perception that 97 cents is a greater deal. To extend this a little further, let's say that you have produced small apple cinnamon tarts with a cost of production of \$1.00 each. You typically utilize a cost-plus pricing method where your standard mark-up is 100 percent. Pricing this way with the tarts would result in a price of \$2.00 per

tart. However, understanding consumer perceptions of prices, you decide to forgo your standard pricing method and instead utilize the psychological pricing method with the tarts, pricing them at \$1.97 each. The \$1.97 price will appeal to the customer's perception that they are getting a deal since they are paying less than \$2.00 for your tart.

Subscription pricing – Subscription pricing is something that most of us are familiar with. Magazines and newspapers employ this pricing method. There are two versions of subscription pricing that can be utilized. With the one version, the customer is charged an initial price for the purchase of the product or service, and then charged an additional fee on a regular schedule (annually, monthly, etc.) for continued use of the product or for upgrades to the product. Let's assume that you have a crop pest-scouting service. You could utilize subscription pricing in the following way. First, to hire your pest-scouting services a farmer would be charged an initial fee, which includes one visit, covers all business costs, and provides a reasonable profit. To continue receiving your scouting services you charge the farmer a monthly fee for which you provide two visits per month and provide recommendations based on your findings.

Another version of this pricing method would have the customer charged on a regular schedule, but without an initial fee. Either type of pricing would work well for agricultural services, such as custom work, CSAs (Community Supported Agriculture), or if you wanted to provide products to your customers on a regular basis, for instance, as with jams of the month.

Price Discounts

Once prices for your products or services have been calculated you can begin to consider whether you want to utilize discounts. There are several types of discounting options that can be used to your advantage when applied appropriately. Carefully consider the type of discount you employ and the frequency of use. Inappropriate or too frequent use can make their use ineffectual.

Quantity discount – Quantity discounts can be cost effective when customers make large purchases. Let's say that you bake strawberry pies and that the box that you use to ship pies to your customers holds 12 pies. For those customers that place orders filling a box, you could implement a discount of 5 percent on their order. This rewards customers for providing you the



ability to efficiently produce and deliver products.

Cumulative quantity discount – A cumulative quantity discount is given to a customer after he or she has purchased a certain quantity or dollar amount of product. Employing this type of discount keeps the customer returning to your business since they can not receive the discount until they have purchased the specified value. This is the type of discount that you often see grocery stores employ around the holidays. For example, by purchasing at least \$300 in groceries, no matter how many trips it takes you, you can earn a discount on the price per pound of a turkey or ham.

Upon first reading it may seem that quantity discounts and cumulative quantity discounts are the same. However, as you can see by the examples, there are subtle differences. Both may also be considered types of loyalty programs. To read about how discounts can be utilized to build consumer loyalty, see the Value-Added Marketing publication “Using Loyalty Programs to Attract Consumers to Value-Added Businesses” (<http://farmbusiness.aers.psu.edu/FMDocs/pubs/UsingLoyaltyProgramstoAttract.pdf>).

Seasonal discount – Seasonal discounts are applied at times when sales are typically slower than other times. For instance, if you observe that sales of a particular product are lower in February and March than during the rest of the year, you may want to consider applying a discount to the product during those

two months in an effort to boost sales.

Cash discount – This type of discount is given to a customer if they pay their bill before a specified date or within a certain time period. For instance, if you allow customers to make purchases on credit and they pay their bill within thirty days of the purchase you could discount their purchase by a small percentage to reward them for timely payment. This type of discount can also be seen as an incentive for continued business.

Promotional discount – Promotional discounts are given to stimulate sales of a product. Promotional discounting is also referred to as promotional pricing and used as a pricing strategy. If you have a new product or if sales of a product are lagging you may consider utilizing this type of discount.

Summary

Pricing, while a vital function, does not need to be overly complicated; knowing the cost to produce or provide your product or service is the first and most important piece. Never price below your cost of production. After determining your cost of production,

“Carefully consider the type of discount you employ and the frequency of use.”

you can choose the pricing method that best fits your business and management style. Your target customer and product qualities need to be considered when choosing a pricing method. Utilizing value-based pricing when your target customer has a fixed income likely will not be successful. Once you have determined product or service prices, consider applying discounts where they seem logical. Discounts can be useful for enticing customers to try your product or to reward them for loyalty. As with choosing a pricing method, choose the type of discount you are going to use by considering your customer, the product or service, as well as your goals for the outcome of discounting.

Additional Resources

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