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SAS-MRKTG2008-03 Rusetski  
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# AN EXPLORATORY STUDY OF MANAGERS' PRICING PREFERENCES

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**Keywords:** pricing strategy; decision-making; price fairness; pricing preferences; cluster analysis

### **Abstract**

Existing literature has suggested several pricing strategies that firms might follow to gain an edge over their rivals. At the same time, research on consumers' responses to price indicates that pricing strategies that are perceived as being unfair may result in serious negative reactions from customers. In the present study, we examine the ways in which considerations of price fairness and competitive strategy combine in managers decisions regarding the price level.

To investigate pricing approaches, we undertook a conjoint experiment involving 116 brand managers. Cluster analysis of the data suggests that managers tend not to pursue identifiable strategies suggested in prior literature or strive to provide "fair prices" that are aligned with a product's unique benefits. Rather, managers often are inclined to simply charge higher, lower, or equal prices compared to their competitors irrespectively of the quality of their products. A discussion of potential risks that such pricing preferences may create is provided.

### **INTRODUCTION**

One of the four pillars of marketing, price plays several roles in marketing strategy. It positions a product to appeal to a certain segment. It can provide a signal of a product's quality to a customer. Price plays an important role in determining the revenue and is one of the most flexible marketing variables for responding to competitive threats. Pricing decisions are typically under the control of brand or product managers. They can be changed without much effort or investment and the result of such changes can be observed immediately on firm's bottom line (Rao 1984).

Erroneous pricing decisions can have both long- and short-term negative consequences for a brand. Setting a price too low reduces a firm's profits, drives down consumers' reference price points, and negatively affects the perceived quality of a product and its overall market positioning. At the same time,

overpricing may have a negative impact on consumers' perception of a brand. Indeed, price is one of the first cues that consumers identify during the shopping process. One important aspect of price is consumer perceptions of fairness. When presented with a price that is higher than a reasonable reference level or not perceived to be justified by a product's benefits, consumers may perceive it as unfair and react in negative ways. Consumer reactions to perceived unfair prices can include withdraw from a purchase, complaints, demanding a refund or revenge actions such as negative word of mouth or even litigation (Xia, Monroe, and Cox 2004). Even more fundamental is the risk of breaking customers' trust (Morgan and Hunt 1994; Sirdeshmukh, Singh, and Sabol 2002) and destroying the relationship that customers develop with their preferred brands (Fournier 1998).

There are a number of recent examples of pricing strategies that were perceived by consumers as unfair and which had negative consequences for the companies in question. For instance, Sony's premium pricing of their TV products when the company clearly lagged in the innovativeness of their products in early 2000s resulted in a significant slowdown in sales of a brand that usually enjoyed fierce loyalty (*New York Times*, March 10, 2005; *Financial Times*, January 17, 2005). Another recent case of public reaction to unfair pricing is the \$2 billion class action lawsuit that has been filed in Ontario Superior Court in September 2007 alleging that major car manufacturers and dealers in Canada artificially inflated prices compared to the US at the same time conspiring to prevent Canadians from buying cars in the US. Interestingly, this practice has been in place at least since 2005 but it was not until 2007 that the price difference became so apparent that

consumers revolted.

Both of the cases noted above represent examples of viable pricing strategies (premium pricing) taken too far and therefore backfiring on decision-makers. Understanding the factors that lead to pricing actions that may be perceived as unfair to consumers is critical in that it will allow us update our pricing models and avoid costly pricing mistakes. At a more general level, relatively few studies have explored how managers go about making price decisions (see Armstrong and Collopy 1996 and Keil, Reibstein and Wittink 2001 for notable exceptions). So, while we have considerable understanding about consumer behavior related to various aspects of price, we have limited knowledge of how managers actually approach pricing decisions. This study is a preliminary attempt to examine the personal preferences of managers when it comes to setting the price of a new product. The main goal of the study was to understand the extent to which managers' pricing choices represent major pricing strategy types suggested by academic publications and how these choices are related to the quality of products.

## **PRICING STRATEGIES AND PRICE FAIRNESS**

Because of the need to maintain a high level of revenue and profit and at the same time keep consumers happy, pricing decisions are inherently ambiguous (Monroe 1990). This is especially true when it comes to pricing new products (Monroe and Bitta 1978) in that there is considerable uncertainty regarding demand, costs, competitive response, etc. Traditionally, two major

pricing strategies were suggested for new product introduction: price skimming and penetration pricing (Dean 1976, Monroe and Bitta 1978). In his review of pricing research, Tellis (1986) suggests more variations (image pricing and price signaling for premium pricing and experience curve pricing for low price strategy), but the core idea is that with premium pricing a product should be offered at prices higher than competitors' that have comparable benefits while penetration pricing implies lower prices.

Tellis (1986) also suggests conditions under which each strategy is viable. Unfortunately, following prescriptions is not always possible. Managers often make pricing decisions under time pressure, and when information is imperfect and incomplete they must rely not only on objective data but also on their intuition and preferences (Kahneman and Tversky 1973). While not necessarily destructive (e.g., Gigerenzer and Hoffrage 1999) these subjective inputs can drive managerial choices in uncertain situations away from the optimum and thus put brands at risk (for example, see Armstrong and Collopy 1996; and Keil, Reibstein and Wittink 2001).

Among managerial preferences that may have an immediate effect on the success of a pricing strategy is the extent to which managers are willing to consider consumers' perceptions of price fairness when setting up prices. The idea of fairness is pivotal for lasting relationships between consumers and brands (Campbell 1999, Fournier 1998). Breach of trust created by unfair prices may result not only in alienating customers (Aaker, Fournier, and Brazel 2004) but in retaliatory actions (Xia, Monroe, and Cox 2004). Consumers arrive at an unfairness judgment by comparing price levels to either their reference price or to

the price of substitute product with comparable levels of benefits (Campbel 1999, Xia, Monroe, and Cox 2004). Thus, it can be expected that if a product is priced above the competition, customers will perceive a price as more unfair if the level of benefits offered is the same or lower compared to a competing product than if the level of benefits is above the competition.

It can be expected that unfair pricing strategies will not be popular with managers. Examples of such unfair pricing practices are pricing inferior products above the competition (charging the same price as competitor for such product most likely will be perceived by consumers as less unfair) and pricing superior product below the competition – an extreme example of undercutting with a potential of incurring significant losses to a company (pricing a superior product on par with the competition will still represent undercutting, but with larger potential for profits). It should be noted that, in general, undercutting strategies are less likely to evoke the feeling of unfairness in consumers compared to overcharging (Xia, Monroe, and Cox 2004). Curiously, however, there are documented instances of negative public reaction to predatory pricing strategies (e.g., *Hindustan Times*, 8 August 2007; Rizkallah and Razzouk 2007), indicating that extreme undercutting strategies have a potential to not only destroy a firm's profits but to negatively affect its relationships with customers.

Under this logic and based on the Tellis' (1986) taxonomy of pricing strategies it can be expected that managers who care about consumers' perceptions of price fairness and at the same time about their company's revenues will favor the following scenarios:

- 1) Undercutting (penetration pricing, experience curve pricing) – i.e., pricing

better products at a point equal to competition and products with equal benefits at a point lower than competition;

2) Premium pricing (price skimming, image pricing, price signaling): pricing inferior products on par with competition and products with equal benefits at premium;

3) Equal/going-rate pricing: pricing inferior and better products on par with the competition;

4) Fair pricing: pricing products according to their relative benefits (pricing products with equal benefits on par with the competition; pricing products with lower relative benefits at a point less than competition; pricing products with greater relative benefits at a point above competition).

In other words, it can be hypothesized that:

*H1: Managers will demonstrate preferences toward traditional pricing strategies;*

and

*H2: Regardless of what traditional strategy managers prefer, they will avoid (show low utilities for) strategies that include unfair pricing.*

To test these hypotheses, we conducted an exploratory study based on a survey of managers at major consumer goods firms. We expected that managers will form natural groups reflective of the set of strategies described above.

## **METHOD**

A sample of 307 brand managers of consumer goods companies was invited to participate in online survey investigating pricing practices in consumer packaged goods firms. Eleven respondents indicated that they were not involved with brand management and pricing and thus, were not qualified for the survey. Of the

remaining 296, 116 completed the survey for a 39.2% response rate.

Respondents were presented with a conjoint experiment asking them to rate the likelihood of their brand management team following several new product pricing scenarios. They were asked to imagine a situation when they were to launch a new product right after their competitor launched a similar one. Respondents were asked to make a pricing decision under each scenario for a fictitious brand extension. In making the decision, respondents' were asked to act in a way that they felt their brand team would behave in that situation.

Nine scenarios were offered with two factors varying: product price and product benefits relative to the closest competitor that was expected to launch a similar product (see the questionnaire in Appendix A). Each factor had three levels: products could be priced lower, equally, or higher than competitor's; and levels of product benefits could be equal to, inferior to, or higher than that of the competitor's.

For each respondent, utilities of every pricing scenario were calculated using SAS TRANSREG procedure. These numbers represent the value that respondents place on each scenario based upon utilities (part-worths) of each level of each manipulated factor. In essence the utilities reflected the extent of managers' preferences toward each scenario. To uncover how managers group with respect to their preferences we performed a cluster analysis with the scenario utilities as the input data.

## **ANALYSIS AND RESULTS**

To analyze if 116 respondents form distinct groups in terms of preferences toward specific scenarios, a two-stage clustering approach has been used (Punj and Stewart's 1983, Lim, Acito, and Rusetski 2006). Initial clustering was done using hierarchical clustering via Ward's method with the goal to determine the number of clusters and to estimate initial values of clusters' centroids. Several techniques can be applied to determine the number of clusters from the hierarchical clustering output. We relied on inspection of the dendrogram, pseudo-F statistics, cubic clustering criterion (CCC), and changes in agglomeration distance obtained through SAS CLUSTER and FASTCLUS procedures (Ketchen and Shook 1996, Milligan and Cooper 1985, Lim, Acito, and Rusetski 2006).

While the pseudo-F statistic did not provide clear indications to what is the best solution (see Table 1), the CCC peaked at the five-cluster solution and agglomeration distance started to increase more rapidly after reaching five clusters as well. Inspection of the dendrogram (Figure 1) also suggested four or five clusters as possible solutions. The four cluster solution seemed incomplete as no clusters showed preference toward lower prices. Yet it has been demonstrated that managers are often more inclined to drop prices rather than increase them (e.g., Armstrong and Collopy 1996). As the absence of such a cluster could be an artifact of the clustering procedure, a five-cluster solution was attempted. While preserving the major clusters found in a four-cluster solution, the new solution provided a more complete picture.

----- INSERT Figure 1 ABOUT HERE -----

After settled on the number of clusters, to ensure reliable grouping an

iterative K-means clustering procedure was used to assign respondents to a predefined number of clusters using cluster centroids obtained in the first stage as seeds. The resulting clusters represent groups of managers that are similar in their pattern of preferences toward different pricing scenarios. To interpret the common patterns we plotted cluster centroids' values (Figure 2).

----- INSERT Figure 2 ABOUT HERE -----

We expected to see groups that will favor pricing strategies that reflect a product's relative benefits and/or clusters that correspond with the known pricing strategies suggested in prior literature (e.g., penetration pricing, skimming, etc.). Instead, we found the following.

Cluster 1 (25 members) "Only Higher!" Members of this cluster clearly favor higher prices with low utility for everything "lower" or "equal".

Cluster 2 (18 members) "Only Equal!" Show strong preference to prices equal to the competition, irrespective of their own product benefits, and clearly dislike pricing practices that are "higher" or "lower".

Cluster 3 (36 members) "Reasonable". Managers in this cluster do not show extreme preferences, but demonstrate a slight inclination toward higher prices but lower utility of the most unfair scenario – pricing an inferior product above the competition.

Cluster 4 (31 members) "Never Lower!" Managers in this group favor higher or equal prices and show low utility for prices lower than competition. Cluster 5 (6 members) "Only Lower!" Clearly favors lower prices.

Note that from strategic standpoint, price level can have different connotation. For instance, equal price can reflect fair pricing (if benefits are on par

with competition), undercutting (if benefits are above the competition), or overcharging (if benefits are below). *Yet the preferences of members of 4 out of 5 clusters are related strictly to the price level, and ignore the level of benefits offered by the product and thus denying strategic meaning of the price.*

It is also disturbing that there was no indication that respondents consistently avoided unfair pricing scenarios (Scenario 2 – less benefits, higher price; and Scenario 7 – more benefits, lower price).

It is possible to speculate that uncovered preferences will be related to brand strength. Clusters 1 and 4 favoring higher prices should have significantly higher brand strength than clusters 2 and 5 favoring lower or equal prices. As a part of the survey we collected managers' perceptions of their brand strength measured along three dimensions: profitability, market share, and growth rate (Deshpande, Farley, and Webster 1993). Comparison of the means of brand strength for all five clusters (Figure 3) using Scheffe's test shows that indeed, there is a significant difference in brand strength between cluster 5 "Only lower!" and clusters 1 "Only higher!" and 4 "Never lower!" ( $p$  equal or less than .01) as well as between cluster 1 "Only Higher" and cluster 3 "Reasonable" ( $p < .01$ ). There was no significant brand strength difference between cluster 2 ("Only Equal!") and clusters 1 and 4 ("Only Higher!" and "Never Lower!")

## **DISCUSSION**

### **Implications**

The implications of this study for theory are in the fact that it demonstrates that prescriptive studies are not being utilized by practitioners to a full extent.

Several reasons can be suggested for this. Models may be too narrowly focused and not perceived as relevant. Models require data that may not be readily available to practitioners. There may be an absence of time for proper analysis and utilization of sophisticated models. This study demonstrates the need for more exploratory and explanatory studies that will look into psychological and organizational processes that are involved in pricing decisions.

Patterns of preferences revealed by the clustering procedure also suggest that a significant number of managers may have a tendency to ignore relative quality of their product when determining how to price it relative to the competition. This suggests that managers' view of pricing strategy may be too narrow, focusing strictly on the price level. Such narrow approach can potentially result in offering either unfair prices and alienating consumers when premium price is being charged for an inferior product, or losing possible profits by undercutting competition too deeply when lower price is being charged for a superior product.

Uncovered relationships between brand strength and pricing preferences indicate possible trouble that may be associated with stronger brand – managers' inclination to charge premium prices no matter how well a product compares to the competition. As discussed above, this inclination may result in pricing that will be perceived as unfair by customers and may trigger desertion to competitors perceived as priced fairly.

It is also interesting how small is cluster 5 "Only lower!" – just 6 respondents out of 116. It has been demonstrated that managers respond to price decreases by the competition more willingly than to price increases (e.g., Armstrong and

Collopy 1996; Keil, Reibstein and Wittink 2001). Yet here we see that majority of respondents favor higher prices as opposed to lower ones. This could be due to the fact that strong brands are overrepresented in our sample – only 24% of respondents rated their brand at scales' midpoint or below. Still, it can be expected that in consumer goods penetration pricing would be represented by a larger number of respondents.

### **Limitations**

Limitations of this study stem directly from its preliminary exploratory nature. First and foremost, no theoretical framework is offered to explain the pattern of managerial pricing preferences. To a large extent this is the result of somewhat unexpected composition of clusters. Deeper investigation is needed into the drivers of managerial pricing preferences and the paucity of work on managerial decision making related to price.

Second, collected data does not allow to clearly distinguish between subjective preferences of individual managers and the extent to which their choices are driven by explicit company's strategy in the marketplace. The conjoint experiment is aimed at uncovering respondents' utilities for various sets of stimuli, and is well suited for investigating and predicting consumer behaviors where personal choice is involved (Allenby et al. 2005). But in the corporate world, managerial choices are often determined not only by managers' personal choices, but also by the overall set of policies and strategies in the company. One indication that uncovered patterns are subjective rather than objective is the unexpected nature of resulting clusters – corporate strategies are usually more balanced and thus resulting preferences reflect either managers' interpretations of

corporate strategy, or their personal preferences. Also, the existence of Cluster 3 (“Reasonable”) that didn’t show significant preference toward specific scenarios suggests that some managers are generally indifferent in their strategy choices, selecting strategies not based on personal utilities but rather on other factors which may include corporate strategies and objective market factors.

Methodological limitations are mostly related to the clustering procedure. Although we tried to approach it with all possible rigor, the absence of reliable statistical techniques enabling determining number of clusters often leaves results open to alternative interpretations. One possibility to avoid this limitation in the future is to develop alternative measures that will allow to measure and analyze managers’ pricing preferences using more conclusive statistical techniques.

### **Future research**

Due to the exploratory nature of the study it raises a number of questions that have a potential to significantly advance our knowledge of pricing process. If uncovered pricing patterns indeed represent personal pricing inclinations of managers it is important to investigate psychological motives that drive managers to accept strategies that are either risky for a brand’s long-term health or undermine firm’s current profitability. Recent advances in regulatory focus theory (Higgins 1997) carry a promise to explain motivational states of managers that can be linked to their strategies. Related to this are questions of longevity of managerial pricing preferences and the impact of managerial experience on the likelihood of belonging to a particular cluster.

The findings in this study will become even more relevant if it will be possible to relate firm-level factors like organizational culture or strategic focus

to certain pricing patterns.

Finally, this study doesn't address the impact of each pattern of pricing preferences on firm's short-term and long-term performance. Longitudinal design will be especially beneficial as it will allow not only monitoring the relationship but addressing other questions like evolution of managerial preferences over the time.

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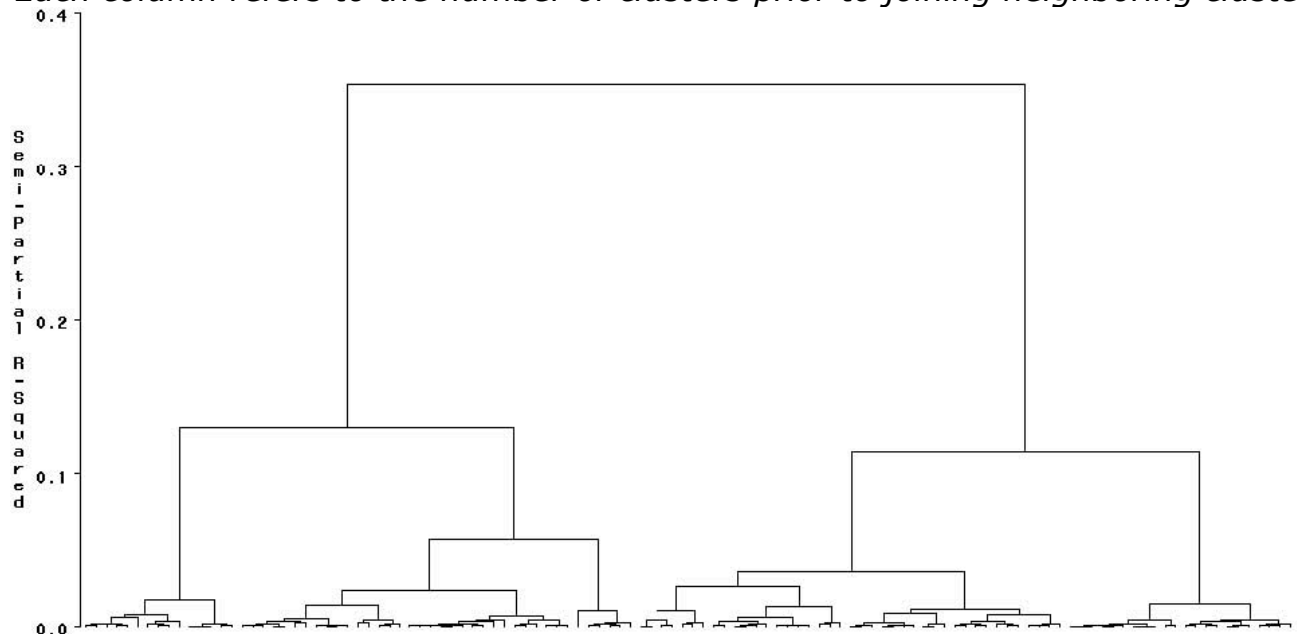
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## TABLES AND FIGURES

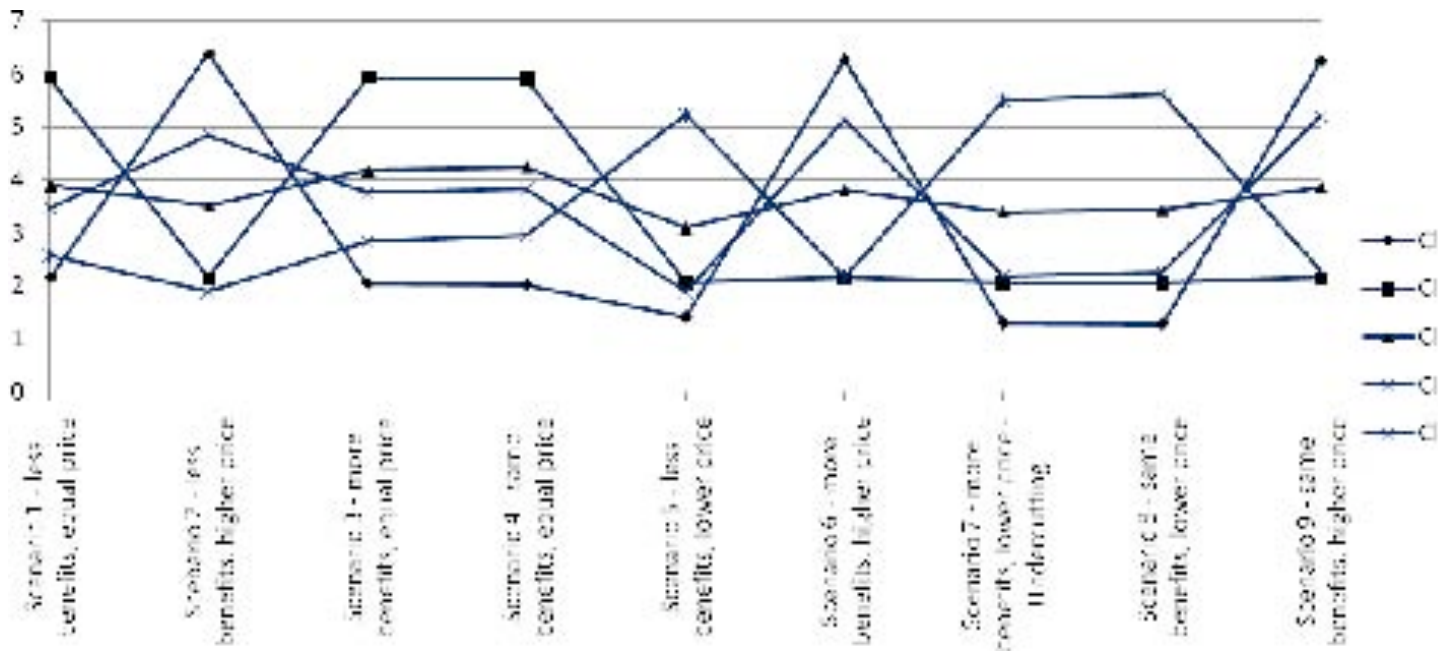
**Table 1: Clustering statistics**

Number of clusters	Statistic 2	3	4	5	6
Pseudo- $F$	77.17	66.67	59.92	56.39	52.40
CCC	37.436	39.302	39.289	40.3	40.296
Agglomeration Distance-Change*	835.51	306.44	270.49	134.06	85.35

\* Each column refers to the number of clusters prior to joining neighboring clusters



**Figure 1: Dendrogram of hierarchical clustering Figure 2: Five-cluster solution**

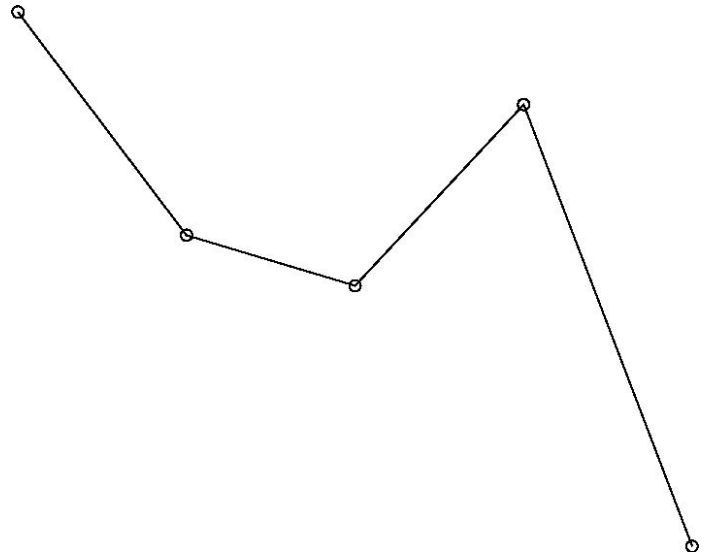


### Mean of Brand strength as a sum of 3 items



12345

**CLUSTER**



**Figure 3: Comparison of means of brand strength among 5 clusters**

## Appendix A: Pricing Scenarios.

Please answer the following question in the context of your actual market and your actual brand management team.

Imagine that your brand team is planning to launch a new product. A similar product has been already launched by your closest competitor. Based upon the information about physical qualities of both your and competitor's products, your team must set the price for your new product.

For each of the 9 scenarios below, please indicate the likelihood that your team would select the pricing action indicated.

Although this is a hypothetical situation, please describe possible actions as they are most likely to happen under current conditions in your organization, NOT as they "should be done"!

**Scenario 1:** The benefits of our product are *less* appealing to consumers compared to the competitor's new product. We would price our product *equal* to the competitor's.

Not at all likely \_\_\_\_\_ • Very likely

1 2 3 4 5 6 7

**Scenario 2:** The benefits of our product are *less* appealing to consumers compared to the competitor's new product. We would price our product *above* the competitor's.

**Scenario 3:** The benefits of our product are *more* appealing to the consumers compared to competitor's new product. We would price our product *equal* to the competitor's.

**Scenario 4:** The benefits of our product are as appealing to consumers as the competitor's new product. We would price our product *equal* to the competitor's

**Scenario 5:** The benefits of our product are *less* appealing to consumers compared to the competitor's new product. We would price our product *below* the competitor's.

**Scenario 6:** The benefits of our product are *more* appealing to consumers compared to the competitor's new product. We would price our product *above* the competitor's.

**Scenario 7:** The benefits of our product are *more* appealing to consumers compared to the competitor's new product. We would price our product *below* the competitor's.

**Scenario 8:** The benefits of our product are as appealing to consumers as the competitor's new product. We would price our product *below* the competitor's.

**Scenario 9:** The benefits of our product are as appealing to consumers as the competitor's new product. We would price our product *above* the competitor's.

All scenarios were measured using 7-point scales going from "Not at all likely" to "Very likely".