TWO

What Supermarkets Don't Want You to Know

Those of you who have visited London recently have probably been to the London Eye, the capital's landmark Ferris wheel. On a sunny day you can purchase a cappuccino from Costa Coffee and sit and sip as the capsules on the wheel rotate high above, occasionally passing between you and the sun . . . one of life's simple pleasures.

Everywhere you look around the Eye you can see vendors with scarce resources, trying to exploit that scarcity. Costa Coffee is the only coffee bar in the immediate area, for instance. There is also a lone souvenir shop doing brisk business. But the most obvious example is the London Eye itself. It towers over most of London's most famous buildings and is the world's largest observation wheel. The scarcity power is clearly considerable, but it is not unlimited: the London Eye may be unique, but it is also optional. People can always choose not to go. Farther along the river, the Millennium Dome (a colossal government-funded white elephant designed for millennial celebrations) is similarly unique: "the largest fabric structure in the world," boasts the local authority. Yet the Dome has proved a commercial disaster because uniqueness alone wasn't enough to persuade people to pay enough to cover the vast costs of its construction. Businesses with scarcity power cannot force us to pay unlimited prices for their products, but they can choose from a variety of strategies to make us pay more. It's time for the Undercover Economist to get to work and find out more.

As the only coffee provider beside the London Eye, the Costa coffee bar wields plenty of scarcity power over the customer. It's not innate to Costa but is reflected glory from the amazing setting. As we know, because customers will pay high prices for coffee in attractive locations, Costa's rent will be high. Costa's landlords have rented out some of this scarcity value to a coffee bar, just like the owners of Manhattan's skyscrapers, or train stations from Waterloo to Shinjuku. Scarcity is for rent—at the right price.

But how should Costa exploit the scarcity they are renting from the London Eye? They could simply raise the price of a cappuccino from £1.75 (about $3) to £3 (nearly $6). Some people would pay it, but many would not. Remember the Millennium Dome: scarcity gives you power, but not limitless power. Alternatively, they could cut prices and sell much more coffee. They could cover wages and ingredients by charging as little as 60 pence ($1) a cup. But unless they were able to increase their sales dozens of times over, they'd not make enough to cover their rent. That's the dilemma: higher margins per cup, but fewer cups; or lower margins on more cups.

It would be nice for Costa to sidestep that dilemma, by charging 60p to people who are not willing to pay more and £3 to people who are willing to pay a lot to enjoy the coffee and the view. That way they would have the high margins whenever they could get them and still sell coffee at a small profit to the skinflints. How to do it, though? Have a price list saying, "Cappuccino, £3, unless you're only willing to pay 60p"?

Cappuccino for the lavish	£3.00
Cappuccino for the thrifty	60p

It does have a certain something, but I doubt it would catch on with the coffee-buying public of London's South Bank. So Costa has to be more subtle.

For a while, Costa hit upon an elegant strategy: Costa, like most other coffee bars these days, offers "Fair Trade" coffee; theirs comes from a leading fair trade brand called Cafédirect. Cafédirect promises to offer good prices to coffee farmers in poor countries. For several years, customers who wished to support third-world farmers—and such customers are apparently not uncommon in London—were charged an extra ten pence (about eighteen cents). They may have believed that the ten pence went to the struggling coffee farmer. The evidence suggested that almost none of that money went anywhere but Costa's bottom line.

Cafédirect paid farmers a premium of between 40 and 55 pence (up to a dollar) per pound of coffee. That relatively small premium can nearly double the income of a farmer in Guatemala, where the average income is less than $2,000 a year. But since the typical cappuccino is made with a quarter-ounce of coffee beans, the premium paid to the farmer should translate into a cost increase of less than a penny a cup.

Of the extra money that Costa charged, more than 90 percent was going missing between the customer and the farmer. So either Costa and Cafédirect were wasting the money (through higher costs) or it was being added to profits. Fair trade coffee associations make a promise to the producer, not the consumer. If you buy fair trade coffee, you are guaranteed that the producer will receive a good price. But there is no guarantee that *you* will receive a good price. The truth is that fair trade coffee wholesalers could pay two, three, or sometimes four times the market price for coffee in the developing world without adding anything noticeable to the production cost of a cappuccino, because coffee beans make up such a small proportion of that cost. Charging an extra ten pence gave a misleading impression of how much it really cost to get hold of that fair trade coffee. After some inquiries by a certain Undercover Economist, Costa worked out that the whole business gave the wrong impression, and at the end of 2004 began to offer fair trade coffee on request, *without* a price premium. Costa abandoned the premium of fair trade coffee because it was bad public relations, not because it was unprofitable.

But *why* was it profitable to charge a higher markup on the cost of production on fair trade coffee than on normal coffee? Certainly not because Costa objected to the whole idea of fair trade and tried to discourage such idealistic behavior with their pricing. The reason has nothing to do with fair trade at all: it's because fair trade coffee allowed Costa to find customers who are willing to pay a bit more if given a reason to do so. By ordering a fair trade cappuccino, you sent two messages to Costa. One message interested them very little:

"I think that fair trade coffee is a product that should be supported."

The second message is the one that they were straining to hear: "I don't really mind paying a bit extra."

This immediately gave Costa the information they were looking for. They know that socially concerned citizens tend to be less careful with their cash in coffee bars, while unconcerned citizens tend to keep their eyes on the price.

Cappuccino for the concerned	£1.85
Cappuccino for the unconcerned	£1.75

Costa's strategy was designed to get maximum value out of the scarcity power they've rented from the London Eye. They are torn between raising prices and losing customers, or lowering prices and losing margins. If they have to charge the same price to every customer, they will simply have to guess the best trade-off between the two options. But if they can charge a high price to the lavish (or concerned) and a low price to the thrifty (or unconcerned), then they can enjoy the best of both worlds. And there is no need to worry on Costa's behalf that this strategy has now been denied to them. Costa has plenty of alternative ways to identify customers for a price increase. Nor is there anything unusually Machiavellian about Costa Coffee. Any well-run business would seek to charge each customer the maximum price he'd be willing to pay—and they do.

Take a Starbucks, any Starbucks. For the sake of argument, take the Starbucks on P Street and 14th in Washington DC. The price list looks like this:

Hot Chocolate	$2.20
Cappuccino	$2.55
Caffé Mocha	$2.75
White Chocolate Mocha	$3.20
20 oz Cappuccino	$3.40

Or, to translate:

Hot Chocolate—no frills	$2.20
Cappuccino—no frills	$2.55
Mix them together—I feel special	$2.75
Use different powder—I feel very special	$3.20
Make it huge—I feel greedy	$3.40

Starbucks isn't merely seeking to offer a variety of alternatives to customers. It's also trying to give the customer every opportunity to signal that they've not been looking at the price. It doesn't cost much more to make a larger cup, to use a flavored syrup, or to add chocolate powder or a squirt of whipped cream. Every single product on the menu above costs Starbucks almost the same to produce, down to the odd nickel or two.

Does this mean that Starbucks is overcharging all of its customers? No. If so, a regular cappuccino or hot chocolate would cost $3.30, and you could have all the frills you wanted for a dime. Perhaps Starbucks would like to do that, but they can't force price-sensitive customers to pay those prices. By charging wildly different prices for products that have largely the same cost, Starbucks is able to smoke out customers who are less sensitive about the price. Starbucks doesn't have a way to identify lavish customers perfectly, so it invites them to hang themselves with a choice of luxurious ropes.

The third way:
Turkeys voting for Thanksgiving

The cleverest and most common way to persuade turkeys to vote for Thanksgiving is the "self-incrimination" strategy—the one Costa Coffee and Starbucks both use when they persuade some of their customers into confessing that they are not sensitive to price. To get customers to give themselves away, the company has to sell products that are at least slightly different from each other. So they offer products in different quantities (a large cappuccino instead of a small one, or an offer of three for the price of two), or with different features (with whipped cream, or white chocolate, or fair trade ingredients), or even in different locations, because a sandwich in a station kiosk is not the same product as a physically identical sandwich in an out-of-town superstore.

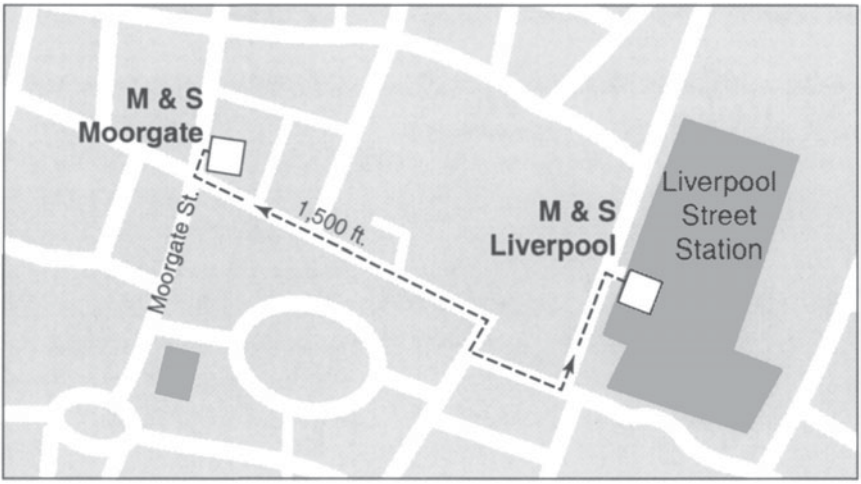
It's reasonable to ask how common this tactic really is. Because the products are different, you never quite know whether the firm is using a price-targeting trick or merely passing on added costs. It could be that it really does cost 10p (about 20¢) more to put fair trade coffee in a cappuccino; maybe cans of whipped cream are expensive to refrigerate and troublesome to clean and the staff hates using them; perhaps large cups of coffee take longer to drink, and so the charge is for table space not coffee—in which case, charging a higher price is not a strategy to get me to incriminate myself but simply Costa passing its costs through to me. But I think it's safe to say that companies are always alert for ways to squeeze the maximum advantage out of whatever scarcity power they have, and price-targeting is the most common way to do that. If it looks like price-targeting, it probably is.

Although use of this strategy is hard to prove, there's plenty of circumstantial evidence around if you know where to look. For instance, the premium you pay for a large cappuccino instead of a small one is the same whether you drink it in the café or take it away. (Except for my favorite coffee shop, the Monmouth in Covent Garden, in London. They are short of space, and will charge a markup for a large cappuccino if you drink it in the shop. However, they charge less for take-out coffee, and it comes in only one size. I have decided they are far too nice to try to make profits.) That doesn't make sense if it's a charge for taking up space. So we have good reasons to believe that coffee bars try for a "self-targeting" strategy, charging high prices to customers who demonstrate a willingness to pay them.

Coffee bars are not alone

Supermarkets have turned price-targeting into an art, developing a vast array of strategies toward that end. Above the main concourse of London's Liverpool Street station, there's a Marks and Spencer "Simply Food" store, catering to busy commuters on the way in and out of London. We know all about the scarcity value of train stations by now, so perhaps it shouldn't surprise us to find that this store isn't cheap, even compared with another branch of

How far would you walk to save 30p?



About 1,500 feet (500 m) is all that separates two Marks and Spencer stores with somewhat different pricing policies. But for most city dwellers it's just not worth the walk.

Marks and Spencer merely fifteen hundred feet or so away, on Moorgate.

I picked up five products at random in the Liverpool Street store and managed to locate four of them in the Moorgate store. Every single one was about 15 percent cheaper there. Big salads were down from £3.50 to £3.00 ($6.60 to $5.65), sandwiches from £2.20 to £1.90 ($4.15 to $3.55). But even when such discrepancies come to light, few city workers would be willing to stray those several blocks to save thirty pence, about half a dollar. A bold and effective piece of price-targeting.

Other supermarkets are more circumspect about their pricing policy. Going undercover once again, I made a comparison between the smallish Sainsbury's supermarket on Tottenham Court Road in the heart of London's West End, and the large store in Dalston, one of East London's less prosperous neighborhoods. It was harder to find examples of identical products selling for different prices, although by no means impossible. Does this mean that Sainsbury's doesn't price-target as much as M&S? Not at all. They simply go about the whole process with more finesse.

When researching Sainsbury's, my approach was the same as with M&S: walk into the shop and see what caught my eye. As you probably know, what catches our eyes as we walk into the supermarket is no coincidence; it's the result of careful planning designed to throw attractive but profitable products in the path of customers. What constitutes an attractive product depends on who those customers are. On Tottenham Court Road the obvious goods were all quite expensive: Tropicana orange juice at £1.95 ($3.66) a liter, Tropicana "Smoothies" at £1.99 ($3.50) for 100ml, 750ml of Vittel mineral water at 80p ($1.50), and so on. It wasn't that these products were more expensive in Tottenham Court Road than in Dalston (only the Vittel was), it was just that in Dalston, cheaper substitutes sprang into view far more readily.

For instance, I couldn't find inexpensive orange juice in the Tottenham Court Road store, but in Dalston, Sainsbury's own brand of fresh chilled juice was sitting next to the Tropicana at about half the price, and the concentrated juice was almost six times cheaper than the Tropicana. Brand-name pasta was the same price in both shops, but only in Dalston was it sitting next to Sainsbury's pasta, which again was almost six times cheaper. The effect was to target the whole Tottenham Court Road store at shoppers who are indifferent to prices, but to aim the Dalston stores at shoppers with a sharper eye for a bargain—while of course giving any price-blind Dalston shoppers plenty of opportunity to show their true colors.

Price-gouging the natural way

The best price-targeters pair their efforts to improve profits with apparently virtuous behavior. We've seen how Costa Coffee trumpeted its commitment to fair trade while using it to identify customers with money to burn. It's also good business to offer discounts to the elderly and to students (translation: charge higher prices to people likely to have jobs). Who but a cynic—or an economist—could object to such commendable behavior?

The favored game at the moment has to be price-gouging the natural way, riding the bandwagon of organic food. Organic food is catching on for a variety of reasons, including the fact that in the wake of repeated food health scares, many people think organic food is better for them, or at least won't kill them. The supermarkets have come to the rescue with a plentiful supply of organic products that happen to be marked up far above their additional costs to the supermarket. In British supermarkets, these are often stacked together, apparently for the convenience of the organic shopper but also to the advantage of the supermarkets who thereby reduce the risk that organic shoppers will notice the price of the typical alternative. In Washington DC's Wholefoods store, just across the street from Starbucks, the vast and luxurious fruit and vegetable section contains both organic and conventionally grown produce side by side . . . but always side by side with a completely different product. The organic bananas are next to the "conventional" (that is, nonorganic) apples; the organic garlic is next to the conventional onions. You will never find the organic bananas next to the conventional bananas, or the organic garlic next to the conventional garlic. The price-comparison would be too sobering.

But is expensive organic food really part of a price-targeting tactic? Organic food should be more expensive: it costs more to produce and, with a shorter shelf life, it is also more expensive to distribute than the standard product. But as with your cappuccino, raw ingredients are only a small part of the price of most food on the supermarket shelves. For example, in the UK, organic milk commands a premium of around fifty cents per quart, but the farmer sees less than twenty cents of this. We should not be surprised that supermarkets are taking the opportunity afforded by the organic food movement to zap customers with well-aimed price increases. My recommendation, if you are convinced of the merits of organic food, is not to let food retailers exploit your enthusiasm: vote with your wallet by supporting any retailer—or direct supplier—who brings the price of organic and nonorganic food closer together.

Mix it up!

Another very common pricing strategy is sale pricing. We're all so used to seeing a storewide sale with hundreds of items reduced in price that we don't pause and ask ourselves why on earth stores do this. When you think hard about it, it becomes quite a puzzling way of setting prices. The effect of a sale is to lower the average price a store charges. But why knock 30 percent off many of your prices twice a year, when you could knock 5 percent off year-round? Varying prices is a lot of hassle for stores because they need to change their labels and their advertising, so why does it make sense for them to go to the trouble of mixing things up?

One explanation is that sales are an effective form of self-targeting. If some customers shop around for a good deal and some customers do not, it's best for stores to have either high prices to pry cash from the loyal (or lazy) customers, or low prices to win business from the bargain hunters. Middle-of-the-road prices are no good: not high enough to exploit loyal customers, not low enough to attract the bargain-hunters. But that's not the end of the story, because if prices were stable, then surely even the most price-insensitive customers would learn where to get particular goods cheaply. So rather than stick to either high or low prices, shops jump between the two extremes.

One common situation is for two supermarkets to be competing for the same customers. As we've discussed, it's hard for one to be systematically more expensive than the other without losing a lot of business, so they will charge similar prices on average, but both will also mix up their prices. That way, both can distinguish the bargain hunters from those in need of specific products, like people shopping to pick up ingredients for a cookbook recipe they are making for a dinner party. Bargain-hunters will pick up whatever is on sale and make something of it. The dinner-party shoppers come to the supermarket to buy specific products and will be less sensitive to prices. The price-targeting strategy only works because the supermarkets always vary the patterns of their special offers, and because it is too much trouble to go to both stores. If shoppers could reliably predict what was to be discounted, they could choose recipes ahead of time, and even choose the appropriate supermarket to pick up the ingredients wherever they're least expensive.

In fact, it is just as accurate, and more illuminating, to turn the "sale" on its head and view prices as premiums on the sale price rather than discounts on the regular price. The random pattern of sales is also a random pattern of price increases—companies find it more profitable to increase prices (above the sale price) by a larger amount on an unpredictable basis than by a small amount in a predictable way. Customers find it troublesome to avoid unpredictable price increases—and may not even notice them for lower-value goods—but easy to avoid predictable ones.

Try to spot other odd mix-ups next time you're in the supermarket. Have you noticed that supermarkets often charge ten times as much for fresh chili peppers in a package as for loose fresh chilies? That's because the typical customer buys such small quantities that he doesn't think to check whether they cost four cents or forty. Randomly tripling the price of a vegetable is a favorite trick: customers who notice the markup just buy a different vegetable that week; customers who don't have self-targeted a whopping price rise.

I once spotted a particularly inspired trick while on a search for potato chips. My favorite brand was available on the top shelf in salt and pepper flavor and on the bottom shelf, just a few feet away, in other flavors, all the same size. The top-shelf potato chips cost 25 percent more, and customers who reached for the top shelf demonstrated that they hadn't made a price-comparison between two near-identical products in near-identical locations. They were more interested in snacking.

Admittedly, for some people the difference in flavors is important. Some will notice the higher price for salt and pepper flavor and, irritated, pay anyway. Others will prefer the different flavors and count themselves lucky that they have inexpensive tastes.

But this is an example of a universal truth about supermarkets: they are full of close (or not so close) substitutes, some cheap, some expensive, and with a strong random element to the pricing. The random element is there so that only shoppers who are careful to notice, remember, and compare prices will get the best bargains. If you want to outwit the supermarkets, simple observation is your best weapon. And if you can't be bothered to do that, you really don't need to save money.

Reality check number one: Does the company really have scarcity power?

It's time for a reality check. When we talk about big companies it is easy to get carried away with notions of how they are infinitely powerful and we are infinitely gullible. Not true.

Remember that no company has power unless it has scarcity, and often that scarcity is something we give them through our own laziness. Nothing is stopping us from walking down the street or driving from one store to another; certainly nothing is stopping us from a bit of mental arithmetic when buying chilies, or from glancing around for two seconds when buying potato chips.

Every store has a tiny amount of scarcity power, if only because it's an effort to walk out and go next door. But some have more scarcity power than others, which is worth thinking about when estimating the risk of being waylaid by price-targeting strategies.

For instance, what is the answer to the question we posed in the previous chapter: why does popcorn cost so much at movie theaters? Is it for the same reason that wine is expensive in restaurants? We know that the first-glance answer in both cases is, "Because once they get you in the door they can charge whatever they want." We also know that this first answer is probably not true. Customers may be dumb, but they're not that dumb. People expect to be charged a lot for wine in restaurants and for popcorn and candy in movie theaters *before* they walk in the door.

Now we have a better answer: it's likely to be a price-targeting strategy. Moviegoers who are sensitive to price will bring their own snacks from home, or go without. People who are not sensitive to price—perhaps because they're on a date and don't want to look stingy—will simply pay for the overpriced popcorn. Very clever.

This is a much better explanation, since in many towns there is only one movie theater, and even in towns with more than one, there is often only one showing the film you want to see.

This gives a theater a lot of scarcity power, and if the manager is smart he'll want to exploit that power to the full.

Yet the same story doesn't ring true for pricey wine at restaurants. The typical restaurant has less scarcity power than a movie theater because in most towns there will be a variety of alternatives. Whenever there is little scarcity power, prices need to reflect costs. Yet even the most ordinary restaurants seem to charge a lot for wine. A better explanation is that one of the big costs in a restaurant business is table space. Restaurateurs would therefore like to charge customers for dawdling, but because they cannot do that, they charge higher prices for products that tend to be consumed in longer meals: not just wine but also appetizers and desserts.

We go to a movie theater to see a movie and to a restaurant to eat, so is the truth also that we always get gouged on "options"? Not at all. One option available in both movie theaters and in restaurants is the option to use the restrooms; this is always an option provided free of charge. Tap water is also free in restaurants. It is not the option that invites the gouging, it's the lack of price sensitivity that allows a business with scarcity power to practice price-targeting.

Reality check number two: Can the company plug leaks?

Perhaps you are a company director rubbing your hands with glee as you read this, planning to deploy a range of clever price-targeting strategies in your own business. Before you get too excited, you'll need to deal with the leaks in your price-targeting system. There are two potentially catastrophic leaks or great holes in an otherwise brilliant marketing scheme. If you don't deal with them, your plans will be in ruins.

The first problem is that supposedly price-insensitive customers may not play the self-targeting game. It's not hard to persuade price-sensitive customers to steer clear of an expensive product, but sometimes it is more difficult to prevent the price-insensitive customers from buying the cheaper one. This is not a problem in the case of small price differences; we have already seen that you can get some customers to pay a modest markup in absolute terms, but the markup can be huge in relative terms, just by wrapping some chilies in a plastic bag, or moving a bag of potato chips up onto the top shelf. When it comes to more substantial buying decisions it is not always so easy.

Some of the most extreme examples come from the travel industry: traveling first class by train or air is much more expensive than buying the coach-class seats, but since the fundamental effect is to get people from A to B, it may be hard to wring much money out of the wealthier passengers. In order to price-target effectively, firms may have to exaggerate the differences between the best service and the worst. There is really no reason at all why coach-class train cars shouldn't have tables, as they typically don't in the UK, for instance, except that potential customers for first class might decide to buy a cheaper ticket when they see how comfortable coach has become. So the coach-class passengers have to suffer.

There is a famous example from the early days of the trains in France:

> It is not because of the few thousand francs which would have to be spent to put a roof over the third-class carriage or to upholster the third-class seats that some company or other has open carriages with wooden benches. . . . What the company is trying to do is prevent the passengers who can pay the second-class fare from traveling third class; it hits the poor, not because it wants to hurt them, but to frighten the rich. . . . And it is again for the same reason that the companies, having proved almost cruel to the third-class passengers and mean to the second class ones, become lavish in dealing with first-class customers. Having refused the poor what is necessary, they give the rich what is superfluous.

The shoddy quality of most airport departure areas across the world is surely part of the same phenomenon. If the free departure areas became comfortable, then airlines would no longer be able to sell business-class tickets on the strength of their "executive" lounges. And it would also explain why flight attendants sometimes physically restrain coach passengers from stepping off the plane before the passengers from first and business class. This is a "service" aimed not at economy-class passengers but at those looking on in pity and disgust from the front of the plane. The message is clear: keep paying for your expensive seats, or next time you might be the wrong side of the flight attendant.

In the supermarkets, we see the same trick: products that seem to be packaged for the express purpose of conveying awful quality. Supermarkets will often produce a store-brand "value" range, displaying crude designs that don't vary whether the product is lemonade, bread, or baked beans. It wouldn't cost much to hire a good designer and print more attractive logos. But that would defeat the object: the packaging is carefully designed to put off customers who are willing to pay more. Even customers who would be willing to pay five times as much for a bottle of lemonade will buy the bargain product unless the supermarket makes some effort to discourage them. So, like the lack of tables in coach-class trains and the uncomfortable seats in airport lounges, the ugly packaging of "value" products is designed to make sure that snooty customers self-target price increases on themselves.

The most surprising examples of all come from the world of computers. For instance, IBM's "LaserWriter E," a low-end laser printer, turned out to be exactly the same piece of equipment as their high-end "LaserWriter"—except that there was an additional chip in the cheaper version to slow it down. The most effective way for IBM to price-target their printers was to design and mass-produce a single printer, then sell it at two prices. But of course to get anyone to buy the expensive printer they had to slow down the cheap one. It seems wasteful, but presumably it was cheaper for IBM to do this than design and manufacture two completely different printers. Intel, the chip manufacturer, played a similar game by selling two very similar processing chips at different prices. In this case, the inferior chip was actually more expensive to produce: it was made by taking the superior chip and doing extra work to disable one of its features.

Software packages often have two or more versions: one has full functionality (the "professional" package), and the other sells to the mass market at a considerably reduced price. What some people don't realize is that the professional version is typically designed first, and certain features are disabled for the mass-market version. Despite the high price of the professional version, it's the cheaper version that actually has an extra up-front cost for the developer, and of course both versions are sold on CDs, which cost the same to manufacture. Computer hardware, and in particular software, has a strange cost structure because of intensive research and development costs, and relatively low manufacturing costs. At the height of the Internet bubble, giddy gurus were claiming that the different cost structure changes everything—but, as we've seen, the basic rules of making money in the hi-tech business are not so different from the rules for train operators or coffee bars.