

# Economics of Adding Value through Product Differentiation

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## Overview

- What is a differentiated product?
- Why can product differentiation create value?
- What attributes are consumers willing to pay for?
- How can profits be increased?
- How can profits be sustained?

## What is a Differentiated Product?

- What happens to sales if a product's price is increased?
  - If sales fall to zero, then no product differentiation.
  - If sales do not fall to zero, then there is some perceived difference in the product.

## Examples of Commodity Products

- Number 2 yellow corn
- 185 pound hog carcass grown in confinement
- Gasoline sold on a corner with two other stations

## Weisengold eggs are not a commodity product



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## News Release from Frito-Lay

- Tostitos Is First Frito-Lay Package To Call Out "0 Grams Trans Fat" On Front

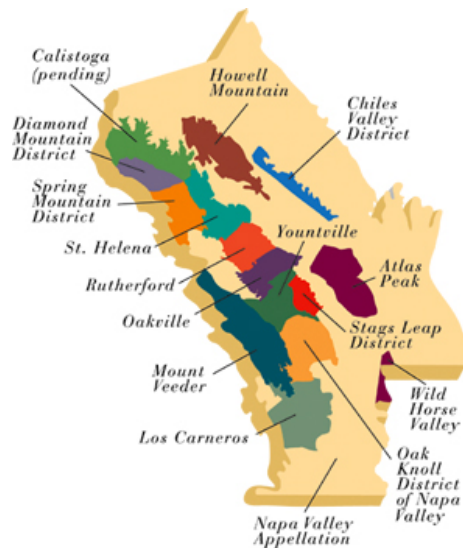
Plano, TX (September 9, 2004) - Frito-Lay announced today it will feature a "0 grams trans fat" message on the front of some of America's favorite snack chips. The Tostitos line of tortilla chips will be the first Frito-Lay product to carry the message on the front of the packaging as part of the brand's new look.

## Valuing Product Attributes – Bruce Babcock

### Many ways to differentiate a product



### Napa Valley Wine Appellations



## Oakville vs Rutherford

- Oakville is mildly affected by fog and wind from the San Pablo Bay that manages to slip past the Yountville Mounts. At the same time, Oakville enjoys the abundant sunshine and warmer temperatures that are characteristic of the Northern Napa Valley.
- Oakville is slightly cooler than Rutherford to the north. Cabernet Sauvignon dominates Rutherford a bit more than Oakville, but the varietal is the undisputed king in both AVAs. [Opus One](#) produces what is probably the most famous wine based on Oakville Cab.
- Rutherford Cabs are grown in slightly warmer temperatures and tend to have earthier, less fruity flavors. On average, they are a little less approachable in their youth, but age longer. Keep in mind that these are very slight and generalized distinctions. Great Oakville Cabs will age for many years and grow more complex and balanced over time as well.

## Why can product differentiation increase profits?

- Commodity producers are price takers
  - If  $\text{Price} > \text{Cost}$ , profits are positive
  - If  $\text{Price} < \text{Cost}$ , lose money
- With a differentiated product price can be raised without losing all sales
- Or firms that differentiate can gain a competitive advantage by entering a new market that has differentiated standards
  - Dairy, meat and egg suppliers for fast food chains

## Valuing Product Attributes – Bruce Babcock



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### Certified "Well Managed Forest"

SCS, the oldest and largest independent organization to certify environmental claims made by business, is accredited by the Forest Stewardship Council (FSC), an international, non-profit association striving to improve forest management worldwide.

SCS examined three vital areas of Big Creek's forest management:

- The sustainability of the timber harvest
- Health and maintenance of the ecosystem
- The company's financial viability and socioeconomic contribution to the community

The evaluation included extensive field investigations and on-site interviews with company employees, contractors, members of local communities, environmental groups, and public agencies.

The SCS team commended Big Creek's forest management, stating, "It represents an example of superior forest stewardship."

For more information about the "Well Managed Forest" certification you can contact [Scientific Certification Systems](#).



FSC accredited certification means that the forest is managed according to strict environmental, social and economic standards.

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## The Home Depot's Environmental Commitment to Sell FSC-Certified Products

- Royal Mahogany Doors from a certified forest in Costa Rica.
- Premwood Doors, an alternative to lauan interior doors.
- Hardwood plywoods by Roseburg F.P. and Columbia F.P.
- FSC-certified dimensional lumber from a large Canadian supplier.
- Flooring underlayment made from recycled newspapers and gypsum sold as a replacement to lauan flooring underlayment.

"Rest assured, as more "green" products become available, The Home Depot will carry them."

What attributes can induce consumers to part with a bit extra?

- Superior taste
- Unique taste
- Superior appearance
- Good for you
- Good for the environment
- Locally raised
- Authentic
- Humanely raised

Which attributes can be “discovered” by consumers?

- Taste and appearance (experience goods)
- Other attributes may or may not exist in a product that claims to have them (credence goods)

### How to increase profits from experience goods

- Create a better product
- Invest in appropriate level of marketing
- Control production costs
- Make sure supply is matched with commitments
- Maintain consistent quality

### How to Make Profits from a Credence Good

- Find an attribute that consumers will actually pay money to obtain
- Source a supply that offers the attribute
- Set up a convincing enough certification system.
- Invest in appropriate level of marketing
- Control production costs
- Make sure supply is matched with commitments



## How Can Value Creation Be Sustained?

- Imitators will soon flood the market and drive profits to zero unless a significant barrier to entry exists
  - High oil, white corn, waxy corn
  - Organic produce
  - non-GMO soybeans

## Types of Barriers to Entry

- Regulatory
- Technological (e.g., fully traceable)
- Geographic
- Capital costs
- Marketing/brand identity

## Geographic Barriers

- American AVA system for wines
- European GI system (PDOs and PGIs)



## Example GIs in the EU

- Parmigiano Reggiano
- Mozzarella di bufala campana
- White Stilton and Blue Stilton
- Welsh beef
- Newcastle brown ale
- Camembert de Normandie
- Roquefort
- Dortmunder bier
- Feta cheese
- Kalamata olives

## GI Restrictions

- Only cheese produced in the three counties of Derbyshire, Leicestershire and Nottinghamshire and made according to a strict code may be called Stilton. There are just six dairies licensed to make Stilton. They are subject to regular audit by an independent inspection agency accredited to European Standard EN 45011.

To be called Stilton, each cheese must:

- be made only in the three counties from local milk which is pasteurized before use
- be made only in a traditional cylindrical shape
- be allowed to form its own crust or coat
- be un-pressed
- have delicate blue veins radiating from the center
- have a taste profile typical of Stilton.

## Brand Loyalty

- Branding a product is the traditional way of creating a barrier to entry
  - Sun-Maid
  - Sunkist
  - Ocean Spray
  - Mondavi
- Creation of a successful brand is expensive
- Maintenance of a brand is expensive

## Summary

- Growers can make money being low-cost producers and selling for a profit at the commodity price, or
- Growers can create a differentiated product, have some control over quality and quantity, and try to behave like consumer-oriented firms worldwide.