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CHAPTER 10 Pricing

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Getting pricing right contributes mightily to business success or failure. But what does getting pricing right mean? The answer to that depends on what you are trying to accomplish with your pricing strategy. Pricing strategy, for purposes of this chapter, is defined as price planning as it relates to internal forces (cost and marketing objectives) and external forces (consumer demand, competition and market trends). Pricing also depends on where your product stands in terms of the product life cycle and where the particular product you are pricing stands in relationship to the basket of other products you sell. Price depends on company size, available resources, industry specifics and competition. Pricing strategy is part and parcel of marketing strategy. This chapter will explore these and other topics relating to pricing with the intent of providing practical tools and insights into this important topic.

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What are we trying to accomplish with our pricing strategy?

Are you seeking to maximize total revenues? Are you seeking to gain market share? Are you trying to establish an upscale, exclusive brand name for your product? Or are you just trying to stay afloat?

Start figuring out your pricing strategy objectives by ranking your priorities:

Goal	Rank		
Maximize sales revenue			
Maximize unit sales			
Maximize profit (dollars)			
Maximize profit (margin)			
Gain market share			
Discourage competitive entry to the market			
Create quality or exclusive brand perception			
Encourage trial of new product			
Increase market knowledge			
Rank each item from the most important (9) to least important (1)			

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Tool 10.1 Pricing Strategy Objectives

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Understanding what you're trying to accomplish will help you garner a better idea of how to get there. All of these things can be accomplished through pricing. Prioritizing what you're trying to accomplish helps provide a focus and direction for resource allocation.

Now that you've got a sense of what you're trying to accomplish by using Tool 10.1, take a look at your existing strategy. "I don't have one," you say? Don't worry; you're not alone. Many fairly sophisticated executives running major businesses rely on seat-of-the-pants-pricing or the "find-out-what-my-competitors-are-charging-and-charge-less" (to steal business) or more (because my product is better) method. At one point in time, did you look at your cost structure, add a mark-up and run with it? That's OK. It's a great place to start and a necessary one. It's also a very common way of pricing.

Take a moment to complete this brief survey regarding your current pricing strategy. First, rate how you're doing in each area on a scale of one to five with one being poor and five being excellent. Then give each factor a high, medium or low relevance ranking:

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Pricing Self Audit	**H – High** **M – Medium** **L – Low**	**Poor**				**Excellent**
Our pricing strategy	Relevance	1	2	3	4	5
Complements our overall marketing strategy						
Is coordinated across functional areas						
Is comprehensive						
Reflects the value our customers place in our product						
Assesses buyer sensitivity						
Considers competitive reaction						
Reflects buyers emotional response						
Accurately reflects fully loaded cost to produce						

Tool 10.2 Pricing Self Audit

So what is wrong with the strategy of figuring out cost per unit, adding a mark-up, then finding out what the competitors are doing and using that information to arrive at a price? Nothing's wrong with that. In fact, both of these are important considerations in determining price. The only problem is these methods fail to take into account the value of your product to your customer, an important consideration addressed in greater detail later in this chapter.

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What does it cost to produce your product?

All products should have a calculated price range, as opposed to one specific and fixed price. This allows flexibility in price that is needed to accomplish different pricing goals (maximizing profit, gaining market share, undercutting the competition, etc.). The low end of the range should be closely tied to your break-even analysis (see following example). To determine the bottom of the pricing range, it's important to understand your cost structure. In the simplest case, where sales volume is fixed, determine the variable cost to produce the product, allocate some portion of fixed costs to each product and add the desired mark-up.

Using this approach the product's price is determined as follows:

price = (unit variable cost + unit allocation to fixed costs) X (1 + mark-up).

Consider this example:

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Gizmo Guidance Systems has a contract to supply the Royal Air Force with advanced aircraft navigational equipment. Under the contract terms, the price of each navigational unit is determined as follows:

The variable cost of producing each unit (labor, components, electricity, etc.) is calculated. Gizmo's cost accountants then allocate some portion of the total fixed costs (salaries, insurance, R&D, building heat, debt service, maintenance, etc.) to each of the navigational units produced under the contract (in this case, the unit volume is known.) Together, these represent the full cost of producing each unit. For illustration, let's use these numbers:

Unit variable cost = $10,000
Unit allocation to fixed cost = $8,000
Mark-up = 15%
Unit price = ($10,000 + 8,000) x (1+.15) = $20,700

Example adapted from the Marketer's Toolkit, Harvard Business School Press.

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Another approach to the cost plus calculation is to determine a desired profit margin. Then take your total cost and divide it by one minus the desired margin to determine the price. For example, the board of directors is expecting a 20% profit margin. Total cost per unit is $100. The formula would then be $100/.8=125. Your price is $125 per unit.

There are two things to watch out for when using a cost-plus model to determine price. First, it is very difficult to accurately calculate and allocate costs on a per unit basis, as seen later in Pricing Predicament #1. The fixed cost per unit is subject to change based on the experience curve, and people tend to underestimate costs. A few things that are typically overlooked include R&D costs and goodwill. Going back and checking actual costs versus estimated costs will help. And second, using this method alone can lead to many dollars being left on the table because it fails to take into account your product's value to the customer. Value to the customer will be discussed in greater detail later in this chapter. Finally, using a cost plus strategy only, runs the risk of pricing the product out of the market in the case of inefficient production techniques. That said, understanding cost is an important first step in developing an overall pricing strategy.

Once you have determined your costs and have determined a pricing starting point, a break-even analysis can help develop a sense of the relationship between cost and unit

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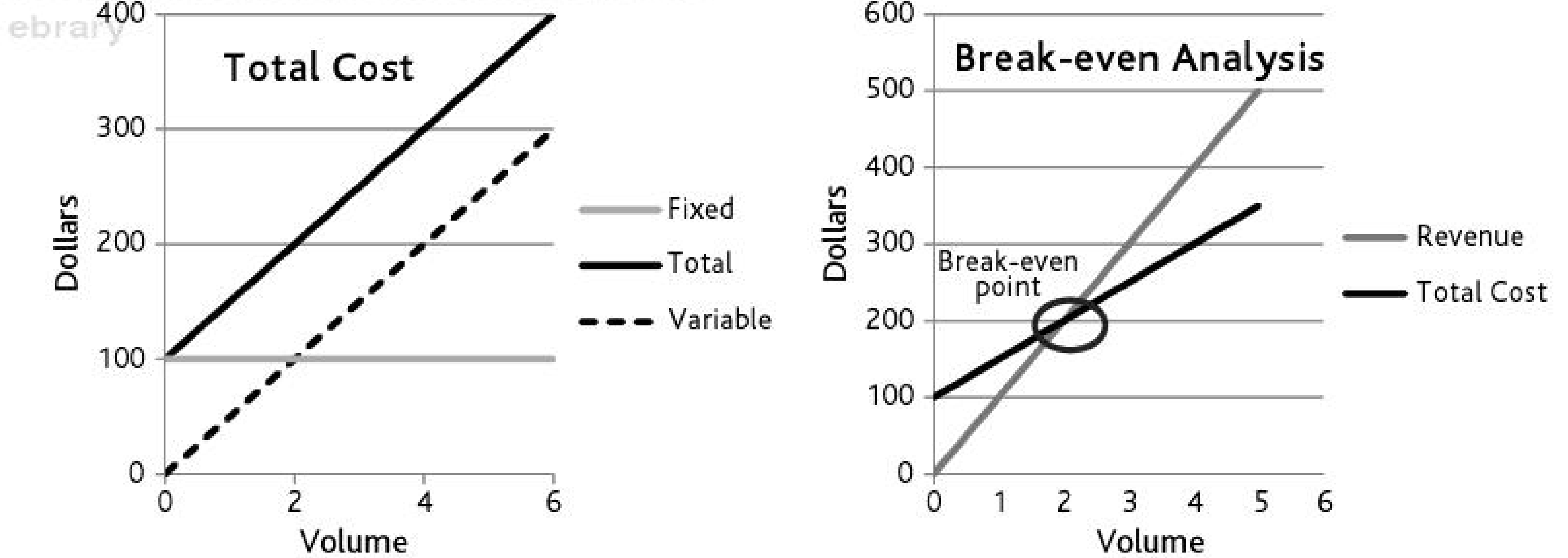

Figure 10.1 Break-Even and Total Cost

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volume. In the simplest terms, the break-even point is the point where sales revenue exactly equals all costs incurred. More sales generate a profit. Fewer sales result in a loss. It may be helpful to graph a break-even analysis. To do this, plot sales volume on the horizontal axis and plot money on the vertical axis. A horizontal line represents fixed costs. Add an upward sloping line for variable costs to get a total cost. With total cost in place, add the revenue line starting at zero. When sales income equals total cost, the business is at break-even. See Figure 10.1 as an easy visual example.

Every business owner and manager should understand the business' break-even point. Ideally, a business will operate as far above break-even as possible for safety.

What do you need to know about your competitor's pricing?

The traditional pricing model includes two steps: determining your costs and adding a mark-up as previously described, then taking a look at what the competition is charging for the same or similar product (or service) and adjusting accordingly. Chapter nine considered the question of "who exactly is my competition?" Identifying the competition and doing market research on their products is an important step in developing a pricing strategy. There are many tools for identifying and analyzing the competition presented in chapter nine.

For purposes of pricing, identify the top three to six competitors in the industry. Here are some ideas on determining exactly who that might be at any time:

- Ask your sales force to track who they are losing business to.
- "Shop" your competitors.
- Buy your competitors' products and try them to see how they compare to yours.
- Browse your competitor's website.
- Read articles in the press for clues to competitor expansion plans and financial health.
- Note if your competitor is hiring by checking job listings.
- Order a Dun and Bradstreet report on your competitors.
- Track your competitor's stock price (if publicly traded).

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- Keep files on the primary competitors in the industry and keep them updated.

Part of competitor analysis is to clearly define the industry. This may be more difficult than it sounds. Take Amazon.com, for example. Are they a bookseller (they certainly sell more than books) or are they an Internet company? Are they a fulfillment platform or a direct to consumer sales platform? Do they compete with Barnes and Noble or Walmart or both? Using the NAICS codes (North American Industry Classification System) can help narrow down your industry. For more information on NAICS codes, refer to these websites: http://www.census.gov/eos/www/naics/ or http://www.naics.com/search.htm.

Once you've identified your industry, take time to analyze it. How many companies compete in your industry? Is competitor intensity high? Is information regarding pricing and product freely available? Answers to these questions will impact your pricing strategy.

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PRICING PREDICAMENT—#1

In the early 2000s, two entrepreneurial women came back from a trip to Europe with an idea to develop a business. Their product was new to the US market. It was a vehicle-sharing program. There were substitute products but no direct competitors. They spent many months estimating their costs and developing their pricing strategy based mainly on a cost plus approach. In addition to understanding their costs, they considered alternative products, and they looked at what the market would bear in terms of price points (points at which the customer will switch products.) Based on market testing, there seemed to be a psychological ceiling to what customers would pay for the product.

They launched the product concept and over the next eight years, the number of customers signed up for the product grew by from basically zero to over 400,000. They now serve thirteen cities and 150 college campuses in the US and Canada. 2009 revenues exceeded $130 million, a ten-fold increase from 2005.

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They have grown rapidly through grass roots efforts and acquisition. They have successfully met or exceeded their growth plans each year. The only goal they have failed to meet is the goal of turning a profit.

In part, they suffered from many traditional start-up company problems. Many of their initial expense forecasts proved to be very low. Technology demands and logistics presented unforeseen difficulties. Low introductory pricing, used initially to woo new customers, proved difficult to increase.

This real life example is a cautionary tale of the importance of getting pricing right. It illustrates many common pricing pitfalls and highlights the difficulty of truly understanding and estimating costs. This company's pricing strategy was geared toward expanding its customer base and introducing its concept to the market. But ultimately, a company has to make money to survive.

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Perhaps the most difficult competitor analysis to perform is for a new product, a first mover product, or a product with unique features. In these cases, not only is there the added challenge of having to educate the potential customer base, there are no direct competitors for comparison. Instead, substitute products come into play. What other products might a customer use in lieu of the new product? This makes comparing prices even more difficult.

If you're now deep into your competitive analysis, a visual (chart or graph) or a table might be helpful. Chart your competitor's products, rating them on important features and benefits, versus their pricing. Put your company and your product on this list to see how you compare both in terms of product features and price. Knowing your competition will help you become a pricing expert. In very competitive industries, pricing at par with the competition may be the best strategy.

How will my competitors react to my pricing decisions?

While on the subject of the competitor's product and their price, it's worth anticipating what competitor reaction will be to changes in potential pricing strategy. If the market is quite competitive, with a number of strong players aggressively competing for customers and if information is readily available, it is safe to assume that the competition will respond quickly to any new pricing strategies. Competitors may choose to match price. They may choose to undercut price or they may choose to wait out the lower price while maintaining their own price (assuming prices won't be able to remain that low for long). In the worst case scenario, if you drop your price, and your competitors respond by dropping their price, a price war may ensue.

Price wars are rarely a good thing for most companies. A price war will drain the industry of profitability. While in the short term, a price war may force industry shake-out, thereby lessening competition, it can force the remaining players to deplete their reserves. In addition, as will be talked about later in this chapter, consumers may become accustomed to lower prices and will be resistant to higher prices at a later date. A price war can permanently damage an industry. On the plus side, while avoiding a price war is important to retaining industry profitability, an industry that is only marginally profitable will discourage market entry by competitors.

How do pricing methods fit with Marketing Strategy?

Consider the following situation as it may apply to marketing strategy. Pricing strategy as it relates to marketing will depend on the goals as discussed in the first paragraph of this chapter. At this point, it is worth mentioning that pricing strategy and a greater marketing strategy are closely tied to product life cycle. In other words, a new product in the introduction phase will require a different pricing strategy than a product in the growth, maturity or decline phases.

During the introduction of a new product to the market, sellers seek to generate demand for their product. This may require considerable resources with heavy marketing support. One pricing strategy aimed at gaining market share is penetration pricing. With penetration pricing, the price of the product is set lower than the laws of supply and

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PRICING PREDICAMENT #2—MARKETING

When you think of Apple, you think technology, quality, first-mover strategy and innovation. But maybe what you should think is pricing strategy. "Jobs is a master of using pricing decoys, bundling and obscurity to make you think his shiny aluminum toys are a good deal" Ben Kunz (2010) said in his *BusinessWeek* article, "Apple's Pricing Decoys." In the competitive high tech world, product popularity doesn't last and prices fall quickly as the second movers pile onto first mover successes. Apple has found ways to make these market dynamics work to their advantage.

Pricing decoys, as defined by Kunz, are products that the manufacturer doesn't really expect you to buy. They merely act as a reference to make other products look better. Consider the classic case of the realtor that shows you the $200,000 house that needs new siding, then shows you the $250,000 house that she really wants to sell you. The $250,000 house may or may not be a good deal. But it feels like a good deal compared to the $200,000 house that needs repair. Apple's tendency to price its products in series (adding features with added cost on top of a base model) serves the same function. If the top priced iPod sells for $399, and you can get one that's almost as good for $229, you think you're getting a good deal.

Decoy pricing has a close relative called reference pricing. Let's say a clothing store wants to charge $100 for a pair of slacks. Is that a lot? Or a little? If you have no reference point for that price, you don't know. But if the same clothing store prices the slacks at $200, then charges $100 (which is what it really wants to get) in a half price sale, the customer has a reference point, and suddenly $100 seems like a good deal.

As these examples show, pricing strategy is closely tied to marketing strategy. Pricing decoys, reference pricing and other related tactics are discussed in the next section.

demand would dictate with the aim of building market share. This strategy can help gain customers who might not otherwise try the product, and it encourages switching from competing products and substitutes. However, unit volume is gained potentially at the expense of profit margin.

Marketers adapting this strategy need to be confident that their cost estimates are accurate, or they may quickly find themselves losing money. In addition, this places great pressure on the production process with the risk that any problems in the supply chain (suppliers delaying shipment of inputs, etc.) will further erode already tight margins. Confidence in the production process is necessary if this strategy is going to work.

Often, this puts a new company starting out in a dilemma. On the one hand, gaining market share, product acceptance and recognition is the goal. On the other hand, production experience isn't there to support lower margins. Production experience or the Learning Curve Effect suggests that each time a task is repeated, efficiency increases. Another downside to a penetration strategy is buyer resistance to price increases and as mentioned, low margins. Low margins do have an advantage in that they discourage new entrants to the market. If penetration pricing seems appealing, your production and distribution plans must support this strategy.

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Another popular choice for products in the introduction phase is skimming. Let's say Apple introduces a newer, faster, slicker mobile device that becomes a must-have for traveling sales people. Those initial buyers can be called lead users. They're the type of user that will buy the product regardless of what it costs. Some lead users may be reimbursed by a corporate expense account. They're not using their own funds for the purchase (see Tool 10.5 later in this chapter). Price is not an issue for lead users of a new first-mover type of product (think back to the days of the first cell phones, or PDAs). The product fills a need and this non-price-sensitive segment of the market is willing to pay for it.

The Harvard Business School's 2006 *Marketer's Toolkit* states that, "Once profits have been skimmed off the must-have segment of the market, the producer drops the price and skims the next tier of interested customers. And on it goes. Each price drop broadens the market for the new product." This is a typical pattern for high-tech products and works well as long as the company enjoys a temporary monopoly.

Meanwhile, the cost of production on the new product is hopefully dropping as the company gains production experience and ramps up capacity. This allows the company to maintain its margins even as the price drops. The risk is that a talented copycat company can jump in and undercut the first-mover with a similar product offered at a lower price. The so-called second mover can learn from the mistakes of the first-mover and exploit a lower cost structure (without the costs of R&D and educating the customer base). An additional risk is consumer anger if the market feels overly manipulated. Apple experienced this with the iPhone as the must-haves resented the 50% price drop that quickly followed their high priced purchases.

Another pricing strategy favored by high tech companies is decoy pricing, as illustrated by the Apple example in Pricing Predicament #2. Although high tech companies use this strategy regularly, they aren't the only ones to practice decoy pricing. This practice happens all around you. Here's a real life example. My husband and I recently went on vacation. We booked a hotel room on the Internet for $159 a night. When we arrived at the hotel, we were presented with a number of room options. We could take the standard room we had booked for $159, we could upgrade for $20 to a newer room in the renovated section of the hotel with breakfast included or we could book a deluxe view room in the newly renovated section of the hotel for $249. It seemed only natural that we should take the $20 upgrade to be in the new wing and that we would congratulate ourselves on the good deal we got while we enjoyed our free breakfast. The decoy in this example is the $249 room. In comparison to that price, our $20 upgrade seemed like a bargain.

Decoy pricing has elements in common with good-better-best pricing. A good-better-best scenario might work as follows. A customer walks into Home Depot wanting to buy some paint. There's the Home Depot brand for $12.99 per gallon, Beher for $16.99 per gallon and the Ralph Lauren designer paint for $20.99 per gallon. According to most studies published on this topic, over 60% of buyers will buy the mid-priced item. The psychology seems pretty clear— the cheap paint is probably too cheap and won't do a quality job, and the designer paint probably isn't worth the money you pay just to get the Ralph Lauren name. So the mid-priced paint is the compromise position. As the seller, it's important to make certain that the mid-priced product has the best margin and is the one you build your business around.

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How can you use segmentation to better understand and manage relationship profitability?

The good-better-best strategy ties into the concept of customer segmentation. Customer segmentation means grouping customers into clusters based on similarities in behavior. Traditionally, segmentation strategies grouped customers according to demographics, attributes, and buying behavior. A more contemporary view of segmentation called value-based segmentation groups customers in terms of revenue and profitability. Analyzing the company's customer base in terms of profitability can help establish a pricing strategy that retains profitable customers and lets go of those that aren't profitable (after attempting to make them profitable). Some commercial banks use this strategy. See Chapter 11 for more details.

Commercial loan officers review detailed monthly analyses of their customers ranked by overall relationship profitability. These rankings include relationship profitability based on loans, deposit accounts, cash management services, etc. These reports help the loan officer determine how to allocate their time profitably (either in servicing their most profitable accounts, improving profitability on moderately profitable accounts, or culling unprofitable accounts). This type of overall profitability reporting also helps the loan officer when pricing new product requests or when competing with other banks for customer retention. The institution can then use customer profitability to incent loan officers to focus on more profitable relationships. A standardized, quantifiable way of measuring customer relationship profitability is a must for every business. The results are often surprising.

Decoy pricing, good-better-best strategies, and customer segmentation can lead to complexity challenges. The arrival of the Internet has decreased the cost of offering flexible pricing and has enhanced the sellers' ability to price discriminate. But there are trade-offs. Customers can be bewildered and frustrated by an overwhelming array of pricing options. Complex tier structures can mystify and turn off a potential customer. These kinds of strategies also require a level of sophistication on the part of your sales force. In theory, your sales force needs to be armed with the knowledge of what they should sell to best maximize firm profitability, not just to maximize their commission. Organizational pricing integration across business functions is addressed later in this chapter.

Back to the paint example, if the Beher paint will do the job for $4 less per gallon, why would a buyer ever purchase Ralph Lauren paint? The answer lies, in part, in the consumer belief that you get what you pay for. Consumers believe that the moderately priced product has acceptable quality, while the higher-priced product has a level of excellence and exclusivity not found in lesser-priced products. Pricing is closely linked to brand image and prestige pricing. It can be a viable strategy for product positioning. This explains why customers are willing to pay more for seemingly imperceptible product differences.

The law of supply and demand suggests that as price falls, demand increases. But, with prestige pricing, just the opposite occurs. Prestige pricing supports a differentiation strategy (see chapter five for a discussion of a discussion of strategy) and must be supported with strong packaging and marketing support. The risk, when adopting a prestige pricing strategy, is that competitors can relatively easily undercut your pricing by offering a copycat product with only slightly different features at a lower cost.

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Loss-leader pricing, aka "bait and hook" pricing, can be an effective pricing strategy as well. If you own a printer or use a cell phone, you're already familiar with this strategy. In it, the manufacturer of the cell phone or printer prices the basic product at a very low price point making it appear to be a low cost option. In order to make the product work, you have to buy the high cost, high margin ink or get locked into a two-year contract. For these companies, the profit is in the ancillary product, not in the product itself.

The risk of course is that competitors will begin making generic replacement parts (ink toner refill kits, for example) either cutting into profits or forcing the original manufacturer to cut the price to maintain market share. Some protection against the incursion of generics is warning consumers that use of generic replacement parts will void warranties. Additionally, printer manufacturers like HP have sued refill kit makers and have attempted to put expiration chips in their cartridges in an effort to fight back.

Another spin on loss leader strategy uses a reduced price on a staple item to help increase store traffic. The idea here is that once inside the store, customers will purchase other higher margin products. Best Buy for example, offers great deals on TV's, while it may sell HDMI cables at a 400% mark-up.

Should you use price promotions?

Price promotions are special short term deals that can be used to introduce a new product or service to the market, entice users of another brand to switch brands, or to clear out excess inventory. Price promotions can take the form of rebates, coupons and sales. Promotional pricing can be an effective short term strategy. However, there are often unintended consequences. Consumers can become so accustomed to promotional pricing that they may become reluctant to purchase at the full price. They may, instead, delay purchases until the price is discounted. Promotions also encourage brand switching which may lead to a lack of customer loyalty. In the long run, price promotions may be better for the buyer than for the seller.

Pricing plans communicate a message to the marketplace about the company and its personality. They reflect other attributes (approachability, affordability, friendliness, exclusivity, etc.) that need to be aligned with the rest of the marketing plan. The pricing strategies discussed above and other common marketing strategies are summarized in Tool 10.3.

What are some customer considerations and are they at odds with organizational pricing goals?

The customer's goal: acquire the most desirable features at the lowest possible price. The producer's goal: maximize profits by minimizing costs of providing features, products, and services that offer greater overall value than the competition. Finding the price point that satisfies both goals is the objective of the successful business owner or manager.

As previously indicated, customers can be a fickle lot waiting for promotions and discounts before making a purchase. They can also be a contrary lot, defying the laws of supply and demand (prestige pricing). Consumer behavior is a complex subject, one only touched on lightly here. The first question to ask of consumers is "how much are they

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Strategy	What it is	When to use it	Things to watch out for
Skimming	Reaping high profits from lead users then resetting price at lower levels.	Use for start-up companies – especially high tech offerings. Allows time for production ramp-up.	Invites competition who undercut your price and copy-catting.
Penetration Pricing	Setting initial price lower than supply/ demand dictates.	Use for start-up companies –creates broad based demand and generates unit volume.	Difficult to raise prices later. Locks company into low margin business.
Experience Curve	Prices gradually decline as cost of production drops.	Maintains cost advantage over later entering competitors. Use for first to market companies that are good at production.	Low cost business requires constant production improvements.
Prestige Pricing	Creates perception of quality or exclusivity through high price.	Use to capture a small but free spending market segment. Tied into marketing/ packaging.	Invites low cost rivals.
Loss Leader or Combination pricing	Combines low priced product with high priced complementary product.	Works with consumable product parts.	Risks under pricing by generic replacement parts.
Promotions	Special, short-term deals(rebates, sales, coupons, etc).	Use to reduce excess inventory, introduce new product, steal competitor's business, retain customers (defensive strategy).	Encourages brand switching. Customers wait for sales.
Good-Better-Best (segmented)	Expand product line to include variations on the product.	When raising prices isn't possible. Mature markets.	Customers trading down.

Tool 10.3 Pricing Strategy Comparison

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willing to pay?" The second question may well be "what price point will force consumers to trade down to lower priced/lower quality products (e.g. going from Beher paint to the Home Depot brand)?"

The cost-plus strategy is an internal strategy. Perhaps it is useful to reverse the process. Instead of having an internal process that flows out to the market, let market forces drive price. How can you determine what price consumers are willing to pay for your product? There are many tools for answering this question. These span the range from simply interviewing the sales force and customers to sophisticated market simulations and conjoint analysis.

Conjoint analysis assumes that buyers value products based on the sum of their parts. For example, the value a golfer places on a golf ball depends on the distance the ball travels, how long it will last, how much it costs, and the perception of quality inherent in the brand name. Knowing how buyers value separate components and how to translate that knowledge into improved profitability is an important piece of developing a pricing strategy. Ric Johnson, founder of the Sawtooth Software Company, explains:

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> *"Conjoint (trade-off) analysis has become one of the most widely-used quantitative methods in Marketing Research. It is used to measure the perceived values of specific product features, to learn how demand for a particular product or service is related to price, and to forecast what the likely acceptance of a product would be if brought to market (n.d.)"*

Rather than directly asking survey respondents what they prefer in a product, or what attributes they find most important, conjoint analysis employs the more realistic context of respondents evaluating potential product profiles. Each profile includes multiple conjoined product features (hence, conjoint analysis), such as brand, speed, memory, price and weight. This may be used for laptop computers, for example.

Conjoint analysis is best used when price is one of multiple product features being evaluated and examined. This would be the case when trying to determine consumer preferences for an entirely new product, for example. If product features are already set, and price is the only flexible variable, then conjoint analysis isn't needed. Conjoint analysis can help achieve specific goals using price, to optimize market share and/or achieving a profit.

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Let's assume your company isn't in a position to hire a consultant or spend money on software for a sophisticated analysis. Maybe you're not comfortable interpreting the data anyway. What else can you do to understand your customer's price sensitivity better? One of the best things you can do is ask your customers about their buying habits. Regardless of how you do it, careful, recurring market research can provide valuable insight into pricing decisions.

Does your price reflect economic value?

It's a common misconception that the price of something reflects its value. Economic value, in its simplest form, is the amount consumers are willing to give up to get something. In a market economy, dollars (or other currency) are the universally accepted measure of how much someone is willing to give up for something. Economic value measures consumer

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preferences. It indicates what consumers are willing to pay for something, as opposed to what that item costs.

It may come as a surprise to sellers that consumers might be willing to pay more to obtain their product than the actual price. In order to capture these extra revenues (and extra profits), an Economic Valuation Estimate (EVE) or True Economic Value (TEV) should be performed on all products and services. Tom Nagle and John Hogan explore the EVE concept in their book, *The Strategy and Tactics of Pricing*. Robert Dolan (1995), formerly of the Harvard Business School, developed the TEV idea. Both strategies follow a similar plan for estimating value.

The process for calculating either EVE or TEV is basically the same and follows these steps as explained by Dr. Larry Robinson and Ralph Zuponcic in their pricing blog:

- **Step 1—Identify the cost of the competitive product or process that the customer views as the best alternative to determine the product's reference value.**

- **Step 2—Identify all factors that differentiate your product from the competitive product or process**. For example:
  Superior (inferior) performance.
  Better (poorer) reliability.
  Additional (reduced) features.
  Lower (higher) maintenance costs.
  Higher (lower) startup costs.
  Faster (slower) service.
  Longer (shorter) useful life.
  Lower (higher) total cost of ownership (TCO).

- **Step 3—Determine the value to the customer of these differentiating factors.** Sources of value may be subjective (such as greater pleasure in consuming the product) or objective (such as cost savings, profit gains). The positive and negative values associated with the product's differentiating attributes are the differentiation value.

- **Step 4—Sum the reference value and the differentiation value to determine the total economic value.** TEV is the value someone would pay when they are fully informed and economically rational when making the purchase decision. The company may also be able to add in a "reputation premium" based on brand equity and a "switching cost premium" if the cost of changing suppliers is a consideration of the buyer.

Tool 10.4 Economic Valuation Estimate

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The formula will end up looking something like this:

TEV = Cost of the best alternative + (or minus) Value of Performance Differential + Premiums

When considering a product's TEV, bear in mind that value depends on the needs and preferences of the individual. Determining consumer preferences and how the market values your product may require some effort, but it's an exercise worth doing.

At this point in pricing strategy development, the bottom end of the price range has been established (using cost plus analysis), as has the top of the range using the EVE or TEV model. The competition has been analyzed with comparative products and features graphed. A price has been set. It's time to test the market and get real feedback.

Be aware that pricing isn't static. Market conditions, input costs, and the product life cycle are all subject to change. Macroeconomic forces, including changes in interest rates, inflation, and unemployment all have an impact on price.

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When should pricing change?

Pricing inertia is a common pricing problem. When prices are low, they tend to stay low. When prices are high, they tend to stay high. While on the one hand, continually changing price can cause confusion and frustration in your market, many firms get stuck in their pricing rut and never change their price. In a cost plus environment, at the very least, pricing should change when underlying costs change. This seems obvious, but it is surprisingly difficult to do.

If your prices need to change due to an alteration in your cost structure but you're concerned about losing customers, consider using the Customer Price Sensitivity Survey (see Tool 10.5) to better understand your customers' buying habits and your risk. For example, if the decision maker for the buying decision isn't using his own money for the purchase, he may be less sensitive to increasing price. If switching costs (changing to another supplier) are high, then the customer again is less likely to leave when prices increase. On the flip side, if the buyer can easily compare price and performance of alternatives, volume may be negatively affected by a price increase.

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Pricing decisions are impacted by economic trends. Consider times of economic recession. The following dilemma is now common among sellers. Input costs are rising, yet consumers are in an unprecedented bargain-hunting mode. Raising prices simply may not be realistic in the current economic climate. Instead, sellers might look at other strategies to keep profits in line with plan. Go back to good-better-best pricing discussed above. Maybe in this market, appealing to the bargain buyer is a good idea. Retailers hope that customers can trade down while maintaining brand loyalty and sales. They can be encouraged to trade back up later.

Product bundling can also be a good strategy when it's difficult to raise prices. A recent advertisement from a local electronics retailer provides an example. The product circular advertised a 3D starter kit that included a free 3D Blu-ray disc player, free 3D glasses, and a few 3D movies, all with the purchase of a 3D TV.

Changes in cost can lead to price changes both upward and downward. If input prices increase, revisiting costs is important. However, as a firm moves along the production

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experience curve, costs should decrease. This allows for more pricing flexibility.

While the company's internal environment is changing based on input costs and process improvements the external environment is changing too. The product's life cycle will also trigger pricing changes. Scheduling regular pricing reviews will help keep the price-value relationship in line. Keeping an eye on what the competition is doing is important here too. When the market share leaders raise their prices, it may present an opportunity.

Price stickiness is the resistance of price to change. Producers tend to think that price changes have to be significant. This depends largely on unit volume of course, but study after study has shown that a minor increase in price can lead to a significant gain in the bottom line. M. V. Marn and R. L. Rosiello (2009) report in "Managing Price, Gaining Profits", that for the 2,463 companies in the Compustat aggregate, a 1% increase in price yields improvement to the bottom line of 11.1% on average. So while raising the price on a $100 item to $110 may trigger a rebellion, what about raising the price to $101? Collecting only an extra dollar on every sale can generate substantial bottom line premiums.

Unless you are a single product/single distribution channel company, you not only have to be aware of competition in the market, you also have to consider competition from within. In the down market, you decide to go with a good-better-best strategy. So you develop a cheaper version of your product. However, you run the risk that your new product will cannibalize your existing product line so don't expect sales to be the aggregate of the new and the old.

Customer Economics:

- Will the decision maker pay for the product using his/her own funds?
- Is the cost of this item substantial as a % of the total project or purchase?
- Is the buyer the end user?
- Does a higher price signal higher quality in this market?

Customer Purchase Barriers:

- Is delivery timing important?
- Is it costly for the buyer to shop around?
- Can the buyer easily compare price and performance of alternatives?
- Are switching costs high?

Competition:

- How does this product differ from the competition?
- Is the company's reputation a factor?
- What other intangibles impact buyer behavior?

Adapted from the *Harvard Business Review*, Manager's Toolkit, Sept–Oct 1995.

Tool 10.5 Customer Price Sensitivity Survey

As an alternative to creating different product versions, different price levels depending on the delivery channel may be an idea. For example, since marketing products on the Internet does not require the overhead of a retail location, products are generally priced lower. Multichannel pricing can create internal competition as well as confusion/frustration on the part of the customer. If the new product is part of a portfolio of products, in addition to deciding price on the new product, it's important to develop a pricing strategy for the existing products.

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The market's tough, so what else can you do to maintain profitability if you can't increase price?

One potential strategy would be to add features to your product that don't cost much. This can make the product more attractive and competitive without adding cost. It can help justify increasing your price. Other alternatives include repackaging the product to give it a new look, which can also help justify a price increase. Discounting the product might be a reasonable defensive strategy to help hold on to market share. Offering warranties is another alternative to lowering price.

How can you be innovative about pricing?

When thinking of pricing, most sellers think of a standard transaction where the buyer pays cash (in some form) for a purchase. When faced with shrinking margins and a tightening market, one consideration would be to offer payment options while maintaining price.

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PRICING PREDICAMENT #3—SERVICE BUSINESS

The equine dentist visited my farm yesterday; I'll call him Bob. While he was floating my horses' teeth (the technical term for filing off the sharp edges), we got to talking about what he was doing with his life these days. Bob is from Louisiana and most of his family still lives there. A family friend recently started a thoroughbred breeding operation in Louisiana. Bob has been splitting his time between Louisiana and Kentucky and plans on spending most of his winters there.

While he was there, he decided to drum up some equine dentistry business. He charges $55 per horse to hand-float teeth in Kentucky. He decided to charge $65 in Louisiana for the same job. I asked him "why the price increase?" He responded that most of his Kentucky clients were well established, and had been paying that price for many years. He didn't want to disrupt his local clientele by raising his prices. Since he was new to Louisiana, he felt he could start with a new, higher price.

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I asked him how his new book of business was developing. He admitted that it wasn't going that well. After much discussion, it came out that in the Louisiana marketplace he was targeting, there was one other equine dentist who floated by hand. He charges $85 per float. There are a number of veterinarians and other specialist who "power float" (using power tools) and they charge $125–$150.

From Bob's perspective, he was raising his price from historical levels, so he felt like he was charging a lot. From the new market's perspective, since he was so "low-priced" that customers were suspicious that he didn't know what he was doing, or didn't do as good a job as the higher priced competitors.

Bob's case illustrates not only the challenges faced by service providers but also the market perception of the price/quality relationship.

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Some of these could include: financing, renting, leasing, or the Netflix model of paying a monthly fee for unlimited access.

Most of what has been discussed thus far has focused on sale of a product. With service businesses comprising approximately 70% of the US GDP, pricing considerations for service businesses deserve attention. Service businesses face unique pricing challenges. The traditional cost plus starting point isn't really relevant. Sure, there are costs associated with the service business—overhead transportation, etc.—but the real challenge is determining what the service provider's time costs. The service business can fall back on the competitor method, but does that really reflect the value brought to the table?

How can you communicate pricing strategy within the company and get organizational buy-in?

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Good communication, as discusses in chapter four, is an important part of implementing pricing strategy. Often, the price you set isn't the price you get! If your sales people have pricing flexibility, there is a tendency to give away price whether or not it's necessary. Sales people often like to give away price. The company goal is to maximize profit. The sales force's goal is to maximize sales. Salespeople are hired to sell the product based on their ability to understand customer needs and to match product to those needs. All too frequently they sell on price.

Salesperson compensation needs to be tied to profitability not just sales. If salespeople are compensated solely on volume, and they can negotiate price, holding the line on a higher price isn't in their best interest. Many salespeople think they need to lead with price. They are convinced that the company should always meet or beat the competitors' pricing. Salespeople forget that they do know how to sell through price objections. Holding the line on price, or even better, getting that extra 1% on price may require revamping the compensation plan and conducting additional sales training.

Managing price doesn't mean just doing one thing right. Instead, it means managing a myriad of diverse issues. Pricing is a cross-functional activity. It requires input from planning, finance, production and sales. Each of these areas contributes. According to the HBS Manager's Toolkit "Marketing contributes the pricing strategy; sales provides specific customer input; production sets supply boundaries; and finance establishes the requirements for the entire company's monetary health." Without strong coordination and good data, implementation of the pricing strategy becomes the downfall of even the best-researched plan. When implementing a pricing strategy company-wide, bear in mind three salient points—know the pricing objective, communicate it so that all participants understand the pricing objective, and make sure that participants are incented to work toward meeting that objective.

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Where should you start?

Every business should have a well documented, well thought out pricing strategy. Following these steps should help get you on your way:

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- Assemble a pricing team. Make sure the major functional areas (planning, finance, sales and production) are all represented.
- Start by articulating your pricing goals. Are you looking to maximize profit? Increase market share? Introduce a new product to the market? Get agreement among the members of the team.
- Understand your industry. Know your customers and your competitors. Understand your industry's structure and its profitability.
- Schedule regular pricing reviews. Make sure that pricing keeps up with changes in input costs, changes in product life cycle and changes within the industry.

Additional Resources

The Professional Pricing Society offers workshops, conferences and online courses for strategic pricing strategy methodology. They offer a Pricing Experts Directory and many other resources. Websites abound with assistance and software for EVE/TEV analysis and Conjoint Analysis.

Pricing books to include in any pricing library: *Competing on Value*, Hanan and Karp, *Power Pricing: How Managing Price Transforms the Bottom Line*, and the classic *Strategy and Tactics of Pricing* by Nagle and Holden.

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