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Implementing Pricing Strategies

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How do producers and sellers choose prices for their products?

Many things will influence how producers and sellers choose prices for their products. Most importantly, available pricing strategies will be determined by the market that the product is sold in. Some markets are highly competitive while others have little—or no—competition. Understanding how these market forces affect pricing strategies is the first step.

What is a price discovery market? How should sellers strategize in these markets?

A price discovery market is one with many sellers competing for business (Rhodes et al. 1998, 174). It is hard to charge high prices because there are so many sellers. If another firm can sell the product for a lower price and still make a profit, they will be able to lower their prices and increase their market share. This keeps pushing the price down until it reaches a "market price." Customers will go to a different company if a seller tries to charge more than the market price.

Whether a product can be traded helps determine how competitive the market is. For example, the market for books is competitive. Where a copy of a book comes from does not change its quality. Books are non-perishable and easily shipped in today's world. If a local bookstore's prices are higher than online prices for the same book, most customers will buy online. Non-perishable, non-differentiated, easily transportable products face the most competition (Rhodes et al. 1998, 175). Additionally, products with substitutes are more competitive. If physical copies of books are too expensive, customers may purchase a tablet for reading books instead.

Prospective producers or sellers can gauge their expected prices and expected costs by analyzing the profits of other firms with similar business models. Pricing info and expense reports are available online although they are not frequently updated. It may be most helpful to see what others in your area do. In price discovery markets it is important to note that charging above the market price for your products will be difficult or even impossible.

Sellers still have options in price discovery markets. Most sellers can seek to reduce their costs or increase their sales. Alternatively, sellers can engage in "loss-leader" pricing. A store owner may decide to sell tomatoes at a loss to bring more customers into the store. Their store may become known for having the most affordable tomatoes in town. Meanwhile, the other products in the store may be marked up to cover those losses. Finally, the seller can try to break out of the price discovery market and enter a price setting market.

What is a price setting market? How should sellers strategize in these markets?

Price setting markets have fewer sellers and less competition. This may happen if the local market is not big enough for two producers. This may also happen for a number of reasons:

- Products are perishable, expensive to transport, or otherwise non-tradable (Rhodes et al. 1998, 180).
- Products are highly differentiated (Mas-Colell et al. 1995, 396).

- Effective branding may create a form of differentiation (Mas-Colell et al. 1995, 396).

In price setting markets, producers and sellers can choose the price they want to charge. A seller may find it easiest to charge a simple markup percentage. Alternatively, they can engage in a number of variable pricing strategies. For example, by charging high initial prices they can earn more revenue from customers who are less patient. Then they can lower the price to increase sales and accommodate more patient customers with smaller budgets. They could also lower prices enough to undercut local competitors and increase their market share. Finally, of course, sellers in price setting markets can seek to reduce their costs to increase their profits.

Can a firm move from a price discovery market to a price setting market?

Firms facing stiff competition may be able to move into less competitive markets where pricing options may be more flexible and profits may be higher. This may be possible if firms differentiate their products, invest resources into branding, or sell to geographically diverse markets.

What are marketing margins?

Marketing margins are the differences between the cost of a product sold and the price received by the seller. In perfectly competitive markets, this represents the value added at each step in the production process. For example, the value added by turning metal into machines or apples into apple pies. In less competitive markets, marketing margins include a markup that each firm in the production process charges. If marketing margins are smaller, costs are lower and products are more profitable. One way to reduce (or eliminate) marketing margins is to vertically integrate.

What is vertical integration and how can it increase profits?

Vertical integration is when a firm or company owns multiple phases of the production process. By doing so, the firm can improve their profits and/or market share (Rhodes et al. 1998, 185).

Suppose there are three steps required to produce a product and one firm for each step. Each firm will buy the raw product, transform it, and sell the closer-to-ready product at a markup for profit. The cost of the final product would include the profits from each of the three firms.

Now suppose one firm owns all three phases of production. The products are passed through the production process without any profit between them. The cost of the final product is the minimum possible cost. The firm can now choose to charge the normal price for a large profit. Alternatively, the firm can undercut the market and charge the lowest price in town.

When is it beneficial to contract?

Producers and buyers may find it helpful to engage in marketing-procurement contracting. These contracts include details for a future purchase or sale that both parties have agreed to. It includes date of delivery, amount, quality, and price. These contracts are beneficial to both the buyer and buyer—farmers can protect against unsold products and buyers can avoid inventory shortages. In this way, contracts reduce risk and smooth demand for products. Additionally, many markets are impossible to enter without marketing-procurement contracts (Rhodes et al. 1998, 186).

What is a marketing-pricing alternative?

Some marketing-pricing alternatives allow producers to vary the timing of their sales. Farmers may vary the timing of pricing, delivery, and/or sales. This may be done by storing products until a better time. Some farmers contract sales over an extended

timeline. Farmers may also pool their products with other farmers through a cooperative or other firm. When pooling, the farmer receives the average price for their quantity and quality of product (Rhodes et al. 1998, 187).

References

Mas-Colell, Andreu, Michael Whinston, and Jerry Green. 1995. Microeconomic Theory. New York: Oxford University Press, 1955.

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