STRATEGY

BEworks

How to Create a Behavioral-Science Driven Pricing Strategy


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We are here because...

...your team is developing a new product or service, or maybe you are revamping an existing product or service. Either way, you want to develop a smart pricing strategy that will complement your marketing in a way that will draw customers in and entice them to buy your product or service.

Most likely, you are here reading this article because you have the desire to use behavioral science to help you think *differently*.

How we typically think about pricing

Prices for goods and services are typically calculated based on supply and demand. That is, the correct price for a product is usually determined as the price at which supply matches demand. Modern manufacturing and distribution make this equation more complex, but nonetheless it remains formulaic.

At the heart of these pricing strategies is the assumption that consumers make choices in ways that are similarly formulaic. The core assumption is that the person making the purchase has a complete set of information to make the decision and they weigh all this information against the alternatives, the opportunity cost, their preferences etc. In other words, individuals have the ability to fully evaluate the information at hand, and match that against clearly defined preferences.

Similarly, when determining consumers' willingness to pay for products, we expect that price should be a function of the value people expect to get from a product; that people are willing to pay more for better products, and for products from brands that they trust. We also expect consumers want the best value for the price they are willing to spend, which leads to the conclusion that discounts will drive sales. Discounts are attractive because they make consumers feel as though they are receiving the same benefit at a lower cost, or that there is now little reason not to buy.

There are gaps in the current approach to pricing strategies

While this framework is useful in many ways, there are key challenges with it: consumers don't always behave as this framework would predict. People's pricing decisions are affected by many emotional, environmental, and contextual influences. We also see consistently that frequent discounting can:

1. Reduce perceived product quality
2. Reduce loyalty because consumers are either permanently anchored to lower prices, or feel uncertain about when to buy because the prices frequently fluctuate
3. Ultimately, hurt brand image

So, although a discounting strategy may seem like the best choice to drive spikes in sales in the short term, the total efficacy of that strategy over time may be lower than expected.

Although many of the typical assumptions on how to price capture an essential part of reality, we are nevertheless still ignoring many other important psychological value-building factors. Indeed, a substantial body of research in the psychology of pricing has demonstrated that there is more to the story, and that relying exclusively on very basic assumptions (such as the ones we list above) provide a limited perspective on pricing.

A different way to think about pricing

The reality is that people do not live in a world where they have complete information about all product features, their alternatives, or tradeoffs between options. In most cases, consumers make decisions with incomplete information and are therefore influenced by other psychological factors.

What we need to acknowledge is that **context matters.** There are contextual factors that influence how consumers perceive value and decide how much they are willing to pay for your products. These factors might include aspects such as the physical environment, packaging & presentation, competitive positioning, effort & fairness, etc.

Context matters: the behavioral science perspective helps you take a more holistic approach to pricing

The initial steps to applying behavioural science to pricing initiatives starts with identifying the patterns of consumer behaviour that are influenced by social and contextual features, rather than just standard economic incentives.

In our work with companies such as Proctor & Gamble and Contact Energy, we have found a set of key behavioral patterns need to be factored into pricing strategies. To give you a taste, here is a sample of the factors we need to consider:

1. People see value in relative terms, not absolute terms
2. Willingness to pay depends on perceptions of trust and fairness
3. People find the act of paying to be painful

People see value in relative terms, not absolute terms

People tend to have a hard time evaluating anything in absolute terms because we simply do not have an internal value meter that tells us how much things are worth. Instead, we use the context for cues to help us evaluate our options, including other products as a guide and our past experience. Think about how much you are willing to pay for a single orange. If you had no knowledge about what other similar fruit have cost, or what you have paid in the past, it would be difficult to determine how much is reasonable – is it $1, $5, or even $10?

This means that when coming up with a price, we need to understand what our customers are used to paying for similar products. This also means that if you can create a way to set your products apart from the market, customers might be more willing to pay more for them. This principle is important to keep in mind especially if you must set the price of new products that do not yet have a clear reference. Companies that introduce new products into the world are in a very powerful position to set a powerful anchor price. This is the reference point to which other similar future products will be compared.

People's willingness to pay depends on perceptions of trust and fairness

Fairness is important to our pricing strategies. This happens because people look at the whole environment to help them decide how much they should pay for something, and they are willing to pay more for products when the price feels fair.

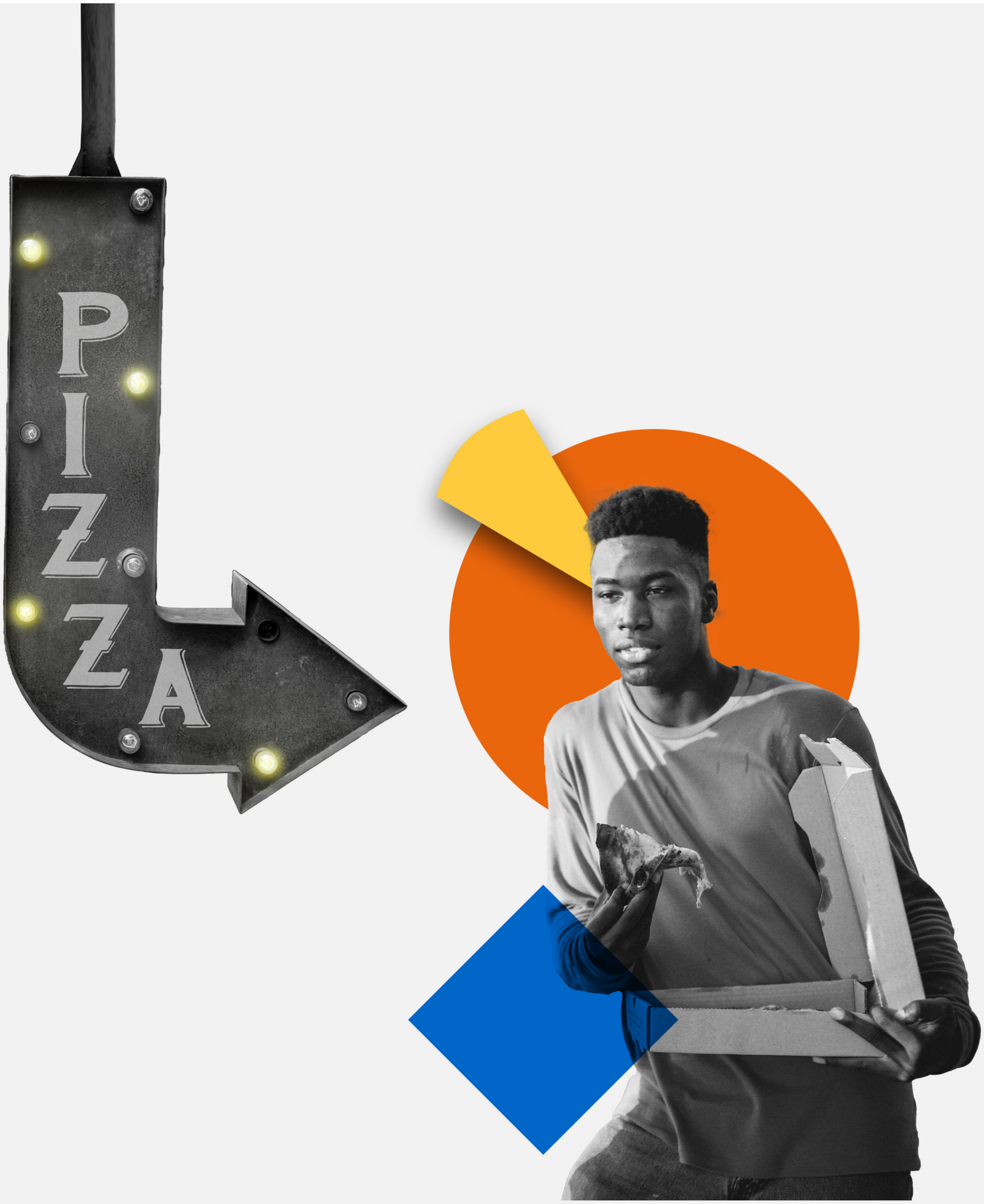
BE in Action – a case study.

We conducted a study with one of Canada's leading bookstores to understand how customer's willingness to pay might be affected by perceptions of fairness and feelings of trust. The context is that this retailer was concerned that their customers would feel betrayed when they found out the in-store books costed more than the same books online, and would therefore leave for competitors such as Amazon. This retailer approached us to help determine if this pricing discrepancy was in fact a problem for their customers, and if it was, how big the problem was.

To start, we operationalized "the problem" into four psychological domains. *Awareness:* Are consumers aware of price discrepancies? *Perception:* How do consumers perceive price discrepancies? *Evaluation:* How do consumers evaluate price discrepancies? *Action:* What is the impact of price differentials on shopping attitudes and behavior?

We tested these questions in an experiment where consumers were shown different book pricing scenarios, and were asked to answer questions that indicated their awareness of the retailer's price issue specifically, and their perceived price fairness, feelings of trust, intention to complain, and willingness to pay. We found that almost 30% of consumers were aware of the pricing discrepancy, with almost half of them feeling low perceived fairness about the pricing and low trust in the retailer. Of those who were aware and perceived low fairness and trust, almost half had the intention to complain, and about a third had low intention to purchase / return to the retailer if online prices were over 20% cheaper than in-store. This was problematic, because based on our statistical modelling we determined that this could lead to almost $60 million in lost revenue for the retailer.

To tackle this problem, we recommended that the retailer needed to first identify what is a justifiable and reasonable pricing discrepancy that customers can tolerate. Based on our data, a reasonable pricing discrepancy ranged from 1 – 15%. This means that price parity between online and retail was not entirely necessary – but that any online prices that fell outside of the 15% discrepancy range simply needed to be adjusted to a slightly higher price. To deal with any remaining effects of reduced retention, we recommended that the retailer must run experiments to test how to effectively justify to customers the 15% price discrepancy.



People find the act of paying to be painful

Imagine this scenario: A new restaurant has opened, and they serve very delicious pizza. But this new restaurant is also experimenting with a new pricing strategy: For each bite you eat, you will be charged 5 cents. How much pizza would you eat? And how much would you enjoy it? If you are like most people, probably not very much. This (thankfully fictional) pricing strategy would make paying extremely salient, and it would feel painful to us. This is why reducing the pain that customers feel when buying your products is so important to how much they value them.

BE in Action – a case study.

Our client was preparing to launch a line of baby car seats featuring safety technology that had the potential to revolutionize the car seat market. To solve the challenge of capturing the attention of expecting parents who have no shortage of car seat options, we designed and tested for a behaviorally-informed pricing strategy.

Based on our analysis of parents' psychological needs and the behavioral barriers they face, we generated pricing and promotion ideas that were designed to appeal to specific cognitive mechanisms, for instance:

1. **Offer a subscription based service ($190 down, and then $19 per month):** reducing customers' pain of paying
2. **Offer a free trial (100 days money-back guarantee):** appealing to the power of free, and overcoming customers' anticipated difficulties with committing to a new brand
3. **Allow customers to determine the price through crowdsourcing:** appealing to the power of social proof, and giving customers' the feeling of autonomy and sense of control

We tested the ideas in an experiment and found that indeed the subscription-based model was highly effective at alleviating the pain of paying while maximizing the perceived value of the product. When particular branding strategies, the experiment results showed unprecedented levels of consumer interest in learning more about the product (>90%), and an extremely high likelihood of purchase intention (>85%).

In sum, our approach allowed us to maximise the perceived value of the product by addressing parents' psychological needs. This case shows that the use of a behavioral approach can help young brands lay the foundation for impactful marketing strategies at launch and in the long-term.

We are merely scratching the surface

The psychological factors we covered above are merely scratching the surface. Our extensive work on the psychology of pricing has revealed many other factors, such as the role of endowment, scarcity, expectations, and value-add promotions in people's willingness to buy and therefore in the development of pricing strategies. We look forward to sharing our vast knowledge with you.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Getting started
with pricing using a behavioral approach

When faced with pricing decisions, the broad questions for businesses to consider are typically the following:

- What are the variables that need to be entered into the pricing equation?
- Of those variables, what psychological barriers are customers are facing when making purchase decisions for your product?
- How can we leverage these biases to determine the optimal prices for your product or services?

To help you add the behavioral approach to your pricing development process, here are a few questions that can get you started:

1) Are you working on an existing or new product/service?
    a) Is there already a pricing strategy? If so, what is it?
    b) What is the current public perception of your brand? Of your product/service?
2) Who is the target customer?
3) What research, if any, have you done already with the target customer to understand their perceptions of your price and/or willingness-to-pay?
    a) What methods were used?
    b) What did you find?
    c) Were there any gaps in insights with this prior research?
    d) What are some outstanding questions you have?
4) What hypotheses do you have about the psychological needs of the target customer?
    a) Why would they find your product/service desirable?
    b) What is your sense on the motivations and obstacles that the customer faces when it comes to purchasing your product/service?
5) What types of pricing strategies are feasible? Which are completely off the table? Why?

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