

How Much Does It Cost?

How do companies determine how much a bar of soap should cost? Why do Gillette razor blades cost the same everywhere, but not Big Macs? And how do you find the best price for an airline ticket? Here are some answers.

By Florian Stahl, illustrations: SANY



1. **The basics** – What is the right price for a bar of soap?

The pricing of a product or service is a crucial part of any company's competitive strategy (we'll see why in a moment). Two factors have to be taken into account when setting a price: the value consumers attach to the product and demand elasticity.

Companies that sell soap need to understand the value consumers in a given market or market segment attach to soap and its characteristics (the quality of the lather, fragrance, etc.). Demand elasticity describes how quickly consumers will

switch to another product, or buy more of the same product, if the price is raised or lowered.

Companies should not base the price of a product on production costs, although many still do – this is old-school thinking. Allowing production costs to determine price leads to prices that are considerably higher or lower than the value consumers attach to the product. If the price is too high, demand drops; if it is too low, no customers would be lost if the price were increased.

Consumers compare the prices of products that serve a similar purpose. If a

competitor is selling soap – whether in bar form, as a liquid or shower gel – that offers the consumer similar benefits at a lower price, then the price needs to be lowered.

2. **Price differentiation** – On hotel booking websites, I notice that there is often a difference between the prices I see when I'm logged in and when I'm not. Why is that?

The vendor may be trying to attract new customers (the price is lower when the user isn't logged in) or to enhance customer >

loyalty (a lower price or points are offered when the user is logged in). New customers without an account may find lower prices than repeat customers who may be able to earn points or miles when booking a room. Without a loyalty program, there is no incentive for customers to identify themselves by logging in, and vendors have no way of differentiating their prices for new and established customers. Airlines have offered a variety of prices for many years, and providers of consumer goods like Pepsi and Coca-Cola have begun to do so as well. German supermarkets are now able to target certain customers, and it is probably only a matter of time before Coop and Migros will be able to use Supercard or Cumulus to identify customers who have purchased Coke during the past few weeks but are now buying Pepsi if it is discounted.

3. **Purchasing power** – Why is the price of Gillette razor blades almost identical all over the world, but the same is not true for Big Macs?

The basic goal is to adjust the price of a product to the prevailing demand and purchasing power in a given country. Price elasticity measures the degree to which demand changes relative to a change in price. It is also affected by the value attached to that product by consumers, the type of product and the brand in a given country. Since purchasing power – the income that is available for consumption – differs from one country to another, prices need to be adjusted accordingly. As a result, many products cost more in Switzerland than in Germany. Owing to differences in price elasticity and purchasing power, the price of a Big Mac differs all over the world. Gillette blades, on the other hand, cost the same everywhere because unlike Big Macs they are not perishable, they can be stored for an extended period of time and they are easy to transport. If they were sold at different prices, this would lead to arbitrage. Dealers would take advantage of price differences by purchasing blades at a low price and then selling them elsewhere for less than the normal price, while still making a profit.

4. **Prices on the internet** – Google, Facebook and other online companies offer users their services free of charge. Why?

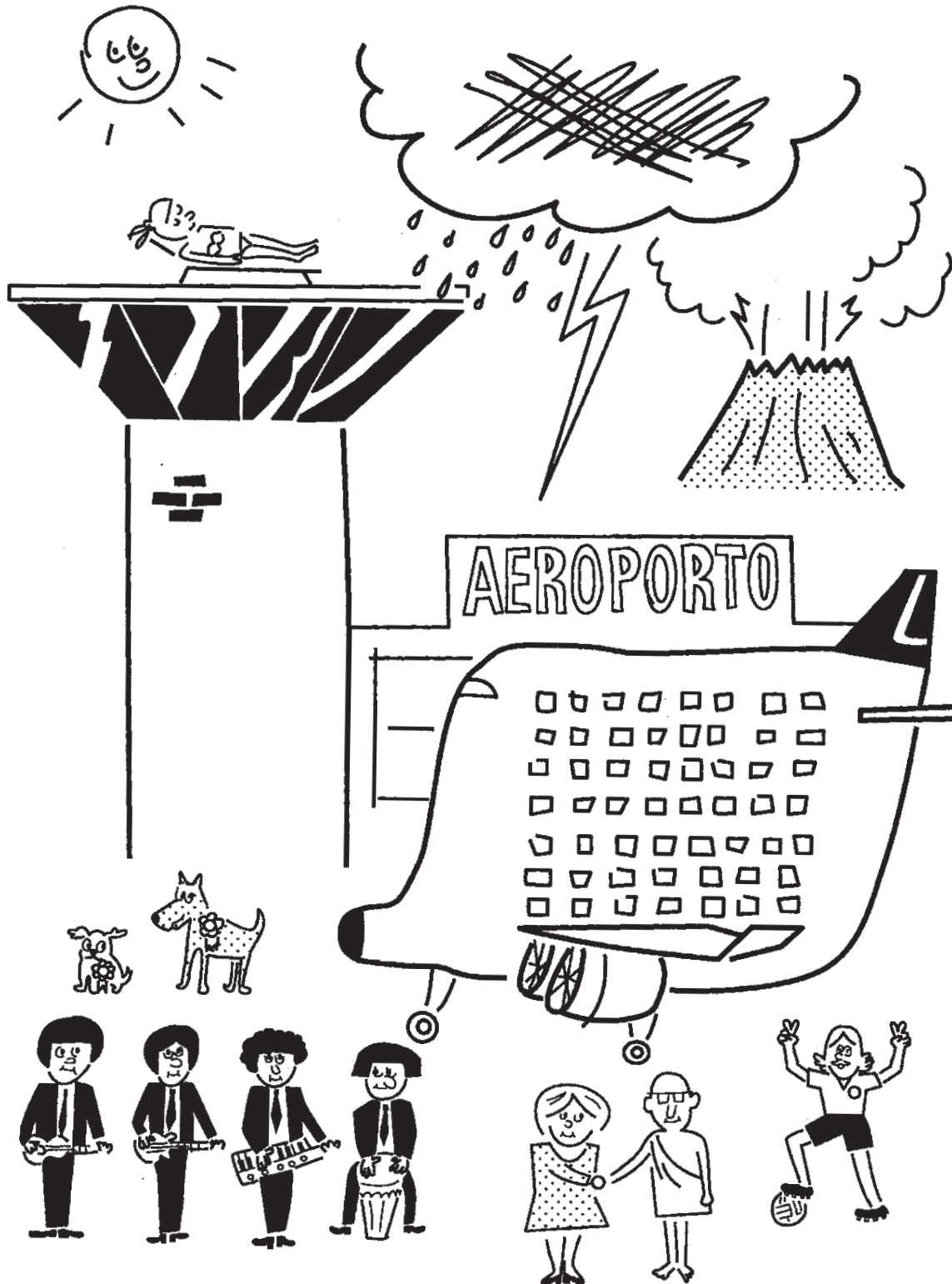
First of all, the services provided by Facebook and Google are subject to what are known as network effects. In a network, the benefit of a service increases with each additional user. This applies particularly to internet platforms, but also to software, apps and credit cards. Only when the price drops to zero is the provider able to attract millions of users, which is what ultimately makes the service truly valuable to the individual. In addition, companies like Face-

book and Google can sell advertising space to commercial customers interested in reaching millions of users of their services. These markets bring two groups of customers together: the users of the digital service and advertisers, and demand from one side affects the other. But only one group pays for the service.

5. **Dynamic pricing** – When will I pay the lowest price for a plane ticket?

Airlines are constantly adjusting their prices, from one second to the next, based on a variety of factors. Those include demand, the number of seats available on a





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specific flight, the competitors on a given route, the day of the week, holidays and events such as trade fairs in the departure or destination city. Even the weather forecast makes a difference. In my experience, you can often find the lowest price by comparing several airlines, including a stopover and booking roughly two months in advance. For example, it is cheaper to fly from Zurich to New York by way of London, Paris or Madrid.

6. *Second-hand products* – Why does the value of a new car drop by 30 percent after a year, although cars are durable goods?

A car's value drops sharply because the buyer has no information about how the car was treated by its original owner. It may have suffered considerable wear and tear; the buyer has no way of knowing. If the car is sold with a dealer warranty, the price

doesn't drop as much. Technological progress plays a role as well. Automobile companies are constantly updating their vehicles and making technological improvements, for example in their computer systems. Thus a car's technological features are no longer state-of-the-art even after just a year. Since the prices of new cars increase only slightly, or in some cases not at all, the value of a used car declines significantly over time. >

7. *The share economy* – Cars, bicycles, apartments: People share everything. What effect does that have on price consciousness?

The share economy is causing a fundamental change in the value consumers attach to products like cars, bicycles or apartments. Ownership of such products is often associated with a certain status, but that is of little relevance when goods are shared. Shared products are useful only in terms of their function, so people value them less highly and are not willing to pay nearly as much.

8. *The free economy* – Music, movies, newspapers: Some contend that we have grown accustomed to a free economy. Is that true? Aren't we willing to pay for value?

Consumers are basically willing to pay for goods and services, based on the value they attach to them. This also holds true for music, movies and newspapers. In the case of newspapers, however, which for 20 years have provided news online to consumers at no charge, the reference price – the price a

consumer or buyer is willing to pay for a certain product, based on a comparison with competing products – has dropped to zero. It is a difficult challenge to change the reference price and begin charging money for products like online news, and this requires a great deal of time and patience on the part of news providers. The New York Times has shown that this is possible; it now charges up to 18 dollars per month for access to its website.

9. *The history of prices* – A telephone call from Germany to the United States costs about 3,000 times less today than 80 years ago, but the price of eggs has remained roughly the same, after adjusting for inflation. How is this possible?

The sharp drop in the cost of telephone calls is due primarily to technological advances and competition. Opening up the telecommunications market to competition has been a significant factor in the decrease in prices. Today this sector is a commodity service in which consumers can easily compare providers, and it is also very difficult for providers to set themselves apart from their competitors. In contrast, little has changed in the technology of egg production and in competition in this area, so the price of eggs is always linked to purchasing power. However, eggs used in the production of foods such as pasta are cheaper than they were 80 years ago.

10. *Flat-rate pricing* – Why is flat-rate pricing feasible for telephone services, music streaming and internet access, but not for toilet paper? Or air travel?

It may indeed be possible in other areas as well! The online retailer Amazon offers a service called “Subscribe & Save” for customers who purchase products on a regular basis. Certain goods, such as personal care products like toilet paper, diapers, creams



How the Internet Is Changing Retail

The trend toward online shopping is reducing employment and price growth, while increasing IT spending in the retail industry.

By Patricia Feubli

and shower gels, as well as groceries and household items, can be delivered regularly and at an interval determined by the customer, and with a discount of five percent. Such services are becoming increasingly popular in the United States and Europe, and they bear some resemblance to the contractual arrangements associated with flat-rate pricing. In the air travel sector, flat rates make little sense for the airlines, since price elasticity and customers' willingness to pay would fluctuate a great deal over time. It is therefore in the interest of the airlines to sell tickets on an individual basis. □

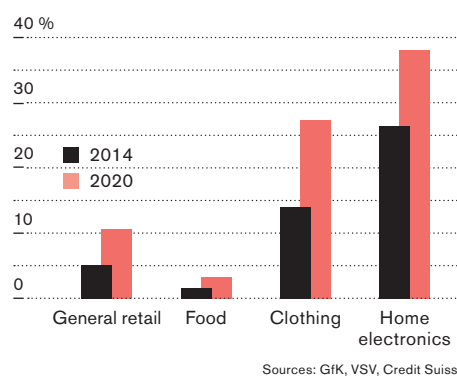
Let's look at this scenario: Mr. and Mrs. Smith want to buy some clothes. They log on to a retailer's website and click on "coats and jackets." They are immediately shown recommendations based on their previous purchases. They discuss their choices with friends on social media, decide on a product, and a drone immediately flies their purchases to their home. If the coat doesn't fit, the drone takes it right back to the "store."

This scenario may still be a bit far-fetched. But according to Credit Suisse's Industry Research team, it's hard to imagine the Swiss retail landscape without e-commerce, even though retailers only generated around 5 percent of their overall revenue online in 2013. In the home electronics segment, for example, e-commerce accounted for one out of every four francs earned in 2013. It's easier to compare devices like cameras online. Consumers rarely need to try them out in-store anymore. Online shopping is also very popular for clothing and shoes. In 2013, the clothing segment generated one-eighth of its revenue online. Greater product selection and the ability to try things on in the comfort of one's own home contribute to the popularity of online clothes-shopping.

Online shopping's share of total retail revenue has grown dramatically in recent years. The trend is reshaping the structure of the retail industry. On the one hand, employment growth is slowing. Online retailers have few, if any, brick-and-mortar locations and therefore tend to need less manpower. In 2013, Switzerland's traditional consumer electronics retailers Media Markt and Interdiscount employed 40 to 140 percent more people per CHF 1 million in revenue than the online retailer Digitec, which has only a few points of sale.

The growth of online shopping is also putting pressure on prices. Companies that

Forecasts: The Growth of Online Retail
Share of total revenue generated through online shopping



sell exclusively online do not have the overhead costs associated with a brick-and-mortar operation: rent for retail space, furnishings and fixtures, and sales staff. That gives them more flexibility in setting their prices. The spread of e-commerce is also lowering the barriers to market entry – for foreign retailers as well. Amazon.de offers Swiss shoppers the same books as books.ch, for 5 percent less, including shipping and customs duty.

As e-commerce increases its share of the retail landscape, retailers are having to spend more on their IT infrastructures. Existing systems often have to be adapted to online retailing and generally need to be expanded to accommodate the complexities of shipping and returns.

In the future, e-commerce will play an increasing role in shaping the retail industry. Our Industry Research team estimates that the share of retail revenue generated online will grow to 11 percent by 2020. □

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