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the psychology of price

How to use price to increase demand, profit and customer satisfaction

Leigh Caldwell

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Appendix B. A theory of psychology and cognition: the background to this book

Acknowledgements

As a teenager, I had a bet with my brother that I'd write a book and have it published by the time I reached the age of … well, let's just say I missed the deadline. But thanks, Owen, for helping provide the initial, indirect stimulus for this work.

The rest of my family have also provided love and support over the years and I'd never have been in the position to write this without the framework and happiness that they provided. My deep gratitude to all of you.

The idea to write this particular book arose from many conversations, long walks and glasses of wine over the years with Annette, who has inspired many ideas and achievements by me and other people. More encouragement and thoughts came from Ebru and from Emma, whose introduction to Ali Yates at Crimson initiated the final part of the process.

The content of the book is informed by many years of doing business, and everyone I've worked with has taught me something. So if we've worked together over the years then you have influenced this book. Special thanks to Bastiaan, Daniel, David, Nabil, Philip, Rajiv and Safina for many conversations and collaborations that helped shape my understanding of this field. Helder Miguel also helped nudge me onto this path.

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Introduction

About half of the contents of this book were originally offered as a training manual for partners and directors of major companies, alongside an expert consulting and research service, at £155 – a bargain considering it could increase your income by hundreds of thousands of pounds each year.

We slashed the price to just £33.50 as a promotional offer, and had a surge of interest from smaller companies.

And now it's been published in paperback so we can get the message out to as many people as possible. The new low price: an irresistible £14.99.

See what I did there? In theory, the previous price of this book should be irrelevant to today's reader. In reality, it's not. The psychological power of naming a higher price implicitly makes people believe that a product has a higher value.

For years, setting prices in the businesses I was involved in, I wondered about the psychology of my customers. Like most new business owners I started out by setting a price based on my costs plus a margin. Sometimes the clients would negotiate and sometimes we'd have to match the price of a competitor. The whole time, though, I was convinced that I must be missing something that was going on inside the heads of my customers. If selling a DVD at £9.99 really works better than selling it at £10, surely there must be something I could use in my pricing strategy too.

In 2002 Daniel Kahneman won the Nobel Prize for Economics. This was when the science of behavioural economics, which combines the practice of economics with the experimental discoveries of psychology, started to become more widely known. As I started learning about it, I soon found that this new research had the answers I'd been looking for. It reveals how consumers perceive different price points, whether it is better to negotiate down from a high starting price, whether people will pay more for a monthly contract, and how to persuade clients to pay for the value they are getting. Eventually I set up a business which specialises in providing pricing advice – the advice that is encapsulated in this book.

Behavioural economics research has revealed a rich set of discoveries relating to how people buy products and services, and how much they are willing to pay. From this research, we and other pricing specialists have designed at least 20 different new pricing approaches, including insights into setting basic positioning, segmentation and pricing strategy, how to present prices in retail or business-to-business environments, and how to use pricing to ensure loyalty without giving up profit margins.

It turns out that psychology is one of the main influences on successful pricing. For some products and services, like those of a London-based software company we worked with, the right psychological approach can increase revenues by more than 200%. The difference isn't always that great: we worked with a magazine publisher in a declining market and the improvement was more like 10%. In every case, understanding consumer psychology gives you the ability to improve your pricing power and increase your profits. Indeed, a business must get its approach to pricing right in order to survive and grow; it is a fundamental matter of strategy, not an optional extra.

This is the first book to tell you, step by step, how to use the psychology of price in your business; no matter what you sell, whether a product or a service, to consumers, to other businesses, or to government. It starts with the first steps in using price to position your product or service, then explains how to price differently for different segments of your market, followed by a series of pricing techniques that help you work with, rather than against, the way your customers' minds work.

Along the way you'll read the story of a unique business: the Chocolate Teapot Company. This is a company which used pricing strategies to create a whole new product category, achieve a premium position for it in several markets, and make big profits by understanding the psychology of its customers. It's also a fictional company, so don't expect to see chocolate teapots on the shelves of your local supermarket any time soon – but everything that happens in this book is based on real examples from other businesses.

Each chapter is divided into three sections.

The first part of each chapter tells the story of the Chocolate Teapot Company, showing a new example of how its founders used pricing techniques to launch a product, increase profits, widen its customer base or defend against competitors. The second part explains the particular pricing approach in more detail, discusses the psychological reasons behind it, and provides other case studies of businesses which have used this approach. The third part is a 'How to apply it' toolkit, giving a step-by-step methodology for applying this technique in your business.

At the end of the book is a list of sources where you can find out more about the research and theories that this book is based on, including references to books and articles where you can learn more.

You can read through the book from start to finish. Or you may prefer to focus just on the story, the discussions or the toolkit: each part can stand alone, though if you read them together each one will help to illuminate the others.

Every business is different, and you will find that some of the techniques and chapters are more relevant to your company than others. In any case, they will all give you some insight into how people think, and how that translates into what they buy.

You can also find the supporting materials and electronic versions of most parts of the toolkit on the book's website, www.psyprice.com.

Please do visit the site, talk to other readers and send me your thoughts. I'd particularly enjoy seeing examples of clever pricing approaches you've used in your own business. The best examples will be promoted on the site and, with your permission, may be used as case studies in future editions of this book.

The seven principles of pricing

1. Pricing should be based on the value to the customer, not the cost to you.

2. Prices should be tangible, so your customers can see what they get for what they pay.

3. Prices should be comparable – on terms that you control.

4. If you want to change your prices, you must reframe the service or product.

5. Price differentiation is the key enabler of profit.

6. Pricing communication shapes the client's perception of value.

7. You must be prepared to lose some sales in order to increase profits.

Chapter 1

Pricing as positioning

I burst out laughing when she told me the name of the product.

"Chocolate teapots? You're joking, right?"

Maggie smiled. "Not at all. But I'm glad you reacted that way. I think we're going to get a lot of attention with this."

She opened a cardboard packet and carefully removed an object about the size of a grapefruit. It did, indeed, appear to be shaped like a teapot – and made of a substance which looked just like milk chocolate.

A kettle was just coming to the boil. She opened the lid of the teapot, placed some leaves inside and, to my puzzlement, poured the boiling water straight in. Somehow it wasn't melting.

She handed the teapot to me and I realised that the object itself was made of a thin shell of clear plastic. The brown, in fact, was fading as the chocolate layer inside started to melt.

"You can pour now or wait longer if you'd like it a bit sweeter. Try it," she said, handing me a cup.

I poured out a small amount. It tasted remarkable. The softly aromatic tea flavour was balanced by a light note *of sweetness, creaminess and bitter cocoa. I sipped it for a few moments then tried pouring out a little more. This time it was stronger, with the tea and chocolate competing for dominance – maybe a little too sweet and intense for my taste. By now the chocolate had all dissolved. After a minute more, I poured out the last of it and the tea had strengthened, dominating the flavours now with just a relatively soft note of cream and sweetness balancing it.*

“What a strange experience,” I said. “Might take some getting used to, but I think you’ve invented something … quite good.”

Maggie smiled. “Nobody really knows what to make of it at first. But mostly people like it – if they take sugar in their tea. I’m developing a bitter version for those who don’t.”

Maggie, whom I’d known since first seeing her pricing methods used in a shop a few years ago had invited me to visit her new company and write something about it. I wasn’t sure yet what the story was going to be, though it was immediately obvious that the product was original enough to be worth writing up. When I first met her, she was working in photography so I wondered if her product might be something related to mobile phones or technology. I had not expected a cup of tea.

“Anyway,” she went on, “the flavour isn’t what I want to show you. The really interesting part is this.”

She opened a door and invited me through to a new room laid out a bit like a shop, with a series of different display shelves.

"Before I show this to you," she asked me, "how much do you think you would pay for one of those teapots?"

I thought about it. "It's very hard to say. I've never really seen anything like it before. How much does it cost to make?"

"Well, there's an interesting question," she said. "But I'm not going to answer it. Have a look at this."

She pointed me towards the first set of shelves. It was laid out like a supermarket aisle, with jars of instant coffee, bags of filter coffee, boxes of 80 and 160 teabags, and, next to them, the chocolate teapots. I looked more closely, to see the prices.

100g Nescafé Instant	*£2.49*
100g Gold Blend	*£3.39*
80 Tetley teabags	*£1.79*
250g Lavazza coffee	*£3.29*
Pack of six chocolate teapots	*£2.79*
Pack of 12 chocolate teapots	*£4.95*

"I'm not sure I'd buy them very often at that price," I said. "I only get six cups for the same price as a whole jar of coffee. It doesn't seem like good value. Are people willing to pay that much for it?"

"Well done – you've spotted the flaw in the positioning here," she replied. "So let me show you this instead."

The next set of shelves looked more like the display in an Italian café. Cups of various sizes were laid out with price tags beside them:

Cappuccino – small	*£1.89*
Cappuccino – medium	*£2.29*
Cappuccino – large	*£2.59*
Americano – small	*£1.69*
Americano – medium	*£2.05*
Americano – large	*£2.35*
Espresso	*£1.29*
Double espresso	*£1.79*
Vanilla frappuccino	*£3.49*
Chocolate teapot	*£2.89*

"OK, I can see how people would buy that," I said. "It's pretty much in the same range as everything else. I can imagine buying it at that price."

"Well, let's look at one more before you decide."

The final shelving unit was actually a small open-fronted refrigerator. In it was a range of dairy and juice products.

Organic yoghurt – single	*£1.09*
Organic yoghurt x 4	*£2.89*
Fresh fruit smoothie – 250ml	*£1.99*
Fresh fruit smoothie – 1l	*£3.69*
Energy drink – single	*£1.15*
Energy drink x 4	*£3.95*
Chocolate teapot – single	*£1.59*

Chocolate teapot x 4 £4.45

I thought about it for a while. "I guess if I were in the habit of buying these kind of things the chocolate teapot would seem like reasonable value. How often do people buy a four-pack of Red Bull, though?"

Maggie opened up a notebook. "There are about two million cans of Red Bull sold every week in UK supermarkets, a million smoothies and – even more tempting – a hundred million pots of yoghurt. So it's not a bad market to get into."

I nodded.

"The point is, the positioning of the product makes a huge difference to how much people will pay for it. If we put it next to the teabags, people will compare it to the price of a teabag or a cup of coffee, which is between 3p and 10p. £2.79 for six seems hugely expensive. But if it's next to a freshly made cappuccino, you're willing to pay £2.89 for just one. A vast difference. We think the sweet spot for the supermarkets is in the fresh snack drink range, similar to a smoothie or a yoghurt, or a packaged hot chocolate. This lets us charge around £2. But there's clearly a market in the café sector too, so we will try to distribute it there as well."

As it turned out over the following months, the café market was a big one. It wasn't clear right away whether it was more valuable as a sales channel in itself, or as a way of creating product awareness for future purchases at the supermarket. In any case, once Maggie got one chain to sell the chocolate teapots, the others followed within six months.

When customers first encounter a new product or service, they usually have only the vaguest idea of what it is worth to them. In a few cases the product may have quantifiable material benefits – this is true of some financial services, and some business purchases. This gives a clear rationale for the price of the service – if something will make you £10,000 in profit, it is probably worth paying up to £9,000 for it.

Mostly, though, it is hard for us to know what we should pay for a product. We might try to predict the enjoyment we will get from consuming it. However, that is intrinsically difficult to guess – and even if we can, it doesn't naturally translate into a sum of money. Instead, we are likely to compare it with something similar we have encountered before and use that as a benchmark.

Imagine your friend from Estonia is visiting, and discovers that one of your neighbourhood pubs serves her favourite drink, which is made in Tallinn from local ingredients. You offer to buy her a glass of it. How much would you expect to pay?

Imagine it is poured from a bottle into a wine glass. You might compare it with wine, and expect to be charged £4 for 175ml. If it's poured into a champagne glass, it might be £7 for the same amount. If you instead discover that it is sold by the half pint, you are likely to compare it with beer, and £2 for the half pint will seem reasonable. If it is served in a shot glass, you would probably think of it as a liqueur and be happy to pay £2 for 25ml. That's a price difference of 11 times, just based on how the drink is presented. Of course the alcohol content is also a factor – but not a factor of 11.

Whichever products we most closely associate a new purchase with are the ones we are likely to use as a price guideline. Most products could potentially be compared with a number of different alternatives. The supplier therefore has the opportunity to shape our expectations by creating an association with a more expensive product.

Chocolate teapots might be seen as similar to teabags, or to freshly made cappuccinos from a coffee shop. The Estonian local tipple might be more like beer, more like whisky or more like champagne. And a service to complete your tax return could be compared with paying £5.50 for registered post, £95 for a software program or £2,000 for a bespoke service from a highly qualified professional.

The benefit matrix

Every product benefit can be seen in terms of something deeper.

Think about your product or service and all the benefits it provides. You should think hard to work out all the reasons somebody might buy from you. Then look in turn at each of those reasons and see if there is something more basic behind it. For instance, the taste of a drink might provide sweetness – which is a basic biological desire – and it might also provide familiarity, comfort and reminders of pleasant memories. These memories in turn can be broken down into something even more basic. Ultimately, every benefit is based on two fundamental emotional drives, pain and pleasure, and two fundamental material benefits, time and money (you can ultimately consider money and time also to be enablers of pleasure, but adding this extra level is not much help in practice).

For example, here’s how it works for the Chocolate Teapot Company:

Primary (level 1) drivers	**Level 2 drivers**	**Level 3 drivers**	**Basic drives**
The taste of chocolate tea	Sweetness		Pleasure
	Energy from sugar		
	Memory associations		
Quenching thirst			Preventing pain
Satisfying a caffeine habit	Reducing tiredness	Productivity at work	Pleasure Increased wealth
The camaraderie of sharing a drink with someone	Social bonds		Pleasure

And here’s an example for an accountancy firm:

Primary (level 1) drivers	**Level 2 drivers**	**Level 3 drivers**	**Basic drives**

Compliance with regulation	Reduced likelihood of fines and penalties	Direct cost savings	Money
	Reduced stress		Reduced pain
	Feelings of order		
	Doing the right thing for society	Sense of community	
Management information	Increased sense of control		Reduced pain
	Better planning	Profits	Money Pleasure
	Improved firm strategy		
Reduced tax bills	Cost saving		Money
	Cash flow improvement	Reduced stress	Reduced pain
		Greater ability to grow the business	Money Pleasure

At the end of the chapter there is a blank version of this table for you to fill in yourself.

This matrix of values shows all the different reasons – conscious and unconscious – that influence somebody to buy your service or product. In any given situation the customer will only consider a small number of these reasons, which is a powerful opportunity for you.

For each of these buying reasons, you have a different set of competitors. A customer has a number of choices they can make to satisfy each of these needs.

For example, a customer who wants to taste something sweet has various options apart from a chocolate teapot. They could also buy a packet of wine gums, or an ordinary cup of tea with sugar, or a dessert. Someone who just wants a hot drink could choose tea, coffee or hot chocolate. And someone who wants the social bond of sharing a drink could go to a café and share a coffee; they could go to the pub for a glass of wine; or they could even go to the cinema.

Each different set of competitors has its own price spectrum. If you make the right choice of competitor and choose your positioning accordingly, you can choose a completely different price point. This will transform your profitability.

The accounting firm described above might choose to focus on one key group of values: compliance (which largely covers doing the annual accounts and tax returns for small firms). If it did so, it would be stuck in a low-value market, being compared with self-employed bookkeepers and high-volume accounting ‘factories’ that have a low cost base and can undercut a traditional accounting firm. This is likely to be a low-profit option.

Alternatively, it could focus on tax consulting: a higher-value market and one where the price charged is easier to tie to the value generated (see the case studies in Chapter 15 for details). Tax consulting perhaps calls for more creativity, and as a result is a less price-competitive market.

The firm could position itself as a business adviser, offering strategic input into its clients' commercial and investment decisions. This decision can unlock high value, because some business decisions can make a difference of many millions of pounds in value; and if the firm plays an integral part in helping its client make the right decision, it can charge a price commensurate with the difference it makes.

However, this last option brings with it a different set of positioning considerations. The market for business advice services is much smaller than that for compliance services. The way a business advice firm needs to present itself to earn confidence from clients is very different from the way an accountant should behave. The firm needs to show the right kind of experience to gain credibility to provide such a service. And most businesses will resist the high fees that come with this service – at least they will if those fees are quoted in the traditional way.

Thus, a firm following this route should instead choose a pricing strategy that does not confront the client immediately with the cost of the service. The best way to do this is to charge a share of money the client doesn't yet have: the benefits of future growth. Firms should look at structures whereby they enter into a joint-venture or revenue-sharing arrangement with a client; where the firm's advice contributes to the success of a new growth market, the firm will end up with a stake in a far more valuable asset than they could ever have persuaded the client to pay in cash.

Many accountants hate this idea. It is more risky to enter into an equity-based or revenue-sharing relationship than to charge a fee in advance, since many client ventures will fail, or stagnate, and will not make much money for the accountant. It requires an investment of time up front while the return, if it ever comes, will be far in the future. It is an unusual approach, with few examples to copy from, and requires an entrepreneurial commitment from the professional that may not come naturally. But those who do it will make far more money than they could have done in the traditional way.

How to apply it

In the 'How to apply it' section of each chapter I will show you a process you can go through to use the insights of that chapter in your own business. The benefit matrix exercise in this chapter is the most important in the book, because the benefits and values of your product or service will then provide the basis for most of the other techniques in the later chapters. You can download more copies of this matrix from the website www.psyprice.com.

First, fill out the benefit matrix by analysing the benefits or value that your customers get from you. Write these benefits into column 1. Each direct benefit is likely to have something deeper underlying it, as shown in the examples above. Put these in column 2, and so on. Ultimately you will get down to the four basic drives: avoidance of pain; pleasure; time; and money.

You may find that there are either more or fewer than four levels of benefit; for example, you might go straight from level 2 drives to avoidance of pain and to pleasure. If you don’t need column 2 or 3, just leave them blank. If you need more columns there are other versions of the table on the website.

Use the value comparison chart on page 14 to choose one of the key benefits (values) of your product, and write down as many other products as you can think of that provide the same benefit. Write down the typical price of the other products. You can then choose which of these competitors you want to position yourself against, and whether you would rather be seen as a teabag or as a freshly made cappuccino.

The ‘units’ column may be hard to fill in. For some products there is a clear unit of value. For example, with transport services it is the distance travelled; for accommodation, the number of nights stayed. Other products or services do not have clear units: for example, the brand value provided by a BMW definitely provides a benefit to the customer, but it is hard to imagine what units this could be measured in. You may be able to think of a way to represent it – perhaps the number of friends and acquaintances who will notice the brand? – but if not, then just leave the units column blank.

The example shown at the top of the chart is for a supplier of health drinks, who has found that its key customer benefits are refreshment, self-image (through the branding of its product) and health (through the vitamins and herbs infused in the drink). Please use the blank rows underneath to fill in your own examples, or download an electronic version from www.psyprice.com.