

Price Walls and Demand Curves in Pricing Strategies

by: Per Sjöfors

In this article, the author explains the concept of price walls – psychological price points where small price changes generate significant changes in sales volume and revenue – and why they – as well as understanding what an actual demand curve looks like for a specific product or product, family, or service – are critical components for developing a successful pricing strategy. Per Sjöfors is the founder of Sjöfors & Partners, a pricing strategy consultant with more than 30 years of pricing experience, and a USA Today, Amazon, & Barnes and Noble best-selling author. He can be reached at contact@sjofors.com.

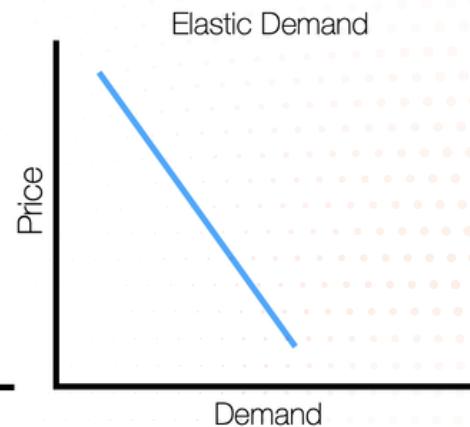
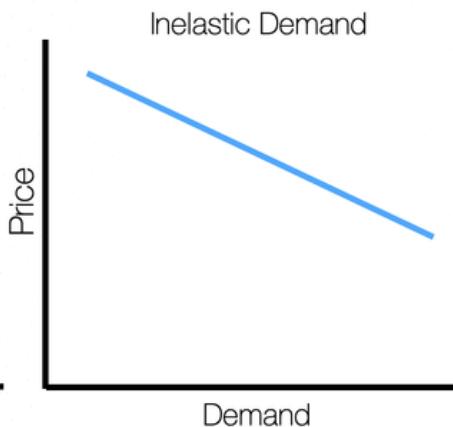
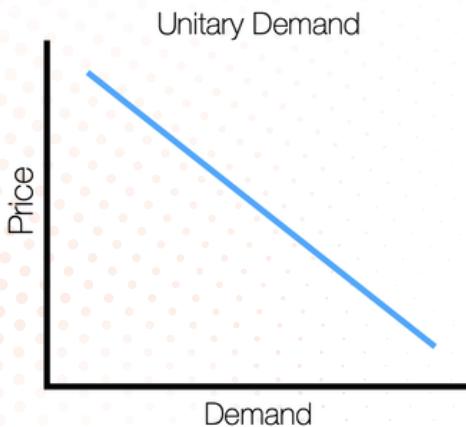


The topic of this article is price walls - an important issue when defining your pricing strategy. Price walls are psychological price points where small price changes generate significant changes in sales volume and revenue.

A price wall can be positive, meaning that sales volume goes up significantly if the price increases and crosses a price wall. Conversely, they can be negative, meaning an increase in price causes sales volume and revenue to drop significantly.

But first, let's talk about price elasticity or elasticity of demand as it's more formally known. It is obvious to everyone that the price will affect the sales volume of a product or service—nothing earth-shattering here. But the way this is taught in business schools is an academic construct with no connection to reality. Even if you haven't been to business school, you've probably been exposed to this traditional academic elasticity of demand curves. On these, sales volume is on the x-axis, price is on the y-axis, and the actual graph is

a straight line. The angle of that straight line could be shallow, which is supposed to mean that demand is inelastic, indicating that sales volume changes relatively little depending on price changes. Or the angle can be steep, which is interpreted as the elasticity of demand is elastic, meaning that sales volume changes considerably when prices are changed. Finally, price elasticity can be unitary, which means a graph at 45 degrees. Thus, a certain percentage of price change will alter sales volume an equal amount.



These price elasticity charts have one thing in common: they have nothing to do with reality. Let's examine why they are false. These curves are developed under several assumptions about an entirely unrealistic market.

First, the curves assume that all buyers buy for the same reason. That is an assumption that will never happen. Some buyers may buy for the same reason, and some buy for other reasons, but all buyers never buy for the same reason. This is common sense, isn't it?

Further, the curves assume that all buyers are in the same circumstance. For obvious reasons, all buyers are not in the same circumstance. To illustrate this, consider the difference

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in willingness to pay, which affects price elasticity in two circumstances. Consider driving, and the gas tank is getting empty. The first circumstance is a willingness to pay for gas when on the way to the hospital with a sick child. The second circumstance is a willingness to pay for gas on the way to the in-law's house. Common sense makes it likely that demand in the first case is highly inelastic, i.e., any gas at any price will do. In the second case, there is no urgency, and the driver may look for a gas station with the lowest price or preferred brand. So, the circumstances are never the same for every single buyer.

Another assumption is that all buyers have the same access to funds or the same budgets. Common sense again tells us this never happens. In B2C business, every consumer has different access to funds. Some have more, some have less, and the same is true when selling in B2B markets. Some budgets are larger than others; some individuals have larger budgets, others do not, and so forth. So, the assumption that access to funds would be equal for all buyers is entirely false, right?

It also assumes that all products and services are equal and could be equally substituted for each other. But, again, common sense says that never happens. Moreover, even if one product is identical to another, some sellers may have added services, delivery times may be different, the brand is different, and any prior good or bad experience and relationship the buyer has had with the choices available affects how the purchase choice is made. So similarly, identical products or services are not equal.

And there are more assumptions. For example, all buyers are equally aware of all the choices

for whatever they are about to buy. But again, common sense says that this never happens. No buyer can be equally aware of every product or service in the specific category they are about to buy, and therefore can compare them, price, and so forth.

And finally, it assumes that buyers make rational decisions. And that never happens either because, as humans, we're not robots; we make irrational decisions, including purchase decisions. That has been proven again and again.

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So, these assumptions here make these traditional demand curves invalid, yet there are people out there touting them.

Another thing that these traditional demand curves erroneously say is that price elasticity is the same at all price intervals, and that's not true either. In some price intervals, it may be inelastic, while in others, it may be elastic.

So, if you have ever thought about these traditional demand curves, please unlearn them.

Instead, let's talk about real demand curves. The first is to consider the price on the X-axis instead of the Y-axis, as done

traditionally. And then, instead, sales volume on the Y-axis. It simply makes a lot more sense.

Let's look at a low price, and we can see that the sales volume is also low. As we consider higher prices, a sort of skewed standard distribution curve follows. As higher prices are considered, sales volume will also increase up to a point. Sales volume is low at low prices because of expectation bias. This means the price sets an expectation of the benefit and quality of what the buyer is about to buy. Please think about it - we've all been there, we hold something in our hands, and we say to ourselves, I kind of want to buy this, but this is so cheap that I don't think it will be good. I think that the seller is over-promising and going to under-deliver. So, I'm not going to buy it.

As prices increase, sales volume increases from that starting point until the curve reaches a crest. With higher prices, a more significant portion of potential buyers equates the higher price with adequate quality. Hence the increase in sales volume as price increases until the curve reaches a crest. Once the price crosses the crest, sales volume will go down because (not earth-shatteringly) as prices increase, more buyers will think the price makes the product or service too expensive. And for them, it doesn't matter how good it is or the level of benefits; it's still too expensive.

This means that the crest of the curve, where the sales volume will reach its maximum, is the price where the maximum number of potential buyers say that the price sends a message of adequate quality and the maximum number of potential buyers say the price

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makes the product or service affordable.

Imagine that demand curve now. The general shape of the curve is not a straight line but somewhat resembles a standard distribution curve.

But there is more. The curve is not smooth, like the standard distribution curve is, but stair-stepped. This means there are price intervals where price does not affect sales volume. Likewise, increasing or decreasing prices does not affect sales volume. But there are other price intervals where price changes lead to a dramatic shift in sales volume—a Price Wall.

A Price Wall to the left of the curve's crest is called a positive Price Wall, as crossing it will lead to higher sales volume, whereas a Price Wall to the right of the crest is a negative Price Wall, as crossing it will lead to lower sales volume. A Price Wall typically affects sales volume by 15% - 25%, but there are occasions when a company may lose or gain half its business by crossing a Price Wall.

Here is an example: I spent some time with one of the VPs at one of the major computer makers just

before the pandemic. He told me they had done some price testing. They took one computer model and started to increase the price one dollar at a time while carefully looking at the growth rate of sales volume. They could increase the price by seventeen dollars and not affect sales volume. So, they just happened to have set the price on one of these price plateaus where nothing happens when prices change. But then when they went up eighteen, sales just fell through the floor. They had just found one of those Price Walls by trial and error. It also means they had been leaving seventeen dollars on the table because they could increase their price by seventeen dollars without affecting sales volume, which makes a difference when selling 10,000 units of this computer daily. And it's a very low-margin product.

I've also experienced clients for whom we recommend an increase in price as their current price is on that portion of the demand curve where increased prices lead to higher sales volume. I've talked to many individuals running companies, saying, "We doubled our prices, and our sales volume doubled as well." They were so underpriced because they

believed those traditional demand curves saying that maximum sales volume happens at the lowest possible price.

So, let me summarize: traditional elasticity of demand curves has nothing to do with reality. And instead, consider that an actual demand curve starts at a low price and moves upwards until it hits a crest. The price where the crest is will lead to the highest sales volume. The crest is at the price where the maximum number of potential buyers think the price is high enough to send a message of adequate quality. And the minimum number of potential buyers think the price is so expensive they can't afford it. So, sales volume will decrease at higher prices above the price of the crest. It's a stair-step. These steps can sometimes be very significant.

It is crucial for anybody considering their pricing strategy to understand what an actual demand curve looks like for a specific product or product, family, or service. If not, the price will end up just on the "wrong" side of a Price Wall, leaving what could be significant money on the table. And you don't want to do that.