Understanding Pricing Issues

By BNET Editorial
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In an era of increasing globalization, the costs of labor, transportation, and materials constantly fluctuate. This presents a problem because it creates new complexities and encourages new competition. This also presents an opportunity because those complexities challenge your organization to re-evaluate its pricing process regularly. Doing this will help you find ways to reduce costs.

Globalization also requires an understanding of general economic conditions, varied government economic and taxation policies, and new and potential competitors—all of which create pressure that influences pricing. Not surprisingly, companies have turned to levers more directly within their control—such as reducing costs and improving process management—as sources of profit growth. If done effectively, this can keep prices relatively stabilized even while margins fluctuate greatly.

Price stability, however, may not best serve your bottom line. Pricing policy can be a strategic opportunity if designed accordingly—for example, by re-engineering the supply chain and production (or service delivery) processes simultaneously. Re-engineering is a method of finding more efficient processes within a business to reduce costs while improving the quality of its products and services. It may result in downsizing and outsourcing as economies and new resources become apparent.

However, strategic pricing can also be a tool to increase profits. Companies that re-engineer their price positions unleash significant profit potential.

What You Need to Know

What are the main issues affecting pricing?

- *Economic forces*, including inflation, wages, disposable income and regulation will influence pricing by market. Supply and demand influence pricing. Generally, when supply exceeds demand, prices will fall. The converse is also true, when demand exceeds supply, prices will rise.
- *Market issues* including customer perceptions and buying behavior, will influence your pricing decisions. Successful pricing is based on a clear understanding of the specific needs and nature of the target market. The culture and maturity of the market also affects pricing decisions, so if there is an acceptance of a particular type of pricing structure or approach then strategies may be somewhat constrained. Finally, if the market is declining, prices may need to be cut simply to compete for a dwindling number of available customers.
- *Competitiveness* clearly affects pricing decisions. If there are a large number of direct competitors, pricing can either be a valuable tool if you are well positioned to capture a large share of the market, or it can be a complete irrelevance, if the market is so price sensitive the product becomes a virtual commodity. To avoid that, it is essential that your product is clearly

differentiated in the consumer’s mind, no matter how many competitors you have. Naturally, where few direct competitors exist, there may be a greater degree of latitude for pricing decisions.

- *Product issues* also influence price. Cost of materials, labor, transportation, processing, marketing, and distribution all come to bear on the final price. The product’s benefits and the value provided to customers are the primary drivers after all costs are factored into the price.

How can a company check whether it is making full use of its pricing opportunities?

Consider the following questions, all of which focus internally on the business:

- What is the price position of all products and services compared to competitors, globally?
- Are customers used as a resource to determine the perceived value of your products and services in relation to your competitors?
- Does your organization use value pricing? Is there a clear understanding of what the company sees as added value, compared to what the customer sees? Do the two match up?
- Are pricing policy and pricing practices routinely and rigorously reviewed?
- Is the company organized in a way that ensures a “balanced” pricing decision will be made?
- Do you understand your competitors’ future pricing strategies and plans?
- If your company does have a clear pricing strategy, is it differentiated for the varied circumstances and market position of each product group and each customer?

What to Do

Know the Routes to Effective Pricing

Three main routes can be identified that lead to more effective pricing:

- exploiting market advantages;
- changing the key process inputs on pricing;
- testing different price points.

Of course, some companies enjoy market or structural circumstances that make pricing management easier such as a monopoly position, or perceived quality leadership. What’s your advantage? If you can, try to develop a unique selling proposition and/or a perceived consumer strength.

Prepare a Pricing Strategy

- compare pricing options and analyze previous sales figures by market;
- understand the market's price sensitivity;
- examine price opportunities and develop insights on an individual product line basis, rather than across a range of products;
- be sure you have the information systems needed to support, monitor, and refine these activities.

There are as many as 12 different pricing strategies available. They often appear to be underexploited. They are summarized below:

Manage Customer Information

There are four approaches to consider, the first of which is based on *segmentation.* This means dividing the market in various ways. For example:

- **Category segmentation.** You can gain insight into each of your product lines by looking at each one's profitability and pricing.
- **Customer segmentation.** This approach identifies pricing opportunities by using detailed customer information.
- **"Bundling."** As core product/service prices come under pressure, companies add related products and services where pricing is more robust (and which equally reinforce the value proposition of the core product/service).
- **Managing trade terms.** This means managing the level of discounts given to customers (middlemen, wholesalers, distributors, volume buyers, etc.) to improve overall returns.

Exploit Structural Advantages

Four options are highlighted here:

- *lowest cost/lowest price*: cost advantages allow market invaders to price their products or services lower and thereby grow share rapidly.
- *supply and demand management*: Taking advantage of the relative "want" or "need" of the product by being sensitive to fluctuations in demand, or competitor inventories. For example, better hotel occupancy systems have enabled users to quote more aggressive room tariffs based on up-to-the-second knowledge of room sales.

- *supplier-customer balance of power*: this can be exploited to make sure that suppliers "contribute" to gross margin success. Tough management of the wholesale price may give you greater flexibility in setting the price for your end-consumer.
- *"open-book" and partnership pricing*: the open-book approach was pioneered in the automotive industry. Sharing information about costs has enabled better suppliers to justify and push through selective price increases.

Develop an Innovative Pricing Strategy and Lead the Market

Pricing can be used to innovate and establish a leadership position in the market. This is accomplished first with branding. It means developing consistently high levels of branding and advertising, enabling the company to maintain a price premium. Next, consider the total value proposition of your product or service, and determine which of the following five strategies are most appropriate:

- *technology-driven*: continuously developing a niche. This works best with technically advanced products that can boost your gross margin.
- *first in*: continually focusing on being first to market gives initial pricing advantages, as well as other benefits.
- *best at*: leadership on all features valued by the customer can give price leadership in both *value pricing* of certain products and *premium pricing* for others.
- *share leadership*: restructuring the portfolio of products offered so that it focuses only on market share leaders where you have more control over pricing and other levers.
- *innovative consumer value*: providing a clear mixing of quality, value, and service to lead in the eyes of the customer.

What to Avoid

You Don't Consult Widely on Pricing Issues

Price decisions are too often made by too few people. Only by sharing the responsibility for pricing can managers begin to understand the importance that pricing can have on the success of the business. Ultimately, decisions on pricing must be measured against other critical factors, such as product value to the customer. In the final analysis, pricing can be an exercise in both strategy and leadership.

You Avoid Short Term Action

Short term thinking about pricing is something to avoid. There are, however, at least two short term pricing options to increase profits, without damaging the company's future prospects or ability to change:

- price squeeze: at one company that had recently been brought back from the brink of business failure, the new chief executive insisted that each product line price be squeezed up 1%. Despite initial internal resistance, this was successfully implemented, and had an immediate impact on the company's net profit.
- price elasticity: look at the way that price and volume relate to each other. Do they balance? For example, products with a low margin (that is, where there isn't a big difference between their production cost and their selling price) can be priced up relatively aggressively so that even if you sell fewer of them (less volume), the impact will be acceptable.

You Fail to Understand the Power of Pricing

How can you tap into pricing potential? By removing the roadblocks that typically operate within the organization—such as:

- leaving responsibility for pricing to the sales team;
- limiting finance team involvement (their inclusion will help ensure that decision making is balanced);
- senior management's detachment from the strategic implications of pricing policy;
- a failure to understand the true net profitability of individual services/products to either your company or your customers.

Where to Learn More

Books:

Baker, Ronald, J., Pricing on Purpose: Creating and Capturing Value. Wiley, 2006.

Nagle, T and Hogan, John, The Strategy and Tactics of Pricing: A Guide to Growing More Profitably. 4th Ed. Prentice-Hall, 2005.

Web Sites:

Professional Pricing Society: www.pricingsociety.com

Institute for Supply Management: www.ism.ws

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