

Chapter 3

Willingness-to-Pay (WTP) in Marketing

“Pricing decisions can be complex and difficult, but they are some of the most important marketing decision variables a manager faces” (Monroe and Cox, 2001).

In designing a pricing strategy, the basis is to set the prices for the goods in view of how much the customers are willing to pay for each of the goods. It is important for the marketer to predict how many of the offered products will be bought at different prices. To predict the demand for different products at different prices the marketer needs a profound understanding of the reaction of his or her customers to different pricing schedules.

There are two distinct concepts that determine how much a customer is willing to pay for goods or services. These are the *maximum price* and the *reservation price*. Both will be introduced and discussed in this chapter. In addition to discussing how consumers make choices for or against goods offered at different prices, it will be illustrated how this behavior differs depending on which concept (maximum price or reservation price) the consumer applies internally.

The main argument is that often a marketer cannot distinguish between the two concepts. Therefore, the subsuming term *willingness-to-pay* (WTP) is used by practitioners as well as by researchers.

Also, it will be rationalized in this chapter that it is reasonable not to distinguish between the maximum price and the reservation price if a pricing strategy is designed. The reason is that regardless of the underlying concept the consumer reaction has the same behavior.

3.1 Maximum Price

The first concept introduced is the maximum price. Following Nagle and Holden (2002, chap. 4) we define it as follows:

Definition 1 *Maximum Price*

The maximum price (p_{max}) of a product is formed by a consumer as the perceived reference price of the reference product plus the differentiation value between the reference product and the product of interest.

Formally the maximum price for a product can be expressed as

$$p_{max} = p_{ref} + p_{diff}.$$

The maximum price is denoted by p_{max} , the reference value is p_{ref} , and p_{diff} is the differentiation value.

The *reference value* for one unit of a product is the cost of the competing product that the customer views as the best alternative. The *differentiation value* is the value of any differences between the product of interest and the reference product.

It will be illustrated how the maximum price works by example: Suppose a hot summer day at the beach.¹ The value of a cool drink is extremely high for most people - perhaps as high as 10,- € for a bottle of cold water. Economists refer to this value as *use value*, or the *utility* gained from a product. If a vendor walked the beach trying to sell water at 10,- €, the people would probably not be willing to pay what the product is really worth to them. They might assume or even know that a competing seller would give them a better deal. A competing seller could be a supermarket which is located just across the street from the beach. Of course a thirsty person had to walk over to the supermarket, but there he or she could probably buy a bottle of water at the price of 2,- €.

In order to set a good price the knowledge of the utility of a product only helps a marketer in rare occasions. Knowing what economists call *exchange value* and what marketers call *economic value to the customer* is more helpful. This value is determined mainly by what alternatives are available for the customer. In the above example people might be willing to pay 4,- € for a bottle of water from a vendor at the beach, rather than walking to a supermarket across the street. Looking closely at the example, by offering the product "at the beach", the vendor is offering a differentiated product compared to the same product at the supermarket. The differentiated product is worth more to the people who are lying on the beach.

Customer behavior based on economic value can be summarized as follows:

A products 'economic value,' then, is *the price of the customer's best alternative (called the reference value) plus the value of whatever differentiates the*

¹Example adapted from Nagle and Holden (2002, p. 74).