Pricing

Mistakes, Models & Psychology

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Introduction

Business owners all have different strengths and specialties. Some are incredibly knowledgeable about their industry; the knowledge they bring to bear is a big advantage and benefit to customers. Some have a gift for developing products and services that people love—whether it's one big idea or a whole series of them, they know what their customers want before the customers do. Some people are gifted at sales and marketing; they can sell *anything*.

But you won't often hear a business owner say that his strength is "knowing how to price things." Even though it's a fundamental part of every business, putting a value on what you're doing, you're more likely to hear confusion in the room when the subject turns to pricing than you are to hear bold confidence. Everybody has to do it—but how?

Pricing Mistakes

Getting your pricing wrong can be a big problem, whether you're priced too high or too low. Consider some of the potential consequences.

Low Pricing. If your pricing is too low, not only are you leaving money on the table, hurting your ability to both invest in the business and pay yourself and your team, but you might be priced so low that you can't make your business profitable. If you're losing money on every sale, you'll never make it up in volume!

Even as you speed along from 1 to 100 to 1,000 sales, all you're doing is succeeding to death. If you can't make enough sales to cover your fixed costs and/or don't price high enough to account for your production costs, then the business cannot work.

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Another problem of low pricing is in the message you send to consumers. If your product is priced dramatically lower than people might expect, you probably think that you're offering people great value. And that might be the case—but it's also possible that you're priced so low that people are suspicious of the quality of what they're getting. You get what you pay for, people start to whisper—and suddenly your brand is in the basement, associated with cheap but disposable purchases, instead of quality, reliability, and real value. People want a good deal, but most people have learned that if something's too good to be true, it probably is.

You can also run into problems when you try to correct the problem. No one likes it when they have to pay more for something (although they'll certainly understand—to a point!). But if people have gotten used to paying one price for your products or services, and then prices jump dramatically, there will be a backlash. Sure, your new price would be more profitable if you kept all your customers—but will you be able to keep all your customers? A first impression goes a long way, and that first price put a value on what you're selling.

If the price then goes up but it's still the same product, expect to hear this a lot: "Why am I paying so much now, when before I only had to pay…?" It's no longer perceived as a good value—even if you think it would be a good value at the new price—because the old, lower number is deflating the perceived value. Customers (usually) understand that businesses need to be profitable, but they're not interested in all the grimy details of how that happens; what they care about is that they used to pay $15, and now you want them to pay $30 for the same thing.

High pricing. Shooting too high when you start pricing brings its own set of problems. While setting your prices too low might bring in the wrong kinds of customers (for example, someone hunting for a bargain instead of someone looking for quality work), setting your prices too high can make it difficult to find any customers at all.

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Above all else, consumers are looking for value. There can be value at any price point, even a high one. But you have to earn that price. Aim too high, and people take one look and walk away shaking their heads. "Sure, it's nice—but I'm not paying *that*!"

You might think that you can just lower your price until you find that sweet spot where people do see value—but like we discussed earlier, first impressions count for a lot.

When you decide that you're priced too high and make a big reduction in your prices, *you* think that you're increasing the value by that much: "So many more people will be interested. Look, folks! You used to have to pay $100 for this, now it's just $25!" Some people will have the reaction you're expecting. But you might be surprised by other possible responses. People who bought earlier at the higher price point are likely to be upset and feel like they wasted their money. And others might wonder what's "wrong" with your products or services that you're cutting prices—is this a sign that it's a boondoggle and you're just desperate? Some people will decide that there's no value to be found at *any* price. Instead of seeing value in the lower price, they see failure.

Don't get me wrong—it's possible to fix your pricing, whether you're too high or too low, if you do it right. It happens. But just as often, businesses do it wrong, including some of the biggest and most well-known. The stories hit the news often enough that you can almost just fill in the blanks:

- The business known for low prices that tries to go more "upscale" by raising prices or eliminating discounts, only to find that all the customers are gone (read much about JC Penney lately?)
- The business that hits a rough patch and responds by cutting prices, only to find that it's now in a death spiral that it can't get out of (check out the prices of the latest Blackberry devices!)

This stuff isn't easy—you're not alone in your struggles! So what are the tricks to making sure you do get it right? We'll look at different pricing models, factors you should consider when setting your pricing strategy, and some of the psychological factors and impacts of pricing. Let's get it right!

Pricing Models

There are many different models you can use when you want to price your products. Some of them are consumer-oriented, while others focus on internal factors at your business. Looking at multiple models will help you find a price that works for each aspect of your business.

Cost-based Pricing. The most basic pricing model is cost-based pricing, a model that is internally focused since it's based on what's happening inside the business. Expressed simply, you add up all your costs, then add in a percentage for profit, and you have a price.

Cost + Profit = Price

It looks so simple, right? But of course, there's a lot more to it than first meets the eye, all thanks to that little four letter word, "cost."

Do you know all the costs in your business? Really, *all* of them?

A lot of people make a mistake here because they're only counting certain kinds of costs, typically costs of production. If all the raw materials cost $10, you can sell for $15 and make a hefty 50 percent profit, right? Not so fast. Let's take a step back and make sure you're counting *all* your costs.

1. First, as we've mentioned you have your **production costs**. That accounts for how much it costs you to provide your product or service—the materials, transportation, etc. To make one widget or deliver your service to one customer, how much does it cost you?
2. Next up is **overhead**. These are your fixed costs—bills that you have to pay whether you make 5, 50, or 500 sales. Some examples include the cost of your working space, equipment, governmental fees, insurance policies, etc. One way or another, you're going to be paying these bills. Things can get a little tricky here because you have to estimate how many sales you're going to make, so that you can spread the overhead costs around.
3. Your **labor** costs might fall into either of the above two categories, depending on how you've set things up. If you have employees on salary, then labor is part of your overhead. Or if workers' hours are dependent on how many products you need to produce or services you need to deliver, then labor is like an additional production cost. Either way, you have to pay your people!
4. Then, **taxes**. Yes, Uncle Sam wants his cut, too. And he will find you if you forget him.
5. Don't forget to **pay yourself**!

Once you've added up all your costs, then you at last have your true baseline price. You cannot drop below your cost (with some exceptions, such as loss leaders where you intentionally price one product or service below cost with the goal of getting people to also buy more of the things you're making a profit on. But be very careful with this strategy!).

Value-based pricing. Value-based pricing is the idea of setting your prices according to the utility that customers get from your products or services. This is a more customer-oriented pricing method, and is especially useful when what you're selling will save the customer money in other ways. Instead of looking at how much it cost you to make something, your pricing is based on how much your customer would have to spend if he or she *didn't* buy from you.

Here's an example: energy-efficient light bulbs. If you bought regular light bulbs, you would spend a certain amount on energy costs and then replacing them regularly when they burn out. The idea behind the new light bulbs is that they will last a lot longer, meaning you don't have to buy as many replacements, and they will run more efficiently, lowering your electric bill each month. Knowing that you'll save money over the long term, the bulb manufacturer charges a premium price up front, above and beyond costs, based on the value of the product to you, the customer.

Another example, a customer might have a range of related needs that cause him or her to buy five different products. You come up with one product that does all five things. You might look to go above your cost-based pricing because you are saving the customer money (and simplifying things) by only making them buy one thing. You just have to price your product below the combined cost of everything the customer had to buy before.

Market Research-based pricing. The last method we'll discuss is based on the kind of research that marketing firms do for businesses—and for a lot of money, we might add. There are a lot of different methods that firms might use, but for our purposes we'll talk about just one, called the van Westendorp Price Sensitivity Meter (or PSM, and named after its creator, Peter van Westendorp). This model is all about the customer and how he or she perceives the value of what you're selling.

A fair warning, the PSM comes with some scary-looking graphs and number-work. But it's actually not that complicated, and you can use the insights that led to the model's creation even if you don't want to go through all the precise number-crunching.

The PSM tries to find the range of prices where the most people are open to buying from you.

Put simply, the PSM tries to find the range of prices where the most people would be open to buying from you. It identifies a low point, below which too many people would be skeptical of the quality of what they're buying, and also a high point, above which too many people think it's too expensive.

Inside that range, then, it's up to you to find the point that makes a profit and fits with how you're positioning your business in the market.

To set up the model, a researcher surveys people with four questions about a particular product or service:

1. At what price would you consider *x* to be too expensive, that you wouldn't consider it?
2. At what price would you consider *x* to be too cheap, that the quality couldn't be very good?
3. At what price would you consider *x* to be starting to get expensive—you'd still consider it, but you would have to think about it?
4. At what price would you consider *x* to be a bargain, or cheap?

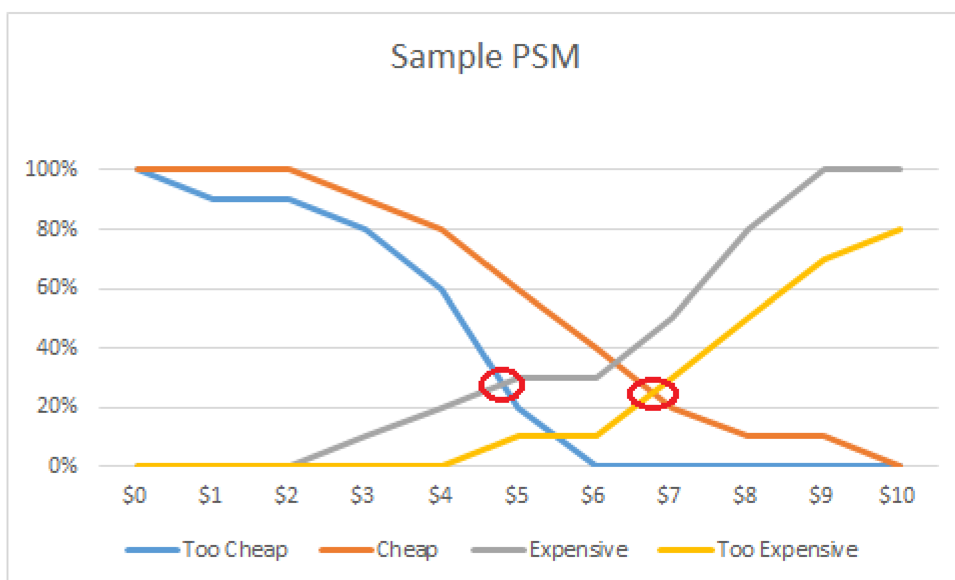
You might get responses that look like this:

Respondent	Too Cheap	Cheap	Expensive	Too Expensive
#1	0	10	15	20
#2	4	8	20	30

And so on.

Then researchers graph the responses to each question, charting the percentage of people at each price who think the price is "Too Cheap," "Cheap," "Expensive," and "Too Expensive." Presumably no one says the product is "Expensive" or "Too Expensive" at $0. Likewise, everyone thinks the product is "Too Cheap" or "Cheap" at $0.

As the price increases, some people will start to think the price is "Expensive" and then "Too Expensive," until eventually everyone has hit the upper limit. At the same time, fewer and fewer people will think the price is "Too Cheap" and then "Cheap," until eventually no one thinks the price is a bargain. Now you have four lines crisscrossing the chart, and the intersection points, circled red in the sample below, give you your price range.



Where the "Too Cheap" line crosses the "Expensive" line is considered the low end of your price range. Below that, too many people think the price is too low. Where the "Too Expensive" line crosses the "Cheap" line is considered the high end of your price range. Above that, too many people think the price is too high. In between is the range of acceptable prices. In the sample chart above, that range is from just under $5 to just under $7.

Even if you don't hire out an expensive marketing firm, you can get some of the benefits of this pricing model. For starters, you can ask the questions of yourself, and get yourself thinking like a consumer. What prices would interest you, and what prices might make you skeptical or turn you away? You can also mimic the strategy on a smaller scale by going to people you know and getting their honest feedback about your products and services. Instead of 400 responses, you might have 10 or 20, but it's a good place to start. But be careful to make sure you're getting honest feedback—don't do anything that might make people edit their responses to avoid hurting your feelings, or prejudice their answers by talking about your own ideas of pricing. You can still get a good idea of an appropriate price range.

Within that range, you'll need to consult several factors (and use trial and error) to find the price that's right for you:

- **Costs.** You don't want to drop below your cost, making *that* the real lower bound.
- **Competitors.** Where are your competitors priced inside that range?

> *Are you looking to maximize profit, like Apple, or to maximize revenue and market share, like Amazon?*

- **Positioning.** How are you positioning yourself in the market compared to those competitors? Are you the budget option and looking to beat them on price, or a high-end option that competes on added value and can price at or above the rest?
- **Strategy.** Are you more interested in maximizing profit by finding the most profitable price point, even if it means bringing in fewer customers (the Apple strategy), or are you trying to maximize revenue and bring in as many customers as you can, even if the profit margin slims (the Amazon strategy)?

The Psychology of Pricing

Once you have a grasp on the right pricing for your business, there are some fascinating psychological studies offering some extra tips for getting the most value from your pricing. Here are a few.

The Super-Number "9." Have you noticed how many prices end in the number "9"? You have so many products priced at $X.99, and then at $9, $29, $99, etc.

We as consumers are trained to see the number "9" as signifying a bargain.

Why? Does it really work? In a word—yes. Researchers from MIT and the University of Chicago tested using different prices on the same items, and found that prices ending in "9" outsold the same item priced for *less*. [i] In the study, clothes priced at $39 sold better not only than the same clothes priced at $44, but also priced at $34. We as consumers are trained to see the number "9" as signifying a bargain, while other numbers, even if they represent a lower price, don't send the same signal. It's the same reason so many items are priced at $X.99—it gets us thinking about the value. Conversely, businesses that want to send the message that they are more upscale will use a round number, first with whole dollar amounts and sometimes just hitting the nearest round price point. Depending on your brand positioning, price accordingly.

Anchoring. The way consumers perceive the price of your product is strongly influenced by other numbers they are encountering at the same time, an effect known as anchoring. If you put an item next to something that's a lot more expensive, suddenly it looks like more of a bargain. Put it next to something a lot cheaper, and it now looks unreasonably expensive.

The high anchor increases value, the low anchor decreases it. Researchers from Stanford and Rice tested the effect in eBay auctions, and found that framing the same item, with identical starting prices, next to cheaper or more expensive items made a big difference in the final price. A $1.99 CD surrounded by $6.99 CDs ended up going for a lot more money than a $1.99 CD surrounded by $0.99 CDs—although, oddly enough, drawing attention to the comparison essentially cancelled the effect. [ii] If you want to increase the perceived value of an offering, surround it with other higher-priced alternatives.

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Options. When you give people choices, they tend to do funny things. For example, if you have three offerings at different price levels, you might think that you're maximizing your revenue because more people will find an option that fits what they want. But what you're actually doing is steering more people toward the middle option. Researchers found that when offered two kinds of beer, one for $1.80 and one for $2.50, a majority of people chose to buy the more expensive beer. They then tried expanding the list to three, with different options.

Adding an even cheaper beer, just $1.60, they found that now the sales numbers reversed, and a huge majority chose the $1.80 beer, with just a few going for the cheapest or most expensive choices. The researchers then replaced the extra-cheap $1.60 option with an extra-premium $3.40 beer. This time, the vast majority went to the $2.50 beer, with just a few choosing the others. In each case, when presented with three options, the middle drew the best. [iii]

The exception comes when you use a useless price point, as in the famous pricing of *The Economist* magazine. You could get an annual web-only subscription for $59, a print-only subscription for $125, or a print-and-web subscription for…$125. Wait, what? That's right, print-and-web was the exact same as just print. Dan Ariely from MIT studied the reason. Surveying his students, he found that presenting them with those prices drove almost all of them to the $125 print-and-web subscription, with a few opting for web-only and exactly zero to the print-only choice. But with another group of students, he removed the print-only option, so that there were only the $59 web-only and $125 print-and-web choices. This time, a big majority went with the web-only option. [iv]

The seemingly useless $125 print option wasn't there to get people to purchase it; it was there to get people to buy the print-and-web subscription! The lesson? A price point that is obviously inferior to another option will make more people see value in that other option. So if one package or product is your biggest priority, having a useless price point nearby will drive people to it.

Conclusion

Pricing might not be easy, but don't let it overwhelm you. By looking at your costs, the actual value you're providing to consumers, and the value people perceive in your business, you can find the right range and narrow in on the sweet spot that brings in customers, revenue, and profits. And don't forget about the psychological factors, either—customers are human beings, an eclectic mix of quirks, habits, and urges. Sometimes all it takes is the slightest push.

[i] Eric T. Anderson and Duncan I. Simester, "Effects of $9 Price Endings on Retail Sales: Evidence from Field Experiments," *Quantitative Marketing and Economics* March 2003, Volume 1, Issue 1, pp 93-110.

[ii] Utpal M. Dholakia and Itamar Simonson, "The Effect of Explicit Reference Points on Consumer Choice and Online Bidding Behavior," Marketing Science May 2005, Volume 24, Issue 2, pp 206-217.

[iii] William Poundstone, "Priceless: The Myth of Fair Value (and How to Take Advantage of It," Hill and Wang, 2011.

[iv] Dan Ariely, "Predictably Irrational: The Hidden Forces That Shape Our Decisions," HarperCollins, 2008.

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