

# \$\$ Pricing \$\$

Steven R. Van Hook, PhD

Key influences on what you can charge.

# What is Price?

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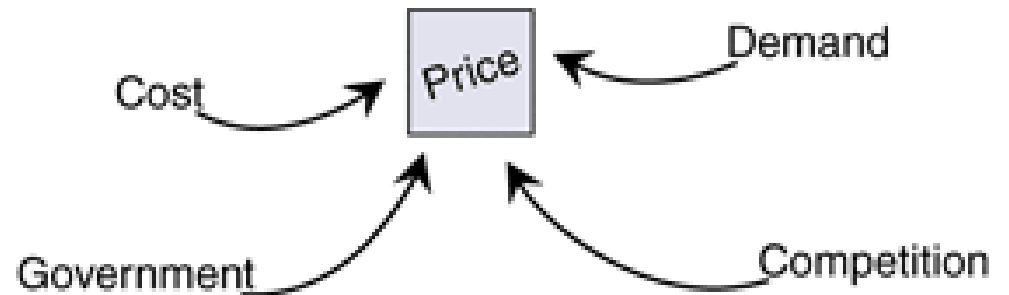
- *Price is the money or goods or services you exchange for something else.*
- *Effective pricing relies on determining the value the customer places on a product and setting the price at a level that encourages a satisfactory exchange for everyone.*



# What impacts your price point?

\$0 -----<|>----- \$\$\$

- Demand
- Competition
- Cost
- Government



# Demands & Price

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*Demand is the quantity of product that buyers are willing to purchase at a given price.*

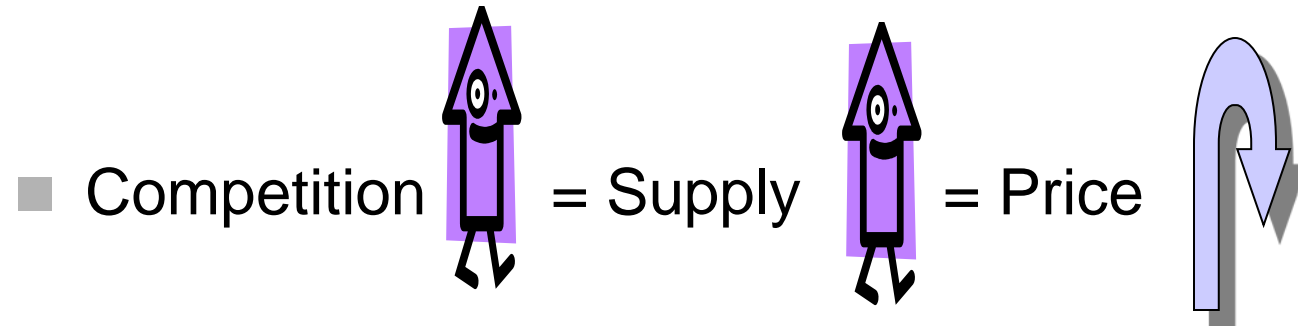


## Factors Impacting Demand ...

- Demographics: more people = more demand
- Regional climate: colder temps = hotter blanket sales
- New tech: improved iPods = upbeat demand
- Health issues: flu outbreak = vitamin sales
- Seasonality: springtime = convertibles

# Competition & Price

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*Differentiation through branding or the other three Ps can redefine the value proposition, mitigating the price pressures of competition.*

# Producer Cost & Price

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- Producer *costs* are recovered by *price* customer pays.
- Producers may sell below costs for strategic ends (e.g., capturing market share such as WalMart).
- Producers may offer pricing alternatives (e.g., rebates, coupons, contract incentives, sales, premium service levels)
- Customers don't care about producer costs; they care about satisfaction.

# Customer Cost & Price

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- Customer *price* covers producer *costs* and *profits*.
- Customer have additional costs beyond the price they pay for a product ...
- Customers pay for shipping, overhead costs of ordering online (computer & connections), gas to get to the store, time spent researching and receiving product, extra difficulties of coordinating support and returns, restocking fees, taxes, etc.

# Government & Price

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- *On antitrust and other grounds, the government may limit the freedom to set prices through regulation, taxes, fees, procedures ...*
- Oil, utilities, alcohol, tobacco, handguns, etc.
- Business recourse: chambers of commerce, industry and trade associations, lobbyists, political contributions, etc.





# Substitution

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- One product may often be easily substituted for another: if the price of orange juice rises, a ready substitution is tomato juice, apple juice, vitamin C, etc.
- Readily substituted products may contribute to high elasticity of demand.



# Elasticity of Demand

- **Elastic Product:** Small change in price leads to big change in demand (e.g., 10% increase in OJ decreases demand by 30%, as buyers use other substitutes).
- **Inelastic Product:** Large change in price leads to small change in demand (e.g., 30% increase in insulin costs decreases demand by only 5%, since there is no buyer substitute)



# Elasticity Formula

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**% of change in demand > 1 is Elastic**  
**% of change in price**

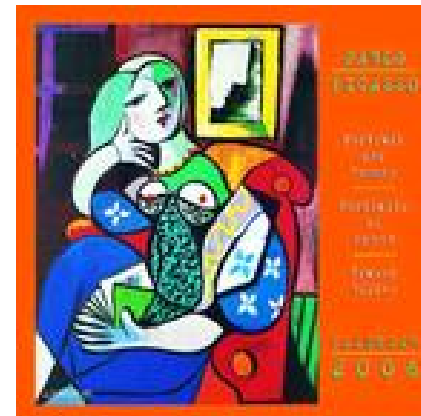
**% of change in demand = 1 is Unitary**  
**% of change in price**

**% of change in demand < 1 is Inelastic**  
**% of change in price**

- **Percentages are universal regardless of currency and quantity measures**

# Elasticity of Supply

- **Cars are an elastic product;** supply from a 50% of capacity production line can be quickly expanded to 100% with a small jump in price.
- **Picasso paintings are inelastic:** no matter how large a jump in price, the supply of new products is zero.



# Quiz: Good idea to change price?

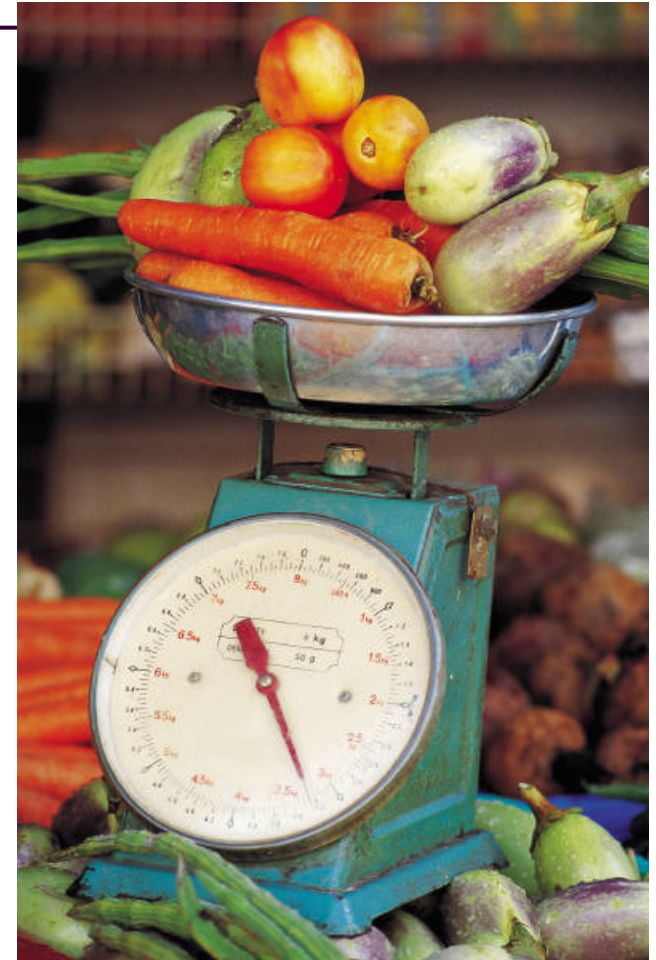
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- **Q:** Does raising cigarette price decrease smoking?
- **A:** Not much, since cigarettes are an inelastic product.
- **Q:** Does raising concert ticket prices increase revenues?
- **A:** Not always, since concerts are an elastic product with other entertainment substitutes.
- **Q:** Does raising gas prices increase revenues?
- **A:** Gas prices are inelastic in the short-run; but elastic in the long run as people buy more fuel efficient cars or use alternative travel.



# Economy of Scale

- **Economy of Scale:**  
Reducing the average production cost by efficiently making more products at a lower per-item cost.
- **Marginal Cost:**  
The cost associated with one additional unit of production.



# Psychology of Pricing

**Given the choice of pay:**

\$30,000 1<sup>st</sup> year

\$40,000 2<sup>nd</sup> year

\$50,000 3<sup>rd</sup> year

**Or**

\$60,000 1<sup>st</sup> year

\$50,000 2<sup>nd</sup> year

\$40,000 3<sup>rd</sup> year

**Which did people choose more often?**

**Option 1: people shy away from diminishing returns, even if it meant more money.**



**Daniel Gilbert**

Department of Psychology  
Harvard University

*"Stumbling on Happiness"*



# Psychology of Pricing

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## People will:

**Spend hours combing for coupons to save 40% off a tube of toothpaste**

**Or drive across town to save \$25 on a \$50 radio (or sales tax, or wait for an hour in-line to save 20-cents on gas)**

**But they won't drive across town to save \$50 on a car purchase**

**People often think in terms of percentages rather than absolutes.**



**Daniel Gilbert**  
Department of Psychology  
Harvard University  
*"Stumbling on Happiness"*



# Psychology of Pricing

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## People will:

**Buy a vacation package that had been marked down from \$600 to \$500**

**Rather than buy a similar package at \$400 that had been on sale for \$300 the day before.**

**It is easier to compare a price with its former price, than to compare more complex specifics of a purchase**



**Daniel Gilbert**  
Department of Psychology  
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# Psychology of Pricing

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## Your Corner Store Has:

**100 bottles of fine zinfandel wine you can't afford to sell for less than \$60 a bottle – the costliest in your shop.**

**Your next most-expensive bottle of wine costs \$35.**

**How do you sell the \$60 wine?**

**Put one \$500 bottle of 1982 Château Haut Brion on the shelf to make the \$60 bottle look like a bargain.**



**Daniel Gilbert**  
Department of Psychology  
Harvard University  
*"Stumbling on Happiness"*

# Costs of Choice

## Jam Taste Sample

- 6 flavors on display:  
40% stop / 30% buy
- 24 flavors on display:  
60% stop / 3% buy



## Tips:

- Average American makes 70 choices per day
- Too many choices overwhelming & demotivating
- 2-3 meaningful choices good / Dozens of choices bad
- Need to be choosy about choosing

~ Sheena Iyengar, *The Art of Choosing*

# Articles on Price

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from **Entrepreneur.com**

- [Secrets to Pricing Your Product](#)
- [Is Your Price Right?](#)
- [The Psychology of Pricing](#)