Snow Shovel Surcharges: The Psychology of Fair Pricing

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INTRO

A miserable winters' morning: freezing temperatures, late for work, car snowed in. You run to the local store only to find that they have raised the price of their snow shovels from $15 to $20 overnight. Is this fair?

When Kahneman et al. posed this question in their seminal 1986 paper, 82% of survey respondents regarded the store's actions as unfair[1].

This result might surprise some people. Is it not a fundamental facet of free markets that prices will change to equate demand with fixed supply? Should opportunistic entrepreneurs not be free to raise fees to capture extra value?

But businesses must be careful: the perception of unfair price increases can impact brand image and long-term commercial success. Just ask pharma company Valeant, whose stock price plummeted 80% following large scale price increases[2]. More recently, Covid-19 has brought the topic of price fairness into public consciousness through the debate over the fair price of a vaccine.

But what is fair pricing? Why is it that we willingly accept daily price changes for some products, like airline tickets, but not others, like shovels during a snowstorm?

WHY TAKE NOTICE?

Two factors are increasing the importance of fair pricing:

1. **Economic downturn:** the current pandemic and recession has left consumers and employers across the world feeling the pinch
2. **Dynamic Pricing:** the increasing adoption of pricing methods that deliver real-time prices changes (think how the cost of an Uber varies by demand and time of day)

The recent backlash to Amazon's hand sanitiser price hikes at the beginning of the Covid-19 pandemic demonstrates how reactions to unfair pricing actions intensify during difficult macroeconomic circumstances[3]. Such instances of unfair pricing will now grow as dynamic pricing percolates into new sectors.

Implemented well, dynamic pricing, can effectively manage demand and supply and expand profits by 25%[4]. But when implemented carelessly, managing the fallout of unfair price changes can be a PR nightmare. For example, Uber's dynamic pricing algorithms quadrupled taxi fares during the 2014 terrorist siege in central Sydney[5]. The resulting outcry and accusations of price gouging has even led to new competitors, such as Kabbee[6], entering the market on the promise of no surge pricing.

Without fair pricing practises, businesses could face anger, reputational damage, and even legal action – especially in the backdrop of a crisis (be it a snowstorm or a pandemic).

THE PSYCHOLOGY BEHIND THE UNFAIRNESS

It is crucial to understand the psychology of price fairness in order to harness dynamic pricing successfully. In most cases, feelings of unfairness stem from a blend of 'loss aversion', 'dual-entitlement'[7] and 'comparability'[8]:

Loss Aversion

Feeling losses more painfully than gains of equal magnitude

Consider arriving at the store to buy your snow shovel on that cold, winter morning. You remember when you passed the store earlier that week, a snow shovel cost $15. Having been mentally benchmarked at this initial price, purchasing at $20 now feels like an unfair loss.

Dual Entitlement

The belief that customers are entitled to reference prices, but companies are also entitled to their reference profits

The store's new, higher snow shovel price would seem fairer if you had recently heard that the nearest snow shovel factory had shut down, causing shovel costs to rise. Price increases that follow cost increases are more justifiable: stores are entitled to their reference (previous) profits. However, if a store's costs and margins remain unchanged, customers generally tend to feel entitled to the previous price.

Comparability

The similarity and salience of other comparable transactions

Imagine you arrive home with your over-priced shovel and chat to your neighbour who is also shovelling snow from their driveway. During the conversation, they mention that they purchased the same shovel two days ago for $15. This would compound the feeling of unfairness. The high comparability between your purchase and theirs only exacerbates the injustice of the price increase.

So how can businesses account for the psychology of fairness in their pricing?

PRICE CHANGE FAIRNESS CHECKLIST

We have developed four simple guidelines to assess the appropriateness of price increases and to implement dynamic pricing fairly:

1. **Price Awareness**

Awareness of a (lower) reference price is central to the loss aversion mechanic. If store customers were unaware of the snow shovel's lower previous price, they would not experience the same feeling of unfairness. In practice, price awareness varies across products and services and is usually correlated with purchase frequency, share of wallet and price transparency. For instance, while most people have an accurate gauge on the price of a pint of milk, the exact reference price of an Uber across London is less well known. Products, such as Uber rides, with a lower price awareness are therefore safer candidates for varying prices.

2. Comparability

To gauge the fairness of price changes, companies should also assess the ease with which a customer can compare their purchase to others. Paying more for a Ryanair flight than another customer on the plane is much less comparable than being charged more for an in-flight snack than the person next to you. Companies should therefore endeavour to maintain consistent prices across highly comparable transactions to ensure fairness.

3. Market & Context

Contextual factors like market norms, competition, product characteristics, the size of the price change and recent events also impact fairness perceptions. Customers accept dynamic price changes as the norm in sectors like hospitality & travel. However, contexts where either the seller has significant market power, there are limited alternatives, or the product is a necessity are viewed as less acceptable arenas in which to capture value through price increases. Moreover, feelings of unfairness are strongest during crises, such as sellers on Amazon increasing hand sanitiser prices during the pandemic.

4. Justification

Finally, Kahneman et al. show that dual entitlement can justify price increases from cost increases. As such, when price increases are noticeable, effectively communicating justifications can improve fairness perceptions. Companies in the energy sector already deploy this technique well by outlining and explaining costs changes on customer bills when tariffs go up[9]. The emerging debate over Covid-19 vaccine prices already features arguments around profit entitlement and cost justifications to ensure fair prices to customers and fair reward to vaccine developers[10].

CONCLUSION

The worry is that unchecked price algorithms or blinkered pricing managers might enact unfair price increases. The importance of ensuring fair price actions has never been greater as purse strings tighten during economic downturns and we leave more decisions to algorithms, which may not account for price awareness, comparability, context or justification. Equipping your business with this checklist, you can embed fair and robust pricing principles and foster improved long-term commercial performance.

ABOUT PEARSON HAM

Pearson Ham is an award-winning pricing consultancy based in London.

We offer tailored pricing solutions that optimise profits, revenues and market performance.

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