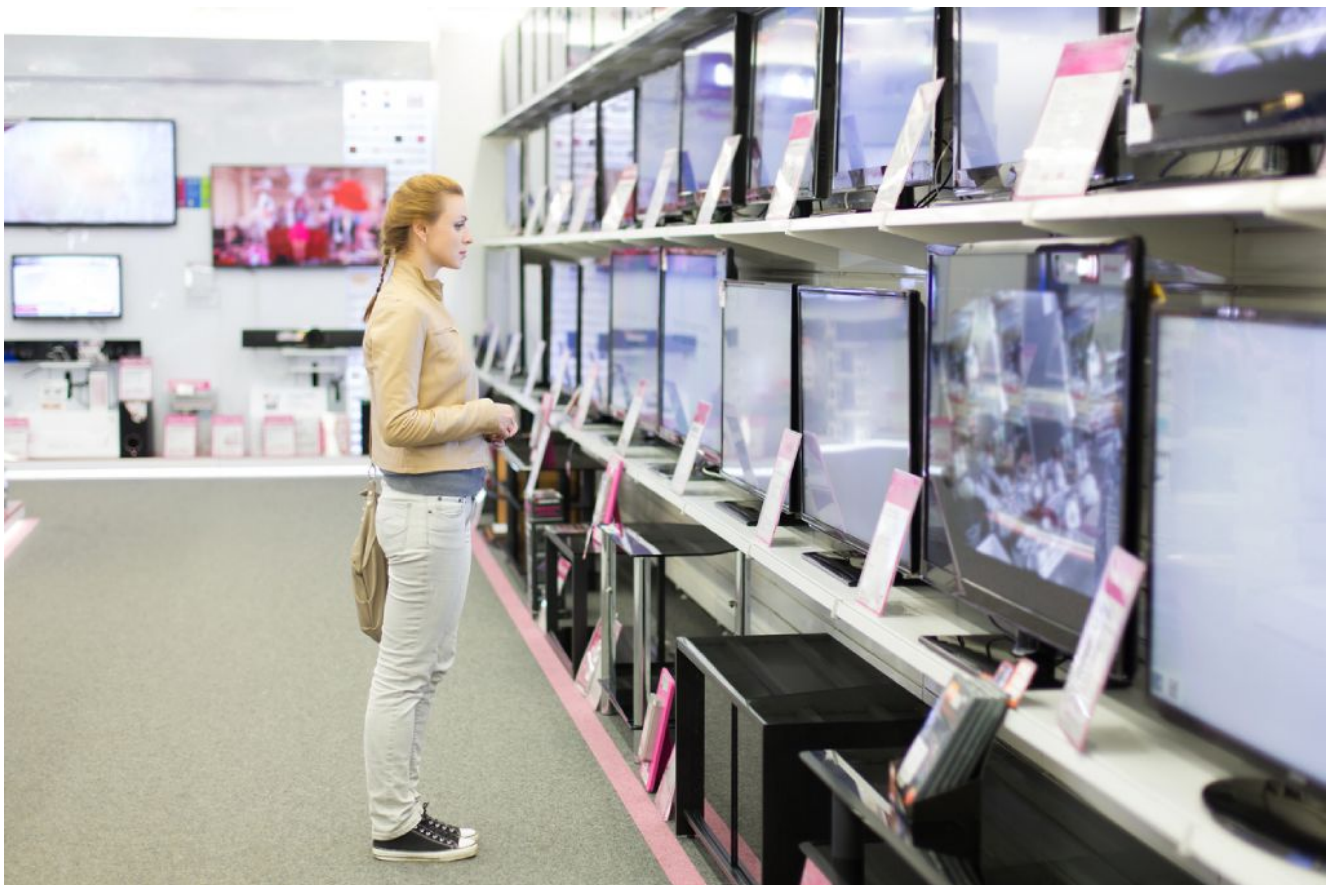


What is the ideal price of a product?

How can you optimize the price of a product or service? For starters, remember that most buying decisions aren't rational.



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The price of a new product or service depends on a wide variety of factors. Price-setters must analyze variable and fixed cost structures, the competition, the evolution of the market, the legal framework, product quality and brand image.

Above all, however, there's demand. Demand must be both understood and, as far as is

possible, anticipated. What is the expected value and what do consumers consider a fair price? What's the maximum they're willing to pay? Are all consumers the same or would some pay a different price for the same item? How will consumers react to a price change?

A new technical note, prepared by IESE professors [Julián Villanueva](#) and **José Antonio Segarra**, with research assistant Iciar Ferrer, addresses all of these issues with real examples and results from various studies.

The psychology of pricing

When we buy things, the decisions we make are more intuitive than rational — something that is worth remembering when we're the ones setting the prices. Here are some of the effects of the "bounded rationality" consumers experience when shopping:

- **They value the alternatives with respect to a reference point** or price range they consider reasonable, which is not necessarily grounded in reality.
- **They evaluate gains and losses differently**, which means a price decrease could help sales to a lesser extent than an increase would hurt sales.
- **They update their pricing references.** If a brand repeatedly relies on price cuts as a tool to acquire new customers, they will find that the prices that consumers have in their heads will keep coming down, making each new promotion less effective.
- **They are more likely to buy a favored product if a clearly inferior product is added to the mix** (the pull effect). When there are two products, and each one is better than the other in some way, and then a third product that is inferior is added to the mix, we see an increase in sales of the product already favored by the consumer. For example, if we have a 100-euro camera with 10 megapixels and a 50-euro camera with 5 megapixels, and then we add a third camera that costs 100 euros and has 8 megapixels, we will see increased sales of the preferred choice.
- **They tend to select the middle option** (the compromise effect). This has happened to most of us with restaurant wine lists. When there are very expensive wines listed, slightly less-expensive wines look cheaper by comparison, and people tend to choose one of them over the cheapest options.
- **Their sensitivity to price changes is not linear.** Therefore, the fact that a 1

percent price increase leads to a 2 percent drop in sales does not necessarily mean that raising prices by 30 percent would translate into a 60 percent drop in sales.

The pricing process

To simplify the complex process of pricing a product, it's essential to be clear on what the goal is. A brand may aim to increase its market share or to discourage potential competitors from entering a market with varying pricing strategies.

After the objective is set, the following steps should be followed:

- **Determine the demand.** Take into account the variables that may affect price sensitivity, such as the uniqueness of the product, its quality, the existence of substitute goods or the difficulty of comparison.
- **Estimate costs.** By knowing the cost structure, you can figure out what the minimum price must be to avoid incurring losses, and establish minimum and maximum prices.
- **Study the competition.** Pricing is one of the main weapons to separate one product from the competition. Consider the pricing strategies and tactics of others, their positioning and pricing changes.
- **Choose your pricing technique.** Methods include pricing by margins, by perceived value, aiming for a certain rate of return, comparing competitors' prices, or by bidding.
- **Determine the final pricing.** It is important to consider the influence of marketing elements, such as advertising. But when it comes to setting the final price, you must also consider how sellers and distributors will feel, how the competition will react, whether suppliers will increase their prices when they see an increase or even if the government might intervene to regulate prices.

Following these steps will lead us to an ideal price — conjuring up a maxim that bears repeating: a product is worth whatever consumers are willing to pay for it.

In addition, the technical note offers instruction on when to vary pricing for the same product or service and how to gauge customer sensitivity to potential price moves. There is also advice on how to avoid price wars and steer clear of any pricing practices that are unethical or illegal.

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