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Methods to Price Your Product

The pricing method you select provides direction on how to set your product price. The way you set prices in your business will change over time, for many reasons. As you learn more about your customers and competition, you may decide to change your pricing method. Use changes in the industry or the development stage of your product as an indicator that it's time to review your pricing strategy.

There are three basic methods to price your product:

- cost-based pricing
- competition-based pricing
- customer-based pricing

Cost-based pricing is where the price includes the cost of ingredients and cost of operating the business.

- include a profit percentage with product cost
- add a percentage to an unknown product cost
- blend of total profit and product cost

Competition-based pricing is where the price covers costs (cost of raw materials and the cost of operating the business) and is comparable to the competitor's price.

- price is the same as the competition
- set price to increase customer base
- seek larger market share through price

Customer-based pricing, also known as value-based pricing, is a system where the price is based on the customer 'demand' or need for the product. If the product is unique or innovative, a value-based price may help create a demand for the product or service.

- use price to support product image
- set price to increase product sales
- design a price range to attract many consumer groups
- set price to increase volume sales
- price a bundle of products to reduce inventory or to excite customers

As you review each pricing method, think about your business, industry and customer. Before you select a pricing method, be sure you understand the range of options available and their disadvantages and advantages. You may want to blend several pricing methods to suit your business and the type of product(s) you sell.

Cost-based pricing

Each of the three cost-based pricing methods described begin with a product cost subtotal. To calculate product cost you need to include the **costs of operating the business,** which could include raw materials, transportation, advertising, wages, rent and other costs incurred in producing the product. Once you have a base cost, then add the profit level you want for the business to the product cost subtotal to determine your product price. The amount of profit you add to the product cost subtotal can be set according to the following three different methods:

- include a profit percentage with product cost (mark-up pricing)
- add a percentage to an unknown product cost (cost-plus pricing)
- price is a blend of total profit and product cost (planned-profit pricing

All types of cost-based pricing will be more accurate if you use a complete product cost subtotal. The key to accuracy is to ensure all cash and non-cash costs (raw material, labour and overhead/operating costs) are included in the product cost subtotal. You need to set a value for your management expertise and labour. The use of your land or capital equipment also must be valued along with depreciation on your machinery and buildings. These values are included in the product cost subtotal.

Include a profit percentage with product cost

Marketers call this method mark-up pricing. Mark-up pricing is favoured by businesses with many products because it is simple to calculate. The profit level you want for the business is expressed in

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a percentage. This percentage is added to the production cost to set product price. Mark-up pricing is common in retail business because of so many types of products and purchases from many vendors.

Example:
Wild Blue Preserves makes 15 different jams and jellies. They set up a small shop in a local mall to sell their products along side other prepared foods. A jar of wild blueberry jelly costs $1.50 per 250 ml jar to produce. The mark-up pricing percentage Wild Blue Preserves plans to use is 40 per cent. The jar of jam will cost $ 2.10 in the shop.

Add a percentage to an unknown product cost

This type of pricing is often called cost-plus pricing. Cost-plus pricing works well if you do not know your production costs. This method is very similar to mark-up pricing. The big difference between mark-up pricing and cost-plus pricing is that both buyer and seller settle on the profit figure or percentage, accepting that the cost of production is an unknown. If you produce custom order products for other firms or individuals, a cost-plus pricing method could reduce your risk. Rather than take a risk on input costs increasing during the project, you could use a cost-plus pricing agreement.

Example:
You have agreed to act as a co-packer for a start-up snack food business, packaging and distributing low-fat energy bars. As a co-packer, you will purchase ingredients through your suppliers, but you are unsure of input costs. The snack food business signs a contract with you to pay for materials costs plus a processing cost of $25 per case.

Price is a blend of total profit and product cost

Otherwise known as planned profit pricing, this method ensures you will earn a total profit for the business. It differs from the first two types of cost-based pricing as they focused on a per unit price. Planned profit pricing combines per unit costs with output projections to calculate product price. Break-even analysis is used to calculate planned profit pricing. Planned profit pricing is well suited to manufacturing businesses. A manufacturer often has the ability to increase or lower production depending upon the demand or profit available.

Example
A special order cake business could set prices according to the size of the orders they receive from various customers. A price break is given to customers who order 10 or more cakes at a time.

The main advantage of planned profit pricing is that it allows the manufacturer to consider how various levels of output can affect the product price. As well, the manufacturer can examine how various prices will affect the amount of output needed.

Disadvantages of cost-based pricing

Before you select a cost-based pricing option, you should consider the disadvantages. There are two important reasons why cost-based pricing doesn't work for some businesses:

Cost-based pricing does not consider how customer demand affects price. Demand for a product will directly affect how much people will pay. If, due to heavy demand, customers believe a product is in short supply, they may be willing to pay more. On the other hand, if demand is very low the customer will look for a discount on the price.

Competition is not included in cost-based pricing methods. Competition should affect how you price your product. The idea of simply adding a profit level or percentage to a product price will only work in industries with limited competition. In a competitive market, cost-based pricing may encourage competitors to enter the market with a lower price.

Competition-based pricing

The big advantage of competition-based pricing is that you are focused on your industry and, therefore, your competition. The industry focus associated with competition-based pricing looks closely at the types of existing and emerging competition. Once you know what your competitors are doing, you can better decide how you will manage your business. You are able to charge a higher price if you can show how the product has a uniqueness or innovative quality and is 'worth' more for the value.

Understanding your competition will take some research. You need to understand:

- what you are selling
- the types of companies you compete with (direct competition)
- the amount and types of substitutes (indirect competition)
- how companies operate in your industry

Check with Statistics Canada, the business section of the local library, the local Chamber of Commerce, the yellow pages or the Internet to help find this information. Use the following questions to learn more about your competition:

- how many competitors operate in my market?
- are my competitors larger or smaller than me?
- are my competitors close by or far away?
- does my industry have barriers to entry such as legislation, extremely expensive or specialized capital equipment or unique ingredients?
- is it difficult for new competitors to enter the industry?
- what types and number of products do my competitors sell?
- what pricing method(s) do my competitors use?

Three competition-based pricing methods are:

- price your product the same as the competition
- set your price to increase customer base
- seek larger market share through price

Price your product the same as the competition

This market pricing method aims to make your product comparable to competitors. Scout out competitors and find out what they charge for similar products. This type of pricing works well if you make standard products.

If you make unique products, you need to decide how specialized your product is. Products can be plotted on a scale according to how unique they are. Homogeneous products are on one end of the scale. Highly differentiated products are on the other end. The term 'highly differentiated' is used to describe products that are unique and cannot be compared to other products on the market. Examples of homogeneous products include eggs, butter and bread. Highly differentiated products may begin as homogeneous products but they have one or more layers of special features like packaging, trademarks, design, flavour, freshness, appearance, etc.

Example:
Sugar-based pancake syrups are homogeneous products. A highly differentiated product would be birch syrup packaged in single-use containers for the bed and breakfast industry.

Set your price to increase customer base

This method is also known as market penetration pricing. To improve your market penetration, you need to select a price that will lure customers away from the competition. This type of pricing intends to improve market share or penetrate the market. To motivate customers to notice your product, and to make a purchase decision, you likely will need to lower the price.

Market penetration pricing works well in the introduction stage of the product life cycle. In highly competitive markets this strategy will sell product quickly, creating economies of scale and market penetration. As you increase production, some of your costs will decrease because of economies of scale. You will save when you buy materials and ingredients in larger quantities. The lower costs per unit may be due to bulk buying of raw materials, marketing costs spread over more units, or more efficient labour.

Example:
An established producer of beef jerky decides to use market penetration pricing at a local convenience store. A study of other convenience stores shows a price range for jerky of $2.00 to $3.00 per 100 gram package. The seller decides to sell their jerky at $1.50 per 100 gram package to sell larger volumes.

Seek larger market share through price

This type of pricing is often called market-share pricing. You need to select a price that will attract and hold as many customers as possible. Most businesses would adopt market-share pricing after market penetration is achieved. Market share happens when you sell large volumes of product into a market.

Companies who seek market share describe the amount of market they supply as a percentage. Market share is calculated by dividing the amount each company sells out of the total market.

Example:
If Alberta Pasta, a fresh pasta processor, sells 1,000 kilograms of product daily into a market of 2,000 kilograms. they hold a 50 per cent market share. Marketers rely heavily on market share to evaluate their success in promotion, pricing, distribution and product strategies.

This pricing method is used mainly by larger, established businesses. The typical user of market share has many economies of scale and wants to measure the success of a marketing campaign.

Disadvantages of competition-based pricing

While competition-based pricing offers advantages; you need to consider the following disadvantages:

- you may ignore your own production costs if you focus too closely on the prices set by competitors
- more time is needed to conduct and update market research
- competitors can easily mimic whatever price you select

Customer-based pricing

Most business owners want to know "at what price do my customers think my product offers good value?" Knowing your customer ensures you take a market focus with your business. You need to find out how your customer feels about various product prices and what they would do if the price changed.

Customers change their buying habits according to product price. As a seller, you need to find out how your target customers view your product. You also need to find out customer attitudes towards various prices or a price change. Think about your target customer and try to answer the following questions:

- does your customer assume price indicates product quality?
- will customers think they are getting their money's worth from your product?
- do your customers care more about prestige than product price?
- what are target customers prepared to pay for your product?

If you are starting a business or targeting a new customer group you may have trouble answering these questions. To find answers, you could casually talk to potential customers or develop a more formal interview questionnaire. Before you decide to conduct a target customer survey, check into the costs of the project, as they can be very expensive.

It is a good idea to have your customer survey reviewed by a marketing professional. They will help you make sure you don't influence your customers' responses. A well-designed survey gives you information you can use in your product choice and pricing.

Five customer-based pricing methods commonly used are:

- use price to support product image
- set price to increase product sales
- design a price range to attract many consumer groups
- set price to increase volume sales
- price a bundle of products to reduce inventory or to excite customers

Use price to support product image

The key to pricing is to be consistent. You want your price to say exactly the same thing as the product image. Prestige-oriented consumers believe a higher price means higher quality, while bargain seekers will only be happy with lower prices. Does your price reflect your product image?

Example:
Go Green Organic Vegetables targets a healthy-for-you product-oriented customer who shops at specialty organic shops. The price for a bag of mesclun mix salad greens is five dollars. This is one dollar above the competition that markets its salad greens through a major grocery store chain.

Set price to increase product sales

Promotional pricing uses lower prices to catch the attention of busy consumers. To attract as many new customers as possible you need to be creative. Methods you can use to expand customer interest include:

- loss leaders (products at extremely low prices)
- coupon books
- holiday specials
- buy-one-get-one-free promotions or larger product containers

Example:
Terrific Teas company circulates a flyer at the local farmers' market that advertises a buy-one-get-one-free promotion with each purchase of tea blends of $10 or more.

Design a price range to attract many consumer groups

When you know a market really well, you can segment it. Segmentation slices a market into definable groups. Rather than pricing for one group, you could design a range of prices that would appeal to several or all of the groups.

There are many ways you can segment the market. For instance, market segment groups could include income levels, age, social class, geography, amount of product consumed, willingness to switch to substitutes, etc.

Example
A processor of pie fillings has segmented its customer group according to the amount of volume consumed. The low-volume user buys three to six jars per year, mid-level users buy six to 10 jars per year while the large user buys 10 to 20 jars per year.

Set price to increase volume sales

Volume pricing is where sellers discount larger volume sales to sell more product. In most cases, large, well established customers are offered volume pricing. This method makes sense when you have economies of scale.

Market gardeners may also find volume pricing useful during peak production times. It is far better to sell your perishable product at a lower cost, than lose profits through high spoilage.

Example:
During peak harvest season a Saskatoon berry grower may sell a U-pick ice cream pail of berries for $6.00 or two pails for $10.00. At the end of the season, that same grower may sell a pail of berries at a significant 20 to 30 per cent discount.

Price a bundle of products to reduce inventory or to excite customers

Slow-moving inventory can get a boost when packaged with a group of popular items. Bargain seekers will be drawn to product bundles that offer good value.

Example:
A Saskatoon berry grower bundles Saskatoon preserves, syrup and chutney in a gift set. Normally, half as much Saskatoon chutney is sold compared to preserves and syrup. When packaged gift sets are offered for sale, chutney sales increase by 30 per cent.

Product bundling can also be designed for other segments of the market. Prestige seekers may choose product bundling if it offers a service component with high quality products. For example: a mushroom grower packages various exotic mushrooms, mixed fresh hot chilli peppers and marinade with a recipe for a mushroom appetizer.

Disadvantages of customer-based pricing

Before you implement a customer-based pricing method, note the following disadvantages. If you are too focused on the customer, you may:

- ignore production costs
- forget about the competition

There are other factors that may affect your pricing strategy. You need to decide how to set both wholesale and retail prices for your product. Volume discounts and rebates must be considered. For more information refer to the *Market Guide for Alberta Food Processors*.

Tips for successful pricing

Good product prices are important to any successful business. Pricing takes creativity, time, research, good recordkeeping and flexibility. You need to balance the costs of producing a product with competition and the perceptions of your target customer to select the right product price. Follow these tips to ensure greater pricing success.

- **Be creative**
  Think of new ways to sell more to existing customers or to attract new customer groups.
- **Listen to your customer**
  Make a point of noting customer comments in a journal or file. Review them periodically to glean new ideas.
- **Do your homework**
  Keep good notes of how you arrived at a price so you can make similar assumptions in the future.
- **Boost your records**
  Good recordkeeping will help you to set a price and to track the performance of your pricing.
- **Cover the basics**
  The three basics of pricing are product price, competition and customers. Blend pricing methods to ensure the three basics are in balance.
- **Be flexible**
  Constantly review both internal and external factors and calculate how a price change would affect the new situation.

Resources

The following resources, tools, business templates may be of value in starting and growing your business "profitably."

- The Essentials of Pricing (Agdex 845-1)
- Pricing Processed Food Products (Agdex 845-3)
- Pricing Horticulture Products (Agdex 845-4)
- Marketing: Will It Sell? (Agdex-845-5)
- Market Research (Agdex 845-6)
- Business Basics for Alberta Food Processors (Agdex 845-11)

The above are available from Alberta Agriculture and Rural Development's website at www.agriculture.alberta.ca/publications.

- Biz Info –Starting and Growing a Business - available from www.agriculture.alberta.ca/bizinfo

For further information contact an Alberta Agriculture and Rural Development New Venture Specialist toll-free at 310-Farm (3276)

Glossary

Break-even point – where total revenue equals total costs not including profit.

Broker – a food broker is a sales agent hired by a producer, processor or manufacturer to encourage sales between a buyer and the seller.

Direct cost – costs that always exist, regardless of how much or how little you sell. They are costs that can be directly traced to producing a product, e.g., raw materials, ingredients, salary, etc.

Direct marketing – product moving from the farm/ processors directly to the consumer and bypassing brokers, distributors or retail channels of trade.

Distribution channel/market channel – describes the route a product takes to reach the consumer/end-user, e.g., direct market channel, retail channel, etc.

Distributor – buys your product and resells it, at a profit, to his account. Distributors offer experience, contacts, and market segments such as gift stores, grocery chains, specialty food stores etc.

Economy of scale – the cost advantages and savings a processor gains when more product units are produced, e.g. purchasing raw materials in bulk reduces the input costs.

Farm gate sales – are sales made directly from the producer to the consumer/end-user, often on site at the farm, e.g. U-pick sales, on-farm sales.

Fixed costs – are consistent costs (overhead) that do not change from month to month. These costs occur no matter how many products are produced. Often they are time related, e.g. monthly rent, yearly real estate taxes, annual machinery costs, depreciation, salaries, etc.

Indirect costs – soft costs associated with production, e.g., real estate taxes, administration costs, overhead/lease/rent options, salaries, etc.

Input costs – includes direct costs (raw ingredients and material) and indirect costs (overhead, production costs, etc.) to produce a good.

Market segment – a group of consumers that have the same buying characteristics or have similar needs.

Market share – indicates the size of market one producer/ company holds. To calculate market share you need to divide the amount of product you sell into the total market number.

Marketing mix – the combination of marketing strategies used to sell a product. The four main elements center around four functions, sometimes called the Four Ps: product, price, place (of distribution), and promotion.

Non-cash costs – do not involve an outlay of cash e.g. depreciation or amortization. Non-cash costs should be included in a product's cost.

Overhead costs – the ongoing expenses of operating a business, e.g., rent, repairs, utilities, insurance, salaries, etc.

Per-unit cost – The cost incurred to produce, store and sell one unit of a product including all fixed costs (e.g., plant and equipment) and all variable costs (e.g., labour, materials, etc.) involved in production.

Primary data – detailed research methods such as interviews or actual buying patterns to provide tailored information about the wants and values of your customers.

Product bundling – is a marketing strategy where several products are for sale as one combined product, e.g., a Saskatoon liquor with a set of crystal glasses.

Product life cycle – a new product progresses through a sequence of stages, which generally include the introduction, growth, maturity and decline stage.

Production costs – the total cost of the product including raw materials, labour, overhead, distribution, etc.

Retail prices – the price charged to a consumer.

Secondary data – information from existing sources and materials already researched or reported on by another source.

Target market – the demographic group of consumers most likely to want or need to buy your product.

Variable costs – costs that increase proportionally to the amount produced. As a rule of thumb, variable costs include direct labour, direct material, equipment repairs, fuel costs for distribution, broker fees, marketing expenses, etc.

Wholesale prices – the price of a product before a middleman (distributor or broker or agent) or retailer has added on their mark-up fees to the price.

Wholesaler – a third party or firm that buys products from producers and processors to sell to food retailers and foodservice. Their main functions are to purchase, transport, sell, assemble, store and distribute.

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