

Figuring Out the Right Price

A new firm entering an existing market may have a hard time making money, given levels of competition, but it is relatively easy to figure out what the best price is to charge: Just look at what everyone else is doing. But how does an entrepreneur bringing a completely new product to market figure out what people are willing to pay?

Sometimes trial and error turn out to be pretty helpful. Suppose you develop a new drink that with one sip turns the drinker's hair a golden shade of blond. How much could you charge for this? One approach might be to experiment with one price in one market and another in a second otherwise similar market and compare sales levels. Firms call this approach "test marketing," and it is commonly used. Suppose, however, you want to know what price you can charge before you invest a lot of money into developing the product. After all, if you learn that the most anyone would pay is \$5 and the average cost of producing this miracle drink is \$10, then it would be nice to know that before you build

an expensive factory! Oftentimes firms try to learn about the demand of potential customers by getting a representative group together, describing the product, and asking about price response. Marketers call such groups "focus groups," and they too are common. Another approach is to look at other products currently serving a need similar to your new product. In this case, an alternative way to turn one's hair blond is dye. Of course it is not a perfect substitute, and so your price need not be the same. But common sense tells us that prices of similar products, satisfying similar needs, will have prices in the same ballpark. Some call this using "benchmark" pricing.