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Revising the Conceptual Basis of Price: A Discussion Paper on the impacts for Residential Agency Agreements

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ABSTRACT

Under the Property Stock and Business Agents Act 2002, and the 2003 Regulations to the act, there is an obligation on agents to set a realistic selling price for residential property. This can create a tension for agents, when faced with winning a listing for sale. The question of how accurately an agent or salesperson can estimate price, and under what conditions raises important questions regarding the nature and sociology of price. This paper critiques various theories of price in the light of the probability of a residential property sale in practice.

The market theory of price is found to have significant practical shortcomings. It is argued that other interpretations may be more successful in understanding the

sociology of price. In particular, it is argued that a revised methodology should be considered in order to push our understanding of property pricing forward.

KEY WORDS

Ethical pricing; sociology of price; price theory; economic methodology

INTRODUCTION

On September 1st, 2003, the Property, Stock and Business Agents Act 2002, and the 2003 Regulations to the act took effect. The Office of Fair Trading administers this legislation and the purpose of the new act was to improve consumer protection and raise the competency and professionalism of agents.¹

There were many changes to the act including:

- Educational qualifications and continuing professional development for both licence and certificate holders.
- Real estate agents must now hold a licence specifically accredited to carry out auctions.
- Corporation licences no longer require at least half of the directors to be licensed.
- Licences and certificates can be issued with conditions imposed
- The on-site residential property managers licence has now been expanded to include caretaker-managers of residential premises.
- Appropriate supervision of the agency practice and staff is vital for the successful operation of the business, and to promote ethical conduct. Recently the commissioner issued guidelines on what constitutes appropriate supervision. These new guidelines come into effect on the 1st March 2005.
- The estimated selling price, which has long been a
“sore point with consumers and ethical agents”.²

It is a well-known point amongst agents that the agent or salesperson estimating to the vendor the highest selling price, would usually obtain the

¹ Real Estate and Renting Services , Office of Fair Trading, Overview of the new Act.

² Real Estate and Renting Services , Office of Fair Trading, Overview of the new Act.

listing for the property. Of course the agents reputation, and previous history in the area would play an important role in the decision making process, however, ultimately the vendor would sway towards the agency who was able to promise the highest price which was usually backed up by the agency's supposed skills and marketing expertise.

It is this last point with regards to the estimated selling price that raises questions of how accurately is the agent or salesperson able to determine the selling price. Therefore the purpose of this paper is to identify whether in fact the agent is able to correctly estimate the selling price and if in fact there could be other considerations such as "outside influences" which could contribute to the "established selling price" differing from the final sale price.

ESTIMATED SELLING PRICE

The new Act clearly states under Section 74 it is an offence for an agent to estimate the selling price with a figure that does not truly reflect the true estimate. Further under Section 73, it is also considered an offence to make a statement (perhaps during the course of marketing the property) where the agent falsely understates the estimated selling price to prospective buyers. Additionally this also includes advertising or promoting the property by falsely understating the estimated selling price.

Under Section 74 of the Act the Commissioner may issue *Substantiation Notices*, where the agent will be asked to provide the evidence of the estimated residential property selling price. This notice is regardless of the method used to market the property; such as private treaty or auction method. The estimate of the selling price could be a statement made orally, in writing, or with methods of advertisement and promotional material.

It is interesting to note that the guidelines issued by the Commissioner for Fair Trading state that the purpose of asking the agent to substantiate is not to penalise agents where the eventual sale price exceeds the agent's genuine estimate. However the guidelines make no reference to a situation where the eventual selling price is over

the estimated selling price. Therefore, the concern appears to relate to the estimated selling price being higher than the final selling price.

The Regulations to the act require the agent's estimated price, and the price at which the property is to be offered for sale also to be entered in the agency agreement. This is illustrated in Figure 1, where the agent will be analysing three sets of figures. The first is the estimated sale price; the second is the price at which the property is to be offered, and thirdly the final selling price.

Figure 1



Figure one highlights the three different phases of prices available for this residential property. In the first instance, this price is based on the expert opinion of the agent during the process of conducting a market appraisal. The second stage is an agreed price between the agent and the vendor. In most situations the agreed selling price to be offered for sale will be at a higher price than the estimated selling price. This is a marketing technique to allow the agent and prospective purchasers to negotiate on the final sale price, which hopefully will be the sale price sought by the vendor. In the third stage the final sale price is accepted, and contracts are prepared accordingly.

Concerns are raised by agents regarding the differences between the eventual selling price and the estimated selling price. The commissioner's guidelines state that

“The price at which a property ultimately sells will be a factor to be considered by Fair Trading in relation to the reasonableness of the agent's estimate”.

However Fair Trading does recognise and states³ that there are other factors that can affect the final selling price. The commissioner's guidelines list a number of external factors that an agent should take into consideration when determining the estimated selling price. These external factors include:

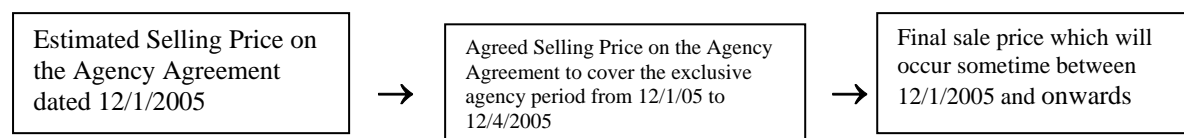
³ Estimated Selling Price Guidelines for Agents, Office of Fair Trading

- prevailing economic conditions
- interest rate movements
- the level of interest in a specific property
- the marketing program and method of sales used
- and seasonal factors.

Interestingly there is no mention in the guidelines, that the property which is listed “today”, will be sold after “many tomorrows” have passed. Surely this should be taken into consideration as a major impact on the price fluctuation alongside with the other external factors mentioned previously.

This time line difference is highlighted in Figure 2; in this example, the agent will list a property for sale, include the estimated selling price on the agency agreement which is dated the day of entering into the sales agreement with the vendor; then there is an agreed time frame to exclusively market the property, with the final time line stage indicating that the property could be sold any where during the agreed time frame.

Figure 2



An important issue to consider with Figure 2, is the impact of this timing difference on the estimated selling price and the final sale price. It has been aptly stated⁴ that

“selling agents create audit trails”

however, to what extent and details will this be necessary, particularly for court purposes.

Acceptable factors in the agent’s working papers includes⁵:

- the features of the property

⁴ V. Mangioni, Estimating the selling price: a valuer’s perspective, Real Estate Institute of NSW Journal, September 2004, Volume 55, No. 8

⁵ Estimated Selling Price Guidelines for Agents, Office of Fair Trading

- future use of the property (such as zoning, redevelopment)
- market demand
- sales of comparable properties
- likely level of demand for the particular property
- recent valuations of the property (if any)
- desired method of sale (such as private treaty or auction method)
- seasonal factors
- economic factors.

Again these acceptable factors would need to be substantiated with adequate notes and all working papers to be retained in the sales file for that particular property. It would appear that the commissioner's guidelines have overlooked the possibility that the time frame from listing the property to obtaining the final sale might cause a price fluctuation either up or down and not relate to these acceptable factors.

How strong or reliable are these working papers to support in court, a challenge that an agent did in fact estimate the selling price correctly? For example if currently today there is a strong demand for that particular type of property, where is the justification that the demand will similarly continue for the next two months? Each suburb has varying turn around time frames from the date of listing the property to the date of "closing" the sale. In some areas the time frame could be 6 to 8 weeks from the time of listing the property to the date of negotiating the sale. In some country areas the argument from agents would be that the time frame is considerably longer. How can an agent prove the demand for that particular type of property?

The commissioner's guidelines also accept that the method used to market the property can produce varying results on the final sale price when compared to the estimated selling price. Again could this evidence be proven in court? The two traditionally accepted methods of marketing a property are commonly referred to as "private treaty", or the "auction method". Therefore, is the commissioner implying that the agent could have a difference in the estimated selling price and the final sale price, because of the marketing method used and further, is the agent then accountable for the marketing method. It is also important to note that different areas and different

vendors have preferences for the choice of marketing techniques for their property, and the vendor's decision might not always reflect the recommendation of the agent. Does this then indicate that agents need to protect themselves by recording all conversation with the vendor, in case of the difference in the final sale price to the estimated selling price?

Therefore, why is it difficult for an agent or salesperson to correctly estimate the selling price of a property, and yet the valuer appointed to value the same property is considered able to nominate a figure, which is considered justifiable and credible. From the agent's perspective, the agent is appointed to appraise the property by giving an estimate on the selling price, without regard to the selling price changing in the future. However, from the valuer's point of view, a valuer is appointed

.....to determine the value of a property in consideration of the inherent and external features of a property⁶

An important point to note though is that the valuation report states the date of the valuation inspection and the date of the valuation report. In other words the valuation of that nominated property is current for a particular point in time (i.e. the date of the valuation report). Therefore, if the same concept was applied to the agency agreements with regards to the estimation of the selling price, it would appear that even if an agent kept good field notes for the basis of this estimation, the time frame from the listing date to the selling date would prohibit accurate justification unless during this time frame, the agent continuously updated the sales files.

Disconcerting is the mention in the commissioner's guidelines, the acceptance of field notes for economic factors, and offers the following suggestion to substantiate any interpretation for these changes,

“the level of demand for property, whether interest rates are on the move, whether the authorities warning about overheated markets”

⁶ V. Mangioni, Estimating the selling price: a valuer's perspective, Real Estate Institute of NSW Journal, September 2004, Volume 55, No. 8

What exactly does the commissioner suggest by the term “the authorities”. Are we referring to newspaper articles, or is the modern day agent required to subscribe to economic journals to further their knowledge and understanding on economical issues. How will the courts prove that the use of newspaper articles is sufficient or insufficient back up for this acceptable issue in the commissioner’s guidelines for influencing external factors. At this point it is worth while to mention that the new Act does not require the agent or salesperson to hold any qualifications in economics, or to undertake any studies in economics, or to participate in continuing professional development for economics, or for that matter, marketing techniques, and whilst it is acknowledged that the Office of Fair Trading has introduced mandatory continuing professional development for licensed agents and certificate holders, the agenda for compulsory topics set down by Fair Trading to the year 2006 makes no mention of these additional skills that would assist the agent to accurately estimate the selling price, and further, the educational requirements for licensing again makes no mention of these important skills.

In summary, in a situation where the agent estimated the selling price of the property for say \$425,000 and the property eventually sold for \$400,000, and there were no major impacts to affect the final selling price, how would the agent justify the difference?

Can the agent justify the difference in the estimated sale price and the final selling price, whilst there were no major impacts, as per the commissioner’s guidelines, and the sales file had correct market data at the point of time of the estimated selling price?

CONCEPTUAL ISSUES

Conventional economic theory posits that price in a free and relatively efficient market will be the result of that balance of supply and demand that will compete price to close to the normal cost of supply(1). Samuelson also reminded his readers that under those conditions necessary for perfect competition, principally perfect knowledge and perfect mobility, both supply and demand would follow the normal cost of production curve, eliminating supernormal profits. All of this is very inconvenient for pricing property since the land component has no essential cost of

production. Although there are easily recognisable supply and demand forces in the market for property, they cannot fit the requirements for perfect competition, leaving Smith's two century old view of land as fundamentally behaving as a monopoly, unchallenged, despite the problems it infers.

Studies of pricing in practice have tended to focus on the tension between theoretical pricing systems, principally the marginalist pricing mechanism derived from the theory of the firm and what is often referred to descriptively as "cost plus pricing" positively evident in the behaviour of most firms (2). Jones outlined both the theoretical deficiency of marginalist pricing as well as recognising its absence in practice, despite recommending his readers adopt its implications (3). Whatever the outcome of this debate in the economics of price, it still offers little comfort for property economists as both ultimately rest on costs.

The economics of monopoly pricing, as suggested first by Joan Robinson (4) and now gaining place in the emphasis on monopolistic competition within economics probably offers greater potential. The shortcoming of monopoly pricing is that it is always ultimately the result of assumptions made by the monopoly side of the transaction (frequently the vendor) about the needs of the other party. Price within this environment is a psychological function that depends variously on the needs of the weaker party, the accuracy of the assumptions of the dominant party and the behaviour of alternate players.

For example, in the case of land property, the vendor needs the benefits offered by a particular site, though alternate similar sites may also be available. Any particular vendor has to estimate the need, expressed in dollar terms, of potential purchasers and likelihood that other property owners may be tempted to sell if the price is raised too far. Within this view of the market, supply behaviour becomes a type of game, and may be understood using game theory. Game theory is best understood as a psychological tool, not a purely economic one (5).

Part of the estimate of potential purchaser need may be investigated sociologically. If it is assumed that the population is composed of individuals who may attach various levels of desire to purchase a particular property, and the distribution of prices that individuals within this population are willing to pay is normal, then a demand curve could be constructed by accumulating them that would resemble an inverted "S".

Within this environment, a prudent and reasonably well informed vendor would hope to achieve a price that is somewhere near the upper turning point of the “S” curve.

In such a case, which is arguably the strategy adopted implicitly by most vendors, the achievement of a particular price is partially dependent on the appearance of those low-probability purchasers who are willing to pay the top price. If purchasers are emerging at a given rate, and each is prepared to pay a price that forms a normally distributed set, then the final price will be highly dependent on the length of the marketing campaign and the willingness of the vendor to hold off selling until a low-probability offering a sufficiently high price emerges.

This view of property pricing offers several important possibilities for adding substantial depth to the understanding of property price, and perhaps other aspects of economic theory as well as contributing timely input into the problem of agent’s listing appraisals. Positive research into property price within this view places more emphasis on the marketing period while holding back from the trap of suggesting that there is indeed a right price for property.

It may be the case, for example, that when estimating the sale price for a property, a listing agent assumes a particular sample of the population will emerge during the marketing period that will include one person willing to pay the price that the agent sets as the value of the property. If the set of persons that does emerge fails to include such a person, it could very well be better attributed to the vagaries of the sampling process, rather than some deeper reality regarding the possibility that no one exists in the population that would not be willing to pay the suggested price. On the other hand, if a person randomly appears early in the marketing campaign who is willing to pay the agreed price, or even more, it may not be the skill or effort of the agent, but again, only chance. Moreover, in such a case, the vendor may never learn the real maximum price that was contained within the sample of purchasers who may have emerged during the entire marketing campaign because the property achieved a quick sale. All of these situations are common enough in practice, though relatively poorly treated by existing economic theory.

CONCLUSION

Current public concern for accuracy on the part of listing agents exposes an important issue in property pricing. The treatment of the matter at a legal level leaves reveals a deeper misunderstanding of the mechanisms that result in a particular sale price.

This paper has outlined the issues that emerge from the current public debate for property economists and surveyed some theoretical lines for its further investigation. It is suggested that more work should be done on developing an understanding of sale price using a sociological model of price formation derived from practical assumptions regarding the behaviour of both vendors and purchasers. Considerable further research is appropriate within this approach, especially focusing on the positive relationship between price and the length of the marketing campaign. It is hoped that by exploring this mechanism a theory of property pricing may be developed that may have the potential to shed light on the appropriateness of price estimates as well as other issues connected with the sale of property.

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