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OBTAINING AND MANAGING REPUTATION PRICE PREMIA IN MARKETS FOR EXPERIENCE GOODS

Evidence from academic research on the wine market

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Summary of Research Findings

- √ Reputations can be conceptualized as the *expected quality* which consumers associate to a product name *before* consuming it.
- √ Producers' reputations play an important role when consumers are uncertain regarding product quality. Firms with good reputation can charge a premium for their products, which can be considered as the cost of a quality insurance policy.
- √ Consumer's willingness to pay for insurance varies proportionally to the consequences economical or other) associated with purchasing and consuming poor quality products. For consumers, collecting information to form quality expectations is a costly activity. Research costs reduce the magnitude of the price premium which the reputation of a name can capture. Thus, a firm may increase its price premium by providing easy access to information regarding the quality of its products.
- √ Names can nest within each other, each one with its own reputation, to identify products with increasing *specificity*. In the wine market, reputations may exist for Country of Origin, Viticultural Area, and winery names. Reputations associated with specific names are more precise, but also entail higher research costs on the consumer side. Less specific, collective names are often shared among numerous firms, and thus good (or developing) reputations may be endangered by free-riding behavior.
- √ Reputation price premia are strongly correlated to producers' historical performance, such as the number of years a name has been in the market, its historical average quality, and its quality consistency.

- **What are experience goods?**
  For many agricultural and food items, consumers cannot assess food quality until after consumption. In the economics and marketing literature, these goods are referred to as experience goods (Nelson, 1970). When purchasing experience goods, consumers search for quality cues to inform them about their product choice. In this setting, producers' reputations become important decision factors.

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[2] Results are compiled from multiple references. Authors and publishers are referenced in the text.

- **What are reputations?**
We can think of reputations as the *expected quality* which, on average, consumers associate to a particular experience good *before* consuming it. Consumers may use multiple sources of information to form quality expectations (e.g. previous experience, word of mouth, product reviews in specialized magazines, advertisement, etc). The reliability of quality information and the cost of obtaining it (*research cost* henceforth) vary depending on the source(s) chosen.

- **Why are reputations important for producers?**
Research shows (Costanigro et al., 2007 and 2009) that producers with good reputations can earn a *price premium* for their products, even when the characteristics of the products sold are comparable to those of lower reputation producers. We can think of this premium as the price of an *insurance policy* certifying the quality of a product to consumers. While most consumers are willing to pay a positive amount to insure against poor quality, forming quality expectations is a costly (in terms of time or money) activity for consumers. Thus, reputation price premia amount to what consumers are willing to pay for quality insurance *net of the research costs* (Costanigro et al., 2009a). If it is too difficult for consumers to form reliable quality expectations, price premia may shrink to zero, even for products of high quality.

- **Consumers' willingness to pay for quality insurance increases with the severity of the consequences associated with consuming poor quality**. Consumers are concerned about quality when consuming poor quality products results in a noticeable loss, either economical (the cost of the purchased product) or of other nature (an illness due to a contaminated product). Consumer's willingness to pay for quality insurance is therefore low when buying an inexpensive wine, but high when purchasing a special bottle for an anniversary. This implies that (at parity of research costs and quality), producers have more opportunities to capture reputation premia in markets for expensive goods, or when consuming poor quality may result in severe health consequences.

- **Private names, collective names and nested reputations.** Often, multiple names may refer to a single product. For example, consumers may differentiate wines by viticultural area, by winery, or by a particular vintage and grape variety. Indeed, names can nest within each other to identify a product with increasing *specificity*. Each of these names may develop its own reputation, leading to the establishment of private (e.g. winery) and collective (e.g. viticultural area) reputations. This distinction is relevant at two levels:

1. The risk of free riding. A winery may lower costs by cutting on quality, and still obtain the price premium deriving from the collective reputation of the production region. Research shows that when reputations are associated with collective names, free-riding may endanger the long run reputation of a name (Winfree & McCluskey, 2005).

2. Market-specific reputation structures. For consumers, quality expectations referring to more specific names are more informative (i.e. provide better quality insurance), but they are also more costly to form. In general, consumers face higher research costs for more specific (generally private) names, and lower for aggregate, less specific names (generally collective). Thus, for low-risk products reputations may form only on collective names (e.g. Idaho potatoes), as consumers may just not be interested in learning about individual firms. The wide price range observable in wine causes both private and collective reputations to play a relevant role in the wine market.

- **How can producers obtain and manage good reputations, and capture a premium in the market?** Results from theoretical models (Costanigro & McCluskey, 2009) and empirical research (Costanigro et al., 2009) using California wine data (see Table 1) and quantile regression techniques show that, all other wine characteristics being equal:

1. The *average quality* of the products marketed under a given name (collective or private) *in the past* is positively correlated with the price premium a name is able to capture (see Figure 1). Good performance in the past is seen by consumers as a guarantee of future performance, and the greater the quality in the past, the larger the reputation price premium in the present.

Table 1: Wine Prices and Associated Tasting Scores, Firm Past Average Tasting Scores and Standard Deviation, Viticultural Area Past Average Tasting Scores and Standard Deviation. Descriptive Statistics, data collected from the Wine Spectator Magazine (1991-2000 issues).

	PRICE*	SCORE	FIRMPQ	FIRMSD	AVAPQ	AVASD
N**	9261	9261	7717	6115	9074	8949
mean	$37.18	86.54	86.65	2.36	86.25	3.50
min	$6.05	60	62.00	0.00	74.67	0.00
p25	$19.76	84	85.00	1.53	85.42	3.14
p50	$27.12	87	87.00	2.19	86.24	3.49
p75	$39.78	89	88.48	2.98	87.68	3.86
max	$2,140.00	99	96.63	14.14	91.00	7.78

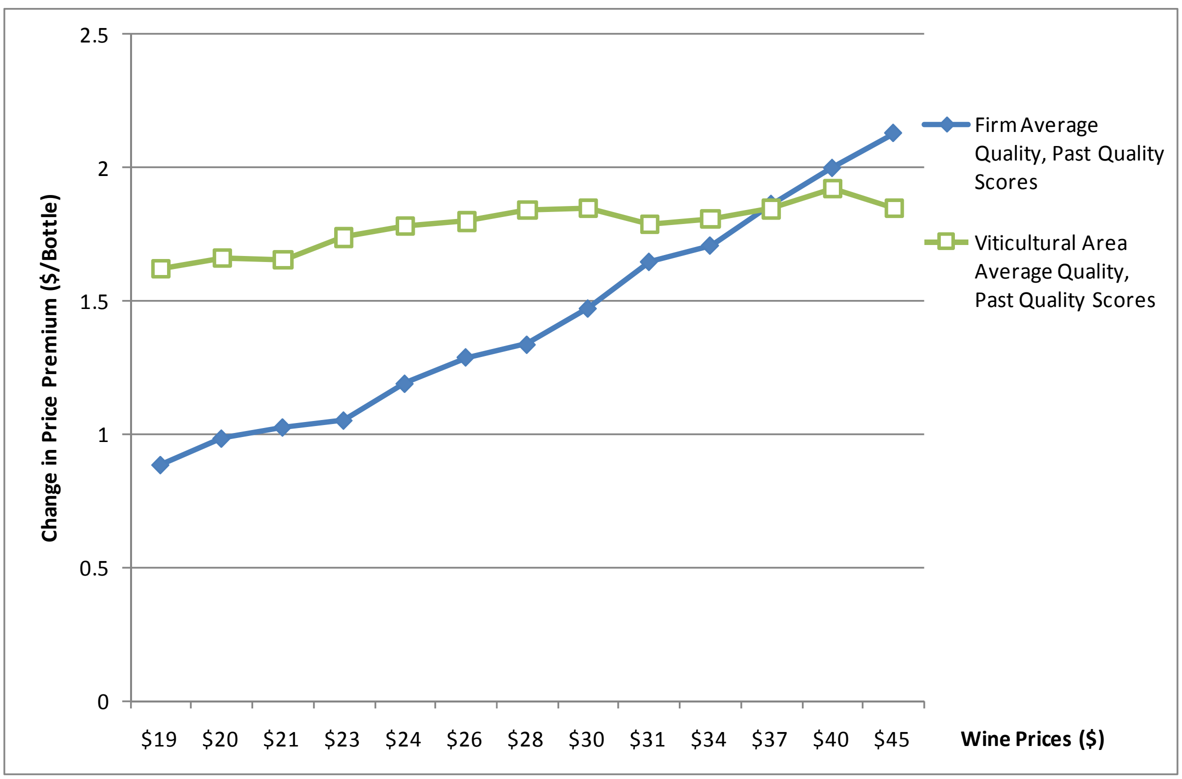

Figure 1. Variation in Price Premium due to a One Unit Increase in Average Past Quality. Estimates Calculated Across Wine Prices. *Source:* Costanigro et al., 2009.

2. *Past average quality influences prices more than current quality*. Present quality performance, although positively correlated with higher price premia, has a smaller effect on it than past quality performance (see Figure 2). This result highlights the importance of reputations in markets for experience goods.

3. *Quality consistency (in the past) influences reputation premia*. The greater the variance in quality of the products marketed under a given name, the lower the price premium (see Figure 3). When a name is associated with inconsistent quality it is harder (more expensive) for consumers to form quality expectations. Furthermore, the name might be perceived as a riskier choice. Both factors contribute in reducing the price premium a name can capture.

4. *The history of a name matters.* While for new names quality expectations need to be formed from scratch, for most consumers the reputations of old names need only to be updated. Thus, at parity of quality performance, old names can capture a larger share of consumers' willingness to pay for quality insurance, because consumers need to search less when dealing with established names. This also holds, but with opposite effects, when a name earns a stigma rather than a good reputation. If a consumer has had a bad experience with a name, he or she may decide to avoid it in the future, even if quality improves overtime. This is especially relevant when, like in the wine case, there are many names to choose from, and the cost of avoiding one is low.

Policy suggestions

- *Knowing the reputation structure of a market is paramount.* Reputation dynamics change across experience goods, and may also vary across the price range of a product. When collective reputations play a relevant role, producers should consider the adoption of policies to discourage free-riding (e.g. by enforcing quality standards).
For the wine case, results show that collective names are most effective at capturing premia in the commercial (cheap) market segment, while winery names become more relevant for premium and ultra-premium wines. Interestingly, collective reputation premia don't disappear as wines become more expensive: while for inexpensive wines only collective reputations seem to matter, for expensive ones both region and winery names are able to capture reputation premia. This suggests a hierarchical selection process on the consumer side, who (when purchasing expensive wines) may use collective reputations to limit the number of winery names on which to collect further more specific quality information.

- *For high quality producers, reducing research costs increases price premia*. Since reputation premia capture consumers' willingness to pay for quality insurance *net* of research costs, providing easy access to truthful and verifiable information on product quality will result in an increase of the price premium captured by high quality names. In the wine market, such effect can be pursued with multiple instruments, such as reviews in specialized magazines, wine competitions or informative advertisement. Providing consumers with an easy access to quality information also reduces the problem of free-riding, which plagues collective reputations: high quality producers are rewarded, while low quality ones are punished.

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Figure 2. An Increase in Average Past Quality is More Effective than Present Quality at Capturing Higher Price Premia. Estimates Calculated Across Wine Prices. *Source:* Costanigro et al.,

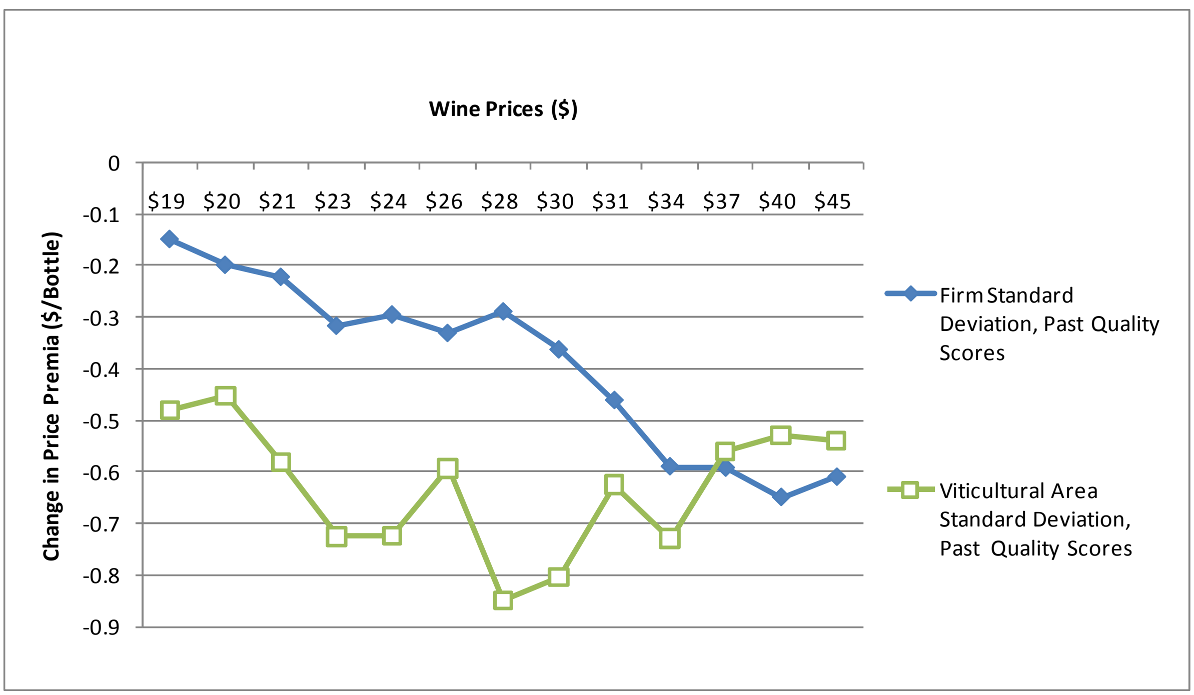

Figure 3. A Decrease in Past Quality Consistency by One Standard Deviation (i.e. Decreasing Consistency) Reduces Price Premia. Estimates Calculated Across Wine Prices. *Source:* Costanigro et al., 2009.